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Tax Incentives:
An Alternative to Revenue Enhancement

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The increasing mobility of international firms and the gradual elimination of barriers to global capital flows have stimulated competition among governments, often through tax incentives. Tax incentive is a strategy to complement other government tools to attract foreign investment.

This paper starts with exploring the rationale behind providing tax incentives and empirical evidence across countries. The paper also comparing of pros and cons for each tool of tax incentive. The analysis will focus on the economics of tax incentives and then followed by the Indonesia's experience with applying these strategies.

In the last section, this paper will conclude and propose recommendation for Indonesia to enhance the state revenue.

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1. Introduction

THE DEBATE ON THE EFFECTIVENESS OF TAX INCENTIVES IS ALWAYS RELATED TO HOW ONE COUNTRY IS ABLE TO LEVERAGE THEIR INVESTMENT CLIMATE, LABOR PRODUCTIVENESS, AS WELL AS IMPROVE INSTITUTIONAL CONDITION AND NOT SOLELY ON GOVERNMENT FISCAL POLICIES.

The increasing mobility of international firms and the gradual elimination of barriers to global capital flows have stimulated competition among governments to attract foreign direct investment, often through tax policies[1]. Taxation is a government main fiscal policy to generate revenues to finance government spending on the goods and services. The ideal tax system in developing countries, in essence, face formidable challenges. First, economy structures in these particular developing and transient economies still rely heavily on agriculture or informal sectors where they are seldom paid a regular and fixed wage. This creates a difficulty in calculating their taxes. Secondly, it is difficult to create an efficient tax administration without a well-educated and well-trained staff, when money is lacking to pay good wages to tax officials and to computerize the operation, and when taxpayers have limited ability to keep account. As a result, governments often take the path of least resistance, developing tax systems that allow them to exploit whatever options are available rather than establishing rational, modern, and efficient tax systems[2]. Third, income distribution is unevenly distributed and constant economic growth is not easily maintained.

With regards to boosting investment and upgrading productivity, most transient economies exercise tax incentives. These incentive include tax credit for new foreign and domestic investment; tax holidays for specific limited time frame for new firms; exemptions from import duties particularly to capital good and establish special economic zones for exporting companies. The debate on the effectiveness of tax incentives is always related to how one country is able to leverage their investment climate, labor productiveness, as well as improve institutional condition. Other factors to be considered in designing tax incentives are (i) inflation – where incentives should offset the effects of inflation; (ii) tax evasion; (iii) technology transfer; iv) the fulfillment of social, environmental and regional non-economic objectives; and (v) the effects on firm's organization[3]. A report prepared by the World Bank in 2005 found that, as a result of foreign direct investment, foreign firms create important spillover effects. The present of export oriented foreign firms is positively correlated with the likelihood of domestic firms making foreign sales.

Investors, on the other hand, consider locating their investments based on several factors such as cheap labor, currency exchange as well as fiscal policies related to tax incentives. Developing countries mostly classified of having underdeveloped capital markets and depend on foreign markets to leverage their domestic production. Developing countries must find ways to attract foreign investment that is good enough to outweigh the economic political or social instabilities that can arise. Measures to reduce the negative influence of nontax issued are addressed through the implementation of beneficial tax policies, which may include tax incentive, tax holidays, and tax sparing provisions[4]. These policies could also lead to harmful tax competition that may cause negative economic consequences for developing countries.

Similar to other policies, tax policies implemented in developing countries are based on trial and error. The problem is that emerging economies do not have a model to rely on that demonstrates the efficient use of their tax systems to provide the critical ingredients for development, including increasing and retaining investment and at the same time increasing tax revenue[5]. Some notable experts mentioned that there are other problems like poverty, corruption, inadequate infrastructure, low employment, and limited reasonable educated officials need to be solved before implementing tax incentives. Foreign direct investment will surely have direct and indirect effects to those problems alleviation; however, the question is whether tax incentives are the right approach.

