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Foreign Direct Investment In Indonesia: Economic Growth IKN

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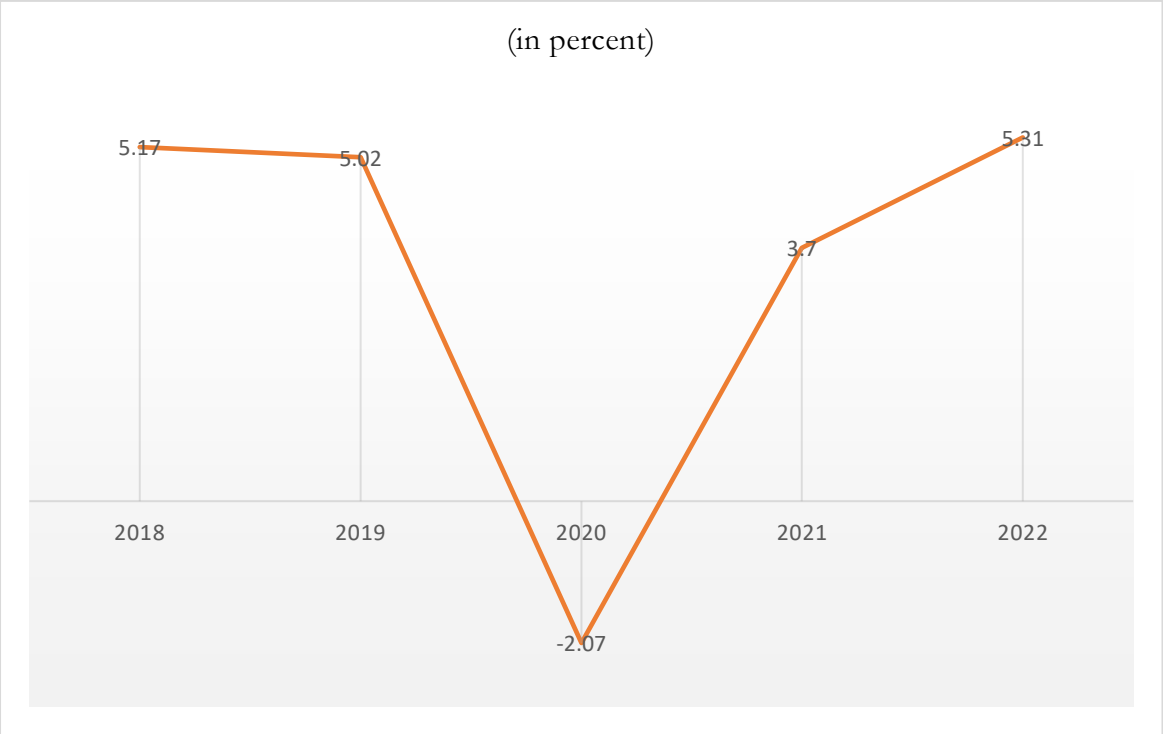
ABSTRACT: IKN is expected to become a sustainable city that will drive the country's economy in Indonesia in the future**.** This research analyses the correlation amidst foreign direct investment, inflation, and environmental degradation with economic growth in IKN. Therefore, this study aims to examine all variables that affect the economic growth of IKN. Thus, this study provides implications for regulators and policymakers on how to optimize IKN's economic growth in a sustainable manner. This analysis utilizes time series data collected from 38 provinces in Indonesia from 2018 to 2022. Secondary data obtained from the websites of the World Bank, BPS, and OECD is utilized in this study. Data testing uses a data panel regression analysis model with Eviews 10 software. The results of this study indicate that Foreign Direct Investment and inflation have a significant positive effect on economic development. Conversely, the environmental degradation has a significant negative impact on economic growth. The findings of this study confirm that economic growth can be enhanced through increasing FDI inflows, maintaining a stable inflation rate, and environmental degradation at a certain level, which can stimulate economic growth. Therefore, all variables in this study contribute to economic growth.

