

**AN ANALYSIS OF LOW TAX JURISDICTIONS AS A MEANS OF INCREASING  
FOREIGN DIRECT INVESTMENTS FROM A SOUTH AFRICAN POINT OF VIEW**

by

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## ABSTRACT

### **AN ANALYSIS OF LOW TAX JURISDICTIONS AS A MEANS OF INCREASING FOREIGN DIRECT INVESTMENTS FROM A SOUTH AFRICAN POINT OF VIEW**

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The purpose of this study is to analyse low tax jurisdictions as a means of attracting direct foreign investment from a South African point of view.

The phenomenon of low tax rates, tax havens and foreign investment have been inextricably linked over years but have gained notoriety since efforts by the Organisation for Economic co-operation and Development (OECD), to harmonise taxation and eliminate unfair tax competition between countries and specifically so with regard to countries classified as tax havens. These efforts have been given further momentum by the recent events known as the worldwide “financial crisis” which have at least partially been blamed on practices followed by tax havens.

The phenomenon of low tax rates has been identified as one measure to increase foreign direct investment (FDI) and therefore stimulate the growth of local economies. Low tax rates have been very successfully exploited by countries labeled as tax havens resulting in high economic growth for such countries. It is recognised that South Africa is in need of foreign investment and specifically fixed investment to accelerate growth and solve specific problems like the high levels of unemployment.

## OPSOMMING

# 'N EVALUERING VAN 'N LAE BELASTINGKOERS BELASTINGSTELSEL AS 'N METODE OM BUITELANDSE BELEGGINGS AAN TE MOEDIG GESIEN UIT 'N SUID- AFRIKAANSE OOGPUNT.

deur

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Die doel van hierdie studie is om 'n ontleding uit 'n Suid-Afrikaanse oogpunt te doen van die aanvaarding van 'n lae koers belastingstelsel soortgelyk aan diè soos gebruik in sogenaamde belastingtoevlugsoorde. Die verskynsel van lae belastingkoerse en buitelandse investering is 'n bewese feit maar het berugtheid verwerf sedert die pogings van die Organisation for Economic Co-operation and Development (OECD), om belastingkoerse te harmoniseer en onbillike belastingwedywering uit te skakel tussen lande en met spesifieke verwysing na lande geklassifiseer as belastingtoevlugsoorde. Hierdie pogings het verdere momentum verwerf na aanleiding van die gebeure wat bekendheid verwerf het as die wêreldwye finansiële krisis wat ten minste gedeeltelik toegeskryf is aan praktyke gevolg deur belastingtoevlugsoorde.

Die praktyk van lae belastingkoerse is geïdentifiseer as een metode om buitelandse investering te stimuleer en sodoende plaaslike ekonomiese groei aan te moedig. Verskeie sogenaamde belastingtoevlugsoorde het sukses behaal deur gebruik te maak van lae belastingkoerse ten einde hoë ekonomiese groei te bewerkstellig. Suid Afrika het 'n behoefte aan buitelandse investering en spesifiek vaste investering ten einde plaaslike groei van die ekonomie aan te moedig en sodoende probleme soos hoë werkloosheidsvlakke aan te spreek.

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# AN ANALYSIS OF LOW TAX JURISDICTIONS AS A MEANS OF INCREASING FOREIGN DIRECT INVESTMENTS FROM A SOUTH AFRICAN POINT OF VIEW

## CHAPTER 1

### INTRODUCTION AND PROBLEM STATEMENT

#### 1.1 BACKGROUND

Carroll (2009:7) states that: “[a]s capital has become more mobile, differences in corporate tax systems have become more important for attracting investment. Some countries have positioned themselves to take advantage of the increasing international mobility of capital.”

The high levels of taxation or even unpopular taxes have given impetus to major political upheavals in history. Acts implemented by British rule in America for example the Stamp Act (1765) and the Tea Act (1773) has acted as a trigger for the American Revolution. (Biswas, 2002:1.)

Similarly when Napoleon Bonaparte abdicated as French Emperor, crowds in Milan (capital of the then Napoleonic Kingdom of Italy) proceeded to break into the Senate building, demolishing the interior and forcing all of the senators to flee. Not satisfied the crowds descended on the house of Guiseppe Prina, the hated Minister of Finance and proceeded to loot the house and eventually killing Prina. His murder also symbolised the end of the Napoleonic regime in Italy. (Grab, 2007: 61.)

Tax literature have recognised that the integration of economies might impose increasing pressure on tax policies as increasing tax rates in one country provides an incentive for taxpayers to relocate abroad (Bènassy-Quèrè, Fontagnè & Lahrèche-Rèvil, 2003:4). The importance of tax competition between countries have also been recognised by Friedman (Biswas, 2002:3) when he stated that: “[c]ompetition



among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods or services they offer for sale and innovation; to improvements in the quality of goods and services and a reduction in their cost. A governmental cartel is no less damaging than a private cartel”.

According to Hines (2004:1) countries offer low tax rates in the belief that, by doing so, they will attract greater investment and activity as would otherwise be forthcoming. Tax havens as a group exhibited 3,3 percent annual per capita (GDP) growth from 1982-1999, whereas the world averaged just 1,4 percent annual GDP growth over the same period (Hines, 2004:1).

Proponents of low tax regimes would argue that non-resident investors would be able to justify investments in a low tax regime as the required post tax return would be easier to achieve than in the case where a high tax regime prevails. This can be demonstrated by a non-resident investor who wants to achieve a post tax return of 10 percent. If a tax rate of 50 percent is levied by the host country the post tax rate return of 10 percent can only be achieved by investing in projects that will render a 20 percent pre-tax rate of return. This will in turn lead to a diminishing number of projects with only the high return projects being selected. (Devereux, 2002:97.)

If the high tax scenario prevails there would be less investment and consequently higher unemployment and lower wages. The non-resident investor will still realise a post tax return of 10 percent but the local economy will need to levy increased taxes on its residents to carry the tax burden. (Devereux, 2002:97.)

The apparent benefits of a tax haven or low tax regime has been contested and resisted by the Organisation for Economic and Co-operative Development (OECD) countries, traditionally higher tax regimes. In 1998 the OECD published a report in which it recorded the factors identifying a tax haven (OECD, 1998:23). The report also accepted a number of recommendations in dealing with tax havens (OECD, 1998:40).

The OECD (1998:16) has identified the following factors as potential harmful effects of tax havens:

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all taxpayers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

## 1.2 PROBLEM STATEMENT

Should South Africa adopt a taxation regime similar to those practiced in low tax jurisdictions to increase international investments? All countries compete against each other over corporate taxes to attract foreign direct investment (FDI). Statutory rates of corporate taxes have fallen considerably over the last decade, leading to substantially lower tax rates in developing countries than in developed countries. (Azèmar & Dèlios, 2006:86.)

According to a recent report on South Africa by the OECD (Barnard & Lysenko, 2010:2) South Africa has had a period characterised by high capital inflows from portfolio investors whilst net foreign direct investment were modest. Growth in GDP has only managed 1,6 percent per annum for the period 1994-2009, well behind most emerging economies (Barnard & Lysenko, 2010:6). In amongst other problems for example low savings and high private consumption it has been pointed out that South Africa has a persistent low employment problem. By the first quarter of 2010 this problem was standing at 25 percent, near 2004 levels. If the number of discouraged

job seekers is taken into account, the unemployment figure is in excess of 30 percent. (Barnard & Lysenko, 2010:10.)

### **1.3 PURPOSE STATEMENT**

The purpose of this study is to analyse the role of low tax rates as a means to increase foreign direct investment and consequently stimulate growth in South Africa.

### **1.4 RESEARCH OBJECTIVES**

The study will consider the following research objectives:

- to analyse the secondary literature on low tax jurisdictions in order to establish a theoretical basis for the study. This will be done by means of a literature review; and
- to analyse low tax jurisdictions as a means to increase foreign direct investment from a South African point of view using the theoretical basis from the literature review as an underpin.

### **1.5 IMPORTANCE OF THE STUDY**

Fiscal incentives and tax rates are often critical ingredients of where to locate investments (Biswas, 2002:5). South Africa has relied on portfolio flows for much of its foreign direct investment. The financial crisis has highlighted the need for increased growth leading to higher employment, more competition and greater innovation. (Barnard & Lysenko, 2010:3.)

Some studies have indicated that a strong link exist between corporate tax rates and the location of foreign direct investment, specifically in developing countries (Azèmar & Delios, 2006:99). This study will analyse the theoretical benefits to South Africa for adopting a low tax rate regime in order to encourage increased foreign direct investment and address the problems of economic growth.

## **1.6 DELINEATION AND LIMITATIONS OF THE STUDY**

The study will limit its scope to those emphasised in its purpose statement. The study will not attempt to analyse or address all:

- the practical considerations associated with low tax rates and FDI, the location of foreign direct investment are often influenced by a number of factors for example political and economic stability, supply of professional and technical staff, ease of importing and exporting components and ease of obtaining permits and licenses; and
- limit itself to the importance to South Africa and will not attempt to address the case for other countries. The subject of tax havens has attracted much attention in recent times. This study will not attempt to justify or criticise the need for tax havens except where relevant to this study as several other factors relating to tax havens other than tax rates have been highlighted specifically by the OECD.

## **1.7 UNDERLYING ASSUMPTIONS**

The following assumptions will apply for purposes of this study:

- South Africa will be regarded as a developing country as its economic status will not classify it amongst the large economies of the world; and
- the assumptions as indicated by several authors concerning the differences between developing and developed countries.

## **1.8 BRIEF OVERVIEW OF CHAPTERS**

### **1.8.1 Chapter 2 – Foreign direct investment**

In this chapter the literature on the role of foreign direct investment and its relation to taxation will be reviewed.

### **1.8.2 Chapter 3 - Tax havens**

This chapter will focus on the existing literature on tax havens, its features, challenges and success.

### **1.8.3 Chapter 4 – A survey of South African tax incentives and FDI**

This chapter will review the literature taxation in South Africa and its ability to attract FDI through the utilisation of tax incentives.

### **1.8.4 Chapter 5 - Considerations for implementing low tax rates for South Africa**

The purpose of this chapter will be a theoretical study to analyse and present the considerations for implementing low tax rates for South Africa. All countries and specifically South Africa has a need for accelerated economic growth. Economic growth is ideally stimulated by investment and specific foreign direct investment. This invariably leads to competition between countries to attract foreign investment. Various studies have been done in relation to the role of tax rates and its impact on investment decisions.

