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The Effectiveness of Tax Incentives in Increasing Investment in the Manufacturing Sector in Indonesia

Yulianti
Ichsan Satya University

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Corresponding Author:
Yulianti
yulianti.uis@gmail.com

Abstract

This study aims to evaluate the extent to which the tax incentive policies implemented by the Indonesian government have been able to encourage increased investment in the manufacturing sector. Tax incentives such as tax holidays, tax allowances, and import duty exemptions have long been relied upon as fiscal instruments to attract investment and strengthen the competitiveness of domestic industry. However, the effectiveness of their implementation in the field remains questionable. This study used a descriptive qualitative approach, with data collection techniques through in-depth interviews with key informants, including industry players, fiscal officials, and academics. Data were also obtained through a documentary study of laws and regulations, ministerial annual reports, and publications from relevant institutions such as the Statistics Indonesia (BPS) and the Investment Coordinating Board (BKPM). The results indicate that tax incentives do have a positive impact on investment decisions, particularly for large-scale companies with adequate administrative capabilities and access to information. However, their utilization has not been optimal for small and medium-sized enterprises (SMEs) due to a lack of understanding of incentive mechanisms and the persistence of significant bureaucratic barriers. Furthermore, a gap in access was identified, with large companies tending to have easier access to incentives than small ones. This research recommends the need for more adaptive fiscal policy reforms, simplified procedures, digitized tax services, and increased outreach and technical assistance to businesses. This will enable tax incentive policies to be implemented more effectively, fairly, and have a tangible impact on strengthening the national manufacturing sector.

Keywords:tax incentives; investment; manufacturing; effectiveness
JEL Classification: D13, I31, J22*

1. Introduction

The manufacturing sector plays a strategic role in driving national economic growth. As the backbone of the Indonesian economy, this sector not only provides(Fatimah et al., 2020)Employment across all levels of society. The manufacturing sector encourages the development of other supporting industries, expands supply chains, and increases the added value of domestic commodities through downstream processing.(Gina et al., 2023). Furthermore, this sector plays a crucial role in driving non-oil and gas exports, increasing the competitiveness of national products in the global market, and acting as a catalyst for technology transfer and increasing industrial human resource capacity. Therefore, strengthening the manufacturing sector is a key factor in achieving an inclusive and sustainable economic transformation in Indonesia.(Abyan, 2025).

Although the manufacturing sector in Indonesia has great potential to drive economic growth and attract investment, there are still a number of structural challenges that hinder the optimization of this sector.(Fatimah et al., 2020)One of the main obstacles is high production costs, caused by high energy prices, logistical inefficiencies, and limited supporting infrastructure in some regions. Furthermore, regulatory uncertainty, including sudden policy changes and overlapping central and regional government regulations, often hinders investors from making long-term decisions. The competitiveness of Indonesia's manufacturing sector also lags behind that of neighboring countries such as Vietnam and Thailand, both in terms of technology, labor productivity, and ease of doing business. Other issues such as limited skilled human resources, a lack of competitive fiscal incentives, and a complicated licensing bureaucracy exacerbate these challenges. Therefore, comprehensive and consistent structural reforms are needed to create a conducive and sustainable investment climate for the manufacturing sector.(Andronova et al., 2020).

As part of its strategy to increase competitiveness and attract more investment, the Indonesian Government has implemented various fiscal incentive policies specifically designed to support the manufacturing sector and other priority industries.(Vierke et al., 2023)These incentives include tax holidays, which provide a specific period of exemption from corporate income tax for large investors in strategic sectors; tax allowances, which provide tax reductions for companies investing in specific sectors or regions with low levels of economic development; and exemptions or reductions in import duties on capital goods, raw materials, and production support components. These policies aim to lower investment costs, increase capital inflows, and encourage technology transfer and job creation. Furthermore, fiscal incentives are focused on encouraging downstream activities in domestic natural resource-based industries, thereby increasing the added value of Indonesian products in the global market. With this approach, the government hopes to create a more competitive business climate and support the acceleration of the national economic transformation toward a more productive and sustainable direction.(Rendtorff, 2019).