This paper starts with exploring the rationale behind providing tax incentives and empirical

1. Morriset, Jacques,"Using Tax Incentives to Attract FDI", The World Bank Note Number 253, February 2003

2. Tanzi, Vito and Howell Zee, "Tax Policy for Developing Countries", IMF Working Paper, IMF, March 2001.

3. Shah, Anwar and Robin Broadway, "How Tax Incentives Affect Decisions to Invest in Developing Countries", Policies Research Working Paper, WPS 1011, The World Bank, November 1992.

4. Pisani, Andres E. Bazo,"Do Developing Countries' Tax Incentives Attract Investment or Create Disaster", Tax Notes International, October 2008. Tax sparing provision is a devise used both by countries taxing worldwide income, which allow a foreign tax credit as well as exemption countries which allow a foreign tax credit for certain kinds of income (like dividends) that are not exempt. The object is to permit developing countries to reduce their income taxes under an incentive scheme for foreign taxpayers without having the residence country collect the spared tax (William B. Barker, 2007)

5. Baker, William B," An International Tax System for Emerging Economies, Tax Sparing, and Development: It is All About Source" 29 Pa. J. Int'l L. 349 (Winter 2007).

Table 1 - Examples of Tax Incentives in the South East Asian Region and Neighboring Countries

Country	Regional Incentives	Sectoral Incentives	Withholding tax
Malaysia	• Labuan Offshore Financial Center; • Pioneer status companies	• Incentives for approved operational headquarters; • Incentives for approved service projects; • Foreign fund management incentive • Tax scheme for venture capital companies.	Waived of withholding tax on dividends payments made by Labuan-based company carrying on an offshore business activity.
Singapore	• Investment allowances; • Pioneer industries; • International financial services	Possible Piggyback	Reduced of withholding tax rate and royalties.
Thailand	Different treatments in three promotional zones.	Certain priority projects such as basic transportation systems, public utilities, environmental protection and restoration, technological development and basic industries.	There is no withholding tax on interest paid to non-resident individuals or companies not carrying on business in Thailand on deposits or loans solely for the purpose of extending loans in a foreign country.
Republic of China	Available, to Special Economic Zones such as Shantou and Shenzhen and Economic and Technological Development Zones such as Beijing and Shanghai.	• At least 10 years of activity; • Exemption from income tax for two year starting with the firs profit-making year; • Additional 50 percent reduction over the subsequent three years.	Waived or reduced withholding tax on interest and royalty in Special Economic Zones.

Source: Tax Incentives and FDI: A Global Survey, UNCTAD, 2000

evidence across countries. This paper also provides comparison of pros and cons for each tool of tax incentive in Section III. In Section IV, the analysis will focus on the economics of tax incentives and then followed by the Indonesia's experience with applying these strategies in Section V. Section VI will conclude and propose recommendation.

2. Tax Incentives in Developing Economies

DEVELOPING ECONOMIES ARE NOT ABLE TO SUPPORT THEMSELVES AND THERE ARE OTHER PROBLEMS THAT NEED TO BE ADDRESSED BEFORE IMPLEMENTING TAX INCENTIVES.

Developing countries greatly depend on foreign direct investment (FDI) to promote their economies and domestic markets, and they are continually trying to attract foreign investment through the implementation of attractive tax policies and other tax measures because "private international capital flows, particularly foreign direct investments, along with international financial stability, are vital complements to national and international development efforts".[6] Tax policies must be established for the long run, "a policy that is seen as temporary may have little effect to attract investments".[7] Tax incentives have consequences both negative and positive, especially developing economies are prone to classic economic and social problems. Some experts argue that tax incentives could be the best tools to address these problems since foreign companies would not enter and engage in the destination countries without them. However, previous experience describes hostile competition between countries in the regions due to the application of tax incentives. Tax incentives require a tremendous effort from the governments not only to offer beneficial tax policies; but also, to create a safe environment to protect existing investments and to attract future ones. Tax incentives can be considered good when they attract FDI that otherwise would not have been made, and when they do not involve a transfer of tax revenue from domestic taxpayers to foreign investors[8].

