

A COMPARATIVE STUDY OF INVESTMENT INCENTIVES AVAILABLE TO THE
MANUFACTURING SECTOR IN SOUTH AFRICA, MALAYSIA AND SINGAPORE

by

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SUMMARY

This study identifies additional investment incentives, applicable to the manufacturing sector, which the South African government could introduce to encourage investors to choose the South African manufacturing sector as a desired investment destination. A comparison is made between the relevant investment incentives provided to manufacturing companies by Malaysia and Singapore and those provided by South Africa, in order to examine the similarities and differences between these incentives.

In the light of these findings, recommendations are made for revised or additional investment incentives in South Africa to promote investment in South African manufacturing companies and reduce some of the barriers that prevent local and foreign investment in South Africa.

Title of dissertation

A COMPARATIVE STUDY OF INVESTMENT INCENTIVES AVAILABLE TO THE MANUFACTURING SECTOR IN SOUTH AFRICA, MALAYSIA AND SINGAPORE

Key terms

Investment incentives; incentives; fiscal incentives; financial incentives; investment; foreign direct investment; promote foreign direct investment; manufacturing sector; economic growth; incentives in South Africa; incentives in Malaysia; incentives in Singapore

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CHAPTER 1

INTRODUCTION

1.1 OVERVIEW OF THE STUDY

The South African government is committed to improving the country's economy, by striving to increase the country's economic growth, increase the levels of investment and reduce unemployment and poverty (Department of National Treasury [National Treasury] 2008(f):iii). South Africa, however, currently faces several obstacles, such as inadequate infrastructure and low skills levels in the labour force, thereby limiting its ability to achieve these goals. These constraints are partly responsible for the low levels of competition in the labour-intensive manufacturing sector and for the small amount of foreign direct investment inflows into the country (The Organisation for Economic Co-Operation and Development [OECD] 2008(b):562).

The growth of the South African manufacturing industry is one of the main factors that contribute to a healthy economy in South Africa (Jones 2002:125). Thirlwall (2002:126) believes that the renewal of growth in the South African economy largely depends on an improvement in the performance of the manufacturing sector. Rodrik (2006:22) agrees that the expansion of manufacturing in South Africa will promote economic growth and employment, which will ultimately lead to an economically stronger nation. Several authors thus concur that the manufacturing industry is an important engine for economic growth and that increased manufacturing is potentially a key element in South Africa's economic growth.

Increased manufacturing activity could be stimulated by increased investment. Elhiraika (2008:7) reported that the rate of investment impacts on the rate of the manufacturing sector's output growth, and therefore a high level of investment

in manufacturing activities is necessary for economic development (Barrell & Pain 1997:1778). Anwar (2008:449) argues that the availability of capital determines the degree of value added in the manufacturing sector, while Abdi (2008:467-468, 474) adds that investment in machinery and equipment influences the output growth and productivity levels of manufacturing activities. It is clear that growth in the manufacturing sector is reliant on new direct investment.

According to South African Deputy Finance Minister Nhlanhla Nene, this much-needed investment could be funded from local sources, without requiring foreign capital, if South Africa could save more. However, South Africa's gross domestic saving rate, which indicates the country's potential to invest, is extremely low (De Bruyn 2009; Worldbank 2010). Arvanitis (2005:68) suggests that South Africa will need to "supplement domestic saving required for higher investment and growth", and goes on to say that this will require foreign direct investment as a source of capital to assist in the growth of the manufacturing sector. Furthermore, foreign direct investment provides inflow of capital, technical knowledge, technology and expertise in organisational and managerial practices. It can also complement domestic development by encouraging export competitiveness, generating employment and increasing financial resources for development (Rajan 2004:12). It is therefore clear that attracting foreign direct investment is a critical factor in advancing the expansion of the manufacturing sector in South Africa.

South Africa possesses basic resources such as abundant labour and low-cost land and buildings that should attract foreign individuals and companies to invest in the country (Asafo-Adjei 2007:92-94). The country is also now regarded as a stable modern state, as confirmed by the fact that South Africa hosted the 2010 FIFA World Cup South Africa™ (OECD 2008(c):9).

However, a lack of skilled workers, high entry barriers for foreign investors and possible insufficient electricity supply are some of the reasons for low foreign investment (OECD 2008(c):12, 37). The removal or minimisation of these obstacles is often difficult or is only achieved over a long-term period (National Industrial Conference Board 1969:1). Investment incentives, which will be defined in paragraph 2.3.1, are usually among the relatively few measures that can be introduced to minimise the effects of investment obstacles and to improve the attractiveness of South Africa as an investment destination. Investment incentives are also one of the few identifiable signs of a country's change in attitude towards foreign and local investment. Various incentives have been found to influence investment decisions, and almost all developing countries provide a variety of incentives as a means of attracting foreign investment. Such incentives can either encourage investment generally or attract investment in selected sectors or geographical areas (OECD 2001:10).

The South African government has introduced various investment incentives in the form of tax incentives and financial incentives (defined in par 2.3.1), to facilitate the growth of certain industries and to promote local and foreign investment in South Africa (Department of Trade and Industry [DTI] 2009). Recently, much attention was specifically focussed on new investment incentives for the manufacturing industry (refer par's 3.2.4, 3.2.5 and 3.2.6), which leads to the question of whether there are more investment incentives that could be initiated to facilitate increased investment in the manufacturing industry.

1.2 RESEARCH QUESTION

This study investigates the following research question: which additional investment incentives, applicable to the manufacturing sector, could the South

African government introduce to encourage foreign investors to choose South Africa as the desired investment destination?

The above research question will be addressed by comparing South Africa's investment incentives for the manufacturing industry with those of two other countries in order to identify incentives which are offered by these other countries but not by South Africa. The introduction of investment incentives that compare favourably with those in other countries, may strengthen the competitive advantage of South Africa to influence the foreign investor's decision when selecting a country in which to base its manufacturing operations and invest in.

1.3 PURPOSE OF THE RESEARCH

The purpose of this research is to compare the investment incentives available to the manufacturing sector in South Africa with those available to selected countries. This comparison would then identify investment incentives applicable to the manufacturing industry which the South African government could consider introducing to attract more investment, especially from foreign countries, which could result in the growth of the South African economy.

The aims of this study are to:

- investigate the determinants of the investment decision of foreign investors, as well as the dynamics of investment incentives as one of the elements that affect the investment decision
- identify the investment incentives in South Africa which are available to the manufacturing industry
- identify the investment incentives offered to the manufacturing industries of two other foreign countries

- compare the investment incentives provided by South Africa with those of the two foreign countries and make recommendations for additional investment incentives, in order to address the possible lack of incentives in South Africa, compared to the situation in the countries under investigation.

1.4 BACKGROUND

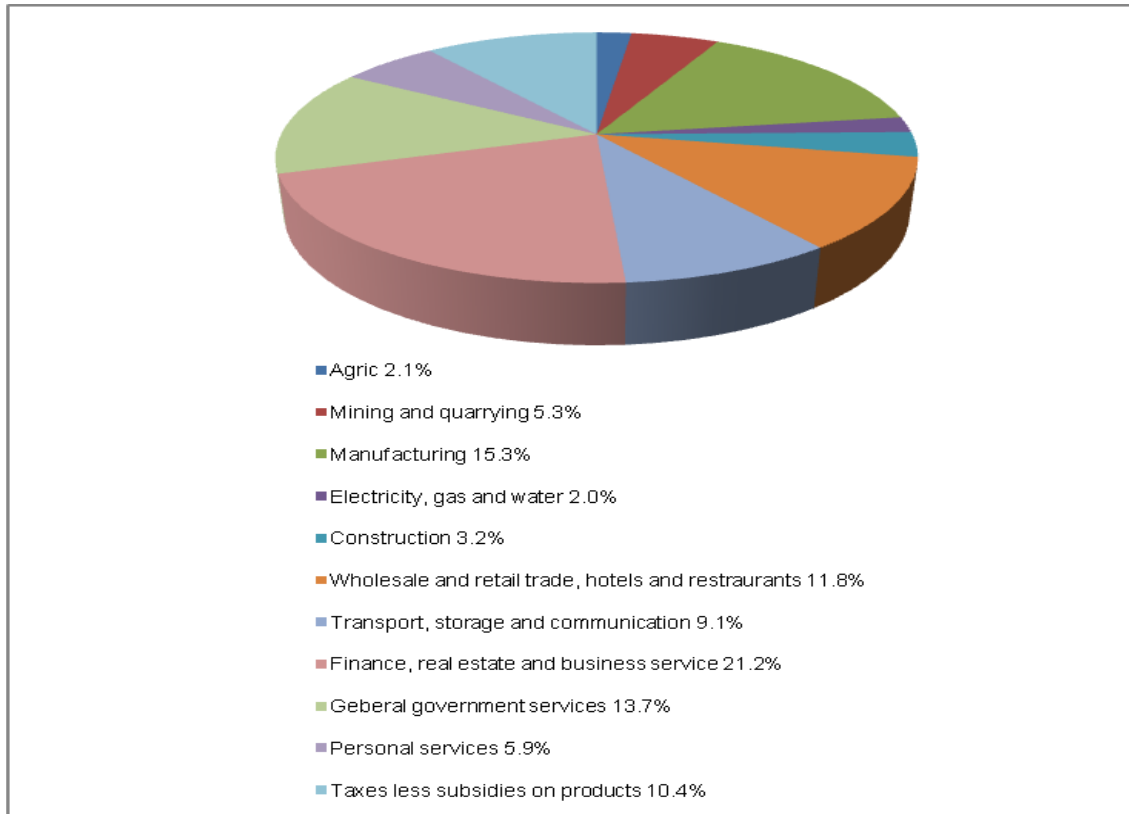
This section explains the fundamental elements on which this study is based. The role and importance of the South African manufacturing sector is considered since this study will focus on investment incentives available to this industry only. The growth of the manufacturing sector is reliant on increased investment, and the importance of foreign direct investment in providing this investment funding is explained. Lastly, the role of investment incentives in attracting local and foreign direct investment is mentioned.

1.4.1 The role of the manufacturing sector in the South African economy

The manufacturing sector has been seen throughout history as being at the forefront of an economy that is advancing to higher levels of innovation and efficiency. Manufactured products are easily traded and profits in the manufacturing sector has an influence on other sectors, resulting in the balanced development of the economy as a whole (Department of Science and Technology 2004:6).

Figure 1.1 illustrates which portion of GDP is represented by each sector in the economy of South Africa, as determined in 2010.

Figure 1.1 GDP per sector in the economy of South Africa



Source: Statistics South Africa (2010(a):15)

Figure 1.1 indicates that the manufacturing sector contributes 15.3% to GDP, which makes it the second largest contributing sector in South Africa. The manufacturing sector also represents 15.2% of the total tax assessed by the South African Revenue Service (SARS) for companies reporting positive taxable income in 2008. The financing (33.5%) and transport (21.3%) sectors are the only ones with assessed tax which are greater than manufacturing (South African Revenue Service [SARS] 2009:111). This confirms that the manufacturing sector is extensively contributing to the economy in the form of collected tax revenue and also provides an indication of its size relative to other industries. The manufacturing sector is, furthermore, the fourth largest employer

and absorbed about 15% of total employment in 2008 (Statistics South Africa 2008(b):27). It is clear that the manufacturing sector is a key contributor to the South African economy.

In recognising the importance of manufacturing in the economy, the South African government launched a National Advanced Manufacturing Technology Strategy (AMTS) in September 2003. The aim of this strategy is to improve the competitiveness of South Africa's manufacturing sector and to encourage innovation which, in turn, will upgrade the entire economy. This will mainly be accomplished by stimulating technological upgrading in the industry (including the acquisition of foreign technology) and facilitating the building of a favourable environment for innovation by supplying skilled human resources, technology infrastructure and funds (Department of Science and Technology 2004:10).

In presenting South Africa's industrial finance and policy interventions in August 2006, the former State President, Mr Mbeki, mentioned that the National Industrial Policy Framework recognises the "importance of manufacturing as the cornerstone of the economy" and that specific emphasis is placed on manufacturing in order to achieve the desired development and growth (Creamer 2006). The National Industrial Policy Framework has further identified the manufacturing sector as one of the main potential contributors to expand exports, particularly in the automotive division (OECD 2008(b):556). The manufacturing sector is also supported by the 2009/2010 National Budget through the allocation of a production subsidy of R870 million over the next three years in support of a new automotive production and development incentive (National Treasury 2009:9).

Although the Department of National Treasury [National Treasury] (2008(f):16) agrees that "manufacturing output is an important driver of GDP, exports and employment", it also recognises that there is a need for this sector's contribution

to the country's economic growth to expand even more. From the above literature review it is evident that the growth of the manufacturing sector is vital, as it has a direct influence on the growth of the economy. This growth could be achieved by increased investment in the manufacturing sector, by both local and foreign investors (Schneider 2000:413).

1.4.2 The importance of investment in the South African manufacturing industry

National Treasury's Medium-term Budget Policy Statement released in 2008 stated that one of the priorities for macroeconomic policy is boosting economic growth (National Treasury 2008(f):iii). In his 2009 budget speech, Mr Trevor Manuel (the previous Minister of Finance) also confirmed that the rebuilding and growth of South Africa's economy is the most important objective of government. One of the principles that government has accepted in achieving this goal, is the building of economic capacity and promoting investment (National Treasury 2009:2). South Africa's government recognises that "capacity constraints, from electricity to skills, can only be broken through higher levels of investment" (National Treasury 2008(e):11).

Increased investment in the manufacturing sector is thus required to facilitate increased production capacity, which will result in the growth of the manufacturing industry (Department of Communications 2009:12-13). Woolfrey (2010) agrees that the increase in manufacturing capacity is dependent upon government's ability to encourage increased investment. Maia and Kuhn (2007) explains that insufficient investment in the production capacity of the South African manufacturing sector has caused this sector to operate at its highest levels of production ability, and the expansion of manufacturing production capacity by increased investment is necessary to adhere to the rising demand in products. Specifically, investment in physical capital used for manufacturing

activities is essential to increase growth in this industry. Investment in capital and infrastructure is crucial in expanding the manufacturing sector, as can be seen by the various sub-sectors of the South African manufacturing sector that have benefited from ongoing infrastructure development (Maia & Kuhn 2007).

Due to South Africa's low levels of domestic saving and investment, foreign direct investment is vital as a source of capital to assist in the growth of the country's manufacturing sector (Arvanitis 2005:73; Root and Ahme 1979:751).

1.4.3 The importance of foreign direct investment in South Africa

Foreign direct investment (to be defined in par 1.5) is increasingly being recognised as an important instrument of economic growth for the host country (Asafo-Adjei 2007:91). Besides bringing in capital, it facilitates access to international markets, as well as the transfer of technology (Shah 2003:22). The significance of foreign direct investment is also recognised by Kamath (2008:35), as his study concludes that foreign direct investment “has a positive impact on exports, imports and has greatly contributed to GDP”, thereby enhancing the growth of the world economy in general. The attitude of most countries towards inward foreign direct investment has changed significantly during the last two decades. Increasingly more developed and developing countries are prioritising policies which strive to create favourable climates to attract foreign direct investment. (Asafo-Adjei 2007:73, 88; World Investment Report 2003:48).

The importance of foreign direct investment in South Africa is proven by the balance of payments for 2008 (National Treasury 2009(b):28). The financial account (income resources) of 9.2% of GDP financed the current account deficit of 8.1% of GDP, resulting in net reserves of 1.1% of GDP. The financial account mainly consists of foreign direct investment and other investment. *Net* (inflow less outflow) foreign direct investment of R53.7 billion represents 3.2% of GDP,

whilst the *inflow* of foreign direct investment (inward foreign direct investment) of R69.4 billion represents 4.1% of GDP. Therefore, inward foreign direct investment represents 45% of the financial account. This clearly illustrates the significance of foreign direct investment for South Africa.

Net foreign direct investment inflow of R35,7 billion occurred in 2005, due to the acquisition of a controlling stake in ABSA Bank Ltd by the UK-based Barclays Plc. In 2004, however, there was a net outflow of foreign capital of R3.6 billion (National Treasury 2006:30). If these figures are compared to the net foreign direct investment inflow of R53.7 billion in 2008 (National Treasury 2009(b): 30), it is clear that foreign direct investment in South Africa has increased extensively in the last few years, which also indicates that foreign investors have a favourable attitude towards South Africa and its potential for growth.

Despite this improvement, Asafo-Adjei (2007:92) and the Organisation for Economic Co-operation and Development (OECD) (2008(b):560) believes that South Africa should be attracting even higher levels of foreign direct investment. National Treasury (2005:24) agrees that South Africa is not attracting sufficient foreign direct investment post-1994 (when results were the highest in 20 years), and the 2004 World Investment Report (2004:5) also states that “South Africa is yet to realise its full potential to attract foreign direct investment”. It is clear that South Africa has much potential to increase its foreign direct investment inflow and to reap the benefits flowing from this investment.

1.4.3.1 Benefits for the host country of increased foreign direct investment

Increased foreign direct investment can result in benefits for the host country, even if the foreign companies operate in wholly-owned entities, since the technology and knowledge employed by foreign firms are transferred to the local economy. These benefits are in the form of various gains or financial

assistance flowing from the foreign company to the host country. For instance, the productivity of local companies may improve as a result of the association with foreign companies, they may imitate multinational companies' technology or hire workers trained by these companies (Easson 2004:16). Other benefits could include an increased pool of capital available for investment by the foreign company in the host country, advancement of the domestic industrial infrastructure, regional expansion or development and an increase in the foreign exchange reserve (Lim 2005:65). Additional benefits of foreign direct investment are discussed in more detail below:

- *Increased tax revenue for the host country.* It is generally multinational companies that involve themselves in foreign direct investment. Since these companies are concerned with making profits, the investment is usually well targeted towards setting up a business that will make money and create jobs. This benefit to the host country is revealed in higher tax revenue. (United Nations Conference on Trade and Development [UNCTAD] 2000:14; Easson 2004:15).
- *Employment creation in the host country.* Increased investment will require more employees, which results in the creation of jobs. Foreign direct investment can also improve the skills and wages of the labour force as multinational companies provide training and better employment opportunities for development of labour. These skills can then be employed elsewhere in the economy (Easson 2004:15).
- *Increased competition for local companies.* Foreign direct investment can have positive effects on the level of competition between local enterprises. If these enterprises are to remain competitive in the open market, they will be forced to introduce new technology or to work harder in order to provide the same standard of goods as supplied by foreign companies in the same market. Increased competition can stimulate local entrepreneurship in the

industry and force them to remain profitable and maintain their position in the market, despite the increase in the number of suppliers (Ngowi 2000:19; Industrial Development Corporation 1997:2).

- *Transfer of new technology and technical assistance from the foreign investor to local companies.* Foreign direct investment facilitates the transfer of technology and specifically new capital inputs of various kinds (Sharma & Abekah 2008:118). Foreign companies that develop new technologies have usually done so at considerable cost. To obtain a reasonable return on this investment they can sell their products incorporating the technology, they can sell the information itself by way of royalty agreements, and they can set up foreign subsidiaries in order to expand the use of the new technology (OECD 2002:168). From South Africa's perspective, the first two options involve importing goods or services, whilst the third option involves the receipt of foreign direct investment and the transfer of new technology. Easson (2004:16) is confident that sophisticated technology would create higher productivity and enhanced product quality.

Even if new technology is not transferred in the host country, foreign-owned enterprises usually provide their suppliers with technical assistance, training and other information to improve the quality of their products. Although multinational companies are not eager to share their trade secrets, they cannot avoid the transfer of managerial skills and knowledge (Kearny 2004:12). This advantage is also very relevant in the manufacturing sector of today as it is becoming more technology and knowledge-based. This means that manufacturing companies will be able to compete when they utilise the latest technology and constantly improve their equipment and people (Kletzien 2008). In all of these respects, foreign direct investment is essential.

1.4.3.2 South Africa's attitude towards and policies on foreign direct investment

The South African government recognises the importance of foreign direct investment in the growth of the economy. During 2007, Minister Trevor Manuel (National Treasury 2007(b)) stated that “policy reforms will raise investment growth rates, pulling in higher levels of foreign direct investment”. Again in 2008, he affirmed that South Africa needs even higher levels of foreign investment to grow the country’s economy, and urged all institutions and businesses involved to support government’s attempt to “make this country an attractive destination for foreign investment” (National Treasury 2008(h)). Government’s commitment is evident in the National Budget, whereby funds are allocated towards the growth of foreign direct investment. The South African government, for example, allocated R359 389 million to the Department of Economic Development and Planning in the 2008/2009 fiscal year and these funds would have been used, inter alia, to promote foreign direct investment in South Africa (National Treasury 2007(c)).

The Department of Trade and Industry (2007:26) recognises that foreign investors play a key role in maintaining high levels of skills and technology in the manufacturing sector, hence the statement in the National Industrial Policy Framework that targeted support should be given to promote foreign direct investment. By increasing foreign direct investment, government anticipates that local firms will be encouraged to focus on innovation and exports, due to the enhanced competition associated with foreign direct investment and by utilising the spill over technology and skills from foreign entities (Deloitte 2008:6; Asafo-Adjei 2007:91). Fedderke & Romm (2006:738) observed that foreign direct investment does have a positive influence on the economic growth of South Africa. The results of their research confirmed a positive spill over effect

of foreign direct investment on technology and labour, which will have a beneficial long-term effect on South Africa's output.

In order to attract and assist potential investors, the government has also established an investment promotion agency, Trade and Investment SA, which provides all the services and facilitation required to consider or establish a new investment (Asafo-Adjei 2007:91). The objectives of this division of the Department of Trade and Industry are to increase the quality and quantity of foreign and domestic direct investment, to develop exports globally and to effectively manage and administer its network of foreign economic offices (DTI 2008(i):1). South Africa has further concluded 71 Double Taxation Agreements with other international countries (PKF 2010:30). This action also indicates that South Africa is encouraging international trade and that the country is creating a favourable climate for foreign direct investment (Pigato 2000:9).

Foreign direct investment is clearly a very important aspect in growing the South African economy. It has a role to play in alleviating the country's economic and social problems (discussed in par. 2.2.1.2), although it is not the solution to these predicaments. Foreign direct investment actually complements local enterprise development, and should not be regarded as a threat. Besides the advantages to treasury (increase in revenue), other benefits such as improved skills and expertise, acquisition of new technologies and access to new markets, should be considered when creating investment promotion policies, such as investment incentives.

1.4.4 Investment incentives as a tool to attract investment in the manufacturing sector

With the expectation that foreign direct investment will raise employment and tax revenue, or that some knowledge and expertise of the foreign companies may extend to the host country's local companies, governments across the world have lowered various entry barriers to foreign investment and have also provided various forms of investment incentives (Morisset & Pirnia 2000:2).

Besides using investment incentives to attract new foreign direct investment to the South African manufacturing sector, this valuable instrument can also be employed to retain current local and foreign direct investment in the manufacturing sector of South Africa and prevent South African manufacturing companies from investing in a foreign country. By studying investment incentive measures that have been introduced in other countries, recommendations can be made for the initiation of investment incentives by the South African government to attract local and foreign direct investment in the manufacturing industry of South Africa. Based on the research findings discussed in this chapter, it is almost certain that this increased investment will contribute to the economic growth in South Africa.

Chapter 2 provides a detailed discussion on investment incentives. This discussion investigates the influence of investment incentives on the investment decision, provides a technical explanation of the nature and meaning of incentives, and explores some of the components of investment incentives, namely the objectives of the host country, costs and design features of incentives and the types of incentives.

1.5 TERMS AND ABBREVIATIONS

The following terms are frequently used in this dissertation:

Investment: “the action or process of investing money for profit” (Oxford dictionary 2010(b)).

Direct investment: the establishment of a subsidiary or branch, either wholly owned or controlled by the investor (Cohen 1978:18).

Foreign direct investment: a lasting interest and control of an entity in one country (foreign direct investor) in a company in another country than that of the foreign direct investor (host country), where the investor has substantial influence on the management of the company by means of a 10% or greater share of ownership (OECD 1996:7; National Treasury 2008(g):73; UNCTAD 2009).

Investment incentives: Tax and other financial incentives offered to companies with the purpose of encouraging them to invest (par 2.3.1).

Multinational companies: Enterprises that are substantially active in more than one economic territory (OECD 2009).

The term “government” refers to the South African government.

The term “local investment” refers to investment by a company in the same country in which the company is established.

The term “incentives” refers to investment incentives.

The term “the Act” refers to the Income Tax Act of South Africa 58 of 1962 (as amended).

1.6 LIMITATIONS OF THE PROBLEM STATEMENT

According to some researchers, investment incentives are only effective as a measure to attract foreign direct investment when all the other determinants for investment of the potential host countries are the same (par 2.2.2). For the purposes of this study, it is assumed that South Africa is alike in all respects to the countries under investigation and that incentives will thus have a positive influence on the investment decision of foreign investors.

This study deals with investment incentives in South Africa and certain other countries. It is not intended to be a study of other measures and factors which could play a role in foreign direct investment and also does not cover the many and diverse factors that affect the investment decision.

This study only considers investment incentives that are directly applicable to the manufacturing sector, and not all existing investment incentives, for example those relating to labour relations, are taken into account.

The term “investment” includes foreign and local direct investment and it is recognised that both may have a critical impact on the growth of the country’s economy. This study, however, focuses mainly on the attraction of foreign direct investment, because much of the evidence discussed above confirms the positive impact of foreign direct investment on economic growth.

1.7 THE RESEARCH METHODOLOGY

This section mentions the research method that was followed to compile the study, explains the selection process that was followed to determine the two

countries that was used for comparison purposes and describes the steps that was followed in completing the study.

1.7.1 The research method

The study made use of a literature review. This involved the collection, analysis and interpretation of relevant published information. The information was obtained from books and articles, as well as electronic sources from the worldwide web.

1.7.2 The selection of countries for comparison purposes

There are several selection methods that could be considered in determining the two foreign countries to be used for comparison purposes in this study, for example the countries included in SADEC, BRICS or Africa. Due to the fact that this study specifically focuses on investment incentives for manufacturing companies, the selection method used in this study purposely make use of information that would ensure the comparability of the manufacturing companies. For this reason, the selection of the two countries included in this study was based on three criteria, namely the performance of the manufacturing sector of each country with reference to manufacturing value added, the GDP per capita and the geographical location of each country. The World Development Bank (2009:212) released the 2009 World Development Indicators report which, *inter alia*, provides data on the amount of value added by the manufacturing sector of most countries in 2007, set out in US dollars for comparison purposes. Manufacturing value added refers to “the sum of gross output less the value of intermediate inputs used in production” (World Development Bank 2009:215). This data was supplied by the United Nations Industrial Development Organisation, which obtained input from various national and international sources such as the World Bank, the United Nations Statistics

Division, the Organisation for Economic Co-operation and Development and the International Monetary Fund (World Development Bank 2009:215).

The amount of manufacturing value added by South Africa during 2007 was the equivalent of \$45 674 000. For the purposes of this study, countries with manufacturing value added values ranging from \$10 million above to \$10 million below South Africa's value added value were identified, in other words, all values between \$35 674 000 and \$55 674 000. Seven countries that met these criteria are listed below, together with the value of their manufacturing value added.

Figure 1.2: Manufacturing value added per country

Country	Manufacturing value added
Argentina	\$51 305 000
Czech Republic	\$42 681 000
Finland	\$43 121 000
Ireland	\$44 801 000
Malaysia	\$52 223 000
Saudi Arabia	\$36 349 000
Singapore	\$38 275 000

Source: World Development Bank (2009:212-214)

These seven countries could thus be compared with South Africa due to the fact that the manufacturing value added of each of these countries is similar to that of South Africa. However, these countries differ vastly in several other respects such as the level of economic development, which could distort the outcome of the comparison. For this reason the gross domestic product (GDP) per capita of these countries was also taken into account for selection purposes. GDP is an

indicator of a country's economic health and capacity and is computed as the sum of all the goods and services consumed, invested, brought into and taken out of the country. The GDP per capita at nominal value refers to the country's GDP divided by its population, converted at market exchange rates to US dollars. This indicator represents the country's economic output in relation to the size of its population and therefore reveals the comparability of the countries (Kaul & Tomaselli-Moschovitis 2009; Pinstripe 2009). The difference in the economic wellbeing of the seven selected countries is illustrated in the following list of GDP per capita, at nominal values for 2007:

Figure 1.3: GDP per capita at nominal values per country

Country	GDP per capita
Argentina	\$6 309
Czech Republic	\$16 372
Finland	\$44 911
Ireland	\$58 883
Malaysia	\$6 146
Saudi Arabia	\$15 416
Singapore	\$34 152

Source: International Monetary Fund (IMF) (2007)

If these figures are compared with South Africa's GDP per capita of \$5 724 (IMF 2007) in 2007, it is clear that only Argentina and Malaysia were similar to South Africa. South Africa is further classified as an emerging and developing country (IMF 2009), which means that it has not achieved sufficient industrialisation relative to its population and usually lacks sophisticated technology and infrastructure (Trade & Export Finance Online 2010). Both Argentina and Malaysia are also classified as emerging and developing countries (IMF 2009). It therefore follows that South Africa could be compared

to one or both of these countries, which have a similar level of economic development and manufacturing value added.

While it would be useful to compare the investment incentives offered by countries that are similar to South Africa in several respects, it would also be beneficial to compare the investment incentives offered by South Africa with those offered by a government with a more advanced economy. This could assist in gaining an understanding of what South Africa's approach should be for future growth. The only advanced economy among the seven countries listed above, with a direct relation to Argentina or Malaysia, is Singapore (IMF 2009), due to the fact that Malaysia and Singapore are situated in the same geographical region of Southeast Asia (World Atlas 2010). Both of these countries' economies are also primarily dependent on manufacturing (Encyclopedia of the Nations 2010; Statistics Singapore Newsletter 2006:7). The fact that Malaysia and Singapore are situated in the same geographical region and are both intensely focused on manufacturing, provides sufficient reason and similarities for comparing them with South Africa.

For the purposes of this study, South Africa was compared with only two countries, and Argentina was consequently disregarded for the comparison. From the manufacturing value added and GDP per capita analysis, no country in the same geographical area as South Africa was identified as being adequately comparable in terms of the above criteria.

The final selection was therefore derived from a consideration of the performance of the manufacturing sector, GDP per capita and the geographical location of the countries. For the purpose of this study, based on the above arguments, Malaysia and Singapore were chosen to be compared to South Africa, in order to investigate the different investment incentives offered to the manufacturing sector by these three countries.

1.7.3 The research process

The research is subdivided into the following steps:

- Step 1: Consider the importance of the manufacturing sector, the need for investment in the manufacturing sector and the importance of foreign direct investment (chapter 1).
- Step 2: Investigate the determinants of the investment decision and the significance of investment incentives as an instrument to influence foreign direct investment decisions. Consider some components relating to investment incentives, such as the benefits to the host country of implementing incentives, the costs involved, the design elements of incentives to make them as effective as possible and the different types of incentives (chapter 2).
- Step 3: Review the South African investment incentive measures available to the manufacturing sector, as well as those offered by Malaysia and Singapore (chapters 3 and 4).
- Step 4: Compare the incentives identified in step 3 above, in order to propose additional investment incentives to possibly be implemented by South Africa which could attract investment in the manufacturing sector (chapter 5).

CHAPTER 2

THE INVESTMENT DECISION AND INVESTMENT INCENTIVES

2.1 INTRODUCTION

The worldwide economy is a reality for most investors who realise that there is a need to diversify beyond the borders of their own countries, and as a result companies are increasingly expanding globally into foreign territory. Due to the growing competition between governments to attract the investment of foreign multinational companies, the attitude towards inward foreign direct investment has improved significantly during the last few decades, and most countries have liberalised their policies to establish a positive environment for foreign direct investment (Asafo-Adjei 2007:73; Blomstrom & Kokko 2003:1).

The purpose of this chapter is to examine the foreign direct investment decision and the dynamics of investment incentives as one of the instruments that may affect the investment decision and attract foreign direct investment. To begin with, the factors that affect the decision regarding foreign direct investment are considered and the influence of investment incentives on the investment decision is discussed. To gain an understanding of investment incentives, some of the components of this instrument are also considered. Firstly, the objectives of the host country in initiating investment incentives, which influence the type of incentive provided, are discussed. Further to this, the costs involved for the host country in granting incentives are mentioned and suggestions are submitted on how incentives should be designed to limit the costs involved and to improve this instrument's effectiveness. Finally, the different types of investment incentives are discussed briefly.

2.2 THE INVESTMENT DECISION OF MULTINATIONAL COMPANIES

It is apparent from the discussion in chapter 1 that foreign direct investment has benefits for the South African economy and it is therefore important for South Africa to attract foreign direct investment. In order to do this, there has to be an understanding of the process that the multinational company will follow in deciding to invest in a particular economy or region.

The decision of multinational companies to look to a country other than their own for investment opportunities, rather than expanding investments in their own country, is a result of several interrelated events and forces. The OECD (2002:167) maintains that multinational companies attempt to utilise their existing structure or intangible assets to recover profits from other countries in the presence of market imperfections in their home country. Cohen (1978:82) lists additional factors such as the need to reduce cyclical risk by means of geographical diversification, access to foreign methods or resources and foreign government incentives (which result in increased profits).

