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Tax Holidays to Increase Investment in Indonesia: MOF Regulation 159

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Abstract: Indonesia is the fourth most populous country in the world with a large domestic market open for investment. On 14th August 2015, the Indonesian Minister of Finance issued Regulation No. 159/PMK.010/2015 on Income Tax Reduction Facility ("Regulation 159"). This regulation revokes the previous regulations on the same issue, i.e., Regulation No. 130/PMK.011/2011 as lastly amended by Minister of Finance Regulation No. 192/PMK.011/2014 ("Previous Regulation"). The regulation is basically a tax holiday period for foreign investments meeting the conditions. This paper discusses the provisions of the regulation and the investment climate in Indonesia. The tax holidays in Indonesia coupled with the improvements in the Corruption Perception Index (CPI) and the large domestic market are indeed attractive for foreign investors.

Key words: Indonesia, tax holiday; corruption perception index; foreign investments
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1. Introduction

Indonesia is the world's largest archipelago and has approximately seventeen thousand islands lying along the equator. Java is the main and most developed island where almost 60% of the Indonesian population live and most of the business and governmental activities are carried out. With a population of around 260 million, Indonesia is the fourth most populous country in the world with a large domestic market open for investment. A large number of Indonesians work overseas and remit money through the banking and money transfer systems, as well as informal means. The informal economy sector in Indonesia is very large therefore official data might not capture the full magnitude of the economy. Indonesia's large domestic market, supported by good political and economic stability, offers a wide range of investment opportunities for foreign and domestic investors.

The major economic sector in Indonesia is the manufacturing and processing sector which contributes around a quarter of the Gross Domestic Product (GDP). Some major industries in this sector are food and beverages, machinery and transportation, chemical and textiles. The lifestyle cafes scene in "university" towns like Jogja and Malang is thriving.

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August 2015 was a busy month for Indonesian President Jokowi; implementing changes to reverse the slow growth. August 12 saw the appointment of new ministers in trade and finance in an attempt to improve policy-making procedures. Then on August 20, the president instructed his cabinet to carry out considerable deregulation measures in order to improve the country’s investment climate; restrictive regulations had always been an obstacle for investments in Indonesia.

Indonesia economy performance under the first year of leadership of Jokowi continued to worsen. Indonesia was in the midst of an economic slowdown, with rising inflation and a weakening rupiah, and slower than expected progress in carrying out much-vaunted infrastructure development.

Tax holiday policy is regarded as a stimulus to increase investment. Successful increase in investment can bring a positive impact for a country, such as creation of new jobs, improving the community economy, and increasing income for the community, which in turn will have an impact also on the increase in tax revenue which can be obtained either from investors or employees.

There are many developing and transition countries who offer tax incentives in order to increase investments: foreign and domestic. Such incentives are largely aimed at attracting foreign investment in production and non-investment activities in the form of financial assets. The creation of the investment is expected to lead to the transfer of technology and management that will enhance the economic development of the country. Tax incentives that are offered by the developing countries to increase investment, have a variety of reasons, such as balancing of their weaknesses in the tax system in the country, to reduce the losses that may be suffered by investors (may be because the infrastructure does not support), a convoluted legal system which may not be in accordance with current conditions, excessive bureaucracy and weak administration in both the tax sector and other sectors in the country (Holland & Vann, 1998).

2. Overview of the Tax Holiday Provisions: Regulation 159

The tax holiday facility described in the regulation No. 159/PMK.010/2015 is a reduction of corporate income tax by anywhere from 10% to 100% of the corporate income tax payable, which could be applicable for a period of five to 15 years starting the fiscal year when the commercial production is commenced. Under certain circumstances, the tax holiday can be extended up to 20 years.

In general, taxpayers that are entitled to the tax holiday facility are:

(1) New taxpayers;

(2) Taxpayers that are operating in pioneer industries;

(3) Taxpayers that have a new authorized capital investment plan of a minimum of 1 trillion IDR (Indonesian Rupiah);

(4) Taxpayers that fulfil the debt to equity ratio set out in the relevant Minister of Finance regulation (Regulation no 169 of 2015) which is 4:1;

(6) Taxpayers that submit a statement letter stating that they are able to deposit funds in Indonesian banks of at least 10% of the capital investment plan; and

(6) Taxpayers that have the status as legal entities in Indonesia the approval of which should be obtained on or after 15th August 2011.

