

**A critical analysis of the fiscal incentives offered to particular South African Special
Economic Zones**

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ABSTRACT

Special Economic Zones (SEZs) have proved an effective tool to encourage and incentivise foreign direct investment in developing countries over the past 50 years. South Africa has been a relatively late adopter of an SEZ regime and only formally incorporated SEZs via the Industrial Development Zone (IDZ) programme in late 2000. The IDZ programme has been largely unsuccessful with limited and slow investment. This has resulted in an overhaul of the programme resulting in the launch of the SEZ programme in 2012 which included the promulgation of the Special Economic Zones Act and a suite of new tax incentives which were announced in the 2013 Taxation Laws Amendment Act.

This study was performed in order to analyse the fiscal incentives available to South African SEZs against the backdrop of successes and failures experienced by other developing nations with more mature SEZ regimes. By firstly reviewing the history of SEZs internationally, context was provided which indicated the need for a successful SEZ programme in South Africa. As globalisation has developed in the modern era, so too has competition for foreign direct investment amongst developing nations. It is thus of paramount importance for South Africa, as late adopters, to ensure that their SEZ programme is designed appropriately.

A detailed analysis of each tax incentive was performed which illustrated where opportunities can be found by foreign investors and additionally highlighted some disincentives in the South African regime. A review of the main incentives offered by the more developed and successful developing nations (Brazil, Russia, India and China) identified certain opportunities where South Africa could learn from the successes and failures of these countries. Further, some specific case studies were analysed in order to glean risks to the sustainability of South Africa's SEZ programme.

From these reviews and comparisons it was found that whilst it may not be possible to predict whether or not South Africa's SEZ programme will be successful, there are some areas where it is suggested that the current fiscal incentives can be enhanced to encourage quicker investment by foreign companies and the creation of investment which has a sustainable benefit to the local economy.

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LIST OF ABBREVIATIONS

Abbreviation	Meaning
BRIC	Brazil, Russia, India and China
BRICS	Brazil, Russia, India, China and South Africa
CCA	Customs Controlled Area
CCAЕ	Customs Controlled Area Enterprise
CIT	Corporate Income Tax
DTI	The Department of Trade and Industry
ETI	Employment Tax Incentive
ETI Act	Employment Tax Incentive Act, 2013 (Act No. 26 of 2013)
FDI	Foreign Direct Investment
IDZ	Industrial Development Zone
Income Tax Act	Income Tax Act, 1962 (Act No. 58 of 1962)
PIT	Personal Income Tax
TTC	Total Tax Contribution
SEZ	Special Economic Zone
SEZ Act	Special Economic Zones Act, 2014 (Act No. 16 of 2014)
VAT	Value-Added Tax
VAT Act	Value-Added Tax Act, 1991 (Act No. 89 of 1991)

1. Introduction

1.1 Background

South Africa is a country with great economic potential and, although it has seen growth over the past 20 years, the progress has been slow and the country still faces massive challenges particularly in respect of poverty and inequality. The National Development Plan, set forth by the Department of the Presidency's National Planning Commission in 2012, aims to eliminate poverty and reduce inequality by 2030 and has identified a failure to implement policies and an absence of broad partnerships as the main reasons for slow progress in the past.¹ As a developing nation, South Africa has a low level of savings making it reliant on foreign capital for development. As a result, the South African government is continually looking for ways in which to attract foreign direct investment (FDI).²

The National Development Plan indicates that:

*Foreign investment will have to play a significant role in a context of curbed savings. These investments lead to rising output, incomes and employment growth. Savings will rise. Over time, a larger share of investment should be funded domestically, but this will depend on how well resources are used in the short term to raise productivity, incomes and employment.*³

This statement identifies three benefits of FDI being:

1. Output . i.e. increased production leading to growth in local and foreign companies;
2. Incomes . i.e. production as a result of the increased output leads to a rise in profits of the relevant companies thereby leading to higher taxable income; and
3. Employment growth . i.e. increased production results in a greater need for skilled and unskilled labour thereby providing job creation.

The Department of Trade and Industry has identified the implementation of Special Economic Zones (SEZs) as a means to attract FDI and therefore exploit the three benefits described above. The Policy on the Development of Special Economic Zones in South Africa defines SEZs as:

...geographically designated areas of a country set aside for specifically targeted economic activities, which are then supported through special arrangements (which

¹ National Planning Commission. *National Development Plan 2030 Our Future-make it work*. 2012, 24.

² Ibid, 31.

³ Ibid, 127

*may include laws) and support systems that are often different from those that apply in the rest of the country.*⁴

The basic characteristics of SEZs are business support services provided by the SEZ operator, reduced red tape and attractive incentives predominantly in the form of fiscal incentives.⁵

SEZs have been used for many years by governments all over the world, in various forms, as a policy instrument to attract FDI and are common where countries have shifted from import substitution to export-led growth policies.⁶ The effectiveness of SEZs is illustrated by their growth in number as the International Labour Organization's most recent database shows an increase from 79 zones in 25 countries in 1975 to some 3,500 zones in 130 countries in 2006.⁷ There are various different types of SEZs including, amongst others, free zones; foreign trade zones; export processing zones; free trade zones and industrial development zones. The core nature of these different types of zones is consistent however, being a designated area where organisations operating within that area, enjoy laws more beneficial to the organisation than what would be applicable had they operated normally in the host country.⁸

South Africa has, over the years, incorporated a variety of different incentives along the lines of SEZ principles. In December 2000, South Africa launched the Industrial Development Zone Programme under the Manufacturing Development Act. This programme has led to the demarcation of the following five⁹ Industrial Development Zones (IDZs):

- Coega IDZ in Port Elizabeth, Eastern Cape;
- East London IDZ in East London, Eastern Cape;
- Richards Bay IDZ in Richards Bay, KwaZulu Natal;
- OR Tambo International Airport IDZ in Kempton Park, Gauteng; and

⁴ Department of Trade and Industry. *Policy on the development of Special Economic Zones in South Africa*. 2012, v.

⁵ Ibid, 1.

⁶ M Engman, O Onodera and E Pinali. *Export Processing Zones: Past and Future Role in Trade and Development*. OECD Trade Policy Working Papers, No 53. 2007, 51.

⁷ International Labour Organisation. *Working paper: ILO database on export processing zones (Revised)*. 2006, 1.

⁸ Farole, T. *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences*. 2011, 23.

⁹ Subsequent to the launch of the Special Economic Zones policy, the DTI has launched another IDZ at Dube Tradeport in Durban.

- Saldanha Bay IDZ in Saldanha Bay, Western Cape (launched in October 2013).¹⁰

The IDZ programme achieved limited success and thus the Department of Trade and Industry (DTI) initiated a review of the IDZ programme which culminated in the release of the SEZ Bill and corresponding SEZ policy in January, 2012. The SEZ Bill intends to convert the current IDZs into SEZs which will be governed by this standalone Act as opposed to being merely a section of the Manufacturing Development Act. The SEZ Policy states:

*The achievements of the existing IDZs are acknowledged, however, the government has felt that more could be achieved if the challenges identified within the existing IDZs could effectively be addressed. Challenges such as, lack of coordinated planning arrangements; insufficient guidance related to governance arrangements; dependence on government funding; lack of targeted investment promotion measures; and inadequate coordination across government agencies have been identified as the key constraints to the success of the programme.*¹¹

The purpose of the programme is predominantly to provide more structure to zones in order to facilitate the ease of operations of organisations intending to invest in the zones through enhanced governance arrangements and improved coordination across government agencies.¹² Through this process of overhauling the IDZ programme, the DTI identified that South Africa's performance is modest when compared with programmes in other developing countries such as China, Korea, India, Malaysia and others.¹³ Whilst the SEZ programme aims to predominantly address the implementation of non-financial incentives, it has also resulted in new financial incentives which have been introduced through the Taxation Laws Amendment Act of 2013.

The main fiscal incentives available to SEZs in South Africa are:

- Accelerated capital allowances on industrial developments on both Greenfield and Brownfield investments;
- Employment incentives through the Employment Tax Incentive Act;
- Reduced Corporate Tax rates; and
- VAT and customs duty relief via the elimination of customs duties and VAT in designated Customs Controlled Areas.

¹⁰ Davies, R. *Address by the Minister of Trade and Industry, Dr Rob Davies to the National Council of Provinces (NCOP), on the Special Economic Zones Bill 2013.* Available <https://www.thedti.gov.za/editspeeches.jsp?id=2997> . Accessed: 22 March 2014.

¹¹ Department of Trade and Industry. *Policy on the development of Special Economic Zones in South Africa.* 2012, v.

¹² Ibid, vi.

¹³ Ibid, 8.

The accelerated capital allowances are not unique to SEZs and are focussed specifically towards industrialisation within South Africa with additional incentives available if such development happens within an SEZ. The Employment Tax Incentive Act no 26 of 2013 has been in force since January 2014 and although it is applicable to all organisations within the country, it contains enhanced incentives for organisations operating within SEZs. The reduced corporate tax rate in Section 12R of the Income Tax Act¹⁴ is specific to organisations operating in SEZs and therefore represents a clear financial fiscal incentive. The concept of Customs Controlled Areas (CCAs) was introduced through the IDZ programme, and it includes, amongst other things, relief from customs duties at time of importation into a CCA; simplified customs procedures; and fiscal incentives on goods when imported.¹⁵

The effectiveness of SEZs depends on a variety of factors. As is illustrated above, the performance of IDZs in South Africa was limited by lack of structure which can be attributed to poor policy implementation, as indicated in the National Development Plan to be an issue across many policies developed by the various spheres of the Government. Whilst fiscal incentives are certainly an important method used to make an SEZ more attractive, they need to be aligned with the economic goals of the host country. Fiscal incentives that are too strong may have the effect of detracting from the country's economy as countries compete in a race to the bottom for foreign investment resulting in the costs or opportunity costs of the incentives exceeding the resulting economic growth.¹⁶ Alternatively, African countries face many microeconomic and macroeconomic challenges which create barriers to foreign organisations looking to invest. Issues such as extensive bureaucracy, perceived corruption and danger and uncertainty in sustainability all impact the risk of investment and therefore the fiscal incentives need to be sufficient to warrant a foreign organisation to accept those risks.¹⁷ It is submitted that the implementation of an effective SEZ programme is thus a balancing act between economic challenges, political policies and fiscal incentives. The first step in ensuring effectiveness is to ensure that the various aspects of the SEZ programme are designed appropriately.

¹⁴ All references to the Income Tax Act in this study refer to the Income Tax Act No 58 of 1962, unless otherwise specified. The current Income Tax Act No 58 of 1962 as referred to in this study, includes Taxation Laws Amendment Act 31 of 2013.

¹⁵ SARS. *The South African Industrial Development Zone concept*. Available: [http://www.sars.gov.za/ClientSegments/Customs-Excise/AboutCustoms/Pages/Industrial-Development-Zone-\(IDZ\).aspx](http://www.sars.gov.za/ClientSegments/Customs-Excise/AboutCustoms/Pages/Industrial-Development-Zone-(IDZ).aspx) Accessed: 22 March 2014.

¹⁶ Jauch, H. *Export processing zones and the quest for sustainable development: a Southern African perspective*. Environment and Urbanization. 2002 v14: 101.

¹⁷ Farole, T. *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences*. 2011, 253.

1.2 Objectives and rationale of the research

This study is a critical analysis of the fiscal incentives available to qualifying companies operating within a Special Economic Zone in South Africa in order to evaluate the adequacy of the design of the incentives. Central to this study are the following two questions:

- Are the fiscal incentives offered to South African SEZs strong enough to attract FDI?
- Are the fiscal incentives offered to South African SEZs too strong which may result in the exploitation of the South African economy?

The central theme of this study, being the question of adequacy of the fiscal incentives of the South African Economic Zones, therefore looks at both sides of the story i.e. whether the incentives are enough and whether they are too much.

Following from these two questions, are a number of considerations:

- What is the history of SEZs and why is South Africa implementing this programme?
- Are the incentives offered practical? i.e. how much benefit do companies actually receive?
- How have other developing nations utilised fiscal incentives to attract FDI?
- If the incentives are successful in attracting FDI, how can the resulting economic growth be sustained?

Although IDZs have been in existence in South Africa for over a decade, there has been limited research on their performance. Various studies have been performed on the design of the different aspects of SEZs internationally and specifically in Africa however these have been broader studies which focus primarily on economic or political issues. In order to identify any weaknesses or opportunities in the design of fiscal incentives it is important to analyse them at this infancy phase of implementation. It is envisaged therefore that this study will aid in identifying such weaknesses and opportunities in order to assist in the implementation of the SEZ programme, specifically in relation to fiscal incentives.

1.3 Limitations

The dissertation is not intended to propose express provisions to be incorporated into the tax legislation in order to better promote the SEZ programme. The dissertation intends only to provide suggestions as to where the problem areas may be and how the current tax legislation could be improved.

As described in the introduction, the success of an SEZ programme is dependent on the design of the fiscal incentives and various other economic and political factors. This study

will analyse mainly the fiscal incentives. Whilst economic and political factors will be considered in discussion on the overall investment climate created within SEZs, these factors will not be analysed in detail as they are beyond the scope of this study.

1.4 Structure of Study

The study is structured as follows:

- Chapter 2 will provide an introduction to Special Economic Zones and detail the different types of Zones and follow on to provide a brief history of Special Economic Zones in South Africa and how they have evolved to the current programme. This chapter serves to give perspective to the current SEZ programme and how the types of zones utilised in South Africa contrast with those used in other countries. The research for this chapter will be through literary review on academic literature on this and related topics.
- Chapter 3 will detail the fiscal incentives available to companies operating in Special Economic Zones in South Africa through looking at incentives specific to Special Economic Zones and other broader industrialisation incentives from which these companies can benefit. The purpose of this chapter is to detail what incentives are available and to highlight any inherent limitations in such incentives. The research for this chapter will be through analysis of the relevant legislation and review of related academic literature and press articles.
- Chapter 4 aims to analyse the South African fiscal incentives against the incentives offered by similar Zones in other countries. The fiscal incentives of zones in other BRICS countries will be reviewed to determine instances where they differ or are or similar to South Africa. This chapter will look to provide opportunities for South Africa to learn from other countries in order to gauge competitiveness and provide the zones with adequately designed fiscal incentives.
- Chapter 5 aims to identify key considerations which South Africa can identify in these early phases of their SEZ programme in order to ensure the sustainability of the economic growth that is likely to result from the FDI and prevent the creation of aggressive competition with other African countries in order to mitigate the risk of a race to the bottom. This will be done by reviewing case studies of the evolution of certain SEZs in other developing countries with a focus on the role that fiscal incentives have played.
- Chapter 6 will provide a conclusion on the adequacy of the fiscal incentives offered to companies operating within South African Special Economic Zones with suggestions on how the fiscal incentives in the South African SEZ programme can be improved.

2. The global and local approach to Special Economic Zones

2.1 Introduction

The Policy on the Development of Special Economic Zones in South Africa defines SEZs as:

*...geographically designated areas of a country set aside for specifically targeted economic activities, which are then supported through special arrangements (which may include laws) and support systems that are often different from those that apply in the rest of the country.*¹⁸

This appears to be a very broad definition which is appropriate as SEZs can be incorporated through a variety of different vehicles. As Farole and Akinci indicate in The World Bank document, *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*, the image of a SEZ may be very different depending who you ask ranging from perspectives of footloose multinational corporations (MNCs+) exploiting local labourers whilst enjoying tax breaks, to success stories like the transformation of Shenzhen from a fishing village to high-growth city.¹⁹ Various different types of SEZs have been used internationally for many centuries and the form of the specific zone is dependent on the policy objectives of the implementing nation. SEZs are usually established with the aim of achieving one or more of the following four policy objectives²⁰:

1. **To attract foreign direct investment (FDI):** Virtually all zones programs, from traditional EPZ to China's large-scale SEZs aim, at least in part, to attract FDI.
2. **To serve as “pressure valves” to alleviate large-scale unemployment:** The SEZ programs of Tunisia and the Dominican Republic are frequently cited as examples of programs that have remained enclaves and have not catalysed dramatic structural economic change, but that nevertheless have remained robust job-creating programs.
3. **In support of a wider economic reform strategy:** In this view, SEZs are a simple tool permitting a country to develop and diversify exports. Zones reduce anti-export

¹⁸ Department of Trade and Industry. *Policy on the development of Special Economic Zones in South Africa*. 2012, v.

¹⁹ Farole, T and Akinci, G. *Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011, 1.

²⁰ FIAS (Foreign Investment Advisory Service). *Special Economic Zones. Performance, Lessons Learned, and Implications for Zone Development*. 2008, 12.

bias while keeping protective barriers intact. The SEZs of China; the Republic of Korea; Mauritius; and Taiwan, China, follow this pattern.

4. **As experimental laboratories for the application of new policies and approaches:** China's large-scale SEZs are classic examples. FDI, legal, land, labour and even pricing policies were introduced and tested first within SEZs before being extended to the rest of the economy.

The following table indicates 5 general types of zones which will be explored in this chapter:

Table 2.1 . Summary of Types of Zones²¹

Type of zone	Development objective	Typical size	Typical location	Activities	Markets	Examples
Free trade zone (commercial-free zone)	Support trade	<50 hectares	Port of entry	Entrepôt and trade-related activity	Domestic, re-export	Colon Free Zone (Panama)
Traditional EPZ	Export manufacturing	<100 hectares	None	Manufacturing or other processing	Mostly export	Bangladesh, Vietnam ¹
Free enterprises (single unit EPZ) ²	Export manufacturing	No minimum	countrywide	Manufacturing or other processing	Mostly export	Mauritius, Mexico
Hybrid EPZ	Export manufacturing	<100 hectares; only part of area is EPZ	None	Manufacturing or other processing	Export and domestic	La Krabang, Thailand
Freeport/SEZ	Integrated development	>1,000 hectares ³	None	Multiuse	Internal, domestic, and export	Aqaba, Shenzhen

Sources: Derived from FIAS (2008) and Farole (2011).

Note: EPZ = export-processing zone; SEZ = special economic zone.

1. Bangladesh passed a new Economic Zones Act in 2010 that will open up the potential of zone activities beyond the traditional EPZs; Vietnam has various forms of economic zones, among which are EPZs.

