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Impact of government spending and corruption on foreign direct investment in Indonesia

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Abstract: Investment is a critical macroeconomic variable for economic growth and development in any country. As a developing country with the fourth largest population in the world, Indonesia is also dependent on investment coming in from both home and abroad. A good investment climate is one of the solutions in overcoming economic problems so that foreign investors can invest in Indonesia. Obviously, various factors influence investors' willingness to invest in Indonesia. The purpose of this study is to examine the impact of government spending, corruption, economic growth and wages on foreign direct investment in Indonesia. The study uses Ordinary Least Square (OLS) multiple linear regression analysis for the research period 2000–2020. The results show that the variables of government spending, corruption and economic growth have positive and significant impact on foreign direct investment, while the variable of salary has negative and significant impact on foreign direct investment. The Indonesian government needs to reduce the level of corruption and wage level to attract investors.

Keywords: foreign direct investment, government expenditure, corruption.

Introduction

Investment is a critical macroeconomic variable for economic growth and development in every country. Investment consists of private investment and public investment (Brima & Brima, 2017). Indonesia as a developing country with the fourth largest population in the world also depends on incoming investment both from within the country and from abroad. Private investment is one of the helpers in the economic development of the country.

This is due to limited funding or resources owned by the country in carrying out economic development activities. Investment can be used as a source of financing to cover limited financing in Indonesia's economic development (Thirafi, 2013). A good investment climate is one solution in overcoming economic problems so that foreign investors can invest in Indonesia. As a developing country, Indonesia obviously requires large funds to carry out economic development in all sectors and catch up with developed countries. Thus, the existence of foreign direct investment should be utilized as well as possible by Indonesia.

Foreign Direct Investment (FDI) is very helpful for Indonesia in implementing national development. Previous research in Nigeria by (Faroh & Shen, 2015), states that FDI can be part of promoting economic growth in developing countries (*host country*), such as labour training, market development, *financial inflow*, technology transfer and skills.

In order to support the creation of a good investment climate, the role of the government is needed. The government with its public spending is an extraordinary government economic instrument (Le & Suruga, 2005). Public spending is used to manage public interests, such as education, health, social security and infrastructure, which are very important to attract FDI (Montagna & Molana, 2005). The Indonesian government for the last few years has been aggressively carrying out investment promotion activities to various countries in the world. The Indonesian government offers convenience in investing in Indonesia which is expected to encourage foreign investors to invest in Indonesia.

To support this effort, the Indonesian government established the Indonesia Investment Authority (INA) on February 16, 2021 and the Ministry of

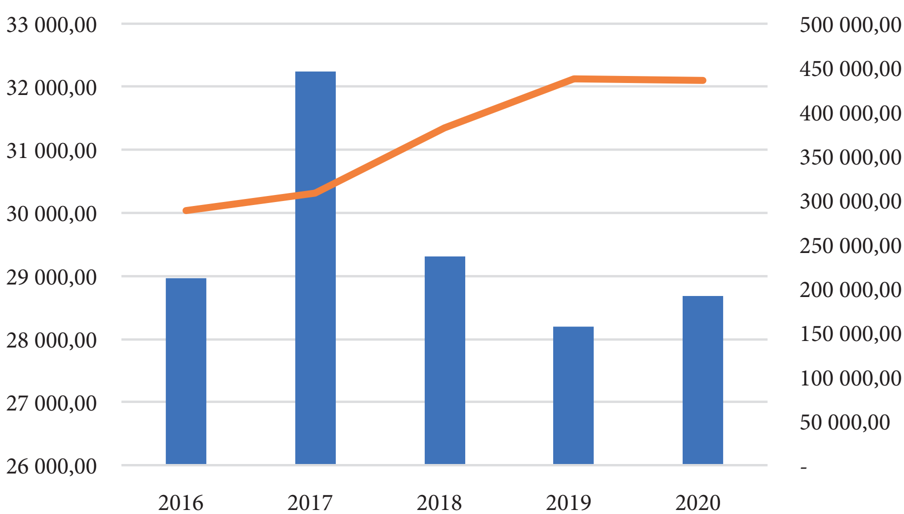

Figure 1. FDI and government expenditure
Source: (Central Statistics Agency and Ministry of Finance, 2021).

