Foreign Direct Investment Location and Tax Incentive Policy in Indonesia

by

I Putu Sudiana

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Table of Contents

Table of Contents .... **iii**
List of Tables .... **viii**
List of Figures .... **xi**
Acknowledgements .... **xiii**
Abstract .... **xv**
Chapter 1. Introduction **1**
1.1 Background… 1
1.2 Overview…. 2
1.3 The Aim of the Thesis 5
1.4 Contribution of Study 6
1.5 The FDI Data….. 7
1.6 Organization of the Thesis 8
Chapter 2. Theory and Evidence on FDI Location and Incentives **11**
2.1 Introduction… 11
2.2 Theories of Foreign Direct Investment 12
2.2.1 Classical Trade and Factor Proportions Theory 12
2.2.2 Product Life Cycle Theory 13
2.2.3 The Theory of Firm-Specific Ownership Advantages 14
2.2.4 The Eclectic or 'OLI' Paradigm 15
2.3 Foreign Direct Investment Locational Theory 17
2.3.1 The Eclectic or 'OLI' Paradigm 17
2.3.2 Agglomeration Economies 19
2.3.3 Institutional Approach 22
2.3.4 Summary on FDI Location Theory 23
2.4 Empirical Evidence on FDI Location 24
2.4.1 'OLI' Paradigm and Classical Location Factors 24
2.4.2 Agglomeration Economies 27
2.4.3 Institutional Approach 30
2.4.4 Summary of the Empirical Evidence 33
2.5 The Theory of Investment Incentives 36
2.5.1 The Definition of an Investment Incentive 36
2.5.2 The Rationale for Investment Incentives 38
2.5.3 Types of Investment Incentive 40
2.5.4 Political Economy of Investment Incentives 43

2.5.5 The Public Value Framework 44
2.6 Empirical Evidence on Investment Incentives 46
2.6.1 Tax Incentives 46
2.6.2 International Nature of Tax Incentives 51
2.7 Conclusions…. 52
Chapter 3. The Indonesian Economy and FDI Policy 56
3.1 Introduction…. 56
3.2 Background on Indonesia 56
3.2.1 Geography of Indonesia 57
3.2.2 Political and Economic History 63
3.2.3 The Indonesia Economy and Taxation System 69
3.3 The Policy Environment for FDI Attraction 76
3.3.1 The Special Areas 76
3.3.2 Taxation Incentives 83
3.3.3 The Investment Environment 87
3.4 Conclusions…. 94
Chapter 4. The Nature of Inward FDI in Indonesia 97
4.1 Introduction…. 97
4.2 FDI Policy in Indonesia in the Post-War Period 97
4.2.1 The Period from 1945 to 1967 98
4.2.2 The Period from 1967 to 2007 99
4.2.3 The Period from 2007 onwards 104
4.3 Project Scale Over Time 105
4.3.1 Investment Scale 106
4.3.2 Investment by Sector 109
4.3.3 Investment by Location 111
4.3.4 Investment by Origin 114
4.4 The Contribution of FDI to the Indonesian Economy 119
4.4.1 Employment in Foreign-Owned Plants 119
4.4.2 The Contribution to Output 121
4.4.3 Productivity 124
4.4.4 Current Account 127
4.5 Conclusions…. 131
Chapter 5. Research Methodology 134
5.1 Introduction…. 134
5.2 The Research Strategy 135

5.2.1 The 'Mixed Methods' Approach....135
5.2.2 The Self-Completion Questionnaire....137
5.2.3 The Face-to-Face Interview....139
5.2.4 The Document Analysis....141
5.3 The Survey Forms....141
5.3.1 The Survey Questionnaire Form....142
5.3.2 Face-to-Face Interview Questions....144
5.3.3 Document Analysis....145
5.4 The Sampling Frameworks and Implementation....146
5.4.1 The Sampling Frameworks....146
5.4.2 Administration....153
5.4.3 Implementation....156
5.5 Conclusions....164
Chapter 6. Questionnaire Survey Results....167
6.1 Introduction....167
6.2 Respondent Characteristics....168
6.3 Nature of the Plants and Companies....169
6.3.1 Plant and Company Characteristics....170
6.3.2 Business Ownership, Sector and Country Origin....173
6.3.3 Employment Size....176
6.3.4 Sales Turnover and Competition Prospects....177
6.4 International Operations and Transportation....179
6.4.1 Output Markets....179
6.4.2 Input Materials....181
6.4.3 Transportation Mode....182
6.5 The Investment Decision....183
6.5.1 Assets Exploiting Motives for FDI....183
6.5.2 Location Decision....185
6.5.3 Investment Factors....185
6.5.4 Information and Support....187
6.6 Taxation Incentives....188
6.7 Evaluation on Business Environment....193
6.8 Conclusions....197
Chapter 7. In-Depth Interview Results....200
7.1 Introduction....200
7.2 The Policymakers....201

7.3 Inward Investment Policy 204
7.3.1 Purpose of Inward Investment Policy 204
7.3.2 Inward Investment Factors 208
7.4 Tax Incentive Policy 213
7.4.1 Reason for Implementing Tax Incentives 213
7.4.2 Tax Incentives and Inward Investment Policy 215
7.4.3 Assessing the Importance of Tax Incentives 219
7.5 Policy Development and Administration 222
7.5.1 Development of Taxation Policy 223
7.5.2 Policy Administration 226
7.6 Policy Evaluation and Future Directions 228
7.6.1 Monitoring and Evaluation 229
7.6.2 Future Policy Directions 232
7.7 Conclusions… 235
Chapter 8. Conclusions and Recommendations 238
8.1 Introduction… 238
8.2 Main Findings and Research Contributions 238
8.2.1 AIM I: Characteristics of and the Factors Influencing FDI Location 239
8.2.2 AIM II: The Role of Tax Incentives Based on Investor Perspectives 244
8.2.3 AIM III: The Role of Tax Incentives Based on Policymaker Perspectives 247
8.3 Discussion and Implications for Tax Policy 250
8.3.1 The Existence and Continuation of Tax Incentive Policy 254
8.4 Limitations and Prospect for Future Research 256
8.5 Conclusions and Recommendations 258
8.5.1 Conclusions 258
8.5.2 Recommendations 261
References 266
Appendix A: Tables 302
Appendix Table A.1.1: Laws/Regulations related Tax Incentives 303
Appendix Table A.3.1: Tax Holiday Periods in Indonesia 309
Appendix Table A.3.2: Workforce by Province, 2008-18 310
Appendix Table A.3.3: Minimum Wages by Province, 2001-15 311
Appendix Table A.3.4: Human Development Index by Province, 2010-17 312
Appendix Table A.3.5: ICT Literacy Rates by Province, 2015-16 313
Appendix Table A.6.1: Responses to Individual Survey Questions 314
Appendix Table A.7.1: The Purpose of Inward Investment Policy 339

Appendix Table A.7.2: Factors Influencing Inward Investment 340
Appendix Table A.7.3: The Reasons for Utilizing Tax Incentives....................................341
Appendix Table A.7.4: The Objectives of Tax Incentives 342
Appendix B: Survey Documents, Letters and Figure 343
Appendix B.5.1: Questionnaire Form 344
Appendix B.5.2: Covering Letter...357
Appendix B.5.3: Structure for Face-to-Face Interviews 358
Appendix B.5.4: Consent Form...360
Appendix B.5.5: Request for Conducting Research in the DGT 362
Appendix B.5.6: Ethical Approval...370
Appendix Figure B.7.1: Related Institutions on Tax Incentive Policy 371

List of Tables

Table 1.1: Indonesian Investment Facilities for FDI, 1967-2017 4
Table 2.1: Industry and Country of Origin Agglomeration Economies 21
Table 2.2: Summary of Empirical Evidence on FDI Location 33
Table 2.3: Advantages and Disadvantages of Different Tax Incentives 41
Table 2.4: Typology of FDI, Tax Incentives and Responsiveness 42
Table 2.5: Types of Incentives in Developed and Developing Economies, 1995 50
Table 3.1: Size and Number of Islands of Each Region 61
Table 3.2: Indonesian Population, 1971-2015 62
Table 3.3: Economic Indicators, 1998-2002 68
Table 3.4: Structure of Indonesian Output, 1970 - 2017 70
Table 3.5: Economic Indicators, 2013-17 70
Table 3.6: Social Indicators, 2013-17 71
Table 3.7: Due Dates for Paying and Filing Taxes 74
Table 3.8: Corporate Income Tax Rates, 1984-2010 74
Table 3.9: Criteria for Automatic CIT Reductions and Rates 75
Table 3.10: The Development of Industrial Areas 78
Table 3.11: Operationally Active SEZs, 2017 81
Table 3.12: Comparison of the Different Types of Special Area 82
Table 3.13: Tax Incentives in the Special Areas and Non-Special Areas 87
Table 3.14: Infrastructure Comparison of ASEAN-5 91
Table 3.15: Logistic Performance Index (LPI), 2010-18 91
Table 3.16: Technological Readiness Index (TRI), 2009-18 92
Table 4.1: Inward FDI Approvals in Indonesia, 1986-92 101
Table 4.2: Comparison between FDI and DDI Realization, 1995-2017 107
Table 4.3: FDI Inflows by Indonesian Region, 2005-17 112
Table 4.4: Largest Sectoral Recipients of FDI by Region, 2005-17 113
Table 4.5: Share of Country Origin to Total FDI Inflow, 2005-17 116
Table 4.6: Three Largest Investors by Origin and Province, 2005-17 117
Table 4.7: Principal Industrial Sectors for FDI by Country of Origin, 2005-17 118
Table 4.8: Employment in Foreign-Owned Plants by Sector, 1990-2015 120
Table 4.9: Employment in Foreign-Owned Plants by Region, 1990-2015 121
Table 4.10: Per-Worker Labour Productivity Levels, 1980-2016 127
Table 4.11: Trade Balance of Indonesia, 2005-17 128

Table 4.12: Shares of Total Manufactured Exports for ASEAN-5, 1985-98 130
Table 5.1: Business Activity and Number of Foreign Taxpayers 149
Table 5.2: Number of Investors in Sample by Tax Office 150
Table 5.3: Progress in the Distribution of Questionnaires 157
Table 5.4: Progress in the Return of Questionnaires 158
Table 5.5: Questionnaire Survey Response Rate by Tax Office 160
Table 5.6: Institutional Background of Respondents 162
Table 5.7: Interviewee Job Level or Position 162
Table 5.8: The Nature of the Documents Analysis 164
Table 6.1: Foreign Investors Registered as Taxpayer by Region 167
Table 6.2: Plant Sector and Age 170
Table 6.3: Characteristics of Plants at Establishment 172
Table 6.4: Ownership Structure and Legal Status 173
Table 6.5: Principal Activity of the Plants 174
Table 6.6: Country of Origin and Head Office Location 176
Table 6.7: Employment in the Plants 177
Table 6.8: Sales Trends 178
Table 6.9: Location of Main Competitors 179
Table 6.10: Destination of Sales 180
Table 6.11: Source of Materials 181
Table 6.12: Product Transportation Mode 183
Table 6.13: Motivation and Determinant Factor for Investment Location 184
Table 6.14: Alternative Locational Choices 185
Table 6.15: Factors Influencing the Investment Decision 186
Table 6.16: Tax Incentives in Investment Appraisals and Negotiations 188
Table 6.17: Tax Incentives in Both Appraisals and Negotiations 189
Table 6.18: Tax Incentives Received At and After Plant Establishment 189
Table 6.19: Importance of Tax Incentives: At and After Plant Establishment 190
Table 6.20: Take-up and ‘Value’ of Tax Incentives 191
Table 6.21: The SAs and Non-SAs Business Satisfaction 194
Table 6.22: Labour Skills and Training 195
Table 6.23: The Investment Issues in Indonesia 196
Table 7.1: Respondent Organisations and Codes 202
Table 7.2: The Rationales for Keeping Tax Incentives Policy 234
Table 8.1: FDI Characteristics in the SAs and Non-SAs 240

Table 8.2: The Role of Tax Incentives on the Investment Decision 245
Table 8.3: Factors Influencing FDI: Policymaker and Investor Perspectives 248
Table 8.4: Tax Incentive Policy Objectives 248
Appendix Table A.1.1: Laws/Regulations related Tax Incentives 303
Appendix Table A.3.1: Tax Holiday Periods in Indonesia 309
Appendix Table A.3.2: Workforce by Province, 2008-18 310
Appendix Table A.3.3: Provincial Minimum Wages by Province, 2001-15 311
Appendix Table A.3.4: Human Development Index by Province, 2010-17 312
Appendix Table A.3.5: ICT Literacy Rates by Province, 2015-16 313
Appendix Table A.6.1: Responses to Individual Survey Questions 314
Appendix Table A.7.1: The Purpose of Inward Investment Policy 339
Appendix Table A.7.2: Factors Influencing Inward Investment 340
Appendix Table A.7.3: The Reasons for Utilizing Tax Incentives 341
Appendix Table A.7.4: The Objectives of Tax Incentives 342

List of Figures

Figure 1.1: FDI Inflows and Tax Incentive Availability, 1981-2016..3
Figure 2.1: The Motives for FDI Location..18
Figure 2.2: Public Value Framework 45
Figure 3.1: Political Map of Indonesia...57
Figure 3.2: The Malacca Straits and Indonesia FTZs...58
Figure 3.3: Structure of Central and Local Government..64
Figure 3.4: Oil and Gas, Taxes, and Non-Tax Revenue, 1969-98 72
Figure 3.5: Tax Revenue Contribution to the State Budget, 2008-17......................................73
Figure 3.6: Indonesian Infrastructure Budget, 2014-19 90
Figure 4.1: Total Foreign and Domestic Investment, 1995-2017...107
Figure 4.2: Number of Projects of Foreign and Domestic Investment, 1995-2017 108
Figure 4.3: Mean Project Scales of FDI and DDI, 1995-2017 109
Figure 4.4: Share of FDI by Sector, 2005-17 110
Figure 4.5: FDI Share by Number of Projects, 2005-17 111
Figure 4.6: FDI Investments' Global Origin, 2005-17...115
Figure 4.7: Employment in Foreign-Owned Plants by Region, 1990-2015..........................120
Figure 4.8: Net Inward FDI as a Ratio to GDP, 1995-2017...122
Figure 4.9: Economic Complexity Index (ECI): ASEAN-6, 1995-2017 123
Figure 4.10: Current Account: ASEAN-5, 2005-17..129
Figure 5.1: The DGT Organizational Structure……………………………………………148
Figure 5.2: Distribution and Return of Questionnaire Forms by Week……………………..159
Figure 5.3: Experience of Face-to-Face Interviewes..163
Figure 6.1: Job Level of Survey Respondents...169
Figure 6.2: Distribution of Plants by Indonesian Region 171
Figure 6.3: The Importance of CIT rate on the Investment Decision....................................192
Figure 6.4: CIT rate and Investment Appraisals..192
Figure 6.5: Business Environment Satisfaction...193
Figure 7.1: The Purpose of Inward Investment Policy 205
Figure 7.2: Inward Investment Factors..208
Figure 7.3: Reasons for Utilising Tax Incentives 214
Figure 7.4: The Objectives of Tax Incentives 216
Figure 7.5: The Importance of Tax Incentive Policy...219

Figure 7.6: Policy Cycle... 223
Figure 8.1: FDI Location Factors and Its Related Theories.. 251
Appendix Figure B.7.1: Related Institutions on Tax Incentive Policy 371

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I hope this thesis will contribute to the richness of the literature, as well as to policy practicalities in my home country. I dedicate this thesis to the broader audience in government and academia, and those who are responsible for improving the investment climate in Indonesia.

Abstract

Foreign Direct Investment (FDI) has become a 'mantra' for developing countries, as not only is it a source of capital to boost economic development, but an important source of employment and technology. Many developing countries provide incentives to attract foreign investors, such as preferential taxes, but the evidence for these is mixed. Some find they are important, but others that they do not affect FDI location. Indonesia is of interest, since it is a large and rapidly developing Asian economy, which has pursued a policy of 'openness' towards FDI. This is supported by a programme of taxes and other incentives, but despite using these measures for more than fifty years their effect is uncertain, and they remain controversial.

The purpose of this thesis is to analyse the characteristics of FDI location in Indonesia and to explore the role of tax and other incentives. Overall, the thesis makes three main contributions. First, it provides an up-to-date analysis of FDI location in Indonesia using an original dataset and covering the 'New Order' period from the mid-1990s. Second, it undertakes a large-scale questionnaire survey of foreign-owned plants in Indonesia to establish their nature and motive for location. Third, the thesis carries out face-to-face interviews with Indonesian policymakers at a high-level to explore the rationale for inward investment and tax incentive policies.

Inward FDI to Indonesia has grown steadily over the last decade, and it is now about US$20 billion per annum. This represents about 2.1% of Indonesian GDP, while comparable domestic investment is about two-thirds smaller, indicating its importance. Making use of realization data provided by the Indonesian Investment Coordinating Board, the thesis shows that the vast majority of FDI in Indonesia is located on Java, the most populous region, and reflects market and labour resource-seeking. Regions outside Java are important more recently and are a target for FDI in mining and agriculture, especially from Europe and America. However, most FDI is from Asia, especially Singapore and Japan. The manufacturing share of FDI has increased over time, although the mean project size is smaller. The thesis finds a sharp division between the Special Areas, in which the incentives are applied intensively, as FDI seeks labour resources and exports, whereas outside these areas it supplies the domestic market.

The survey shows that tax incentives are not the main factor for influencing investors' decisions to locate in Indonesia. Thus, while investors include these incentives in their appraisal, they tend not to be the critical factor for investment in Indonesia. This seems to be well-perceived

by policymakers, so that political economy considerations are important for the continuance of these incentives. Other developing countries offer these incentives, so that the expectation of investors and policymakers is that these subsidies will also be available in Indonesia. Further, the tax incentives have largely evaded scrutiny, and the location of FDI has been attributed to other factors. Finally, by being seen to ‘do something’ to attract FDI in a fairly minimal way, the tax incentives are a means by which the government garners political support.

Chapter 1. Introduction

1.1 Background

Foreign Direct Investment (FDI) is an important source of economic development for many countries (OECD, 2002). As well as promoting economic growth, it offers important benefits to the host country, such as the creation of new jobs (Jones and Wren, 2004) and spillovers from the introduction of new technology and improved human capital (Liu, 2008; Aldaba, 2006; Christiansen *et al*., 2003). Given the greater globalization of the world economy and the perceived benefits of foreign investment, a growing number of countries compete for FDI (UNCTAD, 2000; Blomstrom and Kokko, 2003), which has increased significantly in recent years, especially for developing countries (Masron and Abdullah, 2010; Bissoon, 2012).

As a means of attracting FDI, countries provide incentives to investors, both in the form of tax and non-tax incentives. However, although tax incentives are found to be an important determinant of FDI inflows in some studies (e.g., Morisset, 2003; Keen and Mansour, 2009), there is also evidence that these incentives do not have significant impact on FDI location (Kinda, 2014; Chai and Goyal, 2008). As such, the overall evidence for their role in FDI location is mixed, and the policy implications are unclear (Nuta and Nuta, 2012; Klemm and Van Parys, 2012). In addition, existing research mainly focuses on developed countries, so that there is much less evidence for foreign investment into developing countries, especially Asia (Klemm and Parys, 2012). This is of concern, not just from an academic perspective, but also for policymakers in these countries that are seeking to frame their incentives (Thomas, 2011; Shah, 1995).

Notwithstanding this lack of strong support, the use of incentives as a means of attracting FDI is widespread (Egger and Raff, 2015; Altshuler and Goodspeed, 2015; Devereux *et al*., 2008), including developing countries (Chen *et al*., 2014). Amongst Asian countries, Indonesia is of interest, since it has pursued a programme of incentives to attract FDI for over fifty years in order to realize its economic objective of greater economic growth (Lindblad, 2015; Porter and Ketels, 2007). Appendix Table A.1.1 presents tax incentive policies which has been extensively taken by the Indonesian government each year for more than three decades. Tax incentives will

continue to be the centre of government policy as at the end of 2019, the government proposing an omnibus bill concerning tax regulations and facilities to strengthen the economy.[1]

The effectiveness of tax incentives for FDI in Indonesia is however still unclear, with a lack of research on this topic, so that there is a need for research to seek evidence on the relationship between FDI location and tax incentives in Indonesia. In practice, this may be difficult since according to Dhanani and Hasnain (2002), the effect of tax incentives on inward investment is difficult to measure with any precision. In particular, each government policy has a complex effect that are to both identify and quantify, including tax incentives. Nevertheless, this is the task of this thesis, so that I set myself the task of determining the effect of tax incentives on FDI location in order to provide empirical evidence for the policymaking process.

1.2 Overview

Indonesia has welcomed FDI since the New Order Era in 1967 that is associated with President of Suharto. Before this time, Indonesia had at different times pursued policies of economic nationalism, including in the immediate post-war period the nationalisation of foreign firms in Indonesia. Following the implementation in 1967 of Law 1/1967, Indonesia has 'opened the door' for FDI, and the government introduced tax incentives as a means for attracting foreign investment. The government's attitude towards foreign investment has fluctuated since then, but overall three broad types of tax incentive have been used: relief against profits (e.g., tax holidays), relief against costs (e.g., investment allowance) and tax facilities aimed at investors locating in special areas, comprising Bonded Zone (BZ), Free Trade Zone (FTZ) and Special Economic Zone (SEZ). Each of these is discussed further in this thesis, in Chapter 3.

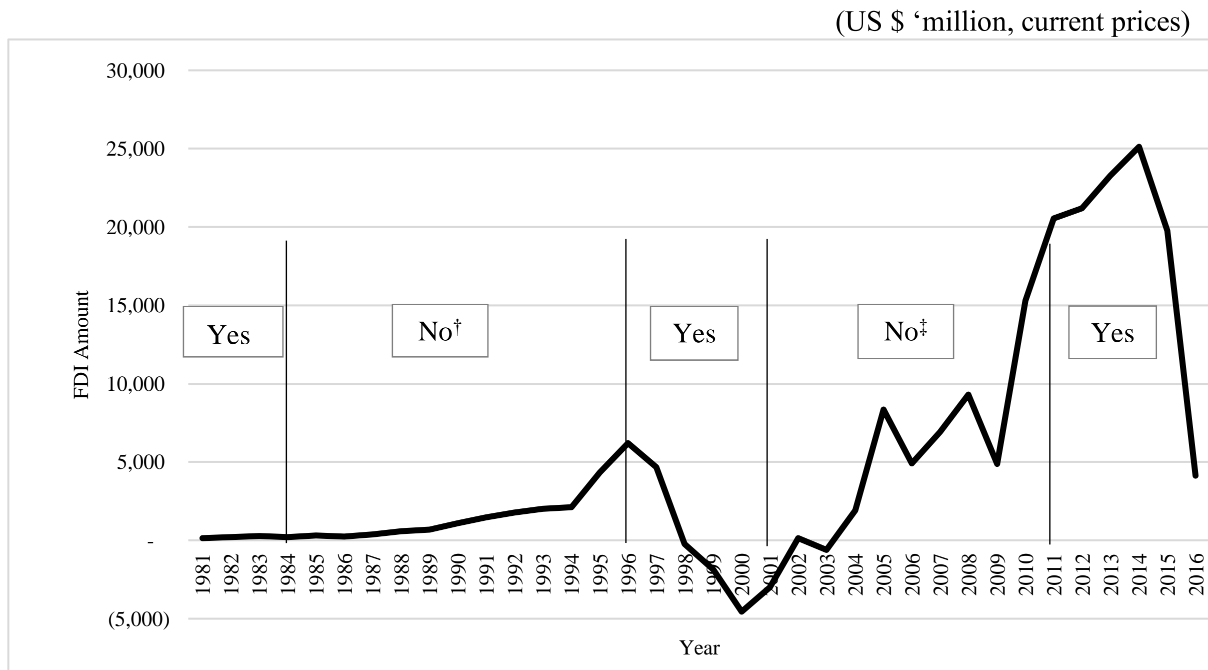
Tax incentive policy has been extensively utilised by the Indonesian government for more than three decades, as shown in Appendix Table A.1.1. However, apart from their persistent use, the policy has frequently changed over time where sometimes taking even a dramatic shift, for example tax holidays which has been widely used by developing countries (Boadway and Shah, 1995; Mintz, 1995). Taking a case of tax holidays, the changeable nature of its policy towards inward FDI since the early 1980s can be seen from Figure 1.1. It shows that tax holidays were used in the early 1980s, again in the late 1990s, and then finally since 2011. Figure 1.1 shows

[1] President Joko Widodo speech during his second-term presidential inauguration 20 October 2019 reaffirmed the need to propose the enactment of Omnibus Law to eliminate obstacles to investment and to create employment (Secretariat General of the House of Representatives (2020), Omnibus Law, *Parliamentary Review*, vol. 2, no. 1).

that there is no simple relationship between the existence of tax holidays and FDI in Indonesia. It is evident from the fact that FDI increases during the period when there were no tax holidays, but decreases when this was not the case (i.e., 1996-2001 or 2011-16).

Figure 1.1: FDI Inflows and Tax Incentive Availability, 1981-2016

(US $ 'million, current prices)



Source: World Development Indicators, World Bank, 2018.
Notes: †= No Tax Holiday and Tax Allowance are available; ‡= No Tax Holiday is available.

The link between FDI and policy is difficult to analyse as at each point of time there are multiple investment facilities put in place. Even though within a period of time (1984-96; 2001-11) there was no tax holiday or tax allowance as shown in Figure 1.1, but in fact the government had switched and implemented other type of tax facilities (i.e., CIT rate reduction) or relaxation for foreign investors ownership as presented in Table 1.1. For example, in 1984 Indonesia implemented Law number 7/1983 concerning Corporate Income Tax which eliminated all tax holidays and tax allowances, but at the same time the government had decreased the CIT rate from 45% to 35% (Wells *et al.*, 2001). Table 1.1 summaries the Indonesian investment facilities over time from 1967 to 2017, divided into five sub-periods to reflect the implementation of tax holidays (see Figure 1.1 above). It shows that in each sub-period, the tax incentives have been used by different Presidencies to influence domestic and foreign investment, but that the mix of these has changed over time. Table 1.1 shows that the policymakers have utilised the tax incentives continually over time, indicating the importance of this research.

Table 1.1: Indonesian Investment Facilities for FDI, 1967-2017

Period	Tax Holiday	Investment Allowances	Import Tax and Duty Free	SAs with preferential taxes	CIT rate reduction*	Foreign Ownership relaxation
1967-84	Y	Y	Y	Y[a]	Y	Y[b]
1984-96	N	N	Y[c]	Y	Y	Y
1996-2001	Y	Y	Y	Y	Y	Y
2001-11	N	Y	Y	Y[d]	Y	Y
2011-17	Y	Y	Y	Y	Y	Y

Source: Author's construction based on relevant laws and regulations.
Notes: Y = policy present; N = policy not present; SA = Special Areas (Bonded Zone / Free Trade Zone / Special Economic Zone). CIT = Corporate Income Tax.
* = Applied for all corporations or partially for those who fulfil certain requirements.
[a] = Bonded Warehouses established (later Bonded Areas / Zones) with the first Government Regulation 20/1972. Free Trade Zone Sabang established (Law 4/1970), later abolished (Law 10/1985) and then resurrected (Law 37/2000). Batam originally established as Industrial Area based on (Presidential Regulation 74/1971). For further details, see Subsection 3.3.1.
[b] = After riots in Jakarta in January 1974, the government restricted the foreign ownership and imposed requirement that foreign investors invested in Indonesia must be in the form of joint venture with local partner and had to rise domestic ownership with minimum of 51% within 10 years (Lindblad, 2015).
[c] = Import duty free in tourist areas, *Financial Notes for Indonesia State Budget Bill*, 1984/85, p. 50.
[d] = Special Economic Zones established (Law 39/2009).

The implementation of various type of investment facilities has increased the difficulties in measuring the effectiveness of tax incentives in attracting FDI inflows. It is because in reality is hard to separate out the effect of a single factor in this way, such as tax incentive policy (which can in fact take many forms), since FDI location is also likely to depend on other factors, including the other tax incentives on offer and global FDI flows, as well as institutional and political considerations. The difficulty in examining FDI is acknowledged by Globerman and Shapiro (1999, p. 514) as follows: "they [tax policies] are sometimes hard to isolate the effect of one factor from other factors, as often because they are more implicit than explicit". The effect of the utilisation or elimination of tax incentive policy on FDI has drawn contrasting views from policymakers, depending on the institutional background. Apart from that, the tax incentives have a political dimension, as they feature when the government announces to the public its plan to increase investment in order to increase economic growth and create employment. Indeed, almost every year in its Financial Notes to the State Budget Bill the Indonesian government puts tax incentives forward as a strategy to increase investment.[2]

[2] The government of Indonesia continuously considers the provision of tax incentives (in very broad terms, regardless its type) as a policy instrument for attracting investment (including FDI). It is stated in the Financial Notes to the State Budget Bill presented by the government to the Indonesian Parliament (the Indonesian House of Representatives) each year, for example in the Financial Notes to the State Budget Bill 1984/1985 page 50;

1.3 The Aim of the Thesis

As we see in the literature, the evidence for the effect of tax incentives on FDI inflows is limited and inconclusive, especially for Indonesia. Most of this evidence is for developed countries, while in the case of developing countries it is for Africa and other Asian countries, which are different contexts to Indonesia. Since there is lack of research on this topic, the thesis aims to fill gaps and seek answers to questions on the role of tax incentive policy for attracting FDI to Indonesia, especially by looking at the role of Special Areas (i.e., Bonded Zones, Free Trade Zones and Special Economic Zones). Looking further on the role of tax incentives, the research also attempts to explore the type of tax incentive that matters the most in different policy areas, distinguishing between general, automatic tax incentives (e.g., a CIT rate reduction, indirect tax exemptions) and targeted, discretionary incentives (e.g., tax holidays and tax allowances).

The research examines the role of tax incentive from the perspective of investors. In addition to looking at this perspective, it also looks at the issue from the perspective of policymakers. Therefore, in short, the principal the aims of the research are as follows:

AIM I: To examine the characteristics and factors influencing FDI location in Indonesia, by comparing Special Areas (SAs) and Non-Special Areas (Non-SAs).

AIM II: To examine the role of tax incentives in influencing FDI location decision based on foreign investors perspectives.

AIM III: To examine the role of tax incentives in attracting FDI inflows into Indonesia from policymakers' point of view.

To achieve these three aims requires a detailed look at how foreign investors and policymakers perceive inward investment and tax incentive policies. The research uses mixed methods that involve both a questionnaire survey of firms in Indonesia and interviews with policymakers. It addresses how and why investment incentives affect the FDI decision. For this purpose, tax incentives are "any deviation from the general tax system that are applied to certain kinds of investments to reduce their tax liability" (James, 2009, p. 3). In order to achieve the first aim

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Financial Notes to the State Budget Bill 2020, page 4). Before year 2000, state budget year was 1 April to 31 March; after year 2000 is January-December (http://www.dpr.go.id/tentang/penetapan-apbn).

(AIM I), the research utilises FDI realization data of Indonesia Investment Coordinating Board (BKPM) from 1995 to 2017 as the main data, accompanied with other sources from the Indonesia Statistics, the World Bank, the Asian Productivity Organization, and other relevant sources. In order to gain understanding on factors influencing FDI inflows, the research utilises survey questionnaire and in-depth interview data. Realizing AIM II, the research mainly utilises survey questionnaire results, while for addressing AIM III, it will be heavily relied on in-depth interview results. However, when it is necessary other secondary data from various sources will also be included.

1.4 Contribution of Study

The research contributes to improve the policymaking process by informing government on the nature of FDI in Indonesia and the factors that determine its location. Regarding the nature of FDI location, this research tries to analyse it by comparing two distinct areas, namely Special Areas and other areas, i.e., the 'Non-Special Areas'. Furthermore, regarding factors influencing FDI location, the thesis tries to understand it from two different point of view, which is from both the investors' perspective and policymakers' perspective.

With regard to the factors that influence the investment location decision, the research studies and presents economic factors and non-economic factors. Economic factors are viewed from various aspects, including taxation. It distinguishes between general, automatic tax incentives and targeted, discretionary tax incentives. The research informs us on whether these are a valuable strategic method for attracting FDI, and whether the government should continue to use them or change to use other policy instruments. In addition, it provide an understanding on how tax incentives affect FDI inflows based on a political economy analysis.

To the best of my knowledge, the research regarding the factors that influence FDI inflows by comparing Special Areas and Non-Special Areas, and by examining the role of different types of tax incentive, has not been covered in existing literature, especially in the Indonesian context. Overall, the research is expected to contribute to the body of knowledge on each of these, and to inform policymaking in the following four ways:

a. To provide a better understanding of the characteristics of FDI location in Indonesia and the determinants that influence it, both in the Special Areas and other areas.

b. To provide an understanding of how investors and policymakers perceive the importance of tax incentives and other factors in attracting FDI, and to provide an explanation of the rationale behind their decision-making.
c. To add the body of knowledge on FDI location, which is by gaining an understanding on the effectiveness of tax incentives in Indonesia and why they might be successful.
d. To provide a more comprehensive understanding about tax incentives in order to develop better public policy in Indonesia, specifically in relation to taxation policy.

The research in the specific context such as Indonesia is important, as even though it can be classified as a developing or ASEAN country, the institutional and economic landscape is heterogeneous and may differ significantly (Wanjiru and Prime, 2018; Delgado *et al*., 2012), and each country has its own uniqueness. In addition, as argued by Du *et al.* (2008), cross-country studies have inherent weakness and they are likely to be confounded by numerous factors. As such, I expect that this research will contribute to understanding the factors that determine FDI location in an Indonesian context, especially in relation to the provision of tax incentives. Thus, unlike some other studies that are quantitative in nature, this research takes a different approach that balances quantitative and qualitative approaches, but to be clear at the outset it does not include regression analysis.

1.5 The FDI Data

The research data used in this thesis are gathered from different sources. The primary data is gathered through the survey questionnaire of foreign investors and by in-depth interviews with policymakers in Indonesia. Secondary data on FDI and on Domestic Direct Investment (DDI) are gathered from the Indonesia Investment Coordinating Board (BKPM). Both FDI and DDI data are based on investment realization, so that it differs from the data presented by United Nations Conference on Trade and Development (UNCTAD) or the World Bank, which are based on the Balance of Payments. These secondary data record the number of projects and the investment realization amount on a yearly basis. They are available by the business sector, country of origin, investment location of the investor and the associated jobs.[3] It is the only data source that gives FDI details at the province and sector levels.[4]

[3] They do not include realizations in the oil and gas, banking, non-bank financial institution, insurance, leasing and household industries (*Domestic and Foreign Direct Investment Realization in Quarter IV and January-December 2017*, Indonesia Investment Coordinating Board (BKPM). Jakarta, Indonesia).
[4] This is based on the Indonesian Standard Industrial Classification (KLBI 2015), as published by the United Nations of Statistical Division (UNSD) in 2008.

1.6 Organization of the Thesis

The thesis is divided into eight chapters, including this Introduction. In order to achieve the research aims, the thesis is organized as follows. In Chapter 2, I set out theory and evidence on FDI location and incentives. This chapter reviews the theoretical literature, which is selected based on its relevance to the thesis. The literature review is focused on theories regarding FDI locational factors by selecting three relevant theories for the thesis. It begins with the eclectic theory, 'the OLI', followed by agglomeration economies and lastly the institutional approach supplemented with public value framework. In essence, the use of different theories is expected to complement each other. Following the theoretical part, this chapter then discusses the empirical research of each of the FDI location theories. The chapter presents empirical evidence for different country groups: developed, developing and specifically for Indonesia when the data are available. As the research looks at the relationship between tax incentives and FDI location, then after presenting the theory and empirical evidence on FDI, this chapter present theories regarding investment incentives. It discusses the definition and the rationale behind it. It follows with an explanation on type of investment facilities, especially tax incentives. Similar to the discussion regarding FDI theories it is complemented with empirical evidence on the use of investment incentives, particularly tax incentives. This chapter also provides a brief explanation of the non-tax incentives.

In Chapter 3, I describe the Indonesian geography, demography, and also the political and economic history of Indonesia. With regard to the geographical location, it tries to explain the strategic location of Indonesia in the Asian region, specifically how its position affects trade and investment between countries in Asia and the Pacific. Regarding demography, it discusses the Indonesian population and how it is spread across the country. This discussion is linked to the potential market size and labour resources that FDI might be interested in. Looking at the political structure, the chapter presents the characteristics of the Indonesian government and institutions related to investment policy. The relationship between government levels - central and local government - is also explained. The chapter also presents the nature of FDI policy over time. As the research focus is on tax incentives, explanation regarding the type of incentives is presented, starting with general aspects and then focusing on the specific issues. This chapter also presents the type of investment areas used in Indonesia, which are classified as Special Areas (SAs) (i.e., Bonded Zones (BZ), Free Trade Zones (FTZ) and Special Economic Zones (SEZ)) and areas outside the SAs (Non-SAs). Finally, it also explains the

investment environment, specifically regarding levels of institutional support, infrastructure development, labour, wages and productivity.

In Chapter 4, I present the nature of inward FDI in Indonesia. The chapter starts with the history of FDI policy, identifying three distinct periods: from 1945 to 1967, from 1967 to 2007, and the period from 2007 onwards. After that, the chapter discusses the change in the investment scale over time, followed by the characteristic of the foreign investment by sector. The nature of FDI in the six regions of Indonesia is discussed, and complemented with explanation of its global origin, and how this has changed over time. Further, the contribution of FDI to the Indonesian economy is discussed. It begins with the employment contribution, followed by the Indonesian GDP, and then its contribution to economic productivity, the trade balance and current account. All of this contributes towards the first aim of this research (AIM I), which is an understanding of the characteristics of FDI in Indonesia.

In Chapter 5, I discuss the methodology that is used in this thesis, and its appropriateness. In order to achieve the research aims, I have decided to choose 'mixed methods' as the research approach. This combines the strength of both quantitative and qualitative methods, which at the same time hopefully can overcome each of their limitations. The research utilises a self-completion questionnaire for gathering data from foreign investors, but for policymakers I use in-depth interviews. The questionnaire survey hopefully will allow me to reach a broader target of firms, while the in-depth interviews are focused on the reasons behind government decision-making regarding FDI and tax incentive policy. In order to complement those two approaches, I also utilise 'document analysis', especially for understanding the context. The data is collected for Indonesia as the research target. From the survey results, I gained 224 completed survey questionnaires and 17 in-depth interviews results with high-ranking policymakers.

In Chapter 6, I present the questionnaire survey results. The survey results are presented by comparing foreign investors located in Special Areas (SAs) and Non-Special Areas (Non-SAs). In general, the Special Areas cover specific investment locations developed by the government or private sector, which have preferences in terms of tax incentives and other non-tax incentives. It starts by explaining the nature of plants and companies registered as foreign investors in Indonesia, such as business ownership, sector, country of origin, employment size, and the characteristics of sales and the main competitors. It is followed with a discussion of the international operations of foreign firms. Regarding the factors that influence foreign investors to invest in Indonesia, I begin with the motivation to invest following the asset-exploiting

motives of the OLI-model. The role of the tax incentives is considered by focusing on their role in investment appraisal and the negotiation process with the government. The chapter ends by presenting an evaluation of the business environment by focusing on what aspects the foreign investors are satisfied or dissatisfied with. In general, this chapter mainly contributes towards the first and second aim (AIMS I and II).

In Chapter 7, I present the in-depth interview results. The aim of this chapter is to present the role of FDI and tax incentive policy from the perspective of policymakers, so that it is mainly to support the achievement of the third aim of the research objectives (AIM III). The chapter presents in-depth results from the interviews with the high-ranking policymakers who are responsible for FDI and tax incentive policies. The discussion starts with the 'big picture' of the role of tax incentive policy and FDI, and the 'policy development cycle'. With regard to FDI, the objective of inward investment policy is considered as well as its determining factors. After that, the discussion is on tax incentive policy and its objectives, including the reasons for using these measures. The presentation is supplemented with an assessment of the importance of tax incentive policy amongst the policymakers from different government institutions. The chapter discusses how tax incentive policy is developed and implemented and considers how government policy is monitored and evaluated.

Finally, Chapter 8, presents the conclusions and recommendations. This chapter summarises the main findings of the thesis, which directly links to each of the research objectives (AIMS I, II and III). It analyses the differences on the characteristics of FDI between the SAs and Non-SAs, and it considers the dominant factors that influence FDI inflows and location that is based on the different theories that are discussed in Chapter 2. The discussion of the research findings regarding the second aim (AIM II) is summarised, which is followed by a discussion of the third research aim (AIM III). In general, the conclusion tries to discuss, analyse and elaborate on the research findings, so that it provides a clearer response to each of the research objectives. It also considers the limitations of the thesis, and the possible improvements for future research. This chapter ends with recommendations for policy improvement in the Indonesian context.

Chapter 2. Theory and Evidence on FDI Location and Incentives

2.1 Introduction

This chapter discusses from a theoretical standpoint the reasons why firms decide to invest in a foreign country and the location factors that determine where this investment occurs. It also reviews the empirical evidence on these locational determinants of foreign direct investment (FDI) more broadly. Subsequent to this, compared to these location factors, it examines the importance of investment incentives for attracting FDI, including taxation. These investment incentives are considered to be an important component of national economic policy, as well as regional policy in order to attract FDI and to generate new jobs to stimulate local economies (Adams *et al.*, 2014). The evidence for the investment incentives in attracting FDI is reviewed in this chapter as a precursor to my later empirical work in Chapters 6 and 7.

FDI is defined in various ways, with the OECD (2008, p. 234), for example, defining it as "a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy in an enterprise that is resident in an economy other than that of the direct investor". Pajunen (2008, p. 653) defines FDI more straightforwardly as "private capital flows from a parent firm to an enterprise outside the parent firm's home country". These activities define a Multi-National Enterprise (MNE), which is a company or other entity that is established in more than one country. The key aspect of these definitions is that the MNE owns and controls activities in different countries, and that this is realised through direct investment in a foreign country; that is, foreign direct investment (Buckley and Casson, 1991).

The notion of the control is also highlighted by Hymer (1960), who argues that the difference between foreign direct investment and more general portfolio investment (i.e., the transfer of capital) is that FDI has the characteristic of the control of operations, whereas portfolio investment confers the share of ownership but not control. This argument is followed by Dunning and Lundan (2008, p. 7), who note that "FDI does not involve any change in ownership, so that the power to control decision making over the use of the transferred resources remains in the hand of the investing entity". Jones and Wren (2006, p. 7) define FDI as "…[a] process where a firm from a country provides capital to an existing or newly-created firm in another country." FDI is therefore a means of direct investment conducted by a foreign entity that invests in the host country, and this can be either in the form of a newly-created (greenfield)

investment or as the expansion of an existing (brownfield) facility.

The structure of this chapter is as follows. The notion of foreign direct investment and why and how firms are able to locate abroad is discussed in the next section. Section 2.3 examines the reasons for and determinants of FDI location, and subsequently, Section 2.4 reviews the empirical evidence on the locational determinants of this investment. Section 2.5 examines the importance of investment incentives to the location decision and Section 2.6 provides empirical evidence for this in the case of both developed and developing countries, where of course the latter includes Indonesia. Conclusions to this chapter are drawn in Section 2.7.

2.2 Theories of Foreign Direct Investment

This section explores the theories on why a MNE conducts foreign investment. It starts with the classical trade theory, leading up to the development of the eclectic theory of Dunning (1979) and the subsequent extensions of the eclectic paradigm. Dunning's theory is seen as the main framework in the international business literature for explaining FDI. The eclectic theory integrates early theories into a general paradigm as it is believed that each theory on its own cannot solely explain FDI, but that they need to be considered together (Meyer, 1998). By sequencing the discussion in this fashion, the chapter shows how FDI theories have developed and how successive theories have sought to address weaknesses with the previous theory. Even though the main theory applied in this research is the eclectic theory, other relevant theories are also considered.

2.2.1 Classical Trade and Factor Proportions Theory

Early theories that aim to explain why FDI occurs are based on international trade theory, and in particular the role of comparative advantage. According to international trade theory a country will produce and trade in the goods in which they have a comparative advantage; that is, they produce goods at a lower opportunity cost, so that they exchange their own goods with different goods from other countries, who in turn have a comparative advantage in their own production. This can be extended to include the notion of absolute advantage, whereby even though one country is more efficient at producing every good compared to another country, it will still be useful to trade since the opportunity costs vary between countries.

A comparative advantage of a country normally occurs as a result of differences in the factor endowments owned by the different countries. According to the Heckscher-Ohlin theorem, countries will specialize in producing the commodity that utilizes the locally abundant factor of production most intensively (see Gandolfo, 2014). Countries therefore specialise in the production of goods of which the country is well-endowed and trade with other countries in those goods for which the country is relatively less well-endowed. With regards to foreign direct investment, locally abundant factors of production will attract investors (firms) from foreign countries to invest to gain the benefits of the locally abundant factors of production in the host country. This arises because the availability of abundant factors means that a foreign investor can reduce its cost of production (capital costs) by locating in that country.

2.2.2 Product Life Cycle Theory

The Product Life Cycle theory is proposed by Vernon (1966), and it seeks to address some of deficiencies of the classical trade and factor proportions theories. The classical trade theory argues that a country will produce goods and services in which it has an advantage, while the factor proportions theory extended this to argue that countries will focus on the production of goods and services that have abundant endowments. However, crucially, both theories only consider production and exchange through exports, so that they do not mention the possibility of foreign direct investment. The Product Life Cycle theory suggests that products have a life-cycle, of which there are three distinct stages – the 'new product stage', the 'maturing product stage' and the 'standardized product stage' (Vernon, 1966). According to this theory, firms will conduct FDI at a particular stage in the life-cycle of the product, and specifically between the maturing and standardized product stages.

The new product stage is where a firm produces a good or service in its home country for the domestic market only. However, as the business develops, the product matures and foreign demand arises. In this maturity stage, firms will produce their product to serve the domestic market and start to serve international markets through exports. Finally, when the product is fully standardized, the need to produce anywhere in the world arises, where the production cost is important, but also the possibility to market the product in the host country and in the firm's home country (see Morgan and Katsikeas, 1997). According to the product life-cycle theory a firm conducts FDI when its product is fully standardized.

In essence this theory argues that the more a product is standardized the more likely the location of production will be changed, for instance, to gain a lower cost of production or access to a market. This theory predicts different stages: from fulfilling the domestic market (stage one); to exporting (stage two); and then to FDI in a country in which it previously exported (stage three). In the third stage, where the product is fully standardized, it is even possible to produce the product in a less-developed country, where the costs of production are lower. If the conditions in the host country are right, the affiliate may replace the exports from the parent company or even export back to the firm's home country (Dunning and Lundan, 2008).

The theory has been challenged as it assumes an ideal product life-cycle with coherent FDI activities, while in reality this might not be always the case (Glowik, 2009). Vernon's theory takes the USA context, which is a large home market that is suitable for firms to begin their business activities, but it ignores the other countries that have a small market scale. Further, Vernon's theory simplifies international trade by assuming that it will occur when a firm is at stage two or three, whereas it might not happen at all, perhaps due to trade barriers, different customer characteristics or other factors that influence production costs, such as investment incentives (Glowik, 2009). An important point is that the theory relates to the USA context at the time that it was proposed. The Product Life Cycle theory has also been challenged in recent years since the sequencing might not strictly follow. The introduction of a new product could be conducted simultaneously in many countries instead of starting in the firms' home country only, so that the theory may have lost some of its validity over time (Barkema *et al.*, 1996).

2.2.3 The Theory of Firm-Specific Ownership Advantages

According to international trade theory, foreign firms will invest in countries to capture their abundant resources, such as labour or natural resources. However, Hymer (1960) criticized this theory based on observations of how FDI flows in practice. First, international trade theory considers the flow of capital as one directional, from developed countries to underdeveloped countries, whereas in fact the flow of capital was not only from developed to underdeveloped countries, but also between developed countries. Second, there is an assumption that a country will only relate to one type of FDI, outward or inward, however countries can both receive and generate capital from inward and outward FDI. Third, the level of outward investment differs between industries, but this should not be the case given the assumption that investment is based on the availability of capital in countries. Finally, the prediction that FDI will lead to capital movements from one country to another country does not relate to the observed practice of

foreign subsidiaries being financed locally. Hence, given all this, Hymer (1960) argues that there must be other factors that influence the FDI decision.

Hymer (1960) argues that international trade theory does not capture the main distinguishing feature of FDI, which is the importance of firm-specific advantages. He believes a foreign investor must possess firm-specific ownership advantages in order to overcome international barriers to production that will occur for the foreign investors compared to domestic firms. These arise from uncertainty and informational disadvantage of the foreign investor operating in a foreign environment (Jones and Wren, 2006). Examples of firm-specific ownership advantages include patents over a technology, superior knowledge, technological advancement and a differentiated product, so that without an ownership advantage the foreign company will be in a disadvantageous position compared to domestic firms in the foreign country.

2.2.4 The Eclectic or 'OLI' Paradigm

The eclectic paradigm was proposed by Dunning, who argues in a series of publications that the existence of FDI cannot be explained by a single theory, but rather a more eclectic approach is needed to draw a reliable and complete story in order to explain the determinant factors of FDI inflows. Dunning (1977, 1979, 1981) includes international trade theory, but also other related theories from economics and international business in order to develop a comprehensive framework to explain FDI. This is known as the eclectic paradigm of FDI or the Ownership-Location-Internalization (OLI) theory.

Dunning argues that in order to conduct FDI, MNEs should acquire three specific advantages, namely ownership, location, and internalization (OLI). The ownership specific advantages (O), similar to that of Hymer's firm-specific advantages, state that for a firm to conduct FDI they must have ownership advantages over other firms in the host countries. Ownership advantages of a firm in the eclectic paradigm are "the extent to which its own enterprises possess, or can gain access to, assets or rights which other enterprises do not possess or to which they cannot gain access, at least on such favorable terms" (Dunning, 1981, p. 109). Ownership advantages can be in the form of firm-specific tangible or intangible assets (Halvorsen, 2012), including a new technology, patents, financial expertise or management expertise. In order to keep control over the ownership advantages, as argued by Hymer, firms have to utilize their advantages for themselves rather than selling or licensing these to other parties (firms) in a foreign country.

This leads to the importance of internalization advantages (I), whereby firms will engage in FDI as a means of keeping and internalizing its ownership advantages rather than externalize them through licensing or similar contracts with other firms (Dunning, 1979). In some ways this can be seen as an extension to Coase's theory of the firm (1937), whereby transaction costs lead to the internalization of activity within the firm rather than through the market. Internalization occurs if the nature of the ownership advantage means the costs of operating through the market are greater than internalizing these advantages, for example, if the firm's advantage is knowledge based and makes market transactions costly and uncertain (Jones and Wren, 2006). Further, licensing firm specific-ownership advantages with other parties might make the firms' future position vulnerable if the licensing partner becomes a competitor.

Finally, given the firm-specific and internalization advantages, the location advantages (L) are that in conducting FDI the firm gains benefits from locating in a host country (Dunning, 1979). This relates to the local endowment of the host country, which are not transferrable or mobile across national boundaries, hence making location in the country necessary for the firm. For example, in order to reduce transportation costs and transaction costs, firms may need to locate and produce their products close to the source of the inputs of production or the main market of the products. If this is not the case then it may not be feasible or optimal for the firm to conduct FDI, but rather it is better to serve the foreign market through exports and produce the product in their home country (Dunning, 1979).

Since its introduction at a 1976 Nobel Symposium on the International Location of Economic Activity (Dunning, 1977, 1991), the eclectic paradigm has been subject to criticism. Rugman (1981) argues that the distinction between the ownership and internalization advantages is blurred, and to some extent Dunning agrees that these advantages have a tendency to be non-separable (Dunning, 1988). It has also been argued that the eclectic (OLI) paradigm is more of a general framework rather than a theory of FDI (Cantwell, 1988) or even "a taxonomy of various determinants of FDI" (Itaki, 1991, p.456). Dunning (2009a, 2001) acknowledges that the OLI theory is more of a paradigm that comprises various theories to explain why a MNE engages in value-added activities across borders. One important aspect of the eclectic (OLI) paradigm, however, is that it has not just focused on the internal advantages of firms from ownership and internalization advantages, but it places emphasis on the locational advantages that are important in the FDI decision-making process. Prior to the eclectic paradigm location was a neglected factor in the FDI literature, but there is now greater focus on the importance of

location in the role of FDI (Dunning, 1998). The following section focuses on location, with attention placed specifically on the main factors that determine where FDI locates.

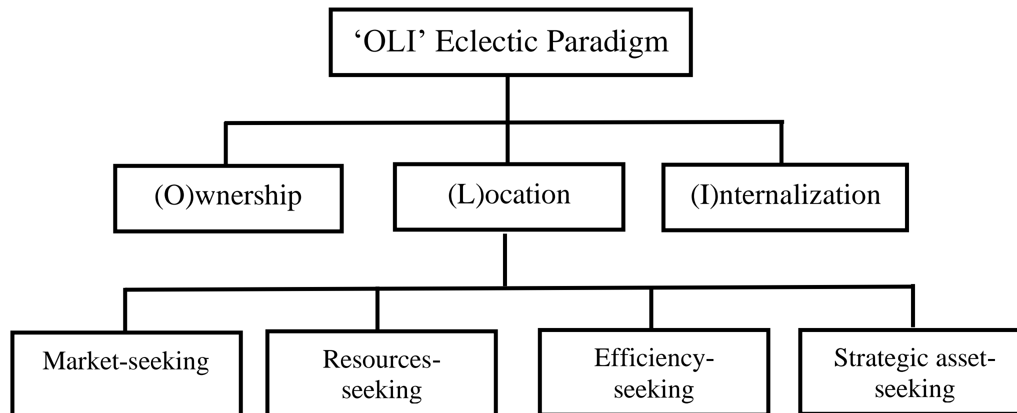
2.3 Foreign Direct Investment Locational Theory

With regard to what is the 'best' theory for explaining FDI inflows, I tend to agree with Makoni (2015), who argues that there is no single FDI theory that comprehensively explains why a firm chooses one location over other possible locations. As such, this section presents a number of theories that are relevant to the research objectives. An important component of Dunning's work on FDI theory is to address location as a critical factor in the FDI decision, since previous theories focus on the characteristics of MNEs as an organizational entity rather than on the geographical pattern of their activities (see Dunning, 2009b). FDI location has become an important aspect of FDI theory and the factors that determine this. The following section discusses these, firstly, in relation to the traditional or classical factors, and secondly, focusing on the more recent emphasis on agglomeration and institutional factors.

2.3.1 The Eclectic or 'OLI' Paradigm

The eclectic paradigm can be used as a starting point for determining the factors that affect FDI location, where according to the paradigm firms make their location decisions in order to optimize, in conjunction with their internalization and ownership advantages (Dunning and Lundan, 2008). A later version of the eclectic paradigm considers FDI to be asset-exploiting or asset-enhancing, with Dunning (2000) developing a taxonomy originally put forward by Behrman (1972) in relation to FDI location. It considers four motives as follows: (1) market-seeking; (2) resource-seeking; (3) efficiency-seeking; and (4) strategic-asset-seeking. In a simple way the relation between the OLI paradigm and these four motives is set out in Figure 2.1. They are now each discussed in some further detail.

Figure 2.1: The Motives for FDI Location



First, market-seeking is where a firm resides in one country to supply goods and services to the market of the host country or a neighbouring country. In many cases, the interaction that the MNEs have with the host country will have previously occurred through exports. However, due, for example, to transport costs or tariff barriers imposed by the host country, a firm may decide to produce goods and services directly in the host country, so that it is very close to the market. Another reason for market-oriented FDI is in order to make the product adaptable to local tastes or needs. A third reason is to reduce the costs of production and transaction costs, so that the firm will be able to reduce the transportation costs of goods and services. Finally, the market-seeking strategy provides a physical presence in a leading market that will improve the firm's image compared to its competitors (Dunning and Lundan 2008; Franco *et al.*, 2010).

However, the market-seeking motive is not always easily judged since a firm may locate in a host country to serve a third country market even though it initially produces goods for the host country (Rugman and Verbeke, 2009). A difficulty with the market-seeking explanation is because of the so-called export-platform FDI, whereby a firm's output in a host country is largely exported rather than used to serve the host country market (Ekholm *et al.*, 2007). The complexity of judging the location advantages is also complicated as it may change over time, following Vernon's product life-cycle. Initially, a firm may choose a host country because of a market-seeking orientation, but later as its products follows the life cycle it may seek the markets of other countries, including the home country market, through imports of the product produced in the foreign country (Rugman and Verbeke, 2009).

Second, resource-seeking is where a firm is prompted to invest in the host country in order to gain specific resources with a higher quality or a lower cost in comparison to its home country. In this context, the motive is the specific resource available in the host country such as cheap

but a well-motivated, unskilled or semiskilled labour force or technological capabilities (Franco *et al.*, 2010). In general, Rugman and Verbeke (2009, p. 153) argue that resource-seeking FDI is consistent with classical trade theory in which a "host country will primarily export resource-based or labour-intensive products with a low technological content". Meanwhile the home country exports the opposite product type (capital intensive and high technological content). However, in understanding resource-seeking motives, it might not solely focus on production *per se*, but on additional location advantages such as infrastructure quality or the institutional and legal framework (Rugman and Verbeke, 2009). This suggests that other resource factors are important in addition to the resource endowment.

Third, efficiency-seeking is where a firm invests in the host country because of the gains from economies of scale or scope (Dunning and Lundan, 2008). As such, efficiency-seeking as an FDI determinant covers products and processes, either from a larger scale or from a variety of products (Cui *et al*., 2014). It may even arise from the rationalization of an MNE's activities across countries, so that in general it is difficult to assess (Rugman and Verbeke, 2009). In this case, investment and tax incentives for location are potentially efficiency-seeking as they reduce the cost of production (Andersen *et al*., 2018; Dunning, 1993a, 1993b).

Finally, the fourth motive for FDI is strategic-asset-seeking motive, where the MNE conducts activities such as acquiring the assets of a company in the host country to promote long-term strategic objectives such as global competitiveness. It is less about exploiting firm's specific advantages than about seeking and augmenting ownership advantages that may be weak within the firm (Ramasamy *et al*., 2012). It may be undertaken by MNEs in emerging or developing economies as a way to acquire technological resources to become internationally competitive (Cui *et al*., 2014; Gaffney *et al*., 2013; Franco, 2013; Makino *et al.*, 2002).

2.3.2 Agglomeration Economies

The location factors considered above are specific to a firm and include natural resources, market size, labour costs and taxes. These are often called the classical location factors to distinguish them from other factors that are non-specific and arise out of advantages from the location close to other firms. These are agglomeration economies, of which Jones and Wren (2006, p. 49) note that "if classical variables are relevant it suggests policy should operate on the traditional location factors in order to attract FDI, but if agglomeration factors are significant then not only may the classical variables and policy have no effect, but it means that FDI is

self-perpetuating (the arrival of FDI may attract further FDI)". Thus, agglomeration economies are potentially an important motive for FDI location.

Agglomeration economies are integral to economic geography (Duranton and Kerr, 2018) and a core topic in location theory that concerns the geographical pattern of economic activity. Glaeser (2010, p. 1) defines agglomeration economies as "the benefit that comes when firms and people locate near one another together in cities and industrial clusters". The objective of studying location theory is to understand the reasons why some plants or firms choose to establish themselves in some particular places over other locations (Ottaviano and Thisse, 2004). Economic geography does not necessarily predict that firms will locate close to a market or resources, but rather from the advantages of being in proximity to other firms. A feature of agglomeration economies is that instead of spreading out their investment across many locations, investors' concentrate investment in a few locations, as a form of increasing returns, so that economic activity is concentrated in a location. It differs from international trade theory that emphases comparative advantage as a source of investment and trade.

The theory of agglomeration economies is a response to a deficiency of the classical location viewpoint (Krugman, 1991), of which there are several aspects. Firstly, localized firms in an area will provide a pool of workers with specific skills for industries in the area that provide mutual benefits for the workers and employers (Marshall, 1920). This will ensure a higher probability of work for workers and a high chance for industries to fulfil its workers' demand. The similarities of industries in an area will make it easier for each firm to find workers with similar capabilities. The possibility that an employee has a job is also high since if one firm has difficulties, other firms may need to expand their activities so that the workers that have similar skills have a greater chance of being absorbed into employment.

Second, the existence of similar firms in one location can support the creation of non-tradable specialized inputs (Marshall, 1920). Because of the similarities in industry, it is possible for a firm to run subsidiaries activities, i.e., input sharing. For example, a large firm that has a large project can contract some of the production process to small firms. This activity will lead to 'symbiotic mutualism', meaning that the large firm will able to fulfill its contract to the buyers, while the small firms can keep machinery and workers employed. Another example is that localized industries can support linkages between the intermediate and final goods suppliers. Input-output linkages occur because firms save their transaction cost as they locate close to their suppliers and customers (see D'Costa *et al.*, 2013).

Finally, as many similar firms locate in an area then informational (knowledge) spillovers can give clustered firms a better production function than isolated producers. If a firm finds a good method to produce output, this knowledge might more easily spread to other firms. In simple terms, a 'good thing' for one firm will duplicate itself to other firms (Marshall, 1920). Tan and Meyer (2011) provide two options for foreign investors to locate in relation to knowledge spillovers: either in the same industry or with firms in the same country of origin. Table 2.1 summarizes the theoretical arguments for these two types of agglomeration economy, and it shows that there are some differences between them. For instance, in the case of industry agglomeration firms are in direct competition and they seek spillovers, whereas in the case of the country of origin the agglomeration arises as there is a higher level of shared trust between firms. The benefits for firms from industry-specific agglomeration economies may be from access to local (industry-specific) knowledge, while the benefits from a similar country of origin is from access to local market knowledge or home country resources. There may also be disadvantages from the clustering of activity, such as firms in the same industry competing for scarce resources and pushing up prices (e.g., labour inputs), the possibility of an MNE's competitors benefiting from knowledge spillovers, or in the case of country of origin agglomeration a reduction in the intensity for resource competition and higher input prices.

Table 2.1: Industry and Country of Origin Agglomeration Economies

	Industry FDI Agglomeration	Country of Origin Agglomeration
Inter-firm relations	• Often in direct competition • Contractual-based operation	• Normally not in direct competition • Benefit from a higher level of trust
Benefits	• Access to local, industry-specific knowledge • Access to local, industry specific resources (such as specialized labour/inputs, partners, customers and infrastructure)	• Access to local market knowledge • Access to local, home-country-specific resources • Easier to gain legitimacy
Costs	• Competition for scarce resources • Knowledge expropriation hazards	• Less-intensive resource competition • Fewer knowledge expropriation hazards

Source: Tan and Meyer (2011). Table 1. p. 507.

Apart from the above agglomeration factors proposed by Marshall, there are other sources of agglomeration proposed in the literature, from transportation costs (Krugman, 1991; Glaeser and Kohlhase, 2004), local amenities (Mukkala, 2004), institution and cultural distance (Du *et al.*, 2012) and geographic distance (Ledyaeva, 2009). Transportation costs are "the costs of transmitting goods, people, information and ideas [which] affect not only the attractiveness of a location but also the decision of firms to locate relative to one another" (Alfaro and Chen, 2018, p. 389). According to these authors, high transportation costs will encourage the incentive to replicate production across countries (horizontal FDI), while transportation costs reduction will promote the exploitation of cross-country cost differences (vertical FDI). Agglomeration economies from geographic proximity reduce these transportation costs when firms, labour and other inputs are nearby. Krugman (1991, p. 497) predicts that with "lower transportation costs, a higher manufacturing share or stronger economies of scale, circular causation sets in, and manufacturing will concentrate in whichever region gets a head start". Low transportation costs may have made natural resources-seeking motives no longer relevant as investments are no longer tied to natural resources (Glaeser and Kohlhase, 2004).

From a different perspective, Mukkala (2004) states that with regard to local amenities the availability of land, suppliers and a workforce with specific skills are the important factors as a source of agglomeration economies. Meanwhile Du *et al*. (2012) state that institutions are important for FDI location for contract enforcement. Foreign investors will locate in areas where there is concentration of other firms from the same industry or home country, so that it has a close cultural distance (Du *et al.*, 2012). With regard to geographical distance, different factors may be important, such as transportation costs (Brude *et al.*, 2014) or the closeness of the consumer market (Ledyaeva, 2009). Jones and Wren (2006) note that recent attention has focused on the external benefits of infrastructure, although they note that it is difficult to distinguish empirically between the classical and agglomeration determinants.

2.3.3 Institutional Approach

The previous theories focus on economic perspectives, whereas the institutional theory offers a different view on why investors conduct investment in a foreign country. North (1981, 1990) believes institutions determine the 'rules of the game' that shape and guide behaviour. Kang and Jiang (2012) note that the OLI paradigm emphases economic efficiency, but that it is the 'institutional legitimacy' that is crucial for investment in a host country. Pajunen (2008) argues that the OLI paradigm only partially explains FDI location and that attention should be given

to institutional factors, and this finds support in Dunning (2006). Good institutions are where the legal framework is well established (Peng, 2002) and this is often context specific, and may be weaker in developing or emerging countries (Buckley *et al.*, 2016). Indeed, more broadly, there is a neglect of the role of institutions in economic geography in determining the location of activity (MacKinnon *et al.*, 2009), while the role of government is also highlighted by Morgan and Katsikeas (1997), who believe that it influences investment.

In understanding institutional theory, Westney (1991, p. 54) begins with the premise that "organizations are social as well as technical phenomena, and that their structures and processes are not shaped purely by technical rationality". Indeed, initially, research on FDI location considered economic factors only (Mudambi and Navarra, 2002), but this shifted when North (1971) hypothesized that institutions play an important role in filling gaps in the market by addressing market failures. In general, the market does not provide complete information, so that agents need other ways to acquire this. North (1990) argues that the main role of an institution is to reduce uncertainty through the establishment of a stable structure of human interaction. Tayeb (2000) notes that this can take many forms, such as an education system, a political or economic system, infrastructure, laws and regulations, accounting practices, tax policies (including incentives), trade unions and pressure groups. Francis *et al.* (2009) argue that an investor's decision depends on the relevant institutional forces. In general, based on various research, the institutional approach has a close link with the institutional quality, but also investment incentives, tax rates, tariffs and political risk (Benassy-Quere *et al*., 2007; Devereux and Griffith, 1998; Loree and Guisinger, 1995; Root and Ahmed, 1978).

2.3.4 Summary on FDI Location Theory

The theories of FDI discussed in this chapter have developed from FDI that was seen as part of a broader international trade theory based on a country's comparative advantage, to a more FDI-specific theory of the eclectic paradigm based on the firm-specific advantages of MNEs. The eclectic theory tries to synthesize the theories on ownership advantages, covering both tangible assets, such as natural endowments, manpower and capital, and intangible assets that in a broad sense include technology, information, management, marketing, entrepreneurial skills, organizational systems, incentive structures and access to intermediate or final goods. These advantages are added to by including the locational advantages that are inherent in the decision-making process to give the literature on FDI a locational dimension.

In the discussion, the theories of FDI location have been grouped into economic (classical and agglomeration theories) and non-economic perspectives (institutional theory). Classical determinants, which are a part of the eclectic theory, emphasize that firms locate to optimize their ownership advantages. However, a separate strand of the location literature emphasizes the importance of agglomeration economies in that firms are more likely to reside in locations where similar companies exist, either in terms of the industry or the country of origin of the firms. This is in order to capture external economies that are generated from the clustering of economic activity. Lastly, the non-economic perspective emphasizes how the institutions of a host country influence investors' decisions in choosing a location. We now turn to the empirical literature to examine the importance of these different FDI locational determinants.

2.4 Empirical Evidence on FDI Location

This section discusses the empirical evidence for the theories that are set out in Section 2.3. In presenting this evidence a distinction is made between market, resource and efficiency-seeking FDI in the case of the classical location factors, whereas more broadly I distinguish between developed and developing countries. When it comes to the empirical evidence for developing countries, I focus on Indonesia, which is specific to this research. At the end of this section, a summary is given that emphasizes the important findings of this section.

2.4.1 'OLI' Paradigm and Classical Location Factors

Market-seeking FDI

In general, the larger the market of the host country the greater is the level of FDI inflows it attracts. It is shown in some studies (Haufler and Wooton, 1999; Barros and Cabral, 2000) that in the absence of government policy competition (i.e., provision of investment incentives) for FDI, foreign firms establish a plant in a large country due to a 'market size effect'. This is because a larger market size creates more opportunities for an investor to benefit from external economies of scale and spillover effects, including marketing (Firdaus, 2010). Many studies find a significant correlation and impact of market size on the location of foreign investment. Wheat (1986) finds that market size can explain 55 percent of the factors influencing investment location. A similar finding on the importance of market size for branch plant location in the USA is found by Friedman *et al.* (1992). Woodward (1992), Coughlin and Segev (2000), Broadman and Recanatini (2001) get similar findings, and likewise more recently by Alam and

Shah (2013) for OECD (Organization for Economic Co-operation and Development) member countries. However, looking at Spain, Villaverde and Maza (2012) find that market size is not relevant at all, but this may be because the FDI is export-driven, and a similar result has been found for other EU countries (Villaverde and Maza, 2015).

Looking at developing countries, Aziz and Mishra (2015) find that market size has significant and positive impacts on FDI inflows to Arab economies. This is confirmed when investors' subjective perspectives are explored. Goh and Wong (2011) explore Malaysia's outward FDI and find that a motivation for investing abroad is to gain better access to the host country markets. The importance of market size for FDI location is also found by Zin (1999), who conducts an interview survey of Malaysian investors. Hiratsuka (2006) examines Malaysian' investors in the ASEAN countries and finds that FDI in developing countries with larger markets could be caused both by market size and efficiency-seeking. Further, in the case of Indonesia, Firdaus (2010) finds that market size is statistically significant in influencing foreign investment at the province level. The variables used to proxy market size are regional gross domestic product and trade development using unloaded and loaded cargo at the port. Azam and Lukman (2010) cannot find any significant effect for the Indonesian market size on FDI.

Resource-seeking FDI

Resource-seeking is considered for both natural and labour resources. In the case of the first of these, Shiells (2003) conducts research for the Commonwealth of Independent States (CIS) and finds that FDI inflows to the CIS countries in the 2000s was mainly resource-seeking. Campos and Kinoshita (2003) find that resource-seeking in the form of natural resources is an important driver for inward FDI to the CIS, including Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan, and Russia. Johnson (2006) assesses the determinants of FDI to the CIS and Central and Eastern European (CEE) countries, but finds that resource-seeking explains FDI in the CIS, but not the large FDI inflows to the CEE countries. Asiedu and Lien (2011) use a linear dynamic panel-data regression for 112 developing countries and they find that natural resources have a negative effect on FDI location in countries where exports are dominated by natural resources. Likewise, for Pakistan, Asif and Majid (2018) find that natural resources have a positive relationship with FDI inflows, owing to its abundant natural resources, such as natural gas, petroleum and coal. In recent years, the ASEAN investment reports show that resource-seeking FDI by European Union investors is concentrated in resource-rich ASEAN countries, including Indonesia (UNCTAD, 2017a).

In the case of labour resource-seeking, Ryou and Song (1993) find Korean FDI in Southeast Asia is mostly concentrated in labour-intensive manufacturing (textiles, garments, footwear, electric and electronic appliances). Thus, from the standpoint of classical location theory this investment is considered as resource-seeking. Apart from this, the need to penetrate into host country markets is becoming a determinant factor for conducting foreign investment. With regard to labour market flexibility in a host country, Javorcik and Spatareanu (2005, p. 400) find that "greater flexibility in the host country (relative to the investor's home country) is associated with a higher likelihood of FDI inflows".

Efficiency-seeking FDI

Much of the research on efficiency-seeking has focused on factors that are also important for resource-seeking, reflecting the difficulty to empirically discriminate between these motives. In general, investors seek locations that have skilled labour, high productivity and / or lower wages. Sakali (2013) conducts econometric analysis for Bulgaria using panel data over the 1990s and 2000s, and finds that inward FDI is motivated by efficiency reasons, which is in addition to market-seeking. Hayakawa *et al.* (2013) use firm-level data to examine the role of home and host country characteristics on FDI location in Japan, Korea and Taiwan. They find that an increase in home country wages by 10% leads to an increase in firms investing abroad by 25%, while higher host country wages have a negative and significant effect on the number of foreign investor inflows (Hayakawa *et al.,* 2013). Bellak *et al.* (2008) analyze FDI across selected Central and Eastern European countries and the effect of labour costs. This research suggests that higher unit and total labour costs have negative impacts on FDI inflows, but that higher labour productivity positively affects inward FDI. In general, greater efficiency in the cost of production increases inward FDI in the host country.

Looking at Japanese investors in the United States, Woodward (1992) finds that automotive investors are more likely to invest in locations with higher concentrations of educated and productive workers. Japanese investors also prefer to locate their investments in areas with low unionization rates (Woodward, 1992). Meanwhile, Coughlin and Segev (2000), looking at productivity using educational attainment as a proxy, find that it has positive correlation with the number of new plants in a location. A different result for education is found by Cheng and Kwan (2000), who look at 29 Chinese regions over 1985 to 1995, and find that it has positive effect on FDI inflows, although it is not statistically significant.

2.4.2 Agglomeration Economies

Own-industry agglomeration economies refer to the condition under which investors locate in a specific and limited area because of the benefits of input sharing, labour market pooling or knowledge spillovers (Marshall, 1920). Agglomeration economies play a fundamental role in the location of economic activity (Tapia *et al*., 2016). Looking at the empirical evidence, there are very many studies that have explored the relationship between these agglomeration economies and the location decisions of foreign investors (Jones, 2017). I distinguish between the above three traditional factors of Marshall (1920), and the non-traditional factors that comprise geographical distance, local amenities and cultural distance.

Traditional factors

Taking Spain, Monseny *et al.* (2011) look at all three mechanisms for agglomeration of input sharing, labour market pooling and knowledge spillovers. Of these, labour market pooling, followed by input sharing, are the most important factors influencing FDI location decisions, whereas they argue that knowledge spillovers are relevant at a local level only. Rosenthal and Strange (2001) find similar results for USA manufacturing industries. Their analysis is conducted at three levels (state, county and zip code), and it shows that labour market pooling is the strongest effect, significantly affecting agglomeration at all three geographical levels, but knowledge spillovers are significant at the lowest geographical level only. Ellison *et al.* (2010) find evidence for each of the three factors, which they associate with the cost of moving goods (i.e., input sharing), people (labour market pooling) and ideas (knowledge spillovers).

Urata and Kawai (2000) find that skilled labour positively affects FDI inflows to developed countries, but it is not significant for developing countries. They find that Japanese firms that invest in developing countries look for lower skilled and cheap labour. Meanwhile, Yeaple (2003) finds that 'hi-tech' MNEs that are skill-intensive invest in countries that are skilled-labour abundant, while for non-skilled intensive MNEs locate in a lower-skilled country. This suggests a country should improve its human capital if it wants to attract more high-tech foreign investors that lead to higher value-added products. In practice, according to the World Bank (2005a), to be successful in FDI attraction the availability of skilled labour is more important to investors than is taxation. However, a major problem facing developing countries is that labour wages seem to increase at a faster rate than productivity, as in the Organization of Eastern Caribbean States (World Bank, 2005a). Lai and Sarkar (2011) use firm-level panel data for

Indian industries, and they find that labour productivity significantly and positively increases FDI inflows, but that wages have a negative effect.

Looking at the Indonesian context, Kuncoro and Wahyuni (2009) find that the agglomeration of manufacturing industries, which as Chapter 3 below shows is mostly located in Java, is because of labour market pooling, but also input sharing as they have advantages in terms of vertical integration with foreign suppliers and a greater access to international markets. A similar point is made by the World Bank (2012) in relation to FDI agglomerations in Greater Jakarta, Bandung, Semarang, Greater Surabaya (all Java), Medan (Sumatera) and Makassar (Sulawesi). This is despite agglomerations appearing more recently outside these areas, such as Cirebon and Pekalongan (both Java) and Lampung (Sumatera). Baskoro *et al.* (2019) investigates the effect of labour productivity on FDI inflows to Indonesia. A random effects analysis of nineteen manufacturing industries over 2001-14 finds that labour productivity has a positive and significant effect in FDI. Wages also have a positive and significant effect, but this might be because they capture the effect of skilled-labour that leads to higher productivity, especially in the manufacturing sector. Taking Indonesia, Djulius (2017) uses econometric modelling and finds that the export orientation of domestic firms is an important factor for the existence of various knowledge spillovers from foreign to domestic companies. Furthermore, a high level of competition and business specialisation among export-oriented domestic firms also promotes knowledge spillovers (Djulius, 2017).

Non-traditional factors

As indicated above, there are three non-traditional factors: geographical distance, local amenities and cultural distance. First, using econometric analysis to examine FDI flows in the Central and South-Eastern European countries over 2001-06, Mateev (2009) finds that the *geographical distance* between the source and host countries has a significant effect on location. The smaller is the distance (i.e., the greater the geographical proximity), the greater the amount of FDI that is attracted (Mateev, 2009). These investors benefit from an associated reduction in transportation costs, since other firms, labour and resources are all located in the same area (Alfaro and Chen, 2018). In the Indonesian context, Imansyah and Nasrudin (2016) use a gravity model and panel data, and they find that there is a negative and significant impact of the distance between the home and host countries on FDI location, and again this can be attributed to transportation costs.

Second, *local amenities*, such as the quality of infrastructure, is a source of agglomeration. Wheeler and Mody (1992), using econometric analysis for manufacturing investment by US multinational companies in 1980s, find that infrastructure quality is a dominant influence on the investor location decision. Using a conditional logit model, Coughlin *et al*. (1991) find that more extensive transportation infrastructure is associated with increased FDI inflows in USA. Likewise, looking at 54 Chinese cities, Head and Ries (1996) find that attractive cities with good quality of infrastructure gain most FDI inflows, and that agglomeration effects increase the direct impact of government policy. Looking at 29 Chinese regions over 1985-95, Cheng and Kwan (2000) get similar findings that infrastructure has a positive effect on FDI. Kumar (2006) uses data for 66 cross-countries and holds other factors constant, and finds that infrastructure availability contributes to the attractiveness of a country for FDI. However, Quazi (2007) finds that infrastructure quality does not significantly affect FDI in seven East Asian countries: China, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand. Infrastructure quality is measured by the number of telephones per thousand people, and caution should be exercised, as Suh and Bae (2008) argue that information and communication technology infrastructure attract FDI inflows in large emerging markets only. Meanwhile, for developed countries that have already achieved a mature level of infrastructure they argue that it will affect national productivity but not attract FDI inflows.

In the case of the Indonesian context, Lipsey and Sjoholm (2011) find that FDI inflows have been lower compared to other countries in the region, especially in manufacturing, which is despite its large market size and abundant labour and natural resources. Reasons for this may be poor infrastructure, a weak business environment, inefficient government institutions and a low education level, while Indonesia has failed to integrate itself fully into the international global production value chains (Lipsey and Sjoholm, 2011). In his previous research, Sjoholm (2002) finds FDI in Indonesia tends to locate in clusters, which increases spatial inequality between regions. However, Azam and Lukman (2010) do not find a relationship between FDI and infrastructure, as proxied by expenditure on electricity, gas, transport and communications.

Third, Halvorsen (2012, p. 679) finds that the "agglomeration of FDI has a positive effect on FDI size when FDI arrives from the same home country", suggesting that *cultural distanc*e is important. In particular, it seems that firms are more confident to increase their investment size if there is an agglomeration of activity arising from the same origin country. Lucke and Eichler (2016) examine 65 developing and transitional host countries, and they find investors are more likely to invest in a country that is less linguistically and religiously diversified compared to

their country of origin. Head *et al.* (1995) use a conditional logit model to explore the location choice of 751 Japanese manufacturing plants in the USA since 1980. They find that Japanese investors prefer to site their plants in areas where there is concentration of previous Japanese investment in similar industries. Hilber and Voicu (2010) use a conditional logit model to investigate the magnitude of different type of agglomeration economies. They find that service sector agglomerations (i.e., employment in the tertiary sector) and industry-specific foreign agglomeration have a significant effect on the foreign investment location decision.

Looking at ASEAN neighbouring countries, Felkner and Townsend (2011) find that high-level enterprises are clustered in and around the capital cities and along major transportation arteries, but that in rural areas it tends to be located near large towns or main roads. Further, in the case of Indonesia, Henderson and Kuncoro (1996) find that investment location is positively affected by market size, but adversely affected by higher labour wages and poorer infrastructure. Further, firms strongly prefer locations with mature plants in related industries. However, the geographical distance has a negative effect, as the greater the distance from the nearest major city, the less likely is investment, presumably due to higher transportation costs (Henderson and Kuncoro, 1996). Deichmann *et al.* (2005) conclude that even though eastern Indonesia is endowed with good natural resources, its investment lags behind the western regions because of its inadequate infrastructure and higher transportation costs.

2.4.3 Institutional Approach

Along with agglomeration economies, institutions are considered an important determinant of FDI location (Campos and Kinoshita, 2003). There are different institutional aspects, but I focus on the quality of institutions and good governance. A further institutional factor is the investment incentive structure, and this is considered in Sections 2.5 and 2.6.

Firstly, in the case of *the institutional quality*, Meyer (2001) finds that the institutions of a host country affect an investor's entry mode in a transition economy. The research was conducted through a questionnaire survey of German and British companies that located their business in the Czech Republic, Hungary, Poland, Romania or Russia. Looking at the Russian case, Bevan *et al.* (2004) find that FDI is positively related to the quality of formal institutions, with investors responding positively to government policy that facilitates the exploitation and augmentation of their own resources and capabilities.

More broadly, using panel data for 164 countries from 1996 to 2006, Buchanan *et al.* (2012) find that the institutional quality matters for FDI inflows, but that "if there are institutional antecedents of FDI volatility and if such volatility is associated with lower economic growth, then the usual policy prescription of attracting FDI into countries by offering the 'correct' macroeconomic environment would be ineffective without an equal emphasis on institutional reform" (p. 88). Kinuthia and Murshed (2015) compare Malaysia and Kenya, and argue that the former has been successful in attracting FDI compared to Kenya because of institutional quality (i.e., macroeconomic stabilization, trade policies and infrastructure).

The impact of institutional quality on the FDI location decision seems to vary depending on whether it is a developed or developing country (Du *et al.*, 2008). Peres *et al.* (2018) find that institutional quality positively affects FDI inflows in developed countries, but that it is insignificant for developing countries. However, using a meta-analysis study, Bailey (2018, p. 144) finds that the "relationship between institutional factors and FDI is significantly larger for developing countries compared to developed countries". Lucke and Eichler (2016) use panel data for 29 source and 65 host countries, and find that institutional quality is an important factor that influences FDI in developing countries, whereas there are conflicting results for developed countries as "higher levels of perceived corruption in developed countries appear to be associated with an increase in FDI" (p. 952). This may be because FDI is rent-seeking, and weaker regulatory control in relatively secure economies actually encourages FDI. Dellis *et al.* (2017) explore European countries and they find that the quality of institutions and economic structures increases FDI inflows. For different economic sectors, Ali *et al.* (2010) find that the institutional quality does not have a robust impact on FDI in the primary sector, but it increases FDI flows for the manufacturing and service sectors.

There are many aspects of government policy that contribute to the ease of starting-up a plant and 'doing business', including the institutional support and a sound regulatory framework. As a proxy, Piwonski (2010) use the 'Doing Business Index' (DBI) constructed by the World Bank (2010) and find a significant effect of this on FDI inflows. The regression results show that an improvement in the DBI rank by one position (out of a total of 183 countries) increases FDI inflows by over $44 million. Morris and Aziz (2011) look at 57 sample countries (36 Sub-Saharan Africa and 21 Asian countries) and get mixed findings. Over the period 2001-05 the research shows a positive relationship between the DBI and FDI in the Sub-Saharan Africa countries, but no effect for Asian countries in each of these years.

Looking at the specific institutional aspects, Bissoon (2012) examines the institutional quality and its relationship to FDI inflows in developing countries. This includes countries in Africa, Latin America and Asia, and it shows that the quality of institutions in developing countries has a very strong effect on FDI flows to a host country. Recent research by Kurul and Yalta (2017) for 113 countries over the period 2002-12 shows that the impact of institutions on FDI depends on the type of institutional indicator, whether this is the control of corruption, government effectiveness, 'voice' (some notion of democracy) or accountability. All of these significantly affect inward FDI, of which voice and accountability are the most important.

Second, institutions are often seen as providing the 'rules of the game' for human interaction in order to develop greater predictability and certainty. This *good governance* then leads to economic and political stability (North, 1990, 1981; Naude and Krugell, 2007), and presumably to greater foreign investment. 'Institutions' mean different things to different scholars (Nelson and Sampat, 2001), but in this case what is relevant is the relationship between FDI location and the enforceability of contracts, stability and policy consistency. Focusing on the last of these, Bond and Samuelson (1989, p. 77) argue that investment presents problems of institutional credibility and commitment because once a firm builds a plant in a foreign country "the plant becomes a potential hostage to the host country government", which is not the case for domestic investment. Therefore, policy consistency as a proxy of good governance is a crucial factor for foreign investment. Naude and Krugell (2007) use cross-country data and find that the rule of law, accountability and political stability all significantly increase FDI location in African countries.

Bartels *et al.* (2014) examine FDI location factors in Sub-Saharan Africa using longitudinal survey data for 2003, 2005 and 2010, and they find that political-economic stability is the most crucial factor for inward FDI. Rashid *et al.* (2017) use panel data over 2000-13 for fifteen Asia Pacific countries to analyse the effect of political stability on FDI inflows, along with the domestic market size, macroeconomic stability, trade openness and economic growth. They find that political stability is the most important factor, while low inflation as a proxy of macroeconomic stability also has a significant effect. Siklar and Kocaman (2018) investigate the relationship between macroeconomic stability and FDI inflows for Turkey using monthly data over 2003-15. The research utilises unit root tests, co-integration analyses, vector error correction model and Granger causality test, and it uses the inflation rate for stability in the real economy and the exchange rate as proxy for the stability of the financial sector. They find that

fluctuations in the rates of inflation and exchange have negative and permanent effects on inward FDI, so that both forms of stability matter.

For Asian countries, Mengistu and Adhikary (2011) use panel data and find that the rule of law and political stability, together with voice and accountability, government effectiveness, regulatory quality and control of corruption, are the six key elements of good governance that significantly stimulate FDI inflows. Recent research by Uddin *et al*., (2019) use multivariate OLS regression analysis on aggregate country-level data and find that among the institutional factors, regulation is the most important factor influencing FDI inflows to Pakistan. However, Jadhav (2012) looks at the BRICS (Brazil, Russia, India, China and South Africa) and finds that institutional and political determinants do not significantly affect the FDI location decision.

2.4.4 Summary of the Empirical Evidence

This section considers the empirical evidence for the FDI location theories that are discussed in Section 2.3. These comprise the classical location factors, agglomeration economies and the institutional approaches. In general, the empirical evidence reveals that each of these factors affects FDI location, and this evidence is summarized in Table 2.2.

Table 2.2: Summary of Empirical Evidence on FDI Location

FDI theory and factor	Relationship to FDI inflows		
	Positive support	Negative support	No support or ambiguous
'OLI' Paradigm and Classical Location Factors			
Market-seeking	Haufler and Wooton (1999); Barros and Cabral (2000); Wheat (1986); Friedman *et al.* (1992); Woodward (1992); Coughlin and Segev (2000); Broadman and Recanatini (2001); Alam and Shah (2013); Aziz and Mishra (2015); Goh and Wong (2011); Zin (1999); Hiratsuka (2006); Firdaus (2010)		Villaverde and Maza (2012); Azam and Lukman (2010)
Resource-seeking	Shiells (2003); Campos and Kinoshita (2003); Asif and Majid (2018); Ryou and Song (1993)	Asiedu and Lien (2011)	Johnson (2006)

Efficiency-seeking	Sakali (2013); Hayakawa *et al.* (2013); Bellak *et al.* (2008); Woodward (1992); Coughlin and Segev (2000); Cheng and Kwan (2000)		
<u>Agglomeration Theory</u>			
Traditional factors	Monseny *et al.* (2011); Rosenthal and Strange (2001); Ellison *et al.* (2010); Kuncoro and Wahyuni (2009); World Bank (2012); Baskoro *et al.* (2019); Urata and Kawai (2000); Yeaple (2003); World Bank (2005a); Lai and Sarkar (2011)		Djulius (2017)
Geographical distance		Mateev (2009) Imansyah and Nasrudin (2016)	
Local amenities (infrastructure)	Wheeler and Mody (1992); Coughlin *et al.* (1991); Head and Ries (1996); Cheng and Kwan (2000); Kumar (2006)		Quazi (2007); Suh and Bae (2008); Azam and Lukman (2010)
Cultural proximity	Halvorsen (2012) Head *et al.* (1995); Felkner and Townsend (2011); Henderson and Kuncoro (1996)		
<u>Institutional Approach</u>			
Institutional quality	Meyer (2001); Bevan *et al.* (2004); Peres *et al.* (2018); Buchanan *et al.* (2012); Lucke and Eichler (2016); Bailey (2018); Piwonski (2010); Bissoon (2012); Kurul and Yalta (2017)	Lucke and Eichler (2016)	Ali *et al.* (2010); Morris and Aziz (2011)
Good governance	Mengistu and Adhikary (2011); Bartles *et al.* (2014); Rashid *et al.* (2017)		Jadhav (2012)

<u>Source</u>: Author’s own compilation.

