Tax Incentives and Foreign Direct Investment in South Africa

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Abstract

The disparity between rich and poor in South Africa ranks amongst the largest in the world. In response to these daunting development challenges, the government has adopted a locally and globally praised macro economic policy known as the Growth, Employment and Redistribution (GEAR) strategy. At its core, GEAR is a commitment to enhance the well being of all South Africans through sustainable economic growth and an improved distribution of economic opportunities. To meet this goal, GEAR estimates that a growth rate of 6 percent coupled with the creation of 400,000 jobs per annum is required. Although such growth has been elusive, it is widely acknowledged that such a goal is attainable. Increasing direct investment by foreign-based companies (FDI) is commonly regarded as the key. Given the Country’s low domestic savings rate, FDI is a crucial source of funds for much needed investment capital. South Africa, however, has failed to attract significant amounts of FDI. Despite greater economic liberalization, foreign investors have continued to spurn South Africa. Modern econometric research has demonstrated that taxation can, under certain circumstances, have a considerable impact on a country’s ability to attract FDI, particularly efficiency seeking FDI. This article examines the competitiveness of South Africa’s tax regime in order to determine if it is a potential cause of the country’s relative FDI dearth.

Keywords: South Africa; economic growth; tax incentives; FDI.

1. Introduction

The peaceful handover of power in 1994 to the democratically elected African National Congress (ANC) government marked the demise of the Apartheid system. Nevertheless overcoming Apartheid’s socio-economic legacy of widespread poverty and income inequality still poses a daunting challenge for the new South Africa.

The disparity between rich and poor in South Africa ranks amongst the largest in the world. World Bank\(^1\) estimates income inequality in South Africa to be at 57.8 percent using the Gini index.\(^2\) A further examination of this figure reveals that the

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\(^1\) World Bank, 2007a, p.67.

\(^2\) The Gini index measures the inequality of income distribution within a country. It varies from zero percent, which indicates perfect equality, with every household earning exactly the same, to a hundred percent, which implies absolute inequality, with a single household earning a country's entire national income.
richest 20 percent of households receive 62.2 percent of total national income, almost eighteen times that of the poorest 20 percent. This places South Africa in seventh position after countries like Honduras and the Central African Republic for the greatest income inequality.

It is therefore clear that many previously disadvantaged South Africans continue to live in abject poverty. 17 million people still do not have access to basic services such as electricity and running water. The deliberate imposition of inferior education on Black South Africans by the Apartheid system has created a severe skills shortage in South Africa with only 20.4 percent of the population having completed grade 12. With the prevalence of HIV/AIDS and the limited availability of healthcare, life expectancy is appallingly low at 45 years. Given these factors, South Africa ranks 121st out of 177 countries in the United Nations’ Human Development Index—just below fellow African state Equatorial Guinea.

In response to these daunting development challenges, the government has adopted a locally and globally praised macroeconomic policy known as the Growth, Employment and Redistribution (Gear) strategy. At its core is a commitment to enhance the well-being of all South Africans through sustainable economic growth and an improved distribution of economic opportunities. To meet this goal, Gear estimates that a growth rate of 6 percent coupled with the creation of 400 000 jobs per annum is required.

Despite its many noteworthy economic achievements of the past decade, the South African economy has been unable to meet these targets. Since 1994 South Africa’s growth rate has averaged only 3 percent and unemployment, rather than declining, has in fact increased to 41 percent of the working age population (including discouraged workers). The failure to achieve GEAR’s vital goals has meant that more than a decade since its demise, Apartheid’s socio-economic legacy continues to haunt South Africa.