Each country that conducts tax breaks and other tax benefits may also experience tax competition from neighboring countries that have similar characteristics. Tax competition attempts to attract investment that might otherwise go to other countries by offering a relatively attractive

6. McDaniel, Paul R,"The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis", 35 Geo Wash In'l L. Rev. 279 (2003).

7. Villela, Luiz and Alberto Barreix,"Taxation and Investment Promotion," Inter-American Development Bank, Department of Integration and Regional Programs, Aug 2002.

8. Margalioth, Yoram,"Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries" 23 Va. Tax Rev. 2003.

tax rates and other favorable provisions to reduce the tax burden on foreign companies. Developing countries are competing against each other to provide better tax and economic situations for foreign investors, but without a well-established tax structure they bring negative effects to their own economies and to international commerce as well[9]. Developing countries often establish tax incentives without having the proper policy planning, so the design and implementation of the tax measure is not well structured – but the need to collect more revenue from foreign investment is helping to create jobs and build infrastructure, this may lead one of the conclusion that the incentive are working[10]. Moreover, by granting preferences and incentives, emerging economies give up a substantial portion of their tax base. IMF studies have documented that widespread tax exemptions have led to low tax ratios, which are major fiscal factors in contributing to fiscal crises in emerging market economies[11].

As shown in Table 1 above, neighboring countries utilized a mix of tax incentives to channel investment to specific regions, sectors and to enhance corporate performance as well as to transfer of technology. Similar to Batam Special Zone in Indonesia, Malaysia also establishes special economic zone in Labuan Offshore Financial Center. The majority of tax incentives granted by these countries relate to investment in manufacture, oil and other mineral resources extraction, and tourism. Malaysia, Singapore, and Philippines also employ additional incentives to attract headquarters of companies through reduced corporate tax rates. Foreign companies engaged in agriculture, forestry, or animal husbandry located in a remote undeveloped area will receive a 15 – 30 percent reduction of income tax rate for a further 10 years after the expiration of the initial tax exemption and reduction period.

3. Types of Tax Incentives

TAX INCENTIVES CAN BE JUSTIFIED IF THEY ADDRESS SOME FORM OF MARKET FAILURE, MOST NOTABLY THOSE INVOLVING EXTERNALITIES.

Tax incentives are part of the tax system of developing countries and are usually established by the Government to grant foreign investors more attractive conditions to invest in their country. This incentive must be created under stable political circumstances[12]. Reducing import tariffs as part of an overall program of trade liberalization is a major policy challenge currently facing many developing countries. Tariff reduction should not lead to unintended changes in the relative rates of effective protection across sectors. One simple way of ensuring that unintended consequences do not occur would be to reduce all nominal tariff rates by the same proportion whenever such rates need to be changed.

While granting tax incentives to promote investment is common in countries around the world, evidence suggests that their effectiveness in attracting incremental investments—above and beyond the level that would have been reached had no incentives been granted—is often questionable. As tax incentives can be abused by existing enterprises disguised as new ones through nominal reorganization, their revenue costs can be high. Moreover, foreign investors, the primary target of most tax incentives, base their decision to enter a country on a whole host of factors of which tax incentives are frequently far from being the most important one. Tax incentives could also be of questionable value to a foreign investor because the true beneficiary of the incentives may not be the investor, but rather the treasury of his home country.

This can come about when any income spared from taxation in the host country is taxed by the investor's home country. Evidence from emerging economies suggests that tax incentives have a more apparent effect on the composition of FD than on its level. Indeed, most government uses tax policies to attract particular types of investment rather than to increase the overall level of investment[13]. A recent study found that large foreign companies, such as those in the automobile sector, are generally in a better position to negotiate special tax regimes and thus to extract rents from host governments[14].