Table 2.2 distinguishes between the studies that offer either positive or negative support for each of these theories, or indeed offers no support at all. This evidence is now discussed. Starting with the classical location factors, with regard to market-seeking FDI, the studies show that a larger market size overwhelmingly increases the likelihood of inward FDI in a host country, and this is the case for both developed and developing countries. In the Indonesian case, it seems market size is also an important factor for attracting FDI. However, in the case of the export-platform motive, an investor may use the host country as a production location to serve surrounding countries. Resource seekers want resources that are not available in the home country or are available there only at a higher cost (Franco *et al*., 2010). They are either natural or labour resources. For Indonesia, this is more likely to be due to natural resources-seeking

(CMCG, 2003). Meanwhile with regard to the labour resources, FDI in developed countries is more likely to seek skilled labour, but in a developing country it seeks low wages. In addition to an abundance of natural resources, Indonesia has abundant human resources, and especially low-skilled labour for labour-intensive manufacturing industries (Wells *et al.*, 2001).

Resource-seeking FDI is linked to efficiency-seeking, with investors seeking good skilled labour and greater productivity. This might be a dilemma for Indonesia, as low labour costs might not be associated with skilled and productive labour. In fact, the improvement of labour productivity in Indonesia is relatively slow, for instance from the mid-1990s to 2000s it is about 4 percent per annum, while China and Vietnam grow at rates between 10 and 20 percent (Manning, 2018). As the trend of FDI is shifting towards knowledge and skill-intensive manufacturing then the competitive advantage of low labour costs may become less relevant, especially for export-oriented firms (Noorbakhsh *et al.*, 1999).

With regard to the empirical studies on agglomeration, the evidence is that input sharing and labour market pooling are the two most important traditional factors influencing FDI inflows. This is also the case for Indonesia. Regarding the non-traditional factors, the more extensive and better quality of the infrastructure then the greater is the FDI inflows to host country. The lower level of FDI inflows into Indonesia, especially in manufacturing is potentially due to its poor infrastructure (Lipsey and Sjoholm, 2011). Firms also generally prefer to locate in similar industries, so that the cultural distance is important, while the geographical distance from the source country negatively affects FDI as it increases transportation costs.

In addition to agglomeration economies, Campos and Kinoshita (2003) argue that institutions are an important factor influencing FDI location decisions, which outweigh the importance of other economic factors, although this research shows that abundant natural resources and labour market resources are also important determinants for attracting FDI inflows. Bailey (2018) finds positive relationships between FDI inflows and each of democratic institutions, political stability and the rule of law. It suggests that a host country with good institutional quality attracts FDI. However, overall, according to Ullah and Khan (2017) the relationship between FDI and the different location determinants varies across countries and regions (including Asia) and over time. In this sense, the factors influencing FDI location decisions may be local and cannot be generalized and applied to all countries or regions in the world, so that this consideration motivates my thesis, and I explore it in the context of Indonesia below.

2.5 The Theory of Investment Incentives

FDI is a source of capital for economic development and economic growth, so that many countries seek to attract FDI using financial incentives, giving rise to competition between countries. Among the many policy instruments that are used, governments utilise investment incentives as a tool, and this is on the assumption that investors seek to profit maximize (Wells *et al.,* 2001). This section reviews the literature on investment incentives. It starts by considering the theory and how the incentives link to location, before reviewing the relationship with FDI. A contrary view is given by Wheeler and Mody (1992), who argue that developing countries that are already doing well in the provision of infrastructure, stable international relations, rapid industrial growth and an expanding domestic market, do not need to use taxes or other incentives to attract FDI. This section also considers the empirical evidence for incentives, including for Indonesia.

2.5.1 The Definition of an Investment Incentive

There is no one definition of an 'investment incentive', and indeed the literature tends to use the terms 'subsidy', 'assistance', 'grant' and 'aid' interchangeably to describe these. While these may be used in different contexts, such as who provides the incentive, its type, objective and nature of the recipients (Gerling, 2002), the differences in terminology are important as they might lead to a different understanding of the nature of an intervention. In 1972, the United States of America Joint Economic Committee defined a subsidy as "the provision of the Federal economic assistance, at the expense of others in economy, to the private sector producers or consumers of a particular good, service or factor of production" (JEC, 1972. p. 18). Thomas (2011) defines investment incentives as subsidies designed to influence the location decision of a firm, while Trojanus (1995), citing Gerling (2002, p.22), defines subsidies as the "selective financial support or other governmental assistance with no equivalent compensation from the recipients, which aims at influencing relative goods or factor prices and hence, the economic structure". He notes that subsidies and incentives are essentially interchangeable terms, which is like Field and Hills (1976), who argue that some terms have a close meaning, such as 'aid' and 'assistance'.

Although, there are conceptual difficulties in defining an investment incentive, in practice it has the following characteristics (Lehner and Meiklejohn, 1991):

(i) The intervention provides a transfer from the government sector that directly or indirectly benefits enterprises and that entails a direct budgetary cost either in terms of expenditure or revenue forgone;

(ii) The recipient must be outside the administrative sector (i.e., government);

(iii) The government must receive no equivalent compensation from the recipient in return for the transfer;

(iv) The intervention is used for the purpose of affecting a given or expected outcome of the market process by changing relative prices so as to encourage or discourage certain economic behavior, e.g., to invest or not, or where to invest; and

(v) The intervention must contain an element of specificity, so that it is destined for specific group of economic agents or for the producers of a particular product, service or factor of production.

Investment incentives can take many forms, such as a grant, tax preference, tax-free period, regulatory policy concessions or some other below-cost input (Thomas, 2011; Oman, 2000). In practice, investment incentives are classified as tax and non-tax incentives (James, 2009), and like subsidies more broadly they are the "economic advantages that government provides to specific enterprises or group of enterprises, with the goal of steering investment into favo[u]red sectors or regions, or of influencing the character of such investment" (p.1).[5] UNCTAD (2014) categorizes incentives into financial, fiscal and other measures, where the latter includes infrastructure or services, market preferences and regulatory concessions, such as exemptions from labour and environmental standards. For the purpose of this thesis, an investment incentive is defined as a government scheme that aims to stimulate investment in specific type of sectors or areas designated by the government in order to pursue certain objectives. This may be achieved through grants or possibly from a reduction in taxation that would otherwise be levied at a higher rate. Meanwhile from the investor side, investment incentives are defined as any type of government policy that favours companies (possibly in the form of a tax reduction), such as by reducing the cost of capital.

[5] It is reflected in the different types of investment incentives that are used. In Germany, incentives are provided in the form of: an investment 'bonus', which was introduced in 1990 as a means to support the acquisition of equipment; an investment grant; a depreciation allowance; tax reductions; but also subsidy programs (Gerling, 2002). In the UK the incentives have been provided in the form of: an accelerated depreciation allowance for tax purposes; investment grants (cash grant towards capital expenditures); loans on favourable terms; and specific schemes to certain sectors or areas (see Wren, 1996; Field and Hills, 1976).

2.5.2 The Rationale for Investment Incentives

In principle, following Wren (1996), the purpose of an investment incentive is to: fine-tune or stabilize the economy; correct balance of payment difficulties; redistribute economic activity between areas; encourage enterprise, innovation and technology transfer; or to potentially deal with unemployment. Eisinger (1988, cited in Peters and Fisher 2004) argues there are at least two reasons for investment incentives. First, to encourage business investment, leading to an increase in local demand for goods and services and hence to greater economic growth and new jobs. Second, to increase government revenue and thereby improve public services.

In general, it can be inferred that the role of government as a 'guardian' of the economy is to ensure all activities run well in terms of both achieving economic growth and a proper distribution of income, including job creation. In order to stimulate investment, a government can use incentives that are designed to affect the location of investment. In the UK, for example, for regional policy purposes that include financial support for FDI location, the government defines designated areas for support, known as Assisted Areas, where these areas cover the less-economically advantaged areas (DBIS, 2014). To fulfill its role a government can intervene in the market, even though as Boland (2003) argues, the investor's decision should be based mainly on market considerations. Out of the many policies that can be used, many governments that seek to attract FDI rely on investment incentives, such as tax incentives, rather than a change in the statutory tax rates. The reasons for this are that: (i) it minimizes the impact on total fiscal revenue; (ii) it is targeted to specific industries or activities that are expected to bring greatest benefits; (iii) it is expected to yield a signaling effect that shows a government's commitment to support or stimulate FDI inflows; and (iv) it is easier to execute rather than a change in the statutory tax rate that requires the support of Parliament (Morisset and Pirnia, 2000; Bond and Samuelson, 1986).

As indicated above, the decision over investment incentives is not merely economic in nature, but it also has political aspects. Indeed, Peacock (1979) argues that government policies are a means for maximizing the support of the electorate in order to extend its term of office. In this sense, investment incentives should not be considered solely as an economic decision but also as a political one. Incentives that benefit certain regions (locations) show the political preference of the government, while research by Biglaiser and Mezzetti (1997) shows that a politician's re-election concerns have an important effect on its actions. Jasinowski (1973)

argues that incentives tend to be used as political instruments to make all parties feel that the government cares about market issues, while, in some cases, politicians make decisions that further their own interests rather than that of their constituents (Biglaiser and Mezzetti, 1997). Since the government is also a political institution, not all their decisions are based purely on economic grounds, although it is difficult to prove this for certain. Most policymakers will argue that all their decisions are based on an economic rationale and not for political gains.

From an economic perspective, government intervention is needed because the market does not always work perfectly (Gerling, 2002). The legitimization for intervention is when the free market fails to make an efficient allocation of economic resources that would otherwise lead to a low level of economic growth, a balance of payments deficit, high inflation and high unemployment. Adam Smith (1776) argues that the best approach is to allow the free market to decide where resources are allocated through the 'invisible hand' of the market, which is a force of competition motivated by self-interest. The implication is that less intervention is better, since the market has its own way to find the best outcome. However, in the inter-war years between 1918 and 1939 it seems that Smith's invisible hand did not work well as many countries were in depression or faced serious economic problems. Keynes (1936) argued that in recessionary conditions private agents do not consume or invest due to uncertainty, so that the government should borrow to intervene directly in the market and increase aggregate economic demand. Of course, one way to intervene is through investment incentives.

During the economic downturn of 1990-91, Germany provided huge incentives to facilitate an economic upswing. Further, Gerling (2002) argues that the restructuring of the German economy after its reunification would not have been possible without government incentives. Many major firms would have failed to survive, while the attempt to attract investors into the disadvantaged Eastern region would have been ineffective. The incentives were expected to increase business capacity and increase demand for labour, whereas the *laissez-faire* doctrine of Smith would have greatly extended the period of economic recovery. However, it is also the case that the incentives are not a panacea for all economic problems since their heavy and sustained use is a burden on the government budget and may encourage inefficiency. Hence, they should have a clear timeframe and a clear target against which they can be assessed.

Overall, the specific rationale for implementing investment incentives, including tax incentives, varies across countries and potentially over time, as well as the nature the economic problem and the potential solutions. Often a country may use investment incentives to promote sectors

of industry or economic activities that are considered as crucial for economic development and that may enable beneficial economic and social spillovers (UNCTAD, 2000; OECD, 2018). Another rationale for these incentives is that governments seek to improve the distribution of income by influencing the location of investment in certain regions, such as in the lagging areas and away from the more-developed areas (OECD, 2018; Farole *et al*., 2018). This, of course, includes the location of FDI, although there may be a political dimension. This might include, for example, using incentives to be internationally competitive in the support offered to mobile investment to improve domestic support (Christiansen *et al*., 2003; Hadari, 1990). In all cases, the incentives are offered to change the nature or the timing of the investment decision.

2.5.3 Types of Investment Incentive

This subsection classifies investment incentives into two groups: fiscal incentives and non-fiscal incentives. Fiscal incentives include taxation, and such things as grants, subsidies, loans, wage subsidies, and job training subsidies (Tavares-Lehmann, 2016), although here the focus is on the former. Non-fiscal incentives include new infrastructure and regulatory matters, such as standards for labour and environmental conditions. They include a good investment climate, the ease of accessing land, starting a business and the ease of trade (James, 2013, p. 2).

Tax provisions are fiscal incentives that are tailored to qualifying investment projects and that are a favourable deviation from the general tax laws and regulations (Fletcher, 2002). The aim is to increase the rate of return of a certain investment or to reduce its risks and costs by reducing the tax burden (UNCTAD, 2000). They can be of many different types: tax havens, tax holidays, reduced corporate income tax rates, investment tax credits, loss carry-forwards, investment allowances, accelerated depreciation, enhanced deduction for qualifying expenses, reduced tax rates on dividends and interest paid abroad, preferential treatment of long-term capital gains, and zero or reduced tariffs (UNCTAD, 2000; Morisset, 2003). According to Fletcher (2002), each has its own advantages and disadvantages, as summarised in Table 2.3.

Table 2.3: Advantages and Disadvantages of Different Tax Incentives

Tax Incentives		
Type	Advantages	Disadvantages
Lower CIT rate	▪ Simple to administer ▪ Revenue costs are more transparent	▪ Largest benefits go to high-return firms that are likely to have invested even without incentive. ▪ Invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing ▪ Acts as windfall to existing investments ▪ Unlike specific benefits may not be tax spared by home country tax authorities
Tax holidays	▪ Simple to administer ▪ Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt) ▪ Same as lower CIT rates, except might be tax spared	▪ Attracts short-run projects ▪ Invites tax avoidance through the indefinite extension of holidays via creative resignation of existing investments as new investment ▪ Creates competitive distortions between old and new firms ▪ Revenue costs are not transparent unless tax filing is required, in which case administrative benefits are foregone
Investment allowances and tax credits	▪ Can be targeted to certain types of investment with highest positive spillovers ▪ Revenue costs are more transparent	▪ Distorts choice of capital assets in favour of short-lived ones, since a further allowance is available each time an asset is replaced. ▪ Qualified enterprises may attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances ▪ Greater administrative burden ▪ Discriminates against investments with delayed returns if loss-carry-forward provisions are inadequate.
Accelerated depreciation	▪ All of the benefits of investment allowances and credits ▪ Does not generally discriminate against long-lived assets ▪ Moves the CIT closer to a consumption-based tax, reducing the distortion against investment typically produced by the regular CIT	▪ Discriminates against investments with delayed returns of loss-carry-forward provisions are inadequate
Exemptions from indirect taxes (VAT, import tariffs, etc.)	▪ Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt)	▪ VAT exemptions may be of little benefit – under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage ▪ Prone to abuse – easy to divert exempt purchases to unintended recipients
Export processing zone [Special Areas]	▪ Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt)	▪ Distorts locational decisions ▪ Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base.

Source: Fletcher (2002).

In terms of the investor type, tax incentives are more effective in attracting efficiency-seeking FDI since it lowers the cost of production (Andersen *et al.*, 2018). This is also more likely for export-oriented rather than market-oriented firms (Reuber, 1973; James, 2009). To make an efficient use of tax incentives in the case of FDI, James (2013) constructs a typology of the tax incentives, as reproduced in Table 2.4. This suggests that taxes are relevant for influencing an investor's location decision when the motivation is efficiency-seeking, but that they may be weak where the motive is for market, resources or strategic-assets.

The provision of a fiscal incentive is inefficient if it is larger than is strictly needed to fulfill its aim, such as the attraction of FDI. This is sometimes known as 'non-additionality' (see Wren, 2005) and it arises because the "tax incentives have been granted for the establishment of firms that did not require them, because the subsidized investment displaces other investments of potential new firms or of established firms, or because the subsidized firms drive other firms out of business" (Usher, 1976, p. 137; Wren, 2005). A simple transfer of funds from the government to a firm without any consequent change in behaviour is inefficient, since all tax carries an 'excess burden', which is a net welfare loss to the economy from a distortion of economic activity due to the taxation (see also Te-Velde, 2001).

Table 2.4: Typology of FDI, Tax Incentives and Responsiveness

Type of Investment	Factor that drives investment	Responsiveness to tax incentives
Market-seeking	Market potential ▪ Market dimensions ▪ Income per capita ▪ Customer specific preferences ▪ Nature of goods and services	Low response. Level playing-field between firms is critical (same tax system for all competitors).
Resource-seeking	Acquisition of natural resources / skills / agglomeration benefits	Low response. FDI driven primarily by non-tax factors
Efficiency-seeking	Lower Costs ▪ Mostly export oriented ▪ Availability of skills at low-cost ▪ Close to markets ▪ Low relocation costs	High response. Firms are expected to compete globally, hence the lower the costs, the better their ability to compete globally
Strategic Asset-seeking	Acquiring Strategic Assets ▪ Brands and market positioning ▪ Know-how ▪ Technology ▪ Distribution networks ▪ Human capital	Low response. FDI is driven by the location of the asset. However lower taxes on capital gains reduces the costs of the transfer of these assets.

Source: Adapted from James (2013).

2.5.4 Political Economy of Investment Incentives

Apart from the positive effects, investment incentives for FDI attraction can have negative impacts and unintended consequences. One of these is a Prisoners Dilemma problem, which is articulated by Halvorsen (2012, p. 670) as follows: "…states often became engaged in bidding wars for the plants – undercutting the potential value of the deals for the winners of these contests". The dilemma occurs as every local, regional or national agent is locked into continuing incentives, which individually have no effect, but that in the aggregate favour the investors, but with an Exchequer cost to each government agent. Indeed, the 'beggar-thy-neighbour' competition may lead to a 'bidding war', such that the incentives that are offered are larger than necessary and the agent regrets the subsidy amount given, which is a form of 'winner's curse' (see Oman, 2000; Christiansen *et al.*, 2003; Nov, 2006; Thaler, 1988).[6]

In general, governments seek investors and investors seek locations, but this relationship is complicated by asymmetric information (Thomas, 2000). The issue is that a government has little information about the intention of a potential investor (e.g., its cost or other offers), but an investor will find it relatively easy to get information about what a government is prepared to offer, since this kind of information is either published or inferred from the government's policy stance. This imbalance in information is detrimental to the government position since Stiglitz (2002) argues that even a small information asymmetry can lead to large differences in the outcome of a bargaining situation. It potentially means that the investor can negotiate to gain more investment incentives from a government than is strictly necessary.

A further problem is that having received an incentive a company could close its operation and start a new company and thereby request further incentives. This could occur for a single country or across countries. The life-cycle theory and the principle of a 'going concern' does not really apply in this case. Moreover, a host country may believe that FDI will bring some positive externalities or spillovers, but in practice a firm may internalize its ownership advantage and not share it with others. Finally, to combat the 'race to the bottom' in tax incentives, Nov (2006) argues that there should be an international agreement on this between governments, which will: (i) limit targeted tax incentives or eliminate them altogether; and (ii)

[6] OECD (2003, p. 12) define FDI competition as "situations in which authorities are induced to make available incentives or modify the FDI incentives they offer (i.e., by making them more generous) as a result of the incentive strategies pursued elsewhere". Another definition on FDI competition by OECD (2003, p.8) is "a situation in which it is individually rational for authorities to increase their offer of incentives to firms, but the collective effect of this competition may produce unintended consequences".

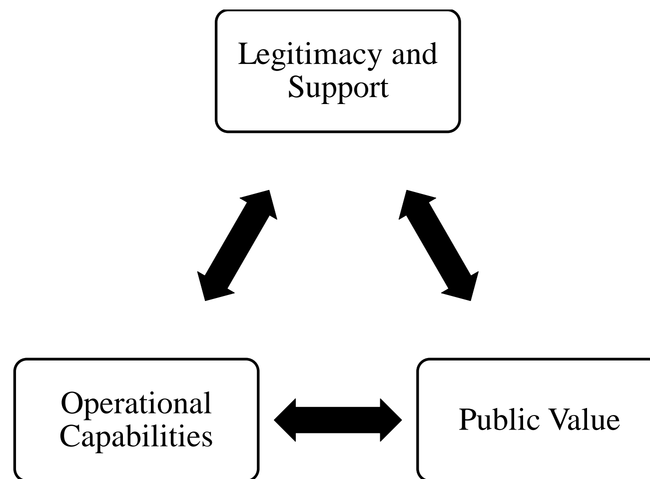
monitor the agreement and impose sanctions on any government that breaks it.

Overall, it could be argued that investment incentives are an undesirable policy, since each country may not implement them if others also chose not to (Tavares-Lehmann, 2016). In practice, because everyone provides incentives, a country may feel that they have to be in the 'race' if they want investment to be located in their country, i.e., the Prisoner's Dilemma problem. A counter argument is that incentives require an increase in government expenditure and that this prevents a 'race to the bottom', since the subsidies must be balanced against the loss of public expenditure, which in fact might discourage FDI. As a further issue, there is considerable variation in the quality of FDI and its impact on a host country. Davies and Ellis (2007) argue that the benefits of FDI are increased through Performance Requirements (PRs), which are "stipulations, imposed on investors, requiring them to meet certain specified goals with respect to their operations in the host country" (UNCTAD, 2003, p. 2). The PRs could include local content requirements, export controls, the requirement to establish joint venture with domestic firms, a requirement to locate the company headquarters, employment, R&D and other requirements. In practice, the PRs can be used to complement investment incentives to enhance the development aims, as well as to prevent market failures or to mitigate the unintended consequences of FDI (UNCTAD, 2003).

2.5.5 The Public Value Framework

As a tool for assessing the existence and continuation of tax incentives, in conjunction with the institutional approach that views the reason for investment as due to institutional legitimacy, this study employs the Public Value Framework (Moore, 1995). This framework can be viewed as a 'critical lens' through which to assess public policy, which is based on the following three strategic aspects: public value; operational capabilities; and legitimacy and support. These interact, and a schematic is shown in Figure 2.2, on which I say more below.

Figure 2.2: Public Value Framework



Source: Moore, 1995.

First, government policy must be something substantively **valuable**, such as maximizing social welfare (e.g., enhancing economic growth, creating new employment, improving economic distribution). However, as public policy is a political activity then it cannot be guaranteed to be absolutely free from political influences. In this case, tax incentive policy might also be used to fulfil political objectives of the policymakers. As argued by Bellak and Leibrecht (2016, p. 64), "… politicians and bureaucrats use taxes and public expenditures to increase their re-election probability or to maximize their own status and influence in political decision making, respectively". Understanding public value is difficult, as 'valuable' is subjective and it can be difficult to find common agreement on its meaning. For example, we might try to analyze the 'value' based on Cost-Benefit Analysis, but this is contentious and the benefits and costs of the policy impact might not be easily measured in monetary terms.

Second, **operational capabilities** mean that the policy must be something that is operationally and administratively feasible to be conducted (i.e., 'doable') by the policymakers (government). The ability of a government to conduct tax incentives policy varies across countries, but in practice, as there are many types of tax incentives, then a government can potentially fit these to their operational capabilities (i.e., budget, administrative system and so on). For example, due to limited cash reserves, developing countries are more likely to use the incentives in the form of allowances or tax exemption, rather than grants or subsidized loans (UNCTAD, 2000).

Third, in order to make the policy sustainable then it should be **gain legitimacy** and **support** from the public and within the government itself. Legitimacy and support are crucial aspects to ensure that the policy can be implemented. Unlike the private sector, where legitimacy and support are based on the willingness of consumers to pay for a product or service, in the public sector the assessment of the legitimacy and support for a policy is more complex.

2.6 Empirical Evidence on Investment Incentives

There is a large literature on investment incentives and their relation to FDI inflows, but this suggests that they have mixed effects (see Bailey (2018) for a meta-analysis). In order to discuss the nature of this evidence I separately consider investment incentives in the form of tax and non-tax incentives. As a tax incentive is part of fiscal policy more broadly, then where necessary I sometimes include them in the discussion of subsidies and grants. The tax incentives and their relation to FDI is discussed according to three important characteristics: the country characteristics, the investment motive and the tax incentive type. The first of these is for developed and developing countries according to the World Economic Situation and Prospect criteria (United Nations, 2017).

2.6.1 Tax Incentives

Country characteristics

Developed countries have a much longer history in the use of tax incentives (and subsidies) compared to developing countries (Thomas, 2007, 2011). Developed countries such as the United Kingdom (UK) used subsidies as part of the Navigation Acts as far back as the 17th century (Wren, 1996), while the United States of America (USA) started to use subsidies in the 19th century for developing the railroads (Sbragia, 1996). Much more recently, Head *et al.* (1999) assesses the effectiveness of USA state promotion efforts, examining 760 Japanese firms locating in the USA over 1980-92. He finds that the provision of foreign trade zones, lower taxes and subsidies have statistically significant effects on FDI, although only a small impact on its distribution. A similar result is obtained by Axarloglou (2005), who explores USA FDI inflows over 1974-94 using panel data, and finds that tax incentives are important for attracting FDI inflows to America. However, even though the USA (both state and local government) generally provides higher incentive rates (subsidies) compared to the European Union, Thomas (2007) argues that its effect on investment location is relatively small.

Buettner and Ruf (2007) examine German multinational companies' investment decisions in 18 developed countries (i.e., 14 EU countries, USA, Canada, Japan and Australia). This finds tax incentives have a significant effect on investment location. Furthermore, apart from the significant effect of tax incentives on investment, the research reveals that statutory tax rate is "the strongest predictive power and yields the strongest effects" (p. 162). Looking at the UK, Devereux *et al*. (2007) explore the relationship between government subsidies under the Regional Selective Assistance (RSA) scheme and the attraction of new plants to the Assisted Areas (areas with a low growth rate and above average unemployment). The period is 1986-92 and it shows that the fiscal incentives (RSA grants) have a small effect in attracting plants, although less responsive to areas with fewer existing plants from the same industry. Also, for the UK, Wren and Jones (2011) assess the effect of government regional grants on FDI over 1985-2005 using a Generalized Methods of Moments estimator. It finds a significant effect of the grants on FDI across the UK regions, although when compared to the scale of FDI, the grant impact is relatively minor (Wren and Jones, 2011). Hence, in general, tax incentives (subsidies and grants) do have significant effects to FDI inflows in developed countries, but the overall magnitude tends to be relatively small, but perhaps reflecting their scale.

Developing countries are a more recent focus for FDI location. Chang and Cheng (1992) investigate the relationship between tax incentives and inward FDI in Taiwan using firm-specific FDI data over 1984-86 and aggregate time series FDI data over 1972-87. They find that tax incentives have an insignificant effect on FDI, including for manufacturing firms, although tax holidays have a significant positive effect on investment in electronics. Almost two decades later, Van-Parys and James (2010) find that over the period 1994-2006 tax incentives are ineffective for attracting FDI in 12 African Franc Zone countries (countries which common currency language that is French). Tuomi (2011) undertakes research for South Africa using survey data and firm interviews, and also finds that the tax incentives play a negligible role in the investment decision for the majority of investors. A similar finding is found by Klemm and Van-Parys (2012) who explore the effectiveness of tax incentives in attracting FDI to over forty Latin America, African and Caribbean countries. This research uses dynamic panel data econometrics for the period 1985-2004, and finds that longer periods for tax holidays are effective in Latin America and the Caribbean, but not for Africa.

With regard to South-East Asian countries, in the case of Malaysia, Boadway *et al*. (1995) find that a tax holiday does not promote investment in the targeted activities and nor does it assist infant industries or disadvantaged economic and social groups. In Thailand, Halvorsen (1995)

finds that corporate tax holidays are ineffective as an investment incentive, since the investment projects would have taken place regardless of the incentives as the rates of return are high, so that the expenditure was 'non-additional' (Halvorsen, 1995). Looking at another South-East Asian country, Botman *et al.* (2010) examine the general tax provision and tax incentives for the Philippines compared to Malaysia, Indonesia, Lao, Vietnam, Cambodia and Thailand. The research shows that the investment incentives are comparable across countries, but the effective tax rate is relatively high in the Philippines. With regard to specific tax incentives, a tax holiday is most attractive for highly-profitable firms, which tend to be more mobile.

In the case of Indonesia, Wells *et al.* (2001) find that the elimination of the tax holiday in 1984 had no significant impact on FDI inflows after, although caution needs to be exercised as the investors were also compensated by a reduction in the statutory corporate income tax rate from 45% to 35%. A decade later, Fahmi (2012) conducts research using an Ordinary Least Squares regression with data from 1981 to 2010, and finds that a tax holiday has an insignificant relationship with FDI inflows. However, Taufik (2014), using a multiple regression model and time series data over 1985-2011, finds that the tax incentives have a significant effect on FDI inflows to Indonesia. More recently, research conducted by Sari *et al.* (2015) on the effect of the tax holiday on economic growth is inconclusive, partly because it may be too soon to explore its effect. Research on specific tax incentives by Basalamah *et al.* (2018), using a descriptive analysis that focuses on the implementation of tax allowance, is also inconclusive, so that all in all the evidence for Indonesia is somewhat uncertain.

Overall, comparing the use of tax incentives between developed and developing countries, Keen and Simone (2004) argue that tax competition has been more pronounced in developing countries. Competition among developing countries is not limited to a reduction in statutory tax rates, but also in the generosity of tax holidays and other tax incentives for attracting FDI inflows (Keen and Simone, 2004). Tax incentives seem to matter for investors when they invest in developed countries, but less so for developing countries. The empirical evidence suggests that this is because the investment climate is similar between developed countries (i.e., in the infrastructure, government service, etc.), so that tax incentives are an important differentiator, whereas in developing countries there are large differences in many fundamental factors, so tax incentives are less important (Keen and Simone, 2004). However, even though they might be categorised as developing countries, each country is unique and they are diverse in nature. This is found by Asiedu (2002) in his research on Sub-Saharan Africa where he finds that the factors that drive FDI flows to this region differs by country (Asiedu, 2002 and 2006).

The investment motive

According to Andersen *et al.* (2018) not all FDI is the same, but that among other things it differs according to the motivation for conducting investment. Following Dunning's classifications set out in Section 2.2.4, this can be grouped into market, resource and efficiency-seeking that are related to the location decision (Dunning, 2000). With regard to the link between taxation and the FDI motive, Nuta and Nuta (2012, p. 57) note that the "effectiveness of fiscal incentives varies depending on the business activity in question and its motivation to invest abroad". Of the three asset-seeking motives, efficiency-seeking seems to be most closely related with the availability of tax incentives, since Kransdorff (2010) argues that they are less important where the investor is either market or resource-seeking. This is because the FDI location decision is closely tied to the market size or availability of resources in a particular country (Dunning, 2004). This is emphasized by others, including the World Bank (2018a) and Andersen *et al*. (2018), with the latter arguing that tax incentives for market- and resource-seeking FDI is likely to be redundant, and therefore should be targeted for elimination.

The above evidence suggests that tax incentives are more attractive for foreign investors from the manufacturing sector with a strong export orientation (Grubert and Mutti, 2000). Indeed, Van-Parys and James (2010) find a positive effect for a tax holiday when targeted at export-oriented firms for twelve Sub-Saharan Africa countriess, and Rolfe *et al.* (1993) gets a similar result for the Caribbean. The central point of efficiency-seeking FDI is that it is about minimizing operating costs, and as argued by Morisset and Pirnia (2001) this investment is more footloose as it competes in highly-competitive international markets. The tax incentive is important for firms operating in multiple markets, such as banks, insurance companies and electronic business, as they can exploit the tax structure of different countries (Nuta and Nuta, 2012). This finding emphasises the point of Clark (2000, p. 1179) who states that "the more mobile the activity, the greater the impact of tax incentives". The investment climate is also important since if it is weak, then a firm will not invest even with generous tax incentives (Anderson *et al.*, 2018), and this is what the evidence for developing countries suggests.

The tax incentive type

As previously noted, there are many forms of tax incentive, although only a few of them are applicable to Indonesia, which is the focus of my dissertation. As indicated above, developed countries tend to utilise investment incentives in the form of subsidies (grants) and local taxes (Goodspeed, 2006), but developing countries do not have the level of resources implied by

subsidies and that involve up-front costs, so that they are more likely to utilise tax holidays and tax allowances (Moran, 1998). We now consider the evidence for these different types of tax incentive, distinguishing between profit-, cost- and location-based activities.

Profit-based tax incentives include the tax holiday, which is utilised by many countries that have a tax incentive policy. Indeed, for Sub-Saharan Africa, Keen and Mansour (2009) find a big shift in the use of the tax holidays, from less than 50 percent in 1980 to more than two-thirds by 2005. In general, the tax holiday is more popular in developing countries compared to developed countries (Klemm and Van-Parys, 2012), and this is confirmed in Table 2.5, which summarises data collected by UNCTAD in 1995. Table 2.5 presents data that has been collected by UNCTAD (1995) on the use of different tax incentives across 103 countries. It provides a disaggregation between developed and developing countries. However, tax holidays have issues since Botman *et al.* (2010, p. 173) argue that "tax holidays are generally not well targeted so that it is considered as the most damaging form of tax incentives and may jeopardize the wider tax system". With regard to its effectiveness, profit-based tax incentives (i.e., tax holiday) shows conflicting results. Taking the Indonesia context, Fahmi (2012) finds that the tax holiday is convincingly proven not to be significant in influencing inward FDI. However, Cleeve (2008) finds an opposite result as his empirical research shows that tax holidays are very important factor for attracting FDI to Sub-Saharan Africa.

Table 2.5: Types of Incentives in Developed and Developing Economies, 1995

Region/ Incentives (countries)	Developed			Developing			Total
	N. America (2)	Europe (45)	Others (4)	L. America (12)	Asia (17)	Africa (23)	(103)
Tax holidays	2	26	2	8	13	16	67
Accelerated depreciation	2	16	3	6	8	12	47
Investment allowances	-	8	-	9	5	4	26
Import duty exemption	2	20	2	11	13	15	63
Duty drawback	1	18	2	10	8	10	49

Source: UNCTAD (1995).
Notes: N. America = North America; L. America = Latin America and the Caribbean.

Cost-based tax incentives include tax allowances and tax credits. Basically, a tax allowance is an allowance against a certain proportion of qualifying capital expenditure incurred within a

certain period of time from the effective date of the tax incentive. It can therefore be used to offset the statutory taxable income in the year of assessment, although compared to the tax holiday it is less popular. Table 2.5 shows that more than 65 percent of countries utilise the tax holidays (67 of 103 countries), but only about 25 percent of them use investment allowances (26 countries), so that cost-based measures are much less popular. A reason for this could be that their value to the investor ultimately depends on the fulfilment of certain conditions (Andersen *et al*., 2018), so they are less certain and hence less attractive. With regard to the effect of the tax allowances on FDI location, Klemm and Van-Parys (2012) find that they do not have any significant impact on investors' decisions to invest in Latin America, Africa or the Caribbean countries, which is the opposite to the result they find for the tax holiday.

Location-based tax incentives are the tax incentives that are applied in specific geographical areas only, such as Special Areas (SAs) and Special Zones (SZs), but which are also known as Special Economic Zones (SEZs), Free Trade Zones (FTZs) or Bonded Zones (BZs).[7] SAs and SZs are "geographically limited areas in which qualified firms can locate and thus benefit from exemption of varying scope of taxes and/or administrative requirements" (Abramovsky *et al*., 2018, p.14). As such, these zones offer facilities that are provided by the government in a location, including exemptions from or a reduction in taxes. In general, the purpose is to reduce the production costs of the companies that are export-orientated. Focusing on Sub-Saharan Africa, Keen and Mansour (2009) find that the number of countries offering these zones has increased significantly between 1980 and 2005. As regards the empirical evidence, Graham (2004) finds that SAs in China in the form of SEZs attract FDI inflows. The success of these SAs has continued as Zeng (2010, p.14) argues that the "SEZs are a major platform for attracting foreign investment". However, this needs to be viewed in the context of China, and I provide evidence in the case of Indonesia in Chapter 6.

2.6.2 International Nature of Tax Incentives

Many developed and developing countries employ tax incentives as a strategy for attracting FDI inflows. In Southeast Asia, at least seven countries (Malaysia, Philippines, Indonesia, Thailand, Cambodia, Vietnam, Lao PDR) employ tax incentives in various forms to this effect (Botman *et al*., 2010). It potentially leads to international tax competition, but in order to avoid

[7] There are many definitions regarding Special Area or Special Zones, but in general they are areas for investment location with specific tax advantages or preferences provided by the government. There are many terms for these, such as Bonded Zone, Free Trade Zone, and Special Economic Zone, which are considered below in Chapter 3.

excessive and unhealthy competition, some countries would have sought to ensure cooperation. This includes codes of conduct for business taxation to avoid 'harmful' tax measures (Morisset, 2003). For instance, the European Union has determined not to use certain tax incentives for investment attraction, such as tax holidays, although it is non-binding on Member States (IMF, OECD, UN and WB, 2015). As such, it is evident that international or regional cooperation on tax matters is not an easy task since countries have their own domestic priorities. In the case of Indonesia, the tax holiday was eliminated in 1984, but even within the ASEAN, where there is economic cooperation, no other country has followed this move (Wells *et al*., 2001).

Regardless of the development stage, both developed and developing countries employ a wide variety of tax incentives. According to UNCTAD (2000), developed countries more frequently use financial incentives such as grants, subsidized loans or loan guarantees, but for developing countries they are more likely to employ incentives that do not require government cash funds, as they might have large budget deficits. Cooperation to avoid excessive use of tax incentives has been on the agenda of international organizations for almost a decade. They have initiated to framework for more effective tax systems, including tax incentives (IMF, OECD, UN and WB, 2011), but in fact international cooperation is easier said than done. However, even though it is difficult to achieve, international tax cooperation between countries is worthwhile since the competition can end-up with a 'race to the bottom' that leads to a 'winner's curse', i.e., countries that 'bid' the most resources to secure an investment may subsequently regret the sum involved in terms of the future benefits received. Moreover, if investors are footloose, then there is no guarantee that an investor will not subsequently uproot and move out to another country with an even better offer in due course, such is the nature of international tax competition.

2.7 Conclusions

This chapter has presented and discussed the theoretical and empirical evidence regarding the nature of FDI, its location and the role of tax incentives and non-tax factors in attracting FDI. The chapter commenced with a discussion of the theories that explain the reasons for foreign investors to conduct FDI, starting with the classical trade and factor proportion theories, and leading to the product life cycle theory and firm-specific ownership advantage theories. The conclusions drawn from the existence of such a wide range of explanations of FDI is that no single theory can sufficiently explain FDI, so that an eclectic approach is needed that draws upon the combination of existing theories on FDI. This is the eclectic or OLI paradigm, which

even though is not free from criticism remains, up to the present, the most used theory to explain FDI and its location, especially in the international business literature.

Following the review of why FDI exists, the chapter considers the theories that explain FDI location, and in particular why foreign investors decide to invest in one location (or country) rather than another location (or country). Of the many approaches, three FDI locational theories are considered, which I think are the most relevant for explaining FDI located in Indonesia. These are the OLI paradigm, agglomeration economies and the institutional approach. The first two focuses on economic perspectives, while the last represents non-economic perspectives. Based on the OLI paradigm, there are three motives for foreign investors to conduct foreign investment. These are market-seeking, resource-seeking and efficiency-seeking, which together are considered as asset-exploiting motives. Regarding agglomeration economies, this chapter focuses on traditional (i.e., input sharing, labour market pooling, knowledge spillovers) and non-traditional factors (i.e., geographical distance, local amenities, cultural distance). In addition to the other two theories, this chapter includes the institutional approach as it is believed that good institutions, political stability and rule of law make foreign investors feel more secure, and so encourage FDI location.

The chapter also discusses the empirical evidence for FDI location, considering evidence for different countries, but with a focus on the evidence for developing countries, such as Indonesia, and on the asset-exploiting motives. In the case of market-seeking FDI the empirical research generally shows that the larger is the host country market then the greater is the attraction of FDI. However, notwithstanding this, other research shows that a foreign investor might consider a location as an export-platform to other countries, and so are less concerned about the domestic market size. In the case of Indonesia, empirical evidence shows conflicting results as there is research that finds that market size is statistically significant in influencing FDI location at the provincial level (Firdaus, 2010), while other research cannot find significant effects for Indonesian market size (Azam and Lukman, 2010). Of course, FDI might locate for reasons of resource-seeking, for example, if a location has an abundance of natural or labour resources. However, the availability of natural resources might have negative effect on FDI if host country exports are dominated by natural resources (Asiedu and Lien, 2011). The dominant exports on natural resources will lower the capital accumulation and lead to lower economic growth. As regards efficiency-seeking, in general FDI flows to a location where the foreign investor can develop its production in the most efficient way, although lower costs may not always be the decisive factor if it is not accompanied with high productivity.

With regards to agglomeration economies, this chapter considered both traditional and non-traditional factors. In the first case, according to Marshall, agglomeration economies occur due to input sharing, labour market pooling or knowledge spillovers. Of these, input sharing and labour market pooling seem to be the main factor attracting FDI inflows. This is the case for Indonesia, where there is evidence for the textile manufacturing industries (labour-intensive in nature) that shows location is mainly in Java due to abundant labour as well as vertical integration with suppliers and consumers. In the case of non-traditional factors, agglomeration economies occur as the result of geographical distance, local amenities and cultural distance. In general, the smaller is the distance between home and host country the greater amount of FDI is attracted, while a better quality of local amenities (such as infrastructure) and a closer cultural connection will also attract inward investors. Institutional factors are also important in attracting FDI inflows, as in general the empirical research shows that good institutions will attract FDI inflows. The good institutions can be measured in the form of low corruption index, rules of law (legal certainty), and political stability. Overall, the empirical literature shows a range of location determinants, but where the importance of each location factor varies due to the type of FDI and the country-specific characteristics of each host and home country.

In order to boost inward investment, many governments utilize investment incentives. In general, there are two types of incentive: fiscal and non-fiscal incentives, where the former includes taxation incentives and the latter focuses on creating a good investment climate. The main purpose of investment incentives is to stabilize the economy, encourage investment and potentially deal with unemployment and there are a number of reasons why countries favour the use of incentives: (i) it minimizes the impact on total fiscal revenue, (ii) it can be targeted to specific industries, (iii) it can act as a signaling effect, and (iv) it is easier to execute rather than changing the statutory tax rate. As governments however are a political institution, then not all their decisions may be based purely on economic grounds so that the decision over the use of investment incentives may also involve a political aspect.

This chapter has also presented empirical evidence on investment incentives as a location determinant of FDI. In the case of tax incentives, it is found that there is no universal effect of tax incentives in relation to inward FDI. Tax incentives are however more likely to be successful in attracting FDI when it is implemented by a country that has a good investment climate, which is generally the case in developed rather than developing countries. Further, it is found that the impact of tax incentives on FDI, as is the case with other location determinants,

varies across countries, industries and even amongst firms within similar industries. In the case of Indonesia, there are only a few studies that analyse the impact of tax incentives. In turn, these tend to focus on tax holidays and overall the evidence is mixed so that the impact for Indonesia is somewhat uncertain. One of the themes that also emerges from the empirical evidence is that tax incentives can have a strong effect on FDI location, but only when the 'non-tax incentives' are favourable so that a good investment climate is a prerequisite for tax incentives to be effective. As many countries utilise tax incentives, international cooperation is needed to avoid excessive tax competition that may cause a 'race to the bottom'.

Overall, inward investment activity is a complex phenomenon and no single theory is superior in understanding and explaining all of its aspects. Therefore, a mix of theories and approaches is needed. In this context, the eclectic or OLI paradigm in addition to agglomeration economies and the institutional approach can be used to better understand the essence of inward investment decisions. Regarding the role of government policy, tax incentives should not necessarily be a stand-alone policy as its effectiveness is very much influenced by many other factors that include non-tax incentive policies as well as a range of country-specific characteristics. In general, the factors influencing FDI location decisions cannot be generalized and instead vary in their importance across countries and regions. Therefore, in order to analyse FDI location in the context of Indonesia, background information on the nature of the Indonesian economy and the role of FDI policy in Indonesia is provided in the next chapter.

Chapter 3. The Indonesian Economy and FDI Policy

3.1 Introduction

The purpose of this chapter is to provide background context on Indonesia in order to better understand the nature of this country as a location for foreign direct investment. The chapter is therefore a foundation to the subsequent discussion and analysis of foreign direct investment in Indonesia in the next chapters. In general, it outlines a picture of the Indonesian economy and traces its political and economic history to its present day in order to understand the current structure of the Indonesian economy. Further, the chapter points out the importance of taxation to the Indonesian economy and highlights its role as an instrument for attracting foreign direct investment. In addition, the chapter describes the broader policy background towards foreign direct investment and explains the use of Special Areas in Indonesia as a policy tool for FDI location, describing the level of institutional support offered to foreign investors.

The structure of the chapter is as follows. Section 3.2 begins with the background context on Indonesia covering its geographical features that are important to understanding its position in the global economy, as well as the political and economic history of Indonesia and structure of its economy. Section 3.3 provides information on the policy environment for attracting FDI and explains the different types of policy area used to attract foreign direct investment and how they differ. Taxation incentives as a factor for FDI location are discussed as well as how they are linked to the different policy areas. The section also outlines the wider policy environment, including the role of institutions and infrastructure. The final section concludes.

3.2 Background on Indonesia

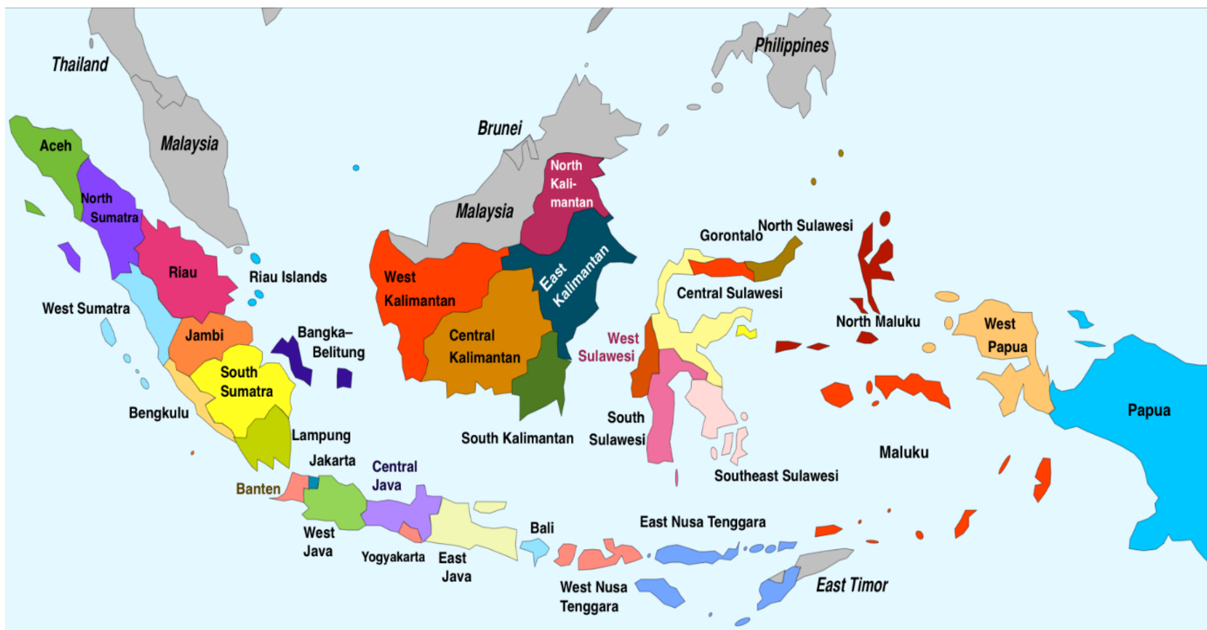
In order to better understand Indonesia as a location for foreign direct investment this section provides some background, covering firstly, its physical geography and location in the global economy, and secondly, an overview of its political and economic history. For the latter, the focus is on the political and economic history following Indonesian independence in August 1945. It covers the subsequent three main political eras of: the 'Old Order', the period after Indonesian independence until the political succession of President Sukarno in 1967; the 'New Order', the 32-year period of President Suharto; and the 'Democratic Reform Order', the period after President Suharto stepped-down in 1998 up to the present time. The section also describes

the current structure of the Indonesian economy, highlighting the importance of taxation for state revenue, and provides an overview of the tax administration system in Indonesia.

3.2.1 Geography of Indonesia

Indonesia is the largest archipelago in the world, consisting of over 17,000 islands scattered on the equator, from 94º45' to 141º01' east longitude and from 06º08' north latitude to 11º05' south latitude (Ministry of Industry, 2016; BPS, 2015). It is located across two continents, Asia and Oceania, and also two oceans, the Pacific and the Indian Oceans. Indonesia has more than 1.9 million square kilometres of land area, and including its maritime area covers an astonishing 7.7 million square kilometres (BPS, 2015). Figure 3.1 presents a map of Indonesia showing the six major regions and the 34 provinces, which are distributed as: 10 provinces in Sumatera, 6 provinces in Java (including Jakarta as the capital city), 6 provinces in Sulawesi, 5 provinces in Kalimantan, 4 provinces in Papua-Maluku, and 3 provinces in Bali-Nusa Tenggara.

Figure 3.1: Political Map of Indonesia

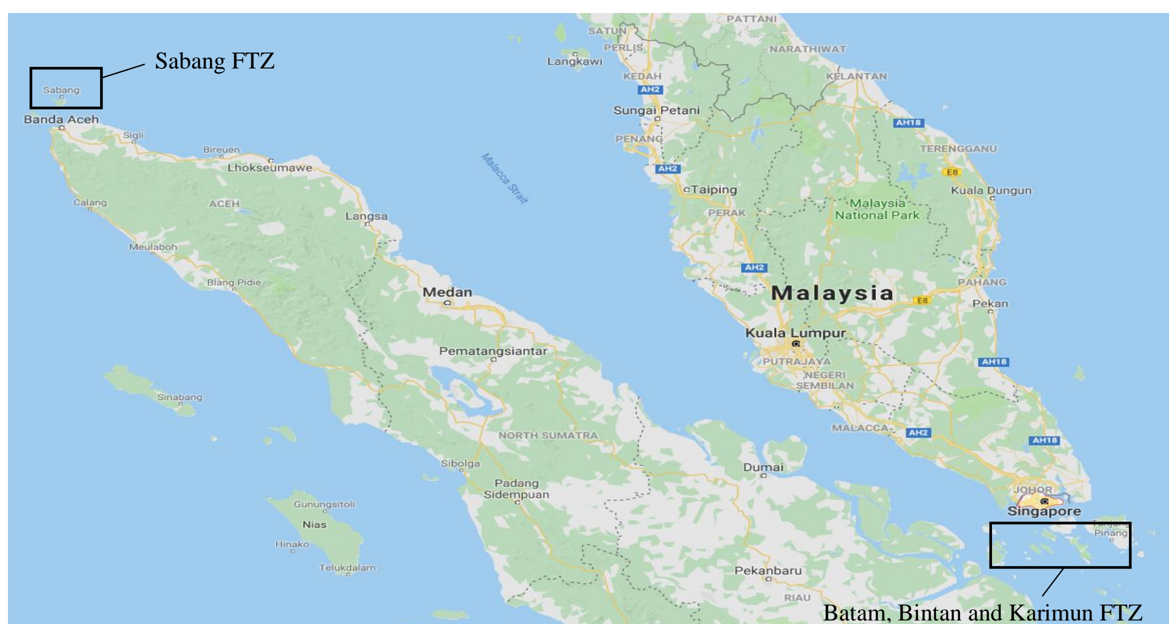


Source:
http://www.geocurrents.info/gc-maps/geocurrents-maps-by-country/geocurrents-maps-of-indonesia

Indonesia not only covers a vast land area, but its ocean water territory is even greater covering approximately 5.8 million square kilometres and accounting for roughly three-quarters of the total area of Indonesia (BPS, 2016). Indonesia is therefore seen as a maritime country and has an important strategic role in international shipping transportation lanes, including a number of key international shipping transportation lanes, such as the Malacca Straits, Sunda Straits, Lombok Straits and Makassar Straits. Among these, the Malacca Straits is considered the most important and covers a distance of 600 miles running northwest to southeast between Indonesia and the coastline of Thailand, Malaysia and Singapore (Ho, 2006; Matthews, 2015). The Malacca Straits is a main corridor for connecting the Indian Ocean and the Pacific Ocean, and therefore the major economies of the Middle East, China, Japan, and Korea, so that it is one of the most important international shipping lanes in the world (Qu and Meng, 2012). As such, it is one of the busiest waterways in the world, with around 70,000 ships passing through it each year and carrying about a third of the world's total traded goods (see Simon, 2011).

Indonesia considers the area along the Malacca Straits a strategic location for business and trade, with the establishment of the Sabang Free Trade Zone (FTZ) in the northernmost and westernmost city of Sumatera in Aceh Province, as shown in Figure 3.2 below. In addition to the Sabang FTZ, Indonesia has the Batam, Bintan and Karimun (BBK) FTZ that is located in the Malayan peninsula close to the end of the Malacca Straits. This is in the Riau Islands Province, which as Figure 3.2 shows, is in close proximity to Singapore (Hutchinson, 2017).

Figure 3.2: The Malacca Straits and Indonesia FTZs



Source: https://www.google.co.uk/maps/place/Singapore

A major geographical feature of Indonesia is that it lies in one of the most volcanically active and earthquake prone areas of the world, the so-called 'ring of fire' (as discussed in Chelminski, 2018; Wardani and Muntohar, 2013). This might adversely affect an investor's decision to locate in Indonesia, with evidence that natural disasters have a negative impact on FDI inflows (Escaleras and Register, 2011; Anuchitworawong and Thampanishvong, 2015). From a survey questionnaire, Hoshit (2018) shows the percentage of investors who put concerns about natural disasters in potential host countries rising from 16.5 percent in 2012 to 17.3 percent in 2016. However, volcanic ash has led to an abundantly fertile soil, so that crop growth is an important feature of the Indonesian landscape and economy (Ministry of Industry, 2017).

Given its tropical location, Indonesia contains some of the largest forests in the world and it is well known as a country with a rich natural biodiversity. The Indonesian territory, where two-thirds is marine area, also provides Indonesia with enormous marine and fishery resources. Indonesia is the second largest fisheries production in marine waters in the world (FAO, 2016), with the sustainable potential of fish resources in 2016 reaching 9.9 million tons (BPS, 2017). Further, Indonesia's marine waters also have biological resources, including mangroves (4.3 million hectares, which are the most extensive in the world), coral reefs (75,000 km square or 14% of global total) and seagrass (BPS, 2017). With its natural resources endowment, Indonesia therefore provides an advantage for primary and manufacturing industries that require access to raw materials, although it could make Indonesia dependent on exporting natural resources and lacking higher value-added activities (Aswicahyono and Soedjito, 2016).

As an archipelagic country, Indonesia shares ocean territory with a number of countries, such as the Malacca Straits which is governed by Indonesia, Thailand, Malaysia and Singapore, but it also has regional land borders with many countries (see Figure 3.1): Sumatera, that borders onto Malaysia, Singapore and Thailand; Kalimantan, that borders with Malaysia; Sulawesi, that has a border with the Philippines; Papua bordering with Papua New Guinea; and East Nusa Tenggara that borders with Timor Leste (that separated themselves from Indonesia after an Independence referendum in 1999). The prevalence of these borders is a crucial issue, but as well as providing challenges it also provides advantages. Giroud (2013, p. 908) states that "proximity breeds investment", so that Indonesia has the advantage of being in proximity with the Association of Southeast Asian Nations (ASEAN) countries, as well as Asia and Australia. The ASEAN is a regional organization with a target to establish economic, political, social, and cultural cooperation and in addition to Indonesia it has nine other members: Malaysia, Thailand, Singapore, Philippines, Brunei, Cambodia, Laos, Vietnam and Myanmar (Keling *et al*., 2011).

In the case of Batam its close proximity makes it an important destination for companies that have economic linkages with Singapore (Smith, 1997; van Grunsven and Hutchinson, 2017).

The geographic and demographic size of each Indonesian region is shown in Table 3.1. Kalimantan is the largest region which accounts for more than 544,000 square kilometres, or about 28 percent of the land area of Indonesia. However, its population density is 29 people per square kilometre, which is a third less populous than Indonesia as a whole. As the second largest region in Indonesia, Papua-Maluku covers an area of 497,000 square kilometres, and it has the highest number of islands (5,439) in Indonesia, which represent 26 percent of the total land area of Indonesia. However, like Kalimantan, Papua-Maluku has a low population density and indeed it has the lowest density in Indonesia with only 15 people per square kilometre.

The next largest regions are Sumatera and Sulawesi, but although they have similar population densities of roughly 100 people per square kilometre, they differ in areal size and population. Sumatera has the second largest population in Indonesia (about 56 million people) and it is the third largest by land area (480,000 square kilometres), spread out across 5,277 islands. Sulawesi has three times less population over a smaller land area and is formed by about 2,500 islands with Sulawesi Island (formerly known as Celebes) as the mainland. The two smallest regions of Indonesia in terms of area are Java (129,438 square kilometres) and Bali-Nusa Tenggara (73,070 square kilometres), as shown in Figure 3.1. However, these are the densest settled regions of Indonesia. Java, containing the capital city of Jakarta, is the most populous region with more than 146 million inhabitants and is the most densely populated region with more than 1,133 people per square kilometres. Bali-Nusa Tenggara is the smallest-sized region in Indonesia, but with a population density level of 195 people per square kilometre.

Table 3.1: Size and Number of Islands of Each Region

Region	Size (square km)	Population	Population Density (people/square km)	Number of Islands
Kalimantan	544,150	15,634,900	28.73	1,061
Papua and Maluku	497,604	7,002,200	14.07	5,439
Sumatera	480,793	56,121,316	116.73	5,277
Sulawesi	188,522	18,973,300	100.64	2,500
Java	129,438	146,675,400	1,133.17	1,086
Bali and Nusa Tenggara	73,070	14,299,800	195.70	2,141
Total	1,913,579	258,706,916	135.20	17,504

Source: BPS-Statistics Indonesia (2016 and 2017).

Indonesia is one of the most populous countries in the world with around 260 million people in 2017 (BPS, 2018). The population size has increased over time steadily and averaging 1.37 percent growth over the last five years. Table 3.2 shows the trend in Indonesian population over 1971-2015, disaggregated by the main islands, where it can be seen that all regions have experienced a population increase. It shows that Java is consistently the most populated island, although its share of the population has fallen slightly over time, from about 64 percent of the total Indonesian population in 1971 to 57 percent in 2015. The largest growth in population arises outside Java, with an average increase of 155.83% over 1971-2015 (90.76% for Java).[8]

[8] Papua and Maluku are the least-populated regions, but have had the largest increase in population of 214% over 1971-2015. The regions of Kalimantan, Sumatera and Sulawesi have the second, third and fourth highest growth rates of 198%, 166%, and 120%. Bali and Nusa Tenggara increased its population by 113% over the period.

Table 3.2: Indonesian Population, 1971-2015

Region	1971	1980	1990	2000	2010	2015
Java	76,086,327	91,269,528	107,581,306	121,352,608	137,033,300	145,143,600
Sumatera	20,808,148	28,016,160	36,506,703	43,309,707	50,860,300	55,272,900
Sulawesi	8,526,901	10,409,533	12,520,711	14,946,488	17,437,100	18,724,000
Kalimantan	5,154,774	6,723,086	9,099,874	11,331,558	13,850,900	15,343,000
Bali-Nusra	6,619,074	7,931,760	9,416,104	11,112,702	13,129,700	14,108,500
Papua-Maluku	2,013,005	2,584,881	3,506,498	4,211,532	6,207,500	6,869,700
Total	119,208,229	146,934,948	178,631,196	206,264,595	238,518,800	255,461,700

Source: BPS-Statistics Indonesia, 2018.
(https://www.bps.go.id/publication/2018/07/03/5a963c1ea9b0fed6497d0845/statistik-indonesia-2018.html).

In terms of the make-up of the population, Indonesia is famous for its diverse culture and ethnicity. There are over 500 ethnic groups inhabiting Indonesia with more than 400 different languages, culture and traditions (Bazzi *et al.*, 2017; Goebel, 2013; ADB, 2002). The major ethnic groups across Indonesia according to a 2010 survey of the Statistics Indonesia agency are Javanese (40%), Sunda (15.5%), Batak (3.6%), Sulawesi (3.2%), Madura (3%) and a range of other groups with less than 3 percent each (BPS, 2010). Further, according to this survey, most of the Indonesian population (79%) speak in their local language with about 20 percent using the national language of *Bahasa Indonesia*. Indonesian people very rarely speak foreign languages, such as English, which is spoken by less than 0.5 percent of the population.

As a multicultural country, issues such as sentiment towards minority groups sometimes arises such as when close to a political event like a general election. An example of this is the attitude towards the indigenous Chinese population when the government deals with large-scale Chinese investment since there is a perception that Chinese firms will bring their own workers, reducing employment opportunities for the native Indonesians (Herlijanto, 2017; Suryadinata, 2017; Setijadi, 2018). Further, a large number of Indonesians perceive Chinese Indonesians to have a dominant position in the Indonesian economy (Fossati *et al*., 2017). The impact of such perceptions is that it leads to difficulties for investment from China since it is limited to certain sectors or locations where the local people are more open to Chinese ethnicity (Fossati *et al.,* 2017). As argued by Gammeltoft and Tarmidi (2011, p.24), "in most other domains of Indonesian economic life the ethnic issue is prominent in the operating modes of Chinese

invested enterprises" underlying the importance of the basic geography and demography to the location of foreign direct investment.

3.2.2 Political and Economic History

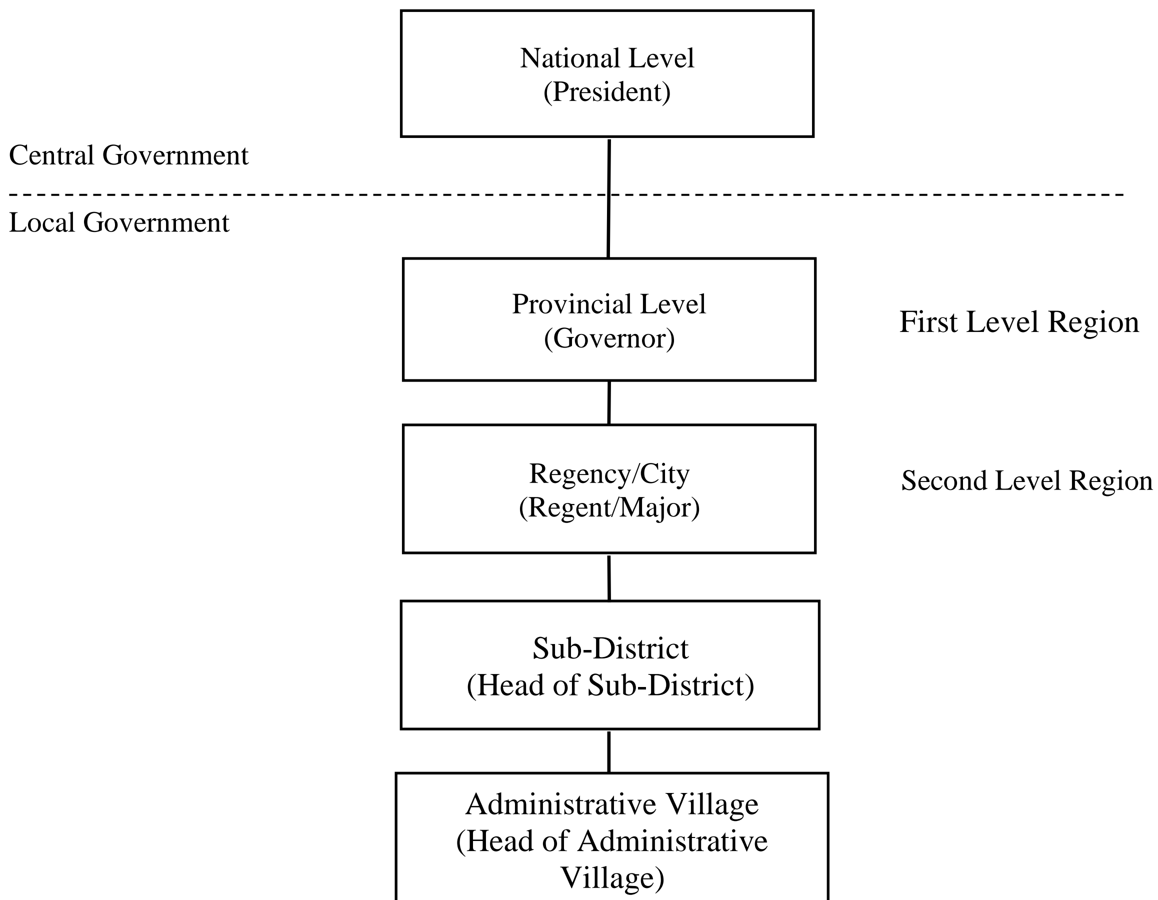
Indonesia is a democratic country with a political system that is based on the *Trias Politica* principle of Montesquieu (1748, cited in Hazo, 1968), in which there is a separation of powers between the Executive, Legislature and Judiciary. The executive power is represented by the President, who is directly elected by the people every 5 years. The first direct election for the President was in 2004, before which the President was determined by the Peoples' Consultative Assembly (the 'MPR') every five years (MacAndrews, 1994). The President is supported by a Ministerial Cabinet, where each Minister is appointed and responsible to the President. As stated by Pramusinto (2016, p. 123, cited in Blomkamp *et al.*, 2017) a Minister is responsible to "translate the vision and missions of the President for five years, which are drawn from the pledges made during election campaigns into policies". The legislative power is held by The Indonesian House of Representatives ('DPR') and Regional Representative Council ('DPD'), both of which are elected for five-year terms in general elections. The DPR, together with the President, are responsible for making Law (Febrian, 2009). The DPR is also responsible for approving the State Budget and for conducting control over the government's activities. The judicial power is in the hands of the Supreme Court. The Justices are not directly elected, but through a selection process by an independent body agreed by the DPR and President.

At the sub-national level Indonesia consists of a number of tiers of local government and these are shown in Figure 3.3. Indonesia's 34 provinces are considered as the 'First Level Region' of local government. Each province is then divided into several regencies/cities at the 'Second Level Region' of autonomy, and as of 2017 there are 514 regencies/cities (BPS, 2018). Below this level, there are the sub-districts and villages. At the First Level Region, each province is headed by a Governor who is elected directly by the people every five years. The Governor is seen as the representative of the central government in the province, coordinating the Regencies /Cities under their jurisdiction and liaising with the central government. Furthermore, each province is then divided into smaller territories namely Regencies and Cities. The Regency or City is headed by a Regent or Major who is also elected directly by the people every five years.[9] All executives for both central government (President) and local government (Governor and

[9] The exception is Jakarta, where the Regent and Major are appointed by the Governor.

Regent/Major) are therefore elected directly by the people. At the lower levels, a head of sub-district is appointed by a Regent/Major, while for the villages these are split between urban and rural communities where a head of urban community 'Lurah' is appointed by the Head of Sub-District but a head of a rural community is elected by the people in the village.

Figure 3.3: Structure of Central and Local Government



Source: author's construct

Indonesia's governmental structure has resulted in its own challenges with regards to policy implementation. Since the Local Government Law 22/1999 in conjunction with Law 32/2004, the central point of autonomy has become the Regency/City (except for Jakarta which is at the provincial level). This is a very big change, and as argued by Bell (2003, p. 3), "[it is] not the provinces that inherit the residual powers and most of the powers devolved but the regencies and cities". This complexity arises as the number of regencies and cities (more than 500) are far greater than the number of provinces at only 34. Given this, many Regencies/Cities have interpreted this autonomy by developing their own local government regulations, increasing the complexity and regulatory burden of the area, especially for investment. For example, since the introduction of regional autonomy more than 30 local ordinances have been enacted by the local governments on average (Matsui, 2005). The Provincial government or even the Central government cannot intervene because it will act against regional autonomy, not least as the argument for policymaking by the Regents/Majors is that they are directly elected by the people and not appointed by the Governor or President (Rudy *et al.*, 2017).

In general, the above political framework has occurred since the introduction of the Democratic Reform Era in 1998. From that moment onwards, Indonesia has experienced a big shift in its political structure, from the authoritarian ('pseudo democratic') regime before 1998 to a more democratic country across all levels of government. In order to provide a clearer understanding of this change and to provide background and context to the Indonesian economy, the following subsections describe the three main political periods that followed Indonesian independence in 1945: the Old Order Era; the New Order Era; and the Democratic Reform Era.

The 'Old Order Era' (1945-67)

After the declaration of independence in 1945, the Indonesian economy had to recover from the hardships suffered after the long period of colonialism under the Dutch and the Japanese. During this period of time the economic growth of Indonesia was very low and unstable due to political instability and inappropriate economic policies such as the nationalisation of foreign investment. Indonesian economic growth was typically 2.0 percent annually, meanwhile the population of Indonesia increased by 2.1 percent per year making Indonesian income per capita stagnant at around US$70 during the 1960s (Soekarni and Syarifuddin, 2011; Van der Eng, 2009). The government during this period was led by President Sukarno who implemented a policy of nationalisation and virtually eliminated foreign direct investment in Indonesia (White, 2012). The central aim of the government was self-sufficiency and import substitution in order to make Indonesia truly independent. Further, in this era government intervention in politics

and economics was dominant with the idiom of the so-called 'guided democracy and guided economy' (White, 2012). This means in effect that the President had the authority to 'direct' democracy and economic activities, which Liddle (1992) classifies as authoritarianism. Robison (1986) states that in a guided economy, the government seeks to conduct central planning and control over distribution, credit and production, as well as over investment.

Under the Old Order Era, the government did not provide strong attention to economic growth. According to Soekarni and Syarifuddin (2011), the Indonesian economy was sub-ordinate to politics as domestic and foreign resources were highly misspent. Over the period, the economy was continuing to decline with the situation worsening when hyperinflation reached up to 600 percent in 1966. Due to political instability, shortages were felt in many sectors, and the main infrastructure was neglected, such as the irrigation system, road networks, electricity, drinking water, railways and telecommunications (Soekarni and Syarifuddin, 2011). It brought the Indonesian economy into a very difficult situation with shortages in food production and the need to import from other countries, which subsequently led to an increase in government debt that stood at about US$ 2.7 billion at the end of Old Order Era (Pauker, 1967).

About two months before President Sukarno stepped-down from the presidency, in January 1967, the government and legislative enacted the Foreign Direct Investment Law, number 1, year 1967 (hereof Law 1/1967). This law was seen as an important means to attract overseas investment and to help boost the ailing Indonesian economy. As such, Law 1/1967 is the hallmark law for FDI in Indonesia as for the first time in its post-independence history it made the Indonesian economy open to foreign investors. However, the implementation of Law 1/1967 was not implemented during the Old Order Era due to political tensions and civil unrest. The Old Order Era ended when Sukarno was overthrown from the presidency by the Temporary General Consultative Assembly ('MPRS') in February 1967 (Bentivegna, 1976).

The 'New Order Era' (1967-98)

The New Order Era began with the presidency of President Suharto in 1967 (formally from March 1968). The era began with President Suharto opening the Indonesian economy to increased investment. As argued by Robison (1986, p.98), "the most fundamental step taken by the New Order after 1965 was a simple one: it provided the conditions for the re-entry of international capital". It started with the implementation of Foreign Direct Investment Law (Law 1/1967), which during the Old Order had failed to be implemented due to the instability. Apart from attracting foreign investment, the government also enhanced domestic investment

through the enactment of the Domestic Direct Investment Law, number 6, year 1968 (hereof Law 6/1968). The features of the investment laws which differentiate the New Order and Old Order Era were: a government guarantee of no nationalisation over foreign investors assets, a duration of the operation of foreign enterprise of at least 30 years, the provision of some fiscal facilities, full authority to select management and the free transfer of profits (Robison, 1986). However, while the government was welcoming to investment, there were some restrictions, so that it was restricted in sectors of strategic importance to the country such as electricity, transportation, public utilities and mass media (Law 1/1967).

A key feature of the New Order Era is political stability and economic growth. In this period (1968-1997), Indonesia experienced rapid economic growth at an average of 7% per annum (Van der Eng, 2009). It coincided with a boom in oil production, so that the government relied heavily on oil and gas exports, which reached a peak in the 1980s when they contributed about 70 percent of government revenue (Hofman *et al*., 2004). During this time Indonesia became a member of the Organization of Petroleum Exporting Countries (OPEC) and a net exporter of oil and gas. Over the New Order Era, Indonesia moved from being a low-income country with income per capita of US$100 in 1970 into a lower-middle income country with income per capita of more than US$ 1,000 in 1997 (Soekarni and Syarifuddin, 2011), and it was referred to as the 'East Asian Miracle' (World Bank, 1993). The period was associated with a reduction in poverty rates from over 60 percent in the late 1960s to 11 percent in 1996 (Hofman *et al.*, 2004). Further, the previous rapid population growth of the earlier era was reduced with the family planning program (*Keluarga Berencana*) leading to a slow-down in the population growth rate to less than two percent per year by the 1990s.

During the New Order Era, economic development was based on Five-Year Development Plans ('Repelita') in accordance with the Guidelines of State Policies ('Garis-Garis Besar Haluan Negara'). Politically, however, it is important to highlight that under the New Order, the President was not directly elected but rather elected by a People's Consultative Assembly. Ultimately, and similar to the succession from the Old Order to the New Order Era, the fall of the New Order resulted from political distrust of the government trigged by student protests and a subsequent nationwide protest. This coincided with the Asian Financial Crisis in 1997, which led to the depreciation of the currency, so that the end of the New Order was associated with both political distrust and severe economic conditions (Eklof, 1999; Phyo, 2012).

The 'Democratic Reform Era' (1998 onwards)

The Democratic Reform Era followed the end of New Order Era (the resignation of President Suharto from office in May 1998), and a feature of this period is the transition to a democratic system (Abdulbaki, 2008). The period after 1998 is considered as the democratic era since the government has been able to fulfil four rules of democracy. These are proposed by Przeworski *et al.* (2000) as: (1) the chief executive is elected; (2) the legislative is elected; (3) there is more than one party; and (4) there is an alternation of power. Prior to 1998, Indonesia is considered to be a 'pseudo democracy' as the government was only able to fulfil the first three rules but failed on the fourth, since there was no alternation of power during the 32 years of President Suharto (Phyo, 2012).

The beginning of the Democratic Reform Era saw the previous Vice President, B. J. Habibie, take the Presidency, but after a general election in 1999 Abdurrahman Wahid became the fourth President of Indonesia. Due however to political disharmony with the legislative, the People's Consultative Assembly removed him from his presidency and swore Megawati Sukarnoputri as the new President in July 2001. Apart from the messy political situation, during this era the Indonesian economy slowly recovered after the Asian Financial Crisis (ADB, 2011; World Bank, 2019a). Table 3.3 shows economic indicators during the critical period of democratic reforms, 1998-2002, with the growth rate increasing from 0.8 percent in 1999 to 4.5 percent in 2002, and the Indonesian currency (Rupiah) reached a new level of about 9,000 rupiah per USD. Foreign direct investment however was slower to recover with negative inflows between 1998 and 2001 before it started to have a positive inflow in 2002.

Table 3.3: Economic Indicators, 1998-2002

Indicator	1998	1999	2000	2001	2002
GDP growth rate (percent annually)	-13.1	0.8	4.9	3.6	4.5
Exchange rate (Rupiah per US Dollar)	10,014	7,855	8,422	10,261	9,311
Net FDI (million US Dollar)	-241	-1,865	-4,551	-2,977	145

Source: ADB. 2011. (https://www.adb.org/sites/default/files/publication/29009/ino.pdf).

During the Democratic Reform Era, there have been many institutional changes, and these include: decentralisation (giving more autonomy to local government based on Law 22/1999 and Law 25/1999); independence of the central bank (based on Law 23/1999; previously the

Governor of Central Bank was a member of Presidential Cabinet); an independent judicial system (Law 35/1999); good governance (anti-corruption, collusion and nepotism) and corruption eradication (Law 28/1999 and Law 31/1999 as amended by Law 20/2001) and the establishment of a Corruption Eradication Commission (Law 30/2002). Another important institutional change is the development of the freedom of press and expression, based on Law 40/1999 (Hofman *et al.,* 2004).

During this era the government has also made significant changes to investment law. The government abolished the Foreign Investment Law and the Domestic Investment Law, and merged these into one Investment Law, number 25, year 2007 (hereof Law 25/2007). A key aim of the new law is to provide more equal treatment between domestic and foreign investors. Under the law, foreign investors are able to hold up to 100 percent ownership in an enterprise, although there are still restrictions on investment in certain sectors of the economy. Overall, the political and investment landscape of Indonesia has changed remarkably since independence, so that Indonesia is now seen as a democratic and more open economy. A more detailed analysis of the Indonesian economy is provided in the next section.

3.2.3 The Indonesia Economy and Taxation System

This subsection presents the main features of the Indonesian economy and the importance of taxation. It discusses the Indonesian tax administration system covering general information about the taxpayer mechanisms for fulfilling tax obligations starting from the registration process, calculation of the tax, process for paying taxes, and reporting the tax fulfilment.

Indonesian Economy

The broad industrial structure of the Indonesian economy is show in Table 3.4, revealing the contribution of each sector to Indonesian GDP over the years from 1970 to 2017. The process of industrialisation in Indonesia started in 1969 under the New Order Era, and it became important in the 1980s after the declining contribution of oil and gas to GDP. Table 3.4 shows that in the 1970s agriculture dominated Indonesian output, with a 45 percent share of the economy. However, this share fell dramatically in the 1980s, since when manufacturing has become much more important, accounting for 43.4 percent of GDP by 2017. Meanwhile the service sector contribution to GDP has grown slowly over time, and is now similar to that of manufacturing so that they are the two main sectors of the Indonesian economy.

Table 3.4: Structure of Indonesian Output, 1970 - 2017

(Percent)

Sector	1970	1980	1990	2000	2010	2017
Agriculture	44.9	24.0	19.4	19.5	14.0	13.0
Manufacturing	18.7	41.7	39.1	43.3	45.3	43.4
Services	36.4	34.3	41.5	37.3	40.7	43.6

Source: Tambunan, 2006 and the World Bank, 2018b (http://wdi.worldbank.org/table/4.2#).

Indonesia is the largest economy in South East Asia with Table 3.5 showing that Indonesian GDP is over 13,500 trillion Rupiah at 2017 (about US$ 1 trillion).[10] By virtue of this Indonesia is a member of the G-20, which comprises a mix of the world's largest advanced and emerging economies. However, with GDP per capita in 2017 of 51 million Rupiahs or about US$ 3,831, Indonesia is classed as an emerging economy and it lies in the category of lower middle-income countries (BPS, 2018; World Bank, 2019a). Indonesia has shown strong economic growth of about 5 percent annually (World Bank, 2019a; BPS, 2018), but despite this Indonesia has been successful in maintaining a relatively low inflation rate, which Table 3.5 shows has fallen from over 8 percent on average at the beginning of the decade to less than 3.5 percent in recent years.

Table 3.5: Economic Indicators, 2013-17

Indicator	2013	2014	2015	2016	2017
GDP, current prices (Rupiah, trillion)	9,546.1	10,569.7	11,526.3	12,406.8	13,588.8
GDP per capita, current prices (Rupiah, million)	38.4	41.9	45.1	48.0	51.9
Economic growth (%)	5.6	5.0	4.9	5.0	5.1
Inflation rate (%)	8.4	8.4	3.4	3.0	3.6
Exports (US$, billion)	182.6	176.0	150.4	145.2	168.8
Imports (US$, billion)	186.6	178.2	142.7	135.7	157.0
Reserve assets (US$, billion)	99.4	111.9	105.9	116.4	130.2

Source: BPS-Statistics Indonesia, 2018.

[10] Foreign exchange middle rates against rupiah at Bank Indonesia in 2017 is: 1 USD = 13,458 IDR (BPS-Statistics Indonesia, 2018, p.446).

Table 3.5 also gives information on Indonesian trade, which shows it has been able to maintain a positive balance of trade (value of exports exceeding the value of imports) in recent years. In order to stabilize the exchange rate, (i.e., Rupiah IDR per US Dollar USD), the Indonesian Central Bank has conducted market intervention, for which it needs reserve assets, but the amount of these reserve assets has increased significantly from about US$23 billion in 1998 to US$130 billion in the beginning of 2018. The reserve assets at the end of 2017 are equivalent to more than six months of imports, which is higher than the minimum standard of three months advised by the IMF (2011). Indonesia has adopted a freely-floating exchange rate regime since 1997, prior to which it implemented a fixed exchange rate and then managed floating exchange rate (Edwards and Sahminan, 2008). The freely-floating exchange rate reduces the need of the Central Bank to make interventions to the foreign exchange market, and this helps to keep reserve assets relatively stable (Heller and Khan, 1978).

With regards to the labour force, Table 3.6 shows that labour force participation in Indonesia is about 66 percent, while the unemployment rate has decreased from 6.2% in 2013 to 5.5% in 2017. In terms of its social impact, the number of citizens who are unable to fulfil their basic needs has declined in percentage terms from 11.4% in 2013 to 10.6% in 2017, although these are still large numbers in absolute terms, i.e., 27.8 million people (BPS, 2018).

Table 3.6: Social Indicators, 2013-17

Indicator	2013	2014	2015	2016	2017
Labour Force Participation Rate (%)	66.8	66.6	65.8	66.3	66.7
Unemployment rate (%)	6.2	5.9	6.2	5.6	5.5
Poor people (%)	11.4	11.2	11.2	10.9	10.6
Human Development Index*	0.681	0.683	0.686	0.691	0.694

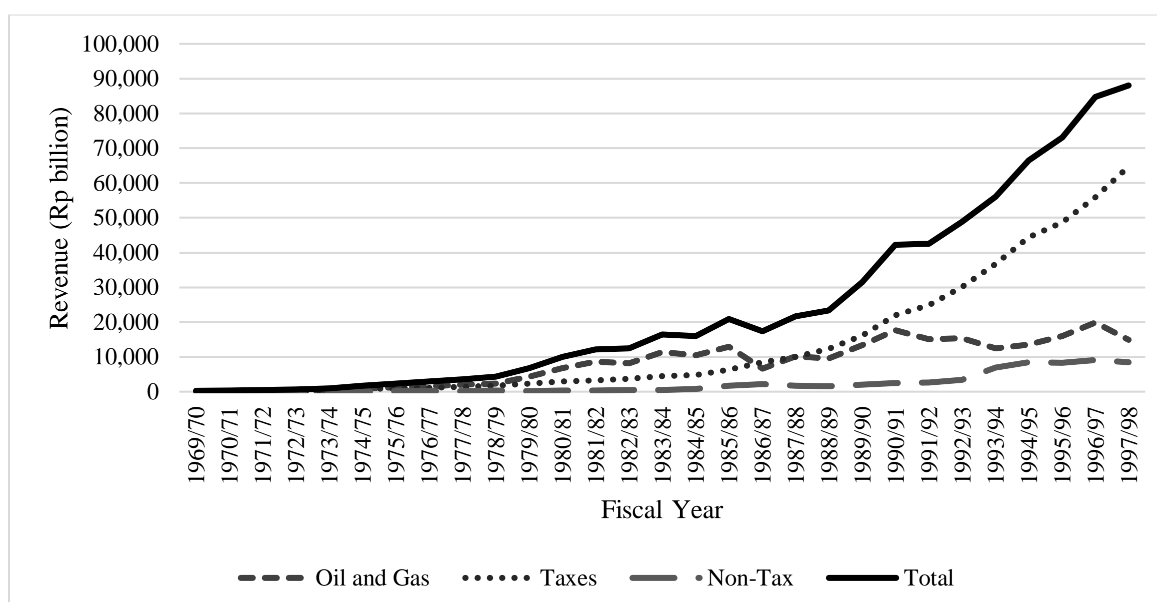
Source: BPS-Statistic Indonesia, 2018; * UNDP, 2018 (http://hdr.undp.org/en/data#).

In relation to the overall quality of life, the United Nations Human Development Index shows a consistent improvement even though this is at a slow rate. However, compared to the other ASEAN countries, Malaysia (global rank 57), Thailand (rank 83) and the Philippines (rank 113), these all outrank Indonesia (rank 116) in 2017 (UNDP, 2018).

Indonesian Taxation System

The role of taxes in Indonesia has changed over time reflecting the change in the structure of the Indonesian economy. During the New Order Era, the role of taxation was not dominant, especially when oil and gas was booming between 1974 and 1988 (during Five Year Development Plan (Repelita) II and III) and Indonesia was a member of OPEC. Figure 3.4 shows the role of oil and gas revenue in the Indonesian state budget from 1969 to 1998 (when Indonesia left OPEC), and it reveals that only after 1989 did tax revenue overtake the contribution to the state budget of oil and gas revenue, which became stagnant from this time onwards.

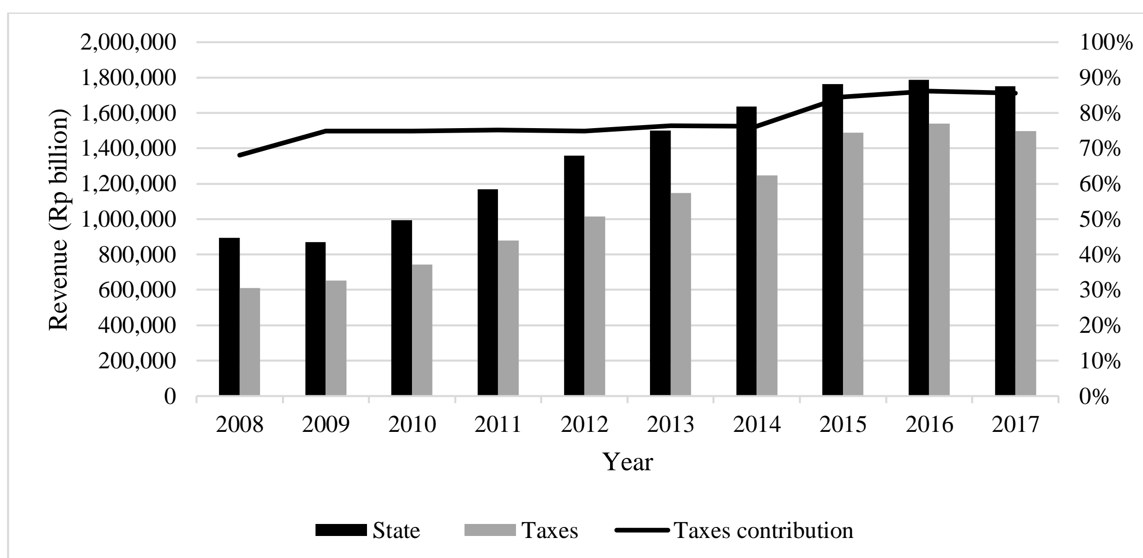
Figure 3.4: Oil and Gas, Taxes, and Non-Tax Revenue, 1969-98



Source: Financial Memorandum and State Budget Draft 1998/1999, Department of Finance. (https://www.kemenkeu.go.id/media/6603/apbn-1998-1999.pdf).

Revenue from taxation is now the dominant form of revenue for Indonesia, and the significant role of tax revenue to the state budget can be seen in the last ten years. Figure 3.5 shows the contribution of taxes to the state budget over 2008-17, where over the last ten years tax revenue has increased substantially from 68 percent in 2008 to 86 percent in 2017. The taxation system in Indonesia is therefore an important component of the economy. Before 1983 the Indonesian tax system was based on an official assessment system, where the tax authority calculated the amount of taxes that need to be paid by taxpayers. However, in 1984 there was a shift from the official assessment system to a self-assessment system, where taxpayers have to calculate their tax payable themselves. The role of the tax office is therefore now mainly administrative, designed to ensure that everyone complies with the law and regulations.