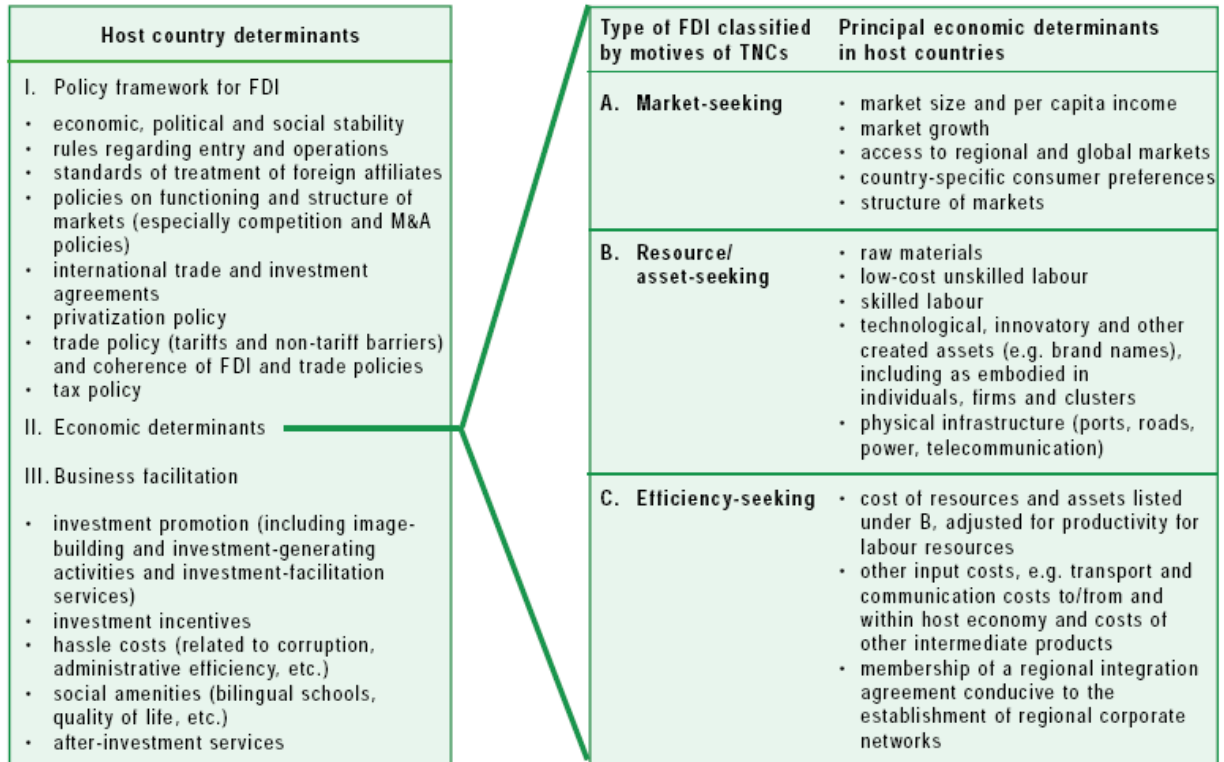
The availability of inputs or resources in another country may persuade a company to undertake production in such a foreign country instead of its home country. These location advantages may include natural resources, global location and inexpensive transport or labour (OECD 2002:168). Probably the major reason why companies would want to invest abroad is to maximise profits and increase growth possibilities. The company might have acquired or developed technology which gives it a competitive advantage in other countries, or the size of the company has increased so rapidly that the existing market is no longer able to support it (Easson 2004:17).

2.2.1 Determinants influencing the decision of multinational companies to invest abroad

Once a company has committed to invest abroad because of one or more of the above factors, several aspects influence the choice of a prospective host country. The economic attractiveness of a country for foreign direct investment depends primarily on its advantages as a location for investors, depending on the investors' needs. Market-seeking investors are interested in large and expanding markets, resource-seeking investors look for abundant natural resources, and export-seeking investors look for a competitive and efficient base for export production (Easson 2004:27).

During the decision phase of the investment process, foreign investors consider the following factors, *inter alia*, as depicted in figure 2.1 below.

FIGURE 2.1: Determinants of foreign direct investment

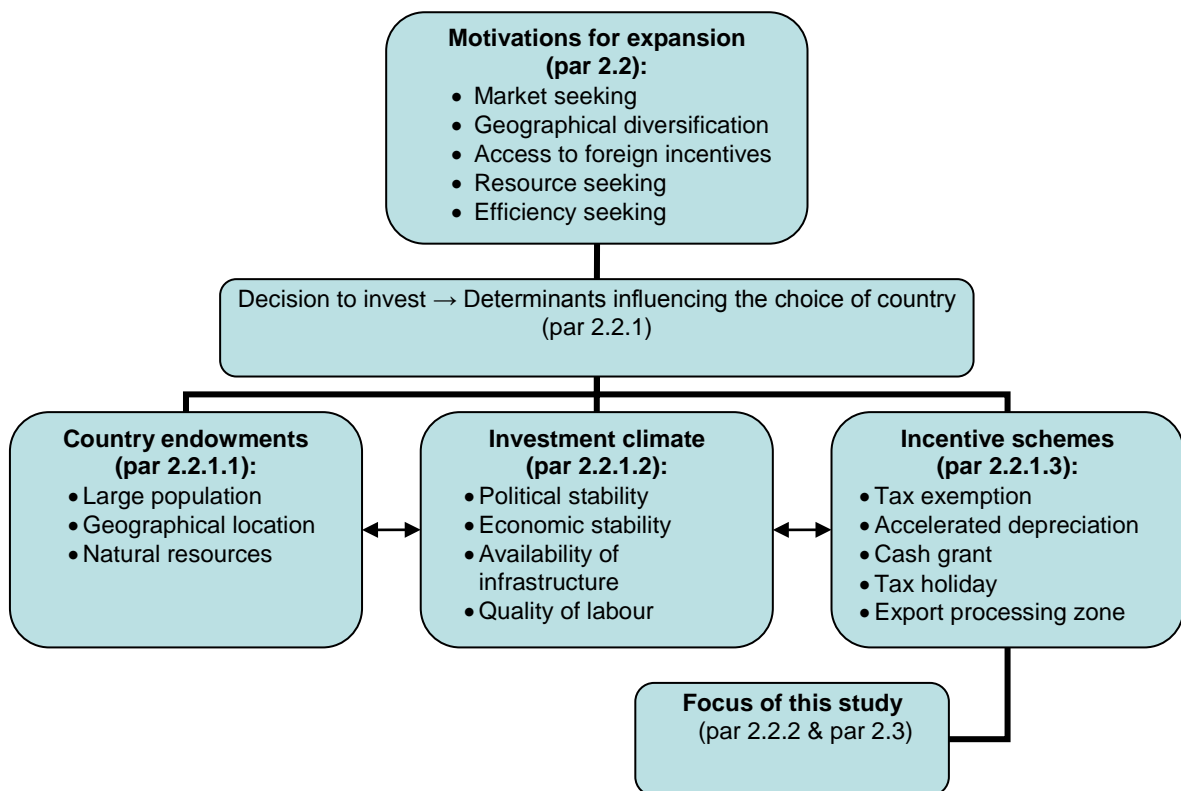


Source: World Investment Report (2003:85)

The determinants that influence the foreign direct investment decision will depend on the investing company. This was illustrated by Kearney (2004:3-4) in conducting the 2004 foreign direct investment confidence index survey. This survey “tracks the impact of likely political, economic and regulatory changes on foreign direct investment intentions and preferences of the leaders of the world’s leading companies”. His study indicated that China, the USA and India (in that order) were rated as the countries in which leading companies had the highest foreign direct investment confidence. China and India were also regarded as the two countries with the most preferred offshore investment locations. China stood out as a leading manufacturer and India as the IT service provider with longer-term market potential.

The determinants mentioned by multinational companies for deciding to invest in these two countries were vastly different. China provided sufficient access to export markets, a favourable cost structure, government incentives and adequate infrastructure, whereas India was preferred for its highly educated workforce, management talent, rule of law, transparency and regulatory environment. From this it is clear that each investment decision takes into account the unique circumstances, qualities and requirements of both the investor and the host country. The following figure graphically illustrates the investment decision.

FIGURE 2.2: The investment decision



Source: Tuomi (2009:117) (adapted)

As indicated above, Tuomi classifies the determinants which influence the investor's choice of a host country (once the decision has been made to invest in a foreign country), into three groups of variables, namely country endowments, the investment climate and investment incentives. These variables, with specific reference to the South African context, are discussed in the following three sections.

2.2.1.1 *Country endowments*

Country endowments refer to the beneficial attributes and elements of a country, such as a large population, geographical location or natural resources (fig 2.2).

South Africa is located at the southern point of Africa. It is a medium-sized country, covering an area of about 1.2 million square kilometres, and has a population of 49.32 million people (International Marketing Council of South Africa 2010). Although South Africa covers less than 3% of the African continent and accommodates less than 6% of its population, it has the largest and most broadly developed economy in Africa (Asafo-Adjei 2007:92). The well-situated geographical location and six deep-sea harbours make the country ideal for international export all over the world. Companies that invest are also able to use South Africa as a starting point to reach other countries in the sub-Saharan region. South Africa is the world's largest producer of gold and platinum and has several natural resources available, such as minerals and ores, timber and agricultural products (Maxwell 2007:1-2; Industrial Development Corporation 1997:8; South Africa Web 2010; DTI 2008(h):1).

2.2.1.2 Investment climate

The investment climate of a country is determined, *inter alia*, by its political and economic stability, availability of infrastructure and quality of labour (fig 2.2). South Africa has a stable democratic system with an international-oriented economy and a stable political system which encourage foreign investment. Government has a positive attitude towards foreign investment and foreign direct investment has grown substantially over the past few years. Foreign and local (domestic) investments are treated in essentially the same way and foreign entities also have access to various national investment incentives. The cost of doing business in South Africa is similar to that of other emerging countries (DTI 2008(h):1; Asafo-Adjei 2007:92-94).

The country has a well-developed infrastructure with both air, land and sea transport which makes transportation less problematic compared to other African countries. Companies can make use of a large financial support structure, which includes a network of merchant banks and financial service specialists (Maxwell 2007:1).

South Africa, however, faces problems such as a high unemployment rate of 25.2%, a lack of economic progress in rural areas, huge socio-economic inequities and poverty (50% of the population live below the poverty line), a lack of skilled workers, the high prevalence of HIV and high criminality. Other negative factors that may influence companies not to choose to invest in South Africa may be the fluctuating currency, extensive labour legislation and possible insufficient electricity supply (Statistics South Africa 2010:vi; Statistics South Africa 2009:3; CIA 2008).

Despite these detracting factors, South Africa does continue to attract foreign direct investment, as is indicated in Laine and Norden's (2007:57) study. This study was conducted to determine why more than 70 Swedish manufacturing companies invest in South Africa. They discovered that the main reason is to utilise the growing African market and to use the country to obtain access to other African countries. South Africa's tax legislation is the reason why these companies would prefer to establish a manufacturing entity as opposed to focusing on imports. They also found that the South African government has purposefully increased the taxation of imports to encourage foreign companies to set up manufacturing or assembling facilities, which will generate more revenue for South Africa and also increase employment. Laine and Norden (2007:57) are confident that "South Africa will be the African country where the majority of all foreign investments will be conducted in the foreseeable future".

2.2.1.3 *Investment incentives*

Investment incentives include, *inter alia*, tax exemptions, accelerated depreciation and cash grants (fig 2.2). In its effort to attract foreign direct investment to the country, South Africa is actively promoting the country as a preferred investment destination by means of several investment incentives. South Africa's positive attitude towards investment incentives was confirmed as early as June 1996 with the implementation of the Growth, Employment and Redistribution (GEAR) strategy. The aim of this initiative was to enhance the country's competitiveness in the global economy, and one of the core elements in realising this goal is initiating tax incentives to encourage new investment (Department of Finance 1996:2).

The South African government's commitment to providing investment incentives in order to encourage local and foreign investment in the country is also illustrated in National Treasury's 2008/2011 Strategic Plan. The government's

policy developments for achieving accelerated economic growth by investing in people, infrastructure and institutions, are as follows (National Treasury 2008(d):8, 23):

“Assistance to the Department of Trade and Industry in the adjudication of projects qualifying for critical infrastructure funding support, oversight of programmes relating to the industrial development zones and other incentives promoting investment in the economy”.

This confirms the positive effect of investment incentives in the South African context. The specific investment incentives applicable to the manufacturing sector which the South African government has initiated are discussed in chapter 3 of this study.

All three of the variables discussed above interact with one another, as indicated in figure 2.2, and a change in one of them could lead to the improvement of one or more of the other variables. Adjustments to either of the first two variables, namely country endowments and the investment climate, would entail a long-term approach by a country’s government. This is due to the fact that a government might have no or little control over some of these factors (for example the availability of natural resources) or these variables are influenced by a number of external factors (for example economic stability) (National Industrial Conference Board 1969:1). The only short-term intervention that could be employed by a country’s government to improve the country’s investment attractiveness, is investment incentives. It is clear that this aspect should receive proper attention as one of the instruments that the South African government could use to attract foreign direct investment to the country, specifically to the manufacturing sector. This study therefore focuses on investment incentives, and this instrument, as a tool to attract foreign direct investment, is explored further in the following section.

2.2.2 Investment incentives as a tool to attract foreign direct investment

A foreign investor's decision regarding an investment location is generally initially based on fundamental determinants and only after this screening phase has been completed, then tax rates, grants and other incentives become important (Lim 2005:63; Nathan-MSI Group 2004:2-11 to 2-12; Fletcher 2002:12). It is thus clear that a broad and consistent framework of other supportive policies should also be present in order for incentives to achieve success in contributing to the growth of the economy (Nathan-MSI Group 2004:3-3).

Despite this fact, an increasing number of host governments have initiated various investment incentives to persuade companies from foreign countries to invest in their jurisdiction (Morisset & Pirnia 2000:2; Li 2006:62; Fletcher 2002:3). Some developing countries (like Malaysia and Costa Rica) have utilised incentives effectively to encourage investment and growth. Since 1986, Malaysia has been offering incentives such as tax holidays of up to 10 years for export-oriented foreign investments with "pioneer" status, an investment tax allowance, a reinvestment allowance, special deductions for training and direct grants for high-tech activities (Nathan-MSI Group 2004:3-3). The United Nations Conference on Trade and Development (UNCTAD) recognised that this incentive policy was one of the primary components in attracting foreign companies to Malaysia (UNCTAD 2002:207).

Costa Rica introduced several investment incentives, including an export processing zone, during the 1970's. These incentives were one of the elements that convinced a large international company to choose Costa Rico as its investment destination above other countries such as Mexico, Brazil, Chile and Thailand (Nathan-MSI Group 2004:3-3). In South Africa, as well, the Motor Industry Development Programme (discussed in paragraph 3.2.5), was a

successful instrument in attracting foreign direct investment in the manufacturing sector (specifically the automotive industry) (OECD 2008(c):77).

According to Rajan (2004:12), incentive measures are utilised to enhance a country's attractiveness and create a business-friendly environment. An argument that is often made in favour of investment incentives is that, if a country's neighbours offer investment incentives, then that country must also offer them if it is to remain competitive. This argument may have some force, especially in circumstances where the investment decision is strongly affected by taxes (Easson 2004:12).

The OECD (2002:169) is convinced that incentives can be the decisive factor influencing an investment decision when an investor has two similar location alternatives. The Nathan-MSI Group (2004:1-1) also noticed that, although the benefit-versus-cost test remains a matter for debate, investment can be increased under some circumstances by means of incentives. Morisset and Pirnia (2000:8) agree that tax policy "do[es] affect the decisions of some investors some of the time". They noticed that foreign direct investment increased more than fivefold between 1985 and 1994 in tax haven countries, which clearly indicates the influence of tax (or the elimination thereof) on foreign direct investment decisions. This influence of investment incentives was confirmed by the OECD (2008:557) in its observation that investors were discouraged to initiate long-term investments in South Africa during 2007, on account of the possibility of the Motor Industry Development Programme incentive being discontinued.

It is clear that incentives may be a decisive factor which influences the investment decision and it can play an important role with regards to foreign direct investment by ensuring that a country's investment climate remains competitive compared with that of other countries. Investment incentives may

therefore well be a valuable instrument to attract foreign direct investment to the manufacturing sector of South Africa, which would have a positive effect on the country's economic growth.

2.2.3 Summary

Today's global investor has a wide choice of investment locations. Several determinants have an effect on the investor's decision about which country to invest in, such as natural resources, economic stability and the availability of investment incentives. The determinants that influence the investor's choice of a host country can be classified into three groups of variables, namely country endowments, the investment climate and investment incentives. Investment incentives are the only one of these three variables that can readily be changed by a country's government to improve the country's attractiveness as an investment destination. It was further established that investment incentives are widely utilised in the global economy of today. This instrument is therefore further explored in this study, as it appears to be a valuable instrument that the South African government could use to attract foreign direct investment to the manufacturing sector of South Africa.

2.3 INVESTMENT INCENTIVES

Foreign direct investment inflows to a specific country or region are the result of investment decisions taken by multinational companies in response to certain factors that attract investment. Countries have mainly sought to increase foreign direct investment by reducing obstacles, creating investor-friendly settings and promoting foreign direct investment, through the use of financial, fiscal or other incentives (World Investment Report 2003:87).

The first incentives were introduced during the Great Depression in 1936 by the states of Mississippi and Louisiana, to recruit industry from other regions, in order to meet the increasing demand for services (Dalehite 2008:36). Since then the impact of tax policies on foreign direct investment evolved and already in the mid-1990s more than 100 countries were providing various foreign direct investment incentives. The introduction of investment incentives have steadily increased and today only a few countries compete for foreign investment without any form of subsidies (Easson 2004:85, Rajan 2004:13; UNCTAD 1996:21). Billy Joubert, tax director at Deloitte, agrees that “most countries offer incentives to attract investors and South Africa needs to offer something too [in order] to be competitive” (Lang 2008).

The financial benefits of incentives can be illustrated as follows: A business considers importing a machine costing R80 000, and the import duties on this machine amount to R10 000. The total cost is thus R90 000, but if an exemption of import duties is provided to the investor as an investment incentive, the total cost is reduced to R80 000. The exemption means that less total capital outlay is necessary and that the prospective rate of return will be raised. Incentives that do not directly reduce initial outlay requirements may still affect financing indirectly through their influence on profits. If exemption from tax for five years is offered and if the tax rate is 50%, after-tax profits will be 100% greater during

the exemption period than they would have been without the incentive. This may make it possible to recover the original investment more rapidly, and could thus be a significant investment motivation.

The practical implication of incentives is shown above. In order to gain an understanding of investment incentives, the following section examines the meaning of incentives, followed by a discussion of some of the components of investment incentives, namely objectives of the host country, costs of incentives, design features of incentives and types of incentives.

2.3.1 Definition of investment incentives, tax incentives and financial incentives

An *incentive* is defined as a reward factor that induces a specific action, such as investment (Oxford dictionary 2010). The South African Institute of Chartered Accountants (2009) also adds that the purpose of an incentive is “to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided”.

An *investment incentive* may be defined as “a financial advantage given to an entity in the form of a direct cash grant or by some alteration in the size or timing of the entity’s tax payments, in return for it making a specified type of investment” (Downer 1974:3). Investment incentives include tax incentives (defined below) such as tax holidays and lower taxes for certain investors, as well as financial incentives (defined below) such as grants and preferential loans to certain companies (PricewaterhouseCoopers 2002:index).

The Southern African Development Community’s (SADC) Memorandum of Understanding on taxation defines *tax incentives* as “fiscal measures that are used to attract local or foreign investment capital to certain economic activities or particular areas in a country”. Probably the most comprehensive definition of

tax incentives, as provided by Zee, Stotsky and Ley (2002), reads as follows:
Tax incentives are

“special tax provisions granted to qualified investment projects that has the effect of lowering the effective tax burden on those projects, relative to the effective tax burden that would be borne by the investors in the absence of the special tax provision”.

Tax incentives are either linked to the purchase of new productive capital, the financing of the capital acquisition or the taxation of profits from the investment (Ngowi 2000:19). In summary, tax incentives can be described as methods used by government to reduce the tax burden of companies by means of a deduction, exclusion or exemption from a tax liability, in order to persuade them to invest in particular projects or sectors for a certain period (Ngowi 2000:22; Business dictionary 2008).

According to Rajan (2004:13), *financial incentives* represent “direct contributions to the firm from the government (including direct capital subsidies, subsidised loans or dedicated infrastructure)”. This contribution from the government, otherwise known as a government grant, is explained by the South African Institute of Chartered Accountants (2009) as government support in the form of the transfer of funds to a company, provided that certain conditions are adhered to. Section 1 of the Income Tax Act also defines a government grant as “an appropriation, grant in aid, subsidy or contribution, in cash or kind, paid by a department listed in Schedule 1 to the Public Service Act, 1994” (s1 of the Act).

For the purposes of this study, *investment incentives* mean tax and other financial incentives offered to companies with the purpose of encouraging them to invest. *Tax incentives* are fiscal measures such as tax deductions, exclusions or exemptions introduced by government to reduce the tax liability of a company when it invests in a particular project. *Financial incentives* refer to direct assistance from government by means of the payment of funds relating to the investment project.

2.3.2 Objectives of the host country in implementing investment incentives for attracting foreign investment

Now that the concept of an investment incentive has been defined, the first component of investment incentives, namely the objectives of the host country in initiating investment incentives will be discussed.

It is critical for the host country to assess its investment conditions and characteristics in order to determine whether possible obstructions to investment could be overcome by the use of incentives (Asafo-Adjei 2007:83). The host country should carefully consider the objectives of incentives in order to make an informed decision about which investment incentives to initiate. Some of these objectives are discussed below.

2.3.2.5 Advertise the host country as a desirable location for foreign investment

Foreign investors may not have full information about what countries would probably ensure high profits for them. Major incentive packages have been justified on the grounds that high return countries may want to “signal” to the world that their location has an attractive business environment. This is usually the argument in favour of tax holidays in developing countries (Bond & Samuelson 1986: 820-826).

Investment incentives do not only attract the attention of the foreign investor to the country as a desirable location for investment, but also indicate the government’s favourable approach towards both domestic and foreign investors, which improves the investment climate (Heller & Kauffman 1963:4). In an attempt to advertise South Africa as an attractive destination for foreign investment, the South African government has initiated “tax reforms, fiscal discipline and the gradual liberalisation of exchange control” (South African Revenue Service 2010).

2.3.2.6 Promote local and foreign investment in the host country, to encourage the growth of the economy

Investment incentives could play a legitimate role in encouraging specific types of investments that generate particular benefits for the economy as a whole, for instance projects that utilise advanced technologies to improve the host country’s technical knowledge, or projects located in a less-developed region of a country which could help to uplift and expand the region (Nathan-MSI Group 2004:3-1 to 3-2; Galenson 1984:2-3).

Investment incentives may also be targeted at investment in regions where unemployment is a serious problem, for example in remote rural regions. Operating from a remote area may however result in higher transportation costs for obtaining production materials and in delivering end-products to markets. This could put that location at a competitive disadvantage and incentives may be offered in cases like these to compensate investors for additional business costs incurred (UNCTAD 2000:15). In the same way, employment-related incentives could improve the employment rate in these rural regions, which in turn may have a direct effect on the growth of the economy (Viherkenta 1991:35). Incentives like these may be relevant to South Africa with its extremely high unemployment rate of 25.2% (Statistics South Africa 2010:vi).

2.3.2.7 Compensate for unavoidable investment obstacles in the host country

In many countries, the attraction of foreign investment is recognised by government as an important objective of economic policy. There are, however, several unintended obstacles for foreign and local investment which the government of the host country is keen to avoid or minimise. The National Industrial Conference Board (1969:1) (a non-profit organisation in the United States of America dedicated to the study of business problems [Johnson 1965]) mentions several of these obstacles, such as corruption and excessive red tape. The OECD (2010) also indicates that foreign investment barriers such as a limitation on foreign ownership and too much government interference with the private sector could result in low foreign direct investment inflow.

Dupasquier and Osakwe (2005:13-16) further identify political instability, low economic growth rates and a lack of policy transparency as some of the factors that limit foreign direct investment. Although governments should first give proper attention to the investment obstacles and change the factors that influence the foreign investment location decision, this could be more difficult or

even fall outside these governments' control (for example market failures). Hence a number of countries have introduced special laws offering tax allowances and financial incentives as an important instrument in their strategies to attract foreign direct investment for economic development (National Industrial Conference Board 1969:1).

2.3.2.8 *Additional objectives*

Apart from attracting investments in quantity, incentive programmes sometimes have additional objectives. The National Industrial Conference Board (1969:64) cites some additional reasons for attracting investment:

- diversifying the economy by attracting particular kinds of industry
- encouraging certain forms of activity (for example research and housing construction)
- expanding exports in order to build foreign exchange reserves.

The objectives of the country will determine which incentive would be most optimal in attracting investment.

2.3.3 Costs of investment incentives

The previous section considered the first component relating to investment incentives, namely the objectives of a host country for initiating investment incentives to attract foreign direct investment. The second component of investment incentives, namely the costs relating to incentives, is examined further.

According to Easson (2004:75), the “benefits of investment incentives are widely exaggerated, while the costs are often underestimated or completely overlooked”. Because of their nature, incentives require some sacrifice of

revenue, but it is generally desirable that the objectives of the incentives be achieved with the least possible revenue sacrifice. The potential gains of incentives should be carefully evaluated and assessed against the administrative and revenue consequences of adopting them (Heller & Kaufman 1963:79).

2.3.3.3 *The administrative implications and burdens of incentives*

The management of incentives usually inflicts a major administration burden. When a selective tax incentive statute is implemented, it involves extremely competent and skilled administrators, accountants and other specialists (Morisset 2003:16). This is a concern for developing countries, as these skilled personnel and specialists are not always available in a predominantly Third World environment. Should these qualified people be available, then the allocation of these personnel to the instigation of a tax incentive statute will mostly necessitate a diversion of these resources away from other responsibilities, such as collecting revenue, imposing existing tax legislation, researching and amending the tax laws and introducing other economic development programmes. The introduction of non-selective or uncomplicated selective provisions may not necessitate a significantly large or wasteful distraction of administrative resources (Zee et al 2002:1501).

Heller and Kauffman (1963:80) warned that when incompetent administrative staff is deployed, taxpayers tend to abuse the system and evade tax. The dangers of mal-administration depend on prevailing conditions in each country (for example corruption and political independence) and on the type of incentive adopted.

2.3.3.4 *The revenue implications of investment incentives*

When an incentive is taken advantage of by investors, less tax is recovered by the country offering the tax incentive, resulting in a reduction of revenue for Treasury. Due to this reduction in revenue, incentives should thus have a considerable influence on investment before they are introduced (World Investment Report 2003:124). The question is whether the country would have received the new foreign investment if no or lower incentives had been offered. In cases where a country offers more incentives than other countries, companies that would have invested even without the existence of investment incentives (or with smaller incentives) benefit, while the host country loses, and there are no net benefits for the economy (Zee et al 2002:1501).

There are legitimate reasons to believe that the costs of investment incentives may be high relative to the benefits of the increased investment. Regardless of their limitations, investment incentives are not expected to be abandoned by most countries as policy instruments for attracting investment. It seems certain that the debate as to whether granting investment incentives to attract direct investment as an appropriate measure will continue. The question is how best to design investment incentives to achieve the objectives at minimum cost, and the following section will investigate this third component relating to investment incentives.

2.3.4 Design of investment incentives

An important function of the corporate tax system is to collect tax revenues on income derived in the host country (Nathan-MSI Group 2004:i). The desire to collect as much tax revenue as possible, while not hindering foreign investors, raises the issue concerning the appropriate design of tax incentive provisions (OECD 2001:13). Policy makers should realise that if incentives are not carefully designed and well administered, there could be side effects that

diminish productivity by distorting resource allocation and losing revenue (Lim 2005:62).

Most incentive programmes attempt to encourage some kind of investment more than others. The objectives of the incentives are reflected in their design characteristics and the conditions under which the various types of incentives are offered (Zee et al 2002:1499). When designing an incentive, governments should consider each of the following design features and characteristics to ensure that the incentive meets the set objective.

2.3.4.7 Fiscal or financial incentives

There are two categories of incentives governments can use to attract investment and governments should consider which one would be the most effective for achieving the intended objective for the country. The first category is fiscal incentives (tax incentives) which are policies designed to reduce the tax burden of a firm, while the second category is financial incentives such as direct contributions to the investor from the government (Lim 2005:65).

Fiscal incentives are specific and the government gives direct inducements to targeted industries or firms to encourage them to invest. The government thus has control and can accurately aim the incentives at the particular industries, firms, transactions, products, types of equipment, geographical location or whatever it wishes to develop. The benefit of fiscal incentives is that they can easily be granted without incurring any significant financial costs at the time of their provision. They are, however, inflexible in individual cases (Lim 2005:74).

Financial incentives include grants, subsidised loans and government insurance at preferential rates. The greatest benefit of financial incentives is that they only reward new investment or capital purchases and therefore do not fund

investments that would in fact have occurred without the incentive. The incentive is thus directly linked to the investment (OECD 2001:69; Nathan-MSI Group 2004:5-1 to 5-3). The negative aspect of these incentives is that they are a direct drain on the government budget and are thus not generally offered by developing countries (Easson 2004:2).

Developed countries frequently employ financial incentives such as grants or subsidised loans, whereas developing countries tend to use fiscal incentives that do not require upfront use of government funds (Easson 2004:2). The OECD (2003:26) also observed that most countries prefer to initiate tax incentives to specifically attract foreign direct investment, due to the fact that the loss of revenue relating to this type of incentive is much smaller than the initial outlay of funds pertaining to financial incentives.

The benefit for a company receiving a grant (financial incentive) is that it will receive the cash compensation earlier than with a tax deduction (fiscal incentive), which only realises at the end of the tax year when the company's tax liability is decreased (South African Institute of Chartered Accountants (SAICA) 2009:9). Since much of the uncertainty about investment returns in developing countries might come from uncertainty about the future government policies, incentives that ensure the up-front allocation of funds to the company tend to persuade it to invest and also provide the most effective assistance (Bond & Samuelson 1986:820-826). Boadway and Shah (1992:97) add that firms will benefit mostly from generous refundability provisions and government grants than from tax provisions that reduce the tax liability. This is specifically the case for companies who are relatively strapped financially or in a loss position, like new growing firms. The United States Department of Energy (2009) also recognise that companies are more inclined to invest in a project when upfront funding is provided by means of a government grant than when a tax credit is provided to reduce taxable income. It is clear that a financial

incentive (grant) would be more beneficial to the investor, as it offers immediate relief through financial assistance, whereas a fiscal incentive provides relief over a period of time by decreasing the investor's tax liability.

2.3.4.8 Discretionary or automatic incentives

Incentives can also be discretionary or automatic policy instruments. Discretionary investment incentives are implemented on a case-by-case basis by administrative decisions. Automatic incentives, in contrast, are available to any firms meeting certain stated objective criteria, such as the type and size of investment, the location of the firm, the ownership of the firm, profitability of the firm, and so forth (OECD 2001:31; Nathan-MSI Group 2004:8-5).

Automatic incentive regimes are easier to implement and they reduce the costs of administering the incentives. They generally involve such incentives as investment tax credits, accelerated depreciation, and subsidies linked to easily measurable indicators such as exports and skilled labour (OECD 2001:31; Nathan-MSI Group 2004:8-5).

Discretionary instruments, on the other hand, are difficult to administer and result in delays and uncertainty for investors. The major benefit of discretionary incentives is that discretion allows the administrators to award incentives only to preferred projects, thereby increasing the cost effectiveness of this instrument by screening out non-desirable projects (OECD 2001:31; Nathan-MSI Group 2004:8-5).

2.3.4.9 *Simplicity*

When designing tax systems, policy makers must keep in mind that complexity in the tax law can impose serious compliance costs on taxpayers, such as the direct costs of hiring technical personnel to ensure compliance with the rules, the introduction and maintenance of data collection systems and the need to take tax into consideration when making business plans. Also, frequent changes to the tax laws can contribute to the perception that the tax system is complex and difficult to comply with (OECD 2001:14). Morisset and Pirnia (2000:22) confirm that simplicity and stability in the tax system play a greater role in the investment decisions of multinationals than generous tax rebates, especially in an environment with great political risks.

2.3.4.10 *Transparency*

Transparency is also an important feature of the investment incentive system. This involves making clear the justification for granting any investment incentive on the basis of well-formulated economic arguments and estimating the revenue costs of granting the incentive based on clearly stated assumptions (Nathan-MSI Group 2004:xvii). All incentives should have a legal basis by including them in the tax legislation, and any changes to such incentives should require amendments to this legislation (OECD 2001:31).

2.3.4.11 *Incentive provisions should encourage urgency on the side of investors*

Incentive programmes should be temporary and terminated once the intended objectives have been achieved. Usually the purpose of granting special tax regimes is to induce investment in a desired window of time. If the possibility of receiving incentives is permanent, there is no added incentive to invest today as

opposed to investing in the future. This can be achieved through sunset provisions, whereby the incentive expires on a specific date, or by avoiding the renewal or extension of incentive programmes (Downer 1974:45).

2.3.4.12 Incentive provisions should avoid inequity between foreign and domestic investors

The appropriateness of an investment incentive will also rely on the fact that it would apply to both domestic and foreign-owned capital (Boadway & Shah 1992:14). Heller and Kaufmann (1963:81) agree that taxpayers who are similarly situated with respect to their income should ideally bear equal tax burdens. When exemption from tax is provided to only one group of taxpayers, it means that others who do not enjoy this exemption must bear a larger burden. It is therefore necessary for consensus to be reached by the country introducing an investment incentive to foreign or local investors only, that the objective of economic development should receive temporary preference over the equity objective.

2.3.4.13 Preliminary assessment and regular monitoring

A preliminary assessment should ideally be done before executing the incentive programme, by using valid up-to-date information (Dalehite 2008:40). In applying this principle, the OECD (2003:22-23) compiled the following checklist to enable host countries to weigh up the costs and benefits of introducing an investment incentive to attract foreign direct investment.

TABLE 2.1: Checklist for foreign direct investment incentive policies

The desirability and appropriateness of offering foreign direct investment incentives:

1. Are foreign direct investment incentives an appropriate tool in the situation under consideration?
2. Are the linkages between the enabling environment and incentives sufficiently well understood?

Frameworks for policy design and implementation:

3. What are the clear objectives and criteria for offering foreign direct investment incentives?
4. At what level of government are these objectives and criteria established, and who is responsible for the implementation?
5. In countries with multiple jurisdictions, how does one prevent local incentives from cancelling each other out?

The appropriateness of strategies and tools:

6. Are the linkages between foreign direct investment attraction and other policy objectives sufficiently clear?
7. Are effects on local business of offering preferential treatment to foreign enterprises sufficiently well understood?
8. Are foreign direct investment incentives offered that do not reflect the degree of selectiveness of the policy goals they are intended to support?
9. Is sufficient attention given to maximising effectiveness and minimising overall long-term costs?

The design and management of programmes:

10. Are programmes being put in place in the absence of the realistic assessment of the resources needed to manage and monitor them?
11. Is the time profile of incentives right? Is it suited to the investment in question, but not open to abuse?
12. Does the imposition of spending limits on the implementing bodies provide adequate safeguards against wastefulness?
13. What procedures are in place to deal with large projects that exceed the normal competencies of the implementing bodies?
14. What should be the maximum duration of an incentives programme?

Transparency and evaluation:

15. Have sound and comprehensive principles for cost-benefit analysis been established?
16. Is cost-benefit analysis performed with sufficient regularity?
17. Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?
18. Is the process of offering foreign direct investment incentives open to scrutiny by policy makers, appropriate parliamentary bodies and civil society?

