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Effectiveness of Tax Rate Reduction in Increasing National Private Investment

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Abstract

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Tax rate reductions are often linked to the growth of private investment, since in theory they increase net profit after tax and create incentives for businesses to expand. This study examines the effectiveness of Indonesia's Corporate Income Tax (CIT) reduction policy in stimulating national private investment. A qualitative descriptive approach was applied, relying on a literature review of scholarly sources and official government fiscal policy reports. The results show that while domestic investment experienced growth after the tax rate cut, the effect was not strictly linear. Investment performance was also shaped by structural elements such as legal certainty, political stability, and bureaucratic efficiency. Several studies further emphasize potential negative implications, particularly the risk of an expanding budget deficit that could weaken productive public financing. Therefore, the policy of reducing tax rates can only achieve optimal effectiveness if it is integrated with broad structural reforms aimed at creating a competitive and sustainable investment ecosystem capable of supporting long-term economic development in Indonesia.

1. Introduction

National private investment holds a strategic role in sustaining a nation's economic progress. Both in theory and in real economic practice, private investment is not only one of the fundamental components in shaping Gross Domestic Product (GDP) but also acts as a central engine that promotes employment growth, productivity enhancement, and structural economic transformation. Capital inflow from private entities drives the expansion of business activities, enlarges national production capacity, and produces a multiplier effect that stimulates a wide range of other economic undertakings. In addition, private sector investment introduces new technologies and innovative business models that can significantly strengthen a country's position in the increasingly competitive global economy.

Among the numerous variables affecting private investment decisions, government fiscal policy especially taxation plays a decisive role. Taxes, functioning as a key fiscal tool, have a dual character. On the one hand, they are an indispensable source of government revenue, while on the other hand, they also influence economic choices and behaviors, particularly investment-related decisions. A high tax burden is often viewed as an obstacle for entrepreneurs and companies, potentially discouraging them from placing additional capital in productive ventures. In contrast, relatively low tax obligations can serve as a motivating factor for investors, since they improve the potential for higher net returns. For that reason, carefully designed tax regulations are vital for creating a climate that supports and attracts new investments (Bordo & Levy, 2021).

Over the past few years, the Indonesian government has launched several fiscal reforms to increase the nation's competitiveness in the international arena. One notable reform is the reduction in the corporate income tax (CIT) rate (Sujarwati, 2020). Referring to Law No. 2 of 2020, the tax rate for corporations was gradually lowered from 25% to 22% during the years 2020–2021, with an official plan to reduce it further to 20% in subsequent periods. This initiative was designed not only as a response to the economic downturn caused by the COVID-19 pandemic but also as a deliberate measure to attract additional domestic and international investment (Kaneva et al., 2022).

The implementation of this tax cut raises interesting questions. From a theoretical perspective, reducing tax obligations should increase the profit retained by businesses after taxation. This increase in post-tax profit is expected to encourage companies to enlarge their production capacities and channel more funds into reinvestment. Yet, in practice, the effectiveness of such a policy in boosting national investment is still debated. Data from the Indonesia Investment Coordinating Board (BKPM) reveals that Domestic Direct Investment (DDI) in 2020 actually declined by around 1.7% compared to the year before. However, improvements were recorded in the following years: investment grew by 7.1% in 2021 and surged by 23.6% in 2022. These positive developments have often been linked not only to the gradual economic recovery but also to the fiscal incentives, including the lowered tax rates (Gechert & Heimberger, 2022).

Such dynamics illustrate that the relationship between taxation policies and investment outcomes does not always demonstrate a straightforward or linear pattern. Business actors consider many other important aspects before committing capital. Elements such as the assurance of legal certainty, the degree of political stability, the overall ease of doing business, and the potential market opportunities all interact with tax policy in shaping investment decisions.

Given these circumstances, deeper examination is necessary to evaluate whether reductions in tax rates can indeed be categorized as an effective instrument for stimulating private sector capital inflows. The objective of this research is to analyze the extent to which tax cuts have influenced private investment in Indonesia. Specifically, the focus is placed on assessing how the adjustment of tax rates has shaped the behavior of business actors and the degree to which these policies have contributed to creating a more dynamic, productive, and competitive national economy. Employing a descriptive method complemented by historical data trend analysis, this study aspires to deliver an impartial understanding of the nexus between taxation and private investment, while also offering valuable input for the formulation of future fiscal strategies.

