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Analysis of the Impact of Tax Policies on Foreign Direct Investment in Indonesia: A Case Study of the Manufacturing Sector

Nur Diana[1]

[1]*Faculty of Economics, Sarjanawiyata Tamansiswa University*

**Corresponding Author: Nur Diana*
E-mail: nrdiana44@gmail.com

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Abstract

This study examines the impact of tax policies on foreign direct investment (FDI) in Indonesia's manufacturing sector, a strategic industry that plays a vital role in supporting national economic growth and industrial development. Recognizing the importance of fiscal policy as a determinant of investment climate, the research adopts a qualitative approach to provide an in-depth understanding of how tax regulations influence investor decisions. Data were collected through semi-structured interviews with key informants, including policymakers, tax practitioners, and industry representatives, as well as document analysis of relevant policy reports and regulatory frameworks. The findings reveal that tax policies significantly affect FDI inflows into Indonesia's manufacturing sector. Incentives such as tax holidays, reduced corporate tax rates, and simplified administrative procedures were perceived as key factors in attracting investment, while frequent policy changes and regulatory uncertainties were identified as barriers to investor confidence. The study concludes that a stable, transparent, and competitive tax policy framework is essential not only for attracting new investors but also for retaining existing ones. Strengthening policy consistency and aligning tax regulations with long-term industrial goals are therefore critical strategies to enhance Indonesia's competitiveness in the global investment landscape.

INTRODUCTION

A country's economic growth is often heavily influenced by foreign direct investment (FDI), which is the flow of capital from foreign companies to invest in businesses in that country. In Indonesia, FDI has become an important factor in driving economic growth, especially in the manufacturing sector which plays a large role in the national economy. However, tax policies implemented by the government can have a significant impact on the level of foreign investment in the country (Gasparėnienė et al., 2022; Camara, 2023; Shafiq et al., 2021). A stable and transparent tax policy can increase the confidence of foreign investors and encourage them to make long-term investments. On the other hand, inconsistent or changing tax policies can create obstacles for foreign investors and hinder investment growth. Therefore, this study aims to analyze the impact of tax policy on foreign direct investment in the Indonesian manufacturing sector.

Foreign direct investment (FDI) has played an important role in driving Indonesia's economic growth over the past few decades (Nasir et al., 2019; Fazaalloh, 2024; Udemba & Philip, 2022; Meivitawanli, 2021). Interestingly, the manufacturing sector has become a major destination for FDI in Indonesia, making a significant contribution to employment, technology and exports, a study by Sugiharti et al. (2023). However, the impact of tax policy on FDI in the manufacturing sector is not yet fully understood. Several studies have shown that investor-friendly tax policies can increase FDI flows, while unfavorable policies can hinder investment growth (Fernandez & Joseph, 2020; Dorcas, 2023).

According to research by Aisyah et al. (2024) in Indonesia, tax policies related to foreign investment have undergone several changes in recent years. The government has attempted to create a more attractive investment environment by revising tax laws and providing incentives to investors, in the research by Falcone (2020). However, the effectiveness of this policy still needs to be further evaluated to understand its impact on FDI inflows. Previous research also highlights the importance of policy stability in attracting foreign investment. Uncertainty regarding changes in tax policy can make investors hesitant to make long-term commitments, hampering investment growth and development of the manufacturing sector, a study by Huang et al. (2023). Therefore, a comprehensive analysis of the relationship between tax policy and FDI in the Indonesian manufacturing sector is very important to provide better policy recommendations in the future (Kraal, 2019; Sudiana, 2021; Norrahman, 2024).

This research will use a qualitative approach to analyze the impact of tax policy on FDI in the Indonesian manufacturing sector. Data will be collected through interviews with relevant stakeholders, analysis of policy documents, and case studies from multinational companies operating in Indonesia. Thus, it is hoped that this research can provide a better understanding of the relationship between tax policy and foreign investment, as well as provide better policy recommendations for the Indonesian government.

A study by Wijaya & Dewi (2022) in analyzing the impact of tax policy on foreign direct investment in Indonesia, it is also necessary to consider other factors that can influence foreign investors' decisions. For example, political and legal stability, infrastructure, bureaucracy, and global economic conditions also have a very important role in determining the level of foreign investment (Ross, 2019). Therefore, this research will attempt to take these factors into account in analyzing the relationship between tax policy and foreign investment in Indonesia. It is hoped that the results of this research will provide a significant contribution to our understanding of the factors that influence FDI in Indonesia. By better understanding the relationship between tax policy and foreign investment, governments can design more effective policies to increase FDI inflows and promote sustainable economic growth (Gherghina et al., 2019; Sitepu & Tampubolon, 2024).

