

THE LOCATION-BASED TAX INCENTIVES IN INDONESIA: SPECIAL ECONOMIC ZONES

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ABSTRACT

Tax incentive policies can be seen as a two-sided coin that has costs and benefits. Many countries adopt location-based policies to address economic disparities between regions in their countries. This essay will discuss the implementation of location-based tax incentives in the form of Special Economic Zones (SEZs) in Indonesia. This paper examines the relevant literature and provisions underlying location-based tax incentives, particularly special economic zones (KEK). SEZ development in Indonesia began in 2009 with the aim of attracting investment, spurring economic growth, and contributing to economic development in the region and the country. However, after more than a decade of its launching, SEZs in Indonesia have not developed optimally. Several problems discourage investors from investing in SEZs, such as infrastructure and land acquisition. Fiscal incentives provided in SEZs are also not very effective in attracting investors.

ABSTRAK

Kebijakan insentif pajak dapat dilihat sebagai mata uang dua sisi yang memiliki sisi biaya dan sisi manfaat. Banyak negara mengadopsi kebijakan berbasis lokasi untuk mengatasi kesenjangan ekonomi antar wilayah di negara mereka. Esai ini akan membahas implementasi insentif pajak berbasis lokasi berupa Kawasan Ekonomi Khusus (KEK) di Indonesia. Makalah ini mengkaji literatur relevan dan ketentuan yang mendasari insentif pajak berbasis lokasi, khususnya Kawasan Ekonomi Khusus (KEK). Pengembangan KEK di Indonesia dimulai pada tahun 2009 dengan tujuan untuk menarik investasi, memacu pertumbuhan ekonomi, dan berkontribusi pada pembangunan ekonomi di daerah dan negara. Namun, setelah lebih dari satu dekade diluncurkan, KEK di Indonesia belum berkembang secara optimal. Beberapa masalah membuat investor enggan berinvestasi di KEK, seperti infrastruktur dan pembebasan lahan. Insentif fiskal yang diberikan di KEK juga tidak terlalu efektif menarik investor.

1. INTRODUCTION

Tax incentives policies can be seen as a double-sided coin that has both cost and benefit attached (Zuo, 2009). Those incentives are widely used in many countries to attract investment and stimulate economic growth. Given the scarcity of fiscal resources, the use of tax incentives is unclear whether the overall benefits outweigh the cost. Moreover, the use of tax incentives to attract investment has not by and large been successful (Thuronyi, 1998). Despite the controversy, the use of tax incentives has been prevalent in many countries (Thuronyi, 1998), including Indonesia.

Indonesia has become more open to offering tax incentives to attract foreign investment by Publishing Foreign Investment Law No.1 on Foreign Investment in 1967 (Zuo, 2009). Under the law, foreign investors in specified sectors were exempt from corporate income tax (CIT) for up to five years and from dividend tax on profits earned over five years. Three years later, The Law was then modified by Law No.11, which offered different special tax incentives. Those policies made Indonesia successfully attract several named multi-national enterprises to invest. In 1984, comprehensive tax reform was enacted. CIT rate was reduced, and selective tax incentives, including tax holidays, were totally eliminated. As a result, the number of foreign direct investment projects dropped briefly, then rose steadily for the remainder of the decade to set a new highest record after 1987. OECD acknowledged that as one of the success stories on eliminating tax incentives (OECD, 2007). However, pressure has been persistent to reinstate tax incentives, and then another tax incentive was reintroduced.

At present, there are several tax incentives offered by the Indonesian government, including tax holidays, tax allowance, reduced tax rate, and location-based tax incentives. In terms of location-based tax incentives, Indonesia has different types of place-based policies, namely Free Trade Zone (FTZ), Bonded Zones, Special Economic Zones (SEZ), and integrated economic development area (known as Kawasan Pengembangan Ekonomi Terpadu/KAPET). This essay will discuss the implementation of location-based tax incentives in the form of Special Economic Zones (SEZ) in Indonesia. The next part of this paper is summarized as follows. Section II presents the literature review of tax incentives in general and location-based tax incentives. Section III provides the research methodology. Subsequently, Section IV studies Indonesia's location-based tax incentives policy, focusing on Special Economic Zones (SEZ). The impacts of Indonesia SEZ are discussed in Section V, and finally, Section VI concludes.