Of all the forms of tax incentives, tax holidays (exemptions from paying tax for a certain period of time) are the most popular among developing countries. According to the United Nations Conference on Trade and Development, as many as 67 countries offered tax holidays. Tax holidays provide benefits as soon as the companies generate income. In practice, tax holiday offers larger benefit for short-term (i.e. footloose industries) investment that might move easily from one jurisdiction to another. Therefore, tax holiday usually prefers the establishment of new multinationals companies

9. Pisani, Op.Cit., 302

10. Ibid.

11. Baker, Op.Cit., at 8

12. Pisani, Op.Cit., page 300

13. Morriset, Jacques, Op.Cit., page 3

14. Oman, C,"Policy Competition for FDI: A Study of Competition among Governments to Attract FDI", Development Center Studies, OECD, Paris, 2000.

Table 2 - Main Categories of Tax Incentives

Category	Specifications
Profit/income-based	Reduction of the standard corporate income tax rate; tax holidays, loss carry forward or carry back to be written off against profits earned later (or earlier)
Capital investment-based	Accelerated depreciation; investment and reinvestment allowance
Labor-based	Reduction in social security contributions; deductions from taxable earnings based on the number of employees or on other labor-related expenditure
Sales -based	Income-tax reductions based on total sales
Value added-based	Income tax reductions or credits based on the net local content of outputs, granting income-tax credits based on net value earned
Based on other particular expenses	Income-tax deduction based on, for example, expenditures relating to marketing and promotional activities
Import-based	Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process
Export-based	• Output-related (e.g. exemptions from export duties; preferential tax treatment for income from exports; income tax reduction for special foreign exchange-earning activities or from manufacturing exports; tax credits on domestic sales in return for export performance) • Input-related (e.g. duty drawbacks; tax credits for duties paid on imported materials or supplies; income-tax credits on net local content of exports; deductions of overseas expenditures and capital allowance for export industries)

Source: UNCTAD, 2000

rather than follow-up capital injections.

Compared with tax holidays, tax credits and investment allowances have a number of advantages. They are much better targeted than tax holidays for promoting particular types of investment and their revenue cost is much more transparent and easier to control. A simple and effective way of administering a tax credit system is to determine the amount of the credit to a qualified enterprise and to "deposit" this amount into a special tax account in the form of a bookkeeping entry[15]. Investment tax credit may be claimed as a percentage of investment expenditures incurred in a year on qualifying capital. Similar to tax holidays, investment tax allowance focuses on new investments. Investment allowances are deductions from taxable income based on some percentage of new investment. There are two notable weaknesses associated with tax credits and investment allowances. First, these incentives tend to distort choice in favor of short-lived capital assets since further credit or allowance becomes available each time an asset is replaced. Second, qualified multinationals may attempt to abuse the system by selling and purchasing the same assets to claim multiple credits or allowances or by acting as a purchasing agent for enterprises not qualified to receive the incentive.

Moreover, multinationals are also allowed to write off capital costs in a shorter time period than is dictated by the capital's economic life through the accelerated depreciation program. Providing accelerated depreciation has the least of the shortcomings associated with tax holidays and all of the virtues of tax credits and investment allowances and overcomes the latter's weakness to boot. Since merely accelerating the depreciation of an asset does not increase the depreciation of the asset beyond its original cost, little distortion in favor of short-term assets is generated. Moreover, accelerated depreciation has two additional merits. First, it is generally least costly, as the forgone revenue (relative to no acceleration) in the early years is at least partially recovered in subsequent years of the asset's life. Second, if the acceleration is made available only temporarily, it could induce a significant short-run surge in investment[16].

The mechanism by which tax incentives can be triggered can be either automatic or fully discretionary of the authorities. An automatic triggering mechanism allows the investment to receive the incentives automatically once it satisfies clearly specified objective qualifying criteria, such as a minimum amount of investment in certain sectors of the economy or inside the proposed economic zones. The relevant authorities have merely to ensure that the qualifying criteria are met. A discretionary triggering mechanism involves approving or denying an application for incentives on the basis of subjective value judgment by the incentive-granting authorities, without formally stated qualifying criteria. Or in other words, this regime relies on case-by-case evaluations that are