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4 NACI, 2003, p.10.
5 There is estimated to be an infection rate of 18.8 percent among South Africans between the ages of 15 and 49, one of the highest in the world. See World Bank, 2006, p.293.
7 Gear, 1996.
8 Such as decreasing inflation to acceptable levels of around 6 percent (National Budget Review, 2007, p.5); reducing the budget deficit to below 3 percent of GDP thereby bringing government debt in line with international norms (National Budget Review, 2007, p.13) and as a result of an ambitious trade liberalisation policy has gained preferential treatment for its exports in major markets like the United States (National Budget Review, 2007, p.28).
10 Since 2004 economic growth has accelerated to approximately 5 percent but has had little impact on reducing unemployment (Nowak & Fisher, 2007, p.5).
<table>
<thead>
<tr>
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<tbody>
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<td>351.2%</td>
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<td>244.3%</td>
<td>2.5%</td>
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<td>Developing economies (without China)</td>
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<td>77.2%</td>
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<tr>
<td>South Africa</td>
<td>0.3%</td>
<td>0.9%</td>
<td>2.6%</td>
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</table>

Table 1: Average growth rate of top developing FDI recipients, 1991-2005
(Sources: UNCTAD, 2006; UNCTAD, 2006a).

Although 6 percent growth, coupled with the creation of 400 000 jobs per annum, has been elusive, it is widely acknowledged that such a goal is attainable. Increasing direct investment by foreign-based companies (FDI) is commonly regarded as the key.\(^{11}\) Given the Country’s low domestic savings rate, FDI is a crucial source of funds for much needed investment capital\(^{12}\). But more than just providing capital, FDI facilitates the dissemination of new technologies and management practices in host countries. This has been shown by modern economic growth theory, supported by some empirical studies, to be indispensable in enhancing a country’s potential growth rate\(^{13}\). Furthermore, FDI represents a vital source of foreign exchange for strengthening South Africa’s foreign currency reserves in order to guard against capital account shocks.\(^{14}\)

South Africa however has failed to attract significant amounts of FDI. Despite greater economic liberalisation, foreign investors have continued to spurn South Africa. It has managed to gain a paltry $24 billion in the last two decades, constituting only 0.25 percent and 0.9 percent of global and developing world FDI respectively (see Table 1). This is well below the inflows of similar emerging markets.

One possible explanation for this lacklustre performance could be the relatively onerous tax burden South Africa places on foreign investors. Modern econometric research has demonstrated that taxation can under certain circumstances have a considerable impact on a country’s ability to attract FDI, particularly efficiency seeking FDI. Thus this article examines the competitiveness of South Africa’s tax regime in order to determine if it is a potential cause of the country’s relative FDI dearth.

2. The influence of taxation on FDI

\(^{11}\) Lewis, 2002, p.26
\(^{12}\) Loots, 2000, p.2.
\(^{13}\) See: Markusen and Venables, 1999; Lim, 2001; Borenstein et al., 1995; and Kumar & Pradhan, 2002.
\(^{14}\) Loots, 2000, p.3.
The relationship between taxation and FDI has been a major focus of tax policy research for more than half a century. The results of econometric studies have changed significantly over time. Historically fiscal considerations were found to have an insignificant impact on FDI. More recent research, however, has concluded that under certain circumstances taxation can be influential in investment decisions. Greater globalization of the world economy, the availability of more detailed economic data and the utilization of more sophisticated analytical techniques have all contributed to this evolution in FDI econometric findings.

Hines in an extensive review of econometric studies conducted over the last 15 years concluded that the consensus view is that on average a 1 percentage point reduction in the effective tax rate would increase FDI by approximately 2 percent.\textsuperscript{15} This estimated effect however is not uniform: tax incentives (like all other determinates) differ in their impact on foreign investment decisions across industries and even among firms in a single industry.

Fiscal incentives typically carry less weight where firms are resource seeking or intend to serve the local market. In such cases, FDI is relatively location bound with market size and resource availability being the overriding determinants.\textsuperscript{16} Efficiency-seeking FDI however, especially in the export oriented manufacturing sector, is more responsive to tax relief.\textsuperscript{17} This type of investment is considerably more footloose in nature as it is made in highly competitive markets with slim margins.\textsuperscript{18} Thus minimizing operating costs, of which taxes can be an important part, is central to the investment decisions of an export oriented manufacturing firm.