Extra-jurisdictional consequences:

19. Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?
20. Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdiction?

Source: OECD (2003:22-23)

These questions are valuable in the upfront evaluation process when government is considering to offer an investment incentive, as well as when the instrument is finally implemented. Periodic review by governments can help them to update incentive packages to provide real value to investors, which will attract more investment. Periodic review will also help governments to prevent revenue leakage by eliminating excessive incentives or unnecessary tax breaks to investors (Nathan-MSI Group 2004:xviii).

Investor companies are often required to fulfil some necessary conditions (such as importing certain assets or creating a number of jobs) in order to obtain the investment incentive, which compels the government to evaluate and monitor these conditions. Alternatively, the distribution of benefits to the investor could be restricted to predetermined limitations, as is the case for South Africa's Industrial Investment Allowance (refer par 3.2.4), forcing the government to monitor the benefits allocated to the company (Nathan-MSI Group 2004:7-21). It is crucial that the continued monitoring of the necessary conditions is put in place and operates effectively. It often happens that a company initially fulfils all the requirements to ensure that it is entitled to the investment incentive, but gradually changes the way it coordinates the investment project to match its business plan. This results in some of the criteria not being applicable any longer (UNCTAD 2000:25).

It is clear that several factors should be kept in mind when designing incentive schemes. The collaboration of all these features determines the type of investment incentive a government will introduce.

2.3.5 Types of incentives

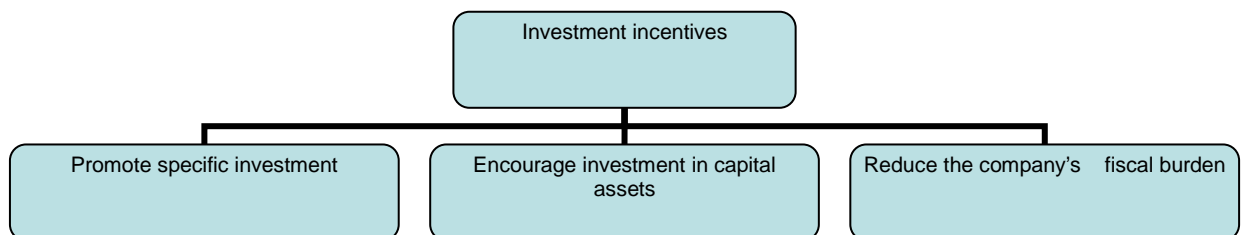
Besides the objectives of the host country to introduce incentives, the costs relating to the incentives and the features that should be considered when designing an investment incentive programme, attention should also be paid to the fourth component of investment incentives, namely the type of incentive instrument to be initiated.

A preliminary analysis of the different investment incentives included in this study (chapters 3 and 4), revealed that they can be classified into the following three categories:

- investment incentives that promote specific investment
- investment incentives that encourage investment in capital assets
- investment incentives that reduce the company's fiscal burden.

These categories are graphically illustrated below:

FIGURE 2.3: Investment incentive categories



The different types of incentives which usually form part of these incentive categories are discussed next.

2.3.5.1 *Investment incentives that promote specific investment*

These investment incentives aim to encourage and facilitate the incorporation of new manufacturing companies and the expansion of existing manufacturing companies in specific industries or geographical areas.

(a) Investment allowance

Investment allowances permit companies to write off a percentage of qualifying investment costs from their taxable income and are usually allowed in the acquisition year or the first year of use of an asset. They provide tax benefits that are additional to the capital allowances deductible for the asset, resulting in total tax deductions exceeding the acquisition cost (OECD 2001:27; UNCTAD 2000:20). This type of incentive is mainly offered in respect of capital expenditure incurred by industrial enterprises (Ngowi 2000:23).

Investment tax allowances promote new investment rather than giving owners of old capital extra gain (as a reduction in corporate tax rates would do). However, investment allowances also have limitations and drawbacks, especially for projects with long gestation periods – where the incentive is received upfront, but the benefits for the economy are only realised in future years, as well as where companies are not able to benefit from the incentive until income is earned (Ngowi 2000:23; Viherkentta 1991:25).

(b) Investment tax credit

The investment tax credit is calculated as a percentage of investment expenditure and this amount is credited against the tax liability, thereby directly reducing the amount of taxes to be paid. The only difference between an investment tax credit and an investment allowance is that the credit reduces the tax liability, whereas the allowance reduces taxable income (Downer 1974:6). Investment tax credits are the preferred form of tax incentives and are equivalent to initial allowances (Zee et al 2001:1504).

(c) Tax holiday

Probably the most frequently used tax incentive is a tax holiday, whereby new firms are allowed a period of time during which they are relieved from the burden of income tax. A tax holiday thus eliminates tax on revenues from investment projects over the holiday period, which tends to encourage investment. This incentive is likely to reward the establishment of a new company rather than the expansion of an existing company and is thus more focussed on the creation of enterprises than on the level of investment (OECD 2001:25).

Although this type of incentive has a tendency to encourage new investment, taxpayers may use this measure to evade taxation of income from other sources. Existing companies may be tempted to start a new company that qualifies for a tax holiday and transfer its existing business and capital to the new company, resulting in a gain for the company and pure revenue loss for the treasury (OECD 2001:84). Another disadvantage of attracting “footloose” investments (companies that relocate easily) by way of temporary benefits such as a tax holiday, is that the companies may exit the country quickly once the benefit period ends (OECD 2001:84).

(d) Indirect tax relief

With the purpose of increasing exports and thus improving the balance of payments of the country as a whole, companies are offered relief from indirect tax on imports that are used to produce items for export (Heller & Kauffman 1963:21). The burden of VAT is normally eliminated by zero-rating export sales. The import duty for exporters can be eliminated by duty drawback schemes (also referred to as refunds or rebates), as well as designating certain locations as export processing zones. This system enables qualifying manufacturers to obtain and sell outputs as if they were extra-territorial for customs purposes (World Investment Report 2003:124).

2.3.5.2 *Investment incentives that encourage investment in capital assets*

Tax legislation usually determines that expenses of a capital nature are not allowed as a deduction against income (s 11(a) of the Act; Inland Revenue Authority of Singapore 2009(e):1; Inland Revenue Board of Malaysia 2010(a)). A relief measure is provided to businesses by means of a tax deduction of the capital costs incurred in respect of the acquisition of assets such as machinery, equipment and vehicles.

(a) Capital allowance

A capital allowance is essentially a deduction allowed against the cost of certain capital assets, thereby allowing the taxpayer to claim the cost of the asset over a period of time (Stiglingh, Venter, De Hart, Koekemoer & Mostert 2009:270). The deduction rate is determined according to the nature of the asset.

(b) Accelerated capital allowance

With this type of incentive, assets may be written off at a rate that is faster than the period allowed for normal capital allowances. This incentive may take the form of an additional annual write-off or an initial allowance, and it increases the present value of the claims by shifting them closer to the time of the investment, thereby creating a cash-flow benefit for the company. If the company is in a loss position during the first few years, it receives no benefit. It is therefore clear that this incentive is of more value to existing businesses. It also targets capital-intensive rather than labour-intensive industries (Nathan-MSI Group 2004:5-6 to 5-7).

2.3.5.3 *Investment incentives that reduce the company's fiscal burden*

These incentives allow the investor to deduct certain expenses from its income, or to apply a lower tax rate to its taxable income. Both of these measures reduce the company's tax liability.

(a) Additional tax deductions

Some countries permit companies to claim deductions greater than 100% for certain qualifying expenses such as approved training programmes, research and development or export marketing. The purpose of the extra deduction is not to stimulate capital investment as such, but rather to encourage businesses to promote other policy objectives (such as the transfer of knowledge and technology) (UNCTAD 2000:22).

(b) Reduced tax rate/preferential tax rate

Morisset and Pirnia (2000:12) recognise that “a low corporate tax rate is, in itself, an incentive... [and]... investors look favourably on a country offering a low statutory tax rate”. The benefit of this type of incentive is that investors are allowed to retain most of the company’s profits, while governments are also able to minimise tax revenue losses by limiting aggressive tax planning. This is made possible by the simplicity of the tax system, which provides a reduced tax rate only, in stead of numerous incentives (Morisset & Pirnia 2000:12).

Developed and developing countries often use this tax incentive to attract investment. The rate reduction may be implemented in two different ways: A low standard rate which uniformly applies to all profitable business activities without biasing the allocation of capital, the choice of production technology or the form of financing; or a preferential tax rate reduction that applies to designated sectors (such as manufacturing or agriculture), or to selected beneficiaries based on discretionary screening criteria (such as small business corporations) (OECD 2001:26).

The first measure averts the problem of giving new investors an unfair advantage over existing producers. Further advantages of a low standard rate are that it is automatic and transparent, it reduces the temptation for abusive tax planning and the administrative process is simplistic. The main drawback is the huge impact on tax revenue, because the tax relief accrues to all businesses, whether or not they are undertaking new investments. The second measure ensures a lower revenue cost to the treasury, because the set of beneficiaries is restricted. Preferential tax rates, however, intensify the administrative burden of determining whether companies comply with the required criteria. This incentive also opens the door for aggressive tax planning by companies engaged in

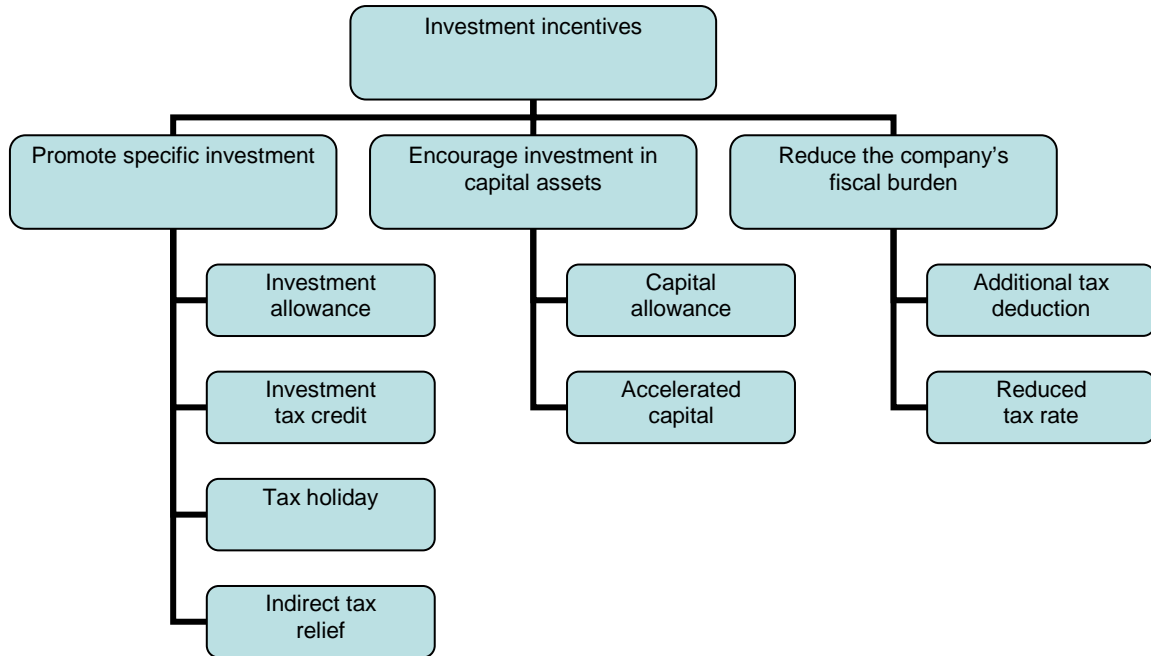
multiple businesses and the revenue loss may be much larger than it appears on the surface (OECD 2001:26).

Lowering the tax rate can be very effective. For example, the Government of Indonesia found that reducing the tax rate from 45% to 35% was equally attractive to most investors as the complex system of incentives that were previously in place (Nathan-MSI Group 2004:3-19). For many years, Hong Kong (China) has also opted for a low effective corporate tax rate for all companies while providing limited or no incentives (UNCTAD 2000:19; Miles 2009).

2.3.6 Summary

An investment incentive is a policy instrument implemented by a country with the purpose of encouraging companies to invest in its economy. The benefits and costs of each incentive instrument must be weighed against each other in light of the objective the incentive is aiming to achieve. The design of the investment incentive may have an important role to play in achieving the objective of the instrument and limiting the costs involved. In this regard, the type of incentive should also be carefully considered to ensure that the objective of the incentive is achieved. The different types of investment incentives can be classified into three categories, as illustrated below.

FIGURE 2.4: Types of investment incentives



2.4 CONCLUSION

Governments recognise that foreign direct investment can contribute to economic growth and development and, as a result, most have given the attraction of investment by multinational companies high priority. A multitude of variables have a strong effect on the investment decisions of multinational companies. These include the availability of raw materials, the availability of infrastructure, the political and economic stability and a beneficial tax policy.

All the determinants that influence the investor's choice of a host country can be classified into three main variables, namely country endowments, the investment climate and investment incentives. The only variable that a government can influence in the short term to improve the country's investment attractiveness is investment incentives. This study therefore focuses on this

instrument as a tool to attract investment to the manufacturing sector of South Africa.

South Africa is regarded as an attractive investment location due to its geographical location, well-developed infrastructure, a stable democratic political system and availability of natural resources. However, there are also drawbacks that could prevent companies from investing in the country, such as the high level of crime, a lack of skilled workers, extensive labour legislation and a possible insufficient supply of electricity.

The granting of investment incentives by developing countries to compensate for obstacles like these and to attract more foreign direct investment has been very popular for decades. Another objective for a country using investment incentives could be to advertise it as a desirable location for new foreign investors to establish a presence in the country, thereby generating benefits such as knowledge transfer, new employment opportunities and increased tax revenue.

It is recognised that these incentives could have high revenue costs and administrative burdens. What is vital, however, is the correct design of these instruments to attract additional investment from preferred investors in the desired industries or regions. Some of the characteristics the tax planner should consider when designing an incentive is the simplicity of the incentive provision, the period for which the incentive will be provided and the monitoring requirements necessitated by the incentive design. The tax planner should also decide whether fiscal or financial incentives, as well as discretionary or automatic incentives would benefit the host country most.

There are numerous types of investment incentives, each with unique features. For the comparison purposes of this study, the investment incentives provided

by South Africa, Malaysia and Singapore are classified into three main categories, namely investment incentives that promote specific investment, investment incentives that encourage investment in capital assets and investment incentives that reduce the company's fiscal burden. In this chapter, some of the types of incentives typically classified under these three categories were mentioned, for example an investment allowance, a tax holiday and a capital allowance. The next chapter deals with the specific investment incentives in each of the above main categories, which are available to manufacturing companies in South Africa.

CHAPTER 3

INVESTMENT INCENTIVES AVAILABLE TO THE MANUFACTURING SECTOR IN SOUTH AFRICA

3.1 INTRODUCTION

As mentioned in the previous two chapters, investment incentives are one of the instruments available to attract local and foreign direct investment. The presence of new foreign investors in South Africa could create valuable benefits such as increased tax revenue and knowledge transfer. Investment incentives also encourage investment by local companies, which contributes to the growth of the country's economy. It is clear that investment incentives are utilised to enhance a country's attractiveness for new and increased investment.

Although incentives may be costly, they have proven to be popular with the governments of certain newly industrialised economies like Korea and Singapore (Terheyden 2000:31). This is also the route the South African government has followed to achieve some of its social and economic objectives (DTI 2009(d)). This chapter provides a brief overview of the South African tax system and then examines the specific investment incentives offered to manufacturing companies by the South African Government.

In South Africa, income tax is levied in terms of the Income Tax Act 58 of 1962 (referred to hereafter as "the Act"). The income tax liability of a South African company is determined by applying the corporate tax rate of 28% to its taxable income. In terms of the Act, taxable income is gross income less exemptions and deductions/allowances. Tax on capital profits realised on the disposal (or deemed disposal) of assets is levied in terms of capital gains tax, which also forms part of taxable income (SARS 2010(a)). South Africa is moving towards a

self-assessment system for income tax, which means that the taxpayer will calculate and report his or her taxable income to SARS and simultaneously pay the calculated outstanding tax (SARS 2010(b)).

The South African government remains dedicated to the development and growth of companies and admits that new enterprises should be created and existing ones should become more competitive in order for the economy to grow (DTI 2008(c)). To facilitate this growth and promote local and foreign investment in South Africa, investment incentives, in the form of fiscal and financial incentives, have been introduced, both in the past and recently (DTI 2009). Fiscal incentives in the form of specific deductions and capital allowances are contained in the Income Tax Act (58 of 1962). These incentives effectively reduce the investor's tax liability, while the purpose of the financial incentives provided by the Department of Trade and Industry (DTI), a division of Government, is to encourage direct investment. This is done by providing the investor with upfront funds to set up business activities or reimbursing the investor for expenses already incurred in respect of a new business enterprise (DTI 2009).

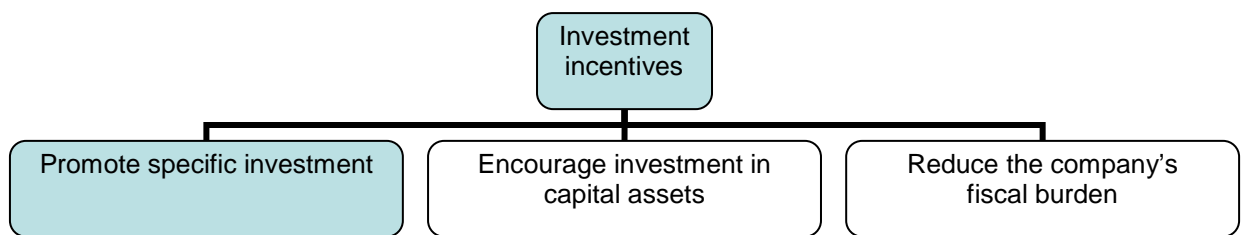
The investment incentives discussed in this chapter provide direct assistance to South African manufacturing companies. They are arranged in three categories, which were found to be common to South Africa, Malaysia and Singapore and are therefore considered to be suitable for comparison purposes. The three categories are as follows:

- investment incentives that promote specific investment
- investment incentives that encourage investment in capital assets
- investment incentives that reduce the company's fiscal burden.

3.2 INVESTMENT INCENTIVES THAT PROMOTE SPECIFIC INVESTMENTS

3.2.1 Introduction

Figure 3.1: Investment incentive category: investment incentives that promote specific investments



As indicated in figure 3.1, this section considers the investment incentives available to manufacturing companies that promote specific investment. Over time, the South African government has introduced specific incentives to stimulate targeted investment and encourage specific behaviours (Government Communication and Information System [GCIS] 1996). The investment incentives discussed in this section appear to have been introduced to encourage and facilitate the incorporation of new manufacturing companies and the expansion of existing ones in specific industries or geographical areas that will benefit the South African economy. Some of these incentives also focus on attracting foreign direct investment.

The incentives discussed in this section (par 3.2.2–3.2.7) are listed in alphabetical order and are either administered by the SARS or made available by the DTI. The last paragraph in this section (par 3.2.8) contains the incentives which were initiated in the past, but have since been withdrawn or have lapsed, and they are listed in the order in which they appeared in the Act.

3.2.2 Foreign Investment Grant

The objective of this cash grant is to encourage foreign businesses to invest in new manufacturing companies by assisting with the cost of relocating productive assets to South Africa from abroad. The foreign investment grant is applicable to South African incorporated companies operating in the manufacturing sector with a foreign direct shareholding of more than 50%. Foreign direct shareholding excludes investment from the South African Customs Union and the Southern African Development Community. The aim of this grant is to subsidise the costs associated with the transportation of new plant and machinery from abroad. The value of this taxable grant is the lower of the actual transportation costs or 15% of the cost of the new plant and machinery acquired abroad, limited to an amount of R10 million (DTI 2008(e):19–20).

3.2.3 Industrial Development Zones (IDZs)

This incentive is designed to promote international competitiveness in South Africa's manufacturing sector and increase the export of South African products. Some of the key objectives of the programme are to attract sustainable foreign direct investment and develop links between domestic and zone-based industries for the optimal use of existing infrastructure, the creation of employment and technology transfers. The significance of this incentive lies in the efficiency of the zone to add value inside its territory and offer investors freedom to access the global market through global production (National Treasury 2004:45; DTI 2008(g)).

IDZs are purpose-built industrial areas with a direct link to an international port or airport (to facilitate immediate access to overseas markets), where world-

class industrial infrastructure and advanced customs procedures are offered. Manufacturers and exporters within a designated zone, known as a Customs Controlled Area, are provided with the facility to import raw material, machinery and assets to be used in production, into the zone free of customs duty and VAT, whilst qualifying for all incentives/deductions/allowances available to South African companies. This in effect, lowers the cost of production (DTI 2008(g); International Marketing Council of South Africa 2008(d)).

There are currently five IDZs in South Africa: Coega (Eastern Cape), East London (Eastern Cape), Richard's Bay (KwaZulu-Natal), OR Tambo International Airport (Gauteng) and Mafikeng (North West). The Coega and East London IDZs have been fully operational for a number of years, while Richard's Bay only received its operating permit in November 2009. OR Tambo International Airport and Mafikeng are still awaiting their operating permits, due to the fact that the different roles and responsibilities of municipal, provincial and national government, as well as the South African Revenue Service, still need to be clarified (Mathews 2010: [1–2]).

By May 2007, 21 investors had committed to locating their businesses within the designated IDZs (GCIS 2007) and the investment value of projects as at May 2008 were estimated at over R28 billion (GCIS 2008). The number of companies that invested in the designated IDZs increased to 39 in 2010, with an estimated investment value of over R31 billion (Mathews 2010:[4–5]); Nelson Mandela Bay Municipality 2010:[1]). Thirty-seven companies have shown interest in investing in the Mafikeng IDZ, as soon as it becomes operational, and the value of investment opportunities in this IDZ is expected to be about R7 billion (Mathews 2010:[4–5]).

This incentive also appears to be very effective in promoting foreign direct investment. In his 2003 Budget Vote speech, the Minister of Trade and Industry stated that IDZs “are attracting sufficient foreign direct investment to stimulate

both local and regional growth” (DTI 2003). This is substantiated by the fact that the Coega IDZ was the target of nine foreign investors in the 2008/2009 fiscal year, which resulted in over R22 billion of new investments and the creation of 4 906 new jobs (National Treasury 2009(c):755).

3.2.4 Industrial Investment Allowance and Industrial Policy Projects (Section 12I)

The initial incentive introduced for strategic projects was the Industrial Investment Allowance. This incentive lapsed during 2005, but was replaced by the Industrial Policy Projects incentive during 2009 (s 12G(4)(h) of the Act; National Treasury 2008:81).

The Industrial Investment Allowance was introduced to encourage large-scale investment by both domestic and foreign investors in specific industry sectors (*inter alia*, the manufacturing of certain products and goods) by providing tax relief, in the form of industrial investment allowances, to qualifying strategic industrial projects (Nathan-MSI Group 2004:7–9).

For a project to qualify for this allowance, there had to be a minimum investment of R50 million in assets, the minimum displacement of existing production and jobs and the project had to be commercially viable (National Treasury 2001:51). Companies involved in qualifying strategic industrial projects were able to claim the following allowance:

- 50% of the cost of industrial assets, limited to R300 million; or
- 100% of the cost of industrial assets in respect of projects with preferred status, limited to R600 million (s 12G(2),(3)(b) of the Act).

The Industrial Investment Allowance was introduced in April 2002, and by May 2003 ten projects had already been approved, attracting investments of almost R3 billion (International Marketing Council of South Africa 2008; DTI 2003). By the time the applications for this allowance had expired, 45 projects, with an estimated investment value of R28.7 billion, had been approved. The allowance expended in relation to these projects was only R10 billion, and it is estimated that 8 446 direct jobs will still be created as these projects continue (GCIS 2008). This clearly illustrates the positive effect of this incentive on the economy.

To continue assisting investors involved in strategic projects in South Africa, government launched the Industrial Policy Projects incentive early in 2009, which replaces the Industrial Investment Allowance incentive. The purpose of this incentive is to assist with the alteration of production methods by promoting investment in manufacturing assets (buildings, plant and machinery used directly in the process of manufacture). These enhanced production methods will improve the productivity of the manufacturing sector and the skills of the labour force (National Treasury 2008:81). An industrial policy project refers to a new or expanding project in the manufacturing sector where a substantial amount will be invested through the acquisition of new and unused manufacturing assets. The project will result in an industry upgrade, by using new technology for improved energy efficiency and by providing skills development (Moneywebtax 2009(b)).

To be eligible for this incentive, a project must have a minimum investment of R200 million, in the case of new projects, and the greater of R30 million or 25% of the value of the existing manufacturing assets, in the case of expanding projects (s 12I(7)(a)(i) of the Act). These thresholds ensure that only projects that are able to offer substantial benefits to the economy will be eligible for this incentive. The project must further comply with a minimum standard of skills

development and must make use of energy-efficient equipment and processes (National Treasury 2008:82–83). A project will be identified as either qualifying or preferred status. This status will determine the level of benefits allocated to the project, based on a point scoring system. The point allocations are based on the utilisation of innovative processes, the utilisation of new technologies that leads to improved energy efficiency, the establishment of business linkages, purchases from small and medium-sized businesses, the creation of direct employment, the development of employees' skills and being located in an IDZ (GCIS 2009(b)).

Projects that achieve qualifying status, by scoring at least five out of a total of ten points, may deduct an additional tax allowance of 35% of the cost of manufacturing assets purchased, limited to a maximum of R550 million. Projects that achieve preferred status by scoring at least eight out of a total of ten points, may deduct an additional tax allowance of 55% of the cost of new manufacturing assets, limited to a maximum of R900 million (s 12I(2),(3) of the Act).

The manufacturing assets must be used in South Africa and must also qualify for an income tax deduction for plant or machinery, which will be used for the first time in a process of manufacture (refer to par 3.3.4) (s 12I(1) of the Act; Deloitte 2009:7). The cost of the asset for the purpose of this incentive is determined as the lesser of the arm's length market value on the date of the acquisition or the actual cost to the investor (National Treasury 2008:84). Furthermore, 50% of these manufacturing assets have to be brought into use within four years from the date of approval. This project may also not receive any other industrial incentive benefits, such as the Enterprise Investment Programme (refer the discussion in par 3.2.6) and may not be subdivided in order to obtain multiple incentives for a single project (SAICA 2009:9).

In addition to the allowance on manufacturing assets, a company may be eligible to claim a further tax deduction on the cost of training provided to employees in conjunction with the qualifying industrial policy project. This allowance is capped at R36 000 per employee over six years and may not exceed R30 million in total in the case of projects with a preferred status and R20 million in the case of qualifying industrial policy projects (s 12I(5) of the Act).

Approval for this incentive must be obtained before the manufacturing assets are contracted. The total amount made available by government for this incentive is R20 billion, and the cut-off date for all applications is 31 December 2014 (National Treasury 2008:84; PWC 2010).

3.2.5 Motor Industry Development Programme and Automotive Production and Development Programme

This incentive is industry specific. The aim of the Motor Industry Development Programme (MIDP) is to increase the international competitiveness of the South African motor manufacturing industry, encouraging foreign currency earnings through increased exports and promoting foreign investment (National Treasury 2000:272).

Three incentives are linked to the MIDP. The first incentive is designed to provide some protection to the motor industry from foreign competition, in the form of a reduction on import duties payable. The second incentive allows manufacturers to rebate import duties against credits earned on component and vehicle exports, thereby encouraging export trade (National Treasury 2000:272). The third incentive is an investment allowance of 20% of the value of buildings, machinery, equipment and tooling to be used in the manufacture of motor vehicles and related components (Deloitte 2009:16).

The South African government completed a review of the MIDP in 2008. This review sought to evaluate the performance of the automotive sector against the MIDP's stated objectives. Government also had to determine whether the incentive regulations were in line with the rules and agreements of the World Trade Organisation. The review revealed that the MIDP had resulted in increased growth and competitiveness in the automotive industry since it was introduced, but that it had not reached the kind of competitive levels to sustain the automotive industry in the global competitive environment. The review further indicated that the programme was an export incentive, which was inconsistent with the World Trade Organisation provisions. Based on the findings of this review, the MIDP incentive has only been extended until the end of 2012 (GCIS 2008(b)).

The MIDP review further confirmed that the automotive industry is the largest and leading manufacturing industry in South Africa and that most of the countries with an automotive industry had provided extensive assistance to this industry to enable it to remain competitive in the global market (GCIS 2008(b)). To continue supporting the automotive industry in South Africa, government introduced the Automotive Production and Development Programme (APDP) in September 2008 which will completely replace the current MIDP from 2013 onwards and will remain in operation until 2020 (Deloitte 2009:17; International Marketing Council of South Africa 2008(b)). The aim of the APDP is to encourage the local manufacturing of vehicles and components and stimulate increased industry investment and employment, while not discriminating between products sold locally and those exported.

This incentive will provide for the following:

- Stable, moderate import tariff protection, by reducing the import duties from 29% to 25% (for built-up vehicles) and 20% (for components) by 2012. The import duties will remain stable at 20% and 25% respectively until 2020, in order to discourage imports and encourage locally produced vehicles.
- A local assembly allowance, which will allow manufacturers that produce a minimum of 50 000 units per annum to import a percentage of components duty free. This percentage will initially be 20% in 2013, when the allowance is introduced, and will be reduced to 18% over a period of three years.
- A production incentive based on production value added. This incentive will be in the form of an import duty credit of 55% in 2013, when the allowance is introduced, and will be reduced to 50% over five years. The import credit can be set off against future automotive imports or claimed as a refund on components and motor vehicles previously imported.
- An automotive investment allowance in the form of a direct grant of 20% of qualifying productive asset value payable over three years, as well as a company-specific support allowance to subsidise new investment expenses relating to training and skills development, technology transfer and research and development. The rate of the last-mentioned allowance will be determined by means of direct negotiation with the DTI. Both allowances were implemented in 2009 (GCIS 2008(b); International Marketing Council of South Africa 2008(b); Car Today 2008; Warrington 2008).

The investment assistance allowance was introduced first because it has an influence on the investment decision. Since actual production will only commence at a later stage, the other incentives will only be implemented at a later date. The reason for the staggered introduction of the different incentives of this programme between 2009 and 2013 is that government is preparing the automotive industry for what is expected from the investors. Investors need to comply with several requirements, and the programme will be strictly monitored and evaluated. The staggered introduction of incentives will allow investors sufficient time to implement and adhere to the applicable conditions in order to receive the incentives (GCIS 2008(b)).

The automotive industry appears to be positive about this new incentive and is committed to utilising it to expand its operations. This is evident from recent announcements by three major automotive manufacturers of planned investment with a combined value of more than R9 billion (Doneva 2010). Powels (Doneva 2010) reveals that these investments originated only in anticipation of the APDP incentive. For example, one of the above three manufacturers, the BMW group, announced in October 2009 that it would invest an amount of R2.2 billion in one of its existing manufacturing plants. The DTI has confirmed that this expansion will be honoured under the APDP incentive and the BMW group has admitted that this incentive was influential in its decision to incur such a large investment (Cunningham 2009).

Automotive manufacturers are actively involved in increasing their local volumes in order to adhere to the requirements of the APDP and to receive the assistance and benefits provided by this incentive (SAAW 2009). Nissan is focused specifically on exceeding the required minimum production units of 50 000 per annum, as required by the local assembly allowance of the APDP. Its new programme, Shift Monozukuri, is aimed at increasing the company's capacity, as part of Nissan's long-term growth strategy (Lynch 2010). General

Motors South Africa, however, is concerned that its Hummer brand will not reach the required minimum production units and that it will not be cost effective to produce components locally for this vehicle. The APDP might compel this company to discontinue its Hummer production line (Cokayne 2008). It is evident that the new APDP incentive is mostly perceived in a positive light by the automotive industry, especially by companies with local manufacturing lines.

3.2.6 Small, Medium Enterprise Development Programme and Enterprise Investment Programme

Government launched the Enterprise Investment Programme (EIP) in July 2008 to replace the Small, Medium Enterprise Development Programme (SMEDP), which had been in operation since September 2000 (DTI 2008(d)); Jessup 2008:1). The SMEDP was designed, *inter alia*, to encourage local and foreign investment in South Africa and it provided incentives to existing local companies to expand their businesses, as well as to new investors to initiate projects in a range of sectors, including manufacturing (DTI 2009(b)).

The grant period was limited to 36 consecutive months and eligible projects could claim a tax-free cash grant for the first two years of a project, based on a percentage of the investment in qualifying fixed assets up to a maximum of R100 000 million. A sliding scale of benefits was applied as the level of the investment increased. In the third year of a project, the same type of benefit was provided, but it was subject to the total employee remuneration reaching a prescribed proportion of declared profits. Qualifying assets were determined on the basis of the industry sector. Qualifying fixed assets for the manufacturing sector included all productive assets such as land and buildings, plant and machinery, commercial motor vehicles and research and development equipment (Trade Invest SA 2008; Dectra 2008).

This incentive has persuaded investors to initiate investment projects and also increase the extent of their investment beyond their initial intention (GCIS 2006). The DTI reported in 2008 that the SMEDP had supported 11 309 projects with a R12.7 billion investment value (GCIS 2008). This confirms that the incentive had a positive influence on investment decisions and was used extensively by companies, resulting in a substantial increase in investment value.

Despite this scheme's success, it needed to be modified in line with the emphasis on targeted enterprise support and hence the SMEDP was replaced with the EIP in 2008 (DTI 2008(c)). This new scheme operates in terms of two sub-programmes: the Manufacturing Investment Programme (MIP) and the Tourism Support Programme (TSP) (DTI 2008(d)). Only the MIP will be discussed further in detail as it pertains to the manufacturing sector, which is the main focus of this study.

The MIP is designed to encourage both local and foreign investment in the manufacturing sector as part of government's policy to support sustained growth within the industry and create additional employment. This incentive programme operates on a point scoring system and points are allocated on the basis of certain criteria such as the size of the labour force and the presence of broad-based black economic empowerment. Manufacturers who are eligible for other incentives recommended by the Manufacturing Development Board of the DTI may not qualify for this incentive (DTI 2008(e):4; SAICA 2009:9).