2. Methods

This research applies a descriptive qualitative method, with the primary objective of providing a deeper comprehension of how tax rate policies relate to the growth of national private investment in Indonesia. The use of this method is considered appropriate because it enables the researcher to describe economic realities in a contextual manner, by exploring and analyzing data drawn from various credible and relevant literature sources. The study relies on which are gathered through a comprehensive library research approach. These data sources include academic journals, research articles, scientific papers, official policy documents, and reports issued by trustworthy institutions. The selection of these sources is carried out carefully to ensure they meet the criteria of credibility, reliability, and relevance to the research problem under discussion. The analytical stage in this study is carried out qualitatively, meaning that the process focuses on examining the content of the selected literature to identify recurring patterns, potential relationships, and theoretical perspectives that can explain how fiscal policy in particular, tax rate adjustments affects the trajectory of private sector investment.

Unlike quantitative studies that rely on numerical or statistical techniques, this research emphasizes descriptive interpretation, aiming to generate a holistic and comprehensive understanding of the phenomenon. The emphasis is on clarifying how tax reductions may influence business decisions regarding capital allocation and investment expansion. In this framework, the tax rate is positioned as the independent variable, while national private investment is defined as the dependent variable. The analysis is centered on explaining the linkage between these two elements and evaluating whether the government's recent tax reduction initiatives have been successful in shaping a more favorable investment environment. At the same time, the study investigates whether these policies have effectively contributed to enhancing the volume and growth of private sector investment across Indonesia's economy.

3. Results

3.1. Theoretical Perspectives on Tax Rate Reduction and Private Investment

Reductions in tax rates are widely recognized as having a substantial influence on private investment behavior, as supported by several economic theories and empirical studies. Within the theoretical framework of economics, lowering tax burdens directly increases the after-tax profitability of firms, thereby offering a stronger motivation for businesses to expand their operations, reinvest retained earnings, or establish new production facilities and branches. This process contributes to creating a more favorable investment climate, particularly for domestic investors whose decisions are often highly sensitive to fiscal burdens. The relationship between tax levels and investment can generally be described as negative: when taxes decline, investment usually rises because the expected post-tax return is higher. Taxes are perceived as an additional component of the cost of capital, meaning that when rates are reduced, the relative cost of undertaking investment becomes lower.

Moreover, tax reductions also affect investor decision-making through various mechanisms, such as improving company liquidity, strengthening competitiveness at the global level, and stimulating aggregate demand, which altogether support greater investment activities. Moon (2022) emphasizes that a decrease in tax rates can effectively foster private investment by raising net corporate income. With reduced tax obligations, firms have a larger pool of funds available for investment in expansion projects, acquisition of machinery, or adoption of innovative technologies. According to Moon, reduced tax burdens also increase a country's appeal to both domestic and international investors, as they improve returns on capital allocation. This underscores the role of tax policy as a crucial determinant of national competitiveness in the international economic landscape. In line with this, Chindengwike (2022) argues that the positive effect of tax reduction may also be transmitted through the aggregate demand channel. Lower taxes not only raise the income of firms but also that of households, which in turn boosts consumption levels and demand for goods and services. In response to the higher demand, companies are encouraged to expand their investment in productive capacity, for example by establishing new facilities or upgrading technology. Nonetheless, Bordo and Levy (2021) provide a critical perspective, warning that if tax cuts trigger significant fiscal deficits, the resulting rise in interest rates could have the opposite effect. Under such conditions, private investment may be crowded out as the government and private sector compete for access to loanable funds.

Tag and Degirmen (2022) present another argument by stating that lower taxes increase economic freedom, which subsequently promotes private investment growth. In their view, when businesses and individuals retain more of their income due to reduced tax obligations, they are able to channel these resources into productive ventures, such as enterprise development or innovation. They further contend that governments should reduce intervention, including high taxation, in order to maximize efficiency in resource allocation, which in turn supports sustainable investment. Similarly, Kallianiotis (2022) highlights that reducing tax burdens can raise private investment by eliminating inefficient fiscal pressures. He argues that excessively high tax collections are often allocated toward unproductive state expenditures, such as projects that fail to deliver long-term benefits. By contrast, lowering tax rates allows the private sector to allocate greater resources toward more profitable initiatives, including infrastructure expansion and technological advancement.The significance of policy credibility is also underlined by Guceri and Albinowski (2021), who note that permanent reductions in tax rates are considerably more effective than temporary adjustments in motivating private investment.

This is because large-scale investment decisions such as the construction of new factories or the development of new products require long-term predictability and assurance. They also point out that the overall design of the tax system, including targeted incentives for research and development, can further strengthen the beneficial impact of lower taxes on business expansion. Complementing this perspective, Jacob (2022) found that decreases in corporate tax rates are positively associated with rising private investment, particularly in industries with high capital intensity like manufacturing. Additionally, the findings of Gechert and Heimberger (2022) reveal that nations implementing lower corporate tax policies generally experience faster domestic investment growth. In such contexts, firms can more effectively allocate resources to expand their operations, whether through the purchase of new equipment or the enlargement of production facilities.

