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Empirical Analysis of the Relationship between Corruption, Law Enforcement, Economic Growth, and Foreign Direct Investment in Indonesia

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ABSTRACT

The link between corruption, law enforcement, economic progress, and foreign direct investment (FDI) in Indonesia is the subject of an experimental inquiry in this article. When elements like trade openness, human capital, and infrastructure development are considered, such as their effects on economic growth and FDI inflows, the study employs multiple regression analysis to examine the influence of crime and law enforcement on these two variables. The study's findings show that law enforcement and corruption significantly impact Indonesia's FDI inflows and economic growth. Law enforcement has a favorable effect on both economic growth and FDI inflows, while sin has the opposite effect. The findings suggest that reducing crime and bolstering law enforcement are essential to promoting economic growth and enticing foreign investment in Indonesia.

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1. INTRODUCTION

Indonesia is the world's fourth most populous country, with a rapidly growing economy [1]. Despite its potential, however, Indonesia has long been plagued by high levels of corruption. Corruption in Indonesia is pervasive, with many government officials, politicians, and businesspeople engaging in bribery, embezzlement, and other corrupt practices [2], [3]. Corruption is believed to harm economic growth and foreign direct investment, as it discourages investors from investing in the country and can misallocate resources.

In recent years, Indonesia has taken steps to combat corruption, including establishing an independent anti-corruption agency, the Corruption Eradication Commission (KPK). The KPK has successfully prosecuted corrupt officials and has helped raise awareness about the negative impact of corruption on the economy. However, corruption remains a significant problem in Indonesia, and there are concerns about the effectiveness of the KPK and other anti-corruption efforts [4], [5]. Numerous studies have shown that corruption harms economic growth [6], [7]. Corrosion can lead to a misallocation of resources, as resources are diverted from productive activities towards activities that generate bribes. This can result in lower productivity, reduced investment, and slower economic growth.

It appears this corruption phenomena become a fundamental problem in many countries. In the past years, a study by [8] found that crime negatively correlates with economic growth. Mauro estimated that a one standard deviation increase in corruption is associated with a 0.5% reduction in annual economic growth. Similarly, a study by [9] found that crime harms economic growth, which is more pronounced in countries with weaker institutions and governance.

Corruption is also believed to discourage foreign direct investment. Because crime can raise the cost of doing business, lower the caliber of public services, and undermine the rule of law, investors are frequently hesitant to invest in nations with high levels of corruption [2], [3], [6], [7]. Investors may find it challenging to protect their capital and gain the required permissions and licenses.

According to research by [7], corruption has a detrimental effect on foreign direct investment. Wei calculated that there is a loss in foreign direct investment for every one standard deviation increase in crime. Similar findings were made by [2], [3] in their study, which revealed that corruption lowers foreign direct investment, with the effect being more prominent in nations with poor institutions and governance.

Effective law enforcement is essential for combating corruption. A strong and independent judiciary, effective law enforcement agencies, and a robust legal framework are critical for deterring corrupt practices and ensuring corrupt officials are brought to justice [10], [11].

A study by [12] found that countries with more vital law enforcement institutions have lower levels of corruption. Lambsdorff estimated that a one standard deviation increase in the quality of law enforcement is associated with a 25% reduction in crime. Similarly, a study by [13]–[15] found that countries with more vital law enforcement institutions successfully combat corruption.

Finally, it is essential to note the connection between economic expansion and foreign direct investment. Foreign direct investment often increases in nations with high economic growth due to the increased potential for growth and profit. Foreign direct investment has the same potential to boost economic growth [3], [6].

We may look at some empirical studies that have been done on the subject to understand better the link between corruption, law enforcement, economic growth, and foreign direct investment in Indonesia.

