TAX INCENTIVES THAT ENABLE FOREIGN DIRECT INVESTMENT

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ABSTRACT

South Africa as developing nation does not attract foreign direct investment in the same quantities as other developing nations. The project examines what foreign direct investment constitutes, the benefits associated with foreign direct investment for host countries and trends in foreign direct investment. Tax incentives associated with foreign direct investment are examined to establish what tax incentives South Africa can offer international investors to enable more foreign direct investment into South Africa. The work is based on a literature review. The findings are that certain matters in South Africa reduce South Africa's chances of obtaining foreign direct investment. Tax incentives should be offered to offset these matters.

DECLARATION

I, Izak Wessels Swart, declare that this project report is my own, unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration in the University of the Witwatersrand, Johannesburg. It has not been submitted for any degree or examination in this or any other university.

Izak Wessels Swart
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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

1. INTRODUCTION

South Africa over the past few years have received little foreign direct investment (FDI) compared to other developing countries such as China, Poland, Brazil and others. Tax incentives are one form of government regulation available to a government that may enable it to attract more FDI to their country. Research has shown that tax incentives in isolation do not attract FDI. Other factors play a more important role in attracting FDI. These factors will be mentioned. Nevertheless, tax incentives can be used to attract FDI that can be beneficial to a country.

1.1 Context of the Study

Currently tax incentives offered to large industrial concerns in South Africa are limited to allowances associated to fixed assets. They are in the form of accelerated wear and tear allowances that are allowed in terms of the sections 12C and 12G of the Income Tax Act, No 58 of 1962.

Other developing countries offer far more advanced and larger incentives than South Africa. These countries also have large FDI flows where South Africa lacks real FDI. In dealings with large foreign companies wishing to invest in South Africa, suggestions were made for additional tax incentives to cater for more investments. Typically these investments would be FDI and would be beneficial to South Africa.

1.2 Purpose of the Study

The purpose of the study is to understand the factors that influence FDI flows. FDI provides host countries with numerous benefits, such as job creation, knowledge transfers and capital to finance further development. Governments around the world are increasingly more competitive when trying to attracting FDI, due to the benefits associated with FDI. South Africa does not attract significant amounts of FDI. In this regard, it is important to understand the factors that influence FDI flows. It is also important to understand what types of tax incentives are offered to attract more FDI. Taking these factors and the types of tax incentives offered by other countries, into account, a further purpose of the study is to identify a type of tax incentive that would enable more FDI to South Africa.

FDI, due to benefits associated with it, is important for South Africa's further development, especially taking into account the unemployment situation in the country. In order to create more employment opportunities, South Africa needs to grow faster economically. It is therefore important to attract more FDI.

1.3 The Problem and Sub-problem

Aim of the report is to identify tax incentives that may enable more FDI. The sub problems are to understand what factors influence FDI flows, the benefits of FDI which causes governments to compete for FDI, what tax incentives are offered by other countries and the costs to governments of such incentives. Taking all of the above into account a suggestion will be made for a well balanced tax incentive that may enable more FDI flows to South Africa.

1.4 Limitations

The report will be limited to secondary research in the form of a literature review and as a consequence will focus on published research on the topic.

1.5 Significance of the Study

An increase in FDI is considered to be an important component in the South African Government growth strategy. The benefits of FDI for South Africa are numerous. However, in terms of global FDI flows, South Africa lags significantly behind competitors. The report aims to identify tax incentives as enablers that can assist in attracting more FDI and consequently allow South Africa to be more competitive in relation to FDI flows.

South Africa faces a number of hurdles when trying to attract FDI. The country does not a have distinct investment personality according to AT Kearney, Global Business Policy Council (2000) and accordingly does not attract significant FDI. Tax incentives by themselves will not attract FDI but should rather act as an enabler to it. However, South Africa should adopt co-ordinated policy that will allow it to attract more FDI. Consequently, the report will identify tax incentives that should enable FDI.

2. THE DEFINITION OF FOREIGN DIRECT INVESTMENT

FDI has over the years formed an important part of globalisation and the internationalisation of economic activities. It is therefore important that the recipients of FDIrecord the receipts accurately in order to compare FDI flows with other countries. Accurate records are also important for thorough analysis and appropriate policymaking. Countries today actively compete for FDI and the accurate measurement of it is important for all stakeholders associated with this type of investment.

The Organisation for Economic Co-Operation and Development (OECD) has provided member states with a benchmark definition of what FDI is. OECD (1999:7) notes that

> "Foreign direct investment reflect the objective of obtaining a lasting interest by a resident entity in one economy ('direct investor') in an entity resident in an economy other than that of the investor ('direct investment enterprise'). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise."

The definition is consistent with the International Monetary Fund's (IMF) definition of FDI (IMF, 1993).

OECD (1999:8) states further that "a foreign direct investor is an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which has a direct investment enterprise – that is a subsidiary, associate or branch – operating in a country other than the country or countries of residence of the foreign direct investor or investors".

A direct investment enterprise is more problematic to define. Obviously ownership and control status come into play. The OECD recommends that a direct investment enterprise be defined as "an incorporated or unincorporated enterprise in which a foreign investor owns 10% or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise" (OECD, 1999:8). The 10% guideline can be problematic to some countries. For example, in South Africa a 10% holding in a company would result in a minority shareholder status, meaning that no real decisions or influence can be obtained. However, should that shareholder be allowed to appoint management, this could lead to considerable influence. In this instance the OECD allows countries some leeway to decide whether or not an enterprise is a direct investment enterprise.

2.1 Measurement of Foreign Direct Investment into South Africa

The South African Reserve Bank (SARB), South Africa's central bank, is responsible for the measurement of FDI into and from South Africa. SARB is responsible for maintaining foreign exchange controls. Foreign exchange controls are mostly aimed at South African residents, however, in some cases foreigners may also be subject to limited controls - such as local borrowing restrictions. Local borrowing restrictions restrict foreign companies to borrowing only from local banks an amount equal to the amount invested. This restriction was recently eased by the Minister of Finance in order to facilitate more FDI.

SARB is best placed to measure foreign investment in and out of South Africa because of exchange controls. The measurement of foreign investment inflows is published in SARB's quarterly bulletins as part of the balance of payments figures. The measurement of FDI inflows are similar to the definition suggested by the OECD and the International Monetary Fund. Direct investment inflow into South Africa is measured as "investment by Foreigners in undertakings in South Africa in which they have individually or collectively in the case of affiliated organisation or persons at least 10% of the voting rights" (SARB, 2004:84).

The method that SARB uses to measure FDI flows into South African is similar to the method suggested by the OECD. South Africa's FDI flows should be comparable to other countries that follow the OECD method to measure foreign investment flows. As stated previously the measurement of FDI is important. Because of the complex nature of the investments some unrelated transactions are mistakenly classified as FDI.

2.2 Investments that do not Constitute Foreign Direct Investment

A number of investments may seem to be FDI; however, on closer inspection they do not meet the criteria suggested by the OECD (1999). For example, the OECD does not consider the transactions set out below as FDI.

When an enterprise undertakes to build or completes a manufacturing plant for which they will provide technical know-how and will be responsible to manage and operate, and for which they are paid a management fee for the services they render, the long term ownership requirement is not met and this is considered merely a cross-border service.

Where technical know-how is provided by a foreign enterprise that then controls quality and production, without an equity stake the activity should be regarded as a cross-border service.

Another example of an investment that is not FDI is the outsourcing agreement whereby a foreign enterprise agrees to pay per item produced. The foreign enterprise supplies all materials and production equipment and after some time the item becomes the property of the host country.

Professional firms such as large accounting firms that operate much like multi-national firms but in which resident partners do not hold an equity stake in non-resident operations, are also not FDI.

Other examples of activities that are not regarded as FDI are representative offices, sales offices, foreign stations, ticket offices, terminal or port facilities for airlines or ship operators.

2.3 Worldwide Measurement of Foreign Direct Investment

Numerous sources of data are now available that show trends in FDI. With FDI becoming more important from an economic perspective the ability to measure it has become important. When measuring FDI most counties subscribe to the IMF Balance of Payments Manual (IMF, 1993). The IMF's definition of FDI is contained in the manual. Consequently, most counties should record outward and inward FDI in a similar manner and their measurement should be comparable with each other.

In 2003, the IMF, in association with the OECD, jointly performed research on how countries measure FDI (IMF & OECD, 2003). Their research was based on the 30 countries that are members of the OECD as well as an additional 31 countries that are members of the IMF. The research found a significant increase in countries that disclose FDI statistics, especially for inward FDI. The increase in disclosure was more significant for non-OECD member countries. Disclosure not only improved for inward FDI but also for outgoing FDI.

Taking into account that countries that are members of the OECD are mostly developed countries and that the other countries in the study are mostly developing countries, it is clear that developing countries are realising the growing importance of FDI.

3. WHY FOREIGN DIRECT INVESTMENT IS IMPORTANT

It is generally believed that inward FDI can play a significant role in the recipient economy. FDI allows for economic growth, access to global markets, international sourced finance, and knowledge and technology transfers. The increasing competitiveness between countries for FDI illustrates its growing importance. There are various reasons why FDI has over the years become more important.

Baliamoune-Lutz (2004) explains the importance of FDI and of adopting a more focused approach to FDI. There are two main reasons for FDI's growing importance. Firstly, the influence of transnational companies has been growing over the last three decades and is strengthened by their ability to have large integrated operations across the world. Secondly, FDI is a major source of capital and an instrument to fight against poverty. This is accentuated by the decline in official development aid, especially to developing countries. Arguably, FDI is more important to developing countries than it is to developed countries.

Sohinger & Harrison (2004) have a different view about why FDI has grown in importance. Low interest rates as a result of the recession in the 1990s in the developed world accompanied by economic and political reforms in Central and Eastern European countries allowed for greater FDI flows. Better returns on investment are expected from investments in developing countries, partly because of the higher risk associated with such investments.

Both points of view give explanations of why FDI flows have increased in recent years and why FDI is important to economies.

Ultimately the belief that FDI enhances or creates economic growth may be the reason why countries are now competing for more FDI. Various studies on economic growth and FDI have been conducted on this particular point and are discussed below.

3.1 Foreign Direct Investment and Economic Growth

Economic growth is important to any country. Ultimately economic growth allows firms to be more profitable than before. Increased economic activity leads to increased business conducted by firms. Market sizes are increased in periods of economic growth and more goods can be sold, thus resulting in increased profits.