### **1.8.5 Chapter 6 – Conclusions**

This chapter will present a summary of findings and conclusions on the research done in previous chapters. This chapter will also conclude on the findings and its

relation to the research questions. The significance of the findings will be addressed and what has been added as new knowledge on the topic.

## CHAPTER 2

### FOREIGN DIRECT INVESTMENT

#### 2.1 INTRODUCTION

In this chapter the role of foreign direct investment and its relation to taxation will be reviewed. The rates of taxation feature as one of the determinants in the investment decision (Easson, 2004:52). This chapter will describe the practice of using tax as an incentive to attract FDI as well the benefits and constraints of doing so. The case for developing countries to utilise tax as a means to attract FDI will be discussed.

#### 2.2 FOREIGN DIRECT INVESTMENT

According to Easson (2004:4) a foreign direct investment may be defined as:

“...[an] investment made to acquire a lasting interest in an enterprise operating in an economic environment other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.”

This is in contrast to “portfolio” investment which generally refers to the acquisition of securities e.g. bonds or shares. Portfolio investment is seen to be “passive”, that is not having any control over or participation in the assets that form the subject of the investment. (Easson, 2004:4.)

To what extent does taxation influence the investment decision? There would appear to be a number of differing opinions despite the substantial number of studies on the subject. Some studies have argued that it should be important as it influences the cost and profitability. Easson (2004:52) states that, as a broad generalisation it seems as if tax considerations:

- play little part in the initial decision to invest abroad;

- may play a more important role in locational decisions;
- are more important for some types of investment than others; and
- are growing in importance.

Hanson (2001:20) reports on the findings of several studies done to establish the impact of taxation on FDI decisions. Recent work in public finance attempts to address these and other identification problems. Hines (in Hanson, 2001:20) summarises research on the impact of taxation on FDI. Contrary to the impression given by Wheeler and Mody, Brainard, Yeaple (in Hanson, 2001:20) a growing tax literature finds that FDI is lower in regions with higher corporate taxes.

Bènassy-Quèrè *et al*, (2003:19) have conducted a similar investigation and have concluded that: “[t]he first set of estimates strongly confirms the sensitivity of FDI to tax differentials, whatever the definition of tax rates, and the alternative specifications of the empirical model. As long as the international investment behavior of firms leads them to react to tax incentives, there might be room for tax competition.”

They further conclude that the results suggest that attracting FDI through low taxation might not prove a very efficient policy, as the sensitivity of inward FDI to lower taxes abroad is not significant, however higher tax rates are harmful to inward FDI, meaning that there should be a strong incentive for high-tax recipient countries to lower the tax burden if they intend to attract FDI. The implications are that when countries that already display relatively low tax rates, recipient countries face little incentive to further cut taxes, whereas high taxation countries should feel a strong incentive to cut taxes. Along these lines, tax competition should not necessarily end up racing to the bottom. The underlying force behind the competition for attracting FDI could rather produce a convergence in tax rates, lead by cuts in high tax countries. (Bènassy-Quèrè *et al*, 2003:23.)

Many emerging economies (developing countries) have dramatically reduced barriers to FDI, and countries have created a policy infrastructure to attract multinational firms.



This is so because there is a view that FDI helps accelerate the process of economic development in host countries. Optimism about the economic consequences of foreign investment, coupled with heightened awareness about the importance of new technologies for economic growth, has contributed to wide-reaching changes in national policies towards FDI. (Hanson, 2001:3.)

According to Easson (2004: 2) FDI can be promoted in different ways but the most common would be:

- a partial or total exemption in corporate tax rates and or customs duties. This may be supported by requirements to establish local presence and facilities and export of goods by the investor;
- tax holidays (i.e. reduction or exemption from tax for a limited period);
- investment credits or allowances for investment in capital assets;
- accelerated depreciation of capital assets;
- deduction rules that permit an amount greater than actual cost to be claimed;
- deduction of credits or reinvested profits;
- reduced rates of withholding tax;
- reduced personal tax for employees;
- exemption from value added tax or other forms of sales tax;
- property tax reductions; and
- reduced import taxes and duties.

Sun (2002:2) records the following additional factors that will also be taken into account for FDI:

- political and macroeconomic stabilities;
- a sound policy and regulatory framework and efficient institutions to support the relevant laws and regulations; and
- physical and social infrastructure.

### **2.3 THE PRACTICE OF TAX INCENTIVES FOR FDI**

In 1996 it was reported that 103 countries have offered tax incentives for FDI's. Each year around 30-40 new incentives are introduced. (Easson, 2004:85.)

Over the last number of years corporate tax rates have generally reduced, some in response to attracting FDI. To this extent countries have found themselves to be in a form of tax competition. Between 1990 and 1998, most countries reduced their maximum corporate income tax rate, with high-tax countries undertaking the largest cuts in absolute terms. In 1998, maximum tax rate on corporate income in the G-24 ranged from a high of 57 percent in Iran to a low of 25 percent in Brazil. Several countries, including Argentina, Columbia, Guatemala, Peru, the Philippines, as well as Sri Lanka, tax corporate income at a flat rate, while others, including Ghana, Iran, Mexico and Trinidad and Tobago, tax income earned by small corporations at rates much lower than for large corporations. (Hanson, 2001:11.)

Hanson (2001:11) identifies the following examples of countries actively pursuing FDI:

- Brazil has offered generous subsidies in a number of instances (GM and Ford). The country gives generous tax incentives to firms that locate manufacturing facilities in the Amazon region;
- unspecified government subsidies appeared to be important in luring Multibras, a U.S.-owned firm, to construct a \$400 million plant to manufacture air conditioners and microwave ovens in Manaus in 1998. Investment subsidies also appeared to be important in convincing Honda to build a motorcycle plant in

the area. In the absence of tax breaks, there appears to be little reason why multinationals would locate in the region; and

- as of the mid 1990s, the United States, the United Kingdom, and Japan granted foreign tax credits to multinational corporations based within their respective borders, and many other high-income countries, including Australia, Canada, France, Germany, the Netherlands, and Switzerland, exempted the foreign earnings of their firms from domestic taxation.

## **2.4 BENEFITS OF TAX INCENTIVES FOR FDI**

It is accepted that FDI would produce benefits for the investor (multi national enterprise), without which the investment will not take place. There is some dispute as to the benefits to the home or host countries. This includes the “race to the bottom” as previously alluded to. Overall evidence would suggest a benefit to the host country. FDI projects with negative outcomes have been restricted to those countries enjoying tariff protection, a practice which has become less common. (Easson, 2004:12.)

Easson (2004:11) records the following benefits of FDI for the host country:

- an increased pool of capital available for investment;
- increased revenue for the host country and community;
- increased employment;
- introduction of new skills and technology; and
- other “spillover” effects.

It would stand to reason that FDI would benefit not only the investor or the hosting country’s government but also the local community where it is resident. There appear to be little literature on this. In the USA the different states and local counties often

lobby for the establishment of foreign plants in their respective counties. Figlio and Blonigen (1999:362) have attempted to measure the impact of FDI on local communities in the USA. They conclude that there are very different results when the effects of local investments are measured against FDI. Foreign plants pay higher wages to the local community although the research was not able to verify whether this was due to a practice by foreign companies or due to the fact that they may require higher skilled workers. The study also concludes that the foreign investments also realised a change in the local government budget allocations, specifically from education to transport and public safety, again the study was not able to validate whether this in fact could only be attributed to foreign investment. The results of the study would seem to confirm very different effects of foreign plants versus local investment.

## **2.5 CONSTRAINTS OF TAX INCENTIVES FOR FDI**

Easson (2004:199) identifies the following constraints:

- internal constraints. These are practical or political in nature. Tax incentives may mean lost revenue for the state. It may therefore not be affordable. This decision can however be influenced by careful targeting of incentives;
- external constraints. The competition to attract investment has led to a universal reduction in tax rates and in many cases to an incentives war between countries. It has had the effect of reducing the fiscal sovereignty of countries;
- the rules of the World Trade Organisation (WTO). This may constitute the only legal restraint in the granting of tax incentives to attract FDI. The WTO/GATT rules amongst other prohibit the use of international taxation as a disguised form of import duty or as a means of subsidising exports. These rules would apply to all member countries. In 1999 a decision in a dispute in an action brought by the EU against the USA imposed important constraints on the use of tax incentives as a means of promoting exports;

- non discrimination: Fundamental to the WTO rules is the principle of non-discrimination. Products and services originating in member countries should be treated alike and should be treated no less or more favourable than domestic products;
- export subsidies. The WTO restricts the use of export subsidies. A subsidy could include any financial contribution by a government that is either foregone or not collected;
- the OECD. The OECD has a broad impact on the tax policies imposed by its member states. Although the OECD has no supranational powers its members undertake binding obligations. In 1998 the OECD published a report on harmful tax competition. In 2000 it published a further report and identified some 47 preferential tax regimes amongst member countries and 35 tax haven regimes. Failure by these countries to address the tax policies identified could lead to counter measures against such countries;
- the European Union. All of the 15 existing members of the EU and several of those intending to become members are members of the OECD. In addition to the restrictions imposed by the OECD they are also subject to further restrictions on their investment incentive policies. Under the code of conduct of the EU its member states will refrain from some forms of tax competition. The EC treaty furthermore prohibit or restrict state aids to industry; and
- the International Monetary Fund and the World Bank. The IMF and the World Bank have campaigned against the use of tax incentives over years. There have been instances where, as a condition to receiving financial assistance, a country has been required to eliminate tax concessions.

## 2.6 THE CASE FOR DEVELOPING COUNTRIES

Developing countries as much as developed countries have a need for FDI as much as they both need revenues to meet their obligations in terms of the supply of public goods and services.

The impact of corporate tax rates on FDI has seldom been investigated in the case of developing countries. All countries, however, compete against each other over corporate taxes to attract FDI. Statutory rates of corporate taxes have fallen considerably over the last decade, leading to substantially lower tax rates in developing countries than in developed countries. Understanding the role of low tax rates in the determination of FDI for developing countries may be crucial as it is unclear whether lower tax rates are seen by investors as a second rank determinant in the case of developing countries. (Azèmar & Delios, 2006:86.)