2. Many EPZ programs offer licenses for both EPZ industrial parks and "single unit" EPZs. Examples include Dominican Republic, Honduras, and Kenya.

3. Some multiuse SEZs, particularly those that do not include a resident population, may be smaller in scale.

2.2 Types of Special Economic Zones

2.2.1 Free Trade Zone (FTZ)

Also known as commercial free zones, these are fenced-in, duty free areas, offering warehousing, storage, and distribution facilities for trade, transshipment, and re-export operations. These are located in most ports of entry around the world.²² These are the oldest and most common form of SEZ and are generally small areas located at a port of entry but segregated from the main area of the port as they lie outside the customs territory of the host

²¹ Farole, T and Akinci, G. *Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011, 2.

²² FIAS (Foreign Investment Advisory Service). *Special Economic Zones. Performance, Lessons Learned, and Implications for Zone Development*. 2008, 3.

country and allow for duty- and tax-free imports of certain goods.²³ An example of this would be the duty-free shopping area of an international airport.

2.2.2 Traditional Export Processing Zone (EPZ)

Usually larger than FTZs, EPZs are industrial estates offering special incentives and facilities for manufacturing and related activities aimed mostly at export markets. The entire area within the zone is exclusively for export-oriented enterprises licensed under an EPZ regime.²⁴ This differs from FTZs in that actual manufacturing or processing occurs in these zones with the focus on export as opposed to simply free trade.

2.2.3 Free enterprises

Also known as Single Factory EPZs, these provide incentives to individual enterprises regardless of location; factories do not have to locate within a designated zone to receive incentives and privileges. They are similar to bonded manufacturing warehouse schemes although they typically offer a broader set of benefits and more flexible controls.²⁵ These have occurred in many African countries where local governments will offer specific incentives to an enterprise in order to encourage them to invest and develop in their country.

2.2.4 Hybrid Export Processing Zone

A sub-divided EPZ which includes a general zone open to all industries and a separate EPZ area reserved for export-oriented, EPZ-registered enterprises.²⁶ These are an evolution of traditional EPZs meaning that modern EPZs are open to a much wider range of industries through relaxing the investment and export requirements of traditional EPZs.²⁷

²³ Woolfrey, S. *Special economic zones and regional integration in Africa*. 2013,3.

²⁴ FIAS (Foreign Investment Advisory Service). *Special Economic Zones. Performance, Lessons Learned, and Implications for Zone Development*. 2008, 3.

²⁵ Ibid

²⁶ Ibid

²⁷ Woolfrey, S. *Special economic zones and regional integration in Africa*. 2013,3.

2.2.5 Freeport/SEZ

These typically encompass much larger areas than FTZs and EPZs. They accommodate all types of activities including tourism and retail sales, permit on-site residence, and provide a broader set of incentives and benefits. The large-scale free ports in China are a traditional example.²⁸

Other types of zones

Other types of zones that are less-frequently used include:

- **Enterprise zones:** the intention of which is to revitalize distressed urban or rural areas through the provision of incentives and financial grants.
- **Specialised zones:** include science/technology parks, petrochemical zones, logistics parks, or airport-based zones.²⁹

2.3 History of Special Economic Zones

2.3.1 The early years: from a trade to an export focus

Whilst only formalised over the last 60 . 70 years, the concept of SEZs has existed for centuries as a means for societies engaged in external trade to have secured areas at ports or strategic locations where their goods can be stored or exchanged. As these secured areas were naturally free of local prohibitions, they developed into free trade zones. Many consider the Island of Delos in the Cyclades as the first approximation of a free zone, in the sense that it provided free-trade-like conditions as a result of its limited size thereby creating a need for the importation of basic commodities, eventually resulting in the development of a major port and trading platform which was later granted toll-free status by the Roman Government in 166BC.³⁰

²⁸ FIAS (Foreign Investment Advisory Service). *Special Economic Zones. Performance, Lessons Learned, and Implications for Zone Development*. 2008, 3.

²⁹ Ibid.

³⁰ Champion, C.B. 2003; Reger, G. 1994 in Baissac, C. *Brief history of SEZs and overview of policy debates*. 2011, 31.

Between the 13th and 17th centuries, cities along the Baltic Sea and through Europe used SEZ like incentives and restrictions to create monopolies in certain trades. The European expansion in the 1800s used SEZ-like charters and privileges extensively as a means to concentrate trade and resources of concessional territories which ultimately resulted in the development of regions including Hong Kong SAR, China and Singapore.³¹

These early SEZs were predominantly FTZs located at ports purely for trade purposes. Traders from various countries could meet within the zone and import, trade and export with little restrictions, essentially a marketplace free of local duties and regulations. The Spanish FTZs were among the first to accommodate industrial production across all FTZs, the inclusion of production processes, however, was on a very limited and localized basis. In 1948, the Commonwealth of Puerto Rico implemented a program to attract US firms to set up manufacturing operations to serve the mainland US market. This export-oriented strategy had 3 primary components consistent with modern day EPZs being: a FTZ for American companies; investment promotion in the US and the financing of infrastructure for rent by investors.³²

Whilst Puerto Rico preceded it, Shannon Free Zone in Ireland is widely credited as being the first formalised EPZ as it combined the attributes of a FTZ with an industrial park resulting in an industrial enclave that exchanged capital, commodities and labour flows with the surrounding economy. The characteristics of Shannon Island included:

- A differential customs regime;
- An investment incentives regime;
- Dedicated support functions to facilitate administrative tasks, from investment to labour;
- An industrial zone with ready-built infrastructure; and
- Co-location with a major transport hub.³³

Whilst Puerto Rico pioneered the combination of incentives, promotion, and industrial buildings; Ireland enhanced this combination by concentrating the components into a strategic geographic location. In the 1960s however, the Mexican Government further developed this approach by offering abundant and cheap labour to US firms as a means to counter the Mexican unemployment problem thus manipulating the concept of an SEZ for a

³¹ Baissac, C. *Brief history of SEZs and overview of policy debates*. 2011, 32 . 37.

³² Ibid.

³³ Ibid.

specific objective by introducing different sets of rules and restricting investment within the zones. The principles of these three zones formed the basic structure of modern day SEZs and predominantly traditional EPZs.³⁴

2.3.2 The late 1900s: globalisation and export processing zones

Since the mid-1960s, the focus within the developing world has been for industrialisation and EPZs have been used as a key instrument to achieve specific policy goals of developing nations. The rapid and sustained growth experienced by Asian EPZs in the 1960s and 1970s, as a result of firms from developed nations exploiting the incentives offered in the developed nations, saw an expansion in the use of EPZs across the continent. Taiwan-China and India took the lead but by the end of the mid 1970s, countries such as Indonesia, Malaysia, the Philippines, Thailand, Singapore, and Sri Lanka followed suit. At the same time, Latin America saw similar success and expansion of SEZs using predominantly FTZ structures. Colombia and the Dominican Republic were early adopters and were quickly followed by El Salvador, Guatemala, Honduras in the early 1970s and later Nicaragua, Jamaica and Costa Rica.³⁵

The Middle East and North Africa initially opened FTZs in countries such as Egypt, Israel, Jordan and Syria which evolved to include manufacturing activities in the 1990s. Sub-Saharan Africa was the last region of the World to embrace the concept of SEZs with early initiatives limited to countries such as Liberia, Mauritius and Senegal. Further development in this region would only be seen in the late 1990s and early 2000s.³⁶

The rapid growth of EPZ programs around the world in the 1970s and 1980s was largely as a result of the globalisation of trade and investment as advancements in technology and communication enabled the vertical and spatial fragmentation of manufacturing into highly integrated global production networks+ particularly in light manufacturing sectors like electronics, automotive components and clothing and textiles which have accounted for the large majority of investment in traditional EPZs. ³⁷

³⁴ Ibid.

³⁵ Ibid.

³⁶ Ibid.

³⁷ Farole, T and Akinci, G. *Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011, 5.

2.3.3 2000s and beyond: the need for sustained development

No other SEZ program has had as much impact internationally as the Chinese program. China initially used SEZs as a test of the controlled restructure of the whole economy through the introduction of capitalism and foreign direct investment. The initial SEZs, in the 1970s, were, much like most other countries, isolated to coastal areas. In the 1980s and 1990s however, the strategy developed to shift inwards to the country's heartland expanding to a large number of regions and towns.³⁸ China launched SEZs on a scale not seen previously and provided a platform for attracting FDI which supported the development of China's export-oriented manufacturing sector and assisted in developing the nation into the economic powerhouse that it is today.³⁹

China's growth and success of their SEZ program has largely been as a result of the scale of their SEZs and their use of wide area SEZs. Their program has been so successful that they have, more recently, expanded it globally through the use of economic cooperation zones+ as seen in China's investment into Africa.⁴⁰ This success has occurred despite the changing of the global trade and investment landscape. The economic success of EPZs in the 1900s can be described in simple terms as the developing nations creating supply for the demand of developed nations. The 2008 and 2009 economic crisis highlighted however, that the United States and European economies can no longer be the only engines of global demand. Most countries will therefore need to design more sophisticated strategies than the basic EPZ in order to attract FDI by MNCs. The challenge is thus to create zones that not only attract FDI, but sustain it without long-term damaging economic effects to the host country. The challenge for countries is to ensure that their SEZ programme is acutely focused and designed toward their long-term economic strategy. Current trends are for zones to move away from traditional EPZ either in the direction of becoming broader wide use SEZs such as multiuse developments encompassing industrial, commercial, residential and even tourism activities; or in the direction of specific high-end services like information communication technology (ICT) and biotech.⁴¹

A further trend seen in the development of modern-SEZs is the increased involvement of private-sectors in zone development and operation. This increased participation of private

³⁸ Baissac, C. *Brief history of SEZs and overview of policy debates*. 2011, 32 . 37.

³⁹ Farole, T and Akinci, G. *Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011, 5.

⁴⁰ Baissac, C. *Brief history of SEZs and overview of policy debates*. 2011, 32 . 37.

⁴¹ Farole, T and Akinci, G. *Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011, 5 -7.

firms has led to significant changes to the range of facilities and services offered. The proportion of privately developed and operated zones has increased from less than 25 percent in the 1980s to approximately 62% with the key factors for this increase being attributed to the perception that private zones are more successful than public zones as well as a general lack of funding for new government zone development.⁴²

2.4 Special Economic Zones in South Africa

2.4.1 SEZs in sub-Saharan Africa

The use of SEZs in Africa dates back to the early 1970s with Liberia and Senegal being the pioneers with the establishment of their EPZs. Mauritius followed suit in the late 1970s with the establishment of a single factory-based EPZ programme. Whilst the Mauritian programme has been very successful and is regarded as a good example of the Enterprise type of zone, other early adopters of SEZs in Africa failed, largely due to poor governance; a lack of institutional frameworks; weak political commitment and implementation capacity; and a lack of proper monitoring and evaluation mechanisms.⁴³ Additionally, many African zone programmes have followed the EPZ model which has proved to be inappropriate as the inflexibility has resulted in failure to integrate the zone into the domestic economy. By focussing purely on exports (as is the case with the EPZ model) the zone will struggle to create a linkage with the local economy, the zone then acts independently of the country so that the only real benefit to the local economy is through fiscal revenue which has already been reduced through incentives.⁴⁴

It wasn't until the late 1990s and early 2000s that more African countries began using SEZs as a tool to shift their economies from import substitution to export-led growth.⁴⁵ A 2008 study identified 114 zones in sub-Saharan Africa⁴⁶ implying that the region accounts for approximately 4% of the world's zones, a proportion roughly in line with the region's share of

⁴² FIAS (Foreign Investment Advisory Service). *Special Economic Zones. Performance, Lessons Learned, and Implications for Zone Development*. 2008, 3.

⁴³ Woolfrey, S. *Special economic zones and regional integration in Africa*. 2013, 8.

⁴⁴ Farole, T. *Special Economic Zones in Africa: Comparing performance and learning from global experience*. 2011, 166.

⁴⁵ Ibid.

⁴⁶ FIAS (Foreign Investment Advisory Service). *Special Economic Zones. Performance, Lessons Learned, and Implications for Zone Development*. 2008, 3.

global trade and investment.⁴⁷ Investment in African zones is predominantly in agro-processing and other natural resource-based production from a wide variety of locations.⁴⁸

A major indicator of the success of an SEZ programme is the amount of employment created. ILO data from 2006 suggests limited contribution of SEZ programmes to employment with an estimated total of just over a million workers employed by firms within SEZs across Africa.⁴⁹ Further to the lack of contribution of employment in African SEZs, evidence has shown that the employment that has been created is at the sacrifice of certain labour laws which raises concern as to whether the FDI created by the SEZs is truly beneficial to the inhabitants of the host country. The relaxation of domestic labour laws to encourage foreign direct investment is common amongst African SEZs and may include removal of minimum wage requirements and basic working condition requirements resulting in poor working conditions. Local governments have rationalised such decisions by describing such relaxation of labour laws as necessary to allay investors' fears of possible industrial unrest. The governments have therefore mitigated the risks inherent in investment in Africa by increasing the incentives rather than attempting to solve the problems that have given rise to these risks.⁵⁰

Thus, although sub-Saharan Africa has seen broad implementation of SEZ policies, the success thereof has been limited by the competition amongst the African countries in a race to the bottom for FDI. It appears that African countries have relied too heavily on fiscal incentives to attract FDI rather than other controllable variables which can be used to create an attractive investment climate.⁵¹ By over-incentivising in order to attract FDI, the costs and opportunity costs of attracting the FDI begin to exceed the economic benefit thus resulting in a system where the SEZ regime is acting in contradiction to the economic goals of the country.

2.4.2 SEZs in South Africa

Although South Africa did not implement an SEZ policy until the year 2000, with the introduction of the IDZ programme, elements of SEZs existed within other government

⁴⁷ Farole, T. *Special Economic Zones in Africa: Comparing performance and learning from global experience*. 2011, 166.

⁴⁸ Ibid.

⁴⁹ Woolfrey, S. *Special Economic Zones and regional integration in Africa*. 2013, 12.

⁵⁰ Jauch, H. *Export processing zones and the quest for sustainable development: a Southern African perspective*. 2002, 105.

⁵¹ Ibid, 106.

policies prior to that. The apartheid government introduced a number of such policies during the 1980s including:

- Deregulation laws to allow the government to declare certain areas free from national laws governing conditions in the workplace;
- Liberalisation programmes introduced from 1988 to reduce import tariffs for inputs into textile, clothing and motor-vehicle industries; and
- Industrial decentralization regulations which enabled the government to grant various concessions and subsidies to companies which were prepared to invest in designated areas, especially in the Bantustan %homelands+.⁵²

Such %disguised SEZs+ differ however from classic SEZs as they were focussed on decentralising national industrialisation in order to prevent migration of the unemployed from the Bantustans to the %white+urban areas+as opposed to the export-focus of classic SEZs and thus were not deliberately situated close to transport facilities such as harbours or airports.⁵³

The development of these disguised SEZs into a formalised policy was halted in 1994 by the country's first democratic elections.⁵⁴ The new government's neoliberal policies would however, ultimately result in the development of the IDZ programme which was adopted on 1 December 2000. The IDZ programme was developed by the Department of Trade and Industry with the aim of attracting foreign and local direct investment for the development of economic potential in specific geographical areas. Such areas would be designated as an IDZ by the Minister of Trade and Industry if he is satisfied that it:

- Facilitates the creation of an industrial complex;
- Has a strategic economic advantage;
- Provides the location for the establishment of strategic investments;
- Enables the exploitation of resource-intensive industries;
- Takes advantage of existing industrial capacity, promotes integration with local industry and increases value-added production; and

⁵² Hirsch, A. *An export processing zone strategy for South Africa?*. 1993, Trade Monitor 1.

⁵³ Jauch, H. *Export processing zones and the quest for sustainable development: a Southern African perspective*. 2002, 109.

⁵⁴ Ibid, 110..

- Creates employment and other economic and social benefits in the region in which it is located.⁵⁵

As at the date of this research, five IDZs⁵⁶ have been established in South Africa as shown in the below table:

Name	Location	Date	Industries	Size	Comments
Coega Industrial Development Zone (Coega IDZ)	Port Elizabeth, Eastern Cape	2001	Automotive, agro-processing, chemicals, general manufacturing, business processing and outsourcing and energy	11,000ha	This is the largest IDZ in the Southern Hemisphere however, despite being designated in 2001, its first investor only started to operate in 2007. ⁵⁷
East London Industrial Development Zone (ELIDZ)	East London, Eastern Cape	2002	Automotive, marine aquaculture, agro-processing of biofuels, food, timber processing, pharmaceuticals, ICT, electronics and business process outsourcing and offshoring	430ha	The automotive sector is the most developed in the IDZ and constitutes about 90% of all economic activities with Mercedes-Benz South Africa as one of its major investors. ⁵⁸
Richards Bay Industrial Development Zone (RBIDZ)	Richards Bay, KwaZulu Natal	2002	Aluminium, furniture, titanium, dry dock (ship repair) and the synthetic wood cluster.	350ha	Although designated in 2002, it only secured its operator permit in 2011 and until December 2013, it had only one investor. ⁵⁹
OR Tambo International Airport Industrial Development Zone (ORTIA)	Johannesburg, Gauteng	2010	Jewellery manufacturing and aerotropolis	725ha	The IDZ is not yet operational with construction on the planned jewellery manufacturing precinct expected to start before March 2015. ⁶⁰ Recent media has suggested that the province is

⁵⁵ SARS. *Industrial Development Zones – External Guide*. 2013, 6.

⁵⁶ On 1 July 2014, the national minister of the DTI designated Dube Tradeport in Durban an IDZ however this is still in its infancy and is excluded from this study.

⁵⁷ Pelsler, H and Clark, J. *Industry to get tax break, subsidies*. 2012. Available: <http://www.moneyweb.co.za/moneyweb-political-economy/industry-to-get-tax-break-subsidies?sn=2009+Detail> Accessed: 22 March 2014.

⁵⁸ Ibid.

⁵⁹ Ibid.

⁶⁰ Kolver, L. *Construction of Gauteng Jewellery Manufacturing Precinct to start this FY*. 2014. Available: <http://www.engineeringnews.co.za/article/construction-of-gauteng-jewellery-manufacturing-precinct-to-start-this-fy-2014-06-17> Accessed: 24 August 2014.