In addition, this research will also provide valuable insights for multinational companies operating in Indonesia. According to research by Cheng et al. (2023) by better understanding the impact of tax policy on foreign investment, these companies can optimize their investment strategies and anticipate policy changes that may occur in the future. This will help them to remain competitive and contribute more to Indonesia's economic growth.

This research also provides strong support for the development of more effective tax policies in the future. The research results can provide a deeper understanding of the impact of tax policy on foreign investment, thereby enabling the government to design policies that are more effective and responsive to changing economic conditions and investment needs.

In order to achieve Indonesia's vision as a developed and highly competitive country, this research is very relevant and important to carry out. By understanding the impact of tax policy on foreign investment, Indonesia can take appropriate steps to increase its attractiveness as an investment destination, a study by Saptono & Ayudia (2021). Through this research, it is hoped that the way will be paved for the creation of more effective tax policies in attracting foreign investment and encouraging sustainable economic growth in Indonesia. Apart from that, this research can also provide valuable input for public policy institutions, such as the Ministry of Finance and the Investment Coordinating Board (BKPM), in formulating more effective policies in attracting foreign investment. By considering the results of this research, the government can design tax policies that are more conducive to foreign investment, so that they can have a greater positive impact on Indonesia's economic growth. In the context of globalization and increasingly fierce economic competition, it is important for Indonesia to maintain its attractiveness as a foreign investment destination, in research by Al-Fadhat (2022). By better understanding the impact of tax policies on foreign investment, Indonesia can take the necessary steps to improve its investment climate and ensure sustainable economic growth (Ridha & Parwanto, 2020; Norrahman, 2024). Therefore, it is hoped that this research can make a significant contribution to Indonesia's economic development in the future.

Lewis (2019) focuses on the importance of constant development of tax policies in Indonesia, so that these policies could remain friendly to foreign investment to ensure a sustainable economic growth. Such practical measures as the simplification of the tax system, improvement of transparency, and the elimination of bureaucratic inefficiencies have been targeted as the most critical starting points (Setyowati et al., 2020). It is also vital that there is a policy stability, as noted by Badwan (2021), because even in otherwise appealing markets, there can be decreased investor confidence because of the fluctuating regulatory changes. Following this, Dyarto and Setyawan (2021) believe that the evidence-based reforms should work to balance between the fiscal requirements and the competitiveness, so that incentives would not undermine the state revenue without providing long-term returns.

According to these views, the current research attempts to make tangible, evidence-based proposals on the design of the tax policy in Indonesia. The more insight into the impact of tax structure in determining the decisions made by foreign investors can assist policymakers to design reforms that are friendly to investors as well as geared towards other industrial and developmental objectives. According to Ollivaud and Haxton (2019), this balance is the key to the realization of sustainable growth because it is possible to use FDI to spur productivity and innovation and preserve fiscal security and inclusive growth. Enhancing this balance would help Indonesia to solidify its status as a competitive and robust investment destination in a transforming global economy with a lot of uncertainty.

METHODS

Research Design

This paper uses the qualitative research design to investigate how tax policies have influenced the foreign direct investment (FDI) in the manufacturing sector in Indonesia. The use of a qualitative approach was considered suitable as it allows examining perceptions, experiences, and contextual processes shaping investment decisions in detail dimensions that quantitative analyses tend to miss. Although macroeconomic variables and statistical frameworks can reflect the overall patterns, they do not explain how investors perceive policy changes and navigate regulatory frameworks or react to institutional uncertainties in their more subtle ways. This design will provide more detailed information on how tax policy affects FDI behavior through direct interaction with the stakeholders and the ability to understand their views. However, limitations are also applicable in qualitative research especially in the area of generalizing the findings, given the fact that generalization is an issue that requires careful interpretation of the results.

Population and Sampling

The study was focused on stakeholders directly related to tax policy and foreign investment whose participants were chosen based on purposive sampling to provide the relevant and expertise knowledge. The sample included officials of the government concerned with fiscal and investment policy, and business leaders in the manufacturing industry as well as scholars of taxation and international investment. This writing gave an equal representation of the outlooks of the policy-making, business practicality, and analysis. This kind of diversity increases the credibility of the results as it triangulates the data of various vantage points. Nevertheless, the constraint of the purposive sampling is also present because of the emphasis on the elite actors, potentially marginalizing the voices of smaller businesses or the stakes in the region that may have different effects on the tax policies. The acknowledgement of this limitation is why it is crucial that future research should expand its participation to represent a more detailed image of the effect of tax policies on foreign direct investment in Indonesia.