A non-taxable cash grant is provided based on the value of the investment in plant, machinery and equipment and commercial vehicles required for establishing new operations, as well as the expansion of existing operations. Investment projects of less than R5 million are eligible for a grant equal to 30% of the total investment cost, payable over a period of three years. Investment

projects in excess of R5 million are eligible for a grant equal to between 15% and 30% of the total investment cost, payable over a period of two years. All approved projects are monitored and the payment of the grant is subject to the project meeting certain performance requirements (DTI 2008(d); DTI 2008(e):31; International Marketing Council of South Africa 2008(c)).

3.2.7 Support Programme for Industrial Innovation

This incentive serves to promote technological development in South Africa through the provision of financial assistance to all South African registered enterprises in manufacturing or software development that engage in the development of innovative, competitive products and/or processes. The development should make a significant contribution to improving technology (DTI 2008(b)).

The incentive benefits are based on qualifying development expenditure, which refers to all costs incurred from the beginning of basic research up to the point when a pre-production model has been created (Mthembu 2009:2).

In terms of this incentive, the following three schemes are available to successful applicants:

- The Matching Scheme is exclusively available to all small, micro and medium enterprises (SMMEs) engaged in manufacturing or in an information technology-related project where qualifying development expenditure is less than R1,5 million per project. To qualify as a SMME, the enterprise must have less than 200 employees, less than R51 million turnover and less than R19 million total gross assets (excluding fixed property). Successful

applicants will receive a taxable cash grant of 50% of actual direct costs incurred in a development activity.

- The Partnership Scheme is available to all enterprises engaged in manufacturing or an information technology-related project where development expenditure exceeds R3 million. Successful applicants receive a taxable cash grant of 50% of the company's qualifying development expenditure. These funds, however, must be paid back on the commercial success of the product or process in the form of a levy system based on net sales.
- The Product Process Development Scheme is available to small, very small and micro black-owned private sector enterprises whose members are actively involved in the management of a business engaged in a manufacturing project. A taxable cash grant of between 65% and 85% of the qualifying development expenditure incurred during the technical development stage is available, with a maximum grant of R500 000 per project (DTI 2008(b); SPII 2008).

3.2.8 Investment incentives granted previously but withdrawn after a specific period

Some investment incentives have a limited life span and are provided for a particular period only. They are usually introduced to encourage specific investment or behaviour which is not required indefinitely.

The incentives applicable to manufacturing companies that have been withdrawn are listed in the order in which they appeared in the Act.

3.2.8.1 Enhanced start-up expense deduction for small business corporations (Section 12E(3A))

One of the support measures introduced to encourage the incorporation of small business corporations was a double deduction of expenditure and losses actually incurred by these entities in the tax year that they commenced trading. This incentive therefore allowed the deduction of an amount which is not actually incurred, in order to encourage entities to initiate a new business venture (Jordaan, Kolitz, Stein & Stiglingh 2006:176). The double deduction could, however, not exceed R20 000. For example, if the small business corporation incurred R100 000 deductible expenditure in the tax year during which it commenced its trading activities, it would have received a total tax deduction of R120 000 (National Treasury 2003:53; South Africa 2003:62).

This incentive is, however, no longer applicable in respect of years of assessment ending on or after 1 April 2005 (South Africa 2005:8–9), due to the fact that other tax relief measures for small business corporations were introduced in 2005, such as a beneficial tax rate structure and accelerated depreciation rates for capital asset acquisitions (see discussion in par 3.4.4 & 3.3.6 respectively) (National Treasury 2005:7).

3.2.8.2 Tax holiday scheme (Section 37H)

In the South African Growth Employment and Redistribution (GEAR) strategy announced in 1996, the Minister of Finance introduced a tax holiday scheme to contribute to the attainment of South Africa's industrial development goals (GCIS 1997). The tax holiday is intended to promote investment in the manufacturing sector, which is essential for international competitiveness and increased growth and development (GCIS 1996). This scheme came into effect on 1 October 1996 and lapsed on 30 September 1999 (s 37H(1),(5) of the Act). It may, however, still be applicable to approved projects.

This tax holiday scheme permitted a manufacturing company not to be liable to pay any tax on its taxable income for a specific period. Certain approved manufacturing businesses carrying on a qualifying project for the first time and meeting certain investment requirements received this tax holiday for two to six consecutive years, depending on which of the requirements they had met. The key criteria related to labour absorption, regional location and industrial priority (s 37H(7),(9) of the Act; Malan 1998:34-35; Bell 2008).

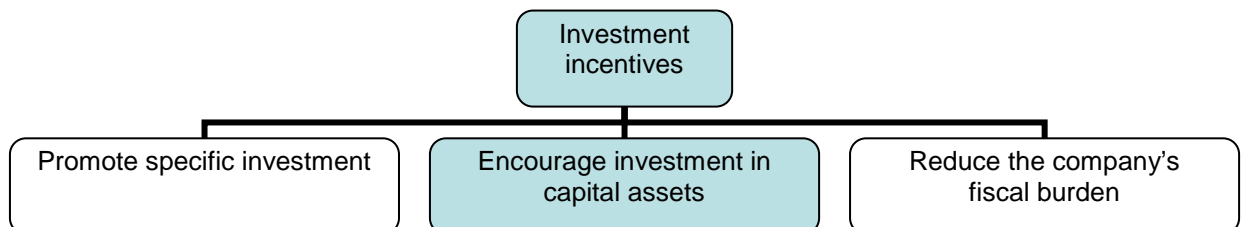
The DTI reported in 2000 that 174 projects were making use of the tax holiday scheme when this incentive was withdrawn, with an investment value of R6.6 billion. These projects also created 15 000 job opportunities (National Treasury 2000). However, owing to the fact that a tax concession in the form of a corporate tax rate reduction from 35% to 30% in 1999 was offered to companies, government decided not to extend the expiry date of the tax holiday on 30 September 1999 (GCIS 1999).

3.3 INVESTMENT INCENTIVES THAT ENCOURAGE INVESTMENT IN CAPITAL ASSETS

3.3.1 Introduction

The incentives discussed above were mainly aimed at initiating new or increased investment of a specific nature. In addition to these, there are incentives that encourage the incorporation and expansion of general manufacturing activities. These incentives are mainly focused on changes in production methods and improved technology usage, which are achieved through increased capital investment (GCIS 1997(b)). As indicated in figure 3.2, this section considers investment incentives that encourage investment in capital assets.

Figure 3.2: Investment incentive category: investment incentives that encourage investment in capital assets



The investor receives relief from the significant costs involved in the investment in capital assets by means of certain capital allowances contained in the Act. A capital allowance is essentially a deduction of certain capital assets allowed against income, thus it allows the investor to claim the cost of the asset over a period of time and it reduces the investor's tax liability (Stiglingh et al 2009:270). The capital allowances pertaining to manufacturing companies are administered

by the South African Revenue Service and are listed in this section in the order in which they appear in the Act.

3.3.2 Movable assets: wear-and-tear allowance (Section 11(e))

In terms of section 11(e) of the Act, a deduction is allowed of the amount by which the value of any machinery, implements, utensils and articles, for which no other allowance has been granted and which are used for purposes of trade, has decreased on account of the wear and tear of these assets during the year of assessment. Manufacturers therefore utilise this deduction for assets specifically used as part of their operations, such as generators, which are not regarded as manufacturing assets for the purpose of manufacturing allowances, such as section 12C (see discussion in par 3.3.4) and section 13 (see discussion in par 3.3.7).

The acquisition cost of the asset usually forms the basis of the allowance. An investor's cost of installing and erecting an asset, including shipping and delivery charges, is added to its cost for the purpose of the calculation of the allowance. Where the asset is acquired in a foreign country, the practice is to convert the price to rand on the contract date or the date of delivery, if there is a lengthy time lapse before delivery. The cost of any machinery, implements, utensils or articles can be increased by moving expenses (from one location to another) (s 11(e)(iiA), (v) of the Act). The asset is written off over its estimated useful life. The annual allowance is determined by the asset's estimated useful life, but must be reduced proportionately if the asset was acquired during the year (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks, De Swardt & Jordaan 2009(b):170–171). The annual wear-and-tear rates acceptable to SARS are set out in Interpretation Note 47. Some of these rates are listed below (SARS 2008(e):20):

Furniture and fittings	16.67%
Passenger vehicles	20%
Computers	33.33%
Software	50%
Office equipment	20%
Generators	6.67%

3.3.3 Movable assets used in the production of renewable energy (Section 12B)

The manufacturing of bio-fuels is an effective strategy for generating renewable and environmentally friendly forms of energy. Production of these fuels also has a significant effect on the upliftment of rural areas as electrical power can more readily be provided to be utilised in these clinics and households. In order to strengthen renewable energy technologies and optimise their implementation, an incentive, in the form of an accelerated depreciation allowance, is offered to investors involved in the manufacturing of these fuels (Department of Minerals and Energy 2003:i, ii & xii).

The cost of new or used machinery, implements, utensils and articles utilised in the production of bio-diesel/bio-ethanol or in the generation of electricity from renewable energy sources, such as wind, sunlight and water, may be claimed over three years. Fifty per cent of the acquisition cost is allowed as a deduction in the year the equipment is brought into use for the first time, 30% is allowed in the second year and 20% in the third year (s 12B(1),(2) of the Act SARS 2008(c):72).

3.3.4 Plant and machinery used by manufacturers (Section 12C)

Section 12C of the Act makes provision for a deduction in respect of the cost of machinery, plant, utensils or articles used by manufacturers, which would otherwise not be deductible for income tax purposes. It appears that the objective of this allowance is to stimulate the investment in manufacturing capital assets.

The cost of all *new and unused* machinery, plant, utensils or articles acquired on or after 1 March 2002 that are used in the process of manufacture may be claimed at 40% of the cost of the asset in the first year of use and 20% of the cost for the subsequent three years (s 12C(1)(c) of the Act). The allowance for *used* (second-hand) assets is granted at a rate of 20% of the cost in the year of assessment in which the asset is brought into use, as well as the four succeeding years (s 12C(1) of the Act).

3.3.5 Rail transport: rolling stock (Section 12DA)

Rail transport is a cost effective means of moving assets and products around the country, and the use of this infrastructure reduces the cost of doing business in South Africa (Stark 2008). Most companies would, however, prefer to invest in trucks as a means of transportation, due to the fact that the acquisition cost of trucks can be claimed for tax purposes over four years, while rolling stock (trains and carriages) may only be claimed over 14 years, which is the useful life of these assets. The government recognised that the development of the rail transport infrastructure and investment in this industry are vital and has introduced an accelerated allowance claimable on the acquisition or improvements of any rolling stock on or after 1 January 2008 that is used for the transportation of people or goods in the production of income (South Africa 2008:38; National Treasury 2007:40). Manufacturing companies

that utilise rail transport may choose to invest in their own rolling stock for the transportation of their raw material or finished manufactured goods from one location to another and will thus be entitled to claim this allowance.

The allowance is calculated at 20% of the cost of the rolling stock and is not proportioned if the rolling stock was brought into use for only part of the year. The total cost will thus be claimable over a five-year period, which is in line with other major transportation items such as ships and aircrafts. Only owners of the rolling stock that use it wholly or mainly for the transportation of goods are entitled to make use of this accelerated depreciation rate (s 12DA) of the Act; National Treasury 2007:40).

3.3.6 Movable assets of small business corporations (Section 12E)

During his budget speech on 23 February 2000, the then Minister of Finance, Trevor Manuel, acknowledged that “the development of small and medium size enterprises is fundamentally important to the growth and employment potential of our economy” (GCIS 2000). The government realised that it needs to support these enterprises and improve the scope of offerings to small businesses (DTI 2005).

In order to encourage the incorporation of small businesses, the Act makes provision for a small business corporation to claim a 100% deduction of the cost of acquiring manufacturing plant and machinery in the year the asset is brought into use. An accelerated allowance is also granted for assets other than manufacturing plant and machinery used by the business. Fifty per cent of the cost of these assets may be claimed in the first year of assessment during which the assets are brought into use for the first time, 30% in the second year and 20% in the third year (s 12E(1), (1A)(b) of the Act; SARS 2008(c):60, 65).

For this deduction to apply, the entity must be a small business corporation, as defined in the Act. To be classified as a small business corporation, the establishment must comply with the following requirements:

- The shareholders or members must be natural persons (individuals).
- Shareholders or members may not hold any shares or interest in the equity of any other company (other than a listed company, unit trust, share block company or sectional title body corporate).
- The gross income of the corporation for the tax year may not exceed R14 million.
- Investment income and income from rendering a personal service must be less than 20% of the total of all receipts and accruals (other than those of a capital nature) and all capital gains of the company/close corporation.
- The company/close corporation may not be a personal service provider (s 12E(4)) of the Act).

3.3.7 Buildings and improvements (Section 13(1) and section 13quin)

In order to encourage companies to invest in *industrial* buildings, section 13(1) of the Act provides an annual allowance on the cost to an investor of the erection or purchase of certain industrial or similar buildings and of effecting improvements to such buildings. The annual allowance is based on the cost of the building or improvements, other than repairs. The building must be used wholly or mainly for the purpose of carrying on a process of manufacture, in the course of the investor's trade (s 13(1)) of the Act). The annual allowance is

granted in full even though the building has or the improvements have been used for only a part of the year of assessment (Stiglingh et al 2009(b):181). When the investor only has the right of use of the building and incurs improvements to the building in terms of an agreement with the government of the Republic of South Africa, as the owner of the building, then this allowance can be claimed by the investor, although the investor does not own the building (s 12N of the Act).

The annual allowance is claimed at 5% of the cost of the building. An accelerated allowance rate of 10% is available for qualifying buildings and improvements where erection commenced on or after 1 July 1996 but before 30 September 1999, and if the building or improvements were brought into use by the investor no later than 31 March 2000 (s 13(1) proviso (b), (c) of the Act; SARS 2008(c):61).

Before section 13*quin* was introduced, a manufacturer could only claim an allowance on industrial buildings, and not on any other buildings such as warehouses and offices, used as part of its trade. However, since 2008, a company that acquires a new *commercial* building for administrative or trading activities or effect improvements to it, can claim an annual allowance of 5% of the cost of the building or improvements (s 13*quin*(1)) of the Act; National Treasury 2007:45). This allowance enables a manufacturer to claim the capital cost of all non-manufacturing buildings.

3.3.8 Urban development zones (Section 13quat)

During 2003, the South African government realised that no current accelerated tax allowances were provided in respect of any buildings and that the maximum deductible allowance of 5% per annum was not sufficient encouragement for investors to maintain the existing infrastructure in urban areas (National Treasury 2003:52). The urban development zone incentive is intended to counter decay and stimulate urban regeneration by encouraging the private sector to embark on urban and inner city renewal. The aim is to encourage investment in areas with high population capacity, urban areas with developed transport infrastructure for trains, buses or taxis and central business districts (SARS 2006:1). A manufacturing company that owns a warehouse or whose trade also includes commercial activities such as selling its own manufactured goods at a retail shop, will be able to employ this incentive.

Owners or lessors who refurbish a building within a designated urban zone or construct a new commercial or residential building in an underutilised designated urban area will receive one of the following accelerated depreciation allowances:

- refurbishment of a building: 20% straight-line depreciation allowance over a five-year period.
- construction of a new commercial or residential building as well as extensions and additions to existing buildings: an 11-year write-off period with a 20% write off in the first year and an 8% write off thereafter (s 13quat(3) of the Act).

The allowance is calculated on the cost of erection or refurbishment, which includes the cost of demolishing any existing building. The deduction will only be allowed if the building is used solely for the purposes of trade and the

taxpayer provides (with his or her tax return) a certificate from the municipality stating that the building is located in a demarcated area (s 13^{quat}(1),(4) of the Act). The costs must be incurred after the Minister of Finance had published particulars of the areas demarcated by the municipalities in the Gazette, but before March 2014, on which date this tax incentive will expire (SARS 2006:2 & 12; SARS 2008(c):67–68). When the investor only has the right of use of the building and incurs improvements to the building in terms of an agreement with the government of the Republic of South Africa, as the owner of the building, then this allowance can be claimed by the investor, although the investor does not own the building (s 12N of the Act).

Although investors have complained about the complexities of the application process and that the duration of the incentive is too short, Johannesburg has made successful use of this opportunity since its introduction in June 2005. As at July 2008, investments of five billion rand had been initiated in the City of Johannesburg, of which one billion rand worth had been completed. Approximately 40 000 jobs were created in the construction of these projects (Visser 2008).

3.3.9 Environmental assets and expenditure (Section 37B)

The manufacturing industry is obliged by law to incur capital environmental expenditure to preserve the environment or to incur expenses to rehabilitate and restore land previously used in respect of its trade. These expenses were not deductible until recently due to the fact that they were not incurred in the process of manufacture or they were incurred after the cessation of trade, which is not in the production of income (National Treasury 2007:42). However, from 8 January 2008, section 37B of the Act allows for the deduction of these expenses in order to encourage companies to consider the environment (HG.org 2009). This incentive may apply to manufacturers whose activities have

an impact on the environment and who would need to invest in environmental assets.

A capital allowance is afforded to new and unused environmental treatment and recycling assets which include an air, water and solid waste treatment and recycling plant, as well as pollution control and monitoring equipment. The allowance is equal to 40% of the cost in the year it is brought into use for the first time, and 20% in each of the three succeeding years. These assets must be ancillary to the manufacturing process and there must be a legal obligation to utilise these assets in order to protect the environment (National Treasury 2007:43; Mundi 2009).

There is also an allowance for new and unused environmental waste disposal assets which include an air, water and solid waste disposal site, dam, dump, reservoir or another structure of a similar nature. This allowance is equal to 5% of the cost in the year it is brought into use for the first time, and 5% in each succeeding year. These assets must be of a permanent nature, be ancillary to the manufacturing process and be required by law in order to protect the environment (National Treasury 2007:43; Mundi 2009).

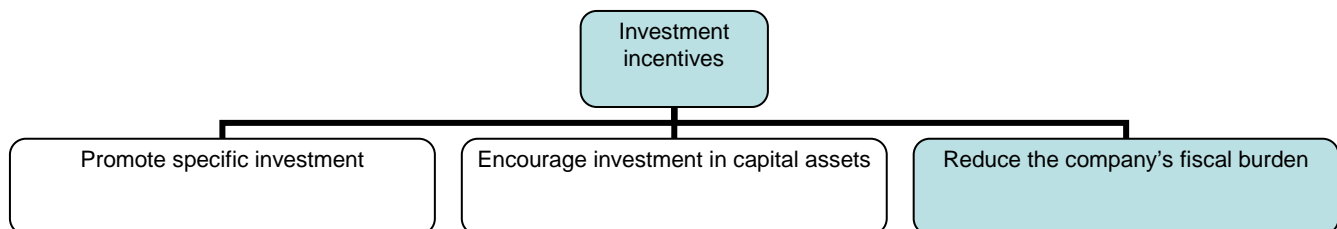
The investor will also be entitled to deduct expenditure incurred for remediation and restoration of the environment resulting from a trade previously carried on, if there is a legal obligation to incur these expenses and if the expenses would otherwise have been allowed as a deduction should the investor still have been carrying on a trade. The effect of this deduction is that the expense is claimed as if the initial trade had never ceased (National Treasury 2007:44).

3.4 INVESTMENT INCENTIVES THAT REDUCE THE COMPANY'S FISCAL BURDEN

3.4.1 Introduction

All the investment incentives discussed thus far are directly associated with manufacturing companies and many of these incentives are granted exclusively to manufacturing companies. In addition, there are general incentives and tax concessions available to all South African companies, which may thus also assist manufacturing companies. As indicated in figure 3.3, this section considers the investment incentives available to manufacturing companies which reduce the companies' fiscal burden.

Figure 3.3: Investment incentive category: investment incentives that reduce the company's fiscal burden



Incentives like these are offered to encourage any company to invest in specific projects within its existing business, for example research and development. Other incentives are aimed at reducing the tax liability of certain companies by providing a beneficial tax rate. The first two incentives discussed in this section were chosen because they were recently introduced or revised and are very relevant to the development of manufacturing companies. These incentives are listed in the order in which they appear in the Act. The final incentive in this

section is relevant to all South African companies that comply with the specified criteria and it also has an influence on the tax liability of these companies.

3.4.2 Research and development (Section 11D)

Innovation, research and technological development increase productivity, which in turn results in increased economic growth and international competitiveness (National Treasury 2006:7). Given the high costs involved in research and development, as well as the high levels of technical risk, government has seen fit to introduce a tax incentive as a way of indirectly subsidising research and development costs and thereby stimulating scientific research (Department of Science and Technology 2008:1). Manufacturing companies that aim to improve their productivity invent new product lines or enhance their current product quality would be eager to take advantage of this research and development incentive.

This incentive caters for all costs relating to research and development incurred on or after 2 November 2006, and contains the following two sets of deductions:

- Qualifying operating expenses incurred directly in respect of research and development are deductible at 150%.
- The cost of qualifying capital research and development expenditure is deductible over three years: 50% in the year that the asset is brought into use, 30% in the following year and 20% in the third year. This allowance is claimable on the cost of buildings, machinery or plant, utensils and articles used for the first time for the purpose of research and development (s 11D(1),(2) of the Act; SARS 2008(c):67).

In order for research and development expenses to qualify as a deduction, the research and development must be undertaken within the borders of South Africa, and must be performed for the purpose of the discovery of new and practical information of a scientific or technological nature or the creation of any invention, design or computer program or other similar property of a scientific or technological nature. The research and development must therefore be directed towards advancing scientific or technological knowledge. Expenditure incurred in respect of regular management and internal business processes, as well as market research and promotion, do not qualify as research and development (s 11D(5)) of the Act; Department of Science and Technology 2008:1-8).

3.4.3 Learnership agreements (Section 12H)

The purpose of this tax incentive is to “encourage job creation by reducing the cost of hiring and training employees through learnerships and to encourage human capacity development” (SARS 2008(b):1). Due to the fact that the manufacturing sector usually makes use of high technology processes, there is a need for skilled employees to operate this equipment. Continuous development and training is also a requirement for this evolving industry (Baranek 2010). Manufacturing companies would thus be able to utilise this incentive to assist in covering the cost of training their employees.

An income tax deduction, in addition to the deduction of actual training and salary expenses, is available to employers who enter into an approved learnership agreement with an employee. A learnership agreement is an agreement entered into between a learner, an employer and an accredited training provider for a specified period, whereby the employer is obliged to provide the learner with the specified practical experience and the learner is obliged to attend the specified education and training presented by the training provider. In order to obtain approval for the learnership agreement, the

employer has to register it with a Sector Education and Training Authority (SETA) before 1 October 2011 (s 12H(1) of the Act); SARS 2008(b):2; SARS 2008(c):69).

In terms of section 12H of the Act, an employer can claim R30 000 for every year (12 consecutive months) the employee is part of a learnership agreement. The allowance is increased to R50 000 in respect of a disabled learner. Should the learnership agreement be terminated before the end of a period of 12 consecutive months, the employer can claim a pro rata portion of the commencement allowance. On completion of a learnership agreement, another R30 000 can be claimed for agreements of less than 24 months, or, in the case of agreements exceeding 24 months, an amount of R30 000 can be claimed for each number of consecutive 12-month periods for the duration of the agreement (s 12H (2), (3), (4) of the Act; SAICA 2009(b):7).

3.4.4 Preferential tax rates

Income tax is paid by a South African resident on his or her worldwide taxable income, regardless of the source of the income (SARS 2009(c):3). Income tax is levied at a flat rate of 28% for an incorporated entity, such as companies and close corporations. However, if the entity qualifies as a small business corporation (see the requirements in par. 3.3.6), it is taxed on the basis of a split-rate system. No tax is levied on the first R57 000 of taxable income, amounts between R57 001 and R300 000 are taxed at 10% and all taxable income over R300 001 is taxed at 28% (PKF 2010:8).

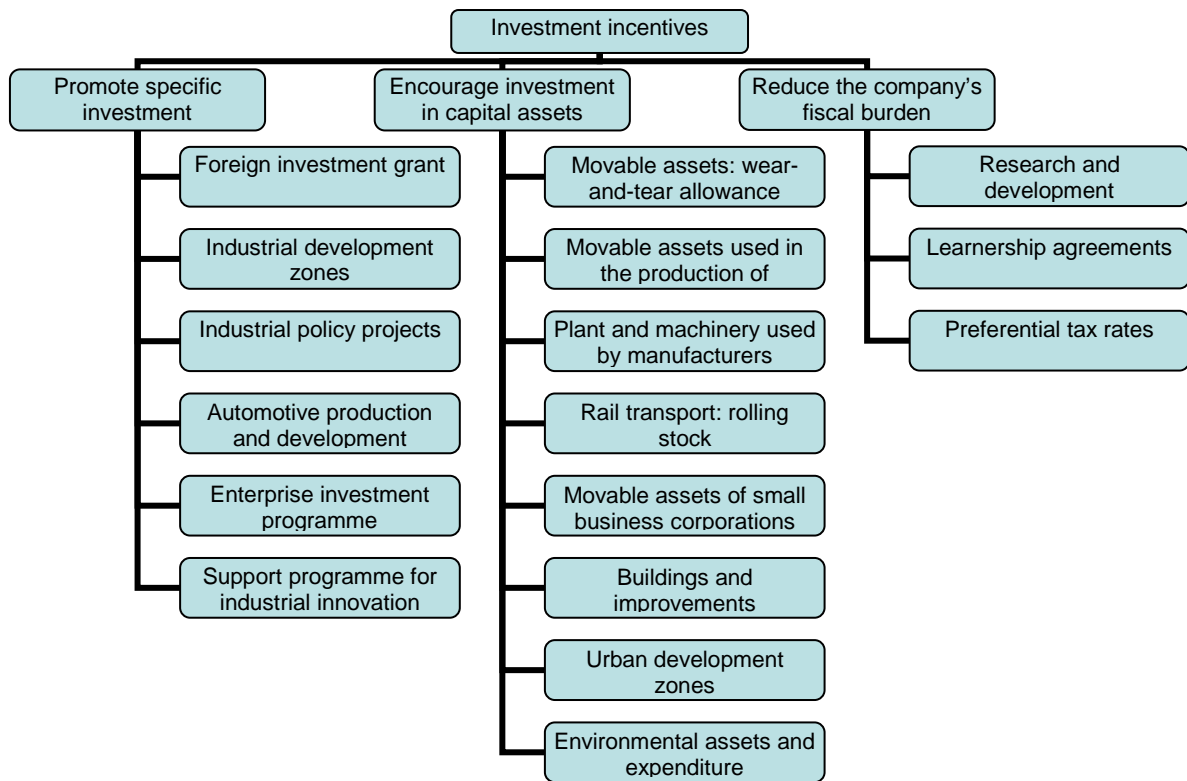
In order to simplify the tax system and reduce the tax compliance burden of businesses with an annual turnover of less than R1 million, an optional simplified tax system has been introduced. This turnover tax will replace income tax, capital gains tax, tax on dividends and value added tax. It allows the

qualifying taxpayer to calculate its tax liability based on taxable turnover only and the usual calculations for determining taxable income are not applicable. Taxable turnover is the total amount received by the entity with a few specific inclusions, such as investment income of a company, and exclusions, such as government grants (SARS 2009(b):4-5). The rates that are applied to this taxable turnover ranges between 0% and 7%, depending on the total amount of turnover (SARS 2009(b):2).

3.5 CONCLUSION

Over time, the South African Government has introduced a number of investment incentives to promote local and foreign investment in the country. This chapter has identified and examined 19 investment incentives, 17 of which are currently relevant to manufacturing companies in South Africa. These 17 investment incentives were classified into the following three categories: six incentives focus on promoting specific investment, eight incentives aim to encourage investment in capital assets and three incentives contribute to the reduction of a company's fiscal burden. These incentives are graphically illustrated in figure 3.4.

Figure 3.4: South African investment incentives available to manufacturers



Most of the South African investment incentives for manufacturing companies focus on encouraging investment in capital assets. They provide capital allowances which permit the manufacturer to claim the cost of certain capital assets, such as plant and machinery and industrial buildings, over a shorter period of time than other entities, which should encourage increased investment in fixed assets used in the manufacturing process.

In addition, six of the South African investment incentives focus on the promotion of a specific investment. These incentives consist mainly of grants initiated by government which are offered to investors to encourage local and

foreign investment in a specific industry or geographical area, for example the automotive industry and IDZs. Three investment incentives that reduce the company's fiscal burden are also available to manufacturers, namely expenses relating to research and development, expenses relating to learnership agreements and preferential tax rates, if all the requirements as stipulated in the Act are met.

Of interest is the fact that South Africa has recently given much attention to investment incentives for the manufacturing industry and three of the incentives discussed in this study have been introduced during the last three years. The Enterprise Investment Programme (par 3.2.6) commenced in 2008, The Industrial Policy Projects incentive (par 3.2.4) was introduced in 2009 and the Automotive Production and Development Programme (par 3.2.5) was initiated in 2009 and the implementation of this programme will continue until 2013.

In order to identify any additional incentives the South African government could consider introducing to assist the manufacturing industry and to remain competitive for investment in the global market, it is necessary to perform a comparison with other countries. The next chapter will investigate what incentives are offered to manufacturers in Malaysia and Singapore. This will be followed by a chapter discussing the comparison between South Africa and these two countries.

CHAPTER 4

INVESTMENT INCENTIVES IN OTHER COUNTRIES

4.1 INTRODUCTION

The previous chapter examined the investment incentives currently available to manufacturing companies in South Africa. The South African government offers 17 incentives that manufacturers can use to facilitate the development and growth of these companies in the country. Most of these incentives are designed to promote investment in a specific activity or industry and the benefit is offered to the manufacturer by means of a cash grant or tax deduction. There are a number of capital allowances as well which allow a deduction of part of the acquisition cost of capital assets, such as plant and machinery and industrial buildings, in an effort to encourage investment in capital assets. Incentives that reduce the company's fiscal burden, such as the deduction of costs relating to research and development and learnership agreements, are also applicable to manufacturing companies.

It is interesting and informative to examine various, and in some instances, creative investment incentives that other countries offer to encourage and support investment in the manufacturing sector (Prescott 1991). Comparisons between the investment incentives offered to the same sector by South Africa and other countries will enable the identification of incentives that the South African government could implement in order to achieve its manufacturing investment goals, as discussed in par 1.4.1. This chapter provides an overview of the different investment incentives offered to manufacturing entities by two other countries, namely Malaysia and Singapore.

Malaysia and Singapore are both attractive investment destinations as both countries' economies are open for international trade (International Export

Support 2009; Monetary Authority of Singapore 2009). These countries have initiated different incentives to attract more investment in an attempt to encourage economic growth. Singapore was one of the first Southeast Asian countries to offer investment incentives in 1960 (Baumüller 2009:8–9) and in 2007, was recognised as the country providing the most attractive investment incentives in the world (Singapore Economic Development Board [SEDB] 2007). Malaysia also started to initiate generous incentives in the late 1960s and focused extensively on the relocation of manufacturing activities to Asia in the 1980s (Baumüller 2009:9). Baumüller's (2009:13) study into the impact of investment incentives in Southeast Asia revealed that incentives have been a major contributing factor in attracting foreign direct investment to Singapore and Malaysia, resulting in the stimulation of economic development and export growth.

The most popular incentives in Southeast Asian countries are tax incentives, reduced duties on imports used for export purposes and designated zones. These incentives are mainly focused on attracting foreign direct investment. Other incentives are offered to encourage investment in underdeveloped areas or specific industries and to facilitate the transfer of technology and knowledge (Baumüller 2009:9–10). Incentives that provide double deduction of certain expenses which would have a positive effect on the economy of the country are particularly popular in Malaysia and Singapore (Easson 2004:148). The investment incentives offered by Malaysia will be discussed first, followed by a discussion of the investment incentives offered by Singapore.

4.2 INVESTMENT INCENTIVES IN MALAYSIA AVAILABLE, *INTER ALIA*, TO MANUFACTURING COMPANIES

Malaysia is located in Southeast Asia, which is regarded as one of the fastest emerging areas in the world. This country has a population of over 26 million

and is a major manufacturer of palm oil, natural rubber, tin and tropical hardwoods (Doing Business 2009(b); Kluwer Law International and CCH Asia [Kluwer] 2005(a):3101). The manufacturing sector is a major contributor to the economy. At the end of 2004, manufactured products accounted for 80% of the country's total exports, and in January 2006, the manufacturing sector contributed 31% of Malaysia's GDP (Business Service Industry 2004; Associated Chambers of Commerce and Industry of India 2006). The country's focus on technological development is a huge advantage for manufacturers in Malaysia because it offers a cost-competitive location with modern-day technology for investors based in the country.

Furthermore, due to Malaysia's easy global access via several air and shipping routes and its favourable business environment, the country is an attractive location for trade and investment and has become one of the world's most preferred destinations for investors wishing to set up offshore manufacturing operations. This is substantiated by the fact that more than 5 000 foreign companies from over 40 countries have established and expanded their businesses in Malaysia (Malaysian Industrial Development Authority [MIDA] 2009(g); Bernardi, Franschini & Shope 2006:218).

Malaysia's income tax law is contained in the Income Tax Act (47 of 1967) as well as in supplementary legislation. The Inland Revenue Board of Malaysia is the government's agent in the administration and collection of income tax (Kluwer 2005(a):7403 & 16101). A self-assessment system for individuals has been operational since 2004, but companies are still required to submit full disclosure in a tax return (Inland Revenue Board of Malaysia [IRBM] 2010). A company is considered a taxable legal entity separate from its shareholders and income accrued or received from a source inside Malaysia by resident companies is taxed in Malaysia. A company is considered to be a Malaysian resident if it is managed and controlled in Malaysia (Oleynik 2003:27).

Certain deductions such as expenditure incurred wholly and exclusively in the production of gross income, cash contributions to federal authorities, promotional expenses and capital allowances are allowed to reduce income (Bernardi et al 2006:226). The income tax liability of a company is determined by applying the corporate income tax rate of 25% (PKF 2009:1) to the company's chargeable income, which is the remaining amount of income after adjusting for deductible expenses (Lawyerment 2009). No capital gains tax (known as real property gains tax) has been charged since 1 April 2007 (MIDA 2010). It is evident that in some respects, Malaysia's tax system is similar to South Africa's tax system in the sense that companies are taxed as separate legal entities, as opposed to group taxation, and a self-assessment system is operational, although only applicable to individuals in Malaysia.

