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| | | |
|-----|---|-----------|
| | NATING MINISTRY FOR POLITICAL, LEGAL AND SECURITY AFFAIRS | |
| | <i>Ima Puspita, Eko Sembodo, Tri Suratmi</i> | 266 - 285 |
| 32. | QUALITY CONTROL OF STONE PLATE PRODUCTS <i>Rudi Hartono, Siti Nurainul Jannah, Mitha Istia Mulyadewi, Desi Fatmawati, Hadi Paramu</i> | 286 - 293 |
| 33. | G20 IMPACT ON INDUSTRIAL DEVELOPMENT IN INDONESIA <i>Lutfiah Cahya Firdani, Ni Wayan Shintya, Anggraini Dwi Sa'idah, Mochamad Adi Kurniawan, Ahmad Iqbal Pamungkas</i> | 294 |
| 34. | DETERMINANT OF STOCK RETURN (STUDY ON COSMETICS AND HOUSEHOLD FIRMS) <i>Isti Fadah, Hevi Fitriani, Ana Mufidah, Yustri Baihaqi</i> | 295 - 303 |
| 35. | PERFORMANCE AND OWNERSHIP IN RELATION WITH THE INITIATION OF DIVIDEND POLICY <i>Desmintari</i> | 304 - 315 |
| 36. | PORTFOLIO FORMATION AND IT'S PERFORMANCE EVALUATION IN INDONESIAN CAPITAL MARKETS <i>Renea Shinta Aminda</i> | 316 - 326 |
| 37. | RELATIONSHIP OF INTERNATIONAL TRADE AND ENERGY CONSUMPTION TO ECONOMIC GROWTH IN INDONESIA 1980 – 2014 <i>Harris Eka Sidharta, Lilis Yulianti, Teguh Hadi Priyono</i> | 327 - 333 |
| 38. | SHARES AND BONDS IN INTERNATIONAL TRADE <i>Kiki Aprilia Timingsih, Sebastiana Viphindartin, Zainuri</i> | 334 - 339 |
| 39. | EMPOWERING INDONESIA AND MAURITIUS INVESTMENT BASED ON LQSHIFT LQSHARE ANALYSIS AND POLICY ON TAX HAVEN COUNTRY <i>Ratri Ardianto, Sebastiana Viphindartin, Zainuri</i> | 340 - 348 |
| 40. | ANALYSIS OF THE INFLUENCE OF ECONOMIC AND INSTITUTIONAL FACTORS ON FOREIGN DIRECT INVESTMENT <i>Tunjung Sekar Laksmi Pandhit, Siti Aisyah Tri Rahayu</i> | 349 - 354 |
| 41. | THE POTENTIAL OF EARNINGS MANAGEMENT ON WEALTH TRANSFER OF SOCIETY AND MANAGERS <i>Retno Indah Hermawati, Imam Ghozali</i> | 355 - 361 |
| 42. | MODEL OF ACCELERATION OF HALAL INDUSTRY DEVELOPMENT THROUGH IMPLEMENTATION OF SHARIA LAW IN INDONESIA <i>Ajeng Sonial Manara, Arif Rachman Eka Permata</i> | 362 - 371 |

Analysis of the Influence of Economic and Institutional Factors on Foreign Direct Investment

Tanjung Sekar Laksmi Pandhit, Siti Aisyah Tri Rahayu

Abstract

Foreign Direct Investment is a source of capital for some developing and developed countries. The entry of foreign direct investment to various countries is adapted to the economic conditions and conditions of the constitutional terms of the host country. This study aims to analyze the economic factors and institutional factors that can affect of foreign investment inflows in 10 Asia Pacific countries during 2008-2018.

The data used in the study are secondary data obtained from several institutions such as World Bank, UNCTAD, Heritage Foundation, Transparency International, and World Governance Indicators. The model used is the estimation of GLS Fixed Effects.

The results of the analysis suggest that foreign direct investment is influenced by economic factors, namely market size, while the institutional factors affecting foreign direct investment are economic freedom, corruption, and political stability. Therefore, institutional factors need to be considered by the government because it directly affects the direct inflow of foreign investment in a country.

The inflow of foreign direct investment requires a favorable investment climate for host country and home country. The investment climate can be conditioned by economic, social, and political arrangements. If the economic and political conditions of a country stable, then foreign investors believe more invest in a country.