Based on FDI data from China, Hsiao & Shen (2003) calculated that a 1% increase in FDI could lead to a 0.0485 of 1% increase in gross domestic product (GDP) in China. In the long term this would ultimately lead to an increase of 7.548% in GDP. Conversely, a 1% increase in GDP could lead to an increase of 2.117% in FDI. Ultimately in the long term FDI could increase by 34%. The above clearly demonstrates that FDI is an important aspect in China’s growth.

Borensztein, De Gregorio & Lee (1994) found that FDI contributes and affects economic growth in two ways. The results from the Borensztein *et al* (1994) study show, firstly, that FDI contributes to higher productivity than domestic investments, provided that the host country has an appropriate level of human capital. Human capital is important because of its interaction with FDI in the host country. Secondly, FDI increases investment in the host economy more than one to one, which suggests that that FDI has complimentary effects with domestic firms.

It is important to note that economic growth is very much dependant on the situation in the host country and is not necessarily automatic (Blomstrom, 2002). FDI and trade are an important catalyst for economic growth in developing countries. However, FDI may be attracted to countries that have open trade policies and are growing faster or are expected to grow faster than other countries (Makki & Somwaru, 2004). However, Makki & Somwaru (2004) found that, using cross section data on the basis of a sample of 66 developing countries over 30 years, trade and FDI contribute to economic growth. Their studies have also found that the benefits of FDI are greatly enhanced if the country has good human capital.

Human capital is an important element that may or may not allow for economic growth. Human capital strengthens productivity of capital machinery and labour (Hsiao & Shen, 2003). Human capital has both internal and external affects. Internally, an individual's own human capital will increase his or her productivity. Externally, the combination of all factors is made more productive by the average level of skill or human capital. As Blomstrom (2002) has pointed out, the situation in the host country is an important aspect of economic growth. Human capital influences how effective FDI will be in a host country. Likewise, FDI has a positive impact on human capital because of the knowledge and technology transfers that are associated with FDI.

3.2 Foreign Direct Investment and Technology Transfers

Apart from the investment flows associated with FDI, foreign technology, knowledge, managerial skills and other inputs that allow host countries to be more competitive internationally are important aspects of FDI (United Nations Conference on Trade and Development, 2003b).

According to the United Nations Conference on Trade and Development (2003b) transnational companies (TNCs) are the main source of innovation. TNCs also dominate global FDI flows. Innovation is often the main competitive factor that allows companies to become multinational. Also without innovation as competitive factor TNCs may lose business. As TNCs are the world's major innovators, they are also the main sources of technology transfers. This role is even more observed in industries that are prone to highly technological activities. TNCs transfer technology by way of internalised flows. Internalised flows are considered to be flows between a multinational company and its subsidiaries or companies under its control.

Internalised flows are probably the most efficient manner to transfer technology, if not the only method for some technologies. Innovators may be unwilling to part with new technology to third parties, especially as new innovations may give competitors an advantage. External transfers also occur, but are dependant on the host country's abilities. Should the host country already be an innovative country with good resources to exploit new technologies, it may be less expensive to purchase technology from third parties. However, internal transfers are still the preferred route. Internal transfer does give some assurance that the new technology will be used and that training on the technology will take place. TNCs have the structures and ability to allow for new technology to be used. Therefore FDI, of which TNCs are the main source, is a very efficient method of transferring technology.

Technology-intensive industries are seen to offer rapid economic growth. It is also envisaged that in the future technology-intensive industries will surpass normal industrial activities that have always been the drivers of economic growth. As such developing countries with low levels of technology can benefit greatly from technology transfers, thereby enhancing their economies. According to the United Nations Conference on Trade and Development (2003b) technology-intensive industrial activities offer other benefits apart from rapid economic growth. Other important benefits include greater learning potential and greater potential for other spillover effects.

3.3 Foreign Direct Investment and Other Spillover Benefits

Other spillover benefits for host countries include increased domestic investment activity and development of human capital.

FDI is important for developing counties. Developing countries generally have low saving rates. Foreign investment, by way of portfolio investment or direct investment, is an important source of finance for developing countries. It is also generally considered that FDI contributes to new technology and new jobs. Even with low domestic saving rates developing countries that receive FDI increase their domestic investments (Makki & Somwaru, 2004). A more investment friendly environment is created when attracting FDI, which spills over into domestic investment.

Human capital, as pointed out in 2.1 above, is an important aspect of FDI. FDI allows for technology transfers, which ultimately impact on human capital. New technology must be mastered by those people who will use it. The learning process enhances human capital. However, as pointed earlier, human capital, or the lack thereof, will also determine how successful FDI will be and how the other spillovers affect host countries.

Other studies; namely, McKinsey (2004) and Blomstrom (2002) show how FDI can positively affect host countries. McKinsey (2004) carried out a study of 14 emerging markets and found that in 13 out of 14 cases, FDI unquestionably assisted the receiving economy. Productivity and output in the sectors receiving FDI increased, national income increased, and prices decreased.

According to McKinsey (2004), local consumers in developing countries are the largest beneficiaries of FDI. Most companies investing abroad do so to enter local markets. It is estimated, by McKinsey, that nearly 80% of foreign investments are made for this reason. Local prices fall because foreigners improve efficiencies and productivity as result of new capital, technology and management skills. In such cases less efficient operations either improve or exit the market. All of the above also contribute to developing local human capital.

McKinsey (2004) cites Wal-Mart entering the Mexican market as an example where FDI resulted in lower prices for consumers. Wal-Mart's everyday low prices policy ended both the local retailers' hold on the market and their high margins. Some analysts credit Wal-Mart for Mexico's low inflation rate. Another example where consumers benefited is India, especially in the automotive sector. Prices in this sector have been decreasing by 8% to 10% per annum since 1992 when the Indian government allowed more foreign manufactures into the country.

McKinsey (2004) also found that good jobs are created by FDI. Efficiency-seeking investments, where investors seek countries with cheap production costs in order to export goods to countries with high cost structures, lead to job creation. Efficiency-seeking investments are very positive for local economies as they create jobs and boost output without threatening domestic companies. McKinsey found that investors in this category paid wages equivalent to local competitors or in some case even higher wages. Foreign companies pay higher wages in order to attract better employees. Also higher wages motivate employees and reduce employee turnover. The above may seem to negate the cost savings associated with lower wages; however, paying higher wages is still less expensive that producing in high cost-structure countries. All of the above contribute to the improvement of human capital in host countries.

Blomstrom (2002) lists some general spillover effects of multi-national companies investing in host countries. Break ups of supply bottlenecks occur; however, this depends on the host country's level of technology. New know-how is introduced by new technology that is imported; workers are trained in this new technology that ultimately increases the host country's human capital. Monopolies are broken down or competition is increased. Standardisation, inventory and quality control techniques are transferred to host countries, all of which increase managerial qualities in host countries that also increase human capital. Local firms are forced to compete, to increase their managerial effectiveness and to adopt strategies used by multi-national companies.

According to Makki & Somwaru (2004), past studies of FDI show that FDI and trade have a positive impact on economic growth. However, results of economic growth are not uniform for countries attracting FDI. The impact of FDI depends greatly on the host country's level of human capital, infrastructure, economic stability, trade policies and domestic investment. The choice of where FDI is made depends on these factors. These determinates of FDI explain FDI flows, from a theoretical perspective.

4. DETERMINATES OF FOREIGN DIRECT INVESMENT

A number of studies have been conducted over the past years that show trends in FDI and why certain countries are favoured above others. Investors have numerous options when deciding to invest or expand abroad. They can export, enter into licence agreements, form strategic alliances, enter into joint ventures or invest directly abroad (Sohinger & Harrison, 2004). Dunning (1993) suggested by way of his Ownership Location and International paradigm that investors choose FDI because of three determinates: ownership, location and internationalisation advantages. The ownership advantage arises when a firm has superior technology and management knowledge that allow the firm to compete irrespective of transaction costs. Location advantages occur when the host economy has large markets or has the potential to create large markets. Large markets can be created by way of trade liberalisation, low cost inputs or good infrastructure. Internationalisation advantage occurs when cost benefits are realised by way of foreign investment, such as when investing directly in a host country is cheaper than exporting to that country. Jalilian (1996) adds that FDI is also determined by market imperfections and firm specific advantages.

4.1 Characteristics of Host Countries that Attract Foreign Direct Investment

According to Jun (1996), FDI is highly discriminatory. Middle income developing countries have been more successful in attracting FDI than low income countries.

Campos & Kinoshita (2003) consider the characteristics of host countries that attract FDI. According to Dunning (1993) the emerging consensus is that the motives of foreign investors play a role in determining where investments will be placed. Three types of FDI were identified, namely: market-seeking FDI, resource- or asset-seeking FDI and efficiency-seeking FDI.

4.2 Types of Foreign Direct Investment

Market-seeking FDI is also called horizontal FDI. The purpose of this type of FDI is to serve local and regional markets and it involves the replication of production facilities in host countries. Other reasons for this type of FDI are tariff jumping and export substituting. High tariffs and transport cost are the main drivers of this type of FDI.

Resource- or asset-seeking FDI occurs when investments are made to acquire resources not available in the investor's home country. The resources are normally raw materials, natural resources or low cost labour. This type of FDI is also known as vertical or export-orientated FDI. Firms relocate part of the production process to the host country. Clearly countries with large natural resources will attract this type of FDI.

Efficiency-seeking FDI relies on economies of scale and scope. A clear example of this type of FDI is the investments made in countries that will obtain European Union membership such as Poland, Czech Republic and Hungary. Efficiency-seeking FDI allows for regional corporate networks to be established. Also economies of scale are intrinsic to efficiency-seeking FDI.

Together the elements of each type of FDI seem to suggest that countries with large markets, low cost labour, large deposits of natural resources and that are close to major western markets should attract FDI. Other factors such as agglomeration economics, exports, business environment and policy influences also play an important role and are discussed separately below.

4.3 Agglomeration Economics

Agglomeration economies (Campos & Kinoshita, 2003) play a role in determining the direction of FDI flows. New investors copy past investment decisions or choose to invest where other investors have in the past. Investors in this category hope to benefit from spillovers from other investments already in place. Commonly the spillovers that occur are knowledge spillovers, specialised labour and intermediate inputs.

Research on this topic relates mainly to United States' outbound FDI. Research conducted by Wheeler & Mody (1992) suggests that United State investors rely on agglomeration when deciding where to invest. Industry level agglomeration plays an important role for Japanese investors when deciding where to invest (Head, Ries and Swenson, 1995).