Regulation 159 states that the nine industries considered as pioneer industries are as follows:

(1) Upstream metal;

(2) Oil refinery;

(3) Natural oil and gas-based organic chemical;

(4) Industrial machinery manufacturing;

(5) Agricultural, forestry and fishery-based processing industries;

(6) Telecommunication, information and communication (Minimum new capital investment plan can be reduce to at least IDR 500 billion);

(7) Marine transportation;

(8) Processing industry that is a main industry in a Special Economic Zone; and

(9) Economic infrastructure, that is not under the Government and Business Entity Cooperation scheme.

To obtain this tax holiday facility, a taxpayer has to submit an application to the Chairman of the Indonesia Investment Coordinating Board (“BKPM”). The chairman of BKPM and relevant ministers will conduct certain steps to review the application for the tax holiday facility, which would include looking at whether the industry of the taxpayer falls into the category of pioneer industries set out in Regulation 159.

If the application for the tax holiday facility has fulfilled the requirements, the Chairman of BKPM will recommend that the Minister of Finance provide the tax holiday facility. The Minister of Finance will then form a verification committee. Then the Minister of Finance will decide whether or not to grant the tax holiday facility to the taxpayer.

Corporate taxpayers who obtain the tax holiday reduction facility are not allowed to:

(1) Import or purchase used capital goods which relocated from other country or company related to capital investment which get the facility.

(2) Do main business activity which not match its plan and not included in pioneer industry criteria during the period of facility.

(3) Transfer of assets and/or ownership of corporate taxpayer during the period of facility.

(4) Relocate capital investment to other province in Indonesia or overseas starting the effectiveness of facility up to 5 fiscal years after expiration of the facility; and/or

(5) Change accounting policy in order to transfer profit or loss period of facility to subsequent period and vice versa, including revenue and/or expense recognition method and depreciation and/or inventory valuation method, starting the effectiveness of facility up to 5 fiscal years after expiration of the facility.

Corporate income tax reduction facility will be void when taxpayer:

(1) At the commencement of commercial production, capital investment realization is less than its plan.

(2) Does not place the required funds in Indonesia banks and/or such funds is withdrawn before capital investment realization.

(3) Does not submit the required report as per the regulation.

(4) Break any restrictions.

(5) Does not propose advance pricing agreement for export oriented taxpayer who has related parties transactions as mentioned in Minister of Finance Regulation which regulate such provisions.

(6) Based on investigation, violate the facility for tax avoidance or evasion.

Under Article 12 of the regulation a corporate taxpayer who gets income tax facility under article 31A income tax law cannot get income tax reduction facility under the 159 regulation, and vice versa.

3. Tax Incentives

UNCTAD (United Nations Conference on Trade and Development) defines tax incentives as any incentives that reduce the tax burden of companies in order to encourage firms to invest in specific projects or sectors. Fletcher (2002) defines tax incentive as any tax provision granted to a qualified investment project that represents a favourable deviation from the provisions applicable to investment projects in general. In other words, the characteristic of a tax incentive is that it only applies to a certain project.

Prasetya (2008) explained that UNCTAD reported some of the objectives of tax incentives by the state. Some of these objectives includes:

(a) Regional investment

It usually include the provision of support the outer regions of the city, the construction of industrial zone is a bit far from the city and therefore there will be pollution of environment, high level of urbanization, and population density in urban areas can be reduced.

(b) Quality improvement

Quality improvement is usually cultivated by making the bonded area for industries that are export oriented.

(c) Sector investment

Tax incentives can be given to the areas of business that are regarded as essential for development. Provision of this incentive is intended to stimulate the development of industry, manufacturing, tourism, or the exploration of natural resources.

(d) Transfer of technology

Incentives are given to industries that are pioneers and by providing special incentives for activities that are in relation to research and development in order to stimulate transfer of technology.

Another point of view is provided by Holland and Vann (1998), which describes the purpose of giving tax incentives are as follows:

(a) Regional development

Regional development is a general purpose as to tax incentives provision mostly in the industrialized countries and other countries.