Investment. The INA is a generic issue investment institution and invests by co-investment with investor partners, both domestic and foreign. The investment objective of the original Indonesian *Sovereign Wealth Fund* (SWF) is to manage domestic assets that are deemed necessary for development. Looking at Figure 1, it can be seen that there was an increase in foreign direct investment from 2019 to 2020 despite the COVID-19 pandemic. The Indonesian government still aims to prevent the COVID-19 pandemic from disrupting economic stability too deeply, so that the budget allocation for economic functions is sought to remain stable. It can be seen from the government spending that it decreased slightly from Rp437,540 billion to Rp435,969 billion.

In 2021, the Indonesian government is optimistic to increase investment. Based on Bappenas data, investment realization in 2021 is targeted to reach Rp858.5 trillion, higher than the 2020 realisation target of Rp817.2 trillion. This optimism is supported by the implementation of the Job Creation Act and the expected more conducive employment climate.

The desire of investors to invest in Indonesia is obviously influenced by various factors. Economic growth is one of the factors that affect foreign investment. The long-term growth rate in a country will improve the economic situation in that country (Sournia and Benhabib Abderrezzak, 2013). A good GDP growth rate will have a positive effect on the country because it will attract investors to invest (Shahzad & Al-Swidi, 2013). However, according to (Jayachandran & Seilan, 2010), high or low economic growth rates have no effect on the existence of FDI, based on research that has been done.

In addition, corruption has been identified as a variable that determines FDI inflows. Corruption is known as an international problem because it is an economic and social problem that affects every country in the world (Argandoña, 2006). Misuse of public resources for private gain is classified as corruption (Myint, 2000). Therefore, the effects of corruption can lead to a reduction in the amount of investment, can cause economic growth to stagnate, prevent prospective job opportunities due to FDI inflows and inefficient use of limited government resources (Hossain, 2016).

A recent study by the IMF (2018) shows that corruption and poor governance are associated with higher inequality and lower inclusive growth, while (United Nations Conference on Trade and Development (UNCTAD), 2017) reports that total world FDI inflows reached US$1.75 trillion in 2016, of which only 37% flowed to developing countries. Countries that attract larger FDI inflows find it easier to implement investment projects and achieve economic development and growth. According to the OECD (Organization for Economic CoOperation and Development) report, a 1% increase in corruption will reduce economic growth by 0.73%, and as a result of corruption it has an impact on an increase of 10% in business costs (Makhlouf, 2016:36).

Therefore, many countries are adopting investment measures and carrying out legal and institutional reforms to attract more FDI into their economies.

Compared to the benefits of domestic investment in creating jobs, FDI can enhance or maximize some of the benefits that domestic investment has generated in developing countries. For example, FDI inflows to developing countries can introduce more advanced technologies, managerial and marketing practices. Partnerships with foreign investors also help companies in developing countries to benefit from better market access and increased market share, to reduce costs and to exploit natural resources (Gerschewski, 2013).

In Transparency International's report released on 28 January, 2021, Indonesia's 2020 corruption index (CPI) fell to 102 out of 180 countries. In 2019, Indonesia ranked 85. This downgrade shows that the level of corruption in Indonesia is increasing. This is of course a threat to the increase in foreign direct investment in Indonesia.

According to the World Bank (2017), foreign direct investment has become the largest source of external financing in developing countries. However, although FDI inflows to developing countries continue to increase every year, its quality and role in achieving sustainable economic growth is still questionable. For example, (Sadik & Bolbol, 2001) show that the quality of FDI in developing countries is very poor and the technological spillovers arising from FDI inflows have not been seen. Finally, the FDI flows to Arab countries are considered to be very weak compared to the rest of the world (Krogstrup & Matar, 2005).

