

The impact of the Strategic Investment Programme (SIP) on encouraging investment and job creation in South Africa

3553 words

ABSTRACT

The strategic investment programme (SIP) implemented and introduced by government in 2001 and discontinued in 2005 had mixed success in attracting investment and creating new jobs for unskilled labourers. This paper aims to investigate the economic theory and the empirical case behind providing tax incentives in South Africa (SA), focussing particularly on the SIP. The essay aims to determine whether this incentive was indeed effective in attracting Foreign Direct Investment (FDI) and local investment, and whether it resulted in the intended sustainable growth, and job creation for unskilled workers. The qualitative and quantitative evidence reviewed in this essay supports the hypothesis that the SIP has not necessarily created jobs for the poor, but instead it may actually have had the unintended effect of raising the demand for *skilled* labour, to complement the rising capital intensity in manufacturing instead. This essay concludes with some recommendations for policymakers, and provides alternative measures which can be used to attract investment and which will create sustainable employment.

1. Introduction

The SIP will be tackled in three components. Firstly a brief explanation of the SIP will be provided. Following that, the impact of the SIP on FDI will be explored; and thereafter the impact of the SIP on employment creation will be assessed. The underlying theme of FDI and employment creation will include exploring the impact of capital intensity on job creation.

1.1. Background to SIP

The main aim of the Strategic Investment Program was to contribute to the growth, development and competitiveness of specific industry sectors (Babour 2005:23). These included manufacturing of any goods or products other than

tobacco; computer related manufacturing and also certain Research & Development (R&D) activities. The rationale was to provide tax deductions additional to normal tax deductions for large projects with qualifying investments of between R50m and R600m. The sole tax benefit was an Initial Capital Allowance (ICA) of 50% or 100% depending on the qualifying points score. Points were awarded for 'fit' of the project to strategic goals and employment creation. The ICA was additional to the normal depreciation and thus meant that firms incentivised by the SIP could benefit by operating in a tax free environment for many years (Barbour, 2005:23).

During November 2001 South Africa adopted the SIP as part of a larger package of tax incentives that sought to encourage investment into South Africa from both local and foreign investors. As one of its key strategic incentives, the 1996 Growth Employment and Redistribution (GEAR) policy aimed to stimulate new investment in competitive and labour absorbing projects. In addition, economic growth was required to stem from labour intensive sectors so that growth could be motivated by job creation. In order to address this, the Department of Trade and Industry (DTI) and Trade and Investment South Africa (TISA) have provided incentives to investors through three main strategic programmes, namely the SIP Foreign Investment Grant (FIG) and the Motor Industry Development Program MIDP, with the intention of promoting employment and job creation.

1.2 Major weaknesses of SIP

Although the SIP was regarded as a well designed tax incentive it had some weaknesses. Included here were that, its criteria were not clearly stipulated and fully objective, but left some discretion regarding qualifying projects up to the minister of Trade and Industry. This is since it relied on a point scoring system, upon which projects were scored according to criteria such as 'indirect job creation'. Since the precise number of jobs created is difficult to quantify and prove, it may have been easily manipulated. Hence, due to the fact that individual discretion was relied upon to decide between projects, certain valuable projects may have been overlooked. This also means that the

SIP may have allocated funds to projects which did not in reality create as many unskilled jobs as claimed by the beneficiaries of the incentive. This paper aims to explore whether the SIP resulted in a substantial reduction in unemployment.

2. Theory behind tax incentives

Since the SIP was classified as a tax incentive programme, it is necessary to define what a tax incentive constitutes. Barbour (2005:2) defines an incentive as 'any measurable advantage accorded to specific enterprises or categories of enterprises'. In developing countries with emerging markets, and especially in those that aim at becoming integrated with international economies, tax policy must play a particularly sensitive role (Tanzi & Zee, 2000:300). Thus, in order for tax incentives to be efficient, they need to be carefully designed. The design of the SIP was not vividly clear and hence left to discretion of individuals. According to Easson & Zolt (2002:34) the objectives of any tax incentive programme should be clearly stipulated. The type of tax incentive programme should be crafted to best fit the objective and the government should estimate the anticipated costs and benefits of the incentive program in a manner similar to other types of tax expenditure analysis. In the case of the SIP the main objective was attracting new investments in order to create jobs. Furthermore the incentive program should be designed to minimise the opportunities for corruption in the granting of incentives. The point scoring methodology of the SIP which gave merits for indirect job creation could have left room for corruption, since as stated above, this figure can be manipulated.