Keywords: Foreign direct investment, market size, economic freedom, corruption, political stability, GLS Fixed Effects

1. Introduction

Foreign direct investment in a country can describe the economic condition of a country in the global era. Every country in the world tries to attract foreign investment from abroad in the hope of having a positive impact on the domestic economy as income. This is in accordance with the opinions of Classical and Neo Classical economists regarding international trade that can encourage economic growth in a country (Nopirin, 1994: 125).

Multinational theory according to Krugman and Obstfeld (1997: 171) explains the expansion of companies from one country to another. Expansion from the origin company is called a home company that provides capital to subsidiaries in the form of direct foreign investment flows. Multinational companies often become loans or international capital flows (Krugman and Obstfeld, 1997: 171).

According to Erdogan and Atakli (2012) foreign investment as a resource that can move to another country by people and organizations. According to him foreign direct investment can overcome the crisis in several countries. Research conducted by Erdogan and Atakli (2012) mentions the crisis in the last quarter of 2008 appeared in the United States, then spread to Europe and other countries. Therefore, this study determines the beginning of the year 2008 to see the development of foreign direct investment in several Asia-Pacific countries (Erdogan & Atakli, 2012). In addition, the ASEAN Investment Report 2012 also mentions that in 2008 and 2009 the impact of global economic uncertainty.

Foreign direct investment occur when a company from a country (home country)

invests in a company in another country (host country). Host country will receive benefits from investment inflows and home country can expand so that the company is categorized as a multinational company. In reality, investment always contains risks both economically and in the political situation of a country. Bodie, Kane, and Marcus (2006) analyze there are several risk factors in international investment such as exchange rate risk and country-specific risk. One country-specific risk is political risk and economic risk. Some political risks such as government stability, corruption, internal and external conflicts. Financial risks in the PRS assessment are foreign debt, interest on foreign debt, exchange rate stability, and current account. Economic risk through GDP per capita, annual real GDP growth, inflation rate, budget balance, and current account balance.

Even though investments are identical with various risks, investors do observe the host country before investing. Economists argue that trade policies applied in practice are dominated by political interests rather than seeing profits for the state (Krugman and Obstfeld, 1997: 222). A good international policy is when there is synchronization between economic and non-economic aspects such as cultural aspects, political aspects, and security aspects (Boediono, 2015: 153).

According to Castro and Nunes (2013) the inflow of foreign direct investment is not only influenced by economic factors but also business facilities and institutional frameworks, in this case corruption is considered an important determinant. According to Dickie and Layman (1988: 143-162) that there are several factors that can affect investment such as: (1) the tax system; (2) flexibility; (3) other sources of capital; (4) stock prices; (5) expansion; (6) politics. Research conducted by Freckleton, Wright, and Craigwell (2011) quotes from The World Bank (2000) that each year there are funds that are lost about 1 trillion US Dollars or about 5% of world GDP lost due to corruption. According to Rose-Ackerman (1999) the greater the government's contribution to the bureaucracy can increase corruption.

The value for measuring the level of corruption in a country uses the corruption perception index published by Transparency International. The Corruption Perception Index is a combination index of various international surveys and corruption assessments collected by various reputable institutions. The index consists of thirteen independent institutions specializing in government and business climate analysis that includes expert judgment and the views of employers (Transparency International, 2017). The criteria set by Transparency International for countries with values close to 0 mean that they are increasingly corrupt, while the closer to the value of 100 countries has a low level of corruption. This is consistent with the explanation of Hamidi and Hmadi (2017) that the index in Transparency International is measured from the interval 0-100 where 0 (very corrupt) and 100 (not corrupt).

Various studies prove the positive and negative effects of corruption on foreign direct investment. Therefore, this research is considered important by examining the relationship of corruption to foreign direct investment. The year of observation was carried out in 2008-2016 so that it became the latest year of previous research. The selection of state objects is carried out by listing 7 Asia-Pacific countries which are members of ASEAN plus Australia, Japan, Hong Kong because the three countries have a high corruption index in the Asia-Pacific. This study included several independent variables such as pair size variables measured through real GDP, trade openness variables measured through net exports, economic freedom variables through the economic freedom index, corruption variables, corruption control variables, and political stability variables.