1. Literature review

Research on government spending with foreign direct investment is discussed in (Ul Husnain et al., 2011) which looks at government spending, foreign direct investment and economic growth using the *Simple Accounting Framework*. This study shows that government spending inhibits economic growth, which then has an impact on Foreign Direct Investment. In addition, (Umar & Alabede, 2017) looked at the impact of capital expenditure on foreign direct investment in Nigeria using the *Ordinary Least Square* (OLS) method. The results show that capital expenditure has a negative effect on foreign direct investment. In the ASEAN region itself, research on the impact of government spending on foreign direct investment was carried out by (Othman et al., 2018) using panel data and a pooled mean group. The result is that government spending has a positive impact on foreign direct investment in the long run.

There have been several studies on the relationship between economic growth and foreign investment, for example (Asiamah et al., 2019) conducted research on the determinants of Foreign Direct Investment in Ghana using the causal research design method. This study gives the result that the gross domestic product has a positive effect on Foreign Direct Investment. Another view but the same result was put forward by (Kubo, 2019) who conducted research on the determinants of Japanese Foreign Direct Investment in Southeast Asia for the 2008–2015 period, using the regression method and industry-specific panel data.

Another study was conducted by (Kakoti, 2019) regarding outward Foreign Direct Investment in India for the period 1980–2016. Using the ARDL *(Autoregressive Distributive Lag)* model, it was found that the gross domestic product had a positive and significant effect on the outward movement of Foreign Direct Investment in India. The same results and methods were also carried out by (Mokuolu, 2018) in India, (Na & Lightfoot, 2006; Okafor, 2012; Siddiqui & Aumeboonsuke, 2014).

Many researchers have found a link between corruption and foreign direct investment. (Gasanova et al., 2017) identified that corruption affects a country's investment attractiveness. (Bayar & Alakbarov, 2016) found that in some countries corruption has a negative impact on FDI, while in other countries it has a positive impact on FDI.

Several studies have reported a negative relationship between FDI inflows and corruption. According to Transparency International (2017), no country in the world is free of corruption, which means corruption is a worldwide problem and affects the economy in different ways. For example, corruption affects people's trust in their government. It also affects living standards by causing a loss of economic resources, reducing incentives to work, allowing people to be less productive, and it can increase the cost of doing business for investors.

(Egger & Winner, 2005) found that corruption is positively correlated with the level of FDI in the host country, while Gutierrez (2015) argues that corruption has no effect on FDI inflows because it is concentrated in capital-intensive industries related to the exploitation of natural resources.

On the other hand, corruption is considered to have an adverse impact on FDI inflows (Al-Sadig, 2009; Castro & Nunes, 2013; Epaphra & Massawe, 2017; Hossain, 2016; Quazi et al., 2014; Smarzynska & Wei, 2000). In contrast, other studies report that corruption does not appear to hinder FDI inflows (Biglaiser & Jr., 2006; Quazi et al., 2014).

The minimum wage has become one of the main problems in Indonesia as workers demand an increase in the minimum wage, and this demand occurs every year. This creates a major impact on employment and worker well-being in the medium- and long-term – productivity on the worker side and financial performance and FDI on the enterprise side. First, the minimum wage will grow faster than inflation and productivity. Second, government intervention in setting wages can hinder the collective bargaining process between employers and trade unions. Third, the demand to increase the minimum wage every year substantially affects foreign direct investment in Indonesia and a large number of foreign direct investors have withdrawn their investment due to high labour costs (Tambunan, 2006). Another study conducted by (Dewata & Swara, 2013) showed that labour wages had a negative and significant effect on foreign direct investment in Indonesia in 1990–2012.

Different results were presented by (Hayami et al., 2012), who conducted a study in Japan and found that workers receive premium income if they work with companies that engage in outbound FDI which involves ownership of at least 50% in some foreign companies. Workers with higher ranks benefit more, yet even some non-managerial workers may benefit. These wage benefits are highly dependent on the level of ownership in the FDI project. On the other hand, the increase in foreign employment is not beneficial for the workers' wages unless they are at the highest rank.

2. Methodology

The data collected and used in this study is secondary data, including mainly the data on the government spending, corruption perception index, wage rate, economic growth and foreign direct investment for the period 2000–2020.