Agglomeration economies can be self-reinforcing. Once the initial FDI is obtained, more will follow. Past FDI flows, in this case, should be a good predictor of FDI that may follow.

4.4 Exports and Foreign Direct Investment

Jun (1996) writes that export-orientated economies tend to attract and encourage FDI. He suggests that exports are one of the most important determinates for FDI. However, exports are more important to countries that have high FDI flows than low FDI flow countries. High and low flow FDI countries are structurally different and there are substantial differences between the macro-economic variables in these countries. Manufacturing exports are critical to FDI flows. The manufacturing export industry is more stable than services-based FDI. Services-based FDI has in the past fuelled growth in FDI. However, services, by their very nature, are less stable than export manufacturing. Currency fluctuations and internal economic factors play a significant role in the performance of the services industry. Services-section FDI is location bound and generates local currency earnings that are vulnerable to currency risks (World Bank, 2004). Although also critical for the manufacturing industry, currency fluctuations and internal economic factors are somewhat less important in the short term.

Export driven FDI is particularly successful in small open economies such as those of Singapore and Ireland which adhere to export promotion policies. In Africa, Mali and Mozambique's experiences attest to receiving more FDI as a consequence of export promotion policies (Baliamoune–Lutz, 2004).

FDI flows are increasingly directed to the services industry. However, a country should establish a manufacturing export industry as this will lead to more sustainable FDI inflows (Jun, 1996).

4.5 Business Environment and Foreign Direct Investment

Baliamoune-Lutz (2004) writes that empirical literature does not always present a unanimous view of what determines FDI flows. Baliamoune-Lutz (2004) suggests however that literature on FDI would support the proposition that FDI is attracted more to countries that have liberated their economies by way of trade openness and export orientation. Economic growth in developing countries is not a major determinate of FDI provided that the business environment is satisfactory. Indicators of the business environment would be rule of law, transparency, political stability and human capital. Market size is important when other indicators are weak; this is especially true of China. Geography is important; Shatz and Venables (2000) found that after adjusting for market share, most FDI remained close to its home country. Cultural links and colonial heritage are important. Baliamoune-Lutz (2004) illustrates this by way of example. Between 1992 and 1994 British investors invested US$1.3 billion in South Africa, which was previously a British colony. Morocco, on the other hand, received US$90 million. During the same period France invested US$56 million in South Africa but US$286 million in Morocco, previous French colony.

The business environment plays an important role when determining where to invest. This determinate of FDI has become more important to in-transition economies (Coolidge, 1999). Transition economies, notably the Czech Republic, Estonia and Hungary, received vast amounts of FDI mainly from privatisation proceeds after the fall of communism. FDI flows diminished in these countries when no more assets were left to sell. The key issue for transition economies is how to attract FDI into greenfield initiatives and private assets. Eastern European economies are attractive to investors because of their perceived well qualified low cost labour, long-term market potential and access to rich natural resources. Business environment also plays a significant role in this regard.

Coolidge (1999) discusses what makes a favourable business environment. Countries with few restrictions on FDI, sound company laws or commercial codes and who impose no restrictions on current account transactions and little or no restrictions on capital account transactions are considered ideal business environments for FDI. Part of creating a good business environment is to allow for more private investments. Investment incentives are used for this purpose. Central and Eastern European incentives are becoming more and more sophisticated. During the privatisation stage, tax holidays were offered, although they were later discontinued. With the threat of lower FDI after the privatisation stage, tax holidays are once again being introduced. However, some Eastern European countries have reduced their overall tax rates for all investors and others are flirting with the idea of abolishing corporate tax altogether. The tax holidays that are being introduced are far more sophisticated, transparent and automated than they were during the privatisation stage. Incentives that are offered are accelerated depreciation, more generous loss-carrying forward provisions, tax investment allowances and investment tax credits. The incentives offered are normally granted automatically by the tax code in the country offering the incentive.

Business regulation is another important aspect of the business environment (Coolidge, 1999). Many countries have sound legal frameworks. However, the implementation of these frameworks may be inconsistent, corrupt or even unfair. For example, in Latvia a company registration can take place within three days whereas in Slovakia a company registration takes three months. Customs procedures also play an important role in determining the business environment. Customs problems often deter foreign investors. Multinational companies cannot be seen as not adhering to the law even if it is the norm to do so. Mergers and acquisitions are also an important form of FDI. Corporate governance plays a significant role in FDI in relation to mergers and acquisitions (Coolidge, 1999). Weak controls to protect minority shareholders and interests also influence the business environment. Protecting minority shareholders interests is an important form of corporate governance.

4.6 Policy Influences on Foreign Direct Investment

The OECD (2003) conducted a study in on policies that influence FDI in OECD member countries. Structural policies play an important role in determining where to invest, especially for OECD member countries. According to the OECD (2003) numerous restrictions still exist for FDI in some countries. Labour market policies and product market regulations also impact on FDI. The OECD found that restrictions placed on foreign ownership and governance discourages the activities of foreign investors and FDI flows especially in electricity, transport and telecoms industries in certain countries. Restrictive labour and product market regulations also act as barriers to FDI. Countries with strict employment protection and high labour income taxation show low levels of inward FDI flow. Countries with similar domestic product market restrictions also show low levels of inward FDI flow. Market restrictions add to the cost of doing business and create unnecessary barriers to entry, resulting in low levels of FDI.

Although all the points above show from a theoretical perspective what determines FDI flows, the trends show where foreign investments are actually made and which countries benefited significantly from FDI flows in the past.

5. TRENDS IN FOREIGN DIRECT INVESTMENT TO DEVELOPING COUNTRIES

Worldwide net FDI flows to developing countries reduced to an estimated US$135.2 billion in 2003 from US$147 billion in 2002 and US$175 billion in 2001 (World Bank, 2004). The year 2003 was the second year of decline in worldwide FDI flows. It showed a reduction of 9% from 2002 and a 26% reduction from 1999. This is despite the fact that China continues to receive increasing amounts of FDI. It is anticipated that FDI flows will increase in 2004 and 2005 as a consequence of the expected upswing in the global economy.

According to the World Bank (2004) the decrease in FDI to developing countries in 2003 was largely attributed to middle income countries. Middle income countries received less FDI. Geographically Latin America and the Caribbean suffered the largest declines in FDI flows. Latin America and the Caribbean attracted large amounts of FDI during the1990s mostly in the form of service orientated FDI. As discussed in 3.3 above (Exports and FDI), service-orientated FDI is location bound and generates local currency earnings that are predisposed to currency risks and devaluations. Banking and infrastructure FDI is vulnerable to regulatory risks. Banking or investment assets can be disposed of swiftly on the international market. As a result of sectoral changes on FDI and the currency devaluation in Argentina and Brazil, service-sector FDI in the region declined.

Another reason for the decline in FDI to developing countries is that investors reduced their exposure to developing counties by calling back inter-company loans and repatriating earnings to the home country (World Bank, 2004). In some cases foreign investors completely divested from certain countries.

5.1 Top Ten Developing Countries Recipients of Foreign Direct Investment

The top ten developing country recipients of FDI in 2003 were China, Brazil, Mexico, Argentina, Poland, Czech Republic, Chile, Venezuela, Thailand and India, (World Bank, 2004). These countries accounted for 69% of all FDI flows to developing countries in 2003. In 2000 the top ten developing countries accounted for 78% of FDI flows to developing countries. However, FDI as a share of gross domestic product fell from 2.8% in 2002 to 2.4% in 2003. Four of the top ten countries experienced a decline in FDI; Argentina, Brazil, Czech Republic and Mexico experienced declines of 12% or more in 2003.

5.2 Regional Patterns of Foreign Direct Investment to Developing Countries

The regional composition of FDI has been changing over the past few years (World Bank, 2004). As mentioned before, Latin America and the Caribbean accounted for the reduction in FDI flows to developing countries for the past three years. Latin America and the Caribbean share in FDI to developing countries fell 43% between 2001 and 2003. The decline in 2003 was largely as a result of a drop in FDI to Brazil and, to a lesser extent, Argentina. Some reasons for the decline are that no privatisation deals took place in 2003 and limited cross-border merger and acquisition activities occurred. It must be noted that privatisation deals declined from an average of US$30 billion from 1998 to 2000 to zero in 2003. It is, however, believed by the World Bank (2004) that the major reason for the decline in the region is the service sector's vulnerability to financial crisis.

In contrast, FDI to East Asia and the Pacific remained strong, and an estimated US$57 billion flowed into the region. The region's share of FDI to developing countries rose slightly from 38% in 2002 to 42% in 2003. Most notable in this region is that China received 94% of the region's FDI for developing countries during this period. This is despite the occurrence of the SARS epidemic in early 2003.

FDI to Central Asia and Europe fell to an estimated US$26 billion in 2003. However, FDI for developing countries increased in the 2001 to 2003 period compared to the 1997 to 1999 period. Few privatisation deals were concluded in 2003, which reflects the end of the privatisation boom for some countries, notably Hungary, Czech Republic, Poland and the Slovak Republic. The Russian Federation received a sharp rise in FDI, mostly because of an increase in greenfield investments.

FDI to South Asia increased and this was largely the result of a significant increase in FDI to India. India accounted for 80% of FDI flows in the region, which increased from 72% in 2002. The increase is attributable to easing of restrictions relating to foreign investment in the automobile sector, private banking, power and telecoms sectors in India.

Sub-Saharan Africa experienced a slight increase in FDI and received an estimated US$9 billion in 2003. However, FDI relative to GDP fell to 2.2% in 2003 from 2.5% in 2002. The main beneficiaries in this region were the oil producing countries, Angola, Nigeria and Sudan. These countries received nearly half of the region's FDI.

North Africa and the Middle East received US$2 billion in FDI, which had declined by 24% from the previous year. This region received the lowest FDI for all the regions and accounted for only 1.5% of FDI flows to developing countries.

5.3 The Shift in Composition of Foreign Direct Investment to Services

The service sector is defined by the World Bank (2004) to include sectors in electricity, gas, water, transport, communication, construction, wholesale, retail trade, repairs, hotels, restaurants, transport, storage, finance and insurance, real estate, renting, business services, public administration, defence, education, health, social service, personal service activities, recreational, cultural and sporting activities.