Azèmar and Delios (2006:99) suggest that taxes play a significant role in the location of FDI in developing countries. This suggests that tax competition plays an important role as foreign investors do react to different levels of statutory tax rates. The magnitude of the tax variable impact on FDI confirms the literature's findings on the growing influence of this foreign capital location determinant. However, in parallel, public goods have also experienced an increasing importance in the determination of FDI flows. In addition, firms and individuals will locate in the jurisdiction where they can obtain their most preferred tax-public goods package. This means that a "public goods package" will be considered in which other determinants such as education, infrastructure, and health will also be considered.

In conclusion Azèmar and Delios (2006:103) give some credit to the fear of the so-called race to the bottom, with respect to corporate tax rates, and particularly for developing countries. The downward pressures on the taxation of capital are limited by the importance of public goods and public governance which increase the attractiveness of a host country and which are partly financed by fiscal receipts derived from corporate taxes. The conclusion therefore derived in this paper would

suggest that taxes will play an important role in determining FDI and that other factors such as public governance will also be considered, fears about the “race to the bottom” can therefore not be realistic.

The limited impact of a “race to the bottom” of tax rates is also confirmed by the studies performed by Bènassy-Quèrè *et al*, (2003:26) who concludes that tax rates matter for FDI but other determinants for example market potential and public investment are also considered for FDI.

## **2.7 CONCLUSION**

In a competitive world governments often turn to fiscal incentives to promote FDI. This could take on reduction of duties or tax holidays in developing countries to investment allowances and accelerated depreciation in industrialised countries. Whilst not the only factor in attracting FDI, the popularity of tax incentives to achieve that have grown significantly since the 1990’s. (Sun, 2002:17.)

## CHAPTER 3

### TAX HAVENS

#### 3.1 INTRODUCTION

In this chapter the phenomenon of tax havens and its global impact will be discussed. Attention will also be given to the literature on tax competition.

#### 3.2 BACKGROUND TO TAX HAVENS

Tax havens dates back as far as the 12th century when the city of London exempted merchants from the Hanseatic League of paying any taxes (Oguttu, 2007:23). Despite their early existence tax havens were not frequently used for tax evasion. In modern times some forty jurisdictions have been recognised as tax havens. The European Union is serviced by offshore centres such as the Channel Islands and Guernsey and newer centres such as Gibraltar, Malta and Dublin's International Financial Services Centre (IFSC); Japan by the Pacific islands, including Vanuatu and the Cook Islands; the North America Free Trade Association by the Caribbean and Central American havens. China has Hong Kong; the Gulf states Bahrain; India and South Africa, the Seychelles and Mauritius. The provision of such offshore financial services has lifted small nations from the poverty of developing nations to levels of affluence few would have believed. By offering such facilities these countries have facilitated growth of financial markets and encouraged financial deregulation and convergence in macro and micro economic policies worldwide. (Abbott & Hampton, 1999:1.) The concept of tax havens being used for tax evasion were introduced only after the first world war and by the 1960's several banks from the United States had set up branches in the Caribbean (Oguttu, 2007:23). By the 1980's small island states began to copy established tax haven jurisdictions as a deliberate development strategy. This was often done on the advice of former colonial powers as well as development agencies.



Switzerland has in many respects been the standard bearer in Europe for tax havens with a long history of bank secrecy laws. (Sharman, 2006:21.)

Imperial powers and the international development community actively encouraged the establishment of the first tax havens following the reasoning that:

“[i]f you have a largely subsistence agricultural sector and virtually all your revenue is raised by indirect taxes or resource rents, you do not need income taxes, capital gains taxes, withholding taxes or death duties. If you do not have those taxes, there is no need to enter into tax treaties...” (Sharman, 2006:24).

Tax havens have enjoyed exponential growth over years. Per capita real GDP in tax haven countries grew at an average annual rate of 3,3 percent as opposed to 1,4 percent in the rest of the world for the period 1982 to 1999. Tax havens are viewed with concern in parts of the high-tax world, specifically the OECD countries. The concern is often expressed that the availability of foreign tax haven locations may have the effect of diverting economic activity (especially mobile capital) away from countries with higher tax rates, and eroding tax bases. This in turn will affect the ability of governments in non haven countries to raise adequate revenues. (Hines, 2004:1.)

Pressure from the United States of America’s (USA) authorities has compelled firms to move personnel to tax havens to beat the accusations of “no substantial activity”. In doing so firms established significant substance and economic activity in the havens to the extent that islands such as Bermuda and the Cayman islands became world leaders in the Insurance and hedge fund industries. (Sharman, 2006:22.)

Desai, Foley and Hines (2004:1) measured the effects of tax haven operations on the economic activities of foreign non-haven countries. In 1999, some 59 percent of multinational US firms with significant foreign operations had affiliates in tax havens. Tax havens are believed to accelerate tax competition between countries and therefore divert economic activity and revenue to tax havens. The study concludes that the tax avoidance activities enable high tax countries to maintain their high tax

rates without suffering dramatic reductions in foreign direct investment. Despite the fears of tax competition there has been little reduction over the past 25 years in the corporate tax burden in OECD countries. (Desai *et al*, 2004:1.)

The OECD has pursued an extended program against tax havens which did not always achieve the desired support from member countries. According to Sharman (2006:28) Europe and the United States settled on the OECD initiative against harmful tax competition for different reasons:

- in the case of Europe the prospect of underperforming economies, extensive welfare benefits, underfunded pension schemes and a graying population may leave them particularly vulnerable to tax competition; and
- for the United States of America the initiative was more about exchange of information and money laundering. While the USA established the Financial Action Task Force (FATF) to combat money laundering the European Union (EU) was pushing tax competition and tax harmonisation.
- In recent years the financial crisis which has seen the collapse or threatening collapse of many financial institutions have cast the spotlight again on tax havens as some of the popular views held that the financial products that went awry were hatched in the financial services industry and specifically in tax havens. The OECD through Jeffrey Owens acknowledged that tax havens were not to blame for the crisis. (Dachs, 2009:1.)

Tax havens have been defined by the OECD (1998:23) as jurisdictions where the following conditions prevail:

- no or only nominal taxes. No or only nominal taxation on the relevant income is the starting point to classify a jurisdiction as a tax haven;
- lack of effective exchange of information. Tax havens typically have in place laws or administrative practices under which businesses and individuals can

benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction;

- lack of transparency. A lack of transparency in the operation of the legislative, legal or administrative provisions is another factor in identifying tax havens; and
- no substantial activities. The absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

The features of non-exchange of information, bank secrecy and transparency had long been guarded by the Swiss banks. The practices of the Swiss bank numbered system have been copied in many instances by the havens. Heavy penalties were levied on those who betrayed the identity of account holders. Because no or nominal taxes were in force in tax havens tax evasion was irrelevant as far as crime was concerned and therefore officials were under no obligation to co-operate with investigations from foreign tax authorities. (Sharman, 2006:22.) Of the conditions mentioned above it would appear as if the requirement of no or nominal taxes would be the prime indicator of a tax haven.

Low or nominal tax rates are not restricted to the official tax havens. The following are examples of countries which have applied such in various forms, including subsidies which are a form of tax competition:

- individuals living in the United Kingdom (UK) without being domiciled there to be taxed only on their UK income (Dachs, 2009:1);
- Ireland is now offering a 12,5 percent corporate rate for all companies (Dachs, 2009:1);
- substantial fiscal subsidies in the European union (EU) to agriculture (Biswas, 2002:4);

- foreigners are not taxed on interest or capital gains derived from USA sources (Mitchell, 2007:4); and
- the states Delaware, Wyoming and Nevada in the USA are widely held to practice tax friendly environments which should classify them as tax havens (EU Business, 2009).

### **3.3 TAX COMPETITION AND GLOBALISATION**

The OECD (1998:9) recognises that globalisation has led to the liberalisation of cross-border trade and investment and has been the “single most powerful driving force behind economic growth and rising living standards”. It also recognises that globalisation of trade and investment has fundamentally changed the relationship among domestic tax systems. Removing the non-tax barriers to international commerce and investment and the resulting integration of national economies have greatly increased the potential impact that domestic tax policies can have on other economies. Globalisation has also been one of the driving forces behind tax reforms. Countries have been encouraged to review their tax systems and public expenditures with a view to making adjustments where appropriate to improve the country’s standing as an investment destination. (OECD, 1998:13.)

The reduction in tax rates have been likened to a “race to the bottom” (OECD, 1998:20). This fear originates from the fact that countries will in the process to lower tax rates due to competition from other jurisdictions have no choice but to curtail public spending and therefore not being able to finance a sustainable level of public services (Teather, 2005:55).

Teather (2005:55) points out that the facts do not bear this out. Tax rates in the EU have remained largely static for the period 1995-2002. The only significant changes being in those countries that chose, as a matter of policy to reduce tax rates in order to stimulate their economies.

### 3.4 TAX COMPETITION AND TAX HAVENS

The period since the end of the second world war has given rise to an enormous expansion to states and the liberalisation and integration of European economies, this whilst there has been differences in the composition of revenues between the respective countries. The expansion of the state depended largely on an increased fiscal base. (Lynch, 2007:116.) Globalisation of trade and therefore taxation became not only a feature of the economic landscape but also a fear amongst governments who subscribed to the thesis that the rise in cross border trade and financial flows has outpaced states' capacity to control it. This consequently has led to governments losing power to corporations and market forces. Tax competition is at the heart of disputes about globalisation. Recent advances in technology, transport, logistics and economic deregulation have provided the owners of capital with far more mobility than they had previously. An increasing number of goods and services can be produced in more locations and therefore fostering competition between countries. To attract such investors and investments, countries must adopt market or investor friendly policies or risk capital locating or relocating to other countries. Capital flight or disinvestment is not only detrimental to the macroeconomic plans of governments, but they also erode the tax base. (Sharman, 2006:3.)

