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Rationalization of government structures concerned with foreign direct investment policy in South Africa

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I would like to dedicate this work to my loving wife, Dipuo and our precious daughter Hope. These are the two persons I hold dearest to my heart and whose love, laughter and inspiration gave me the passion to endure and succeed.

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ABSTRACT

This thesis sought to focus attention on the fact that currently in the Republic of South Africa (RSA) there is no specific governmental body that is charged with complete responsibility for policy-making and regulation of foreign direct investment (FDI) in general and multinational enterprise (MNE) investment in particular. This issue was identified for study as it was noted that firstly, several other countries (irrespective of their level of development) have such an organization in place. Secondly and more importantly, it was also noted that there have been several cases in which a multinational enterprise posed legal, social and political challenges for host country governments for which such governments were not empowered to resolve in either the a priori or ex-post facto sense. This inability on the part of governments to deal effectively with the challenges created by the unique characteristics and behaviors of multinational enterprises could possibly have been mitigated through the existence of a governmental unit tasked with MNE regulation.

The objective of the thesis, was to study the feasibility of designing, developing, and/or proposing, for South Africa, a governmental unit for policy making, policy

implementation and control of the inward foreign direct investments of multinational enterprises, where it could firstly be shown that such an administrative unit is indeed needed. The arguments made in the study were framed in the form of a null hypothesis and a single research question. The null hypothesis of the study being: Ho = there is a necessity to formalize a government administrative structure for policy setting and implementation of multinational enterprise regulations in South Africa. The hypothesis was examined in terms of being accepted or rejected based in part upon first resolving the research question of the study which is: Is there a need for foreign direct investment policies that apply exclusively to multinational enterprises? As the thesis was of a qualitative rather than quantitative nature, the methodological approach primarily examined theoretical, empirical and anecdotal evidence to ascertain whether the hypothesis should be supported or rejected. Given that the null hypothesis was not disproved and the research question was answered in the affirmative, the thesis concluded and recommended the establishment of a small specialized unit of experts to serve as part of the public service but independent of any other governmental department or unit. The proposed unit should work to provide support to other government agencies in the areas of research, advice and coordination services. As the environment within which such an organizational unit operates can be expected to be relatively stable over time, and the work of the unit highly specialized, it is envisioned that decision making in the unit will be more centralized than de-centralized. The thesis ended by exploring optional organizational designs with the aim of recommending the appropriate hierarchical arrangements to be established for the proposed organizational unit. More specific answers with respect to, for example, the number of people to be employed, their job descriptions, and the remuneration scales to be applied to their positions are recommended by the thesis for further study.

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CHAPTER 1

INTRODUCTION

…Free markets embody no mechanism that is responsive to all the needs of the planet. Informed regulation is therefore essential to ensure sustainable development. Cleaver, Tony – *Understanding the World Economy: Global issues shaping the future,* 1997 p.23

1.1 Introduction

Public policy analysis is an important public management sub-discipline that provides the necessary tools for improving the levels of efficiency with which public institutions operate. In general terms, the analytical construct of the current thesis is grounded in public policy analysis and is based on gauging the effectiveness with which the South African government can deliver on it's regulatory responsibilities whilst simultaneously giving priority to sustainable development objectives. More specifically, government must balance the need to regulate foreign direct investment with the need to attract much needed investment capital into the country.

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Globalization refers to the trend-wise growth in the level of integration of economies and societies around the world (World Bank 2002:23). With the contemporary phenomenon of globalization taking it's course, issues of poverty and development have found new perspectives from which analysis and the generation of workable resolutions are being created. Generally, globalization has been observed to have benefited some developing countries with rapid growth and prosperity, whilst simultaneously increasing inequality and environmental degradation in the poorest of countries. According to the World Bank (2002:85) the key to harnessing the benefits offered by globalization have less to do with open trade and investment policies but more to do with effective domestic policies and institutions in these and other areas (Cf. Paul and Garred December 2000:3-4). A very specific form in which globalization is taking place is through the foreign direct investment of multinational enterprises. Both, the benefits and the negative externalities associated with this type of investment in host countries is the general focus area of the current thesis.

Although big business (especially in the form of multinational enterprises) has much to contribute towards global economic advancement, a substantial proportion of the organizations that are in a position to operate monopolistically or as oligopolists also tend to operate internationally as multinational enterprises. This circumstance leads to a number of concerns with regards to regulating multinational enterprises least of which are the concern for the competitive effects on local economies as well as concerns over economic and political sovereignty.

Further, due to the fact that multinational enterprises are incorporated under the laws of one country whilst having the flexibility to establish subsidiary or branch operations in other countries, it will not always be possible to regulate, to the full

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extent of the law, those multinational foreign businesses that choose to leave the jurisdictional boundaries of the host country.

A social problem exists or can be defined as done by Hoogerwerf (in Wittrock and Baehr (eds.) 1981:31) who states that "*a [social] problem exists if there is a discrepancy between a goal or some criterion and the perception of an existing or expected situation.*" In the case of multinational enterprise regulation therefore, in defining a problem, or assessing, or justifying policy it is necessary to start with a clear indication of the goals or expected benefits, if any, that the government intends to derive from its relationship with foreign multinational enterprises. Further, as Dunning (1993:566) has stated, "*the success of government policy towards … inward direct investment depends upon the effectiveness of the administrative machinery set up to implement and monitor the policies decided upon.*" It follows then that it is not enough to espouse a general approach to foreign direct investment; but rather it is necessary to articulate the government's policy formally and clearly within well defined organizational structures.

1.2 Point of Departure

The current study topic was motivated by the fact that other studies had neglected to address the issue of government policy concerning foreign direct investment and or multinational enterprise investment in South Africa. A preliminary database search (conducted in May 1999) of all registered research with the Human Sciences Research Council (HSRC) for all South African Universities showed that the topic of multinational enterprises in South Africa had scarcely been studied. By that date (May 1999) there were two other dissertations on multinational enterprises in South Africa. C.O. Howard1993

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(M.A. UCT) examines the Challenges of business and political risk faced by multinational enterprises considering investing in South Africa. R.V. Cohen 1979 (M.B.A. UCT) is also concerned with factors that influence the decisions of foreigners to invest in South Africa, and analyzes these factors to come up with methods of encouraging foreign investment into the country. Cohen's focus is on business management and making recommendations to South African entrepreneurs to engage multinational enterprises in licensing agreements and joint ventures.

The point of departure of the current study is to address and study the role of Government in controlling the entry and overseeing the activities of multinational enterprises in South Africa.

1.3 Problem Statement

Currently in the Republic of South Africa (RSA) there is no specific governmental body at any level of government that is charged with complete responsibility for policy-making and regulation of foreign direct investment in general and multinational enterprise investments in particular. As a result, foreign investment into the country is characterized by a lack of substantive policy, and what policy does exist in the current dispensation is highly fragmented across several departments, directorates and sub-directorates thus leading to high levels of inconsistent policy and low levels of coordination in the administration of such investments and projects. Thus, in light of the perceived effects of foreign direct investment upon the host country and given the size and scope of multinational enterprise business activity in South Africa, closer examination of government policy and administration applicable to these businesses is warranted.

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1.4 Significance of the Study

The relevance of this study relates to the recognition of the importance of foreign capital investments to the local economy. In brief, the macro-economic implications associated with multinational enterprise investments are:

1. Employment creation;
2. Balance of payments effects;
3. Technology and skills transfer;
4. Competitive effects in the local economy;
5. Environmental damage and resource depletion.

Regarding employment creation, it may be argued that multinational enterprises enhance employment levels in the host country by increasing employment. However, this argument is countered by the possibility of job losses in less competitive domestic firms. With regard to the balance of payments considerations, a host country's balance may be improved by the inflow of new capital represented by a direct investment. While on the other hand, this initial gain may be offset by the long-term outflow of capital through repayment of loans and through dividend remittances. In the event that these outflows were to exceed the initial investment, then a net loss to the balance of payments would result. As to the question of technology and skills transfer, the case is often made that multinational enterprises can enhance a host economy through the transfer and dissemination of the advanced technology and managerial skills that they preeminently posses. This assertion, however, inflates the assumption of complete willingness on the part of the multinational enterprise to share its competitive advantages with local firms and workers as dictated by government policy.

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In reference to competitive effects, it is often asserted that multinational enterprises will drive out local competition. However, the counter point is made that a multinational enterprise may buy many goods, services and supplies locally and thus may stimulate local entrepreneurship. Finally, environmental damage and resource depletion are most often seen as externalities associated with multinational enterprises as well as with misguided or weak regulation. The problem that makes this subject worthy of study is the apparent lack of administrative responsibility and control for the entry and activities of multinational enterprises in the Republic of South Africa (RSA).

1.5 The Hypothesis and Research Questions

Ho = There is a necessity to formalize a government administrative structure for policy setting and implementation of multinational enterprise regulations in South Africa.

Research Question 1: Is there a need for foreign direct investment policies that apply exclusively to multinational enterprises?

1.6 The Objectives

Given the important role that multinational enterprises play within a domestic economy, it becomes imperative then to go beyond merely describing their impact and influence. With this in mind, sequentially, the objectives of this study are:

(a) to survey the literature on the theory of multinational enterprises as a backdrop against which an administrative structure for policy-making,

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policy-implementation and control of multinational enterprises in South Africa may be designed, developed and/or proposed;

(b) To examine the historical perspectives of South Africa's investment climate to highlight the crisis brought about by the trade sanctions and disinvestment campaigns against South Africa during the 1980s;

(c) To examine the global foundations for establishing the regulation of multinational enterprises by considering the experiences of selected industrialized and developing countries;

(d) To critically review the existing policy regime on foreign direct investment in South Africa including the rationalization of foreign direct investment policy structures thereof; and

(e) To make policy recommendations on the desired government administrative structure for policy-setting and implementation on multinational enterprise regulation in South Africa.

1.7 Methodology

The methodological approach employed is essentially brought into existence by - and an abstraction of - the objectives defined for this study. Thus, although the subject concerning the economic implications of multinational enterprise operations in the host country is relevant to any discussion of these forms of business endeavor, the focus of this study is rather on the examination, design and development of the appropriate governmental policies and administrative structures for multinational enterprise regulation in the Republic of South Africa. The emphasis is on determining *how* and *where* policy should be formulated and implemented, as opposed to determining *what* the policy should be.

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1.7.1 Research methods and research approach

The principal research method followed is based on surveying the academic literature on foreign direct investment to establish theoretical and practical principles and guidelines for resolving the pertinent policy and structural questions raised thereof. Although this approach is followed throughout the study, the second chapter – A Survey of the Theory of Multinational Enterprises – is dedicated toward this end. More specifically, chapter two seeks to identify the issues of relevance that must be considered prior to formulating, amending and implementing regulatory policy for foreign direct investment. Generally, these issues pertain to understanding the motivation for organizations to become multinational in their operations and the possible positive as well as negative effects of their activities that may occur within the host country.

The second research approach incorporated in the study is comparative policy analysis – which serves as a tool to guide policies and policy structures toward international best practices that may be adaptable to the uniquely South African context. Thirdly, empirical research is conducted by way of discovery and analysis of the currently existing implicit and explicit policy measures and policy structures in South Africa.

Fourthly, an empirical historical review and analysis of the issues and policies of foreign direct investment in South Africa is utilized to gain an understanding of how these have evolved over time as well as providing the contextual setting within which current policy measures can be holistically perceived. Finally, the nature of the study calls upon the active engagement and discourse in subjects spanning various academic disciplines and is focused mainly on the theory of

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public policy processes as well as general administrative sciences and economic theory.

1.7.2 Target population

The target population under study is the majority foreign owned business enterprises operating in South Africa. Majority owned meaning that one person, or a group of persons who share a common interest, hold the controlling share of ownership (51% or more) in the enterprise.

1.7.3 Perceived constraints

The perceived constraints considered for the study are the following:

(a) A complicating factor in studying today's multinationals is the fact that over time many multinational enterprises have combined or shared resources by way of mergers and acquisitions that categorization of a multinational enterprise as an organization with a specific home country of origin gains much complexity. However, the study focus is on host government policies and structures thus, the nationality of the multinational enterprises home country is rendered somewhat extraneous.

(b) Classifying domestic firms that are in partnership with foreign interests as multinational foreign investors is also problematic. This situation can be addressed by focusing on the majority ownership of the business in question. Thus the study will define as foreign investors those businesses that are majority (51percent or more) foreign-owned.

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1.8 Scope

Defining a multinational enterprise is complicated by the fact that there are varying degrees of involvement of foreign businesses into a host country's economy. As stated by Robock and Simmonds (1989:7) "the dividing line to mark the stage at which a company becomes multinational is difficult to determine". Thus it can be ascertained that cross border involvement of business enterprises runs the gamut from the low end of exporting, to intermediately establishing warehouses and marketing operations abroad and at the high end of the spectrum opening up manufacturing operations abroad.

In limiting the scope of the study to manageable proportions, the multinational enterprises dealt with here are those at the high end of the spectrum. That is those enterprises that maintain manufacturing and/or service operations within a host economy/country - such that the country in which the enterprise is incorporated is the home country and the overseas states where production, service provision, employment and sales takes place are the host countries.

The geographic coverage of the study topic is limited to the sovereign boundaries of the Republic of South Africa. Further the focus is on South African policy where South Africa is the host country of foreign direct investment. No significant attempt at coverage of South African policy in regulating it's own (or home) multinationals is undertaken.

The host country's political, social and economic environments within which the multinational enterprise operates set the frame of reference from which regulation and policies evolve. Further, the policy process does not take place instantaneously, but rather occurs incrementally. Thus, although the study's

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temporal focus is on present and proposed future policy initiatives, historical events are discussed as they are philosophically influential to the current states of affairs and additionally serve to define future states as either possible or feasible.

Hierarchically, the study would gain marginally by leaving itself open to policy issues at all three spheres of government. However, the main focus is on national policy and national legislation as these are much more readily accessible than is the case at the sub-national levels of government.

1.9 Sequence of the presentation

Chapter 1, the Introduction of the dissertation identifies the problem to be addressed in the statement of the problem, proposes hypotheses and research questions to be explored in order to resolve the problem, identifies the methodological approach to be used and sets limitations on the scope of the study. Chapter 2 reviews the literature that is relevant to the study topic with the anticipation that later chapters will be made easier to contextualize as a result thereof. In chapter 2 examination is made of early as well as contemporary academic literature that informs policy on the regulation of multinational enterprises (MNEs). Much of the seminal literature was motivated by concerns over the market power that these corporations tend to possess.

Chapter 3 is entitled - Historical Perspective of South Africa's Investment Climate. This chapter aims to provide background and insight into the environments (political, economic and social) within which multinational enterprises operated in South Africa and examines how changes in these environments over time may have impacted on foreign investment decisions on

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the part of multinational enterprises as well their impact on the evolvement of government policy in this area. Chapter 4, Global Foundations for Establishing a Need for the regulation of MNEs, critically examines a number of issues put forward in the literature that argue for a regulatory agenda for foreign investors. These issues are examined in the South African context. In chapter 5, entitled Critical Survey of Existing Policies on Foreign Direct Investment in South Africa, the evaluation of current policies and administrative structures relevant to the regulation of the foreign direct investment of multinational enterprises is conducted. The focus is on scanning, surveying and evaluating any existing, or emerging policies within the South African public sector that impacts on the activities of foreign multinational investors. This survey sets the bases upon which the next chapter (chapter 6) is founded to the extent that proposed changes in structure, or alternatively rationalization, can only be undertaken once the exact nature of the structures and the policies to be dealt with by those structures are made clear.

Chapter 6, Rationalization of Foreign Direct Investment Policy Structures in the South African Government, seeks to assess the scope for rationalization of those government structures identified in the previous chapter in terms of the normative principles of organization theory and cost-benefit analysis. In this regard, perceived shortcomings in the current administrative structural arrangements are identified in order that a more effective and efficient arrangement can be recommended in the final chapter, Chapter 7. Chapter 7, entitled Conclusion and Recommendations, highlights the most pertinent issues for consideration in attempting a restructuring exercise of foreign direct investment policy structures. Chapter 7 also formulates general conclusions and recommendations, and proposes issues for further study.

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1.10 Key concepts and terms

(a) Multinational Enterprise - MNE

Of the many varied uses of the term multinational enterprises (MNEs), the term is used here to refer to enterprises that own (in whole or in part), control and manage production or service facilities outside the country in which they are based. Further, An MNE is classified here as a form of Foreign Direct Investment (FDI); FDI, however, is not limited to multinational enterprise investments, and also includes direct equity investment which normally results in little or no managerial control. Therefore, the term FDI can be (and is) used somewhat interchangeably with the term MNE as the latter is a subset of the former.

(b) Foreign Direct Investment - FDI

The usage of the term foreign direct investment in the context of the study shall refer to investments into a country made by foreign interests. These are capital investments (in terms of size and duration of commitment) and can occur as either physical or equity investments. Physical capital investments are investments in plant and equipment, as in the establishment or support of a multinational affiliate or subsidiary, and typically assume significant management control by the investors or parent company. In contrast, equity capital investments are investments in stock and/or bond ownership and consequently may or may not represent a controlling interest in the management of the investment (depending upon the size of the investment).

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(c) Home Country

A precise definition of the term as it will be used in the study is that offered by Hoogvett and Puxtey (1987) in which they define a home country as " the country from which a foreign investment originates and where the parent company of a multinational corporation is domiciled”.

(d) Host Country

The country in which business enterprises with foreign ownership and/or control are located.

(e) Monopoly

The term monopoly is used to refer to an organization that is the sole producer or supplier of a given good or service. This condition guarantees the organization excessive control over prices and supply of the good or service.

(f) Oligopoly

An oligopoly refers to the few large organizations competing in a given market against each other as well as against a larger number of small companies in that same market. This market characteristic tends to lead to monopolistic market conditions when the above-mentioned large organizations choose to collude with each other to control prices and supply rather than to engage each other in possibly destructive competition.

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(g) Extraterritoriality

Under international law a country can normally only exercise it's jurisdiction and sovereignty within it's own territorial boundaries. However, exceptions to this international legal principle are referred to as cases of extraterritoriality and have been tested in cases of home country governments attempting to exercise control over business enterprises in another country on the basis that these enterprises are incorporated in, and contracted to uphold the laws of, the home country. This is an unresolved issue as many host countries also require foreign business enterprises to submit articles of incorporation in order to register to conduct business in the host country. Extraterritoriality has also been tested in cases of host governments attempting to hold foreign parent companies of subsidiaries liable for the acts of the subsidiary in the host country.

CHAPTER 2

A Survey of the Theory of Multinational Enterprises

2.1 Introduction

As a starting point for an academic discourse of public policy and administration as these may be applied to the subject of foreign direct investments (FDI) by multinational enterprises (MNEs), two preliminary sets of questions need to be considered by policy-makers. The first set of questions should seek to address and understand the general theory on multinational enterprises with regard to explaining the factors that motivate a firm to choose this type of foreign direct investment over exporting or licensing, as well as the factors that have led to the worldwide proliferation of this phenomenon. The second set of questions to be considered by policy-makers should address the multinational enterprises' economic and social impact on host and home countries.

Posing and attempting to resolve these two sets of questions has far reaching implications for host state - foreign investor bargaining relationships in terms of regulation. Additionally, these questions also have implications for identifying any possible abuses of the host state by the multinational enterprise that may occur either outside of or through their negotiating relationship.

In terms of explaining the motivating factors of establishing a multinational enterprise, there exists quite an extensive array of disparate theories and views extending from the pioneering works of Stephen Hymer (1960, 1968) and Raymond Vernon (1966), whose contributions were the market power approach and the product life cycle theory respectively. Later theories that gained

prominence were the oligopolistic follow the leader theory of Knickerbocker (1973), the internalization of transactions costs theories first proposed by Coase (1937, 1960), and John Dunning's (1993) eclectic paradigm. The first section of this chapter reviews these and other theories aimed at the discernment of this issue. These theories are separated and dealt with according to whether or not they assume perfect markets.

The discussion that then follows reviews theories that have been proposed to explain the economic impact, within the host-state, of foreign direct investment in the form of the establishment of multinational enterprise subsidiaries.

2.2 Perfect Market Assumption Theories

The term *perfect capital markets* refers to the economic state of affairs of a market in which prices are set competitively through supply and demand, and in which there are a sufficient number of producers such that these producers become "price-takers" rather than "monopolistic or oligopolistic price setters". Further, the perfect markets assumption contends that there are no barriers to either the entry of a market by producers or to international capital flows.

Although multinational enterprises tend to operate mostly under conditions of imperfect markets, it is still worthwhile to take into consideration those theories that assume perfect markets. This is because perfect market theories do not discount the fact that the foreign direct investment of multinational enterprises normally takes place in imperfect markets, but instead they assume away the complicating factors of imperfect markets on the belief that the structure of the market is inconsequential in their proposed analysis.

Theories based on perfect market assumptions include (but are not limited to) – the differential rates of return, portfolio diversification, and currency differential. Each of these concepts will be reviewed in turn.

2.2.1 Differential rates of return

The Differential rates of return theory argues that foreign direct investment flows are mainly attributable to the differing rates of return on capital that firms can earn in different countries. The argument here is that foreign capital and investment will move out of countries with low relative rates of return on capital to those with higher rates. The underlying rationale of the Mc-Dugall Kemp model (Chen 1983: 18-20) of this hypothesis is that rates of return on capital are inversely related to the availability of capital within a given country such that countries experiencing capital scarcity will pay higher rates for invested capital thereby attracting foreign capital from those countries that possess excess capital. Eventually, investment flows will cease (or at least diminish) as supply and demand forces act to equalize the rates of return to capital of the two countries.

The differential rates of return theory seemed to be supported by empirical evidence pertaining to United States foreign direct investment in the late 1950s. During this period, after-tax rates of return earned by United States subsidiaries in manufacturing in Europe were consistently above the rate of return earned by United States domestic manufacturing investments. However, this same empirical evidence seemed to contradict the differential rates theory during the period of the 1960s when United States foreign direct investment in Europe continued to rise whilst at the same time the rates of return for United States subsidiaries in Europe were consistently below the rates of return on United States domestic manufacturing (Lizondo 1991:69). Additionally, the differential rates of return theory contradicts the available evidence that shows that there is

a substantial amount of two-way foreign direct investment taking place between countries. That is, there are numerous cases in which firms from country A invest in country B at the same time that firms from country B are investing in country A (Chen 1983:18-20; Cf. Lizondo 1991:69).

2.2.2 Portfolio diversification

Portfolio diversification theory uses the same rationale as that used in the differential rates theory but adds to that argument a risk factor. It argues that when a firm is in a position to choose among various alternative investment projects, the determining factors in the decision will be both the differential rates of return and the opportunities to reduce risk through diversification. That is, a firm could reduce it's overall risk by undertaking projects in more than one country since the returns on activities in different countries are likely to be less than perfectly correlated (Lizondo 1991:69). Although a number of empirical studies have been conducted to test this theory, none offers strong support (Hufbauer 1975; Cf. Agarwal 1980).

2.2.3 Currency differential

The currency differential theory asserts that international direct investment flows (as opposed to portfolio investment flows) will tend to move out of countries with strong currencies and into countries with weaker currencies. Several differing models have been proposed to explain this relatively consistent empirical result. Aliber (1971) for example, proposes that this phenomenon might be a result of the fact that investors have a bias against firms from weak currency countries. This bias can be attributed to the fact that weak currencies are perceived to contain greater risk and volatility than stronger currencies. Thus, investors (both in the strong currency country and in the weak currency country) will value the investment stream from the firm of the strong currency country at a higher

capitalization rate. In other words, investors are willing to pay a higher price to invest in the strong currency country firm as compared to the firm from the weak currency country. If this is the case, then firms from weak currency countries will not have an incentive to make direct foreign investments into strong currency countries, while firms from strong currency countries will have an advantage over indigenous firms in the weak currency country and will thus find it profitable to undertake foreign direct investment in such countries.

An alternative explanation of the currency differential findings is offered by Froot and Stein (1989) and is based on information imperfections in the capital market. Their supposition is that information imperfections may lead to a real depreciation of the domestic currency in a given country that effectively lowers the wealth of domestic residents of that country while at the same time increasing the wealth of foreign residents. As a result of the higher relative wealth and thus cheaper input costs obtained by foreign investors, they will find it profitable to invest in the depreciated currency country.

A similar but more complete explanation can be found in Caves (1988). Caves takes this same argument a step further by adding that it is usually in cases where a depreciation in currency is expected to be reversed (i.e. currency appreciation is expected at a later stage) that foreign direct investment is motivated as firms can buy low and sell high.

Most empirical studies of the currency area hypothesis focused on whether an over-valuation of a currency is associated with foreign direct investment outflows and whether an under-valuation is associated with foreign direct investment inflows. Studies conducted of foreign direct investment in the United States, the United Kingdom, Germany, France, and Canada yielded results that were consistent with the hypothesis (Cf. Agarwal, 1980).

2.3 Imperfect Market Theories

The application of classical trade theory as an analytical tool for international trade and investment has important limitations and constraints. These shortcomings relate directly to the simplifying assumptions upon which it's theoretical framework is based - that is, under perfect market assumptions, only goods are assumed to be internationally mobile whereas no consideration is given to the mobility of factors of production. This assumption does not allow for the possibility or existence of foreign direct investment but instead offers a framework for analysis of import and export trade only (Chen 1983: 16).

A further limitation of classical theory is it's assumption that markets are perfectly competitive. Given that oligopolistic and monopolistic markets are the business environments within which multinational enterprises operate and foreign direct investment takes place, the assumption of perfect markets further negates the usefulness of classical trade theory as a tool for studying foreign direct investment and multinational enterprises (Nelson and Silvia in Erdilek (ed.) 1985:97; Cf. Chen 1983:16; Cf. Muchlinski 1995:7). In fact, according to Hymer (1976) the major motivating factor for investing abroad is the existence of imperfect competition at home. Hymer (1976) viewed the extension of the multinational enterprises foreign operations as a strategic move to eliminate competition at home and abroad. Alternatively, Hymer(1976) was saying that control of foreign operations is necessary in order to realize fully the returns on certain advantages and abilities that the firm possesses. Hymer (1976) asserted that these ownership-specific advantages could be maximized through international horizontal and vertical integrations under oligopolistic market conditions.

Imperfect market theories have focused on ownership specific advantages, location specific advantages and internalization advantages. Each of these will be discussed in turn.

2.3.1 Ownership specific advantages

Ownership specific advantages refer to unique characteristics of a particular firm that provide for a competitive advantage over other firms. Examples of this include marketing strategy, advanced technology, capital asset endowment, liquid asset endowment, and human resource capacity. Any of these ownership specific advantages can lead to, or be used to exploit, market imperfections. Market imperfections can further be exploited to the financial benefit of the firm through foreign direct investment.

The approach to explaining ownership specific advantages has been done from a number of different perspectives. The approach taken in the passages to follow is to examine imperfect market theories of ownership specific advantages as explained under the market power approach, oligopolistic reaction theory and the product life cycle theory.

2.3.1 (a) Market power approach

The market power approach focuses on the motivation of the firm to increase it's market power, in the face of stern oligopolistic competition, through the exploitation of it's ownership-specific advantages (Cantwell in Pitelis & Sugden (eds.) 1991:21). It is argued that in the early stages of growth, the oligopolist firm will experience steady growth in the domestic market share. However, domestic market concentration will expand to the limit in an oligopolistic market, and thereafter it is only possible for oligopolists to maintain or increase their market shares by expanding their competition to foreign markets.

The argument is further augmented by two rationalizations as to why the resultant competition into foreign markets, by oligopolists, takes the form of foreign direct investment as opposed to exports (Cowling and Sugden 1987). First, as a way of maximizing foreign profits, the multinational enterprise can better negotiate wages, than is possible by producing at home and exporting, by threatening to exercise it's capability to relatively easily shift production between alternative locations. Second, the multinational enterprise can weaken the bargaining power of trade unions, whose power is magnified by the size of the firm within which they are organized, or by contracting out work previously done within the firm to a network of dependent subcontractors, both locally and internationally.

2.3.1 (b) Oligopolistic explanation for foreign direct investment

The oligopolistic reaction theory is based on the market power dictum but extends the arguments of the market power approach to discuss specific behaviors of firms in oligopolistic industries and markets. By definition, oligopoly theory asserts that rival firms in oligopolistic industries counter each others moves by making similar moves themselves. Knickerbocker (1973) hypothesized that this follow the leader corporate behavior extended to foreign direct investments as well. Knickerbocker (1973) empirically tested the validity of the oligopolistic reaction theory in the case of foreign direct investment by United States (US) multinational enterprises in the post-World War II years of 1948 to 1967. The study was limited in scope to operations of enterprises in manufacturing industries.

The entry concentration index (ECI) is the quantitative measure used in Knickerbocker's study as a measure of the extent to which United States enterprises, by industry, have bunched together the establishment of their foreign manufacturing subsidiaries. An entry concentration index measures the

extent of oligopolistic reaction within a given overseas industry based upon the notion that within a limited period of time, the number of foreign (in this case – United States) subsidiaries established there is an indication of the degree of oligopolistic reaction within that industry. The entry concentration indexes were developed from data on 23 countries within which approximately 83% of all foreign manufacturing subsidiaries of United States firms (excluding those in Canada) were established during 1948-1967.

Additionally, the measure of industry structure used was the industry concentration ratio (ICR): that part of an industry's total output that is produced and sold by the leading four or eight or n firms in an industry and which is expressed as the n-firm concentration ratio. If, for instance, the collective output of the four largest firms in an industry is 80% of total industry output, then the four-firm concentration ratio for that industry will be 80%.

Knickerbocker (1973) draws these two measures together to test the "follow the leader"/oligopolistic reaction theory. The hypothesis (Knickerbocker 1973:53) of the study is that "for US industries involved in international expansion after World War II, the higher the concentration of output of the leading firms in a given industry, the higher that industry's level of oligopolistic reaction".

Among the conclusions reached by Knickerbocker (1973) were first, that entry concentration (the bunching together of foreign direct investments) has been positively associated with industry concentration. Second, the positive association observed between the two variables seems to have been the result of the behavior of a few leading firms in each industry. And third, entry concentration has tended to be most intense in industries in which marketing capabilities, above all else, have been the key to success.

Knickerbocker's (1973) statistical results also revealed a nonlinear relationship between the two key variables (i.e. entry concentration indexes and Industry concentration ratios) such that oligopolistic reaction behavior holds up to a point. Beyond this point industry leaders tend to reduce the intensity of their competition. This finding supports the belief that as the marketing strategies of oligopolists are highly interdependent, the timing and placement of their foreign direct investments may be determined by an understanding (implicit or explicit) among them that excessively intense oligopolistic reaction is contrary to the best interest of all.

Knickerbocker's oligopolistic reaction theory, at best, can only be a partial explanation of foreign direct investment. This theory can explain that oligopolist firms invest defensively to counter the foreign direct investment of the initiating firm, but it does not attempt to explain why the initiating firm chose to invest abroad in the first place (Lizondo 1991:73).

2.3.1 (c) The product life-cycle theory

The product life cycle theory proposed by Vernon (1966) maintains that the foreign investment decisions of the firm are significantly influenced by the life cycle patterns of its main products. More specifically, the decision by the multinational enterprise as to where to locate production facilities is determined by the nature of the firms products vis-à-vis the stage occupied by these products within the product life cycle. Vernon (1966) defines the product life cycle as consisting of three stages, namely – firstly, the new product stage, secondly, the maturing product stage and lastly, the standardized product stage (Vernon 1966 cited in Chen 1983:26-9). The theory assumes that the firm in question is an innovation-based oligopolist from a developed country.

The first stage is the new product stage during which the product is first introduced in the market. During this stage, production facilities and sales are both based within the domestic market. This is due to uncertainties as to the sustainability over time of the product's demand in distant markets.

The second stage is the maturing product stage which is characterized by peak demand for the product in the domestic market and modest but growing demand for the product in overseas markets. The growth in demand for the product in the domestic market occurs as consumers become more knowledgeable about the product while at the same time the products price falls due to improved efficiency and standardization of production processes. Overseas demand and sales of the product develop during this stage as the product meets tough competition in the domestic market. With the eventual saturation of the local market by the innovating firm and it's competitors, the profit levels of the innovating firm are initially maintained through increased exports. It is during the later phases of this stage that the innovating oligopolist invests in production facilities abroad, usually in other developed countries whose income levels and consumer tastes are similar to those of the domestic country.

The third stage is the standardized product stage during which the product has lost it's innovative advantage such that it's production processes are commonly known in other developed countries. At some point, the innovative oligopolist will encounter competitive pressures from developed host country firms who begin to produce a substitute product and may even export some of this product to the home country of the foreign oligopolist. In order to continue profiting from the product, the foreign oligopolist must further reduce costs by investing in production facilities in developing countries. During the initial phases of this stage, the products produced by the foreign oligopolist in the developing countries are usually not for sale in those markets but are instead exported

back to the home country of the oligopolist or to other developed countries. In the latter phases of this stage, the oligopolist will attempt to develop a market for the product in developing countries.

The product life cycle theory is supported by empirical analysis of foreign direct investment for the post-war period up to the early 1970s. That is, the theory is consistent with the rise of foreign direct investment by United States firms in Western European countries before subsequently investing in the developing countries (Chen 1983:28).

The product life cycle theory has been criticized, however, for being a partial theory that addresses itself to foreign direct investment of the market seeking kind only. Other types of foreign direct investment such as resource based and efficiency seeking modalities are unaccounted for (Dunning 1993:71). Further, the product life cycle theory has also been criticized for failing to explain the more contemporary phenomena of foreign direct investment such as the fact that in many cases a new product is introduced to domestic and foreign consumers almost simultaneously (Chen 1983:28).

The declining usefulness of the product life cycle theory of foreign direct investment has been attributed to two factors, namely – the network's spread of multinational enterprises, and the shrinking of the income and technology gap amongst developed nations. The network's spread refers to the fact that modern multinational enterprises tend to invest in a network of subsidiaries around the world, and this network often shares information and resources such that new products can be introduced simultaneously in different parts of the world, or if a product is introduced in country A, the interval of time between the introduction of the product in country A and its first production in country B has been rapidly shrinking. Shrinking technology and income differences amongst developed countries weakens the critical assumption of the product life cycle

theory that innovative oligopolists are motivated to engage in foreign direct investment as a result of markedly different economic conditions in foreign markets (Chen 1983:29; Cf. Cantwell in Pitelis & Sugden (eds.) 1991:37-8).

2.3.1 (d) Some empirical evidence on ownership-specific advantages

From the spectrum of monopolostic ownership-specific advantages available to manufacturers, Lall (1980:Chapter 1) selected to examine technology, product differentiation, capital intensity, scale economies and skills. A sample of 25 industries was extracted from data provided at the two and three digit industry levels. The statistical technique used is ordinary least squares (OLS) multiple regression.

The study examined *monopolistic* advantages in terms of their influence on total foreign involvement (defined as the sum of United States exports and United States foreign production). The focus was on determining how these advantages affected foreign involvement in total as well as in its component parts.

The statistical results indicated that Research and Development (RD), as a measure of technological intensity, exhibited higher propensities for export than for foreign production. However, this finding should take into account the fact that this advantage is most likely to exhibit a 'cyclical' effect. That is, as stated by Lall (1980) "…*in the early stages of innovation, there are both country-specific (large markets, technological infrastructure) and firm-specific (coordination required between scientific, engineering, production and marketing units) reasons for keeping production at home. In later stages, as techniques, skills and products become standardized, foreign demand and competition arises, it becomes an advantage which is easy and profitable to transfer abroad*" (Lall 1980: chapter 1). This 'cyclical' effect, therefore, partly

negates the statistical results with respect to the nature of the relationship between Research and Development and exporting or producing abroad. In this regard, the fact that country-specific and firm-specific advantages also act upon the decision of firms to export indicates that the relationship of Research and Development to exporting or producing abroad is far from being a perfectly linear relationship.

Scale economies are also expected to exhibit a ‘cyclical’ effect as productive capacity first satisfies local demand before expanding overseas. The correlation coefficients on this advantage are more strongly positive and significant for foreign production as compared with those of exports when tested independently. Thus, firms that enjoy economies of scale in production normally prefer foreign production to exporting (Lall 1980: chapter 1).

For each industry, SAL (the number of salaried employees as a percentage of the total work force), PW (the average production wage), and AW (the average wage per employee) were the alternative measures used to approximate ‘skill’. Lall’s findings are that the factor, average production wage, is significantly correlated with exporting but not with foreign production. In contrast, the number of salaried employees as a percentage of the total work force is significantly correlated to foreign production. Thus firms that have a relatively large number of highly skilled salaried employees are more likely to engage in foreign production than firms with a low skilled workforce whose skills are not easily transferable abroad. These results partially support the studies hypothesis that certain employable skills are easily transferable abroad, these transferable skills being high level salaried skills (Lall 1980: chapter 1).

AD (advertising expenditure) – a measure of the propensity for product differentiation, had the expected positive correlation with foreign production. Lall thusly suggests that the ability to differentiate products through significant

expenditures on advertising gives firms that wish to invest abroad a significant advantage over firms with less significant advertising budgets. Alternatively, KL (capital intensity – measured as total net fixed assets in each industry divided by the total number of employees) failed to reach significance on any of the regressions. Furthermore, its sign changed erratically. It was found, therefore, not to be a factor which is important in influencing foreign production (Lall 1980: chapter 1).

Ownership-specific advantages are not exclusive to the market power approach. Other theories take cognizance of these advantages, however, affording them a lesser degree of relevance. The same can be said of other advantages used to explain the motivating factors of foreign direct investment. These include the location-specific advantages and internalization advantages.

2.3.2 Location-specific advantages

Location specific advantages as an explanation of foreign direct investment can be discussed in terms of the following location-specific factors – availability and cost of inputs, marketing factors, bypassing trade restrictions, and factors related to government policies (Chen 1983:25-6). Thus, a firm investing abroad may simply be attracted by the availability in another country of some inputs which are very scarce at home, or by the lower cost of inputs abroad. This case in point is often evidenced by a lower labor cost in the potential host countries. There are usually also advantages of locating production near the market. In doing so, the local market can be better explored, tariff barriers can be avoided, local requirements can be more easily catered for, and transportation cost can be reduced. It is sometimes also true that production via the setting up of subsidiaries in a host country is more accepted by the local people than direct exporting to that country (Chen 1983:25-6).