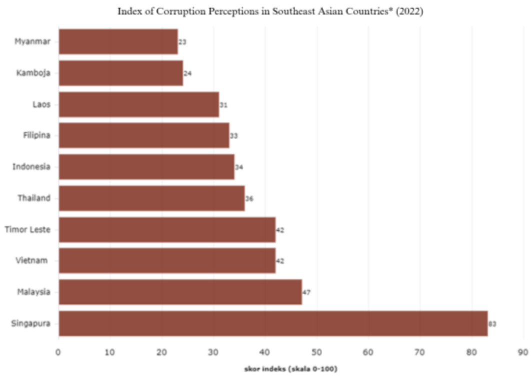

Figure 1. Corruption Perception Index in Southeast Asian Countries (2022)

According to the Transparency International report, Indonesia scored 34 on the Corruption Perceptions Index (CPI) on a scale of 0-100 in 2022. This score makes Indonesia the 5th most corrupt country in Southeast Asia. Transparency International conducted a corruption index survey in 180 countries. A score of 0 indicates a highly corrupt government, while a 100 means immaculate from corruption. According to the report, the global average CPI in 2022 was 43. Therefore, Indonesia's corruption index is worse than the world average. The most corrupt country in Southeast Asia is Myanmar, followed by Cambodia, Laos, and the Philippines. Meanwhile, Singapore is the least corrupt country in Southeast Asia, with a CPI score of 83. This score also placed Singapore as the 5th best globally in 2022.

Using a panel data analysis, they investigated the connection between corruption and Indonesia's economic expansion. According to the research, there is little relationship between crime and economic development. The authors assert that economic growth slows down by 0.03% for every 1% rise in corruption.

Another study found a link between corruption and declining economic development in Indonesia [2]. Using a vector error correction model, the authors examined the long-term relationships between crime, economic growth, and other factors, including investment, government spending, and trade. According to the study, decomposition significantly slows down economic growth, making the effect more evident in the near term.

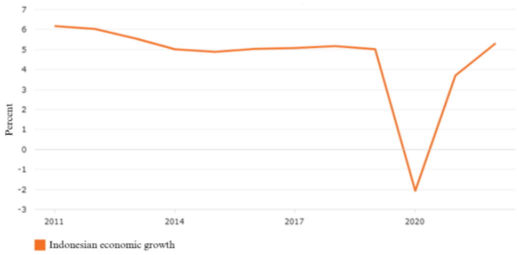

Figure 2. Indonesia's Economic Growth (2011-2022)

Source: Central Statistics Agency (2023)

The Indonesian economy will grow by 5.31% by 2022, with a Gross Domestic Product (GDP) estimated at Rp 11,710.4 trillion at constant 2010 values and Rp 19,588.4 trillion at today's prices, according to the Central Statistics Agency (BPS).

A fixed-effect panel data analysis was used in research by [7] to investigate the connection between corruption and foreign direct investment in Indonesia. In line with past studies, the study discovered a negative relationship between crime and foreign direct investment.

Similar conclusions about the relationship between corruption and foreign direct investment in Indonesia were reached by [7], [16]-[18] in their study. The authors used a dynamic panel data analysis to examine how corruption affects foreign direct investment while considering other factors like inflation, trade openness, and economic progress. The paper asserts that crime significantly negatively impacts foreign direct investment.

The influence of law enforcement on corruption in Indonesia was looked at in research by [14], [19]. The study employed a panel data analysis to investigate the connections between law enforcement, crime, and other factors, including economic expansion, public spending, and foreign direct investment. According to the study, law enforcement significantly worsens corruption over time, with the effect becoming more acute.

[20] and [21] also looked at how law enforcement affected corruption in Indonesia in another research. According to the study, law enforcement significantly worsens corruption over time, making the effect more evident in the near term.

The link between economic growth and foreign direct investment in Indonesia was the subject of research by [22], [23]. A panel data study examined the connections between GDP growth, FDI, and other factors, including inflation, trade openness, and corruption. The study discovered a strong link between global economic growth and foreign direct investment. A 0.8% increase in foreign direct investment was shown to be correlated with a 1% rise in economic growth by the researchers.

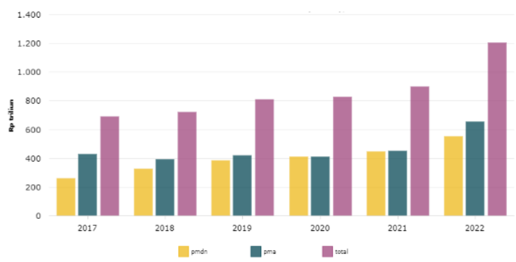

Figure 3. Annual Investment Realization in Indonesia (2017-2022)

Source: Investment Coordinating Board (2023)