Figure 3.5: Tax Revenue Contribution to the State Budget, 2008-17



Source: Ministry of Finance (http://www.data-apbn.kemenkeu.go.id/dataset/details/1011).

All taxes in Indonesia are guided by Laws. With regard to the general provision of taxes it is guided by Law 6/1983, as later amended by Law 16/2009. Taxes in Indonesia are determined by residency. An individual taxpayer is a person who is domiciled in Indonesia and resides in this country for more than 183 days in any twelve-month period. For corporate taxation, it is based on the place of incorporation or effective place of management of the company. In order to be able to run a business in Indonesia, the investor must register with the Directorate General of Taxes (DGT) to get a Tax Identification Number (TIN), although it is only one requirement for obtaining the necessary investment licence from the Indonesia Investment Coordinating Board (the 'BKPM'). For this, the company should also fulfil the deed of incorporation, have a Business Registration Number, a Land Right Certificate and an Environmental Management document under Article 8 of the BKPM Regulation, 6/2018.

In general, after being registered a taxpayer must do three things under the self-assessment system: calculate their tax based on book keeping; pay the taxes payable under the calculation; and report their tax obligation fulfilment through their tax return. A tax return is filed by the taxpayer either monthly or annually, but depending on the tax type, i.e., direct taxes (corporate income tax) and indirect taxes (value added and luxury goods sales taxes). They are crucial for fulfilling the tax obligation, and Table 3.7 gives the due dates for the different tax types. A company is responsible for withholding tax, such as income tax for its employees. Currently, both the payment and reporting of tax returns can be completed online (electronically).

Table 3.7: Due Dates for Paying and Filing Taxes

Tax Type	Monthly		Annually	
	Payment	Filing	Payment	Filing
Corporate Income Tax	15th of the following month	20th of the following month	Before submitting the annual tax return	End of 4th month after the tax year ends
Value Added Tax and Luxury Goods Sales Tax	Before the VAT return filing deadline	End of the following month	_	_
Withholding tax for employee	10th of the following month	20th of the following month	_	_

Source: Indonesia tax regulations

The types of taxation shown in Table 3.7 can be split into direct taxes and indirect taxes. Direct taxes means that the payment of taxes is the taxpayer's burden. Income tax is a direct tax because it becomes the obligation of the entity (i.e., the individual or the corporation). For the individual there is the Personal Income Tax, but for the corporation a Corporate Income Tax (CIT). With regard to corporate income, prior to 1984 Indonesia implemented the "Ordonansi Padjak Perseroan 1925" based on an official assessment system, and the highest CIT rate was 52.5% (Article 10, Company Tax Ordinance, 1925).[11] Table 3.8 gives the CIT rates over 1984-2010, where the progressive tax rate bands are replaced by a single CIT rate from 2009. It shows that the highest CIT rate has decreased from 35% in the 1980s to 25% from 2010.

Table 3.8: Corporate Income Tax Rates, 1984-2010

	1984	1995	2001	2009	2010
Number of bands	Multiple	Multiple	Multiple	Single	Single
CIT tax rates	35%; 25%; 15%	30%; 15%; 10%	30%; 15%; 10%	28%	25%
Tax brackets	> 50 Rp m; >10-50 Rp m; up to 10 Rp m	> 50 Rp m; >25-50 Rp m; up to 25 Rp m	>100 Rp m; >50-100 Rp m; up to 50 Rp m	-	-

Notes: Table shows dates when change was made and the rates that applied thereafter. Tax brackets relate to respective CIT tax rates given in the table. Rp m = million rupiah.

[11] See https://www.hukumonline.com/pusatdata/download/lt51cbf63cb8086/node/lt51cbf61212a88.

In order to make the distinction clear, the thesis utilises the '**CIT rate**' to represent the statutory corporate income tax rate that generally applies to all corporations in Indonesia, as in Table 3.8. It uses the '**CIT rate reduction**' to represent a type of tax incentives in the form of a lower CIT rate that is applied automatically to firms when they fulfil the criteria, as shown in Table 3.9.

Table 3.9: Criteria for Automatic CIT Reductions and Rates

Description	Tax rate
Public company with more than 40 percent of its share is traded in the Indonesian Stock Exchange (IDX)	20%
Companies with gross turnover more than IDR 4.8 billion up to IDR 50 billion	12.5%
Companies with a gross turnover up to IDR 4.8 billion	1%*

Source: Author compilation on Indonesian laws and regulations.
Notes: Since 2018 the 1% tax rate has fallen to 0.5%. For those who eligible, since 2018 there is time limit to utilise the special rate, are: 7 years for individual taxpayers; 4 years for firms in the form of cooperative, limited partnership (*commanditaire vennootschap*), and general partnership; 3 years for limited liability company. * = it is based on gross sales, instead of taxable income.

Generally, the CIT rate reduction is available in the following circumstances: (i) a listing on the Indonesian Stock Exchange (IDX), giving a 5% tax rate reduction (the normal CIT rate is 25%, but 20% after the application of the reduction); (ii) a turnover of more than IDR 4.8 billion up to IDR 50 billion, for a 50% reduction of normal CIT rate (from 25% to 12.5%); and (iii) a turnover of up to IDR 4.8 billion, for a special tax rate of 1% (of gross sales). These are small and medium-sized firms, but from 2018 this rate has decreased to 0.5% of gross sales.

In the case of indirect taxes, these are Value Added Tax (VAT) and a Luxury Goods Sales Tax (LGST). VAT is a tax imposed on the consumption of taxable goods or services within the Indonesian customs area, while LGST is a tax imposed on taxable goods that are classified as a luxury. For indirect taxes the obligation to pay the tax can be transferred to other subjects. VAT utilises a single rate, which is levied on goods or services that are consumed in Indonesia only, so that the VAT rate applied for export products is 0%.[12] LGST in some way tops-up the

[12] The government is allowed to change a rate between 5% and 15% (see Article 7 VAT-LGST Law), but since its implementation a single VAT rate is applied at 10%. In administrating VAT, Indonesia employs the Credit Subtraction Method using invoice as a mean for credit mechanism. In normal conditions, a company is liable for the difference between the value of its outputs minus inputs on which VAT is applicable.

VAT rate. Its aim is to change consumer behaviour with respect to particular types of products or as a means of 'protecting' domestic products. The rate of LGST varies from 10 to 200 percent (see Article 8 VAT-LGST Law). However, in practice, the highest rate for LGST that is applied is 125% for certain types of imported motor vehicles (Ministry of Finance Regulation 33/2017). Like VAT, LGST is only applied to products (goods) that are consumed in Indonesia.

As the state budget becomes more reliant on tax revenue then more effort has been directed towards increasing the amount of this revenue. In general, there are two ways to increase tax revenue, namely the '*Intensifikasi*' and '*Ekstensifikasi*' programmes. *Intensifikasi* means the government will scrutiny all registered taxpayers, especially for those who do not comply with the regulations, while *Ekstensifikasi* means broadening (expanding) the tax base to increase the number of taxpayers or expand tax objects. Further, tax incentives are seen as a method for increasing taxes based on the assumption that it will attract new investors and so increase the number of registered taxpayers. The role of taxation and FDI location is discussed further in the next section.

3.3 The Policy Environment for FDI Attraction

This section discusses the policy conditions that are used in an effort to influence FDI to locate in Indonesia. It first discusses government measures relating to area-based investment location and describes the different types of policy areas in the form of Industrial Areas and Special Areas, where the latter are Bonded Zones (BZ), Free Trade Zones (FTZ) or Special Economic Zones (SEZ). Second, as well as the policies relating to specific areas, the section discusses the taxation options that can be used to attract FDI. Finally, other government measures used to attract FDI inflows to Indonesia through a good investment climate are discussed, including institutional support, infrastructure development and labour market policies.

3.3.1 The Special Areas

In order to support investment, the availability and acquisition of premises or land is crucial (Rajenthran 2002; Ito *et al.*, 2014). Under the Basic Agrarian Principles Law 5/1960 and Spatial Law 24/1992, the government is responsible for the control and management of land utilization in Indonesia, covering matters such as spatial planning and the use of land for residential or industrial use. In the latter case, the Indonesian government can designate an area of land as an

‘Industrial Area’, which is an area that has infrastructure and other facilities. Industrial Areas are developed and managed by the Industrial Estate Companies, and in general, investors located in these areas can benefit from such things as the availability of industrial building, availability to raw materials, proximity to markets, availability of cheap or skilled labour and infrastructure such as roads, ports, warehouses. In laying-out these areas the minimum size for an Industrial Area in a single location is fifty hectares.

Table 3.10 shows how the definition of an Industrial Area has changed over time, covering the New Order (1967-98) and the Democratic Reform (1998 onwards) Eras. For the first generation of Industrial Areas (1970-89), Table 3.10 shows that they were initially dedicated to various activities, but that they are now based on ‘core competencies’, meaning that in each Industrial Area there should be a major company or group of companies in a specific sector, and that other companies in the area should conduct a line of business that supports this. For example, a Tourism Industrial Area will focus on conference centres, exhibitions or hotels. In this case, other supporting companies that are relevant might be restaurants and bars, art and handicrafts, cultural parks, transportations, sport centres, theatres and culinary parks. In terms of infrastructure, in the first generation it was separated from support facilities, but nowadays it is integrated with all the support facilities, while with regard to development, the Industrial Areas have moved from solely encouraging economic growth to also becoming a way of distributing investment to other areas from outside of the main region of Java.

Table 3.10: The Development of Industrial Areas

Aspect	First Generation (1970 - 1989)	Second Generation (1989 - 2010)	Third Generation (2011 - present)
Activity	Diverse, not focused	Not specific	Core competency-based
Infrastructure	Not integrated with support of other facilities	Leads to integration of facilities and infrastructure	Integrated with all the support facilities
Development	Growth encouraged, built and managed by public sector	Private investor encouraged to build with the supervision by the Government	Leads to development of new areas or cities and modern industrial estates focused on specific criteria
Historical	First development (e.g., Jakarta, Surabaya, Medan) in cooperation with local and provincial governments	Opened development to private companies by Presidential decree 53/1989; legal and technical requirements for development and operation established	Began operation of first SEZ in 2012, based on the Law on SEZ of 2009

Source: Adapted from 2017 Investment Report, ASEAN, 2017, p. 109.

As well as Industrial Areas, the government also supports the development of Special Areas, which is an Industrial Area that has been given further additional incentives by the government in the form of fiscal and non-fiscal incentives. The research focuses on three types of Special Area: a Bonded Zone (BZ), a Free Trade Zone (FTZ) and a Special Economic Zone (SEZ).

Bonded Zones. According to Minister of Finance regulation 147/PMK.04/2011 (later replaced by PMK-131/PMK.04/2018), a Bonded Zone is a "bonded piling place to pile imported goods and/or goods originating from other places in the customs area to be processed or combined, the result is mainly for export". A Bonded Zone is normally fully under supervision of Directorate General of Customs and Excise. In general, BZs should be located in an Industrial Area and all entry and release of goods from the BZ should be based on customs notification. Bonded Zones have a long history of development, as they were introduced in 1972 as a

'Bonded Warehouse' under President Suharto, but later rebranded as the Bonded Zones.[13] As of 2018 there are 1,360 Bonded Zone in Indonesia, which are scattered across Java, Sumatera, Kalimantan, Sulawesi, Bali and Nusa Tenggara, Maluku and Papua.[14] However, in terms of distribution, more than ninety percent of the Bonded Zones are in Java. The main types of activity are garments, textiles, electronics, plastic and rubber products, footwear and accessories and related products. With regard to tax incentives, since Bonded Zones are inside customs areas, they apply import taxes and duties (i.e., import duty, VAT, LGST, Import Tax (Income Tax Article 22)). However, since they are also Special Areas that are intended to mainly produce products for export, the government provides 'postponement' or 'not collected' status for imported goods. This helps the cash flow of firms located in the BZs since they do not need to pay import related taxes, and it is expected to make them more competitive in international export markets.

Free Trade Zones. A FTZ is a zone that is separate from the Indonesian customs area, and so exempt from the imposition of Import Duty, Value Added Tax (VAT), Sales Tax on Luxury Goods (LGST), Import Tax (Income Tax Article 22) and Excise Duty. It contrasts with a BZ, which is located inside the Indonesian customs area and so subject to these taxes (i.e., import duty, VAT, LGST, Import Tax (Income Tax Article 22)), although as noted a postponement of import duty and other taxes is granted. Thus, the FTZs and BZs have different tax consequences, even if in the short-run the consequences seem similar. Sabang in Aceh Province (see Figure 3.1) was the first location in Indonesia to be designated as a FTZ, based on Law 4/1970. However, its development as a FTZ was slow, partly caused by a lack of government support, so that in October 1985 it was abolished under Law 10/1985. However, a FTZ in Sabang was resurrected in 2000, based on Law 37/2000, with the aim of capitalising on its locational advantage close to the Malacca Straits, as discussed in Section 3.2.1. However, it remains the case that there is a lack of convincing evidence to show that the Sabang FTZ is a success as an economic engine, and its status is questioned (Bappenas, 2009).

The next FTZ to be introduced in Indonesia was Batam (see Figure 3.2). Initially, Batam was designated as an Industrial Area based on Indonesian Presidential Decree 74/1971, but in order to attract more investment, Indonesia and Singapore signed an agreement in 1990 to cooperate on developing the Riau Islands, which include Batam (Wulandari, 2012). Singapore has tight

[13] Initially, based on Government Regulation 20/1972, as amended by Regulation 31/1977, while Bonded Zone commenced with Government Regulation 22/1986, amended by Regulation 14/1990. This was later superseded by Government Regulation 33/1996 as amended by Regulation 43/1997.
[14] See http://www.beacukai.go.id for the location of these zones.

limits on its land area for supporting industrial expansion, so that in order to overcome this the government of Singapore proposed the development of Batam. Wulandari (2012, p.14) notes that during the Megawati Sukarnoputri administration of 2003, the government of Indonesia "asserted the role of Batam, Bintan and Karimun Islands as a manufacturing base for Singapore". In 2009, the government of Indonesia officially announced the operation of Batam, Bintan and Karimun (BBK) as a Free Trade Zone, even though it had been formally established in 2000 based on Law 36/2000.[15] By 2012, Batam had 21 Industrial Areas with more than 1,000 foreign companies. The Batam Industrial Development Authority (BP Batam) was established (Presidential Decree No. 41/1973), and it has authority to manage and to develop industrial compounds on what is a 415-square-kilometre industrial complex.

Compared with other FTZs in the ASEAN countries, such as Singapore and Malaysia, the FTZs in Indonesia were initially far less reaching in their scope. For example, the Singapore FTZ specialises in facilitating trade and trans-shipment in order to improve the competitiveness of trade-related activities based on time-to market advantages, reduced compliance costs and an increased reliability for business operations (ASEAN, 2017, pp. 161-2). In order to accelerate the development of Batam, the government of Indonesia enacted several Laws regarding FTZs in 2007.[16] As noted, Batam effectively gained its status as a FTZ (together with Bintan dan Karimun) in January 2009 based on Government Regulation 2/2009. However, the status of Batam as a FTZ is time-limited as under Law 39/2009 the intention is to make it a Special Economic Zone (SEZ), which is a third type of Special Area (see below). FTZs that are not converted into a SEZ will be terminated after 70 years from their initial establishment (Article 48 Law 39/2009), so that they will be phased out over time. In total, legally there are currently (at 2019) four FTZs (i.e., Batam, Bintan, Karimun, and Sabang) in Indonesia.[17]

Special Economic Zones. A SEZ is a designated area that is endowed with economic and/or strategic advantages, and in which special facilities and incentives (taxes and non-taxes) are available. These range from the ease of gaining an investment license (see Section 2.6.1), permits for land acquisition and infrastructure development, and favourable treatment in the tax incentive application process. Unlike the FTZs and BZs, a SEZ covers almost all types of

[15] Later amended by Law 44/2007.
[16] These are Law 44/2007 on FTZ, Law 46/2007 on Batam FTZ, Law 47/2007 on Bintan FTZ, and Law 48/2007 on Karimun FTZ.
[17] Legally, there are 4 FTZ in Indonesia. These are Batam, Bintan, Karimun and Sabang. In practise only Batam is considered successful, even though in the last few years it has encountered difficulties. Bintan and Karimun are close to Batam (each FTZ is on a separate island), while Sabang on Weh Island (Aceh Province) has been inactive for some time, and some are unaware of its status. In general, if people talk about FTZ they refer to Batam.

economic activity, including manufacturing, as well as exports, imports and other activities that are international competitive and have a high economic value. Further, a SEZ is not specifically orientated towards exports, which is the case for the BZs and FTZs. In term of facilities and incentives, the SEZs provide benefits in the form of indirect tax incentives (like the two other zones), but also income and local tax incentives. The SEZs are a recent initiative, but in practice they are making slow progress, as it took a number of years to make the SEZs operational. The first such zone is the Sei Mangkei SEZ in Sumatera, which is intended for palm oil and rubber industries. It was officially opened in January 2015, although originally established three years earlier.

Based on Presidential Regulation 2/2015 concerning the National Medium-Term Development Plan (2015-2019), it is expected that 25 SEZs will be in place by the end of 2019, where fifteen of these are focused on manufacturing and ten on tourism. The Law was enacted in 2009, and 12 SEZs are currently approved by the government, of which four SEZs are operationally active up to the end of 2017, as detailed in Table 3.11 below. This shows that the SEZs that have been implemented are distributed across regions (i.e., Sumatera, Java, Sulawesi, Bali and Nusa Tenggara), and that they are split between tourism and manufacturing activities.

Table 3.11: Operationally Active SEZs, 2017

Name	Location	Main Business Activities	Employment
Sei Mangkei	North Sumatera	Manufacturing	3,672
Tanjung Lesung	Banten	Services (Tourism)	1,358
Palu	Central Sulawesi	Manufacturing	1,660
Mandalika	West Nusa Tenggara	Services (Tourism)	1,241

Source: SEZ (2018), Annual Report 2017.

Table 3.12: Comparison of the Different Types of Special Area

	Bonded Zone	Free Trade Zone	Special Economic Zone
Law and regulation	Law 17/2006; Law 10/1995	Law 44/2007; Law 36/2000	Law 39/2009
Existence	Inside Industrial Area: As long as the industrial business licence is valid Outside Industrial Area: Valid for a certain period	70 years from initial establishment	Long-established.
Characteristics of companies	Export-oriented industries	Export-oriented industries. Export-import trade.	Varies (industries clustered based on business focus: i.e., export, logistic, industries, technology development, tourism, energy)
Geography	Located in Industrial Area. Access to public road. Clear boundaries (fences). Single entrance for entry and release of goods. Produce finished goods.	Under jurisdiction of Indonesia but outside customs area. Have clear boundaries.	Under the Republic of Indonesia law jurisdiction. Defined geographic area. Close to international trading hub, international shipping lanes or in an area with resource potential.
Institution	Bonded Zone Operator/Entrepreneur; Directorate General of Custom and Excise.	FTZ authority (i.e., Batam Indonesia Free Zone Authority (BIFZA) – BP Batam (previously known as the Batam Authority))	National Council; Zone/Area Council; Administrator.
Incentives	Tax incentives: Duty and excise; VAT, LGST, import tax.	Tax incentives: Duty and excise; VAT, LGST, import tax.	Tax incentives: Duty and excise; VAT, LGST, import tax. Apart from that, SEZ Law states investment in this area is eligible to receive other type of tax incentives (tax holiday or allowance).
Market	Export; (Domestic = max 25%)	Export	Both export and domestic

Source: Author's compilation based on various sources.

Table 3.12 summarises the differences between the three types of Special Area. In terms of the existence of each type of zone, the BZs and SEZs do not have specific lifespans, whereas the FTZs have a maximum duration of 70 years from the date of their establishment. Based on Law 39/2000, it is expected that all FTZs will be converted to SEZs, or otherwise be terminated. With regard to the market orientation of the products, the BZs and FTZs are mostly for export, but the SEZs are aimed at both domestic and international markets. Companies in the BZs and FTZs therefore have to sell most of their output to the international market, but in the SEZs there is more flexibility as to where they sell their output. Regarding geographical location, the BZs and SEZs are located under Indonesian jurisdiction and inside a customs area, but the FTZs are outside a customs area. Looking at the incentives offered in these three Special Areas, the

SEZs are the most generous as they offer direct tax incentives (i.e., against income tax) in addition to the indirect tax incentives that are offered by other two zones.

3.3.2 Taxation Incentives

This section discusses in greater detail the different types of tax incentive that are available for FDI, including in the Special Areas. In practice, tax incentives are not differentiated between foreign and domestic investors, so that investment is treated equally irrespective of its origin. The tax incentives that are available in the Special Areas are now discussed, followed by a discussion of Tax Holidays, the Investment Allowance, and other tax measures that are available more generally.

Tax Incentives in the Special Areas

Indonesia provides tax preferences to investors that locate their investment in the Special Areas, comprising the Bonded Zones (BZs), Free Trade Zones (FTZs), and Special Economic Zones (SEZs). As mentioned, BZs and FTZs are intended to attract investment that is mainly focused on exports, but SEZs do not have this specific aim. The tax incentives provided to companies in the BZs and FTZs seek to support the competitiveness of their products as they go for export. This involves exempting, postponing or not collecting the import taxes on materials. However, with regard to the SEZs, the tax incentives are provided not only in terms of indirect taxes that link to product efficiency, but also against other taxes such as income tax and local taxes that give a more general benefit to a company (shareholders). In general, investment located in SAs will be entitled to enjoy indirect taxes incentive (i.e., import duty, VAT, LGST, import tax exemptions). However, amongst types of SAs in this thesis, it shows that SEZ provides more generous tax incentives as investors will also entitle to enjoy incentives on income taxes (i.e. tax holiday, tax allowances or CIT rate reduction). Apart from that, investment located in SEZ also potentially receives local tax exemption or reduction. Even though SEZ seems provide the most generous tax incentives, but in fact it is new initiative (the first SEZ was opened in 2015 and only 4 SEZ that are officially open up to 2017) therefore it might not be reflected in this thesis.

The Tax Holiday

The pioneer of the tax holiday in South East Asia is Thailand in 1960, with Indonesia offering these for the first time in 1967 (Ullah and Inaba, 2014). The tax holiday is a period of time when the firm is exempt from the payment of income tax, and from 1967 up to the present time

Appendix Table A.3.1 shows that Indonesia has used the tax holiday as an 'on and off policy'. It is a profit-based incentive as a firm only gains an advantage if it is able to generate profit. It is implemented under Law 1/1967 on foreign investment which was replaced by Law 25/2007 on investment and targeted at new firms rather than existing operations. To be eligible for a tax holiday a firm must satisfy certain criteria, which change frequently. Taking the example of PMK-35/PMK.010/2018, the criteria for a firm to be eligible for a tax holiday are:

(i) The firm is in a 'pioneer industry' that has broad linkages, provides high value-added, that introduces new technology and has strategic value to the national economy.
(ii) The investment is new rather than an expansion of existing operations, and the minimum amount of investment criterion is satisfied.
(iii) The firm meets the required debt to capital ratio and has the status of an Indonesian legal entity.

The focus on the 'pioneer industries' is in order to boost economic growth.[18] When the period of exemption is extended to a longer period, the tax holiday may be given at a reduced rate. The tax holiday has been used intermittently by the Indonesian government since 1967, although frequent changes have been made (see Appendix Table A.3.1).[19] The tax holiday has some drawbacks, since if the firm experiences a loss during the tax holiday period then it does not pay any income tax and receive any exemption, so that they favour companies that generate profits soon after their establishment. Further, the tax holiday is unlikely to benefit a foreign investor if their country of origin implements a credit tax method without a 'tax-sparing' agreement. This is a tax treaty provision, in which a state agrees to grant relief from residence taxation with respect to source taxes that have not actually been paid (taxes that have been 'spared'). In this case, if the company is granted a tax holiday in the host country it pays no tax and there is no credit tax in the home country. In this context, the success of the tax holiday depends on the tax policy in the investor's home country. Indeed, unless there is a tax sparing agreement the tax holiday will shift tax between the host and home countries, so that in effect it subsidises the tax revenue of the investor's home country.

[18] Taking an example of PMK-130/PMK.011/2011 industries eligible for tax holiday are: basic metals, oil refineries, machinery, industries in the field of renewable resources, and communications.
[19] Regulations and dates: PMK-35/PMK.010/2018 (4 April 2018 onwards); PMK-103/PMK.010/2016 (30 June 2016 - 3 April 2018); PMK-159/PMK.010/2015 (16 August 2015 - 29 June 2016); PMK-192/PMK.010/2014 (6 October 2014 - 15 August 2015); and PMK-130/PMK.01/2011 (15 August 2011 - 5 October 2014).

Prior to the implementation of PMK-159 (on 15 August 2015) the existence of tax sparing was a requirement for a tax holiday (see PMK-192), but since the implementation of PMK-159 tax sparing is no longer a requirement. The government now argues that tax sparing is necessary when there is foreign company investing in Indonesia and eligible for a tax holiday. Having a tax sparing agreement with a particular (home) country is only relevant for Indonesia (as host country) when there are many foreign investments coming from a particular country. The elimination of tax sparing has support, as it is argued that FDI flows can be the cause of tax sparing provisions and not a consequence of it (Azemar *et al*., 2007). It means the government will try to accommodate tax sparing with the investors home country when an investment realisation is already in place (i.e., an investor starts to establish a plant).

The Investment Allowance

The tax allowance is a form of tax reduction based on the value of the investment cost that meet certain criteria. It is a cost-based incentive as in general an increase in the deductible cost will lead to a greater reduction in taxable income. The tax allowances are provided in Indonesia under Government Regulation, number 18, year 2015, as amended by Government Regulation 9, year 2016 (Gov. Regs. 18/2015 and 9/2016) that concern Income Tax Facilities for Investment in Certain Business Fields and/or in Specific Areas. Unlike the tax holiday, tax allowances are intended for existing business expansions. They are provided to investors in order to: boost investment and hence economic growth; to improve the distribution of economic development in targeted sectors and/or regions; and to help with the creation of employment in order to increase labour-intensive investment.

Successful applicants for a tax allowance can receive it in one or more ways as follows:

(i) Net income deduction of 30% from the investment amount at 5% a year for six years.
(ii) Accelerated depreciation and amortization.
(iii) Imposition of income tax on dividend income paid to foreign tax subject other than a permanent establishment in Indonesia at 10% or a lower tariff if tax treaty relief is available (instead of paying dividend tax based on normal tax rate which is 20%).
(iv) Loss compensation against net tax profit that is extended for between five and ten years for companies: located in Industrial Areas and / or Bonded Zones; for infrastructure; use of domestic raw materials of at least 70%; employment absorption of 500-1000 people within 5 consecutive years; research and development; reinvestment; and exports of at least 30% of sales.

Other Types of Tax Measure

In addition to the above three types of tax incentives, the use of 'CIT rate reduction' as a tax incentive has been discussed in Subsection 3.2.3. Other types of tax facility, such as VAT refunds or the elimination of tax penalties, do not fit well within the above categorisations, but are worth mentioning as some investors find them important. First, an accelerated VAT refund is provided to companies that are: a compliant taxpayer with a good record of tax payment and reporting; a taxable entrepreneur for VAT purposes with low risk; and have a claim for a small amount of VAT refund. Generally, this type of facility is important for exporting firms that are not located in the Special Areas. As the firm has already paid VAT when they buy materials, but sell the final good abroad that is free from VAT, then they have a VAT overpayment that is eligible for refund. The VAT refund process is normally started with an audit process by the tax authority, which takes times. However, the audit process can be exempted if the company fulfils the above three criteria, but possibly replaced with a post-audit process if needed.

Another type of tax facility or benefit that has been offered in the past is the elimination of penalties (i.e., sanctions) for taxpayers that join a specific tax incentive programme offered by the Indonesian Directorate General of Taxes (DGT). These kinds of measure do not directly link with a government programme to attract FDI, and are more likely to affect existing taxpayers. Indonesia has implemented these facilities several times, including the so-called 'Sunset Policy' from January 2008 to February 2009 and the 'Tax Amnesty' from July 2016 to March 2017 (Law 11/2016). The Sunset Policy allowed taxpayers to amend their previous tax returns and to disclose the correct amount of tax payable, where in return the government did not impose any penalties or undertake any form of tax investigation (Rakhmindyarto, 2011). The Tax Amnesty allowed taxpayers to declare and repatriate assets that might not yet be subject to income tax by paying a certain amount of contribution at a low rate. The Tax Amnesty covered years up to 31 December 2015, but applied different rates.[20]

The different types of tax incentives implemented in the SAs and Non-SAs are summarised in Table 3.13. First, the indirect tax incentives (i.e., import duties, excise duties, VAT, LGST and import tax exemptions) are national tax incentives managed by central government. Generally, these incentives are intended to support firms in the SAs that mainly produce output for export. Second, direct tax incentives are another national tax incentive managed by central government. In the research, I differentiated between the CIT rate reduction that is applied automatically to

[20] For declarations without repatriation, the tax rates applied are 4% (July to September 2016), 6% (October to December 2016) and 10% (January to March 2017), but for onshore assets they were each half of this.

the firms that meet the criteria, and the tax holiday / allowance that is targeted and discretionary as the investors have to apply for it and the decision on it is based on authoritative policymaker's judgment. The third, local tax incentives (i.e., land and building tax), is under local government administration. It is important to note that of the three types of tax incentive, the thesis focuses on the tax incentive policy at national level, so that local tax incentive are not explored in detail. Local tax incentives vary across administrations, making it difficult to generalize.

Table 3.13: Tax Incentives in the Special Areas and Non-Special Areas

Type of Tax Incentives	Target of facilities	Characteristics	Implementation in	
			SAs	Non-SAs
Indirect taxes (i.e., import duty, excise, VAT, LGST, import tax exemptions)	Product/goods	Generally applied for export orientation products	Generally applied	Generally, not applied
Direct taxes: a. CIT rate reduction	Subject/entity	General-automatic	Directly applied when meet criteria	Directly applied when meet criteria
b. Tax holiday/ allowances		Targeted-discretionary	Required to apply	Required to apply
Local taxes (i.e., exemption/reduction on land and building tax)	Object/land-building	Based on local government decision; varies amongst local governments	Depend on each local government	Depend on each local government

Source: Author compilation based on Indonesian regulations.

3.3.3 The Investment Environment

As well as the Special Areas and tax incentives, Indonesia offers a favourable environment for foreign investment through its institutional support, infrastructure and labour market conditions (Buchanan *et al.*, 2012; Abu Bakar *et al.*, 2012; Gao, 2005; Noorbakhsh, *et al.*, 1999). This subsection considers each of these. In terms of the institutional support, it focuses on the role of the institutions that are responsible for accepting foreign investment applications and the nature of this process. On infrastructure, it discusses the capability of Indonesian infrastructure

in terms of both physical and technical infrastructure. Finally, the section discusses the labour market conditions, describing the availability and quality of labour in Indonesia.

Institutional Support

Buchanan *et al*. (2012) argue that institutional quality is of importance to FDI, as a good quality of institutions has a positive and significant effect on FDI location. A similar finding is found by Ullah and Khan (2017) who argue that institutional factors play a role in attracting FDI inflows to the ASEAN region. Institutions and institutional support can be defined as both a set of rules and procedures, and an organization (Hodgson, 2006; North, 1981). My focus here is on how Indonesian organizations deal with the investors that conduct inward FDI.

In the Indonesian context, the government has continuously improved the institutional support to help the investment application process. In the 1967 Foreign Investment Law, it established a Foreign Capital Investment Advisory and Technical Committee on Investment to advise the government on whether an investment licence should be provided in response to an application (Suny and Rochmat, 1972; p. 18). The Advisory Body has support on technical aspects from the Technical Committee on Investment.[21] The main changes on investment policy at this time was that the government guaranteed that it would not conduct nationalisation of foreign companies as the government had done before 1967 during Old Order Era (Suny and Rochmat, 1972). A further decree set-up the Indonesia Investment Coordinating Board (the 'BKPM') in 1973 (Presidential Decree 20/1973). The BKPM replaced a pre-existing investment committee (the Foreign Capital Investment Advisory and Technical Committee on Investment) with a new permanent body for coordinating investment, and the government later strengthened its role by making it directly accountable to the President (Presidential Decree 53/1977). The BKPM's role was expanded in 1981 when it became the institution responsible for the preparation of national investment policy, providing investment licences and coordinating investment activities with other Indonesian institutions (Presidential Decree 33/1981).

During the Suharto era of the New Order (up to 1998), decisions regarding foreign investment were mostly in the President's hands, and no other institution or policymaker could challenge this, including the BKPM. As MacIntyre (2001, p. 93) notes, "in practice, only one institution in the system had the veto power: the presidency". This clearly distinguishes this period from the institutional support provided by the government in the Democratic Reform period. Putting

[21] The Advisory Body and Technical Committee were set-up by Cabinet Presidium Decree 17/EK/KEP/I/1967.

aside the potential negativities of a heavily-centralised government, such as corruption and rent-seeking, the New Order period was however successful in creating a stable political and macroeconomic environment for investment (Tambunan, 2013 and 2006; Rock, 2003), which is a major issue for investors (Leith, 2002). However, the big shift between the Old Order and New Order was an open policy on investment and trade, with Law 1/1967 providing a solid foundation for foreign companies to invest in Indonesia (Tambunan, 2006).

Since the fall of the New Order Era in 1998 Indonesia has marked itself as a democratic country and major changes in the institutional support have been put in place. During the President B. J. Habibie presidency, the granting of licences for foreign investment was shifted to Ministerial level (Head of BKPM), so that only the foreign investments of more than US$100,000,000 were dealt with by the President (Presidential Decree 115/1998). In 1999, the authority for granting a foreign investment licence or permit that had been shifted from the President to BKPM further decentralised to the Foreign Minister and Governors (Presidential Decree 117/1999). This reflected a need for greater regional autonomy (Law 22/1999) and the institutional support for FDI was changed from a centralised to a more decentralised approach.

Notwithstanding this, in 2004, the government sought to develop a one-stop service for granting investment licences. In practice, this was limited in its effects as a Presidential Decree (number 29/2004), is lower than Law (number 22/1999) in the hierarchical position. It also caused confusion by overlapping the responsibility to provide the foreign investment licences between the one-stop service and the local government, as the Presidential Decree could not abolish the authority of the Governors (Sondakh, 2014). It was resolved in 2007 through the enactment of Law 25/2007 on Investment. This means that foreign investment licences are now controlled centrally by the BKPM, and conducted through a one-stop service, known as the *Pelayanan Terpadu Satu Pintu* (PTSP). The changes to the support framework are expected to improve legal certainty, openness, accountability, efficiency and ensure equal treatment.[22]

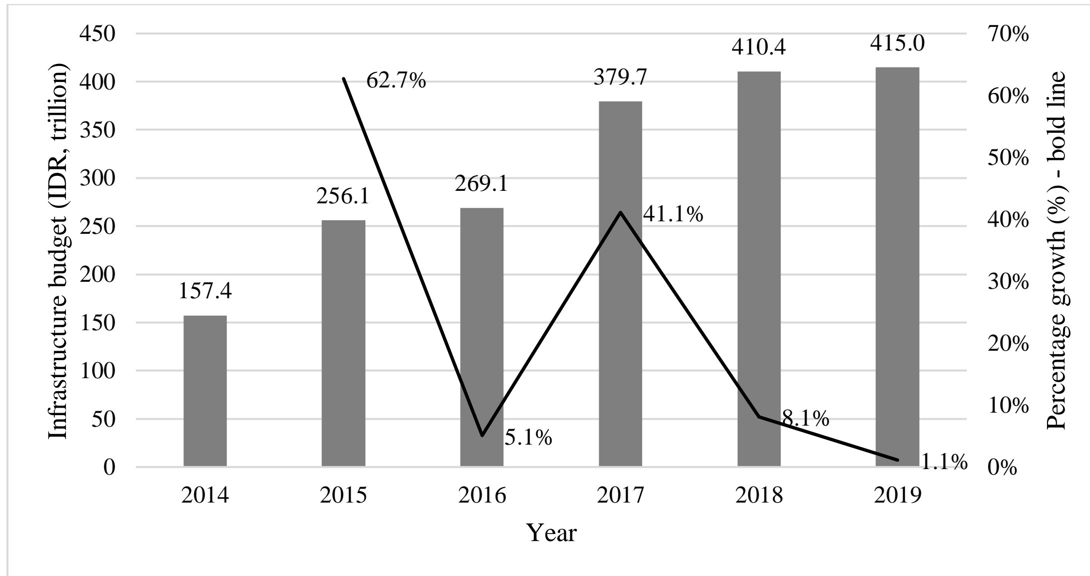
<u>Infrastructure Development</u>

Infrastructure is another important factor for attracting investment to Indonesia (Fitriandi *et al.*, 2014; Bhatt, 2008). Under President Joko Widodo, since 2015 the government has focused on developing infrastructure as a way of accelerating investment (Bappenas, 2014).[23] This can be seen from Figure 3.6 that shows the increased state budget allocated to infrastructure, from 157

[22] Presidential Regulation 27/2009
[23] Presidential Regulation 2/2015

trillion rupiah in 2014 to 415 trillion rupiah in 2019 (163.7 percent increase). The figure shows that the increase has slowed recently (bold line), as Indonesia has experienced difficulties in terms of a current account deficit and exchange rate depreciation (from 1US$ = IDR13,563 in January 2018 to 1US$ = IDR14,800 in September 2018).[24] Since it relies on imported materials it has led to the government to reschedule some of its infrastructure development plans.

Figure 3.6: Indonesian Infrastructure Budget, 2014-19



Source: https://www.kemenkeu.go.id/media/11213/buku-informasi-apbn-2019.pdf.

The importance of infrastructure for reducing trade costs in the wider context of the leading ASEAN-5 countries (Indonesian, Malaysia, Thailand, Philippines and Vietnam) is noted by Ramli and Ismail (2014). Table 3.14 gives comparative indicators of infrastructure according to the World Bank *Enterprise Surveys* (2017). It shows Indonesian firms experience relatively high levels of difficulty associated with electricity supply and transportation.

[24] https://tradingeconomics.com/indonesia/currency

Table 3.14: Infrastructure Comparison of ASEAN-5

Country	Firms identifying or experiencing:			
	Electrical outages (%)	Electricity as a major constraint (%)	Transportation as a major constraint (%)	Water insufficiencies (%)
Indonesia	22.5	14.5	15.8	0.2
Malaysia	18.9	9.4	14.1	17.2
Thailand	8.6	23.7	5.1	0.9
Philippines	26.3	3.7	8.0	8.1
Vietnam	39.9	19.6	21.7	7.9

Source: World Bank, *Enterprise Surveys*, 2017.
(http://www.enterprisesurveys.org/data/exploretopics/infrastructure#east-asia-pacific).

To further assess the quality of infrastructure in Indonesia a *Logistic Performance Index*, as a proxy for infrastructure development, is shown in Table 3.15. This index is also developed by the World Bank (see table note), and it is based on customs services, quality of infrastructure, international shipments, quality logistic services and timelines. Again, comparison is made for the global ranking across the ASEAN-5 countries. Table 3.15 shows that Indonesia has made progress in its logistics performance relative to these other countries over 2010-18, except for Vietnam, but that overall the global ranking of its Indonesia remains relatively low.

Table 3.15: Logistic Performance Index (LPI), 2010-18

Country	2010		2012		2014		2016		2018	
	Score	*Rank*	Score	*Rank*	Score	*Rank*	Score	*Rank*	Score	*Rank*
Indonesia	2.76	*75*	2.94	*59*	3.08	*53*	2.98	*63*	3.15	*46*
Malaysia	3.44	*29*	3.49	*29*	3.59	*25*	3.43	*32*	3.22	*41*
Thailand	3.29	*35*	3.18	*38*	3.43	*35*	3.26	*45*	3.41	*32*
Philippines	3.14	*44*	3.02	*52*	3.00	*57*	2.86	*71*	2.90	*60*
Vietnam	2.96	*53*	3.00	*53*	3.15	*48*	2.98	*64*	3.27	*39*

Source: https://lpi.worldbank.org/international/global.
Notes: LPI aggregates more than 5,000 evaluations. A bigger score / a smaller rank is a better performance.

Apart from physical infrastructure the technical readiness of a country is an important element of infrastructure and competitiveness. Table 3.16 shows the *Technological Readiness Index*, which is produced for the World Economic Forum's *Competitiveness Reports* (see table note).

The index is based on the availability of the latest technology, technology absorption at a firm-level, FDI and technology transfer, internet use, broadband internet subscriptions, internet bandwidth, and mobile-broadband subscription (WEF, 2017, p.16). Again, compared with the ASEAN-5 countries, Table 3.16 shows that Indonesia has made some progress compared to these countries, but that its technological readiness lags that of Malaysia and Thailand.

Table 3.16: Technological Readiness Index (TRI), 2009-18

Country	2009-10		2011-12		2013-14		2015-16		2017-18	
	Score	*Rank*	Score	*Rank*	Score	*Rank*	Score	*Rank*	Score	*Rank*
Indonesia	3.20	*88*	3.33	*94*	3.66	*75*	3.49	*85*	3.86	*80*
Malaysia	4.51	*37*	4.29	*44*	4.17	*51*	4.63	*47*	4.90	*46*
Thailand	3.71	*63*	3.47	*84*	3.56	*78*	4.24	*58*	4.48	*61*
Philippines	3.32	*84*	3.47	*83*	3.58	*77*	3.91	*68*	3.80	*83*
Vietnam	3.45	*73*	3.51	*79*	3.14	*102*	3.32	*92*	3.98	*79*

Source: *The Global Competitiveness Report*, World Economic Forum, various years.
Notes: TRI uses a 7-point scale. A bigger score / a smaller rank represents a better performance.

Labour and Wages

Noorbakhsh *et al.* (2001) and Gao (2005) argue that the quality of human capital (labour) is important for FDI. As the fourth most-populous country in the world, the availability of labour, coupled with its relatively low wages compared to developed countries, are clearly important factors for FDI location in Indonesia (Spar, 1996). The workforce availability has a similar distribution as the population and Appendix Table A.3.2 shows that Java dominates the workforce, especially West Java, East Java and Central Java. Indeed, Java accounts for almost 60 percent of the Indonesian workforce in 2008 and even though it is decreasing it is still accounts for over a half in 2018, at more than 56 percent. The other regions maintain their rankings over time, so that Sumatera is in second place (about 22 percent of the working population) and Sulawesi, Kalimantan, Bali and Nusa Tenggara each have about 6 to 7 percent, while Papua and Maluku has about 2 to 3 percent (Appendix Table A.3.2).

As regards the cost of labour this also varies across the provinces of Indonesia. Assuming that it is related to the minimum wage, Appendix Table A.3.3 presents these wages for each province. It shows that some Javan provinces have the lowest minimum wages in Indonesia, but that some other provinces in Java have the highest minimum wages, so that labour costs vary across the islands. The variation in labour costs has arisen partly because wages are the responsibility of provincial-level governments, with a demand for higher minimum wages sometimes causing labour to be laid-off (ASEAN, 2017, p.138). It is also related to the power of labour in pushing their agenda in the context of local autonomy and with the formation of labour unions. From 2008 to 2014, the average wages of industrial worker rose by 39 percent, while average wages for agricultural sector fell by 12 percent (Tabor, 2015). The growth in industrial wages reflects an increase in the minimum wages, which more than doubled over this period.

Besides looking for cheap labour, foreign investors also look for skilled labour that can increase their productivity (Lipsey and Sjoholm, 2011; OECD, 1996). As argued by Miningou and Tapsoba (2017, p. 4), "the quality of human capital is an essential ingredient for attracting FDI". Looking at the Indonesian context, each provincial government has an incentive to enhance its labour quality and to use this to persuade foreign investors to invest (Iwai and Thompson, 2012). Both parties benefit as the local government gains tax revenue and lower unemployment, while investors gain from higher productivity. It is also a good chance for the Indonesian workforce to get higher wages compared to the wages of domestically-owned firms, since in the mid-2000s the wages in foreign firms are 12 percent higher for blue-collar workers and 20 percent higher for white-collar workers (Lipsey and Sjoholm, 2004; Sjoholm and Lipsey, 2006).

The Indonesian government is aware of the importance of human education, and since 2009 it has allocated a minimum of 20 percent of the State Budget for basic education (12 years education). However, human capital still lags as Indonesia's range of rank is between 61 (upper-rank) and 64 (lower-rank) out of 72 countries in the Program for International Student Assessment (PISA) 2015 (OECD, 2016).[25] There is also a skills-gap as in a 2008 World Bank survey of Indonesian employers, Tabor (2015) reports that two-thirds of companies experienced difficulties in finding employees at a professional or management level. To partly address these issues, the government plans to increase the number of vocational students, but there is currently no clear evidence to demonstrate the effectiveness of this policy.

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[25] Indonesia's range of ranks for PISA 2015 on the following categories: science = 61(upper) - 63 (lower); reading = 61 (upper) - 64 (lower); mathematics = 61 (upper) - 64 (lower). OECD (2016).

In order to examine the quality of the Indonesian workforce by each province and region, the United Nations Human Development Index is shown in Appendix Table A.3.4 over 2010-17. In general, it can be seen that Java has a better quality of labour (a higher index value) compared with the other regions. It is also the case if the skill rates in Information and Communications Technology (ICT) are considered for the age group of 15-24 years. Appendix Table A.3.5 presents the ICT literacy rates for 2015 and 2016, and again Java is in a better position compared with the other regions and provinces. Overall, it is clear that Java is the dominant region in Indonesia in terms of the availability and quality of its labour, and that some of its provinces are also relatively cost competitive.

3.4 Conclusions

This chapter provides background context on Indonesia as a host location for foreign direct investment. Indonesia is uniquely located across two continents, Asia and Oceania, and its close proximity to the ASEAN countries and its maritime nature give it a strategic role in international shipping so that its geographical location is a potential factor for attracting FDI. Indonesia is rich in natural resources, such as oil and gas and mining, and with a population of more than a quarter of a billion in 2015 also has a large pool of labour resources so that it may also be a location that attracts resource-seeking FDI. The demographical features of Indonesia also means that investors may locate in Indonesia for market-seeking FDI. There are however locational challenges related to Indonesia in that it is located on the 'ring of fire' so that investors may avoid Indonesia as a location if they fear there is a high potential for natural disasters. Further, Indonesia has high levels of ethnic diversity that although can lead to cultural richness may also give rise to ethnic and religious tensions.

The political context of Indonesia is also important for FDI location, with three different political periods in Indonesia having occurred since its independence in 1945. The political structure has shifted from authoritarian rule in the era of the Old Order towards increased openness throughout the New Order and into the current Democratic Reform periods. The current Democractic Reform period has been characterised by a number of important institutional changes, in particular a decentralisation of power away from the more centralised authoritative regimes and the implementation of laws removing the previous restrictions that were imposed on FDI. Overall, the political and investment landscape of Indonesia has changed

remarkably since independence, so that Indonesia is now seen as a democratic and more open economy with an improving investment environment for FDI.

The structure of the Indonesian economy has also undergone dramatic changes over its recent history, with large levels of industrialisation followed by a growth in services so that manufacturing and services now dominate the Indonesian economy. The overall Indonesian economy has a GDP of more than one trillion USD making it the largest economy in South East Asia, although in terms of GDP per capita Indonesia is classed as an emerging economy and is placed in the category of a low middle-income country with income per capita in 2017 of roughly 3,800 USD. Further, in terms of social indicators, despite Indonesia having made progress in a range of quality of life measures it lags behind other ASEAN countries so that although the size of Indonesia ensures it is a member of the G-20 group of advanced and emerging economies there is still progress to make in terms of its socio-economic growth. Recent policy directives of increasing expenditure on infrastructure demonstrates the need for Indonesia to catch-up with other countries in the region to further its economic development.

Funding of policy measures such as infrastructure expenditure relies on state revenue, where the main mechanism of raising revenue in Indonesia is through taxation which contributes more than seventy percent of revenue to the state budget. One way of boosting revenue is to increase the number of taxpayers so that providing incentives to attract new investors, such as FDI, is an important policy tool for Indonesia. Attracting FDI may also help Indonesia boost economic growth and development through the benefits that FDI brings into a given location. The use of incentives to attract FDI and to help boost revenue and increase economic growth is evident through the implementation of area-based policies in the form of Industrial Areas and Special Areas, which in the case of the latter covers Bonded Zones, Free Trade Zones, and Special Economic Zones. These areas provide both fiscal and non-fiscal incentives to investors. In the case of fiscal incentives, the Bonded Zones and Free Trade Zones are intended to attract investment that is mainly focused on exports with indirect tax incentives relating to VAT and import and excise duties, while the Special Economic Zones in addition to the above mentioned tax incentives also offer further incentives related to income tax and local taxes and are less oriented towards the export market.

In general, to be eligible for the range of incentives schemes offered by Indonesia the nature of the FDI must often satisfy certain criteria such as operating in a ‘pioneer’ industry that has strategic value to the national economy. The aim of tax policy can therefore again be seen to

not solely be used to attract foreign investment to boost tax revenue but to also boost economic growth and improve the distribution of economic activity in the country. Apart from the development of Special Areas and the implementation of tax incentives to support foreign investment Indonesia also offers institutional support to FDI. Indonesia has made continual changes to its institutional framework for FDI, particularly in the role of the BKPM whose responsibilities involve the preparation and implementation of national investment policy in Indonesia, the provision of licenses for foreign investors, and who are a one-stop service for helping to assist in the location of foreign investors. It is believed that the institutional framework for FDI is important for the legal certainty, openness, accountability and efficiency of the overall investment process and that these are crucial for attracting FDI. The level and nature of FDI in Indonesia is explored in the next chapter.

Chapter 4. The Nature of Inward FDI in Indonesia

4.1 Introduction

Chapter 3 discussed the geography and demography of Indonesia as well as its political and economic history and the structure of the economy. It also considered the nature of its policy towards inward FDI in terms of tax incentives, special areas and the overall business environment. This chapter considers the level and nature of aggregate FDI inflows into Indonesia. It is a precursor to the analysis in the subsequent chapters of the factors determining FDI location in Indonesia, through the questionnaire survey of foreign investors and the face-to-face interviews with policymakers. I begin this chapter by outlining the history of FDI in Indonesia, distinguishing between three broad time periods: the period immediately after independence in 1945 when the government had a very 'closed' view of the economy; the period from the mid-1960s as it moved towards greater openness; and the period after 2007 when it has actively encouraged FDI to facilitate economic development. I show that government policy towards inward FDI has changed across these three periods, and that this has had a dramatic effect on the level and nature of FDI location in Indonesia.

Following this, in Section 4.3, I consider the scale of FDI in Indonesia over time. This starts by comparing FDI with domestic direct investment since the early 1990s, examining the number, scale and mean size of the investments. It is based on data for the investment licences that are administered by the Indonesia Investment Coordinating Board (the 'BKPM'). Each FDI project in Indonesia requires a license, and these data have been obtained for the purpose of this study. I examine the industrial sector (primary, secondary and tertiary) of the investment, its spatial distribution according to the regional location, and the country of origin of the FDI. Subsequently in Section 4.4, I consider the aggregate contribution of FDI inflows to the Indonesian economy in terms of its effect on employment, GDP growth, productivity and the government current account. Section 4.5 summarises the findings of the chapter and considers the implications of these for the later analysis of this thesis.

4.2 FDI Policy in Indonesia in the Post-War Period

Indonesia has taken very different policy stances towards FDI, from the 'closed' period of the Old Order, which had a hostile attitude to foreign investment in early years after independence,

to the ‘open’ period of the Democratic Reform Era and a much greater acceptance of FDI (see Section 3.2.2). It has led to a much more positive view of foreign investment (Thee, 2010; Lindblad, 2015). This section provides a brief history of FDI location in Indonesia, and it is divided into three broad periods: the Old Order Era from 1945 to 1967; the period from 1967 to 2007 that covers the New Order Era up to 1998 and the early years of the Democratic Reform Era; and the period after 2007 since when the government has pursued a non-discriminatory policy towards foreign investment and has been more welcoming. In the following I provide an overview of the major events in each period as they relate to inward investment policy.

4.2.1 The Period from 1945 to 1967

After Indonesian independence in 1945, the government’s attitude towards foreign direct investment was conflicted about whether to welcome foreign investment or to stick with its stance of economic nationalism that discouraged this investment. This was in part driven by a rapid turnover of coalition cabinets, which could have a life of only a few months, so that there was unstable government, and a policy perspective that could swing dramatically in nature from highly liberal to ultra-nationalist (Oei, 1969). Nevertheless, the period as a whole was hallmarked by being relatively closed to foreign investment. In fact, there was almost no FDI under the President Sukarno regime (1945-1967), reflecting the nationalisation of many foreign assets, such as the takeover of Dutch firm assets in 1958, British and Malaysian assets in 1963, and some American and other foreign investors assets in 1965 (OECD, 1999; Lecraw, 1996). According to Redfern (2010), from September 1963 to December 1965 (a 28-month period) no less than 90 companies of different nationalities (British, American, Belgian, and Malaysian) were taken over by the Indonesian government. The foreign assets that were nationalised and transformed into state-owned-enterprises (SOEs) came from oil companies, plantations (i.e., rubber and palm oil), banks, shipping and service industries (Robison, 1986). Furthermore, Indonesia closed itself off from FDI and from May 1965 foreign investors were prohibited by law (Law 16/1965 which abolished Law 78/1958 as amended by Regulation in Lieu of Law 15/1960) from investing in the country (Redfern, 2010).

During this period economic policy was integral to the political strategy, and the decision of the Indonesian government to choose economic nationalisation and socialisation through the expropriation of Dutch enterprises was a direct result of political considerations (Anonymous, 1965; Robison, 1986). Further, President Sukarno’s decision to “dismantle cabinet government and establish presidential authority” in 1958 and the implementation of state capitalism policies

and economic nationalism were fully supported by the Army (Robison, 1986, p. 63). In this period the government believed political aspects came first and that when this was successful it would solve economic problems. It was a period when economic nationalism was dominant, and there was an unfriendly attitude towards foreign investment. In fact, no investors were willing to invest in Indonesia following the expropriation of Dutch firms' assets (White, 2012; Redfern, 2010). The period 1945-67 is therefore characterised by unstable political conditions, partly due to domestic issues such government cabinets changing frequently, but also due to external factors. This included the nationalisation of foreign firm assets, a confrontation with Malaysia that followed the suspension of bilateral trade talks in August 1963 (Anonymous, 1965), and the decision to withdraw from the United Nations in January 1965 (Redfern, 2010). The Sukarno era ended following an attempted coup by the Indonesian Communist Party (the 'PKI') in 1965 (Pauker, 1967).

4.2.2 The Period from 1967 to 2007

This sub-section details Indonesian FDI policy during the New Order Era (1967-98) and early Democratic Reform Era (1998-2007), as discussed in Chapter 3. The period from 1967 to 2007 mainly covers the duration of the implementation of Law 1/1967 as amended by Law 11/1970 concerning Foreign Investment, before it was revoked and no longer valid under the Law 25/2007. As argued by Oei (1969), after Suharto took the presidency in 1967, Indonesia made a major reversal in policy towards foreign investment. During the early years of his presidency, 1967-8, the government of Indonesia returned the companies seized in 1963-5 to their original owners, although this was protracted as the investors were unsure if they could recommence their business in Indonesia (Redfern, 2010). In order to improve macroeconomic conditions President Suharto sought a major change in economic orientation away from the role of state-owned enterprises and direct intervention towards greater reliance on the market mechanism.

The enactment of Law 1/1967 on Foreign Investment Law gave the assurance that the government of Indonesia would not nationalize foreign firms' assets (Article 21), and this represented an important commitment, improving the confidence of foreign investors about Indonesia as a location. Under this law, foreign investors could invest in any sector that was not classified as a restricted sector, although it should be in line with the National and Regional Economic Development Plan for Indonesia, in terms of its location, business sector, size of investment and investors' objectives (Article 4). The sectors that were restricted were those considered important on security grounds (e.g., defence equipment, atomic power, explosive

devices and materials), in strategic sectors (e.g., ports, shipping, flight, railway and mass media) or in the public services (e.g., drinking water and production, transmission and distribution of electricity) (Article 18). Apart from Law 1/1967, Indonesia's commitment to protect foreign investors' proprietary was reflected by the enactment of Law 5/1968 regarding the Settlement of Investment Disputes between States and Nationals of other States. Under this the Indonesian government was willing to follow the procedures of the International Centre for Settlement of Investment Disputes (ICSID) in Washington D. C. (Hornick and Nelson, 1987). During the early years of this period, 1968 and 1969, inward FDI to Indonesia was almost exclusively for the exploration of natural resources rather than in manufacturing (Lindblad, 2015).

In 1970, the Indonesian government amended Law 1/1967 with Law 11/1970. The amendment tightened the provision of tax facilities for FDI, including a reduction of the tax holiday period. Based on Law 1/1967, a tax holiday could be granted for up to 5 years, but under the new amendment law (Law 11/1970) this was reduced to a maximum for 2 years. However, the tax holiday period could be extended, although only under the approval of the Minister of Finance.

The 1970s were marked by momentous events and policy changes, including nationalism. In 1972, the sentiment towards foreign investment was evident in a survey that was conducted by McCawley (1972), which showed that "the domestic economic alarmists are the indigenous (*pribumi*) business groups who loudly object that foreign investors are squeezing Indonesian entrepreneurs out of existence" (p. 17). On another occasion, the sentiment towards Japanese FDI was evident in the so-called 'Malari' incident of January 1974 when riots occurred in Jakarta during the visit of the Japanese Prime Minister. Even though the source of the policy changes cannot be precisely known, the investment climate became more restrictive a year later when it was required that foreign investment should be conducted only as a joint venture with domestic (indigenous Indonesia) firms whose equity had to rise above 50% within ten years (Lindblad, 2015). Further, in May 1975, new foreign direct investment in the logging sector was prohibited even though this met with severe resistance (Robison, 1986). As a consequence of these changes, Indonesia was seen to be "one of the least attractive foreign investment sites in Asia, particularly outside the extractive sector" (Arndt, 1977, p. 13).

There was further significant change over 1974 to 1986, as the Indonesian government tightened its inward investment policy towards a more protectionist stance. This meant that all new foreign investment had to be in the form of a joint venture with a domestic firm and that the existing Indonesian equity in joint venture companies should be increased to a minimum of

51 percent. The number of sectors that were closed to FDI was also increased, tax incentives were reduced and the number of foreign personnel employed in foreign-owned companies was reduced (see Lecraw, 1996, p. 324). Further, over this period, there was economic instability as Indonesia became increasingly dependent on oil and gas generation, as mentioned in Chapter 3. In fact, by 1981, oil and gas accounted for 82% of exports by value and 73% of government revenue (MacIntyre, 1994, p. 250). However, crude oil prices fluctuated wildly, booming in 1973-74, falling back, doubling again in 1979-80 and collapsing in 1986 (DOE, 1985, p. 135). It led to the elimination of all advantageous tax facilities in 1984 (see Appendix Table A.3.1).

The collapse of the oil price in 1986 meant that Indonesia experienced further economic difficulties (Gately, 1986), and in order to improve economic performance the government started to conduct a wide-ranging economic reform (Agrawal, 1995). A major step in this respect was a 'policy package' in May 1986 that contained provisions "to attract more foreign direct investment, especially export-oriented companies and also opening up of several sectors which previously had been closed to foreign investment" (Thee, 1987, p. 395). The package was considered as one of the most successful attempts to attract FDI to Indonesia (Sarwedi, 2002). Table 4.1 shows the very strong increase in FDI inflows into Indonesia over 1986-92, which increased by more than ten-fold. The number of projects also increased above the level of 1986, but suggesting that this investment occurred in much larger projects.

Table 4.1: Inward FDI Approvals in Indonesia, 1986-92

	1986	1987	1988	1990	1992
FDI amount ($ million)	848	1,481	4,409	8,750	10,313
Number of FDI projects	93	130	145	432	305

Sources: Thee (1991) and Agrawal (1995).

From 1983 to 1987 the President provided annual guidance to both domestic and foreign firms on the priorities for investment.[26] The number of sectors included on the 'Priority Investment List' increased in each year, before it was replaced by a 'Negative Investment List' in 1989 (Presidential Decree 21/1989). This essentially was a list of restricted sectors for FDI, or where the investment was conditional (Genthner and Kis-Katos, 2018). The Negative Investment List has since been changed frequently, where between 1989 and 1995 the government changed the

[26] This is the Priority Investment List ('*Daftar Skala Prioritas*') based on Presidential Decree numbers, 34/1983, 51/1984, 55/1985, 22/1986 and 15/1987.

list almost every year.[27] In general however, during this period the government's attitude to foreign investment has changed towards being more open. For example, in 1989, 75 business sectors were restricted for foreign investment, but in 2016 this had reduced to only 20 sectors. Further, from the mid-1980s onwards, the government made deregulation a major priority in economic making policy, including foreign investment. As a consequence, from 1986 to 1990, the BKPM approval of investment showed a strong increase with a main focus on firms that produced for export (Pangestu and Habir, 1990; Parker, 1991).

As the oil boom era ended in the late 1980s (Wihardja, 2016), the government relaxed investment regulations in order to attract further investment into the country. This was particularly related to the level of minimum capital required for foreign firm establishment and foreign investor ownership. This started with Government Regulation number 17/1992, which allows minimum paid-in capital of US$ 250 thousand (which prior to this the minimum capital for foreign investment is no less than US$ 1 million). However, despite these changes, foreign investors were still required to fulfil one of the following requirements: (a) the new established firm should be labour intensive, (b) output products are mostly for export, or (c) producing intermediary products for domestic industries. In addition to the above, the government was also relaxing foreign investment ownership rules so that a 100% foreign firm ownership was allowed as long as it fulfilled one of the following criteria: (1) paid-in capital at least US$ 50 million, (2) the company established in one of investment designated area, or (3) the company is established in a Bonded Zone with 100% production output for export.

The Government Regulation number 17/1992 was amended less than one year later by the Government Regulation number 7/1993 to address the agreement between the governments of Indonesia and Singapore regarding the establishment of an investment area in Bintan dan Karimun Island in the Riau Province. Further changes were also made through Government Regulation number 50/1993 that continued this locational aspect to FDI policy by directing investments towards border areas with other countries. Additional changes were also made to relax foreign ownership rules by decreasing the requirement for paid-in capital from US$ 50 million to US$ 2 million and in the following year Government Regulation 20/1994 allowed foreign investors to invest in Indonesia either in the form of a joint venture (up to 95% foreign ownership share) or as a 100 percent foreign ownership. In practice, investment in the form of

[27] Presidential Decree numbers: 23/1991, 32/1992, 54/1993, 31/1995, 96/1998, 96/2000 and 118/2000. The changes on Negative Investment List continuous with Government Regulation number: 77/2007, 111/2007, 36/2010, 39/2014, and 44/2016.

a joint venture was beneficial as it opened up sectors that were previously restricted and foreign investors were able to gain an investment license for a period up to 30 years, which could be extended with government approval. With respect to the fiscal incentives, the government reintroduced the tax holiday (Regulation number 45/1996), which had been in abeyance (see Appendix Table A.3.1). Overall, a large number of changes were made in a bid to attract FDI and subsequently Indonesia experienced a huge increase in FDI inflows from 1996 onwards.

However, soon after the pick-up in FDI inflows in 1996, the Asian Financial Crisis started in Thailand in 1997, which then affected Indonesia, so that by March 1998 the BKPM approvals of FDI had fallen to less than half of the level that had prevailed in 1977 (Lindblad, 2015). Indonesia experienced a deep economic crisis in 1998 when net FDI inflows actually became negative, as firms disinvested. In fact, in 1996 Indonesia received net FDI inflows of about US$5.5 billion, but by 1998 this had changed dramatically into negative FDI (i.e., net outflows) of about US$400 million (Athukorala, 2003). A similar pattern is presented by Hill (1999, p. 36), who found that over 1997-98 FDI flows declined and translated into a loss of US$6 billion. The financial crisis led to a political crisis and the fall of President Suharto in 1998.

This heralded the end of the New Order Era, and with the inauguration of President B. J. Habibie the start of the Democratic Reform Era. In order to encourage FDI President Habibie liberalised the banking sector by allowing 99% foreign equity ownership shares and allowed the opening of branch offices throughout the country. However, from 1998 to 2006, Indonesia struggled to recover from the economic crisis. An important government policy during this period was the establishment in 2002 of the Corruption Eradication Commission (the ‘KPK’) under President Megawati. More stable economic conditions followed the first direct general election of an Indonesian President that brought Susilo Bambang Yudhoyono into office from 2004 to 2009. During this period new investment laws become the hallmark of policy, and which put foreign and domestic investment on a more equal footing.

Overall, even though FDI was welcomed by the government of Indonesia over the period 1967-2007, it occurred in a relatively restrictive investment climate, which sometimes exhibited a ‘love-hate’ relationship. Economic nationalism was weaker during this period, but sometimes still evident in the form of a cultural rejection of investment from certain countries, and which also resonated to government policy, with a less favourable policy towards foreign investment. However, towards the end of the period, the government of Indonesia had shown a more positive attitude towards FDI inflows, and this has characterised policy from this time forwards.

4.2.3 The Period from 2007 onwards

The period from 2007 is marked by the implementation of Law 25/2007, which merged the Foreign Investment Law (number 1/1967, as amended by number 11/1970) with the Domestic Investment Law (number 6/1968, as amended by number 12/1970) to form one single new law, known as the Investment Law. It is a new era of FDI policy as one of the main features of Law 25/2007 in comparison with the previous law is its equitable and non-discriminatory treatment of investment according to the country of origin. It means that all investors (both foreign and domestic) are treated equally unless provided for by some other laws or regulations.

Another important feature of the period from 2007 is the guarantee of no nationalisation or expropriation of proprietary rights (Article 7, Law 25/2007). This regulation ensures that the past experience of the Old Order Era (from 1958 to 1967) will not be repeated. An investor may also freely transfer their assets to another party and have the right to make transfers out or to repatriate their assets. Law number 25/2007 also gives discretion to the government to provide financial incentives to investors, such as a higher rate of investment depreciation, the carry forward of losses to the next tax year, and lower income tax rates on the dividends paid to foreigners (Porter and Ketels, 2007). In 2011, the government also implemented income taxes relief for Pioneer Industries (Section 3.3.2; Appendix Table A.3.1). The incentive was to be given for between 5 and 10 years. This tax incentive has also been relaxed several times since its introduction, for instance in 2016 when the government extended the period for the tax relief to between 5 and 15 years, and in 2018 it extended it again to a maximum of 20 years.

Apart from the tax incentives, the government has also liberalised its stance towards foreign investment. If the Negative Investment List is compared between 2007 (Government Regulation 77/2007) and 2016 (Government Regulation 44/2016), it shows that the government has loosened the restrictions on foreign investment. For example, comparing Regulation 44/2016 with the previous Regulation 39/2014 it reveals that there are 35 sectors that are no longer restricted for foreign investment, including toll roads, cold storage, tourism and the creative economy. The new investment Law 25/2007 allows 100% foreign equity ownership across the board, which is a positive signal, and according to Lindblad (2015) "was greeted with satisfaction by foreign investors". A result of these changes is that FDI inflows started to increase from 2009 onwards, although if we look at research conducted by Lipsey and Sjoholm (2011), the ratio of FDI to GDP was still lower in Indonesia compared to other countries in

Southeast Asia. Indeed, Lipsey and Sjoholm claim that foreign investors from America choose only to locate in labour-intensive locations like Indonesia, if alternatives are not available elsewhere. This occurs because of the persistent issues regarding institutions, infrastructure, education (productivity) and corruption, while Indonesia is also considered to have "has failed to integrate fully into international production networks" (Lipsey and Sjoholm, 2011, p. 57).

Overall, the years from 2007 i.e., since the implementation of Law 25/2007 are considered to be the period when the government started to be more open and reduced discrimination against FDI. Even though discrimination still exists in the forms of the Negative Investment List, i.e., sectors that foreign firm cannot invest in, restrictions have been reduced significantly over time. From the above discussion, it also seems that changes to FDI policy can be linked with both the country's political conditions and the government's ability to balance the national state budget (the 'APBN') so that when the budget is in a favourable position the government tightens its stance towards FDI, but when it is less favourable the government relaxes its foreign investment policy. Indeed, Lipsey and Sjoholm (2011) consider the attitude of Indonesia towards FDI to be rather ambivalent.

4.3 Project Scale Over Time

This section utilises the Indonesia Investment Coordinating Board (BKPM) data on the realization of Foreign Direct Investment and Domestic Direct Investment in Indonesia to analyse the nature of FDI, and to compare it with domestic investment as a benchmark. The data are presented on an annual basis at current prices and are gathered from the BKPM website on the National Single Window for Investment (NSWI). Some caution is needed as the BKPM data excludes oil and gas, banking, non-bank financial institutions, insurance, leasing and home industries (BKPM, 2018; Hill, 1988). However, they are the only available FDI data at the provincial level, and so offer important insights. They differ, for instance, from the World Development Indicators data of the World Bank, which is based on Balance of Payments transaction data.[28] Further, while prospective, the great advantage is that they are in gross terms and so capture new investment projects.

[28] The FDI realization data of BKPM encompasses the total value of realised projects within a period, but excludes investment in the oil and gas sector, banks and other financial institutions, and home industries. Meanwhile, the FDI data recorded in the Indonesia balance of payments covers data on capital inflows received by FDI companies only from their direct investors and offshore companies within the same group over a defined period, and encompasses direct investment in all economic sectors (see Bank of Indonesia, 2012, p. 13).

In general, when the data is available the analysis is conducted from 1995 to 2017, however some of the analysis is conducted only from 2005 because of data limitation. In the following subsection I analyse the pattern of investment both in aggregate and by the project scale. It is followed by an analysis of the characteristics of the investment according to the sector, location and country of origin. In each case, the discussion is focused on foreign investment, while a comparison is made between foreign and domestic investment when it is appropriate.

4.3.1 Investment Scale

This subsection provides an analysis of FDI in terms of the investment amount, the number of projects and the mean project scale. Table 4.2 shows the comparison of FDI and Domestic Direct Investment (DDI) over the last two decades. The FDI data are based on the investment realization recorded by the BKPM and then converted into Indonesian rupiah using the yearly exchange rate (US$ to Rp) that is provided by the Indonesian Central Bank.

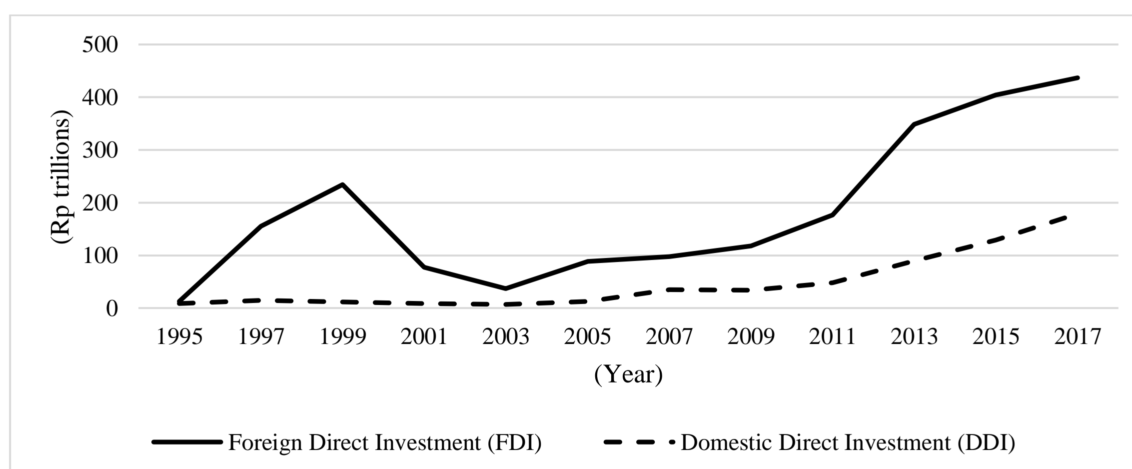
Looking at Table 4.2, in the years 1997-98 the Asian Financial Crisis caused the value of FDI realization (in US$) to fall by more than 80% (from US$ 33,426 million to US$ 5,411 million), although this is caused partly by a fall in the Rupiah, which dropped by 41.5% (from Rp 155 trillion to Rp 91 trillion). Therefore, some caution is needed valuing FDI flows in Rupiahs in these years, although over the period 1998 to 2017 there is no extreme currency depreciation or appreciation. Comparing the FDI and DDI realizations from 1995 to 2017 it can be seen that before 2005 investment has fluctuated for both FDI and DDI. There was high volatility, as FDI inflows increased dramatically in 1997, 1999 and 2002, while there were large falls in 1998, 2000-01, and 2003, but that this volatility is related to the Asian Financial Crisis. Since 2005, both FDI and DDI have shown a strong increase, with the FDI realizations increasing from Rp 88,326 billion in 2005 to Rp 436,784 billion in 2017, while the DDI realization of investment increased by more than fourteen-fold over the same period. Further, Figure 4.1 plots the volume of these investments over time and shows that FDI over 1995-2017 has almost always exceeded the amount of DDI (except in 1996).

Table 4.2: Comparison between FDI and DDI Realization, 1995-2017

Year	FDI US$ million	Exchange rate (Rp/US$)	FDI Projects			DDI Projects		
			Number	Amount (Rp bn)	Mean (Rp bn)	Number	Amount (Rp bn)	Mean (Rp bn)
1995	5,516	2,308	216	12,732	59	274	8,587	31
1996	3,899	2,383	282	9,292	33	360	15,929	44
1997	33,426	4,650	246	155,429	632	259	14,845	57
1998	5,411	16,800	291	90,913	312	213	7,566	36
1999	32,719	7,160	381	234,270	615	196	11,394	58
2000	8,503	9,595	478	81,589	171	226	19,569	87
2001	7,407	10,400	354	77,029	218	134	8,290	62
2002	26,929	8,940	342	240,741	704	84	19,092	227
2003	4,310	8,465	480	36,486	76	118	6,831	58
2004	2,645	9,290	439	24,576	56	122	11,123	91
2005	8,985	9,830	927	88,326	95	182	12,423	68
2006	6,064	9,020	895	54,696	61	135	12,638	94
2007	10,409	9,419	1,002	98,043	98	141	34,639	246
2008	17,561	10,950	1,148	192,294	168	218	16,680	77
2009	12,575	9,400	1,244	118,200	95	244	33,527	137
2010	16,215	8,991	3,069	145,787	48	452	37,153	82
2011	19,442	9,068	3,614	176,302	49	536	47,589	89
2012	24,565	9,670	4,579	237,540	52	451	61,368	136
2013	28,618	12,189	9,612	348,819	36	1,239	89,301	72
2014	28,530	12,440	8,885	354,909	40	629	112,703	179
2015	29,276	13,795	17,738	403,862	23	3,045	129,421	43
2016	28,964	13,436	17,728	389,161	22	2,206	147,119	67
2017	32,240	13,548	26,257	436,784	17	3,855	178,900	46

Sources: FDI and DDI from National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (https://nswi.bkpm.go.id/data_statistik), and exchange rate from Indonesia Central Bank and Statistics Indonesia (2018).
Notes: Current exchange rates at current prices.

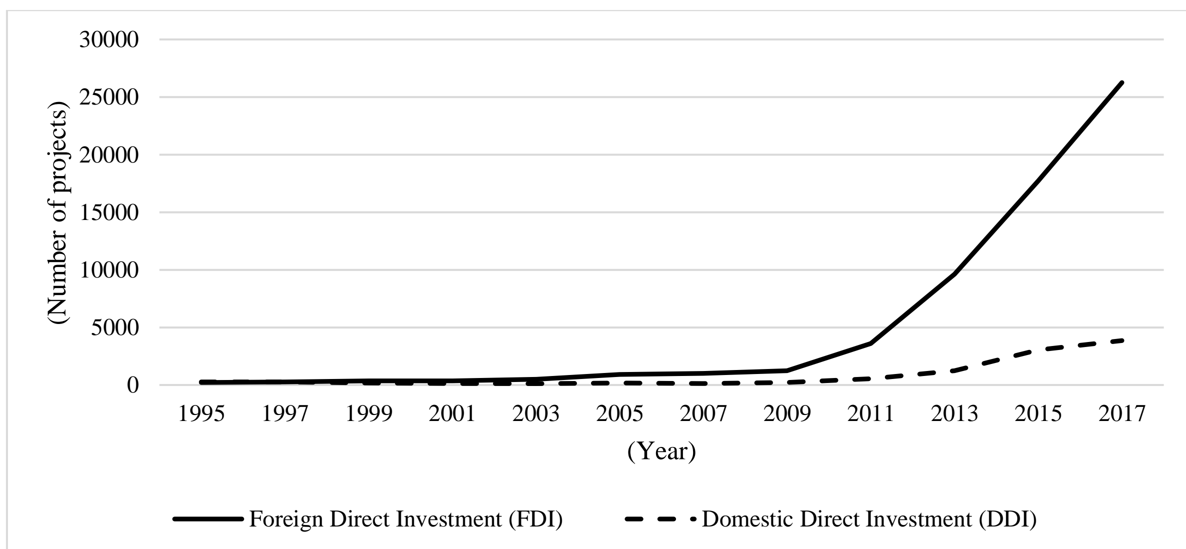
Figure 4.1: Total Foreign and Domestic Investment, 1995-2017



Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).
Note: Current exchange rates at current prices.

Figure 4.2 compares the number of FDI and DDI projects over 1995-2017, and gives a clearer picture as the units of measurement are independent of the exchange rate. The figure shows that at the beginning of the period the number of projects is similar between foreign and domestic investment. However, after the implementation of the new investment law (Law 25/2007), the number of FDI projects increases from 2009 and far exceeds the number of DDI projects from 2011 onwards. Indeed, the increase in the number of FDI projects is much greater than the increase in the aggregate inward investment, and as Table 4.2 shows the average scale of the investment has decreased over time.

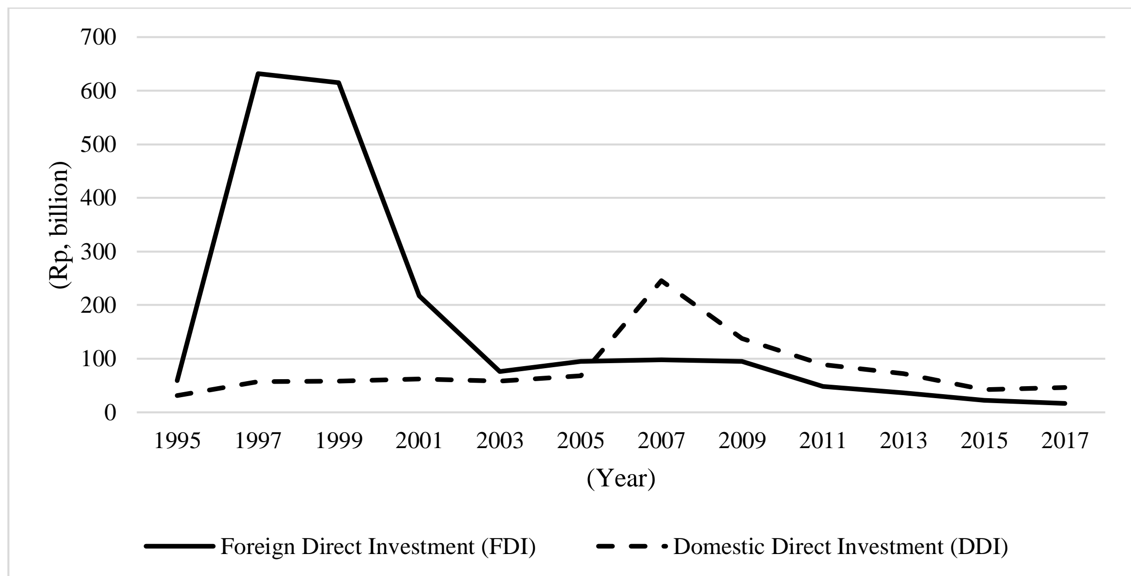
Figure 4.2: Number of Projects of Foreign and Domestic Investment, 1995-2017



Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

The project scale is also evident from Figure 4.3, which shows that the average FDI project scale has decreased from 1999, but that from 2009 onwards the scale of the FDI and DDI projects is very similar. Overall, it shows that the size of FDI projects in Indonesia is getting smaller, and so might be less capital intensive and related to compositional differences such as the sectors in which FDI occurs over time and which is explored in the below section.

Figure 4.3: Mean Project Scales of FDI and DDI, 1995-2017

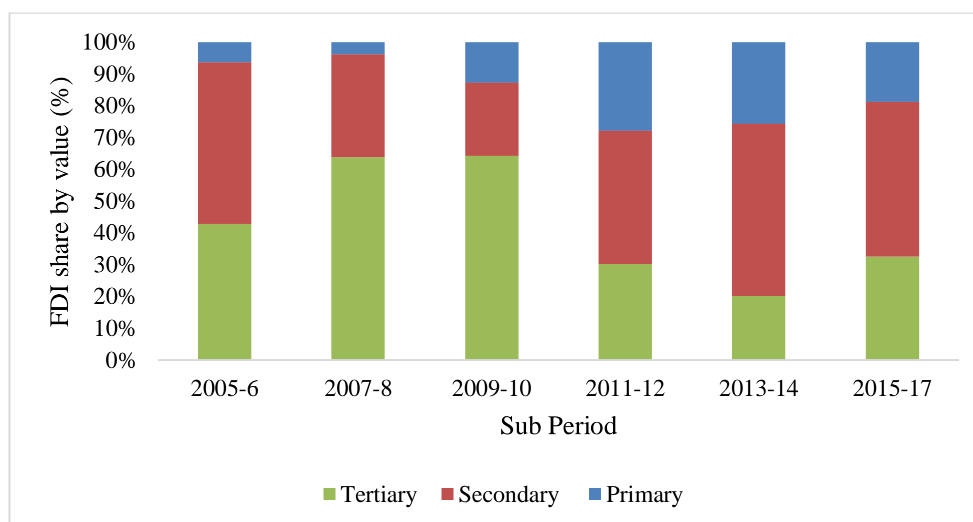


Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).
Note: Current prices.

4.3.2 Investment by Sector

Prior to 2005, the manufacturing sector dominated inward investment, but since this time the primary and tertiary sectors have grown in importance. Figure 4.4 disaggregates the value of FDI flows to Indonesia over 2005-17 according to the primary, secondary (manufacturing) and tertiary sectors. This is for six 2 or 3-year periods. The primary sector consists of agriculture and plantations, livestock, forestry, fishery, and mining, while the secondary sector covers manufacturing industries in food, textiles, leather goods and footwear, wood, paper and printing, chemicals and pharmaceuticals, rubber and plastics, non-metal industry, metal, machinery and electronics, and medical instruments. The tertiary sector includes service activities, such as hotels, retail and tourism, as well as construction.

Figure 4.4: Share of FDI by Sector, 2005-17

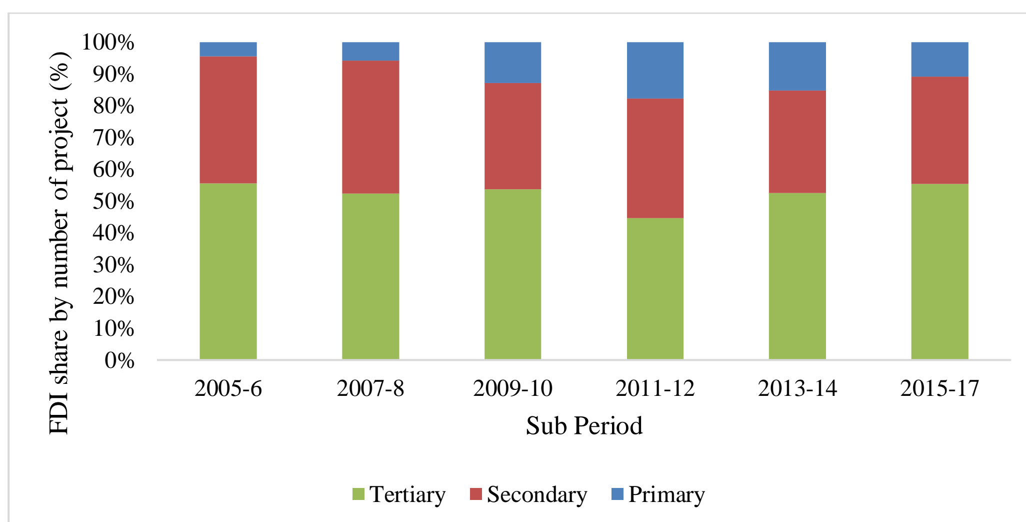


Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM), https://www.bkpm.go.id/images/uploads/.
Note: Current prices.

Figure 4.4 shows that at the beginning of the period, FDI was split roughly evenly between the secondary and tertiary sectors, but that up to around 2010 the scale of investment in the tertiary sector increased, accounting for about 60 percent of the value of FDI. However, since 2010 service sector FDI has fallen back, so that it now represents about a third of total FDI by value. FDI in manufacturing accounts for about half the FDI in Indonesia and there is still a significant amount of FDI related to the primary sector.

Figure 4.5 disaggregates the FDI data by the number of projects according to the same six sub-periods. It shows that the primary sector has the lowest share of the number of projects in each period. Nevertheless, the contribution of the primary sector increased between 2005-06 and 2011-12, but then declined in the last two sub-periods. The manufacturing sector is consistently the second most-important contributor to the number of FDI projects and in general accounts for around 30 to 40 percent of the number of projects in each period, although this has declined over time. Throughout the period, the number of FDI projects is dominated by the tertiary (service) sector where it contributes more than 50% of the total number of projects (only in 2011-12 is its contribution less than half although it still the largest contributor).

Figure 4.5: FDI Share by Number of Projects, 2005-17



Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM), https://www.bkpm.go.id/images/uploads/.

4.3.3 Investment by Location

Table 4.3 presents the FDI inflows to each region of Indonesia from 2005 to 2017, by 3- or 4-year periods. In general, it shows that the pattern of FDI is dominated by Java Island with more than 60 percent of FDI by value, followed by Sumatera and Kalimantan with about 13 percent and 10 percent of investment respectively. Sulawesi and then Papua and Maluku received similar amounts of investment, at around 6 and 5 percent of total FDI, and lastly Bali and Nusa Tenggara received the least amount of investment (only about 3.4 percent of total inward FDI).

Table 4.3: FDI Inflows by Indonesian Region, 2005-17

(US$ millions, current prices)

Region	2005-07	2008-10	2011-13	2014-17	2005-17
Java	20,286 (79.7%)	38,250 (82.5%)	43,279 (59.6%)	62,403 (52.4%)	164,218 (62.3%)
Sumatera	3,590 (14.1%)	2,596 (5.6%)	9,201 (12.7%)	18,740 (15.7%)	34,127 (13.0%)
Kalimantan	1,026 (4.0%)	2,460 (5.3%)	7,901 (10.9%)	15,993 (13.4%)	27,379 (10.4%)
Bali and Nusa Tenggara	283 (1.1%)	1,350 (2.9%)	2,968 (4.1%)	4,364 (3.7%)	8,966 (3.4%)
Sulawesi	241 (0.9%)	1,066 (2.3%)	3,720 (5.1%)	9,868 (8.3%)	14,895 (5.7%)
Papua and Maluku	32 (0.1%)	629 (1.4%)	5,555 (7.6%)	7,641 (6.4%)	13,857 (5.3%)
Total	25,458 (100.0%)	46,350 (100.0%)	72,624 (100.0%)	119,009 (100.0%)	263,443 (100.0%)

Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

In the first sub-period (2005-07) about 80 percent of total FDI was in Java and 14 percent in Sumatera. Kalimantan receives a small portion, about 4 percent, and Bali and Nusa Tenggara get roughly 1 percent, which is not much more than Sulawesi and Papua and Maluku. However, by 2011-13, Table 4.3 shows that FDI increased dramatically in Papua and Maluku and to a lesser extent in Sumatera. These are important destinations for FDI location outside of Java and suggests a less unequal regional distribution of FDI. Indeed, by the last sub-period (2014-17), the value of FDI in Java had fallen to 52 percent, while combined in Papua and Maluku, Sulawesi, and Bali and Nusa Tenggara, it was 18 percent compared with 2 percent in 2005-07.