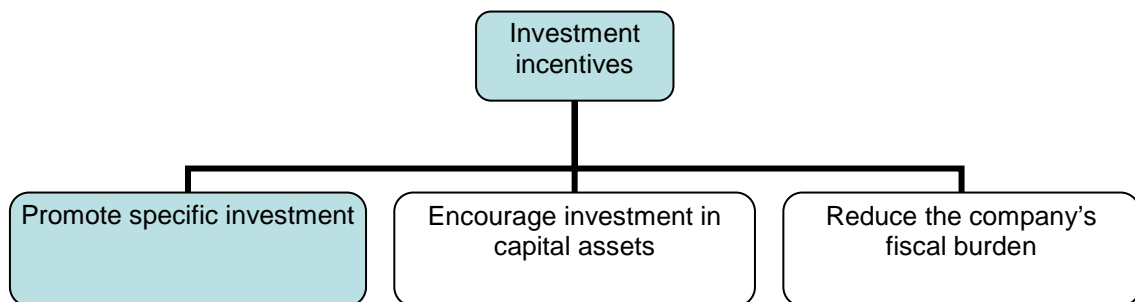
The Malaysian government is keen to attract foreign investment in the manufacturing industry (Helplinelaw 2009) and extensive investment incentives have been initiated to advocate Malaysia as a country of choice for foreign investment (Kluwer 2005(a):3301; MIDA 2008). A number of fiscal incentives, in particular, have been implemented to encourage local and foreign investment in selected industry sectors and promoted areas (PKF 2009:2). Most of the direct and indirect incentives in Malaysia are contained in the Promotion of Investments Act (327 of 1986) and the Income Tax Act (1967) (MIDA 2009:[1]). The Malaysian investment incentives discussed in this chapter are arranged in the same three categories as in chapter 3. The three categories are as follows:

- investment incentives that promote specific investment
- investment incentives that encourage investment in capital assets
- investment incentives that reduce the company's fiscal burden.

4.2.1 Investment incentives that promote specific investments

The first investment incentive category, namely investment incentives that promote specific investments in Malaysia, is discussed in this section, as indicated by figure 4.1.

Figure 4.1: Investment incentive category: investment incentives that promote specific investments in Malaysia



The main investment incentives available to companies in the manufacturing sector of Malaysia are the pioneer status incentive, investment tax allowance and the reinvestment allowance (PKF 2009:2). These incentives are discussed first (pars 4.2.1.1–4.2.1.3), as many of the other incentives refer to them, while the remaining incentives applicable to manufacturing companies, as identified in several worldwide web locations, are discussed thereafter (pars 4.2.1.4–4.2.1.14) and are listed in alphabetical order.

4.2.1.1 *Pioneer status (tax holiday)*

Corporations in the manufacturing sector that participate in a promoted activity or produce a promoted product may be eligible for pioneer status. The list of these promoted activities and products includes the manufacturing of, *inter alia*, rubber products, chemicals and petrochemicals, pharmaceuticals, wood and wood products, iron and steel, machinery and machinery components (Malaysia 1986: s 1(a),(b); IRBM 2009(e)); MIDA 2009(c)).

Companies with pioneer status are exempt from paying income tax on 70% of their statutory income, which represents gross income less revenue expenditure and capital allowances. This exemption period applies for five years from the day production levels reach 30% of capacity. The remaining 30% of the statutory income is taxed at the current corporate income tax rate of 25%. Companies located in the eastern corridor states of Peninsular Malaysia, Sabah, Sarawak and Perlis that are engaged in projects eligible for pioneer status are granted a 85% tax exemption on their statutory income during the five-year period. The aim of this incentive is to encourage investment in specific activities and specific areas (Malaysia 1986: s 1(a),(b); MIDA 2009:[4]; Small and Medium Enterprise Corporation Malaysia 2010).

4.2.1.2 *Investment tax allowance (ITA)*

A company may, however, decide to apply for an investment tax allowance, as opposed to applying for pioneer status. The same approved activities and products as stipulated above for pioneer status are applicable for the granting of the investment tax allowance, but a company may only apply for one of the two incentives (Oleynik 2003:113).

This incentive entitles a company to claim an allowance of 60% on the cost of factory, plant, machinery and other equipment used for a project involved in approved activities and products. The investment tax allowance is granted for a period of five years from the acquisition date of the first qualifying capital expenditure. The amount of the investment tax allowance to be utilised for each year of assessment is restricted to a maximum of 70% of the company's statutory income, while the balance of 30% of the statutory income is taxed at the current corporate income tax rate of 25%. Unutilised allowances may be carried forward to be set off against future profits of the business (Kluwer 2005(a):14204).

4.2.1.3 *Reinvestment allowance*

A reinvestment allowance is available to any corporation that incurs qualifying capital expenditure to expand, automate, modernise or diversify its existing manufacturing business within the same industry, on the condition that such a company has been in operation for at least 36 months (MIDA 2009:[9]).

The amount of the reinvestment allowance is 60% of the capital expenditure incurred within a period of 15 years on factory, plant and machinery used for the expansion, modernisation, automation or diversification activity. This allowance may be utilised against 70% of the statutory income each year and the unutilised reinvestment allowance may be carried forward indefinitely to be set off against future statutory income of the business. The 70% restriction does not apply to projects that exceed the level of productivity as prescribed by the Minister of Finance or projects located in the eastern corridor states of Peninsular Malaysia, Sabah, Sarawak and Perlis. These projects will be able to offset the reinvestment allowance against 100% of the statutory income each year (Malaysia 1967: s 133A; Kluwer 2005(a):14401).

The reinvestment allowance can only be claimed when the building project has been completed or when the plant or machinery is brought into use. The asset for which the reinvestment allowance is granted may not be disposed of within five years. A company is not allowed to claim a reinvestment allowance if the asset was acquired from a related company within the same group where the reinvestment allowance had been previously claimed (Malaysia 1967: s 133A; Malaysia Manufacturers Directory 2009:[3]; MIDA 2009:[9]).

4.2.1.4 *Free industrial zones*

Free industrial zones are areas established for manufacturing companies that produce or assemble products mainly for export. These export-orientated

companies are able to import raw materials, components and machinery and equipment used directly in the manufacturing process duty-free, and are only subject to minimum customs formalities in the import and export of their goods. Companies must be located in one of the 16 available free industrial zones if more than 80% of their products are meant for export and if their raw materials and components are mainly imported (MIDA 2009(h)).

4.2.1.5 *High-technology companies' incentive*

A high-technology company is defined as a company involved in “promoted activities or in the production of promoted products in areas of new and emerging technologies” (MIDA 2009:[5]). The list of these activities and products includes, *inter alia*, the manufacturing of computers, the manufacturing of medical and scientific equipment, the production of optical lenses and the manufacturing of aircraft equipment (MIDA 2009(d)).

One of the following incentives is offered to high-technology companies:

- pioneer status with income tax exemption of 100% of statutory income for a five-year period (IRBM 2009(e)); or
- an investment tax allowance of 60% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (Malaysia 1986: s 1(c); IRBM 2009(a)).

A high-technology company must comply with the following requirements:

- Within three years from the date of operation, the annual local research and development expenditure must be at least 1% of gross sales; and
- At least 7% of the company's employees must be scientific and technical staff with degrees or diplomas and they must have a minimum of five years' experience (Malaysia Manufacturers Directory 2009:[9]).

4.2.1.6 *Industrial adjustment allowance*

A manufacturing corporation that undertakes an approved industrial adjustment programme in the wood-based, textile, machinery and engineering industries in order to increase its competitiveness, may be granted an industrial adjustment allowance. Industrial adjustment refers to any activity undertaken to restructure with the intention of improving industrial technology, increasing productivity and enhancing the efficient use of natural resources (IRBM 2009(b)).

The rate of the allowance which is deducted from the income of a qualifying company varies from 60% to 100%, depending on the activity undertaken by such corporation and the type of industry. The applicable rate is applied to the amount of capital expenditure incurred for factory, plant and machinery in a period of five years. The company must have been in operation before 31 December 1990 and will not be eligible for the reinvestment allowance in respect of the same expenditure (Malaysia 1986: s 3; Kluwer 2005(a):14402).

4.2.1.7 *Industrial linkage programme*

This incentive is focused on vendors that manufacture their own goods which are promoted products in an approved industrial linkages programme. The industrial linkage programme is a Malaysian government initiative aimed at developing small and medium-sized businesses to be competitive and capable suppliers of parts and components to multinational companies, by providing incentives and facilitating access to the market. The list of promoted activities and products in an industrial linkages programme includes the manufacturing of, *inter alia*, plastic products, iron and steel, machinery, machinery components and electronic products (MIDA 2009(f); SME Corp Malaysia 2010:[1]). These vendors are able to claim one of the following incentives:

- pioneer status with income tax exemption of 100% of statutory income for a five-year period; or

- an investment tax allowance of 60% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (Malaysia 1986: s 1(d)).

An alternative incentive is available to vendors who achieve world-class standards in terms of price, quality and capacity of their manufactured products. This incentive aims to encourage vendors to manufacture goods for the international market (MIDA 2009:[7]).

These vendors may qualify for one of the following incentives:

- pioneer status with income tax exemption of 100% of statutory income for a 10-year period; or
- an investment tax allowance of 100% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (MIDA 2009:[7]).

4.2.1.8 *Production of automotive components or systems incentive*

Companies that manufacture qualifying automotive components or systems are eligible for one of the following incentives:

- pioneer status with income tax exemption of 100% of statutory income for a five-year period; or
- an investment tax allowance of 60% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (Kluwer 2005(a):81104).

Qualifying automotive components or systems include, *inter alia*, instrumental panel modules, bumper modules, fuel tank modules, seat modules, airbag systems, engine management systems, exhaust systems and exterior lighting systems (MIDA 2009:[8]).

4.2.1.9 *Production of specialised machinery and equipment incentive*

Specialised machinery and equipment are considered to be machine tools, plastic injection machinery, plastic extrusion machinery, material-handling equipment, packaging machinery, robotics and factory automation equipment, and machinery and equipment for specific industries (MIDA 2009:[7]).

Companies involved in the manufacturing of this specialised machinery and equipment may claim one of the following incentives:

- pioneer status with income tax exemption of 100% of statutory income for a 10-year period; or
- an investment tax allowance of 100% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (Kluwer 2005(a):15601).

Existing locally owned companies that reinvest, by way of expansion or automation, in the manufacturing of specialised machinery and equipment, or in the manufacturing of heavy machinery such as cranes, quarry machinery and port material-handling equipment, are entitled to claim one of the following incentives:

- pioneer status with income tax exemption of 70% of the increased statutory income arising from the reinvestment for a five-year period; or
- an investment tax allowance of 60% on the additional qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 70% of the statutory income each year (MIDA 2009:[7–8]).

4.2.1.10 *Relocation of manufacturing activities to promoted areas incentive*

This incentive was introduced to “reduce the costs of doing business and to provide a competitive business environment” (MIDA 2009:[4]). Existing manufacturing companies that transfer their business to the promoted areas in

the eastern corridor states of Peninsular Malaysia, Sabah, Sarawak and Perlis may qualify for one of the following incentives:

- pioneer status with income tax exemption of 100% of statutory income for a five-year period; or
- an investment tax allowance of 100% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (MIDA 2009:[5]).

4.2.1.11 *Resource-based industries' incentive*

Malaysian companies engaged in the manufacturing of rubber, oil palm and wood-based products that are of export potential may be granted one of the following tax incentives when they incur capital expenditure for the purpose of any expansion:

- pioneer status with tax exemption of 70% (85% for promoted areas) of statutory income for a five-year period; or
- an investment tax allowance of 60% (80% for promoted areas) on qualifying capital expenditure incurred within five years. Qualifying capital expenditure refers to factory, plant, machinery and equipment acquired in relation to the expansion of the business. The allowance is restricted to 70% (85% for promoted areas) of statutory income (Kluwer 2005(a):15603).

4.2.1.12 *Small-scale companies' incentive*

A small-scale manufacturing company incorporated in Malaysia with paid-up capital of ordinary shares of RM2.5 million or less is eligible for the pioneer status incentive or investment tax allowance incentive if shareholder's funds do not exceed RM500 000, and at least 60% of equity is from Malaysia (MIDA 2009:[6]). One of the following criteria must also be met:

- The value added to industrial activities must be at least 15%; or
- The project must play a role in the socio-economic improvement of the rural population (MIDA 2009:[6]).

In order for the company to qualify for this incentive, it must be involved in the manufacturing of products listed as promoted products and activities for small-scale companies (MIDA 2009:[6]). This list of promoted activities and products includes the manufacturing of, *inter alia*, rubber products, wood and wood products, transport components, electrical and electronic products, sports goods and plastic products (MIDA 2009(e)).

The incentive available to qualifying small-scale companies is as follows:

- pioneer status with income tax exemption of 100% of statutory income for a five-year period; or
- an investment tax allowance of 60% on qualifying capital expenditure incurred within a five-year period. The allowance may be utilised against 100% of the statutory income each year (MIDA 2009:[6]).

The full amount of expenses incurred by a small-scale company in respect of reinvesting in plant and machinery during the year of assessment 2009 and/or 2010 can be claimed in the year of acquisition. This accelerated capital allowance is only available for the 2009 and 2010 years of assessment (MIDA 2009:[10]).

4.2.1.13 *Strategic projects incentive*

Strategic projects are defined as projects of national importance involving high technology, large capital investment and long development periods, and which have a significant impact on the Malaysian economy. The following incentives are available to these strategic projects:

- pioneer Status with full tax exemption at statutory income level for a period of 10 years; or
- an investment tax allowance of 100% on qualifying capital expenditure incurred within a five-year period. There are no restrictions pertaining to the statutory income for each assessment year against which this allowance can be offset (Malaysia Manufacturers Directory 2009:[10]).

4.2.1.14 *Tax exemption on the value of increased exports*

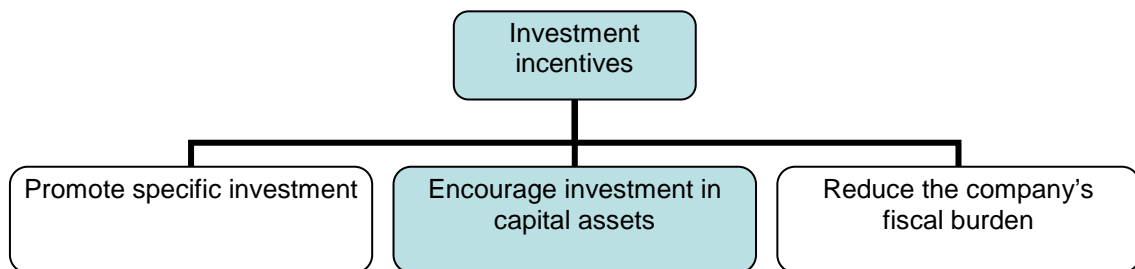
In order to promote the export of higher value-added goods, manufacturing companies are granted an allowance of 10% of the value of increased exports, provided that the exported goods achieve at least 30% value added. Where exported goods reach at least 50% value added, an allowance of 15% will be granted. The term “value added” signifies the selling price of goods less the cost of raw materials. The term “increased exports” refers to the growth of the value of direct exports in relation to the previous year (Kluwer 2005(a):15302–15303).

Manufacturing companies that are considered to be resident in Malaysia, with at least 60% Malaysian equity, are granted incentives with more beneficial exemptions (MIDA 2009:11). These companies receive a tax exemption on statutory income equal to 30% of the value of increased export value, provided it realises a significant increase in exports. The rate is increased to 50% of the value of increased export for a company that succeeds in penetrating new markets. Full exemption on increased export value is granted if the company achieves the highest increase in export in a specific category (Kluwer 2005(a):15302).

This increased exports allowance may be claimed against 85% of the company's statutory income. Unutilised allowances may be carried forward to be set off against future profits of the business (Kluwer 2005(a):15302–15303).

4.2.2 Investment incentives that encourage investment in capital assets

Figure 4.2: Investment incentive categories: investment incentives in Malaysia that encourage investment in capital assets



As indicated by figure 4.2, this section explores the second investment incentive category for Malaysia, namely investment incentives that encourage investment in capital assets. These incentives, which are applicable to manufacturing companies, as identified from several worldwide web locations, are listed in alphabetical order.

4.2.2.1 *Capital allowance on industrial buildings*

A capital allowance may be claimed on capital expenditure incurred for the construction, purchase or improvement of industrial buildings or structures such as warehouses for storing manufactured goods for export and factories. The taxpayer must own the industrial building and the building should be used for the purpose of business (Kluwer 2005(a):7304–7401). The initial allowance is claimed in the year that these costs are incurred and is 10% of the qualifying expenditure. A further 3% of qualifying expenditure can be claimed annually (MIDA 2009b:[1]).

4.2.2.2 *Capital allowance on other non-manufacturing assets*

Capital expenditure incurred to acquire certain other non-manufacturing assets, such as furniture and computers, may also be claimed if the asset is used by the taxpayer in carrying on its trade. An initial allowance of 20% of the capital expenditure is granted for all asset categories. The rate of the annual allowance is 10% for office equipment, furniture and fittings, 20% for commercial vehicles and business passenger cars and 40% for computer and information technology equipment and software (Kluwer 2005(a):7304; PKF 2009).

4.2.2.3 *Capital allowance on plant and machinery*

Capital expenditure incurred to acquire plant and machinery is deductible by means of a capital allowance. The taxpayer must own the plant and machinery and use it for carrying on its trade (Kluwer 2005(a):7303). An initial allowance of 20% of the capital expenditure is granted, while the annual allowance rate is 20% for heavy machinery and motor vehicles and 14% for general plant and equipment (PKF 2009).

Capital expenditure incurred by a company to expand, automate, modernise or diversify its existing manufacturing business after the expiry of the 15-year period during which a reinvestment allowance (see discussion in par 4.2.1.3) may be claimed, is deductible by means of an accelerated capital allowance. This allowance has to be claimed within three years, with an initial allowance of 40% and an annual allowance of 20%. It is only available to companies manufacturing promoted products, such as rubber products, chemicals and petrochemicals, pharmaceuticals, wood and wood products, iron and steel, machinery and machinery components (MIDA 2009:[10]).

Capital expenditure incurred between 10 March 2009 and 31 December 2010 for the acquisition of plant and machinery may be claimed within two years. This

accelerated allowance was granted to encourage investment in plant and machinery (PWC 2009).

4.2.2.4 Capital allowance (accelerated) on equipment to maintain quality of power supply

This incentive aims to compensate companies for incurring capital expenditure on equipment to maintain the quality of the power supply during the interruption thereof. This accelerated capital allowance may be claimed over two years with an allowance of 20% in the first year and an annual allowance of 80% in the second year. The Ministry of Finance determines which equipment is eligible for this allowance (MIDA 2009:[10]).

4.2.2.5 Capital allowance (accelerated) on renovation and refurbishment of business premises

Expenses incurred on the renovation and refurbishment of business premises are not allowed as a deduction and also do not qualify for a capital allowance. However, in order to encourage companies to revamp their business property, an accelerated capital allowance permits the deduction of renovation and refurbishment expenses incurred between 10 March 2009 and 31 December 2010. This deduction is claimed over two years and the maximum allowance is limited to RM100 000 (PWC 2009).

4.2.2.6 Environmental incentive

To promote the protection and conservation of the environment, a capital allowance is offered to companies that acquire environmental protection equipment or set up facilities to store, treat and dispose of toxic and hazardous waste generated by their manufacturing activities. An initial allowance of 40% and an annual allowance of 20% on the capital expenditure incurred for such

equipment or facilities may be claimed. The full amount can thus be deducted in three years (Kluwer 2005(a):15503).

4.2.2.7 *Generation of renewable energy incentive*

A company that makes use of renewable resources to generate energy for consumption in its own manufacturing activities can claim a 100% investment tax allowance. This rate is applied to qualifying capital expenditure incurred within a five-year period to acquire generating equipment and the allowance can be set off against 100% of the company's statutory income for each year of assessment (MIDA 2009(i)).

4.2.2.8 *Infrastructure allowance*

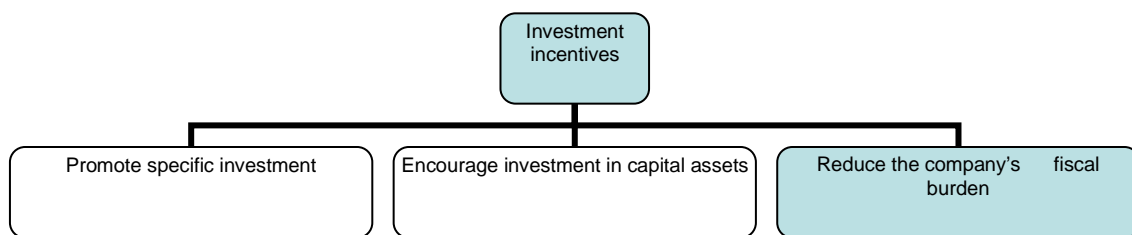
An infrastructure allowance is offered to manufacturing companies that incur capital expenditure on infrastructure and which are located in the promoted areas of the States of Sabah and Sarawak and the eastern corridor of Peninsular Malaysia. The qualifying infrastructure refers to the construction, reconstruction, extension or improvement of any permanent structure in respect of a business in operation in a promoted area (Malaysia 1986: s 4; MIDA 2009b:[4]).

Expenditure that qualifies for other allowances, such as the investment tax allowance, industrial adjustment allowance or reinvestment allowance, may not be claimed by means of this incentive as well. The full amount of the infrastructure expenditure may be claimed against 85% of the company's statutory income. Unutilised allowances will be carried forward to be set off against future profits of the business (Malaysia 1986: sec 4; IRBM 2009(c)).

4.2.3 Investment incentives that reduce the company's fiscal burden

The last investment incentive category for Malaysia, namely investment incentives that reduce the company's fiscal burden, is discussed in this section, as indicated by figure 4.3.

Figure 4.3: Investment incentive categories: investment incentives in Malaysia that reduce the company's fiscal burden



These incentives, which are applicable to manufacturing companies, as identified from several worldwide web locations, are listed in alphabetical order.

4.2.3.1 *Preferential corporate tax rates*

Income tax for resident and non-resident companies is imposed on chargeable income derived from Malaysia at a flat rate of 25% (PKF 2009:1). Companies with paid-up capital of RM2.5 million or less, however, are eligible for a reduced corporate tax rate of 20% on the first RM500 000 of chargeable income. Any income exceeding RM500 000 is taxed at 25% (Kluwer 2005(a):81102; PKF 2009:1).

One of the following requirements has to be met in order to qualify for the reduced tax rate:

- The company's finished products are used as raw materials or components by manufacturing industries;
- The local material content is more than 50% in terms of value;
- The company exports at least 50% of its output; or

- The project contributes towards the socio-economic development of the rural population (Bell 2009).

4.2.3.2 *Research and development incentive*

The Malaysian government encourages research and development activities in the manufacturing sector in order to increase the competitiveness and productivity of companies in this sector (Kluwer 2005(a):15203). The Inland Revenue Board of Malaysia (2004) defines research as "any systematic or intensive study undertaken in the field of science or technology with the objective of using the results of the study for the production or improvement of materials, devices, products, produce or processes".

Research does not include any of the following: routine testing or quality control of materials or products; research in social science or humanities; routine data collections; efficiency surveys or management studies; or market research or sales promotion (Oleynik 2003:123).

Manufacturing companies that undertake research and development projects for the benefit of their own business are entitled to claim an income tax allowance of 50% of the qualifying capital expenditure incurred within a period of 10 years, limited to 70% of the statutory income (Malaysia Manufacturers Directory 2009:[16]).

A double deduction of expenses is granted in respect of revenue costs incurred on approved research and development projects, payments made to approved research and development companies for the use of facilities or services and contributions in cash paid to approved research companies or institutions (Malaysia 1967: s 34A; Kluwer 2005(a):14504).

4.2.3.3 *Training expenses deduction*

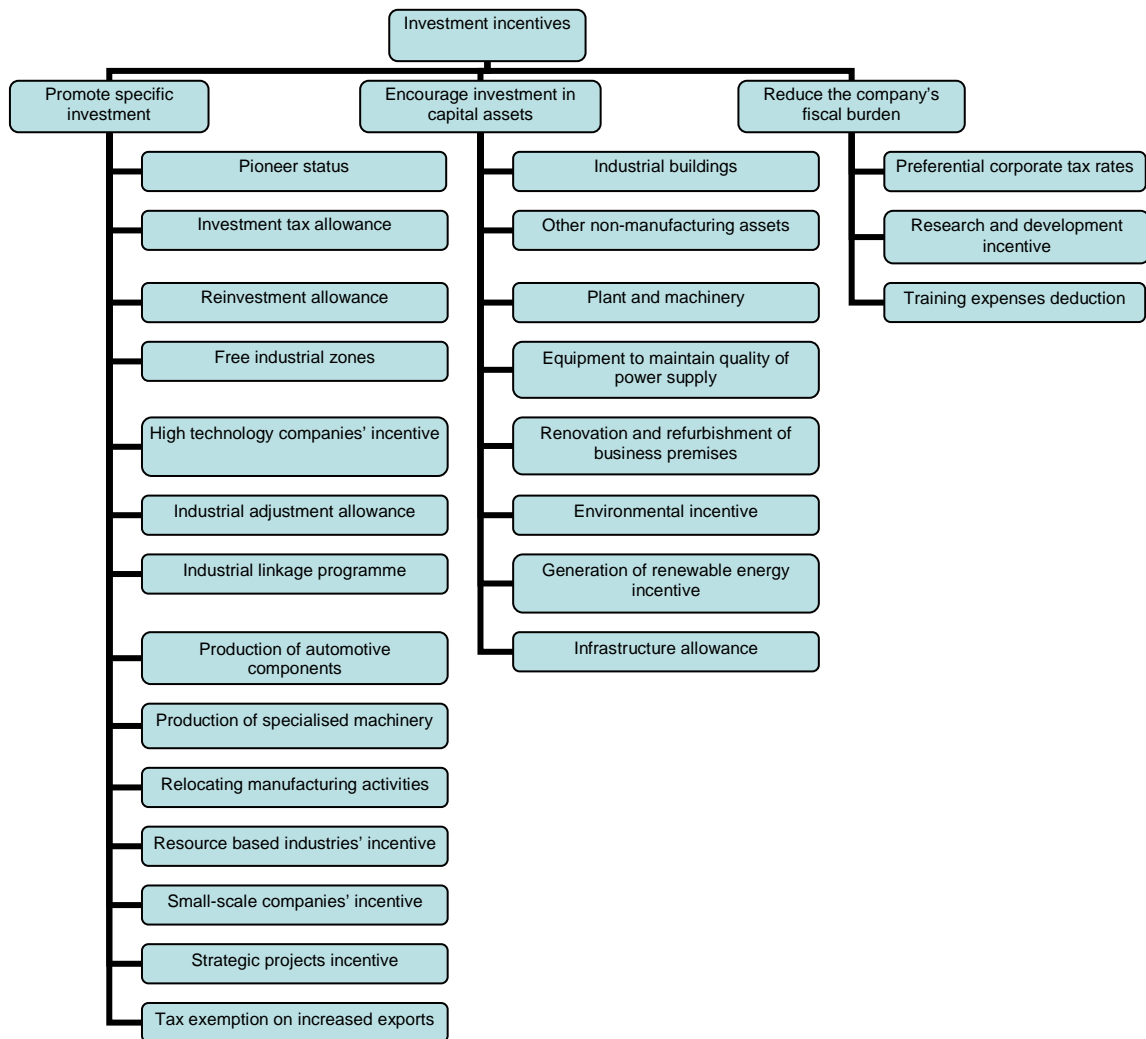
Companies that incur training expenditure before the commencement of business are entitled to claim a single deduction, provided that the trainees are employed by the company when operation commences (Malaysia Manufacturers Directory 2009:[8]).

A double deduction is available for approved training expenditure incurred in the training of employees under an approved training programme by approved training institutions. Manufacturing corporations with 50 or more Malaysian employees registered with the Human Resources Development Fund are not eligible for this incentive, but they are able to seek financial assistance from the fund for employee training (Kluwer 2005(a):14604).

4.2.4 Summary

It is evident that a vast number of investment incentives are offered to manufacturing companies in Malaysia. The 25 incentives discussed above, which were identified in this study as the incentives available to Malaysian manufacturing companies, are graphically depicted in figure 4.4.

Figure 4.4: Investment incentives available to manufacturers in Malaysia



Malaysia’s investment incentives for manufacturers appear to be mainly focused on the production of certain products and the expansion of the manufacturing industry. In order to compare the investment incentives of another foreign country with those of South Africa, the following section explores the investment incentives offered to manufacturing companies in Singapore.

4.3 INVESTMENT INCENTIVES IN SINGAPORE AVAILABLE, *INTER ALIA*, TO MANUFACTURING COMPANIES

Singapore is situated in Southeast Asia and has a population of over four million. It is a highly developed country for global trade and was ranked in 2009 as the world's easiest place to do business (SEDB 2009(c); Doing Business 2009). Singapore is a highly desirable location for the establishment of new business due to its well-established infrastructure and sensible pro-business tax policy (PRLog 2007). As a result, over 7 000 multinational corporations have established their business operations in this country (SEDB 2007(b)). Consequently, a major portion of the economy is represented by foreign investors, especially in the manufacturing sector, which is one of Singapore's major sources of growth (Kluwer 2005(b):3101).

In terms of Singapore tax law, each company is a distinct legal entity and taxed separately. However, during 2003, a group relief system was established, which allows one company to set off its current year losses and excess allowances against the profits of a connected company in the same group of companies (Kluwer 2005(b):7503 & 52402). Currently, gains of a capital nature are not subject to tax in Singapore, except if the gains are recurring in nature (Inland Revenue Authority of Singapore [IRAS] 2010(a)). The Inland Revenue Authority of Singapore is responsible for the administration and collection of taxes and full disclosure is required on the tax returns, as no self-assessment system is operational for income tax purposes (Kluwer 2005(b):7504). It is evident that the tax system of Singapore is vastly different from that of South Africa in the sense that a group relief system is not operational in South Africa, while South Africa has introduced capital gains tax and is moving towards an income tax self-assessment system. However, Singapore's investment incentives are still valuable for comparison with those of South Africa, due to the fact that new investment incentive initiatives could be identified from a country recognised as

a highly desirable investment location. It is therefore worthwhile and informative to explore the different incentives offered to manufacturing companies in Singapore.

The Singapore government aims to increase foreign investment in the country (Kluwer 2005(b):3101). For this reason, Singapore offers a wide range of investment incentives to assist companies to develop and expand their business in the country. These incentives are provided in terms of the Income Tax Act (Ord. 39 of 1947) (Kluwer 2005(b):7100) and the Economic Expansion Incentives (relief from Income Tax) Act (36 of 1967) (SEDB 2009(b)), which are to be read together (Kluwer 2005(b):3201). The incentives granted under the Economic Expansion Incentives (relief from Income Tax) Act (1967) are focused on increasing technology, training and spending in all industries, whereas the Income Tax Act (1947) provides incentives to encourage investment in specific activities or industries. All of these incentives are based on the economic and technological development potential of the industry it is granted to (Kluwer 2005(b):14101–14103).

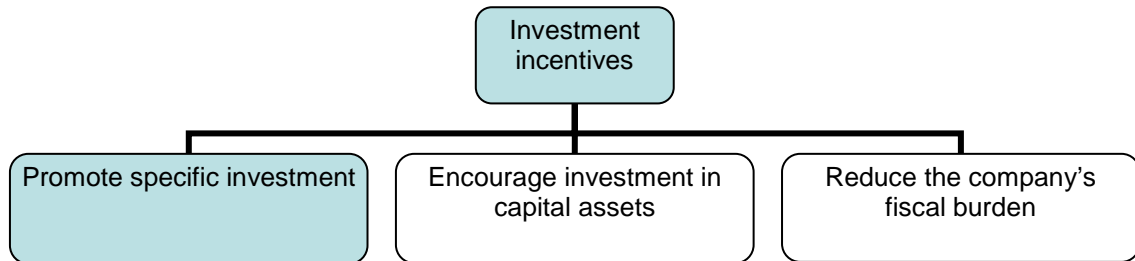
The investment incentives in Singapore discussed in this chapter are arranged in the same three categories that were applied in chapter 3, namely:

- investment incentives that promote specific investment
- investment incentives that encourage investment in capital assets
- investment incentives that reduce the company's fiscal burden.

4.3.1 Investment incentives that promote specific investments

The first investment incentive category, namely investment incentives that promote specific investments in Singapore, is discussed in this section, as indicated by figure 4.5.

Figure 4.5: Investment incentive category: investment incentives that promote specific investments in Singapore



The most commonly used incentives in Singapore are the pioneer incentive and the investment allowance, which are discussed first in this section (pars 4.3.1.1 and 4.3.1.2). These two incentives are mutually exclusive and a company should thus decide which incentive would be more appropriate for its circumstances (Kluwer 2005(b):14303). The applicability of these incentives to a company has, in some instances, an effect on the availability or extent of other incentives. These other investment incentives available to manufacturing companies in Singapore, as identified from several worldwide web locations, are discussed thereafter (par 4.3.1.3–4.3.1.8) and are listed in alphabetical order.

4.3.1.1 *Pioneer status (tax holiday)*

The pioneer status exemption is one of the most commonly used incentives by companies in Singapore (Kluwer 2005(b):14102). This is a clear indication of the success of this incentive.

Full tax exemption is granted to manufacturing companies that produce approved high-technological products. For a project to qualify, the project has to acquire new technologies or knowledge that will enhance the overall industry standards, by way of importing modern processes or equipment which will increase productivity (EnterpriseOne 2009). Most new projects would qualify for

pioneer status, but existing projects that already manufacture products locally without the incentive, will not be considered for this incentive (Singapore 1967:s 7; PWC 2008:17).

During the exemption period, only the trade approved for pioneer status may be carried on, in an effort to prevent companies from using the exemption to benefit non-pioneer activities. Unutilised capital allowances may be carried forward and claimed against the post-pioneer profits (Singapore 1967:s 15; Kluwer 2005(b):14303). The duration of the tax relief ranges between five and 15 years. The maximum period of this exemption was originally 10 years, but it was increased in 2004 to 15 years (Singapore 1967:s 6; Bell 2009(b):[2]).

4.3.1.2 *Investment allowance*

A tax allowance of a specified percentage, up to 100%, is granted on capital expenditure incurred for qualifying projects or activities within a period of five years, starting from the acquisition date of the first qualifying capital expenditure (Singapore 1967:s 68; Kluwer 2005(b):14503–14504). An approved project includes any manufacturing activity (Singapore 1967:s 67). Qualifying capital expenditure includes plant and machinery, factory buildings and the acquisition of know-how or patent rights (Singapore 1967:s 66; PWC 2008:17). No minimum investment amount is stipulated and the asset may not be sold during the period from when the approval for the allowance was granted, until two years after the qualifying period. The allowance is granted in addition to normal capital allowances and may be carried forward if it could not be utilised against the company's losses (Kluwer 2005(b):14401).