Not only have modern econometric studies shown FDI, particularly efficiency-seeking FDI, to be sensitive to tax rates, but also that this sensitivity has in fact increased over time. Altschuler et al., using data aggregated from U.S. Treasury corporate tax return files, found that the elasticity of real capital to changes in after tax returns has increased from 1.5 in 1984 to 2.8 in 1992.\textsuperscript{19}

Blomstrom & Kokko attribute this sharp rise in the influence of tax incentives on FDI to the regionalization and globalization of the world economy.\textsuperscript{20} Trade liberalization, be it globally, through GATT and WTO, or regionally, in the form of the EU, NAFTA or SADC, has made it easier for firms to set up international production networks, resulting in a larger share of output being shipped to international customers or affiliated companies in foreign countries rather than sold to local customers. This has reduced the importance of market size and allowed smaller countries to compete for FDI that would almost certainly have gone to larger countries some decades ago.

In addition to the integration of markets, globalization has also resulted in greater homogeneity in the infrastructure, skills base, labour costs, macroeconomic performance and regulations of many nations, particularly among OECD countries.\textsuperscript{21} This has caused disparities in tax rates between countries to increase in significance.

\textsuperscript{15} This assumes a base corporate income tax rate of around 30%. See Hines, 1999, p.309.
\textsuperscript{16} Dunning, 2002, p.7.
\textsuperscript{17} e.g. Grubert & Mutti, 2000.
\textsuperscript{18} Morisset & Pirnia, 2001, p.82.
\textsuperscript{19} Altschuler et al., 1998, p.21.
\textsuperscript{20} Blomstrom & Kokko, 2003, p.6.
\textsuperscript{21} Bolnick, 2004, 2.11.
as a determinate of FDI. Thus recent studies focusing on FDI competition between US states or EU countries have found tax incentives to have a particularly strong effect.\textsuperscript{22}

Technological advances in communication and transportation over the last two decades have also contributed to this phenomenon. These advances have allowed firms operating in knowledge-based industries such as banks, insurance companies and internet related businesses to become more mobile. Low tax jurisdictions have become increasingly successful in attracting this type of FDI. Hines, in a study of the success of tax havens in attracting FDI, found that although major tax havens constitute less than 1 percent of the world’s population and 2.3 percent of world GDP, they host 8.4 percent of the property, plant and equipment controlled by American firms abroad.\textsuperscript{23} This is considerably more than would be expected given the size of the economies of these havens. A typical example is the Cayman Islands which claims to be the fifth largest financial centre in the world, hosting operations of subsidiaries of 45 of the world’s largest banks.\textsuperscript{24}

Thus modern research has demonstrated that taxation is a decisive factor in attracting FDI, particularly the efficiency seeking variety, especially when the fundamentals of competing investment locations are similar.

\section{3. FDI in South Africa}

FDI has had a long and volatile history in South Africa. Foreign capital from European, particularly British, companies, from as early as 1652, has been largely responsible for the Country’s industrial development.\textsuperscript{25} Particularly after the discovery of diamonds in 1867 and later gold in 1884, foreign investors and entrepreneurs flocked to South Africa eager to make their fortune by exploiting the country’s vast mineral wealth.\textsuperscript{26} The resulting economic booms served to stimulate further FDI, which facilitated the creation of manufacturing and service industries in South Africa.\textsuperscript{27} This general trend of substantial FDI continued well into the 1950s.

But following the 1961 Sharpeville massacre international sentiment towards South Africa changed.\textsuperscript{28} Increased political instability coupled with greater government interference in the economy frightened away many potential foreign investors.\textsuperscript{29,30} This situation deteriorated further after the 1976 Soweto riots. In addition, the international boycott campaign against Apartheid, culminating in official trade and financial sanctions in the 1980s, effectively cut South Africa off

\begin{itemize}
  \item \textsuperscript{22} E.g. Buettner & Ruf, 2005.
  \item \textsuperscript{23} Hines, 2004, p.i.
  \item \textsuperscript{24} Morisset & Pirnia, 2001, p.16.
  \item \textsuperscript{26} Black & Gelb, 2004, p.177.
  \item \textsuperscript{27} Oti-Prempeh, 2003, p.37.
  \item \textsuperscript{28} ibid.
  \item \textsuperscript{29} Bogran & Clark, 1999, p.342.
  \item \textsuperscript{30} Black & Gelb, 2004, p.177.
  \item In order to restrict the flight of foreign capital and halt the sudden deterioration in its balance of payments, South Africa adopted a dual rand currency and exchange rate system (Bogran & Clark, 1999, p.342). Government economic interference became so extensive by the late 1980s that Soviet economists considered South Africa to have the most state-controlled economy of all non-communist countries (Bogran & Clark, 1999, p.340)
\end{itemize}
from foreign capital markets. This resulted in a massive outflow of foreign capital, with 225 US corporations and almost 20 percent of UK firms alone exiting South Africa between 1984 and 1988.