Table 4.4: Largest Sectoral Recipients of FDI by Region, 2005-17

Region and sector	Total investment (US$ billions, current prices)		No. of projects	
Java				
Transport, storage and communications	38.8	(24%)	1,822	(3%)
Motor vehicles and other transport equipment	16.4	(10%)	3,263	(5%)
Chemicals and pharmaceuticals	15.1	(9%)	3,270	(5%)
Electricity, gas and water supply	13.6	(8%)	476	(1%)
Total	164.2	(100%)	67,662	(100%)
Sumatera				
Paper and printing	7.0	(21%)	155	(1%)
Chemicals and pharmaceuticals	4.7	(14%)	747	(7%)
Food	4.5	(13%)	1,535	(15%)
Mining	3.9	(11%)	1,044	(10%)
Total	34.1	(100%)	10,381	(100%)
Kalimantan				
Mining	9.8	(36%)	1,516	(27%)
Agriculture, including plantations	9.0	(33%)	1,561	(28%)
Food	2.4	(9%)	1,098	(20%)
Electricity, gas and water supply	1.2	(4%)	156	(3%)
Total	27.4	(100%)	5,627	(100%)
Bali and Nusa Tenggara				
Mining	3.0	(33%)	182	(2%)
Hotels and restaurants	2.6	(29%)	2,808	(33%)
Electricity, gas and water supply	1.5	(17%)	110	(1%)
Other services	0.5	(6%)	2,496	(30%)
Total	9.0	(100%)	8,399	(100%)
Sulawesi				
Metal, machinery and electronics	4.8	(32%)	341	(11%)
Chemicals and pharmaceuticals	4.2	(28%)	124	(4%)
Mining	2.5	(17%)	745	(24%)
Electricity, gas and water supply	1.2	(8%)	267	(8%)
Total	14.9	(100%)	3,155	(100%)
Papua and Maluku				
Mining	11.0	(79%)	306	(21%)
Agriculture, including plantations	0.7	(5%)	251	(18%)
Metal, machinery and electronics	0.7	(5%)	42	(3%)
Non-metallic minerals	0.6	(4%)	10	(1%)
Total	13.9	(100%)	1,431	(100%)

Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

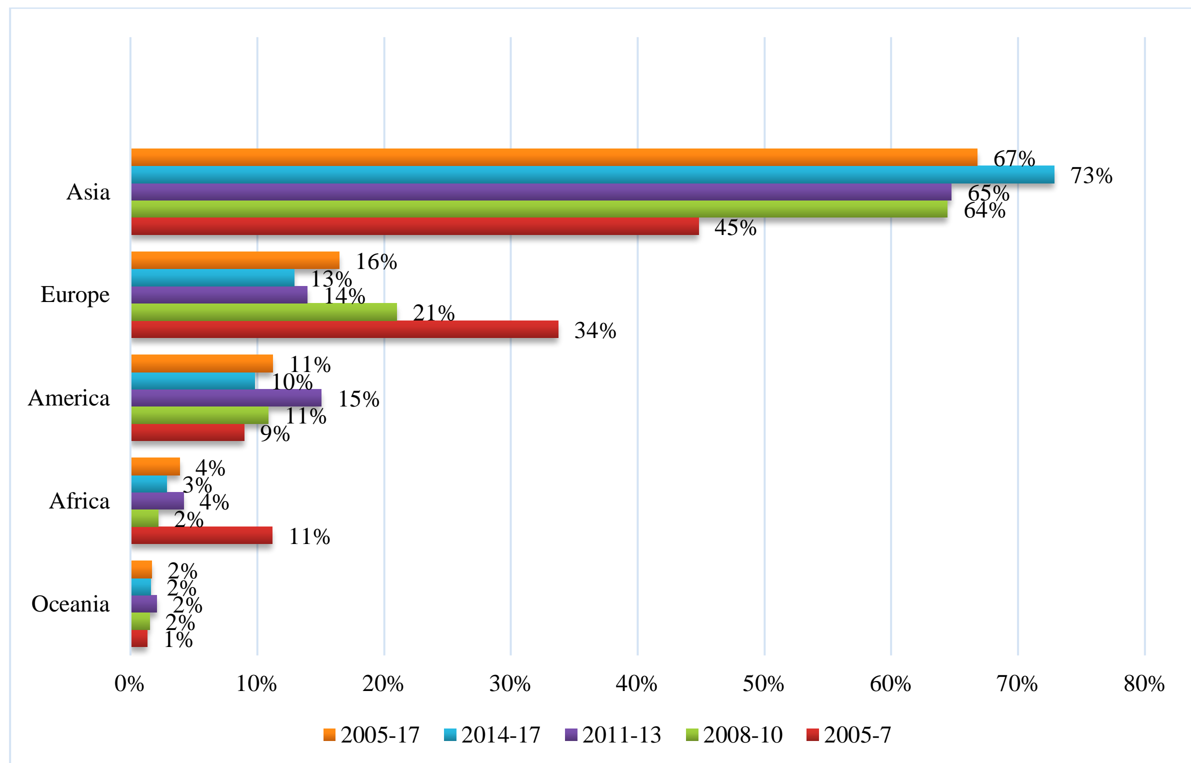
With regard to the regional distribution of foreign investment by sector, Table 4.4 gives the four largest sectoral recipients in each region, and it shows that each region tends to be dominated by manufacturing and mining. According to Hill (1987), market-seeking and the availability of factor supplies is a focus for manufacturing, while outside of Java investors seek natural resources. Table 4.4 shows however that Java is a favourite location for FDI in transportation, storage and communication, and is then followed by manufacturing, both light (motor vehicles and other transportation equipment) and heavy (chemical and pharmaceutical industry). Together with electricity, gas and water supply, these account for about $84 billion of the investment in Java, which is more than 51 percent of total FDI in Java. However, in other regions FDI is more evenly based, with for example in Sumatera a similar amount of FDI in the four main industries of paper and printing, chemical and pharmaceuticals, and food and mining.

Elsewhere, in Kalimantan FDI is dominated by mining, agriculture, food, and utilities, while in Bali and Nusa Tenggara there are distinct features. Bali is a tourist destination and FDI in the hotel and restaurant sector is important, while FDI in Nusa Tenggara is dominated by mining, especially in West Nusa Tenggara. Other important sectors for FDI are services and utilities. Industries that are important for FDI in Sulawesi are metal, non-machinery and equipment, and chemicals and pharmaceuticals. Like other regions outside Java, there is also a focus on mining and utilities. In the case of Papua and Maluku, the most important sector for foreign investment is mining (for almost 80 percent of total FDI inflows to Papua and Maluku). The next most important sectors receive less than one percent of FDI each, comprising agriculture, metals, industry, and non-metallic minerals. In general, it can be seen that outside of Java then FDI is dominated by resource-seeking, especially in the mining sector.

4.3.4 Investment by Origin

In terms of the source of the foreign investments, the majority of FDI inflows into Indonesia comes from other Asian countries. This is apparent from Figure 4.6, which shows the investments' global origin (Asia, Europe, America, Africa and Oceania) for the period 2005-17. It reveals that 67 percent of the foreign investments to Indonesia originate from Asia, and that European countries account for about 16 percent of FDI and America for about 11 percent. Even though Oceania countries are located much closer to Indonesia they record the lowest share of investments in Indonesia at about 2 percent, with Africa accounting for about 4 percent but reflecting their smaller economic size.

Figure 4.6: FDI Investments' Global Origin, 2005-17



Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

Looking in further detail, Figure 4.6 shows different trends for FDI in Indonesia arising from global regions. Asia as a home country for investments has increased in each sub-period over 2005 to 2017. In 2005-07, investments from Asia represented 45% of all foreign investments in Indonesia, but reaching 73% of total investments over 2014-17. The increase in the proportion of FDI investments is also experienced by the American continent, from about 9% in 2005-07 to 10% in 2014-17, although this is much smaller than FDI from Asia. The opposite is the case for investments from Europe and Africa as both of these show a declining proportion of inward investment in Indonesia. Europe contributed more than one-third of total FDI inflows to Indonesia over 2005-07, but by 2014-17 this is just 13%. Investment from Africa also declines, from 11% over 2005-7 to just 3% thirteen years later. Oceania investments consistently have low contribution, which is stable at about 1% to 2% of total FDI inflows.

Table 4.5 gives information on the investments' country of origin for the total FDI inflows into Indonesia, both over 2005-17 and for 3 or 4-year sub-periods. It shows that Singapore is the largest source for FDI in Indonesia, accounting for 23.6 percent of total foreign investment. Japan is the second largest source of investments, but with total investment about half that of Singapore. The Netherlands colonised Indonesia for more than 300 years, and this is the third

largest source (6.9 percent), followed by South Korea (5.1 percent). The USA and Malaysia come next, with about 4 percent each, followed by the British Virgin Islands, United Kingdom, and China, with about 3 percent each. A further one hundred countries or so contribute about a third of the FDI, but this compares with investments from five countries that contribute about a half of total inward FDI in Indonesia (i.e., Singapore, Japan, Netherlands, South Korea and the USA).

Looking in further detail, Table 4.5 shows that Singapore is consistently the investments' main country of origin over time. Even though in 2005-7 it is lower than Netherlands, Singapore dominates from then on (in 2008-10 it contributed almost a third of total foreign investment). Japan is also a main source for FDI in Indonesia and it is stable in terms of investment value. Investment from the Netherlands has trended downwards from the first sub-period, showing its declining influence over time. FDI from South Korea is volatile, while investment from the USA has increased, although it is relatively small. Both Malaysia and China have started to invest much more in Indonesia, growing from 1.7 percent to 6 percent for Malaysia over the whole period, and from 0.3 percent to 6.3 percent for China. Meanwhile, FDI from the UK and the British Virgin Island have declined, from 9.0 and 4.7 to 2.7 and 2.8 percent respectively. The contribution of the other (more than 100) countries has decreased from 38.1 to 30.0 percent.

Table 4.5: Share of Country Origin to Total FDI Inflow, 2005-17

Country	Share to Total Value of FDI Inflow (%)				
	2005-7	2008-10	2011-13	2014-17	2005-17
Singapore	14.1	31.4	20.1	24.7	23.6
Japan	9.8	5.4	12.0	13.4	11.3
Netherlands	15.6	10.7	4.5	5.0	6.9
South Korea	5.5	2.9	7.4	4.6	5.1
United States of America	1.1	2.5	7.1	4.5	4.5
Malaysia	1.7	2.1	2.6	6.0	4.0
British Virgin Islands	4.7	4.7	3.0	2.8	3.4
United Kingdom	9.0	1.8	3.3	2.7	3.3
People's Republic of China	0.3	0.8	0.8	6.3	3.2
Others (>100 countries)	38.1	37.7	39.3	30.0	34.7

Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

Table 4.6 shows the main provinces where FDI locates for each of the five largest country sources shown in Table 4.5. Overall, it shows that there is no consistent pattern for the location of FDI from these five countries. In particular, Central Java received that largest proportion of Singaporean investors, followed by Lampung and Yogyakarta, whereas West Java received the largest proportion of investment from Japan, but also large shares of FDI from South Korea and Netherlands. For the USA, most investment goes to Papua followed by East Kalimantan and Jakarta. The pattern for this investment is different to that of the other countries.

Table 4.6: Three Largest Investors by Origin and Province, 2005-17

Province	Investor' Country Origin				
	Singapore	Japan	Netherlands	South Korea	USA
West Java (Java)		●●●	●	●●	
Banten (Java)		●●		●●●	
Jakarta (Java)		●	●●●		●
Central Java (Java)	●●●				
Yogyakarta (Java)	●				
Lampung (Sumatera)	●●				
East Kalimantan (Kalimantan)				●	●●
West Nusa Tenggara (Bali-Nusa Tenggara)			●●		
Papua (Papua and Maluku)					●●●

Source: National Single Window for Investment (NSWI) database,
Indonesia Investment Coordinating Board.
Notes: Investment size rank: ●●● = 1st; ●● = 2nd; ● = 3rd.

The principal industrial sectors for the main five country investors is shown in Table 4.7, again for the period 2005-17 as a whole. Overall, it shows that the main sector in each case tends to be in manufacturing. Singaporean FDI however is concentrated in transportation, warehousing and telecommunications, followed by agriculture (including plantations) and food manufacturing. Likewise, Japanese FDI tends to be in both light and heavy manufacturing. According to Irawati and Rutten (2011) it confirms the importance of the automotive sector in Java for Japanese FDI (see also Tables 4.4 and Table 4.6). This includes Toyota, Daihatsu, Honda, Mitsubishi and Suzuki, which together account for about 90% of automotive production and sales in Indonesia. Table 4.4 shows that much of the foreign investment in the automotive

sector occurs on Java, and Japanese investors account for more than 75% of this (i.e., US$12.3 of US$16.4 billion over 2015-17).

Table 4.7: Principal Industrial Sectors for FDI by Country of Origin, 2005-17

Country Origin	Business Sector	Investment value (billion US$)
Singapore	▪ Transportation, warehouse and telecommunications	22.1
	▪ Agricultural, including plantations	6.0
	▪ Manufacture of food products	4.1
Japan	▪ Manufacture of motor vehicle and other transport equipment	12.3
	▪ Manufacture machinery and electronics	2.9
	▪ Electricity, gas and water supply	2.1
Netherlands	▪ Transportation, warehouse and telecommunications	10.0
	▪ Mining	2.8
	▪ Manufacture of chemicals and pharmaceuticals	1.4
South Korea	▪ Manufacture of basic metal, non-machinery and equipment	3.4
	▪ Manufacture machinery and electronics	1.8
	▪ Mining	1.1
USA	▪ Mining	10.3
	▪ Trade and repair	0.4
	▪ Manufacture of food products	0.3

Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).
Note: Principal three main sectors for each of the five main investors shown in Table 4.5.

Investors from the Netherlands mainly invest in manufacturing industries, including basic metals, machinery and electronics and basic chemicals, chemical products and pharmaceuticals, but also in mining, such as in West Nusa Tenggara (e.g., PT Newmont Nusa Tenggara). South Korean investors focus on the manufacturing and mining sectors, while USA investors mainly focus on mining, such as PT Freeport MacMoran Copper and Gold, which has exploited copper and gold in Papua since 1973 (Hasan, 2009). In fact, the Grasberg mine in Papua is the single largest producer of gold and the second largest producer of copper in the world (Sethi *et al.*, 2011). Out of US$11 billion FDI in mining in Papua over the period 2005-2017 (Table 4.4), almost 94% of this (i.e., US$10.3 billion) is conducted by American companies.

4.4 The Contribution of FDI to the Indonesian Economy

Section 4.3 has discussed the scale of FDI inflows into Indonesia and its characteristics, so that in this section I describe the contribution of this FDI to the Indonesian economy in terms of employment, output, productivity and the current account. It is acknowledged that in reality the contribution of FDI is difficult to measure with precision, since as Dhanani and Hasnain (2002) note, "each foreign investment provides a complex package of firm-level attributes in varying quantities and quality, which are difficult to separate and quantify" (p. 62). All the same, it is possible to discuss its likely contribution to the economic development of Indonesia using published data, and I begin by considering its role in employment creation.

4.4.1 Employment in Foreign-Owned Plants

Out of many objectives for attracting FDI flows to Indonesia, one of the most important reasons is for employment creation. Table 4.8 shows the aggregate number of employees in foreign-owned companies in Indonesia by sector from 1990 to 2015. Due to the unavailability of data (at the time of writing) I was unable to extend the analysis up to 2017. The data presented in Table 4.8 is from the Indonesian Investment Coordinating Board, and it shows the employment associated with foreign investment, which is on average across 5- or 6-year periods. In general, the number of people employed by foreign-owned plants in Indonesia has increased strongly, from about 379,000 over 1990-94 to over 5 million employment over 2010-15. Associated with this there has been a shift in the nature of the employment. Over 1990-94, manufacturing accounts for 88 percent of employment, while only 7 percent is in the primary sector and 5 percent is in services. However, over 2010-15 these are 59, 26 and 15 percent, so that while manufacturing is still dominant, it has a much-reduced share of employment.

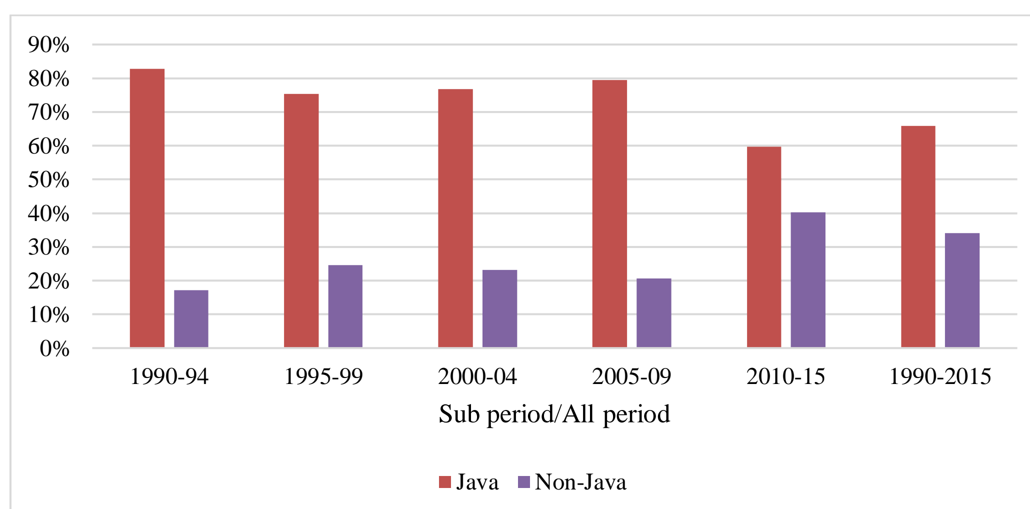
Table 4.8: Employment in Foreign-Owned Plants by Sector, 1990-2015

(thousands)

Sectors	1990-94		1995-99		2000-04		2005-09		2010-15		1990-2015	
	No	(%)	No	(%)	No	(%)	No	(%)	No	(%)	No	(%)
Primary	25	(7)	45	(10)	40	(6)	99	(10)	1,292	(26)	1,501	(20)
Manufacturing	335	(88)	367	(81)	464	(72)	749	(74)	2,973	(59)	4,889	(65)
Services	19	(5)	39	(9)	139	(22)	162	(16)	745	(15)	1,103	(15)
Total	379	(100)	451	(100)	643	(100)	1,010	(100)	5,010	(100)	7,492	(100)

Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

Figure 4.7: Employment in Foreign-Owned Plants by Region, 1990-2015



Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board (BKPM).

In terms of the employment distribution by regions, Figure 4.7 shows that Java is the dominant region compared to all other regions of Indonesia, with almost two-thirds of the employment over 1990-2015. However, it can be seen that the proportion of employment in Java compared with other regions has declined over time. Over 2010-15 about 60 percent of employment in foreign-owned plants is located in Java, compared with 80 percent over 1990-94. A breakdown across all six Indonesian regions is shown in Table 4.9, along with the population size. Again, reflecting the size of the population and workforce of each region (see Appendix Table A.3.2), Java had nearly 5 million jobs in foreign-owned plants over 1990-2015, and Table 4.9 shows that this is nearly four times greater than Sumatera, which is the next highest region.

Table 4.9: Employment in Foreign-Owned Plants by Region, 1990-2015

Region	Population[†] (year 2000)	1990-94	1995-99	2000-04	2005-09	2010-15	1990-2015
Java	121,352,608	313,619	339,977	493,528	801,669	2,991,737	4,940,530
Sumatera	43,309,707	44,768	99,331	113,493	139,542	714,360	1,111,494
Kalimantan	11,331,558	7,190	4,527	17,133	34,367	833,584	896,801
Bali and Nusa Tenggara	11,112,702	6,619	5,374	8,009	19,786	162,874	202,662
Sulawesi	14,946,488	5,626	1,345	5,345	11,541	98,299	122,156
Papua and Maluku	4,211,532	989	528	5,083	2,756	209,090	218,446
Total	206,264,595	378,811	451,082	642,591	1,009,661	5,009,944	7,492,089

Source: National Single Window for Investment (NSWI) database, Indonesia Investment Coordinating Board. [†] = Statistics Indonesia, 2018 at https://www.bps.go.id/statictable/2009/02/20/1267/.

Looking at the regions outside Java, there are some substantial changes over time. Sumatera, which is regarded as the second-rank regional FDI recipient, was surpassed by Kalimantan over 2010-15, making a huge leap in the number of employees compared with the earlier periods. Indeed, employment in foreign-owned plants in Kalimantan increased by more than 24-fold over 2010-15 compared with the previous 5-year period. This seems to arise from the increase in FDI in the primary sector, such as mining and agriculture (see Tables 4.3 and 4.4). Other than Kalimantan, Papua and Maluku has also shown a strong increase in the number of jobs, with a 40-fold increase over 2010-15 compared with 2000-04. This arises because of an increase in mining FDI. Other regions have shown some increase in the amount of employment as well, although not as great as either Kalimantan or Papua and Maluku.

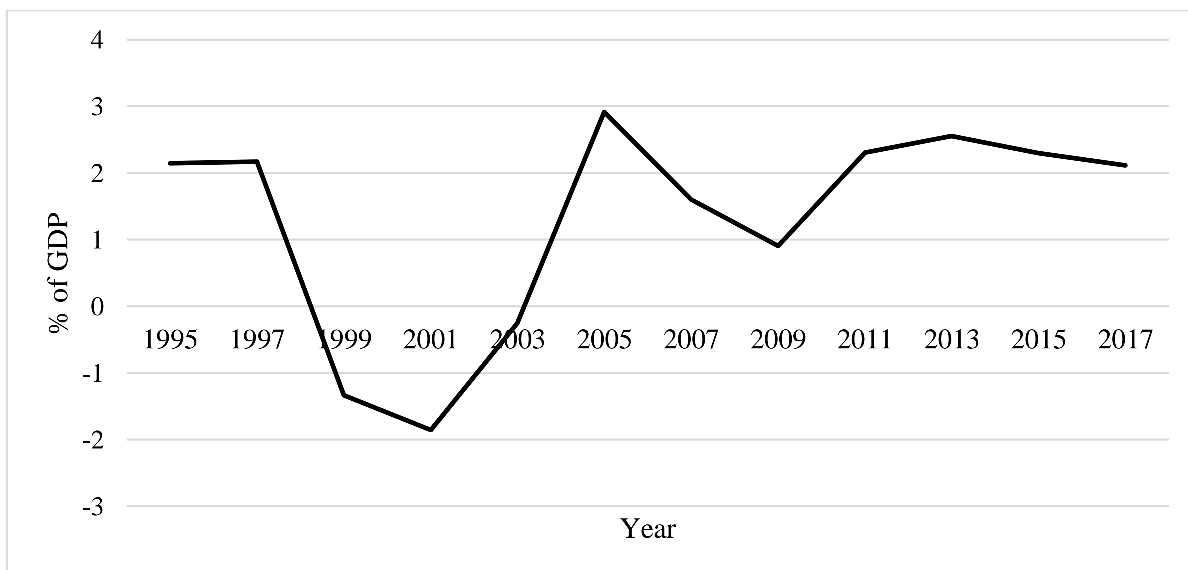
4.4.2 The Contribution to Output

UNCTAD (1999) found that the relationship between FDI and economic growth is not clear since some scholars find a positive impact of FDI on the GDP growth rate, but others find a negative effect. In the case of Indonesia, some research shows a positive effect on output. In particular, Fan and Dickie (2000) find that over 1987 to 1997, FDI directly accounted for over a 20 percent increase in the growth of GDP in the ASEAN-5 countries (Indonesia, Malaysia, Philippines, Singapore and Thailand). The contribution of FDI to economic growth might vary according to the type of trade policy regime. Using cross-sectional data for forty-six developing

countries, Balasubramanyam *et al.* (1996) find a positive impact of FDI on economic growth if a country is focuses more on export promotion policy rather than import substitution. Borensztein *et al*. (1998), using regression analysis based on panel data of 69 developing countries, find that FDI positively affects economic growth only if a country has sufficient human capital above a threshold level (as proxied by educational attainment level).

Figure 4.8 shows net inward FDI in Indonesia relative to its GDP over the period 1995 to 2017, where the UN definition of FDI is used. It shows that the FDI share is on average small, at less than 3 percent of Indonesia GDP over the whole period. Indeed, it was negative following the Asian Financial Crisis in 1998, which carried on until 2003. The Indonesian government tries to increase investment (FDI and DDI) as it cannot just rely on consumption and government expenditure, especially in difficult economic periods, but Figure 4.8 shows that the contribution of net FDI is relatively small, although a larger share of the GDP growth rate.

Figure 4.8: Net Inward FDI as a Ratio to GDP, 1995-2017



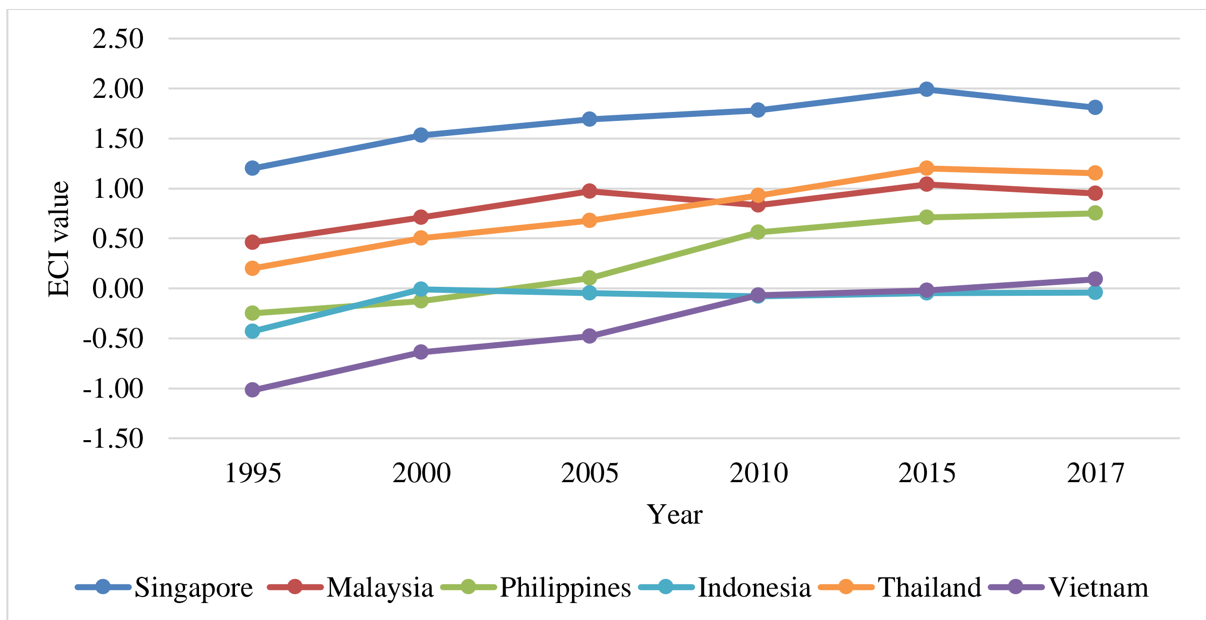
Source: World Development Indicators, World Bank.

With regard to regional development, FDI may be beneficial as there are multiplier effects on the regional economy, although it may not reduce regional disparities. At the aggregate level, Khaliq (2006) found that FDI has a positive effect on Indonesian economic growth, but that its effect varied across sectors. Indeed, as foreign investment is not equally distributed across the regions (Table 4.3) then Sjoholm (1999a; 1999b) argues that the benefit on economic growth of foreign investment (especially in manufacturing industries) is geographically concentrated in a few Indonesia regions. Indeed, even on Java, which has about 65 percent of employment

(Table 4.9), FDI is concentrated in a few provinces such as West Java, East Java and Jakarta (see also Table 4.6), but which follows the general pattern of regional industrial development, especially in non-oil and gas industries (Hill, 1990). In general, the FDI contribution towards economic development is related to its characteristics (see Blonigen and Wang, 2005).

Looking at the output products of Indonesia, especially exported goods, during the period of 1995 to 2017 Indonesia is categorised as a country with low complexity (low added value) products. Using data by the Harvard Growth Lab, Figure 4.9 shows the Economic Complexity Index (ECI) of ASEAN-6 from 1995 to 2017. The Economic Complexity Index represents a diversity and sophistication of exported products, where a positive and higher value represent higher ranking of a country's economic complexity. A country with a high ECI value therefore means the country is able to produce a high diversity and also high sophisticated and unique exported products (i.e., only few other countries produce similar products).

Figure 4.9: Economic Complexity Index (ECI): ASEAN-6, 1995-2017



Source: The Atlas of Economic Complexity (http://atlas.cid.harvard.edu/rankings/2017?country=).
Notes: A higher positive ECI value represents a higher ranked country.

Figure 4.9 shows that Singapore is consistently the country with the highest ECI value among the other ASEAN-6 countries. Thailand comes as the second ranked since 2010, surpassing Malaysia. The Philippines has interesting features as in 2000 it overtook Indonesia to become the fourth highest ranked among the ASEAN-6, while Vietnam also shows an impressive increase as in 1995 it was clearly the lowest ranked. Indonesia is now the lowest ranked of the

AEAN-6 countries with a stagnant performance over the period. In 2017 Indonesian export products continually rely on agricultural and mineral products, which are both considered low complexity products (Hausmann, *et al.*, 2011). Higher levels of complexity tend to depend upon productive knowledge (explicit and tacit) that a country holds to produce their output, which in turn is closely related to levels of productivity (Hausmann, *et al.*, 2011) so that the importance of productivity is discussed in the next sub-section.

4.4.3 Productivity

Apart from its direct benefits, in terms of employment and output, FDI is expected to provide indirect benefits to the Indonesian economy that lead to an increase in economic productivity, such as through the transfer of knowledge or technology. Some research has found evidence of a causal relationship between FDI inflows and productivity, including Nadiri (1993), who found positive and significant effects of US foreign direct investment on productivity growth in manufacturing industries in France, Germany, Japan, and the UK. Taking China, Long *et al.* (2014) find that the effect of FDI on productivity not only depends on the FDI source, but also on the firm ownership type and industrial and provincial characteristics. Private firms are more likely to benefit from horizontal spillovers, but less so from vertical ones (Long *et al*., 2014). Horizontal spillovers occur when the firms benefit from the presence of FDI in the same industry, whereas vertical spillovers arise either upstream or downstream (Lin *et al.*, 2009).

The transfer of technology could occur through one of several means, namely vertical linkages, horizontal linkages, labour turnover, and international technology spillovers, so that FDI is one of several means for acquiring better technology and for improving a country's productivity (JBIC, 2002).[29] Further, it is argued by Jacob and Christopher (2005) that knowledge spillovers can occur through foreign workers employed at domestic companies or domestic workers who work for foreign companies in Indonesia. The transfer of knowledge may also occur when workers switch between similar industries or between different industries (Sjoholm, 1999b). However, in order to make a successful transfer of knowledge that improves productivity it is

[29] These channels are specified as follows (JBIC, 2002, p. 58): *Vertical Linkages*: "MNE affiliates may transfer technologies to local firms that supply them with intermediate goods, or to buyers of their own products"; *Horizontal Linkages*: "local firms in the same industry or phase of the production process may adopt technologies through imitation, or may be forced to upgrade their own technologies due to increased competition from MNE affiliates"; *Labour Turnover*: "workers trained or previously employed by MNE affiliates may transfer their knowledge to other local firms when they switch employers or set up their own businesses; and *International Technology Spillovers*: "MNEs may enhance local technological capability through R&D activities in the host country or through intra-firm transfer of technology (i.e., from the parent firm to its foreign affiliates)".

necessary that there is a minimum threshold level of human capital to facilitate this, which is known as 'absorptive capacity'. Fillat and Woerz (2011) argue that the impact of FDI differs crucially on a country's absorption capacity, which in turn reflects its development stage.

Indonesian Investment Law number 25/2007, Article 10 (3) and (4), states that: "investment companies must improve the competency of Indonesian-national workers through job training in accordance with provisions of laws and regulations and also investment companies that employ foreign workers must conduct training and transfer technology to Indonesian-national workers in accordance with provisions of laws and regulations." Of course, this makes no allowance for the absorption capacity, which may vary across industries and regions. All the same, when a foreign firm does not comply with this law it must pay a compulsory educational and training contribution, which is utilised by the Ministry of Manpower to conduct employee education and training at the site.[30] However, in practice, the obligation on the foreign firm to conduct the transfer of knowledge or technology is not fully implemented because of a lack of enforcement by the government (Thalib, 2014), so that its effect is at best uncertain.

Looking at the empirical evidence, relatively few studies explore the role of FDI in the transfer of knowledge and technology. Taking the case of Indonesia, Blomstrom and Sjoholm (1999) use a 1991 industrial survey of 13,663 establishments to examine the effect from the level of foreign ownership in an economy on technology transfer and spillovers. They find that foreign establishments provide higher levels of labour productivity than do domestic firms due to the spillover effects. However, the increase on labour productivity or degree of spillovers is not affected by the degree of foreign ownership, but merely its presence (Blomstrom and Sjoholm, 1999). Notwithstanding this, Thee (2001) finds that FDI is a major channel of technology transfer to Indonesia, together with technical licensing agreements, capital goods imports and international trade. However, none of these channels is able to encourage domestic firms to develop major changes to their capabilities, and Thee (2001) believes that this arises from the frequent changes to foreign investment policy, so there is uncertainty. Despite this, Takii (2005) finds the presence of positive spillovers from foreign-owned multinational plants in Indonesian manufacturing 1990-95. However, the greater is the share of foreign ownership in a sector the weaker is the magnitude of the spillovers, and this may arise as the technological gap between foreign and local firms is relatively large. Suyanto *et al.* (2009) uses plant-level panel data and finds positive productivity spillovers from FDI in Indonesia, with greater

[30] Minister of Manpower Regulation No. 143 A/MEN/1991 on Educational and Training Obligatory Payments.

spillovers associated with a greater level of competition. In terms of who benefits the most, the research finds that domestic firms with R&D gain relatively more (Suyanto*, et al.,* 2009).

Recently, Djulius (2017), using firm-level data based on annual surveys of Indonesia National Bureau of Statistics, conducted econometric analysis on 3,513 companies in Indonesia over 1996 to 2002, and obtained the following results:

(i) Horizontal spillovers exist in the form of backward linkage for export-oriented domestic companies;
(ii) Vertical spillovers are found for domestic companies with a high-intensity factor;
(iii) Knowledge spillovers generally occur for industry with a high level of specialization;
(iv) Knowledge spillovers can be promoted when there is high level of competition for export-oriented domestic companies; and
(v) Export orientation of domestic companies could be a catalyst for various types of knowledge spillover from foreign companies to domestic companies.

Table 4.10 compares per-worker labour productivity levels of Indonesia with other ASEAN-5 countries for three different years over the period, 1980 to 2016. Per-worker labour productivity level is measured as GDP per-worker in US dollars (APO, 2018). In the case of Indonesia, from 1980 to 2016, per-worker labour productivity increases from US$ 9.1 to US$ 24.9 thousand. However, this improvement is lower than for three of the other ASEAN countries (Singapore, Malaysia, and Thailand) and only marginally better than the Philippines. This slow progress can be seen in comparison with Thailand, which in 1980 was below Indonesia with only US$ 7.8 thousand, but increasing rapidly, passing Indonesia at US$ 28.3 thousand at 2016. Table 4.10 also shows that Singapore continually provides the most productive labour within the ASEAN-5. Overall, while FDI might bring the transfer of technology and knowledge, in aggregate it seems not to significantly improve the productivity of Indonesian workers.

Table 4.10: Per-Worker Labour Productivity Levels, 1980-2016

Country	1980 Prod. (US$ thousands)	1980 %	2000 Prod. (US$ thousands)	2000 %	2016 Prod. (US$ thousands)	2016 (%)
Singapore	46.0	100	101.1	100	131.9	100
Malaysia	20.3	44.1	38.8	38.4	56.4	42.7
Thailand	7.8	17.0	16.8	16.6	28.3	21.5
Indonesia	9.1	19.7	14.5	14.3	24.9	18.9
Philippines	11.8	25.6	12.3	12.1	18.7	14.2

Source: APO Productivity Data Book 2018, Table 14.
Notes: GDP at constant basic prices per worker, using 2011 PPP, reference year 2016; Prod. = Productivity level in thousands of US dollars (2016).

4.4.4 Current Account

The current account is the total of the trade balance (net export of goods and services), plus the net primary income and net secondary income, so that it is the trade balance plus the income balance and current transfer balance. FDI has an ambiguous effect on the current account as it depends on its characteristics, such as whether it is market oriented, its import content and the amount of profits repatriated (Nedeljkovic *et al.,* 2015). In the case of Indonesia, the empirical evidence suggests that FDI might not play a significant contribution to improving the current account. The increase in imported goods and services is much higher than the exports that are delivered by Indonesian firms (including foreign firms in Indonesia), such that Indonesia has experienced a current account deficit since 2012. This is due largely to a deficit in the balance trade, which is shown in Table 4.11 over the period from 2005 to 2017.

Table 4.11: Trade Balance of Indonesia, 2005-17

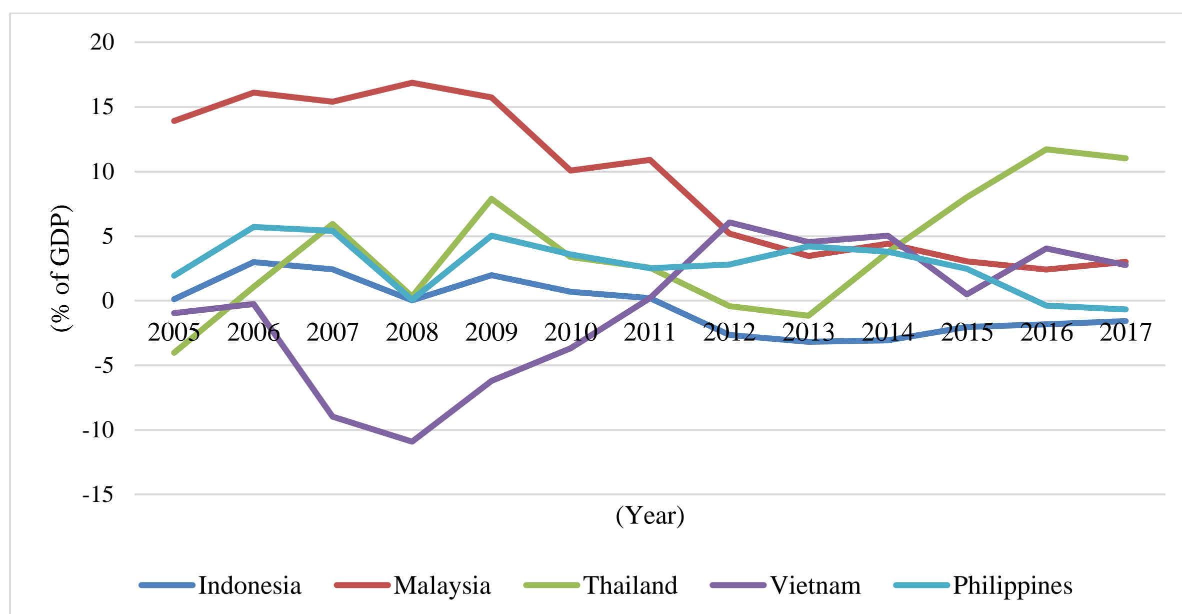
(US$ millions)

Year	Export	Import	Trade Balance
2005	85,660	57,701	27,959
2006	100,799	61,066	39,733
2007	114,101	74,473	39,628
2008	137,020	129,197	7,823
2009	116,510	96,829	19,681
2010	157,779	135,663	22,116
2011	203,497	177,436	26,061
2012	190,020	191,690	-1,670
2013	182,552	186,629	-4,077
2014	176,293	178,179	-1,886
2015	150,366	142,695	7,671
2016	145,186	135,653	9,533
2017	168,828	156,986	11,842

Source: Indonesia Statistics, https://www.bps.go.id/all_newtemplate.php.
Notes: Export = Free on Board (FOB); Import = Cost, Insurance, and Freight (CIF).

Table 4.11 shows that the value of exports has largely decreased since 2012 while the value of imports has fallen. However, 2017 suggests the pattern has reversed, but this is very recent and for one year. Overall, the Indonesian trade balance has increased since 2013 and is positive from 2015, but much smaller than that experienced in the 2000s. However, Figure 4.10 shows that the Indonesian current account has a flat trend and that it has been negative since 2012. It has been the worse current account performance of the ASEAN-5 since 2012.

Figure 4.10: Current Account: ASEAN-5, 2005-17



Source: World Bank Indicator. Accessed: 4 June 2019.
Notes: Current account balance is the sum of net exports of goods and services, net primary income, and net secondary income.

According to Nedeljkovic *et al.* (2015) there are four factors that influence the current account: external shocks; domestic policies; integration in the global marketplace; and the development stage and country demographics. FDI may contribute towards these in an indirect way. For example, if an external shock occurs because domestic growth unexpectedly falls below that of partner countries, then it may lead to higher export demand, but leave the imports unchanged. In this case, foreign investment with its international linkages may accentuate the adverse effect on the current account as it may increase net exports to the growing markets.

A current account deficit might also arise as a result of lower commodities prices, and of course a characteristic of Indonesia's export is resource-based products (commodities) with low value added. Table 4.12 compares the industrial products of Indonesia and four other ASEAN-5 countries according to whether they are resource-based or low-, medium- or high-tech (see Lall, 2000). It shows that Indonesia's products are much more likely to be resource-based, and that this has not much changed over time. As a consequence, it suggests that Indonesia will not be able to generate huge amounts of foreign income to improve its current account.

Table 4.12: Shares of Total Manufactured Exports for ASEAN-5, 1985-98

1985	Resource-based (%)	Low-tech (%)	Medium-tech (%)	High-tech (%)
Indonesia	75.2	15.5	6.4	3.0
Singapore	43.5	8.6	23.4	24.5
Malaysia	53.7	8.0	11.4	26.9
Thailand	37.9	35.4	22.0	4.7
Philippines	56.0	24.1	0.9	11.0
1998	**Resource-based (%)**	**Low-tech (%)**	**Medium-tech (%)**	**High-tech (%)**
Indonesia	38.8	33.0	18.5	9.7
Singapore	14.1	7.0	18.7	60.2
Malaysia	16.7	11.0	20.3	52.1
Thailand	19.3	25.3	20.5	34.8
Philippines	7.2	14.5	10.9	67.4

Source: Reproduced from Lall (2000).
Notes: Resource-based = agro-based/forest-based products, other resource-based products; Low-tech = textile/fashion cluster, other low technology; Medium-tech = automotive products, medium technology process industry, medium technology engineering industry; High-tech = electronic and electrical products, other high technology.

Nedeljkovic *et al.* (2015) finds that an increase of 1 percent of GDP in FDI inflows is associated with 0.17 percent of GDP decrease in the current account of Indonesia. The reason is that FDI inflows increase import demand for intermediate and capital goods more than by the increase in exports, at least in the short-run during the early establishment period of a new plant. A similar negative and significant effect between FDI and the Indonesian current account is found by Falianty (2017), while long before this Dhanani and Hasnain (2002) also argued that FDI adds to the current account deficit due to its higher propensity to import production inputs (i.e., capital goods, intermediate goods, technology). Further, the adverse effect of inward FDI on the current account appears to be increasing. Indonesia, together with the Philippines are the two ASEAN-5 countries to show a negative current account over recent years, with Indonesia experiencing a current account deficit from 2012. In its more long-term history, Indonesia also experienced a negative current account of -2.7 percent of GDP on average between 1986 and 1997 (Nedeljkovic *et al.*, 2015).

4.5 Conclusions

An important aim of this chapter is to provide a description of the nature of inward FDI policies in Indonesia. It starts by considering three post-war periods: 1945-67, 1967-2007, and 2007-date, where each period has had a strongly different policy stance towards inward FDI, varying between very-closed and highly-liberal policies. In the early period of independence, Indonesia tried to develop its economy based on national capacity (through state own enterprises and government), leading to the implementation of nationalist politics, so that the role of foreign investors was limited. It was partly a reaction to colonialism, with Indonesia seeking to build its national pride, but leading to excesses through the nationalisation of many foreign firms' assets in Indonesia. Over time, and in the New Order regime, it was realised that domestic capital was not sufficient to generate economic growth, so the country was opened-up to foreign investment. However, the policies towards FDI were not developed linearly, but rather the period since then has been characterised by its changeable nature, and partly depending on the economic position of the country. Recently, as hallmarked by the implementation of the Investment Law number 25/2007, the government has tried to treat foreign and domestic investment equally. The government stance towards FDI has become more liberal, as indicated through a number of reforms aimed at reducing the number of sectors prohibited for foreign investment, and by increasing the percentage of foreign ownership allowed in many sectors and through the provision of investment incentives, such as tax incentives.

A second important strand of this chapter has been to consider the level of FDI in Indonesia over time, making comparison with domestic direct investment (DDI), but also examining its characteristics in terms of its scale, project size, business sector, regional location and country of origin. The aggregate FDI realization before 2005 shows very high volatility, with dramatic falls in 1998 following the financial crisis and the lowest FDI realization in 2004. However, following Investment Law number 25/2007 FDI has increased in size to levels above that prior to the financial crisis, while in terms of the number of FDI projects there has been a dramatic rise in projects with a ten-fold increase since the law was implemented in 2007. Foreign investment has however decreased in terms of average project scale, so that it is now of a similar scale per project to that of domestic investment indicating a change in the nature of FDI.

The changing nature of FDI can be seen by looking at the investment sector, whereby prior to 2007 amounts of FDI was split roughly evenly between the manufacturing and service sectors, but that since 2010 the scale of the service sector FDI has fallen back so that it now represents

about a third of total FDI by value. However, in terms of the number of projects these are dominated by the service sector where it now contributes more than half of the total number of projects. There has also been an increase in the number of projects in the primary sector, which reflects the importance of natural resources to the Indonesia, which FDI capitalises on.

Regarding the location of the investment, more than half of foreign investments are located in Java Island, and which are concentrated in a few provinces such as West Java, Central Java and Jakarta. The dominant sectors in Java are in services and manufacturing, and it is also in Java where the service sector primarily locates. Outside of Java Island, FDI is dominated by the manufacturing and primary sectors, where the latter reflects the importance of the mining industry in Indonesia. Foreign investors from America and Europe are those more likely to invest outside Java for the purpose of natural resources-seeking. The majority of FDI in Indonesia however arises from Asia, and in terms of specific countries these are from Singapore and Japan. Foreign investments coming from Asia are more likely to locate in the regions of Java, which might reflect labour availability as well as the close proximity to the main market of Indonesia. In particular, Japanese FDI locates in the automotive sector, which in turn is heavily concentrated in Java.

The recent growth of FDI in Indonesia is seen to be important to the Indonesian economy, especially with regards to employment, GDP growth, productivity, and the current account. As a direct contribution to the economy, it is estimated that FDI has generated employment of more than 7.4 million over the period 1990-2015, although the employment distribution is uneven with Java accounting for more than 60% of this with the remainder spread out amongst the other five regions. FDI employment is also concentrated in the manufacturing sector, although this is declining over time reflecting the growing importance of services to the Indonesian economy. Regarding the contribution of FDI to output, although FDI contributes less than 3 percent of Indonesia's GDP there is evidence to suggest that it has an important impact on economic growth. Empirical studies have found that FDI can provide knowledge and technological spillovers to domestic firms, although looking at the overall impact of labour productivity the increase on labour productivity is relatively mild due to the lack of 'absorptive capacity' of the domestic firms. The low increase in labour productivity is also reflected by low Indonesian worker productivity levels compared to other ASEAN countries over the period 1980-2016. Further, any impact on growth may be restricted to certain locations in Indonesia given that FDI is distributed unequally across the regions of Indonesia.

Overall, it seems however that FDI is seen as an important aspect of the Indonesian economy, especially following the recent growth in FDI to Indonesia and the focus placed on FDI by policymakers, in particular the use of tax incentives and location-based policies. The aims of this thesis are to investigate the determinants of FDI location and the role of incentives in influencing FDI location in Indonesia, both from the perspective of the foreign investors and policymakers. It is based on a survey questionnaire to foreign investors and in-depth interviews with policymakers. The methodology for this analysis is discussed in the next chapter.

Chapter 5. Research Methodology

5.1 Introduction

The purpose of this chapter is to provide information on the research methodology and its appropriateness for this thesis. As a research strategy, my research relies on questionnaire and face-to-face surveys both for collecting data and for understanding relevant phenomena. A survey is "a methodological technique that requires a systematic collection of data from populations or samples through the use of the interview or the self-administered questionnaire" (Denzin, 1970, p. 165). More generally, Denscombe (1998) views a survey as a tool to view comprehensively and in detail social phenomena. This later definition indicates that the purpose of a survey is not solely to focus on people as subjects, but that it might be applied to an analysis of documents. There are many types of survey, including postal questionnaires, face-to-face interviews, telephone interviews, document analysis and observation. This thesis uses a survey questionnaire of investors and face-to-face interviews with policymakers supplemented with a document analysis. The basis for each of these instruments is discussed in detail in this chapter.

Broadly, the chapter has two main purposes. The first is to consider the appropriateness of the survey instruments from a methodological point of view, and the second is to outline the nature of the instruments that are used in the thesis, and in particular Chapters 6 and 7. The instruments comprise a self-completion questionnaire to be filled out by the managers or other senior staff of foreign-owned plants located in Indonesia; face-to-face interviews with senior policymakers engaged in the attraction of FDI to Indonesia; and a review of the policy documents. The questionnaire is administered via seven tax offices in Indonesia that have responsibilities for different sectors, but also the Special Area (Free Trade Zone) of Batam, as discussed in Chapter 3. This chapter discusses the administration of the questionnaire, the difficulties that arose and the achieved response rate. It considers the nature of the in-depth face-to-face interviews that were conducted. Overall, the questionnaire survey response rate is 20.4 per cent, giving 224 completed forms, while for the face-to-face interviews it is 22, or about 80 per cent of the target respondents.

The chapter begins by considering the mixed methods methodology for evaluation, and the rationalisation for its use. Following this, a discussion of each type of survey is presented. The survey forms are then considered, which gives details on the nature of the information collected

using each survey instrument. Issues are discussed such as sample selection, administration and implementation. The next two chapters give the results of these surveys.

5.2 The Research Strategy

The research methodology is central to carrying out the investigation, and it arises from an interactive process between the research purpose and question (Newman *et al*., 2003). This section considers the 'mixed methods' approach to research, which has some wide support in the Management Literature, and it considers the reason for choosing this. Furthermore, it discusses the advantages of 'mixed methods' and how it links to the survey as a way to collect data in order to understand real-world phenomena.

5.2.1 The 'Mixed Methods' Approach

In broad terms the research employs 'mixed methods', which is much used in the management and business literatures and often advocated (Johnson and Gray, 2010; Molina-Azorin, 2011; Molina-Azorin and Cameron, 2015; van der Roest *et al.*, 2015; Bazeley, 2015). The mixed methods approach uses "quantitative and qualitative data collection and analysis techniques in either parallel or sequential phases" (Tashakkori and Teddlie, 2003, p.11). Creswell (2009) defines it as "an approach to inquiry involving collecting both quantitative and qualitative data, integrating the two forms of data, and using distinct design that may involve philosophical assumptions and theoretical frameworks" (p. 19). The key point behind this approach is that real world phenomena are complex, so that it is important to understand both the quantitative outcomes of behaviour but also the qualitative processes that underlie, and that therefore lead to a detailed understanding of these outcomes (Tashakkori and Teddlie, 2003).

A huge amount of Economics research is quantitative in nature. In the Management literature there is an on-going debate about the usefulness of quantitative versus qualitative methods, although some argue that this is an unproductive debate, including Creswell and Plano Clark (2007), Tashakkori and Teddlie (2003) and Bryman (1996). Wilkinson and Birmingham (2003) argue that "no single research instrument is inherently superior to any other [so that] all can be used well or poorly" (p. 3). In this context, I do not directly address this debate as I believe that both methods have their own merits as well as their limits. In particular, mixed methods will give a better understanding of the nature of FDI location, and that by combining these

approaches it is expected that the thesis will make for a more comprehensive, informative and solid contribution to understanding.

Firestone (1987) differentiates quantitative and qualitative research methods according to four dimensions: (i) assumptions about the social world; (ii) the purpose of the research; (iii) the approach used; and (iv) the researcher's role. By combining the methods, this thesis will seek to understand the nature of FDI location in Indonesia according to these four dimensions. The purpose is not only to look at the causes of investor and policymaker decision-making, but also to understand 'why' and 'how' FDI happens. In term of the approach, the thesis is relational by mirroring research data to existing theories and paradigms. The researcher's role is sometimes detached, but my working background in taxation adds tacit knowledge to the topic as well. The main reason for adopting a mixed methods approach is because in this thesis I seek to understand human behaviour, both of the investors and policymakers, and in particular the 'why' and 'how' these agents make their investment or policy decisions.

In general, mixed methods is a way to better understand the complexity of social phenomena, as the research gains from the 'power of numbers' and from the possibility of generalisations, which is complemented by the rich context of 'feelings', 'behaviours' and 'culture' (Jemna, 2016). As a research approach, mixed methods is considered to be a 'triangulation design' as it employs both quantitative and qualitative method in collecting and analysing data in order to gain a more complete picture of phenomena (Creswell, 2009).[31] In this context, the issue of the FDI location decision and the role of tax incentives is complex and that cannot be fully explained by using a single method only. Therefore, a full analysis needs to combine multiple source of data, research methods and theory (Denzin, 1978). According to Patton (1990), this kind of triangulation helps the researcher avoid the intrinsic bias of a study's findings.

As a means for collecting data this thesis uses questionnaire and face-to-face surveys to provide quantitative and qualitative information. This research method for data collection is selected by adopting an approach similar to that conducted by Freedman *et al.* (2014; 2009) when they do research on assessing the relationship between Her Majesty's Revenue and Customs (HMRC) and large businesses in the United Kingdom. The former is gained through a structured questionnaire of investors that can be measured or translated into numbers, either cardinal or ordinal. As argued by Bryman (1996), the [questionnaire] survey generates quantifiable data

[31] Long before this, Denzin (1970) argues that triangulation is "the combination of methodologies in the study of the same phenomenon" (p. 297).

from a sample of the population. Meanwhile qualitative data is gained in this thesis through face-to-face interviews with policymakers. This seeks to understand the process of policy formulation and it is in addition to a document analysis. In terms of the nature of the data, the research gathers this from both primary and secondary sources. The primary data is gathered through the structured questionnaire and face-to-face interviews, while the secondary data is elicited from policy documents and regulations that are either obtained directly or requested from government institutions and agencies. In the remainder of this chapter I consider the basis for these different approaches, and for the different instruments.

5.2.2 Self-Completion Questionnaire

As a means for collecting quantitative data, this research utilises a structured questionnaire in the form of a self-completion questionnaire that is filled-out by the respondents and without the direct help of the researcher. As mentioned by Creswell and Plano Clark (2007), the collection of quantitative data might involve using a closed-ended checklist (questionnaire). This type of questionnaire is chosen in order to give more time and also to ensure respondents have enough ‘space’ for expressing their views on particular topics without interference from the researcher. It is expected that the questionnaire will enable data to be collected that to some extent can be quantified, but also captures investor’s opinions. The questionnaire enables me to cover a wide range of target sample firms within the period of time defined by the thesis.

The questionnaire approach means that numerous questions can be asked with regard to the research topic. On the one hand, a broad range of data can be collected regarding investor preferences, attitudes, opinions and behaviour, but on the other hand, there might also be some weaknesses associated with the approach. These include the possibilities that the respondents do not feel strongly incentivized to truthfully respond, or that they forget things due to poor memory. Some scholars argue that a survey with closed-ended questions might jeopardize the validity of the research as respondents might differ in their understanding of the key terms (Bryman, 2016; Buckingham and Saunders, 2004). Moreover, the questionnaire approach has a limited choice of answers, and these may sometimes not reflect the best answer that a respondent may wish to give. To address this, where possible, I include the ‘other’ option as a response to closed-ended questions, but also include some open-ended questions. I am aware of the issue on validity and reliability of a questionnaire, as well as the difficulty of persuading foreign companies to respond, especially on a sensitive topic such as taxation. Therefore, to reduce potential bias when analysing the survey results, data triangulation is utilised whenever

it is possible. Regarding potential bias due to my DGT background, I distance myself from the respondents during questionnaire survey distribution to keep myself out of the process.

The research aim is to investigate the link between the FDI location decision in Indonesia and the key investment location factors, especially tax incentives. To explore important differences in these, I consider cross-tabulating the results according to the characteristics of an investor (see Bryman, 1996). These include the broad economic activity of an investor, such as whether it is in the primary sector (agriculture or mining), secondary sector (heavy or light manufacturing) or the tertiary sector (services). In aggregate, Chapter 4 shows that FDI tends to locate much more heavily in some industries. I also explore differences in FDI location between new 'greenfield' investment and 'brownfield' FDI at an existing site or premises. The research also examines the effect of tax incentives and other forms of support on the firm's investment decision, seeking the firm's opinions on the role and importance of these for both the initial FDI location decision and for any subsequent re-investment.

In its delivery, the questionnaire survey shadows the tax return mechanism that the taxpayers mostly utilise, which I believe is the most effective way to conduct a large survey of this kind in Indonesia. It means that it is paper-based, which reflects the tax filing process in Indonesia, but in combination with an electronic tax return system ('e-SPT'). The e-SPT is a tax report in the form of an electronic file that is submitted to a tax office along with the main summary tax return form that is normally a hardcopy. Usually, for tax returns a taxpayer's attachment requires many pages, but by using e-SPT the tax office helps to reduce the taxpayer's burden and supports the government's environmental 'Go Green' policy. The file needs to be carried on an electronic disc or stick and it is transferred to the tax office computer by a front desk official. The use of full e-filing for tax reporting is still very low for the corporate sector in Indonesia, so that the paper-based approach is optimal for the questionnaire survey.

A paper-based questionnaire survey has other advantages. First, the target respondent for the questionnaire is very specific (i.e., the Chief Executive Officer, Director, General Manager or Finance/Tax Manager), so that the questionnaire form can be handed directly to the company representative or through postal mail, which ensures that it reaches the appropriate person. Second, respondents at this rank are very busy people, so that it is unlikely that they will have enough time sitting in front of screen to fill out an online questionnaire. Finally, there is not an appropriate method to facilitate the distribution of a questionnaire online, as the tax office does

not have information on the taxpayer's email address, or at least they are very reluctant to share this with me as they consider it part of the normal commercial confidentiality.

Overall, the questionnaire has been developed to focus on the issues of interest. It has been specifically developed for this research, and it is believed to be the most suitable tool for gathering valid and relevant information for the thesis. It will be difficult to gather the level and amount of information using either a face-to-face or a telephone surveys, while the questionnaire survey can reach many investors. These are existing foreign-owned companies that are registered and operating in Indonesia at the time of the survey. The respondents are senior or high-ranking managers within the plant, as outlined above, which are expected to be in a position to have knowledge and/or experience regarding the company's strategic decision-making. I now consider the basis for also using a face-to-face interview in this research.

5.2.3 Face-to-Face Interviews

To complement the data collection, face-to-face interviews with policymakers are utilised to understand the relevant phenomena. Whereas the questionnaire survey is more quantitative in nature, these interviews are qualitative. The basis for the qualitative approach is that social reality exists as a 'meaningful interaction between individuals', so that it can be learned by understanding people's point of view, interpretations and meanings (Minichiello *et al*., 1992). As these are expressed through language, then an in-depth interview is one way to reveal these views and opinions. A survey interview is a controlled situation in which one person, the interviewer, asks a list of questions of another person or persons (Keats, 2000). The purpose of the face-to-face interview is to explore the reasons behind a person's answer and to verify its reliability with further questioning and probing.

The face-to-face interview relies on individuals being an important source of knowledge about their own experiences, and it offers an in-depth understanding of the research question, which by itself a self-completed questionnaire may be unable to do (Gubrium and Holstein, 2002). This research uses in-depth interviews as a way to triangulate data gained through the survey questionnaires and the knowledge from the existing theories and literature (Johnson, 2002). It focuses on seeking 'deep' information and understanding on the research issue that goes beyond common explanations or normative answers. In this context, the researcher tries to retrieve the interviewees' thought-process by understanding their perspectives in the language that is

natural to them (Minichiello *et al.*, 1992). It is conversational rather than interrogative in order to reduce the possibility of distortion from language as used in every-day speech.

The face-to-face interviews conducted in this thesis use a semi-structured question list that is observed by the interviewer only. This provides a common pattern regarding the structure of the interviews. It starts by asking about the general policy background, which is followed by information regarding the policy development in relation to FDI location in Indonesia. The questions then focus on policy administration, followed by monitoring, and then finally the policy evaluation. The list of questions focuses on issues linked to the research, but they are posed in a way that allows for flexibility (Minichiello *et al.*, 1992). This might decrease the comparability of the interviews within the study, but it provides more valid explanations of the participant's knowledge and perception of the world.

Compared with other methods, face-to-face interviews permit the researcher to dig deeply and understand the respondents' views regarding the topic. Ideally, the researcher should engage in the process by probing certain lines of questioning and asking for explanation based on what a research participant has responded (King and Horrocks, 2010). Compared to the self-completion questionnaire, the in-depth interviews help to gain a different understanding of the research question or topic, and there is the possibility of elaboration or clarification for both parties (interviewer and interviewee) during the interview itself. The purpose of the approach is scientific explanation, i.e., "to give the cause of whatever phenomenon is to be explained" (Minichiello *et al.*, 1992, p.39), so that, for example, using the interviews I will be able to better understand the 'why' and 'how' tax incentives matter from the policymakers' perspective.

The face-to-face interviews utilize 'purposive' and 'snowballing' sampling methods. The first of these, which is also known as 'judgmental sampling', means that the sample is not selected on a random basis, but rather the interviewees are chosen in a strategic manner to be relevant to the research questions (Bryman, 2016). To gain further information, I conduct snowballing sampling, whereby a group of people relevant to research question are initially sampled, but based on their responses or recommendations, other people may be added who have experience or knowledge that is relevant to the research (Bryman, 2016).

5.2.4 Document Analysis

In addition to the two main data collection methods, one way to gain insight on government policy and in particular to learn about the background to tax incentives and FDI policy is to carry out a 'document analysis'. Document analysis is a systematic procedure for reviewing and analysing documents, either printed or electronic, in order to elicit meaning, to gain an understanding or to develop empirical knowledge (Bowen, 2009; Corbin and Strauss, 2008; Rapley, 2007). Denscombe (1998) argues that the strategy for a survey can be applied to documents as well as to people. The purpose is to gain an insight in order to provide a broader and holistic perspective regarding the rationale for policy. By utilizing official documents, including laws and regulations that are produced by authoritative institutions, the document analysis provides credible information. It is useful in providing background and context, and for tracking policy changes, as well as for the development and verification of findings from other data sources (see Bowen 2009).

Before analysing a document, the researcher needs to make an evaluation of the document with regard to its authenticity, credibility, representativeness and meaning. The analysis can be conducted using 'content analysis', which has potential to disclose opaque aspects that are not otherwise observable, and it can give historical insight and contextualization to the policy at different times. As such, it indicates what might be important at different times. In analysing the documents, Hodder (2010) argues it can be done by comparing between the past and present or between different examples of documents in order to identify patterns. A document cannot 'speak back', but if appropriate procedures are followed, then there is a chance for data [i.e., documents] to confront and help interpretations of phenomena (see Hodder, 2010). To make it clearer at the onset, unlike the two main data collection (questionnaire survey and in-depth interview), document analysis is treated as a supplement to the above two methods. Therefore, in presenting the results, documents analysis will not be reported in a separate chapter, but rather it will be incorporated in each of the discussion of the relevant chapters.

5.3 The Survey Forms

The survey forms that are used in this thesis are now described. This gives information on the data and opinions that are collected through each of the survey instruments. The survey questionnaire and the face-to-face interview forms are given in the Appendices B.5.1 to B.5.4

of this chapter, as described below. This provides the details of the questions or question lists, so that in the body of the text I consider the broad structure of each of these survey forms.

5.3.1 The Survey Questionnaire Form

The questionnaire survey form that is administered to the managers of foreign-owned plants is given in Appendix B.5.1, and the covering letter that is addressed to the interviewees is given in Appendix B.5.2. There are several important features to ensure that the questionnaire form is a reliable tool. First, the form was developed to be as concise as possible, so that in total it is just 12 pages long and has 52 questions. This is an attempt to optimise the response rate, with respondents more likely to complete a form that is shorter in length and less wide-ranging, so that they can clearly understand its purpose. Second, the questionnaire form is delivered on paper and by self-completion, and the rationale for this was discussed above. Finally, the form is divided into six sections. Each section focuses on different aspects of the plant, investment process and policy, and these are described as follows. This should be read in conjunction with the questionnaire form shown in Appendix B.5.1.

Section 1: Personal Details

This section focuses on the personal circumstances of a respondent, such as his or her current position. This is to determine the respondent's background, but also to assess the capacity of the respondent to fill out the questionnaire. It includes information on the length of duration the respondent has worked with the company and prior experience. Information on nationally is important to identify those plants that are locally managed.

Section 2: The Plant at this Site

This section focuses on the plant where the form is addressed. It provides information on the date that the plant and company were established, and on its location in Indonesia, such as a Special Area (i.e., Bonded Zones, Free Trade Zones or Special Economic Zones - see Chapter 3).[32] This information is important as it indicates the tax incentives that are available. I differentiate between the plant at the site and the company in Indonesia, as sometimes a foreign-owned firm might be located at several sites in Indonesia. Information is collected on the main activity, broad sector (primary, manufacture, service) and employment structure. A question

[32] The Indonesian location is according to six regions (Sumatera, Java, Kalimantan, Bali and Nusa Tenggara, Sulawesi and Papua and Maluku) and at a lower spatial level by 34 provinces.

regarding gross sales might be one of the most commercially sensitive questions, but I tried to soften this by asking the respondent to select a range and not the exact amount. Other information is collected for projected performance and export and import activities.

Section 3: The Company

This section examines the company profile. The important information is the legal status of the company, the shareholder ownership, and some sense of the company structure, including subsidiaries. I also ask about the main competitors and the location of its head office.

Section 4: The Initial Investment Decision

This section is very important since it relates closely to the research question. It starts with a question regarding the motives for plant investment, which is related to the literature (Chapter 2) and sets out four main motives: market, resource, efficiency and strategic-asset seeking. This section also details whether or not the investor considered other potential locations when making its decision. Furthermore, it explores the investor views on what factors matter when they invested for the first time in Indonesia. Following this, information is collected on the institutions that were helpful on providing information when investing. It ascertains whether or not the plant received any investment incentive and the type of this incentive(s).

Section 5: The Indonesian Tax System

This section tries to capture more detail regarding the tax system in Indonesia in relation to FDI. It starts by asking the importance of Corporate Income Tax (CIT) and whether or not the investor includes it in their investment appraisal. Furthermore, it clarifies whether or not the investor received any tax incentive during their operation in Indonesia. It also seeks to confirm whether or not the tax incentive matters for their investment. In more detail, this section also examines whether CIT rate reduction is important compared with other forms of tax incentive.

Section 6: The Current Business Environment

The last section focuses on the business environment in which the plant operates. It starts with a question regarding how easy it is doing business in Indonesia according to a set of criteria, including the quality of the labour force. It also probes the easiness of transportation, especially in relation to imports and exports. Finally, it probes in general how the three institutions that are responsible for tax incentive address the needs of inward investors.

The covering letter that is attached to the questionnaire survey form sets out the purpose of the survey and gives assurances regarding confidentiality. It also outlines the mechanism for the return of the survey form. In order to ensure that the questionnaire form is understood by the respondent it is provided in bilingual form, comprising Bahasa Indonesia and English (see Appendix B.5.1 for the English version). The covering letter asks the firm to complete the questionnaire in the language they are familiar with. The letter indicates that the questionnaire survey will take approximately 30-45 minutes to complete. To ensure the validity and reliability of the instrument, a pilot study was conducted before the full roll-out.

Before distributing the questionnaire, a pilot study was conducted. Due to the difficulty of accessing the foreign investors for pilot testing (as I was based in the UK at the time), the preliminary survey was sent to a number of tax officers who has knowledge and experience in dealing with the investors. The survey was tweaked based on feedback provided by pilot study respondents. It was discussed with the supervisors to ensure it can portray the information that intended to be captured. In general, I gained feedback from the tax officers who freely provided comments on the questionnaire. The appropriateness of the wording and the construction of the sentences of the English version were discussed with the supervisors, who are native speakers. For the Bahasa version I asked a fellow Indonesian PhD student to check the appropriateness of the wording and sentences.

5.3.2 Face-to-Face Interview Questions

With regard to the face-to-face interviews, the list of questions was developed in order to give structure to the interview, where these interviews were conducted by myself. As King and Horrocks (2010) argue these questions should "outline the main topics the researcher would like to cover, but be flexible regarding the phrasing of questions and the order in which they are asked" (p. 35). The interviews were conducted with policymakers that are either directly or indirectly involved with FDI attraction, such as through tax incentives. An in-depth face-to-face interview is expected to be completed in 45 minutes. The interview is extended beyond this only if the interviewee agrees to do so. The questions are given in Appendix B.5.3, and they are under three broad headings, focusing on inward investment and tax incentive policies:

<u>Section 1: Inward Investment and Tax Incentive Policy</u>

This section focuses on how industrial development policy is conducted in Indonesia. It explores the motivation for the government to attract foreign direct investment to Indonesia. It

examines the role of tax (and non-tax) incentive policy in attracting foreign direct investment and the location determinants of FDI in Indonesia.

Section 2: Policy Development and Administration

This focuses on how tax incentive policy is developed. It starts by asking which government institution is responsible for proposing this policy, the way in which a proposal is developed and the assessment of its benefits and costs. It examines whether the government is open to input from stakeholders and how the different policy option are weighed. It also asks who has the final say on proceeding with or withdrawing a policy related to foreign investment.

This section also captures how the government runs the administration process for giving tax incentives to investors, and how the process is been conducted. It asks about the responsibilities of each government institution in administering the tax incentives, and whether these incentives are given according to strict criteria or if they are based on discretion by civil servants.

Section 3: Policy Monitoring and Evaluation

This asks about how the government ensures that the process for giving tax incentives is carried out in a proper way. It probes whether there is regular monitoring, and how the government ensures that everything is running as it should be, i.e., that everyone in the government conducts their tasks appropriately and in a timely manner. It is also concerned with how the government ensures that the tax policy meets its objectives. It probes who is responsible for conducting evaluation and how the government judges value-for-money and success or failure with the tax incentive policy. Finally, it examines the criteria that are used by government to assess the tax incentive policies, and the extent to which any unintended consequences are scrutinised.

5.3.3 Document Analysis

The written policy documents that are examined give an historical account and are not subject to ex-post rationalization by the policymakers in the face-to-face interviews. They relate to tax incentives and to the attraction of FDI. They include legal and other regulations, such as from the Director General of Taxes. Other media are available online, such as Powerpoint presentations, reports and notes, and these are considered as documents for the purpose of the analysis. They include downloads from the websites of institutions and documents provided by officials during the interview process. Overall, the documents can be divided into official and non-official documents, which rank from the highest to the lowest levels. The former are

Laws, Government Regulations, Presidential Regulations, Ministerial Regulations and Director General Regulations. The latter include memorandums, notes and presentations, which are valuable in understanding policy development and its implementation. Documents produced by non-government institutions, such as the World Bank, OECD or UNCTAD, are also included.

5.4 The Sampling Frameworks and Implementation

Before the fieldwork could commence it is necessary to obtain ethical approval from Newcastle University. This involved submitting a completed form to the University Ethics Committee. As part of approval process, I had to submit an informed consent form and information about the project, such as assurances on confidentiality and anonymity, data protection and research implications. Ethical approval was granted on 30 December 2016 (ref. no. 10333/2016, see Appendix B.5.6). The purpose of the ethical approval is to ensure that the fieldwork promotes the aims of the research, increases public accountability and support, maintains trust with society, and meets the standard required by the institution for the adoption of best practice. The conduct of the data collection exercises (i.e., of the foreign-owned plants, policymakers and official documents) is now described. This includes the way in which the sample was selected in each case, the administration and implementation of the exercises, and the number of participants or achieved response rates in the respective cases.

5.4.1 The Sampling Frameworks

As the number of units for this research is potentially large (i.e., foreign plants, policymakers, regulations), and there is limitation on the research budget in terms of time and other resources, there is a need to sample. The challenge is how to choose an appropriate sample, so that it is representative of the population. This is considered for the three surveys.

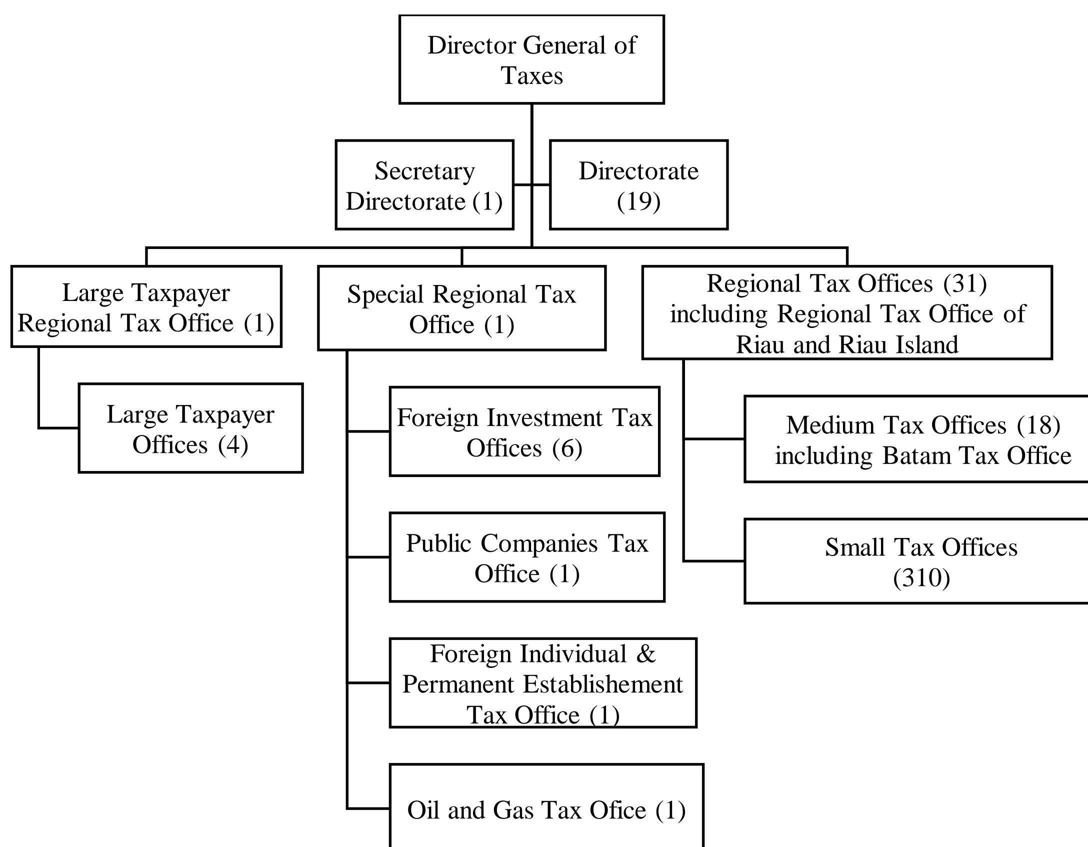
5.4.1.1 Self-Completion Questionnaire Survey

In order to generalise from the survey finding, the sample should be carefully selected and be sufficient in number, so that it is representative of the population and inferences can be drawn. There is no fixed way to draw the sample, but according to Denscombe (1998) the sampling size for small-scale research projects should generally lie in the range of 30 to 250 cases. Fowler (2014) notes that the "size of population from which a sample of a particular size is

drawn has virtually no impact on how well that sample is likely to describe the population" (p. 38). He argues that if all other aspects of sample design and procedures are the same then "a sample of 150 people will describe a population of 15,000 or 15 million with virtually the same degree of accuracy" (p.38). In this research the achieved sample size is set towards the upper end of this range to increase the generality of the results. Given that it is a self-completion questionnaire, for which a reasonable response rate is 25%, it suggests I should distribute around 900 questionnaires to get responses of just over 200 or so.

In order to construct the sample of foreign investors, I utilise information that is collected by the tax offices. Each foreign investor that establishes their business in Indonesia is required to be registered as taxpayer and to have a Tax Identification Number. To determine which of the plants should be included, Figure 5.1 shows the organizational structure of the Directorate General of Taxes (DGT). There are 33 Regional Tax Offices, of which 31 are Regional Tax Offices that administer taxpayers in particular regions (mostly provinces), and the other two are Regional Tax Offices that administer specific taxpayer types, but operate nationwide. Of these, the Special Regional Tax Office is located in Jakarta and it administers nine Special Tax Offices, of which six are Foreign Investment Tax Offices that deal with foreign investors, i.e., mainly larger plants on the island of Java due to the person-to-person nature of the paper-based tax-filing system. They tend to deal with investors in specific activities.

Figure 5.1: The DGT Organizational Structure



Source: Adapted from Directorate General of Taxes (DGT), Indonesia.

In total, at 2017, there are 36,374 foreign investor individual plants that are registered for tax purposes in Indonesia (see Chapter 2), although not all are active taxpayers. In choosing the tax offices to work through, I was guided by four considerations: (i) they administer foreign investors as taxpayers; (ii) the office is nationwide in its coverage or if not it covers a Special Area only; (iii) it is possible to work with the officials at the office in terms with familiarity with the staff; and (iv) it is feasible in practical terms given the time and available resources. To fulfil these criteria, I decided to work with the Special Regional Tax Office of Jakarta and the Regional Tax Office of Riau and Riau Island that are shown in the third tier of Figure 5.1.

The rationale for focusing on these tax offices is as follows. First of all, in the case of the Special Regional Tax Office of Jakarta, I was fairly confident that it would cooperate with my research (criterion (iii)), not least as I used to work for this. This is important, as I intended to utilise the tax offices for the distribution and collection of the completed questionnaire forms (see below). Figure 5.1 shows that the Special Regional Tax Office of Jakarta has six Foreign Investment Tax Offices, and these are all located in Jakarta, making my task manageable in

terms of time and budget, so that criterion (iv) is also satisfied. Second, in order to gain an insight into the investors that choose to locate in a Special Area, I also choose the Batam Tax Office, which falls under the Regional Tax Office of Riau and Riau Island. The reason for selecting this tax office is because Batam is the first Free Trade Zone in Indonesia, and it has a long history of inward investment (see Chapter 3). I was confident that this office would cooperate with my research as I know some people who work at Batam Tax Office. The office is located outside Jakarta, but it is still manageable for me.

I am employee of the Directorate General of Taxes (DGT), but in order to gain access to the names, contacts and addresses of the foreign investors and enlist the help of my colleagues in the tax offices I had to write a formal letter of request to the DGT Head Office, which is given in Appendix B.5.5. I must emphasize that I did not request nor was I given access to the individual taxpayer data for the purpose of conducting this research, which is confidential to the DGT and the individual taxpayer. Nevertheless, gaining information on investor names and addresses was a great advantage, as research in this area is greatly hampered by this (Antonides and Robben, 1995). The DGT gave me permission to access these data and to request the assistance of colleagues in the DGT in carrying out the questionnaire survey.

Table 5.1: Business Activity and Number of Foreign Taxpayers

Unit	Business Activity	Number of Registered Foreign Taxpayer Plants
Tax Office 1	Chemical Industry and Non-Metal Material Products	736
Tax Office 2	Metal and Machinery Industry	720
Tax Office 3	Mining and Trade	454
Tax Office 4	Textiles, Food and Wooden Industry	700
Tax Office 5	Agri-Business and Services	789
Tax Office 6	Services and Trade	849
Batam	All activities	259
Total		4,507

Source: Adapted from DGT's internal data.

The number of foreign investor plants that are registered in each of the seven tax offices is shown in Table 5.1. This table also shows the business activities covered by each office. In total, Table 5.1 shows that there are 4,507 foreign plants registered for tax in these seven tax

offices, which is 12.4% of the 36,374 foreign investor plants registered for tax in Indonesia.[33] It shows that there are a similar number of plants covered by each tax office (in the range 720 to 849), although lower for Mining and Trade (454 investors) and Batam (259). In selecting the sample, I stratified it according to these seven tax offices, so that it is not representative of the actual distribution of FDI in Indonesia by activity, as described in Chapter 4. The reason for this was that it would have meant including virtually all of the plants of Tax Office 4 to be representative of light manufacturing industry, but including relatively few plants from some other tax offices. Rather, it makes sense to stratify the sample by activity, and so spread the survey equally across the tax offices to equalize the workload, and through this to maximise the likely response rate. Finally, the data relate to individual plants, even though a foreign investor may have other plants in Indonesia, but this is probed in the survey and in fact relatively few have other plants in Indonesia.

Table 5.2: Number of Investors in Sample by Tax Office

Unit	Foreign Taxpayers within the criteria	Initial Sample	Additions	Final Sample
Tax Office 1	691	125	26	151
Tax Office 2	672	125	20	145
Tax Office 3	284	125	3	128
Tax Office 4	421	125	131	256
Tax Office 5	486	125	0	125
Tax Office 6	127	125	0	125
Batam	259	125	45	170
Total	2,940	875	225	1,100

Source: DGT Indonesia (author's calculation).

Initially, I randomly selected 125 investors from each tax office for the survey, giving a total sample size of 875 foreign-owned plants, as shown in Table 5.2. The investors were selected using random function on an Excel sheet, but focusing on active taxpayers that had reported a monthly tax return in the last two months to maximise the survey response rate. I nominated a

[33] Regarding number of foreign plants registered for tax of which are not selected as the sample target (36,374 - 4,507 = 31,867) these are spread out over the other tax offices (334 tax offices, see Figure 5.1) across Indonesia. However, it is important to note that the 'main foreign taxpayers' are generally administered under the Special Regional Tax Office of Jakarta. The term 'special' on Special Regional Tax Office name means they are a special tax office that serves: (1) a special type of taxpayer, i.e., foreign taxpayers; (2) selected taxpayers, i.e., large-scale contributions, and (3) national-wide administrative jurisdiction.

Gatekeeper at each tax office, who was responsible for distributing the questionnaire forms on my behalf. The completed questionnaire could be returned in a sealed envelope to either the Gatekeeper by the taxpayers on the next monthly visit to the tax office or directly to me by post. Obviously, enlisting the officials of a tax office in the administration of the survey carries risks in biasing responses, but in my covering letter on Newcastle University headed paper (see Appendix B.5.2), I made it clear about the confidentiality of the replies and that results would be reported in aggregate only. These matters are discussed further in section 5.4.2.1 below.

The Gatekeepers assisted me in chasing-up the non-respondents, but it became clear part way through that the achieved sample size was likely to fall well below 200 completed responses. To increase the number of surveyed firms, I authorised the distribution of an additional 225 questionnaire forms. Given the limited time availability and for the reasons of feasibility, I instructed the Gatekeepers of Tax Offices 1 to 4 and Batam to distribute these further forms as the active taxpayers came in to fill-out their tax returns, but only to the firms making larger tax payments since I was concerned that I might not have enough survey returns from these. In the event, Table 5.2 shows that most of the additional forms were distributed by Tax Office 4, for which I had full support as it where I used to work. The next highest number is 170 distributed questionnaires for the Batam Tax Office. In total, Table 5.2 shows that 1,100 questionnaires were distributed, which is 25 per cent of the plants registered at the seven tax offices. From the table it shows that the number of questionnaires distributed by Tax Office 4 is the largest, but this covers more than one major business sector (i.e., foods, textiles, and light manufactures), where additional interviews may be more easily achieved at the margin. The additional sample was selected from the remaining list of targeted taxpayers that fulfil the criteria of active taxpayers (a monthly tax return submitted in each of the last two months). The difference in the number of firms surveyed across the tax offices is not such an issue as the results are separately reported below for the industries that are shown in Table 5.1.

5.4.1.2 Face-to-Face Interviews

For the face-to-face interviews I used a purposive sampling method for selecting interviewees, as described above. As I am a DGT employee I have prior knowledge about the institutions that are responsible for inward investment policy, so that the individuals selected as the target interviewees was based mainly on their job position, but also on to their job description with respect to the tax incentive policy design and implementation. To gain deeper insights, I was open to snowball sampling, as described above. For instance, if there is someone with the

experience of tax incentives or FDI policies who had moved to other departments. I was also happy to take recommendations from the interviewees about other people that might useful to interview. In this sense I treated the interviewees as subject-matter experts. Neuman (2014) argues that purposive sampling is relevant for research intended to gain a deeper understanding of social phenomena, while snowball sampling increases the relevant number of respondents that have an understanding of the research topic.

There is no fixed number of in-depth interviews to undertake, but the general wisdom is to achieve a 'saturation level', which Minichiello *et al*. (1992) define as "where no additional data can be found that would add to the categories being developed and examined" (p. 199). For this research I expect to get at least one representative of each of the five institutions that have direct links to tax incentive policy: the Ministry of Finance, the Indonesia Investment Coordinating Board, the Ministry of Industry, Directorate General of Taxes and National Council for Special Economic Zone (under the Coordinating Ministry for Economic Affairs). Since policymakers that are in these positions may be reluctant to criticize government policy I also selected the Indonesia Tax Consultant Association in an attempt to get a balanced view. It is an independent organization, which might reveal some original and valuable insights.

In general, the more heterogeneous an institution then the more interviews that I need, but as I interview policymakers in the same administration, where I believe that there are no strong difference of opinion, then this reduces the number of interviews. Guest *et al*. (2006) find that twelve interviews of a homogenous group is all that is needed to reach saturation, so that I decided to interview between 15 and 25 persons. I believe that this is reasonable sample size as I focus on very high-profile policymakers. A lower profile of interviewee might be considered if more detailed technical information was required.

5.4.1.3 Document Analysis

I collected as many documents as possible on tax and investment regulations, including both investment and taxation laws that follow operational regulations. In analysing these laws and regulations, I started at the highest level of law to provide a background on tax incentive policy, and then considered a lower level of regulations to give an explanation on the technical aspects or operationalization of policy. In Indonesia, the hierarchy of laws and regulations is based on Law Number 12 Year 2011 (Article 7 (1)), which from the highest tier is as follows:

(i) Constitution of Republic of Indonesia Year 1945
(ii) Decree of the People's Consultative Assembly
(iii) Law/Government Regulation in Lieu of Law
(iv) Government Regulation
(v) Presidential Regulation
(vi) Provincial Regulation
(vii) Regency/District Regulation

As the research object is national government policy, therefore the last two levels of the above hierarchy are not included because both of them are local government policy. In order to understand the operationalisation of the policy, I included the Ministerial Regulations up to Director General Regulations. According to Article 8 (1) Law 12/2011, Ministerial Regulations and Director General Regulations are legal regulations as it is mandated by higher laws and regulations or based on the policymaker authority. The documents were collected in hardcopy and electronic forms, where this was by formal request to designated institutions or by accessing an institution's website. To gain a holistic understanding, I did not sample, but rather I sought to be as comprehensive as possible.

5.4.2 Administration

This section discusses the data collection process in relation to each survey instrument. This is a very important part of the research that will influence the different response rates.

5.4.2.1 Self-Completion Questionnaire Survey

There are potential alternatives for determining the names and addresses of foreign investors in Indonesia, but the cooperation of the tax offices greatly simplified the process. It gave me the opportunity to identify the key personal within the plants and for both the distribution and for chasing-up the return of the completed questionnaires. To oversee the administration of the questionnaires I travelled to Indonesia and was based there from 8th September to 15th December 2017. Initially, I met with the head of each of the seven tax offices to get their support, indicating to them the purpose of the research and the plan for carrying it out. This aspect was completed soon after my arrival.