2. Literature Review

Research that did by Castro and Nunes (2013) finds out whether corruption inhibits FDI flow in 73 countries during the period 1998-2008 controlled by economic and political

variables. The results of this study indicate that countries with lower levels of corruption, FDI inflows are greater, and the presence of corruption control can be an important strategy to increase FDI inflows. The study uses the GLS Fixed Effects regression research model to see the effect of corruption as a significant determinant of FDI inflows or not. Research by Castro and Nunes (2013) found that large market sizes attract more FDI. In addition, more open markets tend to attract foreign companies. More open economic variables have the potential to offer more efficient allocation of resources, providing economic benefits. Trade openness statistically significant in the expected direction. In this study it is clear that corruption is an important determinant of FDI inflows. The results also show that tax policies, low regulatory burdens that facilitate company installments and growth, and a stable political environment are important factors for foreign investors.

Research that did by Sambharya and Rasheed (2013) uses several independent variables to analyze the effect on FDI consisting of GDP per capita, economic freedom, trade and investment, economic management, government participation in the economy, state interference and corruption, and wages and price. This study uses panel data regression method with a sample of 96 countries during the period 1995-2000. The high level of government participation in the economy has an inverse relationship to the influx of FDI. The high level of state intervention and corruption have a significant negative relationship to FDI inflow. Wages and prices are significantly positive related to FDI inflows and finally political freedom has a positive relationship to FDI inflows.

Another study conducted by Ketkar, et al (2005) regarding the impact of corruption on FDI and income tax. studied 54 countries from 1995-1998 which consisted of developing countries and developed countries, seven of which were the largest source countries for FDI: US, Japan, Germany, Britain, France, Canada and Italy. The independent variables used see the effect on FDI, namely economic growth with GDP proxy, openness of the economy with the proxy of exports and imports (as a percent of GDP), capital control, US FDI returns in various countries obtained from Survey of Current Business, size government with a proxy for government spending, and tax revenue from income tax obtained from Government Finance Yearbook, 2000. The method used by Ketkar, et al is panel data regression. The results of the research by Ketkar, et al (2005) found that high levels of corruption reduce FDI flows. Mathur and Singh's (2011) study also found the effect of corruption on investment decisions. This article shows that foreign investors pay attention to economic freedom (proxy for property rights protection index), in making decisions to invest. Therefore, more democratic countries will probably receive less flows of Foreign Direct Investment (FDI) if economic freedom is not guaranteed. As long as democracy is able to provide greater economic freedom to its citizens, they will also become more attractive places for investors.

Unlike previous studies, Bayar and Alakbarov (2016) did not get the same results regarding the effect of corruption on FDI. This study investigates the interaction between corruption and foreign direct investment in 23 emerging market countries in the 2002-2014 period. The method used is the Durbin-Hausman cointegration test to investigate the long-term relationship between FDI, corruption, and law enforcement. The conclusion obtained is that there are long-term relationships between variables, but corruption and law enforcement do not have a statistically significant impact on FDI flows.

3. Methodology

This study uses panel data with 100 observations outlined in 10 observation countries and 10 years of research. The country used as the object of the study consisted of ten countries in the Asia-Pacific consisting of the Philippines, Indonesia, Malaysia, Singapore, Thailand, Vietnam, Laos, Australia, Japan and Hong Kong. The initial election period was

caused by a crisis in various countries in 2008. This study uses secondary data, namely data collected by other parties (Mubyarto and Suratno, 1981: 50). Some data sources in this study are World Bank for market size data, UNCTAD for trade openness data (export and import), Heritage Foundation for data on economic freedom indexes, Transparency International for perceptions of corruption index data, and World Governance Index (WGI) for corruption control index data and for political stability index data. The specification model used is Fixed Effects GLS which is a Fixed Effects regression estimation form that is given weighting. The GLS method is an OLS method that is applied to the model and transformed so that it meets the requirements of classical assumptions (Gujarati and Porter, 2009: 372). Autocorrelation problems can occur in time series data, whereas heteroscedasticity problems can occur when the variance of UI disturbances, to explanatory variables varies (Gujarati and Porter, 2009: 412 and 471). According to Gujarati and Porter, the two problems of classical assumptions can be overcome through several ways, one of which is to change the OLS estimation method into GLS estimation method by giving weight.

4. Results and Analysis

This study analyzes whether there is an influence of independent variables consisting of non-economic and economic factors on foreign direct investment (FDI) during 2008-2018. Fixed Effects estimation results experience heteroscedasticity and autocorrelation problems, so it is necessary to cure the problem of classical assumptions with GLS estimation. Based on Table 1 the probability variables of market size (GDP), economic freedom variables (EF), corruption variables (CPI), and political stability variables (PS) are smaller than 0.05 so that the independent variables have a significant effect on the dependent variable. The probability of trade openness variable (OT) is 0.42 so that the trade openness variable does not have a significant effect on FDI variables.

