

# **Tax Incentives for Investment in South Africa**

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## **Introduction**

Increasing investment spending has remained one of the most important policy goals in South Africa since the election in 1994. Particularly the need to increase foreign direct investment (FDI) has been a consistent topic in policy debate. However, investment remains elusive and political pressure to improve the investment climate is growing. This essay examines the case for the use of tax incentives as opposed to alternative means of stimulating capital investment. It will begin by reviewing the various policy goals connected with investment spending. These goals together with some evidence on the drivers of investment spending will serve as a foundation for the analysis of tax incentives. This essay will argue while tax incentives can play a role in encouraging investment, improvements in the fundamentals of the investment climate are of far greater importance. We provide some indication of the types of tax incentives that are more effective and how they should be applied to avoid the pitfalls already revealed by history.

## **What is the rationale for desiring higher investment spending?**

Accumulation of physical capital through investment spending is, according to orthodox economic growth theory, an important means of increasing living standards (See Solow (1956)). An increase in the stock of physical capital can increase employment, increase per capita income, expand the variety of goods available to consumers and by consequence of these factors, drive up living standards. Growth theory also identifies technological progress as being the most important source of long run growth (Solow, 1962). We will see that this last observation is also of relevance to policy formation on investment spending. However, based purely on the effects of capital accumulation, there is some rationale to justify incentivising investment.

Investment incentives can also be justified as means for correcting market failure. There are various objectives that government may pursue within this realm. UNCTAD (2000) identified four main categories of objectives that governments pursue with incentives<sup>1</sup>. These categories are regional, sectoral, performance enhancement and transfer of technology. Regional and sectoral investment incentives are provided to enlist the aid of firms in enhancing underdeveloped regions (of the country) and sectors (of the economy). Performance enhancement incentives attempt to improve performance in a particular economic sphere (such as exports for example). Transfer of technology applies directly to FDI and will be discussed in more details later.

The source (i.e. foreign or local) of investment is an important consideration. While FDI generates profits that accrue to the foreign company, these investments can create 'spillover' benefits for the host country. These spillover benefits are often referred to as positive externalities since they produce social gains beyond the (internal) private returns to the foreign firms. It is precisely the presence of positive externalities that provides the justification for government intervention to encourage these investments<sup>2</sup> (see Tanzi & Zee, 2000; Zee, Stotsky & Ley, 2002; Blomström & Kokko, 2003). These externalities can occur where the foreign firms bring new technologies and skills that increase productivity. In this way, encouraging FDI can lead to growth through another channel as previously mentioned. However, these spillover benefits are not necessarily consequences of FDI as observed by Kathuria (1998, 2000). The scope of benefits gained will depend on the degree to which the new techniques and trained workers diffuse throughout the economy.

Other possible effects of FDI include providing employment (often at higher wages than domestic firms according to Farrell, Remes & Schulz (2004)); increased tax revenues and higher competition. FDI inflows can also serve as a more stable means of financing short term current account deficits as opposed to portfolio flows<sup>3</sup>.

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<sup>1</sup> These categories were given with reference to FDI.

Where these investments further develop export markets, they can improve the trade balance in the longer term. In South Africa, with a high unemployment rate and an increasing trade deficit these factors are particularly important.

**Table 1. The Possible Effects of Foreign Direct Investment**

Favourable	Unfavourable
New technologies Local skills development Increased employment Opening export markets Forward/Backward linkages Current account finance Increased tax receipts Increased local competition	Increases foreign wealth Dependency on foreign firms (national security) Can gain monopoly power in local markets by virtue of their better technology/skills

Table 1 above summarises some of the possible effects of promoting FDI. It is a vital point to note that these are possible and not necessarily actual effects of FDI.

However the literature on FDI is generally positive. Farrell, Remes & Schulz (2004) found, in a set of case studies on emerging market industries, that the effects of FDI on domestic economies were unambiguously positive.