To administer the questionnaire, I identified a Gatekeeper within each of the seven tax offices. In general, a Gatekeeper is an Account Representative, who is responsible for administering a particular number of registered taxpayers. Their role is to advise the firms on how to satisfy their tax obligation, including the completion of the tax returns. Of course, an obvious difficulty is that the questionnaire contains questions about the effect of taxation, which could affect the relationship between the investor and the tax official, and bias the responses. However, the questionnaire form is anonymized and based on reference numbers only (see Appendix B.5.1). Further, I included a self-addressed envelope, so that the firms could return the completed forms directly to myself in a sealed envelope and so bypass the Gatekeeper. The return address is via the Head of each Tax Office with direct attention to me as a researcher. In practice, completed forms were received periodically (every week at least) by the secretary of the Head of each Tax Office and passed to me. There is the possibility that the firms may return the questionnaire to me via the Gatekeeper. These different ways of returning the completed forms was set out in the covering letter to the investor (Appendix B.5.2) to reduce any potential bias. I gave assurances to the firms that the completed forms would remain confidential to the research and be reported in an aggregated basis only, from which it was not possible to identify any firm or any small group of firms. I also gave these assurances to the DGT (Appendix B.5.5).

The anonymization of the questionnaire is also a security measure in case a completed form went missing in transit or subsequently, and it gives confidence to the investors to accurately complete the questionnaire, including information such as their sales turnover or even their views on government institutions. I printed the questionnaire in different colours for each of the tax offices. This makes it difficult for anyone to duplicate the questionnaire. Further, it helps with the distribution, collection and monitoring of the survey process, and it helps avoid any misadministration of the questionnaire between the different tax offices.

After I met with the Heads of the Tax Offices, I met with the Gatekeepers. I agreed with them that the questionnaire would be distributed to the investors in the sample using the process of their monthly tax return submission. In the case of Tax Offices 1 to 6 (see Table 5.1), which are each located in Jakarta, firms must file their tax returns between the 15th and 20th of each month, while the return for Value Added Tax is made between the 25th and the end of a month. For the Batam Tax Office it is between the 15th and 20th of each month, as they do not make sales within Indonesia. For each Gatekeeper I prepared a package for each firm in their sample consisting of: (i) the covering letter; (ii) survey questionnaire printed back-to-back in both English and Bahasa; (iii) survey completion instructions; and (iv) self-addressed envelope with

postage paid. These packages were distributed to the firm's representative when they visited the tax office to make their monthly tax returns. The Gatekeeper oversaw the process and completed a list, which consisted of the taxpayer name, the questionnaire code number, the Account Representative name, the date of distribution, and the name of person receiving the package, along with their signature and contact details (phone number and email address).

To facilitate the process and ensure coordination, I also appointed a Senior Gatekeeper as my main contact person. This Senior Gatekeeper was a respected person among the Gatekeepers, who was very supportive of the process. All positions were unpaid, so that I am extremely grateful for the time and effort expended by these individuals. I used the Senior Gatekeeper as a point of contact when I needed to know progress on distributing the questionnaire and returns, and other thing that might help to accelerate the process, as I planned to get back to Newcastle by the end of 2017. When I asked him to do so the Senior Gatekeeper was always very helpful in reminding the Gatekeepers to distribute the questionnaires.

5.4.2.2 Face-to-Face Interviews

The ethical approval by Newcastle University required that the interviews be carried in a good manner, and not have a detrimental effect on either the interviewees, researcher or university. It considered the research to be low risk, but to provide a better understanding of this to an interviewee before agreeing to participate I prepared a consent form. This set out the purpose of the research, the benefit and risk of participation, the research sponsor and confidentiality and anonymity assurances. I also provided my contact details, and the name and address of my principal PhD supervisor to whom a participant could raise concerns or even complain.

To conduct an interview the first step was to request a Research Permit from the institution of the target participant. I sent a formal letter explaining the research to the institution and requested permission to conduct the interview. Institutions can have their own regulations and procedures for these interviews. For instance, Director General of Taxes has DGT Circular Letter SE-23/PJ/2012 concerning Research Permits and Internships, and I had to follow this. For other institutions that I am not familiar with, I gained access using informal channels, such colleagues or endorsements from people who have access to the institutions.

When a Research Permit was granted, I made an appointment with the target official. For a high-rank policymaker, such as Deputy Minister or Secretary General, this was through his or

her secretary. When we got an agreed date, time and location, I took along my pre-prepared documents, such as the consent form, notes and list of questions, as well as the Research Permit and a voice recorder, for which I sought permission. The list of questions was pre-checked in order to gain the appropriate information from the interviewee. In practice, I sometimes needed to make adjustments to the questions to fit with the participant's job description or knowledge relevant to the position. I usually went with the participant's preferences regarding the place and time, unless I already had another meeting scheduled for a roundabout the same time.

When the interview was complete, I later made a transcription from the voice recorder that was verbatim. I used the original language, which was Bahasa Indonesia. The transcripts were assigned a code number, but to keep them secure I did not identify the interviewee on the transcripts, so that the only information that differentiated them was information on the institution. The translation of the transcripts into English was generally not made verbatim, but as a conversation that summarised the meaningful content. However, certain key information from the interviews was translated word-for-word in full.

5.4.2.3 Document Analysis

To administer the scrutiny of the policy documents, I differentiated between the documents that could be gathered directly from the institutions' own websites and those needing further effort by sending a formal request to an institution. Since government policy in Indonesia is widely accessible, there were in general no issues arising from data collection. A researcher can also request data under 'information public disclosure' based on Law Number 14, Year 2008. Information that is prohibited under this concerns an individual taxpayer (investor) who applies for or receives tax incentives. However, information in aggregate terms, such as the number of taxpayers who apply and receive tax incentive in a year can be gathered. For some data on FDI and tax matters I sent a request directly to the Statistics Indonesia.

5.4.3 Implementation

In this section I discuss the success with which each of the survey instruments is carried out, including the response rates in the case of the questionnaire and face-to-face interviews.

5.4.3.1 Self-Completion Questionnaire Survey

The survey as a whole took three months from the distribution of the questionnaire forms to the final collection, i.e., from mid-September to mid-December 2017. The initial distribution of forms took place in the second week of September 2017 utilizing the monthly tax reporting period. Each taxpayer on the list of target respondents, representing a foreign-owned plant in Indonesia, who came to one of the seven tax offices to file their return was given a survey questionnaire package. The Account Representative that provided the questionnaire gave the taxpayer a verbal explanation of the research, and asked them for their help in completing and returning the questionnaire the following month. Respondents were welcome to return it by post if they found this most convenient. Other taxpayers were treated as usual.

The distribution of the questionnaires turned out to be a slow process, and time was pressing, so that starting in early October 2017 I sent through the post all the remaining forms of the original 875 questionnaires that had to that date not been collected. Seventy forms were later returned as the address was not known. A further 225 forms were sent out in late October and early November to achieve the required response rate, and details are given in Table 5.3.

Table 5.3: Progress in the Distribution of Questionnaires

Period	Number of Distributed Questionnaire Forms
September - week 2	88
September - week 3	99
September - week 4	35
October 2017 - week 1	450
October 2017 - week 2	139
October 2017 - week 3	13
October 2017 - week 4	99
November 2017 - week 1	58
November 2017 - week 2	119
Total	1,100

Source: Author's calculations.

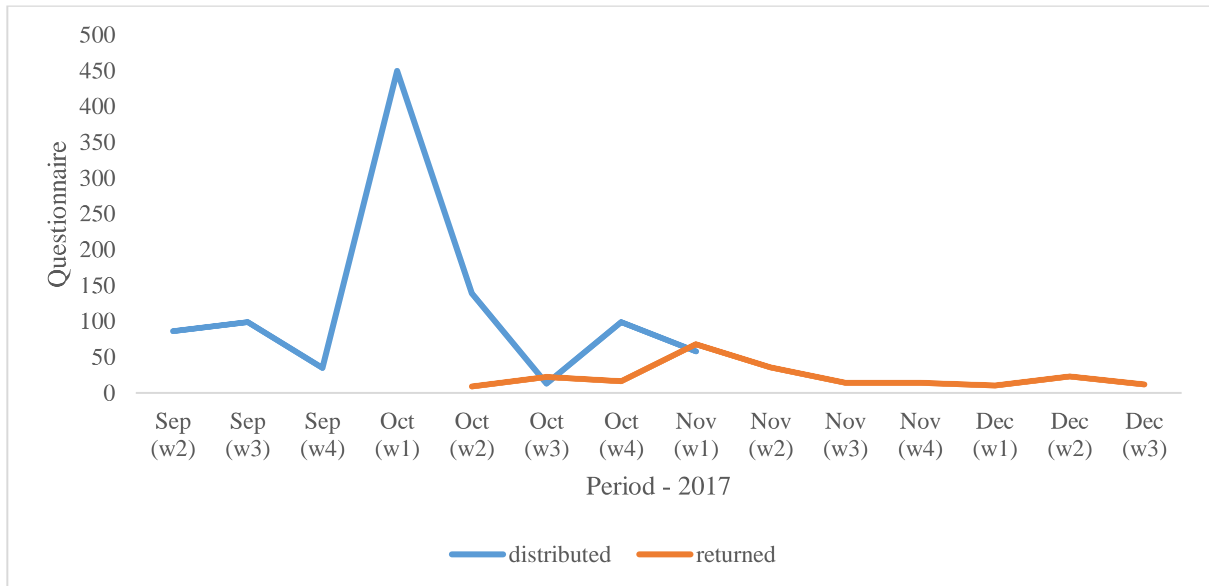
The return of the questionnaires commenced in the second week of October 2017, reaching a peak in the first week of November, and details are given in Table 5.4. I sought to increase the number of responses by asking each tax office to remind the sampled firms to complete the questionnaires and return them as soon as possible. This effort is reflected in the higher number of responses in the second week of December 2017. However, the momentum could not be maintained as the companies were starting to focus on their annual reports before the long holiday period from mid-December. I returned to Newcastle about this time, and I drew the survey to a close at the end of the third week of December 2017. A weekly comparison of the number of forms distributed and returned is shown in Figure 5.2.

Table 5.4: Progress in the Return of Questionnaires

Period	Number of Returned Questionnaire Forms
October 2017 - week 2	9
October 2017 - week 3	22
October 2017 - week 4	16
November 2017 - week 1	68
November 2017 - week 2	36
November 2017 - week 3	14
November 2017 - week 4	14
December 2017 - week 1	10
December 2017 - week 2	23
December 2017 - week 3	12
Total	224

Source: Author's calculation.

Figure 5.2: Distribution and Return of Questionnaire Forms by Week



Source: Author's data.

A sample of 224 completed questionnaires was achieved, giving a response rate of 20.4% of 1,100 distributed forms, including those returned with address marked as unknown. Table 5.5 shows the response rate for each tax office. The much higher response rate for Tax Office 4 is because of the support of this office, with each Account Representative assigned five or six questionnaires for distribution to taxpayers. Given the industry focus of the tax offices (see Table 5.1) it is less of an issue as Tax Office 4 focuses on light manufacturing and most foreign-owned plants are in fact in this sector. Tax Office 5 that focuses on plants in agri-business and services has the lowest response rate, at 8 per cent, while there is a lower response rate for Tax Office 6 that focuses on the service sector more broadly.

Table 5.5: Questionnaire Survey Response Rate by Tax Office

No	Tax Office	Number sampled	Number of returns	Response rate (%)
1	Tax Office 1	151	23	15.2
2	Tax Office 2	145	27	18.6
3	Tax Office 3	128	18	14.1
4	Tax Office 4	256	100	39.1
5	Tax Office 5	125	10	8.0
6	Tax Office 6	125	13	10.4
7	Tax Office - Batam	170	33	19.4
Total response rate		1,100	224	20.4

Source: Author's calculations. See also Table 5.1 on the tax offices.

In general, non-responses may be caused by several factors, such as a lack of incentive for completion or an absence of consequences for non-participation. Offices other than Tax Office 4 seem to have devoted less effort in persuading the plants to fill out and return the questionnaire. Further, as the questionnaires address a general position within a plant, such as the president, director general, manager or tax manager, then this might be another reason for non-response. These people are also of high rank and may be pressed for time, which is another reason for non-completion. Also, as I indicated, some were returned as address unknown.

The proportion of completed questionnaires is 20.4 per cent. Sivo *et al.* (2006) describes a response rate in the range of 17 to 28 per cent as reasonable. It compares well with Yu and Cooper (1983), who find that the response rates for articles published in marketing journals varies from 10 to 28 per cent.[34] In fact, the World Bank has published research based on a survey conducted in 2002 by the Multilateral Investment Guarantee Agency and Deloitte and Touche LLP to 3,000 MNEs with only a 6 per cent response rate (MIGA, 2002, p. 3). Fowler (2014) classifies 'low' and 'high' effort surveys as varying between 9 and 22 per cent in their response rate, so that my response rate compares very favourably. Thus, while a response rate for a self-completion questionnaire of 20.4 per cent may seem modest, it passes the minimum recommended level of 20 per cent for organizational surveys suggested by a range of authors (Ravichandran and Rai, 2000; Malhotra and Grover, 1998; Yu and Cooper, 1983). It is worth remembering that at 224, there is also a large number of responses for the analysis.

[34] These are the *Journal of Applied Psychology* (10 per cent), *Public Opinion Quarterly* (21 per cent) and the *Journal of Marketing Research* (28 per cent).

5.4.3.2 Face-to-Face Interviews

The face-to-face interviews took place in Jakarta, Indonesia and were conducted between 19th October and 29th November 2017. Interviews were carried out according to a schedule agreed with the interviewees, and normally took place in their offices or other suitable place. At the interview I firstly introduced myself and my working background in order to make a rapport, although some of the interviewees were already known to me. I then explained the purpose of the research and how it links to the interview process. I also indicated that the interview will be recorded, but that the informant was free to say that something was not for recording if it was desirable. I explained that the interviewee's personal name and other details will be kept confidential. Lastly, I asked the interviewee to sign the consent form (Appendix B.5.4).

In the interview I asked questions according to the pre-prepared list of questions that acted as a guidance. As explained previously, the semi-structured approach made it possible to make adjustments during the interview, including probing for further explanation or clarification. Each interview took between 45 and 75 minutes, depending on the richness of the discussion. At the end of the interview, I allowed the interviewee time for questions and clarification, and after which I expressed my gratitude and asked for further support should it subsequently be necessary. Generally, the interviews were carried out on a one-to-one basis, but a few were carried out with a group of two or three interviewees. During my period of fieldwork in Indonesia I carried out 16 interviews with 20 people, but on my return to Newcastle I carried out a further interview with officials of the Indonesia Investment Promotion Centre (IIPC) in London. This was conducted with two IIPC officials in 2018 and it enabled me to get a sense of how investment promotion for foreign investors operates in a foreign country.

Overall, 17 face-to-face interviews were conducted with 22 people, and a breakdown of these by institution is given in Table 5.6. This represents 80 per cent of the total target, and in general the interviewees were extremely helpful and supportive. The other 20 per cent of interviews could not be done as within the time available to me in Indonesia it was not possible to match the schedules since some of them were on other duties or travelling abroad. No one actually refused an interview request outright. Table 5.6 shows that most interviews were conducted with staff at the Indonesia Investment Coordinating Board or at the Ministries of Finance or Industry. I believe that the number of respondents is sufficient to cover the information required for the research, and that it is 'saturation point', meaning that no new information would be gleaned by adding further respondents. Galvin (2015) argues it occurs at 12 interviews.

Table 5.6: Institutional Background of Respondents

No.	Institution	Number of Respondents
1	Indonesia Investment Coordinating Board (BKPM)	5
2	Ministry of Finance (MoF)	2
3	Fiscal Agency (BKF)	3
4	Directorate General of Taxes (DGT)	2
5	Ministry of Industry (MoI)	6
6	National Council of Special Economic Zone (SEZ)	1
7	Indonesia Investment Promotion Centre (IIPC)	2
8	Indonesia Tax Consultant Association (IKPI)	1
Total		22

Source: Author's completed face-to-face interviews.

In general, all the respondents were high profile policymakers, and details of their job level or position are given in Table 5.7. Almost all of the interviewees are policymakers who directly link with policy formulation or implementation in relation to tax incentives or FDI. Almost 25 per cent are very high rank, which is at the Deputy Minister or equivalent level.

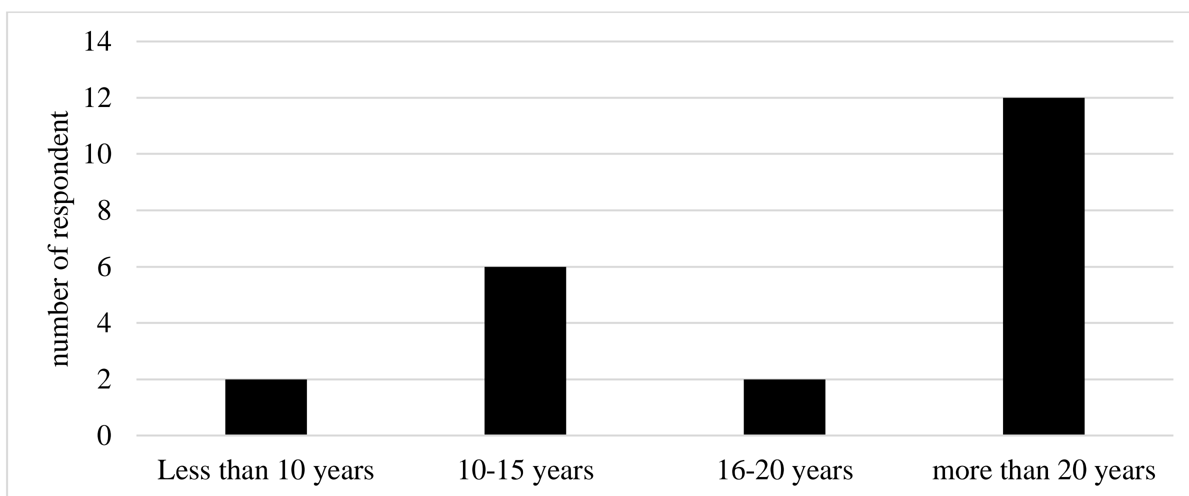
Table 5.7: Interviewee Job Level or Position

No.	Job Level (Position)	Number of Respondents
1	Echelon 1 (Deputy Minister)	4
2	Echelon 2 (Director)	5
3	Echelon 3 (Deputy Director)	6
4	Echelon 4 (Section Chief)	4
5	Executive Management	3
Total		22

Source: Author's completed interviews.

Figure 5.3 shows that about 55 per cent of the interviewees have worked for more than 20 years in the government and/or their profession. Only 9 per cent have less than 10 years' experience.

Figure 5.3: Experience of Face-to-Face Interviewees



Source: Author's completed interviews.

Overall, it is believed that the interviewees all have the relevant tacit knowledge and insight about the research topic. Indeed, respondents of a high rank usually have a wide perspective and they view policy from a macroeconomic standpoint. At a lower rank the respondents had very good knowledge on the detail of implementation and the technical aspects of the policies. Finally, whatever the rank, they all gave very interesting insights on the topic.

5.4.3.3 Document Analysis

Regarding the use of policy document in this thesis, it is not stand-alone analysis, rather it will be incorporated with other two previous survey analysis: survey questionnaire and in-depth interview analysis. The document analysis on FDI regulations and tax incentives involved skimming and reading (i.e., superficial and thorough examinations), in order to make interpretations (Bowen, 2009). In addition to these, operational regulations were reviewed, such as those made by ministers and heads of institutions like the Indonesia Investment Board and Director General of Taxes. A list of these documents by type is given in Table 5.8, along with the nature of the analysis that was undertaken in each case. The information on the laws and regulations were obtained mainly from the institutional websites, but I also received some documents that were provided by the institutions upon request. In order to gain insights of each law and regulation the documents were put in a sequential order and summarised in order to

find patterns. This is in order to reveal information on the aim and nature of the policy process in relation to FDI.

Table 5.8: The Nature of the Documents Analysis

Document type	Nature of analysis	Documents (including but not limited to these)
Laws	• The objective of laws • The reason for amendment • Investment incentive type and criteria • Tax incentive type and criteria	Law 1, year 1967 concerning Foreign Direct Investment; Law 11, year 1970 concerning amendment of Law 1 year 1967; Law 7, year 1983 concerning Income Tax; Law 25, year 2007 concerning Investment.
Government Regulations	• Type of investment incentive and/or tax incentives • Policy objectives • Reason for amendment	Government Regulation 148, year 2000 concerning Income Tax Facility for Investment; Government Regulation 100 year 2012 concerning Implementation of Special Economic Zones.
Presidential Regulations	• The development of Special Economic Zone • Policy objectives	Presidential Regulation 124, year 2012 concerning National Council and Special Economic Zone Council.
Minister Regulations	List of investment that eligible for tax incentives	Minister of Finance Regulation 130/PMK.011/2011 concerning the Provision of Corporate Income Tax Relief or Reduction Facility.
Director General of Taxes Regulations	Technical procedures on how to apply for tax incentives	Director General of Taxes Regulation 41/PJ/2013 concerning Mechanism Tax Facility Provision.

Source: Author's adaptation of DGT's documents and other sources.

5.5 Conclusions

There is relatively little research that has been conducted on the factors influencing FDI flows in Indonesia, and in particular the relationship between FDI inflows and tax incentives, while those studies that have been carried out tend to utilise large data sets to test hypotheses, such as from the World Bank, UNCTAD, BPS or other sources. However, these studies overlook the perspectives of the actors involved, including both investors and policymakers. Therefore, rather than using secondary data to measure the relationship between FDI and tax incentives, in this thesis I seek to collect information directly through surveys of the relevant actors, and through a review of documents, as a better means for understanding the investors' motivations and policymakers' perspectives. This chapter has sought to give a rationale for this approach,

to set out the advantages and disadvantages of each of these, the methodology adopted and to report on the practical implementation, including where relevant the response rates.

This research employs a 'mixed methods' methodological approach. This seeks to utilise the strengths of quantitative and qualitative approaches, and through triangulation to understand the processes at work. This method is believed to be optimal since it provides a more holistic picture, and since it is not used infrequently in the literature is also a contribution to knowledge. As a means of doing mixed methods research, this thesis utilizes a questionnaire survey and in-depth interviews as the main tools for data collection. This is complemented by document analysis. It is expected that these will yield a confluence of evidence that combined lend credibility and confidence to the research, its interpretations and conclusions (see Eisner, 1998).

On the specific instruments, the chapter argues that a questionnaire survey will enable greater understanding of the investors' perceptions regarding the characteristics and factors that influence the FDI location decision in Indonesia as well as their perceptions about tax incentive policies. The in-depth interviews enable understanding of the policymakers' perceptions of FDI and the motives for the using, or not using, tax incentive policy. Finally, as a third pillar of the triangulation strategy, document analysis is used to complement the questionnaires and interviews to provide information regarding the nature and effects of FDI regulations and tax incentive policies.

In general, taxation is a sensitive issue, and many researchers have found it difficult to gain access to information on these data at an individual level in order to conduct research. This thesis has sought to collect this information and to elicit the opinions of the investors through the administration of the questionnaire survey to inward investors. The survey instrument has mainly closed-ended questions, but also open-ended questions, in order to gain primary data directly from the investors. Closed-ended questions generate comparable answers that make it easier to analyse, while open-ended questions reveal other possibilities that might not arise in the researcher's mind and do not frame the responses. Through the use of a questionnaire survey, it is expected that the research will generate a large sample of investors within the research constraints of both time and budget. Regarding the results, the questionnaire survey is primarily quantitative, so that the information gathered can be used to make comparisons between investors, sectors and areas using a cross tabulation analysis.

The in-depth interviews are employed to better understand the policymakers' perspectives on the tax incentive policy for encouraging FDI inflows. The challenge of this approach is that it requires high-ranking respondents to fully understand the policy, given their knowledge of the policy development and implementation. The selected respondents should give different perspectives that allow the researcher to make comparisons or contrasts among policymakers from different institutional backgrounds. In this research, as a government official, it helped me to get access to the designated respondents. Further, my role in the Directorate General of Taxes enabled me to form a sample for the questionnaire survey, for which I benefitted greatly from the assistance of these tax offices in the administration of the survey itself.

The questionnaire survey of Indonesian investors was carried out from mid-September to mid-December 2017. It was distributed to individual senior staff in about 1,100 foreign-owned plants, resulting in 224 completed forms, which is a response rate of 20.4 per cent. Further, out of a target of 27 respondents, about 80 per cent of the in-depth interviews with policymakers were successfully conducted. The results of these exercises are reported in the next few chapters of this thesis. Unlike questionnaire survey and in-depth interview results which are reported in specific chapter, the result of document analysis is not reported separately but incorporated into relevant chapters and discussion. Overall, I believe that the information gathered for this thesis is appropriate for the research, not least as taxation is a sensitive topic for both the investors and policymakers, so that the challenge is to access high-profile respondents in both these areas. Regarding any potential bias that may occur due to researcher background as an employee of the tax office, this is minimised since the questionnaire survey is anonymised and returned in a sealed envelope to be opened by me alone, while there is no clear incentive or disincentive for a firm to participate in the survey. It is made clear to participants that all responses are reported in an anonymized fashion from which it is not possible to identify individual plants or firms. It is expected that the data gained through the survey is able to show the characteristics of FDI and to reveal whether tax incentives are an important factor for investors in deciding a location in Indonesia. Further, it is expected that the survey results will provide information on how policymakers perceive the role of tax incentives for attracting FDI. This is the basis for the remainder of the thesis.

Chapter 6. Questionnaire Survey Results

6.1 Introduction

As discussed in Chapter 5, the main data for this research are gathered through a paper-based questionnaire survey of foreign investors and from face-to-face interviews with policymakers. This chapter presents the results of the questionnaire survey that was conducted in 2017 with foreign investors in Indonesia, while the results of the interviews are discussed in the following chapter. The information discussed in this chapter derives from the 224 completed questionnaire forms, which is equal to a response rate of 20.4 percent. In terms of the spatial distribution, the sample is representative to the number of total foreign investors (plants) on Java and elsewhere, as registered as taxpayers by the Directorate General of Taxes (DGT), as shown in Table 6.1.

Table 6.1: Foreign Investors Registered as Taxpayer by Region

Region	Foreign Taxpayers*		Survey Response	
	Number	Percentage	Number	Percentage
Java	28,357	78%	175	78%
Non-Java	8,017	22%	49	22%
Total	36,374	100%	224	100%

Source: Adapted from DGT's internal data, 2017* and the survey result 2017.

As the research is intended to look at the investment location decision the analysis is based on a comparison between the Special Areas (SAs) and the Non-Special Areas (Non-SAs). As described in Chapter 5, a SA is an area with specific tax advantages or preferences provided by the government, such as a Bonded Zone or Free Trade Zone, while Non-SA simply means an investment in Indonesia that is outside of the SAs. Where possible, the analysis is also based on the industrial sector and activity given the stratification of the sample described in Chapter 5. The chapter is selective in the results that are presented, but for reference the full set of survey results to each question of the questionnaire are given in Appendix Table A.6.1, where the survey form is given in Appendix B.5.1. This also disaggregates these according to the six industrial sectors that were identified in Chapter 5, and used to stratify the sample.

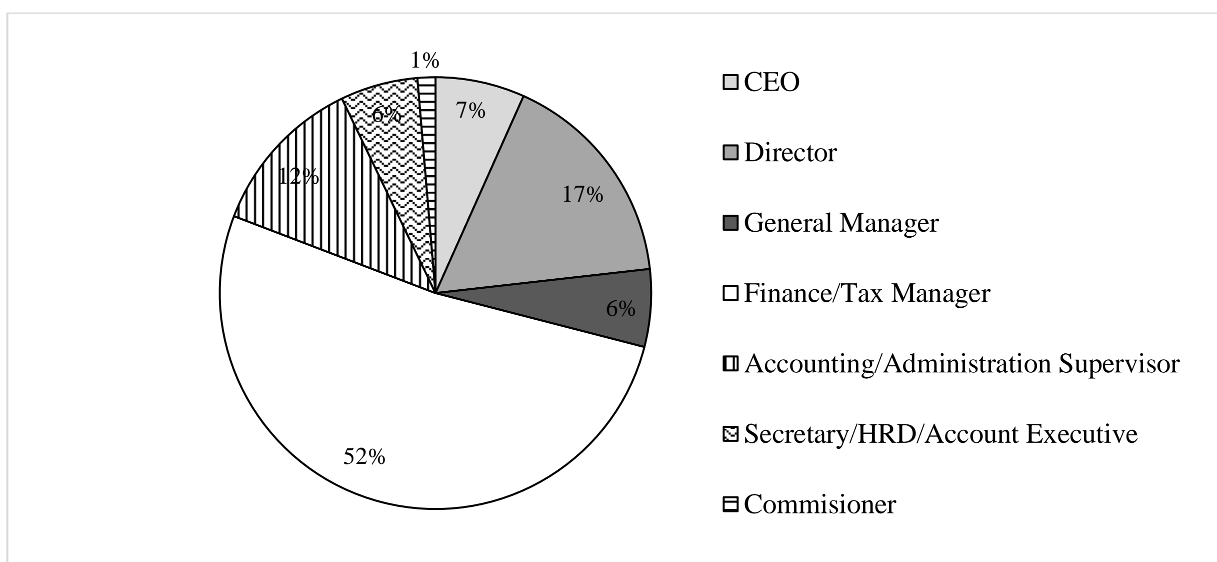
The chapter is organised as follows. Section 6.2 presents the characteristics of the survey respondents, Section 6.3 describes in detail the nature of the plants and companies in the survey, and Section 6.4 discusses the international operations and future prospects of the plants and companies. Section 6.5 considers the factors that matter for the investors in deciding their investment location, and Section 6.6 discusses how the foreign investors perceive government policies, especially taxation incentives. The discussion on how investors view the business environment in Indonesia is the subject of Section 6.7, including how investors perceive the government's role. Finally, conclusions are drawn in Section 6.8.

6.2 Respondent Characteristics

This section considers the respondent characteristics and those of the plants and companies that form the set of completed questionnaires. The survey sought to reach the highest tier of management within the plants, which is important in order to gain the most informed reasons regarding the investment decision. In the survey cover letter, it is clearly stated that the questionnaire form is directed to Chief Operating Officer (CEO)/Director/General Manager/ Finance Manager/Tax Manager of the surveyed plant.

Figure 6.1 shows the respondents job level, which is categorised according to the Chief Operating Officer (CEO); Director; General Manager; Financial/Tax Manager; Accounting/ Administration Supervisor; Secretary/Human Resource Development Officer/Account Executive; and Commissioner. Overall, out of the 224 respondents, about 80 percent (181 respondents) are represented by the designated respondents, while the other 20 percent (43 respondents) are not in a formal managerial position, but presumably in close relation with the decision makers within the plant. About 30 percent of respondents are at the highest position (CEO/Director/General Manager), while more than a half of the respondents are Finance or Tax Managers. So, in general, it is believed that the person who provided the answer of the questionnaire have a good knowledge and understanding of the relevant subject matter.

Figure 6.1: Job Level of Survey Respondents



Source: Q-1.1, Questionnaire survey of Indonesian foreign investors, 2017.

In terms of the length of period serving the company, Q-1.2 of Appendix Table A.6.1 shows that about 43 percent of the respondents have worked for the company for more than 10 years and about 26 percent have been working for between 6 and 10 years, but about 31 percent of respondents have worked for the company for less than 5 years. Furthermore, about 17 percent of the respondents have experienced working for the company at another site (Q-1.3). The respondents' nationalities are mostly Indonesian, so only about 17 percent are foreigners (Q-1.4). This is higher for companies in the SAs (26 percent), compared with those outside (10 percent). The textiles sector provides the highest proportion of foreign national respondents, which is more than thirty percent of the total respondents for this sector.

6.3 Nature of the Plants and Companies

This section describes the characteristics of the plants and companies in the survey responses. This includes information on the geographical location of the plants across regions and provinces, as well as according to the SAs. Table 6.2 below shows that 43 percent of the plants (97) are located in the Special Areas (SAs) and 57 percent (127) are in the Non-Special Areas (Non-SAs). As previously noted, a Special Area is a Free Trade Zone (FTZ) or a Bonded Zone (BZ). They give some privileges to the investors in terms of the easiness of investment, but also benefits in the form of exemptions from certain types of indirect taxes (i.e., Value Added Tax (VAT), Luxury Good Sales Tax (LGST) or Income Tax Article 22) and from customs and duties. This section further looks at the establishment of the plant, i.e., whether it is greenfield

(wholly new plant) or brownfield FDI (merger and acquisition). The plants principal activity and the broad sector classification are also presented, together with the number of employees. Each foreign-owned company generally has only one plant located in Indonesia.

6.3.1 Plant and Company Characteristics

Table 6.2 provides the broad picture of the plants' characteristics according to the industrial sector and the age of the establishment. Out of 97 plants located in the SAs, 38 percent are in the textiles industry, followed by light and heavy manufacturing (29 and 12 percent). Food and services are next with 8 and 7 percent respectively, while 5 percent are in utilities and construction activities. For plants located in the Non-SAs, 23 percent are light manufacturing and 22 percent are in wholesale trade. Next comes textiles with one-fifth of total plants in the Non-SAs, followed by heavy manufacturing and food industries with 17 percent and 13 percent respectively. Finally, 6 percent of the plants are in crop and animal production (including fishery), mining and electricity supply which all of them are classified as 'other' sector. As regards the plant age, Table 6.2 shows that 78 percent were established in the 1990s or 2000s. About 17 percent of the plants were established in 1980s, while the oldest plant set-up in 1943. Only 5 percent of the plants were established after 2010.

Table 6.2: Plant Sector and Age

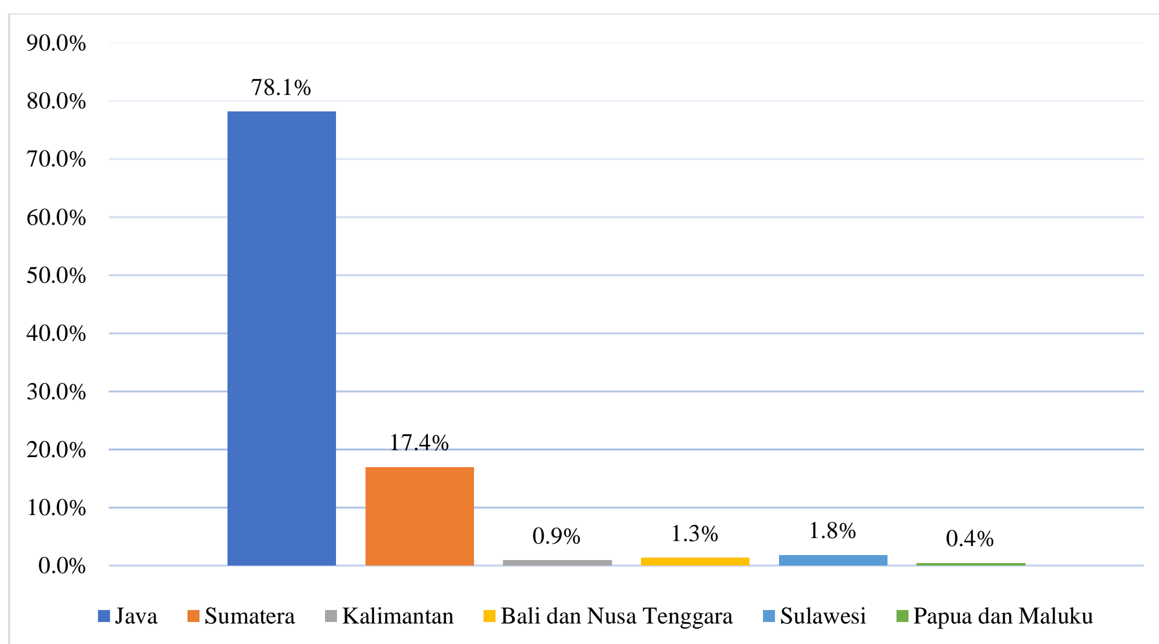
	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Plant sector						
· Food	8	8%	16	13%	24	11%
· Textiles	37	38%	25	20%	62	28%
· Light Manufacturing	28	29%	29	23%	57	25%
· Heavy Manufacturing	12	12%	21	17%	33	15%
· Services	7	7%	28	22%	35	16%
· Other	5	5%	8	6%	13	6%
Plant age						
· Prior to 1990s	10	10%	29	23%	39	17%
· 1990s	39	40%	48	38%	87	39%
· 2000s	44	46%	43	34%	87	39%
· After 2010s	4	4%	7	6%	11	5%
	97		127		224	

Source: Q-2.6 and Q-2.1, Questionnaire survey of Indonesian foreign investors, 2017.

Figure 6.2 shows the distribution of the respondents across the six Indonesian regions (Java, Sumatera, Kalimantan, Bali-Nusa Tenggara, Sulawesi, and Papua-Maluku). It can be seen that

around 78 percent of the respondents are located on Java Island and that a further 17 percent are on Sumatera, so that only 5 percent are located in the other four regions of Indonesia. With regard to the plants in the SAs, most of these are on the islands of Java and Sumatera, at 63 percent and 36 percent respectively (Appendix Table A.6.1, Q-2.3). At the provincial level, most plants are in West Java (about 34.4 percent), followed by Jakarta and Riau islands with about 17 percent and 14 percent respectively (see map in Chapter 3). Outside Java, Riau Island has 15 percent of all plants, followed by North Sumatera at 2 percent, and Bali and South Sulawesi at about one percent each, while the other provinces account for only 4 percent in total. With regard to the plants on Riau Island, these are mostly located in the Batam Island FTZ.

Figure 6.2: Distribution of Plants by Indonesian Region



Source: Q-2.3, Questionnaire survey of Indonesian foreign investors, 2017.
Note: One non-response

Table 6.3 shows the characteristics of the plants at the time of establishment. More than 90 percent of the plants are newly-established plants, i.e., greenfield FDI and this is similar for both the SAs and Non-SAs. Only 17 plants relocated, but most of these (82 percent) came from other regions within Indonesia. Table 6.3 shows that about 84 percent of the plants were established by the company itself, and only 14 percent involving the acquisition of another company that was already located in Indonesia.

Table 6.3: Characteristics of Plants at Establishment

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
When first established, was this a wholly new plant?						
New	90	93%	117	92%	207	92%
Relocated	7	7%	10	8%	17	8%
(a) from within Indonesia	(5)	(72%)	(9)	(90%)	(14)	(82%)
(b) from outside Indonesia	(1)	(14%)	(1)	(10%)	(2)	(12%)
(c) non-response	(1)	(14%)	-	-	(1)	(6%)
Did the company acquire the plant from another firms?						
Yes, it acquired from another firm	12	12%	19	15%	31	14%
No, it is not	83	86%	106	83%	189	84%
Non-response	2	2%	2	2%	4	2%
Does the plant operate under a franchise or license from another company?						
Yes	14	14%	25	20%	39	17%
No	80	82%	101	80%	181	81%
Non-response	3	3%	1	1%	4	2%
Number of plants	97		127		224	

Source: Q-2.4, Q-2.4a, Q-2.5, and Q-2.8, Questionnaire survey of Indonesian foreign investors, 2017.

As regards the entry-mode, the ‘investment entry mode’ is an investment that involves the “ownership by an international company of manufacturing plants or other production units in the target country”, while the ‘contractual entry mode’ is “long-term non-equity associations between an international company and an entity in a foreign target country…” (Root, 1994, p.7). A contractual entry mode normally involves licencing or a franchising activity. Looking at the entry-mode, more than 80 percent of the plants undertake an ‘investment entry mode’, whereas 17 percent indicate their business is a ‘contractual entry mode’. Comparing the SAs and the Non-SAs, the acquisition of a plant is more likely in the latter, at 20 percent, compared with 14 percent for the SAs. The survey (Q-2.8, Appendix Table A.6.1) reveals that licensing and franchising is highest for the service sector (about 31 percent), followed by food (25 percent), heavy and light manufacturing (21 percent and 14 percent) and textiles (11 percent). Licensing and franchising for the investors in the Non-SAs is about 64 percent, which is much higher compared to the SAs, which is 36 percent, so that this is a strong difference.

6.3.2 Business Ownership, Sector and Country Origin

This sub-section examines the ownership structure of the company that owns the plant. This is according to whether it is an independent company, subsidiary or joint venture. An independent company is where it maintains full control of the firm, whereas a subsidiary company is a business entity that is separate from the parent company, where a percentage of the share capital belongs to the parent (Abodohoui *et al.*, 2013). In essence, a parent company partially or fully controls the subsidiary's business activities. A joint venture is where two or more entities agree to undertake economic activities and achieve specific goals by contributing capital to form a business (Markovits, 2014; Saha and Chattopadhyay, 2015). If at least one of the parties comes from a foreign country then it can be regarded as an international joint venture.

Table 6.4 shows the characteristics of the company ownership structure for the surveyed plants and the legal status. Overall, 51 percent of the respondents are independent companies and 43 percent are subsidiary companies. Only a small proportion (4 percent) report themselves as a joint venture. Comparing the ownership structure of companies in the SAs and Non-SAs, there is a similar pattern, but whereas the proportion of independent and subsidiary companies is almost the same in the SAs (49 and 46 percent), it is 53 and 41 percent respectively for the Non-SAs. Regarding the legal status, the responses show that most of the surveyed companies are private (86 percent) and that only 8 percent are public companies. A public company is where the share capital of a company is traded on the stock market exchange (Law 40/2007 concerning Limited Liability Companies), whereas a private company is formed from stock gathered through engagement or contract among private parties (Varcholova and Beslerova, 2013).

Table 6.4: Ownership Structure and Legal Status

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Ownership Structure:						
Independent company	48	49%	67	53%	115	51%
Subsidiary	45	46%	52	41%	97	43%
Joint venture	3	3%	6	5%	9	4%
Non-response	1	1%	2	2%	3	1%
Legal Status:						
Public	11	11%	8	6%	19	8%
Private	81	84%	112	88%	193	86%
Non-response	5	5%	7	6%	12	5%
Number of plants	97		127		224	

Source: Q-3.1, Q-3.2, Questionnaire survey of Indonesian foreign investors, 2017.

The principal activities of the respondents are shown in Table 6.5 according to the proportion of FDI projects in each of the three main sectors: primary, manufacturing and services. In total, about 78 percent of the respondents are in the manufacturing sector, followed by the service sector at 16 percent and primary sector at 6 percent. However, if we further look at the SA and Non-SA classification, the proportion of investment in the manufacturing sector is much higher in the SAs compared to the Non-SAs at 88 and 72 percent respectively. For the service sector, the opposite pattern is evident, as the Non-SAs have a higher proportion of plants (22 percent) compared to the SAs (7 percent). Most of the plants in the manufacturing sector are textiles, food and tobacco, and other light manufacturing (68 percent), while the service sector is dominated by wholesalers and retailer (63 percent). Meanwhile for the primary sector, there is a similar and small number of plants in both the SAs and Non-SAs.

Table 6.5: Principal Activity of the Plants

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Primary:	5	5%	8	6%	13	6%
Agriculture	(0)		(3)		(3)	
Mining, gas and electricity	(1)		(3)		(4)	
Construction	(4)		(2)		(6)	
Manufacturing:	85	88%	91	72%	176	78%
Food and tobacco	(8)		(16)		(24)	
Textiles and apparel	(37)		(25)		(62)	
Motor vehicles	(7)		(6)		(13)	
Rubber and plastics	(6)		(4)		(10)	
Other light manufacture products	(15)		(19)		(34)	
Basic metals	(6)		(7)		(13)	
Chemicals	(3)		(8)		(11)	
Other heavy manufacture products	(3)		(6)		(9)	
Services:	7	7%	28	22%	35	16%
Wholesale and retail	(3)		(19)		(22)	
Transportation	(0)		(4)		(4)	
Other services activities	(4)		(5)		(9)	
Total number of plants	97		127		224	

Source: Q-2.6 and Q-2.7, Questionnaire survey of Indonesian foreign investors, 2017.

The survey reveals that the principal activity of the plant is almost identical to that of the company as a whole (Q-2.6 and Q-3.4, Appendix Table A.6.1). The similarities between the plants and the company business activities in part arise because 83 percent of respondent companies only have one plant in Indonesia, so that these are the same. Indeed, the plant in Indonesia is more likely to be a branch rather than a subsidiary. As a branch plant, which is

"legally inseparable from the parent" (Fiechter *et al.*, 2011, p.7), it does not have the full authority to run its business, but rather must follow the parent-company's policies and guidance.

Looking further at the characteristic of the respondents, Table 6.6 summarises the investors' current country of origin and the location of their headquarters. The country of origin for the Non-SAs shows a quite balanced distribution among the countries. However, for the SAs it seems there is a tendency for the investors to come from particular countries, for instance, the FTZ-Batam is dominated by investment from Singapore, reflecting its close proximity. In fact, almost 70 percent of plants with status as of 'joint countries ownership' in Batam are jointly owned with Singaporean shareholders, so that in total about 60 percent of investors in Batam are from Singapore. Table 6.6 shows that nearly half of the investments (46 percent) originate from two or more countries. This pattern is evident for both the SAs (37 percent) and Non-SAs (52 percent). With regard to joint countries of origin, most of these (83 percent) are formed between Indonesian and other countries. These are mostly with Japan (28 percent) or Singapore (16 percent). Others are with South Korea (12 percent) and Taiwan (5 percent).

Exploring the plants' country of origin, Table 6.6 shows that 9 percent of the total respondents declare their country of origin as Indonesia. This occurs because with the passage of time, the ownership is transferred from a foreign company to an Indonesian company. For example, a joint venture in an airport-related product and service was established in 1992, but as the result of the acquisition of one of the parties in 2012 the company is purely Indonesian owned. With regard to the location of the companies' head offices, Table 6.6 shows that about 50 percent of all respondents have head offices located in Indonesia. Companies in the SAs have a lower proportion of head office located Indonesia, at only 41 percent, while 57 percent for Non-SAs. The companies in FTZ-Batam show that 30 percent of them are located in Singapore, which is a similar proportion to that of the companies that have their headquarters in Indonesia.

Table 6.6: Country of Origin and Head Office Location

	SAs						Non-SAs		Total	
	FTZ		BZ		Total					
	No.	%	No.	%	No.	%	No.	%	No.	%
Country of origin:										
Single countries										
South Korea	1	3%	17	27%	18	19%	8	6%	26	12%
Japan	1	3%	7	11%	8	8%	8	6%	16	7%
Singapore	11	33%	-	-	11	11%	3	2%	14	6%
Indonesia	-	-	7	11%	7	7%	13	10%	20	9%
Other	7	21%	10	16%	17	18%	29	23%	46	21%
Joint countries	13	39%	23	36%	36	37%	66	52%	102	46%
Head office location:										
Indonesia	10	30%	30	47%	40	41%	72	57%	112	50%
Japan	3	9%	9	14%	12	12%	17	13%	29	13%
Singapore	10	30%	1	2%	11	11%	6	5%	17	8%
Korea	1	3%	12	19%	13	13%	-	-	13	6%
USA	1	3%	1	2%	2	2%	2	2%	4	2%
Germany	1	3%	-	-	1	1%	2	2%	3	1%
Netherlands	-	-	-	-	-	-	3	2%	3	1%
Australia	-	-	-	-	-	-	3	2%	3	1%
Other	4	12%	5	7%	9	9%	11	9%	20	9%
Non-response	3	9%	6	9%	9	9%	11	9%	20	9%
Number of plants	33		64		97		127		224	

Source: Q-3.3, Q-3.6, Questionnaire survey of Indonesian foreign investors, 2017.

6.3.3 Employment Size

The employment size is important, since development agencies like to attract larger plants to their countries and regions. First of all, Table 6.7 shows most of respondents (40 percent) are large firms, with at least 500 employees. However, interestingly the sample also includes small plants (1 to 200 employees) of which there are a similar proportion (39 percent). As a contrast between the SAs and Non-SAs, Table 6.7 shows that about half the plants (52 percent) in the SAs are large (more than 500 employees), 14 percent are medium-sized (201 to 500 employees) and 33 percent are small plants (200 or fewer employees). However, in the Non-SAs, small plants are much more important (44 percent), while the large plants account for 31 percent of the respondents and the medium-sized plants for 24 percent.

Regarding the absorption of local people, 96 percent of investors hire virtually all their labour locally, i.e., between 75 and 100 percent of their employees, so that local people predominantly benefit from the working opportunities provided by FDI activities in Indonesia. If we look at

the characteristics of the local people employed, Table 6.7 shows that half are semi-skilled or unskilled labour (51 percent). In practice, technical/skilled labour are typically required for services, heavy manufacturing, and construction and civil engineering projects. This is related to the greater complexity of these investments. The proportion of semi-skilled and unskilled labour is roughly similar between the SAs and Non-SAs, and this also the case for skilled labour. Likewise, managerial level labour contributes 10 percent of total employment, with about 9 percent for the SAs and 10 percent for the Non-SAs, so that in general the skill requirements of the foreign-owned plants is virtually identical between the SAs and Non-SAs.

Table 6.7: Employment in the Plants

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Number of employees:						
Small (1 to 200)	32	33%	56	44%	88	39%
Medium (201 to 500)	14	14%	31	24%	45	20%
Large (more than 500)	50	52%	39	31%	89	40%
Non-response	1	1%	1	1%	2	1%
Local labour employment:						
Up to 75 %	2	2%	7	6%	9	4%
More than 75%	94	97%	120	94%	214	96%
Non-response	1	1%	-	-	1	0%
Employment skilled level:						
Managerial	9	9%	13	10%	22	10%
Technical/skilled	37	38%	50	39%	87	39%
Semi-skilled/unskilled	51	52%	64	50%	115	51%
Number of plants	97		127		224	

Source: Q-2.10, Q-2.11, Q-2.12, Questionnaire survey of Indonesian foreign investors, 2017.

6.3.4 Sales Turnover and Competition Prospects

Table 6.8 shows sales turnover of the plants and also the past and the expected future trends in sales. With regard to gross sales, about half the respondents have annual sales of greater than 100 billion rupiah (about US$ 7.4 million).[35] This is similar for the SAs and Non-SAs, although a slightly higher percentage have sales above 100 billion rupiah in the Non-SAs (54 percent) than in the SAs (46 percent). With regard to the trend in sales, many companies (47 percent) say that in the past few years their business had declined, while 35 percent think they have

[35] Exchange rate US$ 1 = Rp 13,548 (Indonesia Central Bank and Indonesia Statistics, 2018).

increased. The decline in sales is experienced more so by companies in the SAs (54 percent) than in the Non-SAs (42 percent), while only 25 percent of them report an increase in sales (43 percent for the Non-SAs). These trends might arise as the companies in the SAs trade much more in international markets, whereas those in the Non-SAs focus more on domestic markets. It means that when there are economic problems or crises the first group that is usually affected are the export-oriented firms (Tambunan, 2010). Meanwhile for the Non-SAs companies that rely more on the Indonesian market, they have greater resilience in response to global events, which may affect the domestic market with a time-lag (Tambunan, 2010).

Table 6.8: Sales Trends

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Current annual gross sales						
Up to 100 billion rupiah	51	53%	58	46%	109	49%
More than 100 billion rupiah	45	46%	69	54%	114	51%
Non-response	1	1%			1	
Recent trend in sales						
Decreased	52	54%	53	42%	105	47%
Stay the same	20	21%	20	16%	40	18%
Increased	24	25%	54	43%	78	35%
Non-response	1				1	
Expected future sales trend						
Increase a lot	4	4%	16	12%	20	9%
Increase a little	48	49%	75	59%	123	55%
Stay the same	18	19%	25	20%	43	19%
To decline	26	27%	10	8%	36	16%
Non-response	1	1%	1	1%	2	1%
Number of plants	97		127		224	

Source: Q-2.13, Q-2.14, Q-2.15, Questionnaire survey of Indonesian foreign investors, 2017.

Looking to the future, most of respondents believe that their business will increase but not very strongly, so there is some optimism. Companies in the Non-SAs seem more confident with the future, as 71 percent have confidence that their business will increase, while 8 percent believe it will decline. For companies in SA, these are 53 and 27 percent respectively.

Table 6.9 shows how the foreign investors view their main competitors at a plant and company level, although there is a similar pattern for these. Comparing the SAs and Non-SAs, it shows that investors in the SAs mostly consider that their competitors are outside of Indonesia (65 percent), but for the Non-SAs, the greater competition is either local or national. For details of

the business sectors from which the competition arises, Q-2.9 of Appendix Table A.6.1 shows that investors in textiles and light manufacturing believe that their competitors are mainly at the international level. This is because the greatest proportion of their sales is generated from exports (see Q-2.16). It also reflects the foreign investor attitudes towards local and national competitors, who they do not consider as the greatest threat.

Table 6.9: Location of Main Competitors

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Main plant competitors:						
Locally	38	39%	54	43%	92	41%
Nationally	23	24%	59	46%	82	37%
Internationally	63	65%	32	25%	95	42%
Main company competitors:						
Locally	36	37%	60	47%	96	43%
Nationally	22	23%	62	49%	84	38%
Internationally	67	69%	35	28%	102	46%

Source: Q-2.9, Q-3.8, Questionnaire survey of Indonesian foreign investors, 2017.

6.4 International Operations and Transportation

It is possible to use the survey data to explore the international operations of the foreign-owned plants in Indonesia in greater detail. This looks at the trading activities of the plants, including whether it is focused on local, national or international markets in their product and supplier markets. Clearly, it is related to the location of their main competitors, as discussed above.

6.4.1 Output Markets

One of the motivations for investing abroad is to access foreign markets (Dunning, 1993a; Dunning and Lundan, 2008) and this section presents information on the market orientation of the plants. Table 6.10 analyses the destination of the market sales, calculating the sales as the average sales percentage across the plants in each case. Overall, as expected, investors in the SAs are much more likely to sell their product in international markets through exports, with 72 percent of their sales going for export. Partly this reflects the regulations governing the SAs, since companies in an FTZ normally export all of their output, while for investors in the Bonded

Zones only a maximum of 25% can be sold in domestic markets.[36] For companies located in the Non-SAs, most of their output is directed to the domestic market, with about 79 percent of their sales made to either the local or national Indonesian market. The plants in the Non-SAs therefore only export 21 percent of their production, on average. If we look at the total sales made by all companies in the SAs and the Non-SAs, Table 6.10 shows that overall the domestic sales are higher than export sales, at 57 percent compared to 43 percent.

Looking at the location of the export market, the second part of Table 6.10 shows that foreign investors in both the SAs and Non-SAs mainly export to Asia. Overall, 56 percent of the respondents that say they export cite Asia as their primary export market. This is greater for the plants located in the SAs (65 percent) compared to half the plants located in the Non-SAs. Otherwise, and overall, the plants in the SAs export their output to America and Europe (39 and 31 percent respectively), whereas these are much less important in the Non-SAs (11 and 13 percent respectively). When it comes to the specific country, Japan is the main destination for the plants that export, followed by United States of America, Singapore, South Korea, China and Germany.

Table 6.10: Destination of Sales

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Sales made:						
Locally	22	23%	57	45%	79	35%
Nationally	5	5%	43	34%	48	22%
Internationally	70	72%	27	21%	97	43%
Main region for global exports:						
Asia	63	65%	63	50%	126	56%
America	38	39%	14	11%	52	23%
Europe	30	31%	16	13%	46	21%
Other	5	5%	16	13%	21	9%
Number of plants	97		127		224	

Source: Q-2.16, Q-2.18, Questionnaire survey of Indonesian foreign investors, 2017.
Note: Respondents may name more than one region as a main destination for exports, or none at all. The first part calculates the average of percentages given by the firm, and the second part calculates the number of plants citing the region as a main export market.

[36] In particular, PMK-147/PMK.04/2011 Article 27 (7) states that: "…releasing of Bonded Zone Production Result to other place in customs area as intended in Article 26, paragraph (1) e, can be done in a number of at most 25% (twenty five percent) of previous year export value realization and realization of previous year submission value into Bonded Zone".

Overall, referring back to the FDI motives of Dunning (1993a), as set out in Chapter 2, and specifically to market-seeking, it seems that foreign investors in the Non-SAs are more likely to locate according to this. However, market-seeking seems less important for investors in the SAs, as these plants are less likely to seek access to the host country market, but rather export overseas. In this context, what investors seek in the SAs might be called an 'export-platform FDI', and presumably to take advantage of the cheap and abundant labour force in Indonesia. Export-platform FDI means "investment or production in a host country where the output is largely sold in third market and not in the host country market" (Ekholm, *et al.,* 2003, p.1).

6.4.2 Input Materials

Table 6.11 shows the sources of the materials for production or business activities, according to whether it comes from the domestic (local and national) or international market. Again, the percentages in the first part of the table are calculated as the average of the plant input shares, whereas the second part is the number of plants citing it as a main region for materials.

Table 6.11: Source of Materials

	SAs		Non-SAs		Total/Average	
	No.	%	No.	%	No.	%
Materials sourced :						
Locally	62	26%	85	39%	147	33%
Nationally	39	12%	66	24%	105	18%
Internationally	85	63%	91	37%	176	49%
Regions from where sourced :						
Asia	82	71%	87	60%	169	65%
America	8	7%	18	12%	26	10%
Europe	20	17%	23	16%	43	16%
Other	5	4%	17	12%	22	9%
Number of plants	97		127		224	

Source: Q-2.19, Q-2.20, Questionnaire survey of Indonesian foreign investors, 2017.
Note: Respondents may name more than one region as a main destination for exports, or none at all. The first part calculates the average of percentages given by the firm, and the second part calculates the number of plants citing the region as a main export market.

Overall, 176 out of the 224 respondents (79 percent) consider themselves as using imported materials. Table 6.11 shows that on average 49 percent is imported, with plants in the SAs requiring a higher proportion of inputs from international market (63 percent) compared to the

Non-SAs (37 percent). Further, on average, 65 percent of plants that import do so from Asian countries, followed by Europe, at 16 percent, America at 10 percent, and other regions at 9 percent. Comparing the SAs and Non-SAs, 71 percent of SA plants that import materials do so from Asian countries, compared to 60 percent of plants for the Non-SAs. The next most important source is Europe, followed by America, which is the case for the SAs and Non-SAs.

As regards the business activity (Q-2.19, Appendix Table A.6.1), textiles have the highest proportion of materials sourced from imports, at 62 percent on average. The high proportion of material imported for textiles is also reported by Ministry of Trade (2016), which finds that a minimum of 50 percent of textiles production materials are imported. The problem of a high import proportion is worsened by the fact that textiles industry in Indonesia is considered to be a 'tolling' industry. This means that a company does its production based on specific criteria and using materials sourced from the buyer (i.e., the company that orders the work). In this sense, the Indonesian textiles companies cannot reach out to the customer directly. Surprisingly, the services sector is the second highest for the import of materials (59 percent), followed by light manufacturing (50 percent). Food and other industries such as agriculture, construction and utilities are the industries rely least on imported materials.

The previous discussion on labour in Section 6.3.3 was according to the size of the plants. However, questions Q-2.10, Q-2.11, and Q-2.12 in Appendix Table A.6.1 show that labour as input of production is mainly hired from the local labour market. As previously shown (Table 6.7), almost all of the plants employ more than 75 percent of local people.

6.4.3 Transportation Mode

Regarding the mode of transportation used for the delivery of the products, Table 6.12 shows the percentage of sales transported by each mode. Again, these are calculated as the average of the percentages given by the plants. On average, 51 percent of foreign investors choose road as a means for transporting their products, but which is 70 percent for the plants located in the Non-SAs, but only 25 percent for the SAs. This reflects the use of domestic and international markets. The use of railways in Indonesia is low due to the lack of this type of infrastructure. Plants in the SAs mainly use sea transport (67 percent), which is because most of the product goes for export, and so using land or air transport may not be feasible or cost-effective.

Table 6.12: Product Transportation Mode

	SAs		Non-SAs		Total/Average	
	No.	%	No.	%	No.	%
Mode of transport by product value :						
Road	50	25%	101	70%	151	51%
Rail	0	0%	3	0%	3	0%
Sea	77	67%	63	25%	140	42%
Air	48	8%	31	5%	79	7%
Number of plants	97		127		224	

Source: Q-2.17, Questionnaire survey of Indonesian foreign investors, 2017.
Notes: Average of percentage responses. Respondents may choose multiple transport modes.

6.5 The Investment Decision

This section reports on the motive for FDI in Indonesia. It also explores what factors motivate the investor to choose one location compared to another. At the end of this section, the type of support needed by investors to make their investment decision is considered.

6.5.1 Assets Exploiting Motives for FDI

There are four types of FDI motives based on the classical taxonomy, as set out in Chapter 2: (1) market-seeking, (2) resource-seeking, (3) efficiency-seeking, and (4) strategic asset-seeking (Dunning, 1993a; Dunning and Lundan, 2008). With regard to the investors' motivation, some scholars argue it is related to the country investment position, which is linked to the investment development path (Dunning and Narula, 1996; Narula and Guimon, 2010). Rather differently, Franco *et al.* (2010) divides the investors' motivation for FDI into: (1) market-seeking, (2) resource-seeking, and (3) non-marketable asset-seeking. This section discusses what motivates an investor to locate its plant in a particular area, and the factors required for supporting their decision-making process, including information.

Table 6.13: Motivation and Determinant Factor for Investment Location

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Motivation to invest:						
Market-seeking	52	54%	108	85%	160	71%
Consumer market	(41)	(42%)	(102)	(80%)	(143)	(64%)
Producer market	(29)	(30%)	(51)	(40%)	(80)	(36%)
Resource-seeking	83	86%	99	78%	182	81%
Raw materials	(38)	(39%)	(61)	(48%)	(99)	(44%)
Labour resources	(75)	(77%)	(91)	(72%)	(166)	(74%)
Efficiency-seeking	59	61%	86	68%	145	65%
Economic of scale or scope	(53)	(55%)	(83)	(65%)	(136)	(61%)
Risk diversification	(24)	(25%)	(48)	(38%)	(72)	(32%)
Strategic asset-seeking	37	38%	65	51%	102	46%
Acquiring some strategic assets	(37)	(38%)	(65)	(51%)	(102)	(46%)
Number of plants	97		127		224	

Source: Q-4.1, Questionnaire survey of Indonesian foreign investors, 2017.

Table 6.13 considers the investor motivation for conducting foreign investment in Indonesia. In general, resource-seeking is the main motivation, with 81 percent of investors reporting that proximity to labour resources or raw materials was their motive for investing in Indonesia. In fact, the availability of labour resources was a factor for 74 percent of investors. The second most important motivation was market access (71 percent), followed by efficiency-seeking (65 percent). An interesting feature is the contrast between the SAs and Non-SAs. It reveals that the main motivation for investing in the SAs is resource-seeking in the form of labour resources, but that for the Non-SAs it is market access, and especially the domestic market. However, if we examine the top three FDI motives then these are the same for the SAs and Non-SAs, but in a different order. For investors in the SAs they are: (1) labour resources, (2) scale economies and (3) consumer market, but for the Non-SAs: (1) the consumer market, (2) labour resources and (3) scales economies. The motives are consistent with the domestic destination of sales by plants in the Non-SAs and shown in Table 6.10.

Using information in Appendix Table A.6.1 (see Q-4.1), we can examine this by the business sector. It shows investors in textiles, light manufacturing, heavy manufacturing and agriculture, construction and utilities invest in Indonesia because of the availability of labour resources. However, for food and services the motivation is to gain access to the domestic consumer market. Referring back to the proportion of sales, it seems that for both the food and services their sales are mainly made domestically. Appendix Table A.6.1, Q-2.16, shows that 67 percent of food industry sales and 92 percent of service sales are made in local or national market.

6.5.2 Location Decision

We would like to know on how confident the investor is in deciding a location, and in particular, whether they consider other options when making a decision on a particular location. Overall, Table 6.14 reveals the majority of investors (58 percent) have no other locational plan in mind for their investment at the time of investment, whereas 39 percent had some other location in mind. Of these, the second part of Table 6.14 shows that three-questers (73 percent) had some other location in mind, and for about a third (34 percent) it was international. There is little difference between plants in the SAs and Non-SAs, except that in the former case the firms are more likely to consider an alternative investment location outside of Indonesia.

Table 6.14: Alternative Locational Choices

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Consideration of other location:						
Yes	39	40%	49	39%	88	39%
No	54	56%	76	60%	130	58%
Non-response	4	4%	2	2%	6	3%
Other locations considered:						
Locally	11	28%	17	35%	28	32%
Nationally	12	31%	24	49%	36	41%
Internationally	17	44%	13	27%	30	34%
Number of plants	97		127		224	

Source: Q-4.2, Q-4.2a, Questionnaire survey of Indonesian foreign investors, 2017.
Notes: Answers to second part are for those saying ‘yes’ to the first question. Firms may have multiple locations in mind.

6.5.3 Investment Factors

There are many factors that influence a foreign investors’ decision on the investment location. The survey questionnaire listed fourteen possible factors (plus an open-ended option) and these have been at least partly examined in other research. With regard to the survey, Appendix Table A.6.1 (Q-4.3) presents factors influencing FDI decision in Indonesia. In general, most of the investors select (1) political stability and security, (2) cheap labour, (3) availability of skilled labour, (4) good physical infrastructure, (5) general investment climate and (6) geographical location.

When it comes to the SAs and Non-SAs, Table 6.15 shows the factors that influence FDI. Investors similarly regard as important factors 'political stability and security' and 'good physical infrastructure' in both of these. However, investors generally choose SAs because of the availability of cheap and skilled labour. Apart from that, investors locate in SAs is because of 'good geographical location'. For example, the survey reveals that one factor for investors to locate in Batam Island (as one of FTZ) is because of the proximity location to Singapore. Even though it should be acknowledged there are other factors with regard to the importance of Batam for Singaporean investors are the lack of investment land in Singapore but also the availability of cheap labour in Batam relative to Singapore (Wulandari, 2012).

For investors in the Non-SAs it is mostly access to the huge size of the Indonesian market. Apart from that, a large market size needs to be accompanied with strong purchasing power, so that investors also require a growing economy, either at the local or national level. Other than that, investors also need a 'good investment climate'. This makes sense because unlike the SAs, which are intentionally established to support investment, the Non-SAs sometimes have a more challenging environment in terms of the investment climate in a broad sense.

Table 6.15: Factors Influencing the Investment Decision

SAs			Non-SAs		
Factor influencing investment decisions	No	%	Factor influencing investment decisions	No	%
Availability of cheap labour	75	77%	Market size	95	75%
Political stability and security	67	69%	Political stability and security	89	70%
Availability of skilled labour	64	66%	Growing local or national economy	85	67%
Geographical location	61	63%	General investment climate	84	66%
Good physical infrastructure	58	60%	Good physical infrastructure	84	66%
The most important factor of the above			The most important factor of the above		
Availability of cheap labour	-	33%	Market size	-	39%
Availability of skilled labour	-	20%	Political stability and security	-	26%
Number of cases	97		Number of cases	127	

Source: Q-4.3, Q-4.4, Questionnaire survey of Indonesian foreign investors, 2017.

The previous explanation focuses on the factors that matters for deciding investment location. However, when we further asked on what factor that matter the most, the market size is the most important factor followed by availability of cheap labour and political stability. Looking further into each location, investors in the SAs believe that the availability of cheap labour and

skilled labour are the most important factors. For investors in the Non-SAs, market size and political stability and security for their business are the crucial factors.

6.5.4 Information and Support

In order to support investors decision, the availability of information is crucial. The survey asked investors what institutions were useful to them as source of information. The inward investment authority, the BKPM (see Chapter 3), was selected by 84 percent of respondents as an important source of information. This is followed by the DGT and business contacts. It is not surprising that the BKPM is highly important, as this is partly its purpose, but the DGT comes second and we can assume that investors gathered information on taxation in Indonesia. This might be distorted as the survey conducted through tax office (the Gatekeepers). Business contacts are relevant as they are credible and have practical experience of the issues.

Comparing the BKPM and DGT, 80 percent of respondents consider information from the former is 'useful' (i.e., 'quite useful' or 'very useful'), but only 67 percent for DGT. Looking at other potential sources of information, it seems that foreign investors do not receive much support from the Indonesian Embassies where they reside. In fact, the Embassies are the third lowest source of information, just above the *Investor Outlook Reports*, such as on the Global Competitiveness Index (published by World Economic Forum since 1979) or the Ease of Doing Business (published by World Bank since 2004)[37]. That the *Investor Outlook Reports* are not that important is of concern, as the Indonesian government seeks to improve its ranking in these.

As regards information that is useful for the investment decision but not available, investors in the Non-SAs sought: clear, easy, and consistent investment regulations; and economic outlook and statistical data. For investors in the SAs, clear regulations on minimum salaries and wages, and long-term projections on these, were important. This information, gathered through open-ended questions, is available in Appendix Table A.6.1, Q-4.7.

[37] Global Competitiveness Index measures country competitiveness in terms of institutions, policies and level of productivity (http://reports.weforum.org/). Ease of Doing Business measures the effectiveness and quality of business regulation .(www.worldbank.org).

6.6 Taxation Incentives

In order to attract FDI inflows to Indonesia, the government provides incentives for investment, including tax incentives. On these, Table 6.16 presents the use of tax incentives in investment appraisal and negotiations. The questionnaire survey shows that about half of the investors (54 percent) use tax incentives as part of their investment appraisal, but 26 percent do not include them. However, the number of respondents who do not know is 17 percent. Comparing the SAs and Non-SAs, investors in the former are more likely to include them (56% against 50%).

A very different picture arises when it comes to the use of tax incentives as part of investment negotiation with government. Most of investors (67 percent) do not use tax incentives as part of their investment negotiations with the government. Comparing investors in the SAs and Non-SAs, it seems that investors in SAs are less likely to use tax incentives in their investment negotiation. Only 22 percent of investors in the SAs acknowledge that they use tax incentives in bargaining with the government, but for the Non-SAs it is 26 percent. In terms of correlation, Table 6.17 shows that most investors utilise tax incentives as part of its investment appraisal (54 percent), but when it comes to utilization of tax incentives on negotiation process, most of the investors (73 percent) state that they do not utilise it. These two variables have a strong and significant association as shown by a highly significant Pearson Chi-Square value in Table 6.17.

Table 6.16: Tax Incentives in Investment Appraisals and Negotiations

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
Using tax incentives in investment appraisals:						
Yes	54	56%	64	50%	118	54%
No	23	24%	35	28%	58	26%
Don't know	17	18%	22	17%	39	17%
Non-response	3	3%	6	5%	9	4%
Using tax incentives as part of negotiation with the government:						
Yes	21	22%	33	26%	54	24%
No	61	63%	88	69%	149	67%
Non-response	15	15%	6	5%	21	9%
Number of plants	97		127		224	

Source: Q-5.4, Q-4.8, Questionnaire survey of Indonesian foreign investors, 2017.

Table 6.17: Tax Incentives in Both Appraisals and Negotiations

		Use in negotiation		Total
		Yes	No	
Use in investment appraisal	Yes	21.3%	32.5%	53.8%
	No	2.0%	26.9%	28.9%
	Do not know	3.6%	13.7%	17.3%
Total		53 26.9%	144 73.1%	197 100%

Pearson Chi-Square: value = 20.872[a]; df =2; Asymptotic Significance (2-sided) = .000

a. 0 cells (0.0%) have expected count less than 5. The minimum expected count is 9.15.

Source: Q-5.4 and Q-4.8, Questionnaire survey of Indonesian foreign investors, 2017.

Looking at investors' experience of tax incentives, Table 6.18 shows the type of tax incentives that investors received at and after the plant establishment. The questionnaire survey finds that at plant establishment about half the respondents (54%) say they had received a tax incentive, but 41 percent say they had not. From those that received an incentive, indirect tax advantages are most common in the SAs but a CIT rate reduction in the Non-SAs. Indirect tax advantages are received by more than a half of plants in SAs, but the CIT rate reduction by about a quarter of the plants establishing themselves in the Non-SAs.

Table 6.18: Tax Incentives Received At and After Plant Establishment

	At Establishment			After Establishment		
	SAs	Non-SAs	Total	SAs	Non-SAs	Total
Tax incentive received	65 (67%)	56 (44%)	121 (54%)	63 (65%)	46 (36%)	109 (49%)
of which:						
Tax Holiday	10 (10%)	19 (15%)	29 (13%)	6 (6%)	3 (2%)	9 (4%)
Tax Allowance	12 (12%)	26 (20%)	38 (17%)	7 (7%)	7 (6%)	14 (6%)
CIT rate reduction	19 (20%)	33 (26%)	52 (23%)	17 (18%)	22 (17%)	39 (17%)
Indirect tax advantages	56 (58%)	-	56 (25%)	42 (43%)	-	42 (19%)
None	28 (29%)	64 (50%)	92 (41%)	31 (32%)	69 (54%)	100 (45%)
Non-response	4 (4%)	7 (6%)	11 (5%)	3 (3%)	12 (9%)	15 (7%)
Number of plants	97	127	224	97	127	224

Source: Q-4.9 and Q-5.3, Questionnaire survey of Indonesian foreign investors, 2017.

After plant establishment, the survey shows a lower take-up of the tax incentives. Overall, less than a half of respondent had received tax incentives, while number of respondents which claim to never have received them increases, albeit slightly. Looking at type of incentive received, it seems there is similar patterns with establishment period, so that indirect tax advantages are most common in the SAs and the CIT rate reduction in the Non-SAs. These two types of tax incentives can be considered as general and automatic tax incentives. Meanwhile, for the other two types of tax incentives that are discretionary in nature, the tax holiday and tax allowance, only a very small proportion of plants receive them after establishment. As regards their likely importance, the World Bank (2005b, p. 169) argues that "tax holidays are only rarely the decisive factor [for FDI location]". Using a survey of 191 companies that plan to expand their operations it finds only 18 percent for manufacturing and 9 percent for services considered the tax holiday as an important factor in their investment location decision (World Bank, 2005b).

Further understanding the importance of the tax incentives can be gained from the survey in Table 6.19. The responses are much smaller in number, as it is dependent on take-up, and perhaps not surprisingly it shows a similar pattern to Table 6.18. The CIT rate reduction is the most important tax incentives for investors in Non-SAs, both at and after plant establishment, but indirect tax advantages are the most important tax incentive by the respondents in the SAs.

Table 6.19: Importance of Tax Incentives: At and After Plant Establishment

Tax Incentives Types	At Establishment			After Establishment		
	SAs	Non-SAs	Total	SAs	Non-SAs	Total
Tax Holiday	2 (2%)	5 (4%)	7 (3%)	1 (1%)	1 (1%)	2 (1%)
Tax Allowance	1 (1%)	9 (7%)	10 (4%)	1 (1%)	1 (1%)	2 (1%)
CIT rate reduction	10 (10%)	22 (17%)	32 (14%)	9 (9%)	20 (16%)	29 (13%)
Indirect tax advantages for SAs	35 (36%)	-	35 (16%)	22 (23%)	-	22 (10%)

Source: Q-4.10, Q-5.3a Questionnaire survey of Indonesian foreign investors, 2017.
Notes: plants reporting support as most important relative to total number of respondents (SAs = 97, Non-SAs = 127, Total = 224 respondents).

Further exploration on the importance of the tax incentives for investment decisions reveals that the foreign investors in the SAs value these higher than those in the Non-SAs. More than half of the respondents in the SAs consider tax incentives as critical, but only about 28 percent of the respondents in the Non-SAs (Appendix Table A.6.1, Q-5.3b). Regarding the tax incentive that is more likely to be part of the negotiation process, the survey shows that the discretionary

support is more likely to be included, at 62 and 55 percent for the tax holiday and tax allowance respectively (Appendix Table A.6.1, Q-4.8 and Q-4.9). This seems highly plausible.

Table 6.20 presents evidence on the importance of each tax incentive, allowing for the number of plants that receive a tax incentive. It may still be skewed as an investor may only receive one form of incentive, but the relative pattern is interesting. Whether at or after establishment, it shows that the CIT rate reduction is valued most highly by investors. Further, of the discretionary support the investors in the Non-SAs value these more highly, while those in the SAs value the tax holiday relatively less highly, particularly after the plant establishment.

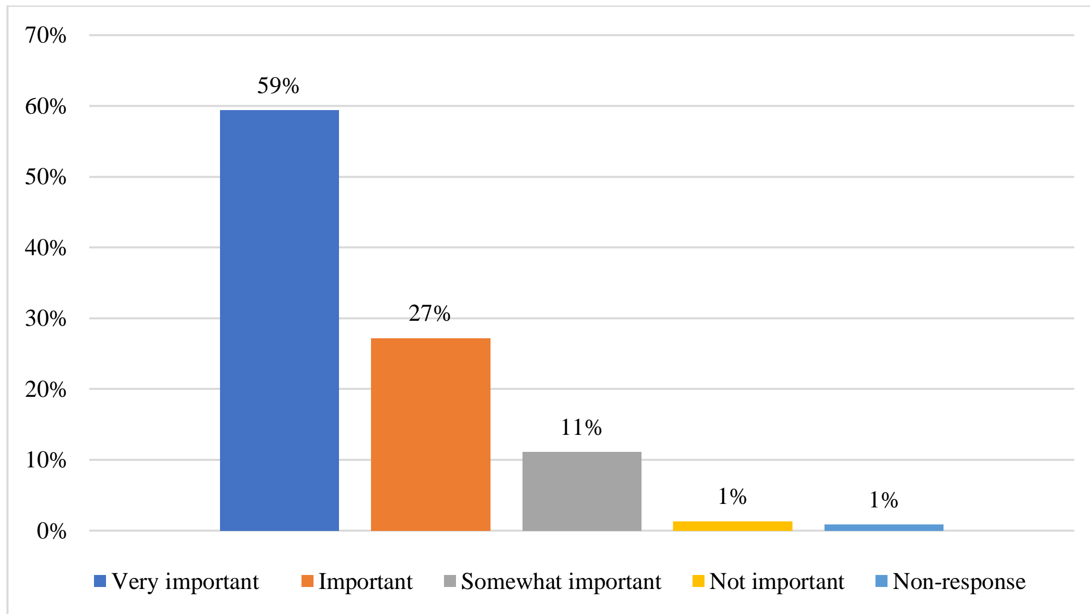
Table 6.20: Take-up and 'Value' of Tax Incentives

	At Establishment				After Establishment			
	Special Areas		Non-SAs		Special Areas		Non-SAs	
	Take-up	Value	Take-up	Value	Take-up	Value	Take-up	Value
(a) Tax exemption (reduction):	30	0.17	55	0.29	18	0.17	12	0.17
(Tax holiday)	(10)	(0.20)	(19)	(0.26)	(6)	(0.17)	(3)	(0.33)
(Tax allowance)	(12)	(0.08)	(26)	(0.35)	(7)	(0.14)	(7)	(0.14)
(Accelerated depreciation)	(8)	(0.25)	(10)	(0.20)	(5)	(0.20)	(2)	(0.00)
(b) CIT rate reduction[1]	19	0.53	33	0.67	17	0.53	22	0.91
(≤ 50 bn Rp gross sales)	(9)	(0.56)	(10)	(0.60)	(7)	(0.43)	(5)	(1.00)
(> 50 bn Rp gross sales)	(10)	(0.50)	(23)	(0.70)	(10)	(0.60)	(17)	(0.88)
(c) Special Area indirect tax advantages	56	0.63	-	-	42	0.52	-	-
(Free Trade Zone)	(19)	(0.63)	-	-	(10)	(0.60)	-	-
(Bonded Zone)	(37)	(0.62)	-	-	(32)	(0.50)	-	-
(d) Other tax measures[2]	25	0.08	38	0.26	20	0.30	26	0.42
Total cases	130	0.40	126	0.38	97	0.41	60	0.53
No. of plants reporting take-up and 'most important'	65	53	56	48	63	40	46	32
No. of plants reporting no tax facilities (%)	28	(30.1)	68	(56.7)	34	(36.2)	69	(59.5)

Source: Q-4.9, Q-4.10 and Q-5.3, Questionnaire survey of Indonesian foreign investors, 2017.
Notes: Take-up = number of plants indicating this. Value = number of plants reporting support as most important as percent of take-up. [1]Sales not always known. [2]Includes employment and health-based counter-cyclical tax measures and temporary import duty relief to encourage certain activities (e.g., engine parts in aircraft construction), but also Indonesian-wide tax amnesty in 2016/17.

As a comparison to the system of tax incentives for the foreign investment decision, it is useful to know the importance of the Corporate Income Tax (CIT) rate, which is a direct tax imposed on company income. Before 2009, Indonesia used multiple CIT rates but from 2009 it is single rate (Table 3.8). The statutory CIT rate is the legal percentage established by law that applies to all corporations, whereas the CIT rate reduction is a tax incentive that is a deviation from this in favour of certain taxpayers (Table 3.9). Figure 6.3 shows the importance of the [statutory] CIT rate on the investment decision. It reveals that more than 86 percent of foreign investors report that it is very important or important, but only one percent believe it is unimportant.

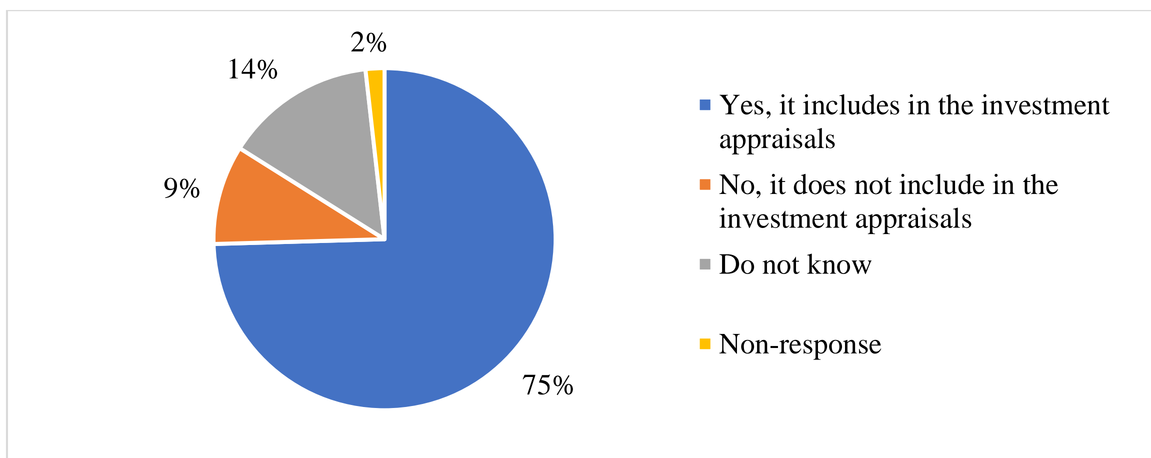
Figure 6.3: The Importance of CIT rate on the Investment Decision



Source: Q-5.1, Questionnaire survey of Indonesian foreign investors, 2017.

The importance of CIT rate is also reflected by its inclusion in investment appraisal. About 75 percent of respondents include the CIT rate in their appraisal, but only 9 percent do not (Figure 6.4). Further, contrasting the importance of the CIT rate and tax incentives, the questionnaire survey reveals that 68 percent perceive the tax incentives and CIT rate to be equally important. However, for those who think they have a different level of importance, more believe the CIT rate is more important. This is logical as CIT is a general tax rate that applies to all income in every year, whereas the tax incentives may be discretionary and one-offs.

Figure 6.4: CIT rate and Investment Appraisals



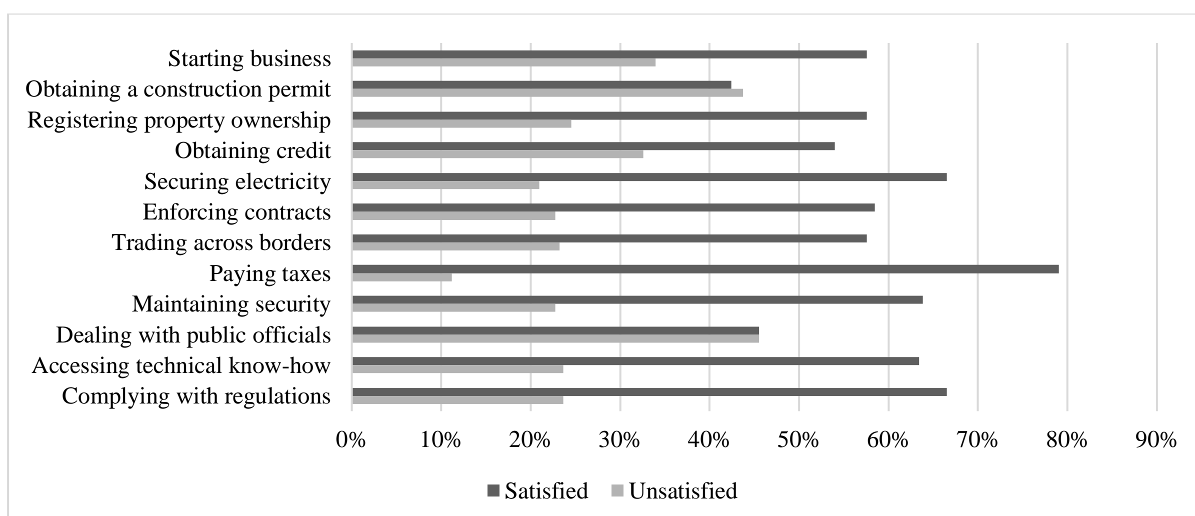
Source: Q-5.2, Questionnaire survey of Indonesian foreign investors, 2017.

A further aspect that is explored in the survey is whether the investors have applied for tax incentives in the last few years. Almost 80 percent of the investors expressed that they have not applied for tax incentives, while 6 percent indicated that they had applied for tax incentives but been rejected. Only about 8 percent of investors had applied for tax incentives and been successful. For those that had been rejected, only a few of them provided an answer. Most believe that they were not fulfilling the requirements, but interestingly some investors believe that it is because the authorities had concerns over a loss of tax receipts. Other simply state that there was no explanation regarding the reason for the rejection of support. Understanding the reasons for those who have not applied for tax incentives, the questionnaire survey reveals that half of them (49 percent) are not aware of the regulations. For another 27 percent it is due to factors such as: not eligible; not relevant; no need for it; unclear and complex regulations; and a high possibility of rejection. No clarification is available on the last of these.

6.7 Evaluation on Business Environment

The following section explores the perception of investors to the business environment during the operational activities in Indonesia. To some extent it can be viewed as an interim evaluation of the business environment. Figure 6.5 shows the investor perception with regard to some investment factors. In order to compare and contrast investors' satisfaction on current business aspects, the questionnaire responses are grouped into 'satisfied' and 'not satisfied'. 'Satisfied' are investors who feels it is very easy or quite easy in dealing with the aspects, and 'not satisfied' covers quite difficult or very difficult.

Figure 6.5: Business Environment Satisfaction



Source: Q-6.1, Questionnaire survey of Indonesian foreign investors, 2017.

The results show that a majority of investors are satisfied with the following aspects: starting a business, registering property ownership, obtaining credit, securing electricity, enforcing contracts, trading across borders, paying taxes, maintaining security, accessing technical know-how, and complying with regulations. However, two business aspects have less than a fifty percent satisfaction level: 'obtaining a construction permit' and 'dealing with public officials'.

Table 6.21: The SAs and Non-SAs Business Satisfaction

Business Environment	SAs		Non-SAs	
	Satisfied	Unsatisfied	Satisfied	Unsatisfied
Starting business	62%	30%	54%	37%
Obtaining a construction permit	51%	36%	36%	50%
Registering property ownership	63%	19%	54%	29%
Obtaining credit	55%	30%	54%	35%
Securing electricity	73%	14%	61%	26%
Enforcing contracts	61%	16%	57%	28%
Trading across borders	55%	27%	50%	26%
Paying taxes	77%	10%	80%	12%
Maintaining security	69%	15%	60%	28%
Dealing with public officials	53%	36%	40%	53%
Accessing technical know-how	67%	21%	61%	26%
Complying with regulations	69%	20%	65%	27%

Source: Q-6.1, Questionnaire survey of Indonesian foreign investors, 2017.

Interestingly, the ease of paying taxes has the highest level of satisfaction in Table 6.21. This may seem problematic, with the investors seemingly wanting to give responses that compliment the tax office, but in fact the government has greatly improved the ease of paying taxes, offering a variety of channels, including an electronic billing (e-billing) mechanism. Indeed, the *Ease of Doing Business Report* (World Bank, 2017) shows that easiness of paying taxes in Indonesia improved internationally from rank 115 the previous year to 104 in 2017, which is when the survey was carried out. Given that these are active taxpayers that engage with the system, the high satisfaction level for paying taxes found in this research might just reflect this and not reveal a potential bias that is influenced by my professional background. Further, I find below that when asked about the quality of service from institutions, 45 percent of the investors report that dealing with the DGT (tax authority) led to difficulties owing to the complexity of regulations, whereas these are 37 and 29 percent for local government and the BKPM, so that the investors do not hesitate to criticise the tax authority when they feel it is justified.