-IDZ)					seeking an international operator to develop an aerotropolis i.e. a terminal city with air, rail and road networks fuelling economic development. ⁶¹
Saldanha Bay Industrial Development Zone	Saldanha Bay, Western Cape	2013	Oil & Gas and Marine Repair engineering and logistics services	330ha	The newest designated IDZ has attracted strong international interest. It has a much narrower focus than the other IDZs and is the first IDZ to apply for a full Customs Control Area licence. ⁶²

Previously, the IDZ programme was administered by the Department of Trade and Industry and existed by virtue of the Manufacturing Development Act. A review of the limited success of the IDZ programme conducted by the DTI culminated in the release of the SEZ Bill and corresponding SEZ policy and ultimately the promulgation of the Special Economic Zones Act No. 16 of 2014 on 19 May 2014 (the SEZ Act⁶³). The SEZ Act will result in all current IDZs being converted into SEZs and seeks to provide structure and governance to the SEZ programme. The SEZ Act is split into the following chapters⁶³:

1. Definitions, objects and applications

- The determination of the SEZ policy and strategy and the establishment of an advisory board and fund in order to assist with the designation, promotion, development, operation and management of SEZs through developing regulatory measures and incentives and the establishment of a single point of contact for the required government services.

2. Purpose, policy and strategy

- The establishment of a policy and strategy by the advisory board in order to achieve the purpose of economic development through the promotion of national economic growth and export by attracting targeted foreign and domestic investment.

3. Special Economic Zones Advisory Board

⁶¹ SANews. *Industrial Development Zone to be created around OR Tambo airport*. Available: <http://www.engineeringnews.co.za/article/industrial-development-zone-to-be-created-around-or-tambo-airport-2013-03-07> Accessed: 24 August 2014.

⁶² Wesgro. *Saldanha Bay Industrial Development Zone*. 2014. Available: <http://wesgro.co.za/investor/sectors/saldanha-bay-industrial-development-zone> Accessed: 24 August 2014.

⁶³ The Special Economic Zones Act, 2014. Act No. 16 of 2014. Government Gazette No. 37664, 19 May 2014.

- The establishment of an advisory board consisting of not more than 15 persons from various positions e.g. DTI, SARS, National Treasury, Transnet, Eskom, the Industrial Development Corporation, business and independent persons.
4. Financing and support measures
 - The establishment of a Special Economic Zones Fund and the implementation protocol thereof
 5. Designation of Special Economic Zones
 - The process for application, designation and governance and management of SEZs.
 6. Special Economic Zone Operator
 - The process for application and the functions of an SEZ operator.
 7. General Provisions
 - Related guidelines and regulations with regard to the conversion of the IDZ programme to the SEZ programme.

The policy on the development of Special Economic Zones⁶⁴ identified the following factors as the rationale for the review of the Industrial Development Zones. These factors inform the policy which attempts to provide a clear policy framework with respect to the development, operations and management of SEZs.

1. Developments in national economic policies and strategies
 - Various changes in key economic policies and strategies post introduction of the IDZ programme.
2. Developments in the global economic environment
 - Drastic changes in the global economic environment particularly increased competition for FDI and a shift in global economic power balance from the West to the East and the formation of geo-political arrangements such as BRICS.
3. The following lessons learnt from the implementation of the IDZ programme:
 - SEZs are key tools used in the fastest growing economies including other BRICS countries.

⁶⁴ Department of Trade and Industry. Policy on the development of Special Economic Zones in South Africa. 2012, 7.

- Leadership and effective implementation may be more important than even a good policy or strategy and coordination across all tiers of government and public entities is necessary to speed up implementation.
- SEZs are a tool for economic development and not an end to itself and are not necessarily permanent but do require focus on the goal of economic or industrial development and therefore require clear strategic investment opportunities and desired industrial capabilities.

4. Modest performance of the programme:

- When compared with programmes in countries such as China, Korea, India, Malaysia and others, the performance of South Africa's IDZ programme is fundamentally modest and falls short of the expectations of all stakeholders, and requires revamping.

Whilst the new SEZ policy aims to rectify the issues faced by the IDZ programme by implementing structure through the advisory board, this comes with the risk that it assumes support from the private sector. As government officials still drive the zones, they will need to ensure there are sufficient incentives to ensure that the zones offer a significant competitive advantage to business environments elsewhere in the country.⁶⁵

2.5 Conclusion

This chapter has discussed the history of SEZs and identified various countries where SEZs have been effective tools to promote FDI and stimulate economic growth. Just as there are success stories, so too are there situations where the results of the implementation of SEZ policies of countries has not been favourable. Such failures can be for a variety of reasons but it is submitted that ultimately a successful SEZ programme needs to have an adequate balance of the following aspects:

- Political . the alignment of SEZ policies with general government policies of the country.
- Economic . the achievement of the economic targets of the programme.

⁶⁵ De Lange, J. *Experts slam special economic zones*. 2012. Available: <http://www.fin24.com/Economy/Experts-slam-special-economic-zones-20120603> Accessed: 22 March 2014.

- Fiscal - the creation of incentives that will stimulate sufficient investment to receive a return on the cost of the implementation of the policy both in infrastructure development and the opportunity cost of fiscal revenue lost by the incentives.

An example of a situation where the implementation of an SEZ programme may be considered as unsuccessful is in a case from 2001 in Namibia. The Namibian government provided massive incentives to Malaysian textile company Ramatex in order to capture a R1 billion investment over competitors South Africa and Madagascar. The incentives included the exclusion of the Labour Act, a 99 year tax exemption on land-use, duty-free imports and duty-free exports. The Namibian government hailed the negotiations as a success as it had won the investment. However opinions are that the exclusion of the Labour Act is not in line with the government policies on labour and exploits the workers (political) and the fiscal incentives are so excessive that the R1 Billion investment is offset by the lost revenue (fiscal). Therefore, although the government may have achieved the economic goal of FDI, it is not in balance with the political and fiscal goals.⁶⁶

In order for South Africa's new SEZ policy to achieve the successes it is proposing, it needs to evaluate whether it will achieve this balance of political, economic and fiscal goals. The SEZ Act aims to provide the structure needed to ensure that the political and economic goals are protected. The basket of fiscal incentives is therefore an important component of the programme that needs to be designed adequately in order to prevent a race to the bottom situation as was seen in the Ramatex case, but whilst still providing a stimulus for investment.

⁶⁶ Jauch, H. *Export processing zones and the quest for sustainable development: a Southern African perspective*. 2002, 106

3. Fiscal incentives available to companies in South African Special Economic Zones

3.1 Introduction

The purpose of this chapter is to describe the fiscal incentives available to companies that operate within SEZs in South Africa. There are incentives related to all three of the major tax revenue sources, being:

- Corporate Income Tax (CIT) in the form of reduced tax rates and accelerated allowances;
- Personal Income Tax (PIT) in the form of Employee Tax Incentives. Whilst this does not incentivise individuals in their personal capacity, it is an incentive to companies that affects the tax contribution to the Personal Income Tax net.
- Indirect Tax in the form of reductions or exclusions from Customs and Value-added Tax (VAT).

The previous IDZ programme in South Africa contained very little in terms of fiscal incentives with only the customs duty rebates and VAT exclusions and an enhanced deduction for industrialisation projects available to investors. The introduction of the SEZ programme identified that there was a need for greater fiscal incentives to encourage investment. The Taxation Laws Amendment Act of 2013 therefore introduced two new incentives in Sections 12R and 12S. These incentives are relatively straight forward in that they offer direct reductions in corporate tax rates for qualifying companies and it is hoped therefore that they will aid in attracting FDI.⁶⁷

The fiscal incentives available to companies operating in SEZs are still relatively new and therefore it cannot be assessed at this stage whether they are working or not. In order to understand their potential however, the chapter concludes with a hypothetical example of how a company operating within an SEZ can utilise these incentives to their advantage.

⁶⁷ Gad, R and Radloff, W. *Tax Incentives To Encourage Growth In SA's Special Economic Zones*. 2013. Available: <http://www.thesait.org.za/news/143340/Tax-Incentives-To-Encourage-Growth-In-Sas-Special-Economic-Zones-.htm> Accessed 26 October 2014.

3.2 Income Tax Incentives

3.2.1 S12R Income Tax Act - Special Economic Zones

Section 12R of the Income Tax Act of 1962 (Act No. 58 of 1962) (Income Tax Act) provides for a reduced rate of tax for qualifying companies operating within a SEZ.

The following aspects of the section are important to note:

- A qualifying company must either be incorporated in or have its place of effective management in the Republic. **The section does not apply to companies who have a permanent establishment in the Republic but place of effective management outside the republic.** Therefore such permanent establishments, for example branches of foreign companies, will not benefit from the section and will be taxed at the standard rate of taxation subject to any applicable double taxation agreements.
- **A qualifying company must carry on business in the category of the special economic zone or must carry on the type of business or provision of services that may be located in a SEZ and such business must be carried on or provided from a fixed place of business situated within a SEZ.** It is therefore, not sufficient just for a company to be located within the SEZ to benefit from the incentive, it must also provide the type of business that may be located within the specific zone as prescribed by the Minister of Trade and Industry. Conversely, it is not sufficient for the operations to only occur within the SEZ, it must be conducted from a fixed place of business situated within the SEZ. This may impact service organisations who provide services at their clients premises located inside the zone but whose fixed place of business is outside the zone. It is unclear what exactly constitutes a fixed place of business and accordingly, it is assumed that this will be determined based on the facts of specific circumstances.
- A qualifying company must derive **more than 90 per cent of its income from the carrying on of business or provision of services within one or more special economic zones.** The practical implication of this is that existing companies would likely incorporate a new subsidiary specific for the particular SEZ in order to separate the income derived within the zone. This increases the compliance burden of companies seeking to operate within an SEZ.
- **Companies operating in the following sectors will not qualify for the incentives:**
 - o Spirits and ethyl alcohol from fermented products and wine (SIC Code 3051);
 - o Beer and other malt liquors and malt (SIC Code 3052);
 - o Tobacco products (SIC Code 3060);
 - o Arms and ammunition (SIC Code 3577); and
 - o Bio-fuels if that manufacture negatively impacts on food security in the Republic.

- **The incentive is that the rate of taxation applied is 15 per cent.** It is unclear how the amount of 15% was determined. It is noted that after applying the dividends tax rate of 15%, the effective tax rate is 27.75% as opposed to the normal effective tax rate of 38.80%. This effective rate of 27.75% is marginally below the standard tax rate of 28% applying to South African companies. It is possible that the rate of 15% was applied in order to bring the effective rate that would be applied to a subsidiary of a foreign company in line with the effective rate of a subsidiary of a South African company operating outside the zone. The below, simple example illustrates this.

Example 3.1

	Subsidiary of Foreign Company Operating in SEZ	Subsidiary of Foreign Company Operating outside SEZ	Subsidiary of RSA Company Operating outside SEZ
Taxable Income	100	100	100
Taxation	15	28	28
Profit after tax	85	72	72
Dividends Tax	12.75	10.8	0
Effective tax	27.75	38.8	28

- S12R is applicable to any year of assessment commencing on or after the date that the Special Economic Zones Act comes in to operation and ceases to apply in respect of any year of assessment commencing on or after 1 January 2024. The Act was promulgated on 19 May 2014 and therefore the section is applicable to years commencing thereafter and the **period limitation was effectively just short of 10 years** based on the initial section. The Taxation Laws Amendment Act, 2014, Act No 43 of 2014 however extended this period limitation to 10 years after the commencement of the carrying on of business in a special economic zone. The Explanatory Memorandum to the Taxation Laws Amendment Bill 2013 indicates that this will be subject to an interim review after 5 years. The time limit may result in a barrier for foreign companies looking at long term investment into the Republic.

- The Explanatory Memorandum to the Taxation Laws Amendment Bill 2013 highlights that **transactions between qualifying companies and other companies may be subject to transfer pricing considerations** in that it will be deemed to be an affected transaction for the purposes of section 31.

3.2.2 S12S Income Tax Act – Deduction in respect of buildings in special economic zones

Section 12S of the Income Tax Act provides for an accelerated allowance on any buildings used by the taxpayer to produce income within a SEZ. The full S12S is detailed in Annexure A.

The following aspects of the section are important to note:

- **A qualifying company (as defined in S12R) may deduct an allowance of 10 per cent of any building or improvement to any building owned by the qualifying company.** This only relates to new and unused improvements and the building must be owned by the qualifying company. Leasehold improvements would therefore not qualify for this deduction unless the improvement is deemed to be owned by the qualifying company in terms of S12N (which provides for depreciation allowances in respect of such obligatory leasehold improvements undertaken on leased land or buildings owned by the government or certain exempt quasi-government entities).
- **The building must be wholly or mainly used by the qualifying company for the purposes of producing income within a SEZ.** As discussed previously, in order for a company to be defined as a qualifying company, its business activities must take place within an SEZ. It stands to reason therefore, that the building or improvement considered in this section must be physically located within an SEZ. The structure of the current IDZs are that the land within the boundaries of the zone is owned by the IDZ operating company and leased to companies seeking to operate in the IDZ. The leases therefore need to be carefully constructed in order to ensure that any building on the leased land is owned by the lessee in order to qualify for this section. Whilst the terms **wholly** and **mainly** are not defined in the Act, it is perceived that the purpose of the building should be to produce income within an SEZ and not as a premises with which to service a target market outside of the SEZ. Whilst this risk is mitigated by the limitation to non SEZ activities of 10% in S12R, it is further reinforced through this sub-clause of S12S.
- **The rate of the allowance, being 10 per cent per annum, roughly equates to the period for which the provision is applicable, as it expires on 1 January 2024.** As the rate is expressed as a percentage and not as a period (i.e. write-off over 10 years),

there may exist situations in the future where, for example, a company incurs costs on a building or improvement in 2018 where they are allowed a 10 per cent accelerated allowance for the first 6 years and thereafter, will be subject to the normal allowance rate as contemplated in section 13 of the Income Tax Act.

3.2.3 Employment Tax Incentives

The employment tax incentives applicable to companies operating within SEZs are provided for in the Employment Tax Incentive of 2013 (Act No 23 of 2013) (ETI Act). The purpose of the ETI Act is:

To provide for an employment tax incentive in the form of an amount by which employees' tax may be reduced; to allow for a claim and payment of an amount where employees' tax cannot be reduced; and to provide for matters connected therewith.

The incentive is in the form of a reduction of the employees' tax liability of a company which qualifies as an eligible employer and the incentive is calculated based on a formula determined by the number of eligible employees. A company will qualify as an eligible employer provided they are registered for employees' tax by virtue of paragraph 15 of the Fourth Schedule to the Income Tax Act.

There are two possible types of qualifying employees, either:

1. An employee between the ages of 18 and 29; or
2. An employee that is employed by a company operating within an SEZ and the employee renders services mainly within the SEZ.

The employee also must (1) be a South African (or an asylum seeker), (2) not be a connected person to the employer, (3) not be a domestic worker and (4) have been employed after 1 October 2013.

The amount of the incentive is calculated per employee; the monthly amount per employee for the first 12 months of that employee's employment is determined as follows:

- If remuneration is less than R2,000 . 50% of the remuneration;
- If remuneration is between R2,000 and R4,000 . R1,000; or
- If remuneration is between R4,000 and R6,000 . an amount calculated as follows:
 - o Incentive = R1,000 . (0.5 x (Remuneration . R4,000))

During each of the 12 months succeeding the initial 12 months of employment, the incentive is calculated as:

- If remuneration is less than R2,000 . 25% of the remuneration;
- If remuneration is between R2,000 and R4,000 . R500; or
- If remuneration is between R4,000 and R6,000 . an amount calculated as follows:
 - o $\text{Incentive} = R500 . (0.25 \times (\text{Remuneration} . R4,000))$

The effect of the above formula is that the ETI is limited to salaries and wages below R6,000 a month. The ETI Act has a time limit in that it does not apply after 1 January 2017, thus it is effective for a period of 3 years only.

3.2.4 Indirect Tax Incentives

The administration of customs controlled areas (CCA) within SEZ is provided for in Section 21A of the Customs and Excise Act of 1964 (Act No 91 of 1964) (Customs Act). This section defines a CCA as:

An area within an IDZ, designated by the Commissioner in concurrence with the Director General: Trade and Industry, which area is controlled by the Commissioner.

According to the SEZ policy, any existing IDZ will be converted to SEZ and therefore the terms are interchangeable. The Customs Act has not yet been amended to refer to SEZ instead of IDZ.

The IDZ programme envisaged that an IDZ would consist of a CCA (or multiple CCAs) where enterprises located therein will attain the benefits of a plethora of indirect tax benefits. The IDZ operator and any enterprises licensed in a CCA of an IDZ will qualify for the following incentives:

- Exemption from VAT on various types of supplies of goods and/or services to and/or from the SACU; and
- A full rebate of import Customs duties on all goods imported by the IDZ operator for the construction of the CCA infrastructure.

The IDZ operator controls the entry/exit point of the CCA with SARS conducting periodic checks on controls and procedures. Effectively any activities conducted within the CCA are free of customs and VAT. If an enterprise were to sell goods manufactured within the CCA to the local market, the duty and VAT originally suspended is brought to account. Sales of goods from the local market to clients in the IDZ will be zero-rated in accordance with schedule 1 of the VAT Act.

The creation of CCAs raises a number of practical issues specifically with regard to VAT. SARS released Interpretation Note 40 in 2012 in order to clarify the VAT implications of the various types of supplies of goods/services to and/or from a CCAE/IDZ operator located in a CCA of an IDZ.