FDI relating to services increased significantly in the 1990s. During the 1990s services-related FDI overtook manufacturing related FDI. By 2002 services accounted for nearly half of all FDI in developing countries. The reason for the increase in service-orientated FDI is that countries have relaxed their trade policies that relate to services and foreigners. Investment policies have also been relaxed to allow foreign participation in service-orientated industries. The relaxation of policies coincided with significant developments in the service sector during the 1990s. This is reflected in the increase in services' share of world GDP of 60% in 1990 to 70% in 2002.

The shift to services in developing countries also has risks. Services are location bound and this makes service-related FDI vulnerable to currency movements and regulatory risk. Indeed, these two characteristics are mainly responsible for the decline in FDI to developing countries over the past two years (World Bank, 2004).

Other elements, such as income growth in developing countries, technological progress and developments in the financial sector, have also assisted the growth in service industries recently.

The demand for services increases as income levels in countries increase. The sectoral composition of FDI mirrors that of GDP in most developing countries; however, this does not apply to Africa. Demand for services in countries has risen with rising income levels. Service-related FDI has grown to meet the demand.

Technological progress has assisted service related FDI is two ways. Communication and transport advances assisted companies in managing geographically diverse operations and supply chains. In doing so a market was created for business-related services such as distribution networks, transport and storage systems. All these services were also exported to developing countries. Secondly, advances in telecommunication created an outsourcing market to low wage countries. An example of this would be the establishment of call centres in India.

A change of law in the United States which allowed banks to merge with offshore entities is one of the developments that allowed for progress in the financial sector. Other developments in the 1980s and 1990s also encouraged banking companies to move to developing countries. Securitisations and improved hedging among other financial instruments assisted banks to better manage their exposure to developing countries more effectively. Other technology improvements in the banking sector such as automatic teller machines, direct fund transfers at point of sale and remote banking on a real time basis also improved the efficiency and scope of financial services.

The shifting of the composition of FDI to the services sector has an important influence on FDI flows. The trend to be more service orientated has resulted in a decline in FDI flows to developing countries.

5.4 Declines in Service Sector Foreign Direct Investment Flows to Developing Countries

As mentioned earlier, the move to FDI on the basis of service sectors resulted in a rise in FDI flows in the 1990s. Likewise this shift has also resulted in a decline in FDI to developing countries (World Bank, 2004). As mentioned earlier this decline is mostly attributable to Latin America and the Caribbean. FDI flows in the region's service sector dropped by 53% in 2002. It is estimated by the World Bank (2004) that this trend continued in 2003.

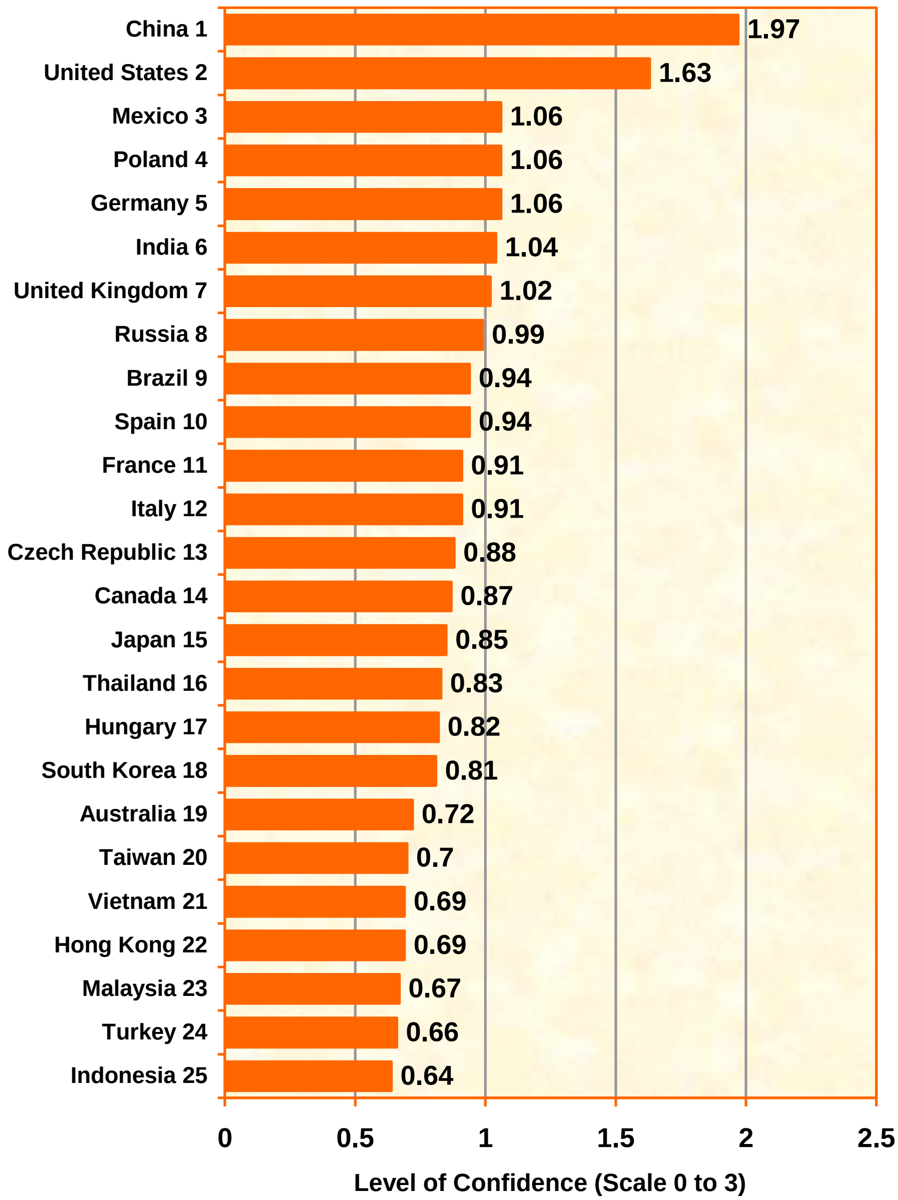
According to the World Bank (2004) the reason for the declines are the deterioration of the region's business climate. Argentina and Brazil suffered major currency devaluation. As explained elsewhere services are directly influenced by currency movements. The lower local currency earnings impacted greatly on investors who financed their investment with foreign currency debt. Argentina also made drastic policy changes that resulted in their currency devaluing between 200% and 300%. United States Dollar-based contracts and assets were converted by the government to Argentinean Peso on a one-to-one basis. Many foreign investors in the service sectors either scaled back their investment or divested from the country.

Although FDI to service sectors decreased in the region, manufacturing FDI increased. The low value of local currencies made export manufacturing possible. Many automobile makers increased their FDI in the region because of the currency declines. The software industry in Argentina also took advantage of the lower currency and the associated lower cost from an international perspective to export software.

5.5 Investor Confidence Levels

AT Kearney conducts a FDI Confidence Index each year (Global Business Policy Council, 2003) and found that, in 2003, senior executives of the world's largest companies remained pessimistic for a third year in a row about the global economy and associated FDI flows. Lengthy corporate restructuring processes, undoing the excesses of the 1990s are complicated by currency volatility accompanied by deflation fears, geopolitical uncertainties and disruptions such as SARS. It is notable that global FDI inflows declined in 2002 to US$651 billion from a peak of US$1.4 billion in 2000. The World Bank (2004) estimates that global FDI flows rose by 6% to US$690 billion in 2003, which is still far from the peak reached in 2000. AT Kearney (Global Business Policy Council, 2003) found that China is the world's most desirable investment location and that this has increased its lead over the United States in this regard. The top 25 planned investment destinations are shown in Figure 1.

Figure 1: FDI Confidence Index, Top 25, September 2003

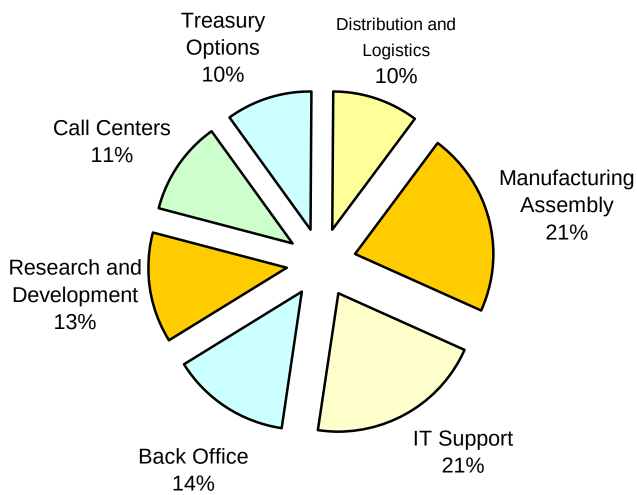


Source: Global Business Policy Council (2003:2)

Other important trends identified by AT Kearney (Global Business Policy Council, 2003), when conducting interviews with executives of the world's largest companies, were a growing appetite for cross-border merger and acquisition type FDI. In 2003, 45% of global investors showed a preference for this form of FDI. However, this is well below the peak of 70% in 2000.

For the first time since 1998 emerging markets are preferred over developed countries as investment destinations, with China leading the way. The reasons cited for this movement toward emerging markets is that it offsets sluggish growth in developed countries by gaining access to higher growth countries, lower-cost markets and that it addresses business continuity issues. Relocating business processes such as data processing, research and development, design, information technology and accounting functions allows companies to cut costs and ensure business continuity. Services seem to be the main driver of this form of FDI, and it is greatly assisted by governments easing restrictions on services-related FDI. In this regard AT Kearney (Global Business Policy Council, 2003) in their survey found that global investors are planning to invest nearly the same amount in information technology support as in manufacturing activities. Other planned activities that companies will invest in are; distribution and logistics, treasury operations, call centres, back office operations and research and development. Figure 2 Illustrates the capabilities that companies plan to send offshore and the percentage of each activity.