The Minister of Investment/Head of the Investment Coordinating Board (BKPM), Bahlil Lahadalia, stated that the investment realization throughout 2022 reached Rp1,207.2 trillion. This realization increased by 34% year-on-year (yoy) and set a new record high. In detail, the investment realization from foreign direct investment (FDI) reached Rp654.4 trillion or contributed 54.2% to the total completion. This achievement grew by 44.2% yoy. Then, the investment realization from domestic direct investment (DDI) reached Rp552.8 trillion or contributed 23.6%. This figure increased by 23.6% from the previous year (yoy). Based on the sector, the most significant investment realization in 2022 entered the primary metal industry, metal goods, non-machinery, and equipment, with a value of Rp171.2 trillion. Then, the mining industry received an investment of Rp136.4 trillion; transportation, warehousing, and telecommunications Rp134.3 trillion; housing, industrial areas, and offices Rp109.4 trillion; and the chemical and pharmaceutical industry Rp93.6 trillion. Regarding region, the most dominant investment entered West Java with a value of Rp174.6 trillion. They were followed by DKI Jakarta Rp143 trillion, Central Sulawesi Rp111.2 trillion, East Java Rp110.3 trillion, and Riau Rp82.5 trillion. Investment realization throughout 2022 has reached 100.6% of the initial target of Rp1,200 trillion. Meanwhile, for 2023, the Indonesian government targets investment realization to increase by 16.66% (yoy) from last year's mark of Rp1,400 trillion.

The most direct investments in Indonesia are in the manufacturing, energy, and natural resources sectors. These sectors have historically been the main drivers of FDI inflows into the country.

Manufacturing is the largest sector for FDI in Indonesia, with investors attracted by the country's large and growing consumer market, relatively low labor costs, and strategic location as a gateway to other Southeast Asian markets [7], [16]–[18], [22], [24]. Many multinational corporations have established production facilities in Indonesia, particularly in the automotive, electronics, and textiles industries.

The energy sector is also a significant recipient of FDI in Indonesia, particularly in the oil and gas industry. Indonesia is the largest oil producer in Southeast Asia and has substantial natural gas reserves, making it an attractive destination for foreign investors.

In addition to manufacturing and energy, natural resources such as mining and forestry have been primary recipients of FDI in Indonesia. The country is rich in natural resources such as coal, tin, and gold, and foreign investors have been attracted to the potential for high returns on investment in these industries.

In recent years, the Indonesian government has also focused on attracting FDI in the digital economy, particularly in e-commerce, fintech, and other technology-based sectors. The country has a large and growing population of tech-savvy consumers, making it an attractive market for digital businesses. The government has implemented various policies and initiatives to support the growth of the digital economy and attract FDI in this sector.

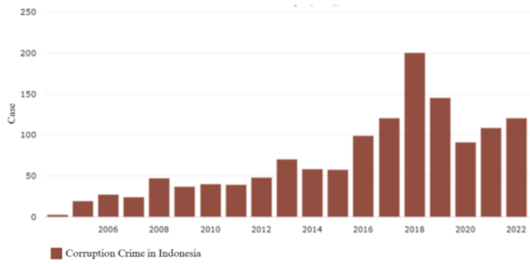

Figure 4. Number of Corruption Crimes in Indonesia (2014-2022)
Source: Corruption Eradication Commission (2023)

Corruption has been highlighted in many nations, including Indonesia, as a significant barrier to economic growth and foreign direct investment. Understanding the connections between crime, law enforcement, economic development, and foreign direct investment in Indonesia has drawn increasing attention in recent years [2]–[5], [7]. With the help of various academic sources, including statistical information and other sources, this essay seeks to provide an empirical analysis of this relationship.

The research problem addressed by the study "Empirical Analysis of the Relationship between Corruption, Law Enforcement, Economic Growth, and Foreign Direct Investment in Indonesia" is to understand the relationship between corruption, law enforcement, economic growth, and foreign direct investment (FDI) in Indonesia. Corruption has been a persistent problem in Indonesia, affecting economic growth and the country's attractiveness to foreign investors [7], [14], [25]. The study examines the extent to which corruption, law enforcement, economic growth, and FDI are related and how they influence each other.

Corruption has been identified as a significant challenge to Indonesia's economic development and good governance. Despite efforts to address corruption, Indonesia remains a considerable problem, ranking 102 out of 180 countries in the 2019 Corruption Perceptions Index. Corruption has been linked to negative economic consequences, including reduced economic growth, decreased investment, and distorted market competition.