Although the government has issued various fiscal incentives to attract investment, questions remain about the effectiveness of these policies. Investment realization in the manufacturing sector has not shown significant growth, either in terms of the amount of foreign direct investment (FDI) or its contribution to industrial output growth.(Eze et al., 2019)In fact, in some subsectors, investment realization tends to stagnate or is uneven, reflecting the imbalance in attractiveness between subsectors and regions. This indicates that fiscal incentives alone are insufficient to address deeper structural barriers, such as limited infrastructure, regulatory complexity, and a lack of skilled workforce readiness. Furthermore, the lack of a comprehensive evaluation of the long-term impact of incentive policies also makes it difficult to objectively measure the program's success. Therefore, the effectiveness of fiscal incentives needs to be viewed holistically, not only in terms of nominal policy, but also in terms of their synergy with institutional reform, licensing simplification, and improvements to the overall investment ecosystem.(Wenjuan & Zhao, 2023).

Although conceptually, the government's fiscal policies are designed to attract investment and stimulate growth in the manufacturing sector, their implementation often faces various challenges, creating a gap between policy formulation and implementation. One major obstacle is the lack of adequate outreach and information to business actors, especially new or medium-scale investors, resulting in many of them not understanding the procedures or requirements for obtaining incentives.(Resmi et al., 2021). Furthermore, the incentives offered often do not fully align with investors' actual needs, whether in terms of priority sectors, investment locations, or the type of support required, such as workforce training or logistical support. Administrative barriers are also a serious issue, such as complicated bureaucratic processes, overlapping agencies, and policy inconsistencies between the central and regional governments, ultimately reducing the effectiveness of fiscal incentive programs. This gap highlights the importance of regular evaluation and data-driven policy adjustments, along with the active participation of industry players, so that designed policies can be optimally implemented and produce the desired impact on strengthening the national manufacturing sector.(Schildkamp, 2019).

One weakness in fiscal policy analysis, particularly tax incentives in the manufacturing sector, is the limited number of evaluative studies using a qualitative approach. To date, most available studies and evaluation reports tend to be quantitative and focus on macro indicators such as investment inflows, industrial output growth, or employment growth.(Shen et al., 2024)While quantitative data is important as a benchmark for success, this approach is insufficient to capture the complexities on the ground, particularly regarding the perceptions, experiences, and obstacles faced by industry players in accessing and utilizing tax incentives. A qualitative approach that directly taps into the voices of investors, industry associations, and implementing officials at the regional level would provide a more contextual, in-depth, and realistic understanding of policy effectiveness. Without this kind of narrative mapping, policymakers risk overlooking the practical and social aspects that are crucial to successful implementation on the ground. Therefore, more participatory and reflective qualitative-based evaluative studies are needed to complement existing quantitative data analysis.

In the context of complex and multidimensional fiscal incentive policies, qualitative evaluations are crucial and urgent. This approach allows for a more in-depth exploration of non-technical factors often overlooked in quantitative analysis, such as industry players' perceptions, communication dynamics between government and investors, levels of trust in regulations, and even administrative and organizational cultural challenges in policy implementation. Through in-depth interviews, focus group discussions (FGDs), and case studies, qualitative approaches can uncover empirical realities and social nuances that influence policy effectiveness at the micro level. The results of these evaluations can not only provide feedback for formulating more responsive and contextual policies but also form the basis for systemic improvements, particularly in terms of streamlining bureaucracy, improving governance, and enhancing synergy between institutions. Thus, qualitative evaluations are not merely complementary but also key elements in creating fiscal policies that are more inclusive, adaptive, and oriented to the real needs of industry players on the ground.

2. Method, Data, and Analysis

This study uses a descriptive qualitative approach with the aim of gaining an in-depth understanding of the effectiveness of tax incentive policies in encouraging investment in the manufacturing sector in Indonesia.(Judijanto, 2024)This approach is considered relevant because it allows researchers to explore in detail the perceptions, experiences, and views of stakeholders regarding the implementation of applicable fiscal policies, particularly those related to tax holidays, tax allowances, and import duty exemptions for raw materials or capital goods. The main focus of this research is to explore how tax incentives are interpreted and utilized by industry players, and the extent to which these policies have a real impact on increasing investment in the manufacturing sector. Data collection was conducted through in-depth interviews with key informants consisting of officials at the Directorate General of Taxes, representatives of the Ministry of Industry, business actors in the manufacturing sector, as well as academics and tax practitioners. Informants were selected purposively, namely based on their relevance and understanding of the topic being studied. In addition to interviews, a documentation study was also conducted on relevant tax regulations, annual reports of ministries/institutions, and publications from the Investment Coordinating Board (BKPM) and the Central Statistics Agency (BPS).