15. Tanzi and Zee, Op.Cit., page 14

16 Ibid.

Table 3 - Proponent and Opponent to Tax Incentives

Proponent	Opponent
Higher profits to the firms	Revenue loss due to redundancy
Positive externalities - spillover effects from the accumulation of knowledge	Revenue loss due to partial redundancy
Signal a country's commitment to facilitating investment	Revenue loss due to reverse foreign aid
Tax competition	Indirect Revenue cost – this occurs if the tax-favored activities undercut the profitability of other producers who do pay taxes due to harsh competition.
Capital mobility – attracting inward flows of foreign investment	Revenue leakage through avoidance and evasion
Compensating for other deficiencies in the investment climate	Revenue leakage through avoidance and evasion – company churning: establishing new company to get the facility
Revenue gains	Transfer pricing practice on purchases and sales
Political cover	Revenue leakage due to false export declaration
Practicality that contributes to other policy objectives such as investment promotion and job creation.	Increasing the tax burden on other activities and persons.
Experience shows that incentives can work	

Effectiveness and Economic Impact of Tax Incentives in the SADC Region, 2004

difficult to administer. Conversely, the authority may see a discretionary triggering mechanism as preferable to an automatic one because it provides them with more flexibility.

This advantage is likely to be outweighed, however, by a variety of problems associated with discretion, most notably a lack of transparency in the decision-making process, which could in turn encourage corruption and rent-seeking activities. If the concern about having an automatic triggering mechanism is the loss of discretion in handling exceptional cases, the preferred safeguard would be to formulate the qualifying criteria in as narrow and specific a fashion as possible, so that incentives are granted only to investments meeting the highest objective and quantifiable standard of merit. On balance, it is advisable to minimize the discretionary element in the incentive-granting process.

General tax incentives may reduce the risk of corruption in developing countries since the policy is applied to all foreign investors[17]. The investments that benefit from tax incentives are additional to what would take place in the absence of the incentives. An investment is financially feasible and viable in the host country but could earn a higher risk-adjusted rate of return in another new location, and the profit differential is high enough that tax incentives will compensate the location change. Additionally, tax incentive gives positive effect if an investment is not viable under the current tax set up, but becomes so due to the tax break. As stated in Table 3 above, tax incentives do cause some negative results. Some selective incentives do no or only change little the attitude of foreign investors. These categorized as superfluous and partial redundancy tax incentives. An example is a resource-based investment such as Mahakam project block in East Kalimantan operated by TOTAL E&P Indonesia. As long as the project is still financial and economically viable, TOTAL cannot simply pull up their operations elsewhere.

4. Economic Analysis of Tax Incentives

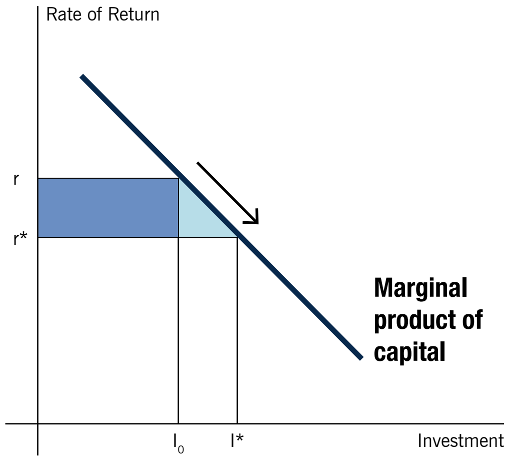
John Maynard Keynes's General Theory set investment as a central variable in the determination of the aggregate level of output. The level of investment is a function of the marginal efficiency of capital weighed against the market interest rate (see Figure 1). The market interest rate itself is considered as the cost of capital for investors. As interest rate or cost of capital decreases (from r to r*), investment will increase (from Io to I*). The application of tax incentives reduces cost of capital, assume all other variables constant, will improve investment. However, there are few elements that the central government needs to identify.