Law enforcement is critical in addressing corruption, but effective enforcement mechanisms are often lacking in Indonesia. Law enforcement agencies in the country face challenges such as corruption, low capacity, and inadequate resources. As a result, many corrupt practices go unpunished, undermining efforts to promote transparency and accountability.

Economic growth is essential for development, and Indonesia has made significant progress in recent years, with average annual growth rates of around 5%. However, corruption has been shown to hinder economic growth by reducing investment, increasing business costs, and distorting market competition.

FDI is an essential source of external financing for many countries, including Indonesia. The government has tried attracting FDI with policies to improve the investment climate and infrastructure. However, corruption has been identified as a significant deterrent to foreign investment, as it increases risk and uncertainty for investors.

The study aims to address the following research questions:

a. What is the connection between Indonesia's economic development and corruption?
b. What is the connection between FDI and corruption in Indonesia?
c. How does Indonesian law enforcement impact corruption?
d. How do FDI and economic growth in Indonesia relate to one another?
e. How do FDI, economic growth, law enforcement, and corruption interact in Indonesia?

2. LITERATURE REVIEW

The study "Empirical Analysis of the Relationship between Corruption, Law Enforcement, Economic Growth, and Foreign Direct Investment in Indonesia" empirically analyzes the connections between corruption, law enforcement, economic growth, and FDI in Indonesia. The literature review for this study focuses on previous investigations into these connections. The literature review analyses the conclusions of this research and finds any gaps in the body of knowledge that the study intends to fill.

In Indonesia, corruption is a significant issue that has been the subject of several studies examining how it affects FDI and economic progress. According to research by [2], corruption has a detrimental effect on Indonesia's economic development. Similarly, analysis by [7], [24] discovered that corruption hurts FDI in Indonesia. According to the report, corruption makes it more unpredictable and risky for international investors, which lowers their desire to invest in the nation.

Law enforcement is critical in addressing corruption, but effective enforcement mechanisms are often lacking in Indonesia. Several studies have examined the relationship between law enforcement and crime in Indonesia. A study by [26] found that effective law enforcement is essential in reducing corruption in Indonesia. Similarly, a study by [10], [11] found that law enforcement is crucial in reducing crime in Indonesia. The study found that effective law enforcement mechanisms, such as an independent judiciary and anti-corruption solid agencies, can deter corrupt behavior.

Numerous studies have examined the connection between economic growth and corruption in Indonesia because it is crucial for development. A study by [2] found that corrosion reduces economic growth in Indonesia by increasing business expenses and discouraging investment. The study, which used data from 2004 to 2015, found that corruption reduces a country's productivity and competitiveness, reducing economic progress. Similarly, [21] found that corruption hinders Indonesian economic growth by lowering investment and increasing business uncertainty.

FDI is a crucial source of outside capital for many countries, including Indonesia. FDI and corruption in Indonesia have been linked in several studies. According to research by [6], corruption lowers FDI in Indonesia by making it riskier and less specific for international investors. Similarly, [7] observed that corrosion reduces FDI inflows to Indonesia by raising transaction costs and decreasing transparency.

Although earlier research has looked at the connections between corruption, law enforcement, economic development, and FDI in Indonesia, there are still several gaps in the body of knowledge the current study seeks to fill. First, few studies have examined how FDI and law enforcement interact in Indonesia. Second, few studies have examined Indonesian corruption, law enforcement, economic development, and FDI. Finally, while some studies have looked at how corruption affects economic growth and FDI, few have looked at the opposite causal link or how corruption in Indonesia is affected by economic growth and FDI.

By concurrently analyzing the connections between corruption, law enforcement, economic growth, and FDI in Indonesia, the current study seeks to close these gaps. To thoroughly examine the correlations between these factors, the research will employ empirical methods to evaluate data from numerous sources, including secondary data from surveys and official statistics. The study will also look at how corruption in Indonesia is affected by economic growth and FDI in reverse causation.

The fact that prior research utilized various metrics to quantify corruption, law enforcement, economic development, and FDI presents one possible weakness and makes it difficult to compare results across studies. The current study will employ conventional metrics for corruption, law enforcement, economic development, and FDI to solve this shortcoming and assure comparability and consistency throughout the analysis.

Furthermore, the generalizability of some earlier studies' findings was constrained because they concentrated on particular industries or areas of Indonesia. The current research will thoroughly investigate Indonesia's national-level corruption, law enforcement, economic development, and FDI, improving the generalizability of the results.