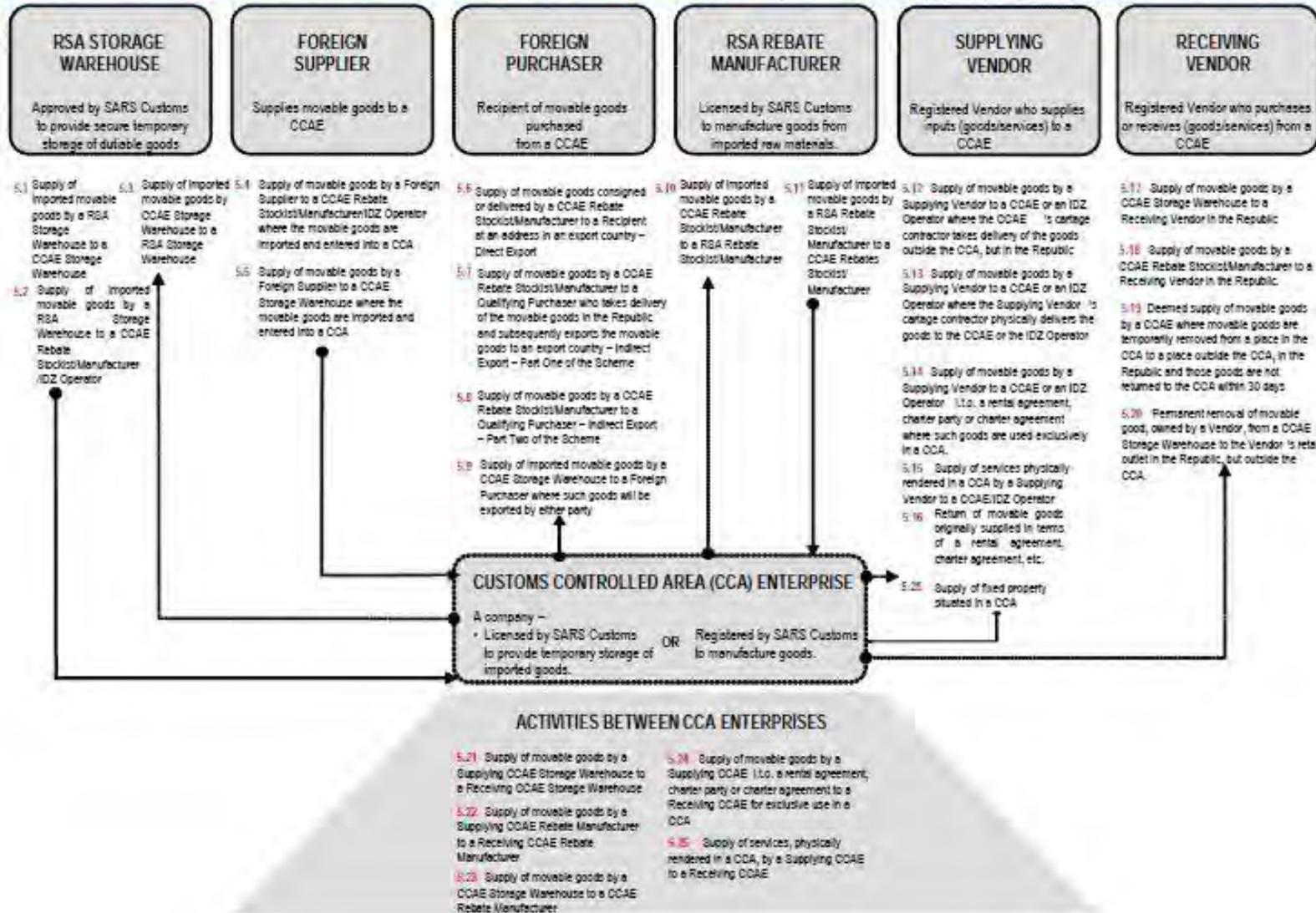
A variety of types of supplies are considered as a result of the CCA incentives. These are illustrated in the diagram on the next page.⁶⁸

The most pertinent points as a result of these supplies are summarised below.

- All persons operating within a CCA are considered to be vendors in the Republic except for a Foreign Supplier (who is not conducting an enterprise as defined in section 1) or a Foreign Purchaser.
- The movement of movable goods from and to a CCA has a VAT implication only if there is a supply of the movable goods as defined in section 1.
- Goods that were imported and entered for storage in a licensed Customs and Excise storage warehouse, but were not entered for home consumption may be supplied at the zero rate.
- Locally supplied goods cannot be warehoused in a licensed Customs and Excise storage warehouse. This is on the basis that goods in a licensed Customs and Excise storage warehouse are not yet entered for home consumption, and therefore cannot be supplied in the Republic as free circulation goods.
- Goods imported into a CCA by a CCAE are exempt from VAT on importation.
- Goods imported into a CCA by an IDZ Operator for use in the construction and maintenance of the infrastructure of the CCA are also exempt from VAT on importation.
- The supply of services physically supplied in a CCA is zero-rated.
- The normal VAT principles apply in respect of the supply of goods and services to recipients in the Republic, i.e. the supply is standard rated, unless it is zero-rated in terms of section 11 or exempt in terms of section 12.
- The normal VAT principles also apply in respect of the export of goods. Where goods are physically delivered to a recipient in an export country, the supply may be zero-rated. Where movable goods are supplied and delivered to a recipient in the Republic, VAT at the standard rate must be levied, except in the specific circumstances provided for in the Scheme.

⁶⁸ Diagram taken directly from Annexure B of Interpretation Note 40: VAT TREATMENT OF THE SUPPLY OF GOODS OR SERVICES TO AND/OR FROM A CUSTOMS CONTROLLED AREA OF AN INDUSTRIAL DEVELOPMENT ZONE

ANNEXURE B
SCHEMATIC REPRESENTATION OF SUPPLIES OF MOVABLE GOODS AND/OR SERVICES TO, AND/OR FROM AN ENTERPRISE LOCATED IN A CCA OF AN IDZ



3.3 Industrial Incentives

There are various other incentives (both tax incentives and broader economic incentives) in South Africa that seek to promote industrial growth both inside and outside SEZs. Such incentives are clear examples of situations where fiscal incentives are closely aligned with the economic development goals of the country as a whole. The most significant of these are described briefly below:

3.3.1 S12I Income Tax Act – Additional investment and training allowances in respect of industrial policy projects

The tax incentive, contained in section 12I of the Income Tax Act, aims to assist the transformation of production processes and methods by supporting investment in manufacturing assets in order to improve the productivity of the South African manufacturing sector and by supporting investment in training of personnel to improve labour productivity and the skills profile of the labour force.⁶⁹

The incentives are in the form of:

- Additional deductions (referred to as an investment allowance) of:
 - i. 55 per cent of the cost of any new and unused manufacturing asset used in an industrial policy project with preferred status; or
 - ii. 100 per cent of the cost of any new and unused manufacturing asset used in an industrial policy with preferred status that is located within an industrial development zone; or
 - iii. 35 per cent of the cost of any new and unused manufacturing asset used in any industrial policy project other than an industrial policy project with preferred status; or
 - iv. 75 per cent of the cost of any new and unused manufacturing asset used in any industrial policy project other than an industrial policy project with preferred status that is located within an industrial development zone.
- Additional deductions (referred to as a training allowance) equal to the cost of training provided to employees in the year of assessment during which the cost of training is incurred for the furtherance of the industrial policy project carried on by that company.

⁶⁹ Edward Nathan Sonnenbergs. *Manufacturing tax incentives and government grants*. 2009. Available: https://www.saica.co.za/integritax/2009/1756_Manufacturing_tax_incentives_and_government_grants.htm Accessed: 24 August 2014.

3.3.2 Other tax incentives

There are various other manufacturing tax incentives in South Africa which, although not specifically focussed at industrialisation or FDI, may find application with firms operating within IDZs. These are briefly summarised in the below table⁷⁰

Incentive Type	Nature of Incentive	Reasons for Incentive
Rebate on import duties in manufacture for home consumption or export	Partial rebate or a rebate of the full duty on certain specified imported goods	To stimulate local manufacture, to reduce input cost of locally manufactured goods which in turn allow local manufacturers to be more competitive in international trade
Special small Business corporation Tax structure	Reduced rate of taxation and special tax regime - presumptive tax, enhanced depreciation regime, capital gains tax relief, relief from skills development levy	Reduce the cost of compliance for small businesses and encourage expansion of small businesses.
Film allowance	An incentive for locally owned productions filming in South Africa; allows rebate up to 35% of qualifying expenditure on productions of a total budget - R2.5 million; R10 m cap	Increase investment in development of new business
Research and Development Allowance	Increased expensing of assets and recurrent expenditures Tax allowance for: (a) purchase of equipment and buildings deducted at 50:30:20% (average 33.3%); (b) current expenditure deducted at 150%.	Increase investment in development of new technologies, production techniques, etc.
Learnership Allowance	Additional deductions for training	Increase skill of workforce, reduce cost of expanded training
Urban Development Zones	Accelerated depreciation allowed for investments in qualified zones	Increase investment in urban areas of SA

3.3.3 Grant schemes

Grant schemes in South Africa are typically governed by a set of rules of a particular government department, but these rules rarely take the form of legislation. Generally, a basic set of rules is published for a particular grant scheme, but these rules are subject to continuous changes.⁷¹ Below is a brief introduction to some of the major grant schemes in South Africa:

- **The support programme for industrial innovation:**
 - o Consists of 3 mutually exclusive cash grant schemes:

⁷⁰ Calitz, E, Wallace, S and Le Roux, B. *The impact of tax incentives to stimulate investment in South Africa*. 2013. Stellenbosch Economic Working Papers: 19/13:12

⁷¹ West, C and Roeleveld, J. *Working paper: INTERNATIONAL ACADEMY OF COMPARATIVE LAW 2014 WORLD CONGRESS VIENNA, AUSTRIA SESSION IV.E. TAXATION AND DEVELOPMENT*. 2014. 9

- The matching scheme - applicable to small and medium-sized enterprises and consists of a 50% subsidy on costs relating to the precompetitive development process.
 - Partnership scheme . similar to the matching scheme but focussed toward larger projects.
 - Product/process development scheme . for smaller businesses with greater proportion of incentive.
- **The Innovation Fund**, which is a programme of the Department of Science and Technology aimed at the promotion of technology innovation projects in science, engineering and technology communities. A 100% cash grant may be available.
 - **The Export Marketing and Investment and Investment Assistance programme**, the benefits of which are available to exporters and aspiring exporters who incur expenses to establish export markets.
 - **The Small Enterprise Development Agency (SEDA)**, which assists small and medium-sized businesses to improve their competitive position by eliminating inherent weaknesses, e.g. by developing new products⁷²

3.4 Illustration

In order to illustrate the effective tax obligations for a foreign company investing in South Africa and the incentives available to the company to invest in a SEZ, the total tax contribution of an example company has been calculated and compared to the same company if it were located within an SEZ.

The total tax contribution (%TC) is a measure of all the different taxes that companies pay and collect. The activities of a company give rise to its obligation to pay and collect taxes. Taxes borne by the company are taxes that are a cost to the company e.g. corporate income tax. Taxes collected are other taxes where companies only administer the collection on behalf of SARS e.g. VAT and PAYE⁷³. Although taxes collected are not costs to the company, they are relevant in analysing the incentives available to FDI in order to illustrate the total fiscal incentive offered and not just the incentives which affect the company's bottom line.

⁷² J. Hattingh, *South Africa - Business and Investment sec. 5.*, Country Surveys IBFD. In West, C and Roeleveld, J. *Working paper: INTERNATIONAL ACADEMY OF COMPARATIVE LAW 2014 WORLD CONGRESS VIENNA, AUSTRIA SESSION IV.E. TAXATION AND DEVELOPMENT.* 2014. 9

⁷³ PriceWaterhouse Coopers. *Total tax contribution: A closer look at the value created by large companies for the fiscus in the form of taxes.* 2013:3.

EXAMPLE 3.1 – Hypothetical illustration of incentives

A foreign company MNC Ltd wishes to do business in South Africa. They have opted to register a subsidiary company in South Africa called LOCALCO. The company manufactures and supplies widgets to customers in the ship and oil rig repair industry. The following key points are relevant:

- LOCALCO has spent R100m on a custom built manufacturing plant on a greenfield project;
- LOCALCO has spent a further R20m on manufacturing equipment;
- Turnover for the current year is R150m. Two different scenarios are analysed from a perspective if the company is located in an SEZ or outside an SEZ:
 - o 1. Turnover is all exported or supplied within the SEZ i.e. products are manufactured in the SEZ and then exported or are ancillary goods/services supplied to companies producing goods for export;
 - o 2. Turnover is all local i.e. produced either in or out the SEZ and then sold to the South African market.
- Cost materials purchased (assumed to have incurred VAT; does not include labour) is R60m. Of this R60m, R40m is imported;
- Labour cost is R40m which is broken up as follows:
 - o R15m paid to lower level employment with salaries averaging R5K per month. The employment is 60% over the age of 30 and 40% under the age of 29.
 - o R15m paid to middle level employment.
 - o R10m paid to upper management.
- Other overhead costs are R10m. These are assumed to have incurred VAT. Included in this is R2m spent on training staff in terms of section 12I of the Income Tax Act.
- LOCALCO has been awarded preferred status in terms of section 12I of the Income Tax Act.
- LOCALCO does not qualify for any of the additional tax incentives discussed in 3.5.2. above nor has it received any grants from the department of trade and industry.

Comparison

The below calculations show the tax obligations of LOCALCO if operating within the normal South African economy.

Example 3.1.1 – Income Tax Analysis

EXPORT COMPANIES . i.e., 100% of sales are exported

INCOME TAX - outside SEZ - export sales			INCOME TAX - within SEZ - export sales		
	R'm	Comments		R'm	Comments
Turnover	150.0	<i>Zero-rated</i>	Turnover	150.0	<i>Zero-rated</i>
Cost of sales imports	-40.0		Cost of sales imports	-40.0	
Customs duty on imports	-7.4	<i>Assumed 18.5% of value of goods</i>	Customs duty on imports	-	<i>Customs Controlled Area</i>
Cost of sales local	-20.0	<i>Excl VAT</i>	Cost of sales local	-20.0	<i>Zero-rated</i>
Direct labour	-15.0		Direct labour	-15.0	
Gross Profit	67.6		Gross Profit	75.0	
Indirect labour	-15.0		Indirect labour	-15.0	
Executive salaries	-10.0		Executive salaries	-10.0	
Overheads	-10.0	<i>Excl VAT</i>	Overheads	-10.0	<i>No VAT or zero-rated</i>
EBITDA	32.6		EBITDA	40.0	
Depreciation - building	-5.0	<i>5% of R100m ito S13</i>	Depreciation - building	-10.0	<i>10% of R100m ito S12R</i>
Depreciation - equipment	-4.0	<i>20% of R20m ito S12C</i>	Depreciation - equipment	-4.0	<i>20% of R20m ito S12C</i>
EBIT	23.6		EBIT	26.0	
<u>Additional tax deductions</u>			<u>Additional tax deductions</u>		
Investment allowance	-11.0	<i>55% of R20m ito S12I</i>	Investment allowance	-20.0	<i>100% of R20m ito S12I</i>
Training allowance	-2.0	<i>100% of R2m ito S12I</i>	Training allowance	-2.0	<i>100% of R2m ito S12I</i>
Taxable income	10.6		Taxable income	4.0	
Tax thereon	-3.0	<i>at 28% SA CIT rate</i>	Tax thereon	-0.6	<i>at 15% ito S12R</i>
Cash flow after tax	29.6	<i>EBITDA less Tax</i>	Cash flow after tax	39.4	<i>EBITDA less Tax</i>

The above illustration looks only at taxes borne by the company and it indicates that in this example, the saving to LOCALCO is R9.8m which is approximately 6.53% of turnover and contributes to an increase in the foreign company's return on investment by approximately 8.17%. A large proportion of the savings is in the form of savings on customs duty on imported goods. By taking advantage of SEZs, companies with similar business models to LOCALCO can benefit greatly from the Customs Controlled Areas. By operating fully within the SEZ; utilising largely foreign suppliers and supplying to customers either also located within the CCA or offshore, the materials purchased and finished goods delivered never fall into the South African customs net and therefore the company can benefit hugely both in costs saved and in administration and compliance costs. The saving in corporate tax is comprised of the accelerated allowances on buildings and the increased section 12I investment allowance as well as the reduced corporate tax rate from 28% to 15%. The accelerated allowances are essentially deferred tax savings however this incentive can greatly enhance cash flow and thereby forms an important incentive for start-up investments by foreign corporations.

LOCAL COMPANIES . i.e. 100% of sales are supplied to South African customers (the domestic market)

<u>INCOME TAX - outside SEZ - local sales</u>			<u>INCOME TAX - within SEZ - local sales</u>		
	R'm	Comments		R'm	Comments
Turnover	150.0	Excl VAT	Turnover	150.0	Excl VAT
Cost of sales imports	-40.0		Cost of sales imports	-40.0	
Customs duty on imports	-7.4	Assumed 18.5% of value of goods	Customs duty on imports	-	Customs Controlled Area
Cost of sales local	-20.0	Excl VAT	Cost of sales local	-20.0	Zero-rated
Direct labour	-15.0		Direct labour	-15.0	
Gross Profit	67.6		Gross Profit	75.0	
Indirect labour	-15.0		Indirect labour	-15.0	
Executive salaries	-10.0		Executive salaries	-10.0	
Overheads	-10.0	Excl VAT	Overheads	-10.0	No VAT or zero-rated
EBITDA	32.6		EBITDA	40.0	
Depreciation - building	-5.0	5% of R100m ito S13	Depreciation - building	-10.0	10% of R100m ito S12R
Depreciation - equipment	-4.0	20% of R20m ito S12C	Depreciation - equipment	-4.0	20% of R20m ito S12C
EBIT	23.6		EBIT	26.0	
Additional tax deductions			Additional tax deductions		
Investment allowance	-11.0	55% of R20m ito S12I	Investment allowance	-20.0	100% of R20m ito S12I
Training allowance	-2.0	100% of R2m ito S12I	Training allowance	-2.0	100% of R2m ito S12I
Taxable income	10.6		Taxable income	4.0	
Tax thereon	-3.0	at 28% SA CIT rate	Tax thereon	-0.6	at 15% ito S12R
Cash flow after tax	29.6	EBITDA less Tax	Cash flow after tax	39.4	EBITDA less Tax

The CIT effect on local companies is the same as export companies as the major differing factor is VAT. It is noted that the company located within an SEZ which supplied to the local market will incur customs duties when the goods are imported into South Africa. This is discussed in the following VAT analysis.