With regard to the economic policies of host governments, subsidiaries are often set up by an investing country firm in the host countries which are not yet subject to trade restrictions. The products produced by these subsidiaries are exported to those markets which have imposed restrictions on the exports of the investing country firm. Lastly, a firm may be attracted to invest abroad because another country offers advantages such as lower tax rates, better infrastructure, greater political stability, and great scope for expansion and the pursuance of corporation goals (Chen 1983:25-6).

2.3.3 Internalization advantages

Internalization advantages refer to the ability of firms to reduce the costs and uncertainties of arms length transactions in the market by integrating business operations with suppliers (backwards integration) and/or distributors (forward integration) through mergers, acquisitions or green-field investment (Cantwell in Pitelis & Sugden (eds.) 1991:24). Backward and forward integration can occur in either the domestic or foreign markets, however, under internalization theory, foreign direct investment is said to be synonymous with market integration/internalization that takes place across national borders and is also thought to be brought about by market imperfections (Lizondo 1991:71; Cf. Chen 1983:31). Thus, for example, lower factor costs abroad would represent a market imperfection as well as a location-specific advantage that would give rise to internalization and thus foreign direct investment. In this case, the market that would be internalized is the low cost factor market in question.

In essence, internalization and foreign direct investment are expected to occur when the net benefits of joint ownership across international borders exceed the net benefits of external trading relationships (Dunning 1993:75). Thus, internalization can be seen to be an attempt by the multinational enterprise to seek gains from efficiency rather than seeking gains from extending market

power and erecting barriers to competition (Cantwell ed. Pitelis & Sugden 1991:25).

Internalization theory has been criticized for focusing on the internal motives of the firm to invest abroad, whilst giving only limited attention to external factors such as government policy and regulation that may affect the benefits and costs of internalization (Robock and Simmonds 1989:47; Cf. Lizondo 1991:72).

2.4 The Eclectic Paradigm

The eclectic paradigm proposed by Dunning (1993:76-86) recognizes the inability of a single theory to provide a comprehensive explanation for foreign direct investment by multinational enterprises. The eclectic paradigm thus attempts to tie together elements (with strong explanatory power) from each of the three aforementioned theories (i.e. - ownership, location, and internalization) in order to offer a more dynamic and complete explanation of foreign direct investment.

In support of Dunning's work, Cantwell (Pitelis & Sugden (eds.) 1991) emphasized the need for a diversity of approach for the following reasons. First, international production may be resource-based, import-substituting, export-platform or of the globally integrated kind, each of which raises distinctive considerations and each of which affects home and host countries in different ways. Second, international production can be studied from three different levels of analysis: macroeconomic (examining broad national and international trends), mesoeconomic (considering the interaction between firms at the industry level) and microeconomic (looking at the international growth of individual firms).

It should be noted that the eclectic paradigm is not an alternative international production theory, rather it is an overall organizing paradigm for identifying the elements from each approach which are most relevant in explaining a wide range of various kinds of international production, and the wide range of different environments in which international production takes place. The eclectic paradigm abstracts from the main theories the varying dynamics between the advantages discussed above. That is the ownership-specific advantages denoted as (O), the location-specific advantages (L) and the internalization advantages (I). Thus, rather than emphasizing a specific advantage as the key determinant of foreign direct investment, the eclectic paradigm seeks to clarify the relationship between different levels of analysis (macro, meso and/or micro) and the different questions to be addressed by the analysis. For example, internalization theory may be the most relevant under certain circumstances or when answering certain kinds of questions (such as those related to backward vertical integration into resource extraction), while locational advantages are the key variable studied in determining the firms competitive strategy in it's final product market (Cantwell in Pitelis & Sugden (eds,) 1991:26).

In general, the eclectic paradigm asserts that if a firm possesses only ownership-specific advantages but not (I) and (L), the firm will, inter alia, be indifferent between the competing options of foreign direct investment, exporting, and licensing. In theory, all three options will be equally viable. If, however, the firm's ownership-specific advantages can be internalized, the firm will prefer to either engage in foreign direct investment or exporting rather than licensing. Further, if the firm possesses ownership-specific advantages which it is able to exploit internationally as a result of locational factors/advantages available in foreign countries, the firm will normally engage exclusively in foreign direct investment as opposed to exporting or licensing (Chen 1983:33).

2.5 The Economic Effects of FDI on the Host Country

Before dealing with the subject matter of the economic effects of foreign direct investment occurring in host countries, it is necessary to first identify how the term 'economic' is to be defined and used in the present context. The New Merriam-Webster dictionary defines the term economic as the subject matter which is concerned with "the satisfaction of material needs of humans" (The New Merriam-Webster Dictionary). This definition can only serve as a partial definition, as the term economic is associated with factors other than material needs as proposed by Eatwell et al. (ed) (1987) in The New Palgrave: A Dictionary of Economics. Eatwell et al. (ed) (1987) point out that even in the pursuit of wealth (or alternatively, material needs), the term economic strongly implies a fundamental need to avoid waste either of labor or of its produce even where these may have no direct relationship to the production, distribution, or consumption of wealth/material needs. Thus the term economy can be used in diverse applications such as in mechanical engineering where the conservation of energy is often referred to as the 'economy of force', and in project management where 'economy of time' is used to signify an efficient allocation of resources that has little or no direct relationship to the production of wealth or the satisfaction of material needs (Eatwell et al. (ed) 1987). The economic effects referred to in this section of the dissertation, shall refer to the usage of the term economic in the broader context as set out by Eatwell et al. (ed) (1987). Thus, for the purposes set forth for this dissertation, economic effects will be taken to refer to monetary (e.g. gross domestic product and per capita income) as well as non-monetary (e.g. employment and literacy) changes occurring in a specified geographic area (domestic, international, regional etc.) brought about by the entry of multinational enterprises into that geographic area.

Compared to the theories proposed to explain the proliferation of foreign direct investment in the form of multinational enterprises, the theories dealing with the economic effects of the foreign direct investment of multinational enterprises in host countries has received much less attention in the literature. Yet, however, these latter theories are equally important policy determinants. The economic effects of foreign direct investment occurring in the host country can be examined from a number of analytical vantage points. Very generally, foreign direct investment has economic implications for host countries that may be associated with economic development, competitive market conditions, and balance of payments effects (Muchlinski 1995:7-8; Cf. Dunning 1993:283). Theory and empirical evidence to be reviewed in this section address each of these factors in turn.

2.5.1 Economic effects of foreign direct investment of multinational enterprises associated with development

Although the terms productive output, economic growth and economic development are often used interchangeably in the literature, there are important definitional nuances that serve to differentiate the terms from each other. Failing to recognize the distinctiveness of these three terms and using them interchangeably and indiscriminately will no doubt result in inconsistent measurement of the economic effects of foreign direct investment (Kindleberger and Audretsch 1983:21). In order to avoid this pitfall, the above-mentioned terms will hereby be defined as follows (Kindelberger and Audretsch 1983:21-3; Cf. Todaro 1981:56; Cf. Morgan and Gardner 1973:186):

(a) Productive output is essentially a static measure of productive activities. Thus productive output is the measure of output obtained by a given level of inputs as measured at a specific point in time.

(b) Economic growth (or it's synonym output growth) can also be defined in terms of output obtained from a specified amount of input, however, economic growth is distinguished from productive output as it is a dynamic (rather than static) measure of productive activities measured longitudinally over a specified period of time. The most common measure of economic growth is a nation's gross national product adjusted for inflation; and lastly,

(c) Economic development is a far broader measure than both productive output and economic growth in that it seeks to recognize factors other than productive inputs and outputs in assessing the contribution of investment to the local economy. That is, economic development, attempts to account for, among other factors, employment, literacy, changes in institutional structures and in some instances even changes in popular attitudes, customs and beliefs.

In keeping with the above conventions with respect to the definition given of economic development, the effects of foreign direct investment on employment will be explored under this section. Also, an important caveat to be addressed before embarking on a discussion of the interactive nature of foreign direct investment with productive output, economic growth and economic development is that as productive output and economic growth limit their definitional scope to productive inputs and output they provide relatively simple quantitative measures whose relationships can be resolved through expression in mathematical form and are therefore readily subject to empirical measurement and testing. On the other hand, owing to the greater detail required to characterize economic development, economic development models are, by default, far less scientific than models of productive output and economic growth and are therefore less amenable to mathematical formulation and proof. The dichotomy lies in the fact that economic development models add greater understanding to the issues at hand whilst at the same time

compromising the scientifically verifiable nature of their findings (Kindleberger 1983:22-3).

2.5.1(a) Foreign direct investment and output growth

Initial attempts to assess the impact of foreign direct investment on productivity levels and output growth within host countries made use of what are now commonly referred to as neo-classical growth-theoretic models of the Solow (1956) type (Herrick and Kindleberger 1983:70; Cf. Todaro 1983:34-9; Cf. De Mello 1997:1). Under these growth models, it was assumed that diminishing returns to physical capital would dictate that foreign direct investment could only affect short run output growth while leaving long run growth unchanged. In essence, the belief was that foreign direct investments initial contribution to growth would diminish over time and thus the economy would return to it's steady state growth path (Herrick and Kindleberger 1983:70).

Contemporary growth models as proposed by DeMello (1997) and others make a case for taking account of endogenous variables that act as channels through which foreign direct investment can be expected to promote growth in the long run. Accordingly, foreign direct investment is expected to contribute to long-run productivity growth by adding to the production functions of the host country through the asymptotic growth catalysts of new inputs and advanced technology. In the case of new inputs, output growth can result from the use of a wider range of intermediate and final goods in foreign direct investment-related production. In the case of new technologies, foreign direct investment is expected to result in productivity gains via spillovers to domestic firms. (Feenstra and Markusen, 1994 cited in De Mello 1997).

In fact, De Mello (1997:10) further maintains that human capital augmentation is the most important channel through which output growth takes place via foreign

direct investment. This is because the potential externality effects brought about by knowledge and technology transfers are expected to be greater than those related to the introduction of new inputs. The external effects associated with foreign direct investment knowledge transfers are measured as the augmentation of the existing stock of knowledge in the recipient country of the foreign direct investment, by way of labor training and skills acquisition and diffusion, on the one hand, and through the introduction of alternative management practices and organizational arrangements on the other (De Mello 1997:10). It has thus been argued that human capital augmentation associated with foreign direct investment is a significant endogenous variable in assessing foreign direct investments impact on growth that has been factored out (or overlooked) by classical models of international trade theory. In essence, under endogenous growth models, foreign direct investment is expected to lead to technology or knowledge transfers which in turn bring about human capital augmentation, the result of which is expected to be long-term process innovations and increasing returns (De Mello 1997:8-9)

Through the use of regression and sensitivity analysis, Borensztein et al. (1998:115-35) demonstrate empirically the relationship that exists between foreign direct investment, economic growth and other variables that may tend to affect economic growth either in conjunction with, or independently of foreign direct investment. Essentially the same set of conclusions as those of De Mello (1997) are reached by Borensztein (1998). Change in the average annual rate of per capita gross domestic product (GDP) is used as the measure of economic growth. The Borensztein (1998) study was conducted by way of examining investment flows from an unspecified number of developed countries going into 69 developing countries during the decades of the 70’s and 80’s.

The results derived from the Borensztein (1998) study suggest that through advanced technology transfer, foreign direct investment contributes relatively

more to growth than does domestic investment. The caveat here being that foreign direct investments contribution to growth can only occur in those cases in which there exists a minimum threshold level of absorptive capability of the advanced technology (this absorptive capability is proxied by a measure of the level of educational attainment of the human capital stock) (Herrick and Kindleberger 1983:70; Cf. Borensztein 1998:117). Ironically, the results derived from Borensztein's (1998) model indicate that foreign direct investment actually decreases economic growth (estimated by gross domestic product) in cases where the absorptive capability is below the threshold measure. He acknowledges that this is inconceivable in the real world and attributes these anomalous results to attempts to model non-linear relationships in linear equations. That is, x and y are most likely non-linear but for simplicity a linear model is defined.

Additionally, Borensztein's (1998) regression results indicate that foreign direct investment on it's own has a positive but minimally significant effect on economic growth, whereas the interaction term which is the product of foreign direct investment and human capital stock (available in the host country) registers a positive and highly significant co-efficient. By testing foreign direct investment and secondary school attainment (the measure of human capital stock) individually alongside their product, Borensztein (1998) was able to simultaneously test whether these variables affect growth by themselves or through the interaction term. His findings indicate that neither foreign direct investment nor human capital stock on their own are significant determinants of economic growth, rather it is only when foreign direct investment is combined with a minimum level of human capital stock that a statistically significant contribution is made to economic growth (Borensztein 1998:123-8).

2.5.1(b) Direction of causation between foreign direct investment and economic growth

A significant point of contention that has been addressed in the literature is the issue of the direction of causation between foreign direct investment and economic growth. Caution must be exercised in those cases where foreign direct investment and economic growth exist in parallelism. In such cases it cannot simply be concluded that foreign direct investment leads to economic growth (or vice-versa) based solely on tests of correlation (Wells in Robinson ed. 1987: 17; Cf. De Mello 1997:27; Cf. Caves 1996:224-6).

Although it has been argued that foreign direct investment leads to human capital augmentation which in turn leads to economic growth, it has also been argued that developing countries that have excellent growth prospects (prior to significant foreign direct investments being undertaken in their economies) simply tend to attract greater levels of foreign investment than those lacking growth potential. In the case of the latter argument, positive and significant domestic economic growth may lead to increases in income and purchasing power of domestic consumers who may in turn attract market seeking foreign investments. Additional growth related variables that may tend to attract foreign investment include the trade regime and degree of macroeconomic stability in the host country (De Mello 1997:27).

2.5.1(b)(i) Granger-causality technique

The Granger-causality technique has been proposed as a tool for determining the direction of causation between foreign direct investment (FDI) and economic growth (De Mello 1997:10-15). Granger causality is calculated as follows:

$$\Delta g_{y,t} = a_0 + a_1 \, \Delta \, \mathrm{FDI}_t + \sum_{i=1}^{n} c_i \, \Delta g_{y,t-i} + \sum_{i=1}^{n} \mathrm{F}_i \, \Delta \, \mathrm{FDI}_{t-i} + u_t \, , \quad (1)$$

and

$$\Delta \text{FDI}_t = b_0 + b_1 \Delta g_{y,t} + \sum_{i=1}^{m} d_i \Delta g_{y,t-i} + \sum_{i=1}^{m} \text{G}_i \Delta \text{FDI}_{t-i} + v_t \,, \qquad (2)$$

where g_y is the rate of growth of output (economic growth), n and m denote the number of lags chosen and u and v are standard error terms.

By this technique, and using formula (1), FDI is said to "Granger-cause" economic growth if lagged (rather than current) values of FDI as well as lagged values of the economic growth rate used in the formulation result in more accurate estimates of the current economic growth rate (See also Borensztein et al 1998:131-3). That is, using equation (1), FDI Granger causes output growth if $a_1 = 0$ and $\text{F}_i \neq 0$.

Similarly, using formula (2), economic growth "Granger-causes" FDI if more accurate estimates of FDI can be obtained from use of lagged values of the economic growth rate as well as lagged values of FDI inflows in the specified equation. Thus, by equation (2) output growth Granger causes FDI if $b_1 = 0$ and $\text{G}_i \neq 0$, and bi-directional Granger causality is obtained if $a_1 = b_1 = 0$ and $\text{F}_i \neq 0$ and $\text{G}_i \neq 0$.

Using the Granger causality technique for the five Latin American countries (i.e. Brazil, Mexico, Venezuela, Chile and Colombia) that hosted most of the region's foreign direct investment during the period 1970-91, De Mello (1997:28-9) found that in all cases the direction of causation was dependent upon the recipient country's trade regime, ranging from import substitution to export promotion. In the case of Brazil, capital accumulation and total factor productivity (TFP) tend to precede economic/output growth, but the direction of causality between the latter and foreign direct investment was indeterminate. For Chile, on the other hand, foreign direct investment tends to precede output growth. The difference in the findings for these two countries is attributed to the fact that during the

period under study, Brazil pursued import substitution policies, while Chile had a much more open trade regime which focused on export promotion.

2.5.1 (b)(ii) Investment development path (IDP)

An alternative approach to Granger-causality is that developed by Dunning (1993:88-9) and supported by Narula (1996:chapter 2) and others which proposes that the direction of causation between foreign direct investment and economic growth can be explained by diagnosing a country's investment development path (IDP). It must be noted that Narula (1996) takes the terms economic growth and economic development to be synonymous and uses them interchangeably. This fact, however, has little or no bearing on the validity of his thesis, as he explicitly expresses that economic development is proxied by gross national product (GNP) per capita (Narula 1996:15), while elsewhere gross national product is also commonly used as a measure of economic growth (Morgan and Gardner 1973:186)(Supra. the definitions in section 2.5.1 above). Thus, if both economic development and economic growth are set equal to gross national product, then economic development can be said to be synonymous with economic growth.

The investment development path (Infra. Figure 2.1) is essentially an analytical framework based on Rostow's stages of growth model (Cf. Todaro 1981:58) and modified to account for the dynamics of Dunning's (1993) eclectic paradigm (Supra Sect. 3.8). Investment development path theory holds that, *ceteris paribus*, all countries advance through five distinct stages of development, and each of these stages affects the level of inward and outward foreign direct investment. Thereafter, aggregated net changes in inward and outward foreign direct investment will then move the country forward along it's development path (Narula 1996:12-19; Cf. Dunning 1993:88-9). The relationship between foreign direct investment and economic growth as explained under investment

development path theory is a symbiotic one in which the direction of causation is a secondary issue to that of the conditions under which the simultaneous occurrence of foreign direct investment and economic growth is observed (Narula 1996:12-19).

Figure 2.1: The pattern of the investment development path

NOI - net outward investment ; GNP - gross national product
Adapted from Narula 1996:22

Economic growth can be mapped out as a country's investment development path. The investment development path is a normative rather than a positive example of the expected interaction between the foreign direct investment of multinational enterprises (NOI) and specified phases of economic development assuming a free-market economy. The reality is that each country is expected to have it's own unique investment development path that is a function of four main variables, namely their resource structure, market size, economic system,

and government organization and regulation of economic activity (Narula 1996:12-19). Similarly, according to the eclectic paradigm upon which the investment development path is founded, the propensity of firms to engage in international production (i.e. the foreign direct investment of multinational enterprises) will be a function of three main variables namely ownership-specific advantages (o), internalization advantages (I) and locational (L) advantages (Supra Sect. 2.4).

The fundamental workings of the investment development path, on the one hand, and the foreign direct investment of multinational enterprises on the other as described by the eclectic paradigm, can be seen as two separate modalities that work together in a single system of simultaneous equations, the interaction of which seeks to resolve one or more unknowns about their interrelatedness (Herrick and Kindleberger 1983:22-3). Investment development path theory accounts for these relations in a stages-of-growth approach as described hereunder (assuming a free market economic system with some degree of export oriented rather than import substituting government policy)(Narula 1996:17,26).

Stage one of the investment development path is characterized by low levels of economic development and economic growth. There are few location based advantages within the host country for foreign firms to exploit other than natural resources and cheap unskilled labor. This deficiency in location based advantages may reflect inadequate domestic markets wherein demand conditions are minimal because of the low per capita income, insufficient infrastructure such as transportation and communication facilities and, most important of all, a poorly educated, trained or motivated labor force. During this stage, foreign firms will prefer to export to and import from this market rather than to engage in foreign direct investment. Government policy towards the conclusion of this stage is directed at reducing some of the market failures by

providing infrastructure and upgrading human capital by way of increased spending on education and training (Narula 1996: chapter 2).

In stage two, owing in part to the effectiveness of government policies in stage one, inward foreign direct investment starts to rise, while outward investment remains low or negligible. Domestic consumption is also expected to experience growth in terms of both size and purchasing power thus stimulating some amount of market seeking inward foreign direct investment. Export oriented inward foreign direct investment may also take place in those countries that have and/or provide infrastructural support such as an adequate transportation network, communication facilities and supplies of both skilled and unskilled labor. Domestic firms may begin to close the technology gap that exists between them and multinational enterprises as a result of government policies regarding technology transfer and accumulation. Although outward foreign direct investment by domestic firms increases during this stage, it does so at a rate that is by now insufficient to offset the rising rate of growth of inward direct investment. By the end of stage two, however, the growth rates of outward direct investment and inward direct investment will begin to converge (Narula 1996: chapter 2).

In stage three of the investment development path, the rate of inward direct investment by foreign firms begins to decline while the rate of outward direct investment of domestic firms rises. Consumers begin to demand higher-quality goods as their incomes rise. In response to consumer demands, labor-intensive production of basic consumer goods by foreign and domestic firms will decline as firms retool themselves for the production of high technology goods. Outward foreign direct investment continues to increase as declining industries (such as labor intensive ones) undertake direct investment abroad in countries that are at lower stages of the investment development path (Narula 1996: chapter 2).

In stage four, the rate of growth of outward direct investment is still faster than that of inward direct investment. In fact, a country is considered to be in stage four of the investment development path when it's outward direct investment equals or surpasses it's inward direct investment. Domestic firms are by now able to compete both at home and abroad with foreign-owned firms owing to higher rates of technology accumulation by domestic firms. Production processes become even more capital intensive than at earlier stages of the investment development path as the cost of capital will be lower than that of labor. A significant proportion of inward direct investment in this stage is from firms originating from other stage four countries and is of an asset-seeking nature (i.e. natural assets and/or created assets). There is also expected to be an increase in the amount of inward direct investment from countries at lower stages of economic growth that is of a market seeking, trade related and asset seeking nature (Narula 1996: chapter 2).

Stage five is the final stage in which net outward investment begins to fall back as outward and inward investment become more balanced. In fact, stage five countries will normally maintain a stable yet fluctuating equilibrium around a roughly equal amount of inward and outward direct investment. This is the scenario that is expected to occur in advanced industrialized nations. With regards to inward direct investment in stage five, this is normally dominated by two distinguishable modes of investment. The first will come from countries at lower stages of the investment development path and will be essentially of the market seeking and knowledge seeking type. The second will be from stage 4 (or stage 5) countries in the form of market seeking, asset seeking, and efficiency seeking investment with greater emphasis on cross-border alliances, mergers and acquisitions. It must be noted, however, that as firms become more sophisticated global operators, their nationalities become blurred. As firms move with countries across the investment development path, they no longer operate principally with the interests of their home nation in mind, as they

trade, source and manufacture in various locations, exploiting created and natural assets wherever it is in their best interests to do so. It is also expected that during this the final stage of the investment development path, firms will increasingly engage in intricate webs of trans-border cooperative ownerships and governance (Narula 1996: chapter 2).

2.5.2 Economic effects of foreign direct investment associated with employment

Employment is an issue that has been argued on both sides of the debate on the foreign direct investment of multinational enterprises. That is, inward foreign direct investment has been argued to contribute to a reduction of unemployment by some whilst others have argued to the contrary.

More specifically, on the one hand, multinational enterprises can contribute to local employment by creating service, supply and distribution linkages with local entrepreneurs. On the other hand, the employment effect of multinational enterprise investments may be negative if local businesses and employment are effectively 'crowded out' by multinational enterprises who do not create linkages but instead enter into direct competition with local businesses (Caves 1996:115-20; Cf. Muchlinski 1995:91; Cf. Daniels and Radebaugh 2001:385-7). Still others have further argued that given that multinational enterprises in general have the potential to affect employment within the host country, policy on multinational enterprises should ensure specified amounts of local participation in their business ventures. In fact a number of countries (mostly third world) have indeed incorporated such requirements in their foreign direct investment policy agendas (Muchlinski 1995:104, 177-181).

Chen (1983) examines the two characteristics of firms, the *choice of technology* and the *propensity to export*, as probable channels through which multinational

enterprise's foreign direct investment leads to employment creation. These will be considered hereunder.

2.5.2 .(a) Choice of technology and employment

With regard to choice of technology, Chen (1983:Chapter 5) argues that the wrong choice of industrial technology by firms can have employment consequences. More specifically, technologically advanced and capital-intensive investment will tend to either have no effect on employment or lead to a reduction in employment, whereas increased employment is expected to result from labor-intensive technology investment. Further, it is also argued that multinational enterprises generally use more capital-intensive and less labor-intensive technologies than local firms (Chen 1983:102). This contention is supported by a number of rationalizations including the following:

- First, technological differences between countries and their firms may make it expensive for foreign firms to adapt or modify their technological processes to be more appropriate for host countries.
- Second, foreign firms/multinational enterprises tend to experience different factor costs from local firms such that they pay higher wage rates to their workers and also normally have better access to international credit. Such factor price conditions would result in their operations being more capital intensive and less labor intensive.
- Third, when faced with a trade-off between instituting labor intensive methods and profit maximization, firms (local and foreign) would normally opt for profits at the expense of labor unless otherwise coerced by government policy.

It should be noted, however, that the empirical evidence on the issue of capital-labor choices of multinational enterprises is rather inconclusive. That is, there

are as many studies that support the hypothesis that multinational enterprises tend to use more capital intensive technologies (than local firms) as there are studies that refute this hypothesis (Chen 1983:103-4). These disparate findings may be the result of the differences in sample countries, industries and firms studied as well as differences in methodological approach of the studies.

2.5.2 (b) Exports and employment

The propensity of firms (both local and foreign) to export has also been shown to lead to employment generation (Chen 1983:Chapter 6). In accordance with the eclectic paradigm (Chen 1983:32-5; Cf. Dunning 1993:76-88; Supra Sect. 2.4), foreign firms choose to invest in host countries whose comparative advantages (i.e. locational advantages) are compatible with their firm specific advantages (i.e. ownership and internalization advantages) and therefore foreign firms may contribute more to production, employment and exports than do local firms. The argument is that if foreign firms invest in industries in which the host country has a comparative advantage, these foreign firms will in fact promote a more efficient use of resources in the host country and concomitantly increase the output and export of manufactured goods of the host country. This increase in output and exports can only be attained through increased employment. Thus, based on this argument, multinational enterprises are expected to contribute more to employment than local firms.

One is cautioned, however, in making this argument unreservedly. Rather, a more competent application of this argument can be made by taking account of all possible counter factual arguments (Dunning 1993:366). There are a number of possible counterfactual scenarios to the expected foreign direct investment of a particular firm - for example, a different foreign firm from the same or a different country may make the investment in place of the firm under

analysis; local firms may make the investment where foreign firms fail to act; or no investment may take place at all.

The employment outcome expected with the foreign direct investment of the multinational enterprise must be compared with the employment outcome expected if the foreign direct investment in question had not been made. The algebraic difference between these two estimated employment outcomes is the more accurate measure of the employment contribution of the foreign direct investment (Dunning 1993:366). Additionally it is recommended that sensitivity analyses be performed on further counterfactual variables such as the type of investment made, the anticipated response of competitors and the policies pursued by home and host governments (Cf. Robock and Simmonds 1989:324).

2.5.3 Foreign direct investment and economic development in the South African context

From the discourse thus far covered in the present chapter, it can be ascertained that foreign direct investment plays no small role in contributing to the development of a nation and the well-being of it's peoples. Although public as well as domestic private investment has kept South Africa's major industrial cities apace with the infrastructural development standards of the worlds leading industrialist countries; unemployment, illiteracy, and poverty are at odds with these achievements (1996 census data cited in South Africa Yearbook 1999:4-17; 1996 census data cited in Mataboge 1999:199-202).

In general it has been stressed that a government's foreign direct investment policy should be consistent with the development plans of that government (Modelski 1979:313). Thus, for example, foreign direct investment policies that encourage mineral extraction may be counter to development goals as "…*they*

may generate few processing industries or do little to raise the level of local skills"(Modelski 1979:313). At the current point in South Africa's development, the government is currently engaged in a re-assessment of growth and development macroeconomic strategies with specific reference to the role to be played by the private sector (both domestic and foreign) in partnership with the public sector. In this regard, the medium term goals of the government's macroeconomic strategy include promoting the following (South African Yearbook 1999:311):

(a) A competitive fast-growing economy that creates sufficient jobs for all work seekers;
(b) A redistribution of income and opportunities in favor of the poor;
(c) A society in which sound health, education and other services are available to all; and,
(d) An environment in which homes are secure and places of work are productive.

The South African National Budget continues to give priority to spending on education, health, welfare and social infrastructure, whilst exercising measures to reduce government debt (for example, through privatization) in an effort to increase both private domestic investment and foreign investment (South Africa Yearbook 1999:311). Additionally, the government has committed itself to drastically increasing productivity-enhancing training through the skills development levy that came into effect in April 2000 under the Skills Development Levies Act 1999 (Act 9 of 1999). The skills development levy is aimed at financially supporting sectoral education and training initiatives through the payment of a 1 percent payroll levy by all employers falling under the ambit of the Act (South Africa Yearbook 1999:311).

2.5.4. Economic effects of multinational enterprises foreign direct investment associated with competitive markets

As discussed above, an analysis of the economic effects occurring within the host country of foreign direct investment by multinational enterprises may be conducted under one of two possible assumptions – i.e. perfect markets or imperfect markets (Parry in Hawkins (ed.) 1979:63-5; Cf. Chen 1983:16-7; Cf. Muchlinski 1995:33-8). Under the analytical assumption of perfect markets, capital (foreign direct investment) is assumed to move from countries with low returns to capital to countries that offer higher returns (for example- due to currency and/or interest rate differentials between home and host countries). This shift in capital is assumed to be unimpeded and is therefore further assumed to result in gains to both the host and home countries as a result of a more efficient global allocation of capital. The assumption of perfect markets, however, is far less realistic than that of imperfect markets especially with respect to explaining the existence and proliferation of multinational enterprises. In this regard, there is much greater empirical support for theories that take account of market imperfections such as barriers to entry and monopolistic or oligopolistic market structures. In fact, the contemporary theory of multinational enterprises (the market power approach and the product cycle theory for example) strongly argues that market imperfections are indeed a necessary condition for domestic firms to become multinational enterprises (Hymer 1960; Cf. Vernon 1966 cited in Hawkins ed. 1979:63-5; Cf. Dunning 1993:429). The competitive market effects of the foreign direct investment of multinational enterprises may be observed, *ceterus paribus*, through changes in industry structure. The dynamics of these possible changes in industry structure are discussed hereunder.

2.5.4 (a) Foreign direct investment of multinational enterprises and Industry Structure

The economic effects of multinational enterprise investment, occurring within the host state, can be assessed in-dept by focusing on the changes in industry structure (Parry in Hawkins ed. 1979:65; Cf. Caves 1996:224-7). In fact the very nature and characteristics of multinational enterprises will determine the nature of their effects on host countries. That is, given that (by definition) the multinational enterprise is a firm that has operations in more than one country, it follows that decision-making within any given multinational enterprise operation cannot always be on its on terms, but rather must take account of global multinational enterprise objectives and global decision-making on the part of the parent company. This global focus of the multinational enterprise is what distinguishes it from the domestic firm in terms of isolating those economic effects that can specifically be attributed to the multinational enterprise investment within the host country. Thus, an example of a global multinational enterprise objective that may have economic consequences for a given host government is the 'restrictive export franchise' which requires a given subsidiary to not compete in certain export markets reserved for other affiliates of the multinational enterprise group. This type of constraint may well benefit the multinational enterprise group but will usually have negative effects within the host economy of the subsidiary by way of dampened industry export performance (Parry in Hawkins (ed.) 1979:65-6; Cf. Muchlinski 1995:387-393).

Additionally, anti-competitive characteristics are inherent in the nature of the multinational enterprise as its global access to capital and advanced technology will allow the multinational enterprise subsidiary to enjoy advantages of monopoly power over and above those available to domestic firms in the host market. Although the aforementioned monopolistic advantages gained by the multinational enterprise subsidiary may result in increased productivity and

lower consumer prices in a given industry, these benefits may be substantially transferred out of the host country generally as a result of the global basis of decision-making on the part of the parent multinational enterprise and more specifically through transfer-pricing practices (Parry in Hawkins (ed.) 1979:66; Cf. Dunning 1993:512-15).

Transfer pricing practices refers to the overstatement of the cost of input and intermediate products acquired by the MNE from an affiliate within the same MNE group/company. This accounting overstatement results in a loss of tax revenue to the host country and an unwarranted tax savings to the MNE which may be transferred out of the host economy in the form of retained earnings and dividends (Parry in Hawkins (ed.) 1979:66; Dunning 1993:512-15). Further effects of MNE transfer pricing are the distortion of prices of final products and the resultant inefficient resource allocation within the host industry (Parry in Hawkins (ed.) 1979:66).

The empirical evidence on the effect of MNE investment on the host industry structure suggests that MNE affiliates tend to hold monopoly power in the host markets in which they operate as measured by the relative size of MNE subsidiaries against the size of local firms in both developed and developing countries (Parry in Hawkins ed. 1979:67; Caves 1996:225). This was found to be the case for United States multinationals in both developed and developing countries as well as for MNEs (regardless of country of origin) in Canada and Australia (Parry in Hawkins ed. 1979:67). Further, it has also become evident that many of the host industries in which MNEs cluster tend to be highly concentrated, perhaps reflecting the structure of the home-country industry. This is indeed the basis for the argument that MNE investment often creates adverse 'branch-plant structures' within the host market by replicating, in the host country, the structure of the home-country industry.

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2.5.4 (b) The technology of multinational enterprises and industry structure

Relative technological advantage, as measured by research and development (R&D) expenditures, is yet another important mechanism through which the multinational enterprise entering a host market can create market imperfections in that host industry (Muchlinski 1995:429; Cf. Caves 1996:229-31; Cf. Dunning 1993:436). The resulting market imperfections, in turn, then have important implications for industry structure. This is a two stage process that involves firstly the creation of monopoly market power by the multinational enterprise through the exercise of it's proprietary rights over it's technology either in the transfer of that technology to local partner firms or by using the technology itself. In the second stage of this two-stage process, the market imperfections created will normally have measurable consequences for the host industry structure by way of the size and number of firms competing in the industry after the multinational enterprise entry has taken place (i.e. market concentration) (Parry in Hawkins (ed.) 1979:71-5; Cf. Dunning 1993:431). The transfer of technology to the multinational enterprise's affiliate or to local firms is considered to be an 'inappropriate' form of technology transfer where the MNE simply adapts to the host industry, home market technology and equipment for which factor costs (labor and capital inputs) differ markedly from those of the host country (or industry). This may lead to a less than optimal scale of plant production by the multinational enterprise in relation to the market size of the host country (Caves 1996:229-31; Muchlinski 1995:429-31). In addition, in the situation in which the initial investment by the MNE is followed by the entry into the host market of other multinational enterprises as competing international oligopolists, the expected outcome will in all likelihood be a highly fragmented industry structure consisting of high-cost, underutilized plants and an inefficient allocation of resources in the host industry (Parry in Hawkins (ed.) 1979:71-5).

The terms and costs under which technology is transferred by the MNE are the basis upon which technology represents a major source of monopoly or oligopoly power in the host industry (Parry in Hawkins (ed.) 1979:71-5). These terms and costs normally take the form of tie-in clauses that place restrictive requirements on the use of the technology or 'know-how' by the subsidiary or local partner and in some cases restrictive requirements may be extended to also impose limitations on their purchasing and export policies as well (Parry in Hawkins (ed.) 1979:71-5). Further, this potential of the multinational enterprise to create monopoly power through terms and costs attached to technology transfer is not strictly intrinsic to the multinational enterprise, but it is also often reinforced by existing patent laws within both host and home countries. The combined result, thereof, is that the monopoly element that may be exploited by the multinational enterprise in the process of technology transfer presents an important constraint on host nations gains from inward investment (Parry in Hawkins 1979:71-5).

2.5.4 (c) Form of multinational enterprise market entry and industry structure

The impact of the foreign direct investment of multinational enterprises on industry structure is also partly dependent on the form in which this market entry takes place. Multinational enterprise market entry can occur in either of three ways – green-field entry, take-over or merger. Each one of these three modes of entry may potentially result in a change in the size and number of firms in the industry in question, which equates to a change in industry concentration and/or industry structure (Parry in Hawkins 1979:71-5; Cf. Dunning 1993:431).

A concise definition of a green-field entry, of which will constitute the prescribed definition to be used throughout this dissertation, is that given by Hoogvelt and Puxty (1987:109) as "*Investments involving the establishment of new firms,*

especially new factories or other physical assets, as opposed to the acquisition of existing establishments." The multinational enterprise that enters an industry through a green-field investment will initially increase the number of firms in a given industry, thereby reducing seller concentration and positively affecting industry structure through increased competition. However, this circumstance may and often does change when the multinational enterprise becomes established in the industry (Parry in Hawkins ed. 1979:71-5; Cf. Dunning 1993:432-3). In this regard, it is important to note that long-term structural changes in the industry occurring after the entry of the multinational enterprise are largely independent of the form of market entry. This being noted, the possible short-run counterfactual outcomes of a green-fields multinational enterprise entry (where it is assumed that the multinational enterprise possesses monopolistic or oligopolistic advantages over domestic firms) may be that (Parry in Hawkins (ed.) 1979:71-5):

(a) *Established* firms may either be displaced or induced to merge in the face of multinational enterprise entry, and/or;

(b) *Marginal* firms may be forced out of the industry and some of the remaining indigenous firms may be forced to merge in order to compete with the new entrant.

Industry structure is expected to become more concentrated where firms (established or marginal) are forced out of the industry following an multinational enterprise green-field entry. This displacement of indigenous firms has implications for allocative efficiency, the term allocative efficiency being defined here as the efficient allocation of factors of production (labor, capital and technology) to their most productive uses such that aggregate factor productivity is optimized (Parry in Hawkins (ed.) 1979:85-7; Cf. Dunning 1993:417-20). Accordingly, where the majority of firms exiting the industry are inefficient marginal competitors, allocative efficiency in the industry is improved.

However, where efficient established firms exit the industry, allocative efficiency is diminished (Parry in Hawkins (eds.) 1979:85-7).

Where the multinational enterprise entry takes place through either take-over or merger with an established firm there will be no net change in the number of firms, unless the take-over or merger involves more than one established firm (Parry in Hawkins 1979:85-7). However, even if the number of firms in an industry remains unchanged thereafter, industry concentration and structure may still be altered due to the effects of having a new dominant firm in the industry that will most likely be able to create or amplify market imperfections such as barriers to entry.

Empirical evidence indicates that multinational enterprises tend to engage more frequently in mergers and takeovers in developed host nations than their indigenous counterparts (Parry in Hawkins 1979:72). Whereas, on the other hand, the principle form of entry by multinational enterprises into developing host industries is through green-field investment (Parry in Hawkins 1979:72).