Data sources come from the Indonesian Central Statistics Agency (BPS), the Ministry of Finance of the Republic of Indonesia and Transparency International.

Research variables

- Government spending is the percentage of central government spending to total state spending in percent (%) sourced from the State Budget (APBN).
- Corruption is the Corruption Perception Index with index units sourced from Transparency International. The corruption perception index uses a scale from 0 to 100, where 0 indicates a very high level of corruption and 100 indicates a very clean level of the public sector.
- The wage rate is the average growth rate of Indonesia's minimum wage in percent (%) sourced from the Central Statistics Agency.
- Economic growth is the aggregate development of income from a certain time to the previous time in units (%) sourced from the Indonesian Central Statistics Agency.
- Foreign Direct Investment is the realisation of investment activities to carry out business in the territory of the Republic of Indonesia carried out by foreign investors, both those who use fully foreign capital and those in joint ventures with domestic investors in US dollars (US$) sourced from the Central Agency of Statistics (Statistics Indonesia).

In this study, a multiple linear equation model will be used using the *ordinary least square* (OLS) regression technique to see the relationship between government spending, corruption, wage levels and economic growth on foreign direct investment. Thus, the general specifications of the structural equation system used in this study are:

Functional Form

$$Y = f(X_1, X_2, X_3, X_4) \tag{1.1}$$

where:
Y = Foreign Direct Investment
X_1 = Government Expenditure
X_2 = economic growth
X_3 = corruption perception index
X_4 = wage rate

3. Results and discussion

Based on the results of the ordinary least square data processing, it can be seen that:

- The government expenditure variable has a positive and significant effect on foreign direct investment in Indonesia. This can be seen from the coefficient value of 0.000633 with a probability of 0.0009, which is smaller than 0.05 (α). These results indicate that the increase in government spending can increase foreign direct investment in Indonesia. This government expenditure is related to the improvement of facilities and infrastructure, telecommunications and various things that encourage the attractiveness of foreign investors to invest in Indonesia. The results of this study are in line with the research conducted by Othman et al., 2018 in the ASEAN region. By seeing results like this, it is certainly hoped that the government will maintain performance in the allocation of government expenditures, where government spending should be more focused on programs that support the improvement of infrastructure and infrastructure development. Investors will certainly prefer a host country with more complete facilities so that they no longer need to spend money to support their investment activities.
- The variable of economic growth shows a positive and significant effect on foreign direct investment, as seen from the coefficient value of 0.089197 with a probability of 0.0187. These results indicate that the increase in Indonesia's economic growth will also encourage an increase in foreign direct investment in Indonesia. Economic growth shows the condition of the economy and becomes a benchmark in assessing the economy of a country. Of course, every foreign investor will first see the economic performance of the country that they will make as an investment destination. The current state of the COVID-19 pandemic has certainly disrupted the economic conditions of every country, including Indonesia. However, based on the data, it can be seen that Indonesia's economic growth only contracted by 2.10%. This shows

that the Indonesian economy can still survive in a pandemic condition and is currently trying to rise together with other countries. The results of this study are in line with Asiamah et.al, 2019, who conducted research in Ghana, and Kubo, 2019, who conducted research in Southeast Asia.

- The corruption variable shows a positive and significant effect on foreign direct investment in Indonesia, as seen from the coefficient value of 0.114029 with a probability of 0.000. These results indicate that the higher the value of the corruption perception index, the higher the foreign direct investment. The corruption perception index is an index where the higher the value with a maximum of 100, the cleaner the country is. Based on these results, it can be seen that foreign direct investment will increase if corruption decreases and the country becomes cleaner. In 2020, Indonesia's corruption perception index of 37 decreased compared to 2019 when it was 40. The Indonesian government needs to take a stand in fighting corruption in Indonesia if it wants foreign direct investment to increase. Eradication of corruption needs to be carried out in all lines of the public sector in order to create a corruption-free country.
- The wage variable has a negative and significant effect on foreign direct investment, as seen from the coefficient value -0.021808 with a probability of 0.0304. These results indicate that an increase in the workers' wages in Indonesia will encourage a decrease in foreign direct investment. Wages are an indicator of the workers' welfare so they always want an increase in wages from year to year. However, for investors, an increase in wages will of course increase the costs they have to spend. Therefore, investors also look at the prevailing wage rates in the host country. In determining the wage level, government intervention is needed to keep the wage level in line with the inflation rate in the country so that investors can understand the reasons for the increase in the wage level. The results of this study are in line with Dewata and Swara, 2013 who also conducted research in Indonesia.