Figure 2: Capabilities that Companies Plan to Send Offshore



Source: Global Business Policy Council (2003:6)

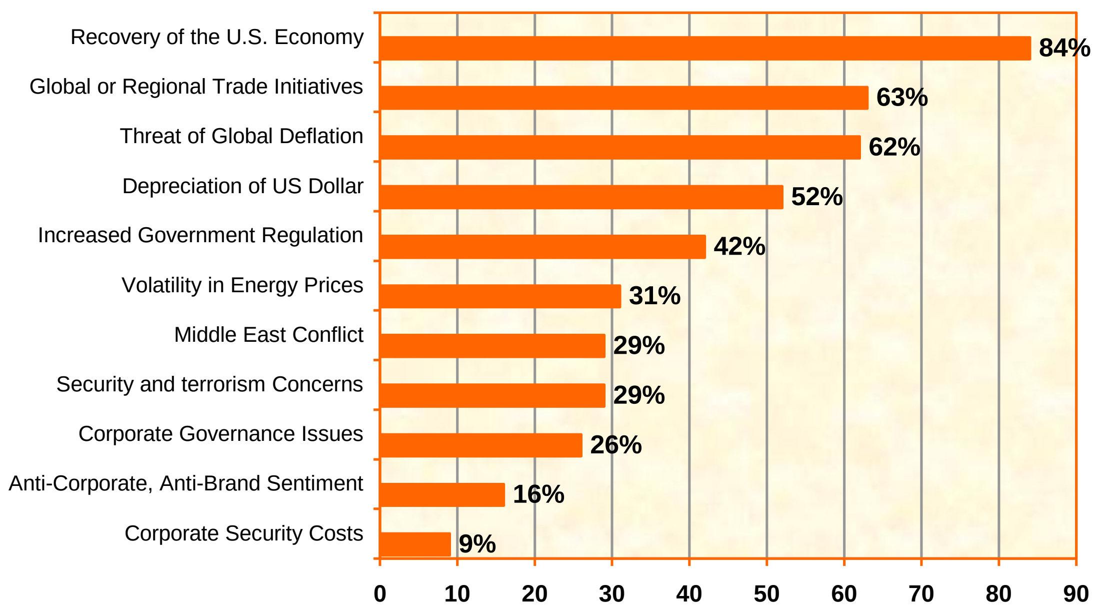
5.6 Global Events that may Influence Foreign Direct Investment Decisions

The recovery of the United States' economy is cited as the most important event with the potential to influence global FDI decisions according AT Kearney (Global Business Policy Council, 2003). Of all global events, global trade is ranked second and the threat of deflation is ranked third in terms of their potential to influence FDI decisions. The United States is the second largest recipient of FDI after China and was for a long period the largest recipient of FDI before this position fell to China. Consequently, any changes within the United States' economy will impact greatly on FDI flows. A United States recovery will lead to greater FDI flows.

Global trade also plays an important role in FDI flows. As companies strategically locate operations around the world, reliance is placed on the global trading system. In this regard much reliance is placed on the World Trade Organisation's (WTO) trade negations, which could, if successful, release billions of dollars into the global economy and create numerous investment opportunities.

The threat of deflation may also affect global FDI. Deflation results from lower pricing and if it takes hold firms lose pricing power, profits reduce, debts increase, bankruptcies increase, unemployment rises and consumers delay purchases, which results in even lower sales. Deflation could affect FDI negatively and until the fear of deflation has subsided it will continue to influence investors' investment decisions. Figure 3 shows the various events and their relative importance in influencing FDI.

Figure 3: Global Events Most Likely to Influence FDI decisions

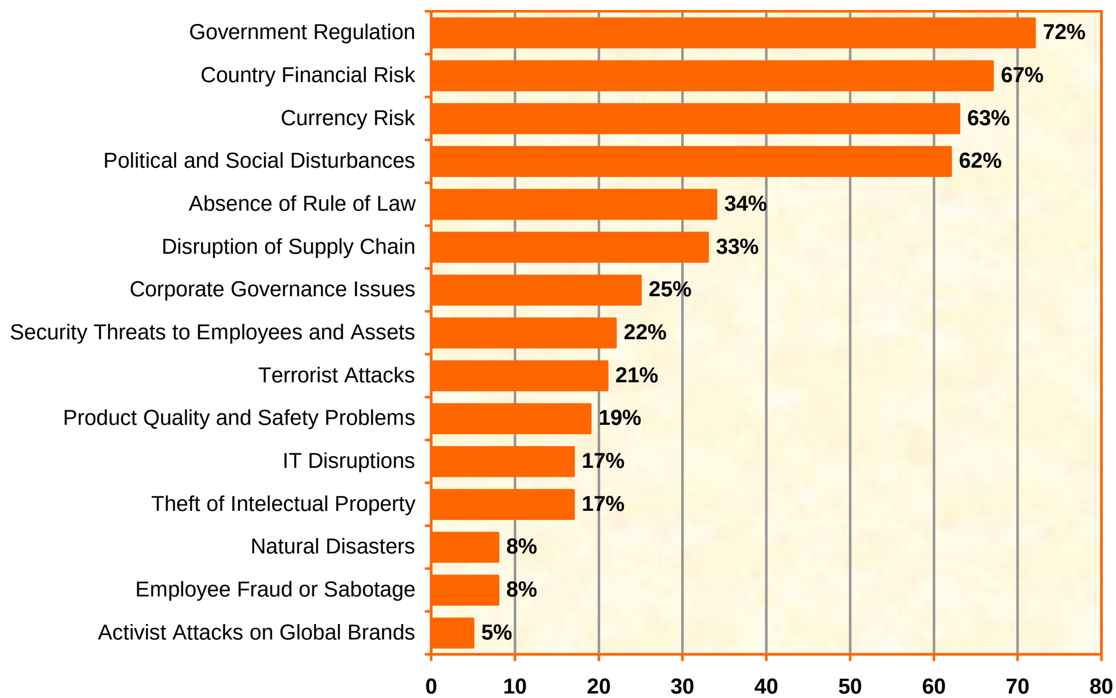


Source: Global Business Policy Council (2003:7)

5.7 Operational Risks faced by International Companies

Government regulation is cited as the largest threat to companies investing abroad. Figure 4 shows what threats are considered important to global companies.

Figure 4: The Most Critical Risks to Corporations



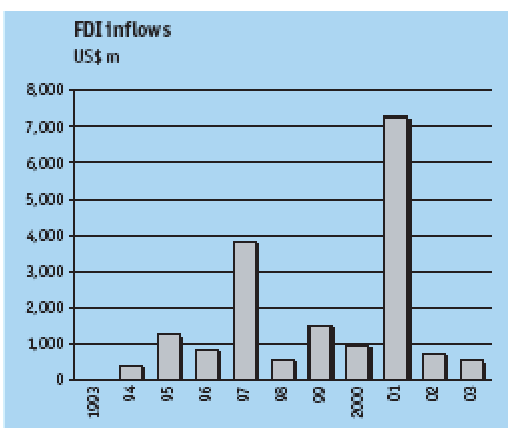
Source: Global Business Policy Council (2003:9)

6. FOREIGN DIRECT INVESTMENT IN SOUTH AFRICA

In 2000 AT Kearney conducted a study of global investors' perceptions of South Africa (Global Business Policy Council, 2000). South Africa hardly attracts any FDI on the scale of other successful developing countries and attracts only a small percentage of FDI compared to developing countries. In reports, discussions about FDI and countries benefiting from it not mention South Africa. The lack of FDI curtails South Africa's development as knowledge transfers and other benefits associated with FDI are not acquired.

According to AT Kearney in Global Business Policy Council (2000), FDI flows to South African are concentrated in telecoms, energy and oil, motor manufacturing, food and beverages and chemicals. These industries account for 60% of South Africa's FDI. Countries that invested in South Africa are also concentrated; 70% of FDI inflows from 1994 to 1998 are from three countries: United States, Malaysia and the United Kingdom. The United States was the largest investor, with Malaysia and the United Kingdom second and third respectively. According to the Economist Intelligence Unit (2004), between 1991 and 2001, the United Kingdom accounted for 74% of FDI inflows to South Africa. During the same period other major investors were Germany, the United States and the Netherlands, which accounted for 6%, 6% and 3% respectively. During this period 38% of FDI flowed into financial and other services, 28% into mining, and 26% into manufacturing. Since the end of the apartheid era, South Africa's FDI inflows range has remained mainly below US$1 billion per annum. Figure 5 shows FDI flows into South Africa.

Figure 5: FDI Flows to South Africa



Source: Economist Intelligence Unit (2004:182)

The year 2001 was a notable exception. FDI flows during that year were US$7.3 billion and were as a result of merger and acquisition activities, notably the De Beers deal. Studies on investor perceptions of South Africa are discussed below with a view to understanding the paucity of FDI flows to the country.

6.1 Investors' Perceptions of South Africa

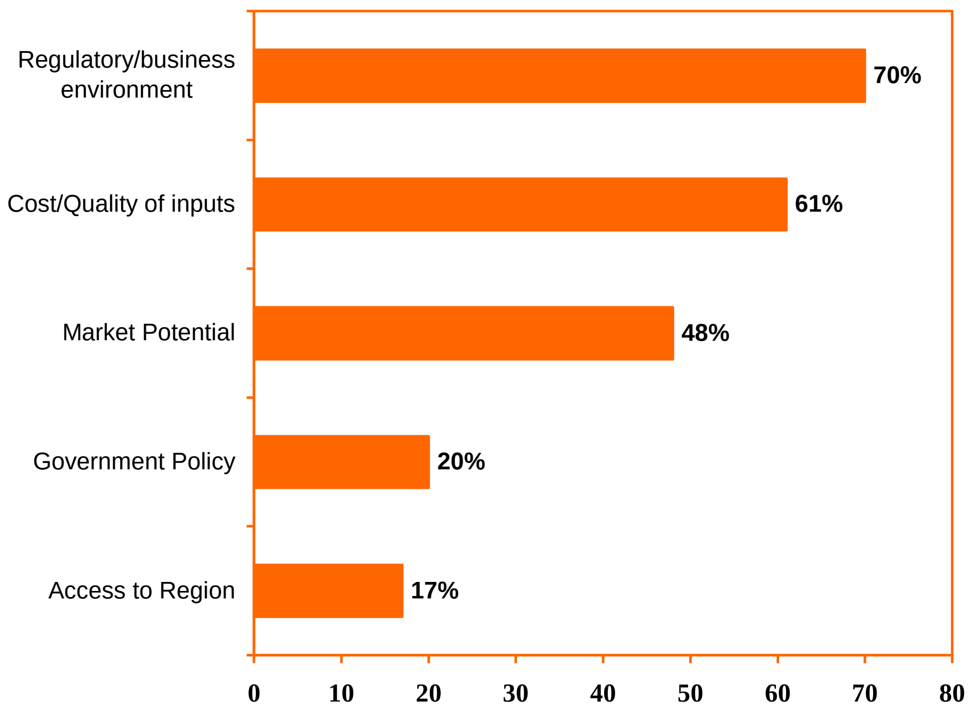
South Africa faces a number of hurdles when trying to attract FDI. The country does not a have distinct investment personality (Global Business Policy Council, 2000) and accordingly does not attract significant FDI. Africa and the Middle East are often treated as one analytical category. South Africa receives the lion's share of FDI and is considered to be the most attractive investment destination in Africa and the Middle East. However, in terms of global FDI and FDI earmarked for developing countries South Africa trails far behind.