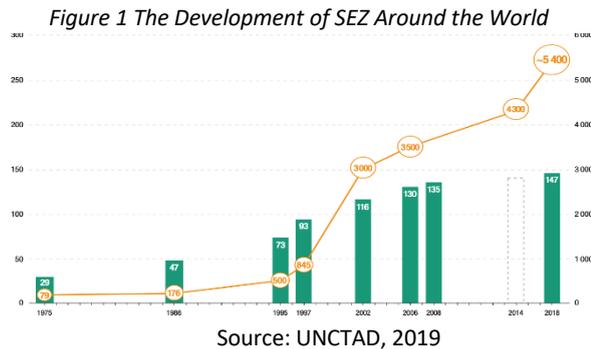
2. LITERATURE REVIEW

Tax incentives can be defined as any special tax provisions granted to qualified investment projects or firms that provide a favourable deviation from the general tax code (The Platform for Collaboration on Tax, 2015). The objective of tax incentives is mainly to stimulate investment, particularly to attract foreign direct investment (FDI). FDI inflows are not only to bring capital to a country but also spur competition which increases the country's overall economic growth. Sometimes countries offer tax incentives to compete with others for international investments (Thuronyi, 1998). Additionally, the other objective of tax incentives is to support specific sectors of the economy or activities associated with industrial development plans or address local development requirements and productivity spillovers (The Platform for Collaboration on Tax, 2015). Tax incentives can come in several types: reduced tax rate, investment allowance, tax exemption or tax holiday, and location-based tax incentive.

Globally, many countries often adopt location-based policies to address economic disparities across regions in their countries. This policy aims to encourage development and economic growth in lagging regions by attracting businesses and human capital as well as improving local public goods (Rothenberg & Temenggung, 2019). To achieve those objectives, designing location-based tax incentives involves a two-step approach – first, targeting areas experiencing geographic inequality and then promoting investments to reduce those inequities (Layser, 2020).

Location-based tax incentives come in various kinds, such as Free Trade Zone (FTZ), bonded zone (BZ), export processing zone (EPZ), or Special Economic Zones (SEZ). SEZ is one of the most popular place-based policies taken by governments around the world (Alexianu & others, 2019). SEZs can be defined as areas with geographic delimitation where governments provide fiscal and regulatory incentives and infrastructure to facilitate industrial activity (UNCTAD, 2019). With their various names and forms, SEZs are expanding globally and have become increasingly popular in the past few decades (The Platform for Collaboration on Tax, 2015). For example, United Nations Conference on Trade and Development (UNCTAD) projected in 2019 that 5,400 SEZs were active in 147 countries, up from only 176 in 47 nations 30 years earlier (see Figure 1). Typically, these zones offer tax incentives, relief from customs duties and tariffs, business-friendly rules for land access, permits, licenses, or employment, and ease of administrative procedures. In addition, infrastructure support is another essential element of SEZ, particularly in

developing countries with poor basic infrastructure for business outside these zones (UNCTAD, 2019).



Despite their prevalence at all levels of governments, location-based investment tax incentives are relatively undertheorized and undefined in the literature (Layser, 2019). The majority of current location-based investment tax incentives are inefficient and inequitable in comparison to other types of incentives (Layser, 2019). Like other place-based strategies, location-based tax incentives are expected to help economically disadvantaged urban, rural, and suburban areas improve their economies. Although evaluating the success or failure of location-based tax incentives is difficult (Thuronyi, 1998). In practice, however, location-based tax incentives have frequently failed to benefit low-income communities in designated geographies (Thuronyi, 1998; Rothenberg & Temenggung, 2019).