Teather (2005:25) sets out the following benefits of tax competition:

- increase in savings and therefore wealth. High taxes erode investment returns and reduce the pool of available investment capital and therefore slowing growth and the potential creation of more jobs. The creation of more jobs is not only central to reducing unemployment but also creates an environment where employers will compete for available skills and will increase wages to recruit appropriate skills, the converse happens in a high tax environment;
- efficient global capital markets. The point is made that multiple layers of tax can be avoided by low tax regimes (tax havens). This problem has been recognised by the OECD and through a range of tax treaties they have attempted to

regulate or reduce the impact of double taxation although this remain a cumbersome set of regulations;

- impact on business. Business now has to compete in the global pool of investors and only the most efficient will survive. Previously the lack of new investors into a country meant that business could afford to be inefficient, the entrance of new and efficient competitors will mean that all businesses will need to be more efficient or face extinction; and
- impact on Governments. The first benefit is one of restraint. As a monopoly supplier of services, governments have an inbuilt tendency of increased costs, inefficiencies and therefore increased taxation. Tax competition allows a taxpayer to move to a more friendly tax environment. Following on from the first, the second benefit is efficiency. If tax competition curtails the natural tendency to increase taxes, the only other way to achieve its objectives is to make better use of existing resources. It also has an impact on which activities governments undertakes and therefore avoid being unduly influenced by minorities or even a desire to pacify the electorate.

Teather (2005:38) also deals with an economic analysis of tax competition. The conclusions in this on economic analysis are perhaps relevant. Teather (2005:42) remarks on the so-called “race to the bottom”; this is where countries compete in lowering tax rates and therefore reduces public spending to a point where tax rates approach zero and therefore also public spending. He points out that this argument remains theoretical and assumes amongst other things that taxes are the only factor in the investment decision.

Teather (2005:45) refers to the following assumptions that are made (incorrectly so) by the opposition of tax competition:

- global capital is fixed. An argument which does not take into account increased savings and therefore an increased pool of capital available for savings and entrepreneurs;
- global capital markets are unaffected by tax systems. The weakness of this argument lies in the assumption that all countries operate similar tax systems with only tax rates being the difference;
- government spending is perfectly efficient. The theoretical base of this argument does not take account of reality where governments, as monopolistic suppliers are known to be inefficient in the supply of goods and services. Tax competition therefore will restrict at least some of the more wasteful projects; and
- governments are perfectly benevolent and knowledgeable. This argument assumes that governments always spend on projects that increase public welfare. Governments however, are selected by a diverse group of voters and the incentive for governments to satisfy those groups irrespective of the economic outcome will be a constant temptation where tax competition is absent.

### **3.5 THE FEATURES OF COUNTRIES THAT BECOME TAX HAVENS**

The factors that define a tax haven have been defined in terms of the OECD as low tax rates, transparency, exchange information and insubstantial activities (OECD, 1998: 23). These characteristics only define countries as tax havens and do not adequately explain the conditions that prevail where such countries are so defined.

Literature would suggest some obvious characteristics and some not so obvious. Dharmapala and Hines (2006:33) have investigated tax havens using a number of features for example population, language, area, origin and latitude. They have identified the following features after measuring the tax havens on the aforementioned characteristics and compared to non-haven countries:

- the most obvious feature is that tax havens are mostly small countries with small populations;
- they score high in GDP compared to non-havens which indicate that they are affluent countries;
- most of them use English as the official language;
- United Nations (UN) membership;
- legal systems are of British origin; and
- low natural resources compared to non havens.

The most notable feature is that havens score well in governance, meaning that they have high quality governance institutions. It is noteworthy that poorly governed countries are virtually absent from the list of tax havens (Dharmapala & Hines, 2006:24).

### **3.6 PROBLEMS FACING TAX HAVENS**

Tax havens have come under increasing pressure in recent years because of its alleged status as countries or jurisdictions that, through their tax and secrecy regimes are eroding the tax base of non-haven countries. (Dharmapala, 2008:2)

This status has resulted in the OECD launching its program against “harmful practices” resulting in its publication “Harmful Tax Competition – an emerging global issue” in 1998. The publication suggests a wide range of tax measures to counteract tax havens and even ominously suggest the use of, although not defined, non tax measures. (OECD, 1998:62.)

It did not aid the case for tax havens when in 2008 the German tax authorities purchased data from a former employee of a Lichtenstein (a tax haven) Bank. The consequence of this was that several German citizens were prosecuted for tax



evasion. The questions on the use of corporate firms to use tax havens are likely to be different. Large portfolio flows are channeled to tax havens by international corporations as well as pension funds as they are likely to use tax havens as a legal method of minimising tax and after tax shareholder value. (Dharmapala, 2008:6.)

Most (non haven) governments insist on taxing economic activity that takes place within their borders, whether undertaken by domestic or foreign firms. There are two alternative approaches to taxing the foreign-source income generated by a country's resident corporations. A "worldwide" system (used for instance by the USA, the UK and Japan) taxes this foreign income. However, to avoid the "double taxation" that would result from the overlapping claims of the source and residence countries, a foreign tax credit (FTC) is allowed for taxes paid to foreign governments. On the other hand, a "territorial" system (used by most other capital exporting countries, such as Germany and the Netherlands) exempts foreign-source income from the home country taxation. There is an obvious advantage for corporate firms in a territorial situation to move income from a high tax territory to a low tax (tax haven) country. This would however not apply to a worldwide taxation situation. It is recorded that the worldwide system also has its detractors. Under a worldwide system credits would be allowed for foreign taxes paid by means of double taxation agreements. The USA would defer such credits until the profits are repatriated to the USA, such profits usually paid in the form of a dividend. (Dharmapala, 2008:7.)

Another method for corporate firms to achieve their aims would be to use transfer pricing mechanisms to allocate profits. Governments insist that "arms length" prices are used. In some markets for example intellectual property this would create problems due to the lack of a regular market and corporate firms can decide where to locate research and design activities in order to ensure that royalty payments flow to tax havens. It has been found that there is a tendency to locate research and design activities in tax havens to achieve such aims. (Dharmapala, 2008:8.)

Companies also use debt as a method (the so called thin capitalisation) to create a situation where interest payments would qualify for tax deductions in the high tax

country and not be subject to tax in the tax haven. This practice has been curtailed by the introduction of “thin capitalisation” rules which limits the deductibility of interest payments in those cases. (Dharmapala, 2008:9.)

Since the decision to invest in tax havens are mostly driven by the home country rules, the decision to invest in a tax haven can be influenced by either changing the home country rules or by adopting a worldwide tax code (Dharmapala, 2008:9).

The OECD initiative to curtail investments in tax havens have had mixed results. Data would suggest that no significant changes in portfolio flows or employment in tax havens have taken place (it is acknowledged that more research is required on this). The conclusion reached is that the OECD initiative will not have any impact on legal tax planning and information sharing. (Dharmapala, 2008:12.)

Investments in tax havens lead to wasteful expenditure both for firms participating in tax haven structures and for non haven countries enforcing their tax codes. Tax havens have been accused of forcing countries to reduce their tax rates below optimum levels. Slemrod and Wilson (2006:5) advocate the full or partial elimination of tax havens declaring it to be in the interest of the improvement of welfare.

According to Slemrod and Wilson ( in Hong & Smart, 2009:84) who have also studied tax competition in the presence of income shifting in a related theoretical framework, they conclude that the presence of income shifting to tax havens reduces welfare in high-tax countries which is in contrast to the work done by Hong and Smart.

### **3.7 OPPORTUNITIES FOR TAX HAVENS**

Increased mobility of goods and services (mobile capital) can give rise to a reduction of corporate tax bases in non haven high-tax countries, a decline in tax revenues and may induce tax competition among governments. Conversely, countries (like tax havens) may attract and retain mobile investment through a reduction in tax rates. In the view of some commentators, indeed, increased mobility can lead to a “race to the bottom” driving business tax rates to minimal levels, due to the fiscal externalities that

mobility creates. These arguments notwithstanding, there appears to be very little evidence of a general decline in effective tax rates on capital in recent years. Research would indicate corporate tax rates to rise or remain stable in the next years and not decline as suggested. (Hong & Smart, 2009:83.)

Based on the work of Hong and Smart (in Dharmapala, 2008:14) it is then suggested that where corporate firms have reduced their effective tax rates by investing in havens they will be willing to invest in the non haven at any given rate. By implication the existence of havens can improve the welfare of non haven countries.

This is supported by Oguttu (2007:45) in her doctoral thesis which states:

“ ..it appears as if tax havens offer advantages to developed countries. It has been observed that funds cannot remain in tax havens and be productive; they should be reinvested into rich and stable economies in the world. It may well be that a high percentage of most of the moneys used to fund investments such as shopping malls or finance companies are being channeled to these countries from tax haven jurisdictions. Thus the OECD’s emphasis on tax base erosion, without acknowledging that OECD countries have benefited from tax havens, leaves the (OECD,) report open to criticism that it is merely an attempt by the governments of powerful countries to protect their tax revenues even if their citizens would benefit from lower taxes.”

### **3.8 CONCLUSION**

Tax havens have been in existence since the 12<sup>th</sup> century (Oguttu, 2007:23). The mobility of capital has give rise to an increase in the numbers of tax havens and they have become very successful in attracting FDI. The robust economic performance of tax hen economies would suggest that they will continue to offer favourable tax terms to investors. Tax havens would appear, despite the arguments that they erode the tax base of high tax countries, to stimulate investment in those counties, making any decisive action against tax havens improbable. It is likely that tax havens will continue to play an important role in world tax affairs. (Hines, 2004:32.)

## CHAPTER 4

### THE CASE FOR SOUTH AFRICA

#### 4.1 INTRODUCTION

In the previous chapters the various elements of foreign direct investment, tax competition and tax havens were reviewed. In this chapter the case for South Africa will be considered, specifically the need to attract FDI and potential lessons to be learnt from the African continent.

#### 4.2 BACKGROUND

A strong macro economic framework policy has helped South African economic growth for a number of years. The slowdown in economic activity since 2008 caused mainly by the world wide economic crisis has highlighted the limitations of a domestic-demand-led growth path which has characterized the South African economy over the past years. (Barnard & Lysenko, 2010:1.)

Over the past decade, South Africa has attracted relatively little foreign direct investment (FDI), its main source of foreign capital coming from considerable amounts of portfolio inflows (mainly shares and bonds). Between 1994 and 2002, FDI inflows amounted to 1,5 percent of GDP a year, on average, whereas portfolio inflows totaled about 3,5 percent of GDP. These outcomes are in contrast with those in countries with similar risk attributes, where FDI is the dominant source of capital flows. Unlike in other emerging markets, the composition of capital inflows in South Africa appears to be skewed toward portfolio investment. (Ahmed, Arezki & Funke, 2005:3.)