Political change and economic reforms in the 1990s did improve foreign investors' perceptions of South Africa, but FDI has nevertheless remained relatively low when compared to other emerging markets. FDI to South Africa has constituted only about 1.5 percent of GDP since 1993, well below the 3 percent average for other middle-income countries. Moreover in the latest United Nation Conference on Trade and Development (UNCTAD) Inward FDI Performance Index, South Africa is ranked a dismal 103nd out of 141 economies, on par with countries like Syria, Pakistan and Papua New Guinea.

South Africa’s relatively poor performance in attracting FDI is, in fact, worse than these figures suggest. Recent FDI data has been artificially inflated by the investments of former South African multinational corporations that are now domiciled in the United Kingdom. The amount of this ‘FDI’ is estimated to be significant. Its extent is reflected in the fact that UK firms are now responsible for a massive 75 percent of all foreign investment in South Africa. Anglo Americans' direct investments alone are thought to constitute about 16 percent of South Africa’s total FDI.

Not only has the quantity of FDI to South Africa been inadequate but its potential economic benefits have also been modest. Most FDI has been in the form of partial cross-border mergers and acquisitions while much needed Greenfield investment has been relatively small. Partial foreign mergers and acquisitions, as opposed to Greenfield investments, rarely result in significant technology transfers and skills development. Thus, while this risk mitigating strategy has allowed foreign investors to acquire established market share with reduced initial outlays, it has severely limited the potential spillover benefits needed to boost South Africa’s long term economic growth rate.

Furthermore much of this FDI has been market or resource seeking. In a study of the nature of FDI to South Africa, Leape & Thomas found that the resource sector has continued to receive the major share of FDI since 1994. Gaining access to local and regional markets has also been a major objective of foreign investors in

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31 Arvanitis, 2005, p.65.
33 Leape & Thomas, 2005, p.2.
34 This index ranks counties by the FDI they receive relative to their economic size, that is, a country's share of global FDI inflows relative to its share in global GDP.
35 Leape & Thomas, 2005, p.ii.
36 Although these investments meet the definition of FDI, they are more akin to portfolio flows in their economic effect (Black & Gelb, 2004, p.181).
37 Arvanitis, 2005, p.66.
38 Leape & Thomas, 2005, p.12.
39 Arvanitis, 2004, p.67: Mergers and acquisitions account for more than 60 percent of total FDI. A large portion of this is made up of a few important investments. These include the investments of Petronas in Engen, Dow Chemicals in Sentrachem, Coca Cola in SA Bottling and the take over of De Beers by Anglo American and associates. Greenfield investments refer to physical investments where previously no structures existed.
40 Black & Gelb, 2004, p.211.
41 Leape & Thomas, 2005, p.12.
South Africa. Estrin & Meyer in a comparative study on FDI to Egypt, India, South Africa and Vietnam found that over 80 percent of the sales from foreign enterprises in South Africa were generated domestically, the highest of all the countries surveyed.\(^\text{42}\)

Thus South Africa has largely been overlooked by foreign firms making efficiency-seeking investments.\(^\text{43}\) Given the growing sensitivity of this particular type of FDI to taxation (as discussed above), it is possible that an uncompetitive tax policy may a possible reason for South Africa’s FDI dearth.

4. The competitiveness of South African tax policy

It is not South Africa’s absolute tax rate but rather the competitiveness of its fiscal policy relative to those of its FDI rivals that affects its attractiveness to foreign investors. The UNCTAD Inward FDI Potential Index provides a useful mechanism for ascertaining who South Africa’s FDI rivals are.