China is considered one of the most successful countries at utilizing SEZs for a wide range of economic growth. Chinese SEZs have significantly contributed to national GDP, exports, employment, and attraction of FDI. In recent years, it was estimated that SEZs accounted for roughly 22% of China GDP, 60% of exports, 46% of FDI, and created over 30 million employments. SEZs have also contributed important roles in bringing new technologies and the adoption of modern management methods to China (Zeng, 2015). There have also been productivity and pricing gains from situating in a SEZ, indicating the presence of agglomeration economies. Within three years of its implementation, SEZ is predicted to have generated a net benefit of US\$15.62 billion. These findings might help to remove widespread scepticism regarding zone programs in developing countries (Lu, Wang & Zhu, 2019).

Apart from China, India is another country that has had success with the SEZ program. In 2016, Chaurey conducted research on evaluating place-based tax incentives in India. The study examined the 2003 New Industrial Policy in Himachal Pradesh and Uttarakhand in North India. Chaurey found that the policy resulted in significant job creation, productivity, investments, and companies' growth. Accordingly, his results suggested that the policy increased welfare, as well as being cost-effective. However, he acknowledged that his findings were

only at medium-term effects and suggested looking at the long-run impacts of the policy (Chaurey, 2017).

In accordance with Chaurey, Ravi studied the impact of Special Economic Zones (SEZ) on general economic activity in India using satellite lights data in 2018. Ravi concluded that SEZs caused substantial growth in local economic activities within five kilometres of the zones. Furthermore, his analysis also showed that SEZs lead to structural changes in the economy, resulting in higher productivity and firm size (in terms of investment, production, and employment). However, Ravi admitted that his study did not conduct explicit cost-benefit calculations of the SEZs policy (Ravi, 2018).

3. METHODOLOGY

This article is a qualitative study that uses literature reviews and documentation studies as its methodologies. This paper examines the relevant literature and provisions that underlie location-based tax incentives, particularly special economic zones (SEZ). The resources under study include laws, regulations, and policy documents on the topic from Indonesia and other jurisdictions. It also includes academic literatures (books, journals, and articles), policy strategies, and plans of the government relating directly to the objective of the study.

4. RESULT AND DISCUSSIONS

4.1. LOCATION-BASED TAX INCENTIVES IN INDONESIA – SPECIAL ECONOMIC ZONES

For centuries, economic activity, employment, and population density have been part of the Indonesian economy. The differences in income and economic activity among the various regions of Indonesia are always a significant consideration for the Indonesian government, especially since this can threaten the unity of the country. For a long time, location-based strategies to promote economic growth in underdeveloped areas have been critical not only in sustaining national unity but also in ensuring that Indonesians residing across the island have equal opportunity (Rothenberg & Temenggung, 2019). The establishment of the SEZ is one of the location-based policies taken by the Indonesian government to address this geospatial inequality.

The basic concept of Special Economic Zones in Indonesia is to prepare the areas with accessibility to the global market (seaport or airport), designed to maximize industrial activities, export, import and other economic activities. Certain facilities and incentives are given to the areas to increase competitiveness and to attract investors to the region. The application of Indonesian SEZ is regulated in Law Number 39 of 2009 concerning Special Economic Zones. According to Article 1 of the Law, Special Economic Zones (Kawasan Ekonomi Khusus/KEK) are

zones with certain boundaries within the territory of the Unitary State of the Republic of Indonesia that are designated for the provision of certain economic services and are granted certain facilities. The facilitation, including tax incentives, is given according to the characteristic of the zone through government regulation (Law Number 39 of 2009). To organize the development of SEZ in Indonesia, The National Council for SEZ was established through a presidential decree consisting of the Coordinating Minister for Economic Affairs, the Minister of Trade, the Minister of Finance, and other relevant ministers (Presidential Decree No. 8 of 2010).