Keywords: FDI, Inflation, Environmental Degradation, IKN

INTRODUCTION

Indonesia plans to move its capital city is being changed from Jakarta to IKN to overcome future challenges. This complies with the ruling of Law Number 3 of 2022 on the Provincial Capital City (Munawaroh et al., 2024). This move made Indonesia a developed and sustainable country with an economy that will enter the world's top five by 2045. In 2023, Indonesia's GDP per capita is estimated at IDR 74,964,701 or US$ 4,919.7, the Indonesian economy experienced a decline in growth from 5.31% to 5.05% (BPS, 2024b). National economic growth will be aided through Cooperation in the ecosystem of three cities: Balikpapan, IKN, and Samarinda. This could boost the regional economy and promote equitable economic growth in the east Kalimantan region until 2045.

Table 1. Gross Domestic Product (GDP) 2018-2023



Source: BPS data 2023 (https://www.bps.go.id)

As a developing nation, Indonesia needs more funds for investment and additional capital with foreign direct investment flows to maintain the community's welfare and create broad employment opportunities (Jan & Ali, 2023). Improving people's welfare aligns with the increase in economic growth (Rahmawati et al., 2021). A country's economic growth rate lets investors know their investment prospects (Fiona & Laulita, 2023). Net foreign direct investment inflows to Indonesia from 2013 to 2022 tend to fluctuate significantly, ranging from $3.92 billion to $23.88 billion. In 2022, foreign direct investment touched $22 billion, an increase of about $0.8 billion compared to the previous year. However, net FDI inflows fell to their lowest point in 2016 at $3.92 billion (World Bank, 2023). The following is the net inflow of FDI into Indonesia from 2013 to 2022, shown in Table 2.

Table 2. FDI inflows to Indonesia from 2013-2022

Year	Net FDI Inflows (in billion US Dollars)
2018	20,58
2019	3,92
2020	16,64
2021	21,81
2022	18,44

Source: World Bank (https://www.worldbank.org/)

Based on data from the Authority of the Capital City Nusantara until December 20, 2023, there were 330 letters of interest in investment Letter of Intent (LoI) that had been received, with 55% being domestic investors and the four most countries that sent LoIs were Singapore, Japan, China,

and Malaysia (Siaran Pers: OIKN 2023). An increase in foreign direct investment can increase productivity and efficient use of resources, making it a key catalyst for economic growth (Shaari et al., 2022). This is supported by Akpan & Eweke (2017), which shows that more significant foreign direct investment positively correlates with increased output productivity. Consistent with the research findings, Emako et al., (2022); Oyegoke & Aras (2020) found that when more FDI enters a country, it also leads to economic improvement. Nevertheless, numerous empirical research examining the effects of foreign direct investment on economic growth yield contradictory results. According to Ingham et al., (2020); Mohamed (2017), FDI inflows harm economic growth.

The Harrod-Domar theory is a theoretical framework that aims to explain economic growth. The Harrod-Domar theory argues that investment and savings of part of the state's income are needed to stimulate economic growth (Oyegoke & Aras, 2020). Harrod-Domar emphasises the importance of allocating part of a country's income to be saved and invested in increasing capital accumulation (Le-Van & Tran-Nam, 2023). This will encourage sustainable and long-term economic growth because the level of public saving is directly associated with the extent of national income. Sugiarto (2019), asserts that investment plays a pivotal position in a country's economic advancement.

From an analytical standpoint, economic growth is impacted by various factors beyond foreign direct investment. Other elements, such as inflation and environmental degradation, contribute to economic growth. Research on foreign direct investment to encourage economic growth of the IKN has yet to be widely studied. Therefore, this research aims to investigate the three variables that may influence the economic growth of IKN. Thus, this study provides implications for regulators and policymakers in optimising the economic growth of IKN sustainably. This research is expected to be serve as a reference resource and consideration for further research on the influence of foreign direct investment and other factors on the economic growth of IKN.

