

# Can business deliver on domestic investment?

**D**uring the 1970s and 1980s, the long-term performance of domestic fixed investment in South Africa deteriorated significantly, contributing directly to the decline in economic growth over the period.

During this period, it was taken as a given that uncertainty was a major determinant of investment performance. There is also little question that reduced investment opportunities and overall economic decline contributed to political change. In the late 1980s business groups inside and outside the country shifted to support the democratisation process, by then seeing the latter as the only way to revive growth prospects.

In the immediate aftermath of the 1994 elections, fixed investment picked up to some extent, compared with the immediately preceding years. But this improvement has not been sustained. Investment rates have remained low, well short of historical peaks and certainly far below the rate necessary to sustain gross domestic product (GDP) growth at levels that could begin to reduce the problems of poverty and unemployment.

Over and above the transition to democracy, there has also been extensive trade liberalisation, while fiscal policy has been resolutely orthodox, and increasingly successful in lowering the deficit. Domestic investment performance might therefore, have been expected to respond more vigorously to the fundamental shift

*The failure to attract foreign direct investment has put the spotlight on domestic investment. Economist **Stephen Gelb** investigates some of the underlying reasons for the failure of private sector investment to rise significantly since 1994.*

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in policy stance. The poor investment performance post-1994 has undoubtedly been influenced by episodes of macroeconomic instability resulting from capital account shocks in 1996, and again in 1998 in the wake of the Asian crisis. However, the impact of these 'should' have been fluctuations around a higher underlying rate.

South African Reserve Bank data shows that the investment rate is just above 15% of GDP but remains well below the levels of the mid-1970s, when aggregate investment peaked at more than 30% of GDP. Much of the decline is as a result of the drop in public sector investment (general government and public corporations). Such investment declined from a total of nearly 18% of GDP in the mid-1970s and about 12,5% in the early 1980s to current levels of 5% and below.

There was a 'blip' during 1998, as a result of the part-privatisation of the state telecommunications corporation, which carried specific investment obligations.

The contribution of private sector investment to total investment rose from an average of about 57% during the 1980s to about 69% during the 1990s. Although private investment rose following the 1994 election, the increase was not sustained. The private rate began to decline in early 1997 and in 1999 was at the same level as before the 1994 election, which was also its lowest level over the preceding 30-years. There has been a slight improvement since 1999, but private sector investment performance is still inferior to that of the late 1970s and late 1980s, both periods of slow recovery from recession. The private sector is investing a much lower share of GDP. Its investment rate is now in the region of 11% of GDP, compared with its peak level of 16,2% in the early 1980s.

The failure of the private sector to increase investment has been somewhat of a puzzle and a frustration for politicians and government policymakers. They have repeatedly argued that the private sector is overly concerned with 'perceptions', as distinct from the 'reality of sound macroeconomic fundamentals'. The media and/or implicitly racist attitudes (on the part of white business towards a black government) are seen as responsible for the perceptions 'gap'.

Leaving aside the political aspects of such claims, they do imply that problems of investor confidence and uncertainty remain relevant in South Africa. In addition, these problems go beyond macroeconomic instability to include issues of political risk.

### **What firms say**

A survey was conducted on behalf of the President's Office amongst 1 400 firms in South Africa between November 1999 and

February 2000 to investigate issues relating to low investment.

The survey was carried out before concerns emerged over government's policy towards stability in the Southern African region and HIV/AIDS. It should also be noted that the period November 1999 to February 2000 was a period of historically high levels for the widely-accepted BER and SACOB business confidence indices. At the time companies were asked to complete the survey, interest rates had been on a downward trend for about 12 months, and the economy was just emerging from the downturn, which had started in late 1996. The Y2K issue was possibly a factor affecting responses for some firms.

The survey found that:

- While most firms make capital investment expenditures on a regular basis, their average investment levels are very low. The vast majority of large firms (more than 50 workers) invest annually, as do most small firms (5-50 workers). But there is a significant proportion of the latter, which invest less frequently.
- 95% of small firms invest less than R1m per annum. Perhaps more surprising, and a cause for concern, is that 44% of large manufacturing firms, and 38% of large service firms, also invest less than R1m annually. Furthermore, approximately three-quarters of large firms invest less than R5m.
- More than half the companies that did invest used retained earnings as their most important source of investment finance, and for about another quarter of the firms, it was the second most important source. Loans from domestic banks are the next most important source of finance: about 30% of firms in three of the four sub-groups cited it as their most important source.
- The investment outlook over the next

two financial years was surprising. Small companies planned expenditures were set to increase more rapidly than those of large firms. But for both, the rate of expenditure increase was very low.