Based on the value of the t-Statistics variable market size (GDP), economic freedom (EF), and political stability, (PS) has a positive influence on FDI. This means that the greater the size of a country's market has a positive impact on the entry of FDI in the country. One of the economic considerations considered by international corporations (MNC) in placing FDI is location-specific advantage. The location chosen in placing FDI in a country is expected to be profitable for MNC companies (Bakry, 2015: 198). Economic freedom in a country also provides opportunities for the entry of FDI funds in a country. According to Goel and Nelson (2005) shows that economic freedom reduces bureaucracy, disruption of bureaucracy and government interference. The stability variable also has a positive impact on the entry of FDI in a country because stable political conditions give investors confidence.

Variable corruption has a negative influence on the entry of foreign investment in a country. Corruption, which can be caused by one or several factors, such as excessive bureaucracy, high policies in the formulation and implementation of policies, inefficiencies and slowness of the legal system, low wages of civil servants and low levels of economic freedom, has the potential to affect many economic aspects such as foreign investment and economic growth (Castro and Nunes, 2013). From the overall regression results, market size variables, economic freedom variables, corruption variables, and political stability variables are in accordance with the theory and several previous studies.

Table 1. The Results of Fixed Effects Regression

| Variabel | Koefisien | Std. Error | t-Statistic | Probabilitas |
|----------|-----------|------------|-------------|--------------|
| C | 1.078871 | 2.904712 | 0.370733 | 0.7119 |
| GDP? | 0.249291 | 0.035015 | 7.119591 | 0.0000 |

| Variabel | Koefisien | Std. Error | t-Statistic | Probabilitas |
|---------------------------|-----------|------------|-------------|--------------|
| OT? | -2.93E-06 | 3.66E-06 | -0.801178 | 0.4256 |
| EF? | 0.114321 | 0.053831 | 2.123717 | 0.0370 |
| CPI? | -0.100773 | 0.032186 | -3.131006 | 0.0025 |
| PS? | 0.062921 | 0.025600 | 2.45861 | 0.0163 |
| Weighted Statistic | | | | |
| R Squared | 0.870460 | | | |
| Adjusted R-Squared | 0.846279 | | | |
| F-statistic | 35.99796 | | | |
| Fixed Effects | | | | |
| (Cross) | | | | |
| _FILIPINA—C | -5.461603 | -4.22544 | | |
| _INDONESIA—C | -5.302311 | -4.384732 | | |
| _MALAYSIA—C | -4.612408 | -3.535537 | | |
| _SINGAPURA—C | 9.734290 | 10.811161 | | |
| _THAILAND—C | -3.875484 | -2.798613 | | |
| _VIETNAM—C | -2.351749 | -1.274878 | | |
| _LAOS—C | -4.642374 | -3.565503 | | |
| _AUSTRALIA—C | -4.095084 | -3.018213 | | |
| _JEPANG—C | -6.868663 | -5.791792 | | |
| _HONGKONG—C | 27.47539 | 28.552261 | | |

source: Secondary data (processed, see Appendix 10)

5. Conclusion

Based on the results of the analysis and discussion in Chapter IV can be concluded as follows:

1. Market accounts have a significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. The effect is positive.
2. Economic freedom has a significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. The effect is positive.
3. Corruption has a significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. This effect is negative
4. Political stability has a significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. The effect is positive.

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by Leon Akbar

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*ANALYSIS OF THE INFLUENCE OF ECONOMIC
AND INSTITUTIONAL FACTORS ON FOREIGN DIRECT
INVESTMENT*

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ABSTRACT

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Introduction

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enforcement. The conclusion obtained is that there are long-term relationships between variables, but corruption and law enforcement do not have a statistically significant impact on FDI flows.

Methodology

This study uses panel data with 100 observations outlined in 10 observation countries and 10 years of research. The country used as the object of the study consisted of ten countries in the Asia-Pacific consisting of the Philippines, Indonesia, Malaysia, Singapore, Thailand, Vietnam, Laos, Australia, Japan and Hong Kong. The initial election period was caused by a crisis in various countries in 2008. This study uses secondary data, namely data collected by other parties (Mubyarto and Suratno, 1981: 50). Some data sources in this study are World Bank for market size data, UNCTAD for trade openness data (export and import), Heritage Foundation for data on economic freedom indexes, Transparency International for perceptions of corruption index data, and World Governance Index (WGI) for corruption control index data and for political stability index data. The specification model used is Fixed Effects GLS which is a Fixed Effects regression estimation form that is given weighting. The GLS method is an OLS method that is applied to the model and transformed so that it meets the requirements of classical assumptions (Gujarati and Porter, 2009: 372). Autocorrelation problems can occur in time series data, whereas heteroscedasticity problems can occur when the variance of UI disturbances, to explanatory variables varies (Gujarati and Porter, 2009: 412 and 471). According to Gujarati and Porter, the two problems of classical assumptions can be overcome through several ways, one of which is to change the OLS estimation method into GLS estimation method by giving weight.