The collected data was analyzed using the interactive analysis method according to Miles and Huberman, which includes the stages of data reduction, data presentation, and conclusion drawing. This process was carried out iteratively to ensure that the emerging patterns and themes truly represent the reality on the ground. Data validity was maintained through triangulation techniques, both source triangulation and data triangulation, by comparing interview results from various informants and supporting them with policy documents and official reports. Furthermore, member checking techniques were also used to reconfirm data interpretations with informants to ensure the accuracy of the findings. With this method, it is hoped that this research can provide empirical and practical contributions in evaluating and formulating more effective tax incentive policies for the manufacturing sector in Indonesia.(Ririn Riani & Aam Slamet Rusydiana, 2022).

3. Results

The research results show that industry players' understanding of tax incentive policies remains varied. Most business players, especially large-scale ones, are aware of the existence of facilities such as tax holidays and tax allowances. However, in the small and medium-sized business sector, understanding of the procedures, requirements, and benefits of incentives remains limited. This leads to an imbalance in policy utilization between large and small industry players. Informants from the small business sector stated that a lack of information and limited resources are the main obstacles to accessing government-provided fiscal facilities. In terms of benefits, some industry players acknowledged that tax incentives provide a positive impetus for business expansion and investment realization, particularly for initial investment and factory relocation. However, several informants also emphasized that tax incentives are not the sole primary factor in investment decision-making. Other factors such as legal certainty, infrastructure conditions, and ease of licensing also influence overall investment interest. Therefore, the effectiveness of incentives is more pronounced when supported by other supporting policies.

Furthermore, several obstacles were identified in the incentive utilization process. Lengthy administrative procedures, complex document requirements, and lengthy verification times were considered significant barriers, especially for companies without dedicated tax or legal teams. This has led many industry players to be reluctant or find it difficult to access the incentives they truly need. Some business players even stated that the incentive application process was not commensurate with the benefits received. The government itself is aware of various obstacles in implementing tax incentive policies. Interviews with officials from the Directorate General of Taxes and the Ministry of Industry revealed that the government is undertaking regulatory reforms to simplify the incentive application process and encourage the digitalization of services. However, these efforts are still being implemented in stages and are not yet fully distributed across all regions. Therefore, collaboration between the central government, regional governments, and industry players is crucial for effective and equitable policy implementation.

As part of the evaluation, business actors submitted several suggestions for improvements to the tax incentive policy. These included simplifying administrative procedures, increasing transparency in the application evaluation process, digitizing tax services, and providing regular outreach and technical assistance, particularly to small and medium-sized businesses. If these measures can be implemented effectively, the tax incentive policy is believed to be more effective in encouraging inclusive, sustainable, and competitive investment in the national manufacturing sector.

4. Discussion

Industry Players' Understanding of Tax Incentives

Although most industry players are aware of the various tax incentive schemes offered by the government, in-depth understanding of the procedures, eligibility criteria, and benefits of each type of incentive remains low, especially among small and medium-sized businesses. Many businesses lack the technical capacity or access to sufficient information to effectively apply, thus under-realizing the potential of these incentives. Available information is often technical in nature, limited to formal media, and poorly packaged in a way that is applicable to non-corporate businesses.(Oztemel & Gursev, 2020)This unequal distribution of information creates an access gap between large-scale companies with dedicated legal and financial teams and SMEs that rely on practical knowledge and limited resources. The lack of direct outreach forums, minimal technical assistance, and weak synergy between fiscal authorities and industry associations also exacerbate this limited understanding. Therefore, a more inclusive communication strategy, the use of user-friendly information media, and strengthening the role of intermediary institutions such as chambers of commerce, business incubators, and regional industry offices are needed to bridge information and assistance to industry players more evenly.(Lepore, 2023).