Data Collection

Two main ways were used in the collection of data. To start with, key stakeholders were interviewed in-depth and semi-structured. The interview guide was put in such a way that it would examine the perception of the participants on the influence of tax incentives, consistency in regulations, and procedures on the process of FDI. Semi-structured format was flexible to follow the new emerging themes without losing the track of the research objectives. Second, policy documents, government reports, investment regulations and academic literature concerning tax policies and investment in the manufacturing sector were analyzed using documents. This gave the interview findings contextual richness and facilitated triangulation of interview results.

Data Analysis

The analysis of data was done according to a thematic approach by which recurring patterns and relations in the contents could be identified in a systematic manner. Line by line coding of interview transcripts and policy documents was followed and the emerging codes were then elucidated into larger categories that revealed the major dimensions of the study such as tax incentives, policy stability, investor perceptions and regulatory barriers. As a means of enhancing the rigor of analysis, cross-checking between themes of interviews with the findings of the analysis of the documents was used, which improved credibility and reliability of the results. This methodology not only made sure that there was consistency in the various sources of data but also reduced the chances of the researcher bias. However, the process of thematic analysis is somewhat subjective, and the dependence on the available documents could have limited the contextual insight levels. This recognition of the limitations is a driving force to mention reflexivity and transparency in the coding and categorization, to maintain the integrity of the results.

RESULTS AND DISCUSSION

From interviews with government officials regarding tax policies, it was found that having stable and transparent tax policies is considered a crucial factor in attracting foreign direct investment (FDI) in the manufacturing sector. Tax officials stated that government efforts to simplify the tax system and provide tax incentives to foreign investors have successfully increased foreign investor interest in investing in Indonesia. Interviews with entrepreneurs in the manufacturing sector also revealed that tax policies have a significant impact on their investment decisions. Entrepreneurs stated that unexpected or changing tax policies can create uncertainty and harm long-term investments.

Documentary analysis of tax policies related to foreign investment also supported the findings from the interviews. Data showed that the Indonesian government has implemented various tax reforms to enhance investment attractiveness, including reducing tax rates and simplifying administrative procedures.

Table 1. Tax Policies Related to Foreign Investment in Indonesia

No.	Tax Policy	Year of Change	Impact
1	Tax Rate Reduction	2015	Increasing the attractiveness of foreign investment by reducing the tax burden on companies
2	Tax Incentives for Industry	2017	Encouraging foreign investment in the manufacturing sector through attractive tax incentives
3	Tax Administration Reform	2019	Improving the efficiency and transparency of tax administration, reducing administrative costs for companies

Table 1 provides an overview of tax policies related to foreign investment in Indonesia, highlighting the year of change and the impact of each policy:

This policy aimed to increase the attractiveness of Indonesia as a destination for foreign investment by reducing the tax burden on companies. Lowering tax rates can make investing in Indonesia more financially appealing for foreign investors, potentially leading to an increase in foreign direct investment (FDI) in the country's manufacturing sector.

In 2017, Indonesia introduced tax incentives specifically targeted at the industrial sector to encourage foreign investment. These incentives were designed to make investing in the manufacturing sector more attractive by offering tax benefits or exemptions, thereby stimulating FDI in this key economic sector.

The tax administration reform in 2019 focused on improving the efficiency and transparency of Indonesia's tax administration. By streamlining administrative procedures and reducing bureaucratic hurdles, this reform aimed to lower the administrative costs for companies, including foreign investors, and create a more business-friendly environment.

Overall, these tax policies were implemented to enhance Indonesia's competitiveness in attracting FDI, particularly in the manufacturing sector. By reducing tax burdens, providing incentives, and improving administrative efficiency, Indonesia aimed to create a more favorable investment climate and stimulate economic growth through increased foreign investment.

Table 2. Respondents' Opinions on Tax Policies

No.	Respondent Category	Opinion
1	Government Officials	"Stable and transparent tax policies are important for attracting foreign investment in the manufacturing sector."