Example 3.1.2 – VAT Analysis

EXPORT COMPANIES

<u>INDIRECT TAX - outside SEZ - export sales</u>			<u>INDIRECT TAX - within SEZ - export sales</u>		
	R'm	Comments		R'm	Comments
Turnover	-	Zero-rated as export sales Assumed 18.5% of 40	Turnover	-	Customs Controlled Area
Cost of sales imports - customs	7.4	(imported Raw Materials)	Cost of sales imports - customs	-	
VAT on imports	-	VAT is charged by supplier however this is claimed back and therefore nil effect	VAT on imports	-	
Cost of sales local	-		Cost of sales local	-	
Direct labour	-		Direct labour	-	
Gross Profit	7.4		Gross Profit	-	
Indirect labour	-		Indirect labour	-	
Executive salaries	-		Executive salaries	-	
Overheads	-	14% of overhead expenses	Overheads	-	
NET VAT AND CUSTOMS	7.4		NET VAT AND CUSTOMS	-	
TOTAL COLLECTED	-	i.e. less customs duty paid	TOTAL COLLECTED	-	i.e. less customs duty paid

Whilst VAT is not a cost borne by the company it is important to consider as it could potentially affect pricing to foreign customers. For example, an oil rig may need repair and so will dock at Saldanha Bay for the repairs to be done. As these repairs are done onshore, the materials used do not qualify as an exempt supply for VAT purposes. Ordinarily therefore, VAT would need to be charged. The foreign Oil Rig is not a VAT vendor and therefore cannot claim the VAT back and effectively will see the price charged as an increased cost. If

this transaction had to occur, however, within an SEZ, the VAT obligation is removed and therefore the foreign customer will pay the VAT exclusive price and there will be no VAT output to declare to SARS by LOCALCO.

In this example, if LOCALCO is located within an SEZ, VAT becomes a nil consideration as all activity happens outside of the South African VAT net. For an export company however, sales are zero-rated in any case and if LOCALCO is located outside of the SEZ, any VAT paid on purchases of raw materials will be claimed back and therefore VAT is effectively a nil consideration. This is therefore similar to the situation if the company were located within an SEZ. The advantage of being located in an SEZ however is that the compliance burden is reduced and timing of cash flows will be more efficient as they will not have to pay VAT on their purchases and then claim the cash back from SARS.

LOCAL COMPANIES

INDIRECT TAX - outside SEZ - local sales			INDIRECT TAX - within SEZ - local sales		
	R'm	Comments		R'm	Comments
Turnover	21.0	14% standard rated Assumed 18.5% of 40	Turnover	27.8	Customs duty at 18.5%
Cost of sales imports - customs	7.4	(imported Raw Materials)	Cost of sales imports	-	
VAT on imports	-	VAT is charged by supplier however this is claimed back and therefore nil effect	Customs duty on imports	27.4	Landed value (150) + customs duty (27.8) + 10% (17.78) x 14%
Cost of sales local	-		Cost of sales local	-	
Direct labour	-		Direct labour	-	
Gross Profit	28.4		Gross Profit	55.1	
Indirect labour	-		Indirect labour	-	
Executive salaries	-		Executive salaries	-	
Overheads	-	14% of overhead expenses	Overheads	-	
NET VAT OBLIGATION	28.4		NET VAT OBLIGATION	55.1	
TOTAL COLLECTED	21.0	i.e. less customs duty paid	TOTAL COLLECTED	55.1	i.e. less customs duty paid

A company located within the SEZ that sells to the local market effectively then exports the products to South Africa. Customs and VAT are calculated similarly to imports into South Africa from other countries for example, despite the fact that goods may be manufactured on South African soil but within the SEZ, the landed cost for the purposes of Customs Duty and VAT calculations will be the final value of the finished goods i.e. the selling price. There will therefore be significant customs duties here. Whilst this is an expense to the customer, it must be taken into account for the TTC analysis as it is an extra contribution to the fiscus due to the decision to be based in the SEZ. There is therefore a major increase in VAT contribution for SEZ companies supplying to the local market as there is no VAT input to claim (as all purchases are zero-rated) and there is VAT and customs duties charged on the sale.

Example 3.1.2 – Employees Tax analysis

BOTH EXPORT AND LOCAL COMPANIES

EMPLOYEES TAX outside SEZ (both export and local)		EMPLOYEES TAX within SEZ (both export and local)	
R'm	Comments	R'm	Comments
Lower level employees	0 <i>Below basic threshold</i>	Lower level employees	0 <i>Below basic threshold</i>
Middle level employees	3.75 <i>R15m at assumed 25% average rate</i>	Middle level employees	3.75 <i>R15m at assumed 25% average rate</i>
Executive salaries	3.30 <i>R10m at assumed 33% average rate</i>	Executive salaries	3.30 <i>R10m at assumed 33% average rate</i>
PAYE obligation	7.1	PAYE obligation	7.1
Employment tax incentive	-0.6 <i>Note 1</i>	Employment tax incentive	-1.5 <i>Note 1</i>
NET PAYE OBLIGATION	6.5	NET PAYE OBLIGATION	5.6
Note 1		Note 1	
Total cost	15 000 000	Total cost	15 000 000
Average wage	5 000	Average wage	5 000
No of employees	3000	No of employees	3000
Above 30 (60%)	1800	Above 30 (60%)	1800
Below 30 (40%)	1200	Below 30 (40%)	1200
ETI per employee	500	ETI per employee	500
Total ETI	600 000 <i>(1,200 x 500)</i>	Total ETI	1 500 000 <i>(3,000 x 500)</i>

By operating within the SEZ, LOCALCO will qualify for the ETI on all employees, not just those older than 30. This results in additional decrease in tax contribution of R0.9m.

Example 3.1.4 – Total Tax Contribution analysis

A comparison of the TCC of LOCALCO operating outside or within an SEZ therefore shows the following:

TOTAL TAX CONTRIBUTION COMPARISON				
	Export Out SEZ	Export In SEZ	Local Out SEZ	Local In SEZ
Taxes borne				
Income Tax	3.0	0.6	3.0	0.6
Customs duty	7.4	-	7.4	-
Taxes collected				
VAT and customs duty	-	-	21.0	55.1
PAYE	6.5	5.6	6.5	5.6
TTC	16.8	6.2	37.8	61.3

The above comparison illustrates the following findings:

- The most beneficial contribution in this example is to be an export company based inside of an SEZ. This is consistent with the goals of the SEZ programme being to incentivise export. There is also an opportunity cost saving in that the company located in the SEZ has vastly reduced administrative obligations on goods imported and on VAT input refund claims.

- The least tax efficient structure is to be a company located inside the SEZ but supplying to the local market. This is a significant issue as it may create a barrier for foreign companies to supply to the local market. It is submitted that it is unlikely that a foreign company would invest in a development in a South African SEZ if they cannot also supply to the South African market. It also prevents the creation of a linkage between the SEZ and the local market. Companies could work around this by having companies located in and out of the SEZ and supplying between the two however this may create transfer pricing issues and logistical issues especially where a foreign company has, for example, invested significantly in a manufacturing plant located within the SEZ. A company that has done this is unlikely to then invest in further development in South Africa unless it is necessary.
- Included in the export companies analysis are companies supplying goods and services to other companies within the SEZs. If the SEZs didn't exist, these companies would still be on South African shores and thus their supplies would be to the South African market. Therefore an important comparison is between companies outside the SEZ selling to the South African market and companies inside the SEZ selling to other SEZ companies (the two highlighted columns). There is a clear benefit here to be located within the SEZ as VAT and customs is ignored resulting in a significant reduction in TTC.

3.5 Conclusion

The implementation of the SEZ programme has introduced some substantial fiscal incentives which, if utilised, could greatly reduce the tax burden on investors. It is perceived that the most beneficial situation to be in, when deciding to be located in or out of the SEZ is for companies that are supplying goods or services to other companies in the SEZ such as described in the marine repair example and pure export companies. There is little incentive for companies looking to supply to the South African market and it is submitted therefore that, unless the incentives are designed better, a foreign company looking to develop a production facility to supply to the South African market would be better off locating outside of the SEZ. It is acknowledged that this is in line with South Africa's export growth strategy however it may create barriers for foreign companies looking to invest. Whilst such foreign companies may still take advantage of other fiscal incentives such as the S12I allowance,

The success or failure of SEZs can be attributed to a variety of factors such as political, economic, governance or incentives. In order to therefore evaluate the likelihood of success of the fiscal incentives, the next chapter seeks to compare the incentives offered in other countries. Brazil, Russia, India, China and South Africa form the BRICS+ countries of leading developing nations. As developing nations, the BRICS countries are all reliant on

FDI for economic growth and as such South Africa's SEZ incentives will be compared to those of the other BRICS countries in order to evaluate whether the incentives are strong enough or whether they are too strong and therefore run the risk of lost revenue to the fiscus.

4. A comparison with Special Economic Zones in other BRICS countries

4.1 Introduction

The BRIC (Brazil, Russia, India and China) idea was first conceived in 2001 by Goldman Sachs as part of an economic modelling exercise to forecast global economic trends over the next half century; the acronym BRIC was first used in 2001 by Goldman Sachs in their Global Economics Paper No. 66, *The World Needs Better Economic BRICs*. The acronym has come into widespread use as a symbol of the shift in global economic power away from the developed G7 economies to the developing nations. At their meeting in New York on 21st September 2010 South Africa was invited to join BRIC and therefore attended the 3rd BRICS Summit in Sanya on 14 April 2011.⁷⁴

Below is a summary of the relevant BRICS countries' status⁷⁵:

- **Brazil** - Brazil is the world's fifth largest country. With an estimated population above 200 million in 2013, it is also the world's fifth most populous country after China, India, the United States, and Indonesia. Brazil has the seventh largest economy in the world in terms of gross domestic product (GDP) derived from purchasing power parity (PPP) calculations.
- **Russia** - Russia is the largest country in the world by territory, covering more than a ninth of the Earth's land area. The business environment in Russia has been steadily improving since the transition from a centrally controlled planned economy to a free market. In recent years, many social reforms have been implemented, the tax system has become fairer and more transparent, and Russia has become increasingly integrated with global markets.
- **India** - India is the seventh-largest country by geographical area, the second-most populous country with over 1.2 billion people. India gained independence in 1947, and is developing into an open-market economy. Economic liberalisation, including reduced controls on foreign trade and investment, began in the early 1990s and has served to accelerate the country's growth, which has averaged more than 7% per year since 2004.
- **China** - The People's Republic of China, commonly known as China, is one of the most populous countries in the world, with over 1.3 billion people. China is the second

⁷⁴ BRICS Forum. *Official website*. Available: <http://www.bricsforum.org/> Accessed: 20 November 2014.

⁷⁵ PWC. *Tax Summaries*. Available: <http://taxsummaries.pwc.com/uk/taxsummaries/wmts.nsf/ID/PPAA-85RDKF> Accessed: 20 November 2014.

largest country in the world by land area. For centuries, China stood as a leading civilisation, outpacing the rest of the world in technology, arts, and sciences. After World War II, the Communists, under Mao Zedong, established a socialist system. After 1978, Mao's successor, Deng Xiaoping, and other leaders focused on market-oriented economic development, and China began to generate significant and steady growth in investment, consumption, and standards of living.

- **South Africa** - South Africa, which became a republic in 1961, is a middle-income, emerging market with an abundant supply of natural resources, such as gold, platinum, and diamonds. South Africa has a modern infrastructure supporting an efficient distribution of goods to major urban centres throughout the region. Growth was robust from 2004 to 2008 as South Africa reaped the benefits of macroeconomic stability and a global commodities boom.

It is evident from the above summaries that the BRICS nations contribute significantly to the global economy and are attractive markets for investment. Indeed, BRICS nations have seen major economic growth in the modern era (predominantly over the last 50 years). This chapter will attempt to assess what role SEZs played in the economic growth of the different BRICS nations. As South Africa is the newest member of BRICS, has the smallest economy and has the youngest SEZ regime, it is submitted that there may be opportunities where South Africa can learn from the successes achieved by the BRIC nations and potentially implement some of their characteristics into the South African SEZ programme. It is acknowledged that there are many factors which may have resulted in foreign investment in BRIC nations's SEZs and so this study will focus mainly on the fiscal incentives offered to evaluate whether there are any types of incentives that may be used in South Africa and alternatively, whether there are any that have not been successful in BRIC nations that should be avoided in South Africa.

It is acknowledged that there are major differences in the economic climates of all 5 of the BRICS nations. Although the South African economy may be more comparable with other African developing countries, this study focussed on a comparison to BRICS nations for the following reasons:

- BRICS nations have already seen some success and failures in developing SEZ programmes and there has been significant research performed on their programmes. As opposed to most African countries whose SEZ programmes have seen limited success and there is limited information available; and

- As BRICS nations span multiple continents, information on their SEZ programmes provides a broader, more globalised perspective on what works or doesn't work when attracting Multi-national Enterprises.

4.2 Brazil

4.2.1 Overview of the tax system in Brazil

Brazil has a highly complex tax system made up of Federal taxes, State taxes and Municipal taxes. The below table gives a general overview of the Brazilian tax system⁷⁶.

Federal taxes		
Based on sales (goods and services)		
Based on profit	State taxes	
Based on immovable property (rural real estate)	Based on sales (goods)	Municipal taxes
Based on credit and exchange	Based on moveable property (motor vehicle)	Based on sales (services) & urban real estate sales
Based on gross payroll	Based on imports (goods)	Based on immovable property (urban real estate)
Based on import/export	Based on donation	Based on imports (services)

Corporate taxes in Brazil are dependent on the size of the entity as different options are available to entities depending on their gross revenue. Small entities (turnover less than USD1.8 million) are subject to tax on gross revenue at a rate between 1.2% and 18% depending on the industry and annual accumulated gross revenues. This is therefore similar to the Turnover tax offered to very small entities in South Africa where entities are only taxed on revenue and therefore deductions are not taken into account. Medium entities (turnover between USD 1.8m and USD 24m) are taxed at a rate of 24% on presumed profit. Presumed profit is 8% of gross revenue for manufacturing and commercial entities and 32% for professional services. This in effect, therefore, is also a turnover tax and the net tax on manufacturing or commercial entities is 1.92% (8% x 24%). All other entities (being entities with gross revenue greater than USD 24m and any smaller entities who do not opt for the simplified turnover tax options) are taxed on 24% of real (actual profit) being accounting profit adjusted for specific inclusions and exclusions in terms of the fiscal rules. The 24% is made up of the corporate income tax of 15% and a social contribution on net income (CSLL)

⁷⁶ Baum, S. *GGI International Tax and Business Guide 2014: Brazil*. 2014, 129-130.

of 9%. For the purposes of any examples in this comparison it is assumed that the entity has applied the standard corporate tax rate of 24% on actual profits⁷⁷. Corporate taxpayers are also subject to a surcharge of 10% on the annual taxable income in excess of BRL 240,000 (approximately USD 120K).

VAT is payable on imports, sales, and transfers of goods and products in the form of (i) a federal excise tax (IPI) at various rates in accordance with the nature of the product (normally around 10% to 15%, but in certain cases ranging to over 300%) and (ii) a state sales and service tax (ICMS) with rates ranging from 7% to 25%. Import tax (II) is levied on the cost, insurance, and freight (CIF) price of the imported good. The rates depend on the degree of necessity and are defined in accordance with the product's tariff code contained in the Mercosur Harmonised System (NCM/SH). The rates tend to be in the range of 10% to 20%, although there are many exceptions that are subject to higher or lower rates⁷⁸.

Brazilian resident companies are taxed on worldwide income, but they may compensate the income tax paid in the country of domicile of the branch, controlled, or associated company, and the tax paid on earnings and capital gains, against the corporate income tax due in Brazil. The amount of tax effectively paid abroad, to be compensated, may not exceed the amount of income tax and surtax due in Brazil on the amount of profits, earnings, and capital gains included in the calculation of taxable income.⁷⁹

4.2.2 Special Economic Zones in Brazil

The first SEZ that was created in Brazil is the Manaus Free Trade Zone (MFTZ). It was formally regulated in 1967 and was set up with the objective of creating an industrial, commercial and agricultural centre in the hinterland of the Amazon Region, which would be equipped with economic conditions that would enable the region to be occupied and developed. It therefore differs from many other countries' SEZ models in that the main intention was not necessarily FDI but rather the creation of a socio-economic base in a previously sparsely populated area of the country. The zone is still operating some 50 years later and as the population of the city of Manaus has grown to over 2 million people, it is seen as a success by the government of Brazil and the administrator of the zone, the Superintendence of the Manaus Free Trade Zone (SUFRAMA).⁸⁰

⁷⁷ Ibid.

⁷⁸ PWC. *Tax Summaries: Brazil*. Available:

<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/JDCN-89HRS8> . Accessed: 18 November 2014.

⁷⁹ Ibid.

⁸⁰ SUFRAMA. *Official website*. Available: <http://www.suframa.gov.br/invest/en-zona-franca-de-manaus.cfm> . Accessed: 19 November 2014.

Based on the success of MFTZ, certain other SEZs have been created in Brazil on the same model as MFTZ. These Free Trade Areas (FTAs) main goals are to improve the supervision of goods entering and leaving the country, strengthen the commercial sector, enable new companies to open, and generate jobs. For these reasons, the FTAs are predominantly situated on the borders of neighbouring countries such as Colombia, French Guiana, Bolivia and Venezuela.⁸¹

4.2.3 Fiscal incentives offered by SEZ's in Brazil

There are a variety of tax incentives available to investors in the MFTZ. These can be summarised as follows⁸²:

Federal Taxes

- IMPORT DUTY (II) - 88% reduction for consumables used in industrialization or proportional do the domestic added value where information technology goods are concerned;
- FEDERAL VALUE ADDED TAX (IPI) . Exempt
- SOCIAL INTEGRATION PROGRAM TAX (PIS) and SOCIAL SECURITY TAX (COFINS) . Zero rated for inputs and internal sales between industries, and 3.65% on finished goods sales to the rest of the country.
- INCOME TAX (IR) - 75% reduction in Income Tax and Non-Reimbursable Extras, exclusively for reinvestments.

State Taxes

- STATE VALUE ADDED TAX (ICMS) . Credit stimulus of between 55% and 100%. In all cases, companies are obliged to contribute to funds for financing further education, tourism, R&D, and small and micro-companies.

Other Incentives

- As well as the tax incentives, the Superintendence of the Manaus Free Trade Zone makes land for industrial uses available to companies for a symbolic price of around USD0.30 per square meter, as a type of location incentive.