First, the government should be able to measure loss of revenue due to tax incentives and match it with the benefit originating from future investment. There is no doubt that tax incentives are costly. The first and most direct associated costs are those associated with the potential loss of revenue for the authorities. Second, possibility of creating adverse selection problems because most of the incentives for intended specific sectors and regions and not on the performance of each entities. Third, conducive central and local regulatory frameworks. These regulations are mostly pertaining to industrial and trade. From Figure 1 below, dark blue rectangle measures the amount of tax revenue forgone (or tax expenditure) by imposing tax incentives and the light blue triangle is the dead-weight loss of creating such policies. Measuring the dead-weight loss is not easy as it looks. Tax incentives may have

17. Pisani, Op.Cit., 301

many other less obvious costs. They influence the investment decisions of private investors, which can distort the allocation of resources. Those investors might just want to get short-term profits. Another cost relates to tax authorities' limited capacity and capability leading to unachievable incentives targets.

Figure 1 - The Theory Investment



Tax incentives can be justified if they address some form of market failure, most notably those involving externalities (economic consequences beyond the specific beneficiary of the tax incentive). For example, incentives targeted to promote high-technology industries that promise to confer significant positive externalities on the rest of the economy are usually legitimate. By far the most compelling case for granting targeted incentives is for meeting regional development needs of these countries. Nevertheless, not all incentives are equally suited for achieving such objectives and some are less cost-effective than others. Unfortunately, the most prevalent forms of incentives found in developing countries tend to be the least meritorious.

Previous research identified that the statistical determinants of the location of investment are market size, labor cost, infrastructure quality, share of industry to Gross Domestic Product, level of FDI, growing domestic markets, and stable international relations[18]. Over the past few decades time-series econometric analysis and numerous surveys of international investors have shown that tax incentives are not the most influential factor for multinationals in selecting investment locations. Both analysis and surveys have confirmed that tax incentives are poor instrument for compensating for negative factors in a country's investment climate[19]. Tax policies, according to recent studies, become more important as a determinant to foreign investments. Increasing regional economic integration has driven tax policies as an important determinant to attract foreign investment.

Foreign investments are also influenced by an accelerated revision of the Revised Negative Lists (*Daftar Negatif List* – DNI) on foreign investment across business sectors. The principle of government strategies to keep revising the DNI is to incorporate on foreign equity investment which apply in some sectors (e.g. horticulture sector), but provides clarity and relaxation for foreign equity in other sectors such as tourism and transport.

5. Indonesia's Experience with Tax Incentives

THE GOVERNMENT IS OFFERING VARIOUS TYPE OF TAX INCENTIVES SUCH AS TAX HOLIDAYS; TAX ALLOWANCES FOR INVESTMENT IN CERTAIN BUSINESS SECTORS OR REGIONS; SIMPLIFICATION OF INCOME TAX CALCULATION WITH CERTAIN AMOUNT OF GROSS INCOME; INCOME TAX REDUCTIONS FOR PUBLICLY LISTED COMPANIES; AND TAX REDUCTIONS FOR RESIDENT CORPORATE TAXPAYERS.

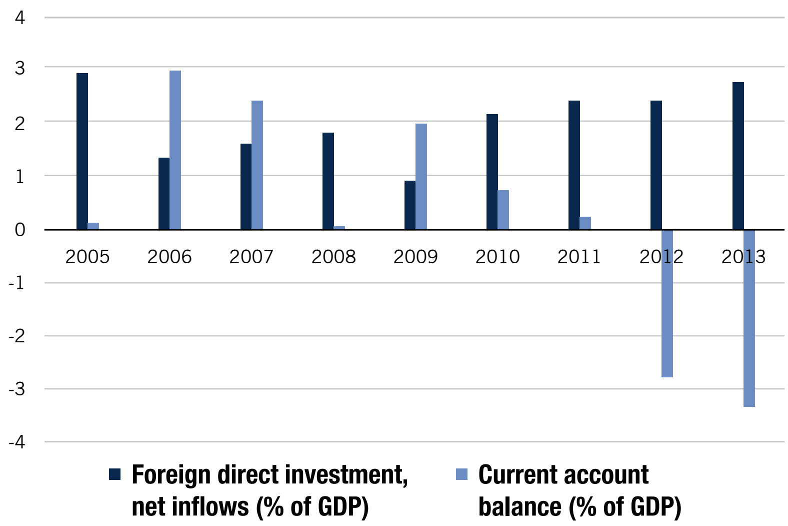
In 2015, the Government has conducted various fiscal and monetary mix policies to anticipate challenging global economic trends that affecting Indonesia's economy. Following the Budget Revision in January 2015, the Government needs to execute its reform agenda that are particularly infrastructure, maritime, agriculture, and social programs. Effective execution of the budget will require increasing in budgeted revenues. However, the Governments will likely face the challenge of adjusting spending to account for lower than expected realized revenues. Tax revenue accounted only 94 percent of the 2014 revised budget target of IDR 1,635.4 trillion. Lower value-added tax (VAT) growth was a major contribution to the weak performance of revenue in 2014. VAT collection growth in 2014 was only 5.8 percent, relative to an 18.8 percent average for 2009 – 2013 and only 85.1 percent relative to the revised 2014 Budget target.