As opposed to the UNCTAD Inward FDI Performance Index discussed above, this ranking rates the same 141 economies on their expected (not actual) attractiveness to foreign investors. It is compiled using generally accepted major FDI determinates such as real per capita income, high-level skills availability, infrastructure capacity, the abundance of natural resources and political and macroeconomic stability.\(^\text{44}\) Taxation however is not taken into account. Thus the extent of the disparity in a country’s FDI potential and its actual FDI performance could be an indication of the competitiveness of its fiscal policy.

South Africa ranks 72nd on UNCTAD’s Inward FDI Potential Index but (as discussed above) comes in at a dismal 103rd place on the Inward FDI Performance Index.\(^\text{45}\) Of the sixteen economies with the closest FDI potential to that of South Africa, only Algeria has performed worse (see table 2). When South Africa’s fiscal inducements are compared to those of some of these countries, the reason for South Africa’s relative rejection by foreign investors becomes apparent.\(^\text{46}\)

South Africa has one of the highest nominal corporate tax rates of countries with a similar FDI attractiveness (see Table 2). At 38 percent it is almost 10 percentage points higher than the average of 28.7 percent.\(^\text{47}\) Furthermore, South Africa is far

\(^{42}\) Estrin & Meyer, 2004, p.35.


\(^{44}\) The Index is based on 12 economic and structural variables measured by the unweighted average of their respective scores on a range of 0-1. These include: GDP per capita, the rate of growth of GDP, the share of exports in GDP, telecoms infrastructure (the average number of telephone lines per 1,000 inhabitants, and mobile phones per 1,000 inhabitants), commercial energy use per capita, share of R&D expenditures in gross national income, share of tertiary students in the population, country risk, exports of natural resources as a percentage of the world total, imports of parts and components of electronics and automobiles as a percentage of the world total, exports of services as a percentage of the world total, and inward FDI stock as a percentage of the world total. (UNCTAD, 2006, p.38).

\(^{45}\) UNCTAD, 2006, pp.277-278.

\(^{46}\) Only countries for which detailed tax information could be found have been included in the comparative fiscal analysis.

\(^{47}\) This figure includes the effective rate of Secondary Tax on Companies (STC). This figure, however, excludes South African branches of foreign entities which are taxed at a rate of 34 percent. (KPMG, 2007, p.21).
<table>
<thead>
<tr>
<th>Countries</th>
<th>UNCTAD FDI potential index ranking</th>
<th>UNCTAD FDI performance index ranking</th>
<th>Nominal corporate tax rate</th>
<th>Effective tax rate</th>
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</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>64</td>
<td>9</td>
<td>15.0%</td>
<td>21.4%</td>
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<tr>
<td>Algeria</td>
<td>65</td>
<td>109</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>66</td>
<td>65</td>
<td>25.0%</td>
<td>-</td>
</tr>
<tr>
<td>Argentina</td>
<td>67</td>
<td>83</td>
<td>35.0%</td>
<td>17.2%</td>
</tr>
<tr>
<td>Turkey</td>
<td>68</td>
<td>95</td>
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<td>20.3%</td>
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<tr>
<td>Tunisia</td>
<td>69</td>
<td>77</td>
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<td>-</td>
</tr>
<tr>
<td>Botswana</td>
<td>70</td>
<td>42</td>
<td>25.0%</td>
<td>-</td>
</tr>
<tr>
<td>Brazil</td>
<td>71</td>
<td>82</td>
<td>34.0%</td>
<td>24.3%</td>
</tr>
<tr>
<td>South Africa</td>
<td>72</td>
<td>103</td>
<td>37.8%</td>
<td>26.5%</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>73</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>74</td>
<td>53</td>
<td>28.0%</td>
<td>17.0%</td>
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<tr>
<td>Costa Rica</td>
<td>75</td>
<td>59</td>
<td>30.0%</td>
<td>-</td>
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<td>Venezuela</td>
<td>76</td>
<td>86</td>
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<td>Mongolia</td>
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<td>-</td>
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<tr>
<td>Armenia</td>
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<td>30</td>
<td>-</td>
<td>-</td>
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<tr>
<td><strong>AVERAGE</strong></td>
<td></td>
<td></td>
<td><strong>28.7%</strong></td>
<td><strong>20.8%</strong></td>
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</table>