Table 1. Results of ordinary least square

Dependent variable: Foreign Direct Investment				
Variable	**Coefficient**	**Standard error**	***t*-Statistic**	**Probability**
C	15.62975	1.338405	11.67789	0.0000
Government Expenditure	0.000633	0.000156	4.060034	0.0009**
Growth	0.089197	0.034092	2.616367	0.0187**
Corruption	0.114029	0.010473	10.88834	0.0000***
Wage	−0.021808	0.009185	−2.374291	0.0304**

Source: Eviews Data Processing Results.

To support the results of the OLS, the following tests were carried out:
a) Normality Test

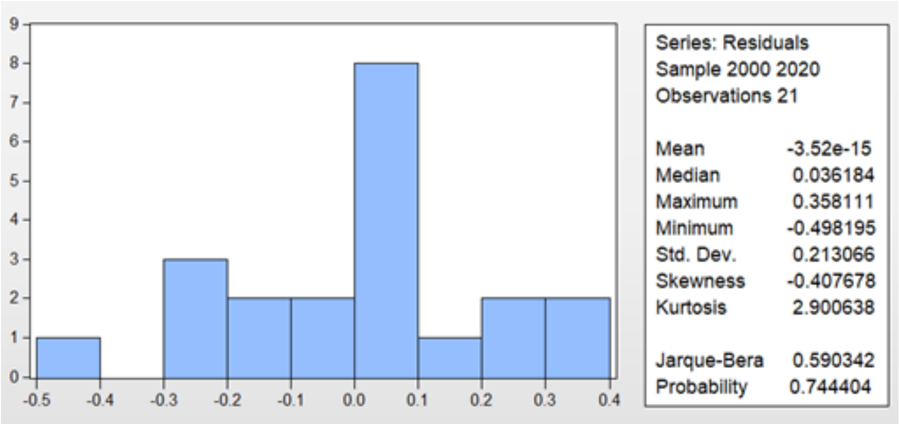

Figure 1. Normality Test
Source: Eviews Data Processing Results.

Based on Table 2, the probability of 0.744404 is greater than 0.05, which indicates that the data used is normally distributed.

b) Multicollinearity Test

Table 2. Multicollinearity Test

Variance Inflation Factors			
	Coefficient	**Uncentered**	**Centered**
Variable	Variance	VIF	VIF
C	1.791328	662.9127	NA
Government Expenditure	2.43E-08	425.2558	2.014304
Growth	0.001162	11.60597	1.236727
Corruption	0.000110	35.09046	2.178635
Wage	8.44E-05	7.523167	1.475014

Source: Eviews Data Processing Results.

Based on Table 2, the value of centred VIF for the variables of government spending, economic growth, corruption and wages is less than 10. This shows that there is no multicollinearity.

c) Heteroscedasticity Test

Table 3. Heteroscedasticity Test

Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	0.711659	Prob. F(4,16)	0.5959
Obs*R-squared	3.171886	Prob. Chi-Square(4)	0.5295
Scaled explained SS	1.749800	Prob. Chi-Square(4)	0.7817

Source: Eviews Data Processing Results.

Based on Table 3, the probability value is above 5% or 0.05 indicating that there is no heteroscedasticity.

d) Auto Correlation Test

Table 4. Auto Correlation Test

Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	0.210503	Prob. F(2,14)	0.8127
Obs*R-squared	0.613073	Prob. Chi-Square(2)	0.7360

Source: Eviews Data Processing Results.

Based on Table 4, the Prob Chi Square(2) value which is the *p*-value of the *Breusch-Godfrey Serial Correlation LM* test, amounting to 0.7360 > 0.05, which means there is no autocorrelation problem.

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