Evidence (Barbour, 2007 & Lewis, 2002) suggests that granting tax incentives to promote investment is common in countries around the world. Analysis suggests that the effectiveness of tax incentives in attracting incremental investment, above and beyond the level that would have taken place if no incentives were given is questionable.

The decision, for foreign investors to enter a country would normally depend on a host of factors, among which the availability of tax incentives is not the most important one. The existence of natural resources, political and economic stability, transparency of legal and regulatory systems, adequacy of supporting institutions for instance banking , transportation , communication and other infrastructure facilities, ease of profit repatriations and economic and skilled workers are usually far more decisive than tax considerations (Tanzi & Zee, 2000:323). If indeed, the above factors are favourable, and the country's tax system is in line with international norms then tax incentives would at best play a role at the margin in influencing an investment decision.

South Africa possesses many of the attractive factors mentioned above: it boasts a well developed financial system, abundance of natural resources and also a coastline for easy transportation of finished goods. A major hindering factor in South Africa's case however, is the shortage of skilled labour. As such, a policy to attract investments which provide employment for unskilled labourers exclusively can be very difficult to design. It is important to take note of the fact that while tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure (Easson & Zolt, 2002:4). Thus, tax incentives alone can not be relied upon entirely, to solve the unemployment problem in South Africa. Tax incentives must be combined with targeted unemployment policies.

2.1 Problems with tax incentives

Evidence on the effectiveness of targeted incentives suggests that such measures rarely attract additional investment, are costly and often distort incentives that lead to further resource misallocations (Lewis, 2002:7). Barbour (2007:1) corroborates the idea that investment incentives are rarely effective or efficient and that the broader investment climate is significantly more important in determining investment decisions. The International Monetary Fund takes the firm line that tax incentives do not stimulate

investment significantly and that when they do, the cost often outweighs the benefit (Barbour, 2007:6). As discussed above many researchers are highly sceptical of the potential of tax incentives.

In many countries, tax authorities do not have sole responsibility or discretion in designing and administering tax incentive programmes. Different government agencies have a role in designing investment regimes and approving projects and monitoring investment. The main objectives of these agencies are to attract investment and are often less concerned with protecting the tax base (Easson & Zolt, 2002:4). Both the National Treasury (NT) and the Department of Trade and Industry (DTI) take a lead in industrial policy and designing of incentives in South Africa which means the lost tax revenue to the South African Revenue Services may not be of as much of a concern to these policy makers. This is since the main aim of these incentives is to target labour intensive sectors.

SA's motivation for subsidising the labour intensive manufacturing sector makes sense a priori. However, both the MIDP and the SIP have resulted in capital intensive, not labour intensive manufacturing investment (Barbour, 2005: vii). The reason for the focus on manufacturing is that manufacturing exports play a central role in the SA government's strategy for spurring growth and employment. However, despite the generous incentive provided by the SIP, the ratio of investment to GDP remained low at 16%. Investments in the manufacturing sector, has been too low to increase or even maintain the number of people employed in the sector (Barbour, 2005: vii).

2.2 Rationale for continued use of investment schemes

Barbour (2005:7) argues that tax incentives offer an easy way to compensate for other government created obstacles in the business environment. In other words, fiscal incentives respond to government failure as much as market failure. It is far more difficult and takes far longer to tackle the investment impediments themselves (low skills base, regulatory compliance costs etc) than to put in place a grant or tax regime to help counterbalance these

impediments. Although it is a second best option to provide a subsidy to counteract an existing distortion, this is what often happens in practice. None the less, Masters (2006) states that experience with tax incentives in the SADC region is mixed , thus in reality in some circumstances tax incentives have helped to stimulate important investments in some countries. Examples of these countries are listed below:

- Tax incentives were seen as an essential element in bringing the giant Mozal aluminium smelter into Mozambique
- In South Africa, the MIDP programme enjoys considerable success in stimulating investment and rapid growth in automotive exports.
- In Namibia, the Ramatex textile factory based its location decision on an incentive package. Source: Masters (2006)

The above examples provide a case for the use of tax incentives in creating investment and spurring economic growth, and show that tax incentives can be used to create a more favourable economic environment

3. Impact of the Strategic Investment Programme on economic growth in South Africa

The subsequent sections will explore the impact of the SIP on attracting labour intensive investment to SA and creating jobs, and also what the costs of the SIP have been.