- The perceived obstacles to investment differed for small and large companies and between manufacturing and the service sector. Large manufacturing firms ranked 'interest rate level' as the largest obstacle followed by crime and social problems. Smaller companies ranked crime and social problems as the largest obstacle followed by 'interest rate level'. Both rated labour regulations as having only slightly less impact than the two most severe obstacles. Smaller firms also indicated that 'uncertainty over government's economic policy' and 'high corporate tax rates' were important factors for them. Large companies were less concerned about these but were concerned about 'inadequate tax *incentives*'. It is significant that neither 'lack of own funds' nor 'lack of access to borrowed funds' was seen as a major problem by either small or large firms. The *cost* of funds was rated much more severely than a lack of availability. Service companies reflected similar patterns to those of manufacturing.
- Companies' most recent capital expenditure was motivated primarily by their search for efficiency and productivity increases. This was followed by responses to aggregate demand, with entry into new markets or attempts to reduce labour utilisation as relatively minor factors.
- The survey looked at whether tax incentives would encourage an increase in investment. Results found that one third of all small firms indicated that *none* of the offered choices would be sufficient to induce higher capital investment. The lowering of company

tax rates from 30% to 25% was the next most preferred option.

- Expenditure on employee training is an important dimension of overall capital expenditure, especially given the skill shortages at the upper levels of the skills ladder. Data revealed that the average level of spending on training was low. Most large firms did undertake some expenditure but a substantial minority of small firms – approximately two-fifths – spent nothing.

### **Factors determining investment**

This section describes survey responses to questions investigating in more depth firm attitudes towards a range of factors identified as potential obstacles to investment.

#### ***Labour regulations***

The survey asked firms to assess the impact of changes to labour legislation especially in the area of dismissals, changing working time provisions, leave provisions, affirmative action and rights to collective action on both their decisions to hire new employees, and on their operating costs.

The impact of firing (dismissal) regulations both on decisions to hire employees and on operating costs was regarded by small and large firms as more serious than any other issue. Aside from this ranking, the average ratings for the other issues are located between 'moderate' and 'no impact'. This throws an interesting light on the interpretation of 'labour regulations' as an obstacle to investment. Initial ratings suggested a far more negative impact on investment than is the case for the direct impact on firm's current employment and profitability. The implication is that firms fear the possibility of future shifts on this issue, and it is this fear, which impacts on the investment decision.

### ***Social issues***

As with the responses to the labour regulations issue, firms' perceptions of crime and social issues as an obstacle to investment are not immediately linked to the direct impact of these problems on the companies' operations. More rigorous statistical testing of the results indicate that only the large manufacturing firms' responses are strongly correlated with responses to the earlier question on investment obstacles. For the other firms, the identification of crime and social issues as an investment obstacle should be seen as a response to the broader socio-political environment, rather than to the specific impact on the firms' own activities. Corruption ranked low on the list of disincentives while on the impact of HIV/AIDS, the response was limited.

### ***Interest and exchange rates***

Larger companies, both manufacturing and services, react more vigorously to changes in interest rates than do small firms. Rate increases force substantial minorities of the large firms, especially in manufacturing to cut back on expansion plans and on debt financing. Almost half of the small firms indicated that the rate increase had no effect on them, which is a surprising result. In terms of changes to the exchange rate, it appeared that it was only amongst the large manufacturing firms that a significant response was found. Within this group one has to unpack differences between exporters and non-exporters. For non-exporters, the exchange rate's impact on investment (machinery purchases) is more significant than the impact on current activity. Amongst large manufacturing exporters, there is an encouragingly vigorous response to the favourable movement of the currency.

### ***Attitudes to government***

The issues addressed include policy consistency, 'business-friendliness' of

policy and the change in the quality of dealings with officials since 1994. (The responses should be interpreted taking account of the fact that the survey questionnaire came explicitly and clearly from the South African government. The survey could have been seen by many firms as an opportunity to 'send a message' to government.) Companies were more positive about effects on their ongoing operations and activities, as reflected in their interactions with government officials, than about government's impact upon the broader operating environment of the company. The majority of companies felt however, that government rarely, if ever took account of their concerns in policymaking, while a strong majority felt policy was unpredictable and inconsistent, without a clear framework.

### **Uncertainty and investor confidence**

There was a noticeable difference in responses between constraints to investment and the actual impact of these investment constraints on day-to-day operations, as distinct from their investment decisions.