AT Kearney (Global Business Policy Council, 2000) found that investors favoured the regulatory and business environment as investment drivers instead of the customary market size and market potential, which suggests that South Africa is a unique investment destination. The report also highlighted that only 16% of the FDI received by South Africa so far qualified for tax incentives. The report also found that the greatest inhibitor for FDI was the rigid labour market.

6.2 Investment Drivers in South Africa

According to the Economist Intelligence Unit (2004), the major source of FDI into South Africa was privatisation and the manufacturing of right-hand drive vehicles. As mentioned above, At Kearney in Global Business Policy Council (2000) found that South Africa's regulatory and business environment is the most attractive feature for foreign investors wishing to invest in South Africa. Other important investment drivers are cost and quality of local inputs, market potential, government policy and access to the region (see Figure 6).

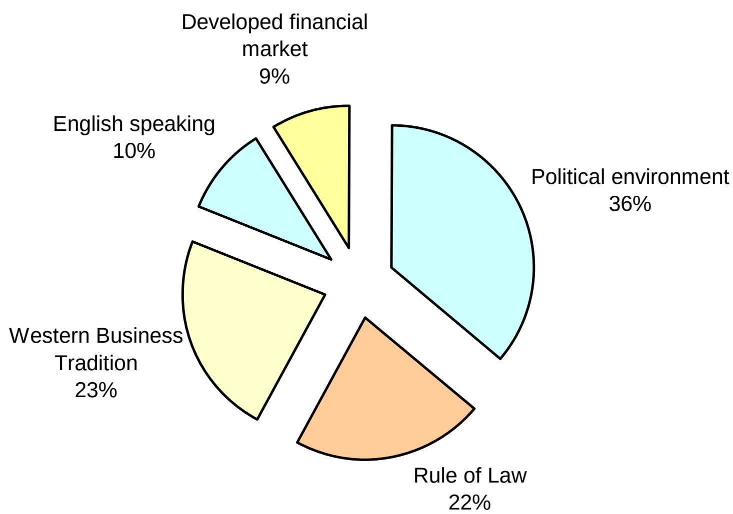
Figure 6: Drivers for Investments in South Africa



Source: Global Business Policy Council (2000:9)

The drivers for the regulatory and business environment are the political environment, rule of law, western business traditions an, English speaking environment and a developed financial market (See figure 7).

Figure 7: Regulatory and Business Environment Drivers Cited



Source: Global Business Policy Council (2000:9)

The cost and quality of local inputs are also an important driver of FDI into South Africa. Factors cited in this category include a good transport infrastructure, large labour force, low wage costs, natural resources and local management skills. Most investors differentiate South African from other developing countries on the basis of its infrastructure and make cost and quality of inputs a more important driver of FDI than in other FDI seeking countries.

Market potential is cited as only the third most important driver of FDI in South Africa. This shows that South Africa is different from other countries. Most of the drivers cited are also cited for other countries; however, they are ranked differently. Market potential is normally ranked as the most important driver of FDI. According to AT Kearney in Global Business Policy Council (2000), a third of non-investors in South Africa rank the country's market potential as a negative. The same applies to other investment drivers, the drivers that are important in South Africa's context lack importance as drivers in the global context.

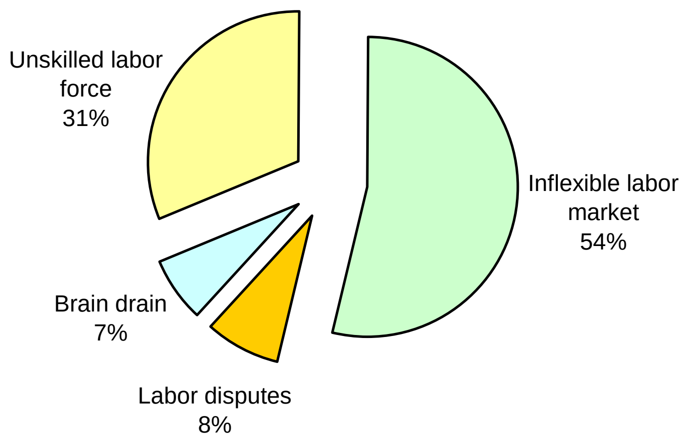
6.3 Negative Factors Affecting Foreign Direct Investment to South Africa

The lack of strong drivers for investment in South Africa measured in terms of the world's drivers for FDI in South Africa can be seen as an impediment to investment into South Africa. Factors that the world views as important are not viewed as important by South Africa. This limits investments in South Africa. In addition to the lack of real investment drivers, AT Kearney (Global Business Policy Council, 2000) found that 57% of participants cited crime and violence as an investment obstacle. The rigid labour market was cited by 55% as an impediment to investment.

Crime was found to be more of an obstacle rather than a deterrent to FDI. Crime is a viewed as a serious social problem in South Africa but not a deciding factor when decisions are made where to invest. However, this does not mean that crime should not be addressed by the authorities.

Significantly, the rigid labour market is viewed more as a deterrent to FDI than crime is. Investors who have already invested in South Africa and who have knowledge of the country, cite the labour market as a deterrent to FDI. An unskilled workforce and an inflexible labour market are the main drivers for this view. Figure 8 illustrates factors of these labour market conditions.

Figure 8: Labour Market Obstacles Cited



Source: Global Business Policy Council (2000:15)

The labour market inflexibility is determined by two factors in South Africa: first, the difficulty experienced when retrenching workers; secondly, the inability to comply with employment equity legislation as a result of low levels of experienced and qualified black employees. Consequently some investors view South Africa's labour as more expensive than that of Asia and Latin America because of productivity gains in those in regions.

The Economist Intelligence Unit (2004) also cites the labour market, which is considered to be overregulated, as an inhibitor to FDI in South Africa. Other factors mentioned are crime and low levels of capital and labour market productivity. Key issues also identified that impact on investors' decisions to invest in South Africa are black economic empowerment and the HIV / AIDS pandemic. Both of these factors influence the labour market. It is common knowledge that the HIV / AIDS virus infects mostly economically active adults. This has serious consequences for the availability of labour but also for the consumer market. As part of black economic empowerment, employers have to implement affirmative action, which restricts employers to hiring black employees. Black economic empowerment also requires that black employees of all levels must be trained. Furthermore, companies must trade with black empowerment companies. Other hindrances to FDI in South Africa are securing work permits for foreign nationals to work in South Africa, even if they are very senior managers, and the lack of incentives offered for FDI.

7. TAX INCENTIVES

According to Wells (1999) the earliest reference to tax incentives was in 1160. Wool weavers were offered tax incentives to locate to Biella in the northern region of Italy. Governments are increasingly competing for more FDI, according to Morisset & Pirnia (2003). Fiscal incentives are widely used by governments to attract FDI. Poor African countries offer tax holidays and import duty exemptions to attract more FDI. Industrial Western European countries provide investment allowances or accelerated depreciation claims. The types of incentives used by region are illustrated in Table 1 below

Table 1: Types of Incentives Used by Region

Region / Major incentive	Africa (23)	Asia (17)	Latin America & Caribbean (12)	Central & Eastern Europe (25)	Western Europe (20)	Other Countries (6)	Total (103)
Tax Holidays	16	13	8	19	7	4	67
Accelerated Depreciation	12	8	6	6	10	5	47
Investment Allowances	4	5	9	3	5		26
Import Duty Exemption	15	13	11	13	7	4	63
Duty Drawback	10	8	10	12	6	3	49

Source: Morisset & Pirnia (2003:4)

According to Blomstrom's (2002) theory, for a company to successfully compete in a foreign market it must own specific assets in knowledge and technology, and have specific skills in organisation structure, management and marketing. Having these assets allows a firm to enter foreign markets successfully. There are several options for a firm wishing to enter markets; they are: exporting items, producing in the host country, entering into joint ventures, franchising, management contracts etc. The decision about where to invest will depend on a number of factors.

Incentives alone will not attract FDI; rather other important factors such as market size and low-cost manufacturing, will determine where investments will be made. In this regard, Blomstrom (2002) suggests that multi national companies are attracted to strong economic fundamentals that are supported by market size, real income levels, skill levels, infrastructure, trade policies and macro-economic stability. This is not to say that tax incentives are not an important consideration for FDI purposes. The location of FDI may be influenced by various incentives. Multi-national companies deciding where to invest may be influenced by incentives to invest in a particular country because of the incentives that are offered.

Clearly tax policies are capable of affecting FDI flows as high tax rates reduce after tax returns (Morisset & Pirnia, 2003). One of the earliest studies on the topic was conducted by Hartman (1984). Hartman (1984) found that taxation does influence FDI. Surveys reviewed by Morisset & Pirnia (2003) have revealed that investment decisions by export-orientated firms are more likely to be affected by tax rates than firms investing for local market potential and specific location advantages. FDI funded by way of retained earnings is also more affected by tax rates as after tax returns are higher because of lower tax rates.

In a study conducted by Coyne (1994), it was found that small investors are more responsive to tax incentives than large investors. Taxes play an important role in the capital structure of small companies. Small companies do not have the resources or the skills to take advantage of sophisticated tax avoidance strategies. In addition, large multi-national companies are often treated differently by host countries wishing to attract investments. According to Morisset & Pirnia (2003), some studies suggest that large multi-national companies in the automobile sector are more likely to negotiate secret deals with host country governments for special tax treatments. Nevertheless, countries with low tax rates are also favoured by multi-national companies. Such countries, especially tax havens, allow for sophisticated tax structuring that result in lower taxes being paid, which explains their success in attracting FDI. OECD Tax Policy Studies (2001) show that there is convincing evidence shows that host country tax policies and incentives are an increasingly important element in FDI decisions. The importance and influence of tax incentives are more pronounced over a period of time. The reasons for the growing importance of tax incentives are the abolishment of exchange controls and investment restrictions around the world, reductions in tax barriers to FDI and globalisation of production.