Results and analysis

This study analyzes whether there is an influence of independent variables consisting of non-economic and economic factors on foreign direct investment (FDI) during 2008-2016. Fixed Effects estimation results experience heteroscedasticity and autocorrelation problems, so it is necessary to cure the problem of classical assumptions with GLS estimation. Based on Table 1 the probability variables of market size (GDP), economic freedom variables (EF), corruption variables (CPI), and political stability variables (PS) are smaller than 0.05 so that the independent variables have a significant effect on the dependent variable. The probability of trade openness variable (OT) is 0.42 so that the trade openness variable does not have a significant effect on FDI variables.

Based on the value of the t-Statistics variable market size (GDP), economic freedom (EF), and political stability, (PS) has a positive influence on FDI. This means that the greater the size of a country's market has a positive impact on the entry of FDI in the country. One of the economic considerations considered by international corporations (MNC) in placing FDI is location-specific advantage. The location chosen in placing FDI in a country is expected to be profitable for MNC companies (Bakry, 2015: 198). Economic

freedom in a country also provides opportunities for the entry of FDI funds in a country. According to Goel and Nelson (2005) shows that economic freedom reduces bureaucracy, disruption of bureaucracy and government interference. The stability variable also has a positive impact on the entry of FDI in a country because stable political conditions give investors confidence.

Variable corruption has a negative influence on the entry of foreign investment in a country. Corruption, which can be caused by one or several factors, such as excessive bureaucracy, high policies in the formulation and implementation of policies, inefficiencies and slowness of the legal system, low wages of civil servants and low levels of economic freedom, has the potential to affect many economic aspects such as foreign investment and economic growth (Castro and Nunes, 2013). From the overall regression results, market size variables, economic freedom variables, corruption variables, and political stability variables are in accordance with the theory and several previous studies.

Table 1 Estimation Result of Fixed Effects Model

| Variabel | Koefisien | Std. Error | t-Statistic | Probabilitas |
|----------------------|-----------|------------|-------------|--------------|
| C | 1.076871 | 2.904712 | 0.370733 | 0.7119 |
| GDP? | 0.249291 | 0.035015 | 7.119591 | 0.0000 |
| OT? | -2.93E-06 | 3.66E-06 | -0.801178 | 0.4256 |
| EF? | 0.114321 | 0.053831 | 2.123717 | 0.0370 |
| CPI? | -0.100773 | 0.032186 | -3.131006 | 0.0025 |
| PS? | 0.062921 | 0.025600 | 2.45861 | 0.0163 |
| Weighted Statistic | | | | |
| R Squared | | 0.870460 | | |
| Adjusted R-Squared | | 0.846279 | | |
| F-statistic | | 35.99796 | | |
| Fixed Effects | | | | |
| (Cross) | | | | |
| _FILIPINA—C | -5.461603 | -4.22544 | | |
| _INDONESIA—C | -5.302311 | -4.384732 | | |
| _MALAYSIA—C | -4.612408 | -3.535537 | | |
| _SINGAPURA—C | 9.734290 | 10.811161 | | |
| _THAILAND—C | -3.875484 | -2.798613 | | |
| _VIETNAM—C | -2.351749 | -1.274878 | | |
| _LAOS—C | -4.642374 | -3.565503 | | |
| _AUSTRALIA—C | -4.095084 | -3.018213 | | |
| _JEPANG—C | -6.868663 | -5.791792 | | |
| _HONGKONG—C | 27.47539 | 28.552261 | | |

Conclusion

Based on the results of the analysis and discussion in Chapter IV can be concluded as follows. Market accounts have a positive significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. Economic freedom has a positive significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. Corruption has a negative significant effect on foreign direct investment inflows in 10 Asian-Pacific countries. Political stability has a positive significant effect on foreign direct investment inflows in 10 Asian-Pacific countries.

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