Foreign Direct Investment

Foreign direct investment affects all economic, cultural, and social areas, as FDI is essential to a country's economic growth (Do, 2023). In many developing countries, private capital depends on foreign direct investment, which is anticipated to enhance economic growth (Alfaro, 2017). The presence of foreign investors directly helps the development of IKN. President Jokowi said foreign investors should invest around 80% to cover the budget. However, the fact is that the plan has yet to be realized, so until now, it has been using APBN funds. While several foreign investors have expressed their interest in investing in IKN through letters of intent (LoI), of the 330 LoI received by the IKN Authority, they are subject to a due feasibility test process (Siaran Pers: OIKN, 2023). Therefore, if there is no flow of foreign direct investment into IKN, Indonesia's economic growth may slow. Foreign direct investment has the potential to enhance economic development by fostering higher productivity and the accumulation of capital (Miao et al., 2021). This research is supported by (Dinh et al., 2019; Emako et al., 2022; Fajrian et al., 2023).

H1: FDI on economic growth has a significant positive relationship.

Inflation

One factor that can affect economic growth is inflation. According to empirical data and theory, the correlation between inflation and economic growth remains a debate among numerous researchers (Srivastava et al., 2023). Therefore, it is crucial to comprehend the connection between economic growth and inflation (Manurung & Yuniasih, 2021). Economists sometimes compare inflation and other economic components that can affect economic growth (Girdzijauskas et al., 2022). The more money circulates in society, the weaker the exchange rate and the higher the necessities in the community. The amount of money in circulation is more significant than the community's needs, which can cause inflation (Mahendra et al., 2024). Additionally, the rise in inflation was partly driven by the decision to relocate the national capital to IKN due to the massive development of IKN. According to the Central Bureau of Statistics, inflation in East Kalimantan was higher at 3.28% year on year (yoy) compared to national inflation of 3.05% (BPS, 2024a). Previous researchers have extensively collected empirical evidence to establish the correlation between inflation and economic growth. The impact of inflation on economic growth can vary depending on its magnitude (Kunthi et al., 2023). Therefore, the findings of Husnain et al., (2024) show that higher inflation rates can harm the economy. These results align with the research (Cantika & Anggoro, 2022; Chamdani & Meirinaldi, 2022).

H2: Inflation and economic growth have a significant negative relationship.

Environmental Degradation

Developing countries face the increasingly intricate task of balancing economic development with environmental preservation as they strive to grow their economies without causing harm to the environment (Van et al., 2024). Environmental degradation occurs when the quality of the environment declines due to damage that reduces its function. In recent years, using fossil fuels has led to a substantial rise in carbon dioxide emissions, which could lead to a rise in climate disasters worldwide (Galvan et al., 2022). Therefore, implementing effective and efficient ecological governance measures can reduce the mismatch between environmental degradation and economic growth (Chen & Liang, 2021). One of the programs launched by IKN is the development of a "Sustainable Forest City," where verdant open space will comprise 75% of the area and zero carbon emission design (Gokkon, 2023). Thus, the higher the environmental degradation in IKN, the slower the economic growth rate in IKN. Previous research by K. Saidi & Hammami (2016) stated that environmental degradation was identified as one of the factors affecting economic growth.

H3: Environment degradation and economic growth have a significant negative correlation.

METHOD

The research model upon which this model is based was developed by Husnain et al., (2024) and was modified by adding environmental degradation variables. This study uses quantitative methods to analyze the connection of FDI, inflation, and environmental degradation to the economic growth in IKN. Economic growth, as quantified by annual GDP, is the dependent variable in this

research. The primary independent variable is FDI inflows, measured in millions of dollars. The control variables of this study include the inflation rate determined using the Consumer Price Index (CPI) and the carbon dioxide emission rate used to measure environmental degradation. Data for each variable was acquired from the online platforms of relevant official organizations, such as GDP, FDI, and inflation received from the World Bank and BPS (Hajdini et al., 2023). Meanwhile, environmental degradation was observed in Indonesia's OECD.