Figure 2 KEK in Indonesia



Source: National Council for Special Economic Zone (2023)

Indonesian SEZs are developed to achieve certain objectives. First, it aims to enhance investment by providing areas with geo-economic and geo-strategic advantages. The second objective is to optimize industry activities, exports, imports, and other high-value economic activities. Furthermore, promoting regional development by creating new economic growth centres that will balance development among regions is another objective. Finally, SEZ also intends to embrace a new model for economic development that incorporates industry, trade, and tourism to create job opportunities.¹

The development of SEZ in Indonesia uses a bottom-up scheme. In this way, the state government establishes SEZs by means of the National Council for SEZs. However, the proposal should originate from local governments or business entities (with local government approval). It is expected that local authorities will effectively address a variety of development and management issues, such as infrastructure, labour, and land (Rothenberg & Temenggung, 2019). The proposed location should follow the Regional Spatial Plan, have clear boundaries, and pose no threats to the conservation zone (Article 4 of Law Number 39 of 2009).

¹ National Council for Special Economic Zone, 'Special Economic Zones' <https://kek.go.id/kek-indonesia> accessed 25 December 2021.

Although SEZ regulation has been in place since 2009, the first SEZ in Indonesia only started operating in 2015, namely Sei Mangkei SEZ in North Sumatra and Tanjung Lesung SEZ in Banten. Currently, twelve Special Economic Zones are operating in Indonesia and eight more locations in the development process (see Figure 2). Typically, Indonesian SEZs are categorized into industrial SEZ and tourism SEZ.

Taxpayers who run businesses in SEZ are granted certain facilities and ease, including taxes, customs, and excise. Provisions on implementation SEZ implementation and the facilities and ease are outlined in Government Regulation No. 40 of 2021 concerning The Implementation of Special Economic Zones. Those facilities include tax incentives in income taxes, value-added taxes (VAT), sales taxes on luxurious goods (STLG), import duties and import-related taxes, and excise. Table 1 describes the types of tax incentives given to investors in SEZ.

Table 1 Fiscal Incentives for Indonesian SEZs

Types of Incentives	Tax Incentives
1 Corporate Income Tax facility	Tax holiday Investment allowance Accelerated depreciation/amortization Special rate for dividend tax Loss carry forward
2 Import income tax exemption (Article 22 Income Tax)	Import income tax exemption
3 Value Added Tax and Sales Tax on Luxurious Goods facilities	Non collected import VAT Non collected VAT for domestic purchase VAT and/or Sales Tax on Luxurious Goods exemptions
4 Duty and Excise facilities	Import duty temporary dispensation Import duty exemption Excise exemption
5 Other Tax facilities	Exemption from income tax on land acquisition, sale or lease on land and building STLGs and income tax on the sale of luxurious goods exemption for tourism SEZ VAT return for individuals holding foreign passport for Tourism SEZ

Source: Obtained from a variety of sources²

4.2. THE IMPACT OF LOCATION-BASED TAX INCENTIVES (SEZ) IN INDONESIA

There has been more than a decade since the SEZ developments policy in Indonesia was launched. The performance of this policy can be observed by its impacts on investments, exports, employment, economic growth, fiscal, and industry related to SEZ.

The primary purpose of SEZ development in Indonesia is to attract investment, both from local and foreign. Therefore, investment realization is one significant indicator in evaluating SEZ. According to the National Council for SEZ annual reports, in 2021, there is an investment realization worth Rp76.75 trillion with the three highest realization of investment are from Galang Batang SEZ, Kendal SEZ, and Gresik SEZ (National Council for SEZ Republic of Indonesia Annual Report 2021). This realization is accounted for 2.8% of national investment realization, which is Rp826.3 trillion.