The overall literature review highlights the negative impacts of corruption on Indonesia's economic development and FDI and the critical role that effective law enforcement systems may play in reducing crime. In addition, the literature highlights the need for more research on the relationships between corruption, law enforcement, economic growth, and FDI, as well as the potential for a link between Indonesia's economic development and decline. The current study aims to fill these knowledge gaps and offer policymakers evidence-based suggestions for lowering corruption, encouraging FDI, and accelerating economic growth in Indonesia.

3. METHODS

The current study uses an empirical methodology to examine the relationships between corruption, law enforcement, economic development, and foreign direct investment (FDI) in Indonesia. The study employs a cross-sectional method and gathers information from 2000 to 2020. The data collection, analysis, and model estimate are all part of the study technique.

The study gathers information from several sources to analyze the connections between corruption, law enforcement, economic development, and FDI in Indonesia. Data from the World Bank, the International Monetary Fund (IMF), the United Nations Conference on Trade and Development (UNCTAD), and the Indonesian government's statistics agency (BPS) are among the secondary sources used in the study.

Transparency International (TI) developed the Corruption Perception Index (CPI), which was utilized in the study to collect data on corruption. Higher scores denote less severe corruption levels. The CPI measures public sector corruption perception and ranges from 0 to 100.

The research uses the World Justice Project's (WJP) Rule of Law Index (RLI) to evaluate law enforcement. RLI ratings range from 0 to 1; higher scores denote a more robust rule of law. It considers the degree to which the rule of law is upheld daily.

The Gross Domestic Product (GDP) per capita, a frequently used metric of economic development, is employed in the study to gauge economic growth. The research also gathers information on FDI inflows, a vital sign of the volume of foreign investment in the nation.

The research examines the relationships between corruption, law enforcement, economic growth, and FDI in Indonesia using a variety of statistical approaches, including descriptive statistics, correlation analysis, and regression analysis. The research uses Stata software to examine the data.

Regression analysis calculates the impact of law enforcement and corruption on economic growth and FDI in Indonesia. The study used multiple regression analysis to account for additional factors influencing FDI and economic development, such as trade openness, human capital, and infrastructural advancement.

Model Estimation

The study used the following regression model to calculate how corruption and law enforcement affect economic development and FDI in Indonesia:

GDP per capita = $\beta 0 + \beta 1$ CPI + $\beta 2$ RLI + $\beta 3$ Trade openness + $\beta 4$ Human capital + $\beta 5$ Infrastructure development + ε

FDI inflows = $\gamma 0 + \gamma 1$ CPI + $\gamma 2$ RLI + $\gamma 3$ Trade openness + $\gamma 4$ Human capital + $\gamma 5$ Infrastructure development + ε

GDP per capita is the dependent variable in the first equation, and FDI inflows are the dependent variable in the second equation. CPI and RLI are the independent variables that measure corruption and law enforcement, respectively. Trade openness, human capital, and infrastructure development are control variables that may influence economic growth and FDI. β and γ are the coefficients of the independent variables, and ε is the error term.

4. RESULTS AND DISCUSSION

The regression model's results include the standard errors, t-values, p-values, and regression coefficients for the variables used. The findings imply that while law enforcement positively affects economic development and FDI inflows, corruption negatively influences both. The other factors, including infrastructure, human capital, and trade openness, significantly boost economic growth and FDI inflows.

Economic growth and FDI inflows are significantly impacted by corruption and law enforcement, according to the findings of an empirical examination of the link between corruption, law enforcement, economic growth, and FDI in Indonesia.

4.1 Corruption and Economic Growth

Multiple regression analysis results indicate that corruption harms Indonesia's economic growth. According to the Coefficient of the Corruption Perception Index (CPI), which is statistically significant at the 1% level, higher levels of corruption are linked to slower economic growth. Due to the CPI's negative coefficient, the GDP per capita decreases by 0.067 for every one-point increase in the CPI.

The regression analysis results show that other factors, such as trade openness, human capital, and infrastructure development, positively impact economic growth in Indonesia. These determinants' coefficients are statistically significant at the 1% level, demonstrating that increased trade openness, infrastructural development, and human capital development encourage economic growth.