2.5.5 Policy implications of regulating multinational enterprises to ensure competitive markets

The policy implications of regulating multinational enterprises to ensure competitive markets are relatively evident in anti-trust laws as well as in technology transfer laws and policies. The discussion that follows explores these two area of policy.

2.5.5 (a) Anti-trust regulation

Where industry structure is characterized by in-efficiently high levels of industry concentration, the regulation of multinational enterprises through anti-trust law

should be considered (Muchlinski 1995:384-6; Cf. Daniels and Radebaugh 2001:389-90). In the exercise of anti-trust laws under such circumstances, it is important to acknowledge that anti-trust laws should not, and normally do not, differentiate between foreign and domestic firms. However, certain characteristics of the multinational enterprise may require special treatment under anti-trust legislation. These characteristics reflect the international market power possessed by the multinational enterprise and its ability to develop international networks of production and distribution in what are often concentrated global markets (Muchlinski 1995:386-7; Parry in Hawkins (ed.) 1979:66-7). Thus, since multinational enterprises come into being as a result of market imperfections that give them a competitive advantage over domestic and/or single country firms vis-à-vis the internalization of markets in intermediate products across national boundaries, the industries in which multinational enterprises are present tend to be highly concentrated and multinational enterprises also tend to be the dominant firms in those industries. This process in particular leads to the development of characteristics in the multinational enterprise which are consistent with several significant barriers to entry into industries, such as (Muchlinski 1995:386):

(i) Engaging in high cost advertising;
(ii) Operating in industries where there are high capital costs to entry; and
(iii) Engaging in high cost research and development.

Moreover, where the multinational enterprise has put into place an international network for the distribution of its products through subsidiaries or through independent distributors, anti-trust regulation will be focused on the anti-competitive nature of any restrictive conditions that may be placed by the multinational enterprise on its controlled or independent distributors. The restrictive conditions in question may include, for example, binding the distributor to an exclusive contract in which the distributor may only distribute

the products of the multinational enterprise, while also limiting the distributors sales to a specified geographical territory. Across international boundaries this type of restrictive condition may result in the partitioning of world geographical markets by multinational enterprises effectively isolating them from competition originating from distributors, or third parties, operating outside the relevant sales territory (Muchlinski 1995:387-393; Cf. Parry in Hawkins 1979: 79-83; Cf. Chen 1983:20-1).

2.5.5 (b) Regulating technology transfer

As foreign direct investment by the multinational enterprise normally takes place as a package of collective inputs (such as technology, management, capital etc.), the degree of indivisibility of this investment package has the effect of creating monopoly power for the investing multinational enterprise, especially with respect to technology transfer (Muchlinski 1995:427-431; Cf. Parry in Hawkins 1979:68-71). That is, the collective nature of the investment package may limit or exclude potential competition in markets for individual inputs. Thus, the market for technology will be monopolized by the multinational enterprise to the extent to which that technology is supported by the other inputs making up the collective investment package (Muchlinski 1995:427-431; Cf. Parry in Hawkins 1979:68-71). Technological advantage also creates monopoly power when it is used to limit competition by restrictive conditions on the recipients of the technology (Parry in Hawkins (ed.) 1979:68-71; Cf. Chen 1983:69).

Antitrust laws can also be used to control the multinational enterprise monopoly element inherent in technological advantage and technology transfer. However, in addition to antitrust law many Less Developed Countries (LDCs) have developed a highly specialized and separate body of law referred to as technology transfer law that, unlike antitrust law, takes account of policy factors that go beyond regulation through competition policy. In fact, the essence of

technology transfer law is to ensure that transferred technology is appropriate to and benefits the host country usually with respect to development; development being defined here as in section 2.5.1 above (Muchlinski 1995:442.; Cf. Parry in Hawkins (ed.) 1979:70; Cf. Weinstein in Modelski ed. 1979:345-6).

The use of technology transfer laws has met with significant resistance in the negotiations in the Uragay Round of the General Agreement of Tariffs and Trade (GATT) (Muchlinski 1995:254-7). This controversy stems from the fact that technology transfer laws may be interpreted as posing a challenge to laws on the intellectual property rights of technology transferors in a number of ways. Firstly, by regulating the terms of transfer, host states do not allow the technology transferor to earn monopoly rents on their technological innovations. Secondly, technology transfer laws may infringe upon the foreign patents and trademarks owned by the transferor through the imposition of performance requirements instituted by the host state. And thirdly, in principle, technology transfer laws generally do not afford foreign investors the same treatment and protection afforded indigenous firms in respect to intellectual property rights (Muchlinski 1995:443-4).

In determining how to proceed with policies that address monopoly creation through technology transfer, host governments are often faced with the dilemma of balancing the interests of the multinational enterprise investor, whose Research and Development commitments are grounded in the expectation of monopoly rents from the transfer or exploitation of it's technological innovations, with the host governments interests in ensuring technology diffusion into the industry and economy while also protecting technology transferees and other market participants from unfair competitive practices. Thus, policy makers who choose to deny multinational enterprises full monopoly rights over their technological innovations run the risk of creating

a disincentive for technology-based foreign investment into their countries (Muchlinski 1995:442; Parry in Hawkins ed. 1979:68-71).

2.5.6 Balance of payments effects of foreign direct investment

A country's '*balance of payments'* refers to the net balance of financial transactions (both private and public) that a given country has with the rest of the world. In other words, the balance of payments is calculated as the difference (or net balance) between financial inflows from foreign sources into a country versus domestic financial outflows accruing to foreign countries. This measure does not take into account financial flows that occur between citizens within the same country (Klein 1986:504; Cf. Robock & Simmonds 1989:319-21).

The payments and receipts that make up the balance of payments account are usually not in balance as individual investors and borrowers enter into international transactions to advance their respective self-interests without regard to the choices of other individuals or the net balance of any country's balance of payments account (Klein 1986:504).

The balance of payments account is considered to be in deficit when expenditures made by domestic residents' abroad are greater than receipts from other countries. A persistent balance of payments deficit normally leads to a decline in the value of a country's currency relative to other countries. Such a currency decline is normally corrected through the use of monetary policy instruments (Klein 1986: 504, 250-76; Cf. Dunning 1993:385).

In considering the balance of payments effects of foreign direct investment, Hufbauer and Adler (1968 cited in Dunning 1993:392-5) approached the analysis by assuming three possible outcomes or counterfactuals. These they

called the classical, the anti-classical and the reverse classical substitution models.

The classical substitution model postulates that domestically held financial capital that is invested abroad results in a net addition to capital formation in the foreign host country receiving the investment and is thus an improvement to that country's balance of payments, while on the other hand, that same investment represents a net capital outflow and a decrease to the balance of payments of the home country. In other words, under the classical substitution model, foreign direct investment is an improvement to the balance of payments of the host country at the expense of the home country.

Alternatively, the reverse classical assumption proposes that foreign direct investment has no effect on the balance of payments of either the host (recipient) or home (originating) country of the investment. Under this hypothesis, foreign direct investment merely displaces domestic investment that would otherwise have taken place in the host country while at the same time causing no change in capital formation in the home country.

Lastly, the anti-classical model assumes that foreign direct investment improves the balance of payments of the host country by increasing plant capacity there whilst leaving the balance of payments and plant capacity unchanged in the home country. The anti-classical approach differs fundamentally from the above mentioned models in that no substitution is assumed to take place at home or abroad. That is, under this approach, foreign direct investment is a net addition to global capital formation, whereas with the classical substitution and the reverse classical models foreign direct investment is assumed to merely shift investment resources between home and host countries without changing the global volume of investment.

Determining which of the three models to use for analyzing the balance of payments effects of foreign direct investment is further dependent upon the assumptions made regarding the macro-economic policy objectives of both the home and host country as well as assumptions pertaining to strategic options and behaviors of investing firms.

Lall and Streeten (1977) produced some empirical work on the balance of payments effects occurring within a host country as a result of foreign direct investment. Data was collected from 159 multinational enterprises with investments in six developing countries (Columbia, India, Iran, Jamaica, Kenya and Malaysia) between 1970 and 1973. The direct and total balance of payments effects for each firm were examined, with the direct effects being defined as those effects that have an immediate impact on the foreign exchanges (Lall and Streeten 1977:130).

In addition to examining the balance of payments effects of particular case studies of foreign direct investment, Lall and Streeten augmented their analysis of the net effects of FDI by comparing these effects with three possible counterfactual scenarios associated with the case in which the foreign direct investment under study does not take place. These they called the 'import substitution' scenario, the 'financial replacement scenario', and the 'most likely local replacement' scenario (Lall and Streeten 1976 cited in Dunning 1993:399).

According to the import substitution scenario, the assumption is that imported goods would substitute for foreign direct investment in the host country. Using this assumption, the balance of payments effect is calculated as the difference between the foreign exchange generated by the foreign direct investment and the foreign exchange that would have been spent on the imported goods assuming the absence of the foreign direct investment. The second approach – the 'financial replacement' scenario – assumes that locally-owned firms would

have made similar investments to those of the multinational enterprise under study. In this case, the net balance of payments effect is adjusted to reflect the difference between the costs of capital faced by the domestic firms and the foreign firm. The third scenario, the 'most likely local replacement' scenario attempts to calculate and make an allowance for that portion of inward foreign direct investment that is not readily substituted or replaced by domestic investment.

Lall and Streeten (1977) devised a composite index based on technological and entrepreneurial capabilities of host countries to assist in determining the most appropriate of these scenarios to use for given investments. Using this approach, Lall and Streeten (1977:Chapters 7 and 8) found that the direct balance of payments effects of sample firms was negative in all of the surveyed countries except Kenya. In the case of Kenya, inward investment was found to be beneficial to the direct balance of payments no matter which of the three scenarios was assumed. However, Kenya was not considered to be a typical host developing country, since an above average number of foreign firms there were export oriented (Lall and Streeten 1977:132).

In Latin America, Vernon (1973 cited in Dunning 1993) found that, inward foreign direct investment has a positive effect on the balance of payments account for a given sample of firms, unless it is assumed that the goods and services arising from the investment would have otherwise been imported. Biersteker (1978 cited in Dunning 1993) obtained similar results for a sample of foreign firms in Nigeria.

2.6 Conclusion

In order to understand the policy implications faced by governments with regard to inward foreign direct investment, it is essential to review the theoretical,

empirical and even anecdotal evidence on the expected long-run effects of this type of investment that may occur within the host country. In this regard, macro-economic variables (employment, the balance of payments account, and the structure of the market) that are hypothesized to be affected by foreign direct investment have been analyzed.

Chen (1983) proposed that foreign direct investment affects employment through either of two channels - the choice of technology used and/or export propensity. The nature of this relationship is that technologically advanced foreign firms have little or no positive effects on employment, whilst the propensity of foreign firms to export is significantly positively correlated with employment. These findings, however, are somewhat inadequate as they simply allude to the total number of jobs created rather than bringing into the analysis more subtle but important criteria such as the quality of jobs, whether there has been a trend to more or less skilled employment, the level of expatriate employment, training, and the indirect employment effects brought about through sub-contracting.

As to the balance of payments, a host state's balance may be improved by the inflow of new capital represented by a direct investment. However, this initial effect is countered by the long-term outflow of capital through repayment of loans and through dividend remittances. A balance of payments deficit would be recorded in circumstances in which these financial outflows exceed the initial investment.

With regard to the competitive effects of foreign direct investment on the host economy, it is often asserted that multinational enterprises will spur domestic firms into greater efficiency by exposing them to new competition. However, in the absence of significant spill-over effects that make new techniques available to local firms, and in the absence of adequate investment capital for local firms

to develop, the net result may be that the foreign firm will drive the local competition out. Given the highly concentrated nature of many of the markets in which multinational enterprises operate, significant anti-competitive effects may result.

Complicating the evaluation of the effects of foreign direct investment on the host country, is the necessity for quite subjective assumptions to be made as to most likely state of affairs given the absence of foreign direct investment. That is, effects can only be meaningfully measured by comparing a state of being with some explicit alternative. Thus, to measure the effects of the foreign direct investment one has to assume what would have happened in the host country if this investment had not been made. Past efforts to measure the effects of foreign direct investment have demonstrated that the results are quite sensitive to the assumptions made.

In addition to examining specific economic effects of inward foreign direct investment, it is also crucial for the policy process that an understanding be cultivated of the factors that motivate a national firm to choose to become multi-national in scope. To this end, the theoretical literature reviewed in this chapter also deals with explaining the existence and proliferation of foreign direct investment. Theories of the multinational enterprise and foreign direct investment gained momentum in the 1960's with the comprehensive works of Hymer (1960, 1968, 1976), Coase (1937, 1960), Knickerbocker (1973) and others whose concerns centered around market imperfections and the possible disruptive forces of foreign multinational firms in developing countries.

One of the major justifications put forward for the essentiality of multinational enterprise policy is related to the issue of their tendency towards restricting competition in the industries and markets in which they operate. To this end, a number of conclusions can be drawn from what has been theoretically and

empirically demonstrated in the literature. Caves (1988), for example, argues that multinational enterprises are prevalent in industries with high levels of concentration simply because the factors that give rise to entry barriers and thus high concentration are the same factors that give rise to the multinational enterprise form of business. Knickerbocker (1973) reached a similar conclusion through empirical testing, showing that a correlation exists between multinational enterprises and market concentration.

Of all of the studies surveyed, none was able to establish directional causation between the foreign direct investment of multinational enterprises and market concentration. Thus, based on the inconclusive nature of the evidence it is doubtful that this issue by itself is enough to establish grounds for the justification of a separate regulatory regime for multinational enterprises. A more realistic and limited approach to giving the issue some consideration in the formulation of foreign direct investment policy specific to multinational enterprises is to explicitly take account of the fact that multinational enterprise investments should take place in a legal environment that is characterized by a well developed competition and anti-trust policy regime. It may be difficult to discriminate against foreign businesses on this or any other basis; however, an awareness of the potential for abuses of a dominant position can at minimum be addressed through improved monitoring in the foreign direct investment policy framework.

Chapter 3

Historical Perspective of South Africa's Investment Climate

3.1 Introduction

The context and relevance of the current chapter to the rest of the dissertation is to a great extent proxied by the following statement taken from Maylam (1986): "…*an underlying assumption of this history is that there exists a constant interplay between the past and present. People's views about the present state of affairs in South Africa must inevitably contain in-built assumptions about South African history. Similarly, present preoccupations and concerns determine to a considerable extent the way in which the past is approached and studied*."

In more specific and narrower terms, it can be shown or at least argued that the general pattern and course of historical events, transitions and adaptation offers an instructive synopsis of why things are as they exist today. In this regard, the current chapter firstly sets out to view the investment environment and it's attendant policy from the beginnings (pre-industrialization and industrialization) of *'industrialization'* in South Africa in order to set the necessary context/framework within which the country's current policies on foreign direct invest can be assessed and critiqued.

Within this same analytical framework, the chapter further endeavors to formally explore the relatively intuitive yet complex assumption that business entities operate in an environment that is wholly dependent on the *social, political, legal* and *economic* vicissitudes of the day. In fact, and especially in the case of foreign owned companies these four environmental forces can be expected to have a significantly greater impact on business performance than is the case with domestic firms. Ultimately, at the extreme, business performance is no longer the issue. The issue advances from one of performing well to one of being able to remain an on-going concern as foreign businesses may be constrained to the point of not being allowed to continue operations in host countries. This point is supported by what has been evidenced globally in a number of cases where multinational enterprises were subjected to corporate nationalization and also in those cases where multinational enterprises, as one of the principal instruments of political and economic embargos, were forced to suspend or terminate their subsidiary operations in host states. The latter of these two cases is indeed the precedent in the South African historical context.

Lastly, given that current circumstances are to some extent influenced and shaped by past events and circumstances, a central and underlying point considered throughout the discussion of this chapter is the point that - perhaps as a result of historical labor relations, socioeconomic turmoil, and the economic disturbances brought about by international sanctions and embargoes during the latter part of the apartheid era, South Africa's existing foreign investment policies may reflect a certain openness to foreign investment that compensates or perhaps even over-compensates for those prior hardships.

3.2 Agricultural, Mining and Manufacturing Investment and Development

As in the case with most of the world's other societies or societal divisions, the cycles and patterns of investment (both foreign and domestic) and development in South Africa moved from agrarian to industrial to information technology. However, the distinctive characteristic of South Africa's history that influenced every aspect of societal life including the stages of investment and development is the system of racial discrimination that came to be known as apartheid. The South African Government used apartheid not only to further the political and social interests of white Afrikaner citizens, it also used apartheid as a springboard for industrialization and development to serve the ends of white economic empowerment (Lowenberg and Kaempfer 2001:33; Cf. Fine and Rustomjee 1996:63; Cf. Maylam 1986:143-152; Cf. Clark 1994:134-7). In the latter instance, white farmers and mine owners solicited and received the assistance of the government in disenfranchising blacks as a way of creating a low wage labor force that would increase the profitability of both industries. The basic strategy employed by the government to disenfranchise blacks was to first alienate them from their land by implementing the 1913 Land Act which ended the system of squatting and sharecropping by Africans on white farms, and the 1936 Native Trust and Land Act which reserved 86% of the total land area of the country for whites only. The combined effect of these two pieces of legislation is that Africans were confined to residing on 14% of the land, most of which was unsuitable for farming and grazing. This effectively destroyed the formally viable and flourishing black peasant farming sector. Thereafter, 'hut taxes' and 'labor taxes' on blacks in the 'homelands' were imposed which heavily taxed blacks earning a living in black areas ('homelands') with the intent of compelling them to work for cash wages in 'white' areas while residing in

black areas (Nattrass cited in Lowenberg and Kaempfer 2001:33-35; Cf. Lipton and Simkins 1993:359-60).

From whence the Afrikaners gained political power, South African governments have used all means at their disposal to further the lot of the Afrikaner population in general and more specifically to solve the "poor whites problem" (Omer-Cooper 1987:171-2; Cf. Clark 1994:48,163). An in-exhaustive list of the tools used to achieve these goals includes 'import substitution industrialization' (ISI), the creation of state owned enterprises, and last but not least - apartheid. Thus, since the earlier stages of development and industrialization, the Government extensively intervened in private markets on the side of white farmers/landowners and mining magnates against black labor (Clark 1994:48,163; Cf. Lipton and Simkins (eds.) 1993:359-60; Cf. Lowenberg and Kaempfer 2001:32-5). There was also a conscious effort on the part of Government to reduce or even eliminate 'dependence' on foreign trade which had intermittently been interrupted by politically motivated trade embargoes since as early as the 1940s (Lowenberg and Kaempfer 2001:6). The pattern of exploitation of the African masses by the government in the name of development and advancement was to continue up until the complete dismantling of apartheid corresponding with the promulgation of the 1993 interim constitution.

In the light of the foregoing discussion, it can be reasonably ascertained that it is virtually impossible to avoid the use of racial and ethnic categories and divisions in chronicling any significant aspect of southern African history since the use of such categories were inherently present in and have been key determinants of the region's past (Maylam 1986:136).

Standard Industrial Classification (SIC) is a universal categorization that lists primary industries to include – agriculture (SIC division A), mining (SIC division B), and manufacturing (SIC division D) and secondary industries to consist of - banking, real estate, and other services sectors. For the sake of keeping the study within a reasonable scope and breadth of exploration, only the most strategic and important (in terms of contribution to GDP) economic sectors will be addressed in this chapter. Thus, in the sections to follow the historical development of the agricultural, mining, and manufacturing sectors will be explored in seriatim.

3.2.1 Agricultural investment and development

The primary directive of any Government policy is to reflect the values and norms of society. Any change in these values and norms necessitates a continued process of policy evaluation. As part of the policy evaluation process, existing as well as prior legislation, programs and policies must be reviewed with the expectation of contributing to the contextual background that informs the policy making process (White Paper on Agriculture 1995:16). This is the approach followed here in reviewing investment and development in the agricultural, mining and manufacturing sectors.

3.2.1.1 Indigenous Agriculture

Historically, agricultural production (of a very limited nature) can be traced back to the first identifiable tribal inhabitants of South Africa. There is strong evidence suggesting that the Khoi-Khoi (named Hottentots by the Dutch) and the San (called Bushmen by the Dutch) are the most ancient of inhabitants of southern Africa whose cultural implements and way of life can be traced back to

the Late Stone Ages. In addition to being hunter-gatherers, the Khoi-Khoi engaged in livestock farming of cattle and sheep for milk, meat and clothing (Omer-Cooper 1987:3-5).

There is also ample archaeological evidence showing that the Iron Age in South Africa began around the fourth and fifth centuries A.D. The Iron Age tribes of southern Africa, who came to be referred to as Bantu and Nguni by European settlers, are believed to have had their origins in central and east Africa. It is these early African inhabitants who were the first South Africans to engage in crop harvesting. In addition to growing crops the Bantu and Nguni were also self-sufficient in smelting iron and other metals mainly for the production of agricultural tools (Omer-Cooper 1987:8).

3.2.1.2 European Settlement and Agriculture

Prior to the discovery and large scale exploitation of minerals in Southern Africa, the basis of economy and exchange was principally driven by agriculture. The early exploitation of the South African landscape by foreign interests was initially based on it's strategic location for European trade routes. Thus, in 1652 the Dutch shipping party of van Riebeeck landed at what is now known as Cape Town to develop a halfway station for shipping expeditions and trade between Europe, India and the East Indies (Butts and Thomas 1986: 56-7). The trade related business interests of the Dutch precipitated their eventual conquest and settlement of the region.

It was under the mandate of the Dutch East India Company that the Cape Colony was established. As a halfway station for trade the exploitation of the land by this time was of a very limited nature. The surface area of the colony

was confined to the small peninsula on which Table Mountain stands. According to the needs of the Company's traders, a small fort was built along with a garden of adequate size to feed and refresh the Company's travelling crews. Meat supplies were gained through barter with the Khoi Khoi peoples of the surrounding areas (Omer-Cooper 1987:17-18).

As the needs of the Dutch East India Company continued to grow, an incessant expansion into the southern African landscape began to take shape. Based on the suggestion of Van Riebeeck, a decision was taken by Company officials to establish small farms to be owned and operated by some of their employees as a way of meeting the increasing demand of the halfway station for food, refreshment and meat. This decision turned out to be the pivotal point upon which the Dutch perception of southern Africa changed from that of a convenient and efficient halfway station for trade to being viewed as an ideal location for settlement (Omer-Cooper 1987:17-18).

By 1679 the Company had expanded its territorial hold well beyond the Cape peninsula to include amongst its land possessions, Hottentots Holland, False Bay, Saldanha Bay and the Tygerberg area. It was also around this time that the Dutch population began to be integrated with latecomer settlers from other parts of Europe, namely Germans and French and Belgian Huguenots. The French and Belgian Huguenots initially sought refuge from religious persecution in Holland before being commissioned off by the Dutch government in Holland to settle in the Cape. These Huguenots possessed superior wine making skills of which they applied towards incubating the highly lucrative Cape wine industry (Omer-Cooper 1987:19-20). The new French, Belgian and German immigrants were encouraged, and in some cases coerced, to adopt the language and culture of the South African Dutch community. This amalgam of European

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immigrants formed a strong cultural and nationalist bond discernibly referring to themselves as Afrikaners or Boers (the Dutch word for – farmer) (Omer-Cooper 1987:21; Cf. Butts & Thomas 1986:57).

3.2.1.3 Modern Agricultural Policy

3.2.1.3 (i) Apartheid-era Agricultural policy and development

As a prerequisite to discussing the South African government's agricultural policies during the apartheid era, it is important to first ensure clarity and develop a common understanding and consistent usage of the terms 'apartheid' and 'apartheid era'.

With regard to the term 'apartheid', a concise definition that will be used throughout this text, is that proposed by Khan (1989:5-6). Khan (1989) defines apartheid as the uniquely South African system of "…legal, institutionalized segregation by race in order to organize society by a racial-ethnic hierarchy at every level". In other words, segregation policies determined under apartheid were the law and any actions taken by any person or institution to contravene those policies were considered illegal. Further, apartheid was implemented to effect segregation in every aspect of the social, political and economic lives of the people.

With regard to defining the term 'apartheid era', the origins of and period of operation of the apartheid system are specified as a continuum that covers almost a hundred years from the promulgations of the original Constitution of the Union of South Africa in 1910 to the first democratic (interim) Constitution of the Republic of South Africa in 1993. Correspondingly, Lowenberg and

Kaempfer (2001:32) define 'apartheid" as a "vector of policies that can be varied in intensity along a continuum…and [that is also] responsive to the relative influences of interest groups that receive benefits or incurs costs associated [with it]…". It is commonly accepted among scholars of South African history and economics that the apartheid system originated as a response on the part of the white working class to the threat of black labor-market competition and has also been used as a tool of white employers to secure land and draw cheap agricultural and mine labor from the rural African sector (Lowenberg and Kaempfer 2001:33).

Government's policy of regulating the agricultural sector along racial and class lines, left in it's wake a negative legacy that has survived and persisted into the present. This apartheid era legacy that has unavoidably been inherited by the present democratic government is what has commonly been referred to as the 'two agricultures' (Lipton and Simpkins (eds.) 1993:360). The 'two agricultures' is epitomized by the reality of two separate agricultural sectors, one for whites and one for blacks. The white agricultural sector has been (and continues to be) heavily subsidized by the government resulting in a highly competitive large-scale capital intensive industry that produced the bulk of domestic as well as export food supplies. The black agricultural sector, on the other hand, received no assistance from the government and remained small-scale, labor intensive and produced mainly for subsistence rather than for markets (domestic or foreign) (Lipton and Simpkins ed. 1993:360). Rather, the government during the apartheid era actually took measures to handicap the black agricultural sector in order to further benefit the white agricultural sector. This approach of the government is exemplified by the 1913 and 1936 Land Acts which restricted black ownership and residence in South Africa to 14 percent of the total surface area of the country. Another significant piece of

legislation that impeded black agricultural development was the 1970 Subdivision of Land Act, which disallowed black smallholder farming in 'white' areas. Throughout this era black farmers were also excluded from access to financial, marketing and other facilities of the numerous agricultural boards that serviced and assisted white farmers only (Lipton and Simkins (ed.) 1993:360).

The paradox of the 'two agricultures' is an area of agricultural policy that is only now being addressed (South Africa - White Paper on Agriculture 1995; Cf. South Africa Yearbook 1999:75). At present the discrepancies in land ownership and production are such that approximately 67,000 white farms produce 95 percent of marketed production on 85 million hectares (ha); while an estimated one million black farmers produce 5 percent of marketed production on 16 million ha (South Africa Yearbook 1999:75).

As the costs of direct support (cheap loans, subsidies and tax breaks) and indirect support (protection from imports, provision of research and extension, favorable terms of trade with the urban sector) to the white agricultural sector had risen exponentially since Union in 1910, it became increasingly clear to government that a reassessment of the costs and benefits of the agricultural system was needed (Lowenberg and Kaempfer 2001:194-96). The costs of subsidizing the white agricultural sector appears to have outweighed the benefits thereof, as is evidenced by the fact that agriculture's contribution to Gross Domestic Product (GDP) has been estimated to have declined from almost 20 percent in 1951 to 6 percent in 1990 (Lipton and Simkins (ed.) 1993:361).

3.2.1.3 (ii) Post-Apartheid agricultural policy and development

The four major challenges that face the South African agricultural sector in this the post-apartheid era are firstly, the social and economic imbalances brought about by the existence of the 'two agricultures' as an inherited challenge to democracy and development of the industry (Supra Sect. 3.2.1.3 (i)); secondly, the poor agricultural resource endowment of the country evidenced by the fact that only 17 million out of 100 million ha of farmland are presently classified as arable, and only 4 million of these are classified as 'high potential arable land'. The remaining 80 million ha of farmland suffers from poor soil content, low and erratic rainfall, and soil erosion and degradation.

Thirdly, amongst the most important factors limiting agricultural production is the availability of water (South Africa 1999:76). The country's average annual rainfall is only 502mm which is well below the world average of 857mm. Further, over the last decade or so, severe droughts, floods, hail storms and frosts have contributed to reduced agricultural production; and fourthly, the industry has also been plagued by inefficiencies and a tendency towards oversupply in maize, wheat, livestock, dairy, sugar and wine production as a direct result of stringent regulation and subsidization. The result of these artificial market supports of the white farming sector has been the frequent tendency towards the dislocation of supply and demand in its trading market.

Oversupply of the market is also partly attributable to unpredictable weather conditions that necessitates that farmers should plan their production with the expectation of natural losses due to bad weather, pests, plagues, and other pathologies. The implications to farmers of oversupply include increased transportation and storage costs, unfavorable volume-to-price ratios and

wastage due to the perishable nature of produce. (Lipton and Simkins 1993:359; Cf. Loxton 1993:216-220; Cf. South Africa Yearbook 1999:76,83).

Despite the above-mentioned challenges to the agricultural sector, South Africa remains self-sufficient in virtually all major agricultural products and is normally a net-exporter of food stocks. Also, despite the industry's steadily declining share of GDP(4.1 percent in 1998/99 as compared to 20 percent in the 1930s) it remains of vital importance to the economy as a provider of essential domestic consumer food requirements whilst also employing approximately one million people in its various sectors (South Africa 1999:75-6).

3.2.1.3 (ii) (a) Marketing

The Marketing of Agricultural Products Act, 1996 (Act 47 of 1996) is the main impetus of the current efforts to reform the industry. The 1996 Act, under the supervision of the National Agricultural Marketing Council, scheduled the termination of all agricultural sector boards and schemes established in terms of the 1986 Marketing Act. By the 5th of January 1998, all agricultural control boards ceased to exist. In terms of the Act, certain limited statutory measures may be introduced in support of the industry, such as statutory levies to finance the research and information functions within a given sector (South Africa 1999:84). As of the closure of the agricultural boards, the key objectives of the NAMC are to integrate disadvantaged and small-scale participants into the mainstream of agriculture and to monitor the efficiency of the market, intervening only to correct market imperfections and socially unacceptable effects (South Africa 1999:84; White Paper on Agriculture 1995:9).

3.2.1.3 (ii) (b) - credit and assistance

In line with it's new policy directive, the national Department of Agriculture resolved to remove itself from direct involvement in agricultural credit delivery by abolishing the Agricultural Credit Board (ACB) and the State Assisted Production Loan Scheme through Financial Intermediaries. The agricultural industry must now seek assistance from the Land Bank and/or private financing from banks, creditors, financial institutions and agricultural co-operatives (South Africa Yearbook 1999:85).

3.2.2 Mining Investment and Development

3.2.2 (i) The importance of mining – Strategic Minerals

Although the bulk of South Africa's minerals are not used domestically but are instead exported, it is by way of these exports that minerals affirm their importance to South Africa both economically and politically. This has been observed in at least two ways.

Firstly, mining exports have consistently been the major source of foreign exchange earnings and the largest contributor to GDP, and secondly, many of the minerals that South Africa produces for export are 'strategic minerals' for which the majority of importing country's have no alternative supplier, insufficient local supplies and for which no mineral substitutes exist (Butts and Thomas 1986:35; South Africa Yearbook 1999:101-6).

Strategic minerals are generally defined as "those minerals determined to be essential to critical civilian and military needs in quantities not available from

domestic sources or secure foreign sources and for which no short term substitutes are available." The extent to which this definition holds is a direct factor of time. That is, minerals considered strategic at some point in time would cease to be considered as such with the passage of time. The passage of time may result in technological breakthroughs that provide acceptable substitutes for a strategic mineral(s). Alternatively, the time factor may also lead to new discoveries of strategic minerals in the importing countries or elsewhere on the globe. Such new discoveries would then compete with exported strategic minerals from South Africa (one of the few producers of minerals classified as strategic) (Butts and Thomas 1986:37-42).

Due to their absolute importance in strategic sectors of industrialized and developing countries, the following minerals have been classified by the United States and its allies as 'strategic minerals' – chromium, manganese, cobalt and the platinum group metals (PGM). Oil during the early 1970s was also considered a strategic mineral as its production and export was controlled by OPEC, and industrialized as well as developing countries had highly limited alternative sources of oil. Thus, the result of the 1973 OPEC oil embargo was to throw oil dependent countries of the world into a prolonged recession.

The European Union, United States and Japan are virtually 100 percent dependent on strategic mineral exports from southern Africa and the former Eastern Block nations. Southern Africa and the former Soviet Union, in combination, control 99 percent of the world's chromium reserves, 98 percent of PGM reserves, 89 percent of manganese reserves and over 60 percent of cobalt reserves (Butts and Thomas 1986:37-42).

The above-mentioned minerals are categorized as strategic in respect of the uses to which they are applied. Perhaps the most conventional as well as important application for Chromium is it's conversion to an alloy in the metallurgical industry. The addition of chrome to steel imparts hardness, strength, oxidation, heat resistance and resistance to corrosion. The resulting alloys are used in superalloys for the aerospace industry, containment vessels for nuclear power plants, petroleum processing facilities, and in the defense industries. In the defense industries, one of the more critical uses of chromium is in the production of key components of jet turbines for military fighter jets. Chromium is also extensively used in the production of stainless steel, which by definition contains between 10 and 18 percent chromium. The United States is an important importer of Chromium. In 1984, U.S. consumption of chromium was approximately 466,000 tons, eighteen percent of which was provided by recycled scrap; the balance was imported. South Africa was the leading chromium supplier to the United States and provided 55 percent of Chromium demand in 1984, followed by Zimbabwe with 8 percent and the former Soviet Union with 7 percent (Butts and Thomas 1986:37-42).

Manganese is an essential element in the production of steel as it serves as a purifying agent which removes the impurities of oxygen and sulfur. There is no known substitute for manganese in this function. The steel industry in the U.S. produced 93 million tons of steel in 1984, worth over $2.6 billion and imported 740,000 tons of manganese. It should be duly noted that the loss of access to manganese imports would make U.S. steel production impossible, given that 99 percent of it is imported. The major sources of manganese ore were South Africa with 31 percent, Gabon with 29 percent, Australia with 17 percent, and Brazil with 12 percent (Butts and Thomas 1986:37-42).

Cobalt is an essential alloying agent in the electrical and aerospace industries. The superalloys which require cobalt cannot be made with substitutes and constitute its most critical use. Each F-100 engine used on F-15 and F-16 U.S. fighter jets requires 910 pounds of cobalt for its ability to withstand stress of up to 20,000 psi and temperatures of 1,800 F. In 1984, the U.S. imported 95 percent of its cobalt. The leading import sources were Zaire with 37 percent, Zambia with 12 percent and Canada with 10 percent. Substitution for cobalt in superalloys cannot be accomplished without a loss of effectiveness and ceramic substitutes will not be available fro some time (Butts and Thomas 1986:37-42).

The platinum group metals of platinum, palladium, iridium, osmium, rhodium and ruthenium are used in a wide variety of domestic applications. The most strategically important of which are in the petroleum refining, petrochemicals and telecommunications industries. In 1984, 91 percent of the PGM consumed in the United States was imported. The leading supplier of PGM to the United States in 1984 was South Africa with 49 percent, followed by the United Kingdom with 15 percent and the Soviet Union with 13 percent (Butts and Thomas 1986:37-42).

3.2.2 (ii) The Importance of Mining – Beneficiation

Beneficiation is generally defined as the upgrading of a primary ore to a stage where the component or component products can be used in a manufacturing process (South Africa's Minerals Industry 1987 – DME 1987:3). In other words, beneficiation refers to the conversion of a raw material (mineral ore) into a finished good or a partially finished good (work in-process good).

The importance of beneficiation relates to the fact that unprocessed goods are normally priced at a fraction of the same goods in beneficiated form. Thus it can be surmised that the export of unbeneficiated minerals represents a substantial loss of value added production and thus employment opportunities, foreign exchange earnings and also losses with respect to international terms of trade (Loxton 1993:247).

Extensive exporting of unbeneficiated primary minerals has essentially become a relic of the colonial era as it is seldom done presently (Rogerson in Taylor and Thrift (eds.) 1982:182-3; Fine and Rustomjee 1996:78). The current trend in many developing countries and South Africa, is to process minerals at least partially, mainly through smelting to produce a concentrate of higher value which is then either refined or, more often, shipped to refineries in more developed economies (Fine and Rustomjee 1996:78; Cf. Loxton 1993:247).

For South Africa in 1987, most of the manganese, phosphate and iron ore entered production processes and/or export markets in un-beneficiated form, while most of the mined metallurgical chrome, copper and nickel were in contrast beneficiated. During 1987, 96 percent of zinc metal production was consumed locally and none exported (South Africa's Minerals Industry 1987 – DME 1987:3).

3.2.2.1 Indigenous Mining

Southern Africa has a long and protracted history of mining exploration and exploitation. This history pre-dates, by several centuries, the landing of the Van Reibeeck party on the Cape Coast in 1652. In fact, evidence has been unearthed (and radio carbon tested) that suggests that tin, gold, copper and

iron were mined and processed in and around the northern and eastern Transvaal and portions of Zimbabwe as far back as the prehistoric Early and Late southern African Iron ages (circa 500 - 1400 AD). These Iron Age mining sites are dispersed across the former Transvaal state with the largest concentration of sites in the Soutpansberg, Waterberg, Rustenburg and Middelburg districts (Maylam 1986:12). Further evidence of Iron-age mining in southern Africa exists in the form of fragments of nickel-bearing bronze found near Rooiberg which were similar in composition to the bronze metals of Sumeria, thus suggesting that there were smelting sites in southern Africa that pre-dated the Christian era. These ancient mineral discoveries have often been used as a guidepost to contemporary mineral explorers to locate new mineral deposits (Butts and Thomas 1986:98-9).

Mineral exploration and exploitation undertaken in southern Africa prior to the landing of the Van Reibeeck party attests to the fact that this mining was done by indigenous Africans whose descendants are the so-called 'Bantu-speaking' Africans (Maylam 1986:13). Indigenous mining was carried out on a small-scale basis and with rudimentary tools and techniques, however, the large-scale mining discoveries and technological advances of the latter part of the 19th century changed the course and pace of development, politics and war in the southern African region up to the present (Butts and Thomas 1986:98-9).

Diamonds were discovered along the Orange River in 1867. This discovery attracted a significant population rush to the area in the form of mining professionals, semi-professionals and laborers. A virtual diamond mining industry developed to the extent that approximately $714 million in diamonds were recovered during the 60 year period following the 1867 discovery. The Orange River area for some time dominated South Africa's economic output

and was considered the backbone of the South African economy (Butts and Thomas 1986:99). The British attempted to seize the opportunity to capitalize on the wealth potential of diamond mining by colonizing the area. The Boers effectively withstood the challenge and the First Anglo-Boer War (1880-1881) ended with a British defeat. However, in 1886, the world's richest gold field was discovered in the Witwatersrand area of the Transvaal near what is now Johannesburg.