Given the growing importance of incentives, it is important to understand what kinds of incentives are provided by countries seeking FDI. A further consideration is the cost associated with the incentive to host countries, which cost must obviously not exceed the benefits associated with the investment that is to be made.

7.1 Tax Incentives Offered by Countries

Governments have several tax instruments that they can use to influence and attract FDI. Corporate tax incentives, such as tax holidays and depreciation allowances, are normally associated with income tax. These kinds of incentives are based on the profits of a company. Unprofitable companies normally do not benefit from such incentives. Other forms of incentives offered include exemptions from custom duties and indirect taxes, although these incentives have been confined by international and bilateral trade treaties. Up-front cash grants are used in industrial countries but not as often in developing countries where the up-front cost associated with such grants precludes them from offering these grants.

Focusing on corporate tax incentives, five types of incentives have been identified by OECD Tax Policy Studies (2001). These are tax holidays, statutory corporate tax rate reduction, special investment allowances, investment tax credits and financing activities. The details of each of these incentive types are discussed below.

7.2 Tax Holiday

As mentioned previously, tax holiday schemes are predominately used by developing countries. In terms of a tax holiday scheme, a new investor that qualifies for a tax holiday is not required to pay any income taxes for a specified time period. A further variant is that the qualifying investor does not pay any tax until he has recovered his up-front capital cost. The rules for tax holidays stipulate what kind of investments will be allowed tax holiday status and when the tax holiday commences. In some instances tax holidays also grant investors exemption from other taxes, while at the same time placing limitations on certain deductions during and after the tax holiday period. The most common deduction to be limited is depreciation.

A tax holiday seems to be a simple form of incentive with relatively low compliance costs. However, strict rules and regulations need to be in place to ensure that the tax holiday is not used in a tax avoidance scheme. Other issues that need to be considered are that records need to be kept of capital expenditure and other items relating to the tax holiday. Rules need to be in place to ensure that payroll taxes and other indirect taxes are paid, unless the tax holiday exempts investors from these types of taxes.

Tax holidays may be targeted at specific regions or industries. Sectoral targeting is normally associated with addressing perceived knowledge gaps in host countries. New investments in this regard will hopefully lead to knowledge transfers. Sectoral targeting is problematic as new entrants into the sector or country are offered incentives whereas investors already in the sector or country are not offered the same incentives. To overcome problems associated with sectoral targeting, countries have in the past allowed tax holidays on the basis of regional targeting. Should a company's assets be invested in a certain region or if 75% of its activities are conducted in a certain region tax holiday status is allowed for income from that region. It should be noted that regional targeted incentives have not been successful in practice. Tax concessions have not been able to counteract negative regional factors, such as a limited labour pool or high transport costs.

Tax holidays are most attractive for firms in profitable sectors or industries where profits are realised early in the live cycle of an investment.

7.3 Statutory Corporate Tax Rate Reduction

A common form of incentive for FDI is to reduce the corporate tax rate. This kind of incentive is used by developing countries and developed countries alike. A low corporate tax rate in itself is an incentive. Small countries such as Hong Kong, Lebanon and Mauritius have opted for this type of incentive (Morisset & Pirnia, 2003). The rate reduction may be broad based and be applicable to all sources of income or may be targeted at income from certain specific activities. The rate reduction incentive allows governments to maintain corporate tax revenues. The lower tax rates allow for fewer tax planning opportunities, and, provided that the tax system is not complicated, an investor-friendly environment is created. According to Morisset & Pirnia (2003), investors look favourably on a country offering a low statutory tax rate especially if the tax rate is below the world norm of 35% to 40%. A low statutory rate signals to investors that the government is allowing market forces to determine where profitable investments are made without undue influence from government.

A low statutory rate, similar to a tax holiday, has some difficulties associated with compliance, definitions and administrative issues, especially if the rate reduction is targeted at certain investments and is not open to all. In these cases rules must be in place to address tax avoidance or classify income to qualify for a lower statutory rate. A further complication for this type of incentive is that investments made before the rate reduction may also qualify for a lower rate. In these cases tax revenues will decrease. The loss of tax revenue will not benefit FDI.

Ultimately statutory rate reductions may lead to the elimination of all taxes. Some countries have become tax havens, especially in the Caribbean and Pacific regions. Other countries have created zones, which focus on exporting that offer similar status. These zones are known as export processing zones and to qualify to be part of such a zone a company must export at least 70% to 80% of its production. Countries that provide these zones normally offer tax holiday status to companies operating in these zones. The tax holiday status is normally granted for a significant period of time.

Tax havens, on the other hand, have attracted a large amount of FDI, especially in the banking and insurance industries. The Cayman Islands claim to be the fifth largest financial centre in the world, according to Morisset & Pirnia (2003). The capital that is being attracted is very mobile because of the types of industries that invest in tax havens. Tax havens have not been very successful in attracting more permanent capital such as head office relocation of manufacturing activities.

7.4 Special Investment Allowances

Many countries in the industrial world allow for fast write offs of investment expenditure. The incentive is provided for either all investments or for specific investments sought by governments. A correctly targeted incentive or allowance can easily lead to the desired activity (Morisset & Pirnia, 2003). The incentive also allows for current investors to qualify, thereby creating a friendly investment environment. By targeting current capital spending, the allowance causes less revenue leakage than a tax holiday would. Special write offs are only as valuable as the tax otherwise payable. It, therefore, follows that this incentive is more valuable in countries where tax rates are higher.

In terms of this incentive, firms are provided with quicker write off periods on qualifying capital cost. In normal circumstances firms are allowed to write off assets over their useful life. In terms of the incentive a write-off period which is shorter than the useful economic life of an asset will be allowed. This treatment does not alter the total amount that will be claimed as a tax deduction; it does, however, bring the claims forward. By bringing the claim forward the present value of the claim is enhanced. Another variant of this incentive is to allow an enhanced claim. In such cases more than the original cost of the asset is claimed as a deduction.

7.5 Investment Tax Credits

In terms of this incentive, special deductions are allowed against corporate tax payable. Tax credits are earned as a percentage of qualifying capital expenditure. Investment tax credits may be flat or incremental. A flat investment credit is earned as a fixed percentage of investment expenditures incurred in the tax year on target capital items. Another form of investment tax credits is an incremental investment tax credit. In terms of this incentive, a tax credit is earned on the basis of investment expenditure incurred in excess of a predetermined base. This base is typically a moving average of investment expenditure incurred by a firm, e.g. the moving average of investment expenditure over the past five years.

The incremental tax credit incentive attempts to improve the targeting of incremental capital expenditures that would not have occurred without the incentive. However, investors do not benefit from this form of incentive if they planned large capital expansions in the past and lower capital expenses in the future. Investment tax credits have the most stimulating impact on short-lived assets or assets that need to be replaced more frequently than others. The reason for this is that the present value of the stream of tax payments on revenues of short-lived assets is smaller than in the case of assets with longer life spans.

As an up-front incentive, the investment tax credit and special investment allowances provide governments with the best cost-to-benefit ratio (OECD Tax Policy Studies, 2001). The main reason for this is that the incentive is only allowed on new investments as opposed to the reduced statutory corporate income tax rate that may benefit old and new investments. A larger reduction in the effective tax rate on investment can be achieved at a lower revenue cost. Also up-front incentives address cash flow constraints that may affect new investments, although this is more problematic for small businesses than for large multi-national companies.

7.6 Financing Incentives

Financing incentives aim to lower the required rate of return a company must offer on it shares. A lower rate of return will allow companies to commence with projects that may otherwise not have qualified. According to the OECD Tax Policy Studies (2001), there are generally three broad categories of financing incentives. They are, firstly, up-front tax incentives such as tax credits that provide shareholders with income tax relief on equity investments in targeted activities; secondly, down stream tax incentives also in the form of tax deductions and credits aimed at dividend or capital gains which should lower investors cost of capital. The last category constitutes flow-through tax incentives, which allow companies to transfer unused tax deductions or tax credits to investors. This form of incentive is to be used for set offs at shareholder level rather than at company or business level. Flow-through incentives are generally used where businesses expect to make losses or be non-taxable for a number of years and would therefore have no use for tax credits or accelerated depreciation allowances.

Down stream tax incentives are more used in the context of FDI than the other incentives. An example of a down-stream incentive would be the elimination of non-resident withholding tax. Another would be the elimination of tax on dividends. A further important consideration is whether or not a host country has a double taxation agreement with the investing countries. A double taxation agreement generally avoids economic double taxing of income. Incentives offered may result in investing companies being taxed in their home countries, which in some cases is an advantage. Careful consideration should be given to avoid the abuse of this kind of incentive, whereby tax incentives are passed to investors as part schemes or tax avoidance practices.

7.7 Negative Aspects of Tax Incentives

There are strong arguments against the use of incentives according to Blomstrom (2002). The most obvious problem associated with incentives is to identify marginal cases that would not have entered the host country without the assistance of incentives. According to McKinsey (2004), governments provide incentives for investment that would have been made without the incentives. India waived 35% corporate taxes for companies that moved their back office operations there. The concession is worth US$6 000 per employee. India commands nearly a third of this market. It is therefore questionable whether these incentives are necessary.

For all the benefits associated with FDI, it is difficult to calculate the future expected benefits, such as increase in growth, employment or knowledge transfers. Future benefits are more difficult to estimate if investments are made solely because of to the incentives that are offered, as opposed to economic fundamentals.

Foreign investors do not fundamentally differ from local investors. Providing incentives to foreign investors only may distort competition and result in significant losses for local companies. The unintended effect of this is that fiscal cost can escalate as local companies also benefit from the incentives that are offered.

Another problem with incentives for foreign investors only is that some investors may become “rent seekers”. As soon as the incentives have expired the “rent seeking” investor tends to seek other opportunities where favourable incentives are available. Providing incentives also encourages corruption. In some instances negotiations need to the take place which may facilitate corruption.

According to McKinsey (2004), generous incentives can cause too much investment. A case in point is Brazil’s automotive industry. A US$100 000 incentive for every job that was created was granted. Foreign carmakers increased their capacity by 40% during the 1990s. By 2002 the industry had 80% over capacity. The capital associated with the expansion could have been more productively used by the automotive industry.

Incentives sometimes subsidise investment that never should have been made. McKinsey (2004) cites an example in Brazil where incentives were offered to consumer electronics companies to relocate to Manaus. The cost of the incentives in 2001 alone was US$576 million. Manaus is located in the middle of the Amazon, 800 km from the nearest port and 4000 km from Sao Paulo. Two months are needed to import needed components from Asia to Manaus and 10 to 20 days are needed to ship completed goods to Sao Paulo. Freight charges add 5% to production cost and skilled labour is often imported, which negates local labour cost advantages.