As mentioned earlier, stimulating exports and employment are other objectives of SEZ policy in Indonesia. In 2021, from 12 operated SEZs, only four SEZs counted exports: Sei Mangkei (Rp6.37 trillion),

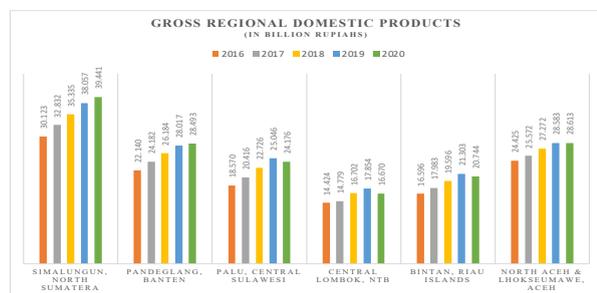
² Rothenberg and Temenggung (2019); Government Regulation Republic of Indonesia No. 40 of 2021.

Galang Batang SEZ (Rp2.6 trillion), Kendal SEZ (Rp300 billion) and Palu SEZ (Rp116 billion) (National Council for SEZ Republic of Indonesia Annual Report 2021). This number shares less than 1% of national exports worth around Rp3,500 trillion (BPS, 2021). In terms of employment, Indonesian SEZ has absorbed nearly 28.984 workforces from the projection of 500,000 job opportunities (National Council for SEZ Republic of Indonesia Annual Report 2014-2020).

The SEZ development is also expected to increase economic growth in the local area. Figure 3 below illustrates gross regional domestic product (GRDP) from 2016-2020 of regions where SEZ is located. However, the graph only presents six SEZ which start operating before 2019 to get analysis in a minimum of three years. From Figure 3, the GRDP of the regions increased slightly over the years and decreased in 2020 since the Corona Virus Disease (COVID-19) pandemic. It can be inferred that the existence of a SEZ in the area does not necessarily result in a significant increase in the GRDP. At this point, the contribution of each SEZ to the GRDP also needs to be examined thoroughly.

A number of fiscal incentives given to taxpayers doing business in SEZ necessarily have an impact on tax collection. The effects are mainly the revenue forgone from tax incentives offered, compared with when the incentives are not given. However, there is no available data to know how much that revenue is forgone. On the other hand, there is also an increase in tax revenue from the unincentivized taxes, such as payroll taxes or income tax on salaries of employment (Article 21 of Income Tax) and withholding taxes. The development of SEZ also contributes to regional tax and locally generated revenue (Pendapatan Asli Daerah/PAD). For example, tourism SEZ will attract tourist visits, subsequently increasing hotel tax, entertainment tax, restaurant tax, and parking tax for the local government.

Figure 3 Gross Regional Domestic Product (GRDP) of Regions with SEZ



Source: Central Agency of Statistics (Badan Pusat Statistik) Indonesia, 2021

The presence of SEZ also contributes to the development of the industry and tourism sectors. Mandalika is one example of tourism SEZ with a positive trend. In 2021, this SEZ succeeded in holding world-race events: Idemitsu Asia Talent Cup (ATC) and World Superbike. Although there is no quantitative analysis of the event's achievement, this

event is considered a success. The events increased hotel occupancy and boosted the local market turnover, contributing to the PAD of Lombok Tengah of Rp69 million (Andita, 2021). Furthermore, this success is also followed by the riders' reviews on their social media which promotes tourism in Lombok region. This success story is then followed by another race event, MotoGP, held the following year. The implementation of the MotoGP event was able to have an impact on the formation of output of IDR 606.92 billion, added value of IDR 315.94 billion, labor wages of IDR 137.67 billion and potential taxes of IDR 14.25 billion (Taupikurrahman and Suwandana, 2022). Unfortunately, the positive development of Mandalika is not followed by other tourism SEZs.