3.1 Analysis of FDI flows to SA

Rusike (2007:18) suggest that FDI to SA is still low relative to the size of the economy and similar developing countries. In addition, Barbour (2005:14) explains that FDI in SA has been lacklustre due to the following factors

- For market seeking investment, the Southern African market economies are too small and are growing too slowly.
- Regional political instability specifically in Zimbabwe spills over to SA creating uncertainty for potential investment
- Crime and HIV/AIDS are at high levels
- There is a shortage of skilled labour in SA
- Regulatory uncertainty, particularly in the telecommunication sector and recently the electricity sector. Source: Barbour (2005)

It can be concluded that in order to improve and enhance FDI in South Africa, the above issues will need to be addressed first.

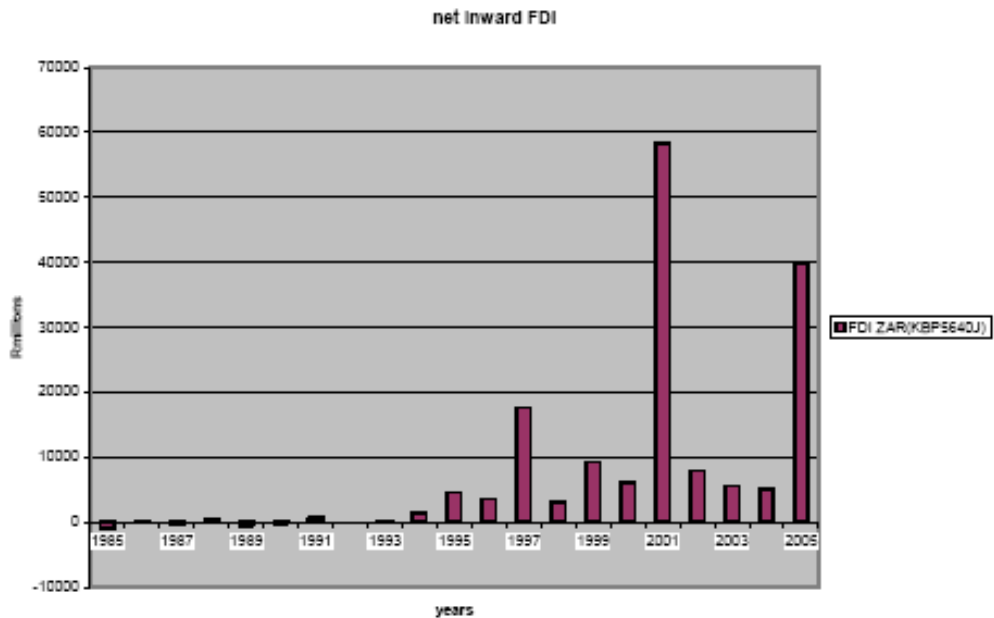
Figure 1 Average annual real growth rates of fixed capital stock by sector

	1960-70	1970-80	1980-90	1990-2002	1994-2002
Agriculture	2.34	2.68	-0.97	-0.81	-0.27
Mining	1.93	6.19	6.04	0.58	0.44
Manufacturing	7.86	8.19	3.28	2.65	2.44
Electricity, gas and water	5.67	7.90	4.22	-2.37	-2.24
Construction	11.49	10.41	-0.48	-0.25	0.44
Retail	5.37	5.15	1.86	1.73	2.17
Transport, storage and communication	4.76	5.88	1.31	1.45	2.07
Financial	5.00	4.95	3.17	1.45	1.66
Community	7.52	6.47	2.84	1.31	1.06
Total	5.36	6.00	2.79	1.13	1.27
General government	6.09	5.90	-0.13	-1.68	0.77
Public corporations	8.47	13.59	8.98	5.47	0.85
Private corporations	4.41	4.60	4.00	2.57	-0.20

Source: Barbour (2005:16)

The above figure indicates that since 1980 real growth rates in manufacturing have been declining on average. This means that firms have managed to increase output by squeezing existing capital equipment harder and by possibly shedding workers rather than by investing in new capital equipment or employment. Since the aim of the SIP was to increase investment in capital projects, the figures above show that average growth rates of fixed capital stock in the 1990's are far lower than they were in the 1960's.