### 4.3 SURVEY OF THE SOUTH AFRICAN ECONOMY

The OECD released a paper in July 2010 in which certain challenges were pointed out and some views were offered to address those (Barnard & Lysenko, 2010:13). Given the resistance of the OECD to low tax rates and tax competition it comes as no surprise that the document is silent on tax rates or the role of tax rates in attracting foreign investment.

Barnard and Lysenko (2010:13) do however point out some of the relevant problems affecting growth in the South Africa context, namely:

- finding a new sustainable growth path. It needs to improve on the framework conditions for business, higher savings, increasing the contribution of exports to growth and strengthen efforts to tackle climate change;
- strengthen the macroeconomic policy framework. This chapter points to the fiscal policies and factors, that is the exchange rates and inflation targeting which for the purposes of this dissertation we will not comment on; and
- closing the labour utilisation gap. A whole chapter is devoted to the perennial problem of unemployment in South Africa and its poor situation also compared to other developing countries. The statement is made that growth is unlikely without rapid employment.

De Wet, Schoeman and Koch (2005:206) argue the merits of the tax mix in the South African context. The results obtained from their model would indicate that, when faced with a fixed revenue constraint it would be beneficial to reduce direct taxes and increase indirect taxes; in fact a consistent decrease of direct taxes would be beneficial to economic growth. The results imply that government may be able to influence growth through reducing direct taxes.

#### 4.4 FOREIGN DIRECT INVESTMENT AND SOUTH AFRICA

Akinboade, Siebrits, and Niedermeier Roussot, (2006:178) records that in a survey conducted by the United Nations Conference on Trade and Development in 2004, investors perceived South Africa as the most attractive destination in Africa. The South African government's strategy for attracting FDI rests on three pillars, namely:

- the maintenance of an attractive business and investment climate characterized by macroeconomic stability and investment-promoting regulatory and legal frameworks;
- investment incentives, including tax holidays, depreciation allowances and relocation assistance to reduce investors' input costs. Assistance includes the Foreign Investment Grant, Strategic Industrial Projects and Critical Infrastructure Fund; and
- the investment-promotion strategy consisting of spatial development initiatives (SDIs) and industrial development zones (IDZs).

In the work done by the IMF capital inflows are characterised as FDI where the investor obtains a lasting interest of more than 10 percent in the foreign enterprise. For the period 1994-2002 South Africa attracted more than 70 percent of its inflows through portfolio investment whilst FDI remained suppressed. For the period under review South Africa attracted three times more portfolio investments than FDI. The statement is made that the composition for capital inflows for South Africa is opposite to other emerging economies which attracted far more FDI than portfolio inflows. South Africa attracted 30 percent of its capital inflow through FDI compared to 70 percent of the comparator countries. (Ahmed *et al*, 2005:4.)

The low and decreasing rate of investment has been one of the most important constraints on economic growth potential of South Africa. Gross capital formation is created by two sources: gross domestic savings and foreign investment. Savings have registered a decline and foreign investment has been highly unstable in South

Africa. South Africa has only attracted 0,33 percent of the global foreign direct investment in the period 2000 to 2002. Since 1994 South Africa has been comparatively unsuccessful in attracting foreign investment. (Akinboade *et al*, 2006:178.)

FDI into South Africa were characterised by a few large transactions adding a more volatile character to FDI. Average FDI in South Africa amounted to only 0,7 percent of GDP if the two large-scale foreign investment transactions - the partial sale of Telkom in 1997 and the Anglo-American takeover of De Beers in 2001 are excluded. (Ahmed *et al*, 2005:4.)

#### **4.5 SOUTH AFRICAN TAX INCENTIVES**

The Minister of Finance of South Africa, Pravin Gordhan has affirmed government's intention to attract international investment to South Africa. The first draft of the 2010 Finance Bill issued on 10 May 2010 contains provisions to make it more attractive for companies to establish their holding company or headquarters in South Africa. The Finance Bill includes relief around capital gains, equity participation of 20 percent or more in foreign companies. There is also relief from South Africa's legislation on controlled foreign companies, secondary tax and future dividend tax on dividend flows from South Africa. (South Africa, 2010.)

The draft legislation does not provide relief on any other form of income other than dividends and capital gains. Management fees, for example will still be taxed at 28 percent. The tax system is still under pressure to reduce tax rates although tax rates have been reduced in the last number of years. Although South Africa boasts a superior infrastructure and financial system, Mauritius has been the preferred choice of investments into Africa because of South Africa's high tax cost and strict exchange controls. (Mattern, 2010.)

#### 4.6 LESSONS FROM MAURITIUS

Mauritius is often referred to in matters concerning low tax rates, investment and economic growth. Despite its location as a remote island in the middle of the Indian Ocean and having a diverse ethnic population as well as dependency on sugar as its main source of income it has made important strides over the years to promote economic growth. Whilst Mauritius benefited from a number of factors, including its agreements on textiles and sugar, it had also launched several initiatives to make it an attractive destination for investors. (Subramanian, 2001:5.)

From the time of independence in 1968 when the sugar industry made up 26 percent of GDP, Mauritius has developed into a country where tourism, manufacturing and financial services accounting for two thirds of GDP. The International Companies Act 1994 (since replaced by the Companies Act 2001) in Mauritius has given investors the opportunity to qualify for favourable tax treatment. International companies cannot obtain relief under double taxation treaties but is exempt from the provisions of the Mauritius Income Tax Act 1995. International companies cannot operate in the Freeport. (Styger, Jhurani & Shimming-Chase, 1999:230.)

Export processing zones (EPZ) have been established in Mauritius which benefited from favourable tax treatment. Since 1982 output has grown on average by 19 percent per year, employment by 24 percent and exports by 11 percent. Although many African countries have introduced EPZ's they failed mostly because of poor institutions and execution. (Subramanian, 2001:5.)

Mauritius also boasts a strong offshore financial centre. At the end of 1997 there were 6 005 licensed offshore entities in Mauritius, up from 4 438 at the end of the previous year. Benefits for offshore banks include exemption from withholding tax on capital gains, dividends and interest. There is no exchange control in Mauritius. (Styger *et al*,1999:235.)



## 4.7 CONCLUSION

For South Africa FDI has been a source of disappointment over the years and cannot be compensated for by portfolio flows. Given the chronic unemployment problem in South Africa there may be an opportunity to stimulate economic growth through the reduction of corporate tax rates.

## CHAPTER 5

# CONSIDERATIONS FOR IMPLEMENTING LOW TAX RATES FOR SOUTH AFRICA

### 5.1 INTRODUCTION

The purpose of this chapter is to present the findings and data on the considerations for implementing low tax rates for South Africa, thereby increasing foreign direct investment and contributing to economic growth.

The extended literature review is an acceptable research method as numerous works have been published by recognised academics specialising in the fields of tax havens, tax competition and foreign direct investment (e.g. Hines, Dharmapala, Mitchell, Slemrod & Wilson). In addition organisations such as the OECD have published substantial work on the subject of tax competition and tax havens. Similarly country specific publications have been released by a number of authoritative bodies including the IMF, United Nations Conference on Trade and Development (UNCTAD) and the OECD.

The results of the chapter will provide the reader with the considerations to implement low tax rates in South Africa as well as the benefits and challenges in doing so.

The following sections will be included in this chapter to illustrate the findings:

- foreign direct investment and tax competition;
- tax havens; and
- the South African scenario.

## 5.2 FOREIGN DIRECT INVESTMENT

### 5.2.1 Introduction

According to Easson (2004:4) a foreign direct investment may be defined as:

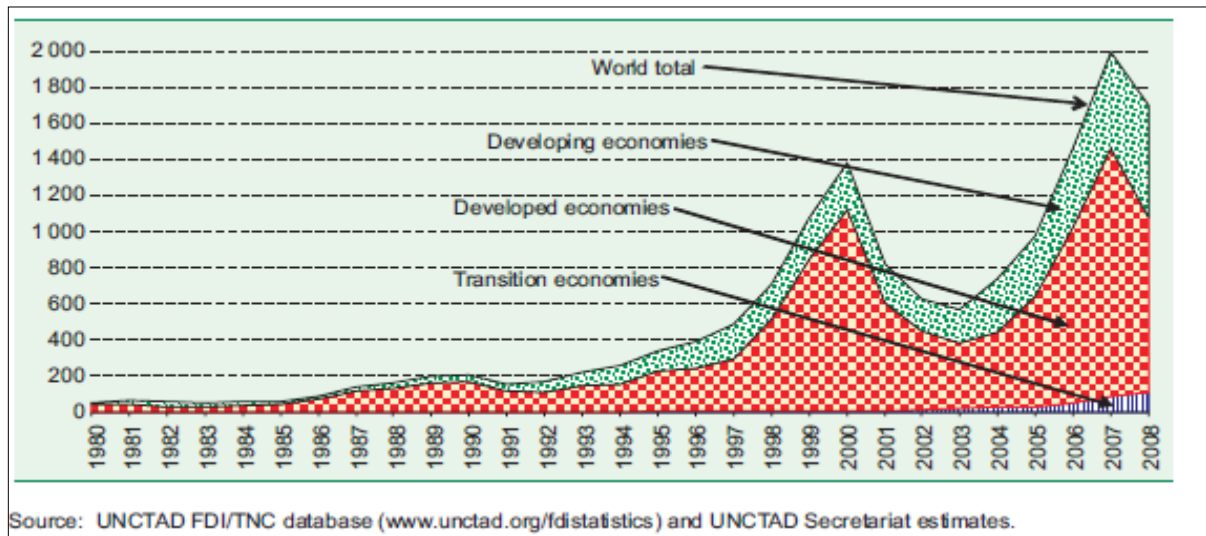
“...[an] investment made to acquire a lasting interest in an enterprise operating in an economic environment other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.”

FDI has proven to be a more stable form of investment than other forms of investment, especially in times of economic crisis. It is instrumental in the rapid and efficient cross-border transfer and adoption of best practice – ranging from technological, managerial as well as environmental and social standards. (Sun, 2002:2.) Contrast this to portfolio investment which is subject to shifts in market sentiment and can lead to larger reversal of capital flows, which can have detrimental economic effects (Ahmed *et al*, 2005:3).

