CHAPTER II

LITERATURE REVIEW

1.1. Previous Research

There are some previous researches that have been done regarding to the topic of this thesis, which is governance quality and tax holiday effect on Foreign Direct Investment and Economic Growth. Discussion on previous study using the variable and statistical analysis where some of the variables and the statistical analysis also employ on this research, therefore researcher using the previous study as a references in doing research. Some previous study selected by researcher is as following:

1) *An Overview of the Impact of Tax Incentives on Foreign Direct Investment in India*, by Kandpal, and Kavidayal (2014). This study attempts to analyze the effect of using different business tax incentives on Foreign Direct Investment in India based on the overview of theoretical and empirical findings. The empirical research on tax incentives shows that they sometimes work in attracting FDI, but it remains unclear whether they are beneficial overall. Some studies conclude that developing countries do not need to offer tax incentives to attract FDI because the decision to invest in a country depends on the country's overall investment climate and some other factors. Through an in-depth analysis on the study, it might be concluded that despite insufficient findings regarding its effectiveness, tax incentives plays a key role in the policy initiatives which are being used to increase their appeal to foreign investors. Moreover, investment by Multinational Corporation has made a significant contribution in the economic development of India.

2) *Do the changes in tax incentives encourage direct investment in China by Taiwanese enterprises?*, by Lin, and Wang (2014). It examined the association between tax incentives on China's 2008 Enterprise Income Tax Law (the 2008 tax law) and inflows of FDI from Taiwanese enterprises (TDI) to China. In addition this study also investigated the effects of industry location and TDI. This study showed that reduced tax rate concessions for foreign enterprises and increased tax rate considerably reduced TDI inflow to China. Furthermore, industry-specific tax incentives became more favorable than location-specific tax incentives after the new tax laws were introduced. The results of joint tests of tax reform and tax incentives indicated that the 2008 tax law did not provide location-specific tax incentives for TDI, while industry-specific tax incentives appeared to be more attractive to TDI. Moreover, Taiwanese enterprises with intensive indirect investment in China as well as with higher shareholdings were inclined to have higher TDI. The implications of these findings implied that foreign direct investment strategy in accordance with industry-specific and location-specific tax incentives can enhance the competitive advantages of multinational companies.

3) *The effectiveness of tax incentives in attracting investment: panel data evidence from the CFA Franc zone*, by Parys, and James (2010). This paper investigate to what extent tax incentives are effective in attracting investment in Sub-Saharan Africa. It test the neo-classical investment theory prediction that tax incentives, by lowering the user cost of capital, raise investment. Next to tax incentives, this study estimate the impact on investment of other investment climate variables that are under direct control of the government, such as the transparency and complexity of the tax system, and the legal

protection of foreign investors. In developing countries these variables might be as important as or even more important than the tax variables themselves. Therefore, this study analyze the policy changes in tax incentives and in the other investment climate variables for 12 CFA Franc Zone countries over the period 1994–2006. Because of their common currency (the CFA Franc) and common language (French) these countries constitute an exceptional basis of comparison to evaluate their 'policy experiments'. The use of panel data econometrics with fixed country and year effects allowing to isolate the impact of the policy changes on investment, as if it were a difference in differences analysis with multiple policy changes. They found that there is no robust positive relationship between tax holidays and investment in the CFA Franc zone. However, increasing the number of legal guarantees for foreign investors and reducing the complexity of the tax system helps to attract investment.

4) *Governance and FDI Attractiveness: Some Evidence from Developing and Developed Countries*, by Saidi, et al (2013). This paper try to study the impact of governance indicators and macroeconomic variables on the attractiveness of foreign direct investment in 20 developed and developing countries over the period 1998–2011 using fixed effects panel regressions. The results generally indicate that only two indicators of governance namely, political stability and regulatory quality have a significant impact on FDI inflows. This indicates, for overall sample, that foreign investors are interested in political stability and regulatory quality in their choice of investment abroad.

5) *An Examination of the Impact of State Governance on Foreign Direct Investment in Vietnam,* by. Pereira (2013). This paper examines the

relationship between state governance and degree of foreign direct investment. Using linear regression techniques, 20 years of foreign direct investment data, and a specific state governance dataset, this paper begins define that relationship. The results show that looking back in the long term there is no significant relationship between the quality of government and number of foreign direct investment projects. However, looking back in the short term, a positive significant relationship is found between the quality of governance and number of licensed FDI projects a year.

6) *Foreign Direct Investment (FDI) and Governance: The Case of MENA*, by Zidi and Ali (2016). This research has aim to answer the question regarding to the relationship between Foreign Direct Investment (FDI) and governance practiced in a given country. The econometrics of panel data is employed for the MEAN region (11 countries) during the period 1996-2014. The results of the econometric estimation show seven variables that are statistically significant, namely the Gross Domestic Product (economic risk variable), the current account balance as % of GDP (economic risk variable), the domestic investment rate (economic risk variable), external debt (financial risk variable), the debt service as percentage of exports (financial risk variable), the functioning of the state (variable governance) and corruption (governance variable). While different parts of the world are competing to further attract FDI, countries in the MENA region need to conduct adequate policies oriented towards improving the business climate and good governance to benefit from these funding streams deemed less expensive.

7) *Impact of Foreign Direct Investment on Economic Growth in Tunisia*, by Wahiba (2014). The purpose of this paper is to study the effects of foreign

direct investment on economic growth while focusing on the various integration procedures followed by the Tunisian economy. Tunisia has adopted policies intended to liberalize the exchanges and flows of capital combined with the increase in exports, privatization and the deregulation, these measurements are based on a change of strategy, in which the import substitution industrialization has been substituted by an approach of development centered on the market by privileging exports and access to foreign investments. The econometric results showed the positive impact of foreign investment on the country's growth, a similar to that of human capital and financial development impact.