Table 2: South Africa and its FDI rivals
(Sources: UNCTAD, 2006; KPMG, 2007; Gordon & Li, 2005).

more parsimonious with fiscal incentives than its FDI competitors. While it is not possible to compare the actual amount of tax revenue forgone, the number and nature of fiscal incentives offered does provide an indication of a country's fiscal generosity.\footnote{Few countries, particularly those in the developing world, report systematically on the amount of potential revenue lost from granting tax incentives. In fact Brazil is the only developing country to disclose its ‘tax expenditure’. South Africa is currently in the process of developing a report (Bolnick, 2004, 4.10).}

Tax holidays (particularly those greater than 5 years) and reduced tax rates are the most generous and most common fiscal incentives provided by developing countries.\footnote{UNCTAD, 2000.} Although at least one is employed by all the other countries surveyed, South Africa currently offers neither (see Table 3).\footnote{In 1996 South Africa did institute a discretionary tax holiday for qualifying manufacturing investment, but this was quickly phased out. In terms of s 37H(5) of the Income Tax Act, no new projects have been approved since 30 September 1999.} In addition, South Africa also falls short in the special deductions and investment allowances granted to investors. Its flagship tax incentive scheme, the Strategic Investment Program (SIP) offers at most 100 percent write-off of the cost of qualifying investment assets in the year in
<table>
<thead>
<tr>
<th>Countries</th>
<th>Tax holiday (years)</th>
<th>Reduced tax rate</th>
<th>Investment allowance/tax credit</th>
<th>Duty/VAT exemption/reduction</th>
<th>R &amp; D allowance</th>
<th>Deduction for qualified expenses</th>
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<td>Completely exempt</td>
<td>Accelerated write-offs</td>
<td>Various</td>
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<tr>
<td>Venezuela</td>
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<td></td>
<td>Tax credit of up to 20%</td>
<td>Completely exempt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>Up to 15 years</td>
<td></td>
<td>Up to 50% reduction for 5 years</td>
<td>Allowance of up to 200%</td>
<td>Completely exempt</td>
<td>Various</td>
</tr>
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<td>Costa Rica</td>
<td>Up to 12 years</td>
<td></td>
<td>Up to 50% reduction for 6 years</td>
<td>Accelerated depreciation allowance</td>
<td>Completely exempt</td>
<td>Various</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Up to 8 years</td>
<td></td>
<td>Up to 65% reduction indefinitely</td>
<td>Completely exempt</td>
<td></td>
<td></td>
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<tr>
<td>Botswana</td>
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<td>Amount discretionary</td>
<td>Accelerated depreciation allowance</td>
<td>Duty exemptions only</td>
<td></td>
<td></td>
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<tr>
<td>Bulgaria</td>
<td>Length discretionary</td>
<td></td>
<td></td>
<td>Completely exempt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Angola</td>
<td>Up to 10 years</td>
<td></td>
<td>Up to 50% reduction</td>
<td>Completely exempt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td></td>
<td>Allowance of up to 100%</td>
<td>Completely exempt</td>
<td>25% for 4 years</td>
<td>Various</td>
<td></td>
</tr>
</tbody>
</table>

**Table 3: A comparative analysis of the incentives offered by South Africa and its FDI competitors**

(Source: UNCTAD, 2000).

which they are brought into use. This is far less than the 200 percent write-offs offered by Turkey and Brazil (see Table 3).

South Africa is however more competitive with regard to indirect tax incentives. Although still fledgling, Industrial Development Zones (IDZs) provide investors with the opportunity for exemption from excise duties, VAT and import duty on assets and inputs used in the production of exports. Sector specific indirect tax reductions are also available. The Motor Industrial Development Program (MIDP) for example is an import-export complementation scheme that allows both motor equipment and motor component manufacturers to earn duty credits from exporting that can be used to offset import duties or sold on the open market. Similar but less extensive incentives are also available to exporters of textiles and clothing under the

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51 This scheme is open to both foreign and domestic firms. The only scheme that is available exclusively to foreigners is the MIDP (see below). The write-offs offered under the SIP are in addition to other allowances for which the assets may qualify in terms of the Income Tax Act (s 12G(2) of the Income Tax Act).