### 5.2.2 The impact of FDI

According to several sources FDI has been extensive in monetary terms and in its importance for economic growth, this is particularly so with reference to developing countries. In 1996 it was reported that 103 countries have offered tax incentives for FDI. Each year around 30 to 40 new incentives are introduced. (Easson, 2004:85.) FDI flows reached \$1,979 billion dollars before the financial crisis caused a decline in 2008 (UNCTAD, 2009:3). Developing and transition countries saw their FDI inflows increase during 2008 to a combined level of 43 percent of FDI inflows. This demonstrates the increasing importance of these economies during a financial crisis – at least for the year 2008. (UNCTAD, 2009:4.) The graph below (Figure 1) illustrates the level and increase of FDI for the period 1980 to 2008.

**Figure 1: FDI inflows, global and by groups of economies from 1980-2008 (billions of dollars)**



Despite the large capital flows reported above the benefits of FDI have been debated and questioned. Several writers have analysed various components of FDI. Studies into the impact of FDI and indeed the justification for FDI seem to be exceptionally difficult and studies on the subject deal with a contained number of elements of FDI. Alfaro, Chanda, Kalemli-Ozcan and Sayek (2010:242) warns that empirical literature finds only weak support for the positive effect of FDI on economic growth. Findings indicate that a country's capacity to benefit from FDI may be limited by local conditions. Hanson (2001:48) contends that FDI is sensitive to host country characteristics, that is higher taxes will deter FDI and an educated workforce and large market will attract FDI. There is only weak evidence to suggest that FDI creates positive spillovers for host countries. Alfaro *et al*, (2010:254) finds that FDI leads to higher growth rates in countries that are financially well developed. When financial markets are adequately developed, the host country is likely to benefit from the link between foreign and domestic firms, creating spillover effects for the local economy.

Bénassy-Quéré, Coupet and Mayer (2007:780) analyse the quality of institutions in the investment decision and finds that bureaucracy, corruption, information, the banking sector and legal institutions are important determinants of FDI. They also find that capital protection and employment protection reduce FDI. De Mello (1997:4) finds

that determinants also include political stability, government intervention in the economy, property rights, the legal rights of foreign firms and international agreements on trade. Policy related incentives such as tax related incentives, subsidised loans and grants as well infrastructure provision are also listed as determinants. On the other hand local content requirements and equity requirements are seen as deterrents to FDI. Sun (2002:2) confirms that political and macroeconomic stabilities, a sound regulatory framework, efficient institutions, physical and social infrastructure are prerequisites to FDI. This is line with the sentiments expressed by the other commentators (Alfaro *et al*, 2010:54; Bénassy-Quéré *et al*, 2007:780; De Mello, 1997:4).

### **5.2.3 Tax competition and FDI**

The phenomenon of tax competition has been attributed mainly to globalisation which has caused a general rise in cross border trade and financial flows. This has allowed owners of capital, especially mobile capital to select the most advantageous option when considering investments and after tax return. Since capital flight and disinvestment threaten macroeconomic plans, countries have had to adopt investor friendly policies which included competitive tax rates; governments that cannot tax effectively cannot do much else. (Sharman, 2006:3.)

This is supported by Biswas (2002:5) who points out that international tax competition and economic development are inextricably linked. This is so as fiscal incentives and the tax environment are often critical ingredients for the location of investments.

Whereas earlier studies prior to 1990 concluded that tax was an insignificant factor in FDI decisions, more recent studies have found a marked relationship between taxation and FDI flows (Easson, 2004:53). Bénassy-Quéré *et al*, (2003:19) confirms the sensitivity of FDI to tax differentials.

Taxation is of little importance in some investment decisions, but for others highly important. A distinction is made between market-oriented FDI as opposed to export-

oriented, the former not being tax sensitive except in extreme cases and the latter being tax sensitive. This is so because for market-oriented investments the tax burden can be passed on to the consumer whereas in the case of export-oriented investments the cost and therefore the tax burden will be exported. (Easson, 2004:54.)

The importance of taxation will also vary based on the industry being targeted. Pharmaceutical companies were found to especially sensitive. (Wilson, 1993:202.) In the case of software companies tax is the primary driver of locational decisions (Wilson, 1993:215). According to Easson (2004:54) this reflects the relative mobility of the investment as well as the choice of possible locations. This is supported by a survey carried out in Europe in 1991 where the relative importance of tax was investigated. For sales outlets 38 percent reported tax as a major factor, for production plants the figure was 48 percent and for financial services 78 percent. (Easson, 2004:55.) The reasons reported by Easson (2004:55) for the growing importance of taxation as a factor for FDI are as follows:

- other factors in the investment decision have become more equal over time, leaving taxation as the remaining factor to consider;
- globalisation has brought about large scale changes in production. Components for product could be manufactured in a number of places before being assembled into the finished product. To that extent manufacturing has become much more export-oriented and therefore more sensitive to tax differentials; and
- the creation of common markets and free trade areas has had a similar effect, making it easier to supply a number of different markets from a single location.

Because there are numerous forms of taxes in most countries it is important to consider which tax considerations are more important than others. If the evidence of the most successful countries as far as FDI is considered, then some would be considered low-tax countries whilst other would be considered high-tax countries and

others lie in between. This would suggest that rather a single tax being important it is the level of “tax mix” that is more important to investors than any one tax. (Easson, 2004:55.)

The most relevant tax rate would appear to be the corporate income tax rate (CIT). The most successful countries seem to have a modest CIT rate. Whilst the nominal rate is important the effective rate is even more important as attention should be paid to tax rules governing deductions, specifically depreciation, thin capitalisation and the rules on losses. (Easson, 2004:56.)

Taxes other than the CIT rate may also play a lesser role. Easson (2004:57) records the following taxes or duties that will also be considered:

- individual income tax;
- capital gains;
- transfer pricing rules; import taxes and duties;
- value added tax ( a minor role as it should be passed on to consumers); and
- withholding taxes (dividends and interest).

A survey was conducted on Fortune 500 firms who were asked to rate in order of importance the different taxes as they affect FDI decisions. The results are given in Table 1.

**Table 1: Relative importance of different taxes**

Taxes/Incentives	Primary importance	Important	Irrelevant
CIT rate	5	27	3
Capital gains tax	1	5	22
VAT rate	1	16	9
Tax holidays	7	23	6
Transfer pricing rules	1	19	10

Source: Easson, (2004:58)

The results would confirm the lesser importance of VAT, capital gains tax and transfer pricing rules.

Tax administration has also proved to be a factor in the investment decision. Easson (2004:59) refers to the following reasons:

- laws are applied arbitrarily;
- interpretation may vary from one district to another;
- excessive penalties; and
- the law is applied differently between different industries.

An administrative feature which is appreciated by investors is the advance ruling ability to clear a transaction for tax purposes.

#### **5.2.4 The debate on tax competition**

As multinational investors began to focus on after tax returns as one of the determinants of where to invest, so countries realised that reducing tax rates could secure foreign investment and capital. Tax became another cost factor. During the 1990's some European countries, mostly high tax countries such as Germany, France and Italy became concerned that the transfer of capital from high tax to low tax economies would limit their ability to raise taxes in the post-war welfare state. This was supported by the theory of a "race to the bottom" which would force countries into a spiral of tax reductions and concessions. These fears gave rise to a concerted effort by countries through organizations such as the OECD to combat what it deems "harmful tax" competition. (Teather, 2005:23.)

The OECD (1998:13) acknowledges the phenomenon of globalisation and its effect on tax systems – notably that globalisation has been the driving force behind tax reforms . Although the OECD acknowledges the positive role played tax reforms it then declares that some of these actions have led to distorting patterns in trade and



investment leading to pressures on tax systems and reducing welfare (OECD, 1998:14).

The OECD (1998:15.) recognising that countries could have differing tax levels and policies argues that this is acceptable as long as they comply with internationally accepted standards. The OECD report is designed to guide countries in doing so.

The above actions by the OECD have set the scene to regulate tax competition between those deemed to be harmful and those that are not. The OECD actions have not been universally accepted by either scholars or countries, specifically tax havens which have been targeted by the OECD as countries falling foul of the harmful tax competition criteria, and therefore leave them exposed to the counteracting measures of the OECD. (OECD, 1998:23.)

Various writers have commented on the phenomenon of tax havens and whether the tax regimes practiced in those countries are harmful or not. Slemrod and Wilson (2006:5) argue that the initiatives against tax havens are justified and that they effectively force countries to reduce tax rates below levels which are efficient. They develop a model which they claim prove that the partial or total elimination of tax havens and therefore the tax competition provided by tax havens would be beneficial.

The results of Slemrod and Wilson are however not accepted by all. The Hong and Smart model (2009:84) predicts that tax will rates not decline, but will remain stable and even rise. They state that the proportion of corporate income taxes to state revenues in OECD countries have been rising over the period 1975-2005. (Hong & Smart, 2009:84.)

Hong and Smart (2009:92) concludes that the availability of international tax planning opportunities (tax havens) may allow countries to maintain and even raise tax rates while preventing any significant reduction of foreign direct investment. Hong and Smart (2009:92) recognise that the outcome of their model contradicts the outcomes of Slemrod and Wilson. The work of Bènassy-Quèrè *et al*, (2003:23) seems to contradict the Slemrod and Wilson model as they predict that tax rates would rather

converge lead by tax cuts in high tax countries. In contrast to the OECD and writers such as Slemrod and Wilson's opposition to tax competition other commentators have defended tax competition and its benefits. Teather (2005:25) identified several positive benefits of tax competition. Also listed by Teather (2005:45) are what he believes to be erroneous assumptions made by the critics of tax competition (refer to chapter 3).

It would appear as if there is not a universally accepted model as to the effects of tax competition specifically those where tax haven regimes are involved.