8) *Foreign Direct Investments as a factor for economic growth in Romania*, by Misztal (2010). The main aim of the article is to present the influence of FDI on the economic growth in Romania between 2000 and 2009. The article consists of two parts. The first part presents a theoretical analysis of the FDI-led growth hypothesis. This part overviews empirical research, while the next one analyses the importance of foreign direct investments for economic growth in Romania using the Vector Autoregression Model (VAR). The elasticity coefficients of gross domestic product (GDP) to changes in gross fixed capital formation, employment, exports of goods and services, and foreign direct investments in Romania are estimated on the basis of impulse response function. Finally, the author offers a decomposition of the gross domestic product variance to assess the degree of GDP determination by changes in gross fixed capital formation, employment, exports of goods and services, and foreign direct investments in Romania.

9) *Foreign Direct Investment, domestic investment, and economic growth in Sub-Saharan Africa*, by Adams (2009). The study analyzes the impact of foreign direct investment (FDI) and domestic investment (DI) on economic growth in Sub-Saharan Africa for the period 1990–2003. The results show that DI is positive and significantly correlated with economic growth in both the OLS and fixed effects estimation, but FDI is positive and significant only in the OLS estimation. The study also found that FDI has an initial negative effect on DI and subsequent positive effect in later periods for the panel of countries studied. The sign and magnitude of the current and lagged FDI coefficients suggest a net crowding out effect. The review of the literature and findings of the study indicate that the continent needs a targeted approach to FDI, increase absorption capacity of local firms, and cooperation between government and MNE to promote their mutual benefit.

All of those previous researches and the relevancies to this research are summarized in Table 2.1. They have contributed to the research topic about governance quality and tax holiday effect on foreign direct investment and economic growth, however none of the previous study using data from Indonesia. Therefore, by employ data from Indonesia this research is expected to enrich the literature and understanding regarding to the effect of governance quality and tax holiday on foreign direct investment and economic growth.

Table 2.1 Summary of Previous Study

No	Research Title, Author, and Year	Objectives and Method	Results
1	An Overview of the Impact of Tax Incentives on Foreign Direct Investment in India. By Dr. Vinay Kandpal, P. C. Kavidayal (2014)	This paper attempts to analyze the effect of using different business tax incentives on FDI in India based on the overview of theoretical and empirical findings.	Despite insufficient findings regarding its effectiveness, tax incentives plays a key role in the policy initiatives which are being used to increase their appeal to foreign investors. Moreover, investment by MNCs has made a significant contribution in the economic development of India.
2	Do the changes in tax incentives encourage direct investment in China by Taiwanese enterprises? By Wan-Ying Lin, Jui-Chih Wang (2014)	This study using regression analysis to examine the effect of tax incentives on Taiwanese Direct Investment (TDI) in China.	Reduced tax rate concessions for foreign enterprises and increased tax rate considerably reduced TDI inflow to China. Furthermore, industry-specific tax incentives became more favorable than location-specific tax incentives.
3	The effectiveness of tax incentives in attracting investment: panel data evidence from the CFA Franc zone. By Stefan Van Parys, Sebastian James (2010)	This paper investigate to what extent tax incentives are effective in attracting investment in Sub-Saharan Africa. It employs quantitative method to test the theory that tax incentives will raise the investment, it also estimate the impact of other investment climate variables on investment.	No robust positives relationship between tax holidays and investment in the CFA Franc zone. However, increasing the number of legal guarantees for foreign investors and reducing the complexity of the tax system helps to attract investment.

No	Research Title, Author, and Year	Objectives and Method	Results
4	Governance and FDI Attractiveness: Some Evidence from Developing and Developed Countries. By Yosra Saidi, Anis Ochi & Houria Ghadri (2013).	This paper uses the model of Baptiste (2005) to address the nature of the impact (positive or negative) of governance indicators on the attractiveness of foreign direct investment on a sample of 20 countries, 10 developed countries and 10 developing countries.	Only two indicators of governance that have a significant impact on FDI inflows; political stability and regulatory quality. In developing countries only the quality of regulation has a significant impact on FDI inflows. Meanwhile political stability, regulatory quality, corruption and bureaucratic, and government effectiveness have significant impact to FDI in developed countries.
5	An Examination of the Impact of State Governance on Foreign Direct Investment in Vietnam. By Stephen Pereira, Jr. (2013)	This paper examines the relationship between state governance and degree of FDI using linear regression techniques, 20 years of FDI data and a specific state governance dataset.	In the long term (20 years) there is no significant relationship between the quality of government and number of foreign direct investment projects. However, in the short term (10 years), there is a positive significant relationship between the quality of governance and number of licensed FDI projects.
6	Foreign Direct Investment (FDI) and Governance: The Case of MENA. By Ahmed Zidi & Tarek Ben Ali (2016)	This paper has aims to find the answer of the relationship between Foreign Direct Investment and governance practiced in a given country. It use econometrics of panel data for MENA region (11 countries) in the period 1996-2014	There are seven variables that statistically significant to FDI on this research. The variables of governance quality are: government effectiveness and control of corruption.

No	Research Title, Author, and Year	Objectives and Method	Results
7	Impact of Foreign Direct Investment on Economic Growth in Tunisia. By Nasfi Fkili Wahiba (2014)	The purpose of this paper is to study the effects of FDI on Economic Growth by employ econometric estimation OLS (Ordinary Least Square) method.	FDI has positive effect to Tunisia economic growth. The other variable (tertiary level, money supply M2, technology, export) have significant effect too
8	FDI as a factor for economic growth in Romania. By Piotr Misztal (2010)	The main aim of this study is to analyze the influence of FDI on the economic growth in Romania between 2000 and 2009 by using literature method and econometric method (Vector Autoregressive model)	The inflow of FDI was one of the key factors determined GDP in Romania during 2000-2009, however, the employment changes has been give the largest impact on GDP growth.
9	Foreign Direct Investment, domestic investment, and economic growth in Sub-Saharan Africa. By Samuel Adams (2009)	The study analyze impact of FDI and domestic investment (DI) on economic growth in Sub Saharan Africa for the period 1990-2003 and employ panel data in OLS method	DI is positive and significantly correlated with economic growth in both OLS and fixed effect estimation, but FDI is positive and significant only in the OLS estimation.