Comparing SAs and Non-SAs, Table 6.21 shows the proportion of investors who are satisfied or unsatisfied with the business environment. In general, companies located in the SAs have a higher satisfaction level compared with companies in the Non-SAs, except for paying taxes, for which further research is needed. Table 6.21 also reveals a high proportion of companies in the Non-SAs that are not satisfied with the process on obtaining a construction permit (50%) and dealing with public officials (53%). The problem with construction permits might occur from the difficulties in accessing land clearance as consequences of lack of land certification and proof of citizen ownership (Lucas, 1992; ADB, 2005). Comparing the SAs and Non-SAs, it is easier to gain land clearance in the SAs than the Non-SAs as the land there is for investment. A similar reasoning applies to public officials, who serve investors in the SAs better as they have a better understanding of business. Meanwhile, officials in the Non-SAs might not be so familiar with firms that operate in and serve international markets.

Table 6.22: Labour Skills and Training

	SAs		Non-SAs		Total	
	No.	%	No.	%	No.	%
How do you value Indonesian labour?						
Good	56	60%	64	50%	122	54%
Moderate	36	37%	55	43%	91	41%
Poor	-	-	4	3%	4	2%
Non-response	3	3%	4	3%	7	3%
Does companies undertake substantial training to match companies' requirement?						
Yes	77	79%	99	78%	176	79%
No	17	18%	24	19%	41	18%
Non-response	3	3%	4	3%	7	3%
Number of plants	97		127		224	

Source: Q-6.2, Q-6.3, Questionnaire survey of Indonesian foreign investors, 2017.

Table 6.22 presents investors preference for Indonesian labour, complemented by information on their labour training. With regard to employment, investors value labour skills in Indonesia as good (54 percent) or moderately good (41 percent), and this is similar for both the SAs and Non-SAs. However, notwithstanding this, almost 80 percent of respondents indicate that they need to take substantial labour training in order to match their company requirements.

Looking at the transportation system, whether it supports their business activities, the majority of respondents indicate that they do not have a problem in terms of transportation network in Indonesia. This is needs to be carefully understood as the biggest cohort of respondents are on

Java Island, which is considered to have a more advanced infrastructure compared with other parts of the country. Even though investors do not experience serious difficulties in term of transportation network, they do have concerns about heavy congestion and a lack of quality in the transportation network. Some respondents hope for improved transportation in the remote areas and between islands, so that this is a major concern for the government.

With regard to the processes of exporting and importing, 79 percent of the respondents indicate that they do not have any problems. Of the rest, investors mostly have difficulties in importing (12 percent), which is caused by unclear regulations that are poorly disseminated. Other factors that might contribute to the difficulties of importing are bureaucracy, with procedures that are too strict, require too many documents, and lead to a long time period for the releasing of goods from the port. These problems lead to increased costs. As regards, the main problems with investing in Indonesia, Table 6.23 shows the most important issues.

Table 6.23: The Investment Issues in Indonesia

Difficulty	Share
Investment regulations	27%
Labour and wages	7%
Taxation regulations	7%
Bureaucracy	3%

Source: Q-6.6, Questionnaire survey of Indonesian foreign investors, 2017.

Of the 63 percent of respondents who responded to this question, only five percent are satisfied with current conditions. However, caution is needed to interpret the result as the number of non-responses is quite high (about 37%). The low level of responses maybe because the survey question (Q-6.6) is an open-ended question that requires effort to write an answer. The low response rate may also be because they all have invested in Indonesia, so this implicitly means they value benefit of investing in Indonesia is higher than cost. I do not believe that the low number of responses is related to my background as a tax officer, since they are not trying to please me, because if they did then they would be complimentary to the DGT. Indeed, when asked about the service quality from three different institutions, namely the BKPM, DGT and local government, many of the investors argue that dealing with the DGT led to difficulties owing to the complexity of regulations (45 percent), compared with 37 and 29 percent for local government and the BKPM. With regard to issues such as a lack of communication, low staff

capability and competency, lack of consistency in decision making, local government posed the greatest difficulties compared with the BKPM and DGT. The local government was also considered to have problems with their administration process, associated with unreasonable delays and the lack of ethical standards. Finally, most investors consider the DGT to have the poorest dispute resolution procedures, so that they are critical of the tax authorities.

6.8 Conclusions

The questionnaire survey provides an understanding of the characteristics of FDI inflows in Indonesia. The sample is broadly in proportion to the actual distribution of foreign investors on Java and the other islands. The survey shows investors are predominantly located in Java (about 78 percent), while the rest is distributed unequally across five other regions in Indonesia. In terms of the ownership structure more than a half of the investors are independent companies, while 43 percent are subsidiary companies. With regard to country of origin, this is dominated by Asian countries (i.e., Japan, Singapore and Korea), and this reflects the distribution of FDI in the BKPM data over 2005-17, as presented in Chapter 4. The business sectors are grouped into six sectors, and overall FDI is primarily in textiles, followed by light manufacturing. The survey results are reported in full in Appendix Table A.6.1. They are reported for the SAs (a designated investment location) and the Non-SAs (investment locations that are outside the SAs), and overall they show some interesting differences between these.

With regard to the investment size, more than a half of the questionnaire respondents in the SAs are large companies with more than 500 employees, but in the Non-SAs 68 percent are small and medium companies with 500 or fewer employees. Regarding employment, FDI in both locations is dominated by local employees, but the majority are semi-skilled or unskilled labour. Concerning the other inputs, the survey results show most materials for companies in the SAs come from international markets (63 percent), but with a similar percentage of investors in the Non-SAs sourcing their materials from either the local or national domestic market. Looking at the output market, there is a similar pattern, as investors in the SAs predominantly target their products for export (72 percent), whereas for the Non-SAs predominantly it is domestic markets (79 percent). Therefore, it is not surprisingly that investors in the SAs acknowledge that their main business competitors are international, whereas for the Non-SAs domestic firms are their main competitors. Linking these to the transportation mod, the survey shows for the SAs, which mainly involve exports, sea transportation is dominant (67 percent), whereas for the Non-SAs the main transportation mode is via roads (70 percent).

Understanding the motivation for foreign investment in Indonesia, the research adopts the asset-exploiting motives for FDI associated with Dunning (1993a, 2000), which are market-seeking, resource-seeking, efficiency-seeking and strategic asset-seeking. In general, the survey shows that the investors' motivation for investing in the SAs is resource-seeking, but also efficiency-seeking. This makes sense, given the importance of international markets for these investors, that basically require competitive prices. However, for investors in the Non-SAs the motives for investment are market-seeking and resource-seeking. It follows since Indonesia has a very large population, which creates a large market size and a large labour force. Focusing on the factors that influence the investment location, in general both the SAs and Non-SAs have quite similar asset-exploiting motives. For the SAs, it is resource-seeking from the availability of labour resources, but including skilled labour. For the Non-SAs, it is market size, but also the purchasing power that is supported by a growing local and national economy. More generally, political stability and security, as well as good physical infrastructure influence investment in both the SAs and Non-SAs. The geographical location is important for investors in the SAs, but this is related to the Batam-FTZ that is dominated by investors from Singapore. For Non-SAs the focus is on the 'general investment climate'.

With regard to the role of tax incentives in attracting the foreign investment, the questionnaire survey reveals that investors include these in their initial investment appraisals, but that when it comes to the negotiations with the government, most investors do not include them. When compared to the take-up of the tax incentives at and after the plant establishment, the survey shows a higher take-up of the tax incentives at plant establishment. This may be because during the establishment investors require a large cash outflow, whereas at the same time the company has not generated income. Therefore, any relaxation of the tax payment is more useful during the plant establishment. While comparing the importance of tax incentives and the Corporate Income Tax (CIT) rate as a statutory tax rate that applies generally to corporations, the survey shows that investors consider them to be about as equally as important.

With regard to the type of tax incentive, investors in the SAs mostly receive these in the form of indirect tax incentives (i.e., import duties, VAT, LGST, import tax exemptions), whereas in the Non-SAs most investors had never received a tax incentive, but for those that had, the CIT rate reduction was the most widely received. In general, the investors are in favour of more 'general incentives', such as a reduction in the CIT tax rate, but less interested in targeted and discretionary tax incentives, such as a tax holiday or tax allowance. This is because they believe

that the government will reject their application for support that is discretionary in nature, since the government focuses on the fulfilment of tax revenue. In fact, inward investors rarely apply for tax incentives as a majority of them are not aware they exist. For the investors that were aware, the application process is thought to be complex, with a low probability of success. In the next chapter I consider the tax incentives from the standpoint of the policymakers.

Chapter 7. In-Depth Interview Results

7.1 Introduction

The previous chapter analysed from the perspective of Indonesian inward investors the factors that influenced their decision to locate in Indonesia and in particular the role that tax incentives had in this process. The chapter reveals that market size, access to cheap labour and political stability are the main locational determinants, and that tax incentives are not a main factor in the FDI location decision for the majority of inward investors. Further, the availability of tax incentives regarding FDI location are rarely explored in the negotiations with the Indonesian government, including at the initial plant establishment, so that in practice the inward investors rarely apply for the tax incentives either because they are unaware of the incentives or because they believe that the chance of success is low. The view of the investors who had experience of applying for the incentives was that the process was complex.

As reviewed in Chapter 3, the tax incentives are however portrayed as an important aspect of overall inward investment policy in Indonesia. Indeed, the range of tax incentives, such as the tax holidays, tax allowances and exemption from import duty, are highlighted as part of the government's yearly investment strategy relating to FDI through Indonesian Budget Statements from 1970/71 through to 2019. Therefore, this chapter aims to present from the perspective of the policymakers' viewpoint, the role of tax incentives in attracting FDI inflows to Indonesia. The chapter utilises face-to-face interviews with key policymakers relating to FDI in Indonesia in order to obtain their opinions on the general FDI policy background, policy development relating to FDI location in Indonesia and the role of the tax incentives in FDI policy.

The policymakers interviewed cover a range of key stakeholders that are involved in the inward investment process in Indonesia, and hence provide an important and unique perspective on the taxation incentives in relation to inward investment in Indonesia. Overall, the chapter finds that taxation incentives are not regarded by policymakers as the most important location factor for FDI. They are thought, however, to still play an important role in attracting inward investors, although the importance attached to the tax incentives does vary according to the policymaking institution. Policymakers thought that a more effective taxation policy would arise from a simpler administrative process and an easier set of requirements for inward investors to fulfil. It is clear however that the policymakers believe that an effective monitoring and evaluation of

tax policy is lacking, so that the interviews with the policymakers have provided an important analysis of taxation policy in relation to foreign direct investment in Indonesia.

The structure of the chapter is as follows. Details of the respondents and the nature of the face-to-face interviews are explained in the next section. The respondents' views are then explored in section 7.3 in relation to the purpose of inward investment policy and the factors that are thought to determine FDI. The specific role of tax incentives in relation to FDI is discussed in section 7.4. The policymakers' perspectives on the development and administration of the tax incentive policy is examined in section 7.5, with the monitoring, evaluation and expectations of this policy discussed in section 7.6. Finally, section 7.7 concludes the chapter.

7.2 The Policymakers

This chapter utilises face-to-face interviews to analyse policymakers' perspectives on FDI and inward investment tax incentive policies in Indonesia. As discussed in the methodology in Chapter 5, a semi-structured approach was used for conducting the in-depth interviews, where a set of pre-prepared questions capturing the main themes and objectives of the interviews were asked to the relevant respondents based on their institution or professional background. The findings presented in this chapter are based on 17 in-depth interviews with 22 respondents conducted between 19th October - 29th November 2017 in Indonesia and in August 2018 in the United Kingdom. In the majority of cases the interviews were conducted on a one-to-one basis, but in the case of four interviews these were conducted in groups of two or three people from the same unit. Table 7.1 shows the different respondents from the various government and policy institutions together with the specific role of the institutions.

The different institutions shown in Table 7.1 all have direct links to inward investment and tax incentive policy in Indonesia. The Indonesia Investment Coordinating Board (BKPM) is a national institution responsible for assisting investors who are seeking to invest in Indonesia and who are responsible for granting investment licenses. The Ministry of Finance (MoF) is the ministry responsible for fiscal policy, i.e., the state treasury. The MoF is therefore responsible for providing incentives, either in terms of tax incentives or other fiscal incentives, for foreign investors. Within the MoF are two specific units, the Fiscal Agency (BKF) and the Directorate General of Taxes (DGT), where the former is responsible for fiscal analysis and strategic fiscal policy and the latter is responsible for collecting revenues and administering tax payments. The Ministry of Industry (MoI) is the ministry responsible for developing national

industrial development policy. All foreign investors investing in Indonesia should have approval or endorsement from the MoI and this ensures they are in line with the National Industrial Development Master Plan and national industrial policy.[38] The National Council for Special Economic Zones (SEZ) is the institution responsible for the development of Special Economic Zones in Indonesia while the Indonesia Investment Promotion Centre (IIPC) is an overseas 'branch' of the BKPM whose responsibility is to promote and assist investors to locate in Indonesia. Finally, the Indonesia Tax Consultant Association (IKPI) is an independent organization that operates outside of the government and whose interests are to provide taxation advice within Indonesia, so provide a neutral point of view regarding tax incentive policy.

Table 7.1: Respondent Organisations and Codes

Institution		Respondents
Name	Roles	Code
Indonesia Investment Coordinating Board (BKPM)	Investment promotions, license, administration and coordination with other institutions	BKPM-A; BKPM-B; BKPM-C; BKPM-D
Ministry of Finance (MoF)	Fiscal policy and state treasury	MoF-A; MoF-B
Fiscal Agency (BKF)	Fiscal policy analysis	BKF-A; BKF-B; BKF-C
Directorate General of Taxes (DGT)	Administrating tax revenue	DGT-A; DGT-B
Ministry of Industry (MoI)	Industrial policy, development	MoI-A; MoI-B; MoI-C
National Council of Special Economic Zone (SEZ)	Policy development and coordinator of SEZ implementation	SEZ-A
Indonesia Investment Promotion Centre (IIPC)	Conducting investment promotions	IIPC-A
Indonesia Tax Consultant Association (IKPI)	Providing tax consultation and assistance to taxpayers (investors)	IKPI-A

Notes: The in-depth interviews are conducted on a one-to-one basis apart from the following interviews that were conducted in groups: BKPM-D 2 respondents; MoI-A 2 respondents; MoI-C 3 respondents and IIPC 2 respondents.
Source: In-depth interviews with the author, 2017-18.

All of the institutions shown in Table 7.1 are governmental institutions, but except for the IKPI, which is a non-governmental agency. Of the government institutions, four are at Ministerial level: the Ministry of Finance, Ministry of Industry, BKPM and National Council of SEZ. The

[38] For example, Master Plan of National Industrial Development 2015-2035 based on Government Regulation number 14, year 2015, and national industrial policy (i.e., Presidential Regulation 28/2008; Presidential Regulation 2/2018).

other three institutions are subordinate to these, with the BKF and DGT under the Ministry of Finance and the IIPC under the BKPM. As a non-governmental institution, the IKPI has indirect links with the other institutions, as made clear in Appendix Figure B.7.1. Regarding tax incentive policy, each institution has a certain level of autonomy in decision-making, but they need to come to a collective agreement and the Minister of Finance has the final decision on certain type of tax incentives, such as a tax holiday. For other types of tax incentive there is less tension as it does not require Minister of Finance as the final decision maker.

All of the respondents in Table 7.1 have a high-ranking profile, with the majority at the level of director or equivalent. In presenting the interview results the identity of the respondents is presented anonymously, for instance "DGT-A, 15 October 2017". The first part of the code "DGT" represents the respondent's institution (in this example the Directorate General of Taxes) with the second part differentiating between the respondents of each institution (i.e., "A"). The date when the interview is conducted is then provided (i.e., "15 October 2017"). In the cases where an interview had multiple respondents then the respondents are grouped into the same code, i.e., BKPM-D with two respondents; MoI-A with two respondents; MoI-C with three respondents and IIPC with two respondents.

Data from the interviews were recorded and transcribed manually in Microsoft Word. In discussing inward investment and tax incentive policy the perspective that is represented by the respondents could however be from the point of view of the individual policymaker or that of the institution. It is of course difficult to differentiate between the personal view and the institutional view, although in the cases where the individual viewpoint significantly differs from the institutional view the policymaker often makes this clear so that the policymakers views are representative of the institution. The discussion here is not intended to confront one institution with another, but rather to see the different policymakers' perspectives from the different institutions.

In presenting the interview results the transcribed data are structured around the established themes that were used as the basis for the interviews and discussed in Chapter 5: (1) inward investment and tax incentive policy; (2) development and administration of tax incentive policy; and (3) policy monitoring and evaluation (see Chapter 5 Subsection 5.3.2 and Appendix B.5.3). It is these themes that provide the structure of the chapter.

7.3 Inward Investment Policy

This section is based on the first theme of the in-depth interview questions relating to the policymaker's perspectives of inward investment policy. In particular, the section explores the policymakers' perceptions regarding the purpose of Indonesian inward investment policy and the relationship between this policy and the broader policy objectives of Indonesia. The section then identifies the main factors that from the policymaker's viewpoint are thought to influence the location of FDI in Indonesia.

7.3.1 Purpose of Inward Investment Policy

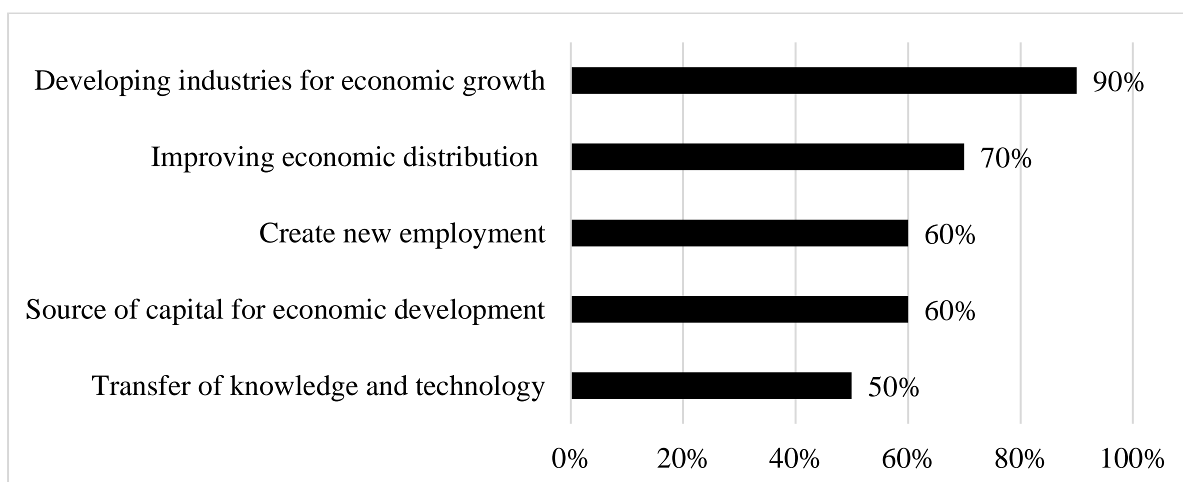
In respect to obtaining policymakers' perceptions regarding the purpose of inward investment policy the following relevant institutions were selected whose tasks and responsibilities are related to FDI inflows policy: BKPM, MoF, BKF and SEZ. Firstly, the BKPM is the institution formally responsible for coordinating both foreign and domestic investment policies and services in Indonesia.[39] Secondly, the Ministry of Finance is the institution responsible for managing state finances and in particular in charge of budget financing of policy, including the provision of tax incentives.[40] Within the Ministry of Finance, the Fiscal Agency (BKF) conducts analysis of fiscal policy and are also responsible for developing fiscal policy. Finally, the National Council for Special Economic Zones has the responsibility to conduct the development of SEZs at the national level and hence given the importance placed on SEZs for attracting FDI are integral to inward investment policy.[41] In total, there were ten respondents from the four institutions who provided their views on inward investment policy so that a different set of perspectives relating to inward investment policy was obtained.

To analyse the question of 'what is the main purpose of attracting FDI to Indonesia?', as a first step the various answers of the respondents were placed into a range of categories with the most common responses presented in Figure 7.1 (a further detailed breakdown of the full list of responses from each respondent for each institution is given in Appendix Table A.7.1). A number of reasons were suggested by each of the respondents, but as can be seen in Figure 7.1 these were generally consistent across the policymakers who were in agreement that inward

[39] Presidential Regulation number 90, year 2007, concerning Indonesia Investment Coordinating Board, in conjunction with Presidential Regulation number 86, year 2012.
[40] Presidential Regulation number 28, year 2015, concerning Ministry of Finance.
[41] Presidential Decree Number 8, year 2010, concerning the National Council for SEZ.

investment policy should be used to: enhance industries and ultimately economic growth; improve the distribution of economic activity among regions, provinces and sectors; generate new employment opportunities; and provide a source of capital for further economic development. The final reason, given by half of the respondents, was to help facilitate the transfer of knowledge and technology and ultimately productivity.

Figure 7.1: The Purpose of Inward Investment Policy



Note: Percentage of responses from a total of 10 interviews.
Source: In-depth interviews with the author, 2017-18.

To further understand why FDI is seen as important in developing these broader policy aims in Indonesia, as well as how these perceptions of FDI differ across institutions, the specific responses of the policymakers are examined in further detail. For instance, the MoF-A respondent explains that economic growth as represented by the increase in Gross Domestic Product (GDP) is one of the basic demands of governments and given that the government cannot rely on consumption to increase growth as consumption has "almost hit its ceiling", that government expenditure also has a "limited budget" and that "net exports are in deficit" then the government needs to "shift and push [foreign] investment as an economic engine".[42] Furthermore, MoF-A explains that both foreign and domestic investment can generate larger multiplier effects in the economy compared to increased consumption:

> "…nowadays, economic growth is very much supported by domestic consumption which is very helpful during economic downturns. However, consumption generally cannot generate multiplier effects towards the national economy as much as investment. Therefore, the government wants to shift its' focus towards investment [including FDI] in order to boost higher multiplier effects in the economy, which will lead to higher economic growth" (MoF-A, 28 November 2017).

[42] The current account balance of Indonesia has had a negative balance, i.e., deficit, since 2012 (World Bank, 2019).

The MoF therefore sees FDI as a means of boosting the Indonesian economy. Related to this is the importance placed by the MoF and BKF respondents on FDI as a provision of capital for the economy, where in particular the BKF respondents argue that domestic capital does not provide enough funds for economic development so that FDI emerges as an important solution:

> "…we have been targeted to provide a certain amount investment by the government, but domestic investment is only able to fulfil about half of them, therefore we need another half from other sources such as foreign investment" (BKF-A, 3 November 2017).

The direct benefits that FDI can provide to Indonesia in terms of boosting employment is also explicitly stated by the BKF, where in addition to economic growth the ability to create new employment and to reduce unemployment rates is discussed:

> "…we would like to have economic growth which increases employment and reduces poverty as the people are able to increase their wealth and prosperity through its jobs. This is the essence of economic development" (BKF-A, 3 November 2017).

Therefore, inward investment policy is also related to government policy for alleviating poverty rates in Indonesia in the hope that new employment will help to increase income levels and reduce poverty:

> "…when we discuss poverty alleviation, what the government needs to do is to ensure the creation of jobs for the Indonesian people. In this context, inward FDI flows will be a trigger for the creation of new employment opportunities" (BKF-C, 23 November 2017).

In this context, government policies related to the creation of new employment opportunities as well as boosting capital and overall growth are the central aims of the Ministry of Finance and the Fiscal Agency (BKF).

Improving the distribution of economic activity is raised by respondents from all of the institutions (70% of respondents), however it is policymakers from the BKPM that in particular (three of out their four respondents) state that the purpose of inward investment policy is to improve the distribution of economic activity across regions (provinces) and sectors (BKPM-A, 2017; BKPM-C, 2017; BKPM-D, 2017). For example, respondents from BKPM argue that in general about 60 percent of investment in Indonesia is concentrated in Java Island with the other 40 percent divided amongst the five other regions (Sumatera, Kalimantan, Bali and Nusa Tenggara, Sulawesi, and Papua and Maluku, as shown in Chapter 4):

> "…our data show that Java is still dominant compared to other regions outside Java. It is BKPMs challenge to push new investment (including FDI) to go outside Java. For that purpose we need to incentivise investment outside Java. [For example] tax allowance is developed in order to support the development of designated regions or intended sectors" (BKPM-A, 19 October 2017).

> "…inward FDI is expected to support economic development and growth across Indonesia regions…we conduct preliminary research regarding what sector the government wants to develop and whether or not the provision of incentives will enhance investment…" (BKPM-C, 25 October 2017).

This suggests that the BKPM has an awareness that FDI can be used as a means to increase growth across Indonesia and not just as a way of boosting the overall Indonesian economy so that attracting FDI throughout Indonesia is a key policy objective of the inward investment agency. A similar argument regarding the importance of inward investment policy to redistribute activity is raised by the National Council for SEZ, which of course may not be surprising since the objectives of the National Council is to establish SEZs to support inward investment and to increase economic growth specifically outside Java:

> "…the establishment of SEZ is designated to create new centre for economic activities especially outside Java Island" (SEZ-A, 29 November 2017).

Finally, although relatively fewer policymakers put the specific policy objective of attracting FDI as a means of transferring knowledge it is still an important objective raised by half of the policymakers. It is mentioned by policymakers in the BKF, BKPM and SEZ and highlights the importance of not just attracting FDI itself to boost capital and employment but of attracting a certain type of FDI to enhance the Indonesian economy:

> "…one vital aspect that we expect from foreign investors is they will bring new technology and are willing to transfer knowledge and technology to the local people. In general, we really have a demand for foreign investors with higher technology capacities rather than basic (traditional) ones…" (BKF-C, 23 November 2017).

> "…we expect FDI inflows will bring new technology which then create new products, especially investors that are able to utilise Indonesian natural resources for further production with higher value added…." (BKPM-D, 7 November 2017).

It shows that there is an explicit demand for foreign investors that embody higher levels of technology and that can provide a function that domestic Indonesian companies may not have the ability to perform. Similarly, it is expected that new foreign investments should be able to produce products with higher value added and not just exploit and export the (raw) natural resources of the Indonesian economy.

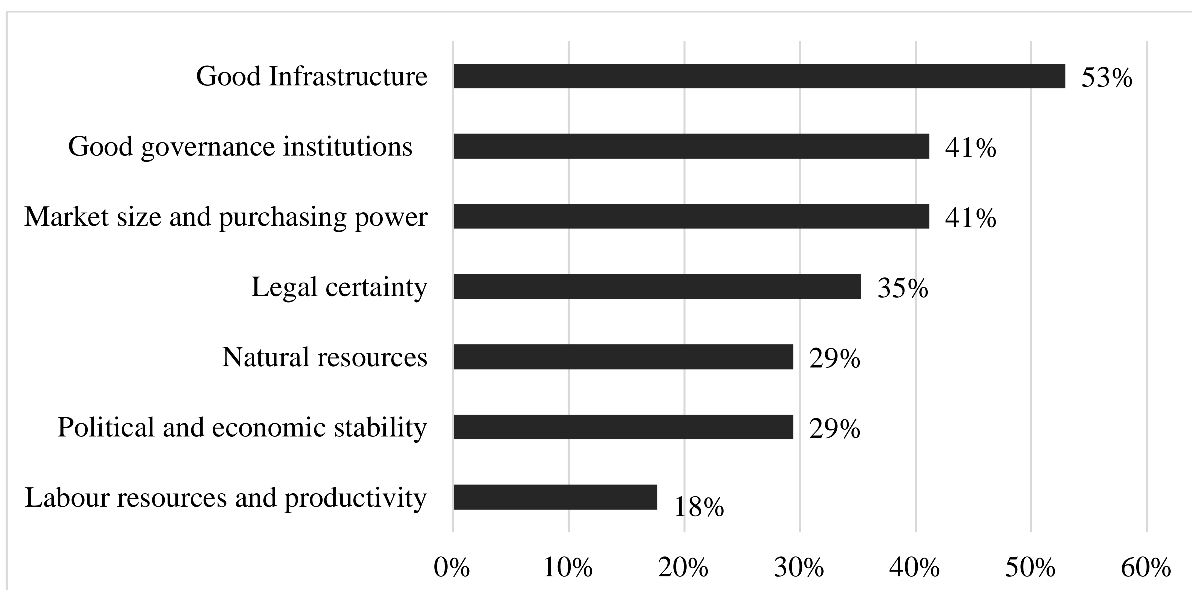
In summary, policymakers believe that foreign investment policy will enhance industrial development and lead to increased economic growth. Further, inward investment is expected to improve the distribution of economic activity across Indonesia so that it is not concentrated in Java. Inward investment is also expected to bring new employment, become a source of capital for complementing domestic capital and bring benefits to domestic business and labour

through a transfer of knowledge and technology. FDI is therefore an important policy objective for the Indonesian government across the various policymaking institutions.

7.3.2 Inward Investment Factors

As part of the general discussion on inward investment policy, the respondents also gave their thoughts on the factors that influence inward investment into Indonesia. These location determinants were raised by all of the policymakers at various points of the interviews, with many factors attributed to influence foreign investment inflows: quality of infrastructure; institutional governance; market size; legal certainty; abundance of natural resources; political and economic stability; competitive labour resources. Interestingly, from all the respondents' answers, not one considered tax incentives as an important factor and not mentioned on their list of answers. Furthermore, for those who were willing to elaborate further regarding investment factors, they placed tax incentives as a very low-ranking factor (DGT-B, 2017; MoF-B, 2017). Figure 7.2 shows the respondents' perspectives on inward investment factors, with a more detailed breakdown by institution given in Appendix Table A.7.2.

Figure 7.2: Inward Investment Factors



Note: Percentage of responses from a total of 17 interviews.
Source: In-depth interviews with the author, 2017-2018.

The most important location factor, as stated by 53 percent of the respondents, is that of infrastructure. This reflects the importance attached to infrastructure by President Joko Widodo on his first-term of presidency and where government spending on infrastructure development

has increased over the period 2014 - 2018 from around 8 percent (Rp157 trillion) of the total state budget in 2014 to 19 percent (Rp410 trillion) of the budget in 2018 (see the discussion in Chapter 3 where Indonesian spending on infrastructure has historically been low relative to other ASEAN countries):

> "…our problem is lack of infrastructure as can be seen in a number of Global Competitiveness Indexes, so that the government [of President Joko Widodo] very much focuses on infrastructure development" (MoF-A, 28 November 2017).
>
> "…it seems [tax incentive] is not really significant [in effecting inward investment]. The existing investment more likely occurred because of infrastructure readiness" (MoI-A, 7 November 2017).

The importance of infrastructure is mainly reflected by the government ministries of the MoF (including the BKF and DGT) and MoI and hence echo the national governmental policy objectives of Indonesia. They are not however raised by the inward investment agency BKPM.

The inward investment agency do however place the importance of institutional quality and legal certainty as important location factors, and these are also of concern across the range of institutions with 41 percent (institutional quality) and 35 percent (legal certainty) of policymakers highlighting this factor. With regards to the good governance associated with institutional quality, this is of particular importance to the inward investment agency as they are the agency involved with the granting of investment licenses and who are also aware of potential problems with this process:

> "…this issue arises when President Joko Widodo visited BKPM after he is sworn as the President. The President had a discussion directly with investors who apply for investment permits at BKPM. Some investors expressed their difficulties in obtaining permits. One of the investors (in the power plant sector) mentioned that they took almost 4 years to obtain the permit" (BKPM-A, 19 October 2017).

Further, the overall importance to investors obtaining investment licenses and permits is also seen at the national governmental level as identified by the Ministry of Finance:

> "…investors who came to Indonesia, generally have more concerns on non-incentives factors…such as the provision of licences and permits for investment" (MoI-A, 7 November 2017).

The ability of inward investors to successfully access and navigate the institutional framework extends into their experiences of the legal environment (MoF-A, 2017; MoF-B, 2017; BKPM-B, 2017; BKPM-D, 2017; IKPI-A, 2017). From a more neutral point of view, IKPI-A stated that "what is promised in regulations should be implemented in reality" because without policy certainty other factors will be irrelevant as investors will lose their trust and confidence in the Indonesian government. Indeed, policymakers have identified the legal environment as one of

the weakest aspects of Indonesia, with for example the BKPM officials illustrating the uncertainty surrounding the legal process by noting cases where tax holiday provisions were initially approved by a verification committee only for BKPM officials to be later informed that the tax holiday was not granted (BKPM-B, 2017; BKPM-D, 2017): [43]

> "…can you imagine how embarrassed we were to the investors? We had informed them that the verification committee had agreed to provide a tax holiday, therefore they do not need to worry and just wait for the Ministry of Finance formal letter of acceptance….but in the end their application was rejected" (BKPM-B, 24 October 2017).

BKPM officials suggested that as a consequence of this they are less likely to give assurances as to whether or not an investor's application will receive a tax holiday so that ultimately there is an increased level of uncertainty surrounding the overall application process. This also has implications for the attraction of inward investment if investors withdraw from their plans to invest in Indonesia and locate where more substantial assurances can be given:

> "…what that I regret most from this uncertainty is … Indonesia losing its opportunity to have an investment which will produce a high value-added product (such as in the chemical industry…Indonesia is still a net importer for this product)" (BKPM-D, 7 November 2017).

The above example highlights the impact of an uncertain regulatory framework on attracting large-scale value-added products that are important to the development of the Indonesian economy and the overall policy aims of the Indonesian government.

The importance of certainty is also reflected in the political and economic stability of Indonesia as a location factor with respondents from the MoF stating that these factors assure investors' confidence and allow them to make business forecasts or projections regarding the cost structure of their investment (MoF-A, 2017). As an analogy, if a country provides investors with generous tax incentives but the country is under political turbulence, for example a military *coup d'état*, then it becomes less likely investors would locate in the country (MoF-A, 2017). The importance of political and economic stability relative to other location factors, and in particular tax incentives, is also demonstrated by the following respondent:

> "…tax is not the only factor that matters for investment decisions…but there are many others such as democratization, institutions, trade and other variables…but of them all, I think political and economic stability is the most important" (BKF-B, 8 November 2017).

[43] A Verification Committee is responsible for assessing taxpayers (investors) application on tax incentives and is established based on Minister of Finance decree. The members consist of Ministry of Finance representatives (including BKF and DGT), Technical Ministry/Institution representatives (i.e., Ministry of Industry, National Council for SEZ), and the BKPM.

Finally, the policymakers also note that the classical location factors related to the market-seeking and resource-seeking determinants of FDI are important in attracting investment (see Chapter 2 for a discussion on the classical location factor of FDI). The role of market-seeking FDI in particular is seen as an important location factor with 41 percent of policymakers arguing that investors are more likely to be attracted by the size of Indonesian market (BKPM-B, 2017; BKF-A, 2017; IIPC-A, 2018) which had a population of more than 250 million in 2017 (BPS, 2018). The market size of Indonesia is also supported by the purchasing power of the 'middle income class', which is expected to keep growing in future years and hence remain a significant location factor (BKF-A, 3 November 2017). The size of the market, along with labour resources, is also seen as the most important factor by the Indonesian Investment Promotion Centre whose role is to promote Indonesia as a destination for FDI so that market size is advertised as an important feature of the Indonesian economy:

> "…in general, each business would like to maximise its profits, so the basic ideas is to find a location where they can sell a lot and generate profits as much as possible. So in this case, the market is the first reason for locating its investment in Indonesia" (IIPC-A, 30 August 2018).

The vast potential of resources is also believed to make Indonesia an attractive investment location through the provision of cheap labour (IIPC-A, 2018):

> "…[investment comes to Indonesia] apart from market size because of the availability of cheap labour. Even though we still lose compared to Vietnam (even cheaper), it is still one of the benefits that investors expect when they invest in Indonesia" (IIPC-A, 30 August 2018),

as well as through its abundance of natural resources (BKF-A, 2017; BKPM-B, 2017; MoI-A, 2017). The importance of the availability of natural resources can be inferred from the statement of BKPM-D (2017) which notes the foreign investment contribution in the locations of Morowali (Central Sulawesi) and Konawe (Southeast Sulawesi) relating to nickel ore (IMIP, 2018). The importance of both market and resource-seeking FDI to Indonesia is summarised below:

> "…at the beginning investors do not focus on taxes, but are more likely concerned with the market size of Indonesia with more than 240 million people…and also natural resources endowments and labour resources availability" (BKF-A, 3 November 2017).

A range of location factors have therefore been identified by the policymakers across the institutions and these reflect the market and resource-seeking nature of FDI as well as the role of the institutional environment and infrastructure of the country. However, the other important aspect arising from the policymaker's responses is the absence of taxation motives as an important location factor. Indeed, 75 percent of policymakers explicitly expressed that "tax is

not the most important factor" (BKF-A, 2017; DGT-A, 2017; MoI-A, 2017) or indicated that taxation is just "a complementing factor or a sweetener" (MoF-A, 2017; BKF-A, 2017; BKF-C, 2017). Taxation is therefore ranked after many other non-tax factors (MoF-A, 2017; MoF-B, 2017; DGT-B, 2017):

> "…if we see tax incentives as a factor for attracting FDI, then it can be classified as a mediocre factor or even at the back row…may be number 7 or 8 or even a teen sequence number…for sure it is not the most important one…" (MoF-B, 29 November 2017).

> "…in my understanding tax incentives is not the only factor and also is not the most important factor for attracting inward investment. If I refer to the literature, it seems tax incentives is somewhere between number tenth or eleventh in rank which means it is not the main factor" (DGT-B, 16 November 2017).

> "…tax is a complementary factor for investment incentives. It can be said as a sweetener" (BKF-A, 3 November 2017).

When considering the importance of tax as a locational determinant it appears the beliefs of the policymakers' conflict with the beliefs of the inward investors. For example, during investment roadshows or within meetings conducted by the government of Indonesia with potential investors, the policymakers reveal that the provision and extent of tax incentives are frequently asked by investors:

> "…just recently (in 2017) an investor (in the chemical sector) showed interest to invest in Indonesia. They sent us a letter and asked whether or not they will gain tax facilities when investing here in Indonesia. Unfortunately, we [BKPM] cannot provide a clear answer. As you may know, finally that investor chose Thailand as their investment location" (BKPM-D, 7 November 2017).

The response of the policymakers is that tax incentives may only be important to the investors when they are deciding upon competing locations with similar attributes, so that although the investors state the importance of tax this is conditional upon the other main attributes of the country such as market size, resources and infrastructure:

> "…[tax incentives] can be seen as the main factor for influencing [foreign] investors decision only if other investment factors are equal. In that case tax incentives become an important differentiator for investment location (BKPM-D, 7 November 2017).

This explains the relatively low importance placed on taxation as a location factor by the policymakers and their focus instead on the more fundamental aspects of the Indonesian economy as a way for Indonesia to successfully compete for inward investors. Tax incentives are therefore seen as important when the location decision is amongst host countries with similar attributes:

> "…providing tax incentives to compete with other countries such as Singapore might not be relevant…simply because they are far more advanced. However, when other countries

> which have relatively similar levels with Indonesia lure investors with tax incentives, then why do we not do similar?" (BKF-C, 23 November 2017).

In summary, policymakers are placing greater emphasis on ensuring Indonesia is able to compete with other potential host countries by focusing on providing high levels of infrastructure and good governance quality in a stable political and economic environment in order to allow investors to access its large market and range of resources. Taxation incentives are therefore a secondary policy measure, but importantly a policy which is thought to have a role in changing the location decision of investors from other similar competing locations. The issues related to these taxation incentives policies are discussed in the following section.

7.4 Tax Incentive Policy

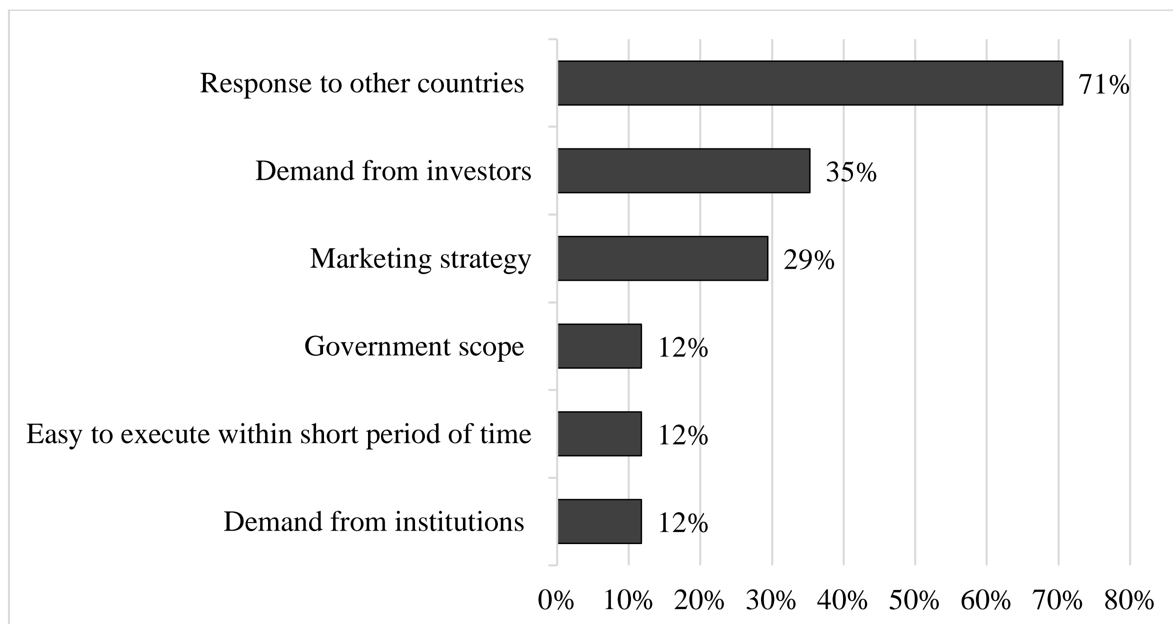
This section provides specific insights on tax incentive policy as part of the set of overall government policies for supporting inward investment into Indonesia. The previous section has shown that although tax incentives may not be seen as the most important factor in attracting inward investment, they are still used as a means of attracting inward investment and particularly in trying to divert investment from other similar host countries. The section begins by exploring why tax incentives are used as part of a broader set of inward investment policies and then explains the specific objectives of tax incentive policy for FDI in Indonesia. Finally, the overall importance of tax incentives to Indonesian inward investment policy is assessed.

7.4.1 Reason for Implementing Tax Incentives

The above section highlights a range of location factors that policymakers believe are important for attracting FDI into Indonesia. Therefore, a range of policy options are available for policymakers, but where relatively less emphasis is placed on the importance of tax incentives. However, tax is still seen as a relevant location factor and particularly so amongst the investors deciding upon similar locations so that this section explores the specific reasons as to why policymakers use tax incentives as part of inward investment policy. These reasons are presented in Figure 7.3 (with a further detailed breakdown by institution in Appendix Table A.7.3), which overwhelmingly shows that tax incentives are used in response to other countries implementing taxation policies to attract FDI as well as in response to investors demand for such policies. From the overall range of reasons provided it is clear that there is limited belief in the fundamental benefits of taxation to attract FDI, but rather tax policies are used because

they are relatively easy to implement and are marketable as well as being used elsewhere and expected from investors.

Figure 7.3: Reasons for Utilising Tax Incentives



Note: Percentage of responses from a total of 17 interviews.
Source: In-depth interviews with the author, 2017-18.

Examining the views of the policymakers in more detail, using tax incentives as an investment policy because other countries use it themselves illustrates the way Indonesia competes with other similar countries for FDI:

> "…other countries in the region such as Thailand, Malaysia and Vietnam are also providing tax incentives for attracting foreign investment. Comparing the provision of tax incentives with Singapore might not be relevant as Indonesia has a large gap in the investment climate. However, for other countries which have similar investment climates as us, the provision of tax incentives is important. We need to remember, nowadays the competition for attracting FDI is already 'head to head' between Indonesia and other countries. When a country provides tax incentives for investors…why don't we do so as well?" (BKF-C, 23 November 2017).

The policymakers therefore use tax incentives as a mirroring strategy, i.e., as a reaction to the policy actions of other countries. The BKF also argues that other countries may themselves be using taxation incentives only because Indonesia are using these incentives, so that there is a further 'interplay of actions' i.e., Indonesian policy can influence and is also influenced by other countries and the countries recognise their interdependence of policy actions.

Policymakers not only respond to other countries but also to investors, with more than one-third of the respondents saying that tax incentives are provided because investors demand these

incentives. The respondents, especially from BKPM, argue that even though tax incentives are not the main issue discussed by investors in their interactions with policymakers it is still almost always raised by the investors. A common question asked by investors is, what kind of taxation incentives can the government of Indonesia offer to investors when they invest in Indonesia (BKPM-A, 2017; BKPM-C, 2017; BKPM-D, 2017; IIPC-A, 2018; MoI-A, 2017; BKF-C, 2017)? Further, given that investors often enquire about taxation incentives then the policymakers can utilise this to create a marketing strategy for attracting foreign investment:

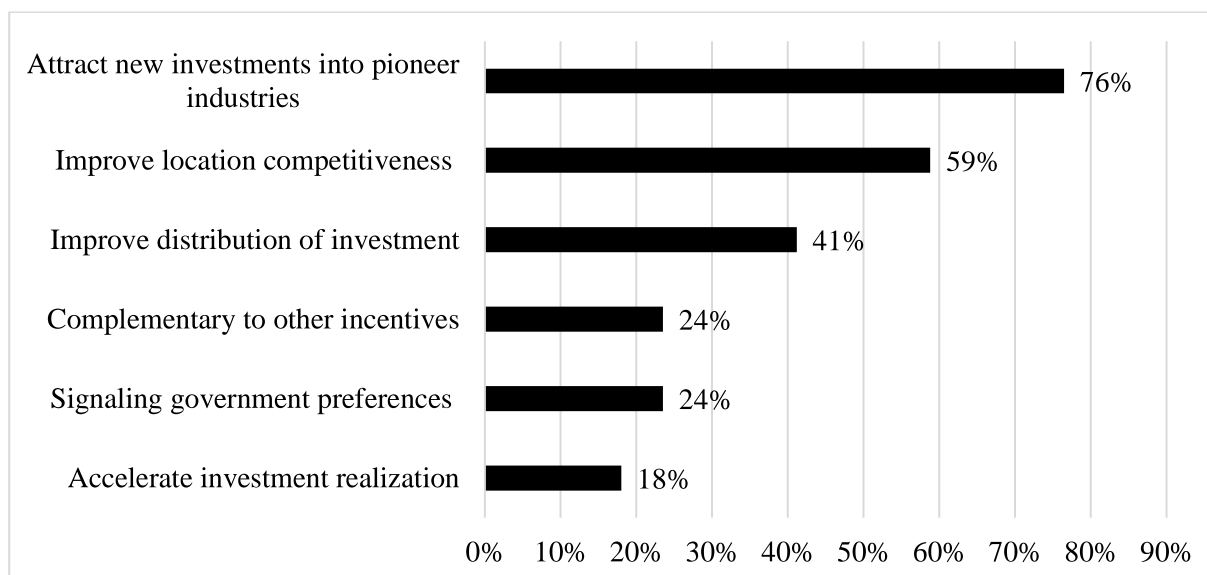
> "…in order to attract foreign investment, government institutions [i.e., DGT] should be aware of the need of a 'gimmick' marketing strategy used by other government institutions [such as BKPM, SEZ, MoI], for instance the exemption of certain taxes such as corporate income tax" (MoI-B, 15 November 2017).

A further pragmatic reason for using tax incentives can be linked to the ease of implementing the policy both in terms of the policy being within the scope of the government's policymaking tools and the relative ease of undertaking the policy. For example, policymakers argue that the use of tax incentives as an instrument for attracting investment is because the policy is within the government's scope of authority and therefore it is something 'doable' (MoF-B, 29 November 2017; MoI-A, 7 November 2017; DGT-B, 16 November 2017). Furthermore, respondents acknowledge that tax incentive policy is a relatively easy option and does not require a long period of time to execute the policy. One of the respondents states that, as a policymaker it needs to show the government that it can actually do something and that taxation is a means of doing this in a relatively easy manner rather than rely on affecting 'God given factors such as huge population for market size' (MoI-A, 7 November 2017). Overall, these responses further illustrate that tax policy is seen as more of a secondary approach to FDI attraction in relation to the range of factors that are thought by policymakers to make a more significant impact on FDI location.

7.4.2 Tax Incentives and Inward Investment Policy

Given that tax incentives are used as part of inward investment policy, are there specific objectives that the incentives can help realise as part of overall government policy? The policymakers were asked about the main objectives of tax incentive policy in relation to inward investment and the various answers provided are shown in Figure 7.4 (with a further breakdown by institution given in Appendix Table A.7.4).

Figure 7.4: The Objectives of Tax Incentives



Note: Percentage of responses from a total of 17 interviews.
Source: In-depth interviews with the author, 2017-18.

According to the respondents, the most important objective of tax incentive policy is for attracting new investment into pioneer industries, where a pioneer industry is defined as an "industry having broad linkages, giving added value and high externality, introducing new technology, as well as having strategic value for the national economy" (PMK-35/2018). The importance of tax incentives in attracting new investments into pioneer industries is represented in the following statement:

> "tax holiday is important for new investors especially in first-time manufacturing industries in particular sectors, for instance the provision of a tax holiday for an Oleochemical company established in Sei Mangke. The holiday was provided because the company produced a new product and introduced new technology" (MoI-B, 15 November 2017).

The importance of pioneer industries is therefore reflected by those investments in pioneer industries being eligible for a wide range of tax incentives and tax holidays (see article 3 section 1 letter (a) of PMK-35/2018). The use of taxation incentives to attract investment into pioneer industries can therefore be seen as a way of helping to achieve the overall inward investment policy aims of developing industries for economic growth, particularly in industries that create new technology and which can further economic development.

Not only are tax incentives used to attract new investments especially for pioneer industries, but they are also used to affect the location of the investment. A majority of the policymakers (59% of respondents) state that tax incentives are used to attract investment to improve the

competitiveness of certain locations in Indonesia and to compensate for the areas' weaknesses. Policymakers in general believe that investment locations are not equal across the regions in Indonesia, with for example locations outside Java to some extent having less quality infrastructure. Therefore, policymakers believe that affirmative action is needed to improve location competitiveness through the attraction of investors. In particular, remote areas do not have adequate levels of infrastructure and the government does not have a sufficient budget for large scale improvement of infrastructure so that attracting investors who are willing to invest and develop their own infrastructure such as roads will be beneficial for these areas in the long run. As a BKPM official argues, without any investment a remote area will struggle to become developed:

> "…few years ago, Konawe was a jungle, but now the regency has a Polytechnic Institute which might even be better than those in Java. This occurs because of foreign investment. Morowali, another regency in [Central] Sulawesi also has foreign investment. In the beginning, the investors have to build their own roads, power plant, port, and also recruit labour by themselves. Now the industry exports its products to the Philippines. Therefore, the government needs to provide something for the investors who would like to invest in such [remote] location…" (BKPM-D, 7 November 2017).

Related to the above, the provision of tax incentives for particular regions is to make a more equal distribution of investment across Indonesia. This view was represented by 41% of interviewees. Given that FDI mainly locates in Java Island rather than the other regions in Indonesia (see Chapter 4 for the location of FDI in Indonesia), tax incentives are expected to become a tool for attracting investors to invest outside Java:

> "…tax incentives in the form of tax allowances is intended to direct investment to certain regions…therefore it is expected it will boost economic activities in that area" (MoF-B, 29 November 2017).

The respondents also believe, although to a lesser extent with just nearly 18% of respondents, that tax incentives are important to help accelerate the investment realization of the investors. BKPM officials argue that the provision of tax incentives, especially the exemption of import tax and duty, will accelerate investment realization:

> "…in practice, investors in the beginning really need support for executing its investment. For instance, they request import duty exemption in regards to tax incentive for capital goods (i.e., machinery, equipment factory establishment)" (BKPM-B, 24 October 2017).

It is believed that the tax incentives will help investors' cash flow and working capital as they do not need to pay tax or duty especially during the establishment period (BKPM-B, 24 October 2017). From this it can be seen that the underlying objective is to turn the investor's commitment to invest into a realised investment and to speed up the execution of the investment. In this case the BKPM-D respondent argues that FDI is only useful when the

investment is executed and not based on the commitment of the investment as only when the investment is realised does the 'real' capital flow to Indonesia:

> "…only when the execution has been started then the money flows to Indonesia and make any different for Indonesia economy. Before that, the story is just a money on the paper without real impact…" (BKPM-D, 7 November 2017).

The provision of tax incentives is also intended to be used as a way of signalling government preference for attracting investors, which as discussed in section 7.4.1 above highlights the importance of marketing the availability of tax incentives to inward investors. This point of view is reflected from almost a quarter of interviewees, such as:

> "…the provision of tax incentives is also intended to develop industrial structure, for instance providing incentives for sectors which can fill in the supply chain. For instance, in the bauxite industry Indonesia generally exports it in the form of raw materials and then Indonesia will import it in the form of aluminium metal. In this case the government would like to develop the manufacturing industry which will be able to process bauxite up to aluminium metal. Therefore, the government needs to provide tax incentives for this sector (bauxite industrial downstream)" (MoI-C, 20 November 2017).

Therefore, tax incentives policy can be considered as the way the government signals its preferences for both investment locations and sectors.

Finally, nearly a quarter of respondents believe that the objective of tax incentives provision is to complement the provision of other incentives. This links back to the previous discussion in subsection 7.2.2, which shows that tax incentives according to policymakers are not the most important factor for attracting foreign investment. In line with these explanations, policymakers believe that tax incentives are only useful as complementing factors:

> "…what we understand, tax incentive is not the main factor for attracting foreign investment, it just a complementary factor. Investors might see Indonesia with more than 240 million population as a large market or because of the existence of natural resources or the availability of cheap labour. After many important factors then the investors lastly might look at tax incentives. We consider it as sweetener" (BKF-A, 3 November 2017).

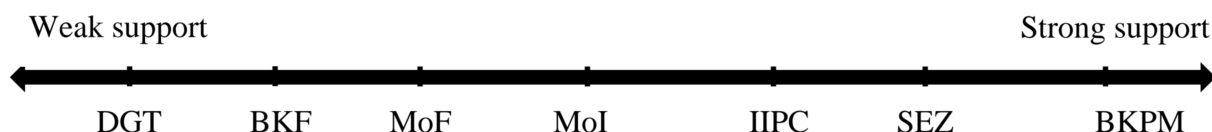
Overall, it can be seen that there is a link between the objectives of taxation incentives for inward investment and the objectives of overall inward investment policy with economic growth, capital development and improving the distribution of economic activity in Indonesia key policy aims in both cases. Further, these objectives relate to improving the fundamental aspects of the Indonesian economy so that taxation incentives can be seen to be complementary to the overall set of factors that are important for attracting inward investment. The way that taxation incentives can be used to signal the importance of FDI to Indonesia also highlights that policymakers are concerned with the perception that inward investors, and other countries, may

have in relation to Indonesian FDI policy. The use of taxation incentives for attracting FDI is therefore seen to be relevant to Indonesian policymakers.

7.4.3 Assessing the Importance of Tax Incentives

The existence of a tax incentives policy and the specific objectives of such a policy suggests that overall the institutions believe that these instruments are important for attracting FDI. However, across the institutions there are differing views on the importance of tax policy with both strong and mild supporters. This section explains the range of views that exist between the institutions, where Figure 7.5 provides a rough outline as to the relative views of policymakers in each institution. Of course, this does not mean that all policymakers in one institution have the same views on the importance of tax incentives, but it does provide an overview of the beliefs held by the senior policymakers in the institutions.

Figure 7.5: The Importance of Tax Incentive Policy



Source: In-depth interviews with the author, 2017-18; author's own construct.

Figure 7.5 shows that the strongest support for tax incentives policy arises from the BKPM, which is the institution responsible for promoting and administrating investment in Indonesia. Indeed, most of the BKPM's respondents strongly support the existence of tax incentives. Officials in the BKPM argue that tax incentives are 'essentially' important (BKPM-D, 2017) and that it can lead to a change in the investor's location decision:

> "…we have experience…investors from Europe say they will invest in Indonesia if the government provides tax incentives, but if not then they will find another location" (BKPM-A, 19 October 2017).

The importance of tax incentives is also expressed by BKPM-B (2017) who believes that tax incentives are useful for accelerating investment realisation and that exemption from paying taxes will help investors' cash flow especially in the early stage of a plant's establishment:

> "…tax facilities (i.e., import tax exemption) on the early stage of plant establishment is very important to accelerate investment realisation. We also receive many complaints, when investors do not receive tax allowances for their application" (BKPM-B, 24 October 2017).

The importance of tax incentives as a policy is also highlighted by the policymakers associated with the Special Economic Zones, where it is believed that in order to make SEZs competitive there needs to be the provision of tax incentives in these zones:

> "…we need to build competitive investment locations not only among regions in Indonesia, but also with other countries in the region… we believe that tax incentives provided by SEZs is the optimum one" (SEZ-A, 29 November 2017).

This suggest that there is a complementary role for policies through both tax incentives and SEZs. It also suggests that the success of a specific inward investment policy objective is actually a result of a combination of different government policies. For instance, if an objective of inward investment policy is to redistribute the location of economic activity then one mechanism of achieving this can be to provide tax incentives to persuade investors to locate outside Java:

> "…in order to move foreign investment outside Java, therefore the government need to provide such incentives, including tax incentives" (BKPM-A, 19 October 2017),

but that this in itself may not be sufficient and that the development of suitable Special Economic Zones as determined by the National Council for SEZ is also required. It therefore suggests that the government institutions have interconnected roles so that the BKPM as the institution responsible for attracting and administrating investment in Indonesia requires support from the National Council for SEZs who develop suitable Special Economic Zones as well as the MoF that controls the provision of tax incentives.

According to the BKPM, the lack of support for tax incentives by Indonesian policymakers arises mainly from the MoF. Further, within the MoF are the DGT and BKF who question the usefulness of tax incentives by suggesting that tax incentives will lead to a potential loss of tax revenue. However, the BKPM official believes this is just 'a hypothetical loss' which in fact does not exist:

> "…some people may argue about potential loss on revenue… but for us there is nothing about potential loss. We will lose if the investor does not invest [in Indonesia] …that is the real loss. Potential loss is just a hypothetical calculation, it is not a real thing" (BKPM-D, 7 November 2017).

The real loss according to the BKPM official is if the investor does not invest in Indonesia because the Indonesian government does not provide tax incentives. Further, if there are no new investors coming to Indonesia, then the existing industries 'will never step out from their current comfort zone' in that existing companies will not be willing to expand or invest in more remote areas outside of Java. Therefore, in order to break up the 'comfort zone', the

government needs to incentivise investors to invest and fill the 'industrial value chain gap across the regions in Indonesia' (BKPM-D, 7 November 2017).

From the viewpoint of the DGT however, the existence of tax incentives has not been proven to increase investment in Indonesia, which they say is evident from the low number of investors who apply for the exemptions (DGT-A, 2017). Furthermore, the DGT-A argues that when tax incentives are important then more general tax incentives (i.e., CIT rate reduction) will be much more useful compared to specific targeted tax incentives (such as a tax holiday or tax allowance). In this context general tax incentives are tax incentives which apply to all taxpayers, while specific or targeted tax incentives applies only to those fulfilling specific requirements:

> "…tax incentives especially the targeted ones are not effective… we can see from the number of investors applying for it…which is very few …" (DGT-A, 19 October 2017).

The above argument is echoed by DGT-B who argues that tax incentives are neither the only factor for attracting investment nor the most important factor and the use of tax incentives is simply because it is the only policy available and manageable at that time. Therefore, it is the ease of the policy that makes taxation policy option and its effectiveness comes from the institutions who can claim that they are undertaking a policy:

> "… tax incentives are not the only factors for attracting foreign investment… it becomes important as it is the only thing that for 'real' can be claimed by institutions as it strategy for attracting FDI…" (DGT-B, 16 November 2017).

The implication of the above is that there is a conflict between the investment promotion agencies who believe that tax incentives are an important tool for attracting FDI and the institutions who are responsible for justifying their fiscal aims and are accountable for spending on tax incentives and believe that attracting FDI is more complex than offering specific incentives. A more measured view is expressed by officials at the Ministry of Industry (MoI-A) who are perhaps less biased than the investment promotion and fiscal institutions and argue that investors do not place too much attention on tax incentives when they start to explore the possibility of investing in Indonesia, but that subsequently taxation can become a decisive factor. The main concerns that usually arise at the start of the investment decision process relate to the quality of infrastructure, energy availability, law and regulation certainty, investment permit process, and other non-tax incentives issues:

> "…some investors that come here, generally are more concerned about the quality of infrastructure in particular regions, legal certainty, investment permit procedures, the availability of energy… they never ask the availability of tax incentives at the first place…" (MoI-A, 7 November 2017).

Overall, the use and effectiveness of tax incentives is summarised by the Indonesia Investment Promotion Centre in that tax incentives are not the only factor to attract FDI but they can be used as part of a portfolio of policy options to create an effective investment climate for FDI. The government might be able to offer tax incentives, but without fulfilling fundamental investment factors then the investment may never arise (IIPC-A, 2018).

> "…in general, investors ask about the taxation system and the incentives that are available, but it is not the main issue. For instance, there was an investor for tyre manufacturing…they will discuss every issue comprehensively and in detail, including any potential benefit that they can get when investing in Indonesia" (IIPC-A, 30 August 2018).

Further, the IIPC also mention the lack of focus of the government inward investment policy, especially when compared to its competitors:

> "…what we certainly are aware of is our weaknesses in promotion. Indonesia investment focus is too broad which makes unclear what the government actually targets. For instance, in tourism, Indonesia has launched 10 new destinations for tourism investment. Why does the government not focus on 2 or 3 instead of 10 tourism investment areas? Singapore in my understanding is very focused in achieving specific targets. They will insist to achieve single target. If it is already achieved then they will expand the target" (IIPC-A, 30 August 2018).

This is echoed by the IKPI who believe that tax incentives matters only if the government has credibility and trust, so that it is the effectiveness of the entire investment environment that is important for attracting FDI. This covers the fundamentals of the economy, the provision of taxation incentives, the regulatory environment and the credibility and trust of the institutions involved in inward investment:

> "…only if what is stated by the law and regulations are implemented, then tax incentives become a credible instrument. Without it, tax incentive policy is only a pseudo policy" (IKPI-A, 26 October 2017).

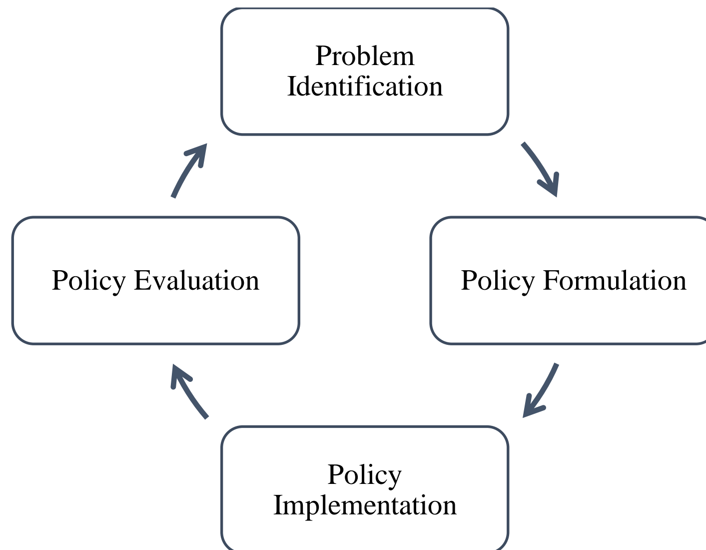
7.5 Policy Development and Administration

The previous sections have shown that the attraction of inward investment is an important policy objective of the Indonesian government and that although tax incentives are not perceived as the ultimate determinant of FDI they are still however an important locational factor, especially when implemented as part of an overall package of inward investment policy. Further, when the Indonesian government uses taxation policy it has specific policy objectives that are related to directing investment to particular sectors and/or specific locations within Indonesia. The aim of this section is to explore firstly how the Indonesian government has developed its policy of taxation incentives and secondly how it implements the policy.

7.5.1 Development of Taxation Policy

There are a number of important stages in developing public policy (Dye, 2013). Figure 7.6 shows these different stages starting from the development of the policy, which involves the identification (agenda setting) of the policy and the formulation of the policy, followed by the implementation (administration) and finally the evaluation of the policy. The evaluation of the policy may then feedback into the continual development of the policy for the future. This section focuses on the development of taxation policy for inward investors and uses the in-depth interviews with those policymakers who are directly related with taxation policy to provide a better understanding of how it has developed.

Figure 7.6: Policy Cycle



Source: Adapted from Dye (2013); Jann and Wegrich (2007).

The initial identification of taxation incentives as a policy can arise from either a 'top-down' approach set from the hierarchy of the government structure so that the institutions involved in the implementation of the policy have limited involvement with the policy agenda or alternatively a 'bottom-up' approach where policy is developed by the institutions based on the identification of issues that have been raised by the economic actors (investors). An example of a top-down approach, provided by a BKPM official, would be when President Joko Widodo as the ultimate head of government, visited BKPM for the first time after being elected in 2014 and addressed concerns regarding levels of inward investment and the need to provide policy support in the form of investment permits and tax incentives:

> "…during his visit to BKPM, the President gave an instruction to BKPM and related institutions to ease investment license processes to improve Indonesia's position in the Ease of Doing Business [ranking], which is expected to be number 40 in 2019. The President also instructed the BKPM and related institutions to support the investment realisation process, for instance land clearing, energy availability, and also appropriate incentives when it possible" (BKPM-A, 19 October 2017).

It is not however solely a top-down approach to taxation incentives policy in Indonesia, as not only do the inward investors themselves ask for incentives:

> "…when firms experience economic downturn, sometimes they come to us and ask to have some tax facilities or tax relaxation" (MoI-A, 7 November 2017),

> "…we receive proposal from business association regarding their need on tax facilities, then we mapped it based on business sector. Based on our internal analyses if we think it is appropriate then we propose a tax incentive policy proposal to Ministry of Finance through BKF …" (BKPM-A, 19 October 2017),

but the views of the investors are also taken into account across the institutions responsible for setting taxation incentives policy signifying an integrated approach to the formulation of tax incentive policy across the institutions involved in the development of tax policy:

> "…for instance, in regard to tax allowance policy, we received proposal from MoI regarding sectors that need to be supported with incentive policy. MoI itself gained the proposal from the business actors (investors). As we receive policy proposals then we will discuss it with other related institutions (Coordinating Minister of Economy, Ministry of Finance (including DGT), Indonesia Investment Coordinating Board and also technical ministry which propose the policy (i.e., MoI)" (BKF-C, 23 November 2017).

This bottom-up approach of taking into account the viewpoints of all institutions involved with the inward investors is discussed by a BKF official who notes that the Ministry of Finance gathers information from investors through the BKPM who then formulate and propose policy proposals to the BKF. The benefit of such an approach to the policy development process is that it provides justification for the use and importance of tax incentive policy (BKF-A, 2017). Overall, it can be seen that the use of tax incentives arises from various sources and that it is a mix of a top-down approach that identifies the policy objective of distributing FDI across specific sectors and locations and a bottom-up approach that identifies the demand from the investors to make taxation incentives available. More importantly it suggests that there is an integrated approach to taxation and inward investment policy across the relevant institutions.

Once a policy has been identified, the next stage involves formulating the specifics of the policy. In the case of taxation incentives the policy formulation will involve the BKPM who are responsible for overall inward investment, the National Council for SEZ who are

responsible for inward investment locating in specific locations within Indonesia and the MoI who implement the National Industrial Development Master Plan which covers taxation incentives. Further, the BKF, DGT and ultimately the Ministry of Finance will scrutinise the policy in regards to its costs and benefits, the likely strengths and weaknesses of the policy and where the "positive sides are more than negative sides than the policy proposal can be agreed to be continued" (BKPM-D, 7 November 2017). Importantly, the decision will be made collectively based on the agreement of all parties' otherwise it would not be implemented as an official regulation:

> "…only if all institutions agreed on policy proposal then it will be passed as government policy. If not, then it needs more time for the institution that proposed a policy to build justification and convince other institutions. …when all institutions have agreed on it then a policy can be signed and announced to the public" (BKF-C, 23 November 2017).

Given the greater scepticism of the Ministry of Finance officials highlighted in the previous section, including the BKF and the DGT, then a solid explanation for proposing tax incentives is needed in order to provide a clear justification for the policy and to convince the full set of policymakers:

> "…for instance, related to tax allowance, applicant proposes that investment with high number of employment (labour intensive) and also with high percentage of local content need to have tax allowance. For instance, they apply 100 employees and Rp100 billion capital as minimum requirement for a company eligible for tax allowance. In this case, MoF will challenge it justification" (BKF-C, 23 November 2017).

Ultimately, policy formulation should result in the policy becoming a legitimate policy (Dye, 2013). An important aspect of this is to include all relevant stakeholders in the process, from the top-down government policies to the bottom-up involvement of the investors. Given the above discussion it can be seen the government aims to include a range of stakeholders in the process of policy development. Overall, it could be concluded that tax incentive policy aims to be a legitimate policy given the detailed processes involved in the development stage of the policy covering the identification of the main objectives of the policy across a range of relevant stakeholders and the formulation of the policy involving a range of relevant institutions. The scrutiny placed by the Ministry of Finance and associated institutions also ensures that policy is developed in a critical manner and not just by the advocates of taxation incentives.

Finally, as might be expected given the number of potential stakeholders involved in inward investment policy, the institutions involved may not cover an exhaustive list and this is raised from the interviews with the independent Indonesia Tax Consultant Association (IKPI) where

it is suggested that some important stakeholders are omitted from the process and that others that are included may not always be relevant.

> "…it is government weaknesses. They picked-up the wrong party (association) which does not know the real problem. In this context, they did not include IKPI in the process, but they included the Chamber of Commerce. In fact, IKPI knows better about any problem in the field because we accompanied our investors' application processes. The representation from other groups such as the Chamber of Commerce does not know the daily problems when an investor applies for incentives. We suggest the government should include people or parties who experienced real process in the field …" (IKPI-A, 26 October 2017).

This criticism however seems to be specifically in the case of the relevant consultancy agencies and reflects the wide range of interested parties involved with taxation and FDI.

7.5.2 Policy Administration

Once the policy formulation has been finalised the next stage of the process is its administration and implementation, which is when the policy becomes a formal regulation with a legal basis. In the case of taxation incentives for inward investment this allows the option for an investor to gain benefits from tax exemptions or reductions (see Chapter 3 for a full discussion on taxation incentives available for inward investors). These tax incentives are not mandatory and are only obtained by an investor after a successful application. Therefore, in this sense, according to BKPM and MoI officials the taxpayer (investor) should be in an 'active mode' as they need to be aware of the policy:

> "…investor is an applicant. If they do not apply for it, they will not get one. Investors should be active …" (BKPM-D, 7 November 2017).

The decision on whether the tax incentive is to be granted or not is based on the government officials' judgement so that the policy is a discretionary policy:

> "…[the provision of tax incentives] depends on the investor's proposal. [The] investor should proactively propose it… We as a government will provide it as along as investors can fulfil the criteria" (MoI-B, 15 November 2017).

The inward investors are therefore responsible for developing a justification as to why they should receive tax incentives. It is expected that the investors should make a cost-benefit analysis that shows the benefits of providing tax incentives will exceed the costs that might occur (tax revenue forgone) as is stated by the MoI official:

> "…when an investor applies for tax incentive (tax holiday), one of the requirements to the investor is to calculate the costs and benefits of the provision of tax incentives. The investor calculates this based on our (MoI) guidance and also sometimes they can hire a consultant. The investor should be able to show, through the exemption of tax for their

> industry, it will be compensated with tax revenue from other sectors (multiplier effect). This should be provided by the investor during the tax holiday application process …" (MoI-A, 7 November 2017).

> "…they have to convince the government that they are really a pioneer industry which will give positive externalities to the Indonesian economy …" (MoI-B, 15 November 2017).

Tax incentives are therefore ultimately seen as a privilege for the investor rather than a government expectation of the investment.

Since 2015 all applications should be lodged to the BKPM (prior to 2015 applications could be made either through the BKPM or the Ministry of Industry).[44] The rationale for the change is to improve the quality of the process by making it faster, easier, inexpensive, transparent, and improving the certainty.[45] However, conversely there are a number of institutions involved in the decision of the granting of the incentive, namely the BKPM, MoF (including DGT and BKF) and the MoI. Taking the case of a typical application for a tax exemption, the investor's application will be assessed by the BKPM, the MoF (including DGT and BKF) and the MoI, in a verification committee and the members of the meeting will discuss whether or not an application will be approved. It emerges from the interviews that it is often the case in the meetings that the main institution to convince regarding the awarding of the incentive is that of the DGT (within the MoF) and that this is a particular challenge for the other institutions:

> "…in regard to BKF, we believe it has quite an open perspective, but it is difficult to convince our colleagues from DGT which may think to secure tax revenue …" (MoI-B, 15 November 2017).

Further, once a decision is made, this recommendation is passed on to the Minister of Finance who will then make the final decision so that the MoF has a crucial role in the implementation of the policy. Given that the ultimate decision on the discretionary incentive is that of the Minister of Finance this can also, in a number of cases, lead to some tensions where an application which has been discussed and approved in the verification committee meeting is not approved at the final stage:

> "…we believe that in regards to the decision regarding an investment is pioneer or not is our (Ministry of Industry) domain. When an investment based on our internal analysis is considered 'pioneer' because it brings new technology and huge economic impact, then we assume there will be no dispute and objection from other institution (MoF). However, in reality it could be rejected by other institutions which in our opinion does

[44] Minister of Finance Regulation number 130 year 2011 in conjunction with number 192 year 2014 concerning the Provision of Facilities for Exemption or Reduction of Corporate Tax Income

[45] See Presidential Regulation number 97 year 2014 concerning The Implementation of One Stop Service. Further technical regulation based on Minister of Finance Regulation number 258/PMK.011/2014; Head of BKPM Regulations number 8 year 2015 and 13 year 2015.

> not fully understand the technical aspect. Even though we certainly know that tax holiday provision is in the Minister of Finance hands. But still we cannot understand (accept) when a three lateral meeting has agreed on something but then the decision is the opposite …" (MoI-A, 7 November 2017).

A similar story is also expressed by a BKPM official who states that he is not always confident enough to promote to an investor that they will be eligible to have tax exemptions:

> "…there was a case of a tax holiday which had been approved by the verification committee (such a three-lateral meeting). The meeting has agreed that the company will be eligible to get a tax holiday. The Minister of Industry had sent a letter to explain that the committee agreed to provide a tax holiday. But unfortunately, a year later when the decision came it was totally different, it is rejected. We are ashamed to the investor as previously we had indicated that they will receive tax holiday …" (BKPM-B, 24 October 2017).

Ultimately this leads to issues with promoting the taxation incentives, as BKPM officers have learned from their experience so that they now provide limited assurances regarding tax incentives given that the final decision can be uncertain:

> "…it seems our language to investors does not promote investment in Indonesia, but that is the fact. We cannot provide assurances for something that we cannot hold for sure. In our activities in BKPM, we heard that legal certainty is a serious issue in Indonesia …" (BKPM-B, 24 October 2017).

Overall, the above process shows that although a range of policymakers and institutions are involved with the development of tax incentive policy, in essence the implementation of the policy is ultimately the decision of central government through the Minister of Finance. Further, the MoF play a crucial role in all stages of the development and administration of tax incentive policy so that although it appears that there is an integrated approach to tax policy across the institutions in practice the ultimate decision rests with the Minister of Finance:

> "…the decision regarding tax facilities (especially tax holiday) is decided by the Minister of Finance based on analysis of BKF and other institutions recommendation. We believe that the MoF has the ability to see the Indonesian economy in a broader and holistic point of view. MoF will not take decision for the sake of protecting state revenue" (MoF-A, 28 November 2017).

Given the relatively limited importance placed on tax incentive policy by the MoF, as seen in section 7.4.3 above, this may have implications for the role that tax incentives play in overall inward investment policy in Indonesia.

7.6 Policy Evaluation and Future Directions

The future existence and modification of a policy is based on the monitoring and evaluation of the current policy. This section focuses on the monitoring and evaluation process of tax

incentive policy in Indonesia and subsequently presents policymakers insights on future directions for the policy.

7.6.1 Monitoring and Evaluation

Monitoring and evaluation are the final stages in the policymaking process, which involves whether or not policies are achieving their stated goals and if so at what cost and with what intended and unintended consequences (Dye, 2013). However, what emerges from the in-depth interviews across all the institutions that are involved in the process of tax incentive policy is that the monitoring and evaluation process is relatively simple and crude, so that there is no sophisticated procedure for conducting the evaluation of the incentives.

Monitoring of tax incentives in Indonesia is conducted every two to three years, but there is no clear standard as to this timeline and instead it is an informal process:

> "…every 2 years for tax allowance and 3 years for tax holiday. [DGT head office] also requests monitoring to be undertaken by the tax office in each location. We normally ask local tax offices to check whether or not tax incentives facilities have been utilised by investors. We also sometimes do a field visit to local tax offices to check the fulfilment of tax obligations by investors who gained tax incentive facilities" (DGT-B, 16 November 2017).

Further, the BKPM official stated that there is no explicit requirement that provides a mandate for BKPM to monitor the effectiveness of tax incentive policy, but instead only when the investment is of a large magnitude will they check the process and in general even this is unlikely to happen:

> "…there is no such explicit regulations which require us to conduct monitoring for tax incentives provision. We do conduct monitoring in more general terms in regards to investment realisation (whether there is an execution on land location, machinery, etc.) ... we might also look at number of foreign workers employed. So, it seems we have more general monitoring on investment realization, instead of tax incentives provision and execution …" (BKPM-B, 24 October 2017).

As the Ministry of Finance and associated institutions within the Ministry (such as the DGT) are ultimately controlling the tax incentives process then from the point of view of the BKPM they should also be central in the monitoring of the policy:

> "…in monitoring the provision of tax incentives, surely DGT has the authority to do that, especially when it comes to tax incentives execution. It is because, when an investor utilises a tax incentive 'voucher' (stipulation decision letter '*surat keputusan penetapan*'), then it should be predetermined through a tax audit conducted by the DGT tax office …" (BKPM-D, 7 November 2017).

However, even the formal monitoring process from the DGT who are responsible for tax audits takes an informal manner and in essence only confirms the eligibility of the company to start utilizing their tax incentives facilities:

> "…we normally just monitor the number of tax incentive certificates that have been issued (stipulation decision letter) and compare with the number of tax incentive certificates that are finally executed (utilization decision letter based on audit results regarding the starting point of the company commercially operating)" (DGT-B, 16 November 2017).

In essence, the main emphasis of the monitoring process is to therefore to examine the different types of tax incentives that are offered and are utilised by the inward investors.

The type of tax incentives most frequently provided and monitored are those that relate to exemptions on import duty rather than tax allowances and tax holidays:

> "…since the implementation of Minister of Finance regulation number PMK-159/2015 which regulates that any application for tax holiday should be submitted via BKPM only [before that applicants could choose to submit it either via MoI or BKPM] …up to now we have not received a single tax holiday application" (BKPM-B, 24 October 2017).

The question that arises from this is why is it the case that there are such small numbers applying for tax allowances and holidays? A senior BKPM official argues that the low number of investors applying for a tax holiday might be because the investors do not know about this incentive, or that they know about the provision of a tax holiday but because in the early stages of the investment they might experience losses a tax holiday will not provide any additional benefit to the firm (BKPM-D, 7 November 2017).[46] Alternatively, another reason might due to the scepticism the investors have regarding a successful application and the length of time taken to reach a decision regarding the application. It suggests that the efficiency of the process has implications on the successful implementation of the scheme.

This leads to issues relating to the evaluation of the scheme. The boundary between monitoring and evaluation of tax incentives is however blurred as tax incentives are mainly evaluated through looking at the number of investors applying for incentives and further the number applying within a particular sector. For example, if there is no application for tax incentives from a particular sector, even though according to government regulations the sector is on the list eligible to apply for the policy, then it emerges from the interviews that a consequence of this is that it will be recommended that the sector should no longer be eligible for the policy:

> "… in evaluating the effectiveness of the tax incentive policy, we review how many investors actually utilise tax incentives. Because in fact out of many sectors on the list

[46] This argument is confirmed with Tax Expenditure Report 2016-17, p. 86 (BKF, 2018).

> there are many of them that receive no application. In this case, we generally propose to eliminate these sectors from the list. We expect that sectors in the list are those sectors that really attract investors preference" (DGT-B, 16 November 2017).

The statement provided by DGT is echoed by an official from the MoI, but who also stated that too many applications from a particular sector would lead to changes to the policy:

> "…however, when the opposite occurs, too many applicants apply for one sector, then we also propose to delete it. It is because we do not want all investment going to one (few) sectors only. We [also] believe tax incentives is an instrument for improving the equality among regions (MoI-B, 15 November 2017).

The above does suggest however that the monitoring and evaluation of tax incentives is indirectly related to the aims of taxation incentives and overall inward investment policy in that importance is placed on specific sectors of the economy and redistribution of economic activity across the regions of Indonesia.

Evaluating policy through monitoring the number of investors across sectors and regions who apply for tax incentives and are granted the incentives is not however a comprehensive evaluation of the policy. With regards to policy evaluation, Dye (2013) argues that evaluation should be focused on the impact of the policy instead of just the output of the policy. However, based on the in-depth interviews it is apparent that there is no such evaluation that looks at the impact of tax incentive policy on inward investment in Indonesia. Indeed, the policymakers acknowledge there is no such specific evaluation which in itself has a clear message about the impact of the policy:

> "… a holistic impact evaluation - it seems not yet…so far we look at whether or not a new firm can make import-substitution products so that we can save our foreign exchange…but for multiplier effects we have not done it yet…certainly we would like to reach that level in the future" (BKF-C, 23 November 2017).

> "…we do have some concerns about this policy impact. We also would like to know…but to be honest we do not have this kind of impact analysis. We will ask our counterpart (i.e., Sub-Directorate of Tax Policy Impact) to conduct the analysis…" (DGT-B, 16 November 2017).

Therefore, the decision to maintain or remove tax incentives as a formal policy mechanism does not depend upon any formal evaluation mechanism but rather rests mainly with the decision of the central government. One of the respondents argues that the existence of tax incentives depends on the government's decision for such a policy, which in turn is linked to the general economic environment. As this is changing dynamically therefore so is tax policy is as well:

> "…the existence of tax incentives is a response to the economic environment. As the economic environment dynamically changes then tax incentive policy should follow this. It might be the acceleration of one sector is considered enough, therefore tax

> incentives might not necessarily be needed then we propose to eliminate it. Then tax incentives might be needed in other sectors" (BKF-A, 3 November 2017).

This also explains why the current evaluation mechanism acts as more of a data collection exercise rather than a process that inputs into a comprehensive evaluation mechanism. Given the absence of any formal evaluation mechanism in the Indonesian government, the in-depth interviews of the policymakers have therefore provided an important approach to evaluating taxation policy of inward investment in Indonesia.

7.6.2 Future Policy Directions

As government officers, the respondents (excluding those in the IKPI) have to implement government regulations. It is unlikely therefore that a government officer will be willing to challenge government regulations as they are all part of the government framework. However, as an individual they may have some thoughts and insights about how to improve tax incentive policy arrangement in the future. These responses regarding the future policy directions that arose from the interviews are now explored.

The first issue to arise was based on having clear policy objectives and clear measurements of achievement. There should be a clearly defined objective to the policy, where BKF-B (2017) argues that "target (criteria) that need to be achieved from a policy should be clearly defined in the beginning". This in turn is important for evaluation as a clear target will make it easier for the government to evaluate its policy. The evaluation of tax incentive policy should therefore be more clearly focused on the benefits and costs and provide a holistic assessment, where a holistic evaluation means that the evaluation does not only look at the value of tax forgone but also the potential benefits of the investment (multiplier effect of investment) for instance: creating employment and developing backward linkages (i.e., raw material suppliers) and forward linkages (i.e., transportation and logistics industries). With regards to taxation, if the government provides a company with a tax holiday for a certain period of time, the government might lose corporate income tax, however the government still gains other taxes in the form of personal income tax (employees' tax) and also Value Added Tax. Additionally, if the company grows there will be a multiplier effect for backward and forward business activities:

> "…we should not be always thinking about short run revenue, we need to think about the long-term period because there are no industries that can be built within one or two years... Our problem actually is government revenue system which very much rely on tax revenue. Any policy which potentially reduces tax, will be opposed or rejected. However, this silent thought has never come out as each institution has rules of thumb:

> ‘be focus on your own tasks and duties’ …as an outspoken comment will make the official in awkward situation…” (MoI-B, 15 November 2017).

Integral to a formal cost-benefit analysis of tax incentive policy is the need to create better tax expenditure reports so that the government can show how much costs or budget is assigned to tax incentives. Of course, the challenge will be the capability to implement this and have the availability of data to support the evaluation.

> “Frankly speaking regarding holistic evaluation that you asked me, we don’t have it for now…” (BKF-C, 23 November 2017).

Secondly, policymakers from the BKPM, SEZ, and MoI would like to see a more simple application mechanism regarding tax incentives and some relaxation on the requirements placed on investors in order to receive incentives. In particular, decisions should be made in the early stage of an investment application so that investors know whether or not they receive the incentive prior to locating in Indonesia. Further, it should be easier to get the approval and any monitoring of the investor can be carried out subsequent to the investment:

> “…we expect the provision of tax incentives, for instance, tax allowance can be based on a ‘check list’. As long as the applicant is fulfilling the list of requirements then they can be guaranteed to be eligible to get the tax allowance. The government can then make a post-audit afterward, for instance, just before the firm starts to claim its tax incentive provision…” (BKPM-B, 24 October 2017).

Regarding the existence of tax incentives, the majority of the interviews demonstrated that it is the belief of the policymakers that tax policy should not be withdrawn. The issue of a ‘race to the bottom’ situation regarding taxation incentives was however raised, where this relates to the use of tax policy as a response to other countries implementing such a policy. This is expressed by a BKPM official, who argues that no one country is isolated from other countries influences so that the actions of other countries has consequences for Indonesia. For example, the statutory corporate income tax rate before 2008 in Indonesia was 35% but after 2010 decreased to 25% as a response to a fall in other local countries tax rates (BKPM-D, 7 November 2017). Instead, tax policy should be based on the national interest, where the BKPM official referred back to 1984 when Indonesia acting on the recommendation of World Bank eliminated all tax incentives (BKPM-D, 2017). However, the impact of a ‘race to the bottom’ scenario was countered by DGT officials who stated that tax incentive policy is unlikely to create a race to the bottom policy because it is not the main factor influencing investors’ decisions:

> “…if tax incentives do really matter and Indonesia has continually opened up this incentive widely, then it should be that many investors apply for it and utilise this

> incentive. But in fact, still very small numbers of investors utilise it" (DGT-B, 16 November 2017).

Furthermore, the respondent stated that:

> "…as far as I am concerned, the reason for tax incentive policy is because Indonesia would like to support the development of certain sectors or region. I never experienced that the government makes a policy in response to other country moves" (DGT-B, 16 November 2017).

Finally, a number of reasons were provided regarding why tax incentive policy should be maintained and these are summarised in Table 7.3.

Table 7.2: The Rationales for Keeping Tax Incentive Policy

Rational	Statement/motivation
Reactive response	"we offer tax incentive, as other countries do" (BKPM-B; MoI-A; MoI-B; SEZ-A)
Client demand	"investors normally ask what government can offer if they invest in Indonesia" (BKPM-D; IIPC-A)
Pragmatism	"this policy is the only thing that we can do within the time-frame" (MoI-A; MoF-B)
Esprit de corps	"as part of government we have to support other government institutions" (MoI-B; DGT-B)
Legal basis	"tax incentive is mandated by taxes law and investment law" (DGT-B; BKPM-D)
Macroeconomic point of view	"we can see the big picture on what the country need" (MoF-A; MoF-B)
Redistribution of activity	"we can map and figure out what sector or region that need foreign investment to accelerate its development" (BKF-A; BKF-C; MoF-B)

Source: In-depth interviews with the author, 2017-18.

Overall, tax incentives exist because of the investors demand for them, because other countries also provide similar offers to investors, it is a type of policy within the government's scope so is a pragmatism decision as it is proposed amongst government institutions then it seems difficult to make strong objections without solid evidence. Further, tax incentives are embedded in Indonesian law and as long as tax incentives are part of national economic policy then the policymakers will be able to use it as an option for inward investment policy. More positively, tax incentive policy should be maintained as it supports crucial government intervention in the economy through active fiscal stimulus (i.e., tax incentives) and is important to help redistribute economic activity among regions and sectors of the economy so plays a role in the overall aims of inward investment policy.