53 South Africa currently has four IDZs: Coega IDZ, Port Elizabeth, Eastern Cape; East London IDZ, East London Eastern Cape; Richard's Bay IDZ, Richard's Bay KwaZulu-Natal and O. R. Tambo IDZ, Kempton Park, Gauteng.

54 Barbour, 2005, p.45.
Duty Credit Certificate Scheme for the Textile Industry.\textsuperscript{55} This is in line with the indirect tax relief offered by the other developing countries surveyed (see Table 3).

South Africa’s already deficient tax incentive schemes have been further weakened by poor implementation. Successive surveys have shown that there is little awareness among potential investors of the incentives available.\textsuperscript{56} Moreover many of the schemes are bureaucratically complex, creating confusion and uncertainty, so much so that a major accountancy firm in South Africa has a practice dedicated to assisting potential investors navigate the application and approval processes.\textsuperscript{57} These tax incentives are time consuming and costly for both the investor and the Government.

South Africa’s fiscal incentive regime also appears to lack strategic focus. Although GEAR sets out to encourage investment in ‘labour-intensive manufacturing’ as a key policy objective, many of the incentives offered favour capital-intensive projects.\textsuperscript{58} The SIP, despite attracting more than R30bn in new investment between 2001 and 2005, created only a paltry 7,000 direct jobs. For example, the motor car industry in South Africa, which is backed by the MIDP, is extremely capital intensive.\textsuperscript{59}

South Africa’s tax incentive schemes have also failed to significantly advance the economic development of poorer regions, another key policy objective.\textsuperscript{60} 78 percent of incentives are estimated to have been taken up by investors in the country’s three wealthiest provinces — Gauteng, KwaZulu-Natal and the Western Cape.\textsuperscript{61}

These problems are compounded by the fact that there is no single government agency charged with overall responsibility for the design and implementation of incentives. The National Treasury, the Department of Trade and Industry, the South African Revenue Service as well as numerous other semi-autonomous government institutions like Khula, the Industrial Development Corporation, the National Research Foundation and the International Trade Administration Commission all play a role.\textsuperscript{62}

The severe uncompetitiveness of its tax policy, which has been borne out by this evidence, offers one possible explanation of why, despite much lauded political and economic reforms, South Africa continues to lag behind similar emerging markets in attracting FDI.

5. The risks of tax incentives for South Africa

Although enhanced fiscal incentives would help South Africa attract much needed foreign fixed capital, they have risks that need to be considered. The potential loss of revenue for the Fiscus could be significant. Some of the FDI that would benefit from additional tax incentives may have taken place regardless, and the

\textsuperscript{55} \textit{ibid}, p.46.
\textsuperscript{56} \textit{ibid}, p.21.
\textsuperscript{57} \textit{ibid}, p.21.
\textsuperscript{58} GEAR, 1996, p.2.
\textsuperscript{59} Barbour, 2005, p.23.
\textsuperscript{60} Bolnick, 2004, A.11.
\textsuperscript{61} Ntingi, 2007, p.11.
\textsuperscript{62} Barbour, 2005, p.23.
fiscal incentive program may be open to abuse from tax avoidance schemes. In such cases where there are no net economic gains to the economy, these ‘free riders’ will benefit at the expense of all South Africans. In order to balance the fiscal budget, this lost revenue will have to be recovered through additional domestic taxes or the curtailing of essential social expenditures.

Tax incentives can also result in costly long run economic distortions. Some activities are pursued over others not because they necessarily have a competitive advantage but because their profitability has been artificially enhanced through preferential tax treatment. In addition to fostering investments with low productivity, this may also draw resources away from other more productive projects. The South African motor industry is a case in point. In order to maintain the sector’s economic viability, the tax incentives granted by the MIDP are estimated to have cost the economy between R500 and R700 million.

Rent seeking and corruption are additional problems associated with tax incentives. Where incentives are large, investors have an inherent interest in maintaining the status quo, sometimes resulting in pay offs to influential government officials. In fact South Africa has already experienced this with one of its domestic financial incentive schemes. The Small and Medium Enterprise Development Program (SMEDP) was suspended in 2005 and its former head of Enterprise Organisation fired for alleged financial mismanagement.