Sampling using panel data from 38 provinces in Indonesia with a time series data approach from 2018 to 2022. This time series data is recorded consistently over the period. Panel data regression analysis is used in this research approach. Ariyani and Firmansyah (2023) define panel data regression as a statistical method integrating time series with cross-sectional data to produce more informative, diverse estimates and more efficient models. The most effective method to analyze panel data is the Chow and Hausman tests. The data collected will be analyzed using software like Eviews 10.

RESULT AND DISCUSSION

Panel Data Regression Models

The selection of a regression model for panel data involves several steps and statistical tests to determine the most appropriate model. The three main models commonly used in panel data regression are the Command Effect Model, Fixed Effects Model (FEM), and Random Effects Model (REM). The following are the steps and tests used in selecting a panel data regression model:

Table 1. Panel Data Regression Model Selection

Chow Test	**Statistic**	**df**	**Prob.**
Cross-section Chi-square	88,312318	33	0,0000
Hausman Test	**Statistic**	**df**	**Prob.**
Cross-section random	1,970965	3	0,5785

Source: Eviews 10 output result, 2024

According to Silvia et al., (2021), The Chow test is a technique employed in panel data regression analysis to ascertain the superiority of the FEM over CEM. The Chow test results in Table 1 show that the P-value is smaller than the significance value (0,05). Therefore, the H0 is rejected. As a result, the FEM is an appropriate model for panel data regression.

According to Fiona & Laulita (2023), The Hausman test is used to ensure the optimal model choice between the REM and the FEM. Table 1 presents the Hausman test results, H0 hypothesis is accepted because the probability value of 0,5785 is greater than the significance value of 0,05. This indicates that REM is a more appropriate model than FEM for the data analyzed.

Table 2. Lagrange Multiplier Test Results

Lagrange Multiplier Test	Prob.
Breusch-Pagan	0,0000

Source: Eviews 10 output result, 2024

After determining that REM is the optimal model based on the Hausman test, the next step is to perform the Lagrange Multiplier (LM) test. The LM test is used to test whether CEM is better than REM (Silvia et al., 2021). This test was developed by Breusch and Pagan, because the probability value of the LM test (0.0000) is smaller than 0,05. Therefore, H0 is rejected so REM is a more suitable model.

Normality Test Results

Table 3. Normality Test Results

Jarque-Bera	Probability
265,5660	0,0000

Source: Eviews 10 output result, 2024

According to Prawoto & Basuki (2016), the test for normality determines whether the residuals in the regression model exhibit a distribution. An effective regression model has residuals that follow a normal distribution. According to the results shown in Table 3, the Jarque-Bera test it shows that the probability value (0.0000) is much smaller than the significance level of 0.05. This means that H0 is rejected which states that the residuals are normally distributed.

Multicollinearity Test Results

Table 4. Multicollinearity Test Results

Coefficient Correlations				
Model		**FDI**	**CPI**	**Carbon Emissions**
1	FDI	1,000000	0,037308	0,087314
	CPI	0,037308	1,000000	0,111612
	Carbon emissions	0,087314	0,111612	1,000000

Source: Eviews 10 output result, 2024

The multicollinearity test is used to ascertain the presence of correlation among the independent variables in the regression model. Multicollinearity is indicated when the correlation between independent variables is sufficiently high, typically exceeding 0,90 (Ghozali, 2018). The findings presented in Table 4 suggest in which the correlation exists coefficient among the independent

variables is below 0,90. Consequently, H0 is accepted, implying that the regression model contains no multicollinearity issues among its independent variables.