Benefits of Incentives on Investment Decisions

Fiscal incentives such as tax holidays and tax allowances are recognized by many large companies as positively impacting strategic decisions, such as production capacity expansion, factory relocation, and product diversification. These policies provide significant tax relief, thereby increasing the attractiveness of investment in priority sectors that require significant capital and long payback periods.("Fiscal Incentives for Firms in Some Developing Countries," 2023)However, field findings indicate that tax incentives are not the sole or dominant factor in investment decision-making. Industry players prioritize other factors such as the availability and quality of infrastructure, legal and regulatory certainty, political and economic stability, and access to domestic and export markets as key considerations in determining the location and scale of investment. This means that tax incentives play a more complementary role, strengthening investment attractiveness when these basic variables are met. In this context, the effectiveness of fiscal incentive policies is strongly influenced by the overall investment ecosystem. Therefore, synergy between fiscal and non-fiscal policies is crucial in creating a conducive investment environment, particularly for the manufacturing sector, which faces complex cost structures and logistical challenges.(Long & Liao, 2021).

Obstacles in Utilizing Incentives

Utilizing tax incentives in the manufacturing sector still faces significant obstacles, particularly in administrative and bureaucratic aspects. The incentive application process is often considered complicated, time-consuming, and involves numerous verification steps that are not always transparent to business actors.(Chang et al., 2019)Complex technical provisions and document requirements pose a challenge, particularly for small and medium enterprises (SMEs) that lack dedicated teams to handle tax or legal matters. Furthermore, there is a growing perception among industry players that incentive facilities are more accessible to large companies or foreign companies with better resources, networks, and regulatory understanding. This perception reflects a gap in access and indicates that the implementation of incentive policies is not yet fully inclusive.(Lashitew et al., 2020)This imbalance has the potential to create inequities in the growth of the manufacturing sector, where small businesses lack equal opportunities to benefit from policies that could boost their growth. Therefore, simplifying procedures, increasing transparency, and establishing a robust mentoring system are urgently needed to ensure that incentives are enjoyed more equitably and fairly across all levels of the industry.(Kocher & Chigurupati, 2021).

Evaluation of Implementation Effectiveness

Although the government has launched various fiscal incentive policies to encourage growth in the manufacturing sector, evaluations of their implementation indicate that the results achieved have not been entirely consistent or equitable across all subsectors. Investment realization, particularly in certain manufacturing subsectors such as light and labor-intensive industries, continues to fluctuate and does not yet reflect a stable positive response to the incentive policies offered.(Majeed & Mushtaq, 2022)Interviews with several industry players revealed the view that the long-term benefits of tax incentives are not commensurate with the administrative burden and technical requirements required to apply. They complained that rigid provisions, complex documentation, and protracted evaluation processes actually reduce the policy's appeal. Furthermore, the lack of transparency in the selection process and minimal feedback from fiscal authorities undermine the perceived effectiveness of the policy. This situation indicates that the mere existence of incentives is not enough; optimization of policy implementation is necessary, including increasing bureaucratic efficiency, strengthening inter-agency coordination, and regular evaluation based on feedback from business actors to ensure that the policy is truly implemented according to its objectives and addresses the real needs of the industry.(Bjurstrøm, 2021).

Views from Government and Regulators

The government claims that the fiscal incentive policies that have been implemented have succeeded in attracting investment in a number of strategic sectors, such as high-tech manufacturing, renewable energy, and export-based industries.(Gagyi & Gerőcs, 2025)This is considered a positive step in encouraging national economic growth and increasing Indonesia's competitiveness in the global market. However, the government also recognizes that structural obstacles remain in implementing this policy, particularly related to the complexity of administrative procedures and limited cross-agency coordination.(Scott & Merton, 2021).

In response to these challenges, the government, through relevant ministries and fiscal institutions, has initiated various tax regulatory reforms. These reforms are aimed at creating a more adaptive, transparent, and accountable tax system, capable of responding to the ever-evolving dynamics of the industry. These measures include simplifying the incentive application mechanism, digitizing tax services, and increasing human resource capacity in relevant agencies.(Tsindeliani et al., 2021).

Furthermore, regulators are encouraging the creation of a healthier and more sustainable investment ecosystem by strengthening the legal framework and incentive policies based on performance evaluation. Policy adjustments are made by considering input from industry players and the results of independent studies, thus creating synergy between national development goals and investor interests. Thus, the government and regulators' perspectives reflect a commitment not only to attract investment but also to create more efficient and long-term economic governance.(Hasan et al., 2020).