3.2. Supporting Tax Rate Reduction in Indonesia and Its Implications for Investment

In Indonesia, the reduction of the corporate income tax rate under the Omnibus Law (UU Cipta Kerja), which lowered the rate from 25 percent to 22 percent as explained by Saptono and Ayudia (2021), is considered a significant fiscal measure with the potential to stimulate private investment. This policy is particularly relevant if Indonesia seeks to remain competitive with other countries in the region such as Vietnam and Singapore, which are often regarded as attractive destinations for capital inflows. Nevertheless, maintaining low tax rates alone does not guarantee substantial investment growth. Several additional factors such as simplified licensing systems, stable political conditions, and strong legal certainty play an equally important role in shaping a favorable investment climate. Without parallel improvements in these areas, the positive effects of reduced tax burdens may be limited. Jacob (2022) highlights that a lower corporate tax rate can function as an incentive for investment; however, its influence will be minimal if it is not supported by broader structural reforms. Within the Indonesian context, complex bureaucratic processes and high levels of corruption often pose greater challenges than the tax rate itself.

As a result, reductions in corporate income taxes must be accompanied by systematic efforts to simplify administrative procedures, cut red tape, and increase transparency if they are to generate meaningful domestic investment growth. Further insights are provided by Wołowiec and Martyniuk (2022), who argue that tax reductions can enhance private investment in certain regions by fostering a more competitive economic environment. Similarly, Deller et al. (2022) observe that jurisdictions applying lower corporate tax rates frequently attract new investments, whether through the establishment of new enterprises or the expansion of existing ones. However, they also stress that this positive correlation becomes more pronounced when adequate infrastructure is in place. Facilities such as reliable transportation, energy availability, and supportive utilities, combined with regulatory systems that ease business activity, are essential in maximizing the impact of lower taxation. Zhang et al. (2018) offers a complementary yet cautious perspective, asserting that the overall effect of tax cuts on investment strongly depends on how governments address the resulting revenue losses. If reductions in corporate taxes are accompanied by cuts in productive public spending for instance, in infrastructure projects or education programs the long-term environment for private investment may deteriorate.

Such reductions could weaken human capital quality or undermine public infrastructure, which are both critical components of an investment-friendly climate. Consequently, Zhang (2018) suggests that any tax reductions should be balanced by improving fiscal efficiency, such as reallocating funds from unproductive expenditure, so that the foundations supporting private sector growth remain intact. Taken together, these perspectives imply that tax policy reforms in Indonesia hold significant promise for boosting private sector investment, but their ultimate success is contingent upon adopting a comprehensive and integrated approach. A strategy that combines lower corporate income tax rates with fundamental structural reforms including bureaucratic streamlining, anti-corruption measures, strengthening of political stability, enhanced legal certainty, and prudent fiscal management is necessary to fully realize the potential benefits. Only by addressing these structural challenges in tandem with tax incentives can Indonesia create a competitive and sustainable investment ecosystem. Such a holistic framework would not only attract greater inflows of domestic and foreign investment but also contribute to steady long-term economic growth.

4. Conclusion

Tax rate reduction is often seen as an important factor in stimulating private investment, as supported by both economic theory and empirical research. From a theoretical standpoint, lower tax rates increase post-tax earnings, which in turn provide stronger motivation for companies to expand operations, undertake innovation, and reallocate retained profits into more productive sectors. In addition, tax reductions contribute to enhancing global competitiveness and promoting economic freedom, while simultaneously fostering a more attractive and secure climate for investment. Nevertheless, the extent to which such fiscal measures are successful depends heavily on the structural characteristics and institutional conditions of each country.

In the Indonesian case, the policy of reducing the corporate income tax from 25% to 22% demonstrates considerable potential to stimulate greater private sector capital inflows. However, the effectiveness of this measure cannot be maximized if it stands alone without broader reforms. Comprehensive improvements are needed, including bureaucratic streamlining, serious anti-corruption initiatives, the assurance of legal certainty, strengthening of infrastructure, and the implementation of prudent fiscal policies. In the absence of these supporting factors, the advantages generated by lower tax burdens may be diminished by persistent institutional obstacles that weaken the investment climate. Therefore, the success of tax rate reduction must be integrated with structural reforms that create a more conducive environment for business activities. Only with this holistic strategy can tax cuts become a genuine driver of investment growth and sustainable long-term economic development in Indonesia.

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