Source: Author summary

1.2. Public Policy

2.2.1 Definition

Public policy can be defined as a policy which is intended to regulate public or citizens. According to Wahab (2014) policy is a purposive series of action or inaction do by an actor or more in dealing with a problem or matter of concern. United Nation (as cited by Wahab, 2014) stated that policy is guideline for action where the guideline can be very simple or complex, general or specific, broad or narrow, vague or unclear, lose or detailed, qualitative or quantitative nature, and public or private. Policy in politic communication is often used interchangeably with the goals, programs, decision, standards, proposals, and grand design that are made by government.

There are several definition of public policy due to some experts, according to Cochran, et al (2009) public policy is an action from government institution or official for resolving an issue which is the public concern. Dye (2005) said that public policy is what the government chooses to do or not to do. It means the government could have an action or no action, that is, what government chooses not to do. Government inaction is considered to have as great an impact on society as government action. Moreover, Dunn (2004) define public policy as a series of choices that are connected which created by agencies or government officials in areas related to administration tasks, such as security and defense, energy, healthcare, education, public welfare, crime, urban and others.

It can be conclude that the definition of public policy is all the government actions either directly or indirectly and will affect citizens' life. The decision or action is intended to address a perceived public problem. Further, the citizens must obey to the regulation which is implemented by government institution.

2.2.2 Public Policy Stages

To do the public policy analysis, it is better to have knowledge about the policy making process or how the policy made. According to Cochran, et al (2009) policy analysis is principally concerned with describing and investigating how and why policies proposed, adopted, and implemented. Afterwards, Dunn (2004) explain that the process of policy analysis is a series of intellectual activities undertaken in the process which is essentially political and manifested in a series of stages called policy making. There are several stages and analysis procedures of public policy process making as proposed by Dunn (2004), namely:

1) Agenda setting.

   The focus on first stage is on how the problems that may become the targets of public policies are identified and specified by the public officials. They must be able to define the public problems to be solved and which one to be priority. In other words, agenda is a collection of problems, understandings of causes, symbols, solutions, and other elements of public problems that come to the attention of members of the public and their governmental officials.

2) Formulation.

   This stage encompasses the creation, identification, or borrowing of proposed courses of action, often called alternatives or options, for resolving public problems. The problems will be discussed and defined so government can decide to create the public policy or not and what policy could be used.

3) Adoption.

   This stage involves deciding which proposed alternative, include taking no action, will be used to handle a problem. In American legislature this function

is performed by majorities. In this stage the support by stakeholders is needed so the policy formulation can get the legitimacy to be enacted.

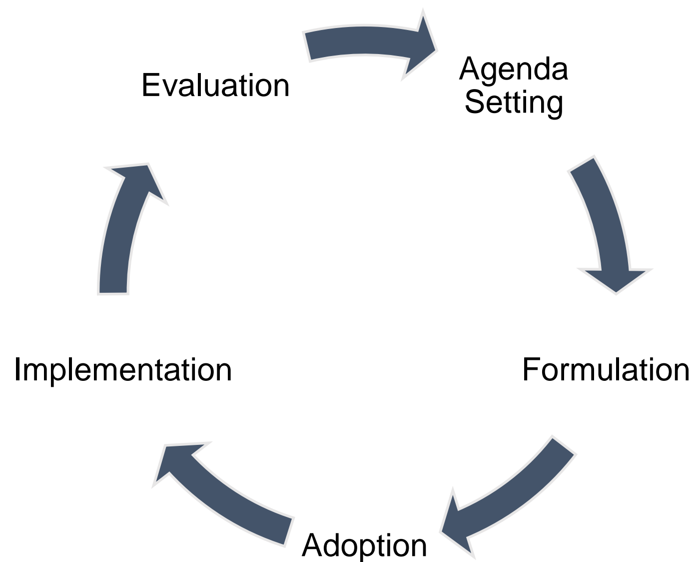
4) Implementation.

This stage is a synonym to administration. The attention is on what is done to carry into effect or apply adopted policies. Often further development or elaboration of policies will occur in the course of their administration. The policy implementation is done by the government administrative agency.

5) Evaluation.

This entails activities intended to determine what a policy is accomplishing, whether the policy implementation achieving its goals, and whether it has other consequences.

The public policy process making stages illustrates on figure 2.1 below



Source: Dunn (2004)

Figure 2.1 Public Policy Process Making Stages

Meanwhile, the other policy analysis on policy process is described by Patton (1986) as the policy evaluation continuum, that is:

1) Ex-ante policy analysis; the preprogram quantitative and qualitative analysis of problems, decision criteria, alternatives, pros and cons, and expected outcomes of implemented policies, and steps necessary for implementation and evaluation.
2) Policy maintenance; the analysis of the policy or program as implemented to assure that it was implemented as designed and does not change unintentionally during implementation.
3) Policy monitoring; the recording of changes after the policy or program is implemented.
4) Ex-post policy evaluation; the quantitative and qualitative analysis of whether the policy objectives were achieved and whether the policy should be continued, modified, or terminated.

Both policy process from Dunn (2004) and Patton (1986) have similarities, that is the evaluation stage which is done at the end of the process to measure or to assess the success and effect of the public policy. Moreover, this research also analyze or evaluate the public policy analysis, therefore the next part is the explanation about the public policy evaluation.

2.2.3 Public Policy Evaluation

Policy study consisting of many fields, namely, policy and politics, policy process, policy analysis, policy evaluation, policy design, policy makers and policy making institutions, and policy implementation (Smith and Larimer 2009). This research focusing on policy evaluation which have objectives to answer the

question “what have the government done?”, “what impact did a particular program or policy have?” by employing quantitative/qualitative, statistics, and expert judgement methodological approach.