**What matters in the investment decision?**

One of the biggest problems with evaluating tax based incentives is identifying which investments are incremental and which would have been made regardless of incentives offered (Zee, Stotsky & Ley, 2002). Where *any* tax incentive is granted to firms that already intend to invest, there is a sizeable deadweight loss. This loss is problematic because even where the costs of the incentives can be calculated (and this is not always possible), the benefits (discussed previously) *caused* by the incentive are so difficult to observe. Given that assessing the actual impact of tax incentives on investor decisions is difficult, there is justification for reviewing what investors perceive as important to their investment decisions.

Farrell, Remes & Schulz (2004), interviewed executives of firms<sup>4</sup> that had chosen to invest in India. They found that financial incentives were the least important factor in the decision to invest. Infrastructure, availability of skilled workers, regulation and accessibility by air were (in order) the factors that these executives ranked above financial incentives. The conclusion made by the authors was that if all else is held equal, these incentives might sway a decision, but those other factors being held constant are of much greater importance. These conclusions are generally supported in the literature (see for example Tanzi & Zee, 2000; Morisset & Pirnia, 2001 and Flatters, 2005).

Morisset & Pirnia (2001) suggest that tax incentives are easier to provide than changes to the tax regime, and can be a means for governments to signal their 'commitment' to investment; as initially suggested by Bond and Samuelson (1986). Spar (1998), investigating Intel's decision to invest in Costa Rica, notes that government support and commitment were of huge importance to their investment decision. However, Costa Rica did not offer the highest incentives among the nations competing for the investment. Thus tax incentives may matter more to firms as a signal of government commitment, than as a financial incentive.

#### Evidence from South Africa

Clarke *et al* (2005) conducted research into the investment climate in South Africa. Their research involved an analysis of survey data from over 800 firms regarding which areas of the investment climate represent the biggest constraints to growth. The factors that emerged on top were, in order: worker skills, macroeconomic instability, labour regulations and crime. The problem of macroeconomic instability, it should be noted, was largely a concern of firms involved in exporting. As such it most likely concerns exchange rate volatility rather than other macroeconomic factors. It would appear that South African firms' concerns are consistent with the

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<sup>4</sup> Firms foreign to India

international literature with regards to the importance of the fundamentals of the investment climate over that of tax incentives.

Despite the evidence presented against the use of tax incentives in general, let us for the moment assume that it is possible that they *can* play a useful role. We now pursue some analysis of the specific tax incentives available, to determine which of these may in fact be useful policy instruments.

### **Theoretical arguments and empirical evidence for tax incentives for investment**

Before continuing, we will for the sake of clarity adopt a formal definition of investment incentives, as quoted below. This definition excludes changes in the *general* tax environment from the definition of tax incentives.

“...a special tax provision granted to qualified investment projects (however determined) that represents a statutorily favourable deviation from a corresponding provision applicable to investment projects in general” (Zee, Stotsky & Ley, 2002: 1498)

The use of tax incentives to attract investment is widespread and their use is increasing (see Tanzi & Zee, 2000; Zee, Stotsky & Ley, 2002 and Blomström & Kokko, 2003). Tax incentives can be granted in a variety of ways, with differing implications for the burden on the domestic treasury (Zee, Stotsky & Ley, 2002). Table 2 below summarizes the most popular forms of tax incentives that are available. The effects of these policies will be individually discussed after some introduction to the costs associated with tax incentives.

