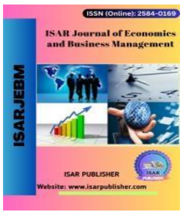

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POLITICAL RISK INDICATORS AND FOREIGN DIRECT INVESTMENT (FDI) ATTRACTION IN INDONESIA

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Abstract: *The objective of this research is to analyze the influence of political stability on foreign direct investment in Indonesia. The data used is secondary data sourced from the Central Bureau of Statistics and the PRS Group. The analysis tool used in this research is multiple linear regression using time series data during the period 2000-2022. Based on the regression results, it was obtained that the variables Political Stability and Absence of Violence partially had a negative effect on foreign direct investment (FDI) in Indonesia, while the variables Government Effectiveness and Regulatory Quality, respectively, had a positive and significant effect on foreign direct investment (FDI) in Indonesia. Meanwhile, simultaneously, the variables Political Stability and Absence of Violence, Government Effectiveness, and Regulatory Quality have a positive effect on foreign direct investment (FDI) in Indonesia.*

Although Political Stability and Absence of Violence do not have a direct effect on FDI in Indonesia, other factors such as Government Effectiveness and Regulatory Quality greatly influence investment decisions. Both of these variables can give investors a sense of security and confidence that despite political uncertainty, they can still operate well in Indonesia thanks to supportive government policies and transparent regulations. Therefore, although Indonesia can face political challenges, if the government can improve the effectiveness of government administration and the quality of regulations, this can be a more dominant factor in attracting foreign investment. The Indonesian government needs to focus on ensuring that existing policies and regulations can provide the necessary guarantees for investors to invest and run their businesses smoothly.

Keywords: *Foreign Direct Investment, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality*.

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Introduction

Foreign Direct Investment (FDI) is an important form of investment in the global economy. FDI is an investment flow carried out by foreign entities or individuals in a country to acquire ownership of productive assets in the investment destination country, in order to generate profits. Countries in the world have made FDI the main component in the process of economic globalization, because FDI has a significant impact on economic growth, technology transfer, job creation, and increasing the competitiveness of domestic industries in recipient countries. However, although FDI has many benefits, not all countries have the ability to attract these foreign investment flows. Likewise, the Indonesian state still faces challenges in optimizing FDI to support Indonesia's economic development. According to Dewi & Septriani, (2023), FDI has a positive impact on the economies of recipient countries, especially in developing countries. Therefore, it is necessary to identify the factors that determine FDI in Indonesia. This aims to design policies that can increase the attractiveness of foreign investment, as well as to overcome obstacles that can reduce the potential benefits of FDI for the country's economy. This is because FDI is one of the main driving factors for the Indonesian economy. According to Johnshon (2006), FDI flows increase economic growth in developing countries. Solow's theory, regarding economic growth, shows that invertation plays a very important role in increasing production capacity and productivity, so that it will ultimately encourage an increase in economic growth.

FDI have an important role in increasing the economic growth of recipient countries, especially for developing countries. In several research results conducted by Rahmadiani & Darmawan

(2023); Gökçeli et l. (2022); Gligorić *et al.* (2017); Marjanać and Grujić (2022); found that Foreign Direct Investment (FDI) has a positive impact on the economic growth of the recipient country. According to Zhang *et al*. (2024), the government must encourage foreign investment to improve the industrial structure and encourage economic growth. Likewise with the research conducted by Fazaalloh (2024); Rao et al. (2023); Khan et al. (2022), that FDI has a positive impact on the economic growth. For Indonesia, FDI not only provides access to external financing, technology and innovation transfer, and better managerial skills, but also helps reduce unemployment in the country (Zaza, 2024). Based on data from the Indonesian Central Bureau of Statistics, from 2000 to 2022, the total flow of FDI projects in Indonesia tends to fluctuate from year to year. The development of Indonesian FDI from 2000 to 2022 can be seen in Figure 1.