Evaluation is an appraisal, rating, and assessment, the activity is relating to gain information about value and benefits of policy results. According to Dunn (2004), public policy evaluation has three functions, namely:

a) Evaluation gives valid and trustable information about policy performance, how far the needs, value, and opportunities can be achieved through public action.
b) Evaluation contributes to clarification and critique of the values that underlie the selection of objectives and targets.
c) Evaluation contributes to other policy analysis method, including the formulation and recommendation. Evaluation can give suggestion to create new policy or revise the policy.

Meanwhile, according to Wibawa (1994), the public policy evaluation has four functions. It could be used as an explanation if the evaluation can help to identify the problem, condition, and actor who support the success or fail the policy implementation. Public policy evaluation also could be a compliance if the evaluation can give information whether the government action or the other stakeholders action is comply with the standards and the policy procedure. Moreover, public policy evaluation is an audit if the evaluation can give information whether the output is reaches the target groups according to the policymakers purpose. Lastly, public policy evaluation is an accounting tool that can measure socio-economic impact of the public policy implementation.

Public policy evaluation involves collecting and analyzing information about the efficiency and effectiveness of policies. The purpose of evaluation is to determine whether goals of the policy have been achieved and to improve policy performance (Cochran, et al 2009). Further, in evaluating the public policy there are six steps to be conducted as explain by Sucman in Winarno (2007). First, identify the aim of the program that will be evaluated. Second, analyze the problem. Third, descript and standardize the activity. Fourth, measure the level of changes. Fifth, determine the causes of changes, is it because the policy or the other causes. Lastly, establish the indicators to determine the existence of an impact.

The steps was created so the evaluation can be running effective, because on the evaluation process there could be problem. The complexity of evaluation process can be an obstacle for the process itself. Therefore, in order to do the public policy evaluation the evaluator must be able to set the measurement of evaluation. Dunn (2004) describing some criteria to direct the evaluator when doing public policy evaluation, namely:

1) Effectiveness; it related to whether the alternative reach the goal or the aim.
2) Efficiency; it show the effort needed to increase the effectiveness or achieve the result.
3) Adequacy; it figures to what extent the desired result can solve the problem.
4) Equity; it shows the effect and effort distribution among the different groups in community.
5) Responsiveness; it related to how far the policy can fulfill the needs, preferences, and values of certain groups.
6) Appropriateness; it related to the value or nominal of the policy outcomes.

Furthermore, there are some types of policy evaluation. According to Rossi, Freeman, and Wright (1979) as cited by Crane (1982) the types of policy evaluation are divided into four, namely:

1) Research for program planning and development, it aims to designing programs in conformity with intended goals. The sample of evaluation questions are extents and distribution of target problem population; research and development for program planning and implementation.
2) Monitoring evaluation, it aims to testing implementation as corresponding to program design. The question are "is it reaching targets?" and "is it delivering services according to design?".
3) Impact evaluation, it aims to testing program effectiveness in reaching program goals. The sample of evaluation questions are "does program causing intended changes?' and "are changes substantively significant?".
4) Cost-benefit or cost-effectiveness analysis. It aims to calculating program economic efficiency. The question are "how much does each service unit cost?" and "how do the total cost and benefit compare?".

Afterward, the evaluation type that used on this research is impact evaluation where the objective is to know the effect of the policy. On this research the goal is to analyze the impact or the effect of governance quality and tax holiday on foreign direct investment and economic growth. To do the impact evaluation, this research is employ a quantitative method which has objectives to define a policy problem, to demonstrate its impact, and to present potential solutions (Yang, 2007). Quantitative method can inform whether a relationship exists between policy design and policy outcomes, test whether the relationship can be

generalized to similar settings, evaluate magnitudes of the effects of policies on social, economic, and political factors, and find better policy alternatives.

Quantitative method on a policy evaluation is needed by government to design the better policies, to understand how policies have performed, and assess what impacts of policies have made. Quantitative method help to evaluate the relative and joint effects of a variety of independent variables on some dependent variables. It informs citizens and stakeholders about the policy choice with some numbers, graphs, and tested relationships. In quantitative evaluation, some statistical analysis can be used, namely, Univariate and bivariate analysis, analysis of variance (ANOVA), multiple regression analysis, time series analysis, event history analysis (EHA), factor analysis, path analysis, and game theory. Further, the multiple regression analysis is selected and used on this research.

1.3. Public Finance

Gruber (2011) wrote on his book that in simple terms public finance is the study of the role of the government in the economy. Then some question about the government intervention are emerge, namely: when should the government intervene in the economy, how might the government intervene, what is the effect of those interventions on economic outcomes, and why do governments choose to intervene in the way that they do. Moreover, Gruber (2011) explain that the government are involve in market economies in two situation, first is the existence of market failures, or the problems that cause a market economy to deliver an outcome that does not maximize efficiency. Second is redistribution, it is the shifting of resources from some groups in society to others.

Furthermore, according to Gruber (2011) there are several different general approaches that the government can take to intervene, they are as follows:

a) Tax or Subsidize private sale or purchase. This also called price mechanism, whereby government policy is used to change the price of a goods through taxes or through subsidies.
b) Restrict or Mandate private sale or purchase. The government can directly restrict private sale or purchase of goods that are overproduced, or mandate private purchase of goods that are under produced and force individuals to buy that goods.
c) Public provision. Government provide the goods directly in order to potentially attain the level of consumption that maximizes social welfare.
d) Public financing of private provision. Governments may want to influence the level of consumption but may not want to involve themselves directly in the provision of a goods.

Afterwards, the effects of government intervention consist of direct and indirect effects. According to Gruber (2011), direct effects of government policy will be predicted if individuals did not change their behavior in response to the interventions, furthermore, the indirect effects will arise only because individuals change their behavior in response to the interventions. In order to government reason do what they do, the answer is the tools of political economy, the theory of how governments make public policy decision. Governments face enormous challenges in figuring out what the public wants and how to choose policies that match those wants.