Figure 2. FDI flows to South Africa



Source: Rusike (2007:17)

A related aim of the SIP was to anchor and entice FDI into South Africa. Results show that FDI inflow has not been consistent and is still very low relative to the size of the economy and other developing countries. Only the years 1997, 2001, and 2005 were outstanding years (Rusike et al, 2007:2)

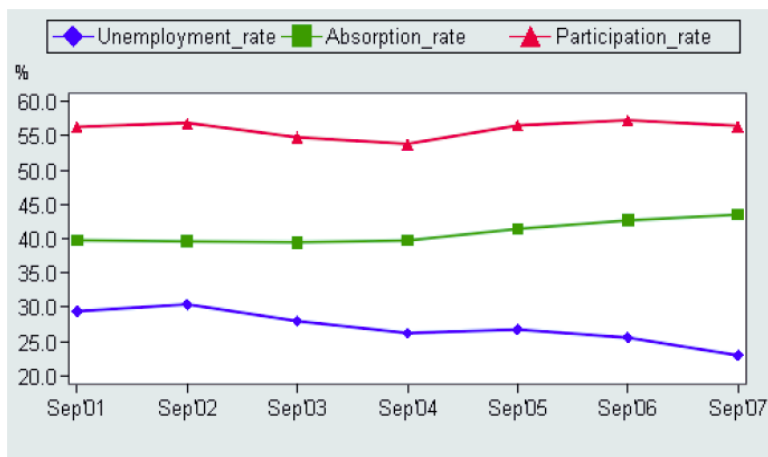
In interpreting the above data in relation to the SIP, the SIP began in November 2001 and ended on the 30th September 2005. The sharp rise in FDI in 2001 can be attributed to the sale of a strategic stake in Telkom, previously a wholly owned government monopoly. For instance, the Thintana Corporation paid around \$1.2billion for 30% of Telkom (Ruisike, 2007). The marked increase is also attributed to the unbundling and delisting of DeBeers. However, FDI inflow dropped in the following years up to 2004 to 5.1 billion. In addition in 2001, inward FDI increased by 671% to R39.7 billion from 5.1 billion in 2004, as a result of a large transaction in acquisition of ABSA (SA) by Barclays (UK) for 33billion rand.

Historically, efforts to attract FDI in SA have gained momentum since after the 1994 political democratisation process. SA's FDI strategy as detailed in GEAR (1996), the Appendix 12 indicated that greater emphasis was placed on private investment in stimulating growth relative to government investment (Ruisike, 2007:13)

When exploring FDI, there are two main types of FDI; one form is Mergers and Acquisitions which do not usually create substantial amounts of new jobs and the other is other Greenfield investment where a company sets up a new operation where none had previously existed. The latter is typically the type of investment which the SIP aimed to encourage since this creates new jobs. The trend analysis suggests that there is little 'Greenfield' investment which would be necessary to stimulate FDI and the economy, but the main source of FDI remains mergers and acquisitions (Ruisike, 2007:17).

3.2 Addressing the unemployment issue regarding labour versus capital intensity

Figure 3. Unemployment, absorption and participation rates, September 2001 to September 2007