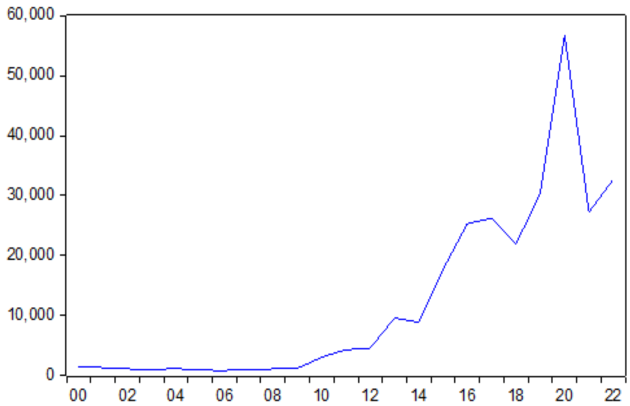

Figure 1. Foreign Direct Investment of Indonesia in 2000-2022 (project)

Source: Central Bureau of Statistics (Data processed)

Although FDI can accelerate economic development, not all countries can make optimal use of it, as many factors influence foreign companies' decisions to invest. The main factors that affect FDI decisions are Political and Economic Stability. FDI in Indonesia is implemented by considering the political risk in the country. The investment will be easier to gather when the political risk in Indonesia is low (Satria & Putra, 2018). Several studies indicate that political risk, as measured by the International Country Risk Guide (ICRG), has a significant impact on the inflow of foreign direct investment (Jeutang & Kesse, 2021). Countries with high levels of political uncertainty tend to face difficulties in attracting FDI. In contrast, countries with a stable political system, consistent economic policies, and clear and trustworthy legal mechanisms are more attractive to foreign investors.

Political Stability is an important indicator in assessing the safety and predictability of a country's political conditions. A stable political environment provides a sense of security for investors to invest, while political instability or violence, whether internal or external, can decrease investor interest. Political instability creates uncertainty that harms business and affects the investment climate. As seen in Indonesia's post-Suharto era with reforms supporting FDI growth, however, according to Putra & Satria (2018), ongoing conflicts in Papua and the South China Sea hindered foreign investors from investing in certain regions at that time.

Some of the factors that are very influential in attracting FDI are political stability, government effectiveness, and quality of regulations. The political stability can be seen from the value of the index political stability and absence of violence, government effectiveness, and regulatory quality. Indonesia's political stability in 2000-2022 tends to fluctuate, as shown in figure 2. Several research results show that political stability, characterized by effective governance and a reduction in internal conflicts, significantly increases FDI Sabir et al. (2019). Foreign direct investment flows are very sensitive to the metrics of governance and political stability Tjandrasa (2021).

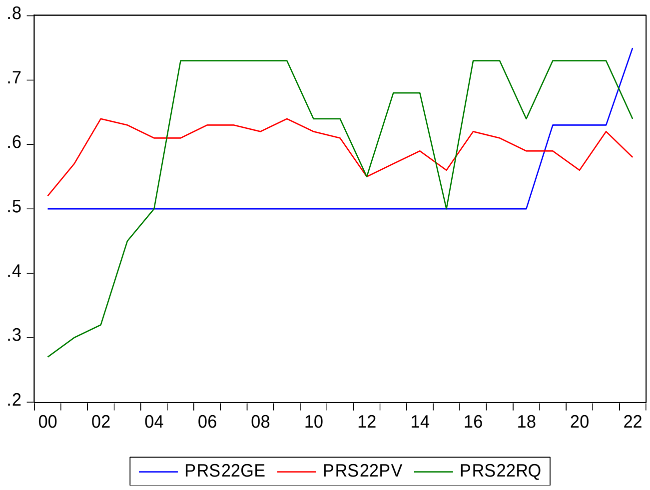

Figure 2. Political Stability and Absence of Violence, Government Effectiveness, and Regulatory Quality of Indonesia in 2000-2022

Source: PRS Group (Data processed)

Several research results show that good political stability will create a favorable climate for businesses to make foreign direct investment (FDI), Elish (2022), Ciesielska-Maciagowska & Koltuniak (2021); Buitrago & Barbosa Camargo (2020). Likewise, the results of research conducted by Sabir et al. (2019); Rashid et al. (2017), and Kinuthia and Murshed (2015). which found that political stability positively affects foreign direct investment. This is because investors have access to a wider consumer base and can operate safely thanks to a stable political environment (Hashmi et al., 2020).

Furthermore, the factor that affects FDI is government effectiveness. Government Effectiveness is the quality of bureaucracy and the government's ability to design and implement policies that support simplification of investment procedures, transparency in decision-making, and efficient public services. Effective governments tend to create a better investment climate by providing legal certainty, ease of business licensing, and providing the infrastructure needed by investors. Conversely, ineffective government and complicated bureaucracy can hinder investment flows and reduce the country's attractiveness to foreign investors.