**Table 2. The most popular tax incentives available**

Type	Description
Tax holidays	Exemptions from corporate taxes for a set period
Preferential tax rates	Reduced corporate tax rates for a set period
Investment allowances*	<i>Additional</i> immediate expensing of a set percentage of the costs of capital investments
Tax credits*	<i>Additional</i> immediate write-off of a set percentage of the costs of capital investments against tax liabilities
Accelerated depreciation	Allows <i>faster</i> depreciation, for tax purposes, of capital assets
VAT/Sales tax exemptions	Exemptions from indirect taxes such as VAT, Sales taxes
Import/export tariff incentives	Exemption/protection of certain firms through the use of import/export tariffs

\*In the case of proportional taxation, these two are materially identical

Table 3 below presents the different types of costs associated with granting tax incentives for investment. In the case of forgone tax receipts there is an additional complication, since in absence of tax sparing agreements, the foreign firm may simply be paying taxes to its home country instead. Clearly this is a discouraging result as tax incentives will represent little in the way of a financial incentive for investors in this situation.

**Table 3: Costs associated with tax incentives for investment**

Cost type	Description
Foregone tax receipts	Tax breaks are a deadweight loss.
Distortions	Incentives can favour some firms/sectors/regions over others; promotion of inefficiency
Administrative costs	Assessing and granting incentives to qualifying firms and monitoring and compliance where there are conditions involved is costly
Social costs	Costs from corruption or rent seeking behaviour.

Source: Derived from Zee, Stotsky & Ley (2002)

Social costs can be minimized through the administrative handling of tax incentives (the trade off is increased administrative costs), although some forms of tax incentives are associated with more social costs than others. Specifically the existence of clear, transparent triggering mechanisms for incentives reduces the risk of social costs (Zee, Stotsky & Ley, 2002). The use of independent reviews of the costs and benefits from tax incentives can mitigate long term social costs, as poorly performing incentives can be re-evaluated and changed.

## Tax Holidays

Tax holidays<sup>5</sup> are the most popular tax incentive among developing countries, but interestingly they are rare, and becoming more so, among developed countries (Zee, Stotsky & Ley, 2002). Blomström & Kokko (2003) point to the fact that these incentives do not require any *outlay* from public funds as an explanation their widespread popularity within developing countries, where public funds are particularly scarce. There is a further advantage since by excluding these firms from the tax base, monitoring and administration costs are avoided by the host country treasury (UNCTAD, 2000). Investing firms are also relieved of the burden of tax administration costs.

However, the disadvantages of tax holidays are substantial. Besides the difficulty of determining which investments were incrementally generated by the incentive, with the firm removed from the tax base, there is no record of how much tax revenue is forgone (Zee, Stotsky & Ley, 2002). Furthermore the existence of tax neutral entities increases the opportunities for tax avoidance through transfer pricing and restructuring. (McLure, 1999). There also exists a significant danger of another type of rent seeking behaviour through restructuring projects or lobbying for policy extensions to increase the duration of incentive benefits (see Wells & Allen, 2001). Even where none of these adverse outcomes emerges, this type of incentive is extremely costly, in terms of taxes forgone.

As for those investors that are attracted by this type of incentive, since they only provide benefits for projects that turn positive profits, those projects that will be most benefited by this incentive are those that are the most likely to have invested regardless (Zee, Stotsky & Ley, 2002). There is also a significant bias towards smaller projects with shorter payback periods that will be able to make more substantial use of incentives (Zee, Stotsky & Ley, 2002), but will provide the least in spillover

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<sup>5</sup> These refer to holidays from corporate income tax. Generally they do not extend to indirect taxes such as VAT.

benefits. These types of investments are often quick to move on once the incentives expire, further reducing their value (Wells & Allen, 2001).

### Preferential Tax Rates

Preferential tax rates<sup>6</sup> are effectively a weakened form of tax holidays. To a large extent they maintain the same advantages and disadvantages, but the differences on aggregate appear to be more positive (Zee, Stotsky & Ley, 2002). Integrating firms into the tax base from the beginning ensures that at least some tax revenue will be received from any profits made. The disadvantage is that the treasury and the firm must go through the usual process compliance monitoring and tax returns respectively. However, since these firms are part of the tax base, forgone tax revenues can be explicitly calculated, improving the transparency of the policy (Zee, Stotsky & Ley, 2002).