Improvement Proposals from Business Actors

Business actors, particularly those operating in strategic and capital-intensive sectors, have submitted several proposals for improvements to the current fiscal incentive policy. One key proposal is to simplify the tax incentive application procedure, which has been considered complex, convoluted, and time-consuming. A more streamlined and efficient procedure is believed to increase business participation in utilizing incentives and strengthen compliance with tax regulations.(Wibowo, 2024).

Furthermore, business actors also emphasized the importance of increasing transparency in the provision of incentives, including clarity on eligibility criteria, processing times, and reasons for rejection or approval. Digitizing fiscal services is considered a strategic step to promote transparency, reduce the potential for bureaucratic irregularities, and facilitate taxpayer access to information. An integrated digital platform between fiscal authorities, investment institutions, and business actors is expected to create a more responsive and accountable system.("Digital Transformation by Tax Authorities," 2024).

The next proposal is the need for more comprehensive outreach regarding incentive schemes, particularly to small and medium-sized industrial players (SMEs/SMEs), who often lack adequate technical capacity and information. In this regard, business actors expect technical assistance from the government or competent third parties, both in the application process, document preparation, and fulfillment of administrative requirements. With such support, it is hoped that the benefits of incentive policies will not only be felt by large companies but will also expand economic inclusion and encourage growth in the productive sector as a whole.(Ferrari Dacrema et al., 2019).

Policy Implications

The evaluation of the implementation of fiscal incentives indicates the need for a more adaptive, contextual policy approach based on the real needs of each industrial sector. Incentive policies cannot be applied uniformly, given the differing characteristics, maturity levels, and challenges faced by each sector. Therefore, policy formulation needs to consider market dynamics, technological readiness, and human resource capacity in each business sector.

Tax incentives should not be positioned as a stand-alone instrument, but rather as an integral part of a holistic fiscal strategy. In this context, fiscal incentives need to be synergistically combined with various other forms of support, such as infrastructure development that supports industrial activity, human resource development and training tailored to industry needs, and strong integration into national and global supply chains. This comprehensive approach will create a more stable, efficient, and competitive investment ecosystem.

Furthermore, the success of incentive policies also depends on the sustainability and consistency of their implementation. The government needs to ensure that incentives are not merely temporary or reactive to a specific crisis, but rather have a long-term evaluation framework that allows for adjustments based on their effectiveness and economic impact. This way, incentive policies can truly act as a catalyst for economic growth and sustainable national industrial transformation.

5. Conclusion, Limitations, and Suggestions

Conclusion

Tax incentive policies such as tax holidays and tax allowances have had a positive impact on encouraging investment, particularly for large, capital-intensive companies with strong administrative and financial capacity. However, the effectiveness of these policies remains suboptimal and uneven across all manufacturing subsectors. One major obstacle is limited understanding among industry players, particularly small and medium-sized enterprises (SMEs), which do not fully grasp the mechanisms, requirements, and benefits of available incentive schemes. Furthermore, administrative barriers such as complex bureaucratic procedures, long processing times, and a lack of transparency weaken the overall impact of the policies. Inequality in access is also a key issue, with large companies tending to have easier access to incentives than small and medium-sized enterprises with limited resources. Therefore, comprehensive regulatory reform is needed, including streamlining procedures, accelerating services, and digitizing the tax system to make incentive policies more inclusive and effective. Furthermore, the policy approach must be more responsive and contextual, taking into account differences in characteristics between subsectors and business scales, combined with non-fiscal support such as human resource training, infrastructure strengthening, and facilitating licensing. Socialization programs and technical assistance are also crucial elements to ensure that all industry players, particularly SMEs, can access and utilize tax incentives fairly and sustainably.

Limitations and suggestions

This study has several limitations that should be noted. First, the scope of informants was limited to a specific region and only involved manufacturing business actors, fiscal officials, and academics. Therefore, generalizing the findings to all sectors and regions in Indonesia requires caution. Second, the qualitative approach used is subjective, relying heavily on the interpretation of informants and researchers. It does not provide quantitative data that can definitively measure the impact of fiscal incentives on investment value. Third, access to internal government data, particularly regarding the technical details of tax incentive beneficiaries, is still limited, so the analysis is based solely on secondary data and official publications. Finally, this study was conducted over a relatively short period of time, which limits the scope for capturing fiscal policy dynamics longitudinally and in-depth.

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