Furthermore, the factor that affects FDI is regulatory quality. Regulatory Quality is the state's ability to design and implement regulations that support economic growth, improve the investment climate, and encourage innovation. A country with good regulatory quality will provide legal certainty and facilitate investment by reducing excessive bureaucracy and providing clear and fair regulations. Conversely, ambiguity or inconsistency in regulation can create uncertainty that is detrimental to investors.

Indonesia, as a developing country with the largest economy in Southeast Asia, has great potential to attract FDI. However, the challenges faced by Indonesia are political uncertainty, changes in regulatory policies, and the quality of the bureaucracy that is sometimes ineffective. Therefore, the purpose of this study is to analyze the influence of political risk on Foreign Direct Investment (FDI) in Indonesia. By understanding the influence of these three factors, it is hoped that it can provide more appropriate policy recommendations for the Indonesian government in increasing the attraction of foreign investment, especially in strategic sectors.

Method

This study aims to explain the relationship between political risk indicators and foreign direct investment (FDI) in Indonesia, using secondary data from the Central Bureau of Statistic and PRS Group. The variables used consisted of one dependent variable, namely FDI, and two independent variables, namely Government Effectiveness, Political Stability and Absence of Violence, and Regulatory Quality, for the period 2000-2022. A double linear regression analysis with the Ordinary Least Squares (OLS) model was used as an analysis tool, which was processed using EViews 9. The equation model used in this study is as follows:

$$PFDI_t = \beta_0 + \beta_1 PRSPV_t + \beta_2 PRSGE_t + \beta_3 PRSRQ_t + \varepsilon_t$$

Where: PFDI is Foreign Direct Investment (project), PRSPV is Political Stability and Absence of Violence, PRSGE is Government Effectiveness, PRSRQ is Regulatory Quality, β0 is Intercept/Constant, β1, β2, β3 is the regression coefficient of PRSGE variables, PRSPV and PRSRQ, t is the time period (2000-2022) anda ε is Error term

Results and Discussions

Based on the results of the normality test, the data used in this study is normally distributed data. This can be seen from the value of the Jarque-Bera Probabilities which is 0.219433. The value of the probability of Jarque-Bera is greater than α (0.05), so it can be concluded that the data is normally distributed. The results of the normality test can be seen in figure 3.

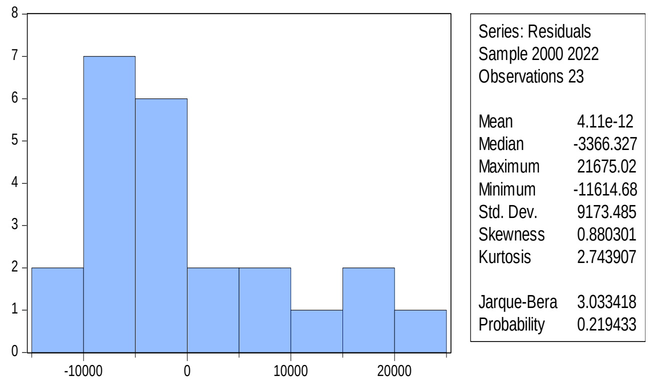

Figure 3. Normality Test Results

Source : secondary data (processed, 2024)

Furthermore, based on the results of the autocorrelation test, the prob value was obtained. Chi-Square by 0.0515. This number is greater than α (0.05), so it can be concluded that there is no autocorrelation in this regression model. The results of the Autocorrelation test can be seen in Table 1.

Table 1. Autocorrelation Test Results

Breusch-Godfrey Serial Correlation LM Test			
F-statistic	3.548703	Prob. F(2,17)	0.0515
Obs*R-squared	6.774188	Prob. Chi-Square(2)	0.0338

Source : secondary data (processed, 2024)

In this regression model, a heterokedasticity test is also performed. The results of the heteroscedasticity test show that this regression model does not find any symptoms of heteroscedasticity. This can be seen from the probability value of Chi-Squared from Obs*R-squared is 0.2207. The results of this heteroscedasticity test can be seen in table 2.

Table 2. Heteroscedasticity test results

Heteroskedasticity Test: Breusch-Pagan-Godfrey:			
F-statistic	1.501491	Prob. F(3,19)	0.2463
Obs*R-squared	4.407793	Prob. Chi-Square(2)	0.2207

Source : secondary data (processed, 2024)

Finally, in this regression model, a multicollinearity test is also carried out, to see the relationship between independent variables. The results of multicollinearity can be seen in Table 3

Table 3. Multicollinearity test results

Variable	PRSGE	PRSPV	PRSRQ
PRSPV	-0.174240	1.000000	0.368565
PRSGE	1.000000	-0.174240	0.236948
PRSRQ	0.236948	0.368565	1.000000

Source : Secondary Data (processed, 2024)

The regression results of this study can be seen in Table 4.