This discovery resulted in a flood of English labor and capital to the area, thus providing an economic incentive for a second British attempt at annexation. This time Britain was successful but the second Anglo-Boer War (1899-1902) left in its wake a deep-seated bitterness and resentment toward the British as a result of war casualties and concentration camp abuses (Butts and Thomas 1986:57).

3.2.2.2 Apartheid-era Mining Industry Development

The modest beginnings of the mining industry through the iron age and beyond experienced exponential growth after the discovery of diamonds in 1867 and gold on the Witwatersrand in 1886. Expansion was further accelerated by the opening up of the coalfields of the Transvaal and Natal, and the discovery of deposits of other minerals, such as those of chromium, platinum, manganese, uranium and many others, the development of which led to South Africa’s positioning as the leading country in the supply of many of the world’s mineral needs (South Africa’s Minerals Industry 1987 – DME 1987:1).

In the years immediately following the formation of the ‘Union of South Africa’ in 1910, government policy was to exploit to the fullest, the wealth potential of the

newly discovered mining deposits in and around Witwatersrand. The intention was to support the development and wealth creation of the mining sector in order that taxation of this wealth would contribute towards the development of other sectors of the economy (Omer-Cooper 1987:101,127). Among the actions taken towards this objective are the provision of:

- Rail links from Witwatersrand to the coast;
- Basic infrastrutural support to the Witwatersrand area; and
- Incentives and support for the development of an explosives/chemicals industry to supply the mines with dynamite for blasting.

Despite claims by successive governments since 1910 that the mining industry developed through the active pursuit of economic policies based on the principles of free market enterprise, encompassing the dependence on the forces of supply and demand with the absence of undue State intervention, there exists evidence to the contrary (South Africa's Minerals Industry 1987 DME 1987:1). Since Union, a plethora of legislation has been enacted to advance the mining industry and white labor, mostly at the expense of African labor. In the mining industry, where labor costs comprised a significant share of total production costs, there was pressure on the part of mine-owners to displace expensive white workers with lower-wage blacks. The Mines and Works Act of 1911, and the Labor Regulation Act of 1911 are examples of government legislation that effectively, though indirectly, kept total labor costs down (by restricting black wages) for the mines whilst reserving skilled and semiskilled jobs for whites (Lowenberg and Kaempfer 2001:35-7, Seidman and Seidman 1977:37-9; Omer-Cooper 1987:158-9).

A key role in the development of the mining industry was played by so called 'mining finance houses'. As surface diamond deposits depleted, more capital-intensive and high technology methods were required to exploit deeper level deposits. Diamond mining was thus transformed from an activity conducted by large numbers of independent diggers to an activity dominated and controlled by large scale capital intensive enterprises commonly known as mining finance houses. The first such enterprise was De Beers, headed by Cecil Rhodes, which proceeded to extensively buy out small claim holders to take advantage of the required economies of scale that it possessed. The Kimberly Central Company run by Barney Barnato, also began to buy up claims in direct competition with De Beers. Kimberly Central eventually merged with De Beers. The other major mining finance houses that invested in the mining industry include Anglo American Corporation, Anglo Transvaal (Anglovaal), Johannesburg Consolidated Investments (Johnnies), Gold fields of South Africa (GFSA, an associate of a British Company, Consolidated Gold Fields), and Union Corporation, Ltd. Of the six major mining finance houses established before 1920, three were founded by South African diamond magnates (Rand Mines – Beit; GFSA-Rhodes; Jonnies-Barnato); two were controlled by German banks; and one, Anglo American, was founded with South African, British and American capital (Seidman and Seidman 1977:39-40; Cf. Omer-Cooper 1987:121-2).

Mining industry development undertaken by the major mining finance houses was augmented to a considerable degree by government investment in mining industry sectors which were considered to be of great importance to the national interest but for which there existed insufficient investment interest in the private sector. It was during the apartheid era that the government provided financial assistance for the establishment of a national steel industry, ISCOR

ltd. Later, through the industrial Development Corporation ltd. (IDC) it financed the Phosphate Development Corporation ltd (FOSKOR) for the supply of phosphate, SASOL which converts coal to oil, and ALUSAF for aluminum production. SOEKOR (Pty) Ltd., formerly the Southern Oil Exploration Corporation Ltd, is engaged in the search for oil and gas, both on land and offshore, and is wholly financed by the Central Energy Fund (Lipton and Simpkins 1993:131-3; South Africa's Minerals Industry 1987 – DME 1987:3).

3.2.2.3 Modern Mining - Economy and Policy

Presently, South Africa's minerals industry is broad based in terms of the variety of mineral commodities mined and traded. Over time, it has not only evolved itself into being the cornerstone of the South African economy, it has also been instrumental in providing surplus capital used to develop the country's economic infrastructure while additionally serving as the outlet for and generator of several sectors of the country's secondary industries (South Africa - DMEA 1987:1; WP Mining and Minerals Policy 1998:3; Fine and Rustomjee 1996:122-3; Loxton 1993:248). Secondary industries spawned by mining include explosives, chemicals, and engineering and capital goods such as drill steels and earthmoving equipment (Fine and Rustomjee 1996:72).

3.2.2.3 (i) Role of mining in the national economy

By 1987 government statistics indicate that just over a thousand mines and quarries were in operation, producing 60 different minerals and exporting mineral commodities to 83 countries. Mining's contribution to Gross Domestic Product (GDP) has averaged about 15% in recent years, while mining's contribution to Gross Domestic Fixed investment (GDFI) was estimated to be

8.9% (or R7.8 billion) (South Africa's Minerals Industry 1987 – DME 1987:1-4; South Africa Yearbook 1999:97-8; Loxton 1993:247). Mineral exports account for almost 40 percent of South Africa's exports and this figure is significantly increased when various processed mineral products such as the ferro-alloys and steel are included. The major importers of South African minerals are North America, Europe and the Far East (South Africa's Minerals Industry 1987:1).

Total employment in the mining industry has been estimated to be on the order of 700,000 people by 1987. The largest sector within the mining industry is gold mining which employs more than 70 percent of the minerals industry's workforce and accounts for almost 35 percent of total World gold production. Other major contributors to the mining industry's share of Gross Domestic Product include platinum, diamond, uranium, iron, copper, manganese, chrome, phosphate and asbestos, as well as several base minerals (South African Minerals Industry 1987:1).

3.2.2.3 (ii) (a) Modern Mining Policy - Privatization

Although there have been several major shifts in government policy regarding the privatization of the above-mentioned industries, the current policy of the government is to privatize all state run enterprises (Fine and Rustomjee 1996:108;Lipton and Simpkins 1993:130-3). After more than 60 years of direct state intervention and investment in industrialization through state owned enterprises, official government policy articulated a need for change and privatization (Lipton and Simkins ed. 1993:129-133). The policy aims and objectives set out in the 1987 White Paper on Privatization and Deregulation in the Republic of South Africa and supported by then President Botha in his 1988

opening speech to parliament affirmed governments intent to privatize (Lipton and Simkins ed. 1993:129-133). ISCOR was the first major state enterprise to be privatized in 1989 and the process continues to this day although under the strain of a strong and vocal anti-privatization movement.

3.2.2.3(ii) (b) Modern Mining Policy - Mining Rights

Mineral rights constitute rights in the land. They are officially registered by the State, and are a form of property protected under the Constitution. Mineral rights are also tradeable (White Paper – Mining and Minerals Policy for South Africa 1998:11).

The government, under the leadership of the Minister of Minerals and Energy Affairs seeks to reform the current system of South African mineral rights that has developed over many years into a ‘dual system’ of prospecting and mining rights. Mining policy is termed 'dual system' in the sense that mineral rights may be vested in either private or public ownership (White Paper – Mining and Minerals Policy for South Africa:11).

This dual system of mineral rights has it’s origins in common law under which ownership of the land includes ownership of the minerals in the land. The law developed in such a way that the right to minerals in respect of land can be separated from the title to the land, for example upon original grant of the land or by subsequent transactions. The owner of land from which mineral rights have not been separated may separate the mineral rights from land ownership by ceding them to another person or by reserving them to himself or herself. The mineral rights are then held under separate title which may include all the

minerals in the land concerned or only a particular mineral or minerals (White Paper – Mining and Minerals Policy for South Africa:11).

South Africa and the United States of America are two of the few major mining countries that have a dual system of public and private ownership of mineral rights. In most other countries the right to minerals is vested in the State (White Paper - Mining and Minerals Policy for South Africa 1998:13-17). The South African government's intent, however, is to do away with the dual system in favor of State ownership of all mining and prospecting rights. This policy is motivated by the government's desire to enable citizens to gain access to rights in land on an equitable basis and is motivated firstly, by Constitutional provisions empowering government to execute reforms to redress the results of past racial discrimination, and secondly by article 2(1) of the UN Charter of Economic Rights and Duties of the State that grants to States full permanent sovereignty, including possession and disposal, over all its natural resources. In summary, Government's long term objective is for all mineral rights to vest in the State for the benefit of and on behalf of all the people of South Africa (White Paper - Mining and Minerals Policy for South Africa 1998:13-17).

Despite the above restructuring of mining and prospecting policy, the South African government intends to maintain the following key objectives thereof, namely to (White Paper – Mining and Minerals Policy for South Africa 1998:13-17):

(i) Promote exploration and investment leading to increased mining output and employment;
(ii) Ensure security of tenure in respect of prospecting and mining operations;

(iii) Prevent hoarding of mineral rights and sterilization of mineral resources;

(iv) Address past racial inequities by ensuring that those previously excluded form participating in the mining industry gain access to mineral resources or benefit from the exploitation thereof;

(v) Recognize the State as custodian of the nation's mineral resources for the benefit of all;

(vi) Take reasonable legislative and other measures, to foster conditions conducive to mining which will enable entrepreneurs to gain access to mineral resources on an equitable basis; and

(vii) Bring about changes in the current system of mineral rights ownership with as little disruption to the mining industry as possible.

The government's policy proposals have met with extensive stakeholder reservations. Among the contentions raised against a transfer of mineral rights to the State are that (White Paper – Mining and Minerals Policy for South Africa: 13-17):

a. The blanket transfer of mineral rights to the State could easily lead to administrative difficulties in a system not geared to the management of mineral rights, extensive delays and hence a loss of investor confidence that could seriously damage the South African mining industry;
b. Holding of mineral rights is a critical parameter in the valuation of a mining company by international investors. The company is valued according to its future potential which depends on an ongoing flow of new projects derived from such mineral holdings;

c. Private ownership of mineral rights based in the law of property is preferable to a pure licensing system of rights based in administrative law and involving administrative discretion. Private ownership affords the absolute long-term security of tenure that attracts investment in exploration, mining and marketing; and
d. A bias towards state ownership would run counter to the Government's philosophy and policy on competition and privatization.

Government policy with regard to the aforementioned is still in the preliminary stages and is currently expressed solely in the form of a discussion document. As there is a vast amount of stakeholder input into the legislative process, the final version of the new legislation is expected to be modified into a much more moderate version than expressed in the discussion document.

3.2.3 Manufacturing Investment and Development

The First and Second World Wars comprised the catalytic force(s) that launched the country into its second industrial revolution, transforming it from a mining economy to a predominantly manufacturing one (Omer-Cooper 1987:182-3). Metals and engineering were the major nodal growth points of war production to the extent that before the war, almost all mining and industrial machinery was imported while the South African engineering industry was mainly occupied in service and maintenance work. As a direct result of wars, it was no longer possible to import the industrial machinery required for local production of consumer and industrial goods. Yet, the South African metals and engineering industries responded to the challenge. By the end of the war South African manufacturing industry was not only capable of mass

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manufacture of a wide range of consumer goods but was also developing the capacity to manufacture the machines with which these goods could be produced. Though still needing technological imports, South African industry had passed the vital point of take-off into self-sustaining growth (Omer-Cooper 1987:182-3: Cf. Clark 1994:107).

After the Second World War, manufacturing development was further spurred by the fact that modern manufacturing technology required vast amounts of capital as well as large markets capable of absorbing its output. It was recognized by the government of the time that these dynamic requirements of manufacturing development could only be achieved through state intervention and support by the private sector. In this regard, the government thus engaged the following strategy (Seidman and Seidman 1977:56-58):

- Provided the capital and technological needs of some of the 'critical basic' industries in close cooperation with domestic and foreign firms;
- Intervened to provide favorable treatment to the import of capital goods and raw materials needed in manufacturing;
- Banned certain consumption goods regarded as non-essential (such as foodstuffs, clothing and luxury items) thereby providing a stimulus to the local production of them, as well as saving foreign exchange; and
- Direct government investment in manufacturing through the establishment of parastatals (public corporations).

The most controversial and perhaps the most effective of the above-mentioned industrialization strategies of the government was the direct investment in parastatals. By the 1970s, government's contribution to gross domestic fixed

investment (GDFI) amounted to almost half of all investment (public and private) in the entire economy (Seidman and Seidman 1977:59-67).

One of the major parastatals involved in the process of manufacturing industrialization is the IDC. Founded in 1940, the IDC played a supporting and lubricating role for infant industries that in turn made their contribution to industrialization. The mission of the IDC at its inception was to 'to facilitate, promote, guide and assist in the financing of new industries and industrial undertakings and schemes for the expansion, better organization and modernization of, and the more efficient carrying out of, operations in existing industries and industrial undertakings' (IDC 1971 – cited in Seidman and Seidman 1977:64; Cf. Fine and Rustomjee 1996:159). Largely through the financial and technical assistance of the IDC, by the early 1970s ISCOR (Iron and Steel Corporation) was producing almost 75 percent of all steel consumed in South Africa, while ESKOM (Electricity and Supply Commission) was supplying about four fifths of the country's electricity, and SASOL produced 12 percent of the country's oil needs (Seidman and Seidman 1977:59-67).

More than 60 years after the establishment of the first parastatals, the government had recorded a high level of success towards industrialization through the development of a well-tooled manufacturing sector (Loxton 1993259-260; Cf. Clark 1994:165). However, the era of the late 1980s ushered in new government thinking on the continued viability of the parastatals. The government planned to privatize all parastatals in the face of numerous economic, political and social challenges during the decade of the 1980s, these challenges included the following (Clark1994:165-169; Cf. Lowenberg and Kaempfer 2001:209-212):

- The gold price dropped from $613 an ounce in 1980 to $359 by 1984;
- Foreign loans amounting to $14billion had been withdrawn by international lenders;
- Sanctions had been implemented by the United States and the European Economic Community;
- The rand had depreciated to a low of 37 U.S. cents;
- Internal unrest prompted the government to enact a state of emergency for more than five years; and
- The evolving cost structure of the parastatals showed that they were using greater amounts of state resources and becoming less profitable.

Although it has been argued by some that the government's call for privatization was an attempt to transfer vast state resources into the exclusively white private sector before turning power over to a black government, it is more likely that the Botha administration succumbed to the abovementioned environmental pressures and sought to partially redress them by obtaining sufficient capital through the sale of state firms (Clark 1994:166).

The reduction of direct government involvement in the economy has been a gradual process that actually began in the 1960s. After 1960, the government established no new state enterprises and instead turned the focus of the IDC to supporting private initiative through such programs as the Export Finance Scheme (1960) to subsidized South African exports, the Border Areas Development Scheme (1960) to finance industries near the African "homelands," and efforts at "rationalization" that merged firms in the same industry under IDC-sponsored holding companies (Clark 1994:166).

3.2.3.1 Outward-Oriented Industrial Policy

Up until 1992, the two key institutions in formulating and implementing industrial policy were the Industrial Development Cooperation (IDC) and the Board of Trade and Industries (BTI) (Fine and Rustomjee 1994:14,179). While the role of the IDC was to move the country towards industrialization through the establishment and support of state-owned industries, the BTI was tasked with improving industrial performance through the administration of tariff policies (Fine and Rostomjee 1994:14, 179). However, tariff protection proved to be an ineffective form of industrial support as indicated by several commissioned reports that led to the emasculation of the BTI by the BTI Amendment Act of 1992 (Fine and Rostomjee 1994:14, 179).

While the Viljoen Commission Report of 1958 supported the use of import tariffs, the Reynders Commission report of 1972 emphasized the need to shift industrialization policy to be outward orientated, and thus the need to reduce import tariffs. Following some of the recommendations of the Reynders Commission, the IDC in 1990 reversed industrial policy in South Africa through a double-pronged strategy which consisted of first reducing import tariffs, the basis of BTI's discretionary power, and secondly, supporting export-oriented capital investment through tax incentives (Fine and Rustomjee 1994:200). As a result of the implementation of the IDC's revised industrial policies, the BTI lost its prominence as a key institution in industrial *policy formulation* and was restructured and renamed the Trade and Industry Advisory Board in 1992 which is now tasked with *advising* the Trade and Industry minister on tariffs and dumping duties (Fine and Rustomjee 1994:202).

3.2.3.2 Disinvestment, Trade Sanctions and the Economy

Apartheid, as previously defined (see 3.2.1.3(i) above), was simultaneously a social, political, legal and economic phenomenon that underscored every aspect of South African societal life. The economics of apartheid has traditionally been studied under either of two divergent and polemic approaches known as the liberal approach and the neo-Marxist approach.

The 'liberal' approach saw apartheid as inherently anti-capitalist in that it interfered with the free movement of supply and demand forces in the economy by protecting white workers from labor-market competition with blacks. In contrast, the neo-Marxist approach viewed apartheid as a uniquely South African form of capitalism, in which apartheid laws served to enhance the productive capacity of the economy by ensuring an elastic supply of black workers at low wage rates (Fine and Rustomjee 1996:21-2; Lowenberg and Kaempfer 2001:1).

Although the distance between these two positions is enormous both in methodology and in conclusion, the international consensus on the efficacy of apartheid encompassed not only it's economic viability, but also examined it's social, political and ethical ramifications in calling for the dismantling of the system.

International trade sanctions and disinvestment campaigns instituted against South Africa in the mid to late 80s were intended to serve as the means through which the apartheid system would be brought to an end. In this regard, apartheid was seen as a system that could not be changed other than through indirect means. Thus, international measures taken to negatively affect the

South African economy were expected to lead to internal pressures (especially from the politically influential business sector) for a dismantling of the system.

Disinvestment, in the present context, is defined as the sale of physical or financial assets in a target country by individuals or governments of foreign nations (Lowenberg and Kaempfer 2001:122). As such, it can readily be ascertained that the intended outcome (on the part of those disinvesting) of disinvestments is to deny the target country access to the physical, financial, or human capital of foreign individuals or foreign-owned multinational firms (Lowenberg and Kaempfer 2001:122).

Economic sanctions, on the hand, refer to import and/or export trade restrictions imposed by sanctioning governments against a specific target country. The intent of sanctions is to bring about policy change in the target country through imposing, or sometimes merely threatening, the severest possible economic harm. The expectation is that the target country will comply by altering its objectionable behavior/policy as long as the cost of doing so is less than the costs brought about by the sanctions (Lowenberg and Kaempfer 2001:80; Cf. Khan 1989:23).

There are several constraints that may impede the effective functioning of sanctions and disinvestment against a target country. A key constraint being that legislated disinvestment often leads to the sale (at bargain basement prices) of fixed assets (plant, equipment and land) of multinational firms of disinvesting countries to domestic firms or multinational firms from countries that are not participating in the disinvestment campaign. The takeover of the assets of disinvesting firms in this manner will result in a continuation of the economic activities under question as well as a continuation of the offending

target state policies. A similar problem exists with the use of trade sanctions in that the economic impacts of the sanctions can be circumvented with relative ease by target countries, by simply channeling their imports and exports to alternative trading partners.

Thus in order for disinvestment campaigns and trade sanctions to have any economic effect in the target country, there must be a concerted and coordinated international effort that involves the participation of as many countries as possible. In the case of the 1986 South Africa sanctions, the sanctioning countries usually chose to boycott those imports that comprised a non-critical share of South Africa's total exports of the good in question (e.g., US and Canadian coal and agricultural sanctions). In other instances where the sanctioning countries were highly dependent on the import of a particular good from South Africa, South Africa's level of trade with the sanctioning countries was generally small relative to world trade, suggesting a highly elastic demand by the rest of the world and readily available substitute markets (this was the case with OECD iron and steel sanctions). Alternatively, in some instances, sanctioning countries imported a large share of South Africa's total exports of a particular good, but the importance of those exports to South Africa (in terms of their share in total South African exports of all goods) was small (e.g., US sanctions on South African apparel). In all of the above-cited cases the level of economic damage to South Africa was minimal (Lowenberg and Kaempfer 2001:111-19) (Cf. Tables 3.1, 3.2 and 3.3 below).

Although economic sanctions and arms embargoes had been launched against South Africa as far back as 1940, it was only by the late 1980s that comprehensive and coordinated international sanctions and disinvestment campaigns became sufficiently encompassing to have a major impact on the

South African economy (Lowenberg and Kaempfer 2001:6). In terms of United States statistics, seven U.S. firms ended their direct investment in South Africa in 1984, and forty in 1985, with the trend peaking at fifty-seven in 1987 (Khan 1989:61-5). Khan (1989:41) estimated the total output multiplier for the South African economy in the mid 70s to be on the order of four. Meaning that a sanctions induced decline in total exports of $1million would have resulted in a decline in output (GDP) of about $4million. The sanctions multiplier disaggregated for the key economic sectors amounted to 1.176 for agriculture, 1.0006 for gold, 1.025 for mining, and 1.377 for food, with all of these sectors expected to indirectly affect many others.

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Table 3.1

Major Trade Sanctions against South Africa, 1986

Country	Imports	Exports
United States	Steel and iron, coal, textiles, agricultural goods, uranium, Krugerrands	Oil Computers to apartheid-enforcing agencies
United Kingdom	Steel and iron, Krugerrands	Oil "Sensitive" equipment to police and army
European Community	Steel and iron	Oil "Sensitive" equipment to police and army
Canada (and the Commonwealth)	Steel and iron, coal, agricultural goods, uranium, Krugerrands	
Japan	Steel and iron, Krugerrands	Computers to apartheid-enforcing agencies

Source: Congressional Quarterly, September 1986, p.2271

Adapted from Khan 1989, p.54

Table 3.2

South Africa's Major Exports and Imports in 1986 (US$ in millions)

IMPORTS	
Non-electric machinery	1,909
Transport equipment	1,254
Electrical machinery	1,032
Chemical elements and compounds	444
Instruments, watches, and clocks	308
Miscellaneous manufactured goods	292
Plastic materials	243
Chemical products	231
Metal manufactured goods	215
Iron and steel	181
EXPORTS	
Non-ferrous metals	1,697
Coal, coke, briquettes	1,405
Iron and steel	1,278
Metalliferous ores	1,041
Non-metal mineral manufactures	733
Fruits and vegetables	621
Chemical elements and compounds	576
Crude fertilizer and minerals	322
Textile fibers	300
Sugar and preparations of honey	195

Source: U.S. General Accounting Office, South Africa. Trends in Trade, Lending, and Investment, Report to Congressional Requesters (April 1988 p. 11).

Adapted from Khan 1989, p. 54

Table 3.3

Flows of Sanctioned South African Exports

Sanctioning Country	Good	Share of South African Export Total to OECD
	Iron and Steel	
U.S.	293,621	31.2%
U.K.	43,257	4.6%
W. Ger.	111,533	11.9%
EC total	274,518	29.2%
Canada	20,153	2.1%
Japan	192,571	20.5%
Total S.A. exports to OECD	940,982	
Total OECD imports	39,223,837	
Total		83.0%
S.A. share of OECD imports		2.4%
S.A. share of world trade		1.6%
	Textiles	
	Fibers	
U.S.	11,398	3.9%
Total S.A. exports to OECD	294,941	
Total OECD imports	9,869,847	
S.A. share of OECD imports		3.0%
S.A. share of world trade		1.7%
	Yarn and Fabrics	
U.S.	22,256	15.9%
Total S.A. exports to OECD	140,026	
Total OECD imports	34,618,015	
S.A. share of OECD imports		0.4%
S.A. share of world trade		0.4%
	Apparel	
U.S.	40,693	64.8%
Total S.A. exports to OECD	62,786	
Total OECD imports	42,151,982	
S.A. share of OECD imports		0.1%
S.A. share of world trade		0.1%
	Coal	
U.S.	43,418	3.3%
Canada	0	0.0%
Total S.A. exports to OECD	1,317,881	
Total OECD imports	14,179,898	
S.A. share of OECD imports		9.3%
S.A. share of world trade		7.1%

Source: OECD *Import Export Tables*; UN Trade Data System.
Note: All figures in $1,000 for 1985, except S.A. share of world trade for 1982.

3.3 CONCLUSION

The current chapter sought to explore the investment climate faced by multinational firms in South Africa largely from a historical perspective. This was done in order to define and clarify the context within which foreign direct investment policy has taken place in South Africa in the past, with the expectation that this historical context has relevant implications for resolving present and future foreign direct investment policy issues. Thus, the central underlying assumption of this chapter is that a cursory exploration of what went before is required to understand and critique what currently exists.

Agriculture, mining and manufacturing are the three largest sectors of the South African economy in terms of contribution to gross domestic product and are thus considered the most relevant in terms of defining the contextual economic environment within which foreign and domestic investment takes place. The deterministic element that runs through every aspect of development and investment in South Africa's recent past is the system of racial discrimination and segregation known as apartheid. Apartheid policy affected not only South Africa's domestic productivity but also affected it's international trade and investment as the international community began to act to undermine it. In the final analysis, the system of apartheid brought itself to an end as, with the passage of time, it increasingly proved itself to be an unworkable political, social and economic system. Although apartheid no longer exists, it has left behind a significant legacy that represents hindrances in many sectors of the economy that are only presently being resolved. In this chapter, each of the above-mentioned economic sectors (agriculture, mining and manufacturing) was

assessed in seriatim in order to derive an indication of the attractiveness of the investment environment to foreign investment.

The agricultural sector of the economy has shifted from first to third place in terms of share of GDP in contemporary times. Although this sector of the economy continues to be plagued by climatic and natural resource encumbrances, it's contribution to GDP and thus development is significant as it employs over a million people and exports the majority of its produce. The apartheid legacy inherited by the agricultural sector is what has come to be called the two agricultures. As apartheid was an expensive system to maintain, there appears to be evidence that the productivity of agriculture was reduced as a direct result of the costs of subsidizing the white farming sector while disenfranchising small-scale black farming.

The mining sector of the economy is credited with moving the country into its so-called second industrial revolution. This sector of the economy is characterized by a concentration of capital ownership among the formally six mining finance houses. Mining also received substantial state support through legislation that provided for cheap African labor. South African mining grew to be important not only to the domestic economy, but also served the strategic minerals needs of much of the advanced industrialized countries. At present, new mining legislation has been promulgated to address the government's concerns about big business exploitation of the long-standing prospecting and mining rights laws, as well as the racial incongruencies of the past.

Manufacturing development and investment grew largely out of the concern of the government to diversify out of the predominantly mining and agricultural based economy. The government's approach was initially to financially support

manufacturing through the extensive taxation of mining. However, government policy later turned to the establishment of public enterprises to (directly and through support of private industry) provide the inputs needed to stimulate and support manufacturing.

The defining period of South Africa's economic history was the crisis brought about by the trade sanctions and disinvestment campaigns against her in the mid to late 1980s. Although these measures were initially ineffective in meeting their objectives of bringing an end to apartheid through the creation of negative economic outcomes in South Africa, the broadening and improved consensus and coordination among sanctioning and disinvesting countries of the world closed up the gap that caused the initial ineffectiveness in the system.

Although an extensive amount of foreign investment was lost to the disinvestment movement, the extent and pace at which foreign investment has returned to South Africa in the post-apartheid era is a defining issue in determining the Government's policy approach to foreign investment. In this regard, a balance must be found between too liberal an approach that may allow for abuses of the state by multinational enterprises, and too restrictive a stance that may tend to stem the flow of much needed inward investment.

Chapter 4

Global Foundations for Establishing a Need for the Regulation of MNEs

4.1 Introduction

Currently in the Republic of South Africa (RSA) there is no governmental body at any level of government that is charged with complete/centralized responsibility for policy-making and regulation of foreign direct investments (FDI) in the form of multinational enterprises (MNEs). Other advanced industrialized countries have long been convinced of the need to regulate this type of investment through such government agencies as the Foreign Investment Review Agency (FIRA) in Canada and the Committee on Foreign Investment in the United States (CFIUS).

In this age of regional trading blocks forming across the globe, countries with the wealth of resources as exists in South Africa need to address trade and investment issues that go beyond simply attracting increasingly greater amounts of foreign investment. That is, although big business has much to contribute towards global economic advancement, unregulated big business is subject to engage in a number of social, legal and economic abuses least of which is the distortion of markets through market domination and the erection of barriers to competition. As case in point, a substantial proportion of the organizations that are in a position to operate monopolistically or as oligopolists also tend to operate internationally as multinational enterprises. The size and scope of foreign direct investment activity in South Africa is significant enough

to warrant concern and closer examination of government policy and administration applicable to these businesses.

A discussion of foreign direct investment and multinational enterprise policy from a public administration perspective, necessitates at the very least a basic understanding of the empirical as well as the theoretical debates on this type of investment. Thus case studies as well as theory are looked upon in this chapter for guidance in addressing the possible legal, political, administrative, social and economic (among other) perplexities posed by this type of investment in South Africa.

The overarching goal of the current chapter is to explore the following research question – i.e., is there a need for multinational enterprise policy for South Africa? Although the next chapter (chapter 5) addresses this question to some extent, it does so from a markedly different perspective than that proposed in this chapter. In chapter 5 the objective is to resolve this question by surveying and evaluating those policies that are currently in place within the existing decentralized arrangement and assessing the level of adequacy of said policies.

In contrast to the approach of chapter 5, the current chapter takes a much broader and comparative approach to resolving the above-mentioned research question. The current chapter will look outside of South Africa for answers to this question. The approach is to analyze events from a number of countries or regions in order to gain a contextual setting against which South African foreign direct investment policy and regulation (or the approbation thereof) can be evaluated. The chapter then narrows its focus to address this fundamental question within the local context through case study examination in order to highlight the appropriateness and need for policy regulating multinational enterprises in South Africa.

4.2 International Perspective on the Justification for MNE regulation

In the process of determining the adequacy of existing foreign direct investment and multinational enterprise policies, and in order to assess the organizational soundness of government structures that exist to implement these policies, it is necessary to first define the terms policy and regulation. A comprehensive definition of policy is given in chapter 5 (Supra Sect. 5.2) and will thus not be duplicated here.

Exploring the universal bases upon which foreign direct investment and multinational enterprise policies stand, begs the question of why this type of investment should be regulated. Regulation is defined in the New Merriam-Webster dictionary as the act, or state, of being regulated; and alternatively as a rule dealing with details of procedure and having the force of law (The New Merriam-Webster dictionary). Regulation derives much of its meaning from its root word regulate, and regulate in turn is defined as the act of fixing or adjusting the time, amount, degree, or rate of (The New Merriam-Webster Dictionary). In discussing the regulation of multinational enterprises, it is instructive to associate the meaning of the term regulation with the aforementioned definitions as opposed to yet another definition that equates regulation to control. The term control suggests rather radical or extreme connotations, and is more aptly used in the context of the power to restrain or direct, which go beyond what is relevant to the discussion that follows.

Amongst the international community of nations a number of motivations have been posited for the essentiality of regulating foreign direct investment at the national, regional and international levels. Most of these rationales regress

upon the vast magnitude of the resources controlled by these enterprises and the resultant economic, social and political power that this wealth infers.
These regulatory policy motivations and actions are best explored from an historical perspective in order to understand the evolvement of foreign direct investment policy to its *current* ideological state and the environmental factors (social, political or economic) that may have contributed to or influenced these policy positions.

One approach to studying this dynamic of the interplay between cause and effect is the systems approach (Parsons 1995:23-5). The systems approach to problem solving provides an organized way of separating institutions and organizations from their environment(s) thus bringing all pertinent relationships into sharper focus. For the case in question, multinational enterprises posses or stand to gain some power (social, political and economic) over their environment – the host country; whilst at the same time, the host country/environment exercises some power (or control) over multinational enterprises through regulation in order to limit the perceived social, political and economic power they may obtain. This set of relationships defines the fundamental and overarching framework within which the foreign direct investment and multinational enterprise policy process takes place and evolves over time (1974 United Nations Report in Modelski 1979:319-20; Cf. Parsons 1995:23-5).

4.2.1 Stages of evolvement of multinational enterprises

Within the context of the systems approach, the need to regulate multinational enterprises is related to the significance given to this type of investment by government administrators and policy makers. In this regard, accepting that multinational enterprises are an important derivative of the world economy, it is instructive to note that at different times throughout history, multinational

enterprises have occupied a greater or lesser place in the field of international trade regulations. At times, concern vis-à-vis controlling the possible abuses of multinational enterprises was prevalent among policy makers and at other times the issue proved to be insipid. These variations in interest over the activities of multinational enterprises can be explained by taking account of Makler's (1982) stages of development of the world economy, in addition to Taylor and Thrifts (1982) description of the development of international capitalism, and Muchlinski's (1995) evolutionary phases of modern multinational enterprises.

Makler (1982:5-12) offers a stageist approach to analyzing the vicissitudes of these dynamics and argues that the world economy (and by default, multinational enterprises) developed through subtle yet clearly distinguishable transitional phases (Cf. Taylor and Thrift 1982:277-284; Cf. Muchlinski 1995:19-33). These phases being:

(a) The shift from feudalism to capitalism;
(b) The stage of competitive capitalism;
(c) The stage of imperialism; and
(d) The stage of transnational capitalism.

The importance of these theoretical phases lies in their specification of the relational values that underlie them. Thus, the relational properties of integration and conflict among firms, markets and states can be discerned in each phase along with the policy responses thereof. Following Makler's (1982) reasoning, it can further be ascertained that foreign direct investments by multinational enterprises are a contemporary phenomenon for which policy stances have understandably been erratic. This political erraticism emanates in part from the lack of empirical work on the effects of inward foreign direct investment and multinational enterprises. The stages of development through which multinational enterprises have evolved are briefly discussed hereunder.

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4.2.1(a) The stage of transition from feudalism to capitalism

The first of Makler's (1982) phases is marked by a transition from feudal economic systems to capitalism and thus covers the period leading up to and including the Industrial Revolution circa the sixteenth century to the early nineteenth century. This period of world economic development was characterized by the accelerated propagation of international trade that was underpinned by the evolvement of distinctive cultural, legal and socio-structural arrangements that proved conducive for the implementation of capitalist economies and societies. Thus, development during this phase was spurred on by; firstly, the freeing of labor from feudal restrictions; secondly, the accumulation of merchant and financial capital; and lastly the growth of international markets.

The industrial revolution also brought about a new mode of trade between industrializing/developing countries (center) and underdeveloped countries (periphery). The nature of this mode of trade was such that industrializing countries had the industrial capacity to concentrate on the production of fully manufactured and luxury goods, for which trade in raw material inputs from underdeveloped countries was essential. Thus began the development of what has since come to be known as the unequal exchange mode of trade between center and periphery countries. The accumulation of surplus capital and the formation of monopolies also resulted from the industrial revolution, which in turn represented the necessary conditions for the development of globally oriented multinational enterprises that could engage in both export trade as well as in foreign direct investment (Taylor and Thrift 1982:279-281).

4.2.1(b) The stage of competitive capitalism

The second of Makler's (1982) stages, competitive capitalism, was prevalent throughout the nineteenth century. Although this stage is characterized by a general acceptance of free-market systems and political sovereignty by the majority of the world's nation-states, there was also a simultaneous and robust ideological shift towards an interdependent world economy dominated by the then colonial superpower, Britain. As the first of the world's nation-states to become truly industrialized by the middle of the nineteenth century, Great Britain was able to manipulate the world economy in favor of British capital supported by British military power and geo-political colonial policies (Makler 1982:5-6).

4.2.1(c) The stage of imperialism

Makler's (1982) third phase, imperialism, extends from the turbulent period of the world economic crisis of 1873-96 to the Second World War. The defining characteristic of this phase was the conquest and colonization of non-industrialized nations by the established industrialized powers of the time. During this phase, however, the rate of growth of foreign direct investment by multinational enterprises declined steadily as a result of global political and economic instability. Thus in this period, the Bolshevik Revolution which brought communism to the Soviet Union cut off trade and investment to a sizable participant of the then global economy. Almost simultaneously (circa late 1920s to early 1930s), the collapse of global capital markets led to the great depression during this period, which also contributed to the slow down in international investment. Lastly, the fear of the outbreak of a Second World War was yet another factor that soured the global investment climate by

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precipitating nationalistic economic policies characterized especially by the erection of high tariff barriers to trade (Muchlinski 1995:22-3).

4.2.1(d) Transnational capitalism

The last of Makler's (1982) phases, transnational capitalism, resulted as an aftermath of the Second World War. Whilst the Second World War precipitated the collapse of the world economy, it also ushered in a period of rebuilding and renewed international competition led by the United States. This phase covers the post Second World War period and runs to the present and is characterized by the expansion of both capital accumulation and foreign direct investments by multinational enterprises. This new era of the international economy is also marked by a greater degree of international economic interdependence than was witnessed in previous phases. Significantly, Makler's (1978) transnational capitalism phase has run concurrently with and been supported by the re-establishment of an organized international monetary system, the development of advanced technologies that facilitated significant economies of scale in production, and vast improvements and innovations in transportation and communications. As a result, the dominance of the multinational enterprise in international production was established during this phase. Consequently, American firms dominated the period from the end of the Second World War into the 1960s. It was only by the decade of the 1970s that American multinational enterprises encountered significant competition from European and Japanese firms. Newly industrializing countries of the periphery have also begun to spawn globally competitive multinational enterprises in this modern era (Muchlinski 1995:25-6).

4.2.2 Post-war foreign direct investment policy

As the nature, structure and size of international firms changed over time, they eventually came to dominate economic life, yet at the same time their predominating presence caused reaction from the environment within which they operated and led to attempts to restrain and control their potential for anti-competitive and other abuses. Muchlinski's (1995:chapter 1) analysis takes us forward from where Makler's analysis ends. Muchlinski (1995) identifies the post Second World War era as the period in which the issue of multinational enterprises came to the forefront of contemporary political debate. The basis for this positioning of multinational enterprises into the geo-political spotlight can be attributed to a growing awareness in academic and popular circles of the potential for the abuse of power especially by multinational enterprises operating in developing host countries as had been demonstrated in a handful of highly sensationalized cases. One of the most important cases in this regard involves the attempted overthrow of the presidential administration of Salvador Allende in Chile in the 1971 by the Central Intelligence Agency (CIA) in cooperation with telecommunications giant International Telephone and Telegraph (IT&T) (Muchlinski 1975:6-7; Cf. United States Senate Subcommittee on Multinational Corporations 1973 cited in Modelski ed. 1979: chapter 14).