Policies based on preferential tax rates reduce the problems associated with tax holidays. Nevertheless, these incentives still maintain, at least in part, most of the same problems as the tax holidays and as such, despite exceeding the usefulness of tax holidays, remain problematic policy instruments (Zee, Stotsky & Ley, 2002).

### Investment allowances, tax credits and accelerated depreciation

Investment allowances, tax credits and accelerated depreciation are all measures that attempt to provide faster cost recovery for capital investments (Zee, Stotsky & Ley, 2002). Biggs (2007) indicates four advantages to these types of incentives. Firstly they provide incentives for long term capital investment, since they allow more rapid recoupment of cash flow. Secondly they are less costly than tax holidays since they are based on investment flows only as opposed to profits. Thirdly, they are imbedded in tax laws and thus do not require separate legislation. Lastly they are less susceptible to transfer pricing and other avoidance schemes.

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<sup>6</sup> As with tax holidays, this generally refers to corporate income taxes only

Another advantage that these incentives have over others is their improved transparency. Since all benefits from these schemes flow from reduced tax liability, these can be accurately recorded. Accountability remains elusive since identification of investment that has been incrementally created, and measurement of the benefits, is still very difficult.

The differences between the three policies are worth noting. Tax credits have a value that is less uncertain because they cannot be altered by changes in the corporate tax rate, in contrast to investment allowances or accelerated depreciation (Zee, Stotsky & Ley, 2002). Tax credits can be based on incremental capital spending above a threshold (sometimes a moving average of past expenditure) or on a flat rate of this spending (UNCTAD, 2000). The former is less likely to reward spending that would have happened in absence of the incentive.

The other two policies both provide deductions from taxable income that are either faster for qualifying investments and/or greater in magnitude (UNCTAD, 2000). All three policies can be significantly eroded by high inflation, making them less attractive to some developing countries, as noted by Biggs (2007). Where investment allowances/tax credits allow deductions in addition to the usual allowances, these are clearly more expensive than accelerated depreciation, but they provide stronger incentives. The quote below offers support to accelerated depreciation above the others discussed.

“Providing tax incentives in the form of accelerated depreciation has the fewest of the shortcomings associated with CIT rate incentives and all of the virtues associated with investment cost-recovery incentives” (Zee, Stotsky & Ley, 2002: 1505)

Interestingly the next quote (below) claims that these policies are most cost-effective, implying that their effect on investment relative to the cost is the most worthwhile. There is some other support in the literature for these incentives over others (see Tanzi & Zee, 2000; Biggs, 2007).

“...some forms of such incentives are to be preferred over others: as a general rule, tax incentives that provide for faster recovery of investment costs (e.g., investment allowances/tax credits and accelerated depreciation) are more cost-effective than those that involve reducing the CIT rate...” (Zee, Stotsky & Ley, 2002: 1510)

### VAT exemptions

Indirect taxes such as VAT are primarily borne by consumers, rather than firms. In South Africa<sup>7</sup> firms that are VAT vendors collect VAT on behalf of the South African Revenue Services (SARS), and as such VAT spent on inputs is creditable. Thus, the only theoretical argument for relieving a firm from having to pay VAT on inputs must be based on relieving firms of a cash-flow burden (Zee, Stotsky & Ley, 2002). The problem with offering zero rating on input goods is that these types of incentives are known to be prone to abuse in avoidance schemes (Tanzi & Zee, 2000). A less risky solution is to improve the speed of VAT recovery. For example, Peru offers an early recovery system for VAT that is spent on capital goods (UNCTAD, 2000). A better option than this, if the VAT collection system is strong enough, is to use a suspensive regime where suppliers of VATable goods to exporting firms do not *collect* VAT from them, thus neutralising the cash-flow problem (Zee, Stotsky & Ley, 2002). Final export goods and services are zero rated for VAT purposes in South Africa and as such there is no need for any policy that exempts exporting firms of VAT collection.