Table 4. Multiple Linear Regression Results

Variable	*Coefficient*	*Std. Error*	*t-Statistic*	Prob.
C	10196.19	48717.22	0.209293	0.8364
PRSPV	-145976.3	74025.84	-1.971964	0.0634
PRSGE	128025.1	34370.55	3.724849	0.0014
PRSRQ	35542.04	15802.87	2.249088	0.0366
R^2 : 0.622217				
Adj.R^2 : 0.562568				
F-statistic : 10.43116				
Prob (F-Statistic) : 0.000282				

Source : Secondary Data (processed, 2024)

Based on the test results in Table 4, the regression equation is obtained as follows:

$$PFDI = 10196.19 - 145976.3 PRSPV + 128025.1 PRSGE + 35542.04 PRSRQ$$

Hypothesis Test

Based on the t-test, the coefficient value for the Political Stability and Absence of Violence variable was obtained at -145976.3 with a probability of 0.0634 (greater than α = 5%). These results show that Political Stability and Absence of Violence have no effect on foreign direct investment (FDI). Meanwhile, the Government Effectiveness variable has a coefficient value of 128025.1 and a probability of 0.0014 (less than $\alpha = 5\%$), which shows that Government Effectiveness has a positive effect on FDI in Indonesia. Likewise, the Regulatory Quality variable has a coefficient value of 35542.04 and a probability of 0.0366 (less than $\alpha = 5\%$), which shows that Regulatory Quality also has a positive effect on FDI in Indonesia. Simultaneously, the variables Government Effectiveness, Political Stability and Absence of Violence, and Regulatory Quality have a positive influence on FDI in Indonesia, which can be seen from the F-statistic value of 10.43116 (positive value) with an F-statistic probability of 0.000282 (less than $\alpha = 5\%$). Based on the results of the determination coefficient test, an R^2 value of 0.6222 was obtained. This shows that around 62.22 percent of FDI variations can be explained by the variables of Government Effectiveness, Political Stability and Absence of Violence, and Regulatory Quality. The remainder, about 37.78 percent of the variation in FDI was explained by other factors not covered by this model, which shows that although this model provides a significant explanation, there are still other factors that affect FDI in Indonesia beyond the variables studied.

Discussion

Based on the regression results, the t-statistical probability of the Political Stability and Absence of Violence variable was obtained at 0.0634. These results show that Political Stability and Absence of Violence have no effect on foreign direct investment in Indonesia. Political instability reflected in profound changes in government policy or social uncertainty may make investors more cautious even though Indonesia shows a good level of political stability statistically.

The results of this study are in line with the results of research conducted by Simanjuntak (2018), where political risk had no significant effect on FDI in Indonesia. These results show that foreign investors do not directly pay attention to political stability or the absence of violence as the main factors in their decision to invest in Indonesia. This means that the most dominant factor in influencing foreign investors' decisions is not political stability and absence of violence, but the quality of regulations, the effectiveness of government, or the greater market potential in Indonesia.

In addition, foreign investors may prioritize other factors that are more directly related to potential economic benefits and investment risks. This emphasizes the importance for Indonesia to strengthen clearer economic and regulatory aspects, such as governance efficiency and regulatory quality, that can provide a sense of security and certainty for investors. While political stability remains important, the study shows that countries with a favorable investment climate in terms of policies and regulations can still attract foreign investment despite certain political risks.

According to Kurecic and Kokotovic (2017) argue that political stability does not significantly affect FDI because investors take political risks for granted. Shan et al. (2018) stated that political stability is one of the factors that hinder the attractiveness of FDI flows. According to Busse and Hefeker, (2007), this is because, with a stable political system, it will actually hinder investors from operating effectively and efficiently in order to make a profit. This is because when political conditions are stable, there is a tendency to enact regulations that can limit investment, bureaucracy that tends to be complicated and policies that cannot be predicted by investors. Therefore, economic instability or inconsistent policies can hurt investor perception. If political tensions, although not immediately visible in the data, but there are socio-economic dynamics that lead to uncertainty, then it can reduce FDI interest. According to Tjandrasa (2021), FDI inflows are very sensitive to government metrics, such as the rule of law, corruption control and regional stability.