A tax on profits or corporate income tax is one of the example of policy product from government which is charged to the company and act as the expense

and deduct the corporate income. Therefore, it might affects the direction and level of future investment, investor may consider to the tax regulation on a country before decide to invest or not. Due to Musgrave (1959) statement, the problem is how the tax affects the investor's choice between holding cash and investing, and between investing at various degrees of risk. Moreover, Musgrave (1973) argued that tax incentives should be designed so as to minimize interference with tax equity, therefore role of central government is needed to create a proper regulation.

1.4. Governance Quality

The concept of governance is not new, World Bank (2010) describing governance in some meaning, namely:

a) Governance is the manner in which power is exercised in the management of a country's economic and social resources for development.
b) Governance is the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services.

Good governance is one of the determinant factor of company to invest on other country and as the motives of Multinational companies to shift from market and resources-seeking to efficiency-seeking, Dunning (2002). As cited from Subasat (2013) study, countries with good governance might receive more FDI because investments cannot be protected in an environment of poor governance and poor governance increases costs and uncertainty. Moreover, OECD (2002) reported that no special incentives would be needed to attract foreign direct investment or indeed domestic investment as long as there is a good governance conditions.

Policy makers and academic agree that good governance matters for economic development. Scholars have discovered that high-quality institutions have the power, over the long run, to raise per capita incomes and promote growth in all parts of the world. Moreover, the “development dividend” paid by good governance is large. A research conducted by World Bank (2007) estimates that when governance is improved by one unit, then incomes rise about three-fold in the long run, and infant mortality declines by two-thirds. Such findings, and the data behind them, reinforce the experience and observations of reform-minded individuals in government, civil society, and the private sector, who know that good governance is essential for development.

2.4.1 Governance Indicators

Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them (Kaufmann, 2010 cited by World Bank, 2016)[1]. In 2015, Kaufmann, Kraay, Mastruzzi (2015) publish a working paper “The Worldwide Governance Indicators” (WGI), it is a project constructs aggregate indicators of six broad dimensions of governance for 215 countries over the period 1996-2014 and reported yearly.

Worldwide Governance Indicators summarize the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. It shows significant

[1] http://info.worldbank.org/governance/wgi/index.aspx#home, accessed on 25/2/2016

improvements in governance in a diverse set of countries around the world. The worldwide governance indicators has done much to refute three notions that are as pernicious as they are fallacious. They are, First, Governance cannot be measured, at least not with enough precision to be useful; Second, The industrialized countries are well-governed, while the developing world suffers from uniformly poor governance; Third, Significant progress to improve governance and curb corruption cannot occur in a short time.

The governance quality rate using scale among -2.5 (weak) and 2.5 (strong), and these data are collected from year 1996 – 2014 and gathered from a number of surveys of households and firms, commercial business information providers, non-governmental organizations, international organizations, and private sector firms. In 1996 to 2002, the survey was done every two years, and after 2002 the research has been conducted every year.

Kaufmann construct two measurement of governance corresponding for each of the area, in total it resulting three areas and six dimensions of governance. The three areas and six governance indicators are:

a. The process by which governments are selected, monitored, and replaced:
    1) Voice and Accountability (VA) is the perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
    2) Political Stability and Absence of Violence/Terrorism (PV) measures the perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism.

b. The capacity of the government to effectively formulate and implement sound policies:

    3) Government Effectiveness (GE) reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

    4) Regulatory Quality (RQ) is a perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

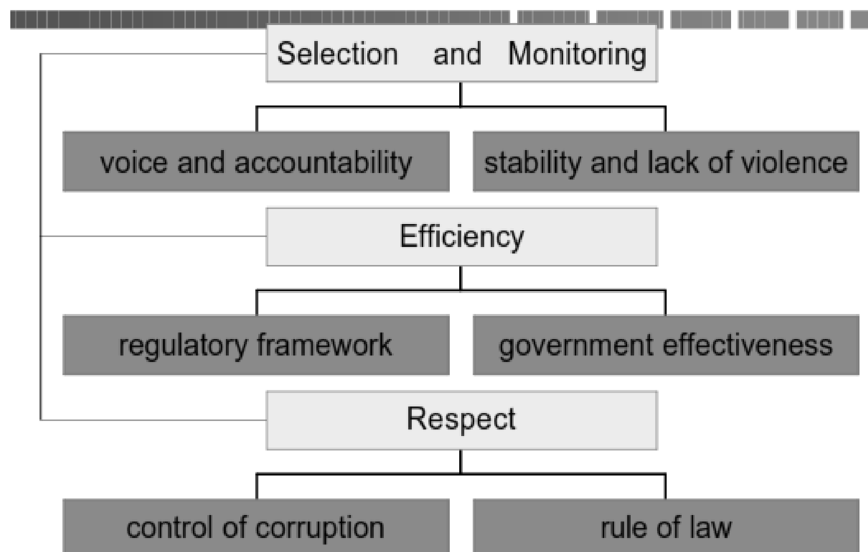
c. The respect of citizens and the state for the institutions that govern economic and social interactions among them:

    5) Rule of Law (RL) is capturing the perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

    6) Control of Corruption (CC) reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

The six indicators of governance quality are related each other and should not be thought of as being somehow independent of one another. It is strongly to use the indicator together, i.e. better accountability could lead to less corruption, or that a more effective government can provide a better regulatory environment, or that respect for the rule of law leads to fairer processes for selecting and replacing governments and less abuse of public office for private gain. They will show their function if used together as the influence factor of FDI.

Figure 2.2 below is the correlation between three exercised areas and the six governance indicators.



Source: World Bank

Figure 2.2 Governance Indicators

1.5. Tax Incentives

Tax incentives was created by the government in order to attract investor come to host country and invest their money. This is one of the country's attractiveness that managed by government. UNCTAD (United Nations Conferences on Trade and Development, 2008) define tax incentive as an incentive that reduce corporate tax burden with the objective to encourage the companies to investing on a project or a certain sector. Moreover, Zee, Stotsky, and Ley (2002), define tax incentive from two different views, statutory term and effective term. In statutory term tax incentive is a special tax provision granted to qualified investment projects that represents a statutory favorable deviation from a corresponding provision applicable to investment projects in general. Meanwhile, in effective term tax incentive is s special tax provision granted to qualified

investment projects that has the effect of lowering the effective tax burden – measured in some way – on those projects, relative to the effective tax burden that would be borne by the investors in the absence of the special tax provision. Under this definition, all tax incentives are, therefore, necessarily effective.