Heteroscedasticity Test

Table 5. Heteroscedasticity Test Results

Model		Sig.
1	FDI	0,1274
	CPI	0,6927
	Carbon emissions	0,1268

Source: Eviews 10 output result, 2024

According to Silvia et al., (2021), the goal of the heteroscedasticity test is to assess the presence of unequal variances to determine whether there is inequality in the regression model between the residuals of one observation and another. The Glesjer test, as described by Ghozali (2018), can be employed to evaluate heteroscedasticity. The findings, shown in Table 5, indicate that the P-value of each independent variable is higher than 0,05. This suggests that the data is devoid of heteroscedasticity issues.

Autocorrelation Test Results

Table 6. Autocorrelation Test Results

Model	Durbin-Watson
1	1,432628

Source: Eviews 10 output result, 2024

According to Ghozali (2018), in a linear regression model, the Autocorrelation test examines whether there is a correlation between residuals in the period t and residuals in the period t-1. Autocorrelation occurs when consecutive observations in a time series are interrelated. The Durbin-Watson test is used for autocorrelation at the regression model output so that the DU value and less than 4-DU results are obtained where the DU value in this study is 1,5. The 4-DU value is 2,25 so it can be said that 1,5<1,43<2,25. These conditions show that the data is free of autocorrelation problems.

F-Test Result

Table 7. F-Test Result

Variable Dependent	Prob(F-statistic)
GDP	0,0000

Source: Eviews 10 output result, 2024

The F test is utilized to ascertain whether the independent and dependent variables exert a simultaneous influence. The F-test results are shown in Table 7, when the Prob(F-statistic) value

is less than 0,05 it can be interpreted that there is at least one independent variable that has a simultaneous significant effect on the dependent variable. Therefore, this model is applicable for studying economic growth.

Determination Coefficient Test Result

Table 8. Determination Coefficient Test Result

Variable Dependent	R^2	R^2Adj
GDP	0,203261	0,188774

Source: Eviews 10 output result, 2024

The coefficient of determination test quantifies how much the model can account for the variability observed in the independent variable. The coefficient of determination test results shown in Table 8 that the Adjusted R-square value has a value of 0,203261, which indicates that the independent variable affects the dependent variable by 20,33% and other variables not considered in this study affect the remaining part.

Hypothesis Test Result

Table 9. Hypothesis Test Result

Variable	Coefficient	Std.Error	t-Statistic	Prob.
GDP (Y)	10,60362	6,695722	1,583640	0,1157
FDI (X1)	0,000807	0,000187	4,327298	0,0000
CPI (X2)	0,002037	0,000480	4,241682	0,0000
Carbon Emissions (X3)	-0,027690	0,009525	-2,907166	0,0041

Source: Eviews 10 output result, 2024

Hypothesis testing determines whether the hypothesis is accepted or rejected based on population parameters. The results are shown in Table 9, with each independent variable having a P-value below 0,05. Therefore, H1 and H2 have a significant positive effect on economic growth, while H3 has a significant negative impact. The following is an explanation for each hypothesis.

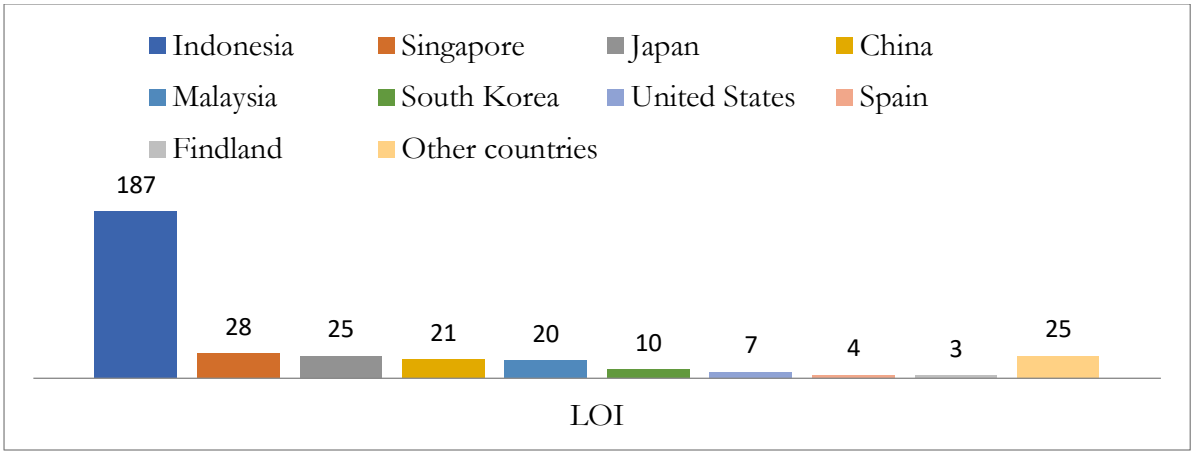
Impact of Foreign Direct Investment on Economic Growth