Next, based on the results of the t-test, the probability of the government effectiveness variable was obtained of 0.0014. These results show that government effectiveness has a positive and significant effect on FDI in Indonesia. This means that when there is an increase in the government effectiveness index, it will significantly encourage an increase in Foreign Direct Investment (FDI) and vice versa, if there is a decrease in effectiveness (bureaucratic quality), foreign direct investment will also decrease. The indicator used in measuring government effectiveness is bureaucratic quality. High bureaucratic quality will have an impact on creating an environment conducive to foreign direct investment (FDI). Furthermore, when viewed from the Indonesian government effectiveness data sourced from the PRS Group, the average government effectiveness was obtained at 0.53. The government effectiveness index (bureaucratic quality) value of 0.53 shows that Indonesia faces significant challenges in attracting FDI. This is due to policy instability, inefficient administrative processes, and a lack of bureaucratic autonomy from political pressure. Therefore, to increase Indonesia's attractiveness as a foreign investment destination, bureaucratic reform, increased transparency, and policy stability are needed.

For an investor, the existence of a strong, efficient, and corruption-free bureaucratic system can improve the investment climate, reduce transaction costs, and provide certainty for investing. Therefore, the effectiveness of the Indonesian government, especially in terms of bureaucratic quality, is a very important factor in attracting FDI. When governments are more effective, investors will feel safer and trust that policies will stabilize and support their business growth.

In this case, improvements in the Government Effectiveness index will increase Indonesia's attractiveness to foreign investors because it provides a guarantee of ease of doing business, transparency in decision-making, and efficient management. Therefore, efforts to improve the quality of government in terms of regulations, bureaucracy, and transparency will have a direct impact on increasing FDI. According to Alam et a.l (2017) in their research found that government effectiveness has a positive impact on economic growth.

Meanwhile, based on the results of the t-test, the probability of the regulatory quality variable was obtained of 0.0366. These results show that the regulatory quality variable has a positive and significant effect on FDI in Indonesia. Based on data from PRS Group, the regulatory quality index is relatively high The high regulatory quality index shows that regulations in Indonesia are clearer, more transparent, and can support foreign investment. This positive result indicates that when Indonesia improves the quality of regulations, FDI also tends to increase. This is because investors will be more interested in investing in a country that has stable legal and regulatory certainty. This means that if Indonesia improves the quality of regulations by making rules clearer, easier to follow, and consistent, this will create a more attractive climate for foreign investors to invest in Indonesia. This is because investors tend to look for countries with predictable and fair regulations, so improving the quality of regulation is a strategic step to attract more FDI. According to Yu et al., 2019, investment control policies are one of the factors that drive FDI.

Although Political Stability and Absence of Violence partially have a negative effect on FDI, the variables of Government Effectiveness and regulatory quality have a positive and significant effect on FDI. This suggests that improvements in government efficiency and regulatory quality can offset the negative effects of political instability. While there are some challenges in terms of political stability that may have a negative impact on FDI, government effectiveness and regulatory quality serve as balancing factors that strengthen Indonesia's attractiveness to investors. As the quality of government and regulation improves, these three factors together will create a better investment climate. These results confirm that while political instability may be a deterrent factor for FDI, improvements in government effectiveness and regulatory quality can overcome these challenges. In addition, other factors such as Indonesia's economic condition are also factors that investors pay more attention to.

Conclusion

Based on the regression results, it was obtained that the variables Political Stability and Absence of Violence partially had a negative effect on foreign direct investment (FDI) in Indonesia, while the variables Government Effectiveness and Regulatory Quality, respectively, had a positive and significant effect on foreign direct investment (FDI) in Indonesia. Meanwhile, simultaneously, the variables Political Stability and Absence of Violence, Government Effectiveness, and Regulatory Quality have a positive effect on foreign direct investment (FDI) in Indonesia. Although Political Stability and Absence of Violence do not have a direct effect on FDI in Indonesia, other factors such as Government Effectiveness and Regulatory Quality greatly influence investment decisions. Both of these variables can give investors a sense of security and confidence that despite political uncertainty, they can still operate well in Indonesia thanks to supportive government policies and transparent regulations. Therefore, although Indonesia can face political challenges, if the government can improve the effectiveness of government administration and the quality of regulations, this can be a more dominant factor in attracting foreign investment. The Indonesian government needs to focus on ensuring that existing policies and regulations can provide the necessary guarantees for investors to invest and run their businesses smoothly.

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