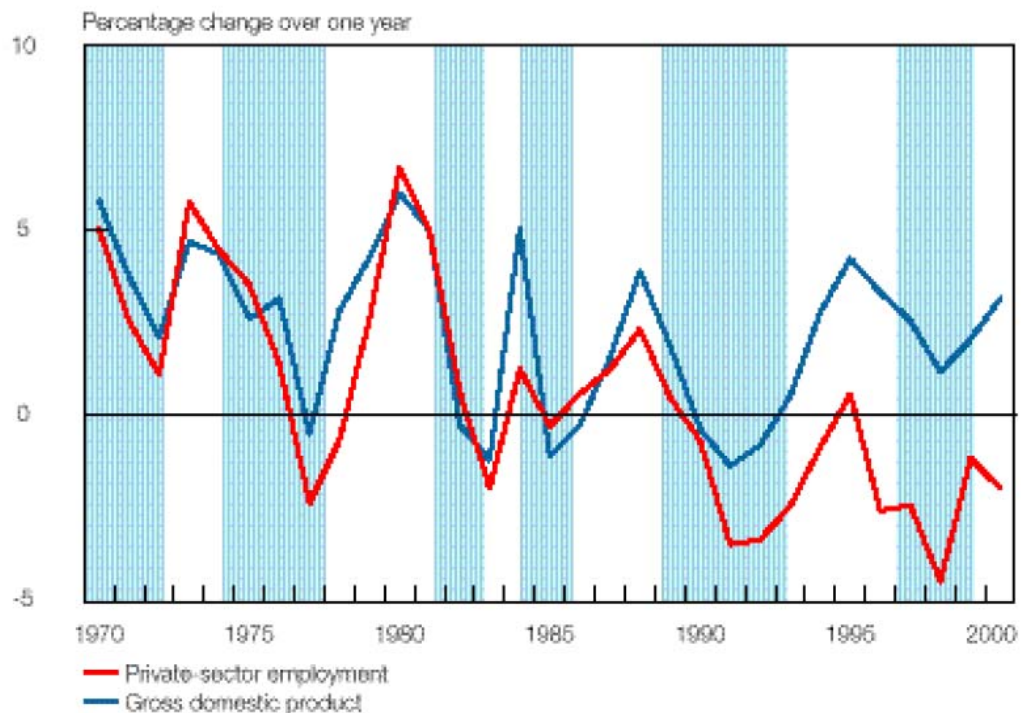


Source: LFS September (2005)

The above diagram shows that during September 2005 unemployment was approximately 26%, whilst in September 2001 when the SIP was implemented it was approximately 29%. Thus it can be concluded that the SIP did not result in a substantial reduction in unemployment.

The South African government's objective of job creation and poverty eradication depends on the success of policies that promote employment of unskilled labour. However, the problem is that in sectors which employ less educated workers, capital intensity has risen. Recent economic growth has mainly benefited sectors that rely more on relatively skilled labour (Samson, 2001)

Figure 4 Private sector employment and GDP

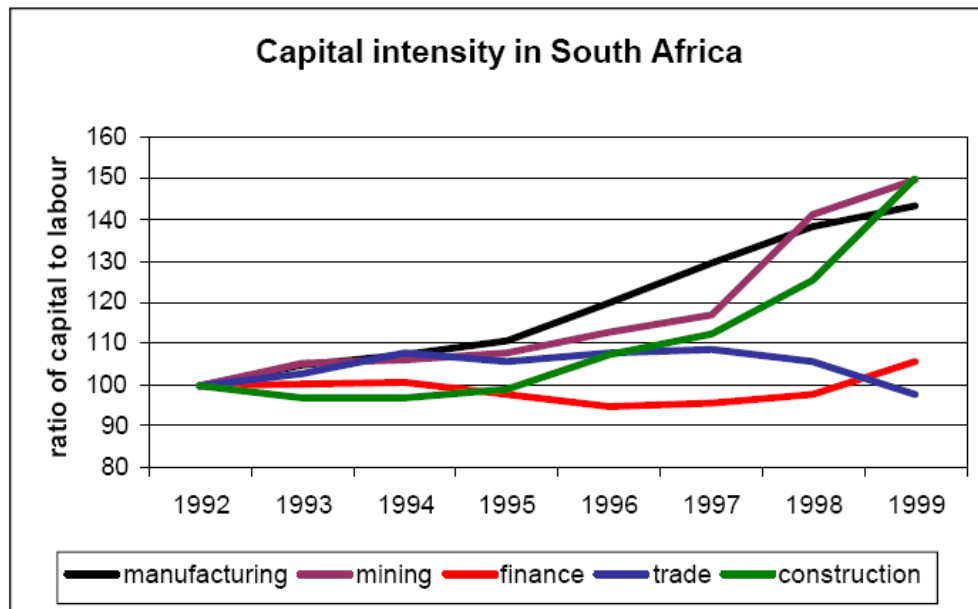


Source: Samson et al (2001:2)

The phenomenon known as 'jobless growth' is a term used by some economists to explain the decoupling of growth and employment where during the 1990's rates of job creation began to rise more slowly than economic

growth during economic upturns and fell more rapidly during downturns. The South African Reserve Bank attributes this jobless growth in part to rising capital intensity (SARB Annual Report, 2001) cited in Samson, 2001. As shown in the figure above, during the period from the 1990's onwards GDP was rising but employment did not keep pace with the rise in GDP, meaning that even though GDP was improving there was still unemployment.

Figure 5 Capital Intensity in South Africa



Source: Samson (2001:11)

The above diagram illustrates that capital intensity has been rising since 1999 particularly in manufacturing, mining, and construction. This is a problem since these are the sectors which are the greatest employers of unskilled people. Rising capital intensity may thus have resulted in job losses in these areas.