This allowance may not be claimed if pioneer status has been granted to the company (Bell 2009(b):[4]). A company should thus consider whether an investment allowance or pioneer status will provide the greatest benefit to the

company, based on realistic profit projections for the manufacturing activity and the amount of capital expenditure involved. This incentive will be most beneficial if significant amounts of capital expenditure are required for a project (Kluwer 2005(b):14401).

4.3.1.3 *Development and expansion incentive*

This scheme is offered to pioneer status companies that incur capital investment to upgrade or expand production capacity after the pioneer tax relief period has expired (Singapore 1967:s 19I; Bell 2009(b):[2]). The manufacturing activity must generate substantial economic benefits for Singapore (Kluwer 2005(b):14503). This incentive provides a lower corporate tax rate of 5% for a period of 10 years on all qualifying profits above a predetermined base (Singapore 1967:s 19K; SEDB 2009:[2]). The total tax relief period may be extended to a maximum period of 20 years (Kluwer 2005(b):14503).

4.3.1.4 *Expansion incentive*

The aim of this incentive is to promote automation processes in the manufacturing sector in an effort to increase productivity. Approved companies, with investment in equipment and machinery used for manufacturing activities exceeding S\$10 million, may be granted a tax relief period for up to 10 years. The increase in profits after the expansion was implemented is exempt from corporate income tax (Bell 2009(b):[2–3]; Enter Singapore Business 2009).

4.3.1.5 *Exemption on increased exports*

Manufacturing companies involved in export activities are eligible for a tax exemption from corporate income tax for a period of three to 15 years. The exempt amount is calculated as 90% of the gross annual increased export income (Bell 2009b:[3]).

4.3.1.6 *Free trade zone*

A free trade zone is a designated area where the payment of duties and taxes on imported goods is repealed or delayed. Singapore has five free trade zones where raw materials, equipment and products can be imported, stored and exported with zero import or export duties payable. Goods and services tax is also not charged on imported goods brought into this free trade zone for re-export purposes. However, if goods are transferred to the local market, the goods and services tax then becomes payable (IRAS 2010(b)). This incentive thus primarily benefits manufacturing companies situated in a free trade zone that import and produce products mainly for export (EnterpriseOne 2010).

4.3.1.7 *Innovation development scheme*

This grant, in the form of a co-funding facility, is available to manufacturing companies registered in Singapore that incur expenditure to improve their products, processes and applications. The expenditure incurred must lead to significant improvement in the company's productivity, as well as increase the industry's innovation capacity. The amount of the grant is based on the type of expenditure incurred, and the percentages of the expenditure which are reimbursed to the company are listed below (SEDB 2008; SEDB 2009:[3]).

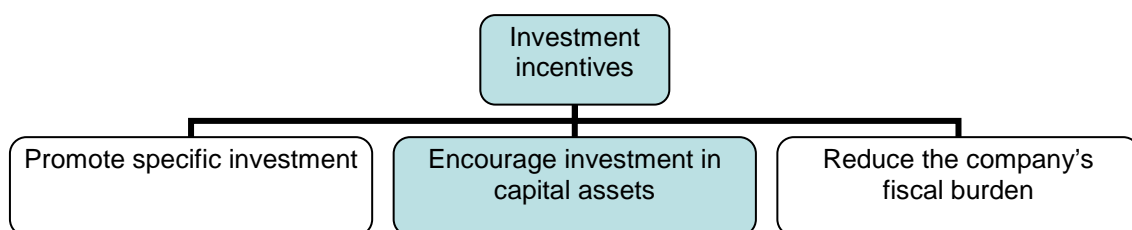
- manpower cost – 50%
- equipment and materials – 30%
- professional services – 50% for local suppliers; 30% for foreign suppliers
- intellectual property rights – 30%

4.3.1.8 Start-up companies' incentive

This incentive aims to help start-up companies save their cash flow and profits in the first few years of trading (SGEntrepreneurs 2008:[2]). Qualifying start-up companies can enjoy a three-year tax exemption of 100% on the first S\$100 000 of chargeable income and 50% on the next S\$200 000 of chargeable income (Ministry of Finance Singapore 2009(b)). If the company incurs losses during this three-year exemption period, the exemption may not be carried forward and the company will thus not benefit from this incentive. A company can qualify for this exemption if it is incorporated in and is a tax resident of Singapore during the three-year exemption period. In addition, there must be no more than 20 shareholders during this same period who are all natural persons, or, where some of the shareholders are companies, at least one shareholder must be a natural person and this shareholder must beneficially hold at least 10% of the issued shares (IRAS 2009(b)). Should a company not meet these requirements, it may still use the partial tax exemption (see discussion in par 4.3.3.3) that applies to all companies (IRAS 2009).

4.3.2 Investment incentives that encourage investment in capital assets

Figure 4.6: Investment incentive categories: investment incentives in Singapore that encourage investment in capital assets



As indicated in figure 4.6, this section explores the second investment incentive category for Singapore, namely investment incentives that encourage investment in capital assets. These incentives, which are applicable to

manufacturing companies, as identified from several worldwide web locations, are listed in alphabetical order.

4.3.2.1 *Capital allowance on industrial buildings*

Before 22 February 2010, the capital expenditure incurred by all manufacturers on industrial buildings and structures was deductible by means of an initial allowance of 25% and an annual allowance of 3% (Singapore 1947:s 16; PWC 2008:15). This incentive was terminated and replaced by the land intensification allowance to encourage efficient use of industrial land and improve land productivity. This new allowance may be claimed after 22 February 2010, and is only applicable to industrial users whose buildings or structures belong to one of these nine industry sectors: pharmaceuticals, petrochemicals, petroleum, specialties, other chemicals, semiconductor-wafer fabrication, aerospace, marine and offshore engineering and solar cell manufacturing. An initial allowance of 25% and an annual allowance of 5% on capital expenditure will be granted (Singapore Budget 2010).

4.3.2.2 *Capital allowance on other non-manufacturing assets*

A 100% wear-and-tear allowance is available on capital expenditure incurred on computer equipment, prescribed office automation equipment, robots, generators, pollution control and energy-efficient equipment, certain noise reduction equipment and certain diesel-driven vehicles (PWC 2008:15).

4.3.2.3 *Capital allowance on plant and machinery*

An initial wear-and-tear allowance of 20% is allowable on plant and machinery and the remaining acquisition cost is claimable on a straight-line basis over the working life of the asset as contained in the Sixth Schedule of the Income Tax Act (1947), ranging from five to 16 years (Singapore 1947:s 19). Plant and

machinery refers to the equipment used by the company for carrying on its trade. It is not trading stock and it also does not form part of the business premises or property by means of a fixed item (SEDB 2009(b):[2]).

An accelerated tax allowance can be claimed on all machinery and equipment except for motorcars, motorcycles and light goods vehicles, purchased before the 2009 year of assessment in equal instalments over three consecutive years (IRAS 2009(c):[5]).

The cost of plant and machinery acquired during the 2010 and 2011 years of assessment may be claimed over two years. This accelerated allowance permits a deduction of 75% of the capital expenditure in the first year of assessment and 25% of the capital expenditure in the second year of assessment (Singapore 1947:s 19A; IRAS 2009(d):[5]).

4.3.2.4 *Capital allowance on building renovations*

Capital expenditure on renovations or refurbishment works incurred between 16 February 2008 and 15 February 2013 may be claimed over three years on a straight-line basis. The maximum amount which may be deducted every three years is S\$150 000 (Singapore 1947:s 14Q(3); IRAS 2009(e):[3]). Qualifying capital expenditure of this nature expensed during the 2010 and 2011 years of assessment may be deducted in one year instead of three years, limited to S\$150 000 (Singapore 1947:s 14Q(3A); IRAS 2009(d):[5]).

Some examples of the qualifying expenditure relating to renovations or refurbishment works are electrical installation and wiring, water systems, kitchen fittings, doors and gates, wall coverings, floorings and windows (IRAS 2009(e):[4]).

4.3.2.5 *Energy efficiency incentives*

The Energy Efficiency Improvement Assistance Scheme offers co-funding to manufacturing companies to encourage them to perform energy audits and obtain recommendations on energy saving methods. Funding is available for up to 50% of the costs to conduct an accredited audit, but this grant is limited to \$200 000 for a single manufacturing facility (E2Singapore 2009).

Another incentive that encourages existing companies to substitute inefficient energy-consuming equipment for energy-saving equipment is an accelerated depreciation tax allowance. The rate of this allowance is 100% and it allows the taxpayer to claim the cost of qualifying energy-efficient equipment in one year (National Climate Change Committee 2009).

A cash incentive is also provided to owners of existing buildings to encourage them to effect energy efficiency improvements. Funding is provided for up to 35% of the costs involved in this upgrade process, limited to \$1,5 million (Building and Construction Authority 2009).

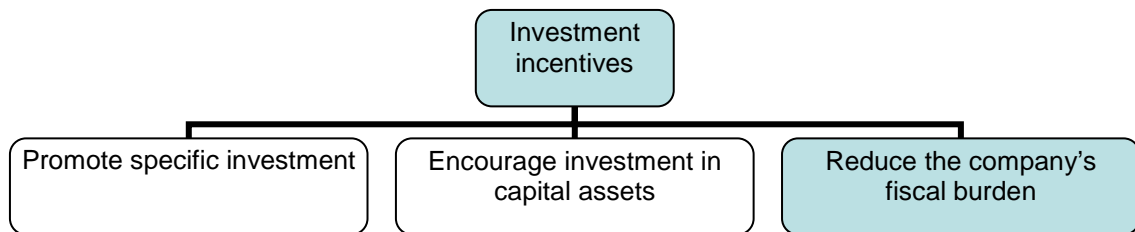
4.3.2.6 *Environment incentive*

The 3R Fund of the Singapore government provides co-funding to companies that engage in recycling and waste reduction projects as part of their manufacturing activities. Projects relating to the design of new methods to reduce waste at the production stage, as well as the installation of new waste sorting and recycling infrastructure, qualify for funding of up to 80% of the costs incurred for equipment, manpower and professional services. This grant is limited to S\$1 million per project (National Environment Agency 2009).

4.3.3 Investment incentives that reduce the company's fiscal burden

The last investment incentive category for Singapore, namely investment incentives that reduce the company's fiscal burden, is discussed in this section, as indicated in figure 4.7.

Figure 4.7: Investment incentive categories: investment incentives in Singapore that reduce the company's fiscal burden



These incentives which are applicable to manufacturing companies, as identified from several worldwide web locations, are listed in alphabetical order.

4.3.3.1 *Approved foreign loan incentive*

A manufacturing company that obtains a loan from its parent company situated in a country other than Singapore would be eligible for this incentive. Full or partial exemption on withholding tax for interest payments to non-residents is granted. The minimum amount of the loan is S\$200 000 and it may only be utilised to purchase productive equipment (SEDB 2009:[1]). This incentive appears to be focused on promoting foreign direct investment.

4.3.3.2 *Approved royalty incentive*

This incentive grants full or partial exemption on withholding tax for royalties or technical assistance fees payable to non-residents for the transfer of technology or know-how to Singapore companies (PWC 2008:17). The technology or knowledge transferred to Singapore must be more innovative than the current

industry average. This incentive enables manufacturing companies in Singapore with an overseas parent company to reduce their overall cost and encourages them to transfer high-level technology and knowledge to Singapore (SEDB 2009:[2]). It is clear that the aim of this incentive is to encourage foreign direct investment and the transfer of foreign technology and knowledge to Singapore.

4.3.3.3 *Corporate tax rate and partial exemption*

In order to attract and stimulate investment in the country, Singapore has lowered its corporate tax rate repeatedly in the last few years (Kluwer 2005(b):7102). The tax rate was reduced from 22% to 20% in 2005, and again to 18% in 2008 (IRAS 2009). As from the 2010 year of assessment, resident and non-resident companies pay income tax at a flat rate of 17% (IRAS 2009(d)), with a partial exemption of chargeable income as follows:

- 75% of the first S\$10 000; and
- 50% of the next S\$290 000 (Ministry of Finance Singapore 2009(c)).

4.3.3.4 *Research and development incentives*

A number of incentives are available to manufacturing companies that conduct research and development, in-house or outsourced to any research and development organisation, as part of their trade to improve their products or manufacturing processes. The Inland Revenue Authority of Singapore (2008:1) defines research as

"any systematic, investigative and experimental study that involves novelty or technical risk carried out in the field of science or technology with the object of acquiring new knowledge or using the results of the study for the

production or improvement of materials, devices, products, produce or processes”.

Research does not include quality control or routine testing of materials, devices, products or produce; research in social science or humanities; routine data collections; efficiency surveys or management studies; market research or sales promotion; routine or cosmetic modifications or changes to materials, processes or methods; or development of computer software that is not intended to be sold or distributed (IRAS 2008:1–2).

A tax deduction of 150% of qualifying research and development expenses is permitted for research and development conducted in Singapore. This incentive is available for the 2009 to 2015 years of assessment. Qualifying research and development expenditure includes staff costs, consumables or any other matter prescribed by the Minister (Singapore 1947:s 14DA; Bell 2009(b):[4]).

A double deduction may be claimed for research and development expenses incurred in-house or by a contracted third party organisation in respect of computer software, information industries, medical research and laboratory testing. In order to qualify for the double deduction, the research and development activities must be performed in Singapore (Singapore 1947:s 14E; SEDB 2009:[2]; Bell 2009(b):[4]).

Another research and development tax allowance is available to profitable companies in an effort to encourage them to commence research and development activities. Companies with chargeable income may claim this allowance during the 2009 and 2013 years of assessment. The amount is calculated as 50% of the first S\$300 000 of the company’s chargeable income, or such lower amount if the chargeable income is less than S\$300 000, for each year of assessment (IRAS 2008:30).

The research and development incentive for start-up enterprises permits a qualifying company to surrender its tax-adjusted losses in exchange for a cash grant of up to S\$20 250. This incentive supports start-up companies that incur extensive research and development expenses in developing a product in the first few years and consequently suffer losses. Companies like these, which have no chargeable income during the early period of trading, would evidently not benefit from tax allowances or tax relief (EnterpriseOne 2009(b)). This benefit is granted for each of the first three years of assessment which fall within the 2009 to 2013 years of assessment. In order to qualify for this incentive, start-up companies must comply with all of the following requirements:

- The company is incorporated in and is a tax resident of Singapore;
- Any of the first three years of assessment for the company falls between the 2009 to 2013 years of assessment;
- The company has not been liable for any tax payment;
- At least S\$150 000 qualifying expenditure has been incurred for in-house research and development during the period for which a claim is made; and
- Ongoing research and development activities are carried out at the time of the claim (PWC 2008:18).

Another scheme, the research grant for companies, provides a partial grant which compensates a company for investing in equipment, training and professional services in respect of research and development projects. The project must create new research and development competencies and bring about more employment and training of research professionals (SEDB 2009:[3]).

4.3.4 Summary

The 18 investment incentives discussed above, which were identified in this study as the incentives available to manufacturing companies in Singapore, are graphically illustrated in figure 4.8.

Figure 4.8: Investment incentives available to manufacturers in Singapore

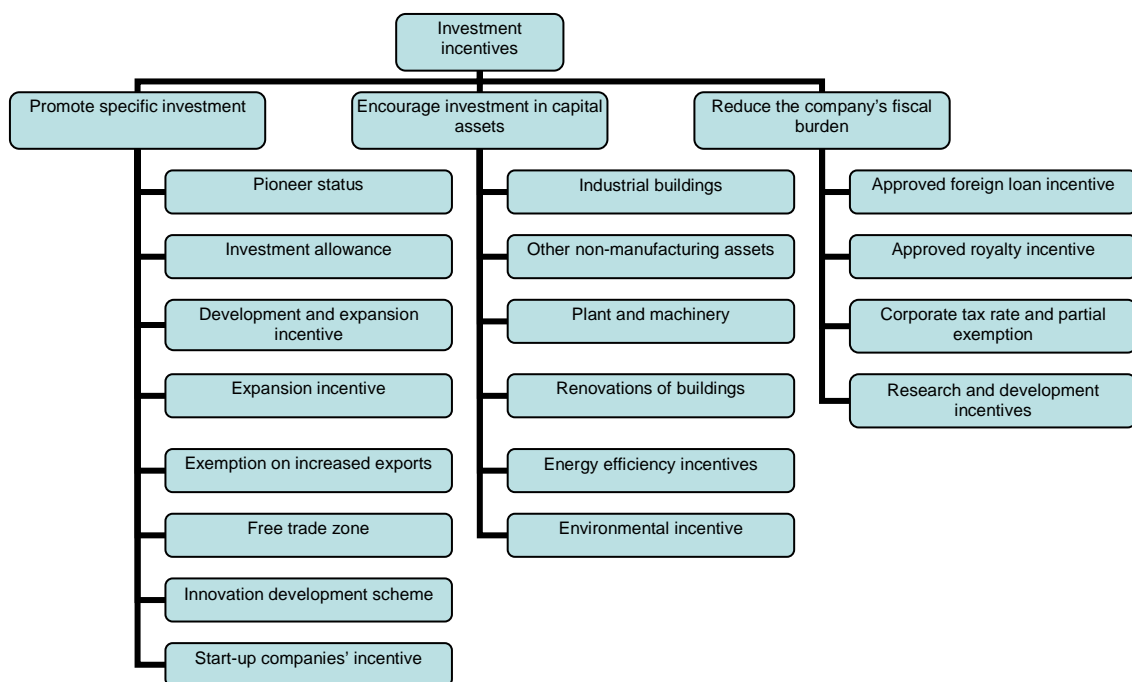


Figure 4.10 clearly shows that Singapore's investment incentives are more evenly distributed among the three incentive categories, than those of Malaysia. Although more incentives are initiated to promote specific investment, substantial assistance is also offered to encourage investment in capital assets and to reduce a company's fiscal burden. This might be an indication that advanced economies have a different approach to and objective for investment incentives.

It is evident that the type of incentives provided by Malaysia and Singapore are diverse. However, many similar incentives have also been initiated by both of these countries. It would be interesting to see how all of the investment incentives offered by Malaysia and Singapore compare with those offered by South Africa. The next chapter explores this in relation to all of the investment incentives discussed thus far.

4.4 CONCLUSION

This chapter explored the investment incentives offered to manufacturing companies in Malaysia and Singapore. These two countries were selected on the strength of the similarities between the performance of their manufacturing sectors and that of the South African manufacturing sector. The GDP income per capita of these countries was also taken into consideration for the selection process. The manufacturing sectors of Malaysia and Singapore are major contributors to their respective economies, both these countries are attractive locations for trade and investment and incentives have been a major contributing factor in attracting foreign direct investment to Singapore and Malaysia, resulting in the stimulation of economic development and export growth. A comparison between the investment incentives offered by South Africa, Malaysia and Singapore to manufacturers in these three countries could therefore be valuable in order to identify possible additional incentives that could be implemented by South Africa to assist manufacturers and to remain competitive for foreign direct investment in the manufacturing sector.

Malaysia has introduced 25 investment incentives to assist manufacturers. Most of these incentives focus on the promotion of specific investments, such as the production of certain promoted products, or on the development and expansion of manufacturing activities by means of reinvestment. Capital allowances on assets such as industrial buildings, manufacturing equipment and equipment for

power supply also form a significant part of all the incentives offered to manufacturers. Deductions are granted for specific expenses such as research and development and employee training as well.

Singapore offers 18 investment incentives to manufacturing companies. This country has a balanced approach between promoting specific investment and encouraging investment in capital assets and other specific activities. The production of certain products is specifically promoted, as in the case of Malaysia, and the increase, development and automation of manufacturing activities are encouraged by incentives such as the innovation development scheme and expansion incentive. Capital allowances on several assets such as manufacturing plant and environmental protection equipment are allowed. Singapore furthermore provides exemptions and deductions for specific expenses such as research and development and interest and royalty payments to non-residents.

The next chapter provides a comparison between the incentives offered by South Africa, Malaysia and Singapore, and a number of recommendations will be presented for new or revised investment incentives which the South African government could consider implementing.

CHAPTER 5

COMPARISON BETWEEN INVESTMENT INCENTIVES OFFERED BY SOUTH AFRICA, MALAYSIA AND SINGAPORE

5.1 INTRODUCTION

In chapters 3 and 4 of this study, the investment incentives offered to the manufacturing industry by the governments of South Africa, Malaysia and Singapore respectively, were discussed. Although each incentive is unique and designed for a specific objective, it is evident that there are some common features among these incentives. However, some incentives have been introduced by only one or two of the countries under investigation and not the other(s). The exact similarities and differences in the incentive designs would be revealed by means of comparing these investment incentives.

Prescott (1991:17) cautions that a comparison between countries in respect of the particular features of their tax system should be done circumspectly. The tax systems of countries usually differ vastly and it may not be possible to compare specific features without taking into account the general system of which they are part. For example, the different rules governing the deductibility of costs and the corporate tax rates that vary from one country to the next, may affect the value of any deduction against chargeable income and the resulting benefit of an incentive. However, valuable information, as discussed later in this chapter, may nevertheless be gained from a comparison between only the investment incentives applicable to the manufacturing industry offered by South Africa, Malaysia and Singapore, without taking into account their tax systems.

This chapter compares and discusses the similarities and differences between the investment incentives offered by South Africa and those offered by Malaysia and Singapore. Table 5.1 lists the incentives of all three countries discussed in

this study, according to the three categories used thus far, for comparative purposes. This indicates similar incentives offered by more than one country, as well as unusual incentives offered by only one country. The table does not include investment incentives that were previously offered by South Africa, but subsequently withdrawn. In some instances, more than one incentive offered by a country relates to the same type of investment activity or purpose. These incentives were, therefore, grouped together in the table, resulting in fewer listed incentives in table 5.1 compared with those listed in the final summary of the separate sections pertaining to each country (par 3.5, par 4.2.4 and par 4.3.4). The classification of the comparison indication disclosed in the last column of table 5.1 (class) is explained as follows:

A = Incentives offered by one country only

B = Incentives offered by South Africa and one of the two selected countries only

C = Incentives offered by South Africa, Malaysia and Singapore

D = Incentives offered by Malaysia and Singapore only

Table 5.1: Comparison of manufacturing investment incentives offered by South Africa, Malaysia and Singapore

SOUTH AFRICA	MALAYSIA	SINGAPORE	CLASS
INVESTMENT INCENTIVES THAT PROMOTE SPECIFIC INVESTMENTS			
Strategic projects Par 3.2.4	Strategic projects Par 4.2.1.6, par 4.2.1.13	-	B
Industrial Development Zones Par 3.2.3	Industrial Development Zones Par 4.2.1.4	Industrial Development Zones Par 4.3.1.6	C
-	Tax exemption on increased exports Par 4.2.1.15	Tax exemption on increased exports Par 4.3.1.5	D
Relocation of manufacturing activities Par 3.2.2	Relocation of manufacturing activities Par 4.2.1.10	-	B
Automotive Production and Development Par 3.2.5	Automotive Production and Development: Par 4.2.1.8	-	B
Enterprise Investment Programme Par 3.2.6 (new)	-	-	A
Support Programme for Industrial Innovation: Par 3.2.7	Support Programme for Industrial Innovation: Par 4.2.1.5	Support Programme for Industrial Innovation: Par 4.3.1.7	C
-	Tax holiday – pioneer status Par 4.2.1.1	Tax holiday – pioneer status Par 4.3.1.1	D
-	Investment tax allowance Par 4.2.1.2	Investment tax allowance Par 4.3.1.2	D
Reinvestment and development incentive: Par 3.2.6 (expand)	Reinvestment and development incentive: Par 4.2.1.3	Reinvestment and development incentive: Par 4.3.1.3, par 4.3.1.4	C
-	Industrial linkage programme Par 4.2.1.7	-	A
-	Production of specialised machinery and equipment: Par 4.2.1.9	-	A
-	Resource based industries' incentive Par 4.2.1.11	-	A
Small-scale companies' incentive Par 3.3.6	Small-scale companies' incentive Par 4.2.1.12	-	B
-	-	Start-up companies' incentive Par 4.3.1.8	A
INVESTMENT INCENTIVES THAT ENCOURAGE INVESTMENT IN CAPITAL ASSETS			
Non-manufacturing assets: wear-and-tear allowance: Par 3.3.2	Non-manufacturing assets: wear-and-tear allowance: Par 4.2.2.2, par 4.2.2.4	Non-manufacturing assets: wear-and-tear allowance: Par 4.3.2.2	C
Movable assets: production of renewable energy: Par 3.3.3	Movable assets: production of renewable energy: Par 4.2.2.7	-	B
Plant and machinery used by manufacturers: Par 3.3.4	Plant and machinery used by manufacturers: Par 4.2.2.3	Plant and machinery used by manufacturers: Par 4.3.2.3	C
Rail transport: rolling stock Par 3.3.5	-	-	A
Industrial buildings and improvements Par 3.3.7	Industrial buildings and improvements Par 4.2.2.1	Industrial buildings and improvements: Par 4.3.2.1	C
Environmental expenditure Par 3.3.9	Environmental expenditure Par 4.2.2.6	Environmental expenditure Par 4.3.2.5, par 4.3.2.6	C
Renovation of business premises and infrastructure: Par 3.3.8	Renovation of business premises and infrastructure: Par 4.2.2.5, par 4.2.2.8	Renovation of business premises and infrastructure: Par 4.3.2.4	C
INVESTMENT INCENTIVES THAT REDUCE THE COMPANY'S FISCAL BURDEN			
Research and development Par 3.4.2	Research and development Par 4.2.3.2	Research and development Par 4.3.3.4	C
Learnership agreements and training expenses: Par 3.4.3	Learnership agreements and training expenses: Par 4.2.3.3	-	B
Preferential tax rates Par 3.4.4	Preferential tax rates Par 4.2.3.1	Preferential tax rates Par 4.3.3.3	C
-	-	Approved foreign loan incentive Par 4.3.3.1	A
-	-	Approved royalty incentive Par 4.3.3.2	A

Table 5.1 shows that South Africa and Singapore offer 18 and 16 types of investment incentives, respectively, to manufacturing companies, whereas Malaysia offers a total of 22 types of investment incentives. Of the three countries, Malaysia appears to have adopted the most aggressive attitude towards incentives. The total number of incentives per category above indicates that Malaysia's approach to investment incentives is mainly focused on promoting specific investment and capital spending, while Singapore also focuses on encouraging specific investment, capital spending and other preferred activities. Similar to Malaysia, South Africa's focus is jointly on promoting specific investment and encouraging expenditure on capital assets, but South Africa offers fewer incentives than Malaysia.

The reason for the difference in Singapore's approach to incentives, compared to those of Malaysia and South Africa, could be the fact that Singapore has an advanced economy as opposed to Malaysia and South Africa, which are both emerging and developing economies (refer par 1.7.2). This could indicate that it is not essential for advanced economies to focus significantly on promoting capital expenditure or developing specific areas or industries, but instead, to offer grants, exemptions or tax-deductible expenses in order to encourage a specific desired activity such as exports (par 4.3.1.5 & 4.3.1.6), foreign direct investment (par 4.3.3.1 & par 4.3.3.2) or research and development (par 4.3.3.4). By contrast, developing countries such as South Africa and Malaysia may still need to develop and expand certain industries and the capital investment thereof, resulting in a different approach to incentives.

The comparison in table 5.1 indicates that each one of the three countries offers incentives which have not been initiated by any of the other countries involved in this study (classification A). In this regard, South Africa has introduced two incentives and Malaysia and Singapore have each initiated three incentives, which will be discussed first in this chapter (par 5.2–5.4). Furthermore, there are

six incentives which are offered by both South Africa and Malaysia (classification B), while South Africa, Malaysia and Singapore have initiated ten incentives that are similar between the three countries (classification C). The next section of this chapter will focus on the comparison between these incentives that the selected countries have in common (par 5.5 & par 5.6), followed by a discussion (in par 5.7) of another three incentives that are offered by both Malaysia and Singapore, but not by South Africa (classification D).

5.2 INCENTIVES OFFERED BY SOUTH AFRICA ONLY

A closer look at the individual investment incentives listed in table 5.1 reveals that South Africa has introduced two incentives that are not offered by either of the other two countries.

5.2.1 Enterprise Investment Programme

The Enterprise Investment Programme encourages new and increased investment in the manufacturing sector by providing a grant that is linked to the total capital investment cost (par 3.2.6). The part of this incentive that relates to increased investment to expand existing manufacturing activities is discussed later in paragraph 5.6.1.3, as Malaysia and Singapore also have a similar incentive. These two countries do not, however, offer an incentive to encourage *new* manufacturing activities in *general*. Most of the incentives aimed at the manufacturing sectors of Malaysia and Singapore focus exclusively on manufacturing activities relating to specific products or regions (paragraphs 4.2.1.1, 4.2.1.2, 4.3.1.1 & 4.3.1.2). South Africa's Enterprise Investment Programme incentive is therefore unique, compared with the incentive in the other two countries, as all new manufacturing companies benefit from the incentive offered to them. The reason why an incentive like this has been introduced by South Africa only, could be that the South African government

recognises that investment by all manufacturers, existing and new, will make a vital contribution to the growth of the economy (National Treasury 2008:5).

5.2.2 Rolling stock

The other incentive offered only by South Africa, and not by Malaysia or Singapore, is a capital allowance granted on rolling stock for rail transport (par 3.3.5). This incentive is probably particularly relevant to South Africa due to the fact that the use of rail transport is encouraged as the preferred means of transporting goods in order to make use of cost-effective infrastructure in South Africa, as explained in paragraph 3.3.5.

5.3 INCENTIVES OFFERED BY MALAYSIA ONLY

According to table 5.1, Malaysia offers three incentives to manufacturing companies which are not available to manufacturers in Singapore or South Africa.

5.3.1 Industrial Linkage Programme

The Industrial Linkage Programme provides an incentive to vendors who manufacture their own goods in an industrial linkages programme, if these goods are classified as promoted products, such as plastic products, iron and steel, machinery, machinery components and electronic products. The benefit enjoyed by these manufacturers is a 100% tax exemption for five years or an investment tax allowance of 60%. (par 4.2.1.7).

5.3.2 Specialised machinery and equipment

Another unique Malaysian incentive is offered to new manufacturers of specialised machinery and equipment, such as plastic injection and extrusion

machinery, robotics, factory automation equipment and machinery for specific industries. These companies may qualify for a 100% tax exemption for ten years or a 100% investment tax allowance. A reduced benefit is offered to existing locally owned companies that expand or automate their existing activities in the manufacturing of specialised machinery and equipment (par 4.2.1.9). The technology involved in the manufacturing of specialised machinery and equipment should be advanced, which is in line with the country's goal of technological development (par 4.2).

5.3.3 Resource-based incentive

A resource-based incentive is offered when local companies incur capital expenditure for the expansion of their activities in the manufacturing of rubber, oil palm and wood-based products that are of export potential. These products are some of Malaysia's natural resources which the country uses extensively for manufacturing purposes. The incentive provides a tax exemption of 70% for five years or an investment tax allowance of 60% (par 4.2 & par 4.2.1.11).

All three of the above incentives encourage manufacturers to produce or use specific items. The focus is either on promoted products, such as iron and steel, specialised machinery, such as robotics, or natural resources, such as rubber. In chapter 3 of this study, the discussion of incentives offered to South African manufacturers revealed that South Africa has been focusing specifically on the manufacturing of automotive products (par. 3.2.5). No other South African incentives relating to the use of other products or resources were identified. Therefore, the South African government could consider introducing some or all of the three incentives discussed above when the need arises to increase the production of specific products or the use of specific natural resources.

The benefit offered by each of the incentives initiated by Malaysia only is either a partial or full tax exemption or an investment tax allowance on the capital expenditure. The tax exemption of profits, otherwise known as a tax holiday, is not currently offered in South Africa, although this incentive was in fact introduced in the country in earlier years in an effort to promote investment in the manufacturing sector (par 3.2.8.2). If South Africa would consider following the example of Malaysia in providing a tax holiday to manufacturing companies, then the possible impact of such an incentive should be examined first. Wells, Allen, Morisset and Pirnia (2001:41-43 & 45) argue that, although tax holidays are useful in signalling a welcoming attitude of the country towards local and foreign investment and are generally introduced to enable the country to remain competitive with neighbouring countries, this type of incentive is extremely costly and not that effective in influencing the decisions of foreign investors.

An incentive like this would not be sufficient to convince an investor to invest in a country with many negative factors, such as an unstable government system and extensive investment requirements. Furthermore, only profitable companies can benefit from a tax holiday, and no assistance would thus be available to start-up companies. A tax holiday is also no solution to a high corporate tax rate, because investors realise that they would be subject to the excessive corporate tax rate once the tax holiday period has expired (Wells *et al* 2001:45). Therefore, as far as South African circumstances are concerned, the deduction of a tax allowance on the capital expenditure is proposed instead of a tax holiday. In an effort to motivate manufacturers to engage in manufacturing of the specified product or resource or to expand existing manufacturing activities in this field, a significant deduction over a short period would be preferable.

5.4 INCENTIVES OFFERED BY SINGAPORE ONLY

Table 5.1 indicates that Singapore has introduced three manufacturing incentives that are not offered by Malaysia or South Africa.

5.4.1 Start-up companies

The first incentive aims to assist start-up companies by offering a tax exemption on part of their chargeable income for the first three years, resulting in a reduced tax liability. This enables these new companies to accumulate their cash flow and profits in the first few years in order to become more profitable (par 4.3.1.8). South Africa offered a similar incentive in previous years, but it was withdrawn, due to the introduction of other incentive measures. Small business corporations in South Africa could claim a double deduction, limited to R20 000, of expenditure and losses actually incurred by them in the tax year in which they commenced trading. This would result in a decrease in the taxable income and consequently a lower tax liability (par 3.2.8.1).

It is clear that South Africa is aware of and has explored the use of an incentive like the one currently offered by Singapore to start-up companies, although South Africa only applied this incentive to small business corporations. This incentive could be reintroduced in an effort to encourage new manufacturing companies to commence business. As discussed in paragraph 5.3.3, a tax exemption or tax holiday would probably not be a feasible option, but a double deduction of certain expenses or losses, as previously offered by South Africa, could be of assistance South African start-up companies.