The results of testing hypothesis 1, shown in Table 9, evidence demonstrate a statistically substantial positive correlation between foreign direct investment and economic growth. The statistical analysis reveals an important finding, as noted in the P-value of 0,0200, lower than the predetermined significance level (α) of 0,05. The results show that a 1% increase in FDI will increase economic growth by 0,0008071% (FDI coefficient = 0,000807). The positive impact can be seen from the positive coefficient effect value, which indicates that economic progress is in line with the increasing inflow of FDI into Indonesia.

Developing countries increasingly recognize the impact of foreign direct investment on their economies (Y. Saidi & Ochi, 2023). Therefore, developing countries require foreign direct

investment to sustain their economic progress and avoid the adverse cycle of inadequate economic development (Emako et al., 2022). The results of this study align with Abdillah et al., (2020) that the flow of funds from developed to developing countries will significantly impact the transfer of technology and knowledge. This contributes to increased economic activity, improved employment prospects, and further economic growth. Simply put, fluctuations FDI inflows and outflows significantly affect economic growth.

Graph 1. Total number of Letters of Intent/LOI at IKN



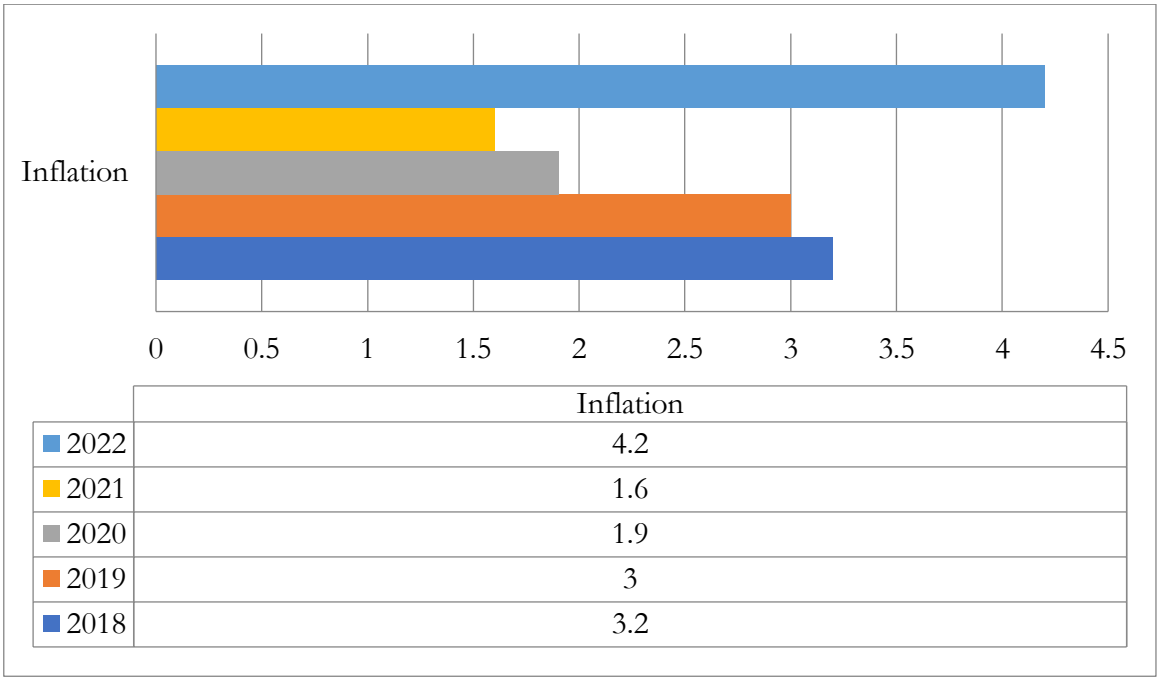
Source: OIKN, 2024 (https://www.ikn.go.id/)