Samson (2001:6) state that the ILO report shows that SA continues to specialise in capital intensive goods in the face of high rates of unemployment, and that the rates of capital intensity has been rising since 1999. This may explain why a rise in GDP does not resolve unemployment since it may mean that capital is being substituted for labour. In order to prove

this, Samson, (2001) quotes an empirical study, which estimates two million job losses over the past twenty years from inappropriate capital intensity. A salient point is that many studies have found that capital complements skilled labour but substitutes for unskilled labour in the production process (Samson, 2001:7)

Small industries are usually less capital intensive and less automated, and should therefore favour labour over capital. Fourie (1997:367) states that there are numerous possible causes amongst them tax distortions, scarcity of skilled workers, anti competitive behaviour by large SA conglomerates that undermine smaller labour intensive enterprises. This may be aggravating the problem of job creation by smaller firms who try to create jobs and remain profitable.

Another problem which may be seen as a hindering factor to job creation in SA is the numerous employment regulations which result in making the labour market inflexible. Acts such as the Employment Equity Act (EEA), Basic Conditions of Employment Act (BCEA), and minimum wage law, raise the costs of doing business for all firms and may result in them losing their competitive advantage. SA labour needs to become cost effective against machine equipment both locally and abroad.

Another factor hampering labour intensive productivity measures is that policies need to adjust in order to affect the relative prices of capital and labour. Higher capital oriented taxes, reduced capital subsidies (particularly through the tax system) and a weaker rand raise the relative price of capital. These policies are not necessarily detrimental to economic growth, unless they can effectively shift factor demand toward job creation. The capital freed from eliminating capital subsidies can support social investment objectives. Employment subsidies and tax incentives can help to re balance the skewed relative prices of capital and labour that reinforce the trend towards capital intensity.

3.3 Foregone Revenue

According to Ntingi (2007) the foregone tax revenue from the SIP was R10 billion rand, whilst it attracted only a total of R30 billion in new investments. Despite the large amount of foregone revenue, the SIP only created a modest 7000 direct jobs. These figures show that the SIP was a costly tax incentive with limited benefits.

4. Policy Recommendations

In order to create employment for unskilled labourers, tax incentives on their own may not be effective since, firstly, they result in foregone tax revenue and secondly, they do not give any guarantee of creating labour intensive projects.

In this regard tax incentives offered along with some type of public works programme may prove beneficial. According to Dreze (2006) India has implemented a system called the National Rural Employment Guarantee Act (NREGA). This works on a system of job cards where government has promised 100 days of employment for every household. The SA government could intervene by incentivising private firms to employ unemployed people for a certain number of days in the year and provide tax breaks for firms who cooperate. Secondly, it may be necessary to relax some of the numerous labour laws which limit job creation and pose too many restrictions on the labour market. Relaxing these laws together with providing tax incentives; may prove beneficial to job creation enabling small as well as large firms to remain competitive, and may alter the choice of firms substituting capital for labour. Thirdly, employment subsidies and tax incentives should be designed to correct the skewed balance in the relative prices of capital and labour, in order to make labour cheaper than capital. Fourthly, Instead of focussing exclusively on trying to create suitable job opportunities for unskilled workers, government should refocus its goals and better target skills development, through tax subsidies to develop the skills of unskilled workers.

5. Conclusions

This essay aimed to explore the effectiveness of a tax incentive known as the SIP on encouraging foreign and local investment and job creation. It was found that the incentive resulted in a large amount of foregone tax revenue and did not create as many jobs as had been anticipated. In order to assess the impacts of the SIP on economic growth in SA, FDI figures were analysed as well as employment figures. The foregone tax revenue was also assessed. It was found that although FDI increased in 2001 and 2005, this was mainly due to mergers and acquisitions, not Greenfield investment. The aim of the SIP was to encourage sectors which would result in Greenfield, or new investment which would create employment.

Following that the impact of the SIP on employment was investigated. Data showed that during the years that the SIP was in operation, unemployment did not decrease considerably and only 7000 direct jobs were created.

Finally, the foregone revenue from the tax incentive was R10 billion rand which meant it drew significant resources. The above findings suggest that the benefits of the SIP outweighed the costs, since valuable tax revenue was lost on an incentive which did not result in sustainable growth for SA.

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