5.4.2 Royalties and interest payments to non-residents

The last two incentives initiated by Singapore only are offered to companies in Singapore that incur expenses payable to non-residents. The one incentive is applicable to a manufacturing company that pays interest on a loan obtained from its non-resident holding company situated in another country. The Singaporean company is eligible for full or partial exemption on withholding tax relating to these interest payments. The loan amounting to more than S\$200 000 must be used to purchase productive equipment only (par 4.3.3.1). The other incentive grants full or partial exemption on withholding tax for royalties or technical assistance fees payable to non-residents. The payment of these expenses enables manufacturing companies in Singapore to transfer high-level technology and knowledge from their overseas parent company to Singapore at a lower cost (par 4.3.3.2).

The purpose of these two incentives seems to be to encourage foreign direct investment and the transfer of foreign technology and know-how by assisting local companies to reduce their cost of business in Singapore. South Africa intends to increase foreign direct investment and obtain foreign expertise (par 1.4.2), and incentives like these could be extremely effective in realising this objective. It is therefore proposed that the South African government should consider introducing an incentive that offers exemption of withholding tax on interest and royalties or technical assistance fees payable to non-residents.

5.5 INCENTIVES OFFERED BY SOUTH AFRICA AND ONE OF THE TWO SELECTED COUNTRIES ONLY

According to table 5.1, there are six incentives which are offered both by South Africa and Malaysia, and not by Singapore. These incentives are probably more relevant to emerging and developing economies, such as South Africa and

Malaysia. There are no incentives in common between only South Africa and Singapore. The reason for this could again be that Singapore is an advanced economy, whereas South Africa is an emerging and developing economy. This could be indicative of different investment approaches or strategies, together with the fact that these two countries are not located in the same geographical area, which may have necessitated certain common incentives, as in the case with Malaysia and Singapore.

A comparison between the incentives offered by both South Africa and Malaysia reveals that, although the objectives of the incentives they have in common might be the same, the benefits of these incentives to the manufacturer differ in most instances. The table in annexure A summarises the incentive benefits offered by each country. Each benefit is concisely explained in order to disclose it in table format. The explanation of abbreviations or shorter terms used is listed at the end of the table. The following discussion of the comparison between these incentives considers only the benefit offered to the manufacturer, and does not examine any other requirements that need to be met in order to make use of these incentives or limitations that apply.

5.5.1 Investment incentives that promote specific investment

5.5.1.1 Strategic projects

Both South Africa and Malaysia provide an incentive for strategic projects relating to an intensive investment in particular industries that could have a significant impact on the economy of the country. A South African manufacturing company may claim an additional allowance of 35% or 55% of the cost of manufacturing assets, depending on the qualifying status of the project. Malaysia provides full tax exemption for five years to a strategic project with pioneer status, or an investment tax allowance of 100% on the capital

expenditure incurred within a period of five years. Furthermore, Malaysia provides an allowance of 60% to 100% of capital expenditure, depending on the activity undertaken, to manufacturing companies undertaking an industrial adjustment programme in specific industries in order to *increase* its productivity and enhance effective utilisation of natural resources.

Although Malaysia seems to offer greater incentives to manufacturers for strategic projects, it should be noted that South Africa does provide a significant deduction rate for capital expenses, which is in addition to the existing income tax deduction for manufacturing plant and machinery. If the higher of the two allowance rates in respect of strategic projects, namely 55%, is added to the allowance rate of new plant and machinery in the year of acquisition, namely 40% (refer par 3.3.4), a deduction of just below 100% is permitted. This allowance rate is almost the same as that offered by Malaysia.

5.5.1.2 Relocation of manufacturing activities

Although both South Africa and Malaysia offer an incentive to relocate manufacturing activities to a specific location, the objective and design of these incentives are different. South Africa provides a grant of 15% of the transportation costs incurred to relocate new plant and machinery into the country from abroad, whereas Malaysia provides an income tax exemption for five years or an investment tax allowance of 100% for five years to existing local manufacturing companies that transfer their business to promoted areas in the country.

It is clear that South Africa's objective is to encourage foreign investment into the country's manufacturing industry, while Malaysia's aim is to increase local investment in specific regions in the country. This could explain why the design of the incentives is different. Should a situation arise in South Africa where

increased investment in manufacturing activities in a specific region of the country is required, government could explore granting an additional allowance on capital investment in order to provide a tax benefit to a manufacturer for relocating its existing business.

5.5.1.3 The automotive industry

South Africa has an extensive incentive programme for the automotive industry, which entails the following benefits: import duty reduced to 25%, no import duty on 20% of components used for local assembly, an import duty credit of 55% based on production value added and a grant of 20% of productive assets. Malaysia grants a 100% tax exemption for five years or a 60% investment tax allowance for five years to companies that manufacture automotive components.

South Africa has a far more intricate design for this incentive than Malaysia, which is apparent from the four types of benefits offered to South African manufacturers. The focus of South Africa's incentive falls mainly on reducing or exempting import duty, whereas Malaysia's incentive does not refer to this. Furthermore, South Africa provides a cash grant, whereas Malaysia offers a tax exemption or tax deduction. South Africa's automotive incentive was recently reviewed and reinvented (refer par 3.2.5), and the South African government appears to have invested significant consideration into this incentive programme in an effort to encourage increased industry investment in South Africa. For this reason, it is not proposed that the government consider any immediate adjustment to the South African incentive.

5.5.1.4 Small business corporations

Small business corporations in South Africa may deduct the full purchase cost of manufacturing machinery in the year of acquisition. An allowance of 50% in

year 1, 30% in year 2 and 20% in year 3 may be claimed in respect of other capital assets. Malaysia offers a tax exemption for five years or an investment tax allowance of 60% for five years to small-scale companies. Furthermore, an accelerated capital allowance of 100% may be claimed by these companies when they reinvest in plant and machinery during the 2009 and 2010 years of assessment.

Although the designs of these incentives offered by the two countries are different, the benefits of South Africa's incentives for small business corporations appear to be comparable to those provided by Malaysia. Due to the fact that South Africa allows a full deduction of the cost of manufacturing assets, there would be no reason to consider initiating an accelerated allowance, as Malaysia did.

5.5.1.5 Summary

The above comparison reveals that the incentives offered by South Africa and Malaysia with respect to strategic projects and small-scale companies are similar. It was acknowledged that South Africa could make use of the incentive relating to the local relocation of manufacturing activities, should the need arise in the future to expand a certain regional location in the country. Due to the fact that the South African incentive for the automotive industry has been recently revised, no amendment to this new incentive is proposed.

5.5.2 Investment incentives that encourage investment in capital assets

5.5.2.1 Renewable resources to generate energy

Both South Africa and Malaysia allow a deduction for capital costs incurred in respect of renewable resources to generate energy. South African companies that manufacture or generate renewable energy sources may claim the capital

costs incurred over three years, namely 50% in year 1, 30% in year 2 and 20% in year 3. A Malaysian company that makes use of renewable resources to generate energy for its manufacturing activities may claim a 100% investment tax allowance every year for five years in respect of the costs incurred in acquiring generating equipment.

Evidently Malaysia appears to be providing a more beneficial investment incentive than South Africa. However, due to the fact that half of the capital costs incurred by a South African company may be claimed in the year of acquisition, a significant deduction is allowed initially. The remaining amount is then deductible over the next two years, which is not an extensive period.

5.5.2.2 Summary

The comparison between the capital allowances that only South Africa and Malaysia have in common shows that the benefit of the allowance that Malaysian companies can claim is greater than the benefit of the allowance that South African companies can claim. The reason for this is that although the full amount of capital expenditure is deductible by manufacturing companies in both countries, South African companies are only allowed to claim the capital cost over a longer period. If the need arises in the future to promote the production of renewable energy in South Africa even more, an accelerated allowance of 100% could be considered.

5.5.3 Investment incentives that reduce the company's fiscal burden

5.5.3.1 Employee training

Both South Africa and Malaysia provide an incentive to train employees under an approved training programme by approved training institutions. South Africa

offers a deduction of R30 000 or R50 000, depending on whether or not the employee is disabled, for every year that the employee is part of a learnership agreement, as well as when the learnership agreement is completed. All of these deductions are claimed in addition to the deduction for actual training expenses. A Malaysian company with fewer than 50 employees may claim a double deduction of training expenditure incurred under an approved training programme.

5.5.3.2 Summary

The granting of a double deduction of training expenditure by the Malaysian government seems generous. However, the South African government allows additional deductions to the single deduction of training expenses. These two incentives could therefore provide more or less the same benefit to companies in South Africa and Malaysia, depending on the amount of training expenses incurred by them. Unless it is found that significant training expenses are incurred by South African companies, no recommendation is made about revising the learnership agreement incentive offered by South Africa.

5.6 INCENTIVES OFFERED BY SOUTH AFRICA, MALAYSIA AND SINGAPORE

All three countries involved in this comparison offer several similar investment incentives to manufacturing companies. Figure 5.1 shows that South Africa, Malaysia and Singapore have a total of ten investment incentives in common, which would indicate that South Africa is at the same level as Malaysia and Singapore in terms of these deductions and allowances. On closer inspection, however, it is clear that the deduction amount, allowance rate or other assistance offered by these three countries per investment incentive varies in most instances, which would have an impact on the benefit a manufacturing company would receive. The table in annexure B summarises the incentive

benefits offered by each country. Each benefit is concisely disclosed in table format. The explanation of abbreviations or shorter terms used is listed at the end of the table.

The similarities and differences between these incentive benefits are discussed briefly in order to compare the investment incentives offered by South Africa with those offered by Malaysia and Singapore. The discussion below only takes into account the assistance provided to a manufacturing company, and does not consider any other requirements that need to be met in order to utilise these incentives or any limitations that apply.

5.6.1 Investment incentives that promote specific investment

5.6.1.1 Industrial development zones (IDZs)

South Africa, Malaysia and Singapore have IDZs where manufacturers may import raw material, machinery and assets free of customs duty. In South Africa, there is also no value added tax is charged on imported goods and in Singapore, imported goods are also free of goods and services tax. The import incentives of all three countries by means of an IDZ are very similar and it would thus appear that there is no need for South Africa to enhance its incentive design.

5.6.1.2 Industrial innovation

Incentives are provided to companies in South Africa, Malaysia and Singapore to encourage the use of new and emerging technologies to develop innovative and competitive products or processes (industrial innovation). In South Africa, a grant of 50 to 85% of the development costs incurred in such a project is offered to manufacturing companies. In Malaysia, a company involved in the production of promoted products with emerging technologies, such as computers, may

enjoy a 100% income tax exemption for five years, if it has pioneer status. Alternatively, a company like this may claim an investment tax allowance of 60% on capital expenditure for five years. In Singapore, innovation is encouraged by means of a grant in the form of co-funding of capital expenditure incurred by the manufacturing company, based on the level of support needed.

South Africa and Singapore are similar in that they provide the same type of incentive, namely a cash grant, to increase any manufacturing industry's innovation capacity. Malaysia, however, prefers to offer tax exemption or a generous tax deduction, but these benefits are applicable to certain manufacturing companies only. It is interesting to note that South Africa measures up to an advanced economy, namely that of Singapore, with regard to this specific incentive, as it provides a cash benefit, which immediately provides assistance to the manufacturer, instead of allowing a tax deduction. As mentioned in chapter 2, a company would benefit more from a generous grant than from a generous tax deduction, or even a tax exemption for a limited period. Furthermore, South Africa's investment incentive is offered to any company that introduces new and emerging technologies to its manufacturing activities, whereas Malaysia's incentive is limited to companies that manufacture certain promoted products. It is therefore concluded that the investment incentive offered by South Africa is in line with those offered by Malaysia and Singapore, and no further recommendations are made about amending this incentive.

5.6.1.3 Reinvestment allowance

In order to expand the manufacturing industry and encourage local and foreign investment, the South African government offers a grant of 15% to 30% of capital investment costs incurred with respect to establishing new operations or expanding existing ones. This grant is payable over a period of up to three

years. A Malaysian company that incurs capital costs to expand or automate its existing manufacturing activities may claim a 60% reinvestment allowance for a period of 15 years. Companies in Singapore that expand their production capacity after their pioneer status has expired, enjoy the benefit of a reduced corporate tax rate of 5% on profits above a predetermined base for a further ten years. Another incentive offered by Singapore to manufacturing companies that invest more than S\$10 million in equipment and machinery to increase productivity, is the tax exemption of increased profits, after the expansion, for a period of up to ten years.

The incentives offered by all three countries to encourage the development of the manufacturing industry differ vastly. South Africa provides a cash grant over three years, Malaysia permits the deduction of a tax allowance for 15 years and Singapore provides a lower tax rate or tax exemption of certain profits for ten years. As with the incentive discussed in the previous paragraph, South Africa again prefers to provide a cash grant to reimburse capital expenditure incurred by a manufacturing company. Although a cash benefit would be more effective to encourage new manufacturers, in particular, to incur this type of investment cost (as discussed in chapter 2), there is clearly some scope for South Africa to explore the possibility of providing different or additional types of incentives to achieve its aim of expanding the manufacturing industry.

One of the above investment incentives offered by Singapore could play a valuable role specifically in expanding existing manufacturing activities and could also be of great value to the manufacturer. This incentive provides income tax exemption of *increased* profits that occur as a result of the expansion of manufacturing activities. An incentive like this could ensure that the capital investment would actually increase the productivity and profitability of the manufacturing industry, owing to the fact that the benefit to the manufacturer is directly linked to performance.

However, there would be an additional administrative burden to determine the amount of increased profits, and the South African government would initially also not receive any tax revenue from the increased profits. The impact of these negative factors could be reduced by the fact that the country's economy would benefit from the growth in the manufacturing sector (Thirlwall 2002:40) and that the tax revenue would increase after the exemption period had elapsed. If the South African government is determined to expand the manufacturing industry, it is recommended that a new investment incentive be considered which would allow the tax exemption of increased profits resulting from increased capital investment.

5.6.1.4 Summary

The comparison between the investment incentives of South Africa, Malaysia and Singapore which promote specific investment reveals that all three countries have similar incentives for IDZs. It is also concluded that South Africa's incentives for the innovation of products and processes provide generous benefits to the manufacturer, although they differ from the incentives offered by Malaysia and Singapore. A comparison of the three countries' investment incentives for reinvestment and expansion revealed that, although each country has a different incentive design, South Africa offers investment incentive benefits that are in line with those offered by Malaysia and Singapore. An interesting incentive offered by Singapore was identified, namely the reinvestment allowance that promotes increased profits from the expansion of manufacturing activities. The introduction of a similar incentive in South Africa could expand the country's manufacturing sector. It is thus suggested that the South African government should consider introducing a new investment incentive that would allow the tax exemption of increased profits resulting from increased capital investment.

5.6.2 Investment incentives that encourage investment in capital assets

5.6.2.1 Non-manufacturing assets

Wear-and-tear allowances on various non-manufacturing assets, such as furniture and equipment, are deductible by manufacturing companies in South Africa, Malaysia and Singapore. The rate of deduction offered by all three countries depends on the type of asset. A generator was selected for comparison, as this asset would be significant in ensuring continued manufacturing operation in the event of power failures. South African companies may claim 6.67% on the acquisition cost of a generator over 15 years, whereas a company in Malaysia may claim 20% in the year of acquisition and 80% in the following year, and a company in Singapore may claim the full cost in the year of acquisition.

It is clear that South Africa is not that generous with its deductions for generators, as only a small portion of the acquisition cost is claimable every year. Companies in Malaysia and Singapore have a greater incentive to purchase this type of asset, due to the fact that the cost is deductible within two years or less. It is obvious that continued manufacturing operations are necessary for the industry to be profitable. For this reason, and in the light of the possible lack of electricity supply by the South African Electricity Supply Commission (ESCOM) (South Africa Government Online 2008; Department of Minerals and Energy 2010), it is proposed that the South African government increase the wear-and-tear allowance rate for generators. If Malaysia, another developing country, is taken as an example, it is suggested that the acquisition cost of generators be deductible over two years, with any percentage allocated to each year.

5.6.2.2 Manufacturing plant and machinery

South Africa offers an allowance on manufacturing plant and machinery of 40% in the year of acquisition and 20% over the next three years. Malaysia offers a 20% allowance over five years for heavy machinery and vehicles, but the allowance on plant and equipment is claimed at 34% in year 1 and 14% in the following four years. An initial allowance of 20% may be claimed on plant and machinery acquired in Singapore, and the remaining cost is claimed over the working life of the asset, ranging from five to 16 years. This comparison highlights the fact that South African companies are allowed to claim the cost of manufacturing plant and machinery over a shorter period than the other two countries.

An *accelerated* allowance on manufacturing plant and machinery acquired between or after certain dates is also available to manufacturing companies in Malaysia and Singapore. This results in the cost of the asset being deducted over a shorter period than the period discussed in the previous paragraph. A company in Malaysia is allowed a 50% deduction over two years when manufacturing plant and machinery are acquired between 10 March 2009 and 31 December 2010, whereas a 75% deduction is allowed in year 1 and 25% in year 2 on manufacturing plant and machinery acquired in Singapore during the 2010 and 2011 years of assessment.

Another accelerated allowance granted by Singapore, which is still in operation, relates to the costs incurred for plant and machinery acquired before 2009, which may be claimed at a rate of 33.3% over three years. Malaysia further permits the deduction of capital expenditure incurred to automate or modernise existing manufacturing activities after the expiry of a 15-year investment tax allowance. This deduction is claimed over three years, with a 60% allowance in year 1 and 20% allowance in the following two years.

The accelerated allowance on new plant and machinery offered by both Malaysia and Singapore thus permits manufacturing companies to claim the cost over a period of two to three years. These accelerated allowances appear to be more beneficial than the allowance offered by South Africa, which is claimable over four years. Manufacturers in Malaysia and Singapore would be more inclined to acquire new plant and machinery during the specified dates than a manufacturer in South Africa. However, it should be noted that South Africa has been offering its accelerated allowance over a longer period, and manufacturers are encouraged to purchase new plant and machinery at any given time and not only within a time frame of two years. This would probably persuade South African manufacturers to invest in new plant and machinery more often, which could result in a more productive manufacturing industry. No further recommendations are thus offered in order to enhance this incentive.

5.6.2.3 Industrial buildings

The cost incurred in South Africa in respect of purchasing and improving industrial buildings, as well as commercial buildings such as warehouses or offices, may be claimed over 20 years at a rate of 5%. In Malaysia, these industrial buildings are claimed at 13% in year 1 and 3% in the following 29 years, while warehouse buildings used for export purposes are claimed at 10% in year 1 and 3% in the following 30 years. In Singapore, the cost of industrial buildings is claimed by means of an initial allowance of 25% and an annual allowance of 3% before 22 February 2010 and 5% thereafter. It is clear that South Africa is the only country that does not offer an increased allowance rate in the year of acquisition, although the country's annual rate is higher than that of Malaysia and Singapore.

An increased deduction in the year of acquisition may rather encourage a manufacturing company to invest in industrial buildings and improvements than

a higher annual rate, due to the fact that the immediate benefit of a tax deduction of a greater portion of the capital expenditure compensates for the large initial capital outlay (deposit and transfer duty) in the year of acquisition. In this way the capital expenditure and the major benefit of the investment incentive are linked to each other in the same year of assessment. It is thus proposed that the design of the South African industrial buildings and improvements investment incentive be revised in order to allow a significant initial allowance in the year of acquisition, together with an annual allowance thereafter. If the example of Malaysia, another developing country, is followed, then an initial allowance of between 10% and 15% should be sufficient. Accordingly, the annual allowance could be reduced from 5% to 3%.

5.6.2.4 Environmental assets

A South African manufacturer may claim an allowance of 40% in year 1 and 20% in the following three years, in respect of the expenses incurred to install environmental treatment and recycling assets. Environmental assets used for waste disposal are deductible at 5% over 20 years. Furthermore, the South African government allows the full deduction of expenses incurred for the remediation and restoration of an area used by a manufacturer in performing its activities. Expenses incurred by a Malaysian company to set up environmental protection equipment to treat, recycle and dispose of the waste generated by its manufacturing activities are deducted over three years, with a 60% allowance in the first year and 20% allowance in the following two years. The government of Singapore provides funding of up to 80% of the costs incurred to acquire and install waste sorting and recycling infrastructure, as well as the costs incurred to design waste-reducing methods for manufacturing activities. Funding of up to 50% of the costs is also available to conduct an audit for energy-saving methods. Singapore also allows a 100% deduction of the costs incurred to

acquire energy-efficient equipment. It is clear that the environmental protection incentives offered by these three countries are very different.

South Africa's allowances are claimed over a longer period than those of Malaysia, but South Africa allows a remediation and restoration deduction as well, which Malaysia and Singapore do not offer. Singapore has a different approach to South Africa and Malaysia, as it allows a generous deduction for energy-saving equipment and provides a cash incentive which would immediately reimburse some or most of the capital cost incurred by a manufacturer with regard to energy saving and waste reduction. Although Malaysia and Singapore appear to offer greater assistance to the manufacturer than South Africa, it is difficult to compare the environmental incentives provided by these three countries, as the design of each incentive is unique.

It is clear that the design of the current South African environmental incentives was carefully considered, as three different types of environmental expenditure are deductible. In the future, the South African government could consider Singapore's investment incentives relating to environmental protection should the need arise to encourage this type of expenditure even more. However, no recommendations are made at this time to adjust these investment incentives currently offered by South Africa.

5.6.2.5 Refurbishment or renovation of buildings

Expenses relating to the *refurbishment* or *renovation* of a commercial building situated in a specified area in South Africa are deductible over five years at a rate of 20% per annum. The *construction* costs of a new commercial or residential building within these specified areas may qualify for a 20% allowance in year 1 and 8% in the following 10 years. Malaysian companies may claim expenses incurred between 10 March 2009 and 31 December 2010

for the renovation and refurbishment of business premises over two years, with a 50% allowance in each year. Furthermore, capital expenditure incurred on infrastructure located in a specific area may be deducted in full. Renovation expenses incurred by a company in Singapore between 16 February 2008 and 15 February 2013 may be deducted over three years at a rate of 33.3% per annum, while expenses incurred in the 2010 and 2011 years of assessment may be deducted in one year.

All three countries offer a capital allowance for the acquisition or renovation of commercial business premises, although the rates offered by Malaysia and Singapore are more generous than those provided by South Africa. Both South Africa and Malaysia also offer a capital allowance in respect of the construction of commercial buildings and infrastructure in a specified area, and again it is evident that the rate provided by Malaysia is much higher than that of South Africa. However, due to the fact that commercial buildings and buildings in designated zones are not expected to form a significant part of a manufacturer's activities or expenses, no recommendations are currently made to increase the deduction rates allowed by South Africa.

5.6.2.6 Summary

The comparison between the capital allowance incentives offered by all three countries under review shows that South Africa's incentives for plant and machinery, environmental expenditure and the renovation of business premises offer manufacturers substantial benefits, although they are mostly different from those offered by Malaysia and Singapore. No recommendations are thus made about changing the investment design of these incentives. However, it is proposed that South Africa should increase the deductible allowance rates for generators and industrial buildings.

5.6.3 Investment incentives that reduce the company's fiscal burden

5.6.3.1 Research and development

In South Africa, operating expenses in respect of research and development are deductible at a rate of 150% and capital expenses are deductible over three years (50% in year 1, 30% in year 2 and 20% in year 3). In Malaysia, the revenue costs relating to research and development are deductible at a rate of 200%, whilst only 50% of the capital expenditure incurred within ten years may be claimed. The situation in Singapore is similar to that in South Africa, in that Singapore allows a deduction of operating expenses, such as staff costs and consumables, at a rate of 150%. However, it seems that no deduction is specifically provided for capital expenditure relating to general research and development. Nevertheless, Singapore offers various other incentives to encourage research and development, such as a 200% deduction of expenses for research on specific items, an allowance of 50% of the first S\$300 000 of the chargeable income of profitable companies, a cash grant for three years to start-up companies and a partial grant for new research and development which results in new competencies, increased employment opportunities and additional training.

The comparison between South Africa, Malaysia and Singapore reveals that the research and development incentives of all three countries have various features and rates in common, which implies that South Africa's research incentive compares favourably with those of the other two countries. Hence no recommendations about any adjustments to the current design of the research and development incentive are therefore made at this time. It is interesting to note, however, that Singapore offers a variety of additional research incentives, which focus on several types of taxpayers or certain forms of research. The South African government could investigate and consider these incentives, if

the need arises in the future to further encourage research and development activities.

5.6.3.2 Corporate tax rates

The corporate tax rates of South Africa (28%) and Malaysia (25%) are similar. It is acknowledged, however, that a tax rate that is 3% lower could have a significant impact on a company with high taxable income. Both South Africa and Malaysia also offer special corporate tax rates to small-scale companies, although South Africa seems to provide the most beneficial scenario, with the first R46 000 taxable income being exempt from tax, and taxable income below R300 000 being taxed at 10%. Malaysia's special tax rate for small-scale companies is 20% on the first RM500 000. It is clear that Singapore's tax rate differs vastly from those prescribed in South Africa and Malaysia, as Singapore has a corporate tax rate of only 17%, with the first S\$290 000 taxable income of all companies being partially exempt from tax. It is evident that this low tax rate is a significant incentive to any profitable manufacturing company.

It should be noted, however, that Singapore is an advanced economy, which could contribute substantially to the fact that this country is able to charge a significantly low corporate tax rate. It is assumed that an incentive like this would thus not be ideal for a developing country like South Africa which relies heavily on its tax revenue from companies (which constitutes 37% of taxes on income and profits) (National Treasury 2010:73). Although South Africa decreased its corporate tax rate from 35% to 30% in 1999, then to 29% in 2005, and again to 28% in 2008 (Accountancy SA 2010:4), a further reduction in the corporate tax rate may be required to ensure the country's comparability to other countries such as Malaysia.

It is acknowledged that several factors would influence a decision like this. Furthermore, the South African taxpayers have appealed to the government via the “Tips for Trevor” forum and opposition parties (Business Report 2009; Trevor calls for more tax tips 2009), to lower the corporate tax rate and it is expected that serious consideration has been given to this aspect by the Minister of Finance. If it were possible and beneficial for all parties involved, government would have recently decreased the corporate tax rate. Therefore, no further recommendation is made to lower the corporate tax rate with immediate effect.

5.6.3.3 Summary

It is clear from the above discussion that South Africa compares favourably with Malaysia and Singapore with regard to incentives that reduce the company’s fiscal burden. Although no immediate change to the corporate income tax rate of South Africa is proposed, the South African government could consider implementing some or all of Singapore’s wide range of research and development incentives in the future, should the need for an even higher increase in this type of expenditure arise.

5.7 INCENTIVES OFFERED BY MALAYSIA AND SINGAPORE ONLY

Probably the most important discovery in this comparison between the three countries is the three incentives offered by both Malaysia and Singapore, but not by South Africa. It should be considered whether one or more of these three incentives could be implemented by South Africa in an effort to enhance the country’s competitive advantage to attract local and foreign manufacturers. Malaysia is an emerging and developing economy and Singapore an advanced economy, which should result in relatively few common investment incentives between these two countries due to the difference in economic development and the approach to investment incentives. However, these two countries are

located in the same geographical area, and this could have necessitated certain common incentives to enable the countries to remain competitive as an investment location or to develop certain common activities.

5.7.1 The partial or full tax holiday and investment tax allowance

The partial or full tax holiday (par 4.2.1.1 & par 4.3.1.1) and the investment tax allowance (par 4.2.1.2 & par 4.3.1.2) incentives are granted to manufacturing companies that specifically produce preferred products, otherwise known as companies with pioneer status. A company may only apply for one of these two investment incentives and the decision to grant them is based on the company's estimated profitability and the amount of capital expenditure required for the project. The tax holiday in Malaysia provides partial exemption from paying income tax, while Singapore grants full tax exemption. Malaysia offers an investment tax allowance of 60% of the capital expenditure relating to qualifying projects incurred within five years, whereas Singapore offers an investment tax allowance of up to 100% of capital expenditure incurred within five years.

These incentives focus specifically on encouraging investment in the manufacture of specific products such as pharmaceuticals, wood, rubber and steel in the case of Malaysia, and high-technology products in the case of Singapore. Further benefits are also provided for companies with pioneer status that invest in a specific region of Malaysia, in order to encourage investment in a particular geographical area. It is clear that the aim of all these incentives is to promote the production of specific items that are significant to each of these countries.

As mentioned in paragraph 5.3, South Africa might consider an investment tax allowance incentive if the production of specific products needs to be promoted in the future, but at this point in time, the introduction of a tax exemption/holiday

is not preferred. It should be noted that a full deduction of capital expenditure allowed over a short period of time is expected to be more beneficial to a manufacturer, than only the deduction of 60% of the capital cost, although it is claimed in the year of acquisition. Therefore, if it is not viable for the South Africa government to offer a 100% investment tax allowance in the year of acquisition, it would be more favourable for manufacturers to be offered an accelerated wear-and-tear allowance over two or three years.

5.7.2 Increased exports

Another incentive offered by both Malaysia and Singapore is focused on increased exports (par 4.2.1.15 & par 4.3.1.5). Manufacturing companies in Malaysia may claim an allowance of up to 100% of the value of increased exports, while manufacturing companies in Singapore are granted a tax exemption from corporate income tax of 90% of annual increased export income for three to 15 years.

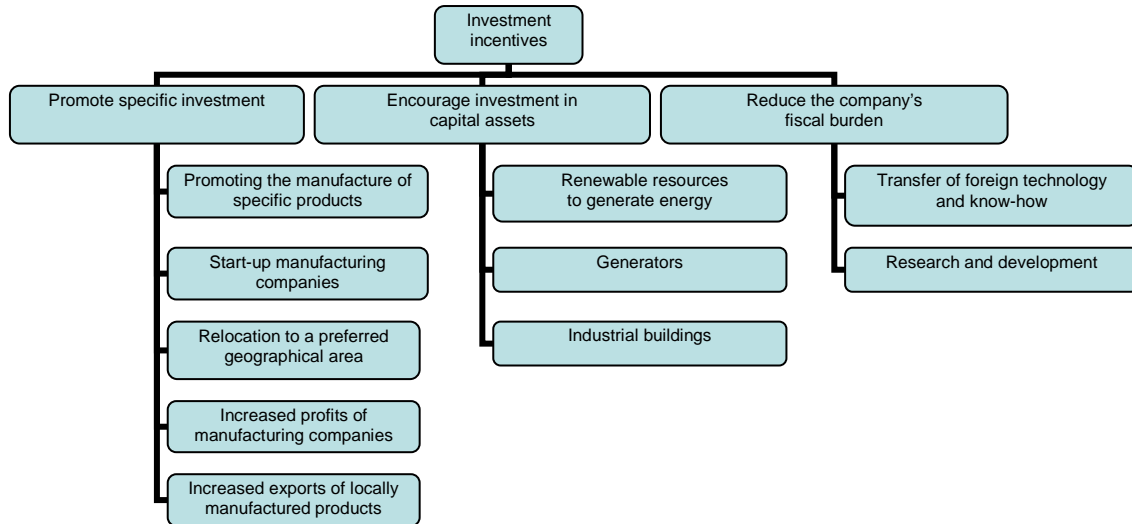
This is a direct approach to increasing exports by compensating companies for the actual annual *increase in export income*, whereas other export promotion incentives offered by all three countries under review aim to indirectly promote the increase in exports by assisting companies in decreasing their costs relating to exports. The exemption of increased export income or the deduction of an amount equal to increased export income may encourage manufacturers to actively endeavour to increase their export revenue, as it would increase their profitability but not their tax liability. An incentive like this could be highly effective in South Africa, and it is thus recommended that the South African government consider introducing an incentive of this kind.

5.8 RECOMMENDATIONS

The comparison between manufacturing investment incentives offered by South Africa, Malaysia and Singapore reveals that a large number of South African incentives are equivalent to the incentives available to manufacturers in the other two countries. It would therefore appear that South Africa generally has adequate investment incentives in place to assist manufacturers. However, this study identified a number of incentives that the South African government could introduce or amend in an attempt to provide additional assistance to manufacturing companies and to remain competitive with other countries for foreign investment in the manufacturing sector.

It is proposed that these recommendations be considered by the South African government. It is expected that these incentives would further encourage companies to invest in South Africa's manufacturing sector, which would help to expand and develop the country's manufacturing sector. Some of the suggestions relate to the introduction of new incentives that Malaysia and/or Singapore offer, while other suggestions relate to the amendment of current incentives offered to South African manufacturers. The 10 recommendations made in this study regarding new or revised investment incentives are listed under the three main incentive categories, as indicated in figure 5.1.

Figure 5.1: Recommendations for new or revised investment incentives in South Africa



5.8.1 Investment incentives that promote specific investment

5.8.1.1 *Promoting the manufacture of specific products*

Malaysia provides three incentives that encourage manufacturers to produce or use specific items. The focus is either on promoted products, such as iron and steel, specialised machinery, such as robotics, or natural resources, such as rubber. One of the South African incentives aims at promoting the manufacture of automotive products specifically, but no other South African incentive focuses on the use of any specific products or resources. It is recommended that Malaysia’s incentives be considered should the need arise to encourage the manufacture of specific products or the use of specific natural resources in South African. The suggested benefit to the manufacturer would entail a significant deduction of capital expenditure, by means of an accelerated wear-and-tear allowance over a short period, such as two years (par 5.3).

5.8.1.2 *Start-up manufacturing companies*

Singapore offers a tax exemption to start-up companies on part of their chargeable income for the first three years, which enables them to start making profits and build up their cash reserves. It is recommended that South Africa introduce this incentive for start-up manufacturing companies in order to encourage new investment in this industry. The suggested benefit to the investor is a partial exemption of profits or a double deduction of a limited amount of expenses or losses in the first two to three years (par 5.4.1).

5.8.1.3 *Relocation to a preferred geographical area*

A Malaysian company may claim an income tax exemption for five years or an investment tax allowance of 100% of capital expenditure incurred for five years when it relocates its business to a promoted area in the country. The aim of this incentive is to encourage manufacturing companies to establish their activities in a preferred geographical location in need of development. If the South African government could identify a specific region in the country that requires increased investment to promote development, an incentive such as this, where an additional allowance is granted on capital investment incurred by manufacturing companies to relocate their business, would be ideal (par 5.5.1.2).

5.8.1.4 *Increased profits of manufacturing companies*

Singapore offers a tax exemption on increased profits resulting from an extensive additional investment in equipment and machinery incurred to increase productivity. An incentive like this would encourage a manufacturer to increase its productivity and profitability, which would contribute to the growth of the manufacturing sector. It is recommended that the South African government

should grant a partial or full exemption of increased profits resulting from a significant amount of increased capital investment for a limited period (par 5.6.1.3).