### Tariff and Duty incentives

Exemptions from import and/or export tariffs are common worldwide (Zee, Stotsky & Ley, 2002: 1510). UNCTAD (2000) observes that there are several ways in which these can be used to incentivise investment. Governments can grant protective import tariffs on final goods that protect an investor’s local markets. Another option is give exemptions to import tariffs on capital goods, reducing the cost of investment to firms. The third option is to grant firms exemptions from import taxes for their

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<sup>7</sup> Here we depart from the previous pattern of discussing these issues in terms of an abstract country because of the specific nature of indirect taxes in South Africa.

inputs and/or exemptions from export taxes for their output products. Export processing zones are a popular means of applying these types of trade based tax incentives (Zee, Stotsky & Ley, 2002).

This particular version of incentives strays into the region of trade reform. Following our definition<sup>8</sup> on incentives, we are restricting attention here to relaxing trade policy regulation for certain individuals. This is essentially a protectionist policy since it gives advantages to domestic firms. The evidence on these policies is that they promote inefficiency and market distortions and are to be avoided (UNCTAD, 2000). General reforms to trade policy avoid the distortions caused by protectionism. Also, where incentives are offered for 'export only' producers there are often problems with corruption and/or lack of enforcements, resulting on leakages into the domestic market (Zee, Stotsky & Ley, 2002). These types of policies also risk violating World Trade Organisation (WTO) rules (Blomström & Kokko, 2003).

#### Review of some important conclusions

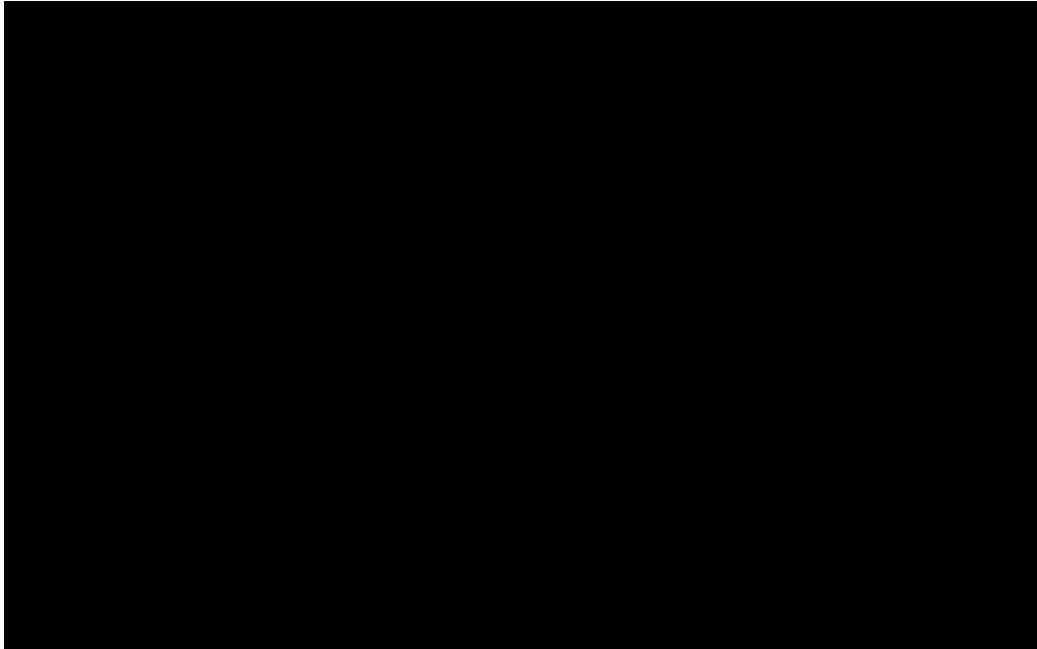
The case for tax incentives for investment as discussed so far is not convincing. There are many costs involved and in most cases these are difficult to measure. The benefits from these policies are similarly difficult to measure, making accountability problematic. However some incentives are shown to be more cost effective and transparent than others. The incentives that fall into this category are accelerated depreciation, investment allowances and tax credits. For tax incentives in general, transparent triggering mechanisms and independent review are vital for reducing social costs.