### **5.2.5 The position of South Africa**

The slowdown in the economy over the past few years has highlighted the limitations of a domestic demand led economy (Barnard & Lysenko, 2010:1). In a recent statement by Kganyago (in Manshantsha, 2010) when referring to the potential investment by Walmart: "the country is in need of foreign direct investment and Walmart's investment is exactly that". Ahmed *et al*, (2005:3) confirms the disappointing inflows of FDI as well as the distorted relationship between portfolio and FDI flows for South Africa. As is illustrated over the period 1994-2002 FDI inflows amounted to only 1,5 percent of GDP per year. In countries with similar attributes FDI is the dominant source of inflows. Table 2 below clearly reflects this imbalance. Whereas FDI promote the transfer of technology, skills, market access, portfolio flows can quickly reverse when market sentiment change. FDI is regarded as the most resilient form of investment especially in time of crisis. (Ahmed *et al*, 2005:3.)

**Table 2: Pattern of capital inflows (as a percentage of GDP)**

Country details	Average FDI 1994-2002
All countries	
FDI	2,7
Portfolio inflows	0,4
Equity flows	0,3
Bond inflows	0,2
Selected countries	
FDI	2,6
Portfolio inflows	1,0
Equity flows	0,5
Bond inflows	0,5
South Africa	
FDI	1,5
Portfolio inflows	3,5
Equity flows	2,5
Bond inflows	1,0

Memorandum items: FDI share (in % of total GDP)	
All countries	85,9
Selected countries	72,7
South Africa	29,5

Source: Ahmed *et al*, (2005:18)

Despite the concern of some writers as to the effectiveness of FDI it would nevertheless appear as if FDI, if promoted correctly can have the benefits anticipated for economic growth.

Sun (2002:2) records the following factors will to be taken into account for FDI:

- political and macroeconomic stabilities;
- a sound policy and regulatory framework and efficient institutions to support the relevant laws and regulations; and

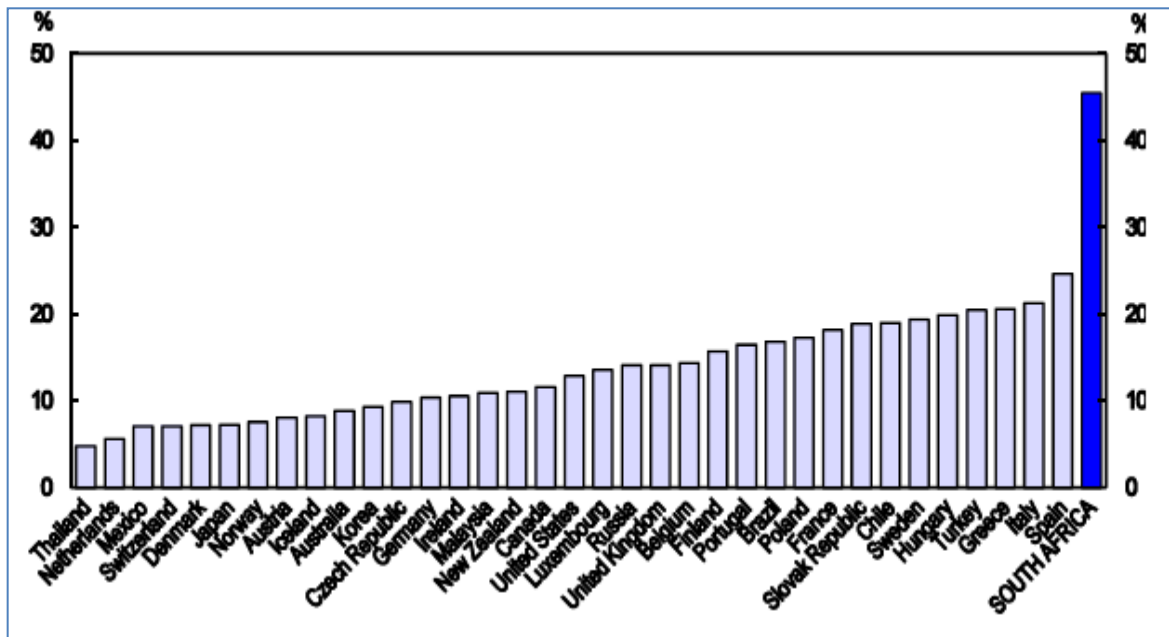
- physical and social infrastructure, including roads, communications and skilled labour.

Ahmed *et al*, (2005:6) records some of the reasons why African countries do not attract adequate FDI:

- less open than other emerging markets;
- are perceived to be more risky than other markets; and
- despite improvements made in the policy regulation environment, have lost ground relative to other markets.

As identified by Barnard and Lysenko (2010:13), South Africa needs to find a sustainable growth path, a stronger macroeconomic policy framework and to close the labour utilisation gap. The unemployment gap specifically has become a major concern for future growth prospects. This is reflected in Figure 2 where South Africa boasts the highest unemployment of a number of countries.

Figure 2: Youth unemployment rate (persons aged 15-24 years)



Source: OECD (2010:10)

In a survey conducted by the United Nations Conference on Trade and Development in 2004, investors perceived South Africa as the most attractive destination in Africa (Akinboade *et al*, 2006:178). Given that South Africa faces significant challenges to promote growth and close the labour utilisation gap it may be that utilising tax rates could provide some of the compelling arguments to attract FDI. The practice of tax incentives is well established – in 1996 some 103 countries have offered tax incentives for FDI (Easson, 2004:85).

Some of the reasons for FDI to be considered by South Africa are:

- an increased pool of capital available for investment (Easson, 2004:11);
- increased revenue for the host country and community (Easson, 2004:11);
- increased employment (Easson, 2004:11);
- introduction of new skills and technology (Easson, 2004:11);

- other spillover effects (Easson, 2004:11);
- it would be easier for a larger country to attract FDI through tax incentives than a smaller country (Haufler & Wooton, 1999:137);
- countries with well developed financial markets have greater success in generating benefits from FDI (Alfaro *et al*, 2010:54);
- taxes play a significant role in locating FDI in developing countries (Azèmar & Delios, 2006:99); and
- taxes are an important determinant of location, specifically for certain industries, for example manufacturing, pharmaceuticals and software (Wilson, 1993:201).

## **5.3 TAX HAVENS**

### **5.3.1 Introduction**

Refer to chapter 3 on the history and development of tax havens. From the above one can deduce that tax havens have been around for centuries and have managed to, especially in recent times not only survive but also become successful in their own right. The growth in tax havens in recent years can be attributed to the deregulation of financial markets, growth in world trade and investment, and the globalisation of the financial services industry (Biswas, 2002:6). This is borne out by the fact that In 1999 some 59 percent of US multinational firms had a significant presence in tax havens (Desai *et al*, 2004:1). Islands such as Bermuda and the Cayman Islands became world leaders in insurance and hedge fund industries (Sharman, 2006:22).

### **5.3.2 Debate on tax havens**

Tax havens have gained notoriety recently, specifically through initiatives launched by the OECD. Refer to chapter 3 for the review of OECD actions. Although the OECD report focuses on tax havens, it also includes “harmful preferential tax regimes” which

could include any country or practice outside of tax havens. This could have implications for many existing arrangements to attract foreign direct investment which is essentially the primary reason for adopting aggressive tax policies. The literature describes many arrangements where tax rates could be construed as low or nominal by nature; for example in the USA, states such as Delaware, Nevada and Wyoming are but examples in the USA context (EU Business.com, 2009). In Europe countries such as Ireland, the Netherlands and Switzerland have become adept at attracting investors through favourable tax rates (Carroll, 2009:5).

Actions by the OECD have not met with universal acceptance. It has been reported that US companies with a presence in tax havens are considering moving their companies elsewhere, notably Ireland and Switzerland in anticipation of changes to the US deferral system which will have negative effects on those US companies operating in tax havens. It is reported that Switzerland, through their competing districts can offer rates as low as 8 to 10 percent, whilst the Irish corporate tax rate is 12,5 percent. The argument presented by international companies is that they need to stay competitive in the global economy – and that includes the rate of tax payable, failing which they may become takeover targets for opposition companies. (McGregor, 2009.)

### **5.3.3 In defence of tax havens**

Refer to chapter 3 for a review of tax havens. Tax havens are widely believed to accelerate tax competition between governments. The tax avoidance opportunities presented by tax havens may allow other countries to maintain high tax rates without sacrificing FDI. The proliferation and widespread use of tax havens may suppress what would otherwise be an aggressive competition between other countries to reduce taxes in order to attract and maintain investment. This is borne out by the fact that, despite the incentives in place to compete over tax rates, the tax burden on corporate income in OECD countries has fallen little, if at all, over the past 25 years. (Desai, Foley & Hines, 2005:220.)

Various commentators have published papers on tax competition and the role of tax havens, (good or bad). Commentators have not agreed on their assessment of tax havens and whether their practices are good or bad for the economic health of the world. Some commentators have concluded that tax revenue are diverted from high tax countries which invoke a “race to the bottom”, all due to the fact that high tax countries are compelled to compete with low tax countries, notably tax havens. In so doing the high tax country will not be able to honour its delivery on public goods and services. They therefore argue that the total or partial elimination of tax havens will benefit all. (Slemrod & Wilson, 2006:7.)

The view of Slemrod and Wilson is not consistent with the view expressed by Hong and Smart (2009:92) who argues that high tax countries actually benefit from tax havens and allow the high tax country to maintain high tax rates without sacrificing significant capital outflows. Desai *et al*, (2004:22) argues that multinational companies who established a presence in tax havens expand rather than contract their activities in non haven countries. It would appear as if further research would be required to assess the impact of tax havens on the economies of the world.

#### **5.3.4 South Africa as tax haven**

In a recent announcement, the Mo Ibrahim foundation published their index for the best governed country in Africa and Mauritius, a tax haven, was listed as the best governed country. South Africa, a non haven country and the biggest economy in Africa, was only listed as the fifth best governed country in Africa. Of interest is the fact that listed in second place is the Seychelles, another tax haven. (Mo Ibrahim, 2010.) Countries listed as tax havens can therefore not be dismissed as mere “tax havens” as the evidence would suggest that they are well governed with quality institutions.

South Africa has like any other country, a need to stimulate economic growth. To this end FDI is critical in achieving the goals of economic growth (Manshantsha,



2010).The FDI inflows for several periods have been disappointing, skewed by portfolio flows that are not sustainable (Ahmed *et al*, 2005:3).