Indonesia's efforts to develop the IKN have attracted foreign investors. The development of IKN is a significant effort that requires large investments and cooperation between the government and business actors. To encourage investment in IKN, the government implemented a policy outlined in Government Regulation 12 of 2023. This policy aims to provide business licenses, streamline business processes, and offer ease of investment to businesses in the city to accelerate the economic growth of IKN. The prospect of significant investment returns and good economic growth conditions attract foreign investors to invest (Oyegoke & Aras, 2020).

The Impact of Inflation on Economic Growth

The results of hypothesis 2 testing in Table 9 indicate that the P-value (0,0000) is smaller than the significance level (0,05). Therefore, the inflation rate has a significant positive impact on economic growth. A 1% higher inflation will lead to a 0,002037% increase in economic growth. The results of this analysis are not in agreement with the hypothesis because the relationship between inflation and economic growth can be different depending on the ongoing economic conditions. This shows that there is a difference between what is assumed in the hypothesis and what is observed in the data. In some cases, inflation may encourage people to spend their money faster, as people fear that the value of their money will decline in the event of inflation. This higher consumption can drive to economic growth (Mahendra et al., 2024). According to Srivastava et al., (2023), it states that price stability as measured by the inflation rate can stimulate economic growth and help maintain people's purchasing power.

Graph 2. Indonesia's Inflation Rate 2018-2022



	Inflation
2022	4.2
2021	1.6
2020	1.9
2019	3
2018	3.2

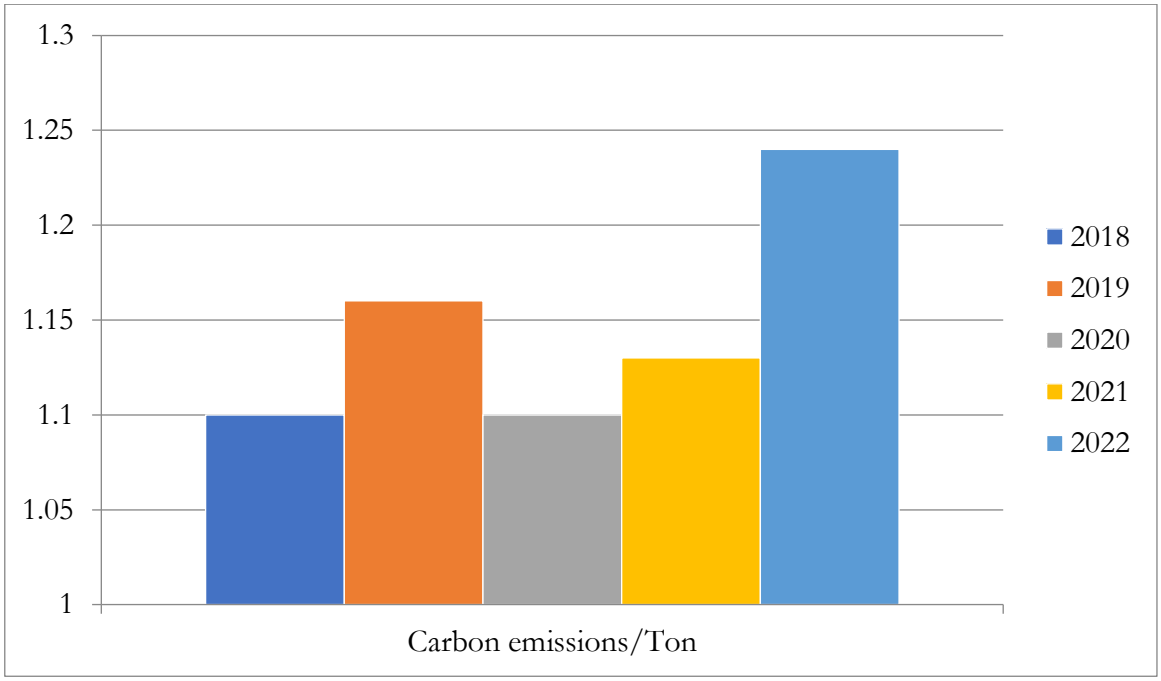
Source: World Bank,2023 (https://www.worldbank.org/)