(b) Employment creation

This incentive is given to increase investments that provide employment to reduce unemployment, or to hire people with certain specifications.

(c) Free trade or export processing zones

Export processing zones is closely related to the increased investment in export-oriented. Over the last 30 years, these incentives are widely used in over 50 countries worldwide, especially by developing countries. Through these incentives, companies can import machinery, raw materials, and other components with tax-free, with a goal to export the finished goods.

(d) Transfer of technology

Many countries imposed the tax incentives in order to attract investment that will bring improved technology, or research and development activities.

(e) Export promotion

In developing countries mainly in Asia, incentives intended to attract export-oriented investments are more effective than other forms of incentives.

Holland and Vann (1998) states that for investors, the actual tax system is not really important compared to other considerations. The first consideration for investors is the basis of economic conditions and institutional situation of the country. The country's political stability, predictability of government policy, and legislation are things that are considered more by investors. Tax incentives alone cannot substitute the above considerations, it is more important to consider the overall tax system. Tax incentives would be beneficial if factors other than taxes also support the process of investing, such as the presence of labour, availability of raw materials, energy, and capital costs.

4. Investment Environment and FDI

In general, English is spoken at a business level in Indonesia. However, if dealing with government or undertaking business outside the main cities, some translation may be required.

Negotiations can be quite lengthy. Often it takes several meetings before coming to an agreement. Initial meetings generally serve to make acquaintances. Indonesia is a relationship-driven market. Business relationships in Indonesia are based on trust and familiarity, therefore personal contacts and networks are important in making business deals.

The tax incentive is only seen as a small part of the consideration of a variety of other considerations that are significant for investors before finally coming to a decision in investing. Therefore, the government must increase the quality and improve the investment environment in Indonesia, in order so that the investment level in Indonesia can be realized.

There is a need for a good transparency system and a clear investment rules on tax regulations. One of the obstacles for foreign investments has always been the level of perceived corruption in Indonesia. In 2006 Indonesia score on the annual Corruption Perception Index (CPI) was only 24. The CPI is compiled by Transparency International; a German based politically non-partisan and non-governmental organization. The CPI score ranges from 0 to 100 where the higher the score the less the perception of corruption exists. The CPI generally defines corruption as "the misuse of public power for private benefits". The CPI ranks around 168 countries on a scale from 100 (very clean) to 0 (highly corrupt). Indonesia was ranked 107th with a score of 34 in 2014 ranking and improved to rank 88th in 2016 ranking with a score of 37. Table 1 shows the score and ranking for Indonesia from 2006 to 2016.

Shao et al. (2007) and Podobnik et al. (2008) found a correlation between higher CPI and higher long-term economic growth and an increase of GDP growth of 1.7% for every one unit increase in country CPI score. The research also shows a *power-law*[1] dependency linking higher CPI score to higher rates of foreign investments in a country.

One of the obstacles for the Indonesian government in attracting foreign investment has also been infrastructure. Indonesia has around 390 thousand kilometres of roads, 6.5 thousand kilometres of railways, and over 21 kilometres of waterways. In addition, Indonesia developed an extensive air transport network that encompasses 652 airports to ensure that all Indonesia's islands are accessible, by either sea or air. These are still insufficient and the government are actively trying to enhance the infrastructure, including increasing the number

[1] In Statistics, a power law is a functional relationship between 2 quantities, where a relative change in one quantity results in a proportional relative change in the other quantity, independent of the initial size of those quantities: one quantity varies as a power of another. Available online at: https://en.m.wikipedia.org/wiki/Power-law.

of international airports.

Table 1 Statistic of Foreign Direct Investment Realization Based on Capital Investment Activity Report by Sector 2016