Tax incentives have been used extensively by tax havens to attract FDI, resulting in annual growth in GDP per capita of 3,3 percent as opposed to 1,4 percent for the rest of the world for the period 1982-1999 (Hines, 2004:1). South Africa utilise tax and non-tax incentives to attract investors to South Africa. The Department of Trade and Industry (2010:115) records the following incentives for potential investors:

- research and development (R&D) tax incentive programme. This is available in terms of section 11(d) of the Income Tax Act no 58 of 1962;
- Industrial development zone (IDZ) programme. This is a purpose built estate which contains a customs-secured area (CSA). A CSA will be exempt from VAT and import duties; (section 11(1)(m) of the VAT Act no. 88 of 1991)
- critical infrastructure programme (CIP);
- automotive production and development programme;
- enterprise investment programme (EIP);
- foreign investment grant (FIG);
- business process outsourcing and offshoring investment incentive (BPO&O);
- technology and human resources for industry programme (THRIP);
- support programme for industrial innovation (SPII);
- seda technology programme (STP);
- location film and television production incentive;
- South African film and television production and co-production incentive;

- clothing and textile competitiveness programme (CTCP);
- production incentive (PI); and
- export marketing and investment assistance scheme (EMIA);

The Income Tax Act contains a number of provisions that could be classified as incentives. Whereas section 11(a) of the Income Tax Act renders expenditure of a capital nature not deductible, section 11(e) makes provision for the deduction of wear and tear on capital items that are not subject to a special allowance in terms of section 12. Section 12 contains several provisions for deductions of a capital nature.

In the recently announced draft taxation amendment laws bill, provisions were added to make South Africa more attractive as destination for company head quarters as well as fund managers. The provisions, although containing relief from capital gains tax, secondary tax, dividend withholding taxes and exchange controls, it provides no relief from income tax. (Mattern, 2010.) South Africa, although not a member of the OECD, is a member of the G20 group of countries and is probably concerned about the potential of falling foul of the OECD's campaign against harmful tax competition. Table 3 illustrates the relative position of South Africa to a few high tax countries as well as some neighbouring countries, notably Botswana and Mauritius, both of which boast lower taxes than South Africa. Mauritius is also mentioned as a tax haven.

**Table 3: How South Africa's taxes compare**

Country	Top marginal rate, personal tax	Corporate tax rate	Capital gains tax rate	VAT/GST (Yes)	VAT/GST (No)	VAT/GST rate
UK	50%	28%	28%	√		15%
US	35%	35%	35%		√	Varies amongst states, goods and services
Germany	47,5%	28-33%	28-33%	√		19%

Country	Top marginal rate, personal tax	Corporate tax rate	Capital gains tax rate	VAT/GST (Yes)	VAT/GST (No)	VAT/GST rate
Botswana	25%	15%	Effective 11,25% or 18,75%	√		10%
Mauritius	15%	15%	N/A	√		15%
Brazil	27,5%	34%	34%	√		20% average – national, 7-25% state vat
RSA	40%	28%	Effective 14%	√		14%

Source: Carte (2009)

It would therefore appear as if current measures to attract FDI to South Africa are inadequate and lack the popularity enjoyed by a number of tax havens.

Mauritius has provided some insight into the recipe employed to solve some of the once serious economic problems of the island. The economy has gone from a single crop agricultural economy to a thriving import, manufacturing and export country. (Subramanian, 2001:3.) It has signed double taxation treaties with 35 countries with 6 more agreements waiting for signature (PricewaterhouseCoopers, 2009). Table 3 illustrates that Mauritius has the lowest nominal tax rates of the countries listed in the table. In addition to low tax rates it operates a free port and thriving offshore centre (Styger *et al*, 1999:234). Mauritius also scores well when it comes to governing of the country. Consistent with the views expressed by other commentators like Dharmapala (2008:2), Mauritius is a well governed country, confirmed by the recent Mo Ibrahim index (Mo Ibrahim, 2010).

South Africa will need to rethink its use of tax rates as the current measures do not seem to have the desired effect for attracting FDI. In so doing it will need to be cognisant of the views of the OECD on harmful tax competition. It may well be that a combination of tax incentives and rates provide the necessary interest for improved

FDI. Also mentioned was that a change in the tax mix as suggested by De Wet *et al*, (2005:206) and Easson (2004:55) could be considered. South Africa already has much of the ingredients of the recipe, including the prerequisites of tax administration and an advance tax ruling system (Easson, 2004:59).

In the final analysis the comments of Hines (2004:2) may well be worth considering, namely that : “...even very low rates of direct taxation of business investment may yield significant tax revenues if economic activity expands in response, producing wealth and expenditure that augment tax bases.”

## CHAPTER 6

### CONCLUSIONS

#### 6.1 INTRODUCTION

All countries have a need for economic growth. As most countries would not be able to finance growth from domestic investment only, countries strive to attract foreign investors, also known as foreign direct investment. In order to attract foreign investment, governments would use a variety of tools including fiscal instruments such as taxation in one form or another to convince foreign investors to establish a presence in the country.

This chapter will conclude on whether South Africa can use taxation in a similar manner as tax havens in order to attract foreign direct investment.

#### 6.2 PURPOSE STATEMENT AND OBJECTIVES

The purpose of this study was to analyse the role of low tax rates as a means to increase foreign direct investment and consequently stimulate growth in South Africa. This was done and the conclusion reached.

The study considered the following research objectives:

- to analyse the secondary literature on low tax jurisdictions in order to establish a theoretical basis for the study. This was done in chapters 2, 3, and 4; and
- to analyse low tax jurisdictions as a means to increase foreign direct investment from a South African point of view. This was done in chapter 5.

### 6.3 SUMMARY OF FINDINGS

Despite the voluminous work done on foreign direct investment there seem to be contradictory views on whether it aids economic growth or to what extent. Like most other decisions about fiscal policy, the execution would seem to be as important as the intent. Foreign direct investment can only realise benefits in a suitable environment. Foreign investment is hardly found in countries with a poor regulatory environment, inadequate infrastructure and deficient institutions. The contrary is rather true, despite a favourable view of South Africa from investors, South Africa has not been able to secure adequate FDI. South Africa has the ingredients to convince investors of its standing as a country with a strong macroeconomic framework, strong institutions and an extensive infrastructure, especially from a regional basis to attract investors. As pointed out by literature on foreign direct investment, even though the benefits are sometimes questioned, well developed financial markets are one of the enabling features of foreign direct investment, a feature which South Africa can rightly claim to be one of the advanced on the continent.

Tax competition, which is inextricably linked to attracting foreign investment, has received much publicity in recent years, much of it negative. The campaign of the OECD to stamp out what it called “harmful tax competition” gained ground as high tax countries became concerned that capital were flowing to low tax destinations – specifically countries branded as tax havens, to this end the OECD set criteria for tax havens with the threat of counter measures should these countries not conform to OECD rules and practices. At the heart of the debate is not so much whether countries agree to exchange of information but whether low or nominal tax structures will be tolerated. Since most of the OECD member countries are known to be high tax countries it is not certain whether the debate will progress past exchange of information agreements. The phenomenon of tax competition is resident in any fiscal incentive to attract investors – something high tax countries also practice through subsidies, exemptions and tax holidays. It is conceivable that future forms of tax

competition may be scrutinized by the OECD and will lead to much debate amongst members and non-members of the OECD.

Tax havens have been in existence for centuries, the most evident feature of a tax haven being the absence of or only modest taxes being levied. Tax havens of today are far more sophisticated as is evident by the operations conducted by hedge funds and captive insurance industries from tax havens. Tax havens are also characterised by strong institutions of government as is evident by the Mo Ibrahim award going to Mauritius with the Seychelles taking second place – both labeled as tax havens. The agreements on exchange of information will probably make tax havens less attractive for unscrupulous tax payers wishing to avoid tax liabilities in their own countries. Tax havens as sovereign countries in their own right will continue to manage their economies as best they can which includes making it attractive for investors.

South Africa has a poor record as far as foreign direct investment is concerned. It has relied on portfolio flows for much of the capital inflows to the country, this despite what would seem many incentives from the department of Trade and Industry and National Treasury. It would seem as if the “package” offered by South Africa is not sufficient to attract foreign direct investment. Several commentators have pointed out that there is any number of factors in the investment decision and that foreign investment is seldom attracted to countries with poor institutions. It may be argued that South Africa would qualify on the grounds of its economic framework, infrastructure and institutions. The current levels of tax would appear not to be attractive enough despite efforts by South Africa to make the country attractive for headquarter companies and fund managers. It is probable that South Africa, although not a member of the OECD does not want to upset that organisation with its fiscal incentives. Mauritius has proved that low tax rates need not be associated with “parasitic tax havens” as some commentators have labeled them.

South Africa has reached critical levels of unemployment and needs to institute measures to promote strong economic growth. For South Africa there is an

opportunity to devise a clever range of tax incentives that can compete with low tax countries.

## **6.4 CONCLUSIONS**

Taxation as a determinant, although not the only determinant has been increasing in importance relative to the investment decision. South Africa although boasting a number of measures to attract foreign investment has not utilised tax rates to do so. Despite achieving favourable mention from investor surveys as well as the factors such as strong institutions, economic frameworks and infrastructure, foreign direct investment have been lacking. Commentators have pointed out that many of the distinguishing features such as institutions and governance have become accepted as the norm and taxation has become an important differential to attract foreign investment. South Africa already possesses most of the ingredients to compete but it will need to be more creative to attract foreign direct investment in the face of fierce competition. Investors have the luxury of choosing the best investment destination, South Africa is ideally placed in Africa to be the destiny of choice, and it will need to employ all its capacity to attract investors, including the use of reduced tax rates and incentives, even if this means a less harmonious relationship with the OECD.

## **6.5 SUMMARY OF CONTRIBUTIONS**

There is no simple formula for foreign direct investment. Much depends on the “package” presented in order for the investor to consider the alternatives. Tax differentials have become more important in the investment decision than previously.

Tax havens although vilified by specifically by the OECD will probably weather the storm although they may have to adapt to survive. The OECD representing high tax countries will continue to campaign against tax havens and what it deems harmful tax practices. Several countries outside of tax havens have incentives in place normally associated with tax havens to attract investors. There is no commentator that suggests that tax competition will abate as it is a means of luring foreign investment.



South Africa has demonstrated a willingness to attract foreign investors to South Africa with several incentives targeted at potential investors. Given the fact that the incentives do not translate into reduced tax rates it is not envisaged that South Africa as an investment destination will be able to compete with low tax countries in the region, specifically Mauritius.

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