7.7 Conclusions

This chapter has presented policymakers' view of inward investment and tax incentive policies in Indonesia. In general, policymakers believe that inward FDI is primarily important to enhance industrial development, which in turn is expected to increase economic growth. Further, the creation of new employment and capital are seen to be important aspects of FDI, and the transfer of knowledge and technology from foreign investors to local firms will also improve the long-term outlook of the Indonesian economy. Given the important role of FDI for Indonesia, the policymakers subsequently provided their views on the main factors that are thought to influence this investment to Indonesia, which are infrastructure, good governance of institutions, market size, legal certainty, the availability of natural resources, political and economic stability, and the availability of labour resources. However, policies relating to tax incentives were not among these main inward investment factors. Despite this, policymakers do believe that taxation incentives can make a difference to FDI location, especially for those investors that are choosing between locations with similar levels of the more fundamental location determinants that are listed above.

Even though tax incentives are not listed amongst the most important factors for attracting FDI the government of Indonesia does utilise them. From the overall range of reasons provided it suggests there is limited belief in the benefits of taxation to attract FDI, but rather tax policies are used because they are relatively easy to implement and marketable, as well as being used elsewhere and 'expected' by investors. Again, it suggests that the tax policy is seen as more of a secondary approach to attract FDI compared to the range of factors highlighted above, and that are thought by policymakers to more significantly impact on the location decision.

Nevertheless, in many cases taxation policy is still thought to impact on FDI location. Further, taxation incentives have specific aims to fulfil in relation to overall investment policy. For example, tax incentives may be able to attract new investment to 'pioneering' industries, as well as improve the distribution of economic activity in Indonesia that is currently concentrated on Java Island. Taxation incentives are also considered effective when used as complementary to other incentives and are thought to provide a means for signalling government preferences for the preferential treatment of certain sectors or regions.

The existence of a tax incentive policy and the specific objectives of such a policy suggests that the institutions believe that these instruments are important for attracting FDI. However, across

the institutions there are differing views on the importance of tax policy with both strong and mild supporters. These range from strong support from the inward investment agency, BKPM, to more critical views on taxation incentives from the Ministry of Finance and their associated institutions. As such, there is conflict between the investment promotion agencies that believe tax incentives are an important tool for attracting FDI and the institutions who are responsible for justifying their fiscal aims, and who believe that attracting FDI is more complex than simply offering specific or general forms of incentive.

The range of Indonesian institutions involved in taxation policy may impact on its development. An integrated approach to developing tax policy across institutions would provide an open and 'joined-up' response to developing policy, and the interviews reveal that there is a high level of communication across the institutions. Indeed, the policymakers believe that each institution has equal opportunities to present and defend their policy proposal. After a policy is approved and launched, the next stage is the implementation of the policy, but at this stage of the process the institutions are no longer considered as equal. In general, the policymakers argue that the Ministry of Finance is more powerful, and that it is responsible for the final decision on the tax incentives. It can lead to a situation where some policymakers feel powerless when they need to utilise tax incentives for inward investment. Further, given the relatively limited importance placed on tax incentive policy by the Ministry of Finance, this may have implications for the role that tax incentives play in overall inward investment policy in Indonesia.

The success of the tax incentive policy can only be achieved if there is a successful monitoring and evaluation process, but with regard to this it seems the policymakers do not have a clear understanding about the success of the tax incentive policy. The evaluation process is relatively limited and it is mainly based on the number of investors who apply for tax incentives and how many of them are finally granted the incentives (i.e., input measures). From the interviews with the policymakers the main government evaluations that have occurred are indirectly related to the aims of taxation incentives and inward investment policy, in that importance is placed on specific sectors of the economy and the redistribution of economic activity across the regions of Indonesia. Further, there is in general no clear and standard procedure for conducting the monitoring and evaluation of tax policy, and no comprehensive and holistic evaluation on the impact of the incentives, so that these evaluations are partial and limited.

What is clear, however, through the policymakers' thoughts on the overall tax incentives and its relation to inward investment is that although tax incentives are not the most important policy

aspect, none of the policymakers propose the elimination of tax incentives. Indeed, in essence they believe that the tax incentives are important to, amongst other reasons, help redistribute economic activity among regions and sectors of the economy, and so play an important role in the overall aims of inward investment policy. Although in term of effectiveness, tax incentive policy may still be questionable, given the absence of any formal evaluation mechanism in the Indonesian government, the interviews with the policymakers provide an important approach to evaluating taxation policy in relation to foreign direct investment in Indonesia.

Chapter 8. Conclusions and Recommendations

8.1 Introduction

Foreign Direct Investment (FDI) has received a great deal of attention and many countries have sought to attract it, including through the provision of tax incentives for investment (World Bank, 2018a). While researchers have attempted to establish the link between the incentives and FDI location, the results are not conclusive, so that the debate is ongoing. In the case of Indonesia, FDI is vital to supplement domestic investment, which is much smaller. It has long-used tax incentives, and as such, it is important to understand the role of these incentives. This research is carried out to establish their effect on FDI location in Indonesia. Mixed methods are used in the thesis that comprise a large-scale questionnaire survey of foreign investors and in-depth interviews with policymakers, supported by a complementary document analysis.

This thesis explores the characteristics of FDI in Indonesia and the factors that underlie its location. Specifically, it explores the motivations for FDI and tax incentive policy from the perspective of both foreign investors and policymakers. The purpose is to understand the effect of the tax incentives in influencing a foreign investor's decision about its investment location. Of course, policymakers have their own beliefs, interests and goals, that operate in a highly constrained and politically strategic environment (de-Mesquita, 2016). The aim of the thesis is therefore to gain a better understanding on how policymakers perceive the effectiveness of the tax incentives and the reasons for their continuance. Unlike some existing research that focuses on the econometric relationship between FDI location and tax incentives, the thesis emphasizes the issues of 'why' and 'how' the tax incentives work, or do not.

8.2 Main Findings and Research Contributions

This conclusion presents an explanation of the results and its contributions in relation to the research aims that are set out in Chapter 1. There are three aims, as follows, and the findings are discussed in relation to each of these, in the following subsections:

AIM I: To examine the characteristics and factors influencing FDI location in Indonesia, and by comparing Special Areas (SAs) and Non-Special Areas (Non-SAs).

AIM II: To examine the role of tax incentives in influencing FDI location based on the perspectives of the foreign investors.

AIM III: To examine the role of tax incentives in attracting FDI inflows into Indonesia from the policymakers' point of view.

8.2.1 AIM I: Characteristics and the Factors Influencing FDI Location

This part summarises the results on the characteristics and factors that influence FDI location (AIM I). Regarding the characteristics of FDI inflows in Indonesia, my findings are based on the results of the questionnaire survey carried out in 2017. A distinction is made between the investments located in the Special Areas (SAs) and Non-Special Areas (Non-SAs), which is an important contribution to the existing literature. SAs are designated areas for investment that receive preferential treatment in the form of tax and non-tax incentives. There are many types of SA, comprising: a Bonded Zone (BZ); a Free Trade Zone (FTZ); and a Special Economic Zone (SEZ). Forty-three percent of the respondents to the questionnaire survey are located in SAs (97 of 224 respondents), of which one-third are in Batam (the dominant FTZ in Indonesia). The Non-SAs are areas outside the SAs that do not have specific privileges. Overall, 78 percent of foreign taxpayers (28,357 of 36,374 cases) are located on Java Island, which is the most densely populated island in Indonesia. It is useful to understand the different characteristics of FDI inflows in these two distinct locations. Table 8.1 encapsulates the characteristics of the FDI that locates in the SAs and Non-SAs, based on the results form the survey. To my knowledge, the characteristics of and the factors influencing FDI location based on comparison between the SAs and Non-SAs has not previously been carried out in an Indonesian context.

Table 8.1: FDI Characteristics in the SAs and Non-SAs

Criteria	Main Characteristics	
	SAs	Non-SAs
1. FDI motive	Resource-seeking; Efficiency-seeking	Market-seeking; Resource-seeking
2. Output market	International (exports)	Domestic (local and national)
3. Input material	International (imports)	Domestic (local and national)
4. Competitor	International firms	Domestic firms
5. Transport mode	Sea	Road
6. Employment	Predominantly local people; majority employs > 500 people	Predominantly local people; majority employs < 500 people
7. Business sector	Manufacturing	Manufacturing and services
8. Investor origin	Asia (South Korea, Singapore, Japan)	Asia (Japan, South Korea, Singapore)
9. Regional location	BZ / FTZ (Java and Sumatera)	All over, but predominantly Java
10. Tax incentive included:		
a. Appraisal	Yes	Yes
b. Negotiation	No	No
11. CIT rate included in:		
a. Investment decision	Important	Important and stronger than SAs
b. Investment appraisal	Predominantly include it	Relatively higher than SAs
12. Tax incentive type	Indirect taxes. Imports duties, VAT, LGST and Income Tax	Direct taxes. CIT rate reduction
13. Business environment	Predominantly better off	Relatively less than SAs

Source: Summarised from Appendix Table A.6.1 - Questionnaire Survey 2017.
Notes: Table shows the predominant characteristics of FDI in the Special Areas (SAs) and elsewhere. BZ = Bonded Zone; FTZ = Free Trade Zone; CIT = Corporate Income Tax; VAT = Value Added Tax; LGST = Luxury Goods Sales Tax.

Table 8.1 shows important differences in the main characteristics of FDI according to whether it is located in the SAs or in Non-SAs. Starting with the SAs, the questionnaire survey reveals that the main motivation for foreign investment is resource-seeking, and specifically to benefit from the availability of cheap labour. This investment motive seems plausible when it is linked with the target market of foreign investors in the SAs. In general, the survey shows that **output market** orientation of foreign investments in SAs is international markets. The survey reveals about three-quarters (72 percent) of investors in the SAs sell their product in the international market (i.e., exports). The resource-seeking motive makes sense since international markets are highly competitive, so that foreign investors must be able to produce output at a low price

compared to their international competitors. Locating in areas with relatively cheap labour is a strategy to maintain low production costs and generate more competitive price. Interestingly when it focuses on input materials, the questionnaire survey reveals foreign investors in the SAs rely on imported **input materials.** This may occur because of the unavailability of input materials domestically or because foreign investors in the SAs do not face duties and receive exemption from taxes when importing capital and materials for production activities.

The main motivation of foreign investors to locate outside the SAs (i.e., Non-SAs) is market-seeking. This finding is unsurprising as Indonesia is the fourth most-populous country in the world with around 260 million inhabitants in 2017 that represents a huge market potential for investors. The market-seeking motive of investors in the Non-SAs is further confirmed by the survey results on the output market. This shows that 79 percent of output produced by foreign firms in Non-SAs is for the domestic market, either local or national. Further, unlike the SAs, most of inputs for investments in the Non-SAs (63 percent) is sourced from domestic markets, either local or national. Consistent with this, in terms of the business competitors of the foreign investors in the SAs and Non-SAs, Table 8.1 shows that investors in the SAs face **competition** in international markets, whereas in the Non-SAs it is from national or local markets for both inputs and outputs. As such, as the main mode for shifting its products firms located in the SAs that mainly focus on exports use sea transport, whereas in the Non-SAs it is roads, which again is not surprising since most FDI in the Non-SAs is located on Java Island.

With regard to the employment size of the plants, FDI that is located in the SAs is generally larger compared with that in the Non-SAs. The questionnaire survey shows that about a half of the respondents in the SAs (52 percent) employ more than 500 people, whereas for FDI in the Non-SAs a majority (about 70 percent) employ less than 500 people. FDI in both the SAs and Non-SAs predominately employs local people over foreign workers. However, it needs to be noted that the questionnaire survey reveals that the employees are lower skilled, so that they are either unskilled (about 50 percent) or technically-skilled only (almost 40 percent).

The foreign investments in the SAs are predominantly in the manufacturing sector, but for the Non-SAs it is both manufacturing and services. This reflects the incentives of the SAs for the import of materials, and the greater importance of local and national markets outside the SAs. The dominant origin for the foreign investors is Asia, i.e., Singapore, Japan and South Korea, but the reasons for this differ across these three countries. The different order of these by the three countries in Table 8.1 shows the descending proportion by country of origin. This is based

on questionnaire survey data, but it is similar to the actual share of total FDI inflow for 2005-17: Singapore has 23.6% share to total value of FDI, followed with Japan (11.3%), and South Korea is fourth ranked with 5.1% (Table 4.5). Japanese FDI has a long history in Indonesia, and it began when Indonesia received loan aid from Japan's Official Development Assistance. In the 1980s its purpose was import-substitution and it was set up to serve the large, domestic market (Kinoshita, 1986; Thee, 1994). Japanese FDI is dominant in the automotive sector and it has more than 90 percent of the domestic market share (Irawati and Rutten, 2011).

Important for inward FDI from Singapore was the agreement of the Indonesia and Singapore governments in 1989 to develop the Batamindo Industrial Park on Batam as a centre for the electrical and electronics manufacturing industries (van-Grunsven and Hutchinson, 2017). This was influenced by the geographical proximity of Batam to Singapore, as well as by land availability and low labour costs (van-Campenhout and de Graaf, 2013; Ho, 2011), and it is in line with the government of Singapore plan to relocate industry. There is a view that Batam is a backyard for Singaporean investment, where they establish the plant or warehouse in Batam, and head office or marketing in Singapore (Wulandari, 2012). The questionnaire survey shows the main factor influencing foreign investments in Batam is its geographical location (88% of respondents). Batam is a SA and it gained the status of an FTZ in 2009. In the 1990s, Indonesia was the largest recipient of South Korean FDI in the ASEAN countries, with two-thirds of all outward Korean FDI in footwear and more than a quarter of it in apparel and in textiles. This is due to the low labour costs in Indonesia (Lindblad, 2000).

The questionnaire survey reveals the use of **tax incentives** as part of investment appraisal and negotiation for investment decision is quite similar between FDI in the SAs and Non-SAs. Just over a half of investors in SAs include tax incentives in their investment appraisal, which is slightly greater than for the Non-SAs. However, more than two-thirds of foreign investors do not consider tax incentives as important, and only about a quarter acknowledged that they used it when negotiating their plan to invest with the government. With regard to ongoing business activity, the survey reveals that the majority (almost 87%) of foreign investments consider the Corporate Income Tax (CIT), which is a direct tax imposed on company income, as important to their investment decisions, with about 59% of them valuing it as very important. Foreign investors in the Non-SAs put a greater value on the CIT rate compared with those in the SAs. The importance of the CIT rate is demonstrated when it comes to investment appraisal, as three-quarters of foreign investors include it in these appraisals. This is slightly higher for the Non-SAs compared to the SAs, at 77% and 71% respectively.

With regard to the type of tax incentive during the establishment of the foreign plant, the survey reveals that indirect tax advantages that are related to imports (i.e., import duties, VAT, LGST and Income Tax Article 22) are considered as the most important tax incentive by more than two-thirds of respondents in the SAs. A CIT rate reduction is the second most important tax incentive, but selected by just one-fifth of respondents. However, nearly a half of foreign firms in the Non-SAs believe that CIT rate reduction is the most important tax incentive, followed by tax allowances, with around 20 percent of respondents. A similar pattern exists for the tax incentives received after the establishment, and this shows that automatic tax incentives (i.e., indirect tax advantages and a CIT rate reduction) are generally favoured over discretionary tax incentives (i.e., tax holiday and tax allowance), which are based on a subjective judgement by the policymaker. Interestingly, for foreign investors in the Non-SAs, which considered tax allowances as the second important tax incentives during the initial establishment, their view changes to other types of tax measure after establishment, such as the easiness of a VAT refund, import duties and tax amnesties, which are automatic and available to everyone. It supports the view that automatic non-targeted tax incentives are highly valued by taxpayers (DGT-A, 19 October 2017), while targeted and discretionary tax incentives have a low take-up.

The above FDI location pattern between the SAs and Non-SAs is consistent with the classical factors, but also with the eclectic or ‘OLI’ paradigm of Dunning (1977, 2000). However, there are other theories of FDI, including the agglomeration economies and institutional approaches, and these also help explain some of the FDI location behaviour in Indonesia. These approaches try to explain location in terms of non-tax factors, such as the ‘easiness of doing business’ or infrastructure (Table 8.1, point 13). According to James (2013) they are a prerequisite for the tax incentives to be effective. Our main results in terms of these are as follows.

Apart from classical location factor as explain early consisting labour resources, market size, natural resources and taxes, there is also advantages from the location of firms being close to other firms, which are the so-called **agglomeration economies**. In simple way, agglomeration is a concentration of firms in cities or industrial clusters due to factors such as abundant labour that creates a pool of workers, quality of infrastructure and geographical distance that reduces the logistic and transportation cost as many input factors or market are nearby. These could all be factors for attracting firms to reside in an area, which then attracts other firms to locate in the same area, and creates a self-perpetuating build-up of FDI (Jones and Wren, 2006).

Based on existing research it is evident that agglomeration economies occur in Indonesia in terms of labour market pooling and quality infrastructure (Henderson and Kuncoro, 1996; Arhansya, 2010). Indeed, the questionnaire survey reveals that foreign investors locate in the SAs and Non-SAs because of labour availability, and that good physical infrastructure is also a factor (Table 6.15). If anything, these are valued higher in the SAs, which may be related to these being designed to support the development of centres for investment location (Widodo, 2013). Therefore, it is unsurprisingly that well-established SAs such as Batam become a self-perpetuating location for FDI, although newly-created SEZs outside Java might not yet fulfil the criteria for agglomeration economies. In the case of Batam, the questionnaire survey also reveals that foreign investors locate there because of its geographical proximity to Singapore.

The 'ease of doing business' is a proxy for the **institutional quality** and governance, and the questionnaire survey results show that in relation to the initial plant establishment, the foreign investors in the SAs have a better level of satisfaction than the Non-SAs. On specific matters, more than half of respondents in Non-SAs are unsatisfied, such as obtaining a construction permit or dealing with public officials. With regard to taxation, investors experience difficulties with the complexity of regulations, which to a lesser extent is also the case for local government and the BKPM, the central government institution responsible for designing investment policy. For local government, the main issue is unreasonable delays in administration (i.e., 'red tape'), which to a lesser degree is also the case for the BKPM and DGT, the institution responsible for collecting and administrating tax payment. A general problem across all institutions is a lack of communication skills, which may affect the ability of government officers to effectively disseminate regulations. A lack of consistency in decision making and poor dispute resolution were issues specific to the DGT. With regard to the construction permits, which are issued by the local government for buildings or plants, it makes sense that foreign investors in the SAs are less dissatisfied with these, since these are areas designated for investment and they are administered by specific bodies, such as the National Council and Administrator for the SEZs, the Batam FTZ Authority and the Bonded Zone Authority.

8.2.2 AIM II: The Role of Tax Incentives Based on Investor Perspectives

This section considers the findings with respect to AIM II, which is an understanding of the role of tax incentives on the FDI location decision, but again from the perspective of the foreign

investor. Table 8.2 summarises the role of tax incentives both from initial investment decision and after establishment, and by again by comparing investors in the SAs and Non-SAs.

Table 8.2: The Role of Tax Incentives on the Investment Decision: Investor Perspectives

Criteria	Foreign Investor Perspective in:	
	SAs	Non-SAs
Initial investment decision	Included in appraisal, not included in negotiation	Included in appraisal, not included in negotiation
At establishment: a. dominant type b. the most important	Indirect tax (taxes related to import and duties exemption)	Direct tax (CIT rate reduction)
After establishment: a. dominant type b. the most important	Indirect tax (taxes related to import and duties exemption)	Direct tax (CIT rate reduction)
Role of tax incentives and CIT rate	Broadly similar	Broadly similar
Tax incentives preference	Indirect tax advantages for import of capital and materials	Automatic and non-targeted (i.e., CIT rate reduction)

Source: Summarised from Appendix Table A.6.1 - Questionnaire Survey 2017.

As noted previously in Subsection 8.2.1, Table 8.2 shows that at the initial stage of investment, the majority of investors include tax incentives in their investment appraisal, but then when it comes to investment negotiation with the government most of them do not consider it as a factor that affects their investment decision. These are the case for investments in both the SAs and Non-SAs (Table 6.16). Looking at the degree of association between the inclusion of the tax incentives in investment appraisal and its use in the negotiation process a Chi-Square test shows that they have a significant positive correlation across investors (Table 6.17).

Focusing on tax incentives received at the time of **plant establishment**, as noted previously, the survey reveals that a majority of foreign investors in the SAs (58 percent) have received indirect tax incentives (Appendix Table A.6.1, Q-4.9), whereas it is smaller for the Non-SAs (46 percent). The survey shows that CIT rate reduction is claimed by the largest proportion of investors in the Non-SAs (26 percent). As regards the most important tax incentive, amongst those that have received an incentive, indirect tax incentives are most important for the foreign

investors in SAs and the CIT rate reduction for those in the Non-SAs (Appendix Table A.6.1, Q-4.10). **After the establishment**, the questionnaire survey results show similar pattern, as most foreign investors in SAs have received indirect tax incentives and the CIT rate reduction in the Non-SAs. Similar results are also obtained for the investors' preferences.

Interestingly, after the plant establishment the number of foreign investors who received tax incentives is much lower and their importance is also lower (Table 6.19). This seems logical, as the plant start-up costs are likely to be considerable and before the plant has generated any income. In general, foreign investors believe that tax incentives are most important at the plant establishment, although for those plants located in the Non-SAs the opposite is the case. This might because these plants are much smaller in scale and so have smaller start-up costs. It is reflected in the low interest of investors in applying for tax incentives after their establishment. Indeed, the majority of respondents state that they have never applied for a tax incentive in the last few years, at 85 and 75 percent for SAs and Non-SAs (Appendix Table A.6.1, Q-5.6).

This seems to contradict the previous results where many foreign investors acknowledge they had received tax incentives, but here most of them state that they had never applied for it. This is because they are referring to discretionary assistance, whereas it is important to understand that the CIT rate reduction is a general and automatic tax incentive (for example, for gross sales from 4.8 billion up to 50 billion rupiah, firms are eligible for 50% CIT rate reduction). As the reason for this, almost two-thirds of respondents to the survey (who expressed an opinion) state that they were not aware of the tax incentives (Appendix Table A.6.1, Q-5.7). It may be linked to the difficulties of dealing with institutions, such as weak communication, or the complexity of regulations, which increases uncertainty (Kreye, 2019; van der Vorst and Beulens, 2002; Davis, 1993). Regulatory complexity is perceived as a major issue by investors when dealing with government institutions, and especially the tax authority (Appendix Table A.6.1, Q-6.7). Indeed, the number of tax holidays granted by the Indonesian government to foreign investors over 2012-16 is only six and there are 93 tax allowance cases over 2007-17 (BKPM internal data, as of 19 October 2017). This compares with the 36,000 foreign taxpayers registered in Indonesia at 2017.

Comparing the importance of the tax incentives (including the reduction in the CIT rate) with the CIT rate itself on the investment decision, the questionnaire survey reveals that the foreign investors in the SAs and Non-SAs consider these to be equally important, at about two-thirds. Meanwhile, 15 percent argue that tax incentives are less important than the CIT rate, and 11

percent state the opposite. Interestingly, if we look back to the year 1984 when the Indonesian government temporarily eliminated the tax holiday, foreign investment increased, but it might because investors were compensated by a decrease in the statutory CIT rate from 45% to 35%. This potentially points to the importance of the CIT rate.

Finally, in general the survey results show tax incentives are not the most important factor influencing FDI location decision. Tax incentives may have marginal importance as a majority of investors included it in their investment assessment (appraisal), even though it is not part of negotiation aspect with government prior their investment decision. However, looking at many types of incentives, Table 8.2 shows that general and automatic tax incentive policy is more important compared with the targeted and discretionary tax incentive policy (i.e., tax holiday or tax allowance). This finding can be regarded as another contribution of the thesis, especially as it shows comparison between investors perspective in SAs and Non-SAs in the Indonesian context. Foreign investors generally prefer to have CIT rate reductions and indirect tax advantages for imports for productions activities. However, as CIT rate reduction is available nationally then it does not have locational differences effects. Only, indirect tax advantages in SAs have a locational effect as they are applied generally for investors in the SAs.

8.2.3 AIM III: The Role of Tax Incentives Based on Policymaker Perspectives

This section considers the role of tax incentives from the policymakers' perspective. In Chapter 7 it was shown that policymakers believe that tax incentive policy is not an important factor for influencing the foreign investors to invest in Indonesia. The main factors affecting the FDI location decision are given in Table 8.3. It is for both policymaker and investor perspectives, and the factors are presented in the descending order of importance.

In general, the factors in Table 8.3 that influence the investor location decision are likely to be classical in nature (market size, natural resources, labour resources) or agglomeration factors (quality of infrastructure, geographical location). Neither policymakers nor foreign investors consider tax incentives to be one of these factors. Tax incentives could be classified as part of good governance or legal certainty, but in itself it is not a standalone factor.

Table 8.3: Factors Influencing FDI: Policymaker and Investor Perspectives

Rank	Policymakers	Investors
First	Quality of infrastructure	Political stability and security
Second	Good governance / institutions	Availability of cheap labour
Third	Market size / purchasing power	Availability of skilled labour
Fourth	Legal certainty	Good physical infrastructure
Fifth	Natural resources	General investment climate
Sixth	Political / economic stability	Geographical location
Seventh	Labour resources / productivity	Market size

Source: In-depth interview and questionnaire survey results.
Notes: General investment climate on questionnaire survey basically covers good governance / institutions and legal certainty on policymakers' in-depth interview results.

Table 8.4 shows the objectives of the tax incentive policy from policymakers' point of view, showing the percentage of policymakers saying so. Most agree the objective is to attract new investment, while the tax incentives are considered an important means for improving location competitiveness. In practice, this refers to areas outside Java Island, as the policy is expected to improve the distribution of investment across Indonesia. A quarter of respondents consider tax incentives to be complementary to other investment incentives, and a similar minority view is that they signal a government preference for specific sectors or locations. Finally, a fifth of policymakers believe that the provision of tax incentives is expected to support the investment realisation, as it helps the cash flow of investors, such as at the establishment of a plant.

Table 8.4: Tax Incentive Policy Objectives

Policy objectives	Percentage
Attracting new investment	76%
Improve location competitiveness	59%
Improve distribution of investment	41%
Complementary to other incentives	24%
Signal government preferences (sector or region)	24%
Accelerate investment realization	18%

Source: Figure 7.4.

Despite tax incentives not being an important factor in the investment decision, they continue to exist, and so it is important to explore the policymaker justification for this. Interestingly, the primary reason for the tax incentives is as a response to other countries having a similar policy, which is argued by 71% of policymakers. As a second reason, 35 percent argue that the existence of tax incentives is because investors demand it. A marketing strategy is third (29%), while with less than a quarter of policymakers: demand by government institutions; it is within the 'scope' of government; and easy to execute within a short period of time.

Trying to understand the policymakers' preferences for the tax incentive policy, the in-depth interviews reveal two distinctive tendencies. Policymakers who work for an institution that is responsible for attracting investment and supervising industrial development, including those responsible for enhancing economic areas, are more likely to give strong support for the tax incentives. However, policymakers who are assigned to work for the state budget revenue are more likely to provide only mild support. As part of government, the latter group do not oppose the government policy on tax incentives, but they also do not actively propose or strongly encourage the policy so that they act in a passive manner.

The differing perspectives regarding the existence of tax incentive policy can be understood when it is traced back to the policy cycle (Dye, 2013; Jann and Wegrich, 2007). Starting from the problem identification, the interview results show that the tax incentives arise from either a 'top-down' or 'bottom-up' approach to decision-making. The former means it derives from the government hierarchical structure, but for the latter means it arises from economic actors. Regarding policy formulation, the interview results show that the tax incentive policy was formulated collectively by related government institutions, and that without this, it would never exist or it would find legitimacy hard to gain. Further, in the implementation stage, the face-to-face interviews reveal that the incentives are viewed as a 'privilege' for the foreign investors, rather than as a government expectation of higher investment as a result of the policy.

Related to this, the in-depth interviews reveal that in reality there is an imbalance of power between the government institutions, even though the process of tax incentives, especially tax holidays and allowances, is based on collective decision-making. This is through a verification committee or a trilateral meeting of the BKPM, Ministry of Finance (including BKF and DGT) and Ministry of Industry, whereas in practice the final decision (and especially the tax holiday) is at the discretion of the Minister of Finance. This is problematic, insofar as there is a technical

team that decides on investors' applications, but their decision can be waived by the Minister of Finance, who has a final say and is a politically-appointed position. This makes the decision-making potentially based on non-economic factors and not free from political influence.

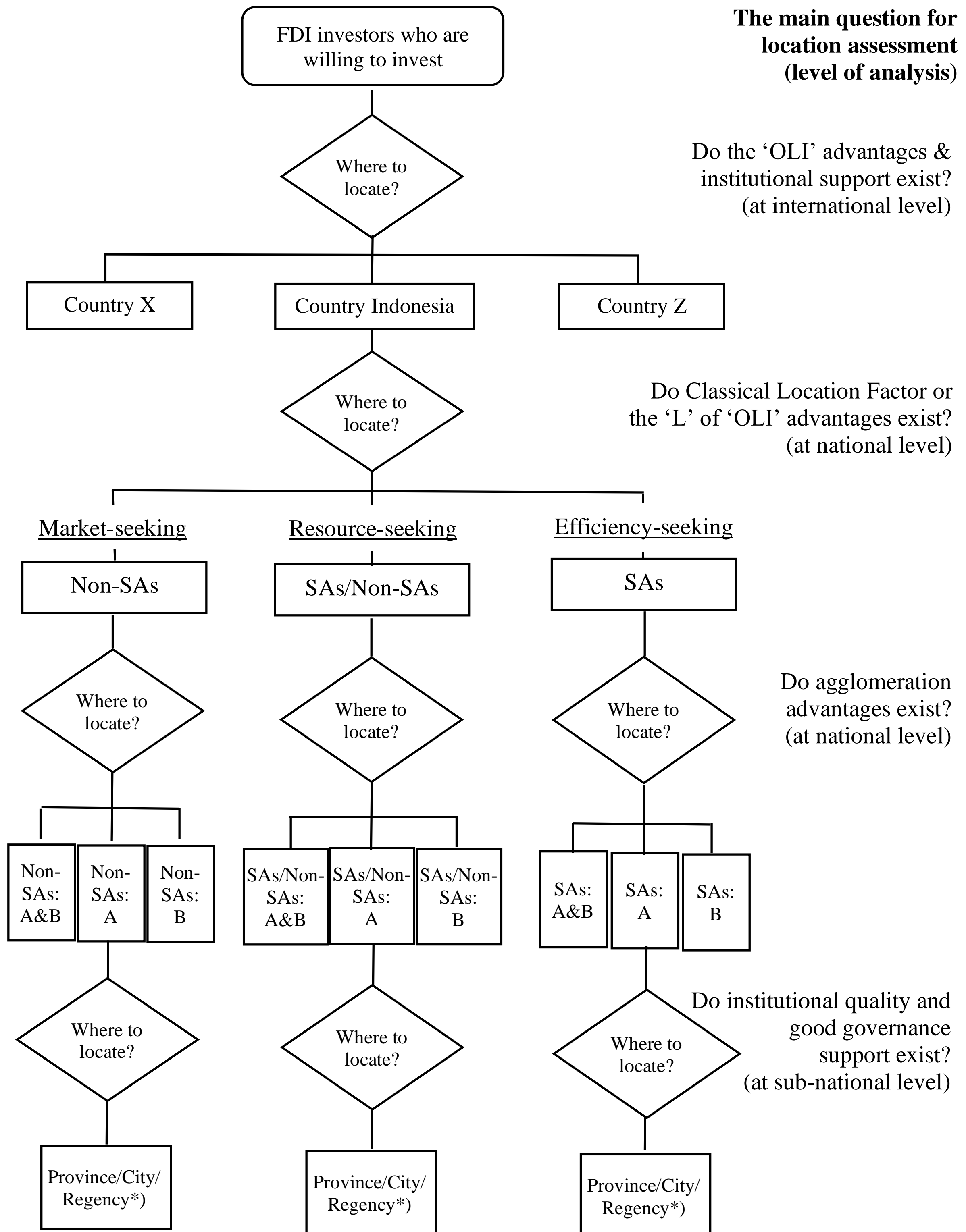
Finally, looking at policy monitoring and evaluation that is required to check whether a policy is or has achieved its stated objectives and for policy improvement, the face-to-face interviews reveal there is no formal monitoring and evaluation mechanism to assess the policy impact. In practice, the evaluation process only focuses on output measures, such as the number of tax incentives granted or executed, so that it does not consider outcomes. The in-depth interview reveals a paradox regarding the future of the tax incentives. Even though the policy is not the most important factor for the location decision, when all other investment factors are equal then the tax incentives may be an important differentiator for the foreign investment decision.

In summary, considering all the findings, the thesis has contributed to the understanding of the nature of FDI inflows to Indonesia, distinguishing between the foreign investor perspectives in the Special Areas and Non-Special Areas, as summarised in Table 8.1. Despite the fact that the research shows that tax incentives do not have important role in influencing foreign investors investment decision, the research reveals that amongst different types of tax incentives, general and automatic tax incentives are favoured over targeted and discretionary tax incentives. To my knowledge, the comparison of investor and policymaker perspectives on the role of the tax incentives in attracting FDI is also a genuine research contribution in the Indonesian context. All in all, the research findings are a precursor for further examination of the implications of the existing policy implementation, and for considering future policy recommendations.

8.3 Discussion and Implications for Tax Policy

This section discusses the findings in relation to the existing literature. The discussion on the characteristics and factors that influence FDI inflows are linked to the eclectic 'OLI' Paradigm, agglomeration economies and the institutional approach. To guide the discussion, Figure 8.1 summarises the FDI location factors in relation to these related theories or paradigms.

Figure 8.1: FDI Location Factors and Its Related Theories



Source: author own construct.
Notes: FDI = Foreign Direct Investment; SAs = Special Areas; Non-SAs = Non-Special Areas; A = labour market pooling; B = infrastructure readiness; *) = institutional quality and good governance.

Figure 8.1 shows that FDI in Indonesia can be explained firstly by the eclectic ‘OLI’ paradigm as it is believed that foreign investors that invest in Indonesia are able to gain ownership (O), location (L) and internalization (I) advantages. The decision to locate will be influenced by the investment motivation, which is explained through classical location factors or the ‘L’ of ‘OLI’ paradigm, in the form of market-seeking, resource-seeking and efficiency-seeking. At a national level, Indonesia is considered to have advantages of a large population which produces a large market size and abundance of labour resources. Further, Indonesia is endowed with an abundance of natural resources. If these are important then an investor may choose to locate in the Non-SAs. If the labour skill matches the investors requirements, then it might also fulfil efficiency-seeking. Tax incentives in this context will support efficiency-seeking, as it lowers the cost of production. The ability of foreign firms to produce output at a competitive price benefits those who would like to market their products internationally (export oriented). In the case of resource and efficiency-seeking the foreign investors might consider the SAs.

With regard to the role of tax incentives, during the initial investment process foreign investors include tax incentives and the CIT rate in their investment assessment. However, tax incentives are not an issue when the foreign investors come to negotiation process with the government. Understanding further the role of tax incentives during the investment establishment period and afterwards, this thesis consistently shows that general and automatic tax incentives are the main type of tax incentive that foreign investors have enjoyed, and that they are considered as the most important compared with targeted and discretionary tax incentives. It might explain why the investors do not include tax incentives in their negotiation with the Indonesian authorities. Unlike discretionary, targeted tax incentives, such as a tax holiday or tax allowance, that require the fulfilment of certain requirements, automatic, non-targeted incentives are available as long as the foreign investors fits the criteria, such as sales between 4.8 billion and 50 billion rupiah for the 50% CIT rate reduction. The questionnaire survey reveals that a concern of foreign investors on tax incentive policy is that they are simple, clear, and consistent, but, of course, the discretionary incentives are not totally free from the subjectivity of policymakers.

The agglomeration and institutional approaches provide other perspectives on FDI location, for which support is found in the questionnaire survey. According to the former, FDI location in Indonesia is related to labour market pooling and infrastructure. Java has better infrastructure compared with other Indonesian locations and so it is not surprisingly that the majority of FDI is located in this island. The very large population on Java Island means labour market pooling is possible, while infrastructure and labour market pooling are also well-established in the SAs

such as Batam. The survey supports the existing literature (Narjoko, 2008; Arhansya, 2010), which shows the importance of these for attracting foreign investment to Indonesia.

Institutions are also important for understanding FDI location in Indonesia, as investors seek good institutional quality and governance, although this is less certain. FDI requires a permit from local government, especially in the Non-SAs, while in the SAs the relevant authority may be relevant, such as for land permits. The survey results reveal some weakness regarding the institutional quality and governance of local government, such as delays in administration (i.e., 'red tape'). Another issue is the minimum wages policy, which is not explored much in the survey, but there are serious concerns. Since 2000, the regulation of minimum wages has been transferred from the Ministry of Manpower to the provincial level (the Governors), and this has resulted in very strong increases in minimum wages. For instance, in 2001 and 2002, the minimum labour wage increased by 21 percent and 39 percent in Jakarta, while nationally it increased by about 16 percent in each year. It is acknowledged by policymakers who state that "we have a serious problem on labour policy … a very populist approach which tends to be very unfriendly to investors" (MoF-A, 28 November 2017). Others point to the problem of regional decentralization, which has created uncertainty. Thus, Batam has the status of both a Special Area (FTZ) managed by an authority but also an administrative city that is led by an executive that is elected by the people (Aritenang, 2017).

Institutional quality and governance also has implications for tax incentive policy. The survey reveals that when dealing with the Indonesian tax authority foreign firms experience difficulties caused by regulatory complexity and that the investment regulations are not clear. The survey confirms the weak legal certainty in Indonesia found as far back as 1969 by Oei (1969, p. 44), "the Business International meeting in [J]akarta discussed the frequent changes in government regulations, particularly in the field of foreign trade, making it impossible for investors, especially in the manufacturing sector, to make cost calculations". More recently, James (2016, p. 155) writes that "[t]ax incentives are further complicated by the fact that they change quite often". This continues as the questionnaire survey finds that investors complain about unclear regulations which can be seen to result from policy uncertainty (Appendix Table A.6.1, Q-6.5).

The Indonesian policy stance on tax incentives has changed frequently. Investment-related policy has typically been restrictive, and it is liberalized only in times of economic downturn (Patunru and Rahardja, 2015; Sjoholm, 2016). The lack of consistency is seen from the face-to-face interviews, which show conflicting evidence between the regulatory objective and its

implementation. Even though, the government provides generous tax incentives, in practice not many investors utilize these owing to a lack of awareness and legal uncertainty. From the questionnaire survey it can be seen that while investors are eligible for tax incentives, they do not apply for these as they assume it will be fruitless. Some investors also perceive that the government does not really want to provide the incentives, but rather they are used for signaling purposes only. As such, Indonesian FDI policy, including tax incentives, is seen by investors as 'sitting on the fence', with have no clear position, and which can be easily changed.

The research findings confirm the existing literature that shows that "tax incentives play a relatively minor role in a good promotion programme, and good long-term investors are not the ones most susceptible to short-term inducements" (UNCTAD, 1999, p. 319). The thesis finds tax incentives are not the most important factor for investment location decision. This is similar to Wells *et al.* (2001), who argue that "the elimination of tax holidays in 1983 had no impact on the foreign direct investment (FDI) into Indonesia but the government felt pressured by a temporary dip in FDI in 1994 to reintroduce them." However, some caution is required as at this time the government also decreased the CIT rate from 45% to 35%, so that eliminating the tax holiday might not have made an investor any worse-off compared to before.

While though there is no convincing evidence regarding the importance of tax incentive policy in influencing FDI inflows, it is difficult to argue for the sudden elimination of tax incentives. This is because it will send bad signal to investors (stakeholders) by indicating that the business environment in Indonesia is uncertain and possibly hostile. Apart from that, policymakers will not buy into this proposal, since they do not have other realistic policy options. Therefore, the most reasonable proposal is to eliminate the provision of tax incentives gradually. During the transition period, the government need to focus on improving more the investment environment that may be more long-term in nature, including labour productivity, wages competitiveness, infrastructure readiness, good institutional quality and governance. Therefore, it is important to emphasise that tax incentive policy is not a stand-alone policy, but rather it should be framed within a much broader context by which the government influences investment location.

8.3.1 The Existence and Continuation of Tax Incentive Policy

While its intensity has varied, tax incentive policy to encourage FDI inflows has been used in Indonesia for a long period of time. As discussed in Chapter 2, a public value framework can be used to understand its existence in conjunction with institutional approach. Basically, public

policy requires legitimacy and support to ensure both its existence and continuation.

First of all, **public value** means a policy must deliver something that is substantively of 'value'. Theoretically, the aim of the tax incentives to attract FDI inflows is to maximize social welfare by enhancing economic growth, opening new employment, improving technology transfer and know-how, improving economic distribution and a source of capital for development (Chapter 7). These are clearly something of value, at least in principle. However, since public policy is a political activity then it cannot be guaranteed to be free of political influence. In simple terms, tax incentives are valuable as they reduce investment costs and may also make production more competitive. Based on the questionnaire survey, investors take tax incentives into account in their appraisal, but when it comes to negotiation it is not a main concern. Based on the in-depth interviews, it is revealed that amongst those who successfully apply for tax incentives, many do not take them up. As such, the tax incentives may therefore just be for purpose of signalling the government preferences and being seen as 'pro-business and pro-investment'.

Second, **operational capabilities** mean the policy must be something that is administratively feasible, and so can be conducted by the administrators of policy. Since tax incentives have been implemented on-and-off for more than 50 years in Indonesia then it can be argued that the government is able to conduct the policy. This is notwithstanding that some policymakers acknowledge that there are difficulties in implementing the tax incentive policy in the in-depth interviews. For example, on applications, more than one institution is responsible for receiving and administrating these (Ministry of Industry or BKPM), although since 2015 it is considered by the BKPM only. On decision-making, there are difficulties and disagreements between the institutions, so for example in deciding on the investor eligibility as a 'pioneer industry'. Prior to 2018, the decision on tax incentives provision also takes a long period of time, and for some tax holidays this was more than one year. On monitoring and evaluation, there is no clear and formal way to conduct these activities, including what aspects need to be assessed in order to decide on whether the policy is successful. The government does not have data to assess the impact of tax incentives on investment. Overall, the government has operational capabilities to run the tax incentive policy, but it is possible to conclude that it is relatively basic in nature.

Finally, **legitimacy** and **support**. It is believed that tax incentive policy gain supports or at least no objection. This is because the tax incentive policy either benefits the 'stakeholders' or is neutral. As argued by Jensen and Malesky (2018, p. 64), "…voters [citizens] do not have ability to directly observe factors that affect [foreign] firm' location decisions, but they do have

priors on the policy levers that are most effective investment". Specifically, when a foreign firm invests in a designated location in Indonesia, then the policymaker can point to the tax incentives as the cause, but if a firm does not locate, then the policymaker can argue that they have made the maximum effort, including generous incentives (Jensen and Malesky, 2018).

Tax incentives are likely to be a signalling tool to investors and public regarding government preferential sectors or regions that will be supported through taxes and other incentives. As argued by Wilkinson and Klaes (2018), in order to be effective, the government policy must have **credibility**, but from the interviews there is no convincing evidence that this is the case. The questionnaire survey shows that many investors do not believe that government will be willing to support their applications due to issues such as the government struggling to get state budget revenue. This is recognised by some policymakers in the in-depth interviews, especially from outside the main institutions, who argue that ineffective tax incentives occur because the decision is subjective and based on the Minister of Finance's discretionary powers.

Wells *et al*. (2001) thinks that policymakers believe tax incentives are an important factor, but the evidence here is that policymakers are fully aware that tax incentive policy is not the main factor in attracting FDI (Subsection 8.2.1). However, when it comes to the objective of the tax incentives, the policymakers still claim that they are a tool for attracting foreign investment. This can be understood since in reality "tax is driven not only by economics but also politics" (James, 2016, p. 154). Thus, it hard to reject that the true reason for the use of tax incentives are that they are under government control (scope) and are relatively easy to implement, if not administer, while they bring the government popularity benefits. For the institutions that are responsible for attracting FDI and supervising industrial development, they strongly advise to keeping the incentives to make Indonesia internationally competitive in the attraction of FDI, but making the application and decision process better. For those responsible for collecting state budget through tax revenue, they might not in the position to either strongly encourage or reject the policy, as, the policymakers will never reject tax incentive policy.

8.4 Limitations and Prospect for Future Research

The questionnaire survey and in-depth interviews results have the drawback of subjectivity, but I believe these two methods do offer insights into the relative importance of FDI factors and tax incentive policy. In order to reduce subjective bias, the research utilises triangulation methods in term of data collection, theory/paradigm and research evidence. With the aim of

ensuring good variety in the respondents for questionnaire survey, I selected all six foreign tax offices in Indonesia, so that it is representative across all sectors. Meanwhile for policymakers, I decided to include eight different institutions, which are involved in tax incentive policy, including its development and implementation. Regarding theory/paradigm, I utilize at least three major theories or paradigms namely eclectic 'OLI' paradigm, agglomeration economies, and institutional approach. Complementary, I also utilise public value framework for analysing the tax incentive policy existence. Further, in addition to the questionnaire survey and in-depth interviews, I also utilize document analysis to support the analysis as well as to check potential bias on subjectivity answer by respondents. As the main objective of this research is to understand the factors that underlie the FDI location decision, I do not focus on testing hypothesis using an econometric approach or on the correlation between factors, but rather the research is intended to identify and understand the processes of social or political mechanism. As such, I am not able to make generalisations, but rather the aim of thesis is on understanding phenomena and that is placed in the specific context of Indonesia.

With regard to the number of respondents, this research is able to achieve 224 questionnaire survey responses and 22 respondents for in-depth interviews, which is slightly below the target. Regarding the questionnaire survey, it is difficult to get access to respondents in very high-ranking positions (e.g., CEO or Director), but if I did not have a very good relationship with the gatekeepers this number would be even lower, especially as there was no incentive for a respondent to complete the questionnaire survey, and these are busy people. Additionally, research on tax is something that people are reluctant to take part in. For the in-depth interviews with policymakers, even though the response is slightly lower than expected, and at the outset I would like to have interviewed Ministers, in practice I achieved these interviews with Deputy Ministers. I consider this to be very good, as they have an appropriate level of understanding. Further, across the targeted institutions, the research has gained a very good representation.

The research is able to gather a large amount of data on investment location factors, including the role of tax incentives, from both the investor and policymaker perspectives. Unfortunately, the research has not much explored the data and presented the link between investors location preferences and type of tax incentives, including the business sector (e.g., foods, textiles, light manufactures, heavy manufactures and services). Building on this research, it would be useful if future research can be complemented with an econometric analysis of the factors identified in this research to see what factors matter most in terms of the actual location decision.

Research on 'regionalisation', for instance, that compares each region in Indonesia regarding the relative role of these factors for influencing FDI location, might also be useful.

8.5 Conclusions and Recommendations

To understand the relationship between tax incentive policy and inward investment, it cannot be simply based on a cost-benefit analysis or an econometric analysis without considering the nature of the policy in a political environment. This research aims to contribute to the existing literature from a different angle by presenting both the investors' and policymakers' point of view regarding tax incentives and FDI location. It does not produce a straightforward answer, but instead offers a more general proposition that can be matched with the political reality. I now conclude, by presenting a summary of the main conclusions and giving recommendations from the thesis that potentially improve the Indonesian policy regarding FDI location.

8.5.1 Conclusions

The nominal amount of FDI inflows to Indonesia between 1995 and 2017 is virtually always higher than Domestic Direct Investment. This is paralleled by the number of FDI projects, which shows a significant increase, especially from 2009, although the average project scale is smaller over this period. Analysing FDI by sector, the secondary sector is more important than the tertiary and primary sectors, while all Indonesian regions have become important for FDI location, although Java Island remains dominant. FDI in Java is in manufacturing industries, such as consumer goods, transportation and electronic, but outside Java, it has a greater focus on natural resources (mining, oil and gas), agriculture (palm oil). The inward FDI is dominated by Asian countries, especially Singapore, Japan, South Korea. Looking at the contribution of FDI towards the Indonesian economy, foreign-owned plants created almost 7.5 million jobs over 1990 to 2015, and in individual sectors this is about 65 percent of manufacturing employment, 20 percent of primary employment and 15 percent of services employment. In total, this is about 60 percent of the jobs created on Java over 1990-2015.

As regards the motives for FDI, the thesis offers support for different theories, for which an important distinction is made between the Special Areas and other areas ('Non-Special Areas'). On the eclectic 'OLI' paradigm, it shows FDI location in the SAs is resource-seeking, with the availability of cheap labour as a main factor, but in the Non-SAs it is market-seeking, reflecting

the large Indonesian market. On agglomeration economies, labour market pooling is important for the SAs, consistent with the resource-seeking motivation, and for Batam, the geographical proximity to Singapore also matters. More broadly, on Java it is infrastructure readiness and labour market pooling. On the institutional approach, the thesis shows institutional quality and good governance are important, leading to greater certainty for investors.

On the role of tax incentives in influencing the FDI location decision, the thesis finds that tax incentives are not the most important factor. This is supported by questionnaire results, which show that foreign investors do not utilize tax incentives during negotiations with the authorities before they make decision to invest in Indonesia. The reason for foreign investors to locate in Indonesia is either market-seeking (those who located in Non-SAs) or resource-seeking (in the SAs). This is similar to existing research that suggests that tax incentives have a low impact on an investor's decision when the motive is market-seeking, resources-seeking or strategic asset-seeking, but that it matters only for efficiency-seeking motives (James, 2013). For the two types of investment location (SAs and Non-SAs), foreign investments in the SAs might be partially affected by tax incentives as it is evident from the survey that a secondary reason is efficiency-seeking. This is plausible as investors in the SAs are mainly targeting their outputs for international export markets, so that low production costs are paramount.

Looking at the existing tax incentive policy, general and automatic tax incentives such as the CIT rate reduction or indirect taxes advantages in the SAs are favoured by foreign investors. At the plant establishment, nearly 58 percent of foreign investors in SAs had received indirect tax incentives (e.g., import duties, VAT, LGST, import tax exemptions), but a half of foreign investors in Non-SAs acknowledge that they had never received a tax incentive. A similar pattern is evident after the plant establishment or during the operational phase, but when the take up of the tax incentives is lower. After establishment, investors in the SAs claim that they had received tax incentives mainly in the form of the above indirect tax advantages, but most of those outside the SAs claim that they had never received tax incentives. Among those in the Non-SAs who had received tax incentives, this was mainly in the form of a CIT rate reduction (17 percent). However, this is applied nationally and it does not have a locational differentiator. With regard to targeted and discretionary tax incentives, such as a tax holiday or tax allowance, these are small in number, and they do not have aggregate-level effects. Only the tax allowance is differentiated by location as it has regional criteria. After establishment, the arguments made by foreign investors regarding the importance of tax incentives is likely to relate to their post-establishment operations.

While tax incentives are not the main factor influencing the inward investment decision, they may still have some impact as a majority of firms include them in their investment appraisals. Foreign investors do not include the tax incentives in their initial negotiations perhaps because these are general and automatic, such as the CIT rate reduction and the indirect tax advantages of the SAs. Indeed, subject to the eligibility criteria, they are certain. A negotiation is therefore only necessary for the targeted and discretionary tax incentives, such as the tax holiday.

The in-depth interviews show that policymakers do not consider the tax incentives to be an important factor in the FDI location decision, but rather as complementary to other policies. It differs from the 1980s when they believed that they really mattered. In general, there is split opinion on the tax incentives; one group strongly supports them, but the other gives only mild support. However, none of them strongly opposed the existence of the incentives. Reconciling investors and policymakers' perspectives, the tax incentives are in general not a main factor, but rather complementary in improving the competitiveness of regions (may relevant for tax allowance only), which in this context can be read as outside Java. Tax incentives in the form of indirect tax advantages (i.e., import duties, VAT, LGST, import tax exemptions) are expected to accelerate investment realisation. Meanwhile, the tax incentives for attracting investment in new 'pioneer industries' is not compelling as the number of foreign investments that receive these is limited. In general, tax incentive policy cannot be treated as a stand-alone policy, but it should be framed within the government policy framework. Overall, it seems general and automatic tax incentives are favoured by investors, whereas targeted and discretionary schemes are seen as having the inherent problems of increasing the investor uncertainty.

There is an apparent paradox, since the tax incentive policy is not considered to be the most important factor for influencing the foreign investment decision, but neither is there strong opposition to its continued existence, either from investors or policymakers. The explanation is because the tax incentives are required by the Indonesian government since other countries use them, and it therefore seems likely that the tax incentive will continue to exist. This can be justified using a public value framework. In particular, tax incentive policy will be supporting FDI inflows since FDI has valuable objectives such as opening new employment, increasing economic growth, and allowing transfer of technology and know-how. Tax incentive policy is also designed to improve investment distribution across Indonesia, which up to present time is Java-centric. Since tax incentive policy is a public policy, then it needs political support from different stakeholders. Within government, even though there are some challenges, there is no

strong objection to them. Meanwhile from business actors, they support them or are neutral because the policy does not harm their interest. The public has no strong interest as they do not directly affect them. The tax incentive policy is also well-within the scope of the Indonesian government since it has experience of implementing these measures for more than fifty years.

8.5.2 Recommendations

Based on the above conclusions, I propose that the government needs to gradually eliminate the tax incentives and start to focus on developing the fundamental business environment, including labour productivity, quality of infrastructure, institutions quality and good governance. During the transition period, the government needs to refine the use of tax incentive policy. Therefore, I propose the following recommendations for improving the use of tax incentives during the transition period to achieve the best outcome for FDI inflows to Indonesia. There are four main recommendations, of which the first three are prerequisites for a better use of tax incentives and leading to its successful elimination at a later date.

Recommendation 1: **Maintaining Indonesia's Location-Specific Advantages**

The questionnaire survey results show that **market size** is the main motive for foreign investors to establish their firms in Non-SAs. The government therefore needs to increase and maintain the purchasing power of Indonesian people to help create a virtuous circle of growth. This in turn suggests low inflation and macroeconomic stability. It can focus on import substitution by, for example, persuading firms to establish their plants in Indonesia to serve the domestic market. In this case, tax incentive policy can play an important role in shifting business from 'traders' to producers by supporting the establishment of appropriate manufacturers.

As part of maintaining its locational advantage, the government also needs to improve **labour resource** productivity. The questionnaire survey reveals that the main motivation for foreign investors in the SAs is unskilled labour at low cost (resource-seeking). Meanwhile for foreign investors in the Non-SAs, the availability of cheap labour is the second most important reason for FDI. However, these advantages will diminish if wages increase without improvements in productivity. The regionally-determined increase in minimum labour wages is a factor in this. Evidence for outward FDI due to wages increases is evident for South Korea between 1985-90 (Park, 1991 cited in Lee, 1994) and Singapore in 1980s (van Campenhout and de Graaf, 2013). Wages in the SAs should not be determined by the governors, but rather by a national body that is accountable to the central Ministry of Manpower. Further, increases in productivity is very

much linked to the educational and labour training system. The tax incentives could be targeted to developing skilled labour, although the challenge is to decide what types of education and training to target. If the government is able to leverage productivity through greater education and training then the resource-seeking factor may support efficiency-seeking FDI.

The questionnaire survey results confirm that **natural resources-seeking** (i.e., raw materials or mining) is a motivation for foreign investors to invest in Indonesia, especially outside Java. As presented in Chapter 4, investors from Europe and America invested in Indonesia outside Java Island because of natural resources and commodities. The government needs to have a clear strategy on how to utilise the natural resources to the best possible advantage, and over a long time period, especially for unrenewable resources such as mining, oil and gas. The government needs to consider foreign investment not just for exploiting and exporting raw materials from Indonesia, but to support the establishment of manufacturing industries that create added value for Indonesia. For example, investors could be made to form partnerships with private or state-owned companies with downstream industry in a certain period of time. The overuse and excessive exploitation of natural resources has future ramifications. Tax incentive policy can be used to support the manufacturers that make the best use of natural resources. Meanwhile, for investors in tourism sector, incentives might be given for those who can maintain its natural and cultural environment, so that it can be preserved for future generations.

Recommendation 2: Improve Agglomeration Economies for Area Development

Agglomeration economies are important as they can lead to virtuous circles of development and may help in the sustaining of development in the areas outside of Java in particular. The existing research finds that infrastructure quality is an important source of agglomeration economies, leading to similar firms locating in the same area. In a broader context, Java with its better infrastructure (and large market size) attract companies in similar activities, such as transportation or automotives. In order to attract FDI outside Java, the government needs to set-up relevant infrastructure elsewhere. This includes connectivity infrastructure, for getting inputs to the plant and the output to market. Apart from infrastructure, labour market pooling is also important. An improvement of labour quality will increase productivity and thereby maintain the locational advantages of labour as a source of agglomeration economy. As mentioned above, tax incentives (e.g., tax allowances) can be directed toward companies that conduct training and education for their employees. They can be differentiated between the Special Areas for export orientation, and with indirect tax incentives and investment areas for the domestic market that do not necessarily require indirect tax incentives.

Recommendation 3: Improve the Institutional Quality

Changes in government policy is normal, but frequent changes and 'U-turns' lead to confusion and weaken the credibility of government actions. In general, foreign investors demand sound economic policy, which enables them to make business projections and plan ahead, so that they can reap returns from their investment. However, legal uncertainty is damaging for the trust of foreign investors. A loss of government credibility weakens its policies, since the questionnaire survey reveals that investors may not apply for a discretionary tax incentive since they do not believe in government will grant it, perhaps due to the issues with the state budget or because of political interference. It is acknowledged by some policymakers during in-depth interviews, especially for those who work for institutions that are responsible for attracting FDI. Based on an institutional approach it is recommended that the government needs to respect the policies that have been put in place and show consistency in their actions towards investors.

Recommendation 4: Improve the Operation and Effectiveness of Tax Incentives

The objective of this research is to provide reasonable recommendations that can be agreed and implemented by policymakers. Recommending the elimination of tax incentives straightway is not practically feasible, since it will be rejected out-of-hand by policymakers. Therefore, this research proposes the gradual elimination of tax incentives. It avoids a sudden policy change that will seen as bad in the eyes of investors and other stakeholders. The recommendation is to improve the operation and effectiveness of tax incentive policy, while the government sets out a plan for gradual elimination of these and the improvement of the investment environment (recommendation 1 to 3). Therefore, there are several recommendations for a more effective and efficient use of this policy.

Firstly, tax incentives should be designed based on clearer objectives or targets, that can be clearly monitored and evaluated to check whether these have been met. In this context, a clear objective is not simply a means of attracting foreign investment, but more specifically it is the expected benefits of this investment for the Indonesian economy.

Secondly, tax incentives should be designed and directed toward efficiency-seeking investment and not for market-seeking, resource-seeking or strategic asset-seeking investment. Providing tax incentives for the last three of these motives wastes government resources (i.e., deadweight spending), since these investments are likely to have been undertaken in any event.

Thirdly, the application and provision of the tax incentives should be a simple and transparent process. The provision of tax incentives should be treated as administrative activities carried out by bureaucrats, rather than made by political actors, such as a Government Minister. Further, looking at the policy formulation, the tax incentives should be designed and agreed by all relevant stakeholders with no veto to avoid the domination of one institution over any other. During the policy formulation process each stakeholder should have a clear sense of what they propose and backed-up by empirical evidence (i.e., 'evidence-based policy').

Fourthly, tax incentives that lower the cost of investment and production (e.g., indirect tax advantages such as import duties, VAT, LGST, import tax exemptions) are often preferred over the profit-based tax incentives that are targeted and based on discretionary decision (i.e., tax holiday and tax allowance). Amongst the profit-based tax incentives, the general and automatic subsidies (e.g., a CIT rate reduction) is preferred over targeted and discretionary schemes. Indirect tax incentives for special areas might be retained, but applied strictly with a focus on export-orientated firms.

Fifthly, the monitoring and evaluation of tax incentive policy is one of the weakest parts of the existing tax policy, so the government needs to make regular evaluations of the effectiveness this policy. It should be holistic, and so not just considering the tax forgone and narrow benefits to the firm, but covering other costs and benefits to the Indonesia economy as a whole.

Sixthly, regarding the business activities that are entitled for tax incentive policy and following the above recommendations, I propose the following criteria to improve the effectiveness of the tax incentives. These criteria should be treated as cumulative, which means that firms that are able to fulfil more criteria are eligible for bigger tax incentives. The criteria are: (a) activities that create substantial employment or improve labour productivity; (b) activities that utilise natural resources endowments into downstream products with high value added for Indonesia; (c) activities that utilise local contents and support a national value chain (backward or forward linkage industries); (d) activities that produce import substitution products; and (e) activities that serve international markets (i.e., export oriented) but sourced in Indonesia.

Seventhly, regarding the gradual elimination of tax incentives, the government needs to reduce and avoid the more generous tax incentives, while they need to focus on developing the business environment such as labour quality and productivity, competitive wages scheme, better quality infrastructure, and good institutional and governance (both local and central government). As

the business environment is improved, then so the government can continue to reduce or limit the utilization of the tax incentives for attracting FDI.

Finally, implementation of tax incentive policy is related to other countries' policy actions, but Indonesia is a member of several international organisations. This may help to facilitate greater international cooperation and efforts to reduce international tax competition should be considered and supported.

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Appendix A: Tables

Appendix Table A.1.1: Laws/Regulations related Tax Incentives for (Foreign) Investment

Year	Regulation		Concerning
	Type/Level	Number	
2019	Government Reg.	PP-78/2019	Income Tax Facility for Investment in Certain Sectors and/or Regions
	Government Reg.	PP-45/2019	Amendment to PP- 94/2010 concerning Calculation of Taxable Income and Tax Payment during Fiscal Year
2018	Ministry Reg.	PMK-150/PMK.010/2018	The Provision of Corporate Income Tax Reduction Facility
	Ministry Reg.	PMK-35/PMK.010/2018	The Provision of Corporate Income Tax Reduction Facility
	Ministry Reg.	PMK-12/PMK.010/2018	Import Duties Borne by the Government for Certain Industry Sectors for Fiscal Year 2018
	BKPM Reg.	Perka BKPM 5/2018	Business Sectors and Pioneer Industries which Eligible for CIT Reduction and Its Procedures
2017	BKPM Reg.	Perka BKPM 13/2017	Guidance and Procedures for Investment Licenses and Investment Facilities
2016	Ministry Reg.	PMK-103/PMK.010/2016	Amendment to Minister of Finance Regulation No 159/PMK.010/2015 concerning CIT Reduction Facility
	Government Reg.	PP-9/2016	Amendment to PP-18/2015 concerning Income Tax Facility for Investment in Certain Sectors and/or Regions
	BKPM Reg.	Perka BKPM 8/2016	2nd Amendment to Perka BKPM 14/2015 concerning Guidelines and Procedures for Principal License on Investment
	BKPM Reg.	Perka BKPM 6/2016	Amendment to Perka BKPM 14/2015 concerning Guidelines and Procedures for Principal License on Investment
2015	Government Reg.	PP-18/2015	Income Tax Facility for Investment in Certain Sectors and/or Regions
	BKPM Reg.	Perka BKPM 19/2015	Amendment to Perka BKPM 13/2015 concerning Procedures for Application of Corporate Incomes Tax Reduction Facility

	Ministry Reg.	PMK-188/PMK.010/2015	2nd Amendment to PMK-176/PMK.011/2009 concerning Exemption of Import Duty on Machinery, Goods and Materials for Establishment or Development of Industry in relation to Investment
	Ministry Reg.	PMK-159/PMK.010/2015	The Provision of Corporate Income Tax Reduction Facility
	Ministry Reg.	PMK-89/PMK.010/2015	Procedures on the Provision of Income Tax Facilities for Investment in Certain Business Sectors or Regions and Transfer of Assets and Sanctions on Domestic Taxpayers Given Tax Facilities
	BKPM Reg.	Perka BKPM 18/2015	Amendment to Perka BKPM 8/2015 concerning Procedures for Application of Income Tax Facility for Foreign Direct Investment in Certain Business Sectors and/or Regions
	BKPM Reg.	Perka BKPM 16/2015	Guidelines and Procedures for Investment Facilities
	BKPM Reg.	Perka BKPM 14/2015	Guidelines and Procedures for Principal License on Investment
	BKPM Reg.	Perka BKPM 13/2015	Procedures for Application of Corporate Incomes Tax Reduction Facility
	BKPM Reg.	Perka BKPM 8/2015	Procedures for Application of Income Tax Facility for Foreign Direct Investment in Certain Business Sectors and/or Regions
2014	Ministry Reg.	PMK-248/PMK.011/2014	Import Duty Borne by the Government on Goods and Materials Used to Produce Goods and Services for Public Interest and Improvement on the Competitiveness for Certain Business Sector
	Ministry Reg.	PMK-192/PMK.011/2014	Amendment to PMK-130/PMK.011/2011 regarding the Provision of Corporate Income Tax Exemption or Reduction Facility
	Law	No 3/2014	Industry
2013	Ministry Reg.	PMK-176/PMK.04/2013	Amendment to PMK-254/PMK.04/2011 concerning Exemption of Import Duty on Goods and Materials Used for Manufacturing Process with Export Purposes

	DGT Reg.	Per-41/PJ/2013	Procedures on the Provision of Income Tax Facilities, Determination of Capital Investment Realization, Reporting Submission Obligation, and Revocation on the Decision of Income Tax Facility Provision for the Investment in Certain Business Sectors and/or Regions
2012	Ministry Reg.	PMK-144/PMK.011/2012	The Provision of Income Tax Facilities for Investment in Certain Business Sectors or Regions
	Ministry Reg.	PMK-76/PMK.011/2012	Amendment to PMK-176/PMK.011/2009 concerning Exemption of Import Duty on Machinery, Goods and Materials for Establishment or Development of Industry in relation to Investment
2011	Government Reg.	PP-52/2011	2nd Amendment to PP-1/2007 concerning Income Tax Facilities for Capital Investment in Certain Business Sectors and/or Certain Regions
	Ministry Reg.	PMK-254/PMK.04/2011	Exemption of Import Duty on Goods and Materials Used for Manufacturing Process with Export Purposes
	Ministry Reg.	PMK-130/PMK.011/2011	The Provision of Corporate Income Tax Exemption or Reduction Facility
	Ministry Reg.	93/M-IND/PER/11/2011	Guidelines and Procedures for Application on Corporate Income Tax Exemption and Decrease in Industrial Sector
2010	Government Reg.	PP-94/2010	Calculation of Taxable Incomes and Settlement of Income Tax in Current Year
	Ministry Reg.	PMK-21/PMK.011/2010	The Provision of Taxes and Customs Facilities for Renewable Energy Business Activities
2009	Law	No 39/2009	Special Economic Zone
	Ministry Reg.	PMK-176/PMK.011/2009	Exemption of Import Duty on Machinery, Goods and Materials for Establishment or Development of Industry in relation to Investment
2008	Law	No 36/2008	Amendment of Law No 7/1983 concerning Corporate Income Tax
	Government Reg.	PP-62/2008	1st Amendment to PP-1/2007 concerning Income Tax Facilities for Capital Investment in Certain Business Sectors and/or Certain Regions
2007	Law	No 25/2007	Investment
	Government Reg.	PP-1/2007	Income Tax Facilities for Capital Investment in Certain Business Sectors and/or Certain Regions

	Ministry Reg.	PMK-16/PMK.03/2007	The Provision of Income Tax Facilities for Investment in Certain Business Sectors and/or Certain Regions
	DGT Reg.	Per-67/PJ/2007	The Procedures on the Provision of Income Tax Facilities for Investment in Certain Business Sectors and/or Certain Regions
2006	Law	No 17/2006	Amendment of Law No 10 Year 1995 concerning Customs
2005	Ministry Reg.	PMK-47/PMK.04/2005	Procedures for the Entry and Realising Goods into and from Free Trade Areas and Free Ports
2004	Ministry Reg.	PMK-587/PMK.04/2004	6th Amendment to KMK-291/KMK.05/1997 concerning Bonded Zone
2003	Government Reg.	PP-63/2003	The Treatment for VAT and LGST in the Bonded Zone of Batam Industrial Area
2002	Ministry Reg.	KMK-37/KMK.04/2002	5th Amendment of Minister of Finance Regulation No 291/KMK.05/1997 concerning BZ
2001	Government Reg.	PP-12/2001	VAT Exemption on Import and/or Transfer for Strategic Taxable Goods
2000	Ministry Reg.	KMK-571/KMK.04/2000	Procedures on the Provision of Income Tax Facilities to the Taxpayer who invested in Certain Sectors and Regions
	Government Reg.	PP-148/2000	Income Tax Facilities for Capital Investment in Certain Business Sectors and/or Certain Regions
	Government Reg.	PP-138/2000	Calculation of Taxable Incomes and Settlement of Income Tax in Current Year
	Ministry Reg.	KMK-135/KMK.05/2000	Relief of Import Duty on Machines, Goods and Materials in the Framework of Building/Development of Industries/Service Industries
	Ministry Reg.	KMK-94/KMK.05/2000	4th Amendment of Minister of Finance Regulation No 291/KMK.05/1997 concerning BZ
1999	Ministry Reg.	KMK-349/KMK.01/1999	3rd Amendment of Minister of Finance Regulation No 291/KMK.05/1997 concerning BZ
1998	Government Reg.	PP-83/1998	Amendment to PP-47/1994 concerning Calculation of Taxable Incomes and Settlement of Income Tax in Current Year
	Ministry Reg.	KMK-292/KMK.01/1998	2nd Amendment of Minister of Finance Regulation No 291/KMK.05/1997 concerning BZ
	Ministry Reg.	KMK-44/KMK.04/1998	Income Tax Deemed by the Government for Taxable Income Generated from Certain Business Industries based on PP 45 Year 1996

1997	Ministry Reg.	KMK-547/KMK.01/1997	1st Amendment of Minister of Finance Regulation No 291/KMK.05/1997 concerning BZ
	Ministry Reg.	KMK-545/KMK.01/1997	Amendment to
	Ministry Reg.	KMK-297/KMK.01/1997	Exemption of Import Duty on Machines, Goods and Materials in the Framework of Development of Industries/Service Industries
	Ministry Reg.	KMK-291/KMK.05/1997	Bonded Zone
1996	Government Reg.	PP-45/1996	Income Tax on Corporate Taxpayer Income for Certain Industries
1995	Law	No 10/1995	Customs
	President Reg.	Keppres 31/1995	List of Business Sectors Closed for Investment
1994	Government Reg.	PP-47/1994	Calculation of Taxable Incomes and Settlement of Income Tax in Current Year
	Government Reg.	PP-34/1994	Taxes Facilities for Capital Investment in Certain Business Sectors and/or Certain Regions
1993	Government Reg.	PP-39/1993	Amendment to PP-42/1985 concerning Implementation of Income Tax Law 1984
1992	Government Reg.	PP-63/1992	Definition of Remote Areas and Type Compensation in the form of Fringe Benefits in the Implementation of Law No 7 Year 1983 concerning Income Tax as Amended by Law No 7 Year 1991
	Government Reg.	PP-62/1992	Business Sectors of Joint Venture Business Partner in the Implementation of Law No 7 Year 1983 concerning Income Tax as Amended by Law No 7 Year 1991
1991	President Reg.	Keppres 23/1991	List of Business Sectors Closed for Investment
1990	Ministry Reg.	KMK-748/KMK.04/1990	50% cut off on Land and Building Tax for 8 years to investors who invest in certain area
1989	President Reg.	Keppres 21/1989	List of Business Sectors Closed for Investment
1988	President Reg.	Keppres 49/1988	VAT import mechanism for intermediate goods used to produce export goods
1987	President Reg.	Keppres 51/1987	VAT import mechanism for materials used to produce export goods
1986	Government Reg.	PP-22/1986	Bonded Zone
1985	Government Reg.	PP-42/1985	The Implementation of Income Tax Law 1984 (No 7/1983)

1984	Ministry Reg.	KMK-827/KMK.04/1984	Postponement of Import VAT on Selected Capital Goods
1983	Government Reg.	PP-36/1983	The Implementation of Income Tax Law 1984 (No 7/1983)
	Law	No 8/1983	Value Added Tax and Luxury Good Sales Tax
	Law	No 7/1983	Income Tax

Source: Authors compilation on Indonesia Laws and Regulations.

Notes: The above list might not cover all of law and regulations, but these all show how the government of Indonesia in different level/structure always consider tax incentives as their instrument to attract (foreign) investment. These also presents the intensity uses of tax incentive policy by the policymakers (every year from 1983 to 2019). Government Reg. = Government Regulation (Peraturan Pemerintah) with abbreviation is ‘PP’; President Reg. = President Regulation (Keputusan Presiden) with the abbreviation ‘Keppres’; Ministry Reg. = Ministry Regulation (i.e., Peraturan Menteri Keuangan /Keputusan Menteri Keuangan) with the abbreviation is ‘PMK / KMK’; BKPM Reg. = Badan Koordinasi Penanaman Modal (Indonesia Investment Coordinating Board) Regulation (i.e., Peraturan Kepala BKPM) with the abbreviation ‘Perka BKPM’; DGT Reg. = Directorate General of Taxes Regulation (i.e., Peraturan Direktur Jenderal Pajak) with the abbreviation ‘Per’.

Appendix Table A.3.1: Tax Holiday Periods in Indonesia

Period	Regulation	Description	Existence
1967-1983	• Law 1/1967 • Law 11/1970	In the levy of company tax through a proportional rate of not more than 50% for a period not exceeding five years after expiration of the exemption period	Yes
1984-1996	Law 7/1983	The provision of tax facilities was abrogated	No
1996-2000	• Law 10/1994 • Government Regulation 45/1996 dated 8 July 1996	• Amendment of Law 7/1983. • Re-enactment of Tax Holiday	Yes
2001-2011	Government Regulation 148/2000, effective since 1 January 2001	Nullification of Government Regulation 45/1996, dated 8 July 1996	No
2011-2015	PMK-130/PMK.011/2011 jo. PMK-192/PMK.011/2014	• Corporate Income Tax Relief may be provided for a period 5 to 10 years • At the end of the provision of Corporate Income Tax relief, Taxpayers shall be provided with Corporate Income Tax reduction at 50% (fifty percent) of the outstanding Income Tax for 2 (two) fiscal years.	Yes
2015-2018	• Law 7/1983 jo. Law 36/2008 concerning Income Tax • Law 25/2007 concerning Investment • PMK-103/PMK.010/2016 jo. PMK-159/ PMK.010/2015 concerning Provision of Corporate Income Tax Reduction Facility • BKPM Regulation 13/2015 concerning Procedures for the Provision of Income Tax Reduction Facility	• Corporate Income Tax reduction by 10% up to 100% • Facility can be provided for a period of 5 to 15 years • Time period of tax facility can be extended based on Minister of Finance discretionary decisions.	Yes
2018 onwards	• PMK-35/PMK.010/2018 concerning Provision of Corporate Income Tax Reduction Facility • BKPM Regulation 5/2018 regarding Sector and Type of Pioneer Industry Eligible for Tax Reduction and Its Procedures	• New established company should be considered as 'pioneer industry' • Corporate Income Tax reduction 100% • Facility is given based on the amount of investment: 5 years (500 to <1000 billion rupiah); 7 years (1000 to <5000 billion rupiah); 10 years (5000 to 15000 billion rupiah); 15 years (15000 to <30000 billion rupiah); and 20 years (30000 billion rupiah or more).	Yes

Note: Directorate General of Taxes' internal data on Indonesian tax and investment regulations, summarised.

Appendix Table A.3.2: Workforce by Province, 2008-18

Province (Region)	Number of Workforce (thousands)										
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Aceh (SUM)	1,781	1,865	1,933	2,065	2,088	2,135	2,173	2,261	2,235	2,330	2,354
North Sumatera (SUM)	5,931	6,322	6,403	6,501	6,684	6,625	6,766	6,593	6,594	6,716	7,227
West Sumatera (SUM)	2,126	2,181	2,273	2,321	2,407	2,455	2,503	2,481	2,577	2,618	2,742
Riau (SUM)	2,234	2,304	2,348	2,601	2,620	2,811	2,801	2,974	2,978	3,128	3,296
Jambi (SUM)	1,257	1,342	1,351	1,535	1,554	1,591	1,570	1,692	1,696	1,792	1,846
South Sumatera (SUM)	3,454	3,488	3,619	3,801	3,960	3,951	4,022	4,018	4,054	4,244	4,368
Bengkulu (SUM)	836	868	879	905	930	947	968	975	1,000	1,034	1,033
Lampung (SUM)	3,659	3,738	3,754	3,885	3,991	3,970	4,029	4,061	4,038	4,271	4,396
Bangka Belitung Isl. (SUM)	501	556	551	609	614	661	641	692	688	728	757
Riau Island (SUM)	653	669	704	839	862	903	892	895	913	1,053	1,066
Jakarta (JAV)	4,559	4,758	4,746	5,038	5,259	5,127	5,189	5,548	5,311	5,462	5,429
West Java (JAV)	18,427	19,045	19,214	20,365	20,410	20,741	21,287	22,333	22,177	22,644	22,774
Central Java (JAV)	17,341	16,610	17,131	17,339	17,431	17,406	17,716	18,293	17,915	18,199	18,234
Yogyakarta (JAV)	1,984	2,049	2,067	1,973	1,958	1,952	2,033	2,098	2,097	2,116	2,142
East Java (JAV)	20,117	20,317	20,623	20,300	20,024	20,396	20,718	20,692	20,498	20,890	21,005
Banten (JAV)	4,254	4,457	4,443	5,195	5,439	5,523	5,479	5,697	5,686	5,969	6,088
Bali (BNT)	2,095	2,061	2,117	2,296	2,295	2,376	2,410	2,459	2,382	2,469	2,607
West Nusra (BNT)	2,073	2,040	2,127	2,195	2,213	2,289	2,335	2,411	2,383	2,521	2,459
East Nusra (BNT)	2,211	2,343	2,388	2,259	2,295	2,342	2,383	2,406	2,445	2,503	2,559
West Kalimantan (KAL)	2,166	2,257	2,277	2,298	2,335	2,336	2,369	2,370	2,416	2,505	2,561
Central Kalimantan (KAL)	1,078	1,081	1,101	1,152	1,187	1,208	1,248	1,288	1,286	1,371	1,397
South Kalimantan (KAL)	1,713	1,754	1,847	1,845	1,898	1,956	2,018	2,068	2,052	2,152	2,191
East Kalimantan (KAL)	1,249	1,488	1,535	1,713	1,813	1,863	1,924	1,649	1,650	1,679	1,815
North Kalimantan (KAL)	-	-	-	-	-	-	-	287	287	325	348
North Sulawesi (SUL)	1,047	1,077	1,074	1,081	1,138	1,116	1,159	1,180	1,184	1,259	1,254
Central Sulawesi (SUL)	1,219	1,236	1,287	1,364	1,416	1,391	1,428	1,427	1,495	1,557	1,570
South Sulawesi (SUL)	3,277	3,392	3,561	3,681	3,706	3,705	3,678	3,756	3,775	3,992	4,174
South-East Sulawesi (SUL)	963	986	1,034	1,072	1,109	1,085	1,136	1,168	1,212	1,261	1,287
Gorontalo (SUL)	423	463	485	466	482	493	521	534	563	590	622
West Sulawesi (SUL)	478	516	546	599	584	596	601	648	642	642	663
Maluku (PM)	554	590	625	704	692	719	728	711	733	769	772
North Maluku (PM)	417	441	422	484	476	490	493	519	531	557	588
West Papua (PM)	344	361	368	381	387	379	408	408	437	442	461
Papua (PM)	1,054	1,090	1,166	1,563	1,563	1,630	1,689	1,710	1,743	1,754	1,851
Total	111,475	113,745	115,999	120,425	121,820	123,168	125,315	128,302	127,673	131,542	133,936

Source: Statistic Indonesia (BPS). See https://www.bps.go.id/subject/6/tenaga-kerja.html#subjekViewTab3.
Note: Region – SUM=Sumatera, JAV=Java, BNT=Bali and Nusa Tenggara, KAL=Kalimantan, SUL=Sulawesi and PM = Papua and Maluku.

Appendix Table A.3.3: Minimum Wages by Province, 2001-15

Province (Region)	Minimum Wage (Rupiah, thousands)														
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Aceh (SUM)	300	330	425	550	620	820	850	1,000	1,200	1,300	1,350	1,400	1,550	1,750	1,900
North Sumatera (SUM)	341	464	505	537	600	738	761	822	905	965	1,036	1,200	1,375	1,506	1,625
West Sumatera (SUM)	250	385	435	480	540	650	725	800	880	940	1,055	1,150	1,350	1,490	1,615
Riau (SUM)	329	394	438	477	552	637	710	800	902	1,016	1,120	1,238	1,400	1,700	1,878
Jambi (SUM)	245	304	390	425	485	563	658	724	800	900	1,028	1,143	1,300	1,502	1,710
South Sumatera (SUM)	255	332	404	460	504	604	662	743	825	928	1,048	1,195	1,630	1,825	1,974
Bengkulu (SUM)	240	295	330	363	430	516	645	690	735	780	815	930	1,200	1,350	1,500
Lampung (SUM)	240	310	350	378	405	505	555	617	691	768	855	975	1,150	1,399	1,581
Bangka Belitung Isl. (SUM)	255	345	380	448	560	640	720	813	850	910	1,024	1,110	1,265	1,640	2,100
Riau Island (SUM)	422	-	-	-	557	760	805	833	892	925	975	1,015	1,365	1,665	1,954
Jakarta (JAV)	426	591	632	672	712	819	901	973	1,070	1,118	1,290	1,529	2,200	2,441	2,700
West Java (JAV)	245	281	320	367	408	448	517	568	628	672	732	780	850	1,000	1,000
Central Java (JAV)	245	315	340	365	390	450	500	547	575	660	675	765	830	910	910,
Yogyakarta (JAV)	238	322	360	365	400	460	500	586	700	746	808	893	947	989	989
East Java (JAV)	220	245	274	310	340	390	449	500	570	630	705	745	866	1,000	1,000
Banten (JAV)	245	360	475	515	585	662	747	837	918	955	1,000	1,042	1,170	1,325	1,600
Bali (BNT)	310	341	410	425	448	510	622	683	760	829	890	968	1,181	1,543	1,621
West Nusra (BNT)	240	320	375	413	475	550	645	730	833	891	950	1,000	1,100	1,210	1,330
East Nusra (BNT)	275	330	350	400	450	550	600	650	725	800	850	925	1,010	1,150	1,250
West Kalimantan (KAL)	305	380	400	420	445	512	560	645	705	741	803	900	1,060	1,380	1,560
Central Kalimantan (KAL)	362	362	425	482	524	634	666	766	873	987	1,135	1,327	1,553	1,724	1,896
South Kalimantan (KAL)	295	378	425	482	536	629	745	825	930	1,025	1,126	1,225	1,338	1,620	1,870
East Kalimantan (KAL)	300	500	540	573	600	702	767	890	955	1,002	1,084	1,177	1,752	1,886	2,026
North Kalimantan (KAL)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2,026
North Sulawesi (SUL)	372	438	495	545	600	714	750	845	930	1,000	1,050	1,250	1,550	1,900	2,150
Central Sulawesi (SUL)	245	350	410	450	490	575	615	670	720	778	828	885	995	1,250	1,500
South Sulawesi (SUL)	300	375	415	455	510	612	673	741	905	1,000	1,100	1,200	1,440	1,800	2,000
South-East Sulawesi (SUL)	275	325	390	470	499	573	640	700	770	860	930	1,032	1,125	1,400	1,652
Gorontalo (SUL)	372	375	410	430	435	527	560	600	675	710	763	838	1,175	1,325	1,600
West Sulawesi (SUL)	-	-	-	-	-	612	691	761	909	944	1,006	1,127	1,165	1,400	1,656
Maluku (PM)	230	285	370	450	500	575	635	700	775	840	900	975	1,275	1,415	1,650
North Maluku (PM)	230	322	370	400	440	528	660	700	770	847	889	960	1,201	1,441	1,578
West Papua (PM)	-	-	-	-	-	823	987	1,106	1,180	1,210	1,410	1,450	1,720	1,870	2,015
Papua (PM)	400	530	600	650	700	823	987	1,106	1,216	1,317	1,403	1,585	1,710	2,040	2,193
Average	280	363	415	459	508	609	682	757	842	909	989	1,089	1,297	1,510	1,668

Source: Statistic Indonesia (BPS). See https://www.bps.go.id/linkTableDinamis/view/id/917.
Note: Region – SUM = Sumatera, JAV = Java, BNT = Bali and Nusa Tenggara, KAL = Kalimantan, SUL = Sulawesi and PM = Papua and Maluku.

Appendix Table A.3.4: Human Development Index by Province, 2010-17

Province (Region)/National	2010	2011	2012	2013	2014	2015	2016	2017
Aceh (SUM)	67.1	67.5	67.8	68.3	68.8	69.5	70.0	70.6
North Sumatera (SUM)	67.1	67.3	67.7	68.4	68.9	69.5	70.0	70.6
West Sumatera (SUM)	67.3	67.8	68.4	68.9	69.4	70.0	70.7	71.2
Riau (SUM)	68.7	68.9	69.2	69.9	70.3	70.8	71.2	71.8
Jambi (SUM)	65.4	66.1	66.9	67.8	68.2	68.9	69.6	70.0
South Sumatera (SUM)	64.4	65.1	65.8	66.2	66.8	67.5	68.2	68.9
Bengkulu (SUM)	65.4	66.0	66.6	67.5	68.1	68.6	69.3	70.0
Lampung (SUM)	63.7	64.2	64.9	65.7	66.4	67.0	67.7	68.3
Bangka Belitung Isl. (SUM)	66.0	66.6	67.2	67.9	68.3	69.1	69.6	70.0
Riau Island (SUM)	71.1	71.6	72.4	73.0	73.4	73.8	74.0	74.5
Jakarta (JAV)	76.3	77.0	77.5	78.1	78.4	79.0	80.0	80.1
West Java (JAV)	66.2	66.7	67.3	68.3	68.8	70.0	70.1	70.7
Central Java (JAV)	66.1	66.6	67.2	68.0	68.8	69.5	70.0	70.5
Yogyakarta (JAV)	75.4	75.9	76.2	76.4	76.8	77.6	78.4	78.9
East Java (JAV)	65.4	66.1	66.7	67.6	68.1	69.0	69.7	70.3
Banten (JAV)	67.5	68.2	68.9	69.5	69.9	70.3	71.0	71.4
Bali (BNT)	70.1	70.9	71.6	72.1	72.5	73.3	73.7	74.3
West Nusra (BNT)	61.2	62.1	63.0	63.8	64.3	65.2	65.8	66.6
East Nusra (BNT)	59.2	60.2	60.8	61.7	62.3	62.7	63.1	63.7
West Kalimantan (KAL)	62.0	62.4	63.4	64.3	64.9	65.6	65.9	66.3
Central Kalimantan (KAL)	66.0	66.4	66.7	67.4	67.8	68.5	69.1	69.8
South Kalimantan (KAL)	65.2	65.9	66.7	67.2	67.6	68.4	69.1	69.7
East Kalimantan (KAL)	71.3	72.0	72.6	73.2	73.8	74.2	74.6	75.1
North Kalimantan (KAL)	-	-	-	68.0	68.6	68.8	69.2	69.8
North Sulawesi (SUL)	67.8	68.3	69.0	69.5	70.0	70.4	71.1	71.7
Central Sulawesi (SUL)	63.3	64.3	65.0	65.8	66.4	66.8	67.5	68.1
South Sulawesi (SUL)	66.0	66.7	67.3	67.9	68.5	69.2	69.8	70.3
South-East Sulawesi (SUL)	66.0	66.5	67.1	67.6	68.1	68.8	69.3	69.9
Gorontalo (SUL)	62.7	63.5	64.2	64.7	65.2	65.9	66.3	67.0
West Sulawesi (SUL)	59.7	60.6	61.0	61.5	62.2	63.0	63.6	64.3
Maluku (PM)	64.3	64.8	65.4	66.1	66.7	67.1	67.6	68.2
North Maluku (PM)	62.8	63.2	63.9	64.8	65.2	65.9	66.6	67.2
West Papua (PM)	59.6	59.9	60.3	60.9	61.3	61.7	62.2	63.0
Papua (PM)	54.5	55.0	55.6	56.3	56.8	57.3	58.1	59.1
Indonesia	66.5	67.1	67.7	68.3	68.9	69.6	70.2	70.8

Source: Statistic Indonesia (BPS).
See https://www.bps.go.id/subject/26/indeks-pembangunan-manusia.html#subjekViewTab3.