Furthermore tax incentives can impose substantial administrative and compliance costs on both governments and foreign investors. They inherently complicate the tax system as different rules are applied to different taxpayers. Complex legislation, skilled staff and sophisticated systems are needed to prevent tax avoidance, diverting limited resources from other important administrative tasks. Moreover these controls can result in delays and uncertainty, which increase financial risks for foreign investors.

Thus, while tax incentives may increase South Africa’s FDI inflows, if not managed effectively, they could have a detrimental effect on the country’s economy.

6. Conclusion

Attracting substantial amounts of FDI is widely regarded as crucial for South Africa to overcome Apartheid’s unconscionable legacy of deprivation and destitution. South Africa, however, has been largely overlooked by foreign investors

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63 Zee et al., 2002, p.2.
65 Zee et al., 2002, p.5.
69 Ntingi, 2007, p.11.
70 This program was used to promote small and medium size businesses in the manufacturing, agrarian, biotech, tourism, culture, business services and ICT sectors. It provided for a 3 year grant of up to R100m per enterprise per project. (Barbour, 2005, p.39.
72 Flatters, 2005, p.6.
73 Morisset & Pirnia, 2001, p.22.
in favour of other developing countries. This trend is particularly acute in the case of more footloose efficiency-seeking FDI.

The long term solution to this FDI performance problem is widely recognised to lie in strengthening the country’s investment fundamentals. To this end, the South African government has instituted policies aimed at skills development; upgrading transport, communications and energy infrastructure; reducing crime and expanding the scope of the Southern African common market. In the shorter term, however, offering foreign investors competitive tax incentives could enhance FDI inflows and bolster economic development.

South Africa, with its limited tax incentives and relatively high nominal corporate tax rate, has a significantly more onerous fiscal policy than its peers. Moreover, the few incentives schemes that are on offer suffer from implementation deficiencies. There is little awareness among potential investors of the tax relief available and the application and approval processes are opaque and administratively burdensome. Furthermore, the kinds of the fiscal incentives offered are incongruent with South Africa’s industrial policy. Given the influence of taxation on foreign investment decisions, this poorly implemented fiscal regime has surely contributed to the country’s FDI woes.

Clearly, South Africa’s tax incentive regime is in need of reform. Of late, this has been widely discussed in public policy circles and the financial press. South Africa’s flagship tax incentives schemes, the SIP and the MIDP, are both currently under review by the DTI. There is however no consensus among the major economic players on this issue. The Congress of South African Trade Unions (COSATU) has come out in favour of extending these programs, citing the role of tax incentives in increasing FDI and consequently generating employment. The South African Chamber of Business (SACOB), however, has been less enthusiastic. The Chamber has cited worries that local businesses may have to cover the deficit (in the form of higher domestic taxes) from which the fiscus will suffer as a result of providing foreign investors with more tax relief.

However, these deliberations, despite the intensity of debate, have been far too limited. They have focused only on superficial changes, merely tinkering with South Africa’s current tax incentive schemes, either by broadening their scope or increasing the amount of tax relief they offer. These will do little to solve the country’s socio-economic problems, and do not evaluate all the potential costs of tax incentives.

In order to maximise the net economic benefits of tax incentives, a complete overhaul of South Africa’s fiscal policy towards FDI is required. The ad hoc programs currently offered need to be replaced by a comprehensive fiscal regime that is aligned with the country’s development objectives. But even the best tax policy can produce poor results if not well implemented. Thus, South Africa also requires a holistic and sophisticated management approach, encompassing

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74 Ntingi, 2007, p.11.
75 Temkin, 2007, p. 3.
76 This position has been supported by motor manufacturers in South Africa. Johan van Zyl, the chief executive of Toyota South Africa, speaking at the SA Automotive Week warned that without incentives the motor industry in South Africa would not be viable. This industry, excluding component manufacturers, has created 36 000 jobs and is expected to add a further 4000 by 2020 if the status quo is maintained (Gokayne, 2007, p.4).
77 Bolnick, 2004, 1.3.
marketing, administration and performance evaluation. Such a strategy could certainly help advance South Africa’s continuing struggle for financial uplifting and sustainable economic development.

7. Bibliography


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