Moreover, according to Shah (1995), tax incentives are provision of preferential treatments to some investment that can be categorized from sectorial (manufacturing or services), type of assets (machinery or power plant), form of organization (small or large enterprise), or financing type (debt or equity). Furthermore, Morisset (2003) argued that tax incentive is a reduction in the corporate income tax rate, through tax holidays or temporary rebates for certain types of investment or companies. This is supported by Fakile and Adegbile (2011) research that tax incentives are part of the tax system of developing countries and usually established by governments in order to grant foreign investors more attractive conditions to invest in their country.

2.5.1 Types of Tax Incentives

Each countries have different type of tax incentives, and it depends on their need and what they can give to investor. Clark, et al (2007), explained several types of fiscal incentives as follow: tax holiday, corporate income tax (CIT) reduction, exemption of CIT, accelerated capital allowances, investment tax credits, location based incentives, reduced taxes on dividends and interest, preferential treatment of long-term capital gains, deduction for qualifying expenses, exemption from indirect taxes, and free zones and special economic zones. Afterwards, Fletcher (2002) categorized tax incentives into six types, namely, reduced corporate income tax rates, tax holiday, investment allowances and tax

credits, accelerated depreciation, exemption from indirect taxes, and export processing zones.

Another scholars (Holland and Vann, 1998) divide tax incentives into five, they are: tax holiday; investment allowances and tax credit; timing differences; reduced tax rates; and administrative discretion. Further, Easson and Zolt (2002) explaining that in general the forms of tax incentives are: reduced corporate income tax rates; tax holiday; investment credits or allowances; tax credit accounts; accelerated depreciation of capital assets; favorable deduction rules for certain types of expenditure; deductions or credits for reinvested profits; reduced rates of withholding tax on remittances to the home country; personal income tax or social security reductions for executives and employees; sales tax or VAT reductions; reduced import taxes and customs duties; property tax reductions; and creation of special "zones". However, not every type of tax incentives are available in host country, for instance in Indonesia, the tax incentives are given in form of tax holiday and tax allowances to investor. Moreover, regarding the topic of this thesis, analysis on types of tax incentives will focus on tax holiday.

2.5.2 Purposes of Tax Incentives

UNCTAD (2008) reported that there are some objectives to be achieved by a country when giving tax incentives, they are:

a) Regional Investment; it supporting the area outside the city. The development of industrial area that far from the city can reduce the environmental pollution, the urbanization, and reduce the population density in urban city.

b) Sectoral investment; tax incentives could be awarded to the business sectors that have important function for country's development. Tax incentives aiming to stimulate the industrial development, manufacture, tourism, or the natural exploration.
c) Quality improvement; it is usually done by creating a bonded zone for industries that have export orientation.
d) Technology transfer; it is giving incentive to pioneer industries or by providing special incentive for the activities on research and development that can bring the new technology too.

Moreover, Holland and Vann (1998) explaining the purposes of tax incentives are for regional development, employment creation, technology transfer, export promotion, and free trade or export processing zones.

2.5.3 Tax Holiday

In developing countries, government must be able to promote their competitive and comparative advantages with various incentives for the entry of capital investment. Tax holiday is the favorite tax incentive that given on developing countries to attract foreign investors, Easson, Zolt (2002). Compared to another tax incentives, administration on tax holiday process is more simple than the other tax incentives. Tax holiday also can prevent the corruption because the company or tax payers did not necessary to contact with tax administration officer, Fletcher (2002). Moreover, Holland and Vann (1998) said that this incentive is aim to facilitate new company which is starting the business operation on host country. By employ tax holiday facility the company will be exempted from corporate income tax (CIT) for a certain period as regulated.

However, as cited from Fletcher (2002), there are some disadvantages from tax holiday, namely:

a) Tax holiday is same as lower CIT rates, except might be tax spared.
b) Tax holiday attracts short-run projects only.
c) Invites tax avoidance through the indefinite extension of holidays via creative redesign of existing investment as new investment.
d) Creates competitive distortion between old and new firms.
e) Revenue costs are not transparent unless tax filling is required, in which case administrative benefits are foregone.

1.6. Foreign Direct Investment

2.6.1 Definition

Foreign investment has been regulated in some regulations in Indonesia. One of the most crucial regulation is Act No. 25 year 2007 about investment. According to that act, foreign investment is the activities of domestic investors to do business in the territory of the Republic of Indonesia, made by a foreign investor, whether using foreign capital and joint venture with domestic investors. Due to Graham & Spaulding (1995, cited by Oriakhi, Osemwengie, Amaechi, 2014), in classical way, FDI is an action of a company from a country to make physical investment into building a factory in another country. FDI seen as a form of lending or finance in the area of equity participation.

Moreover, according to UNCTAD (2013, cited by Bobek, et al, 2015), FDI is defined as an investments that acquire long lasting interest that operates outside of the investor country. FDI consist of reinvesting earning, equity capital and other capital (intra company loans). Also licensing, franchising, management contracts,

product sharing, subcontracting, alliances, goodwill or grants named non-equity forms of investment can be FDI. This explain that FDI is a long term investment, and mostly they are more than 10 years.

Dunning and Rugman (1985, cited by Pereira, 2013) stated that foreign direct investment is “a modality by which firms extends their territorial horizons abroad”. Therefore, when the company from home country expand their business to host country, it’s not only move the capital, but also the control through the company by brought some resources, such as human resources, and their management system. They brought capable human resources to be placed in managerial level and have authority or power to control the company. In addition, Easson (2004), defines FDI as an investment made to acquire a long term interest in an enterprise operating in an economic environment other than that of the investor, with the investor’s purpose being to have an effective voting decision in the management of the enterprise.