From the descriptions above, SEZs, which are expected to be one of Indonesia's pillars of economic growth, have not yet developed optimally. Several obstacles discourage investors from investing in SEZs. First, the lack of supporting infrastructures in SEZs. Although complex infrastructures such as toll roads, seaports, and airports are available in SEZs, supporting activities like hospitals, schools or entertainments are considered minimal in most cases. Other infrastructures for business activities are still lacking, including power plants, clean water supply, wastewater treatment plants, fibre optic networks, and natural gas networks. The next cause is probably the problem of land acquisition. This problem happened in the development of Tanjung Api-Api SEZ and Arun Lhokseumawe SEZ. Subsequently, there is also a problem of land speculators who bought lands and have land business in the SEZ area and have made land prices soar. This case happens in Palu and Mandalika SEZ. To address the land acquisition issue, a new SEZ proposal must have at least 50% of land ownership, as specified by the Job Creation Law 2020 (Theodora & Grahadyarini, 2021).

It has been mentioned previously that Indonesia provides a variety of location-based policies, with various tax incentives offered. As an illustration, Table 2 compares tax incentives given in SEZs and other location-based policies in Indonesia. The table shows that incentives given in SEZs seem much more favourable than those offered in different types of zones. However, those fiscal incentives provided are apparently ineffective in attracting investors.

Incentives in SEZ are considered not interesting enough for investors, compared to other incentives available in areas other than SEZ, such as industrial estates. The facilities and conveniences offered by several SEZs are often unable to compete with industrial estates that also exist in the area. For example, Batang Integrated Industrial Estate in Central Java is developing much more rapidly than Kendal SEZ. In addition, investors are more likely to invest in other areas with slightly fewer incentives but better access and location. Hence, SEZs in remote

regions tend to be less developed than other SEZs (Theodora & Grahadyarini, 2021).

Table 2 Location-Based Tax Incentives in Indonesia

Types of Incentives		F T Z	Bon ded Zon e	KA PET	Indus trial Estat e	S E Z
1	Corporate Income Tax facility					
	Tax holiday	-	-	-	v	v
	Investment allowance	-	-	v	v	v
	Accelerated depreciation/a mortization	-	-	v	v	v
	Special rate for dividend tax	-	-	v	v	v
	Loss carry forward	-	-	-	v	v
2	Import income tax exemption (Article 22 Income Tax)	v	v	v	-	v
3	Value Added Tax and Sales Tax on Luxurious Goods facilities					
	Non collected import VAT	v	v	v	v	v
	Non collected VAT for domestic purchase	v	v	v	v	v
	VAT and/or Sales Tax on Luxurious Goods exemptions	v	v	-	-	v
	VAT return for individuals holding foreign passport	-	-	-	-	v
4	Duty and Excise facilities					
	Import duty temporary dispensation	-	v	v	-	v
	Import duty exemption	v	-	-	v	v
	Excise exemption	v	v	v	v	v

Soruce: obtained from a variety of sources³

Despite the slow growth of SEZs, the government has established six new SEZs over the last two years. As a result, Indonesia has 20 SEZs, with six still under development. To be developed effectively, SEZs must overcome the challenges above. Besides, SEZs should have specificity or exclusivity compared to different zones to attract investors.

5. CONCLUSION

Many countries often adopt location-based policies to address geospatial economic disparities. This policy intends to attract businesses and human capital to increase development and economic growth. Among various types of place-based policies, SEZ is one of the most popular ones in the world. In general, SEZ has the following characteristics: located in a specific area, managed by a single administration or management with incentives and facilities.

The development of SEZs in Indonesia was started in 2009. It aims to attract investment, spur economic growth, and contribute to economic developments in local areas and the country. However, after more than a decade of its launching, the SEZs in Indonesia have not yet developed optimally. Some problems discourage investors from investing in SEZs, such as infrastructures and land acquisition. The fiscal incentives provided in SEZs are also not very effective in attracting investors. SEZs must overcome these challenges to be effective in accelerating the national economy of Indonesia.

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