Although Makler's analysis looks largely at the economic environment within which multinational enterprises evolved, Muchlinski's work focuses more explicitly on the policy dimension of host states towards multinational enterprises in the post World War II period. Policies towards multinational enterprises have, of design and necessity, differed across regions and countries. The discussion to follow deals with a small but significant sample of policy approaches applied in key regions and countries in the post Second World War era. The sample of regions and countries includes Europe, Japan, the United States and Africa.

4.2.2 (a) Europe

Whilst the Second World War left much of Europe's physical and economic infrastructure demolished, it also led to the rise of United States domination in world trade and economic affairs. A natural manifestation of this development was the rapid proliferation of United States multinational enterprises throughout the world (Muchlinski 1995:3-4). By the 1960s, however, this trend began to meet ideological resistance from Europeans in particular who began to express misgivings about the overwhelming presence of United States firms in the European market, particularly in crucial high tech industries. Ironically, it was felt that although United States capital and business had played a major role in rebuilding Europe, these same United States interests also stood to impede European economic success if left unchecked. Thus, the policy orientation toward multinational enterprises in Europe by the early 1960s favored regulation especially at the supranational level (Muchlinski 1995:3-4).

4.2.2 (b) Japan

Japanese economic policy also favored regulation over multinational enterprises in the immediate post war era. Unlike the situation in Europe, Japan received far less foreign assistance in rebuilding its war torn infrastructure and economy. Instead, Japan made extensive use of protective trade barriers and highly restrictive policies on inward foreign direct investment. Although the Japanese firmly restricted the entry of multinational enterprises within their borders, they still managed to benefit from access to foreign capital and technology by accepting foreign loans and licensing contracts. As one of the few countries in the world with consistent foreign trade surpluses, Japan drew attention and pressure from her major trading partners and the Organization for Economic Cooperation and Development (OECD) to liberalize

it's foreign investment policies. This external pressure combined with pressures from within Japan from a business community that feared restrictive trade reprisals and wanted to guarantee themselves continued export markets and access to foreign technology. These pressures lead to a gradual easing of foreign investment policies from the late 1960s onward despite initial resistance to reform from the state bureaucracy and special interest groups (Muchlinski 1995:3-4).

4.2.2 (c) The United States of America

In the United States, the 1970s ushered in a period of intense public concern and debate over both inward and outward foreign direct investment. On the one hand, domestic United States firms lobbied for protection from cheap state sponsored imports; and on the other hand, United States labor unions lobbied for legislation that would curb the flow of outward direct investment as a way of keeping jobs in the United States. Union efforts in this regard culminated with the Burke-Hartke Bill of 1972. Although the Burke-Hartke Bill did not succeed in being enacted into law, it's foundational principles and policies continued to influence import control laws. Since the congressional debate over the Burke-Hartke Bill, United States economic policy has not attempted to limit outward foreign direct investment but has put in place controls to review inward direct investment into strategic and national security sectors (Muchlinski 1995:3-4).

4.2.2 (d) Africa

On the African continent, the post-war era coincided with the reversal of the colonial movement. Thus, from around 1945 to 1975 the major European powers (i.e. Britain, France, the Netherlands, Belgium, Spain and Portugal) granted independence to their colonies in Africa and elsewhere. Despite the fact that the majority of African countries gained independence during this

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period, this independence was essentially of a political nature only. The European powers continued to dominate the continent economically and socially. Economic domination took place firstly through trade which was characterized by the uneven exchange of raw minerals out of the Africa for manufactured goods from Europe, and secondly through the extraction of excess rents and profits via private multinational European firms (Muchlinski 1995:3-4; Cf. Seidman and Seidman 1977:7-8). As was discussed earlier in the chapter, unindustrialized countries lacked the industrial and intellectual capacity to undertake full production processes for finished goods and instead acquired much needed foreign exchange by trading their agricultural and mineral goods. Although South Africa is now considered an industrialized country, the government recognizes that there is still a lack of sufficient beneficiation taking place in mining and minerals production.

Generally, African policy towards foreign direct investment in the early post war period was articulated through African representation in the United Nations under the aegis of the Group of 77. The Group of 77 (named after the 77 initial member states that constituted it) was formed within the United Nations to give a voice to the un-industrialized and developing countries in the United Nations. The Group held an overwhelming majority in the United Nations and represented an important source of pressure and reforms in the areas of international, regional and unilateral foreign direct investment policies in the underdeveloped and developing countries (Muchlinski 1995:5-6; Cf. Modelski 1979:265-8). The Group of 77 expressed deep reservations about the possible negative effects of foreign direct investment in the newly independent and less developed countries (LDCs) of the world. The Group of 77 thusly managed to exercise its influence within the United Nations by getting a resolution passed to have the Secretary General of the United Nations appoint a Group of Eminent Persons to study and report on the effects of green-field foreign direct investments of multinational enterprises on development in less developed

countries. Policies that emerged from the work of the Group of Eminent Persons aimed to control the ability of multinational enterprises to (Muchlinski 1995:5-6):

(i) Evade national regulation and taxation;
(ii) Use technological and capital endowments to monopolize markets; and
(iii) Engage in non-economic abuses of the host state such as through political subversion, the introduction of alien cultural values and lifestyles, and the generation of intergovernmental confrontations between home and host states.

The Group of Eminent Persons envisaged that these foundational and ideological prescriptions would define the principles upon which host countries of foreign direct investment could formulate their policies (Muchlinski 1995:5-6). It was further envisioned that the abovementioned United Nations prescriptions would be adopted at the levels of individual states, regionally and supra-nationally (Muchlinski 1995:5-6). United Nations protocols on foreign direct investment at that point in time were indirectly countered by the Organization for Economic Cooperation and Development (OECD). By 1976, the OECD was made up of twenty-four member sates, the majority of whom were industrialized countries (such as the United States, Canada, Britain, France, Japan, and West Germany). Although the OECD issued its "Declaration of International Investment and Multinational Enterprises" its approach to the issue of foreign direct investment seemingly favored the positions of industrialized/developed countries over those of underdeveloped countries (Modelski 1979:265-6).

4.3 Contemporary Thinking on the Regulation of Multinational Enterprises

The above-mentioned postwar policy orientations are not particularly representative of the current thinking on the regulation of the foreign direct investment of multinational enterprises. Since the 1970s there has been a gradual shift towards openness globally and especially in the former socialist states of the Eastern Bloc. There has also been an increase in the number of countries that have introduced laws that aim to attract inward foreign direct investment. The trend seems to be moving towards moderating tax and other incentives to multinational enterprises with provisional requirements regarding improved technology transfer, job creation and industrial development (Muchklinski 1995:9-11; Cf. Dunning 1993:571-2). These largely global trends and generalizations are decomposed to give a more detailed and regionally specific analysis of foreign direct investment policy in the passages that follow.

4.3.1 Six factors that influence foreign direct investment policy

By integrating Makler's (1982) work (which looks at the evolvement of firms into multinational enterprises) with Muchlinski's (1995) analysis of the historical positioning of policies regulating multinational enterprises it can be argued that foreign direct investment policies of host government's are highly influenced by (or perhaps even determined by) the following six factors, namely (Cf. Dunning 1993:chapter 19,and pages 579-83; Cf. Muchlinski 1995:90-102):

(a) The growth and proliferation of multinational enterprises;
(b) Economic effects of foreign direct investment associated with competitive markets;

(c) Economic effects of foreign direct investment associated with developmental objectives of host nations (especially in developing countries);
(d) Social and cultural intrusion and domination;
(e) National sovereignty; and
(f) Legal concerns (with particular reference to corporate responsibility, dispute resolution and international law).

Each of these will be discussed in turn in the following sections, with the exception of the economic effects of inward foreign direct investment as this has been covered earlier in the dissertation (Supra chapter 2) and will therefore not be repeated here.

4.3.1(a) Growth and proliferation of multinational enterprises

Although academics and practitioners may not be in agreement on many of the key points concerning the impacts of multinational enterprise investment, empirical as well as anecdotal evidence clearly bears out the fact that as a result of their phenomenal growth over the past half century, they have become significant role players in the economic and political affairs of both host and home countries (1974 United Nations Report cited in Modelski 1979:309).

Generally, in the policy process and in the political environment, unanticipated change and the pace of that change causes immediacy of response and reformulation of priorities. Thus, large-scale and rapid institutional, structural or environmental change that may have some bearing on the public interest will usually lead to calls from the electorate for policy responses on the part of the elected. In this regard, by the decade of the 1960s, world attention, academic literature and public policy were drawn to multinational enterprise at a time directly corresponding with their most active rate of proliferation (Muchlinski

1995:3-7); The United Nations Department of Economic and Social Affairs (1973 United Nations Report cited in Modelski 1979:23-4), expressed major reservations about the fact that –

> "… *The value added by each of the top ten multinational corporations in 1971 was in excess of $3 billion – or greater than the gross national product of over 80 countries. The value added of all multinational corporations, estimated roughly at $500 billion in 1971, was about one-fifth of world gross national product, not including the centrally planned economies. [Thus], International production, defined as production subject to foreign control or decision and measured by the sales of foreign affiliates of multinational corporations, has surpassed trade as the main vehicle of international economic exchange. It is estimated that international production reached approximately $330 billion in 1971. This was somewhat larger than total exports of all market economies ($310 billion).*"

Although readily verifiable, statistical comparisons of this kind (i.e. between the profit margins of multinationals and the gross national product of countries) may or may not have signaled any significant relationship in real as opposed to perceived terms (1973 United Nations Report cited in Modelski 1979:23-4; Dunning 1993:6-10). Instead, this information tends to serve more explicitly to shed some light on the motivations, composition of and/or changes in the policy environment during the decades of the 1960s and 1970s.

Further, although the growth and proliferation of the multinational enterprise has been identified as an important factor in the determination of multinational enterprise regulatory policy, this growth and proliferation was in turn determined by a number of other factors including the following (Dunning 1993:105-9; Cf. Spybey 1992:135; Cf. Muchlinski 1995:22):

1. The industrial revolution and its technological and legal innovations;
2. Foreign raw material and mineral wealth and availability; and
3. Overcoming tariff barriers.

4.3.1(a)(i) Significance of the Industrial Revolution

Historians and economists are unable to set a definitive timeframe within which the multinational form of business commenced. Scholars of this field prefer to date the beginnings of this form of business enterprise with the period(s) in history when their activity and influence was most significant. Thus, although historical references can be affirmed as far back as the colonizing activities and enterprises of the Phoenicians and the Romans, and at later stages in history to the colonizing period of the Europeans in South America and Africa (Dunning 1993:96; Cf. Muchlinski 1995: chapter 2), the relevant period is the Industrial Revolution - which is described as the birth of the *modern* multinationals (Spybey 1992:135; Muchlinski 1995:19-20).

Mass production and important mechanical inventions and innovations that occurred during this period expedited the expansion of production capacity and increased profits and reinvestment capital, which in turn facilitated increased international trade and opportunities for international production by multinational enterprises. Of the many innovations of this era, mass communication and mass transportation (combined with improved business and management

strategies) were amongst the key elements in the proliferation of foreign direct investment (Spybey 1992:135).

The industrial revolution is also slated as the period in which a change in the legal structuring of large business enterprises facilitated their national and international expansion (Spybey 1992:135). Due to the large amount of financial capital required to launch large-scale production facilities, shared ownership through the joint-stock company arrangement had existed since at least the Middle Ages. Spybey (1992) notes that with the introduction of the limited liability legal concept during the second half of the nineteenth century, shareholding became less risky and more attractive as investors were held liable for debts of the company only to extent of their original investment or shareholding. Thus the debt burden in cases of liquidation or insolvency was shared proportionally amongst investors. In other words, an investor could not lose more than his equity share invested in a limited liability company. The popularity of this type of legal business entity was sufficient, at that time, to precipitate the development of capital markets in all the industrialized countries. A secondary consequence of the development of capital markets was the growth, development and proliferation of multinational enterprises that were able to easily access capital markets for the procurement of investment capital (Spybey 1992:135). Thus, it can be noted that the introduction of the limited liability form of business was a significant factor that contributed to the proliferation of multinational enterprises in the period of the industrial revolution.

4.3.1(a)(ii) Multinantional enterprises in search of raw materials

Another important factor that contributed to the proliferation of multinational enterprises was the lack of natural resources and minerals in the home countries of the multinational enterprises. Muchlinksi's (1995:22) analysis of the half century or so prior to the First World War decomposes world distribution of

direct foreign investment by industry as follow: 55 percent in primary products (i.e. raw materials and agriculture), 20 percent in railways, 15 percent in manufacturing and 10 percent in trade and distribution, with the remainder in public utilities and financial services. The emphasis on primary products during this period coincides with the gearing of the industrial revolution and is indicative of the reliance, at that time, of the industrializing world on the less industrialized third world countries for the provision of raw material and mineral inputs.

4.3.1(a)(iii) Overcoming tariff barriers

In essence firms that have sufficient capital and asset endowments have the option of exporting to foreign markets, licensing their products to local producers in foreign markets, or establishing their own production facilities abroad (Caves 1996:27). An important factor determining which of these options is followed is the global incidence of import trade tariffs. The existence of high tariffs and import quotas has been forwarded as a motivating factor for the proliferation of international production. The rationale here is that where foreign domestic markets are restrictive towards imports, the international enterprise will prefer to avoid high import charges (in the form of tariffs, quotas and other import limiting measures) by setting up production facilities in those markets.

In this regard, Muchlinski (1995:23) has identified the inter- war period 1918 - 1939 as a period of growth and proliferation of multinational enterprises that was significantly above the pre-war levels (i.e. prior to 1914). This Muchlinski (1995) associates or attributes to the relatively high tariff barriers endemic during the period surrounding the First World War. These high tariff levels in turn were representative of the highly nationalistic, import substituting economic

policies engaged in by states prior to and during the war years as a means of shielding themselves against the world depression (Muchlinski 1995:23).

4.3.1 (b) Social effects associated with inward foreign direct investment

A key concern of the United Nations with regards to the issue of foreign direct investment in the post war era is the *social dimension*. The Merriam-Webster Dictionary (1992:684) defines the word social as – naturally living and growing in groups or communities. For the purposes specific to this thesis, the term 'social dimension' is defined as the shared traditions, customs, belief systems, and norms that serve to define a group of people. Given the latter definition, social dimension can be seen as being made up of a number of elemental parts, these parts themselves being alternatively and collectively defined as *culture* (Cf. Daniels and Radebaugh 2001:47). Thus the terms social dimension and culture are used interchangeably.

The pragmatism of this definitional exercise serves to enhance the general understanding of the policy framework aimed at addressing issues in the social dimension (i.e. the social effects associated with inward foreign direct investment). In terms of foreign direct investment policies coming from the United Nations, as indicated above (Supra - sect. 4.2.2), the Group of Eminent Persons in the United Nations aimed to prevent, through regulation, the ability of multinational enterprises to engage in non-economic abuses of the host state such as through political subversion, the introduction of alien cultural values and lifestyles, and the generation of intergovernmental confrontations between home and host states (Muchlinski 1995:6).

Focusing on the cultural aspect of non-economic abuses of the host state by multinational enterprises, Daniels and Radebaugh (2001:50) suggest that the appropriate scope for analysis is the nation-state. This is because "…*the*

similarities among people is both a cause and an effect of national boundaries…[and also] the laws governing business operations apply primarily along national lines." Thus, within the nation-state, culture can be analyzed in terms of (Muchlinski 1995:6):

1. its method of sustaining itself via transmission and adoption from one generation to the next; and
2. the manner in which it evolves.

In terms of transmission, culture is normally successfully transferred by way of observation and verbal communication and flows in the direction of parent to child, or teacher to pupil, or social leader to follower(s), and also even from one peer to another (Muchlinski 1995:6). In terms of cultural evolution, this can either be voluntary or forced/imposed (forced cultural change is also commonly referred to as cultural imperialism). Voluntary change occurs when the culture is not interfered with in any way by other cultures, but instead natural environmental conditions change and the culture adapts itself to such changes. An example of voluntary change is when a significant drop in agricultural productivity, due to natural environmental changes such as drought and soil erosion, causes migration from rural and farming areas to urban areas. This is in contrast to forced cultural change where the direct cause of the change in culture is the introduction of foreign cultural elements (Muchlinski 1995:6). Daniels and Radebaugh (2001:50) note that multinational enterprises tend to be conduits of imposed cultural change and thusly governments have attempted to control the entry and business practices of multinational enterprises in order to protect some semblance of their cultural identity and heritage.

The two principal, and diametrically opposing, arguments concerning the contribution of multinational enterprises to cultural imperialism are modernization theory on the one hand and dependency theory on the other.

Whereas modernization theory tend to be overly optimistic about the ease and appropriateness of transforming cultures of underdeveloped countries into Western style cultures, dependency theory is extremely pessimistic of such transformations and proposes that the very structure of the capitalist world-economy creates unequal development internationally and in-equitable distribution of public resources domestically (Robock and Simmonds 1989:310; Spybey 1992:1). Spybey (1992:134-5) argues that a more accurate reflection of cultural change vis-à-vis international investment lies somewhere in the ideological center of the continuum between these two polar extremes. In this regard Spybey (1992) characterizes the organizational structure and behavior of MNEs as being conducive to, but not guaranteeing, social control and manipulation by enabling certain social, political and economic activities while restraining others. Spbey's (1992) claim is partly supported and documented by Taylor and Thrift (1982:296) who find that "…*the recent intensification in the center's use of peripheral resources, markets and labor has been accompanied by an intensification of cultural domination*."

Corporate advertising on a global scale, is yet another and, perhaps the most important mechanism through which multinational enterprises influence cultural change (Taylor and Thrift 1982:276-7; Dunning 1993:536). By necessity, mass production and commodity supply on a global scale require the development of mass markets that will demand these global products. In turn, the establishment of the demand for the multinational enterprises products is normally accomplished through advertising that aims at creating a global homogenization of cultural wants, needs, tastes and behaviors (Ewan 1976:12 cited in Taylor and Thrift 1982:291). As previously noted, governments that fear compromising their unique cultural identity due to the business activities of multinational enterprises will consider regulatory control measures as a stop-gap solution (Dunning 1993:534-5).

4.3.1 (c) National sovereignty

The more extreme but less frequently occurring justification for multinational enterprise regulation is that of the perceived threat of contravention of national sovereignty by multinational enterprises through political, social, cultural and economic obstruction or intervention (Dunning 1993:19; Sunkel in Modelski ed. 1979:13). National sovereignty issues, as a basis for multinational enterprise regulation, have found expression in the legislation of almost all countries that maintain some level of policy on foreign direct investment. However, geographic demarcation and distinction can be drawn between those countries and global regions that give greater consideration to the national sovereignty issue and those that give it a more subordinate position in their foreign direct investment policy. In respect of these generalized policy stances (rooted in the sovereignty debate) and based on informed research of foreign direct investment policy, these geographical divisions can be made as follows (Spybey 1992: part IV):

Middle Eastern, Latin American, Sub-Saharan Africa, Eastern Europe, Asia, East Asia, The United States, United Kingdom and Western Europe. The discussion here will be limited to the three most relevant areas in terms of the sovereignty issue.

4.3.1(c)(i) Central and Latin America

Dependency theorists broadly contend that although the former European colonies were granted *political* independence, their inherited economic arrangements essentially remained dependent on servicing the enterprises and markets of their colonizers (Spybey 1992:20; Muchlinski 1995: 98-9). Further, even after gaining *complete* independence the continuing domination of these newly independent states was subsequently exercised through the exploitative

investments of the earliest European (and American) multinational enterprises within their borders. These investments were (and for several generations continued to be) in primary production and mining. Thus, foreign direct investment activity amounted to an exchange of low-priced raw materials from developing countries for high-priced manufactured goods from the industrialized countries (Spybey 1992:159). This 'unequal exchange' was in essence the primary objection to multinational enterprise investment extended by the dependency school and their focus for policy reform.

Perhaps as a result of their actual experiences with foreign investors, and/or based on a strong nationalistic and cultural identity (Dunning 1993:532-3), Central and Latin American countries gave new momentum to dependency theory during the period of the 1930s to the 1970s. For South American economists of that era 'dependencia' came to represent not only a connotative description of a set of international economic conditions but also more importantly, 'dependencia' as an ideology perpetuated a highly influential political movement that brought about significant change in foreign investment policy in this geographic region. Thus, 'dependencia' was the driving force behind the restrictive policy approach adopted by the Latin Americans (Muchlinski 1995:98-9; Cf. Sunkel 1972 in Modelski (ed.) 1979:chapter 13; Cf. Spybey 1992:23-7).

The culminating points of this political movement took place in Chile under the presidency of Salvador Allende, with the nationalization of American oil companies in Chile and the subsequent subversive efforts by International telephone and telegraph (ITT) to overthrow his administration (United States Senate 1973 cited in Modelski ed. 1979: chapter 14). 'Dependencia' was concerned not only with the economic situation, but was also concerned secondarily with social and cultural domination.

4.3.1(c)(ii) Middle East and Islamic States

National sovereignty concerns have been much more pronounced in this region of the world than in most others. Further, the key difference between the degree of nationalism expressed in this part of the world as opposed to others, is that almost every condition of life – social, political and economic is carried out according to strict adherence to the rules of the region's dominant religious doctrine which is Islam. Thus, for example, 'Islamic Law' affects the business community by prohibiting the charging of interest in any and all interactions (Spybey 1992:213). Beyond this, there have been periods (especially in the 1980s) in which a clear contempt for foreign influence (especially Western) was demonstrated.

In fact, history demonstrates that the culture, politics and economies of this region until relatively recently remained free of Western influence (Spybey 1992:213). Western colonialism did not extend into the Arab States due in large part to the impervious rule of successive Islamic empires. As a consequence, European maritime activities required the circumvention of these territories in order to reach India and the Far East.

The Second World War, however, involved the Arab states tangentially as the French and British allied forces came to the assistance of the Arab states in their battle against the German supported Turks. The conclusion of WWII ironically brought the Middle East under the control of the allied forces who adopted a divide and conquer strategy to their encroachment into the region. France obtained a League of Nations' mandate over Lebanon and Syria, with significant oil concessions in Iraq, whilst the British mandate apportioned to themselves Iraq, Palestine and Transjordan. Later, with the discovery of major oil fields in the Saudi Arabian peninsula, the USA also gained major oil concessions there.

Thus, Western capitalists have maintained a formidable investment presence in this region since discovering the vast oil reserves contained therein (Spybey 1992:213). This discovery coincided with the end of the First World War and the fall of the Ottoman Empire (Spybey 1992:210). Further, despite the general rejection of foreign culture and influence in the Middle East and the domination of society by Islamic dogma, these sets of conditions has not resulted in autarkic economic relations with the rest of the World. Whilst maintaining economic relations with Western business interests, the political and social nationalist phenomenon was directed most strongly toward the Western powers. A key event leading to this build-up of resentment toward the West can be attributed to the creation of a Jewish state within Palestine.

This Jewish state was the product of British foreign policy under the Balfour Declaration of 1917 and has enjoyed substantial financial and military support of the Western allies especially the United States of America. Two major wars and the numerous lesser military conflicts between Israel and the mobilized and united Arab states served as a prelude to the complex and uneasy relationship that currently exists between foreign investors and governments in the Middle East.

Further, the rise to power of Ayatollah Khomeini in Iran in 1979 marked a significant move toward Islamic fundamentalism and anti-western sentiment in the region. Other influential leaders in this movement (circa 1980's) include Moamar Khadafi of Libya, and Sadam Hussain of Iraq. Thus, as Dunning (1993:533) generally points out concerning the Middle East "…*notably [in] Iran and Iraq, the contemporary resurgence of Islamic fundamentalism is dominating all trading relationships with the outside world. Their unwillingness to accept inward direct investment from countries whose economic policies and cultures are perceived to undermine these beliefs is hardly less great than the communist world less than a decade ago*".

4.3.1(c)(iii) The Former Soviet Union and Eastern Europe

The current foreign direct investment policy approach in this region of the world can be characterized as a complete revision and reversal of past policies followed by these formally socialist governments (Muchlinski 1995:23). This dynamic transformation in foreign direct investment policy approach necessarily is taking place in an environment of uncertainty as this change in policy represents a microcosm of the larger transition from socialist economies to capitalist market economies. This greater transition in ideology came about in the late 1980s and early to mid 1990s after socialism endured approximately one hundred years in the former Soviet Union and fifty years in Eastern and Central Europe. Understandably the details of foreign direct investment policy have not been clearly worked out relative to other areas of economic policy reforms. One of the key issues currently being addressed in this regard is the issue of privatization and private property rights.

Although foreign investment and privatization are the agenda issues of the day in this region, history of the socialist movement in the Soviet Union and Eastern Europe indicates that the national sovereignty issue was the primary driving force behind much of government policy to date - both domestic and international. Foreign direct investment policy, as an extension of international relations was thus characterized by a closed system of trade and investment limited to the CMEA (Council for Mutual Economic Assistance) countries (Bleaney 1988:52).

A cursory examination of the socialist economic mechanism reveals that foreign direct investment was essentially non-existent. That is, since the state owned and/or controlled all means of production (both agricultural and industrial), the possibility of foreign direct investment was not a reality at this point in history. However, one aspect of the national sovereignty issue showed itself by way of

the massive military buildup during the cold war. Since at least the 1950s, the Soviet leadership was determined to compete with the West (especially the USA) on economic, technological and military grounds (further, they were determined to prove the superiority of their socialist system of government). Early successes in all three of these areas in the 50s and 60s were met with steady decline in the 70s and 80s (the military priority being the exception) (Bleaney 1988:Chapter 2). Political upheavals in the region combined with the systematic failures of technology and economy led to the fall of the Berlin Wall in 1989 and the disintegration of the Soviet Union in 1991.

Currently, this region is in an embryonic stage of economic policy development as it moves away from the central planning model towards integration into the international economy. It should be noted, however, that a number of states in the region now have in place advanced measures concerning foreign direct investment. For example, the protection of foreign investments is guaranteed in Estonia with relevant laws and international agreements. Also on the books are bilateral agreements on the promotion and protection of investments, which have, been concluded with Switzerland, Germany and the United States of America as well as taxation avoidance and double taxation agreements with a number of other states. However, for the region as a whole, the major stumbling block (as noted above) is the inconsistency contained in the property rights issue.

4.3.1 (d) Multinational enterprises, corporate responsibility and international law

The very nature of the multinational enterprise, that is a business enterprise legally incorporated in one country and conducting it's business affairs in a number of different countries, opens up the possibility of avoidance of accountability in the legal domain. In this regard, a number of well documented

cases – for example, Union Carbide in Bhopal India, and Cape Plc. in South Africa – reveal that local as well as international law has, to date, not offered adequate and/or timely solutions to problems arising in cases dealing with extraterritorial jurisdiction. This is evidenced by the fact that the fundamental principle of international law is to confer upon each state exclusive sovereignty over the territory it controls (Muchlinski 1995:124). Strict adherence to this principle carries with it the corollary duty of non-intervention on the part of other states. Thus, this requirement of non-intervention essentially negates the ability of states to pursue legal claims against their home-country firms located in foreign jurisdictions. In fact, as Muchlinksi states "…*any assertion of extraterritorial jurisdiction by a state would amount to a violation of international law. Such a view might be unduly restrictive of a state's legitimate interest in the effective enforcement of its laws against [multinational enterprises] MNEs*."

A highly instructive, and perhaps deterministic, case for the South African legal and regulatory framework on inward foreign direct investment is the case of Lubbe vs. Cape Plc. Cape Plc is an asbestos mining, processing and distributing company whose articles of incorporation are founded in England in 1893 under the name – Cape Asbestos Company Limited (Westlaw 2003; Van Niekerk 2001; Coombs 2002). Cape Plc, had been engaged in asbestos mining in South Africa from 1893 to 1979, mainly in what is now the Northern Cape Province and Limpopo Province. It also began operating an asbestos processing factory in Benoni near Johannesburg in 1940. From 1948 its South African business activities were conducted through wholly owned subsidiaries with head offices in Johannesburg. In 1979 the company sold all its mining and mining related interests in South Africa, with the exception of its Benoni factory, to a local company. In 1989 it sold the Benoni factory and has since then ceased to have any physical presence or assets in South Africa, thus effectively putting itself out of jurisdictional reach of the South African legal system.

In 1997 the first of 11 writs was served on Cape Plc, the defendant, in England by South African plaintiffs. The basis for this lawsuit can be summarized as follows:

- 7,500 South African plaintiffs, resident in South Africa, claimed damages for personal injuries (and in some cases death) allegedly suffered as the result of exposure to asbestos and its related products that were mined, processed and distributed in South Africa by Cape Plc during its tenure in the country.
- the claim is made against the defendant as a parent company which, allegedly knowing that exposure to asbestos was gravely injurious to health, failed to take proper steps to ensure that proper working practices were followed and proper safety precautions observed. In this way, it is contended that, the defendant breached a duty of care which it owed to those working for its subsidiaries or living in the area of their operations, with the result that the plaintiffs thereby suffered personal injury and loss.
- The major stumbling block to resolving this case was the issue of whether the proceedings brought by the plaintiffs against the defendant should be tried in England or in South Africa. It took several court cases and two Appeals Court hearings in England to resolve this issue before the case could be heard in the House of Lords of the English court system.

With regards to the issue of the appropriate forum in which to hear the case, arguments centered around common law principles set in a similar case, Spiliada Maritime Corporation v. Cansulex Ltd. [1987] A.C. 460, heard before the House of Lords of the English legal system. On the basis of the precedence set in Spiliada, if it can be successfully argued that a foreign plaintiff will not obtain justice against an English defendant in the plaintiff's home country, the English court may not grant a stay (a refusal) to have the case heard in

England. By the conclusion of the hearings in the second Court of Appeals, Lubbe v. Cape Plc. passed the Spiliada test, thus favoring having the case heard in England.

The plaintiffs further argued that a second test for assigning the case to the British courts is that of Article 6 of the European Convention on Human Rights. As Article 6 is consistent with the Spiliada test in principle, it was successfully argued that granting a stay of the proceedings in favor of South Africa as the legal forum would amount to a violation of the Article since the lack of funding and legal representation that the plaintiffs encountered in South Africa would deny them a fair trial on terms of litigious equality with the defendant.

Comparing Lubbe v. Cape Plc. with an earlier case against Cape Plc., Gisondi v. Cape Plc., demonstrates the lack of adequate protection for South African complainants in certain cases of extraterritorial jurisdiction. Vincenzina Gisondi and three other Italian plaintiffs successfully sued Cape Plc. for damages in England. There are numerous similarities, with the Lubbe case, in terms of both the nature of the writs and arguments presented with one critical exception – i.e. attorneys for Gisondi successfully argued for consideration under Article 2 of the Brussels Convention to which both England and Italy are signatory states. Under Article 2 of the Brussels Convention the English courts were compelled to not decline jurisdiction in favor of the Italian legal system and accordingly the defendant had no opportunity to apply for a stay on the grounds of forum non conveniens (inappropriate forum). Unfortunately for South African claimants, international agreements that make up the Brussels Convention only apply to states that are party to the Convention, thus South African claimants bear a greater burden than some of their counterparts in pursuing legal remedy in foreign courts.

4.4 Conclusion

South Africa has on the whole always maintained an open stance towards inward foreign direct investment. The disruptions in these inward flows, experienced in the 1970s and 1980s, were externally generated (through divestment, dis-investment and embargos) as opposed to being the result of a change to a more closed regulatory regime on the part of government. It has been demonstrated in this chapter that most other countries and regions of the world have felt the need not only to regulate inward foreign direct investment, but have also felt the need to regularly review these policies as internal and external environmental circumstances changed.

As policy based on theory cannot always take account of all counterfactual possibilities, there are often loopholes in laws and policies that are to be exploited. It is therefore the norm that case studies have been the driving force for change. In particular, the case involving the attempted overthrow of the Chilean government by telecommunications giant ITT and the CIA brought with it renewed awareness of possible abuses of a foreign multinational enterprise within a host country and suggested new policy options for governments to pursue. Another important case, especially for South African foreign direct investment policy, is that of Lubbe v. Cape Plc. in which a British company, Cape Plc., owned and operated asbestos mining and processing concerns in South Africa for almost 100 years. By 1989 the company no longer had a physical presence in the country and was therefore beyond the reach of South African law and South African claimants seeking compensation for alleged asbestos poisoning due to the negligent conduct of the company. Although the case was eventually settled in 2001 in England, the difficulties experienced in getting to that stage provide valuable lessons for a renewed assessment of South African government policy. In this regard, the Brussels Convention, in Article 2, provides a model that should be considered for South Africa.

Chapter 5

Critical Review of Existing Policies on Foreign Direct Investment in South Africa

5.1 Introduction

Given that the purpose of this dissertation is to determine the efficiency prospects offered by way of the rationalization of government structures that are involved in the regulation of foreign direct investment policy, it must be noted that examination of these structures cannot take place in isolation of the underlying policies. These policies must first be understood and articulated before their implementing structured can be evaluated. To this end the current chapter first sets out to get clarification on what is meant by the term policy and how the process of policy determination is realized. Further, a survey of foreign direct investment and/or multinational enterprise policies in South Africa is undertaken in order to give clarity to where specific policies are housed as well as how they are administered in relation to other policies in the same area.

Comparatively, foreign direct investment and multinational enterprise policies that have been applied in other countries are surveyed in order to examine alternative policy options that may (or may not) prove effective in the South African context. This chapter serves as a prelude to next chapter that examines if rationalization and/or re-organization may provide the necessary framework under which foreign direct investment and multinational enterprise policy can be more effectively delivered than is currently the case.

5.2 Public policy defined

Parsons (1995:2) gives pragmatic value to the term public policy by defining separately and then examining together it's component parts. Thus he defines 'public' at great length before tackling the definition of 'policy' with the same zeal. The integration of these two terms/concepts is then derived. In short, Parsons defines public (in relation to private) as encompassing that sphere of life that is not purely private, but is instead the common domain of all in society. More specifically, Parsons defines public as comprising "that dimension of human activity which is regarded as requiring governmental or social regulation or intervention, or at least common action" (Parsons 1995:3). Although this definition recognizes the interventionist role of government, it is not entirely inconsistent with the laissez faire principle and the belief that market forces left to their own devises would maximize the welfare of not only individuals in markets but also that of the public at large. Instead, the role of the state was seen to be that of merely creating and maintaining 'free' market conditions through limited intervention in the economy and the maintenance of law and order (Gildenhuys 1997:2-8). The term public thusly accurately refers to all areas of activity of the state as defined here.

Of the many definitions offered for the term policy, a fairly succinct definition is that offered by Anderson (1975:3) who states that a policy is: "*A purposive course of action followed by an actor or set of actors in dealing with a problem or matter of concern*". This definition regards policy as what is actually done (a purposive course of action) as opposed to what is proposed, decided upon or intended. Further, this definition also requires the clear identification and specification of a problem, the resolution of which requires policy intervention. Combining the aforementioned definitions of public and of policy, it can be ascertained that public policy as an integrated term refers to problem solving actions undertaken by government.

5.3 Public policy and change

Policies tend to be dynamic in nature. Policy change can be viewed as taking place within the context of one or more of four ideal types of change: policy innovation, policy succession, policy maintenance and termination (Hogwood and Peters 1983:26; Cf. Brewer and de Leon 1983:17-21). Each of these types of policy change are briefly discussed hereunder.

5.3.1 Policy Innovation

Policy innovation represents the creation of a new area of policy that occurs as a result of the entry of an institution/governmental unit into an activity in which it has not previously been involved. The key challenge faced by the institution in attempting such an endeavor is the fact that newly established organizational, legislative and budgetary provisions normally start from an unstable base founded in an uncertain environment. The level of complexity of policy innovation can thus be expected to greatly surpass that of other types of policy changes that merely involve changes to already existing organizational structures and policy regimes (Hogwood and Peters 1983:26-9).

5.3.2 Policy succession

Policy succession, on the other hand, refers to *significant* modification or outright replacement of standing policies (and their organizational structures) as a strategy to adapt the organization to internal and/or environmental change. This type of policy change does not, by definition, involve the organization engaging in a new field of activity. Instead, under this type of policy change the objectives (ends) remain the same while the mechanisms of program delivery (means) are changed (Hogwood and Peters 1983:26-9).

5.3.3 Policy maintenance

Alternatively, policy maintenance can be thought of as the continuous monitoring and amending of standing policies. Unlike policy innovation and policy succession, policy maintenance does not involve, to any significant extent, changing either the objectives (ends) or the means of the organization. Instead, policy maintenance changes are characterized by the attempt to improve upon the use of existing program delivery mechanisms (means) in order to conform to the original policy objectives (ends) (Hogwood and Peters 1983:26-9).

5.3.4 Policy termination

Lastly, policy termination involves the complete or partial dissolution of organizational structures and the attendant legislation thereof, as well as the complete cessation of public expenditure on policy related activities and programs. Although policy termination is a rare form of policy change in the public sector, it's importance lies in the fact that it calls for the continuous evaluation of organizations and their policies, activities and programs and further calls for their termination where this is justified from an effectivity and efficiency basis (Hogwood and Peters 1983:26-9; Cf. Brewer and de Leon 1983:20-1).

5.4 Public Policy Determinants

Other important influences over and possible determinants of public policies are public policy role players, public policy formulation processes, and the legislative processes required for the enactment of government reorganizations and rationalization. A brief discussion of each of these factors follows.

5.4.1 Public policy role players

Although the activity of formulating public policy is normally concluded at some level (usually top) within the government administration, public policy development is not the exclusive domain of any person or assemblage of persons either within or outside of government. Rather, all citizens [and non-citizens who have an interest (ex. financial) in a given country] are able to affect public policy with varying degrees of influence. Anderson (1975) addresses this point by differentiating between the more influential official policy makers and the usually less influential unofficial policy-makers (Anderson 1975:37-48; Cf. Hanekom 1987:21). Official policy-makers are those policy-makers whose official decisions are recognized as legally binding. Included among this grouping of individuals are legislators, executives, administrators and judges. It is not, however, uncommon for these public policy actors to be influenced and/or controlled by unofficial policy-makers, such as political party bosses and special interest groups.