NO.	SEKTOR / Sector	2010	2011	2012	2013	2014	2015	2016
		foreign Direct Investment in Millions USD						
I	**SEKTOR PRIMER / *Primary Sector***	3033.90	4883.17	5933.07	6471.84	6991.26	6236.42	4501.94
1	Tanaman Pangan & Perkebunan / *Food Crops & Plantation*	750.96	1222.49	1601.87	1605.34	2206.72	2072.02	1589.15
2	Peternakan / *Livestock*	25.03	21.14	19.82	11.30	30.82	75.13	48.91
3	Kehutanan / *Forestry*	39.36	10.33	26.94	28.83	53.33	18.98	78.23
4	Perikanan / *Fishery*	18.02	9.99	28.99	10.01	35.29	53.10	43.27
5	Pertambangan / *Mining*	2200.55	3619.22	4255.45	4816.36	4665.10	4017.20	2742.39
II	**SEKTOR SEKUNDER / *Secondary Sector***	3337.30	6789.65	11769.95	15858.78	13019.27	11763.07	16687.56
6	Industri Makanan / *Food Industry*	1025.75	1104.64	1782.95	2117.74	3139.58	1521.18	2114.95
7	Industri Tekstil / *Textile Industry*	154.80	497.26	473.12	750.70	422.49	433.43	321.31
8	Ind. Barang Dari Kulit & Alas Kaki / *Leather Goods & Footwear Industry*	130.38	255.01	158.88	96.19	210.66	161.58	144.37
9	Industri Kayu / *Wood Industry*	43.06	51.14	76.29	39.50	63.65	47.11	267.54
10	Ind. Kertas dan Percetakan/*Paper and Printing Industry*	46.41	257.53	1306.61	1168.88	706.49	706.93	2786.55
11	Ind. Kimia dan Farmasi / *Chemical and Pharmaceutical Industry*	793.36	1467.40	2769.79	3142.31	2323.37	1955.75	2889.12
12	Ind. Karet dan Plastik / *Rubber and Plastic Industry*	104.31	369.96	660.30	472.22	543.91	694.47	737.33
13	Ind. Mineral Non Logam / *Non Metallic Mineral Industry*	28.40	137.15	145.76	874.13	916.88	1302.81	1076.05
14	Ind. Logam, Mesin & Elektronik / *Metal, Machinery & Electronic Industry*	589.51	1772.78	2452.62	3327.09	2471.95	3092.49	3897.08
15	Ind. Instru. Kedokteran, Presisi & Optik & Jam/*Medical Preci. & Optical Instru, Watches & Clock Industry*	0.00	41.92	3.40	26.08	7.24	6.87	8.76
16	Ind. Kendaraan Bermotor & Alat Transportasi Lain/*Motor Vehicles & Other Transport Equip. Industry*	393.77	770.13	1840.05	3732.24	2061.28	1757.26	2369.35
17	Industri Lainnya / *Other Industry*	27.56	64.74	100.19	111.70	151.77	83.21	75.16
III	**SEKTOR TERSIER / *Tertiary Sector***	9843.57	7801.72	6861.65	6286.91	8519.17	11276.45	7774.58
18	Listrik, Gas dan Air / *Electricity, Gas & Water Supply*	1428.62	1864.93	1514.57	2221.75	1248.81	3028.92	2139.63
19	Konstruksi / *Construction*	618.35	353.70	239.57	526.81	1383.61	954.52	186.86
20	Perdagangan & Reparasi / *Trade & Repair*	773.58	826.00	483.58	606.50	866.80	625.05	670.39
21	Hotel & Restoran / *Hotel & Restaurant*	346.61	242.24	768.16	462.52	513.11	650.19	887.76
22	Transportasi, Gudang & Komunikasi/*Transport, Storage & Communication*	5072.12	3798.86	2808.23	1449.87	3000.89	3289.89	750.18
23	Perumahan, Kawasan Ind & Perkantoran/*Real Estate, Ind. Estate & Business Activities*	1050.36	198.65	401.78	677.72	1168.43	2433.58	2321.53
24	Jasa Lainnya / *Other Services*	553.93	517.33	645.77	341.74	337.51	294.30	818.21
	JUMLAH / *Total*	16214.77	19474.53	24564.67	28617.54	28529.70	29275.94	28964.07

CATATAN/Note: Excluding of Oil & Gas Banking. Non Bank Financial Institution, Insurance, Leasing, Investment which licenses issued by technical/sectoral agency, Porto Follo as well as Household investment.
Source: Badan Koordinasi Penanaman Modal (BKPM)

The Indonesian government is actively promoting a Public Private Partnership (PPP) scheme as an instrument to invite investment in the infrastructure sector. Under the PPP scheme, the government provides a list of potential infrastructure projects around Indonesia to be developed under cooperation with the private sector.