The introduction of a final tax of 1 percent on annual gross turnover for small medium enterprises with gross turnover below IDR 4.8

18. United Nations," Report of the International Conference on Financing for Development," Monterrey, Mexico, Mar. 18-22, 2002.

19. Morisset, Jacquest, Op.Cit., page 2

Figure 2 - Current Account and Foreign Direct Investment (%GDP)



Source: World Development Indicators, the World Bank, 2015

billion in July 2013, and the consequent increase in the VAT registration threshold to IDR 4.8 billion may have negatively impacted both Corporate Income Tax (CIT) and VAT collection[20]. For 2015, the Government sets a target of IDR 1,762 trillion from tax revenue as stated in the revised budget. It requires extra efforts that in the Financial Note of the Revised Budget states increased effectiveness and efficiency in collection, resting on institutional and organizational improvements, including improved human resource and IT capacity, and better exchange of information with other agencies and institutions. On the tax policy side, numerous announcements have been made regarding policy measures that the government is considering that includes a travel ban and jailing of large tax debtors, the possibility of tax amnesty, and increase in mining royalty rates, and the introduction of new taxes on new oil and gas production sharing contract (PSC) holders.

Current account deficit narrowed from more than 3 percent in 2013 to around 2.8 percent of GDP in 2014. However, both exports and import were declined by 10.4 percent and 5.9 percent respectively in quarter 4 2014. The continued weakness in exports and imports is consistent with soft external and domestic demand conditions. In addition, both net FDI and portfolio inflows were surging and start diminishing in quarter 4 compared to the previous four quarter. The impact of granting tax facilities during 2005-2013 on FDI was not completely clear. The FDI increased with or without the tax incentives. These conditions also happened before the Asian Crisis. For example, the FDI in Indonesia increased significantly after the facilities in 1984. By looking at Figure 2, it is obvious that external and domestic macroeconomic conditions play a major role in determining number of FDI. Association between increasing numbers of tax incentive regulations enacted and FDI is not fully comprehensible and needs further research.

The Government of Indonesia recently enacted the new Regulation No. 18/2015 on tax allowances for new investment in certain business and/or regions. The Government is offering various type of tax incentives such as tax holidays; tax allowances for investment in certain business sectors or regions; simplification of income tax calculation with certain amount of gross income; income tax reductions for publicly listed companies; and tax reductions for resident corporate taxpayers. Scopes of new/pioneer industries that are eligible to tax holidays are basic metal industries, oil refineries, oil and gas source-based organic chemicals, machinery, renewable resource industries, or telecommunication equipment. The companies must be newly established and conduct their business within the abovementioned scopes. The main requirement is the company needs to make investment of IDR1 trillion at minimum. As part of this facility, Directorate General of Tax (DGT) will exempt the companies from paying corporate income tax for about 5 to 10 years, from the start-up of initial production, a 50 percent tax reduction for two years after the tax holidays period ends and subject to extension with further consideration from the DGT.