Unofficial policy-makers, on the other hand, have no legal endorsement of their decisions and wishes, although they may be able to influence policy through pressure exerted on official policy-makers. Included in this grouping of persons are special interest groups, political parties, non-governmental organizations (NGOs) and citizens based organizations (CBOs).

5.4.2 Public policy formulation

Upon receipt of policy proposals from the administrative and executive branches of government, legislators must engage in the process of debate, amendment, ratification and enactment on those policy proposals that they consider to be worthwhile. Policy formulation at the legislative level of government is thus a two-stage process that includes firstly, deciding what should (or should not) be done to resolve a particular problem, and secondly drafting legislation to give

effect to the solutions decided upon (Anderson 1975:70; Cf. Gildenhuys 1997: chapter 4). Bills that have been passed into law (Acts) represent an important indicator of the actual content of public policy (Anderson 1975:70).

5.4.3 Rationalization within the public policy process

The authority to execute structural change by way of rationalization or reorganization within the South African government administration is shared amongst the Executive and Legislative branches of government, with the Judiciary playing a secondary role given it's mandate to make a determination as to the constitutionality of the agency in question and the procedures to be followed for its creation (Roux et. al 1997:chapter 3; Cf. Cloete 1998:chapter 4).

The Constitution of the Republic of South Africa,1996, Act 108 of 1996 confers legislative authority upon the bicameral Parliament which consists of the National Assembly and the National Council of Provinces. The procedures for getting a bill passed - in this case a bill concerned with an administrative reorganization - are based on the system of checks and balances whereby both divisions of Parliament as well as the President must scrutinize the bill before it is signed into law by the President. Section 75(1) of the Constitution stipulates that a bill originating from and passed in the National Assembly must be forwarded to the National Council of Provinces for consideration. If the bill is also passed by the National Council of Provinces without amendments, it then must be submitted to the President for assent. If, however, the bill is rejected by the Council or affirmed by the Council subject to amended changes, the bill must be returned to the Assembly for reconsideration before resubmission to the President for assent. In the case of matters dealing with Provincial affairs, Section 76 (2) of the constitution specifies the reverse order of the procedure of Section 75(1) such that when the National Council of Provinces passes a bill it must be submitted to the National Assembly for consideration before being presented to the President for assent.

The President is also a significant role player in administrative reorganization as the President possesses not only the affirming vote on legislative matters vis-à-vis signing a bill into law; but the President also maintains the constitutional authority to prepare and initiate legislation; develop and implement national policy; appoint commissions of inquiry; as well as being responsible for coordinating the functions of state departments and administrations. [Sections 84 and 85 of the Constitution of South Africa 1996 (Act 108 of 1996)].

5.5 Review of FDI/MNE policies – South Africa

Policies can either be explicit or implicit. Explicit policies are often referred to as rules since they clearly state what is or is not to be done, whereas implicit policies are open to interpretation and merely provide guidelines for those charged with their implementation (Roux et. al 1997:125; Cf. Brewer and de Leon 1983:268). This being noted, it can further be stated that policies can exist even though they have not been clearly articulated or documented. Although it may be correctly stated that there is no institutional unit within which foreign direct investment policy is *coordinated* in the South African public sector, it is not the case that these policies are non-existent. Several departments and sub-units hold some responsibility in the formulation and implementation of foreign investment policy. Thus for example, the South African Reserve Bank is in charge of regulating exchange controls that put limits on the amount of money and other capital assets that can be brought into or taken out of the country; while the Company registrar's office under the Department of Trade and Industry is responsible for setting registration requirements for internal (domestic) and external (foreign) companies while at the same time several subunits under the Department of Trade and Industry provide investment and export incentives to foreign investors in order to attract greater amounts of foreign direct investment. This section of the current chapter is ultimately concerned with the possibility of putting in place a government structure that would coordinate all areas of policy involving foreign direct investment in order to provide a consistent and measured

approach to determining the appropriate forms and levels of foreign direct investment policies. The underlying questions that need to be raised in this regard relate to whether or not the Government is engaged in unhealthy and excessive competition with other governments to attract foreign direct investment; and are all governmental units that regulate some aspect of foreign direct investment acting in a unified and coordinated manner in formulating their policies?

The discussion that follows attempts to partially resolve these two questions by conducting a critical review of the foreign direct investment policies that exist in each of the following governmental units: the Department of Trade and Industry; the Competition Commission; the South African Reserve Bank; the Department of Environmental Affairs and Tourism, and the Department of Minerals and Energy (for a comprehensive summary see Table 5/1 below).

5.5.1 Department of Trade and Industry

A synoptic picture of the policy approach of the South African government towards multinational enterprises and foreign direct investment can be constructed mainly from the work of the Department of Trade and Industry and its affiliated governmental and quasi-governmental organizations. In order to counteract the low savings and investment rates occurring in the economy, the Department of Trade and Industry has set for itself a key strategic objective of promoting domestic and foreign direct investment. This object is being pursued primarily through concentrating investments into Spatial Development Initiatives (SDIs). Spatial Development Initiatives represent one of the Government's key industrial policies aimed at fostering sustainable industrial development in areas with viable economic potential but where poverty and unemployment rates are amongst the highest in the nation (South Africa Yearbook 1999:288-90).

The Department of Trade and Industry also pursues more generic investment promotion initiatives aimed at foreign investors such as marketing South Africa as an investment destination, conducting investment missions, investment facilitation services, and investment incentives (Accelerating Growth and Development: The contribution of an integrated manufacturing strategy – Department of Trade and Industry, 2003:46-7). A primary example of the type of investment incentives offered for foreign investors is the Foreign Investment Grant (FIG). The Foreign Investment Grant provides 15% cost recovery (up to a maximum amount of R3m per entity) for foreign entrepreneurs to transport into South Africa, new machinery and equipment as part of their invested capital (DTI website 2004).

Other support mechanisms employed by the Department of Trade and Industry to support foreign direct investment include the Foreign Direct Investment Scheme (FDIS), the Export Marketing & Investment Assistance Scheme (EMIA), and the Inward Investment Missions Scheme (IIMS) all of which provide financial assistance to exporters to partially cover costs incurred in the process of recruiting new foreign direct investment into South Africa (Department of Trade and Industry website 2004).

5.5.1. (a) Manufacturing industry

Although South African economic activity can be categorically divided into major-divisions, divisions, and further sub-divided into major groups and subgroups, (or alternatively into sectors and industries) the Department of Trade and Industry is organized to attend mostly to the needs of the manufacturing industry. The Motor Industry (regulated by the DTI's Directorate: Motor Assembly and Components) has benefited significantly from international competition and accordingly has been one of the largest recipients of foreign investment of any manufacturing sector since April 1994. Measures taken by the Directorate to increase competition in this industry include a gradual reduction in tariff

protection and the abolition of local content requirements. At the same time, the directorate introduced a range of incentives for both domestic and foreign investors that are designed to upgrade the capacity of the industry in all spheres (DTI Annual Report 1996-7:48-54).

5.5.1. (b) External trade and investment relations

Although there is not yet in place a multilateral system for the promotion and protection of foreign direct investment, South Africa does have a number of bilateral agreements entered into by the Department of Trade and Industry and foreign partner governments. Bilateral Investment and Protection (BIP) agreements generally stipulate that, *inter alia*, investors should receive national or most favored nation treatment, that investors or investments will not be treated in a discriminatory manner and they will receive fair, equitable and just treatment. While investments may be expropriated (normally only for a public purpose) such action gives rise to the right of market related compensation which shall be prompt, adequate and effective. The agreements also guarantee the right to transfer of profits and remittances and other transfers related to investments, including the repatriation of investments themselves. By 1997, South Africa was in the process of *negotiating* BITs with over 20 other countries and had signed BITs with Austria, Canada, Cuba, Denmark, France, Germany, Netherlands, South Korea, Switzerland and the United Kingdom (Annual Report - Department of Trade and Industry 1996-7:100 -102). By March 1999, 28 bilateral investment treaties had been entered into by South Africa (South Africa Yearbook 1999:285).

5.5.1. (c) Company Registrars Office

The Company Registrars Office exists as a chief-directorate within the Department of Trade and Industry and is responsible for the provision of efficient and speedy companies registration services to both domestic and foreign businesses (DTI Annual Report 1996-7:109). These registrations are governed under the legislation encapsulated in the Companies Act 61 of 1973, the requirements of which do not differentiate, to a significant degree, between foreign and local investors in terms of establishing a business enterprise in the country. The following specific references to foreign investors can, however, be noted:

(i) Chapter XIII (ss 322-336) of the Act requires that external (foreign) companies must, within twenty-one days after establishment of the place of business in the Republic, lodge with the Registrar a certified copy of its Memorandum and Articles of Association, a list of the names and addresses of the directors, and the names and addresses of one or more persons resident in the Republic and authorized to accept service of process and notices on behalf of the company. The Registrar must be advised of any alteration in the names and addresses of these persons.

(ii) Every external company shall appoint and shall at all times have an auditor within the meaning of this Act and shall not later than fourteen days after such appointment or any change in office of the auditor, lodge with the Registrar in the prescribed form a notice stating the name and address of such auditor or the change in such office.

(iii) Lastly, an external company must lodge with the Registrar annual accounting records.

Importantly, the Act requires that the Registrar, upon receiving payment of the prescribed registration fee, '*shall register the said memorandum in the register*

kept by him under section 5, distinguishing the registration from the registrations in respect of companies incorporated in the Republic'. This is an important requirement and can be taken as a first and important step in the process of MNE regulation as it assists in distinguishing foreign from domestic firms, thus facilitating the processes of promoting, monitoring, and controlling foreign investment in the country.

By 1999, the Registrars office was concerned solely with the task of registering and licensing businesses, and the financial data they required to accomplish this task was not being captured or made available to other government departments or agencies (Interview with Deputy Director- Company Registrars Office- April 1999)(DTI Annual Report 1996-7:108-9). This deficiency in record keeping and information sharing was indicative of both a lack of appropriate information systems and administrative coordination between government departments. These deficiencies have been identified and are currently being addressed by the Registrars Office.

5.5.1.(d) Department of Trade and Industry - Directorate: Technology Promotion

The Directorate: Technology Promotion in the Department of Trade and Industry is responsible for overseeing the provisions of The Inventions Development Act, 1962 (Act No 31 of 1962) which calls for "the promotion of and development and exploitation in the public interest of certain discoveries, inventions and improvements and to establish a South African Inventions Development Corporation and to prescribe its powers and functions and the manner in which it shall be managed and controlled" (DTI website: www.thedti.gov.za). The Directorate is also responsible for administering the Technology Transfer Guarantee Fund, the aim of which is to make local and international technology available to South African Small Medium and Micro Enterprises (SMMEs), (DTI website: www.thedti.gov.za). With respect to foreign direct investment, it can thus be observed that the Directorate: Technology Promotion is the Governments

main institutional role player with respect to the execution of technology transfer policy. It can further be observed that the policy approach of the government in this regard, is one of support and facilitation rather than of control through, for example, a body of technology transfer laws that places restrictive and local participative requirements on potential investors.

5.5.2 Competition Commission

The Competition Act, 1998 (Act 89 of 1998) provides for the establishment of a Competition Commission consisting of an Inspectorate and an Adjudicating Body. Although the Competition Commission is an independent advisory body that is attached to the Ministry of Trade and Industry, its decisions may be appealed to the Competition Tribunal and the Competition Appeal Court (South Africa Yearbook 1999: 285).

The functions and duties of the Competition Commission are specified by Section 21 of the Competition Act. These functions and duties include investigating anti-competitive conduct in contravention of the Act; assessing the impact of mergers and acquisitions on competition and taking appropriate action; monitoring competitive levels and market transparency in the economy; identifying impediments to competition and playing an advocacy role in addressing these impediments (DTI website: www.thedti.gov.za).

While striving to meet these goals, the Competition Commission must also balance these against the broader social and economic goals as outlined in the Act, such as employment, international competitiveness, efficiency and technology gains, as well as the development and promotion of small and medium sized businesses and firms owned or controlled by historically disadvantaged persons. The Competition Commission attempts to facilitate the achievement of this wide array of goals by working collaboratively with other regulatory authorities (DTI website: www.thedti.gov.za).

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Although competition policy normally does not distinguish between foreign and domestic companies, large foreign investors who may be in a position to dominate particular industries or markets (a dominant position, according to the Act, is defined as a market share of 35 percent or more) are also subject to control under the competition law regime (South Africa Yearbook 1999:285)(Muchlinski 1995: chapter 11).

5.5.3 The South African Reserve Bank (SARB)

The South African Reserve bank is the central bank of South Africa, and as such it is tasked primarily with "[protecting] the value of the currency in the interest of balanced and sustainable economic growth in the Republic" (section 3 of the South African Reserve Bank Act 90 of 1989; Cf. section 224 of the Constitution - Act 108 of 1996). One of the key instruments historically used by the Bank towards this end has been exchange control policy. Exchange controls focus on controlling the flow of funds and capital assets into and out of the country in order to stabilize and maintain sufficient levels of the country's gold and foreign currency reserves (Mollentze 2000:38).

In 1961 the South African government introduced exchange controls for non-residents only. This policy initiative effectively created a dual exchange rate system whereby certain foreign equity investments into South Africa were carried out in financial rand, while all other transactions were conducted in commercial rand. By 1971 the Reserve Bank had also implemented a policy of exchange controls on South African residents.

The turnaround in the Governments reliance on strict exchange controls to stabilize the value of the currency began to take place around the mid-80s, corresponding with the recommendations of the De Kock Commission. In 1983 the financial rand (and thus the dual exchange system) was abolished. Further, with the dismantling of the system of apartheid, South Africa's full participation in

the global economy was welcomed by South Africa's trading partners (Mollentze 2000:39). In order for South Africa to successfully integrate into the global economy, South Africa had to open up its economy to both inward and outward trade and foreign direct investment. This global economic integration thus required, among other, the gradual removal by South Africa of exchange controls that served to hinder the cross-border flows of capital and goods (Quarterly Bulletin – SARB – March 1999:40).

5.5.4 Department of Minerals and Energy

South Africa's mining industry has, since its inception, been one of the key pillars of the South African economy. By 1997 the industry accounted for approximately 10 percent of gross domestic fixed investment (GDFI) while sales of primary minerals alone accounted for 40 percent of total export revenue. (South Africa Yearbook 1999:97). The government department that is responsible for exercising executive and administrative control and regulation over the mining industry is the Department of Minerals and Energy. With regards to mining policy, the primary objectives of the Department are to:

- Promote exploration and investment leading to increased mining output and employment;
- Ensure security of tenure of mining rights;
- Address past racial inequities by assisting those previously excluded from participating in the mining industry to gain access to mineral rights;
- Recognize the responsibility of the State as custodian of the nation's mineral rights; and
- Take reasonable legislative and other measures, to foster conditions conducive to mining which will enable entrepreneurs to gain access to mineral rights on an equitable basis.

Policy reforms undertaken by the department have been particularly influenced by the regulatory proceedings occurring in the areas of labor legislation, environmental legislation, and the international competition for inward direct investment in the minerals sector from developed and developing countries (Green Paper, 1998 - Mineral Policy for South Africa). In working through policy reforms, the Department has identified the following factors for consideration (Green Paper, 1998 - Mineral Policy for South Africa):

- The South African mining industry, one of the country's few world-class industries, has the capacity to continue to generate wealth and employment opportunities on a large-scale.
- Mining is an international business and South Africa has to compete against developed and developing countries to attract both foreign and local investment. However, many mining projects in South Africa have tended to be unusually large and long term, requiring massive capital and entailing a high degree of risk.
- South Africa has an exceptional minerals endowment, and in several major commodities has the potential to supply far more than the world markets can consume.
- As articulated in its macroeconomic strategy, Government has committed itself to a continuing process of economic liberalization, thus strengthening the competitive capacity of the economy, fiscal and tariff reform and bureaucratic deregulation. These are essential steps towards enhancing the country's competitiveness, attracting foreign direct and portfolio investment and creating a climate conducive to business expansion. The mining industry among others will benefit in the long term from these developments.
- By its very nature the mining industry has the potential to endanger human health and safety as well as the physical environment. It is the responsibility of Government to establish a regulatory framework that

minimizes such dangers without imposing excessive cost burdens on the industry and thereby jeopardizing its economic viability.

Mineral rights policy is an important aspect of mining policy in general. South Africa's current system of mineral rights is a dual system that allows for the ownership of mineral rights by the State as well as by private owners. The present governmental administration, however, is of the belief that it's objectives as set out above cannot be met under the present system. In place of the status quo, the State has articulated the following sub-objectives in respect of mineral rights (Green Paper, 1998 - Mineral Policy of South Africa):

(i) Government recognizes the inherent constitutional constraints of changing the current mineral rights system, but it does not accept South Africa's system of dual state and private ownership of mineral rights;
(ii) Government's long-term objective is for all mineral rights to vest in the State;
(iii) State-owned mineral rights will not be alienated;
(iv) Government will promote minerals development by applying the "use it or lose it" principle; and
(v) Government will take transfer of mineral rights in cases where a holder of mineral rights cannot be readily traced or where mineral rights have not been taken cession of and are still registered in the name of a deceased.

The Department's policy towards foreign direct investment is further expressed in tax legislation that is unique to the mining industry. The rationale for having a specialized tax structure for the mining industry is based on the fact that (Green Paper, 1998 - Minerals Policy for South Africa):

a) the risk to reward ratio in exploration is high, and mining itself is attended by a high degree of geological, project and market risks;
b) particularly in big-scale and deep-level operations large amounts of capital are required. This capital is at high risk over a long period;
c) mining companies are usually required to provide their own infrastructures because of the remote location of mining deposits;
d) mining involves the realization of a wasting asset and the mine has little or no residual value. Continuing investment is therefore necessary in exploration, the acquisition of rights to mine and the development of new mines. All these activities form an essential part of the mining business cycle;
e) taxes that increase mining costs have the effect of increasing the cut-off grade of ore, thus reducing the life of a mine and sterilizing mineral assets. It has therefore long been recognized that, in principle, mines should be taxed on profit and not in a manner which increases costs;
f) In view of international competition for investment funds, the tax system should be designed to assist in attracting and retaining investment in South Africa;

Thus this is in line with the above-mentioned basis for mining taxation, Government's tax policies for the mining industry are aimed at (Green Paper, 1998 - Minerals Policy for South Africa):

(i) ensuring that the tax regime will be consistent and stable and that the aggregate rate of tax will be internationally competitive;
(ii) seeking, wherever possible, to minimize taxes which increase the costs of mining; and
(iii) ensuring that the tax system does not inhibit mining but encourages the efficient use of resources.

Foreign investors thus find that South African mining policy seeks to offer investors, in general, a cost effective investment option through a tax scheme that is favorable to mineral prospecting and exploration. In terms of ownership, however, investors are no longer assured of the right of ownership over mining land nor the right to conduct mining operations on that land. These rights are to be vested in the State.

Foreign investors will also find that they will be held to greater account for the negative externalities of their activities in this sector. However, although the State is in the process of legislating remedial measures to be placed on mining operators that require the recovery of the costs for environmental damage, pollution, ecological degradation and/or harm to human health caused by such operators, the Department spent R20 million during the 2002-2003 fiscal year on the rehabilitation of abandoned mines. Of this amount, R17 million was spent on rehabilitating asbestos mines alone (Mineral and Petroleum Resources Development Bill 2002, section 42; Cf. Department of Minerals and Energy – Annual Report 2002/3: p.14)

5.5.5 Department of Environmental Affairs and Tourism

The Department of Environmental Affairs and Tourism administers, among other legislative Acts, the National Environmental Management Act (Act No. 107 of 1998). The Act recognizes, in it's preamble, that "…*everyone has the right to have the environment protected, for the benefit of present and future generations, through reasonable legislative and other measures that - prevent pollution and ecological degradation; promote conservation; and secure ecologically sustainable development and use of natural resources while promoting justifiable economic and social development*."

According to this legislation (and the Bill of Rights of the Constitution, Act 108 of 1996), the people have the power to hold government accountable for abuses to

the environment caused by government or any other transgressors as the environment is considered (by government) to belong to all the people of the country (White Paper - Environmental Management Policy for South Africa 1998:20). Thus, government's responsibilities with respect to the alienation of public resources (such as renewable and non-renewable natural resources) are to ensure that the people of the country are not substantially disenfranchised by the unchecked transfer of ownership of land and other public resources to private investors (White Paper - Environmental Management Policy for South Africa 1998:20). Further, section 28 of the Act places a duty of care and remedial repair on those persons and/or organizations who cause environmental damage, pollution or harm to human health. These persons/organizations are also responsible for the costs of further preventive measures to reduce the risks of re-occurrence of any of the aforementioned violations.

Table 5.1

Summary of FDI related policies as per responsible institution

Department of Trade and Industry	**Competition Commission**	**South African Reserve Bank**	**Department of Minerals and Energy**	**Department of Environmental Affairs and Tourims**
Spatial Development initiatives	Competition policy	Exchange controls (gradually being phased out).	Mining industry tax legislation	
Investment incentives			Power to expropriate land and impose remedial costs on mining investors	Power to expropriate land and impose remedial costs on mining investors
Bilateral Investment and Protection Agreements				
Companies registration				
Technology transfer				

5.6 Alternative policy options reviewed

It is possible to compare ideological approaches and policies along the continuum of liberal/non-interventionist to conservative/insular. Summarily, the two extremes of this continuum can be depicted as in table 5.1.

Table 5.2

Liberal versus conservative policy options

Liberal/non-interventionist	**Conservative/insular**
Investment incentives	Screening laws
Lack of specialized controls over FDI	Indigenization laws
Export processing zones and related policy enclaves	
Regional, bilateral and multilateral liberalization agreements	

(Adapted from Dunning 1993:554-560 and Muchlinski 1995:172-3)

To have a basis of comparison for the liberal/interventionist approach to foreign direct investment, the conservative/insular approach is discussed next in further detail. The former approach will not be discussed at this juncture as it has already been covered under the foregoing subtopics of this chapter (Supra. Par. 5.5).

Policies that fall under the conservative/insular approach are normally undertaken at either the stage of entry of foreign direct investment into the country (screening laws) or during the operational phase in which the multinational enterprise is already established in the host country and will then have operating, performance or other requirements imposed on it (Dunning

1993:554-560)(Muchlinski 1995:172-3). Screening laws, and indigenization laws are briefly explained hereunder.

5.6.1. Screening laws

Screening laws refer to the evaluation, case-by-case, of the suitability of inward investment proposals in lieu of granting authorization for the investment to take place. Screening laws are one of the most commonly used methods of regulating foreign direct investment and have been used by countries that are both liberal towards foreign direct investment as well as by countries that are not. Countries of the former type welcome foreign investment but are also concerned about the loss of national (economic, political and social) sovereignty or adverse economic consequences that may accompany such investments under certain circumstances, whereas countries of the latter type are ideologically bound to limit inward direct investment for the sake of national sovereignty (Muchlinski 1995:194-5). Screening laws often come with conditions attached. These conditions are usually in the form of performance requirements that aim to ensure that the investor contributes positively to growth and development through such performance related measures as minimum export requirements and local content requirements in production processes (Muchlinski 1995:195; Cf. Dunning 1993:559).

There is no institutional mechanism in place in the South African context to impose screening laws. This is not necessarily a criticism as screening laws are generally thought to inhibit the flow of inward direct investment and additionally, South African policy tends to lean to the liberal side of the policy continuum outlined in tables 5/2 and 5/1. Thus in maintaining consistency between (and aligning) the ideological approach of government to the types of policy instruments used, screening laws do not and should not feature in any proposed rationalization effort.

5.6.2 Indigenization laws

Indigenization laws tend to have a converse relationship to laws that exercise specialized controls over foreign direct investment and may appear in three forms. Firstly, and most commonly, are indigenization laws that place legal restrictions on the percentage of ownership that can be held by foreign interests in local companies. Secondly, there are indigenization laws that aim to give citizens of host countries the opportunity to purchase shares in investing foreign firms. It can therefore be seen that the rationale behind the first two types of indigenization laws described above, is to increase the participation of host state nationals in the economy. A third type of indigenization law is in the form of restrictions on the participation of foreign investment in certain sectors of the host states economy. This type of restriction is usually motivated by the perceived need to protect, from foreign domination, industries that are relevant to national security and defence, as well as industries that are considered to be culturally significant (eg. media and broadcasting industries) (Muchlinski 1995:175-185; Cf. Dunning 1993:559).

In the South African context, although there are no distinct indigenization laws in place, certain culturally sensitive industries, such as the South African Broadcasting Company are run as parastatal organizations under the direct ownership and control of the government. Likewise Denel, the State's defence manufacturer is also a government parastatal, although it has recently been partially privatized. This being the case, the need for indiginization laws is partially mitigated as long as foreign ownership and control of defence and cultural industries is government controlled through other operational strategies.

5.7 Conclusion

From the foregoing discussions of this chapter and particularly with respect to the categorization of foreign direct investment policy approaches as depicted in tables 5.1 and 5.2, it can be discerned that South African public policy vis-à-vis foreign direct investment is formulated from a liberal approach that encourages (rather than restricts) this type of investment. This being the case, there is little evidence of specialized controls that restrict the entry of the foreign direct investment of multinational enterprises. Rather, especially since the lifting of the veil of apartheid, Government has put measures into place to encourage and boost the levels of inward direct investment into the country as a means of addressing the country's low savings and investment rates as well as to improve the level of development of the country. Although these foreign direct investment promotion measures were discussed in relative detail, it must be noted that the specifics of the exact number, characteristics and qualifying conditions of incentives and other promotional measures tend to change over time. Even so, the general tone of the policy approach remains consistent over the long term.

The processes of establishing and operating a foreign business in South Africa currently involves administrative oversight from more than one government department. This is because the activities of foreign firms within the country are expected to fall within the functional responsibilities of several departments. As identified in this chapter, the most relevant departments in this regard are the departments of Trade and Industry, Minerals and Energy, Environmental Affairs and Tourism as well as the South African Reserve Bank.

There appears to be a high level of consistency across the South African public sector in what is being articulated as the government's policy towards foreign investors, however, there are issues of coordination that need to be addressed. More specifically, the powers and functions of the minister of Minerals and Energy, and those of the minister of Environmental Affairs and Tourism overlap

in certain critical areas. Thus, for example, The Minerals and Petroleum Resources Development Bill (Notice 541 of 2002) and the National Environmental Management Act of 1998 (Act No. 107 of 1998) both empower their respective ministers to expropriate land and/or impose remedial costs for damages caused by investors. Without the duty on the part of both ministers to inform and cooperate with each other in these gray areas, loopholes in the legislative framework may be created. Although it is possible that the current South African Cabinet committee system may to some extent fulfill this coordinating function, it can also be discerned that coordination needs to take place not just at the Executive cabinet level. Coordination of foreign direct investment policies that are specific to the investment of multinational enterprises must occur at all levels of policy analysis, policy drafting and implementation. What may be needed is the creation of a coordinating body or institution that will stay abreast of all policies and legislation applicable to foreign investors and will thus be in a position to ensure a coordinated effort on the part of government with respect to regulating investment (both domestic and foreign). With this in mind, the next chapter addresses issues of coordination, rationalization and other organizational dynamics.

Chapter 6

Rationalization of Foreign Direct Investment Policy Structures in the South African Government

6.1 Introduction

Extending the discussion of the previous chapter (Supra. chapter 5) where it was shown that South Africa has no unit (department, directorate, sub-directorate or advisory council) of government that is exclusively responsible for overseeing and/or administering policy on the foreign direct investment of multinational enterprises, the current chapter seeks to further explore the extent to which foreign direct investment policy in the South African government may be rendered ineffective given the highly fragmented and decentralized nature of these policy dynamics. To this end, and against the backdrop that the central objective of this study is to test the hypothesis – *Ho = There is a necessity to formalize a government administrative structure for policy setting and implementation of Multinational enterprise (MNE) regulation in South Africa*; if the null hypothesis is not disproved this chapter aims to partially resolve this hypothesis by assessing the prospects offered for remedial relief by the analytical paradigms of organization theory with specific reference there under, to rationalization or alternatively structural re-organization.

6.2 Defining rationalization, organization and organization theory

6.2.1 Defining rationalization

Although the term rationalization is used with great frequency in the public administration discipline, ironically, it is also a term that has received little attention within the discipline in terms of being formally defined. As a starting point for reconciling the way in which the term rationalization is to be used in this thesis, reference is made to the definition offered by Banki (1981). Banki (1981) very generally defines rationalization in the management context as "…*referring to the principles, methods and processes which are aimed at and utilized in achieving, maintaining or increasing overall organizational or system efficiency*." Thus, from Banki's (1981) definition any management processes or activities that are designed to increase overall organizational efficiency can be considered to be part and parcel of the process of rationalization. This definition of rationalization is in-effectively broad and thusly does not make allowance for a pragmatic application of the term.

Alternatively, Parsons (1995:15-6) discusses rationality, and thus by default rationalization, under the auspices of policy-making stating that "…*to have a policy is to have rational reasons or arguments which contain both a claim to an understanding of a problem and a solution*." The implication being that to rationalize is to develop and implement problem-solving policies that are based on an assured understanding of both the problem at hand as well as its solutions. Parsons (1995) further states that "…*As Max Weber showed, the growth of industrial civilization brought about a search for more rational forms of organization for the state, commerce and industry*." Parsons (1995) definitions of rationality and rationalization are far less general than those of Banki (1981).

Yet, while Parsons (1995) is theoretically complete in his definitions, these definitions are not practically definitive in relating the types of problems and solutions to be dealt with, nor the types of organizational restructuring implied thereof. Roux et al. (1997:39) indirectly address these definitional shortcomings by relating the term rationalization to the reduction in the number of South African public executives institutions from the mid 1970s onwards that was based on reducing redundancy through extensive analyses of the functions of all of the various public executive institutions.

In order to give greater clarity of meaning to the context in which the term rationalization is used in this text, it can be noted that although the terms rationalization and re-organization are often used interchangeably in the literature, there are slight nuances that can be asserted between the terms. In this regard, the term rationalization is generally used to refer to streamlining by eliminating redundant activities through the compartmentalization and departmentalization of related work activities (Roux et al. 1997:39-40; Cf. Bellone 1980:10-12), while re-organization, on the other hand, is used to refer to the reconfiguration of existing institutional structures (e.g. structural changes to the organization's organogram) with the aim of seeking greater efficiency and effectiveness in the carrying out of work related activities (Hogwood and Peters 1983;69-70; Cf. Chandler and Plano 1982:147-8; Cf. Gortner et al. 1987:chapter 4). Based mainly on the lack of specificity in differentiating these two terms in the literature and in an attempt to take as broad and holistic an approach as possible, for the purposes set forth in the problem statement, hypothesis and objectives of this dissertation, the two terms shall herewith be used interchangeably. Thus, rationalization is taken here to refer not only to reductionism in government, but also refers to re-configurations of organizational structures.

6.2.2 Defining organization and organization theory

Although the literature suggests that there is no authoritative definition of the term *organization*, this same prose simultaneously stresses that it is imperative that a general understanding of the term be posited prior to discussion of the broader concept of *organization theory* (Meyer 1985: 58; Cf. Roux et al. 1997:7-8). Generally and very vaguely, the term organization is applicable to every aspect of human interaction wherein a large and/or complex task is tackled by a group of persons working in concert rather than by a single individual working alone (Meyer 1985:58; Cf. Farazmand ed. 1994:55). Defining organization in this way, it can be ascertained that organization is by no means a modern concept. Even the most ancient and primitive of men were able to organize themselves for the betterment of their collective social groupings (Roux et al. 1997:3-4).

Organization theory, in contrast, seeks to explain the formation, functioning and termination of organizations. In it's most elemental interpretation, and focusing on its functional and operational implications, organization theory can be thought of as that branch of the social sciences that is fundamentally concerned with the efficient performance of the organization in as far as performance is dependent upon the internal and external structural relationships of the organization. Thus organization theory focuses internally mostly on the hierarchical relations within the organization, and externally on the influence that the environment external to the organization may exert on the organization (Meyer 1985:43-6; Cf. Roux et al 1997:8).

Organization and/or organization theory can further be understood within the contextual frameworks of both public policy making and public administration. In respect of the former, the public policy cycle can be described as the stages

through which any public policy must progress in order to become operational and organizing is a key component in this progression. In general, the policy cycle would normally include the following stages (Hogwood and Peters 1983:8):

(a) Agenda-setting – in which problems existing in the society are perceived as requiring some actions by government to correct them, and those problems are moved on to some sort of official agenda for resolution;
(b) Policy formulation – in which the policy instruments which will be used to attempt to alleviate the difficulties perceived in the environment are designed;
(c) Legitimation – in which the policy instruments are accorded the authority of the state, through some form of official action. This action may be legislative, regulatory, or popular, for example, initiatives or referenda;
(d) Organization – in which some organizational structures are developed to administer the policy. This may, of course, simply involve assigning the policy to an existing organization rather than creating an entirely new structure;
(e) Implementation – in which the administrative structures attempt to make the policy work in practice;
(f) Evaluation – in which the outputs and consequences of the outputs are analyzed and assessed according to some criteria; and
(g) Termination – various procedures have been developed to make organizations and other policymaking bodies consider termination of organizations and functions more often than they might otherwise.

In the policy making cycle, therefore, it can be argued that the best made policies will not be implemented properly where the suitability of the organization structure has not been examined. The importance of organization in the policy

making process thus relates to the manner in which it provides the appropriate mechanisms through which efficient service delivery can take place.
From a public administration perspective, organization can also be defined as one of the key generic administrative functions of public managers (Roux et al. 1997:8-11). These generic functions can be summarized as follows:

- policy making;
- organizing;
- financing;
- personnel;
- determination of work procedures; and
- control

Although organizing is claimed by both the political science (public policy making) and public administration fields of study as belonging to their particular genus, the mechanisms of the process of organizing remain the same regardless of the paradigm that claims ownership of it. Somewhat over-simplistically, under either paradigmatic discourse, organizing roughly entails the arrangement of work activities and the development of the hierarchical structures within which this work is to take place. Thus once policies are put in place in the policy making process or plans are finalized and readied for implementation in the public administration field, the next step is to ensure that the most optimal organizational structure for carrying out those polices and plans are in place (or developed).

One of the most comprehensive and eclectic definitions of organization is that proposed by Meyer (1985). Meyer (1985:57-60) contends that almost every definition of organization contains some or all of the following five elements (to a

greater or lesser degree) – identity, purpose, structure, boundaries, and interchange with environments. More specifically, identity is associated with the name given to an organization. The name of an organization helps to differentiate it from all other organizations as well as providing information (among other) about the organizations mission, goals, output and ownership. As the second defining element of organization, purpose is what makes formal organizations differ from informal organizations. Purpose being here defined as - reasonably well defined tasks and the attendant accountability for carrying out those tasks. Structure, the third defining element of organization, is present in most formal organizations and is the element that makes it possible to break complex tasks into smaller and more manageable ones through such mechanisms as specialization and delegation. Boundaries is yet a fourth defining characteristic of organization, as it is important for defining the organization's internal and external environments in terms of certifying who may or may not constitute the organization's membership. Boundaries are far more clearly defined for formal organizations than for informal groupings of people. Lastly, the organization's interchange with the environment refers to the process by which inputs are acquired from the environment and outputs flow from the organization to the environment. While the organization's existence depends on the cyclical flow of this interchange with the environment, the same is not necessarily true of informal group structures.

In the sub-sections that follow, the overarching attempt is focused on gaining a meaningful understanding of contemporary organizations with particular attention being paid to seeking direction on identifying the fundamental issues associated with efficiently and effectively establishing new organizational units or alternatively re-structuring existing organizational units to accommodate new policy initiatives. This mostly academic exercise begins with an exposition of the

evolvement of classical and neo-classical organization theory to it's current contemporary state and ends with an exploratory comparison of contemporary divergent thinking on organizations. To this we now turn.

6.3 Evolvement of organization theory

Mapping out the development of organization theory chronologically, three distinct yet partially overlapping schools of thought can be identified – these are the classical, neo-classical and contemporary organizational perspectives (Roux et al. 1997:chapter 2; Cf. Farazmand 1994:chapter 1; Cf. Kramer 1981:chapter 4). Each of these is discussed in turn hereunder.

6.3.1. Classical organization theory

Common usage of the term bureaucracy has over the years become synonymous with the term organization generally, and more specifically it describes a distinct type of public organization. That is, bureaucracy is commonly understood to refer to public organizations in which power resides in the hands of public officials rather than with politicians or citizens and voters (Kramer 1981:83; Cf. Weiss and Barton ed. 1980:7). Furthermore, bureaucracies are also commonly associated with organizations plagued by inflexible rules of operation (Weiss and Barton ed. 1980:7). One of the earliest recordings of the usage of the term bureaucracy dates back to 1745 and is attributed to Vincent de Gournay, a French Physicist and philosopher (Kramer 1981:83). Since then the term has been further popularized in the eighteenth and nineteenth centuries and especially so in the early 20th century in the works of Max Weber. The contemporaries of Weber during this time were Frederick W. Taylor, Luther Gulick, and Henri Fayol. In fact, the publications of these four

notable contributors to the discipline of formal organization studies are normally classified together under the heading of classical organization theory (Farazmand 1994:8-11; Cf. Roux et al. 1997:19-24). Roux et al. (1997:19) make a further useful division of the school of classical organization theory into three relatively distinct strains – i.e., the bureaucratic approach of Max Weber, the scientific management approach of Frederick Taylor and the administrative theories of Henri Fayol. Following along the lines of the analysis of classical organization theory made by Roux et al. (1997), the discussion that follows reviews the bureaucratic approach, the scientific management approach and the general administrative approach in turn.

6.3.1 (a) The bureaucratic approach

In addition to Taylor, Gulick and Fayol, Karl Marx may also be considered as a fifth notable contributor to classical organization theory by way of his propagation of political, sociological and economic ideas that served as important antecedents of the classical organization genre. Although the writings of Karl Marx (1818-1883) cover a broad spectrum of academic disciplines, his contributions to and influence in the area of organization studies relate to his analysis of systems of government and how they may or may not empower or support the relationship between labor and capital. Thus, for example, Marx proposed that capitalist societies tend to subordinate the interests of labor to those of capital (those who own and control the means of production). In this regard, some of the areas covered in his works include scholarship on such themes as hierarchy, power and authority, autonomy and freedom, and contradictions and crises, all of which in turn relate directly to issues of efficient and effective organization (Farazmand 1994:5-7).