Note: Region – SUM = Sumatera, JAV = Java, BNT = Bali and Nusa Tenggara, KAL = Kalimantan, SUL = Sulawesi, and PM = Papua and Maluku.

Appendix Table A.3.5: ICT Literacy Rates by Province, 2015-16

Province (Region)/National	Percentage	
	2015	2016
1. Aceh (SUM)	36.8	39.9
2. North Sumatera (SUM)	44.6	51.1
3. West Sumatera (SUM)	56.3	59.4
4. Riau (SUM)	52.3	56.3
5. Jambi (SUM)	50.6	53.5
6. South Sumatera (SUM)	44.0	49.5
7. Bengkulu (SUM)	48.5	49.9
8. Lampung (SUM)	33.7	45.1
9. Bangka Belitung Islands (SUM)	49.1	55.9
10. Riau Islands (SUM)	68.6	76.6
11. Jakarta (JAV)	80.0	82.5
12. West Java (JAV)	55.7	61.8
13. Central Java (JAV)	56.0	63.6
14. Yogyakarta (JAV)	83.2	85.4
15. East Java (JAV)	54.4	61.5
16. Banten (JAV)	51.6	59.4
17. Bali (BNT)	66.6	76.4
18. West Nusa Tenggara (BNT)	36.8	46.6
19. East Nusa Tenggara (BNT)	22.5	29.1
20. West Kalimantan (KAL)	37.0	44.6
21. Central Kalimantan (KAL)	45.3	51.7
22. South Kalimantan (KAL)	56.5	62.8
23. East Kalimantan (KAL)	64.3	73.1
24. North Kalimantan (KAL)	53.9	63.4
25. North Sulawesi (SUL)	54.9	62.3
26. Central Sulawesi (SUL)	38.7	44.4
27. South Sulawesi (SUL)	51.5	55.0
28. South-East Sulawesi (SUL)	42.3	49.7
29. Gorontalo (SUL)	44.8	52.9
30. West Sulawesi (SUL)	32.4	39.6
31. Maluku (PM)	38.6	43.0
32. North Maluku (PM)	27.2	30.2
33. West Papua (PM)	37.5	39.4
34. Papua (PM)	17.0	23.1
Indonesia	51.8	58.2

Source: Statistic Indonesia (BPS). See https://www.bps.go.id/site/resultTab.

Notes: 15-24 Years-olds only. Region – SUM = Sumatera, JAV = Java, BNT = Bali and Nusa Tenggara, KAL = Kalimantan, SUL = Sulawesi and PM = Papua and Maluku.

Appendix Table A.6.1: Responses to Individual Survey Questions

(Explanation and definition of terms given at the end of this Appendix)

Q-1.1 What is your job title/position?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. CEO		8	4		2	1	15	7	8
2. Director	4	12	7	6	6	2	37	19	18
3. General Manager	1	3	3	1	4	1	13	8	5
4. Finance/Tax Manager	17	25	32	18	18	6	116	39	77
5. Accounting/Administration Supervisor	1	10	4	6	4	2	27	15	12
6. Secretary/HRD/Account Executive	1	3	6	2	1		13	8	5
7. Commissioner		1	1			1	3	1	2
Total	24	62	57	33	35	13	224	97	127

Q-1.2 How many years have you worked for the present company? (in years)

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
up to 5 years	7	19	14	11	11	6	68	31	37
6-10	8	17	15	8	9	2	59	30	29
11-15	5	10	7	7	9	2	40	14	26
16-20	3	6	13	2	6	1	31	13	18
21-25	1	6	7	3		2	19	7	12
26 years and more		3	1	2			6	1	5
Non-response		1					1	1	
Total	24	62	57	33	35	13	224	97	127

Q-1.3 Prior to working at this plant did you work for the same company at another site?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	3	10	11	5	9	1	39	18	21
0. No	21	51	46	28	26	12	184	78	106
Non-response		1					1	1	
Total	24	62	57	33	35	13	224	97	127

Q-1.4 Are you an Indonesian national?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	22	42	50	27	32	11	184	70	114
0. No	2	19	7	5	3	2	38	25	13
Non-response		1		1			2	2	
Total	24	62	57	33	35	13	224	97	127

Q-2.1 When was this Plant established?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1960s and before				1	1	1	3		3
1970s	1	7	3	3		1	15	5	10
1980s	2	6	7	5	1		21	5	16
1990s	14	21	22	18	8	4	87	39	48
2000s	7	26	23	5	22	4	87	44	43
2010s		2	2		2	1	7	3	4
Non-response				1	1	2	4	1	3
Total	24	62	57	33	35	13	224	97	127

Q-2.2 Is the Plant located in a Special Economic Zone/Free Trade Zone/Bonded Area?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	8	37	28	12	7	5	97	97	
0. No	16	25	29	21	28	8	127		127
Non-response									
Total	24	62	57	33	35	13	224	97	127

Q-2.3 Can you confirm the region in which this Plant is located?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Java	18	59	37	26	31	4	175	61	114
2. Sumatera	4	3	18	7	2	5	39	35	4
3. Kalimantan			1			1	2		2
4. Bali and Nusa Tenggara					2	1	3		3
5. Sulawesi	2		1			1	4	1	3
6. Papua and Maluku						1	1		1
Total	24	62	57	33	35	13	224	97	127

Q-2.3a Can you confirm the province in which this Plant is located?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. North Sumatera (2)	2	1				1	4	1	3
2. Riau Island (6)	1	2	17	7	2	4	33	33	
3. Jakarta (11)	5	7	3	5	15	3	38	12	26
4. West Java (12)	7	32	22	9	7		77	32	45
5. Banten (13)	2	10	5	7	4		28	5	23
6. Central Java (14)	1	8	5	1	1		16	9	7
7. East Java (16)	3	1	1	2	1		8	3	5
8. Bali (17)					2		2		2
9. South Sulawesi (28)			1			1	2		2
10. Other (99)	3		2		1	3	9	2	7
Non-response		1	1	2	2	1	7		7
Total	24	62	57	33	35	13	224	97	127

Q-2.4 When first established, was this a wholly new plant, or was it relocated from elsewhere?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. New	23	55	54	32	32	11	207	90	117
2. Relocated	1	7	3	1	3	2	17	7	10
Total	24	62	57	33	35	13	224	97	127

Q-2.4a If relocated, where was the Plant previously?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
North Sumatera						1	1		1
Jakarta		2			1		3	2	1
West Java		2	1		1		4	2	2
Banten					1		1		1
Central Java		1		1			2	1	1
East Java		1	1				2		2
West Nusa Tenggara						1	1		1
Taiwan		1					1		1
Singapore			1				1	1	
Non-response	1						1	1	
Total	1	7	3	1	3	2	17	7	10

Q-2.5 Did the company acquire this Plant from another firm?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	8	6	4	5	4	4	31	12	19
0. No	16	55	51	28	30	9	189	83	106
Non-response		1	2		1		4	2	2
Total	24	62	57	33	35	13	224	97	127

Q-2.6 What is the Plant's principal activity?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Manufacture of food products (10)	23						23	7	16
2. Manufacture of tobacco products (12)	1						1	1	
3. Manufacture of textiles (13)		29					29	9	20
4. Manufacture of wearing apparel (14)		32					32	27	5
5. Manufacture of leather and related products (15)		1					1	1	
6. Manufacture of wood and of products of wood (16)			2				2		2
7. Manufacture of paper and paper products (17)			1				1		1
8. Printing and reproduction of recorded media (18)			1				1	1	
9. Manufacture of pharmaceuticals, medicinal chemical (21)			1				1		1
10. Manufacture of rubber and plastics products (22)			10				10	6	4
11. Manufacture of computer, electronic and optical products (26)			3				3	3	
12. Manufacture of electrical equipment (27)			6				6	4	2
13. Manufacture of machinery (28)			4				4	2	2
14. Manufacture of motor vehicles, trailers and semi-trailers (29)			13				13	7	6
15. Manufacture of furniture (31)			9				9	2	7
16. Other manufacturing (32)			5				5	2	3
17. Repair and installation of machinery and equipment (33)			2				2	1	1
18. Manufacture of chemicals and chemical products (20)				11			11	3	8
19. Manufacture of other non-metallic mineral products (23)				7			7	1	6
20. Manufacture of basic metals (24)				13			13	6	7
21. Manufacture of fabricated metal products, non-machinery (25)				2			2	2	

22. Wholesale and retail trade and repair of motor vehicles (45)					13		13	1	12
23. Wholesale trade, except of motor vehicles (46)					9		9	2	7
24. Land transport and transport via pipelines (49)					3		3		3
25. Warehousing and support activities for transportation (52)					1		1		1
26. Accommodation (55)					1		1		1
27. Telecommunications (61)					1		1	1	
28. Computer programming, consultancy and related activities (62)					1		1		1
29. Information service activities (63)					1		1	1	
30. Activities of head offices; management consultancy (70)					1		1		1
31. Service to buildings and landscape activities (81)					1		1	1	
32. Office administrative and other business support (82)					1		1		1
33. Other personal service activities (96)					2		2	1	1
34. Crop and animal production and related service activities (01)						2	2		2
35. Fishing and aquaculture (03)						1	1		1
36. Mining of metal ores (07)						1	1		1
37. Electricity, gas, steam and air conditioning supply (35)						3	3	1	2
38. Construction of buildings (41)						2	2		2
39. Civil engineering (42)						2	2	2	
40. Specialized construction activities (43)						2	2	2	
Total	24	62	57	33	35	13	224	97	127

Q-2.7 In what broad sector does the Plant operate?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Primary (included construction and utilities)						13	13	5	8
2. Manufacturing	24	62	57	33			176	85	91
3. Services					35		35	7	28
Total	24	62	57	33	35	13	224	97	127

Q-2.8 Does the Plant operate under a franchise or license from another company?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	6	7	8	7	11		39	14	25
2. No	18	53	48	25	24	13	181	80	101
Non-response		2	1	1			4	3	1
Total	24	62	57	33	35	13	224	97	127

Q-2.9 Where are the Plant's main competitors located?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
a. Locally	11	20	21	15	19	6	92	38	54
b. Nationally	14	19	16	15	14	4	82	23	59
c. Internationally	8	34	32	10	7	4	95	63	32

Q-2.10 Approximately, how many people are employed at this Plant?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. 1-5						2	2	1	1
2. 6-10					3		3		3
3. 11-25			4	2	7	2	15	6	9
4. 26-50	1	2	1	2	9	2	17	6	11
5. 51-100		3	10	3	5	2	23	5	18
6. 101-200	5	4	8	7	4		28	14	14
7. 201-500	7	10	14	7	5	2	45	14	31
8. more than 500	10	42	20	12	2	3	89	50	39
Non-response	1	1					2	1	1
Total	24	62	57	33	35	13	224	97	127

Q-2.11 What proportion of the Plant's employees are hired from the local labour market?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. up to 25%	1	1	1				3		3
2. 26 to 50 %		1				1	2		2
3. 51 to 75 %		1		1	2		4	2	2
4. 76 to 100%	23	58	56	32	33	12	214	94	120
Non-response		1					1	1	
Total	24	62	57	33	35	13	224	97	127

Q-2.12 What percentage of the Plant's employee are? (sum to 100%)

Options	Food	Text	ManL	ManH	Serv	Other	Average	SA	Non-SA
a. Managerial	8%	7%	9%	9%	17%	16%	10%	9%	10%
b. Technical/skilled	28%	39%	33%	42%	51%	42%	39%	38%	39%
c. Semi-skilled/unskilled	64%	54%	59%	49%	32%	43%	51%	52%	50%

Q-2.13 Approximately, what is the annual gross sales of this Plant?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. < Rp 4.8 billion	1	1	5	1	2	2	12	6	6
2. Rp 4.9-10 billion		2	1	1	3	2	9	6	3
3. Rp 11-20 billion		3	9	1	6	2	21	9	12
4. Rp 21-50 billion	1	11	6	5	9	3	35	17	18
5. Rp 51-100 billion	3	10	11	2	6		32	13	19
6. > Rp 101 billion	19	34	25	23	9	4	114	45	69
Non-response		1					1	1	
Total	24	62	57	33	35	13	224	97	127

Q-2.14 Over the past 2-3 years what has happened to the sales turnover at this Plant?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Decreased	8	26	28	17	17	9	105	52	53
2. Stay the same	2	14	13	3	5	3	40	20	20
3. Increased	14	21	16	13	13	1	78	24	54
Non-response		1					1	1	
Total	24	62	57	33	35	13	224	97	127

Q-2.15 Do you expect your sales to increase over the next 2-3 years?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes a lot	2	2	5	2	8	1	20	4	16
2. Yes, a little	15	32	30	20	19	7	123	48	75
3. No, stay the same	6	10	13	6	6	2	43	18	25
4. No, to decline	1	16	9	5	2	3	36	26	10
Non-response		2					2	1	1
Total	24	62	57	33	35	13	224	97	127

Q-2.16 What percentage of the Plant's sales are made:

Options	Food	Text	ManL	ManH	Serv	Other	Average	SA	Non-SA
a. Locally	36%	23%	30%	36%	56%	58%	35%	23%	45%
b. Nationally	31%	13%	13%	28%	36%	24%	22%	5%	34%
c. Internationally	34%	64%	56%	36%	8%	18%	43%	72%	21%

Q-2.17 [pre-question] When selling the Plant's product, what is mode of transportation?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
a. Road	18	36	40	26	26	5	151	50	101
b. Rail	0	0	0	0	3	0	3	0	3
c. Sea	16	45	40	23	13	3	140	77	63
d. Air	5	34	19	3	16	2	79	48	31
e. Not relevant	0	1	2	0	5	3	11	3	8

Q-2.17 When selling the Plant's product, roughly what percentage by value is transported by the following means?

Options	Food	Text	ManL	ManH	Serv	Other	Average	SA	Non-SA
a. Road	56%	38%	41%	62%	72%	56%	51%	25%	70%
b. Rail	0%	0%	0%	0%	1%	0%	0%	0%	0%
c. Sea	43%	54%	52%	38%	14%	30%	42%	67%	25%
d. Air	1%	8%	7%	0%	13%	14%	7%	8%	5%
e. Not relevant	0%	0%	0%	0%	0%	0%	0%	0%	0%

Q-2.18 If you export, what global regions are your main export markets?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
a. Asia	15	32	44	21	12	2	126	63	63
b. America	4	30	11	5	2	0	52	38	14
c. Europe	8	20	11	4	2	1	46	30	16
d. Other	4	3	8	2	2	2	21	5	16

Q-2.18a If you export, what global countries are your main export markets?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Japan (105)	5	16	21	7	1	0	50	26	24
2. United States of America (222)	5	22	7	3	1	0	38	29	9
3. Singapore (187)	5	1	14	6	6	2	34	21	13
4. South Korea (194)	5	14	8	3	0	0	30	15	15
5. China (45)	2	12	7	4	0	0	25	16	9
6. Germany (78)	3	9	7	2	0	0	21	15	6
7. Malaysia (125)	4	1	9	5	1	0	20	6	14
8. Thailand (207)	4	2	6	5	3	0	20	4	16
9. Vietnam (228)	3	5	3	5	2	0	18	5	13
10. United Kingdom (221)	2	4	4	1	0	0	11	10	1
11. Australia (12)	4	3	1	1	0	1	10	4	6
12. Philippines (165)	5	0	2	2	1	0	10		10
13. Taiwan (204)	4	1	4	1	0	0	10	3	7
14. Italy (103)	2	4	0	2	0	0	8	4	4
15. Netherlands (147)	2	5	1	0	0	0	8	6	2
16. Others (300)	13	21	27	22	3	1	87	27	60
Total	68	120	121	69	18	4	400	191	209

Q-2.19 What materials are sourced:

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
a. Locally	14	39	45	21	18	10	147	62	85
b. Nationally	18	23	27	17	14	6	105	39	66
c. Internationally	19	52	49	27	22	7	176	85	91

Q-2.19 What percentage of your materials are sourced:

Options	Food	Text	ManL	ManH	Serv	Other	Average	SA	Non-SA
a. Locally	33%	28%	37%	32%	31%	53%	33%	26%	39%
b. Nationally	48%	10%	14%	24%	10%	28%	18%	12%	24%
c. Internationally	19%	62%	50%	44%	59%	19%	49%	63%	37%

Q-2.20 If you import, what global regions are your main source of import?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
a. Asia	16	50	51	26	22	4	169	82	87
b. America	2	8	7	3	4	2	26	8	18
c. Europe	9	11	8	5	10		43	20	23
d. Other	5	6	3	2	3	3	22	5	17

Q-2.20a If you import, what global countries are your main source of import?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. China (45)	7	27	20	13	12		79	40	39
2. South Korea (194)	1	25	15	6	4		51	29	22
3. Japan (105)	1	9	18	10	8	3	49	21	28
4. Singapore (187)	4	3	15	9	9	2	42	23	19
5. Malaysia (125)	7	5	10	4	5		31	15	16
6. Thailand (207)	3	6	7	3	9		28	10	18
7. Taiwan (204)		12	7	6	1		26	14	12
8. United States of America (222)		6	5	2	3	2	18	6	12
9. Germany (78)	3	4	4	2	4		17	7	10
10. India (96)	2	5	3	3	3		16	4	12
11. Australia (12)	2	6	1	2		2	13	1	12
12. Hongkong (93)		9	1	1	1		12	8	4
13. Italy (103)	2	3	3	1	2		11	6	5
14. Vietnam (228)		4	3	3	1		11	6	5
15. Brazil (28)	2	4		1			7	1	6
16. Others (300)	13	18	5	3	16	1	56	19	37
Total	47	146	117	69	78	10	467	210	257

Q-3.1 What is the ownership structure of this Company?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Independent company	12	31	33	16	14	9	115	48	67
2. Subsidiary of a larger corporation	12	26	21	16	18	4	97	45	52
3. Other (Joint-Venture)		3	2	1	3		9	3	6
Non-response		2	1				3	1	2
Total	24	62	57	33	35	13	224	97	127

Q-3.2 What is the legal status of the Company?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Public		7	7	2	3		19	11	8
2. Private	24	52	46	28	30	13	193	81	112
Non-response		3	4	3	2		12	5	7
Total	24	62	57	33	35	13	224	97	127

Q-3.3 What is the nationality structure of the Company?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Indonesia (97)	14	29	21	12	21	8	105	32	73
2. Japan (105)	1	7	18	10	7	2	45	16	29
3. Singapore (187)	3	6	11	5	12	4	41	23	18
4. South Korea (194)		27	7	3	1		38	26	12
5. Taiwan (204)		2	4	4			10	2	8
6. Hongkong (93)	2	4	2				8	4	4
7. United Kingdom (221)	1	1	1	2	1	1	7	2	5
8. China (45)	1		2	2	1		6	3	3
9. United State of America (222)	2			2		2	6	2	4
10. Australia (12)	3			1	1		5	0	5
11. India (96)		2	1	2			5	3	2
12. Malaysia (125)	1			3	1		5	4	1
13. Netherlands (147)	3			1			4	0	4
14. Thailand (207)			1	1	2		4	1	3
15. BVI (29)		1	1	1			3	2	1
16. Germany (78)			2		1		3	0	3
17. Belgium (20)		2					2	2	0
18. France (72)	1				1		2	0	2
19. Switzerland (202)	1		1				2	1	1
20. Non-Indonesia /Foreign Country (300)	4	4	6	2	1	1	18	8	10
21. Others	2	1		1	2	1	7	3	4

Q-3.4 What is the principal activity of the Company?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Manufacture of food products (10)	23						23	7	16
2. Manufacture of tobacco products (12)	1						1	1	
3. Manufacture of textiles (13)		29					29	9	20
4. Manufacture of wearing apparel (14)		32					32	27	5
5. Manufacture of leather and related products (15)		1					1	1	
6. Manufacture of wood and of products of wood (16)			2				2		2
7. Manufacture of paper and paper products (17)			1				1		1

8. Printing and reproduction of recorded media (18)	1				1	1	
9. Manufacture of pharmaceuticals, medicinal chemical (21)	1				1		1
10. Manufacture of rubber and plastics products (22)	10				10	6	4
11. Manufacture of computer, electronic and optical products (26)	3				3	3	
12. Manufacture of electrical equipment (27)	7				7	5	2
13. Manufacture of machinery (28)	5				5	3	2
14. Manufacture of motor vehicles, trailers and semi-trailers (29)	11				11	5	6
15. Manufacture of furniture (31)	9				9	2	7
16. Other manufacturing (32)	5				5	2	3
17. Repair and installation of machinery and equipment (33)	2				2	1	1
18. Manufacture of chemicals and chemical products (20)		11			11	3	8
19. Manufacture of other non-metallic mineral products (23)		7			7	1	6
20. Manufacture of basic metals (24)		12			12	6	6
21. Manufacture of fabricated metal products, non-machinery (25)		3			3	2	1
22. Wholesale and retail trade and repair of motor vehicles (45)			13		13	1	12
23. Wholesale trade, except of motor vehicles (46)			9		9	2	7
24. Land transport and transport via pipelines (49)			3		3		3
25. Warehousing and support activities for transportation (52)			1		1		1
26. Accommodation (55)			1		1		1
27. Telecommunications (61)			1		1	1	
28. Computer programming, consultancy and related activities (62)			1		1		1
29. Information service activities (63)			1		1	1	
30. Activities of head offices; management consultancy (70)			1		1		1
31. Service to buildings and landscape activities (81)			1		1	1	
32. Office administrative and other business support (82)			1		1		1
33. Other personal service activities (96)			2		2	1	1
34. Crop and animal production and related service activities (01)				2	2		2
35. Fishing and aquaculture (03)				1	1		1

36. Mining of metal ores (07)						1	1		1
37. Electricity, gas, steam and air conditioning supply (35)						3	3	1	2
38. Construction of buildings (41)						2	2		2
39. Civil engineering (42)						2	2	2	
40. Specialized construction activities (43)						2	2	2	
Total	24	62	57	33	35	13	224	97	127

Q-3.5 Does the Company have plants other than this one located in Indonesia?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	2	11	6	10	6	2	37	13	24
0. No	22	50	51	23	29	11	186	83	103
Non-response		1					1	1	
Total	24	62	57	33	35	13	224	97	127

Q-3.5a If Yes, how many?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. 1	1	6	3	1	2		13	5	8
2. 2		2	1	2	2	1	8	4	4
3. 3		2		2			4	2	2
4. 4	1	1	1			1	4	2	2
5. 5			1		1		2		2
6. more than 5				4	1		5		5
Total	2	11	6	9	6	2	36	13	23

Q-3.5b If Yes, what is the location of other plant?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Java	2	14	2	14	5		37	13	24
2. Sumatera	1	1	1	4	3	2	12	3	9
3. Kalimantan				1	1	1	3		3
4. Bali and Nusa Tenggara									
5. Sulawesi	1			1			2	1	1
6. Papua and Maluku						2	2		2
7. Asia (outside Indonesia)		2	7	3			12	7	5
8. America		1	1				2	1	1
Total	4	18	11	23	9	5	70	25	45

Q-3.6 In what country is the Company Head Office located?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Indonesia [97]	14	34	30	13	14	7	112	40	72
2. Japan [105]	2	5	10	7	4	1	29	12	17
3. Singapore [187]		1	6	2	7	1	17	11	6
4. Korea [194]		11	2				13	13	
5. USA [222]	1	1	1	1			4	2	2
6. Germany [78]			2		1		3	1	2
7. Netherlands [147]	2			1			3		3
8. Australia [12]				1	1	1	3		3
9. Belgium [20]		2					2	2	
10. China [45]	1		1				2	1	1
11. France [72]	1				1		2		2
12. Malaysia [125]	1			1			2	2	
13. Norway [156]			1			1	2	1	1
14. Switzerland [202]	1		1				2	1	1
15. United Kingdom [221]				2			2		2
16. Other		2	1		2	1	6	2	4
Non-response	1	6	2	5	5	1	20	9	11
Total	24	62	57	33	35	13	224	97	127

Q-3.7 Approximately, what are the sales of the Company's global operation? (in Rupiah)

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
a. up to Rp 4.8 billion	4	3	2	1	4	1	15	4	11
b. Rp 4.9 to 10 billion		1	2		2		5	4	1
c. Rp 11 to 20 billion		2	9	2	5	1	19	8	11
d. Rp 21 to 50 billion		13	2	4	4	2	25	13	12
e. Rp 51 to 100 billion	2	9	9	2	3	1	26	15	11
f. more than Rp 100 billion	14	30	20	21	10	5	100	39	61
Non-response	4	4	13	3	7	3	34	14	20
Total	24	62	57	33	35	13	224	97	127

Q-3.8 Where are the Company's main competitors located?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Locally	10	20	22	16	21	7	96	36	60
2. Nationally	17	17	15	15	16	4	84	22	62
3. Internationally	8	39	32	13	5	5	102	67	35

Q-4.1 How best describes the Company's motive for setting-up Plant in Indonesia?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Getting close to main consumer market	17	27	36	26	31	6	143	41	102
2. Getting close to main producer market	11	22	22	12	9	4	80	29	51
3. Getting close to raw materials	15	26	28	14	10	6	99	38	61
4. Getting close to labour resources	12	54	46	28	17	9	166	75	91
5. Economies of scale or scope	15	34	38	21	21	7	136	53	83
6. Risk diversification	6	23	21	11	9	2	72	24	48
7. Acquiring some strategic assets	11	28	27	15	14	7	102	37	65

Q-4.2 In setting-up the Plant at its current location, did you consider other sites?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	6	25	25	17	11	4	88	39	49
0. No	17	36	31	14	23	9	130	54	76
Non-response	1	1	1	2	1		6	4	2
Total	24	62	57	33	35	13	224	97	127

Q-4.2a If Yes, was this:

Options	Food	Text	ManL	ManH	Serv	Other	Total	SEZ	NonSEZ
a. Locally		10	7	6	5		28	11	17
b. Nationally	4	10	10	4	4	4	36	12	24
c. Internationally	1	8	7	10	3	1	30	17	13

Q-4.3 When setting-up the Plant, which of the following were important?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. General investment climate	14	36	37	20	22	10	139	55	84
2. Market size	18	27	30	23	27	5	130	35	95
3. Growing local or national economy	14	36	29	20	21	6	126	41	85
4. Weak competition from other local or national companies	2	13	12	8	3	5	43	15	28
5. Availability of skilled labour	13	42	40	21	21	6	143	64	79
6. Availability of cheap labour	12	50	44	24	12	8	150	75	75
7. Productive workforce	9	33	33	15	9	4	103	52	51
8. Availability of natural resources	13	18	20	13	6	6	76	24	52
9. Good physical infrastructure	18	42	37	20	18	7	142	58	84
10. Good electronic infrastructure	7	32	25	9	15	5	93	37	56
11. Geographical location	19	33	37	22	18	9	138	61	77
12. Political stability and security	18	44	48	19	19	8	156	67	89
13. Regulatory framework and economic policy coherence	11	29	38	15	14	4	111	45	66
14. Investment protection and promotion	8	29	34	11	18	3	103	41	62
15. Other reasons	1	2	2	1	0	1	7	3	4

Q-4.4 Of the above factors, which was the most important?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. General investment climate		6	5	2	5	3	21	10	11
2. Market size	9	7	9	10	11		46	9	37
3. Growing local or national economy	3	6	1	2	2	2	16	6	10
4. Weak competition from other local or national companies			1				1		1
5. Availability of skilled labour		11	2	2			15	13	2
6. Availability of cheap labour	2	18	8	4			32	25	7
7. Productive workforce		2					2	2	
8. Availability of natural resources	5		8	2		2	17	5	12
9. Good physical infrastructure		1	1	2	2		6		6
10. Good electronic infrastructure							0		
11. Geographical location	1		4	1	1	1	8	6	2
12. Political stability and security	2	6	9	5	8	1	31	8	23
13. Regulatory framework and economic policy coherence		1	1	2	1		5		5
14. Investment protection and promotion	1		3		1	1	6	4	2
15. Other reasons						1	1		1
Non-response	1	4	5	1	4	2	17	9	8
Total	24	62	57	33	35	13	224	97	127

Q-4.5 When setting-up the Plant in Indonesia what sources of information were helpful to you?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. BKPM	22	54	47	28	28	9	188	77	111
2. DGT	18	44	43	16	25	6	152	64	88
3. Indonesia Embassy	6	21	20	11	5	2	65	29	36
4. Other national government agencies	8	28	29	14	18	5	102	43	59
5. Local agencies	13	37	30	11	19	7	117	47	70
6. Local contacts	9	27	24	10	9	5	84	39	45
7. Business contacts	11	40	34	22	18	9	134	55	79
8. Investor Outlook Reports (Global Competitiveness, Ease of Doing Business, etc)	5	8	14	9	4	2	42	17	25
9. Other		2	1				3		3

Q-4.6 If you used BKPM or the DGT how useful did you find them in helping with your investment?

BKPM

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very useful	10	30	29	13	18	2	102	41	61
2. Quite useful	11	23	19	10	10	4	77	33	44
1. Not very useful	1	5	5	5	2	6	24	9	15
0. Very unhelpful	1			1			2	2	
Non-response	1	4	4	4	5	1	19	12	7
Total	24	62	57	33	35	13	224	97	127

DGT

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very useful	6	26	28	5	14	2	81	36	45
2. Quite useful	12	17	15	11	9	4	68	26	42
1. Not very useful	3	8	8	7	4	4	34	17	17
0. Very unhelpful	1				2		3	1	2
Non-response	2	11	6	10	6	3	38	17	21
Total	24	62	57	33	35	13	224	97	127

Q-4.7 What other information that was not available would have been useful for your investment decision?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Labour and wages [regulations, long term projection increase]		5	2		1		8	8	
2. Investment regulation [clear, easy and consistent]	1	6	5	5	2	1	20	2	18
3. Taxation regulations including tax incentives	1	1	1	2	3		8	4	4
4. Export-import regulation and procedures [including custom and excise]			3		1		4	1	3
5. Energy [electricity]	1	1		1			3		3
6. Infrastructure readiness		1	1	2	1		5	2	3
7. Economic outlook and statistical data	1	3	6	4	4	1	19	6	13
8. Culture and social network	1	1	4			1	7	2	5
9. Land (location) status and regulation		1	1			1	3	1	2

Q-4.8 Did you use tax incentives as part of your negotiation with the Indonesian government before deciding to set-up?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	5	15	11	12	9	2	54	21	33
0. No	17	40	40	18	23	11	149	61	88
Non-response	2	7	6	3	3		21	15	6
Total	24	62	57	33	35	13	224	97	127

Q-4.9 When first investing did the company receive any of the following forms of financial support?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Tax holiday		11	8	4	6		29	10	19
2. Tax allowance	3	10	8	8	8	1	38	12	26
3. Reduced CIT (CIT rate reduction)	3	18	10	9	9	3	52	19	33
4. Accelerated depreciation		10	3	5			18	8	10
5. Employment based reduction in taxes	1	15	4	3	5		28	14	14
6. Health care-based reduction in taxes		9	3	1	3		16	8	8
7. SEZ/FTZ/Bonded Area tax advantages	6	22	16	7	3	2	56	56	
8. Other	1	5	8	2		3	19	3	16
9. None	15	20	23	13	18	7	96	28	68

Q-4.10 Which of the above kinds of support was the most important?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Tax holiday		2	3	1	1		7	2	5
2. Tax allowance	1	1	2	3	2	1	10	1	9
3. Reduced CIT (CIT rate reduction)	2	11	6	6	5	2	32	10	22
4. Accelerated depreciation		2		2			4	2	2
5. Employment based reduction in taxes		1	1				2	1	1
6. Health care-based reduction in taxes									
7. SEZ/FTZ/Bonded Area tax advantages	2	16	9	4	3	1	35	35	
8. Other		3	5			2	10	1	9

Q-5.1 In general, how important is the Corporate Income Tax rate for your investment decision?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very important	15	36	36	25	18	3	133	53	80
2. Important	7	19	10	5	13	7	61	31	30
1. Somewhat important	2	6	10	3	2	2	25	12	13
0. Not important			1		1	1	3		3
Non-response		1			1		2	1	1
Total	24	62	57	33	35	13	224	97	127

Q-5.2 Do you include the value of the Corporate Income Tax rate in your investment appraisals?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
2. Yes	21	46	41	25	27	7	167	69	98
1. No	1	4	6	4	2	4	21	10	11
0. Do not know	2	11	8	4	5	2	32	16	16
Non-response		1	2		1		4	2	2
Total	24	62	57	33	35	13	224	97	127

Q-5.3 In the last few years, have you received any of the following Tax Incentives (other than at the start-up of the Plant)?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Tax holiday		4	3		2		9	6	3
2. Tax allowance		5	3	4	2		14	7	7
3. Reduced CIT (CIT rate reduction)	1	14	10	8	5	1	39	17	22
4. Accelerated depreciation	1	3	1	1	1		7	5	2
5. Employment based reduction in taxes		3		1	2		6	5	1
6. Health care-based reduction in taxes		2		1	1		4	3	1
7. SEZ/FTZ/Bonded Area tax advantages	7	20	7	4	3	1	42	42	
8. Other	2	13	10	5	4	2	36	12	24
9. None	13	20	30	15	17	8	103	34	69

Q-5.3a If so, which of the above was the most important to you?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Tax holiday		1	1				2	1	1
2. Tax allowance				2			2	1	1
3. Reduced CIT (CIT rate reduction)	1	8	8	7	4	1	29	9	20
4. Accelerated depreciation					1		1	1	
5. Employment based reduction in taxes									
6. Health care based reduction in taxes									
7. SEZ/FTZ/Bonded Area tax advantages	2	10	6	2	1	1	22	22	
8. Other	1	5	6	3		1	16	6	10
	4	24	21	14	6	3	72	40	32

Q-5.3b If so, was it critical to your investment decision?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
2. Yes	7	33	20	14	9	3	86	51	35
1. No		2	4	2	2		10	2	8
0. Don't know	1	3	2	2	3	1	12	7	5

Q-5.4 Do you include the value of these Tax Incentives in your investment appraisals?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
2. Yes	10	41	24	21	17	5	118	54	64
1. No	8	12	17	5	10	6	58	23	35
0. Don't know	5	8	13	6	5	2	39	17	22
Non-response	1	1	3	1	3		9	3	6
Total	24	62	57	33	35	13	224	97	127

Q-5.5 Are the Tax Incentives more or less important to you than the Corporate Income Tax rate [statutory CIT rate] in your investment decisions?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. More important	4	8	5	2	6		25	7	18
2. Less important	7	3	10	5	7	1	33	11	22
1. About the same	11	49	39	24	18	12	153	75	78
Non-response	2	2	3	2	4		13	4	9
Total	24	62	57	33	35	13	224	97	127

Q-5.6 Have you applied for a Tax Incentives in the last few years and been refused?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Yes, I have been refused	1	2	2	7	1	1	14	2	12
2. No, I have not been refused	1	4	4	4	3	1	17	9	8
1. No, I have not applied	21	51	47	21	27	11	178	83	95
Non-response	1	5	4	1	4		15	3	12
Total	24	62	57	33	35	13	224	97	127

Q-5.6a If Yes, you have been refused, please specify the reason for the refusal:

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Tax authority concerns on collecting tax			2				2	1	1
2. No explanation (not clear)				1		1	2		2
3. Not fulfilling the requirements		1		3			4	1	3
4. Complexity regulations					1		1		1
Total	0	1	2	4	1	1	9	2	7

Q-5.7 If you have never applied for a tax incentives, why is this?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
2. Not aware	9	34	26	17	16	7	109	58	51
1. Other reason	10	12	18	7	11	2	60	18	42
Non-response	5	16	13	9	8	4	55	21	34
Total	24	62	57	33	35	13	224	97	127

Q-5.7a Other reason (please specify):

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. is part of the existing contract already						1	1		1
2. has joined tax amnesty		1					1	1	
3. not eligible	4	6	8	3	4		25	9	16
4. not relevant (i.e., company loss)	5	1	3		1	1	11	4	7
5. unclear and complex's regulations		1	2	1	1		5	1	4
6. high possibility of rejection			1	1	3		5	1	4
7. no need		2	2	1	2		7	1	6
8. miss out the moment			1				1		1

Q-6.1 How easy is it to do business in Indonesia?

a. Starting business

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	1	3	6		1		11	5	6
2. Quite easy	12	37	32	15	16	6	118	55	63
1. Quite difficult	7	18	12	15	10	2	64	29	35
0. Very difficult	2		3		4	3	12		12
Non-response	2	4	4	3	4	2	19	8	11
Total	24	62	57	33	35	13	224	97	127

b. Obtaining a construction permit

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	1		3				4	2	2
2. Quite easy	10	28	29	13	6	5	91	47	44
1. Quite difficult	9	22	17	16	16	4	84	29	55
0. Very difficult	1	6	1	1	3	2	14	6	8
Non-response	3	6	7	3	10	2	31	13	18
Total	24	62	57	33	35	13	224	97	127

c. Registering property ownership

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	1		1				2	1	1
2. Quite easy	12	37	37	19	16	6	127	60	67
1. Quite difficult	7	13	9	7	8	4	48	16	32
0. Very difficult		2	1	1	2	1	7	2	5
Non-response	4	10	9	6	9	2	40	18	22
Total	24	62	57	33	35	13	224	97	127

d. Obtaining credit

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	2	4	1	3			10	6	4
2. Quite easy	12	33	29	18	15	4	111	47	64
1. Quite difficult	6	11	12	9	11	7	56	23	33
0. Very difficult	1	7	7	1	1		17	6	11
Non-response	3	7	8	2	8	2	30	15	15
Total	24	62	57	33	35	13	224	97	127

e. Securing electricity

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	1	3	5				9	6	3
2. Quite easy	14	39	36	25	18	8	140	65	75
1. Quite difficult	7	13	5	6	8	3	42	12	30
0. Very difficult		1	3	1			5	2	3
Non-response	2	6	8	1	9	2	28	12	16
Total	24	62	57	33	35	13	224	97	127

f. Enforcing contracts

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	1	2	3	1	1		8	3	5
2. Quite easy	12	39	36	19	11	6	123	56	67
1. Quite difficult	7	11	6	9	11	3	47	15	32
0. Very difficult		1			1	2	4	1	3
Non-response	4	9	12	4	11	2	42	22	20
Total	24	62	57	33	35	13	224	97	127

g. Trading across borders

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	2	1	5	3	1		12	7	5
2. Quite easy	12	35	26	16	13	3	105	46	59
1. Quite difficult	8	11	13	9	7	4	52	22	30
0. Very difficult		1	2	1	1	2	7	4	3
Non-response	2	14	11	4	13	4	48	18	30
Total	24	62	57	33	35	13	224	97	127

h. Paying taxes

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	2	7	17	4	1	1	32	15	17
2. Quite easy	16	40	33	23	26	7	145	60	85
1. Quite difficult	4	8	1	4	1	2	20	9	11
0. Very difficult				1	3	1	5	1	4
Non-response	2	7	6	1	4	2	22	12	10
Total	24	62	57	33	35	13	224	97	127

i. Maintaining security

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy		3	4				7	4	3
2. Quite easy	12	40	36	18	23	7	136	63	73
1. Quite difficult	9	11	11	12	2	3	48	15	33
0. Very difficult					2	1	3		3
Non-response	3	8	6	3	8	2	30	15	15
Total	24	62	57	33	35	13	224	97	127

j. Dealing with public officials

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy		2	4				6	3	3
2. Quite easy	12	30	27	9	12	6	96	48	48
1. Quite difficult	6	20	20	17	16	1	80	27	53
0. Very difficult	4	5	2	5	2	4	22	8	14
Non-response	2	5	4	2	5	2	20	11	9
Total	24	62	57	33	35	13	224	97	127

k. Accessing technical know-how

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy			3				3	2	1
2. Quite easy	13	39	39	22	17	9	139	63	76
1. Quite difficult	8	12	9	8	8	1	46	18	28
0. Very difficult		2	1	1	2	1	7	2	5
Non-response	3	9	5	2	8	2	29	12	17
Total	24	62	57	33	35	13	224	97	127

l. Complying with regulations

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
3. Very easy	2	1	6	1			10	5	5
2. Quite easy	13	41	37	19	20	9	139	62	77
1. Quite difficult	6	12	10	10	8		46	15	31
0. Very difficult	1	2		1	1	2	7	4	3
Non-response	2	6	4	2	6	2	22	11	11
Total	24	62	57	33	35	13	224	97	127

Q-6.2 Related to your business, how do you value labour skills in Indonesia?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
2. Good	14	36	29	15	23	5	122	58	64
1. Moderate	9	24	26	18	9	5	91	36	55
0. Poor	1	1			1	1	4		4
Non-response		1	2		2	2	7	3	4
Total	24	62	57	33	35	13	224	97	127

Q-6.3 Do you undertake substantial skills training to match your requirements?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	19	51	43	29	28	6	176	77	99
0. No	5	10	12	4	5	5	41	17	24
Non-response		1	2		2	2	7	3	4
Total	24	62	57	33	35	13	224	97	127

Q-6.4 Do you experience difficulties with the transport network in Indonesia?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Yes	8	25	14	9	11	5	72	30	42
0. No	16	36	41	24	21	6	144	65	79
Non-response		1	2		3	2	8	2	6
Total	24	62	57	33	35	13	224	97	127

Q-6.4a If Yes, please specify

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Lack of infrastructure (quality and network)	2	5	4	2	1	2	16	6	10
2. Remote area				1	1	1	3		3
3. Heavy traffic congestion	2	18	10	4	9	2	45	21	24
4. High transportation cost (i.e., transport between islands)	1	1		1			3		3
5. Complexity in the field	1						1		1
6. Dwelling time at port	1						1	1	
7. Lack of good ethical conduct	1						1	1	

Q-6.5 If relevant, do you experience difficulties in exporting or importing?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
2, 1. Yes - exporting and importing		1	3	1		1	6	3	3
2. Yes - exporting		1				2	3	2	1
1. Yes - importing	2	4	5	8	7		26	7	19
0. No	21	56	45	24	24	7	177	82	95
Non-response	1		4		4	3	12	3	9
Total	24	62	57	33	35	13	224	97	127

Q-6.5a If Yes, please specify

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Export restriction						1	1		1
2. Unclear regulations (keep changes; lack dissemination)		1	4	5	2		12	4	8
3. Take long process (i.e., red-line, dwelling time)	1	1	1		2		5	1	4
4. Lack of service standard (i.e., too strict; too many documents)	1	2	1	1		1	6	3	3
5. License/permits/local regulations		1	1		1		3	1	2
6. Hight cost of export-import		1		3			4	1	3
7. Incompetent officers						1	1		1

Q-6.6 What is the main difficulty that you have experienced when investing in Indonesia?

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Infrastructure readiness	1	2	1				4	3	1
2. Bureaucracy	1	1			2	2	6	2	4
3. Investment regulations	6	11	19	10	11	4	61	26	35
4. Taxation regulations		4	3	2	6		15	4	11
5. Local permits		1		1			2		2
6. Labour and wages	1	8	3	3			15	10	5
7. Difficult bank loan access		1			1		2		2
8. Lack of good ethical standard	1	1	3				5	1	4
9. Thought competition				3	1	1	5		5
10. Land permits			1	1		1	3	1	2
11. Lack of raw material	2						2	1	1
12. Human resources			1				1		1
13. Import and export			1		1		2	1	1
14. High cost of production		1	1				2	2	
15. Lack of communication		1			1		2		2
16. Global crisis			1				1	1	
17. Everything is ok so far	1	3	6			2	12	6	6
Non-response	11	28	17	13	12	3	84	39	45
Total	24	62	57	33	35	13	224	97	127

Q-6.7 When dealing with the following agencies, have you experienced any difficulties?

BKPM

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Complexity of regulations	9	16	16	8	11	5	65	28	37
2. Lack of communication	2	11	10	6	9	3	41	18	23
3. Low capabilities or incompetence of staff	1	2	2		2	3	10	4	6
4. Lack of consistency in decision-making	1	4	5	3	2	2	17	8	9
5. Unreasonable delays in administration	2	6	11	3	6	4	32	15	17
6. Poor dispute resolution procedures		2		1	1	3	7	2	5
7. Lack of good ethical standard		1		1	1	2	5	1	4

DGT

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Complexity of regulations	10	27	21	16	20	7	101	40	61
2. Lack of communication	7	12	11	10	9	4	53	20	33
3. Low capabilities or incompetence of staff	2	3	6	5	6	2	24	5	19
4. Lack of consistency in decision-making	2	11	9	11	12	1	46	15	31
5. Unreasonable delays in administration	5	8	8	7	10	2	40	13	27
6. Poor dispute resolution procedures	5	8	10	9	9	3	44	13	31
7. Lack of good ethical standard	2	4	3	4	4	2	19	6	13

Local Government

Options	Food	Text	ManL	ManH	Serv	Other	Total	SA	Non-SA
1. Complexity of regulations	10	23	18	17	9	6	83	34	49
2. Lack of communication	7	16	21	16	13	6	79	30	49
3. Low capabilities or incompetence of staff	6	15	19	11	13	4	68	23	45
4. Lack of consistency in decision-making	6	11	11	10	9	5	52	22	30
5. Unreasonable delays in administration	12	23	20	17	13	6	91	31	60
6. Poor dispute resolution procedures	5	8	9	3	6	5	36	12	24
7. Lack of good ethical standard	4	11	12	8	10	6	51	18	33

Notes:

Table entries are number of survey responses. 'Total' is the sum across all six industries and 'Average' is weighted according to the number of responses for each industry.

Food = Food and Tobacco Products; Text = Textiles and Related Products; ManL = Light Manufacturing; ManH = Heavy Manufacturing; Serv = Services; Other = Agriculture, Mining, Construction and Utilities; SA = Special Area (Special Economic Zone / Free Trade Zone / Bonded Zone); Non-SA = other areas; BKPM = *Badan Koordinasi Penanaman Modal* (Indonesia Investment Coordinating Board); and DGT = *Direktorat Jenderal Pajak* (Directorate General of Taxes).

Appendix Table A.7.1: The Purpose of Inward Investment Policy

Responses	BKPM				MoF		DGT		BKF			MoI			SEZ	IIPC	IKPI	Total Resp.	Percentage of responses
	A	B	C	D	A	B	A	B	A	B	C	A	B	C	A	A	A		
Developing industries for economic growth	1	1	1	-	1	1	-	-	1	1	1	-	-	-	1	-	-	9	90%
Improving economic distribution	1	-	1	1	-	1	-	-	1	-	1	-	-	-	1	-	-	7	70%
Create new employment	-	1	1	-	-	1	-	-	1	-	1	-	-	-	1	-	-	6	60%
Source of capital for economic development	1	-	-	1	1	1	-	-	1	-	1	-	-	-	-	-	-	6	60%
Transfer knowledge and technology	-	-	1	1	-	-	-	-	1	-	1	-	-	-	1	-	-	5	50%
Fulfilling institutional target	1	-	-	1	-	-	-	-	-	-	-	-	-	-	-	-	-	2	20%
Improving productivity	-	-	-	-	-	1	-	-	-	-	-	-	-	-	-	-	-	1	10%

Source: author calculation based on in-depth interviews, 2017-18.
Note: Total respondents = 10 (BKPM; MoF; BKF; SEZ).

Appendix Table A.7.2: Factors Influencing Inward Investment

Responses	BKPM				MoF		DGT		BKF			MoI			SEZ	IIPC	IKPI	Total Resp.	Percentage of responses
	A	B	C	D	A	B	A	B	A	B	C	A	B	C	A	A	A		
Good infrastructure	-	-	-	-	1	1	-	1	1	1	1	1	-	1	1	-	-	9	53%
Good governance institutions	1	-	-	-	1	1	-	-	-	1	1	1	-	-	-	-	1	7	41%
Market size and purchasing power	-	1	1	-	-	-	-	-	1	-	1	1	1	-	-	1	-	7	41%
Legal certainty	-	-	-	1	1	1	1	-	-	-	-	1	-	-	-	-	1	6	35%
Natural resources	-	1	-	-	-	-	-	-	1	-	-	1	1	-	-	-	1	5	29%
Political and economic stability	-	-	-	-	-	1	1	-	-	1	1	-	1	-	-	-	-	5	29%
Labour resources and productivity	-	-	-	-	1	-	1	-	-	-	-	-	-	-	-	1	-	3	18%

Source: Author calculation based on in-depth interviews, 2017-18.
Note: Total respondents = 22; with 17 interview activities.

Appendix Table A.7.3: The Reasons for Utilizing Tax Incentives

Responses	BKPM				MoF		DGT		BKF			MoI			SEZ	IIPC	IKPI	Total Resp.	Percentage of responses
	A	B	C	D	A	B	A	B	A	B	C	A	B	C	A	A	A		
Response to other countries	1	1	1	1	1	1	-	-	1	1	-	1	1	-	1	-	1	12	71%
Demand from investors	1	-	1	1	-	-	-	-	-	-	1	1	-	-	-	1	-	6	35%
Marketing strategy	-	1	-	-	-	1	-	-	-	1	-	1	1	-	-	-	-	5	29%
Government scope	-	-	-	-	-	1	-	-	-	-	-	1	-	-	-	-	-	2	12%
Easy to execute within short period of time	-	-	-	-	-	1	-	-	-	-	-	1	-	-	-	-	-	2	12%
Demand from institutions	-	1	-	-	-	-	-	1	-	-	-	-	-	-	-	-	-	2	12%

Source: Author calculation based on in-depth interviews, 2017-18.
Notes: Total respondents = 22; with 17 interview activities.

Appendix Table A.7.4: The Objectives of Tax Incentives

Responses	BKPM				MoF		DGT		BKF			MoI			SEZ	IIPC	IKPI	Total Resp.	Percentage of responses
	A	B	C	D	A	B	A	B	A	B	C	A	B	C	A	A	A		
Attract new investments into pioneer industries	1	1	1	1	1	-	1	1	-	1	1	1	1	1	1	-	-	13	76%
Improve location competitiveness	1	-	-	1	1	1	1	-	1	1	-	1	-	1	1	-	-	10	59%
Improve distribution of investment	1	-	-	1	-	1	-	-	-	-	1	-	1	1	1	-	-	7	41%
Complementary other incentive	-	-	-	-	1	1	-	-	1	1	-	-	-	-	-	-	-	4	24%
Signalling government preferences	-	-	-	-	-	-	-	1	-	-	-	1	1	1	-	-	-	4	24%
Accelerate investment realization	-	1	-	1	1	-	-	-	-	-	-	-	-	-	-	-	-	3	18%

Source: Author calculation based on in-depth interviews, 2017-18.
Notes: Total respondents = 22; with 17 interview activities.

Appendix B: Survey Documents, Letters and Figure

Appendix B.5.1: Questionnaire Form

QUESTIONNAIRE
FDI LOCATION IN INDONESIA

Please tick relevant response and give an explanation as required.

All information supplied in this questionnaire will be held in the strictest confidence and reported in a manner such that individual respondents and businesses cannot be identified.

Gatekeeper Number	Company Number
☐☐☐ ☐ ☐☐	☐☐

Section 1: Personal Details

1.1 What is your job title/position? ……..………………………………………………

1.2 How many years have you worked for the present company? ……………… years

1.3 Prior to working at this plant did you work for the same company at another site?

☐ Yes

☐ No

If Yes, where was this? ………………………………………………

1.4 Are you an Indonesian national?

☐ Yes

☐ No

Section 2: The Plant at this Site

The 'Plant' refers to the business that is located at this site

2.1 When was this Plant established? Year: …………………

2.2 Is the Plant located in a Special Economic Zone or Bounded Area (Kawasan Berikat)?

☐ Yes

☐ No

2.3 Can you confirm the region and province in which this Plant is located?

Region ***(Please tick one box only)***	Province **(*Please specify*)**
☐ Java	…………………………………………………
☐ Sumatera	…………………………………………………
☐ Kalimantan	…………………………………………………
☐ Bali and Nusa Tenggara	…………………………………………………
☐ Sulawesi	…………………………………………………
☐ Papua and Maluku	…………………………………………………

2.4 When first established, was this a wholly new plant, or was it relocated from elsewhere? ***(Please tick one box)***

☐ New

☐ Relocated

If relocated, where was the Plant previously? **(*Please specify*)** …………………..……

2.5 Did the company acquire this Plant from another firm?

☐ Yes

☐ No

2.6 What is the Plant's principal activity? ***(Please specify)***……………………..…….

…………………………………………………………………………………………………...

……………………………………………………………………………………………………

2.7 In what broad sector does the Plant operate? ***(Please tick one box only)***

- ☐ Primary
- ☐ Manufacturing
- ☐ Services

2.8 Does the Plant operate under a franchise or license from another company?

- ☐ Yes
- ☐ No

2.9 Where are the Plant's main competitors located? ***(Please tick all relevant boxes)***

- ☐ Locally (within the same province)
- ☐ Nationally (other Indonesian provinces)
- ☐ Internationally (outside Indonesia)

2.10 Approximately, how many people are employed at this Plant? ***(Please tick one box)***

☐ 1-5	☐ 51-100
☐ 6-10	☐ 101-200
☐ 11-25	☐ 201-500
☐ 26-50	☐ more than 500

2.11 What proportion of the Plant's employees are hired from the local labour market? …….. %

2.12 What percentage of the Plant's employees are? **(*Please sum to 100%)***

- ☐ Managerial : …………………………%
- ☐ Technical/skilled : …………………………%
- ☐ Semi-skilled/unskilled : …………………………%

2.13 Approximately, what is the annual gross sales of this Plant? ***(Please tick one box)***

☐ < Rp 4.8 billion	☐ Rp 4.9-10 billion	☐ Rp 11-20 billion
☐ Rp 21-50 billion	☐ Rp 51-100 billion	☐ > Rp 101 billion

2.14 Over the past 2-3 years what has happened to the sales turnover at this Plant? (***Please tick one box only***)

☐ Decreased ☐ Stay the same ☐ Increased

2.15 Do you expect your sales to increase over the next 2-3 years?

☐ Yes, a lot ☐ Yes, a little ☐ No, stay the same ☐ No, to decline

2.16 What percentage of the Plant's sales are made: ***(Please sum to 100%)***

☐ Locally (within the same province) ……………………….…%

☐ Nationally (other Indonesian provinces) ……………………%

☐ Internationally (outside Indonesia) ………………………… %

2.17 When selling the Plant's product, roughly what percentage by value is transported by the following means? (***Please sum to 100%***)

☐ Road : ………………………………..%

☐ Rail : ………………………………..%

☐ Sea : ………………………………..%

☐ Air : ………………………………..%

☐ Not relevant

2.18 **If you export**, what global regions and countries are your main export markets? (***Please tick all boxes that apply and specify***)

Region Countries

☐ Asia : ……………………………………………………………..

☐ Americas : ……………………………………………………………..

☐ Europe : ……………………………………………………………..

☐ Other : ……………………………………………………………..

2.19 What percentage of your materials are sourced: ***(Please sum to 100%)***

☐ Locally (within the same province) …………………………%

☐ Nationally (other Indonesian provinces) ……………….…..%

☐ Internationally (outside Indonesia) …………………………%

2.20 **<u>If you import</u>**, what global regions and countries are your main source of import? **(*Please tick all boxes that apply and specify*)**

<u>Region</u> <u>Countries</u>

☐ Asia : …………………………………………………………..

☐ Americas : …………………………………………………………..

☐ Europe : …………………………………………………………..

☐ Other : …………………………………………………………..

<u>Section 3: The Company</u>

<u>These questions related to Company to which the Plant belongs.</u>

3.1 What is the ownership structure of this Company? ***(Please tick one box)***

☐ Independent company

☐ Subsidiary of a larger corporation

☐ Other ***(Please specify)***..

3.2 What is the legal status of the Company? ***(Please tick one box)***

☐ Public

☐ Private

☐ Other ***(Please specify)***..

3.3 What is the nationality and ownership structure of the Company? ***(Please specify)***

<u>Nationality</u> <u>Share (%)</u>

……………………………………… …………………

……………………………………… …………………

……………………………………… …………………

3.4 What is the principal activity of the Company? ***(Please specify)***

………………………………………………………………………………………………

3.5 Does the Company have plants other than this one located in Indonesia?

☐ Yes

☐ No

<u>If Yes</u>, How many? ………………………

<u>If Yes</u>, What is the location and activity of up to three of most important other plants?

<u>Region</u>	<u>Province</u>	<u>Activity</u>
……………………	……………………….	………………………….
……………………	……………………….	………………………….
……………………	……………………….	………………………….

3.6 In what country is the Company's Head Office located?

……………………………………………………………………

3.7 Approximately, what are the sales of the Company's global operation? ***(in Rupiah)***

Rp ……………………………………………………

3.8 Where are the Company's main competitors located? ***(Please tick all that apply)***

☐ Locally (within the same province)

☐ Nationally (other Indonesian provinces)

☐ Internationally (outside Indonesia)

Section 4: The Initial Investment Decision

4.1 How best describes the Company's motive for setting-up this Plant in Indonesia? **(*Please tick all relevant boxes and indicate rank of importance, i.e. 1st, 2nd, 3rd…*)**

Market seeking		Rank
• Getting close to main consumer market	☐	………..
• Getting close to main producer market	☐	………..
Resource seeking		
• Getting close to raw materials	☐	………..
• Getting close to labour resources	☐	………..
Efficiency seeking		
• Economies of scale or scope	☐	………..
• Risk diversification	☐	………..
Strategic-asset seeking		
• Acquiring some strategic assets	☐	………..

4.2 In setting-up the Plant at its current location, did you consider other sites?

☐ Yes

☐ No

If Yes, was this: ***(Please tick one box and specify alternative location)***

☐ Locally (within the same province) ……………………………………...

☐ Nationally (other Indonesian provinces) ………………………………..

☐ Internationally (outside Indonesia) ……………………………………..…

4.3 When setting-up the Plant, which of the following were important? **(*Please tick all that apply*)**

☐ General investment climate

☐ Market size

☐ Growing local or national economy

☐ Weak competition from other local or national companies

☐ Availability of skilled labour

☐ Availability of cheap labour

- ☐ Productive workforce
- ☐ Availability of natural resources
- ☐ Good physical infrastructure
- ☐ Good electronic infrastructure
- ☐ Geographical location
- ☐ Political stability and security
- ☐ Regulatory framework and economic policy coherence
- ☐ Investment protection and promotion
- ☐ Other reasons ***(Please specify)*** ……………………………………….

4.4 Of the above factors, which was the most important? **(*Please specify one only*)**

…………………………………………………………………………..

4.5 When setting-up the Plant in Indonesia what sources of information were helpful to you? ***(Please tick all that apply)***

- ☐ **BKPM**: Badan Koordinasi Penanaman Modal (Indonesia Investment Board)
- ☐ **DJP**: Direktorat Jenderal Pajak (Directorate General of Taxes)
- ☐ Indonesian Embassy
- ☐ Other national government agencies
- ☐ Local agencies
- ☐ Local contacts
- ☐ Business contacts
- ☐ Investor Outlook Reports (e.g. Global Competitiveness Index, Ease of Doing Business, Standard and Poor, etc.)
- ☐ Other ***(Please specify)*** ……………………………………………………………….

4.6 If you used the **BKPM** or the **DJP** how useful did you find them in helping with your investment? ***(Please tick one box only per row)***

	Very useful	Quite useful	Not very useful	Very unhelpful
BKPM	☐	☐	☐	☐
DJP	☐	☐	☐	☐

4.7 What other information that was not available would have been useful for your investment decision? ***(Please specify)***

…………………………………………………………………………………………..

…………………………………………………………………….………………….

4.8 Did you use tax incentives as part of your negotiation with the Indonesian government before deciding to set-up?

☐ Yes

☐ No

4.9 When first investing did the company receive any of the following forms of financial support? ***(Please tick all that apply)***

☐ Tax Holiday

☐ Tax Allowance

☐ Reduced CIT (CIT Rate Reduction)

☐ Accelerated Depreciation

☐ Employment Based Reduction in Taxes

☐ Health Care Based Reduction in Taxes

☐ Special Economic Zone/Bounded Area Tax advantages

☐ Other ***(Please specify)*** ……………………………………

☐ None

4.10 Which of the above kinds of support was the most important? ***(Please specify)***

…………………………………………………………………………..

Section 5: The Indonesian Tax System

5.1 In general, how important is the Corporate Income Tax rate for your investment decisions? ***(Please tick one box only)***

☐ Very important

☐ Important

☐ Somewhat important

☐ Not important

5.2 Do you include the value of the Corporate Income Tax rate in your investment appraisals? ***(Please tick <u>one</u> box <u>only</u>)***

☐ Yes

☐ No

☐ Don't know

5.3 In the last few tax years, have you received any of the following Tax Incentives (<u>other than at the start-up of the Plant</u>)? ***(Please tick all that apply)***

☐ Tax Holiday

☐ Tax Allowance

☐ Reduced CIT (CIT Rate Reduction)

☐ Accelerated Depreciation

☐ Employment Based Reduction in Taxes

☐ Health Care Based Reduction in Taxes

☐ Special Economic Zone/Bounded Area Tax advantages

☐ Other ***(Please specify)*** ……………………………………

☐ None

<u>If so</u>, which of the above was most important to you? ***(Please specify one only)***

……………………………………………………………………………………

<u>If so</u>, was it critical to your investment decision? ***(Please tick <u>one</u> box <u>only</u>)***

☐ Yes

☐ No

☐ Don't know

5.4 Do you include the value of these Tax Incentives in your investment appraisals?

☐ Yes

☐ No

☐ Don't know

5.5 Are the Tax Incentives more or less important to you than the Corporate Income Tax rate in your investment decisions?

☐ More important

☐ Less important

☐ About the same

5.6 Have you applied for a Tax Incentive in the last few years and been refused? (***Please tick one box only***)

☐ Yes, I have been refused

☐ No, I have not been refused

☐ No, I have not applied

If Yes, I have been refused, please specify the reason for the refusal:

…………………………………………………………………………………………

…………………………………………………………………………………………

5.7 If you have never applied for a tax incentive, why is this?

☐ Not aware

☐ Other reason, ***Please specify*** ……………………………………....................

………………………………………………………………………………………

Section 6: The Current Business Environment

6.1 How easy is it to do business in Indonesia? ***(Please tick one box only per row).***

	Very easy	Quite easy	Quite difficult	Very difficult
Starting a business	☐	☐	☐	☐
Obtaining a construction permit	☐	☐	☐	☐
Registering property ownership	☐	☐	☐	☐
Obtaining credit	☐	☐	☐	☐
Securing electricity	☐	☐	☐	☐
Enforcing contracts	☐	☐	☐	☐
Trading across borders	☐	☐	☐	☐

Paying taxes	☐	☐	☐	☐
Maintaining security	☐	☐	☐	☐
Dealing with public officials	☐	☐	☐	☐
Accessing technical know-how	☐	☐	☐	☐
Complying with regulations	☐	☐	☐	☐

6.2 Related to your business, how do you value labour skills in Indonesia?

☐ Good

☐ Moderate

☐ Poor

6.3 Do you undertake substantial skills training to match your requirements?

☐ Yes

☐ No

6.4 Do you experience difficulties with the transport network in Indonesia?

☐ Yes

☐ No

<u>If Yes</u>, please specify: ……………………………………………………………..

…………………………………………………………………………………………..

6.5 If relevant, do you experience difficulties in exporting or importing?

☐ Yes - exporting

☐ Yes - importing

☐ No

<u>If Yes</u>, please specify: ……………………………………………………………..

…………………………………………………………………………………………..

6.6 What is the main difficulty that you have experienced when investing in Indonesia? ***(Please specify)***

…………………………………………………………………………………………..

……………………………………………………………………………………………

6.7 When dealing with the following agencies, have you experienced any difficulties? (***Please tick all that apply***)

	BKPM	DJP	Local Government
Complexity of regulations	☐	☐	☐
Lack of communication	☐	☐	☐
Low capabilities or incompetence of staff	☐	☐	☐
Lack of consistency in decision-making	☐	☐	☐
Unreasonable delays in administration	☐	☐	☐
Poor dispute resolution procedures	☐	☐	☐
Corruption or unethical behaviour	☐	☐	☐

BKPM = Indonesia Investment Board; **DJP** = Directorate General of Taxes.

Thank you for your time and cooperation

Your help is greatly appreciated

Please return this form in the enclosed addressed envelope.

Appendix B.5.2: Covering Letter

Challenge Today, Change Tomorrow

August 17th 2017

Dear CEO/Director/General Manager/Tax Manager,

My name is I Putu Sudiana. I am an Indonesian national, who is undertaking PhD research at Newcastle University in the United Kingdom, sponsored by the Indonesian government. I am conducting this research on the location of Foreign Direct Investment (FDI) in Indonesia and tax incentives policy. I would like to enlist your help by participating in the questionnaire survey of firms that I am undertaking.

The aim of this research is to provide a comprehensive analysis of the determinants of FDI location in Indonesia, with particular focus on the role of tax incentives. The research will enable the Indonesian government to develop better its investment policy in relation to tax incentives.

I would be grateful if you could complete the enclosed questionnaire form and return this to me using the enclosed envelope at the following address:

Yth. Kepala KPP PMA Empat
Attn. I Putu Sudiana (Researcher)
KPP Penanaman Modal Asing Empat
Jl. Taman Makam Pahlawan Kalibata
Jakarta Selatan 12750

I have sought to keep the questionnaire as short as possible and to focus on the issues that are of relevance to my research. The questionnaire is in both Bahasa and English, so please complete it in the language which you are most familiar with. I can assure you that all information will be treated in strictest confidence and reported in aggregate terms from which it is not possible to identify any individual or firm. To facilitate this, the form has been anonymized using a unique reference number that is known only to me.

Thank you very much for taking the time to assist me in my educational endeavors. The completion and return of the questionnaire will indicate your willingness to participate in this study. If you require additional information, please contact me at the number or email listed below. Further, you may also contact my lead PhD supervisor in the UK, Professor Colin Wren at colin.wren@newcastle.ac.uk.

Yours sincerely,

I Putu Sudiana
PhD student in Economics.
Newcastle University Business School, 5 Barrack Road, Newcastle upon Tyne, United Kingdom, NE1 4SE.
Phone: +44 775250 6585 or +62 8788 7032 889.
Email: i.p.sudiana2@newcastle.ac.uk or iputu.sudiana@gmail.com

Project Ethical Approval: Ref. 10333/2016

Business School reception: +44 (0) 191 208 1500
Postgraduate office: +44 (0) 191 208 1580
Undergraduate office: +44 (0) 191 208 1532
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Appendix B.5.3: Structure for Face-to-Face Interviews

I. Inward Investment and Tax Incentive Policy

I.1. What is the main purpose for attracting FDI to Indonesia?

I.2. What are the linkages between FDI attraction and other policy objectives?

I.3. What is the objective of Tax Incentives?

I.4. How do we know that tax incentive the government provide is the most effective and efficient way to attract investors (and not just the easiest way to do)? How do you value it?

I.5. Does government publicly know the cost of the incentives? What is it?

I.6. Is cost-benefit analysis performed with sufficient regularity?

I.7. Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?

I.8. Is the government aware about any unintended effects of the tax incentives? What it might be? How to overcome it?

I.9. Tax incentives might be utilised in improperly (tax holiday might be utilised by mobile (‘footloose’) activities rather than long-term business. What does your opinion about it?

II. Policy Development and Administration

II.1. Within the government where did the proposal for tax incentives arise?

II.2. When deciding tax incentives policy, did government consult other stakeholders? How did the process exactly? Who were they?

II.3. What is the mechanism for appraising the introduction of tax incentives?

II.4. How does the government decide the type of incentives that investors interested in?

II.5. What are the rational for varying the tax incentives according to size, region, sector etc.?

II.6. How does the government weigh-up competing interests?

II.7. What do you think should be the duration of an incentive program?

II.8. Who has power to decide the incentives?

II.9. Is the process of offering FDI incentives open to scrutiny by policymakers, appropriate parliamentary bodies and civil society?

II.10. What procedures are in place to deal with large projects that exceed the normal competences of the implementing bodies?

III. Policy Monitoring and Evaluation

III.1. How does the government value the success or otherwise of the tax incentives?

III.2. How does the government ensure the tax incentives programme is well administered?

III.3. Is there a regular assessment on company (taxpayer) eligibility which has been granted tax incentives?

III.4. Who evaluate the implementation of tax incentive policy? How often the process? What was the result?

III.5. What attention is given to maximizing the effectiveness and minimizing the overall long-term cost of incentives? Are evaluations carried out?

III.6. Have the tax incentives been successful? What is the basis? Where is evidence?

III.7. Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?

III.8. Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdictions?

III.9. What do you think about the issue on racing to the bottom among ASEAN countries? How to avoid/overcome it?

III.10. Do you agree that although countries may perceive that they have the freedom to design their tax systems as they wish, in reality, they are forced to do so according to what their neighbours are doing?

III.11. Does government have a Benefit and Cost Analysis on tax incentives impacts? How the government ensure that benefit exceed the cost so that the policy is justified?

III.12. Are effects on local business (small business) of offering preferential treatment to foreign-owned enterprise (big company) sufficiently well understood?

Appendix B.5.4: Consent Form

Informed Consent

Challenge
Today,
Change
Tomorrow

TITLE OF STUDY

Tax Incentives and Foreign Direct Investment Location in Indonesia

RESEARCHER

Name	: I Putu Sudiana
Sponsor	: Lembaga Pengelola Dana Pendidikan (LPDP), on secondment from Direktorat Jenderal Pajak
Department	: PhD student in Economics, Newcastle University Business School
Address	: 5 Barrack Road, Newcastle upon Tyne, United Kingdom, NE1 4SE
Phone	: +447752506585 or +6287887032889
Email	: i.p.sudiana2@newcastle.ac.uk or iputu.sudiana@gmail.com

PURPOSE OF STUDY

The aim of this research is to provide a comprehensive analysis of the determinants of FDI location in Indonesia, with particular focus on the role of tax incentives. Specifically, there are three main objectives. First, the research will examine the characteristics of FDI in Indonesia, analyzing these patterns over time, industry, country of origin and location. Second, it will investigate the effect of tax incentives on firms' investment decisions in Indonesia. Third, it will examine the location determinants of FDI in Indonesia at the province level.

THE STUDY PROCEDURE

1. Before participating in interview the researcher will provide basic information about the project.
2. The interviewee may ask for clarification regarding the research project.
3. The interview will be conducted either in Bahasa Indonesia or in English whichever the interviewee prefers.
4. The interview will take approximately 45 minutes and will be extended only if the participant agrees to do so.
5. The conversation during the interview will be recorded in order to avoid misunderstanding when it transferred into a written form. If the participant has concerns about this, the participant may ask the researcher to not record the conversation.

RISKS

As far as the researcher is concerned, this interview will not involve any risk for the participant. However, if you feel uncomfortable to participate, you may decline to answer any or all of the questions and you may terminate your involvement at any time if you choose.

BENEFITS

There is no individual benefit that can be provided to the participant. The benefit of this research in general hopefully will enable the government of Indonesia to develop better investment policy, especially in relations to tax incentives.

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Challenge Today, Change Tomorrow

CONFIDENTIALITY

Your responses to this research project will be reported in a form that is anonymized, unless express wish is given otherwise, and such that it is possible to identify the organization but not the individual respondent involved. Every effort will be made by the researcher to preserve your confidentiality in the way the information is held. This involves:

- Assigning code numbers for participants that will be used on all research notes and documents.
- Keeping notes, interview transcriptions, and any other identifying participant information in a locked file cabinet in the personal possession of the researcher.
- The information will in due course be shredded.

CONTACT INFORMATION

If you have questions about this study, you may contact the researcher whose contact information is provided on the first page. If you have questions regarding your rights as a research participant, that you do not feel you can discuss with the Researcher, please contact lead PhD supervisor in the UK, Professor Colin Wren at colin.wren@newcastle.ac.uk or phone at +44 0191 20 81644.

VOLUNTARY PARTICIPATION

Your participation in this study is voluntary. It is up to you to decide whether or not to take part in this study. If you decide to take part according to the above conditions then please sign your consent below.

After signing the consent, you are still free to withdraw at any time and without giving a reason. Withdrawing from this interview will not affect the relationship you have, if any, with the researcher. If you withdraw from this interview before data collection is completed, your data will be returned to you or destroyed.

CONSENT

I have read and I understand the provided information and have had the opportunity to ask questions. I understand that my participation is voluntary and that I am free to withdraw at any time, without giving a reason and without cost. I understand that I will be given a copy of this consent form. I voluntarily agree to take part in this study.

Participant's name ______________________ Position ________________________

Signature ____________________ Date____________

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Undergraduate office: +44 (0) 191 208 1532
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EFMD EQUIS ACCREDITED

Accredited by Association of MBAs

Appendix B.5.5: Request for Conducting Research in the DGT

5 Barrack Road
Newcastle upon Tyne
NE1 4SE
United Kingdom

Director of Tax Dissemination, Service and Public Relations
Head Office of the Directorate General of Taxes,
Main Building 16th Floor
Jl. Jenderal Gatot Subroto Kav. 40-42
Jakarta 12190 - Indonesia

14th June 2017

Subject: Request for a Research Permit

Dear Sir,

I am writing to request your permission to carry out a questionnaire survey of foreign-owned firms in Indonesia. I am an employee of the Directorate General of Taxes, but I am on leave to carry out PhD research in Newcastle-upon-Tyne, UK. The topic of my research is "The Political Economy of Tax Incentives and Foreign Direct Investment Location in Indonesia". This research has great policy relevance that is likely to shed important results on the effect of tax incentives on inward investment in Indonesia. It will inform policymakers on how to improve economic development.

The PhD research is funded by a scholarship under the Indonesia Endowment Fund for Education (Lembaga Pengelola Dana Pendidikan). It is supervised by Professor Colin Wren and Dr. Jonathan Jones at Newcastle University Business School. A key component of this research, for which I request a Research Permit, is to collect data from foreign-owned firms in Indonesia through interview survey. I wish to administer a self-completion questionnaire to get an achieved sample size of 200. In addition, I am planning in-depth face-to-face interviews with several tax officials, plus a detailed statistical analysis of secondary data.

To conduct the self-completion survey I am aim to enlist the support of local tax offices, both in handing-out the questionnaires and as a return address. I will spend a total

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Postgraduate office: +44 (0) 191 208 1580
Undergraduate office: +44 (0) 191 208 1532
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of 3-4 months in Indonesia to organize and facilitate the survey. A full list on the tax offices that I am seeking administrative support from is attached.

The research has been assessed by the Newcastle University Ethical Committee. As part of this, I have undertaken to respect the confidentiality of the participants, so that the questionnaire form is anonymized and it will not be possible to identify individual firms from the analyses. The research background and objectives, its significance and the research methods can be seen in the attached Research Proposal. I also attach a formal letter of my study assignment from the Director General of Taxes and a written statement from my supervisor regarding this Research Permit request.

Should you have any questions regarding this research then please contact me at my email address. You are of course also welcome to contact my supervisors, Prof. C. Wren (colin.wren@newcastle.ac.uk); Dr. J. Jones (jonathan.jones@newcastle.ac.uk).

I look forward to hearing from you. Thank you very much for your kind attention.

Yours faithfully,

I Putu Sudiana
5 Barrack Road
Newcastle upon Tyne
United Kingdom – NE1 4SE
Email: i.p.sudiana2@newcastle.ac.uk or iputu.sudiana@gmail.com
Student Number 160537529
Phone: +44 77 5250 6585 or +62 8788 7032 889

Employee ID number: 197602101999031002
Rank: Penata Tk. I/IIId
Status: DGT Official on study leave at Newcastle University, United Kingdom.

ATTACHMENT I

Tax Officials requested as source of information on in-depth interview

1. Director General of Taxes
2. Director of International Taxation
3. Director of Tax Regulation I
4. Director of Tax Regulation II
5. Director of Tax Potential, Compliance and Revenue
6. Director of Tax Dissemination, Service and Public Relations

Tax Units as a location for survey

1. Jakarta Special Regional Tax Office
2. Foreign Investment Tax Office – One
3. Foreign Investment Tax Office – Two
4. Foreign Investment Tax Office – Three
5. Foreign Investment Tax Office – Four
6. Foreign Investment Tax Office – Five
7. Foreign Investment Tax Office – Six

Tax Units for requesting Statistical Data

1. Directorate of Tax Information Technology
2. Jakarta Special Regional Tax Office

Newcastle University
Business School

5 Barrack Road
Newcastle upon Tyne
NE1 4SE
United Kingdom

14th June 2017

To whom it may concerns,

Subject: Research Confirmation

This is to confirm that I Putu Sudiana (student no. 160537529) is a PhD student at Newcastle University. He is carrying out research at the Business School. His topic is "The Political Economy of Tax Incentives and Foreign Direct Investment Location in Indonesia". He is jointly supervised by Dr. Jonathan Jones and myself.

Putu commenced at Newcastle University in September 2016 and as part of his research he plans to conduct filed-work in Indonesia. The data will be obtained through a self-completion survey questionnaire of investors and in-depth interviews with officials. He will also conduct in-depth statistical analysis of secondary data.

Yours faithfully,

Professor Colin Wren
(colin.wren@newcastle.ac.uk)
Economics,
Business School.

Business School reception: +44 (0) 191 208 1500
Postgraduate office: +44 (0) 191 208 1580
Undergraduate office: +44 (0) 191 208 1532
University switchboard: +44 (0) 191 208 6000
ncl.ac.uk/nubs

KEMENTERIAN KEUANGAN REPUBLIK INDONESIA
DIREKTORAT JENDERAL PAJAK
DIREKTORAT PENYULUHAN, PELAYANAN, DAN HUBUNGAN MASYARAKAT

JALAN JENDERAL GATOT SUBROTO KAV. 40-42, JAKARTA 12190, KOTAK POS 124
TELEPON (021) 5250208, 5251509; FAKSIMILE (021) 5736088; SITUS www.pajak.go.id
LAYANAN INFORMASI DAN PENGADUAN KRING PAJAK (021) 1500200;
EMAIL pengaduan@pajak.go.id, informasi@pajak.go.id

Nomor : S- 715 /PJ.091/2017 20 Juli 2017
Sifat : Biasa
Hal : Pemberian Izin Riset

Yth. Professor Colin Wren, Business School Newcastle University
United Kingdom

Menjawab surat Professor Colin Wren, Business School Newcastle University nomor tanggal 14 Juni 2017 hal Research Confirmation atas :

Nama/NPM : I Putu Sudiana /1660537529

dengan ini kami memberikan izin kepada mahasiswa yang bersangkutan untuk melakukan penelitian (riset) pada Unit Kerja DJP terlampir, sepanjang bahan-bahan keterangan/data yang didapat hanya digunakan untuk keperluan akademis dan tidak menyangkut rahasia jabatan/negara sebagaimana diatur dalam ketentuan Pasal 34 Undang-undang Nomor 6 Tahun 1983 tentang Ketentuan Umum dan Tata Cara Perpajakan sebagaimana telah diubah terakhir dengan Undang-Undang Nomor 16 Tahun 2009.

Surat izin ini berlaku selama 6 (enam) bulan sejak tanggal diterbitkan dan dapat diperpanjang paling lama 3 (tiga) bulan dengan mengajukan perpanjangan secara tertulis yang disampaikan paling lambat 1 (satu) minggu sebelum berakhirnya masa berlaku surat ini.

Setelah selesai melaksanakan penelitian (riset), mahasiswa yang bersangkutan wajib menyerahkan salinan hasil penelitian (riset) tersebut dalam bentuk *hard-copy* ke Perpustakaan Kantor Pusat DJP dengan alamat Gedung Utama, Lantai 3 Jl. Jenderal Gatot Subroto Kav. 40-42 Jakarta Selatan 12190 dan dalam bentuk *soft-copy* melalui email: perpustakaan.pajak@gmail.com dan/atau perpustakaan@pajak.go.id.

Demikian surat ini dibuat agar dapat dipergunakan sebagaimana mestinya.

a.n. Direktur
Plh. Kasubdit Penyuluhan Perpajakan,

Sari Kesumawati
NIP 19751212 199603 2 001

Tembusan:
Direktur Penyuluhan, Pelayanan, dan Hubungan Masyarakat

Kp.: PJ.091/PJ.0913/2017

KEMENTERIAN KEUANGAN REPUBLIK INDONESIA
DIREKTORAT JENDERAL PAJAK
DIREKTORAT PENYULUHAN, PELAYANAN, DAN HUBUNGAN MASYARAKAT

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TELEPON (021) 5250208, 5251509; FAKSIMILE (021) 5736088; SITUS www.pajak.go.id
LAYANAN INFORMASI DAN PENGADUAN KRING PAJAK (021) 1500200;
EMAIL pengaduan@pajak.go.id, informasi@pajak.go.id

Nomor : S- 70 /PJ.091/2017 6 Juli 2017
Sifat : Biasa
Lampiran : Satu Set
Hal : Pemberitahuan Pemberian Izin Riset

Yth. Pimpinan Unit Kerja sebagaimana Terlampir
Di Tempat

Sehubungan dengan surat Professor Colin Wren, Business School Newcastle University nomor tanggal 14 Juni 2017 hal Research Confirmation atas:

Nama/NPM : I Putu Sudiana / 1660537529
Jenjang Pendidikan : Strata 3
Universitas : Newcastle University
Disertasi : *The Political Economy of Tax Incentives and Foreign Direct Investment Location in Indonesia*

dengan ini kami sampaikan hal-hal sebagai berikut:

1. Dalam Surat Edaran Direktur Jenderal Pajak Nomor: SE-23/PJ/2012 tanggal 25 April 2012 tentang Pemberian Izin Penelitian (Riset) dan/atau Praktik Kerja Lapangan di Lingkungan Direktorat Jenderal Pajak, antara lain dijelaskan bahwa:
   a. Setiap mahasiswa atau masyarakat atau badan/lembaga penelitian yang akan melakukan penelitian di lingkungan Direktorat Jenderal Pajak wajib memperoleh surat izin dari pejabat yang berwenang.
   b. Izin penelitian (riset) berlaku selama satu periode, dengan jangka waktu satu semester, dan dapat diperpanjang paling lama 3 (tiga) bulan dengan mengajukan perpanjangan secara tertulis yang disampaikan paling lambat satu minggu sebelum periode berakhir.
   c. Dasar pertimbangan pemberian izin penelitian (riset) antara lain:
      i. Kesesuaian terhadap ilmu yang dipelajari dan jurusan/program studi di sekolah atau perguruan tinggi/universitas;
      ii. Materi penelitian bermanfaat dan sejalan dengan program di Direktorat Jenderal Pajak;
2. Sehubungan dengan hal tersebut di atas, kami telah menerbitkan surat izin penelitian dengan nomor S-70/PJ.091/2017 tanggal 6 Juli 2017 untuk melakukan penelitian (riset) pada Unit Kerja DJP Terlampir.

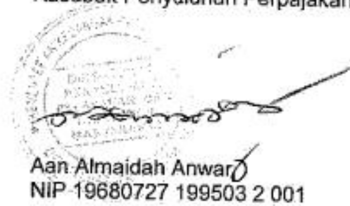
3. Izin...

Kp.: PJ.091/PJ.0913/2017

3. Izin penelitian (riset) diberikan untuk membantu yang bersangkutan memperoleh bahan-bahan keterangan/informasi/data-data yang hanya digunakan untuk keperluan akademis dan tidak menyangkut rahasia jabatan/negara sebagaimana diatur dalam ketentuan Pasal 34 Undang-Undang Nomor 6 Tahun 1983 tentang Ketentuan Umum dan Tata Cara Perpajakan sebagaimana telah diubah terakhir dengan Undang-Undang Nomor 16 Tahun 2009.

Demikian surat ini dibuat agar dapat dipergunakan sebagaimana mestinya.

a.n. Direktur
Kasubdit Penyuluhan Perpajakan,



Aan Almaidah Anwar
NIP 19680727 199503 2 001

Tembusan:
Direktur Penyuluhan, Pelayanan, dan Hubungan Masyarakat

Kp.: PJ.091/PJ.0913/2017

Lampiran
Surat Direktur P2Humas
Nomor : S- 700 /PJ.091/2017
Tanggal : 6 Juli 2017

Daftar Unit Kerja DJP Yang Menjadi Objek Penelitian

No.	Unit Kerja	Alamat	Kota
1.	KPP Penanaman Modal Asing Empat	Jalan TMP Kalibata	Jakarta Selatan
2.	KPP Penanaman Modal Asing Enam	Jalan TMP Kalibata	Jakarta Selatan

Kp.: PJ.091/PJ.0913/2017

Appendix B.5.6: Ethical Approval

Ethics Form Completed for Project: The Political Economy of Tax Incentives and Foreign Direct Investment: A Case Study of Indonesia and the United Kingdom

Policy & Information Team, Newcastle University <noreply@limeservice.com>

Wed 30/11/2016 22:38

To: Putu Sudiana (PGR) <I.P.Sudiana2@newcastle.ac.uk>

Ref: 10333/2016

Thank you for submitting the ethical approval form for the project 'The Political Economy of Tax Incentives and Foreign Direct Investment: A Case Study of Indonesia and the United Kingdom' (Lead Investigator:I Putu Sudiana). Expected to run from 02/01/2017 to 25/09/2019.

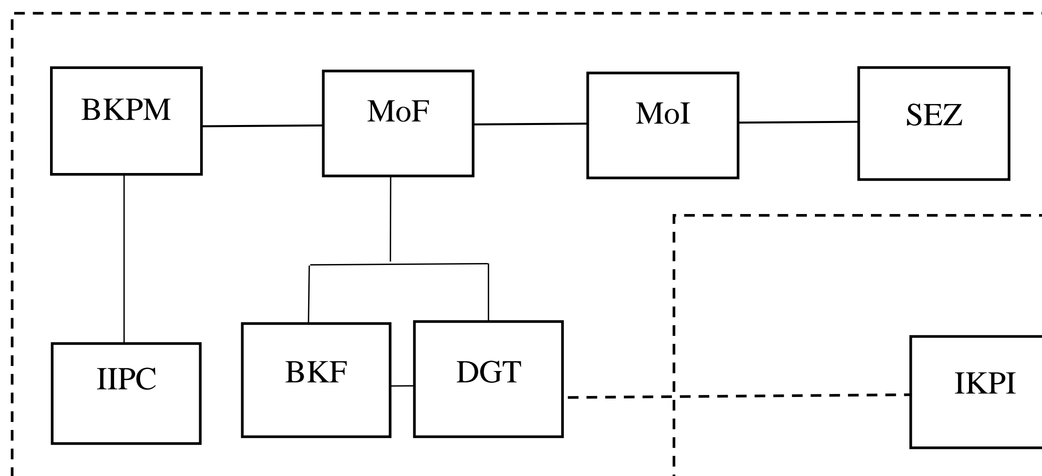
Based on your answers the University Ethics Committee grants its approval for your project to progress. Please be aware that if you make any significant changes to your project then you should complete this form again as further review may be required. If you have any queries please contact res.policy@ncl.ac.uk

Best wishes

Policy & Information Team, Newcastle University Research Office

res.policy@ncl.ac.uk

Appendix Figure B.7.1: Related Institutions on Tax Incentive Policy



Notes:
BKPM = Badan Koordinasi Penanaman Modal (Indonesia Investment Coordinating Board)
MoF = Ministry of Finance (Kementerian Keuangan)
MoI = Ministry of Industry (Kementerian Perindustrian)
SEZ = National Council of Special Economic Zone (Dewan Nasional Kawasan Ekonomi Khusus)
IIPC = Indonesia Investment Promotion Center (Pusat Promosi Investasi Indonesia)
BKF = Badan Kebijakan Fiskal (Fiscal Agency)
DGT = Directorate General of Taxes (Direktorat Jenderal Pajak)
IKPI = Ikatan Konsultan Pajak Indonesia (Indonesia Tax Consultant Association)

BKPM, MoF, MoI and National Council of SEZ are at Ministerial level. BKF and DGT are at echelon I level. IIPC is equivalent to echelon II level. Meanwhile, IKPI is a non-governmental agency.

Solid line = direct link or coordination.
Dashed line = indirect link or coordination.