FDI can be classified in different forms regarding to the point of view, the recipient country view and the investor view (Bobek, et al, 2015). From the recipient country view, FDI is classified as Export-enhancing FDI, when FDI affects in transferring a new type of technology in order to increase host country export competitiveness. The second is Import-substituting FDI, when FDI produce goods for the host country which is at that time imported from another country. Meanwhile, from the point of investor view, FDI is categorized as Horizontal FDI, when FDI produce similar or same product in the foreign country; Vertical FDI, when FDI build an operation as a supplier or a distributor; and Conglomerate FDI, it is a combination between vertical and horizontal FDI.

Moreover, based on the entry modes, FDI can be in the form of cross-border mergers and acquisitions (C-B M&As), it is takeover or merger with an existing local firm; and Greenfield investments, it means the establishment of a wholly new operation in a foreign country (Bobek, et al, 2015). There are also FDI net inflows which present the value of inward direct investments made by non-resident investors in the reporting economy, and FDI net outflows which present the value of outward direct investments made by the residents of reporting economy to external economies (OECD, 2013).

2.6.2 Determinants of FDI

As cited from Bobek, et al, (2015), the most famous and cited of FDI motives is proposed by Dunning (1993) and developed from the OLI framework (Dunning 1977). FDI decisions involve an assessment of three type advantages: ownership, location, and internationalization (OLI). First, the company must look to the ownership advantage such as patents, trademark, and know-how, it will explain why a company want to become a multinational. Second, the location advantage explain the choosing of where a company will invest, for instance, low trade barrier, low tax burden, or low labor cost will be the company consideration. Lastly, internationalization advantage explain how the company entering the foreign market and gain more benefit. Company will consider to establish the business directly through foreign direct investment or buy the license on other firms in foreign market.

Moreover, the primary motives of foreign investors that proposed by Dunning (1993) is created on following categories:

a) Resources seeking; foreign investor searching new natural resources or cheap labor cost on destination country. This occur when investor country is missing of raw material and natural resources, also the labor cost in home country is more expensive.
b) Market seeking; foreign investor searching new customer or buyer for their goods and services.
c) Strategic asset seeking; foreign investor want to build new business strategic on host country, such as expand distribution network or employ new technology.
d) Efficiency seeking; foreign investor looking for lower cost structure in host country. The cost of starting business in destination country might be lower than in original or other country.

Furthermore, FDI flows are influenced by some factors as explained in many literatures. Clark, et al (2007) explain the factors influencing FDI are divided into two group, first non-tax factors, which consist of market size, access to raw materials, availability and cost of skilled labor, access to infrastructure, transportation costs, access to output markets, political stability, macro-economic stability, and financing costs. Second, tax factors consisting of transparency, simplicity, stability and certainty in the application of the tax law and in tax administration, then tax rates, and tax incentives.

In World Investment Report by UNCTAD (1998, cited by Bobek, et al, 2015, p.107) the influence factors are classified into three, namely:

1) Factors related to natural resources extraction, new market acquiring and greater efficiency named as microeconomic factors;
2) Political and economic factors meaning international FDI agreements, privatization policy, the trade and fiscal policy; and
3) Factors related to FDI promotion, location attractiveness, and incentives for investments.

Blomstrom & Kokko (2003) give highlight that in general country's industrial policies is the main determinant for attracting FDI and maximizing their benefits. Hence, a lot of country especially developing country build their own strategy to gain as much positive effects from international capital flows by enhancing the local supply of human capital and modern infrastructure and by improving other fundamentals for economic growth. Several empirical studies that focus on determinant of FDI in developing countries argued that political risk, political instability, corruption and non-transparent institutional, and bad governance are the significance factors of FDI inward. It could harm the business climate, and therefore reduce FDI inflows (Singh and Jun, 1995; Wang and Swain, 1997; Morisset, 2000, cited by Saidi et al, 2013).

2.6.3 Effects of FDI

As written on Act No. 25 year 2007 about investment, the aims of investment is to increase national economic growth, creating more job opportunities, increase sustainable economic development, encourage the society economy, and increase the community welfare. Moreover, if an investment comes

from multinational companies or foreign investment, it will bring indirect benefit and plays an important role in the development and in poverty reduction. Foreign investment will bring several positive effects in reducing unemployment, transfer of new knowledge, transfer of new technology, develop management knowledge, and generate additional tax revenue, increase engagement of local companies in supplier and subcontractor networks, and on the development and economic growth of the host country, Bobek, et al, (2015).

FDI benefits are proven from some literature and they are different among countries. In research conducted by Rana and Dowling (1988) about "Foreign Capital and Asia Economic Growth" conclude that foreign capital has positive effect to development in Asia's developing countries. Due to Lin (2008) research, FDI bring benefits if an investment environment is open and has active competition policies. The democratic investment regime and trade, privatization, deregulation and macroeconomic stability are very important factors by helping maximizing the benefits of FDI. Razin and Sadka (1999) argued that the beneficiary country (host country) will receive some benefit from FDI, FDI allows the transfer of technology, particularly in the form of new varieties of capital inputs which is cannot be achieved through financial investment or goods and services trade in.

Effects of FDI are positive due to the investment time period, Reisen (1999). While Cantwell (1989) and Perez (1998) believe that the positive effects of FDI depend on the sector of investor choice. On the other side, the negative effects of FDI can occur if condition for FDI are unfavorable. They are uncompetitive behavior of foreign owned companies, reduction of productivity of the host country, concentration increase in the domestic market, closure of local firm, shrinking

domestic stock market, low pricing for sold assets, pressure on current account and elimination of competition in the domestic market, Bobek, et al, (2015).