Each zone has a different suite of fiscal incentives however the main incentives that are common across all FTAs are the suspension of the federal import tax II and the suspension

⁸¹ Ibid.

⁸² Ibid.

of the tax over industrialised products. These are ordinarily suspended until the final products enter the Brazilian territory. If the raw materials are utilised within the zone on defined set of activities, the suspensions are converted into exemptions.⁸³

4.2.4 A comparison between South African and Brazilian SEZ incentives

The SEZ programme in South Africa has a somewhat different goal, being that of FDI, to the goals of Brazilian FTZs or FTAs, being primarily that of population redistribution and control of cross-border trade. There are however certain similarities in the incentives offered. Brazil has less defined income tax incentives which is likely due to the incentives being focussed more on trade than investment. The suspension of federal import duties and state VAT is, although more complicated, similar to the customs controlled areas in South Africa. The structure of these incentives in Brazil focus on specific activities within the zone which converts the suspension into an exemption for example, agriculture, tourism, storage, and industrialisation. This creates an additional incentive over the South African CCAs. In South Africa, any goods manufactured within the zones, are subject to import duties when they cross the border of the SEZ (i.e. re-enter South Africa) whereas in Brazil, certain goods will never be subject to import duties, if they qualify for exemption.

An additional area of comparison between South African and Brazilian SEZs are the choice of location. Although this aspect is not necessarily a fiscal decision, it may be used to enhance the SEZ programme in South Africa. The previous IDZ programme in South Africa focused location choices on points of entry/exit and were mainly ports. There were no IDZs created on land border points with neighbouring countries. It is acknowledged that trade agreements in terms of the SADAC region already exist to incentivise trade between neighbouring countries, however it is submitted that, similar to Brazil, the establishment of zones along local borders such as Namibia, Botswana, Zimbabwe or Mozambique may serve to incentivise FDI for MNEs looking to invest into sub-Saharan Africa and additionally, create infrastructure and employment in certain rural areas along these borders.

4.3 Russia

4.3.1 Overview of the tax system in Russia

The standard corporate tax rate in Russia is 20% of taxable income. This is payable as 2% to the federal budget and 18% to regional budgets. The regional authorities may, at their discretion, reduce their regional profits to as low as 13.5%. The overall tax rate can therefore

⁸³ Duran, R. *Free Trade Zones in Brazil*. The Brazil Business. Available: <http://thebrazilbusiness.com/article/free-trade-zones-in-brazil> Accessed: 19 November 2014.

vary from 15.5% to 20%.⁸⁴ Russian legal entities pay tax on their worldwide income (credit relief is available for foreign tax paid up to the amount of the Russian tax liability that would have been due on the same amount under Russian rules). Foreign legal entities pay tax on Russia-source income derived through a PE (at 20%) and are also subject to withholding tax (WHT) on income from Russian sources not related to a PE (at rates varying from 10% to 20%, depending on the type of income and the method used to calculate it).⁸⁵

VAT is a federal tax in Russia, payable to the federal budget and follows a classical output-input system. VAT is charged at a standard rate of 18% on most goods and services. Under the reverse-charge mechanism, a Russian company must account for VAT on any payment it makes to a non-tax registered foreign company, if the payment is connected to a supply of goods or services considered to be supplied in Russia, based on the VAT place of supply rules and not falling under any VAT exemption based on the domestic VAT law. In addition to VAT, customs duties are levied on assets imported into the Russian Federation. The rate varies according to the tariff code of the goods imported and the country of origin (generally, the rate varies from 0% to 20% of the customs value of imported goods).⁸⁶

4.3.2 Special Economic Zones in Russia

Due to the previous communist regime, Russia were quite late to implement SEZs when compared with other developing nations. The first SEZs in post-Soviet Russia appeared in the 1990s but were not very successful due to their lack of governance and structure. A lack of a legal framework in early zones meant that companies were able to manipulate their incentives without contributing to their goal of generating investment.⁸⁷ In 2005, two main laws concerning SEZs in Russia were passed which created the required legal framework and a new administrative system governed by the Ministry of Economic Development. 2005 . 2009 are considered the early phase of legislative framework formation and pilot zones implementation. In 2009 the phase of active infrastructure engineering and construction began.⁸⁸ Currently, Russia's SEZs are industry focussed and are categorised as either industry, technology, tourism or logistics. Since active construction commenced in 2009,

⁸⁴ Timokhin, P. *GGI International Tax and Business Guide 2014: Russia*. 2014, 349-350.

⁸⁵ PWC. *Tax Summaries: Russian Federation*. Available: <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/JDCN-89HTPA> . Accessed: 18 November 2014.

⁸⁶ Ibid.

⁸⁷ Sheviakova, M. *Special Economic Zones in Russia: A General Look*. 2010, 1-4.

⁸⁸ Ibid.

Russia has developed 17 zones with a combined area of over 16,000 ha and have seen investment from approximately 340 investors from 23 different countries.⁸⁹

4.3.3 Fiscal incentives offered by SEZ's in Russia

Certain incentives available to investors in Russian SEZs are guaranteed by legislation and are set by the federal governments. Other incentives are variable depending on the specific SEZ and are determined by the relevant regional (state) government. The Russian Federation guarantees protection from negative changes in tax legislation to SEZ investors. Below is a summary of the relevant tax incentives⁹⁰:

- Federal income tax (usually 2%) is guaranteed to be 0%.
- Regional income tax (usually between 13.5% and 18%) is set at a maximum of 13.5% but can be as low as 0%. The tax holidays provided by state authorities on regional level will last from 5 to 10 years.
- Investors have a right not to pay the enterprise property tax since the moment of its registration (in average, the tax rate in Russia is 2,2%).
- SEZ investors are exempted from land tax (about 1,5%).
- Investors are completely exempt from transport tax.
- Insurance contribution rates for residents of techno-innovative SEZs, industrial SEZs performing techno-innovative activities and residents of tourism clusters are reduced. From 2012 to 2017 the insurance contributions rates will amount 14%, in 2018 - 21%, in 2019 - 28%.
- Industrial and tourist SEZ investors have a right to use accelerated amortisation, setting a multiplying factor to fixed assets (but not more than 2).
- Free customs zones (FCZs) exist within SEZs and allow for foreign goods to be imported to Russia (equipment, raw materials, componentry and building materials) and are stationed and used without import duties, taxes and non-tariff measures.

4.3.4 A comparison between South African and Russian SEZ incentives

⁸⁹ Special Economic Zones JSC. *Official website*. Available: <http://eng.russeze.ru/>. Accessed: 18 November 2014.

⁹⁰ Ministry of Economic Development of the Russian Federation. *Russian Special Economic Zones: Special conditions for business enterprising in Russia*. (presentation) Available: <http://eng.russeze.ru/>. Accessed 18 November 2014.

The standard corporate income tax (CIT) rate incentive offered in Russia appears to be vastly superior to South Africa's incentive. The guaranteed reduction in CIT in Russia is only a reduction from 20% to 13.5% (a saving of 6.5%) compared to the South African reduction from 28% to 15% (a saving of 13%). However, the 13.5% stated above is a maximum percentage and certain zones have approved tax rates of 0%. The FCZ incentives operates effectively the same as South Africa's Customs Controlled Areas by allowing free trade zones whereby trade within the area does not attract indirect taxes such as import duties, customs and VAT. In addition to the standard income tax reductions, Russian SEZs have been granted tax holidays on other taxes unique to their country such as property tax, land tax and transport tax. It is submitted that similar such taxes in South Africa e.g. rates; are not relevant for comparison as in South African SEZs, the land is owned by the SEZ operator in partnership with the government and hence the investor would not be subject to any land taxes. Hence South African SEZs are comparable with Russian SEZs in that respect.

The growth and expansion of the Russian SEZ offering can be attributed to many factors such as their structure, governance, location etc. however the attractive tax rate of as low as 0% cannot be ignored. In South Africa, the previous IDZ programme did not have a CIT incentive and hence it is submitted that this may have been a major factor contributing to the lack of progress of the IDZ programme. It is further submitted that variable tax rates depending on the specific SEZ may be an opportunity for South Africa to attract FDI within their SEZs as it may become a flexible bargaining tool for the Department of Trade and Industry as opposed to a set rate determined in terms of the Income Tax Act. Such a set rate provides potential investors with a ~~take~~ take it or leave it scenario which may be a deterring factor for large MNEs who seek to bargain with local governments for attractive incentives.

4.4 India

4.4.1 Overview of the tax system in India

Corporate tax rates are determined by the source of income. Indian companies are subject to tax at a standard rate of 30% on taxable income with a tax surcharge of 5%/10% if income exceeds INR 10 million/INR 100 million respectively (approximately USD 160K / USD 1.6m). Foreign companies are subject to tax at rates of 40% with a surcharge of 2%/5% if income exceeds INR 10 million/INR 100 million respectively. Both foreign and local companies are subject to a further cess on tax (tax on the tax paid) of 3%.⁹¹

Currently, there is no VAT on imports into India. Exports are zero-rated. This means that while exports are not charged to VAT, VAT charged on components purchased and used in

⁹¹ Marwah, R and Bairagra, A. *GGI International Tax and Business Guide 2014: India*. 2014, 223-224.

the manufacture of export goods or goods purchased for export is available to the purchaser as a refund based on the state VAT legislations. The state VAT is charged at different rates varying from 5% to 15% with a few exceptions where the VAT is charged at a lower or higher rate. The rate of VAT depends on the nature of the goods involved and varies from state to state. Customs duty is levied by the Central Government on goods imported into, and exported from, India. The rate of customs duty applicable to a product imported or exported depends upon its classification under the Customs Tariff Act, 1975. With regard to exports from India, customs duty is levied only on a very limited list of goods.⁹²

4.4.2 Special Economic Zones in India

Export Processing Zones (EPZs) have existed in India since 1965 and the development of SEZs can be described in three distinct phases⁹³:

- 1965 . 1985 . The government acknowledged the problem of negative terms of trade i.e. imports had higher values than exports. The first EPZ was set up in Kandla, Gujarat. Four more followed in 1984 however these lacked real incentives and were largely unsuccessful.
- 1986 . 2000 . The consolidation phase . in order to provide a solution for the economic crisis in 1991, the Indian government revamped existing EPZs resulting in relaxed controls on trade, business and investment and additional fiscal incentives.
- 2000 . onwards . the government implemented a new SEZ scheme which was legislated in 2005.

The five main objectives of the SEZ policy are⁹⁴:

1. An improvement in economic activity;
2. Increased exports;
3. Greater investment;
4. Expanded employment; and
5. Better infrastructure.

⁹² PWC. *Tax Summaries: India*. Available:

<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/JDCN-89HSLG> . Accessed: 18 November 2014.

⁹³ Bhojwani, S. *Government policy, employment and urbanization: evidence from India's Special Economic Zones*. 2011, 1 . 14.

⁹⁴ Ibid.

Since the implementation of the new SEZ policy in 2005, the Indian Government has approved 564 SEZs of which 192 were operational as at 30 June 2014⁹⁵. The Indian Government of 2005 were supported by the public in the implementation of the SEZ policy as it was seen as a means to encourage foreign investment and the export industry through extensive tax incentives. The approval of many of the zones however, resulted in the displacement of thousands of individuals who not surprisingly opposed the projects, often violently. By 2008 projects were being cancelled due to local opposition⁹⁶. By 2012, the SEZ policy had all but been abandoned due to the widespread opposition by the public and also due to additional export incentives available to exporters outside the SEZs that were introduced by government which dis-incentivised the need to be based inside an SEZ⁹⁷. Despite prior opposition to the SEZ policy, the present Indian Government remains committed to the development of SEZs as a means to achieve their aforementioned goals.

4.4.3 Fiscal incentives offered by SEZ's in India

The incentives and facilities offered to the units in SEZs for attracting investments into the SEZs, including foreign investment include⁹⁸:-

- Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units
- 100% Income Tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for next 5 years.
- Exemption from minimum alternate tax under section 115JB of the Income Tax Act.
- Exemption from Central Sales Tax.
- Exemption from Service Tax.
- Exemption from State sales tax and other levies as extended by the respective State Governments.

⁹⁵ Government of India Ministry of Commerce & Industry. *Fact Sheet on Special Economic Zones*. Available: <http://www.sezindia.nic.in/about-fsheet.asp> . Accessed: 19 November 2014.

⁹⁶ Potter, A. *India: A Return to Special Economic Zones*. [Article]. Available: <http://thediplomat.com/2014/09/india-a-return-to-special-economic-zones/> Accessed: 19 November 2014.

⁹⁷ Mishra, AR. *Study lists why India's special economic zones policy didn't work*. [Article] Available: http://www.livemint.com/Politics/pZ1V1BKItKNV1tzWqIIshL/Study-lists-why-Indias-special-economic-zones-policy-didnt.html?utm_source=copy Accessed: 19 November 2014.

⁹⁸ Government of India Ministry of Commerce & Industry. *Incentives and facilities offered to the SEZs*. [Website] Available: <http://www.sezindia.nic.in/about-fi.asp> Accessed: 19 November 2014.

A unique incentive offered to Indian SEZs is the 100% Income Tax exemption on export income under Section 10AA of the Income Tax Act of India (The India Act). This section of the India Act provides for an apportionment of profit between export and local profits. The formula is:

$$\text{Profits of undertaking} \times (\text{Export Turnover} / \text{Total Turnover})$$

This section provides a clear incentive purely for export purposes which is in line with the goals of the SEZ policy. This is important for India as a large portion of the economy is service oriented and in particular IT services. One of the most common refrains against the SEZs has been that they failed to achieve their intended objective of encouraging manufacturing exports from India and instead became attractive centres for information technology firms to avail of tax incentives by shifting to the zones from domestic tariff areas.⁹⁹

4.4.4 A comparison between South African and Indian SEZ incentives

A clear distinction between South African SEZ incentives and Indian SEZ incentives is that of the Income Tax incentive being focused purely at income from exports. Whilst this was designed in India as a means to prevent misuse of the SEZ incentives by service enterprises, it may not necessarily be applicable to South Africa. Certain of South Africa's SEZs are focused on service industries such as the Saldanha Bay IDZ which lists oil rig and marine repair as a priority industry. If a similar incentive were to be introduced in South Africa, it may potentially exclude many service companies and therefore it is unlikely to provide any real incentive. It is submitted however, that the concept of allocating the income tax incentive to a specific type of income may be of use to South African SEZs as it provides a stronger incentive to those companies involved in the particular industry than a blanket set rate incentive as is currently in place with the 15% rate of Section 12R of the South African Income Tax rate. An example of this may be providing for a 15% CIT rate on any business activities undertaken within an SEZ with a 100% exemption on any business activities conducted in terms of the industries categorised as part of the specific SEZ e.g. export and marine repair.

4.5 China

4.5.1 Overview of the tax system in China

⁹⁹ Mishra, AR. *Study lists why India's special economic zones policy didn't work*. [Article] Available: http://www.livemint.com/Politics/pZ1V1BKitKNV1tzWqIIShL/Study-lists-why-Indias-special-economic-zones-policy-didnt.html?utm_source=copy Accessed: 19 November 2014.

The income tax rate for domestic and foreign enterprise is uniformly 25%. Small-profit enterprises qualify for a reduced tax rate of 20% and high-tech enterprises qualify for an even further reduced tax rate of 15%.¹⁰⁰ Tax resident enterprises (TREs) are subject to corporate income tax (CIT) on their worldwide income. A non-TRE that has no establishment or place in China is taxed only on its China-source income. A non-TRE with an establishment or place in China shall pay CIT on income derived by such establishment or place from sources in China as well as income derived from outside China that effectively is connected with such establishment or place.¹⁰¹

The sales or importation of goods and the provision of repairs, replacement, and processing services are subject to VAT. VAT is charged at a standard rate of 17%, and the rate for small-scale taxpayer is 3%. The sales of certain necessity goods may be subject to VAT at a reduced rate of 13%, as specified in the VAT regulations. Export of goods from China may be entitled to a refund of VAT incurred on materials purchased domestically. The refund rates range from 0% to 17%. There is a prescribed formula for determining the amount of refund, under which many products do not obtain the full refund of input VAT credit and suffer different degrees of export VAT costs. In general, a customs duty is charged in either specific or ad valorem terms. For specific duty, a lump sum amount is charged based on a quantitative amount of the goods (e.g. CNY 100 per unit or per kg). For ad valorem duty, the customs value of the goods is multiplied by an ad valorem duty rate to arrive at the amount of duty payable. The applicable duty rate generally is determined based on the origin of the goods.¹⁰²

4.5.2 Special Economic Zones in China

China is considered by many to be the world's foremost success story in using SEZs to build up industrial capacity. China has seen unprecedented growth over the past 3 decades and although this rise is debated all over the world, the use of special economic zones and industrial clusters are undoubtedly, two important engines for driving the country's growth. In fact, the Chinese Government believe so strongly in the concept of SEZs that in the mid-1990s, after nearly 20 years of bringing in foreign investment, technology and skills, the

¹⁰⁰ Yuanguan, RH. *GGI International Tax and Business Guide 2014: China*. 2014, 150.

¹⁰¹ PWC. *Tax Summaries: China, the People's Republic of*. Available: <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/JDCN-89HRZD> . Accessed: 18 November 2014.

¹⁰² Ibid.

Chinese Government began to emphasize 'going out' i.e. establishing SEZs in other countries as a vehicle for finding new markets for Chinese goods and services.¹⁰³

The creation of SEZs in China started slowly as part of their early economic reforms. Four zones were created in 1979 as experiments in the management of market liberalisation and to attract FDI. China had not yet opened the door to international trade and so these zones were used as a way to test economic policies in foreign trade and investment. Because China had just reopened to foreign trade and investment, the zones saw almost immediate success. Based on the success of these four initial zones, the Chinese government expanded their SEZ programme rapidly by creating different types of SEZs and much larger SEZs based on the principles established by the initial four zones¹⁰⁴. In 1984, 14 Chinese coastal cities set up industrial and technological development zones mainly nurturing specific industries. In 1988 the entire island of Hainan became an SEZ and in 1990, a large part of Shanghai, China's biggest city, was restricted as the Pudong New Area zone. In China, the term SEZ normally refers to their seven largest zones which are comprehensive, functionally diverse and cover a large land area. In addition to these SEZs there are a variety of different types of zones such as economic and technological development zones (ETDZ), free trade zones (FTZ), export-processing zones (EPZ) and high-tech industrial development zones (HIDZ). The below table shows the current make-up of SEZs in China¹⁰⁵:

Table 4.1 - No of different SEZ's in China

Type	Abbreviation	Number
Economic and Technological Development Zones	ETDZ	54
High-tech Industrial Development Zones	HIDZ	54
Free Trade Zones	FTZ	15
Export Processing Zone	EPZ	58
Special Economic Zones	SEZ	7
TOTAL		188

4.5.3 Fiscal incentives offered by SEZ's in China

¹⁰³ Brautigam, D and Xiaoyang, T. *China's investment in Special Economic Zones in Africa*. The World Bank . Special Economic Zones: Progress, Emerging Challenges and Future Directions. 2011, 69-100.