Amongst the classical organization theorists, Max Weber was arguably the most influenced by the work of Karl Marx (Farazmand 1994:9; Cf. Kramer 1981:83-5). In line with Marx's thinking, Weber was also fundamentally concerned with "…*the relationships between power – the ability to make people do what they do not ordinarily do – and authority – legitimate power*"(Kramer 1981:83). Additionally, Weber strongly believed that bureaucracy was the most efficient form of organization. In fact he defined an 'ideal type' bureaucracy which possesses the following characteristics (Roux et al. 1997:23; Cf. Farazmand 1994:9):

1. A well planned hierarchy with clearly defined areas of authority and responsibility;
2. A clear division of work to make specialization of functions possible;
3. A system of rules and regulations depicting the rights and responsibilities of the holders of positions, as well as a system of well-prepared procedures pertaining to the way in which the work and functions have to be performed;
4. A system of strict and systematic discipline and control within which the workers have to operate;
5. Merit based recruitment and promotion; and
6. Maintenance of files and records for future administrative action

As with most other proponents of classical organization theory, Weber believed that a highly structured and tightly controlled organization was the only type of organization that could operate efficiently. His 'ideal type' organization was prescriptive rather than descriptive and as such was intended to serve as a rational model to which organizations (public, private or other) were to aspire. Although Weber's ideal type model has been heavily criticized in recent times, it

is still a model that is widely prescribed to in today's modern organizations (Farazmand 1981:9).

Weber's model has been criticized for, amongst other, taking the organization's external environment as a given by assuming that greater internal efficiency is to be accomplished through focusing exclusively on internal organization or re-organization (Farazmand 1981:8-9; Cf. Roux et al. 1997:24-5). Critics also argue that Weber's ideal type bureaucracy pays little attention to how organizational efficiency can be enhanced through the acknowledgement and attempted satisfaction of human needs and aspirations. Further, it is also argued that Weber's approach leads to the build up of inflexible working arrangements by promoting red tape and delays in decision making (Farazmand 1981:9; Cf. Kramer 1981:87-8).

6.3.1 (b) Scientific management

As a point of departure along the organization theory line of reasoning, Frederick Taylor, Henry Gantt, Frank and Lillian Gilbreth, among others made up what came to be popularly known as the scientific management school. The central thesis underpinning this school of thought was the application of 'the scientific method' to the management process in general and to organizational dynamics in particular. Taylor's work was directed towards low skilled workers/laborers who occupied the bottom ranks of the organizational hierarchy. As a former engineer, Taylor proposed that similar to the design concepts incorporated in the production of factory machinery and equipment, human beings could also be made to be more productive through motion studies. It was thought, by the proponents of this school, that there was 'one best way' of doing any job. By establishing and training workers in this 'one best way', workers would

experience no wasted motion and effort, leading to greater productivity. Workers were also to be paid by the job rather than per hour as a further incentive towards greater output and productivity.

In terms of organizational dynamics, scientific management theorists believed that tight control and close supervision of workers was necessary to ensure that workers carried out their tasks according to strictly and scientifically established procedures. This mode of control was to be provided through a top-down authoritarian management approach that was mechanistic rather than organic, in which decision making was centralized rather than de-centralized, with narrow spans of control, inflexible chains of command and where work was departmentalized according to functional specialization (Kramer 1981:88).

The academic criticisms leveled against scientific management echo a similar resonance to that contained in the criticisms made against Max Weber's ideal bureaucracy. That is, the failure to recognize the effects of environmental and human relation forces on organizational efficiency made these models incomplete, unrealistic and unworkable. Despite these criticisms, the theory and practice of scientific management has also been credited with a number of significant contributions to modern living such as, for an example, the arrangement and standardization of typewriter keys to facilitate high-speed and efficient typing (Kramer 1981:89). Scientific management is also credited for being the conceptual foundation upon which more modern theories of organization are built (Roux et. al 1997:25).

6.3.1 (c) General Management Theory/Administrative Theories

As indicated above, classical organization theory was not confined to scientific management alone, but instead contained within it a second major stream of reasoning and theory that came to be known as the general management school of thought. Among the most prominent proponents of general management theory are Henri Fayol, James Mooney, Alan Reilly, Luther Gulick and Lyndall Urwick. Whilst scientific management focused attention on improving the work output of blue collar workers at the bottom of the organizational hierarchy, general management theorists focused on the supervisory and management levels of the hierarchy paying particular attention to what managers had to do or know in order to improve the organization's performance. In addition to framing elements of management – i.e. planning, organizing, supervision, coordination and control, Fayol also proposed fourteen principles of management which are (Roux et. al 1997:21):

- distribution of work;
- authority and responsibility;
- discipline;
- the subordination of individual interests to the general interest of the institution;
- reasonable remuneration of personnel;
- centralization of authority;
- scalar hierarchical authority;
- orderly hierarchical structure;
- equality in treatment of personnel;
- stable and guaranteed terms of service of personnel;
- emphasis on individual initiative; and

- maintaining the *esprit de corps*.

As can be seen from the above, the general management approach closely mirrors that of scientific management especially with respect to the stern belief in centralization and control, whilst however, general management was aimed at reforming management rather than blue collar workers/laborers. The work of Gulick and Urwick is also placed within the academic scope of general management theory. Gulick and Urwick's principle contribution to the field is in their taxonomic proposal of organizing principles that suggests that institutions should be structured according to four basic criteria, namely (Roux et. al 1997:22; Cf. Kramer 1981:90-3):

- according to objectives which need to be reached;
- according to process or function to be performed;
- according to the needs of the client to be served; and
- according to the geographical area where the service is required.

Gulick and Urwick recommended that the above four issues be evaluated and compared to determine the most effective way in which a particular organization should be structured. Thus, for example, an organizational unit can choose to be organized and divided into sub-units located in and serving several geographical areas where the resources and capacity exists to duplicate facilities and services to these several different areas, and where doing so would result in better service to clients; the same organizational unit may rather choose to operate from one central location in which defined objectives, functions, and types of clients are serviced through appropriately defined and structured sub-units if the benefits of doing so outweigh the costs. Although much of the work of Gulick and Urwick is representative of an outdated mechanistic way of thinking, the above four

principles have not been subjected to much criticism, perhaps owing to their timeless utility.

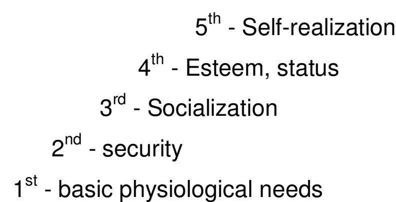
6.3.2 Neo-classical organization theory

The neo-classical school of organization theory developed out of a perceived need to address the shortcomings gleaned in the scientific management approach of the classical school of organization. Originating largely out of the pioneering work of Elton Mayo and Fritz Roethlisberger during the 1920s and 1930s, the neo-classical school particularly sought to draw the human factor into organizational analysis, design and management (Roux et. al 1997:25-7; Cf. Kramer 1981:97-8). Mayo and Roethlisberger of the Harvard Business School designed and conducted experiments aimed at determining whether efficiency in work tasks and productivity could be increased through improved work conditions. Although their experiments initially focused on the relationship between factory lighting and productivity, they did not manage to establish any such relationship. Instead, they came to the conclusion that where productivity increased it was not because of work conditions but rather because of the attention paid to and the importance given to employees needs. More specifically, and rather ironically, the intermediate findings of the Hawthorne experiments were that productivity increased whether factory lighting was increased, decreased or kept the same. Further experimentation led Mayo and Roethlisberger to conclude that productivity was primarily affected by the awareness of experimental subjects to the fact that they were being observed. This scientifically derived conundrum came to be popularly known as the Hawthorne effect.

In summary, the neo-classical school accepted the general propositions of scientific management and administrative management, but only on condition that they include the recognition of the human element in their analysis (Kramer 1981:101-3). Mayo and Roethisberger were supported in their neo-classicalist reflections by amongst others, Abraham Maslow and Douglas McGregor.

As with other scholars labeled as organizational humanists, Abraham Maslow approached issues of organization from the perspective of human psychological and physiological needs. Maslow believed that organizational performance was ultimately dependent upon the satisfaction of the needs of the employees of the organization. These basic human needs applied universally to all employees and were arranged hierarchically as in figure 6.1 below. Higher order needs could only be satisfied if the needs below them had also been met, and every person aspired to reach the highest order need identified, i.e. - 'self-actualization'. By allowing employees to strive to attain their own personal needs and goals within the organizational context, the organization would in fact be unleashing the positive and often hidden potential of its employees towards the furtherance of organizational performance (Kramer 1981:101-3; Cf. Golembiewski and Eddy eds. 1978:210-211).

Figure 6.1: Maslow's Hierarchy of Needs



Adapted from Kramer 1981:102

Douglas McGregor, a second important exponent of neo-classical theory, superimposed and analyzed Maslow's hierarchy of needs against Taylor's 'efficient organization' and Weber's 'ideal bureaucracy'. More specifically, McGregor hypothesized that 'classical' organizational structures were not conducive to the promotion of the needs of individuals in the organization. In making his case, McGregor identified two diametrically opposed organizational types or structures – namely 'Theory X' and 'Theory Y' organizations.

Theory X organizations are characterized as being structured according to classical organization principles and were defined as having the following general properties (Kramer 1981:103):

1. Management is responsible for organizing the elements of productive enterprise – money, materials, equipment, people – in the interest of economic ends;
2. With respect to people, this is a process of directing their efforts, motivating them, controlling their actions, modifying their behavior to fit the needs of the organization; and
3. Without this active intervention by management, people would be passive – even resistant – to organizational needs. They must therefore be persuaded, rewarded, punished, controlled – their activities must be directed. This is management's task – in managing subordinate managers or workers.

Further, the underlying assumptions upon which Theory X-type organizations were created include the following (Kramer 1981:104):

1. The average man is by nature indolent – he works as little as possible;
2. He lacks ambition, dislikes responsibility, prefers to be led;
3. He is inherently self-centered, indifferent to organizational needs;
4. He is by nature, resistant to change; and
5. He is gullible, not very bright, the ready dupe of the charlatan and the demagogue.

McGregror and other organizational humanists rejected this view of human nature and human behavior, attributing the Theory X mindset to classical organization theorists. Instead, McGregor subscribed to what he termed Theory Y thinking which he defined as harvesting directly opposing views to Theory X. Under Theory Y, employees are not considered lazy, but if they are found to be so, it is the organizational structure that is to be blamed rather than the employees themselves. That is, Theory X-type organizations create barriers for employees to advance up Maslow's hierarchy of needs. The lack of personal fulfillment experienced by employees would then lead to the dysfunctional behaviors indicated above. Thus, under Theory Y (Kramer 1981:105):

1. Management is responsible for organizing the elements of productive enterprise – money, materials, equipment, people – in the interest of economic ends;
2. People are not by nature passive or resistant to organizational needs. They have become so as a result of experience in organizations;
3. The motivation, the potential for development, the capacity for assuming responsibility, the readiness to direct behavior toward organizational goals

are all present in people. Management does not put them there. It is a responsibility of management to make it possible for people to recognize and develop these human characteristics for themselves; and

4. The essential task of management is to arrange organizational conditions and methods of operation so that people can achieve their own goals best by directing their own efforts toward organizational objectives.

McGregor's Theory X- Theory Y formulation is heavily biased towards Theory Y-type organizations. McGregor, therefore, was one dimensional and unrealistic in his thinking on organizations, as no one system or model can work in every given situation. More specifically, neo-classical organization theory is as incomplete in it's rationalizations as it's predecessor (classical organization theory) in that it favors one set of guiding principles over any other without taking account of any possible contribution(s) to be made by opposing views. Further research indicates that the Theory X paradigm is most effective in situations where the organization is faced with a stable external environment and has a task environment that is relatively routine, and the Theory Y-type paradigm is better suited to highly unstable and unpredictable external environments in which organizational survival depends on navigation through a highly innovative task environment (Kramer 1981:105-6). The openness to the possible contributions of a number of alternative organization theories is representative of the most recent thinking on organizations and is normally referred to as contemporary organization theory the discussion of which follows forthwith.

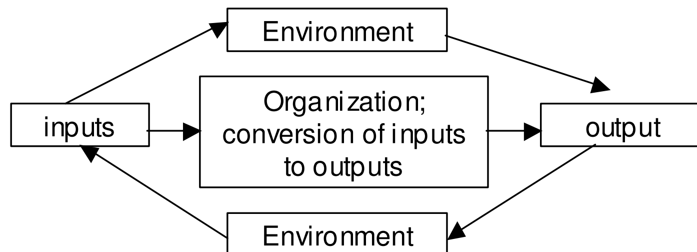
6.3.3 Contemporary Organization Theory

The more current theories of organization, contemporary organization theories, are based upon contingency and systems approaches. Contemporary writers do

not discard, at least in whole, the foundational elements of the classical and neo-classical schools of thought. Instead, contemporary models incorporate these elements and build upon them by taking account of the organization's external environment. To this end, contemporary organization theory rests on three key tenets that relate specifically to the environment, namely (Roux et. al 1997:28-33; see also figure 6.2 Infra.):

1. Taking account of the environment within which the organization operates, and thusly assuming that the organization is an open system that is affected by external forces;
2. Acknowledging that as an open system, the organization perpetuates it's survival by taking inputs from the external environment, processing these inputs internally, and producing an output that flows back out to the external environment; and
3. Acknowledgement of the fact that differing external environmental conditions will require contingent approaches with regards to organization theory, planning, and action.

Figure 6.2: A simple open system



Adapted from Roux et al. (1997:30)

At least one strong criticism can be made against contemporary theory. That being the lack of distinction made between public and private sector organizations. Public and private sector organizations have greatly divergent objective and task sets and face very different environmental forces. As a result, there is considerable room for the development of a sector specific approach to contemporary systems analysis and organizational structural design.

6.3.4 Optimum hierarchical structure recommended

From the foregoing discussions on the several and chronologically arranged theoretical bases of organization theory, it may correctly be discerned that in today's fast paced, competitive and dynamic environment, the most appropriate organizational theoretical analysis should follow along the lines of contemporary organization theory as it is the only paradigm to date in which environmental forces are taken account of. By the same token, however, classical and neo-

classical theories are not to be discounted as their principles are foundational to those of contemporary theory and may actually work out to be more efficient for organizations that face relatively stable and predictable external environments (Meyer 1985:49-51; Cf. Roux et. al 1997:32-3).

The structural design options available for organizing include, among others, the traditional forms of line; line and staff; functional and committee structures (Hodgson 1969:34-40). Large and modern organizations, such as those tasked with carrying out public policy in the public domain, incorporate elements of all four of these traditional forms in what is commonly referred to as a pyramidal structure (Hodgson 1969:40-60). The shape that a pyramidal structure tends to conform to is a function of, among other, the number of levels of authority; span of control specified for each authoritative position; and the degree to which decision making has been decentralized (Hodgson 1969:40-60; Cf. Roux et al. 1997:73-84).

In organizing, it may also be necessary to expand the focus of the organizing effort beyond the confines of the pyramidal structure defined. In other words, it is necessary to specify whether departmentalization will take place within the pyramid, or whether it must take place geographically (Hodgson 1969:40-60; Cf. Gortner et al. 1987:107-110). Where the geographical spread of clients is broad – creation, separation and distinction is required between a central office and those of geographically spread branch (regional, local etc.) offices vis-à-vis their differing objectives and responsibilities.

It is here recommended that for the case under study, the appropriate organizational structure within which foreign direct investment policies should be maintained should generally aim to be more mechanistic than organic as there

needs to be a comfortable level of stability in the policies to which investors, foreign and domestic, will be subjected. Also, departmentalization based on specialization is required given the degree of complexity and diversity of the domestic industrial sectors within which investment takes place. Specialization of departments is further supported by the fact that the proposed organization needs to have a broad scope of knowledge and expertise in such diverse fields as sustainable development, competition policy, and technology transfer. Additionally, geographical departmentalization may also be required if regulatory monitoring and control of investment strategies and activities is determined to be a high priority activity of the proposed organization. In terms of determining specific functions to be departmentalized geographically, the benefits of some functions such as registration and filing must be weighed against the costs involved in duplicating such functions across the country, especially in light of the fact that it should be relatively feasible for potential investors to correspond with a single centralized office.

Simultaneously, sensitivity to environmental forces may demand a more contemporary approach to various other organizational dynamics. For instance, the installation of performance management systems throughout the public sector requires a management by objectives approach to goal setting and performance monitoring thereby requiring lower levels of formalization and control. International environmental forces may also impose pressures on the proposed institution's regulatory framework thusly requiring the organization to be more flexible and organic in scanning the environment through its research functions and in the policy-making domain. Although it is envisioned that the institution is expected to play a largely regulatory role, sector and industry specific policy can also be expected to be generated from proposals to the legislature coming from the proposed organization. It is further recommended

that the establishment of the proposed organization be in the form of an independent institution that is part of government but separate from all other governmental departments. This is to ensure a more effective coordination role as well as to ensure that the institution can act without pressures of fear, favor and undue influence.

The commonality shared by all of the above theoretical approaches to structuring organizations is the attempt to provide answers as to how organizational performance can be assured and/or improved. In fact, it is commonly argued by organization theorists that "…*the choice of a particular form of organizational change should clearly turn on some estimate of its probable costs and benefits*" (Szanton 1981:10). To this end, organization theories are supported by other epistemological efforts that seek to quantify and measure the performance of public organizations. Thus, discussion of the measurement of the performance of public organizations and the implications this may have for organization structure follows.

6.4 Measurement of Organizational Performance and Structure

One approach to assessing the performance of public organizations is through the analysis of the programs and projects that these organizations may undertake as part of their functional responsibilities. Thus, given that organizations and their sub-structures come into existence to meet specified goals they must therefore be continually evaluated to measure their effectiveness in meeting these goals. The outcome of such evaluation may result in either a change in the goals required of the organization, change in the organization's procedures and methods, or change in the organization by way of growth, reorganization, or reduction. Thus, the importance of evaluation relates to its

implications for structural and required change in organization. The processes for conducting such evaluations in the public sector are addressed hereunder. The discussion begins with a brief review of some of the major complexities involved in public sector performance evaluation. This is followed by a discussion of the actual methods of evaluation for public projects and programs [Internal rate of return (IRR), Net present value (NPV) and cost-benefit analysis (CBA)] and the implications these may have for how organizations ought to be structured. The approach to evaluation taken in the South African public sector is also examined.

6.4.1 Public versus private sector program and project evaluation

Worldwide, there exists a strong current of opinion that private business operates more efficiently than public organizations as can be deduced from the culmination of the overwhelmingly international trend towards privatization. This public mind-set can be traced back to the earliest branching off within the field of accounting to form government accounting/public accounting (Meyer and Webster 1985:26-28).

In the United States (circa early1950s), for example, not only was there a drive within management circles in government to emulate operating practices employed in the private sector, but additionally the accounting practices of private industry were seen as an important tool for improved performance via the evaluation feedback loop. That is, public accounting moved beyond complete dependence on control through budgeting to adopt from private accounting such key changes in principles as the change from cash basis to accrual basis accounting for operational and reporting purposes (Meyer 1985:26- 28).

Unfortunately, this view of improving performance and efficiency in the public sector overlooked the fact that any activity, be it private or public has effects beyond those intended. As an imperative, these external effects must be taken account of if the objective is to make evaluation as complete, accurate, meaningful and useful as possible. Thus, when formulating an opinion on the performance of an organization (public or private) precaution must be taken such that one's view should not be limited to quantitative considerations of revenues and expenditures whilst overlooking the objectives of the organization and the outcomes of the organizations activities both quantitative and qualitative. As will become apparent from the discussion that follows, this is especially critical for public sector organizations.

6.4.2 Complexities of public sector evaluation

Szanton (1981:18) makes the point that "…*the truth that structural reorganization is painful, costly, and uncertain in outcome argues that it should not be undertaken until the evidence is clear that current structures are inadequate and that the changes proposed will actually improve matters*". The clarity of this point is underscored by the complexity of the task(s) involved in assessing administrative outputs and arriving at optimal solutions for actual or perceived inadequacies.

Three distinguishable and complicating features of evaluation of government programs can be identified. First, is the problem of determining the appropriate variables to use to represent such performance measures as benefits and costs (or gains and losses). The benefits to consumers of the construction of a road may include, for example, savings in the form of reduced costs for transported goods; reduced travel costs due to savings in petrol consumption; and time

saved as a result of reduced traffic. Determining and arraying these variables can prove to be a time consuming and difficult task.

Incompatible with the Pareto standard of efficiency (the Pareto efficiency standard defines as efficient that program or project that makes at least one person better off whilst at the same time making no other person worse off), most government programs affect several groups of stakeholders at once, producing gains for some and losses for others. Thus, given that governments are responsible to all of its citizens for their welfare and wellbeing, evaluation of government programs should include the benefits and costs accruing to all these citizens. For example, a government program may provide benefits to consumers through lower costs for services, while causing losses for both alternative suppliers of the service and taxpayers who finance the program. The gains and losses for all three stakeholders must be included in assessing the success of the program (Fisher 1988:26-7; Cf. Gramlich 1981:44).

Second, another complicating factor is that many of the variables considered as gains and losses are not easily quantifiable and thus measurable. In line with a government's obligations and commitments to its citizens, program benefits and costs must be evaluated beyond profit maximization results and take account of non-monetary variables such as pollution, health and safety, or even wastes of people's time. Changes in any of these accounts should be included in the calculation (Gramlich 1981:4-5).

Third, the pricing of resources or benefits is more complicated for public than for private enterprises. Whereas private business evaluates benefits and costs using market prices alone, governments may have to adjust market prices to reflect social costs or benefits that are not captured in these prices (Gramlich

1981:4). The prices that are adjusted to take account of such externalities are known as shadow prices (Mishan 1976: chapters 13 and 14).

6.4.3 Methods of evaluation

The methods of evaluating the performance of government programs and projects have long been a subject that has challenged researchers in the social sciences. The approach taken by scholars of management and administration tend to focus on the internal encumbrances to effective performance, such as communication, compensation and motivation. Examples of theories and methods from this field include the goals approach, competing values approach and participant satisfaction surveys (Rainey 1991:208-218).

In contrast, the standard method employed by economists (and consequently the focal point of this section of the paper) in evaluating public and private programs and projects is the cost-benefit analysis (CBA) method, the central criterion of which is simply that the benefits of a program must outweigh its costs. Compared to the general approach of management and administration scientists, the economists' analysis has focused much more on the environment external to the organization, taking as the key determinant of public performance the concept of consumer surplus. Consumer surplus is basically a representation of the degree to which program clients/consumers value program goods and services and can be defined as the excess of the amount a consumer is willing to pay for a given good or service over the amount actually paid (Mishan 1976:25) Graphically, consumer surplus is an area under the demand curve that is specified by (or a function of) the demand curve, price, quantity demanded, and marginal and average costs (Mishan 1976:17-54)(Infra. Figure 6.3).

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Figure 6.3: consumer surplus

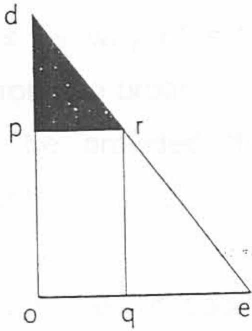
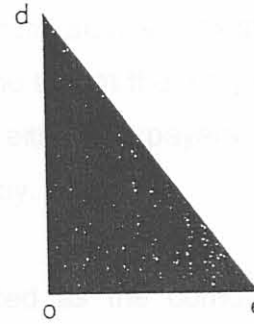


Figure 6.4: demand curve and consumer surplus



Both figures adapted from Mishan 1976:27

The demand curve for consumer goods and services is a function of sundry variables and includes income distribution, consumer tastes, and the prices of substitute and complementary goods. When graphed, the demand curve shows the maximum amount consumers are willing to pay for the good or service in question. Therefore, it can be seen that any point above (to the right of) the demand curve would represent a loss to consumers, and any point below (to the left of) the demand curve represents a price that is below what the consumer is willing to pay at that given quantity and is thus a gain to consumers. In the limiting case of a free public service to consumers, the entire area under the demand curve (the shaded area of figure 6/4) is equal to or less than the maximum amount consumers are willing to pay for the service, and thus the entire shaded area represents consumers surplus (Mishan 1976:27).

However, in valuing a government service, it is necessary to shift the focus of the analysis from that of the consumer surplus of program clients/beneficiaries to

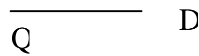
measuring the consumer surplus of society as a whole. Indeed, it is important to know how well the intended beneficiaries of a program are being served, but since many of the costs for providing these services are borne by taxpayers (and other citizens by way of external effects), the cost-benefit analysis must be considered from the broader societal perspective. Thus the truism that no public service can be provided "free" i.e. without cost to either taxpayers, the consumers of the service, or society at large comes into play.

The demand curve for society then, can be represented as the cumulative demand of all of society for that specific government program as determined by the median-voter (the median vote is that choice that lies in the middle of all available choices such that half the choices are below and half the choices are above the outcome of the vote; see also Fisher 1988:53). With this demand curve specified, figure 6.3 shows that at a given quantity (q) of service desired by society, the price (p) is the price level at which government will provide the service. Total expenditure of society is simply price times quantity which is graphically equivalent to the vector op times the vector oq, and thus also equivalent geometrically to the area oprq. The area qodr represents total gain to consumers at quantity (q). Subtracting program expenditure oprq from total gain to consumers qodr leaves the area pdr which is defined as consumer surplus (Mishan 1976:27; Cf. Gramlich 1981: 29). Consumer surplus, once determined, must be included as a benefit in the cost-benefit analysis (Mishan 1976:27).

Prato (1998:127-8, 266-7) extends the considerations of cost-benefit analysis to include the concept of Net Social Benefit (NSB)(Infra. Figure 6.5). As opposed to the cost-benefit evaluations that take *consumer* surplus to be the most pertinent (and in some cases the only) measure of social benefit, NSB includes the benefits and costs of both *producers* and *consumers*. Given that NSB is the

amount by which benefits exceed cost, Prato demonstrates that the entire area under the demand curve up to point (q) comprises consumer and producer benefit, and the entire area up to the same equilibrium point (q) under the supply curve represents consumer and producer cost. Thus, subtracting the area under the supply curve from the area under the demand curve specifies the area considered NSB which is therefore equal to consumer surplus plus producer surplus.

Figure 6.5: Net social benefit of consumers and producers



(Adapted from Prato 1998:127, 269)

With respect to public sector evaluation, whether or not one chooses to think of total social surplus to include producer surplus, depends on the evaluator's perception or treatment of the institution of government. For those who argue that government constitutes the collective will of society and that costs incurred by government are in actuality costs to taxpayers and citizens; to equate government costs of providing public services with producer costs, would amount to double-counting that which has already been estimated as consumer costs. This conclusion is implied in Prato's analysis as he limits his discussion to producers and consumers only. This rationale would lead to the conclusion that cost-benefit calculations should be limited to considering the gains and losses of two sets of stake-holders only - either private producers and private consumers

in the private sector, or government (as producer) and private consumers, or government (as producer) and private producers (as the consumer).

A more complete and perhaps more legitimate cost-benefit comparison for public sector evaluation would be to consider separately the gains and losses of consumers, producers, and government as done by Harberger (cited in Haveman & Margolis 1983:Chapter 5) in contrasting the evaluation methods of cost-benefit analysis with the basic-needs approach. In Harberger's analysis a government subsidy simultaneously causes a loss for government and gains for both producers and consumers, or a loss for government and neither producers nor consumers gain.

From figure 6.6 (Infra.) below it can be seen that the interests of each of these three stakeholders can be considered together graphically. This graphical presentation works well to elucidate cost-benefit results of changes along the price axis. The total cost to government of the subsidy is given by the area TRGF and the proportion of this subsidy that is a benefit to producers is given by the area SRGE, while the benefit to consumers is depicted by SEFT. Alternatively, the basic-needs approach considers the same problem but from the vantage point of the quantity axis as shown in figure 6.7. Both approaches lead to the same result in this simplified example.

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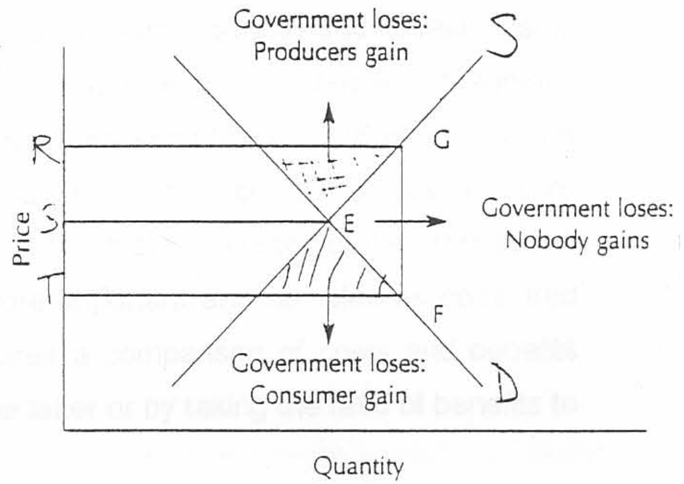
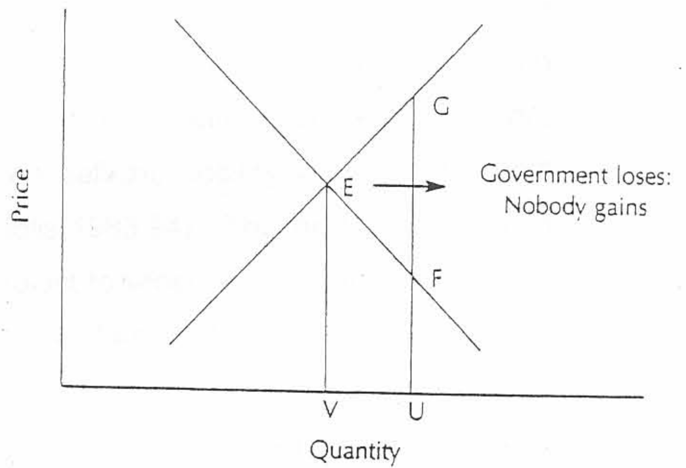
Figure 6.6: Cost-benefit analysis to include government



Adapted from Haveman & Magolis 1983:115

Figure 6.7: Basic-needs approach to include government



Adapted from Haveman & Magolis 1983:115

The advantage of the preceding graphical presentation of cost-benefit analysis is that it simplifies and clarifies the concept of consumer surplus and its relationship to its determining factors. However, the graphical analysis requires pragmatic application. This would entail a three stage process of first identifying and listing all benefits and costs, second, converting them to their present values, and third to compare these by ratio or net benefit. The first two stages of the process will be addressed here as they are the more important and complex as compared with the final stage which simply requires a comparison of costs and benefits either by subtracting the former from the latter or by taking the ratio of benefits to costs.

6.4.4 Benefits and costs to include in cost-benefit analysis

Answering the question as to which costs and benefits must be included in cost-benefit analysis requires a consideration of society's gains and losses in general as well as requiring a definition of the relevant *primary* stakeholders to include in the cost-benefit analysis analysis. Society may be defined differently for each program under study based on how wide-ranging the effects of the program are estimated to be (for further discussion on defining society in the cost-benefit analysis context see Haveman and Margolis 1983:94). This being noted, it can be considered, for example, whether a project to widen a road can be evaluated in the same way as a program that provides welfare benefits to the elderly.

Government agencies, the programs they oversee and the services they provide can best be understood and evaluated in terms of the following three basic functions of government – allocative, distributive, and regulatory (Gramlich 1981: 35). The benefits and costs to be considered in each of these categories of government activities are discussed in brief hereunder.

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6.4.4 (a) Allocative expenditure programs

Allocative expenditure programs are those that simply allocate funds for the provision of public services at the national and sub-national level such as national defence, police services and fire protection. This category also includes physical investment programs – which are those programs whose services involve the provision of some capital construction such as infrastructure (roads, bridges, and dams)(Fisher 1988; Cf. Gramlich1981). By their very nature physical investment projects will undoubtedly effect change upon the environment and may thus require a unique set of evaluation tools (within the cost-benefit model) manifestly different from those required of other types of programs. An excellent example of this is the environmental impact assessment required of most physical investment projects. As in most developed and developing/emerging market economies, the *Constitution of the Republic of South Africa*, Act 108 of 1996 (in the Bill of Rights) supports and promotes legislation that ensures the prevention of pollution, promotion of conservation, and the assurance that economic and social development will not contravene ecological sustainability. Further, a significant yet recent piece of South Africa's legislation in this regard is the *National Environmental Management Act*, 1998 (Act 107 of 1998) that as its basis requires an Environmental Implementation and Management Plan of every national department whose activities may impact on the physical environment.

Comparatively, evaluation of other *allocative* program categories such as those listed above (police, fire and national defence) may require instead the inclusion of such quantitative measures or statistics as number of reported cases and their direction of growth or change (Cf. Fisher 1988:304).

6.4.4 (b) Distributive expenditure programs

Distributive expenditure programs refer to programs that attempt to change the income distribution in society. These programs are usually carried out through government's taxing function, welfare programs and human investment programs.

A progressive tax system that imposes a proportionately greater tax burden on the richer members of society than on the poor can be thought of as being a distributive program as it attempts to provide for a more equitable distribution of society's wealth. Welfare and Human investment programs also have as their goal the redistribution of society's wealth, but through different means.

Welfare and human investment programs can be considered more similar to each other than they are different. Perhaps the most significant difference between the two is that the expected outcomes of welfare programs are less well defined than those for human investment programs. Thus, welfare programs generally have as their objective the provision of basic needs to those members of society who are unable to 'adequately' sustain themselves. A common approach to evaluating the efficiency of welfare programs uses the measure defined as the welfare ratio – which is a family's total realized income (including welfare benefits received) relative to its level of need (based on family size, age and location) (Haveman & Margolis 1983:Chapter 9; Cf. Gramlich 1981:Chapter 7). When this ratio is found to be less than one, the family is determined to be in poverty for that year. When the ratio is between 1.0 and 1.25, the family is considered near poverty, and when the ratio is above 1.25, the family is considered non-poor. Simply stated, the object of this approach is to balance re-distributive gains to program recipients against losses incurred by program

contributors. The question to be answered is – "by how much does society gain in transferring income from contributing to recipient families?"(Gramlich & Wolkoff cited in Haveman & Margolis 1983:187).

6.4.4 (c) Human investment programs

Human investment programs, in comparison, also provide benefits directly to citizens and include programs for the provision of public education, health, and job training. What differentiates these programs from welfare programs is that their outcome is expected to benefit society (in the long-run) to a greater extent than welfare programs. Thus educational attainment and job skills can be defined as the appropriate benefits of such programs whilst costs would include the costs to society of financing the programs (Gramlich 1981:160; Cf. Fisher 1988:305).

6.4.4 (d) Regulatory programs

For the objectives and hypothesis defined for the current study, the appropriate classification for the discussion of foreign direct investment policies would fall under regulatory type programs. Regulatory activities of government can be simply thought of as government mandates placed on private sector enterprises concerning what to do and what not to do (Gramlich 1981: 201). From a cost-benefit framework of analysis these types of programs can be judged by weighting the costs - compliance costs of private producers, and usually also costs to consumers by way of higher costs and prices for the regulated goods - with the benefits accruing to society at large of improved products (safer products) or processes (ex. - cleaner environment).

6.4.5 Time value considerations in cost-benefit analysis

Generally, program and project cash flows that are one year or less in duration can be estimated using current prices. However, for cash flows of longer duration, the time value of money becomes a significant consideration given the realities of inflation and interest rates. The value of a dollar received tomorrow is worth less than a dollar received today and therefore (future) cash amounts must enter into the analysis at their present values in order to facilitate meaningful comparisons.

The standard way in which anticipated future cash amounts can be assigned a current value is by use of an interest factor or discount rate that compensates the investor for amongst other things time, inflation and risk. This discount rate, once determined, is a cardinal concept and a key factor in performing a competent benefit-cost analysis. The decision to accept or reject a project or the decision to select the optimal project amongst two or more alternative projects is especially sensitive with respect to the evaluation method applied and the magnitude of the discount rate used.

The internal rate of return (IRR) and net present value (NPV) criteria are the two most widely accepted approaches to using discounted cash flows in benefit-cost evaluations. IRR and NPV are calculated using the following formulas:

(1) $$\text{NPV} = \sum_{t=0}^{T} \frac{B_t - C_t}{(1+r)^t}$$

(2) $$\text{IRR: } 0 = \sum_{t=0}^{T} \frac{B_t - C_t}{(1+i)^t}$$

where: t = each individual year of the project

T = number of years the project lasts

B_t = total benefits in year t (or each year)

C_t = total cost in year t

r = discount rate in NPV formula

i = discount rate in IRR formula

As can be seen, these methods use essentially the same formula and differ only with respect to how that formula is used.

The net present value approach [eq. (1)] requires estimates for benefits, costs, and the discount rate. If the discount rate used results in a positive net benefit (i.e. the present value of all benefits is greater than the present value of all costs), the project can be considered an acceptable option. In contrast, using the internal rate of return method requires estimating benefits and costs only, and the discount rate is solved for (with equation 2) rather than estimated. The principle here is to compute that rate of discount (known as the internal rate of return - or i in equation 2.) that would at minimum equate the present value of all benefits to all costs. This is done by setting PV = 0 and solving for i. By this criterion the project has positive net benefits and should be accepted if $i > r$, where the estimated r can be thought of as the opportunity cost of capital. Alternatively, when faced with two or more projects and scarce resources, projects can be arrayed according to the value of i where the optimal decision is to select the project(s) with the highest i value(s).

It is generally accepted and can easily be shown that the net present value method is the more consistent of the two investment decision criteria. While both methods need to be used cautiously and with particular attention being paid to potential pitfalls, the internal rate of return method has been shown to be ineffective as a decision tool for a number of reasons including:

1. The solution of the internal rate of return formula can result in two or more discount rates. This mathematical contradiction is evident when costs occur at more than one point during the life of the investment. This is because solving for the unknown in the internal rate of return formulation is equivalent to solving for the root or roots of a polynomial equation (Chaing 1984:17-53; Cf. Mishan 1976:183-95). The following example given by Mishan (1976:187-8) illustrates this anomaly:

   An investment stream of - 100, 420, - 400 has two different rates of return, 46% and 174%, that solve the internal rate of return equation.