Meanwhile, on the economic side, foreign direct investment from MNCs could bring some negative impact (Todaro, 2012), they are:

a) Although MNCs provide capital, they may lower domestic savings and investment rates by substituting for private savings, and failing to reinvest much of their profits. MNCs also create a large fraction of their capital locally in the developing country itself, and this may lead to the over fullness of investment from local corporation.
b) Although the impact of MNC investment is to improve the foreign exchange position of the recipient nation, its long-run impact may be can reduce foreign-exchange earnings or at least make the net increase smaller than it appeared. It occur as a result of substantial important of intermediate products and capital goods and because of the overseas repatriation of profits.
c) Although MNCs give contribution to public revenue in the form of corporate taxes, their contribution is considerably less than it might appear as a result of liberal tax concessions.
d) The management, entrepreneurial skills, ideas, technology, and overseas contacts provided by MNCs may have little impact on developing local sources of these scarce skills and resources. Moreover, it could inhibit their development by restrict the growth of local entrepreneurship as a result of the MNCs dominance of local markets.

1.7. Economic Growth

Most of countries do the development in order to increase their economic growth and to pursue national welfare, the success indicator of country development can be measured from the change of total product of goods and services they have or gross domestic product. The issue emerge in developing countries is how to achieve economic growth with the available situation and condition where it is low of private capital, underdeveloped market, and surplus labour (Haque, 1999). Moreover, Haque (1999) argued that the developing countries problem is less saving and capital, and excessive surplus labor, therefore Keynesian theory as cited by IMF (2014) which allow the government intervention on the country economy through public policies, became the dominant theoretical framework for developing countries development. Keynes (1936) supported the government intervention during times of economic turmoil for the development of the country.

In order to improve the countries development, government need to collect the capital and have additional investment to increase the country economic growth, moreover, country should expand the industrial progress, and solve the population problem due to the development objective to move the economy to a better situation. Usually developing countries are rich with its natural resources but they have lack in capability to utilize it, either lack in technology, human resources or capital. This condition is the obstacles of developing countries to change their economic potential into economic benefit and make economic output to increase the economic growth. Gruber (2011) stated that more savings – more capital, and more capital - more growth, savings can be act as an engine of growth and this insight remains important for growth economics today.

Due to Rostow (1960, cited by Todaro, 2012), transition from underdevelopment to development can be described in terms of a series of steps or stages through which all countries must proceed. The developed countries already passed the stage of “take off into self-sustaining growth”, and the underdeveloped countries are still in either the traditional society or the “preconditions” stage which had to follow a certain set of rules of development to take off into self-sustaining economic growth. One of the basic strategies of development necessary for any take off was the mobilization of domestic and foreign saving in order to generate sufficient investment to accelerate economic growth.

Harrod-Domar growth model which is the advance of Keynes theory is a functional economic relationship in which the growth rate of gross domestic product “g” depends directly on the national net saving rate “s” and inversely on the national capital-output ratio “c”. This model described the economic mechanism that more investment will lead to more growth, moreover, in order to growth new investments are needed to representing net additions to the capital stock. It assume on this model that there is some direct economy relationship between the size of the total capital stock “K” and total GDP “Y”, for example, if $3 of capital is always necessary to produce an annual $1 stream of GDP, it follows that any net additions to the capital stock in the form of new investment will bring about corresponding increases in the flow of national output, GDP. This relationship is also known as incremental capital output ratio (ICOR).

The simple equation as written in Todaro (2012) is:

$$\Delta Y/Y = s/c \qquad (2.1)$$

Where the rate of growth of GDP "ΔY/Y" is determined by the net national savings ratio "s" and the national capital output ratio "c". From that equation it can be said that in the absence of government, the growth rate of national income will be directly or positively related to the saving ratio. Moreover, it can be conclude that the more country can saving or add the investment, the greater the growth of that GDP will be, and vice versa, the higher of capital output ratio, the lower the rate of GDP growth will be.

Afterwards, there is neoclassical growth model which is developed by Robert Solow called Solow neoclassical growth model. This theory is different from the Harrod-Domar formulation, it explain that economic growth not only determined by capital, but also the second factor, labor, and the third independent variable, technology. Therefore the equation is:

$$Y = K^{\alpha} (AL)^{1-\alpha} \quad (2.2)$$

Where Y is gross domestic product, K is the stock of capital (may include human capital as well as physical capital), L is labor, and A represents the productivity of labor. According to traditional neoclassical growth theory, output growth resulted from one or more of three factors: increases in labor quantity and quality (through population growth and education), increases in capital (through saving and investment), and improvements in technology.

Meanwhile, to increase the capital from investment, a country should implement the economic system where can receive outside parties activities such as trade or foreign investment. Due to Todaro (2012), there are two types of economic system, namely:

1) Closed economies (those with no external activities) with lower savings rates grow more slowly in the short run than those with savings rates and tend to

converge to lower per capita income levels. It is an economy in which there are no foreign trade transactions or other economic contacts with the rest of the world.

2) Open economies (those with trade, foreign investment, etc.) experience income convergence at higher levels as capital flows from rich countries to poor counties where capital-labor ratios are lower and thus returns on investments are higher. It is an economy that practices foreign trade and has extensive financial and nonfinancial contacts with the rest of the world.

Therefore, the less of foreign investment inflow to developing country could slow down the growth in the economies of the developing world. Vice versa, the openness could encourage greater access to foreign production ideas that can raise the rate of technological progress.

According to the theory of neo-classical economic growth, Todaro (2012) conclude the three components of economic growth as follows:

1) Capital accumulation. It results when some proportion of present income is saved and invested in order to augment future output and income. For example all new investments in land, physical equipment, and human resources through improvements in health, education, and job skills. These directly productive investments are supplemented by investments in what is known as social and economic infrastructure (roads, railways, electricity, water, sanitation, and communication) which facilitates and integrates economic activities.

2) Growth in population and then eventual growth in the labor force. It has been considered as a positive factor in stimulating economic growth. A larger labor

force means more productive workers, and a large overall population increases the potential size of domestic markets.

3) Technological progress, new ways of accomplishing tasks. It increased application of new scientific knowledge in the form of inventions and innovations with regard to both physical and human capital. In simplest form, technological progress results from new and improved ways of accomplishing traditional tasks such as growing crops, making clothing, or building a house.