Although the most significant constraints on investment were also seen as having a negative impact on ongoing operations, the costs imposed on the latter were perceived as fairly moderate, while the barriers to further investment and expansion were relatively severe. This disjuncture suggests that despite the historically high levels of published confidence indices at the time of the fieldwork, the survey still suggests that uncertainty and lack of investor confidence – linked to social and political issues, rather macroeconomic 'fundamentals' – are major barriers to investment in South Africa. This is over and above the direct effects of the cost of capital (via interest rates), profitability (via

labour costs) and market demand.

How should the socio-political confidence factor be interpreted? A critical factor underpinning the connection between the present and the future is the stability of the broad institutional framework. Property rights are central to this along with the rule of law, and the predictability of policy and administration. Property rights are often taken to mean simply ownership rights of individuals and firms over their assets or their labour. Fragile or insecure property rights reflect weak contract enforcement leading to perceived or actual threats of loss of ownership of assets via expropriation.

But a *broader* interpretation of property rights, more appropriate to South African circumstances, is that it involves not just ownership of assets, but also adequate *control* over returns to assets. In other words, claims on the *future distribution of income* generated by assets. On this basis, property rights are inadequately protected if there is a possibility of economic policy shifts, which would result in far-reaching changes in the income distribution regime. Secure property rights have historically been one of the keys to economic growth. Entrepreneurs do not have an incentive to invest or innovate if they are uncertain about their claims on future returns from the operation of the assets they have purchased and installed.

The implication of this analysis is that South African firms are insecure over property rights. What underlies this insecurity? It goes beyond a simple reaction to statements by government leaders. Rather, firms do not feel they have sufficient control over the future returns to their activities. They identify high risks of losses through private criminal acts against firm assets, owners or employees. More importantly, they expect or fear far-reaching policy shifts - to the regimes

regulating taxes or input costs, for example - which could fundamentally affect the future distribution of returns.

South African firms' fear of large expected future losses, whether from crime or from strongly redistributionist policy regimes, is linked to the high levels of economic *polarisation* in South African society. The relationship between insecure property rights and low investor confidence is not unique to South Africa, but is common in societies, which are highly distributionally polarised.

It is also not surprising in a society which has experienced a recent democratic transition, as South Africa has, that firms assess the probability of loss to be relatively large - 'bad news' is likely. This is not a consequence of attitudes per se to government, but rather a concern that government will be overwhelmed by 'popular' demands for redistribution and this will lead to a fundamental policy shift.

## **Raising investment**

What are the prospects for improved investment performance? The standard policy measures to raise investment rates will only make a significant difference if the underlying confidence issues are also addressed.

Polarisation means that improved distribution is a political imperative for government, at least in the medium to long term. This makes it more difficult for government to commit *credibly* to an economic policy framework which does not result in redistribution. In other words, firms are less likely to believe that 'the rules of the game' are settled for the long term if these rules do not credibly address inequality and polarisation in the society, and thereby increase security over property rights. If government actively addresses distributional issues, investors will be less anxious about this demand spilling over into far-reaching



*Is business willing and able?*

policy shifts and more certainty about claims on their future incomes.

What features of a new framework to address distribution would make it credible?

- ❑ *Reflect a social consensus* that has wide and explicit support across the society, including all social partners.
- ❑ *Shift towards the more equitable distribution of wealth and income earning assets.* The concern with current incomes provides incentives for groups to try to increase their income shares at the expense of other groups, and to try to build political support for a bigger share of transfers out of current income. By shifting the focus to income-earning *assets* – such as skills and ‘human capital’ (the most essential), housing, land and infrastructure – groups would by contrast face incentives to contribute to overall growth so as to acquire rising income streams into the future. A shift to a *future* growth perspective, rather than a current income perspective, would be a clear signal to firms that their own claim on the future returns on their assets was not threatened.
- ❑ *Produce some degree of success*

*relatively quickly.* This will require more far-reaching measures to achieve equity in asset distribution, as well as rapid improvements in policy implementation (‘service delivery’) in areas such as education, health, housing and household infrastructure, all of which are essential to enhancing human capital.

- ❑ *Maintain macroeconomic stability.* In an internationally open economy, premature or overly rapid relaxation of fiscal or monetary policy could lead to a macroeconomic shock and capital outflows which would greatly slow down efforts to improve distributional equity. But at the same time, too contractionary a stance will also hold back greater equity. The impact of macroeconomic shocks is greatly mitigated if distributional conflict is well managed: a credible and effective framework for addressing distribution would therefore produce additional gross benefits.

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*This is an edited version of a longer paper. Gelb is director of The EDGE Institute – a non-profit economic research institute. The paper is available at [www.the-edge.org.za](http://www.the-edge.org.za). Tel: (011) 339-1757.*