7.8 Incentives Offered for Foreign Direct Investment in South Africa

South Africa does not offer any real incentives for FDI. Nevertheless, the Economist Intelligence Unit (2004) argues that South Africa has great potential for FDI. The potential is illustrated by investments made in the automotive industry for domestic markets, regional markets and exports. According to the Economist Intelligence Unit (2004), the lack of incentives offered by South Africa is one of the reasons why South Africa has low FDI flows.

The Department of Trade and Industry's web site shows what incentives are available to foreign investors. A Foreign Investment Grant is available to foreigners who invest in new manufacturing business in South Africa. This is a cash incentive and will cover 15% of the cost of establishing a new manufacturing concern in South Africa, limited to R3 million per applicant.

A further potential incentive for foreigners wishing to invest in South Africa is a Strategic Industrial Projects incentive. The incentive is an income tax allowance based on the cost of the industrial project and is allowed as a tax deduction in terms of section 12G of the Income Tax Act, no 58 of 1962. Depending on the situation an allowance of 100% or 50% of the cost of an industrial project may be allowed as a deduction for income tax purposes. The 100% or 50% is determined on a points system. The allowance is, however, capped at R600 million in the case of a 100% allowance or R300 million in the case of a 50% allowance. The total value of the incentive is capped at R10 billion, which is small in comparison to world FDI flows and FDI flows to developing countries. The incentive is essentially an accelerated wear and tear allowance on the basis of the cost of assets associated with the industrial project.

Other incentives are provided by the Income Tax Act. These incentives are based are also based on wear and tear allowances. Over the years, accelerated wear and tear is allowed for processes of manufacturing. Section 12C of the Income Tax Act, no 58 of 1962, allows an initial 40% wear and tear allowance on machinery used in the process of manufacturing. Thereafter a 20% per annum allowance is allowed. This allowance between 1999 and 2001 allowed a 33% per annum write off.

The predecessor of section 12C is section 12B. This allowance, now only available to farmers, is an initial allowance of 50% and thereafter a further 30% allowance and a 20% allowance in the final year.

Most of the current incentives are geared towards the manufacturing industry. Some building allowances, which may act as an incentive, are available to hotel owners, taxpayers investing run-down designated urban areas and taxpayers erecting residential units. However, these allowances are not frequently used by South African taxpayers and are only allowed in very specific circumstances.

Industrial development zones are being created in South Africa and are being offered by the Department of Trade and Industry to encourage international competitiveness. These zones will be purpose-built industrial estates. These estates will be linked to an international port or airport. A duty free operating environment will be created. However, corporate tax incentives seemingly will not be offered.

In terms of global FDI flows, the incentives for investment in South Africa are very small or even insignificant. The incentives do not address the issues that seem to prohibit investment in South Africa. The current incentives address economic factors that are identified as needed in South Africa. The largest incentive in terms of monetary value in South Africa is the Strategic Industrial Projects incentive. The points system used to determine allowances in the Strategic Industrial Projects incentive is geared toward employment creation, a factor that is critical for the future development of South Africa and its social stability. Given the low levels of FDI in South Africa, incentives offered should perhaps address the reasons why investments are not made.

8. FOREIGN DIRECT INVESTMENT AND INCENTIVES IN SOUTH AFRICA

The South African government has formulated its approach to investment policy on the basis of static domestic investment and low FDI, according to the United Nations Conference on Trade and Development (2003a). No special tax allowances are provided for FDI in particular, except for the Foreign Investment Grant which is very limited. In terms of government policy all investments are treated equally, no special treatment is available for FDI. Foreign and domestic investors have the same access to services provided by the government and to incentives. The government has also moved away from privatisation and now favours public-private partnerships, which in all likelihood may result in more restrictions being placed on investors. Without any real privatisation, large FDI flows are unlikely to take place.

It is a well known fact that South Africa suffers a skills shortage. The United Nations Conference on Trade and Development (2003a) found that 85% of employers in the Johannesburg Metropolitan area experience difficulties in finding skilled employees for managerial and professional positions. In this regard investors view the lack of skills as the main source of low growth in the country.

During the past few years South Africa's economy has been well managed. Macro-economic principles and fundamentals have remained stable. It is perceived that where other countries are managed in a similar fashion FDI flows increase. Consequently, the reasons for the low investment rates in South Africa are complex and uncertain and should be researched further.

Given the lack of FDI and the static domestic investment rate, incentives should be offered to investors. Two items that are perceived to cause low investment rates are an inflexible labour market and black empowerment policies. Both are mentioned by the Economist Intelligence Unit (2004) as impediments to FDI. It, therefore, follows that incentives should perhaps be allowed for these two elements.

8.1 Labour Market Incentives

One of the qualifying criteria for a Strategic Industrial Project incentive is employment. The employment factor is a very important determinant of the Strategic Industrial Project formula, which determines the amount allowed for the incentive. It can either allow a taxpayer to claim or to enhance the claim to the maximum allowed amount of R600 million that can be allowed.

It is common knowledge that South Africa has battled unemployment for a number of years. The official unemployment rate is 29.5% according to the Department of Trade and Industry. Unemployment is especially pervasive in black households with nearly 50% of black males being unemployed. The criticism levelled at South Africa is that its employees are unskilled and that the labour market is inflexible. Currently South Africa has programmes that address training issues for employees. A skills levy is charged at 1% of payroll cost. However, employers are allowed to claim training costs from Sectoral Education Training Agencies (SETAs). Hopefully in the future the training programmes will succeed in increasing available skills in South Africa. Nevertheless, the labour market remains inflexible as a result of restrictive legislation. The legislation is not likely to change in the short term.

Given the benefits associated with employment, the South African government should award companies some incentives to compensate for the restrictive labour laws. A suggestion might be a special allowance, such as one that allows for a double deduction of employment cost associated with certain types of employees or all employees. Employers would be encouraged to employ more people as they would receive a larger tax deduction. The incentive can easily be modified either to allow for all types of employees or to target a certain type of employee. The incentive should be large enough to make up for the inflexible labour market. Currently a training incentive is available in terms of section 12H of the Income Tax Act. No 58 of 1962. The value of the incentive is R50 000 per employee that is trained in terms of an accredited training programme. Accordingly, a special incentive such as the one proposed should not be too difficult to implement.

Given the nature of employees' tax in South Africa such an allowance can easily be managed. Payroll records, which must be submitted to the South African Revenue Service annually, can easily be used to substantiate the claims. The loss to government coffers would be made up by the economic benefits associated with more employment opportunities. More employees' tax would be received. More value added tax will be received as the unemployed would have disposable income. From an economic perspective it must be taken into account that employment creation has a multiplier effect. Employment will after all create more employment. However, the benefits and cost associated with the proposed incentive require further research.

8.2 Black Economic Empowerment

As pointed out earlier, government regulations are the most prohibitive factor in relation to FDI. South Africa has a host of regulations that apply to businesses. According to the Department of Trade and Industry the main government regulations in South Africa relating to business is taxation, competition policies, intellectual property rights, environmental regulations, labour regulations, exchange controls and financial regulations. Most of these regulations are based on international standards and will be found in most developed countries. It should be noted that AT Kearney (Global Business Policy Council, 2000) found that South Africa's regulatory and business environment was the strongest driver of FDI in South Africa.

Black Economic Empowerment (BEE) is essential for South Africa's further development. Government views BEE as an important part of its growth strategy according to the Department of Trade and Industry. Broad-based black empowerment is governed by the Broad-Based Black Economic Empowerment Act, no 53 of 2003. In terms of the Act the Minister of Trade and Industry must provide a strategy to fulfil BEE.

The Department of Trade and Industry has prepared a strategy document for BEE. The policy objectives of BEE are: to have a substantial increase in the number of black people who have ownership and control of existing businesses; to provide a substantial increase in new black enterprises, black-empowered enterprises and black-engendered enterprises, and to create a significant increase in the number of black people in the executive and senior managements of enterprises (Department of Trade and Industry, undated). The policy instruments that the government will use to achieve BEE are legislation and regulations.

Having acknowledged the importance of BEE to South Africa government intervention is, nevertheless, viewed as the most serious risk for FDI. BEE is a substantial government intervention which states who must own what and who a company may employ. The Economist Intelligence Unit (2004) also views BEE as a negative factor for FDI flows to South Africa.

Without BEE only certain sectors of the economy will continue to grow and benefit economically, which will affect South Africa’s stability. The sooner that black people are economically empowered the better for South Africa, and constructive prejudice should be viewed as a temporary measure. However, FDI will be influenced by BEE regulations. For this reason an incentive should be provided for FDI, where BEE is required. The incentive must address the cost associated with BEE. The type of incentive required should be researched further as a mixture of types of incentives is the most likely the answer.

Potentially the most beneficial incentive would be the removal of Secondary Tax on Companies (STC) for qualifying investors. STC is imposed in terms of the section 64B of the Income Tax Act, no 58 of 1962. It is viewed as a problematic tax for foreigners. STC is charged at a rate of 12.5%. Unlike domestic investors, foreigner investors do not qualify for an exemption of STC. STC increases the effective tax rate of a company to 38%, provided the company declares all its profits as dividends. The scrapping of this tax for foreigners, which at the same time would further the cause of BEE, would act as an incentive.

9. CONCLUSION

Tax Incentives in themselves will not increase FDI flows to South Africa. Many other economic variables would need to change. Further research is required to determine why investment in South Africa is low and thus establish which variables must be altered and how. However, the Economist Intelligence Unit (2004) found that South Africa needs incentives to compete with other developing countries for FDI

Introducing incentives for FDI will clearly show South Africa’s intention to attract FDI. Naturally the cost of incentives offered should not outweigh the benefits associated with new FDI flowing into the country. In this regard South Africa has two important economic and social issues that need to be addressed.

Unemployment causes numerous social problems as well as economic problems. Offering incentives to create employment by way of FDI could assist the South African economy. The other important factor is black economic empowerment. BEE can be viewed in either a negative or a positive light for business in South Africa. Although it must be seen as a temporary measure, investment may be lost as a consequence of BEE. Accordingly, an incentive for conforming to BEE regulations for FDI should be offered. Such an incentive may well take the form, or include, some of the tax incentives that have been explored in this report.

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