Foreign investors remain positive about the country's long-term prospects, as evidenced by still surging foreign direct investment levels. Despite frequent coverage of the nation's ongoing economic challenges, international investors are increasingly putting their money on the Indonesian growth story, encouraged by the bigger picture, and the market continues to present untapped business opportunities aplenty.

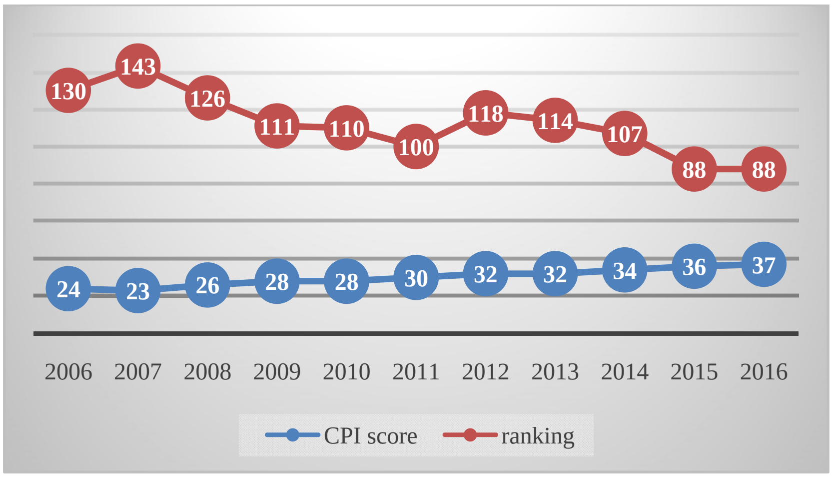

Figure 1 CPI Score and Ranking for Indonesia

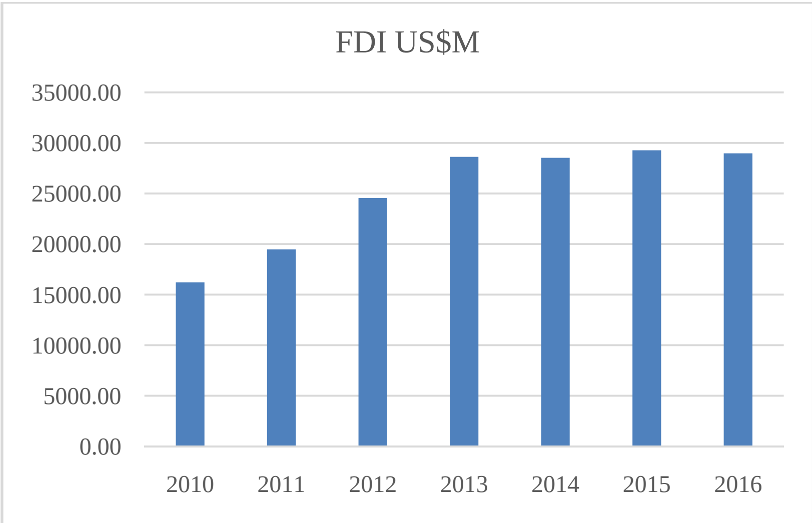

Figure 2 Foreign Direct Investment in Indonesia 2010-2016

(the detailed numbers by sector are in the table in the appendix)

Source: BKPM[2]

Within the context of the last half-decade, this FDI pattern is hardly an anomaly; foreign direct investment into Indonesia has risen steadily over recent years in line with the country's emergence as a major player on the international stage.

The latest foreign direct investment figures emphatically support the idea that Indonesia remains a viable and promising market for overseas interests, particularly for those willing to weather short-term challenges in pursuit of long-term gain.

The series of bold moves indicates the ardent endeavor by the incumbent regime to improve Indonesia's economy. Restrictive regulations are still a major obstacle, together with stifling red tape and high levels of corruption in business. Inadequate infrastructure is also to blame. However regulation 159, the PPP scheme and the improvements in CPI indicates that Indonesia is on the right path and getting to the crux of the issues afflicting the economy. Yet only time will tell if this new direction endures and is enough to turn things around for South

[2] Badan Koordinasi Penanaman Modal.

East Asia's largest economy and to fulfil its potential.

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