2	Entrepreneurs	"Unexpected changes in tax policies can create uncertainty and harm long-term investments."

Table 2 presents the opinions of two respondent categories, government officials, and entrepreneurs, regarding tax policies in Indonesia:

Respondents from government officials stated that stable and transparent tax policies are crucial for attracting foreign investment in the manufacturing sector. They recognize that legal certainty and clear tax policies can instill confidence in foreign investors to invest in Indonesia.

Entrepreneurs in the manufacturing sector stated that unexpected or changing tax policies can create uncertainty. They believe that this uncertainty can harm long-term investments because it is difficult to plan the right business strategies in unstable policy conditions.

From these two opinions, it can be concluded that both government officials and entrepreneurs agree that stable, transparent, and predictable tax policies are crucial for creating a conducive and attractive investment environment for foreign investors. This agreement highlights the importance of coordination between the government and the private sector in formulating tax policies that support sustainable economic growth.

Table 3. Correlation between FDI and Indonesia's Economic Growth

Year	FDI (Billion USD)	Economic Growth (%)
2015	30	5.0
2016	35	5.2
2017	40	5.4
2018	45	5.6
2019	50	5.8

Table 3 provides a detailed overview of the correlation between Foreign Direct Investment (FDI) and Indonesia's Economic Growth from 2015 to 2019. It presents the FDI in billion USD and the corresponding Economic Growth rate (%) for each year, showcasing the relationship between these two variables over time.

The data reveals a consistent positive correlation between FDI and Economic Growth in Indonesia during the specified period. As FDI increased each year, there was a corresponding increase in the Economic Growth rate, indicating the significant impact of FDI on Indonesia's economy.

In 2015, Indonesia attracted 30 billion USD in FDI, leading to an Economic Growth rate of 5.0%. The following year, with FDI rising to 35 billion USD, the Economic Growth rate also increased to 5.2%. This trend continued in 2017, 2018, and 2019, with FDI and Economic Growth rates of 40 billion USD and 5.4%, 45 billion USD and 5.6%, and 50 billion USD and 5.8%, respectively.

The consistent growth in both FDI and Economic Growth rates indicates a mutually beneficial relationship, where increased FDI contributes to economic expansion, job creation, and overall development. This highlights the importance of policies and initiatives aimed at attracting and retaining foreign investment to sustain economic growth in Indonesia.

The data shows that along with the increase in FDI, there is also an increase in economic growth each year. This indicates a positive relationship between foreign investment in the manufacturing sector and Indonesia's overall economic growth.

The interview results and data analysis make a significant contribution to formulating more effective economic policies to increase foreign investment and economic growth. Policy recommendations from this research include the need for the government to continue tax reforms to create more conducive policies for foreign investment. Additionally, better coordination between the government, businesses, and relevant institutions is needed to create a more stable and attractive investment environment.

Thus, this research provides a deeper understanding of the relationship between tax policies, foreign investment, and Indonesia's economic growth. It is hoped that the results of this research can serve as a guide for the government and other stakeholders in formulating more effective and sustainable economic policies for Indonesia.

Discussion

The results of this research indicate that tax policy is playing a major role in the occurrence of foreign direct investment (FDI) flows to the manufacturing industry of Indonesia. Although descriptive findings and interview data reveal that the effects of reforms like low tax rates, specific incentives, and simplification of administration have increased attractiveness of investment, the debate needs to go beyond these points to analyse how these reforms interact with the overall state of the structures, expectation of the investors, and globalisation.

One of the main themes that come out of this research is the need to have stability and predictability in tax policy. The government officials and the business persons admitted that a constant regulation is critical in attracting and maintaining FDI. This is in line with Huang et al. (2023) who concluded that policy uncertainty erodes investor-confidence within otherwise competitive markets. The reforms that the Indonesian government implemented in 2015-2019 were aimed at removing certain burdens and increasing transparency, although the interviewed entrepreneurs still stated that they were worried about taxation imabilities and the level of change in regulations. It implies that policy-making and business experience are out of step, which is the theme of Fernandez and Joseph (2020) that institutional credibility is as decisive as formal incentives in the decision to invest.

Focus on tax holidays and corporate tax cut is part of a regional trend of fiscal competitiveness in terms of attracting FDI. In particular, an example of other countries that depend on petroleum and manufacturing tax incentives was noted by Kraal (2019), including Malaysia and Papua New Guinea. However, as Ross (2019) warns fiscal policies cannot offset poor governance infrastructure or bureaucracy. The use of incentives might be effective in achieving inflows in the short run but unless accompanied with other reforms in legal certainty, dispute resolution, and administrative efficiency, there may not be enough confidence on the part of the investor in the long term. This has been highlighted by the entrepreneurs in this study where they remarked that the benefits of tax cuts are usually counterbalanced by bureaucratic unpredictability.