**Why do governments offer tax incentives for investment if the evidence is so negative?**

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<sup>8</sup> See page 5

Having covered theory and primarily *international evidence* for the majority of popular tax incentives, we find remarkably little support for these policies. We now pose a question that has been answered only partially so far: if the evidence on these incentives is so negative, why do so many countries offer them and why are they increasing? The table below summarises some of the arguments put forward to explain the prevalence of investment incentives.



While the existence of signalling effects supports the decision of governments to provide incentives, this can easily lead to a “keeping up with the neighbours” situation (see Oman, 2000). Indeed when Ramatex announced its decision to invest over R1bn in Namibia over South Africa, Minister of Finance Trevor Manuel took criticism, for not offering better incentives. He defended the stance by saying that South Africa did not want to involve its self in such a “race to the bottom”, meaning that they would not compete on incentives (Leuvenink, 2001).

Returning to the table; what support do the ‘success stories’ grant to the argument for the use of tax incentives? The stories often referred to include Ireland, Costa Rica and several East Asian countries. The problem with these success stories is that

they mislead with respect to the policies that were at the root of the successes. Ireland's success in attracting FDI is attributed to strong fundamentals including low corporate taxes, access to skilled labour, first class infrastructure and access to the EU market (Blomström & Kokko, 2003). Intel, in deciding to invest in Costa Rica, claimed that the most important reason for the decision rested on a good match of the fundamental factors that they required (Spar, 1998). These examples lend support to the hypothesis that the popularity of investment incentives was partially caused by a misunderstanding of what really drove all these success stories.

### **South Africa's experience with tax incentives for investment**

South Africa has experience with a range of tax incentives for investment already. The extent of the history is too large to cover here, but some of the more important aspects are briefly summarised in table 6 (below). The common theme with the international evidence is the lack of convincing evidence to accurately assess the granted incentives. The SIP Programme however is given some more detailed discussion, since calls for a revival of this programme render it particularly relevant.

**Table 5: A selection of tax incentives in South Africa**

<b>Type</b>	<b>Description</b>
Tax Holidays	Between 1996 and 1999 tax holiday's were offered for certain 'new' projects
Tariff/Indirect tax exemptions	Still offered in Industrial development zones (IDZ's) around the
Tariff protection	The Motor Industry Development Plan (MIDP) provides among other things continued protection against competing imports for
Investment allowance	The Small and Medium Enterprise Development Plan (SMEDP) still provides investment support.
Accelerated depreciation	A accelerated depreciation scheme is allowed for industrial

*Source: Derived from Vickers (2002) and Huxham & Haupt (2007)*

### The SIP Programme

The Strategic Industrial Projects (SIP) Programme was introduced in 2001, with the aim of increasing industrial investment from both foreign and local sources. Awarding of incentives was based on mandatory criteria as well as a point scoring system. The programme allowed for additional tax breaks on the purchase of certain assets used for qualifying projects of either 50% or 100% of cost, depending on its

characteristics<sup>9</sup>. The assets included plant and machinery, buildings and improvements where the minimum investment exceeded R50m. While the original proposal for the SIP programme included IT and R&D in the definition of industrial projects, this was omitted from the final version. (SAICA, 2005)

The awarding process (described above) attempted to select projects that were linked to spillover benefits such as employment provision, infrastructure provision and others (Masters, 2006). However, the risks of such onerous conditions are that they decrease the attractiveness of the incentive. Kaplan (2008) commented that a policy to increase investment spending need not try and address every South African policy issue at the same time. The hitch in terms of transparency was that there was an element of discretion allowed to the Minister of the Department of Trade and Industry (DTI). However, at least all incentives granted had to be published in the government gazette, ensuring transparency for the recipients of incentives and amount actually awarded (Masters, 2006).