¹⁰⁴ Zhihua Zeng, D. *How Do Special Economic Zones and Industrial Clusters Drive China's Rapid Development?* The World Bank - Policy Research Working Paper 5583. 2011, 1-47.

¹⁰⁵ Derived from statistics from China Knowledge. Available: <http://www.chinaknowledge.com/Manufacturing/Introduction.aspx?subchap=3&content=10> Accessed: 20 November 2014.

Different preferential policies are implemented in different industrial parks. A comparison is made below of the policies among the four major types of development zones, i.e. ETDZs, HIDZs, FTZs and EPZs.

Table 4.2 - Comparison of policies of four major types of industrial parks¹⁰⁶

	ETDZs	HIDzs	FTZs	EPZs
Corporate Income Tax Rate (for foreign-invested production enterprises)	25%	25%	25%	25%
Corporate Income Tax Rate (for high-tech enterprises)	15%, for the high-tech industries encouraged by the nation			
Custom Duty and Value-Added Tax (VAT) (on self-use equipment and spare parts)	For the enterprises belonging to the category of encouraged industries, custom duty and VAT will be exempted.		Exempted	
Custom Duty and Value-Added Tax (VAT) (on office appliance)	No exemptions		Exempted	
Custom Duty and Value-Added Tax (VAT) (on raw materials and parts)	Only enterprises involved in the processing trade are exempted.		Exempted	
VAT Rate	13% for agriculture-related projects			
	17% for others			
Licenses for equipment, raw materials and office appliances (for processing trade enterprises)	For enterprises in the category of encouraged industries, licenses are exempted.		Licenses not required for all processing trade enterprises.	
Tax on finished products using duty-free materials (sold domestically)	Levy on finished products.	Levy on imported raw materials and parts only.	Levy on finished products	
VAT Refund for finished products made using domestic raw materials	VAT will be refunded following departure of shipment from China.		Immediate VAT refund for domestic raw materials upon entering the zone.	
Ratio Between Export and Domestic sales	To be decided by investors as long as their projects are in compliance with national industry guidelines and are excluded from export license and quota management.	No restriction		Normally there are certain limitations for EPZs.

Whilst the above table shows effectively no incentive for corporate income tax, it does not include the seven national SEZs. Previously there was a 15% CIT rate in SEZs which was a significant reduction from the then standard rate of 30%. Recent reforms however have

¹⁰⁶ China Knowledge. *Introduction to China Industrial Parks*. [Official Website]. Available: <http://www.chinaknowledge.com/Manufacturing/Introduction.aspx?subchap=3&content=11> Accessed: 20 November 2014.

decreased the standard rate to 25% and limited the reduced rate of 15% to new high-technology enterprises. This is however, not only applicable to SEZs; there is also a geographically based incentive focused on high-technology enterprises established on or after 2008. This incentive is a two year tax holiday followed by three years of tax levied at 12.5%.¹⁰⁷

4.5.4 A comparison between South African and Chinese SEZ incentives

Whilst the South African CIT incentive of 15% from the standard rate of 28% is stronger than the Chinese incentive of 15% from the standard rate of 25% (applicable only high-technology enterprises), the Chinese regime introduces a tax holiday which does not exist in South Africa. By providing companies with a tax holiday for the first two years of operation, it is intended to provide them with a tax break for the start-up period. Whilst it is submitted that the nature of investment in SEZ by foreign enterprises is that it often requires substantial start-up costs within the first two years regardless, such a tax holiday may just provide foreign firms with that additional incentive that can be the catalyst for the decision to invest in a South African SEZ.

Unlike South Africa, the incentives offered in China are very industry focused and generally incentives are only available to high-technology enterprises or those in encouraged industries. Examples of these encouraged industries are textiles, light manufacturing, information technology and construction materials. It is perceived that this may be due to China coming from a position of having experienced success and economic growth in the past i.e. coming from a position of power to choose their industries. What is important to note however, is that any new reforms or incentives offered, have first been tested within selected zones in order to gauge their success. This is potentially an approach the South African SEZs, through the Department of Trade and Industry (DTI), could explore. It is submitted that by granting the DTI authority to offer reduced CIT rates within certain priority industries, the SEZ advisory committee will be able to monitor the efficacy of certain incentives and the global investment appetite for certain industries.

Chinese SEZs have historically evolved from export-oriented zones and hence it is logical that the priority of their incentives are in the form of export incentives. China's FTZs and EPZs operate similarly to South Africa's CCA in that enterprises are exempt from Customs Duty and VAT. There also exists a VAT refund for finished products made using domestic raw materials. This refund is claimed following departure of the shipment from China or in the case of EPZs, as soon as the products enter the zone. This creates an additional

¹⁰⁷ Deloitte. *China Taxation and Investment 2014*. 2014, 3.

incentive for companies that are not within a zone themselves but supply to enterprises within the zones and thereby creates a linkage between foreign and domestic firms which increases the benefit of the zones to the local economy.

4.6 Conclusion

The purpose of this chapter was to compare the fiscal incentives offered by BRIC nations' SEZ programmes to those offered by South Africa's SEZ programme to evaluate the adequacy of South Africa's fiscal incentives. The key findings of this comparison can be summarised as follows:

- Brazil has focussed on certain key industries (such as agriculture) which will never attract import duties on their goods when they move from within the zone to the domestic market.
- The location of zones in Brazil, along the border, aides in investment in their zones by companies looking to trade in multiple countries.
- Variable tax rates which can be set by the zones themselves in Russia, allow zones to bargain with potential investors thereby allowing a more flexible investment climate.
- Russia is also a relatively young SEZ programme but their CIT incentive is much stronger with even a full exemption available in certain zones.
- India has different incentives depending on the industry in which the foreign company operates in order to promote certain attractive industries (such as information technology) and limit the growth of other industries that may be exploited.
- China's CIT incentive includes a tax holiday which gives a tax break to start-up companies for their first 2 years of operation.
- Similar to India, China offers industry specific CIT incentives in order to promote certain industries (such as textiles and high tech products).
- China offers a refund on import duty on goods manufactured using local raw materials thereby creating a linkage between the domestic market and SEZs.

5. Case studies affecting the sustainability of South African Special Economic Zones

5.1 Introduction

The review of the largely unsuccessful IDZ programme in South Africa indicates that a major weakness of the programme was a lack of tax incentives. As found in this study, various additional tax incentives were introduced along with the SEZ programme in order to respond to this challenge and stimulate FDI. The predominant question of this study is whether or not the South African fiscal incentives are adequate. Embedded in this question of adequacy is a consideration of the long-term effects of the fiscal incentives. The incentives may be adequate in attracting FDI in the short term, say the next 10 years as envisaged by the Special Economic Zones Act, but is that then considered adequate in line with the South African Economic goals as portrayed in the National Development Plan (NDP). The NDP lays out a plan for sustainable economic growth and it is submitted therefore, that the intention of the Special Economic Zones is not merely to be a catalyst for short term FDI but rather a platform for development of infrastructure and skills that will ensure the South African economy benefits from the FDI long after the initial 10 year implementation of the tax incentives.

5.2 When Trade Preferences and Tax Breaks are No Longer Enough

5.2.1 Introduction

Fortunately, as South Africa is considered a late adopter of the SEZ concept, there exists evidence from other countries who have faced similar challenges in the past. One such country is the Dominican Republic which, after seeing initial success in their Free Zone based model in the 1980s, faced threats to their model and therefore their source of FDI between 1999 and 2003 and were forced to implement measures broader than trade preferences and tax breaks in order to revive the stagnated SEZ model.¹⁰⁸

5.2.2 The Dominican Republic Case

The Dominican Republic (DR) was one of the original pioneers of free zones (FZs) in the Western Hemisphere and saw success as early as the 1970s as a result of the offshoring of the US textile and garment industry. Various factors eventually caused a slowdown to FDI in DR however with the most significant external factor being the growing prominence of Asian textile manufacturing. The FZ programme has stagnated to such a point that its contribution

¹⁰⁸ Burgaud, J-M and Farole, T. *The Challenge of Adjustment in the Dominican Republic's Free Zones in Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011. 159 . 181.

to national GDP was halved in only five years from 2004 . 2009. The initial success of the DR FZ model was largely due to tax incentives and trade preferences which the government utilised in response to the stagnation by implementing even further incentives. Examples of new reforms are:

- Customs procedures were streamlined,
- Tariffs were reduced,
- Import surcharges and export taxes were eliminated,
- And new legislation was adopted on government procurement, competition policy, and intellectual property rights.¹⁰⁹

These reforms have seen limited success and evidence shows that the situation has in fact worsened with exports declining considerable since 2009.

The DR FZ programme relied on the following four factors¹¹⁰:

- **Trade preferences** . duty free access to the United States on certain products. This may be considered comparable to South African customs controlled areas.
- **Low wages** . wage arbitrage opportunity between United States and DR. Not comparable with South Africa.
- **Competitive exchange rate** . a devalued exchange rate assisted exports but should not be relied upon as it is an external factor.
- **Fiscal incentives** . preferential corporate income tax, import duties, VAT and property taxes within the zone. Comparable to South African reduced CIT rate of 15%.

In a study on the history and achievements of the FZ program in the Dominican Republic by the World Bank, the authors state:

The Dominican Republic's experience highlights the limitations of FZ programs that rely on sources of competitiveness that are unlikely to remain sustainable—specifically, low wages, trade preferences, and fiscal incentives. Although these all may offer valuable advantage in the short term, the Dominican Republic (like many countries who have embarked on export processing zones) failed to build

¹⁰⁹ Ibid

¹¹⁰ Ibid.

competitiveness in parallel, through investments in education and skills, and through integration of FZ firms with the local economy. ¹¹¹

The decline in FDI and exports in DR has been most significant since 2009 and can largely be attributed to the global economic crisis however it highlights more fundamental competitiveness issues that will remain a major challenge to the sustainability of the program into the future. ¹¹²

5.2.3 Mitigating the risk to sustainability

The DR government implemented various measures to respond to their challenges however many of these responses appear to be designed to bolster the existing basis of competitiveness rather than addressing structural issues. The key structural issues faced by the DR are similar to those faced by other developing countries implementing export-processing programmes. These can be summarised as:

- Overreliance on trade preferences

Trade preferences such as free trade agreements between countries (i.e. no duty free access to other markets) can serve as critical catalysts to trade between countries, however it can also cause complacency in terms of market focus and competitiveness. ¹¹³

- Failure to integrate with the local economy

In order to integrate with the local economy, legislation needs to support forward and backward linkages to the local market. The DR legislation did provide for forward linkages in that FZ companies were free to export up to 20% of their produce to the domestic territory provided all applicable tariffs and duties are paid. The DR legislation favoured backward linkages as Suppliers from the domestic economy to FZ companies are exempt from import duties on the raw materials used in this production. In successful FZ programs, for example, Malaysia and the Republic of Korea, the development of strong local clusters is acknowledged as making a significant contribution to the successful upgrading of FZ-based manufacturers by giving them access to competitively priced, world-class quality inputs. ¹¹⁴

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Ibid.

¹¹⁴ Ibid.

- Lack of attention to skills development and wider social upgrading

History has shown that foreign companies have contributed little to skills development by opting to import skilled labour whilst using the local labour, such as in DR, for unskilled, labour intensive work with little interest or incentive to advance the employees. Lower minimum wage incentives offered by many SEZs in developing countries has exacerbated this issue.¹¹⁵

5.2.4 Application to South Africa

There is significant scope for the South African government to apply the learnings from cases such as the Dominican Republic when analysing the tax incentives offered by South African Economic Zones. Similarly to the Dominican Republic, the South African SEZ programme is dependent on internal and external factors such as trade preferences and fiscal incentives.

Below is an analysis of the above three identified structural issues with suggestions offered for how the South African government can structure tax incentives to mitigate the sustainability risks:

- Overreliance on trade preferences

Whilst South Africa does rely on trade preferences to a certain extent through the Southern African Customs Union (SACU), the SEZ programme is focussed more toward broader production and export to nations further abroad than the neighbouring countries. The customs controlled area incentives are not limited to specific countries and it is submitted therefore that this is not a significant risk to the South African SEZs.

- Failure to integrate with the local economy

The South African VAT Act treats sales from domestic companies to SEZ companies as exports and hence are zero-rated which greatly supports backward linkages into the economy. In order to incentivise forward linkages, South Africa may consider providing a similar incentive to DR where sales from SEZ companies to local companies only attract import duties on raw materials that they had imported prior to manufacture i.e. raw materials and labour costs are excluded from the cost of goods for customs duty purposes.

¹¹⁵ Ibid.

- Lack of attention to skills and wider social upgrading

Currently there is no real incentive for foreign companies to contribute to skills and wider social upgrading. Elsewhere in the country, the Broad Based Black Economic Empowerment (BBBEE) programme provides for incentives in terms of better levels based on such contributions which can assist in doing business with other South African companies or the South African government. This is, however, little incentive to foreign companies whose main goal is to export their products. The only labour based tax incentive for SEZ companies is the Employment Tax Incentive Act which in fact supports the employment of lower income employees and not the advancement of their skills. South Africa should therefore investigate incentives which aide in skills development of South African employees. It is submitted that a basis for this may be the system used for BBBEE certification where points are awarded based on contributions e.g. corporate social investment, number of South Africans in management positions etc. A suggestion is then that such levels be used to determine the tax incentives available to the foreign companies e.g. a standard foreign company will be taxed at 15% whereas one with a higher level of contribution can be reduced to 10%. It is submitted that this will provide an incentive whilst not being a barrier to entry into the South African SEZs as may be the case if employing South Africans was a pre-requisite.

5.3. Developments in Africa: issues pertinent to the continent

5.3.1 Introduction

This study has analysed SEZ programmes in other developing countries as a means to understand what fiscal incentives may be effective for South Africa's new SEZ programme. However, to base the programme purely on success stories, such as that of China, is dangerous as it ignores issues unique to the African continent. The African experience with SEZs has not been anywhere near as successful as policy makers hoped it would be. The World Bank, in 2011, undertook a study to comprehensively assess Africa's recent experience with developing SEZs in order to provide evidence on the factors that determine success in SEZ programmes.¹¹⁶ This study forms the basis of this sub-chapter which analyses the fiscal incentive aspects of African SEZs in order to find application to South Africa's SEZ programme.

¹¹⁶ Farole, T. *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. 2011. 1-3.

Failures in individual African SEZ projects can be attributed to a variety of factors, including poor location, lack of effective strategic planning and management, national policy instability, and weak governance.¹¹⁷ Such factors create a poor investment climate i.e. unattractive risks, opportunities and transactions costs involved in operating and running a business inside the zone. A survey by the World Bank indicated that trade preferences and corporate tax incentives ranked fourth and fifth respectively in criteria for selecting and investment location in African countries.¹¹⁸ By analysing these criteria, the South African programme can identify opportunities to attract and retain investors.

5.3.2 Tariffs and preferences

Most African countries (South Africa included) offer similar import incentives being the use of duty-free import materials, components, and capital equipment in production. However, competitive differentiation is available to African SEZs in markets where they have preferential access through preferential trade agreements. An example of this is the US African Growth and Opportunity Act of 2000 (AGOA) which allows manufacturers to use fabric from third countries thereby granting foreign companies access to US markets through African SEZs. South Africa is eligible for certain, but not all, of the trade preferences available under AGOA. As much as preferential trade agreements can be an opportunity, it can also create disadvantages to SEZ companies especially in relation to regional trade. Some of the African SEZs are at a disadvantage compared with other locations in their country, because regional trade agreements may not give full preferences to exports from SEZs. For example, in the Economic Community of West African States (ECOWAS), SEZ exports are not considered to originate from within the trading bloc and are not given preferential access.¹¹⁹ The growth of regional trade agreements is therefore a potential threat to SEZ competitiveness, especially combined with local market restrictions. It stands to reason, then, that the converse of this also holds true. The growth of SEZs can be seen to be a potential threat to the economic goals of regional trade agreements. By offering tariff incentives and trade preferences to foreign SEZ companies may be anti-competitive to other countries that are party to the relevant regional trade agreements.

5.3.3 Level of taxes

The provision of corporate and other tax incentives is a long-established practice in SEZs worldwide. Tax incentives have proven to be an important catalyst for investment in SEZ

¹¹⁷ Watson, P. L. 2001. "Export Processing Zones: Has Africa Missed the Boat? Not Yet!" Africa Region Working Paper Series No. 17. World Bank, Washington, DC

¹¹⁸ Farole, T. *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. 2011. 133-150.