Under the new regulation, furthermore, it states that 66 business sectors and 77 business sectors in certain regions are eligible for tax allowances. In order to receive the allowance, DGT scrutinize the eligible recipients by their investment plan,

20 The World Bank," Indonesia Economic Quarterly: High Expectations", March 2015.

strategy towards export, having a high number of workers and use high local content for their production. The facility will provide an investment allowance at 30 percent of total investment. Other than that, it will also take into account accelerated depreciation, a lower income tax rate for dividends paid to foreigner, loss compensation for 5 to 10 years depending on the conditions of location, number of local workers, capital expenditure for social infrastructure, research and development expenses, and utilization of domestic raw materials.

Publicly listed companies also receive income tax reductions. To be eligible, taxpayers should list a minimum of 40 percent of stocks, owned by at least 300 parties, where each owns less than 5 percent of all stocks. The corporate income tax rate reduction is 5 percent lower than the normal rate. Started around the third quarter of 2013, the Government has delivered a package that is focused on economic stabilization and structural reforms and has four pillars[21]. First, supporting foreign direct investment by removing impediments to progressing with key strategic investment projects, simplifying licensing requirements, and expediting the revision of the negative investment list. Second, measures aimed at improving the current account balance, by providing tax breaks for export-oriented firms, and raise domestically produced biodiesel requirements in the fuel mix (to help dampen fuel imports). Third, measures aimed at maintaining employment growth, including tax breaks for labor-intensive sector, relaxation of some restrictions in bounded zones, and revisions to the minimum wage setting process. Fourth, measures to counter inflation, mainly by replacing import restriction with price-based mechanisms for beef and horticultural products.

6. Conclusion and Recommendation

This paper tries to address that providing tax incentives is a strategy to complement other government tools to attract foreign investment. Previous literature, indeed, suggest that the incentives may play some roles in determining foreign investors to locate their investment in Indonesia. Tax incentives are more a function as the sufficient condition rather than as the necessary one[22]. Political stability; macroeconomic volatility and complex institutional conditions such as regulatory framework and enforcement; capacity and readiness of the administration appear to be the most important investment climate variables that need to be addressed and improved by authorities in order to promote FDI. Not to mention coordination across line ministries in terms of regulations synchronization and implementation.

Tax incentives and other tax measures to attract foreign investments are costly and ineffective for developing countries if not done properly. The economic cost of tax incentives is one of the major problems in trying to attract foreign investment. Tax incentives might also distort decision-making, erode the tax base, may lead the government to surrender the ability to tax domestic taxpayers to avoid discriminatory treatment, and may bring negative nontax economic effects to the host country, including the creation of greater income inequality between individuals or regions in a developing country, environmental damage, erosion of the tax base, and crowding out the local capabilities[23]. Tax incentives might also create trade wars with neighboring countries

There are many other issues developing countries including Indonesia must work on correcting before engaging in the implementation of tax incentives. Tax incentives for FDI provide host country benefits only if the country has achieved minimum level of human capital, stock, infrastructure, etc[24]. Further, developing countries must address issues such as political instability, infrastructure, regulation, and others before deciding to apply tax breaks to attract investments. If manage properly, tax incentives provide benefits for developing countries because the investment create new employment, infrastructure, and transfer of technology. In the end, these countries must provide a safe investment climate, political and social stability, transparent and reduction of corruption and a reliable legal structure to provide more certainty to investors. Let alone tax incentives will not create incremental benefit to the economy.

Effective tax incentives also minimize moral hazard and adverse selection problems. Moral hazard problem arises because some companies only want to extract short-term profits in the expense of greater government revenue loss. In addition, current regulations that specifically based on location, size and business sectors create adverse selection problems. It is much better to provide incentives to foreign companies that fulfill list of criteria prepared by BKPM, Ministry of Trade, Ministry of Industry, and Ministry of Home Affairs.

21. The World Bank, "Indonesia Economic Quarterly: Continuing Adjustment", October 2013.

22. Iksan, Moh,"

23. McDaniel, Op.Cit., at 282

24. Ibid.

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