5.8.1.5 Increased exports of locally manufactured products

The full value of annual increased exports of a Malaysian company is excluded from its taxable income, while 90% of annual increased exports are excluded from the taxable income of a company in Singapore. Incentives such as these, which encourage exports, have a direct effect on the actual increase in the profitability of manufacturing companies involved in the export of their goods. This would be a valuable tool to persuade manufacturers to actively strive to increase their export revenue. It is recommended that the South African government should introduce a new incentive to promote increased exports of locally manufactured products by partially or fully exempting increased revenue, resulting from increased exports, from taxable income for a limited period (par 5.7.2).

5.8.2 Investment incentives that encourage investment in capital assets

5.8.2.1 Renewable resources to generate energy

Malaysian manufacturing companies that incur capital costs to acquire equipment that use renewable resources to generate energy, may claim a 100% investment tax allowance for five years. The capital costs incurred by South African companies to generate renewable energy sources may be claimed over three years, with a 50% allowance in year 1, a 30% allowance in year 2 and 20% allowance in year 3. If the need arises in future to further promote the production of renewable energy in South Africa, an accelerated allowance of 100% of the capital costs is proposed (par 5.5.2.1).

5.8.2.2 *Generators*

Continued operations are vital for the profitability of the manufacturing industry, and generators are an essential asset to ensure the sustainability of power supply, especially in the South African context where the supply of energy is sometimes inadequate. Malaysia allows the deduction of the acquisition cost of generators over two years, 20% in year 1 and 80% in year 2, while Singapore permits the full deduction of the cost in the year of acquisition. To align South Africa's wear-and-tear allowance rate, which is currently 6.67% over 15 years, with those of Malaysia and Singapore, it is recommended that the South African government allows the deduction of the full acquisition cost of generators over two years, either equally with 50% each year, or 20% in the year of acquisition and 80% in the subsequent year, as is the current allowance in Malaysia (par 5.6.2.1).

5.8.2.3 *Industrial buildings*

Although South Africa's annual allowance rate for industrial buildings of 5% is higher than those permitted by Malaysia and Singapore of 3%, no initial allowance in the year of acquisition is offered to South African manufacturing companies. Malaysia offers an initial allowance of 13%, while Singapore offers one of 25%. This increased deduction in the year that the capital layout is incurred would compensate the investor to a great extent, as the tax benefit is linked to the large initial investment, which would assist the company's cash-flow status. It is recommended that South Africa should introduce an initial allowance on industrial buildings of between 10% and 15% and accordingly reduce the annual allowance from 5% to 3% (par 5.6.2.3).

5.8.3 Investment incentives that reduce a company's fiscal burden

5.8.3.1 Transfer of foreign technology and know-how

Singapore offers full or partial exemption on withholding tax relating to interest paid on loans obtained to acquire productive equipment, and on technical assistance fees paid by a manufacturing company to its non-resident holding company. This reduction in business costs encourages foreign direct investment, which results in the transfer of foreign technology and know-how to the host country. It is recommended that the South African government should introduce a new incentive similar to this one, in order to achieve its aim of increasing foreign direct investment. The proposed benefit to the investor is a full exemption of withholding tax on interest payments and royalties or technical fees payable to non-residents (par 5.4.2).

5.8.3.2 Research and development

All three countries under investigation provide a research and development incentive which allows the deduction of operating expenses at a higher rate than 100%, but only South Africa and Malaysia offer a deduction for capital expenses incurred for this purpose. However, Singapore offers a wide range of other incentives to encourage new and specific research and development. It is recommended that the South African government should consider these incentives if it becomes necessary to further encourage research and development. The following benefits to companies are suggested: a double deduction of expenses relating to research performed on specific items, a research and development allowance of 50% of a part of taxable income (for example the first R300 000), a cash grant for start-up companies conducting research to develop a product and a partial grant for equipment, training and professional services incurred for new research (par 5.6.3.1).

The above recommendations are based solely on the comparison of the manufacturing investment incentives offered by South Africa, Malaysia and Singapore and the identification of significant differences between these incentives. It is acknowledged that the new or revised incentives should not merely be introduced by South Africa without careful consideration of all aspects thereof, and the impact the incentives would have on the economy. There are several factors that influence a decision to introduce a new incentive or amend an existing one. Some of these factors are the economic objectives of the host country (par 2.3.2) and the costs involved (par 2.3.3). The unique design of each incentive should also be carefully considered in order to achieve the desired outcome (par 2.3.4). Therefore, the South African government would first need to assess whether the proposed new or revised incentives would be practical and effective in South Africa's unique circumstances, prior to implementing any of these incentives.

5.9 CONCLUSION

This chapter compared the similarities and differences between investment incentives offered to the manufacturing industry by South Africa and those offered by Malaysia and Singapore. The comparison revealed that the three countries have several incentives in common, although closer inspection confirmed that the benefits of these incentives for manufacturers are different in most cases.

It was determined that the design and/or benefits of a large number of South African incentives, such as strategic projects, IDZs and allowances for plant and machinery, are equivalent to the incentives available to manufacturers in the other two countries. Compared to Malaysia and Singapore, South Africa therefore appears to have sufficient investment incentives in place to assist manufacturers. However, this study identified a number of additional incentives

and amendments to current incentives which the South African government could consider in order to provide additional assistance to manufacturing companies and to enable them to remain competitive with other countries for foreign investment in the manufacturing sector.

The recommendations made in this study focus on the following: the manufacture of specific products, assistance for start-up manufacturing companies, the relocation of manufacturing activities to a preferred geographical area, the expansion of the manufacturing sector, an increase in the exports of locally manufactured products, an increase in the production of renewable energy, the acquisition of generators, the acquisition of industrial buildings, the transfer of foreign technology and know-how and the encouragement of further research and development.

It is proposed that the South African government should consider implementing some or all of these measures if it is found to coincide with government's growth objectives, contribute to the growth of the economy and benefit all parties involved.

CHAPTER 6

CONCLUSION

6.1 INTRODUCTION

The purpose of this study was to compare the investment incentives available to the manufacturing sector in South Africa with those available to Malaysia and Singapore, in order to identify additional investment incentives for the manufacturing sector which the South African government could institute to remain competitive with other countries for foreign direct investment. To achieve this objective, some aspects pertaining to the investment decision and investment incentives, as one of the variables that influence the investment decision, were explored (chapter 2). A comprehensive literature study was then undertaken to identify the investment incentives offered to manufacturing companies by South Africa, Malaysia and Singapore (chapters 3 & 4). A detailed comparison between these incentives was performed in order to identify the similarities and differences between these benefits offered by these three countries (chapter 5). Based on the results of this comparison, recommendations were made about investment incentives that South Africa could revise or introduce (chapter 5).

6.2 INVESTMENT AND INVESTMENT INCENTIVES

The South African government recognises that economic growth and development is its primary objective. One of the principles that government has adopted in achieving this goal is the building of economic capacity and promoting investment (National Treasury 2009:2). There is no doubt that increased local and foreign direct investment is a crucial aspect of the South African economy. This study focused specifically on investment in the manufacturing sector, as it is acknowledged that the manufacturing industry is a

vital engine for economic development and increased manufacturing is potentially a key element for increased economic growth (par 1.4.1).

Due to the fact that local investment has been restricted by South Africa's low saving rates, foreign direct investment fulfils a vital role in contributing to the country's economic growth (Arvantis 2005:73). Government makes it clear that the country should thus be attracting higher levels of foreign direct investment to achieve higher investment in the manufacturing sector (National Treasury 2007(a); DTI 2007:26). Foreign direct investment provides valuable benefits to the host country, such as increased tax revenue, transfer of new technology, new capital inputs and improved skills (par 1.4.3.1).

The investment decision of foreign investors is influenced by several factors, such as the economic, political and social stability of the host country, the tax policies of the home and host country, market size, the availability of resources and investment incentives (par 2.2.1). Although an investor would initially consider the first few determinants mentioned above, research has shown that investment incentives often influence the investment decision (par 2.2.2). Once the choices have been narrowed down to a few countries with similar characteristics, investment incentives can fulfil a decisive role in the final location decisions of foreign companies (OECD 2002:169). Investment incentives are also the only short-term intervention that a country's government can employ in order to improve the country's investment attractiveness (par 2.2.1).

For the purposes of this study, investment incentives refer to tax and other financial incentives offered to enterprises in an effort to encourage them to invest. An investment incentive is one of the instruments which are widely used to attract more investment into a country and to remain competitive with other countries for investment, due to the fact that it enhances a country's

attractiveness for new and increased investment and makes the investment climate more favourable (par 2.3.2). These instruments are also utilised to compensate for unavoidable investment obstacles which, in South Africa's circumstances, are the high crime level, a high HIV-occurrence and the lack of skilled workers (par 2.2.1.2). The South African government is actively using investment incentives to promote the country as a preferred investment destination in its efforts to attract foreign direct investment to the country (National Treasury 2008(d):23).

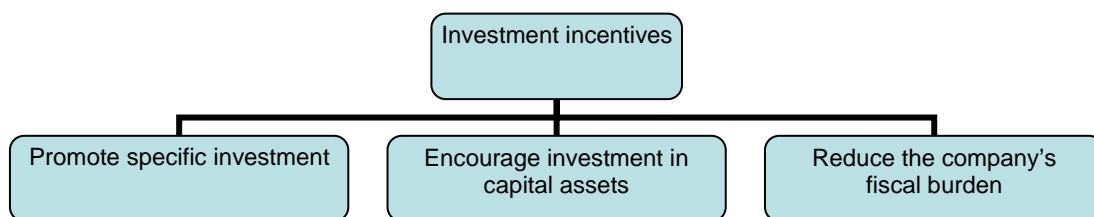
Although investment incentives may be very effective in attracting investments to South Africa, there are revenue costs and administrative burdens associated with this instrument. However, the benefits from increased foreign direct investment are highly valuable to the host country and can offset the stream of costs associated with the tax incentive provision (par 2.3.3). The costs involved in offering investment incentives can be reduced if these instruments are properly designed. When designing investment incentives, the South African government should consider whether an incentive should be a fiscal or financial instrument, as well as a discretionary or automatic policy instrument. Some of the primary aspects of designing a successful incentive are the simplicity of the tax legislation or incentive programme, transparency in granting incentives and equity between foreign and domestic investors. The relevance and appropriateness of incentive strategies should be regularly monitored to ensure that the incentive achieves the objective for which it was introduced (par 2.3.4). There are several types of investment incentives. In this study, the incentives were classified in the following three categories, which were found to be effective for comparative purposes:

- investment incentives that promote specific investment, such as an investment allowance, an investment tax credit, a tax holiday and export promotion and development programmes

- investment incentives that encourage investment in capital assets, which refer to the deduction of capital allowances and accelerated capital allowances
- investment incentives that reduce the company's fiscal burden, which allow the deduction of certain expenses against income or provide a reduced tax rate which decreases the investor's tax liability (par 2.3.5).

These categories are graphically illustrated below:

Figure 6.1: Investment incentive categories



6.3 INVESTMENT INCENTIVES IN SOUTH AFRICA

South Africa offers many investment incentives to achieve some of its economic objectives and chapter 3 of this study identified 17 incentives currently available to manufacturing companies in South Africa. Three of these incentives were initiated within the last three years, which indicates that South Africa is currently paying attention to investment incentives. It was found that South African investment incentives focus mainly on capital allowances, which allow the investor to claim the capital costs incurred in acquiring assets used in its trade, over a period of time (par 3.5). Some of these capital allowances are offered for manufacturing plant and equipment, buildings and improvements, movable assets of small business corporations and urban development zones (par 3.3).

Several other investment incentives are also offered with the intention of promoting specific investments, such as the Automotive Production and Development Programme, the Enterprise Investment Programme and the Industrial Policy Project. These incentives mostly provide assistance in the form of a cash grant or financial assistance from government (par 3.2). Manufacturing companies can also make use of other incentives that reduce the company's fiscal burden, such as deductible expenses relating to research and development and learnership agreements (par 3.4).

6.4 INVESTMENT INCENTIVES IN MALAYSIA AND SINGAPORE

In order to identify other incentive strategies that South Africa could introduce to attract additional investment, Malaysia and Singapore were selected for comparison purposes. The selection was based on an analysis of the performance of the manufacturing sector, GDP per capita and the geographical location of each country (par 1.7.2). By comparing the investment incentives offered to the manufacturing sector by South Africa with those offered by Malaysia and Singapore, it was possible to identify the incentives that South Africa could introduce in order to remain competitive for foreign direct investment and achieve its goal of economic growth.

In paragraph 4.2 of this study, 25 incentives were identified that apply to manufacturing companies in Malaysia. Most of these incentives focus on the promotion of specific investments, such as small-scale companies, strategic projects, the production of specialised machinery and the production of certain promoted products (par 4.2.4). A significant number of incentives are also offered to encourage investment in capital assets, for example, manufacturing equipment, industrial buildings, equipment for power supply and the renovation of business premises. Investment in training and research activities is also

encouraged by means of incentives offering double deductions, which reduces the company's fiscal burden.

Paragraph 4.3 further identified 18 investment incentives that apply to manufacturing companies in Singapore. It is evident from the study that Singapore has a balanced approach towards providing assistance to manufacturing companies, as these incentives are spread almost equally among the three incentive categories (par 4.3.4). Some of the incentives which focus on the promotion of specific investments relate to high-technology products, start-up companies and processes that encourage efficiency and economic benefits. Capital allowances are offered in respect of manufacturing plant and equipment, industrial buildings and the renovation of business premises, in order to encourage investment in capital assets. A company's fiscal burden is also reduced by means of the deduction of expenses relating to research and development and the exemption of interest and royalty payments to non-residents from withholding tax.

6.5 COMPARISON OF THE INVESTMENT INCENTIVES OFFERED BY ALL THREE COUNTRIES

Following the identification of the above investment incentives, the similarities and differences between investment incentives offered by South Africa and those offered by Malaysia and Singapore were compared in chapter 5 of this study. Table 5.1 summarises all of these incentives according to the three incentive categories used for this study. It was found that each one of the three countries offers two or more unique incentives. In this regard, South Africa has introduced two incentives and Malaysia and Singapore three incentives each, which none of the other countries covered in this study have introduced.

The three countries have a number of incentives in common. Both South Africa and Malaysia offer the same six incentives, while South Africa, Malaysia and Singapore have introduced ten incentives that are similar. Although the three countries appear to have several incentives in common, closer inspection confirmed that in most instances, the benefits of these incentives for manufacturers are different, as indicated in tables A and B. The respective benefits of each incentive were therefore analysed and compared in more detail and these findings are summarised below.

6.5.1 Incentives offered by South Africa and Malaysia only

The study identified six incentives that are offered by both South Africa and Malaysia, but not by Singapore. The conclusion drawn is that these incentives would probably be more relevant to emerging and developing economies such as those of South Africa and Malaysia.

6.6.3.1 Investment incentives that promote specific investment

The comparison between common incentives offered by South Africa and Malaysia revealed that both countries offer similar benefits that apply to strategic projects and small-scale companies (par 5.5.1.1 & par 5.5.1.4). Although both South Africa and Malaysia provide an incentive for the relocation of manufacturing activities, it was established that South Africa's objective is to encourage foreign investment into the country's manufacturing industry, while Malaysia's aim is to increase local investment in specific regions of the country. It was acknowledged that South Africa could make use of Malaysia's design for the relocation incentive, should the need arise in the future to encourage investment in specific regional locations in the country (par 5.5.1.2). Due to the fact that the South African incentive for the automotive industry has recently

been revised, no amendment to this new incentive was recommended (par 5.5.1.3).

6.5.1.2 Investment incentives that encourage investment in capital assets

The comparison between the capital allowances provided for by both South Africa and Malaysia indicated that the rate of the allowance on movable assets for the production of renewable energy offered by Malaysia is higher than that offered by South Africa. However, the differences between these rates are insignificant, and South African companies are still able to claim the capital cost over a short period of three years. It is suggested that if the need arises in the future to further promote the production of renewable energy in South Africa, an accelerated allowance of 100% could be considered (par 5.5.2.1).

6.5.1.3 Investment incentives that reduce the company's fiscal burden

The incentive provided by South Africa and Malaysia to train employees offers a similar benefit to companies in both countries, depending on the amount of training expenses incurred by them. Based on this finding, no recommendation was made regarding the revision of the learnership agreement incentive offered by South Africa (par 5.5.3.1).

6.5.2 Incentives offered by all three countries

All three countries included in this study offer several similar investment incentives to manufacturing companies. The study identified ten common investment incentives in South Africa, Malaysia and Singapore (table 5.1). This indicates that South Africa is at the same level as Malaysia and Singapore in terms of these deductions and allowances. The similarities and differences between these common incentives are summarised below.

6.5.2.1 *Investment incentives that promote specific investment*

The detailed comparison between investment incentives in South Africa, Malaysia and Singapore that promote specific investment reveals that similar incentives are offered by all three countries with respect to IDZs (par 5.6.1.1). It was also concluded that South Africa's incentives for the innovation of products and processes provide generous benefits to the manufacturer, although these differ from the incentives offered by Malaysia and Singapore (par 5.6.1.2). A comparison of the three countries' investment incentives for reinvestment and expansion indicated that although the design of the incentive in each country is different, South Africa offers investment incentive benefits which are in line with those offered by Malaysia and Singapore. An interesting additional reinvestment incentive offered by Singapore was identified, which could influence the expansion of the manufacturing sector in South Africa (par 5.6.1.3). It is thus recommended that the South African government should consider a new investment incentive that would allow the tax exemption of increased profits resulting from increased capital investment.

6.5.2.2 *Investment incentives that encourage investment in capital assets*

The comparison between the capital allowance incentives offered by all three countries under review showed that South Africa's incentives for plant and machinery (par 5.6.2.2), environmental expenditure (par 5.6.2.4) and the renovation of business premises (par 5.6.2.5) provide similar benefits for manufacturers. However, the design of these incentives generally differs from that of the incentives offered by Malaysia and Singapore. Based on this finding, no recommendation is made regarding a change in the investment design of these incentives. It is, however, recommended that South Africa should increase the deductible allowance rates for generators and industrial buildings, as these rates were found to be markedly low in comparison with those in Malaysia and Singapore (par 5.6.2.1 & par 5.6.2.3).

6.5.2.3 *Investment incentives that reduce the company's fiscal burden*

The incentives offered by South Africa are comparable with those offered by Malaysia and Singapore with regard to research and development allowances (par 5.6.3.1). South Africa's corporate tax rate is also similar to that of Malaysia, which is also a developing economy. Singapore's low tax rate of 17%, however, differs vastly from South Africa's tax rate of 28%, and the reason for this could be that Singapore has a developed economy which is able to sustain a low tax rate (par 5.6.3.2). Although no immediate change to the corporate income tax rate of South Africa is recommended, the South African government should consider implementing some or all of Singapore's wide range of research and development incentives in future, should the need arise for an even higher increase in this type of expenditure.

6.5.3 Incentives offered by Malaysia only

Malaysia has introduced three incentives for manufacturing companies that neither Singapore nor South Africa offers. All three of these incentives encourage manufacturers to produce or use specific items. The focus is either on promoted products, such as iron and steel (par 5.3.1), specialised machinery such as robotics (par 5.3.2), or natural resources, such as rubber (par 5.3.3). South Africa has been concentrating specifically on the manufacture of automotive products, with none of the other South African incentives focusing on the use of any specific products or resources (par 3.2.5). Hence South Africa could consider introducing some or all of the three incentives offered by Malaysia relating to specific items, should the need arise to increase the production of specific products or the use of specific natural resources.

The benefit offered by each of the above incentives is either a partial or full tax exemption or an investment tax allowance on the capital expenditure. South

Africa does not currently offer the tax exemption of profits, otherwise known as a tax holiday, as it has been established that tax holidays are extremely costly and not that effective in influencing the decisions of foreign investors. For South African circumstances therefore the deduction of a tax allowance on the capital expenditure incurred with respect to the above incentives is recommended instead of a tax holiday. In an effort to motivate manufacturers to engage in the manufacture of a specific product or resource or expand existing manufacturing activities in this field, a significant deduction over a short period would be advisable (par 5.3.3).

6.5.4 Incentives offered by Singapore only

Singapore offers three manufacturing incentives that are not available to manufacturers in Malaysia or South Africa. One of these incentives offers a reduced tax liability to start-up companies by excluding part of their income from chargeable income for the first three years of trading. This incentive enables new companies to accumulate their cash flow and profits in the initial trading years to enable them to become more profitable or to enable more investment in capital assets. Although South Africa did previously offer a similar incentive, it is recommended that this incentive should be reintroduced in the future with the intention of encouraging new manufacturing companies to commence business in South Africa. A tax exemption or tax holiday is not recommended, but a double deduction of certain expenses or losses, as previously offered by South Africa, could be effective in assisting start-up manufacturing companies in South Africa (par 5.4.1).

The purpose of two other incentives offered only by Singapore is to encourage foreign direct investment and the transfer of foreign technology and know-how by assisting local companies to reduce their cost of business in respect of the interest and technical assistance fees paid to non-resident holding companies in

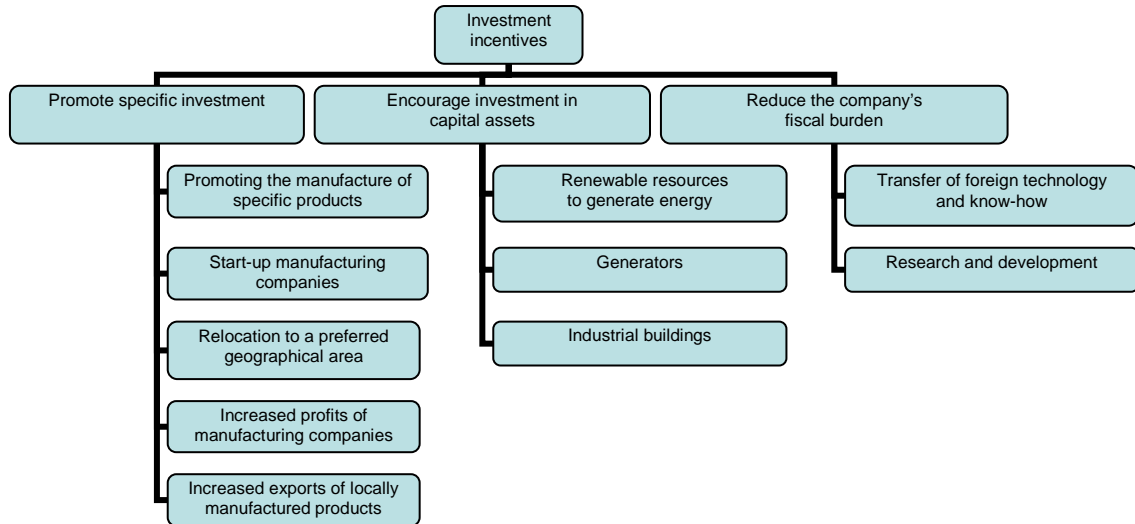
Singapore (par 5.4.1). In view of the fact that South Africa intends to increase foreign direct investment and obtain foreign expertise, incentives like these could be considered in realising this objective.

6.6 RECOMMENDATIONS

This study investigated the question of which additional investment incentives, applicable to the manufacturing sector, the South African government could introduce to encourage foreign investors to choose South Africa as the desired investment destination (par 1.2). The investment incentives provided by South Africa, Malaysia and Singapore were discussed and compared to identify the investment incentives which the South African Government could consider introducing. From the detailed analysis of the comparison between these three countries, South Africa generally appears to have sufficient investment incentives in place to assist manufacturers. However, a number of recommendations are made for adjustments to current South African incentives or the introduction of new South African incentives which could increase investment in the manufacturing sector and improve the country's competitiveness as an attractive destination for investment compared with other worldwide investment locations.

The 10 recommendations which are submitted for consideration by the South African government are discussed below and they are listed under the three main incentive categories used in this study, as indicated in figure 6.2.

Figure 6.2: Recommendations for new or revised investment incentives in South Africa



6.6.1 Investment incentives that promote specific investment

- Introduce an incentive to encourage the manufacture of specific products by allowing a significant deduction of capital expenditure by means of an accelerated wear-and-tear allowance over a short period such as two years (par 5.3).
- Introduce an incentive to assist start-up manufacturing companies by providing a partial exemption of profits or a double deduction of a limited amount of expenses or losses in the first two to three years of trading (par 5.4.1).
- Initiate an incentive to encourage the relocation of manufacturing activities to a preferred geographical area by providing a 100% allowance on capital expenditure incurred (par 5.5.1.2).
- Introduce an incentive to encourage the expansion of the manufacturing sector by providing a partial or full exemption for a limited period of increased profits resulting from increased capital investment (par 5.6.1.3).

- Initiate an incentive to encourage increased exports of locally manufactured products by providing a partial or full exemption for a limited period of increased revenue resulting from increased exports (par 5.7.2).

6.6.2 Investment incentives that encourage investment in capital assets

- Amend the capital allowance on equipment used to produce renewable energy by providing an accelerated allowance of 100% of the capital cost incurred (par 5.5.2.1).
- Amend the current wear-and-tear allowance rate for generators to allow the deduction of the full cost over two years, either equally with 50% each year, or 20% in the year of acquisition and 80% in the subsequent year, which is the permissible rate in Malaysia (par 5.6.2.1).
- Amend the current allowable deduction rate for industrial buildings by introducing an initial allowance of between 10% and 15% and reducing the annual allowance from 5% to 3% (par 5.6.2.3).

6.6.3 Investment incentives that reduce the company's fiscal burden

- Introduce an incentive to encourage foreign direct investment in the manufacturing sector and the transfer of foreign technology and know-how by providing a full exemption of withholding tax on interest payments and royalties or technical fees payable to non-residents (par 5.4.2).
- Introduce additional incentives to encourage research and development even further by providing a double deduction of expenses relating to research performed on specific items, a research and development allowance of 50% of a part of taxable income (for example the first R300 000), a cash grant to start-up companies conducting research to

develop a product and a partial grant for equipment, training and professional services incurred in respect of new research (par 5.6.3.1).

6.7 FURTHER RESEARCH

This research study identified the following areas that merit further research and refinement:

- *Implementation of the recommended investment incentives*

The South African government cannot simply introduce incentives without careful consideration of all aspects involved and their impact on the economy. Several factors influence a decision to introduce an incentive or amend a current one. In order to achieve the desired outcome, the unique design of each incentive should also be carefully considered. A further study could therefore evaluate whether existing incentives have an effect on the country's economic activity and whether the new or revised incentives, as proposed in this study, would be practical and effective in South Africa's unique circumstances.

- *Utilisation of investment incentives by manufacturing companies*

It is clear from this study that several investment incentives are offered to South African manufacturing companies. A further study could determine whether these incentives are actually utilised by manufacturing companies in South Africa and what effect they have on the companies' investment decision and profitability.

- *Investment incentives in another economic sector*

A similar study to this one could be performed in order to identify any additional investment incentives in another South African economic sector such as agriculture or mining.

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Annexure A: Summary of investment incentives that South Africa and Malaysia have in common

	SOUTH AFRICA	MALAYSIA
Investment incentives that promote specific investment		
Strategic projects	35% or 55% (Par 3.2.4)	<ul style="list-style-type: none"> • 100% exemption - 5 years/100% ITA for 5 years • 60%-100% allowance (Par 4.2.1.6 & par 4.2.1.13)
Relocation of manufacturing activities	Grant: 15% of transportation costs (Par 3.2.2)	100% exemption - 5 years/100% ITA for 5 years (Par 4.2.1.10)
Automotive production and development	<ul style="list-style-type: none"> • Import duty reduced to 25% • No import duty on 20% of components • Import duty credit of 55% • Grant - 20% of productive assets (Par 3.2.5) 	100% exemption - 5 years/60% ITA for 5 years (Par 4.2.1.8)
Small-scale companies' incentive	<ul style="list-style-type: none"> • Manufacturing machinery - 100% • Other assets: year 1 - 50%, year 2 - 30%, year 3 - 20% (Par 3.3.6) 	<ul style="list-style-type: none"> • 100% exemption - 5 years/60% ITA for 5 years • 100% of reinvestment expenses in 2009 and 2010 (Par 4.2.1.12)

Annexure A (continued)

	SOUTH AFRICA	MALAYSIA
Capital allowances		
Movable assets used in the production of renewable energy	Year 1 – 50% Year 2 – 30% Year 3 – 20% (Par 3.3.3)	100% ITA for 5 years (Par 4.2.2.7)
Other grants and tax-deductible expenses		
Training expenses and learnership agreements	Commence agreement - R20 000/R30 000 per employee Complete training – R30 000 per employee/R30 000 per employee per year of agreement (Par 3.4.3)	200% or financial assistance (Par 4.2.3.3)

Abbreviations

ITA – investment tax allowance

Initial – initial allowance

Annual – annual allowance

Annexure B: Summary of investment incentives that South Africa, Malaysia and Singapore have in common

	SOUTH AFRICA	MALAYSIA	SINGAPORE
Investment incentives that promote specific investment			
IDZs	No customs duty and VAT on imports (Par 3.2.3)	No customs duty on imports (Par 4.2.1.4)	<ul style="list-style-type: none"> No customs duty on imports or exports No goods and services tax on imports (Par 4.3.1.6)
Support Programme for Industrial Innovation	Grant of 50-85% of development costs incurred (Par 3.2.7)	High-technology company: - Pioneer: 100% for 5 years - ITA: 60% for 5 years (Par 4.2.1.5)	Grant: co-funding of capital equipment (Par 4.3.1.7)
Reinvestment allowance and expansion incentive	Grant of 15-30% of investment costs to expand over 3 years (Par 3.2.6 expand)	60% of capital expenditure for 15 years (Par 4.2.1.3)	<ul style="list-style-type: none"> Expand after pioneer period: corporate tax rate = 5% on profits above predetermined base for 10 years Equipment investment >\$10 m: increased profits exempt for up to 10 years (Par 4.3.1.3 & par 4.3.1.4)

Annexure B (continued)

	SOUTH AFRICA	MALAYSIA	SINGAPORE
Capital allowances			
Non-manufacturing assets: wear-and-tear allowance	Several generators – 6.67% for 15 years (Par 3.3.2)	Several generators – year 1: 20% year 2:80% (Par 4.2.2.2 & par 4.2.2.4)	Several = 100% generators – 100% (Par 4.3.2.2)
Plant and machinery used by manufacturers - general	After 1 March 2002: year 1 – 40% years 2, 3, & 4 - 20% (Par 3.3.4)	Heavy machinery and vehicles: 20% for 5 years Plant and equipment: year 1 - 34%, years 2-5 - 14% Accelerated: <ul style="list-style-type: none"> • Acquired between 10 March 2009 and 31 December 2010: years 1, 2 - 50% • Expand after 15 year ITA: year 1 - 60%, years 2 & 3 - 20% (Par 4.2.2.3) 	Initial = 20% Annual = remaining cost claimed over 5 to 16 years Accelerated: <ul style="list-style-type: none"> • Acquired during 2010 and 2011: year 1 = 75%, year 2 = 25% • Acquired before 2009: 33.3% for 3 years (Par 4.3.2.3)

Annexure B (continued)

	SOUTH AFRICA	MALAYSIA	SINGAPORE
Industrial buildings and improvements	<ul style="list-style-type: none"> • Industrial building: 5% for 20 years • Commercial building: 5% for 20 years (Par 3.3.7) 	Year 1 - 13%, years 2-30 - 3% (Par 4.2.2.1)	Initial = 25% Annual = 3%/5% (Par 4.3.2.1)
Environmental expenditure	<ul style="list-style-type: none"> • Environmental treatment and recycling assets – year 1 - 40%, years 2, 3 & - 20% • Environmental waste disposal assets – 5% • Environmental remediation and restoration costs – 100% (Par 3.3.9) 	Environmental protection equipment: year 1 - 60%: years 2 & 3 - 20% (Par 4.2.2.6)	<ul style="list-style-type: none"> • Funding for 80% of costs for waste reduction and recycling • Funding for 50% of conducting an audit on energy-saving methods • Energy-saving equipment: 100% (Par 4.3.2.5 & par 4.3.2.6)
Renovation of business premises and infrastructure	<ul style="list-style-type: none"> • Refurbishment designated zone = 20% for 5 years • Construction in designated zone = year 1 - 20%, years 2-11 - 8% (Par 3.3.8) 	<ul style="list-style-type: none"> • Renovations between 10 March 2009 and 31 December 2010: years 1 & 2 - 50% • Infrastructure in promoted area: 100% (Par 4.2.2.5 & par 4.2.2.8) 	<ul style="list-style-type: none"> • Renovations between 16 February 2008 and 15 February 2013: 33,3% for 3 years • 2010 & 2011 - 100% (Par 4.3.2.4)

Annexure B (continued)

	SOUTH AFRICA	MALAYSIA	SINGAPORE
Other grants and tax-deductible expenses			
Research and development	<ul style="list-style-type: none"> • Qualifying operating expenses – 150% • Capital expenses – year 1 – 50% year 2 – 30% year 3 – 20% (Par 3.4.2) 	<ul style="list-style-type: none"> • Revenue costs: 200% • Capital expenditure: 50% of costs incurred within 10 years (Par 4.2.3.2) 	<ul style="list-style-type: none"> • Staff cost and consumables = 150% • Expenses for research on specific items = 200% • R&D allowance = 50% of first S\$300 000 chargeable income • Start-up companies: cash grant of S\$20 250 for 3 years and surrender tax loss • Partial grant: equipment, training and professional services costs for new research (Par 4.3.2.4)

Annexure B (continued)

	SOUTH AFRICA	MALAYSIA	SINGAPORE
Preferential tax rates	<ul style="list-style-type: none"> • Corporate tax rate = 28% • Small business corporations: first R46 000 = 0% R46 001 - R300 000 = 10%, above R300 000 = 28% Turnover <R1 m = 0-7% on turnover only (Par 3.4.4) 	<ul style="list-style-type: none"> • Corporate tax rate = 25% • Small-scale companies: 20% on the first RM 500,000 of chargeable income, 25% income exceeding RM 500 000 (Par 4.2.3.1) 	Corporate tax rate = 17% and partial exemption of chargeable income: - 75% of the first S\$10 000; and - 50% of the next S\$290 000 (Par 4.3.2.3)

Abbreviations

ITA – investment tax allowance

Initial – initial allowance

Annual – annual allowance