2. For investment projects whose benefits and costs expire within the period of one year, the net present value method is acceptable because for investments of this duration, the net present value of benefits over costs is equal to the undiscounted net benefits. However, *i* in the internal rate of return formula cannot be computed to give a meaningful measure (Gramlich 1981:93).

It is therefore advisable to use the net present value method for all cost-benefit discounting calculations and decisions.

6.4.6 Appropriate discount rate

For public sector investments, before the translation of monetary benefits and costs into equivalent and comparable present value figures, the issue of the appropriate discount rate to be used – the unknown in the net present value (NPV) formula – must be resolved. As yet, in the academic discourse on this matter, there exists no firm consensus amongst the more prominent scholars. Some even reversing or modifying their positions as the subject continues to be

studied and debated (Gramlich 1981:96). Essentially, the three competing perspectives on determining the discount rate for public investments are the gross before-tax rate of interest on private investment, the weighted average of the gross before-tax rate of interest on private investment, and the after-tax rate of return on private savings, and the social optimum rate of discount (Gramlich 1981:95). A brief discussion of each of these follows.

6.4.6 (a) Gross before-tax rate of interest on private investment

The rationale for using the gross before-tax rate of interest on private investment as the discount rate for public investments assumes an equivalence between the two types of investments (public and private) before taxes such that investing in one is an opportunity cost for not investing in the other. The underlying assumption is that because many governments exempt a substantial proportion of their bond and security issues from taxes, a rational comparison of returns for public and private investment can only be made on a pre-tax basis. However, this construction overlooks the fact that private and public investments can never be commensurate, as their corresponding discount rates must not just account for tax differences but must also be adjusted to account for risk. As a result of government regulation, investments above a particular level of risk are unavailable for public investment thus resulting in a lower required rate of return and discount rate for public investments (Prato 1998:266; Cf. Bradford cited in Haveman & Margolis 1983: 130).

6.4.6 (b) Weighted average rate of return

This approach to determining the discount rate to be used for valuing public investments is based on the premise that funds available for public investment can be estimated as the opportunity cost of funds that would otherwise have been used for private investment and/or private consumption. The opportunity cost of the former is estimated as the before-tax return on private investment and the opportunity cost of the latter is estimated as the after-tax return on consumer saving. The rationale here is that the weighted average of these two opportunity costs is the best estimate for the public investment discount rate.

Gramlich's (1981) argument against the use of this weighted average method is based primarily on the inclusion of the after-tax return on consumer saving. When calculated using 'real' data, this rate quite often turns out to be negative after adjusting for inflation and government regulation that puts a ceiling on the amount of interest payable to consumers through bank savings accounts.

This after-tax rate cannot therefore be taken as the rate investors require to invest their savings in public projects, but rather this rate reflects the constraints imposed by government on consumer savings.

6.4.6 (c) Social discount rate

It has been shown and it is generally accepted that the required rate of return on government investments (i.e. the economy's risk-free rate of return on investment) is closely approximated by the long-run real growth rate of the economy (Reilly 1985:10-19; Cf. Gramlich 1981:101-7).

This derivation of the appropriate discount rate for evaluating public investments is based on the premise that this is the optimal rate of discount that maximizes return (or equivalently output) where this maximum return occurs at the highest point on the production function. Gramlich (1981) shows that the slope of the tangent to the production function at this point is equal to the slope of the capital requirements curve which is in turn equal to the growth rate of the economy.

6.4.7 Cost-benefit adjustments

For government projects it is usually not possible to compare all benefits to all costs as the cost-benefit method requires. In those cases where the benefits of a project are not easily quantifiable, two alternatives to the cost-benefit analysis are cost effectiveness evaluations and monetarizing costs and benefits.

6.4.7 (a) Cost effectiveness

The cost effectiveness approach rests on the premise that where benefits are not easily quantified it is feasible to compare alternative programs with the same objectives based on costs alone. This method indirectly maximizes net benefit by directly minimizing costs. "Benefit-cost analysis is really a framework for organizing thoughts, for listing pros and cons, and for placing a value on each consideration. In many situations there will be some considerations that cannot easily be enumerated or valued and where the benefit-cost analysis becomes somewhat more conjectural. Yet the sensible way to deal with such omitted considerations is not to abandon all efforts to measure all benefits and costs, but rather to [modify the cost-benefit analysis to accommodate varying circumstances] … *viewed in this light, even if benefit-cost analysis alone does*

not make any decisions, it can serve a valuable purpose in focusing decisions on the critical elements" (Gramlich 1981:5).

6.4.7 (b) Monetarizing costs and benefits

It is obviously not possible to assign a monetary value to each variable considered relevant to a cost-benefit calculation. Rather than attempting to convert all direct and indirect benefits and costs into monetary terms, Prato (1998:ch.12) suggests the utilization of multiple criterion decision analysis (Cf. Gramlich 1981:5). In short, this analytical approach accommodates the combining of monetary and non-monetary cost-benefit assessments into a single study by simply quantifying that which is quantifiable and listing and ranking those variables than are non-quantifiable in monetary terms. This should result in more accurate and meaningful impact measures than would be obtained by assigning arbitrary and subjective monetary values to such factors as aesthetics. Further, the temptation to exclude from the analysis one or more factors because they cannot be monetarized, would lead to underestimation of costs or overestimation of benefits.

6.4.8 Efficiency considerations in cost-benefit analysis

The decision by government to take on a project or to provide a service, is motivated by efficiency concerns. That is, if inefficiency (in terms of price and/or quantity) exists in the private market for the delivery of needed services to the public, government is obliged to intervene in that market by providing the service or product in question more affordably and efficiently than is currently the case.

6.4.8 (a) Pareto efficiency principle

Among the efficiency concepts that may be used in parallelism with a cost-benefit analysis are the Pareto efficiency standard and the Kaldor-Hicks criterion (Gramlich 1981:42). The Pareto standard defines efficiency as a state of affairs in which it is not possible to make at least one person better off without making someone else worse off (Fisher 1988:27; Cf. Gramlich 1981:42). The practicality of this concept is questionable as it is rare to encounter a government program that meets this standard (Gramlich 1981:42). Rather the usefulness of this theorem lies not in it's stated requirement for bringing about or determining efficiency, but in its implicit recognition of possible externalities of programs that must be accounted for.

6.4.8(b) Kaldor-Hicks efficiency principle

The Kaldor-Hicks principle basically extends the rationale of Pareto efficiency by defining as efficient government programs in which the gainers could compensate the losers and still be better off. Stokey and Zeckhauser re-phrase this principle in more pragmatic terms: "In any choice situation, select the (policy) alternative that produces the greatest net benefit."(cited in Gramlich 1981:43). Here the combined financial gains and losses of all stakeholders are summed together to derive the net benefit. This total is then compared to the total cost of the program or project. The option with the highest *benefit-to-cost ratio* or *net benefit* differential is to be selected (Gramlich 1981: 117).

Government programs that are concerned with distributive equity normally adjust the Kaldor-Hicks cost-benefit measures by using a simple weighted average technique that assigns greater consideration or weight to gains and losses of

low-income or disadvantaged groups. Gramlich correctly cautions however, that "… *the distributional weighting of gains and losses is typically one of the most speculative aspects of any evaluation*" (Gramlich 1981:120).

6.4.9 Evaluation methods in the South African public service

Section 196 of Act 108 of 1996 assigns to the Public Service Commission (PSC) the task of *'promoting effective and efficient public administration and a high standard of professional ethics in the public service'*. This is to be accomplished through the evaluation and oversight functions of the Public Service Commission as specified under sub-sections (4)(b) and (4)(c) which are:

(b) to investigate, monitor and evaluate the organization and administration, and the personnel practices, of the public service; and
(c) to propose measures to ensure effective and efficient performance within the public sector.

Although the Public Service Commission is essentially the government's policy-making body in the areas of public performance management, implementation of these performance management mandates is carried out by the Department of Public Service and Administration. A key initiative currently being carried out by the Department is the implementation of Performance Agreements. Heavy consultation (between managers and subordinates) is involved in effecting these agreements and there exists a fair amount of flexibility in defining performance measures. The scope of the agreements, however, is heavily weighted toward internally focused measures.

In addition to the mandate required of the Public Service Commission, the responsibility for performance evaluation in the South African public service is shared with the office of the Auditor General (AG). The Auditor General's office fulfills it's constitutional mandate to evaluate public sector performance through its accounting and management auditing activities. The work of the Auditor General is therefore fundamentally centered in the discipline of public accounting and is focused on the efficient, competent and honest use of public funds (Annual Report of the Auditor General: 1997-8).

The observation is made here that the quantitative approach of the Auditor General's office needs to be increasingly tempered with qualitative performance appraisal that is also externally focused. To this end, the Department of Education has positioned itself as a conspicuous example of the shifting importance being given to externally focused program evaluation in the S.A. Public Sector. Specifically, the review committee that studied the efficiency and effectiveness of "Curriculum 2005" effectively balanced the 1997 Auditor General's audit of their department with qualitative assessments of the social objectives and outcomes of one of the department's most significant programs.

6.4.10 Summary – Measurement of performance and structure

The private sector enterprise is normally concerned primarily with maximizing profits, however, in this era of social consciousness and corporate responsibility, private enterprises are increasingly being forced to consider the externalities of conducting business. Conventionally, at least up until very recently, private business compared or decided upon investments using capital budgeting techniques which applied essentially the same benefit-cost analysis used in evaluating public programs and projects. However, private sector cost-benefit

analysis had been focused almost exclusively on monetary gains and losses and excluded externalities in the calculation. In recent decades, this focus of analysis has experienced a slow but steady paradigm shift brought on in many respects by the constraints put upon private businesses by the legal environment in which they operate and in which they are held responsible and accountable for their actions. Further, private corporations are increasingly adopting the philosophy of corporate responsibility not just for the sake of benevolence or legal sanction, but good business practice and economic survival dictate these largely public considerations.

It is increasingly clear that the evaluation considerations for both private and public investment are converging. However, regardless of the degree of conformity between these two types of evaluation, arguably there must always be a higher moral standard placed on public enterprise investments as the private enterprise will always possess an opportunistic self-interest epitomized in the profit motive whereas the public sector will always be responsible - almost paternalistically - for citizen welfare. Consequently, the scope of inclusion of benefits, costs and externalities will always be broader for public investments than for private enterprise investments.

An important caveat is that there can be no precise determination of net benefit for public programs and projects. Rather, it is only possible to arrive at conclusions or decisions based on rough estimation and subjective determinations given the nature of the problem of limiting the variables to be included in the analysis (for example - plant life and endangered species) and measuring them. However, despite the imprecise and subjective nature of cost-benefit analysis it still remains a worthwhile effort as it at some level substantiates the external implications of government activities when one

considers the connectivity of relationships that exist in society in general as well as between society's members and the physical environment.

6.5 Regulation and Structure

In defining a social problem, Hoogerwerf (in Wittrock and Baehr (eds.) 1981) states that "…*a [social] problem exists if there is a discrepancy between a goal or some criterion and the perception of an existing or expected situation*." In the case of the regulation of multinational enterprises therefore, in defining the problem, or assessing, or justifying a policy (or set of policies) it is necessary to start with a clear indication of the goals or expected benefits, if any, that the government intends to derive from its relationship with multinational enterprises. In turn, this can only take place in an organized manner wherein organizational systems and structures are in place to oversee the administration of the thusly concluded set of policies.

In order to give effect to, monitor and review policies decided upon, such policies must be housed in the appropriate institution(s) of government. It is not enough for government to espouse a general approach to foreign direct investment; it is necessary to articulate the government's policy formally and clearly within a clearly defined administrative framework. This point is strongly emphasized by Dunning (1993:566), for example, who states that "…*the success of government policy towards … inward direct investment depends upon the effectiveness of the administrative machinery set up to implement and monitor the policies decided upon*." Mhlanga (2003) is also of the opinion that social policies are sure to fail where such policies are hurriedly set up and promulgated in countries that fail to also establish the necessary institutional mechanisms to continuously monitor and review said policies. It can further be argued by extrapolation, that countries

that have neglected to centralize their foreign direct investment policy structures may have experienced inefficiency in coordinating the various tasks, responsibilities and objectives of the several ministries involved in some manner in the administration of this type of investment. As an example, there may emerge conflicting regulations coming simultaneously from a Ministry of Labor and a Ministry of Science and Technology. This may occur where the former Ministry is primarily concerned with attracting labor-intensive job creating multinational enterprise investment, while at the same time the priorities of the latter Ministry involve upgrading domestic technological and innovatory capacity, an objective which may tend to reduce labor-intensive employment (Dunning 1993:566).

6.5.1 Developing a regulatory framework for the regulation of multinational enterprises

Academic inquiry and literature, of the 1950s and 1960s, aimed at investigating the intrinsic nature and proliferation of multinational enterprises led to policy assessment that in large part suggested tighter regulation of this type of business enterprise. This shift of policy orientation was in large measure based upon research findings that confirmed the ability of multinational enterprises to transcend national regulatory boundaries, as well as confirming the potential for monopoly control of markets by multinational enterprises. The multinational enterprise was thus seen to be a unique form of business enterprise that required a specialized regulatory framework to control against its possible abuses of host states (Muchlinski 1995:7). Since the 1960s, however, there have been several additional major ideological influences on the regulation of multinational enterprises. These ideological strands are the ‘neo-classical market analysis’ of the multinational enterprise, the ‘orthodox post-war economic’ perspective, the

'Marxist' perspective and the 'nationalist' perspective, and more recently the 'environmental' perspective and 'global consumerism' (Muchlinski 1995:90-101). In order to present a balanced approach to understanding regulatory motivations and current approaches to host state regulation of multinational enterprises, these major ideological influences that have been shown to affect the extent and nature of multinational enterprise regulation will be discussed hereunder.

6.5.1 (a) Neo-classical market analysis

The underlying assumption of the neo-classical market perspective is based on the laissez faire principle that the market operates most efficiently when left to its own devices. Therefore, this view purports a minimalist approach to multinational enterprise regulation. The multinational enterprise is seen as a crucial conduit for the proper development and advancement of the international economy through its unique abilities to integrate and coordinate resource allocation globally. As such, multinational enterprises can only fulfill this role if they are uninhibited in the establishment and operation of affiliates wherever and whenever needed. The major criticism leveled against the neo-classical perspective is that it fails to recognize that countries differ fundamentally and as a result an 'open door' approach to multinational enterprise regulation will not always result in an equal international spread of the benefits to be derived from the foreign direct investment of multinational enterprises (Muchlinski 1995:93). This concern is partly addressed in the 'orthodox economic' perspective on multinational enterprise regulation which is discussed forthwith.

6.5.1 (b) The orthodox post-war economic perspective

Whereas the neo-classical perspective saw free and unregulated markets as the path to global economic efficiency, the orthodox post-war approach argued that without some amount of intervention markets can and do become imperfect allocators of resources. Large corporations (both domestic and foreign multinational enterprises) were seen to have the ability to dominate and monopolize markets thereby causing markets to function inefficiently. Orthodox exponents suggested that such market failures could only be controlled for by the use of selective public sector interventions. The Orthodox approach does, however, recognize the potential gains that may accrue to nation states from the foreign direct investment activities of multinational enterprises and as such, this approach sees over-restrictive controls as self defeating. In the final analysis, the orthodox school takes a middle of the road approach tailored to specific circumstances of nation states and multinational enterprises. Examples of diversity of regulations that fall under this perspective are the low intervention approach of existing and draft voluntary international codes of conduct concerning multinational enterprises and European Community proposals for greater disclosure and accountability, and the high intervention approach exemplified by national laws requiring indigenous involvement in the ownership and control of local subsidiaries of foreign corporations (Muchlinski 1995:93-5).

6.5.1 (c) The Marxist perspective

Based on the views and arguments of Karl Marx on the exploitation of labor by capital, the Marxist perspective sees multinational enterprises as agents of capital exporting countries that have the power to control both the flow of raw materials and finished products in and out of less developed countries (LDCs) as

a result of the multinational enterprises monopolistic control of the market(s) concerned. According to this perspective, this exploitative relationship justified excessive regulatory measures such as nationalization and expropriation (Muchlinski 1995:95-7).

6.5.1 (d) The Nationalist perspective

The ideological basis of the nationalist perspective on multinational enterprise regulation takes expression, among other, in the pro-nationalist sentiments of 'dependency theory' especially with respect to prioritizing national independence, self-determination and cultural autonomy in relations with multinational enterprises. In this regard, for example, large foreign firms are seen to be a threat to the way of life of the people in the host country by way of displacing cultural identity and adapting local consumer tastes to those of foreign origins mainly by investing heavily in advertising. There is also a fear of interference in the political sphere of the host country by multinational enterprises as had been demonstrated in Chile and elsewhere (Supra. Sect. 4.2.2).

The more overzealous nationalistic approaches have been criticized for being self-defeating as they may actually tend towards a greater degree of dependency than that which they seek to avoid through nationalization and expropriation. This is because they give preferentiality to the replacement of foreign management corps and techniques with less efficient local substitutes (Muchlinski 1995:97-9).

6.5.1 (e) The Environmental perspective

Environmental concerns are among the more contemporary issues that have entered the debate on multinational enterprise regulation. According to the environmental perspective two important areas that need to be taken account of in developing a regulatory framework for multinational enterprises are firstly, environmental health and safety, and secondly, incidence of exploitation of countries that are regarded as environmental pollution havens. With respect to the former, environmentalists call for provision to be made for the development of an international legal regulatory body on group liability for damage caused by environmental hazards under the control of multinational enterprises, more certain rules on the provision of compensation in the case of accidents, and improved disclosure on health and safety issues. With regards to the latter, the environmental approach calls for regional or preferably international coordination and consensus on pollution standards (Muchlinski 1995:99-100).

6.5.1 (f) Global consumerism

Although theorists of global consumerism accept that there are going to be social and cultural changes brought on by the presence and activities of multinational enterprises in host countries, they do not necessarily accept that these changes should be considered in a negative light. Instead, they welcome the creation of a new global culture and lifestyle perpetuated in large measure by transnational media and advertising firms that aim to develop consumer tastes for the products sold by multinational enterprises. The drive to satisfy these new consumer demands is expected to contribute to development as job creation and increasingly higher standards of living will be have to be the economic and social policies prioritized by host country governments (Muchlinski 1995:100-101).

6.5.2 Normative jurisdictional levels of regulation

Against the backdrop of the varying beliefs about the extent to which multinational enterprises should be regulated, each individual nation-state needs to determine its own particular regulatory framework based on its predominating political and ideological orientation towards the foreign direct investment activity of multinational enterprises. To this end, optimization of a regulatory framework for multinational enterprises requires going through a two-stage analytical process that consists of firstly analyzing the substantive content of any regulatory agenda that is currently in place, and secondly, evaluating these against the normative jurisdictional levels and methods of regulation, as have commonly been applied globally, so as to identify effective policy options that may be available to policy makers (Muchlinski 1995:90). The first stage of this process, i.e. analyzing substantive policy content, was covered in the previous chapter (Supra. chapter 5) of this dissertation. With regard to the normative jurisdictional levels and methods of regulation, host states can exercise regulation over multinational enterprises through either the national, regional or international levels. Each of these will be discussed in turn, hereunder.

6.5.2 (a) National level of regulation

The national level of regulation can be subdivided into unilateral and bilateral regulatory frameworks. The unilateral branch of the national level of regulation is indicative of cases in which a host country acts alone in determining what regulations will apply to multinational enterprises and foreign direct investment with little or no concern for how these policies may affect the multinational enterprise in question, the home county of the multinational enterprise in question or any other incidental stakeholders. In contrast, the bilateral approach

to regulation at the national level involves agreements between host and home countries of multinational enterprises on issues of regulatory control. Here the interests of the multinational enterprise, host country and home country are given due consideration and compromise is reached between them in determining the most appropriate regulatory policies (Dunning 1993:574-8; Cf. Muchlinski 1995:107-111).

Although the national level of regulation is the most common approach to regulating multinational enterprises, it has been criticized for failing to provide consistency in how multinational enterprises are to be regulated domestically as well as in the international arena. That is, as the main aim of host government regulation of multinational enterprises at the national level is to negotiate and secure the greatest economic and social gains from the foreign direct investment activities of multinational enterprises, this level of regulation may in principle and theory lead to as many different regulatory regimes as there are countries in the world. The problem that this circumstance creates for individual countries as well as for the global economy at large is that multinational enterprises will be in advantaged position to play one country against the other as countries compete to attract foreign direct investment. Such competition would prove to be an inefficient use of resources such as investment incentives. In terms of consistency on the domestic front, too many regulatory agendas may develop as these may evolve from bi-lateral (as opposed to regional or international) negotiations and agreements between a particular host state and a number of home states representing the interests of their multinational enterprises in the host country. It can thus be concluded that bilateral treaties are limited in their ability to provide the appropriate and efficient solution to regulatory problems since they represent specific regimes applicable only to the signatory states of those specific treaties.

A further significant criticism of the national level approach is that it does not take account of the mismatch that exists between the territorial and jurisdictional limits of the laws of the regulating host state, and the global spread of the economic interests and activities of multinational enterprises operating from within the host state's borders (Muchlinski 1995:107-111). As has been documented in Lubbe v. Cape Plc and other cases (Supra. Sect. 4.3.2), this mismatch has tended to lead to international legal complications for which most individual host governments lack the legal capacity to resolve.

6.5.2 (b) Regional level of regulation

The regional level of multinational enterprise regulation refers specifically to the establishment of supranational regulatory policies as well as supranational regulatory bodies to administer those policies. The coverage of that regulation being greater than that of the bi-lateral form yet lesser than that of the international form. In other words the geographic coverage of the regional level of regulation is limited to groups of countries that share a distinct (and normally contiguous) geographic area and who would benefit from the establishment of a common market, currency and/or political system.

Regional regulation of multinational enterprises serves to address some of the shortcomings identified in the national (unilateral and bilateral) approach. As such, regional regulation has the potential to reduce the mismatch between the territorial and jurisdictional reach of host states and the geographical scope of multinational enterprise operations. However, this is the case only for firms operating exclusively within the territorial region of the participating states. With respect to firms operating both within and outside the common region, the problem of jurisdictional limitation may re-emerge whereby host governments

that belong to the region may encounter difficulties applying their laws and regulations to multinational enterprises whose operations extend outside of the region (Muchlinski 1995:111-12). One notable shortcoming of the regional approach, however, is that it may tend to divide the world up into regional blocs of countries that compete with each other for the foreign direct investment of multinational enterprises (Muchlinski 1995:111-12; Cf. Dunning 1993:574-8).

6.5.2 (c) International level of regulation

Host state regulation of multinational enterprises at the international level involves an international collaborative effort by the majority of the world's states. Although this level of regulation would appear to be the most efficient in terms of rectifying the mismatch between jurisdictional control of host states and the geographical scope of multinational enterprise operations, it may also prove to be the most difficult to accomplish. This is because firstly, international regulation can only take place where national jurisdiction is curtailed, and secondly, given the great amount of diversity that exists in national ideologies, it would be difficult to reach an international consensus on how the international regulatory framework should be constituted (Muchlinski 1995:112-14; Cf. Dunning 1993:574-8; Cf. Modelski ed. 1979:274-5).

6.6 Conclusion

Although all stages within the policy cycle are crucial, in the current context the most important decisions have to be taken as to the organizational structure within which multinational enterprise policy will take place. Once multinational enterprise policies have been studied and formulated, either a new organizational unit can be developed for the administration of this policy, or an existing

administrative unit can add multinational enterprise regulation to their functional responsibilities. A third option would be to leave the current system intact.

Focusing on the first two options for organizing, the key issues here relate to which option is most efficient in terms of administrative effectiveness and also which option is most efficient in terms of administrative cost. Resolving these issues requires a cost-benefit focus of analysis. In this regard, either option will require additional costs, so before choosing one as the optimal situation, a cost/benefit assessment has to be made to determine whether the added benefits of the proposed organizational change(s) justifies the implementing costs (thus, also addressing the third option of leaving the system intact). Considering this question first, requires us to specify an objective measure for the costs to be compared as well as a basis for comparison. Thus, since there is no current administrative directorate or unit for foreign direct investment and multinational enterprise policy, comparison has to be made on the basis of the costs of implementing and maintaining a new system versus the economic and social costs and benefits related to the current system (i.e. the opportunity costs of not having a regulatory unit). As has been indicated in this chapter, although cost benefit analysis cannot provide absolute answers or precise measures, it's still remains a worthwhile exercise as it goes a long way towards providing objective bases for comparison for determining the optimality of organizations and their structures in terms of their performance.

From the discussion posed in section 6.5 of the dissertation, it can be deduced that the scope for rationalization of foreign direct investment policy structures in the South African context can also be partially resolved by firstly taking account of the Governments ideological stance on regulation, and secondly by making a determination as to the most effective levels of policy making, implementation

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and mediation of such regulation. Additionally, account must also be taken of a number of other potentially deterministic factors discussed elsewhere in this dissertation such as a benefit-cost analysis of a proposed rationalization, applied organization theory and the economic and social effects that regulated as well as un-regulated foreign direct investment may entail. These are but a few of the deterministic factors that have been explored thus far in the dissertation and the concluding chapter (Infra. chapter 7) attempts to draw to a central divergent point, each of these considerations in order to recommend the most optimal basis for the aforementioned rationalization.

CHAPTER 7

Conclusion and Recommendations

7.1 Introduction

Academic interest and inquiry of multinational enterprises is a relatively recent phenomenon, as the first serious attempts to understand this type of business enterprise were undertaken in the late 1950s and early 1960s. The comprehensive works of Coase (1937, 1960), Hymer (1960, 1968) and Knickerbocker (1973), among others alluded to market imperfections and the possible disruptive economic forces of multinational firms operating in developing and third world countries. Guided by the literature, regulatory measures were proposed and implemented in a number of countries.

Similarly, this dissertation was primarily concerned with deriving public policy solutions to economically related public problems. Specifically, one problem identified for closer examination and in-depth analysis was that of the positive as well as negative effects on the domestic population of foreign direct investment by multinational enterprises. The literature search of the study identified both positive and negative consequences from this type of investment on, among other, employment, technology transfer, balance of payments and environmental damage and resource depletion. In this regard, *inter-alia*, the foreign direct investment of multinational enterprises may either increase or decrease employment, restrict or facilitate technology transfer, improve or worsen the nations balance of payments, and possibly bypass responsibility for harming the environment and the peoples of the host state. These issues were

partially resolved in chapter 2 – A Survey of the Theory of Multinational Enterprises.

A second, and higher order problem also identified for study relates to the optimization of the positive aspects of the foreign direct investment of multinational enterprises for the benefit of the host country of such investment. The study proposed that one avenue by which such an optimization may take place is through an efficient, effective and well coordinated regulatory framework. Accordingly, the problem statement of the study is concerned with the fact that there is no single governmental body at any level of government that is charged with complete responsibility for policy-making and regulation of this type of investment in South Africa. This concern is warranted in light of the possibility of occurrence of the negative effects associated with multinational enterprises.

The development of a hypothesis brings the study closer to at least a partial solution of the problem statement as hypothesis testing represents a critical link between scientific research and its conclusions. Specifically, the hypothesis of the study is given by the null hypothesis, Ho = There is a necessity to formalize a Government administrative structure for policy setting and implementation of multinational enterprise regulation in South Africa. The extent to which the hypothesis of the study may have been proved or disproved depended on first addressing the research question of the study. The research question being – Is there a need for foreign direct investment policies that apply exclusively to multinational enterprises? The research question was answered in the affirmative throughout the study and especially so in chapter 4 (Supra 4.3.1 f) in which it was demonstrated that weak or non-existent regulation of foreign direct investment is likely to leave a nation vulnerable to the negative externalities associated with this type of investment. The externalities examined in chapter 4 dealt with environmental and health damages caused by foreign corporations

that exercised certain legal principles to absent themselves from the jurisdictional reach of host countries.

The hypothesis, on the other hand, was not disproved in the sense that the evidence in chapter 5 concluded that the current regulatory framework can be strengthened through the appointment of a dedicated unit that is tasked with ensuring that the implementation of foreign direct investment policies takes place in an integrated and coordinated manner in the South African public sector. It was shown in chapter 5 that several departmental units and sub-units have some amount of regulatory authority over foreign investors, and without appropriate efforts at coordination of their activities, policy deficiencies such as pockets of no-mans land and overlapping may materialize.

Once the issues raised by the research question and the hypothesis had been established and dealt with, attention was then given to issues of organizing as a means to giving greater substance to what was implied by the results of the hypothesis testing. Organization theory was looked upon (in chapter 5 and more extensively so in chapter 6) to give guidance on assuring that the appropriate organizational dynamics are in place to optimize the effectiveness of foreign direct investment policies, and more specifically to optimize the potential benefits to the Government from inward foreign direct investment. Additionally, it was argued in chapter 5 that, although there is a body of foreign direct investment laws and policies, and these foreign direct investment policies effectively reflect the political ideology of the ruling party, there also exists significant scope for the integration and coordination of these regulatory efforts.

7.2 Summary and conclusions of each chapter

The objective set for the study was to design, develop, and/or propose an administrative structure (unit) for policy making, policy implementation, and

control of multinational enterprises where it could be shown that such an administrative unit is indeed needed. Each chapter of the dissertation contributed towards satisfying this objective by either demonstrating the need for the administrative unit in question, or by attempting to resolve the question of the optimal structural design of such a proposed unit. A synopsis of the conclusions of each chapter follows.

7.2.1 Chapter 1 – Introduction

Chapter 1 merely defined the nature and scope of the study in its entirety, and thus no conclusions were evolved for this chapter.

7.2.2 Chapter 2 – A Survey of the Theory of Multinational Enterprises

The findings of theoretical and empirical research on the effects of inward foreign direct investment on host governments are an important and instructive tool for policy makers to take account of in determining the nature and extent to which multinational enterprises should be regulated. From the review of the literature it was concluded that the effects of the presence of foreign multinational enterprises in the host country can be observed through changes in among other, employment, balance of payments, and the competitiveness of domestic firms. With respect to the direction of change observed in each of these factors, consensus in the literature does not exist.

7.2.3 Chapter 3 – Historical Perspective of South Africa's Investment Climate

The two key conclusions teased out of chapter 3 are that firstly, agriculture, mining and manufacturing are the three largest sectors of the South African economy in terms of contribution to GDP and are thus considered the most relevant in terms of defining the contextual economic environment within which

foreign direct investment takes place; And secondly, the deterministic element that runs through every aspect of development and investment in South Africa's recent past is the system of racial discrimination and segregation known as apartheid.

Although apartheid no longer exists, it has left behind a significant legacy that represents hindrances in many sectors of the economy that are only presently being resolved. As an example of apartheid's legacy, it can be noted that the agricultural sector of the economy has shifted from first to third place in terms of share of GDP in contemporary times. The once thriving agricultural sector benefited white land-owners and farmers at the expense of black farmers under the system of apartheid. As apartheid was an expensive system to maintain, there appears to be evidence that the productivity of agriculture was reduced as a direct result of the apartheid system.

7.2.4 Chapter 4 – Global Foundations for Establishing a Need for the Regulation of Multinational Enterprises

With respect to foreign direct investment in South Africa, the court case of Lubbe v. Cape Plc. offers lessons to be learnt (not just for South Africa) on the issue of regulating multinational enterprises. Cape Plc., an asbestos mining multinational enterprise, effectively put itself out of the jurisdictional reach of the South African legal system when it abandoned it's South African mining operations in 1979 after allegedly causing asbestos related illnesses to employees and community members living in the vicinity of Cape Plc. mining operations. It was demonstrated in chapter 4 that this legal case, in particular, exposed some of the weaknesses in the South African system of regulating foreign investment.

7.2.5 Chapter 5 – Critical Review and Analysis of Existing Policies on Foreign Direct Investment in South Africa

It was shown in chapter 5 that South African public policy vis-à-vis foreign direct investment is formulated from a liberal approach that encourages (rather than restricts) this type of investment. The work of this chapter and the dissertation as a whole did not seek to argue against this liberal approach, nor did it seek to support it. Instead, the approach of the study was to take a neutral stance on the issues and allow the research findings to suggest the degree of liberalization to be afforded to foreign investors. The main focus of the study, however, was based on determining the most optimal organizational structure(s) to be used in managing pre-existing policies on foreign direct investment. One of the key findings of chapter 5 is that, although there appears to be a high level of consistency across the South African public sector in what is being articulated as the government's policy toward foreign investors, there are issues of integration and coordination that need to be addressed. As an example, the powers and functions of the Minister of Minerals and Energy, and those of the Minister of Environmental Affairs and Tourism overlap in certain critical areas of control over investors (both domestic and foreign). Although it is possible to fulfill this coordination function at the executive level through cabinet committee processes, it was further argued in chapter 5 that this task would be better handled by a small governmental unit dedicated to all matters of policy formulation, regulation and monitoring of foreign investment. Further suggestions as to the organizational dynamics of this proposed unit were also explored in this chapter.

7.2.6 Chapter 6 – Rationalization of Foreign Direct Investment Policy Structures in the South African Government

The work of chapter 6 argued, based on what was demonstrated in chapter 5 and in the literature on organizing and rationalization, that there is scope for the rationalization of foreign direct investment policy structures in the South African public sector.

7.3 Recommendations

Chapter 3 argued that although an extensive amount of foreign investment capital was lost to the disinvestments campaign of the 1980s, the extent and pace at which foreign investment has returned to South Africa in the post-apartheid era is one of the defining issues in determining the Government's policy approach to foreign investment. There is also the issue of the low domestic savings and investment rates that was discussed in chapter 2 (Supra. Sect. 2.5.4) and chapter 5 (Supra. Sect. 5.7), that serve as a motivator for the Governments policy of attracting greater amounts of foreign direct investment into the country.

With respect to the Government's approach to foreign direct investment policy, and in spite of the Government's ideological stance, it is recommended that a balance must be found between too liberal an approach that may allow for abuses of the state by multinational enterprises, and too restrictive a stance that may tend to stem the flow of much needed inward investment capital.

It was demonstrated in the dissertation, through the empirical case approach, that Lubbe v. Cape Plc. sets an important legal precedence for South African foreign direct investment law and policy. Comparing Lubbe v. Cape Plc. with Gisondi v. Cape Plc. demonstrated that South African claimants have little

support or international legal standing to successfully bring a case for damages against foreign multinational enterprises, where such multinational enterprises are no longer domiciled in the Republic of South Africa. Given the facts of Lubbe v. Cape Plc., it is recommended that the Government look to Article 2 of the Brussels Convention as a model for bilateral, regional or even international dispute resolution in cases involving multinational enterprises.

It was shown in chapter 5 that The Minerals and Petroleum Resources Development Bill (Notice 541 of 2002) and the National Environmental Management Act of 1998 (Act 107 of 1998) both empower their respective ministers to expropriate land and/or impose remedial costs for damages from investors (foreign or domestic). Without the duty on the part of both ministers to inform and cooperate with each other, duplication, gray areas and loopholes in the legislative framework are exposed. It is recommended that a coordinating body be created that will be solely responsible for all aspects of law that have important implications for multinational enterprise investors. Through such a coordinating body, all parties involved in specific aspects of law and policy relating directly or indirectly to multinational enterprises will be able to stay abreast of what is going on elsewhere in the public domain, that may affect or be affected by their decisions.

Given that the hypothesis of the dissertation is: *Ho = There is a necessity to formalize a government administrative structure for policy setting and implementation of multinational enterprise regulation in South Africa*; and given that the null hypothesis was not disproved, Chapter 6 of the dissertation begs the question of the most appropriate structure for the proposed unit specified in the hypothesis. A general precept of the physical sciences is that form follows function, or alternatively, in the language of public administration, strategy informs structure. Conclusions as to the form that the organizational unit that is being proposed should take are drawn largely from organization theory with

specific reference thereunder to rationalization and cost benefit analysis. Based on the arguments put forward in the dissertation, it is recommended that a small specialized unit of experts be organized into an organizational structure that is part of the public service but independent of any other governmental department or unit. The unit should work to provide support to other government agencies in the areas of research, advice and coordination services. In order to operate most effectively, this unit should encompass aspects of both classical as well as neo-classical organization theory. As the environment within which such an organizational unit operates can be expected to be relatively stable over time, and the work of the unit highly specialized, it is envisioned that decision making in the unit will be more centralized than de-centralized.

7.4 Issues for Further Study

The current study sought to determine the need for an organizational unit that is fully responsible for the coordination of all aspects of foreign direct investment and multinational enterprise policy. The study also sought to determine what this organization will look like in very general terms. The ending point of the study suggests for further study the detailed design of such an organization in more specific terms – such as the number of people to be employed, a determination of the knowledge and skills needed, the remuneration scales to be applied, communication channels etc. This would amount to a multidisciplinary study for one well versed in human resources management, economics and public policy.

7.5 Conclusion

Cleaver (1997) cautions that "…*Free markets embody no mechanism that is responsive to all the needs of the planet. Informed regulation is therefore essential to ensure sustainable development*". In a free-market system (as exists in South Africa) minimal government interference in the affairs of private business enterprises is expected to lead to the greatest possible levels of economic efficiency. Further, although government's role in private markets should ideally be kept to the minimum, there still remains a duty on the part of government to ensure that certain market conditions exist within which the free market system can operate relatively unimpeded. These market related regulatory responsibilities of government include among other, ensuring that private markets are free of oligopolistic price fixing collusion and the "unfair business practices" of monopolists.

With respect to government regulation, multinational enterprises pose a more complex set of problems than do their domestic counterparts. This is due to the fact that multinational enterprises are incorporated under the laws of one country whilst having the flexibility to establish subsidiary or branch operations in other countries. This being the case it will not always be possible to regulate, to the full extent of the law, those multinational foreign businesses that choose to leave the jurisdictional boundaries of the host country. This scenario has played itself out in Lubbe vs. Cape Plc. (Supra 4.3.1 (d)) in which the asbestos mining and supply company, Cape Plc abandoned it's South African mining operations and sought legal protection in the UK courts from South African litigants who suffered health damages as a result of Cape Plc operations. The current study examined Lubbe vs. Cape Plc and recommended that the Brussels Convention stood as a model from which to frame and resolve future similar incidents.

Although equally important, in the current study policy issues were secondary to administrative issues concerned with rationalization and finding the organizational dynamics most suited to addressing foreign direct investment policies in South Africa. The major concern addressed by the study in this regard is the fact that there currently exists no unit of government in South Africa that is tasked solely with overseeing and coordinating policies that relate to the foreign direct investment of multinational enterprises. Establishing the need for and the development of such a governmental unit has been the primary concern of the current study as well as being the basis upon which issues for further research were proposed.

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