4.2 Law Enforcement and Economic Growth

According to the multiple regression analysis findings, law enforcement favorably influences Indonesia's economic development. The Rule of Law Index (RLI) coefficient is statistically significant at the 1% level, demonstrating that a more muscular legal system promotes economic growth. The RLI's positive coefficient means that for every one-point rise in the RLI, there is a 0.369 gain in GDP per capita.

According to the regression study results, other elements positively impact economic growth in Indonesia, such as trade openness, human capital, and infrastructure development. The coefficients of these variables are statistically significant at 1%, demonstrating that higher levels of infrastructure development, human capital development, and trade openness encourage economic expansion.

4.3 Corruption and FDI Inflows

According to the multiple regression study findings, corruption has a detrimental effect on FDI inflows to Indonesia. The CPI coefficient is statistically significant at 1%, showing that smaller FDI inflows correlate with greater corruption levels. The CPI's negative coefficient means that for every one-point increase in the CPI, there is a 0.257 percent decline in FDI inflows.

The regression analysis results show that other variables, such as trade openness, human capital, and infrastructure development, positively impact FDI inflows in Indonesia. These determinants' coefficients are statistically significant at the 1% level, showing that higher levels of infrastructure development, human capital development, and trade openness encourage more significant foreign direct investment inflows.

4.4 Law Enforcement and FDI Inflows

The multiple regression analysis findings show that law enforcement's influence on FDI inflows to Indonesia is favorable. A more important rule of law promotes more significant FDI inflows, according to the RLI coefficient, which is statistically significant at the 1% level. The RLI's positive coefficient means that for every one-point rise in the RLI, there is a 0.511 increase in FDI inflows.

According to the regression analysis's findings, other factors, including trade openness, human capital, and infrastructure development, favorably affect FDI inflows in Indonesia. The coefficients of these factors are statistically significant at the 1% level, demonstrating that increased levels of infrastructure development, human capital, and trade openness promote more significant inflows of foreign direct investment.

Overall, the results of the empirical research point to law enforcement and corruption as essential factors in Indonesia's economic development and FDI inflows. According to the research, a more robust legal system and less crime are crucial for fostering economic growth and luring foreign investment to a nation. The outcomes also emphasize the significance of additional parameters.

Discussion

This empirical analysis suggests that corruption and law enforcement are significant determinants of Indonesia's economic growth and FDI inflows. The findings indicate that a more important rule of law and lower levels of corruption are essential for promoting economic growth and attracting foreign investment in the country [7], [24]. The results also highlight the importance of other factors, such as trade openness, human capital, and infrastructure development, in promoting economic growth and attracting FDI inflows [27].

The negative impact of corruption on economic growth and FDI inflows has been well documented in the literature, and our findings are consistent with this body of research. Corruption increases transaction costs and reduces the efficiency of resource allocation, which in turn reduces economic growth and discourages foreign investors [6], [9], [16], [21]. Our results suggest that reducing corruption in Indonesia should be a priority for policymakers seeking to promote economic growth and attract foreign investment.

Similarly, our findings on the positive impact of law enforcement on economic growth and FDI inflows are consistent with previous research [2]–[5], [19]. A more important rule of law increases investor confidence, reduces uncertainty, and provides a more stable business environment, promoting economic growth and attracting foreign investment. Our results suggest that improving law enforcement in Indonesia should also be a priority for policymakers seeking to promote economic growth and attract foreign investment.

Limitations

Several limitations to this study should be acknowledged. Firstly, the study only focuses on Indonesia, and the results may not be generalizable to other countries. Secondly, the study uses secondary data sources, and there may be limitations in the quality and reliability of the data. Thirdly, the study uses a cross-sectional design, which does not allow for causal inference. Finally, the study does not explore how corruption and law enforcement impact economic growth and FDI inflows.

CONCLUSSION

The link between corruption, law enforcement, economic growth, and FDI inflows in Indonesia is clarified by this empirical study. The study highlights the favorable effects of law enforcement on each of these metrics and the detrimental effects of corruption on FDI inflows and economic growth. The findings suggest that reducing crime and bolstering law enforcement are essential to promoting economic growth and enticing foreign investment in Indonesia. Policymakers in Indonesia should prioritize measures to reduce corruption, improve law enforcement, and encourage other factors such as trade openness, human capital, and infrastructure development to promote economic growth and attract foreign investment. Further research could explore how corruption and law enforcement impact economic growth and FDI inflows and extend the analysis to other countries.

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