**Table 6. Results from the SIP Programme by March 2004**

	<b>Feb-2003</b>	<b>Mar-2004</b>	<b>Cumulative</b>
Applications received	20	20	40
Total investment	R3bn	R36bn	R39bn
Number approved	10	15	25
Allowance approved	R1.9bn	R4.7bn	R6.6bn
Direct employment creation	1672	1107	2779
Indirect employment creation	19118	45845	64963
Infrastructure expenditure	R83m	R3.4bn	R3.5bn
SMME Support	R1163m	R773m	R1936m

*Source: Derived from data from the DTI*

Table 3 above gives at least some measure of the benefits of the SIP programme. While the costs are explicit (R6.6bn foregone in tax revenues), the benefits are not. How much of this investment (and hence infrastructure expenditure, employment creation and SMME support) was incremental is a vital question for determining the success of the project. A further difficulty is that the 'benefits' claimed by the DTI in

<sup>9</sup> Projects with preferred status (points system) received a 100% tax break on qualifying assets (limited to R600m); others received 50% (limited to R300m). For more information, see SAICA (2005).

terms of employment creation includes indirect employment which is difficult to verify and believed to be inflated (Flatters, 2005).

Regarding the actual breakdown of firms that received the incentive (see DTI, 2004): there was unfortunately little in the way of breaking into new industries. Much of the investment was concentrated into the traditional commodity-based sectors that have driven the South African economy for so long. This indicates that the SIP programme failed to address the task of developing new industries in South Africa.

The SIP programme was terminated by treasury in 2005, with the comment “It has served its purpose, and an interdepartmental task team will now review the lessons from this programme.” (SARS, 2005). Prof Dave Kaplan (2008), previously the chief economist of the DTI admits that a report was produced, but never released to the public. Trevor Manuel in his 2008 budget speech announced that R5bn was being allocated to tax incentives for investment over the next three years (Manual, 2008). Why this move is being made without releasing the report on the SIP programme for public scrutiny? What do the DTI and/or Treasury have to hide?

It may well be that the SIP programme was in fact successful; there is not sufficient evidence to move beyond conjecture. However if a similar programme is to be used in the future (given the budget, this appears likely) there should be some type of independent study put in place to determine its true impact.

### **Concluding Remarks**

The empirical and theoretical support for tax incentives is not strong. Cost effectiveness, transparency and accountability are problems, and the extent of these problems is largely unknown. The overwhelming consensus is that tax incentives may be useful sometimes, but are generally no substitute for the fundamentals of the investment climate. This is not to say that investment incentives have no place in South Africa. However, they should be considered subordinate to policies that drive improvement in the fundamentals of the investment climate.

Regarding the optimal use of tax incentives, the lessons learned from evidence, both local and international, must not be ignored. Three broad lessons emerge from this essay. Firstly, tax incentives that promote faster cost recovery such as accelerated depreciation and investment allowances are preferable to tax holidays, preferential tax rates, indirect tax exemptions and preferential tariff treatment. Secondly the triggering mechanism for granting incentive benefits must be explicit and the administration of this mechanism transparent. Thirdly, any tax incentive that is put in place must be subject to independent review that is made available for public scrutiny. Policies not subject to this type of conditions invite rent seeking, corruption and welfare losses.

Few would dispute the claim that many mistakes have been made in the use of tax incentives. What is unfortunate is how many of those mistakes have been repeated. An old adage provides an appropriate ending here. "A fool repeats his mistakes. A wise man learns from his mistakes. A genius learns from the mistakes of others<sup>10</sup>." Let us hope that we can give ourselves a chance to avoid the first category; learning from what mistakes have been made already and ensuring that the mistakes of the future do not go unnoticed.

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<sup>10</sup> Source: Unknown.

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