¹¹⁹ Ibid.

programmes especially in the early stages of development. SEZ regimes however need to ensure they do not become overly reliant on granting general tax incentives rather than addressing other aspects of the investment environment, raising the risk of a race to the bottom with other zones.¹²⁰ A survey by the World Bank across countries in Africa as well as other developing nations showed that most countries offered substantial exemption periods on their headline corporate tax and it is submitted that such exemption period, which is not offered by South Africa, can be an excellent catalyst for initial investment for example, a full exemption on all corporate income tax for the first 2 years of operation of a company investing in an SEZ. The World Bank survey went further to ask the question of whether tax incentives have a significant effect on the economies of a typical investor i.e. how beneficial is the incentive to the investor and therefore what is the likelihood that investment decisions will be swayed by tax incentives. They found that, when analysed over a 20 year period, the benefit of tax incentives can result in increases of up to 4% of revenue for a large investor and up to 6% of revenue for a small investor with African countries performing marginally lower than other developing countries.¹²¹

5.3.4 Application to South Africa

The study by the World Bank referred to above concludes that of the five main issues that affect investor behaviour in African SEZs, the first three, being (1) cost and quality of utilities; (2) access to transport infrastructure; and (3) business regulatory environment are the most critical. This implies that whilst the fourth and fifth issue ((4) tariffs, duties, and rules of origin; and (5) level of corporate taxes) are key considerations taken into account by investors, they are not sufficient to sway investor decisions i.e. no matter how great the incentives are, if the country has performed poorly in terms of utilities, transport and regulations, investors are likely to ignore the incentives. The World Bank study showed that other African countries have performed poorly in terms of creating an attractive business environment at a national and SEZ level and this is where a competitive advantage may lie for South Africa. If South Africa were to compete with other SEZ programmes by increasing fiscal incentives, the likely result is a race to the bottom situation where whichever country offers the best incentive will receive the investment and it is common cause in situations like this, that the real winner is the investor and not the country receiving the investment. South Africa should rather look to improve the business environment by addressing the day-to-day challenges that will make investors ability to do business easier such as ensuring there is a steady flow of power, avoiding delays in the flow of goods in and out of the zone, efficient operations etc. It is acknowledged that there may be resource constraints to consider and to mitigate that risk, it

¹²⁰ Ibid.

¹²¹ Ibid.

is submitted that South African SEZs could look to attract expertise from outside our borders, from countries with more experience in managing SEZs, to assist with the logistical challenges of creating an attractive investment climate.

5.3 Conclusion

This chapter looked at some case studies in order to ascertain risks and opportunities that can be addressed by South African SEZs in order to ensure their sustainability with a specific focus on how fiscal incentives should be managed. The example of the Dominican Republic was analysed where it showed that despite very attractive fiscal incentives, particularly in the form of preferential trade agreements, investment in their SEZ programme declined over the years. This decline can be attributed to the government resistance to extend the SEZ programme beyond the borders of the zones. In order to avoid this therefore, South Africa needs to ensure they do not rely too heavily on fiscal incentives and take a strategic view to the SEZs which will ensure they constantly evolve to create an attractive investment environment but also contribute sufficiently to the country's skill base and infrastructure so that if there is a disinvestment in the future, the impact on the economy is reduced. This conclusion is supported by the World Bank survey of African countries which showed that although fiscal incentives are important in attracting investors, the logistical challenges are critical. The government has control over these elements and this suggests the importance of SEZ policy and management, and the potential for zones to play a significant role in influencing investor location decisions.

6. Summary of findings and conclusions

6.1 Summary of findings

The purpose of this study was to analyse and evaluate the appropriateness of the fiscal incentives offered to South African Special Economic Zones. The outcome of it is not too attempt to predict whether or not South African Special Economic Zones will be successful or not as this is dependent on a variety of facts, such as political or economic, which are beyond the scope of this study. The South African SEZ regime is still in its infancy and so the study has attempted to provide context for the incentives offered to South African SEZs in terms of past history and success and failure cases from other more experienced countries.

The study initially investigated the history of SEZs globally and in South Africa and in doing so it identified that with the onset of globalisation in the modern era, developing countries have utilised various forms of SEZ as effective tools to promote FDI which has significant economic growth in many developing countries. As global trade only opened to South Africa in the post-apartheid era, the country was relatively late in implementing an SEZ strategy. The IDZ programme was implemented in December 2000 however it saw very poor results with only 5 zones being created in a 13 year period with very little investment in the zones. On review of the IDZ programme, the DTI identified the following reasons for review of the IDZ programme and implementation of the new SEZ programme:

- Developments in national economic policies and strategies such as the introduction of the NDP.
- Developments in the global economic environment such as the increase in attention towards the BRICS nations has emphasised the need for greater involvement by the South African government in promoting the SEZ regime.
- Leadership and effective implementation are critical to the success of SEZs and this has resulted in the creation of an SEZ advisory board according to the SEZ Act.
- The IDZ programme performed modestly and thus greater incentives were introduced in 2013.¹²²

This review indicated that South Africa is on the right track in terms of its approach to SEZs as documented in official documentation such as the NDP, the SEZ policy and the SEZ Act however it remains to be seen whether the implementation will be effective.

Through the overhaul of the IDZ programme, South Africa implemented various new tax incentives. The most significant of these is a direct reduction in CIT for companies in SEZs

¹²² Department of Trade and Industry. *Policy on the development of Special Economic Zones in South Africa*. 2012, 7.

from 28% to 15% and an accelerated depreciation on buildings owned. Whilst these incentives are greater than that which existed under the IDZ programme they do not appear to be substantial enough to create the catalyst for investment that the SEZ is designed to be. This is because, as discussed in chapter 5, foreign companies only see tax incentives as the 5th most important characteristic when deciding whether to invest in African countries¹²³ and at a 15% CIT and applying dividends tax, an investment in a South African SEZ could still cost a foreign company up to 27.75% tax a year which is relatively high in comparison to other developing countries. It is a difficult task to decide on a reduced tax incentive rate as, either the reduced rate can be a catalyst for creating investment which will be perceived as a success, however, if it does not create FDI, it really would not matter if the rate was 15% or the standard 28% and thus the additional 13% is lost revenue to the fiscus on companies already invested in the SEZ (i.e. those that invested for reasons other than the tax incentive). It is legislated that this rate is applicable for ten years and is subject to review in five years time which implies that the South African government is testing it out which is a conservative approach.

The accelerated building allowance does appear to be attractive in deferring tax and thus providing a cash flow incentive to these companies. Complications may arise however in that land within the SEZs are generally owned by the government or SEZ operator and thus lease contracts will need to be carefully drafted in order to ensure companies receive this benefit. Further, the SEZ policy indicates the need for effective leadership and implementation of the SEZ programme. Evidence has shown¹²⁴ that SEZs have seen little success in Africa and the zone regimes that perform best across the board. Kenya and Lesotho are characterized mainly by zone enclaves (industrial estates), most of which make significant use of prebuilt factory units. Thus implying that South Africa may see more success in building and owning the infrastructure which can be leased to foreign companies rather than incentivising companies to build their own infrastructure.

The example illustrating the effect of tax incentives in chapter 3 shows that there are CIT incentives available to SEZ companies however the biggest contributor is as a result of customs duties not being imposed in CCA on imported goods. As this incentive was also available in the unsuccessful IDZ programme, it stands to reason that it is not an effective catalyst for attracting investment. A potential reason for this is the barrier it creates for supply to the local market as a result of full customs and VAT being charged on goods manufactured within the zone and then imported into South Africa. The newer incentives

¹²³ Farole, T. *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. 2011. 133-150.

¹²⁴ Ibid

offered by the SEZ programme are likely to be ineffectual as they offer very limited savings on a practical level with the contribution of the ETI being particularly negligible and the limited timeframe of two years meaning that it is unlikely to be a contributor to any attraction of FDI.

By analysing the SEZ programmes in other BRICS nations, the study was able to identify differences with the South African programme and, although the other BRICS nations may have different goals for their programmes, certain methodologies in their systems can be used to improve South African incentives. The following key points were identified in this part of the study:

- A major reason for China's success is that they have used their SEZs as testing grounds for various incentives. South Africa currently has a very conservative approach to their SEZ incentives. With only 5 SEZs currently in South Africa and with limited investment in them, it is unlikely that South Africa will lose a significant amount of fiscal revenue by dramatically increasing the incentives. Russia has CIT rates as low as 0% and has flexibility whereby different zones can offer different CIT rates as a negotiating tool. Alternatively, the 2 year CIT holiday as provided by China has proven to be an effective catalyst for FDI. As South Africa, like Russia, is a young SEZ regime, it is submitted that they will need stronger CIT incentives to attract FDI.
- An effective incentive in China is the refund offered on import duties on goods manufactured in SEZs using local raw materials. Not only does open up the SEZ Company to the local market thereby removing this investment barrier, it creates a linkage to the local economy. It is submitted that local companies can therefore benefit from doing business with foreign companies which will assist in decreasing the reliance on SEZ investors, transferring skills to local businessmen and providing growth to the overall economy, and not just within the SEZ enclave.

As important as it is to know where we have come from, it is also important to know where we are going. As discussed in chapter 5, South Africa needs to incorporate strategies now in the early phases of their SEZ programme to ensure sustainability of the FDI which the zones hope to attract. Key to this is avoiding reliance on fiscal incentives. The Dominican Republic case illustrated that an overdependence on trade preferences meant that companies disinvested when more attractive destinations became available. These destinations were more attractive for a variety of reasons and as discovered in the World Bank Survey, investors tend to favour cost and quality of utilities; access to transport infrastructure; and business regulatory environment over tariff preferences and levels of taxes when making investment decisions in developing countries. The South African government therefore will

need to ensure they are committed and involved in the development of all SEZs in order to make the zones into a holistic attractive investment climate. The research has shown that is not sufficient to merely create zones with fiscal incentives and hope that MNCs will invest. The government and zone operators need to ensure that an attractive investment climate is created and thereafter ensure that investors are integrated into the local economy and contribute to wider skills development thereby contributing to the sustainability of the zones.

6.2 Recommendations

Based on the research in this study, the following are recommendations of how the current fiscal incentives can be enhanced to create an attractive and sustainable investment climate for FDI:

6.2.1 Rebate on imports from FDI

Currently the situation where a company operates in an SEZ but supplies to the local economy suffers a heavy disincentive. The example in chapter 3 illustrates that the fictitious LOCALCO would have a significantly higher TTC if located within an SEZ and supplied to the local economy. This is due to the fact that there will be customs duty and VAT charged on any goods imported despite them being manufactured within a zone on South African soil potentially utilising South African raw materials and South African labour. It is submitted that a rebate similar to that offered in China should be incorporated in order to turn this disincentive into an incentive. This would result in the landed costs of goods for customs duty and VAT purposes excluding any costs on South African raw materials and South African labour. These indirect taxes will then effectively only be paid on the foreign component of the product. It is envisaged that this incentive will assist in attracting FDI from MNCs who want to utilise the zones for export from South Africa and import into South Africa thus creating a more holistic investment climate. This should create a linkage between the zones and the South African local economy and the reduction on the labour component should also incentivise companies to utilise South African labour therefore creating jobs and contributing to wider skills development.

6.2.2 Flexible Corporate Income Tax rates

Currently the CIT is at a fixed rate across all zones at 15% with no clear evidence of how this rate was determined and whether or not it will be effective. Although this study has not analysed the economic effects such as the cost of the incentive on the local economy, it is surmised that due to low level of current investment in South African zones, a further reduction in CIT will unlikely cause a significant drain on the National Treasury. As discussed in this study, China has effectively used SEZs as a test for various strategies and Russia has

employed a variable tax rate dependent on the relevant zone. The SEZ Act makes provision for an advisory board made up of:

- One representative from the DTI;
- One representative from SARS;
- One representative from National Treasury;
- One representative from the department responsible for public enterprises;
- One representative from Transnet SOC Limited;
- One representative from Eskom SOC Limited;
- One representative from the Industrial Development Corporation;
- Three persons each representing organised business, labour and civil society; and
- Five persons appointed on the basis of their knowledge experience and expertise relevant to SEZs.

It is recommended that the SEZ advisory board be given the authority in terms of the Income Tax Act to designate CIT rates to specific zones. CIT rates can therefore be used as a bargaining tool to attract investment in specific zones. For example, if a major investor is willing to invest in the Saldanha Bay zone but needs a lower than 15% CIT rate, the SEZ advisory board will be able to reduce the rate (within a range of approved rates e.g. between 5 and 15%) in order to attract the investor. It is acknowledged that this may create a race to the bottom situation where the economy may suffer as a result of over-incentivising foreign investors however the safeguard exists in that the advisory board should be sufficiently skilled to mitigate this risk.

6.2.3 Creation of a linkage between fiscal incentives and skills development

As discussed in chapter 5, currently there is no real incentive for foreign companies to contribute to skills and wider social upgrading. Elsewhere in the country, the Broad Based Black Economic Empowerment (BBBEE) programme provides for incentives in terms of better levels based on such contributions which can assist in doing business with other South African companies or the South African government. The BBBEE programme works on a points scoring system where companies achieve a certain level based on the number of points they score. Points are scored for a variety of factors such as ownership, contribution to skills development, demographic of management etc. There is little incentive for exporting countries to score more BBBEE points as they are unlikely to generate much business in South Africa and therefore their BBBEE level is irrelevant. It is suggested, however, that by developing a similar system for SEZ based companies where additional tax incentives are awarded to companies based on, for example, their employment of South Africans or expenditure on training, foreign companies will be motivated to invest in South African skills

thereby creating a linkage between SEZ investment (which may have a limited lifespan as discussed elsewhere in this study) and wider skills development which may create a sustainable benefit to the country.

6.3 Non-fiscal considerations

Whilst this study only investigated the fiscal incentives of South African SEZs, it would be remiss to not mention the current trends in SEZ development internationally as these may affect the future success of all zones despite the fiscal incentives. As mentioned in the study, China has seen wide success with their use of zones and in analysing them, two important trends emerged in China's SEZ development.

6.3.1 Wider SEZ development

Recent years have seen China (and many other countries) shift away from the more traditional EPZ model focussed on manufacturing activities in order to export, to SEZs with emphasis on physical, strategic, and financial links between the zones and local economies, and a shift away from fiscal incentives to value added services and a greater focus on differentiation through the investment climate in the zone¹²⁵. Such wider SEZs encompass either a broader spectrum of activities, such as multiuse developments encompassing industrial, commercial, residential, and even tourism activities or highly specialized developments focused on specific high-end services like information and communication technology (ICT) and biotech.¹²⁶ South Africa therefore needs to ensure that their SEZs are not limited in their ability to adapt to trends in the international sphere and they should look to ensure that their zones are flexible enough to respond to investors' needs. Zone operators should be looking to develop their zones to include broader services such as residential and support services (e.g. schools, recreational, utilities) in order to create an attractive investment climate. Another growing trend is the importance of zones that are privately owned, developed, or operated¹²⁷. South Africa does allow for private SEZ operators and it is envisaged that the SEZ advisory board will provide the necessary oversight in aligning the private operation of zones with the political and economic goals of the government.

6.3.2 China's Investment in Special Economic Zones in Africa

In 2006, as part of the implementation of its 11th five-year plan, the Chinese government announced that it would establish up to 50 overseas economic and trade cooperation

¹²⁵ Farole, T and Akinji, G. *Special Economic Zones: Progress, Emerging Challenges and Future Directions*. 2011, 6.

¹²⁶ Ibid, 7.

¹²⁷ Ibid.

zones.¹²⁸ This policy illustrates a remarkable change in strategy for SEZs as they are no longer a vehicle for bringing foreign investment into China but as one which can also be used to facilitate Chinese investment into other countries. This has a number of objectives such as:

- Increasing the demand for Chinese products like machinery;
- By producing overseas and exporting to Europe or North America, Chinese companies would be able to avoid trade frictions and barriers imposed on exports from China;
- Create economies of scale for overseas investment in order to assist smaller Chinese firms to venture overseas; and
- A method to transfer an element of China's success to other developing countries.

These zones typically involve a partnership between Chinese and local governments where the zones conform to local legislation whilst the Chinese government provide support and further incentives from home. Development and management of these zones in Africa are carried out by Chinese developers and operators with the local government providing the infrastructure.¹²⁹

China's initiative to develop SEZs in Sub-Saharan Africa is still in its early stages however certain challenges have presented themselves. These are largely related to lack of experience and skills in Africa. This has resulted in failure to deliver a world class investment environment. On the basis of their experience at home, Chinese developers expect host governments to support zone development actively; instead, they are finding in some projects (e.g., Ethiopia) that governments allocate land to developers and do little else. Developers have been frustrated by the lack of progress or poor quality of infrastructure provided by some local governments outside the zones.¹³⁰

This trend exhibited by China illustrates two significant opportunities for South African SEZs:

1. Early indications again highlights a real need for South African SEZs to create an attractive investment climate. If South Africa are able to fulfil the infrastructural and operational needs of foreign investors, they will have a significant competitive advantage over other African countries thereby making any competition on tax incentives redundant and avoiding a race to the bottom scenario.

¹²⁸ Brautigam, D and Xiaoyang, T. *China's investment in Special Economic Zones in Africa*. The World Bank . Special Economic Zones: Progress, Emerging Challenges and Future Directions. 2011, 69-100.

¹²⁹ Ibid.

¹³⁰ Ibid.

2. By taking advantage of China's desire to invest into Africa, there is an opportunity for South African SEZs to leverage off the experience of Chinese operators in order to learn from them in order to create the most attractive environment for both Chinese and other foreign investors.

6.4 Concluding remarks

South Africa is at a critical point in their SEZ development and thus research in order to provide context for aspects of the SEZ programme is of paramount importance. The introduction to the study identified the following two critical questions to be addressed:

- Are the fiscal incentives offered to South African SEZs strong enough to attract FDI?
- Are the fiscal incentives offered to South African SEZs too strong which may result in the exploitation of the South African economy?

It is impossible to conclude on whether or not the South African fiscal incentives will be successful in attracting FDI as there are a variety of factors that may ultimately result in the success or failure of South Africa's zones. It is submitted that at current investment levels, the companies invested in existing SEZs do not contribute enough to the economy for there to be a significant drain on the fiscus as a result of SEZ incentives. What the study has shown is that whilst the current basket of fiscal incentives offered to South African SEZs is an improvement to the IDZ programme, the most significant incentive, being the creation of CCAs, has not changed and thus this is potentially where the DTI needs to focus any further revisions to the incentives. Whilst the goal of the SEZ programme is to attract FDI, it is important to establish how it is intended for that FDI to be utilised to the benefit of the local economy. It is inadequate to merely provide incentives and hope that investors will come. The success of the fiscal incentives in South African SEZs is therefore reliant on the level of involvement and commitment from the government to development of the Zones. It is submitted that there is real opportunity for South Africa to utilise the fiscal incentives discussed in this study to their benefit however the SEZs must not be treated as a foreign enclave of the country but rather as an area integrated into the local economy providing incentives for foreign investors in return for the skills transfer and job opportunities that their investment is intended to provide thus creating a mutually beneficial investment climate.

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