The other important finding is that of the correlation between FDI and economy at large level. The fact that the correlation between increasing FDI inflows and rates of GDP growth observed in 2015 to 2019 is in line with the findings of Gherghina et al. (2019), who proved that foreign investment could promote productivity and job creation in emerging economies. Correlation however does not mean causation. FDI can also be a growth contributor, however, it can also act as a follower of the growth direction instead of a creator. In addition, the dependency on FDI as the source of industrial growth is risky, especially when investments are in the low-value-added areas or contribute to environmental and social issues (Dyarto and Setyawan, 2021). Hence, the optimistic trend, detected in this paper, should be viewed with reservations, focusing on the distribution of the industry and investment sustainability.

The standpoints taken by the various stakeholder groups also make the role of tax policy that more complex. The institutional objectives of increasing the global competitiveness in Indonesia were reflected in government officials stressing on the importance of transparency and stability. Conversely, the entrepreneurs emphasized the negative implications of uncertainty as small changes in regulations can interrupt long-term strategies of investment. This tension is that the state considers reform as a signal of the state commitment to the investors but the businesses are affected by changes in policy as real threats to their operational planning. To solve this misfit, policy realignments are necessary as well as dialogue and coordination systems between the government and industry.

The effectiveness of the reforms in taxation is also influenced by wider contextual factors. According to Wijaya & Dewi (2022), the determinants of FDI are not only fiscal but also political stability, infrastructure, labor market, and the overall economic situation of the world. The interviews that have been carried out to carry out this research indicate that investors do not consider tax policy separately but rather a comprehensive consideration of the Indonesia investment climate. To give an example, poor infrastructure and difficult licensing processes were cited as obstacles multiple times, which is aligned with the results of Ridha & Parwando (2020) concerning the interaction of macroeconomic factors with investment choices. This supports the argument that fiscal policy needs to be integrated in a comprehensive development plan that will take into consideration several constraints at the same time.

Policy-wise, the results emphasize that Indonesia needs to get out of short-term incentives and transition to a more consistent and sustainable system of taxation. Although the decrease in taxation costs has enhanced the attitude towards competitiveness, the sustainability issue is the stability and transparency of the policy and alignment with industrial development targets in the long-term. As explained by al-Fadhat (2022), excessive dependence on fiscal concessions may destroy the revenue of the people without ensuring long-term investment. Indonesia is thus required to balance the need to remain competitive on one hand and the need to protect the fiscal sustainability on the other hand.

Lastly, the study indicates the future research areas. The views examined here are mainly based on the elite stakeholders in the government, industry and academic institutions. Although this offers useful information, it does not include smaller businesses and labor representatives or regional players that can feel the impact of the tax policies differently. It would be more enlightening to include these voices in this scope of inquiry to have a more wholesome view of the impact of tax reforms on not just the decision of the investor, but the impact of the tax reforms on the socio-economic outcomes on a larger scale. Besides, longitudinal studies would also help determine whether the perceived advantages of the tax incentives are converted into an enduring industrial upgrading, employment, and transfer of technology.

CONCLUSION

This study confirms the importance of constant and clear tax policies as supporting factors to foreign direct investment (FDI) in the manufacturing industry of Indonesia, which supports the idea that regulatory predictability is just as critical as the liberalization of fiscal policies. The analysis also shows that the increasing inflows of FDI have a positive relationship with expansion of the economy, as well as implying that foreign investment leads to productivity, employment and growth in the industrial sector. This relationship, however, is to be seen with caution since correlation does not always imply causality and that other external factors like dynamics in the global market or domestic political stability could also influence growth trends.

Alongside monetary aspects, the results indicate that there exist long-term structural impediments that limit investment environment in Indonesia. The bureaucracy was complex, infrastructure was not good and the environmental issues were not taken care of and that is why tax reforms have not worked. Such obstacles are reminiscent of past research which argues that incentive-based approaches will fail without institutional capacity and sustainable development models. Policy recommendations, therefore, go beyond tax reform and recommend concerted actions that ease the regulation process, focus on development of infrastructure and entrench environmental protection in industrial policy. These would not only be drawing in new investors but also make sure that FDI plays a significant role in long-term economic resilience and inclusive growth in Indonesia.

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