Indonesia is trying to maintain a stable inflation rate, especially in the context of the construction of the country's new capital city. Proactive measures taken to control inflation can help promote sustainable economic growth. Stable inflation can provide a strong foundation for long-term economic growth. This is consistent with research Budiman & Arifin (2024); Smith (2021) showing that inflation has a positive impact on economic growth in the long run, the positive impact of inflation depends on the level and type of inflation that exists.

The Impact of Environmental Degradation on Economic Growth

The results of testing hypothesis 3 as presented in Table 9, show that the P-value is smaller than the significance value (0,0041 < 0,05). The results of the coefficient value indicate a significant negative impact that causes a decrease in economic growth of -0.027690% for every 1% increase in environmental degradation. Environmental degradation can cause various economic problems, such as decreased productivity, higher health costs, and economic instability. This is in line with Aye & Edoja (2017); Saidi & Hammami (2016), who point out that environmental degradation has a long-term negative impact on economic growth. When the environment is degraded, such as increased carbon emissions, forest destruction, air and water pollution, and soil degradation, it can hinder economic growth.

Graph 3. Carbon emission levels in Indonesia 2018-2022



Source: OECD Data, 2023 (https://www.oecd.org/)

The nexus between environmental degradation and economic growth has attracted the attention of policymakers, practitioners and researchers in recent years. In accordance with the commitment of the new capital city, IKN implements the concept of a zero carbon emission city by 2045. Therefore, Indonesia seeks to achieve sustainable economic growth in the new capital city by considering the impact of environmental degradation. Sustainable economic development must pay attention to environmental conditions in order to maintain the balance of the natural environment for the benefit of future generations, because environmental degradation in the long run has an impact on slowing the rate of economic growth (Warsame et al., 2024). This result is in line with research (Seetanah et al., 2019) which shows that the relationship between environmental degradation and economic growth has a significant negative impact in Small Island Developing States.

CONCLUSION

According to the findings of hypothesis testing in this research, it can be concluded that Foreign Direct Investment, inflation rate, and environmental degradation simultaneously influence economic growth in IKN. Based on the panel data regression model analysis with time series data from 38 provinces in Indonesia from 2018 to 2022. This study shows there exists a strong correlation between FDI and economic development. This suggests that increased FDI has the potential to boost economic growth. Furthermore, this study found that the control variables, especially the inflation, significantly positively affect economic growth in IKN. This indicates that inflation can support economic development. However, environmental degradation negatively affects economic growth in IKN. The findings of this research can improve understanding and

provide a basis for economic policy decision-making in improving economic growth through increasing FDI inflows by at least 80% to stimulate economic growth in IKN. In addition, the Indonesian government should ensure attention to the direct impact of inflation to strengthen sustainable economic growth. Furthermore, policymakers are required to take effective measures in maintaining a balance between economic growth and environmental preservation. Therefore, this can be taken into consideration for future research.

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