ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES

Volume 32(7), 2023

N. Nuzulman[1]
Raja Masbar[2]
B. S. Nazamuddin[3]
M. Shabri Abd. Majid[4]

DOES DEMOCRACY MATTER FOR ECONOMIC GROWTH? EMPIRICAL EVIDENCE FROM INDONESIA[5]

This study aims to empirically examine the mediating effect of investment on the relationship between democracy indices (i.e., civil freedom, political freedom, and democratic institutions) and economic growth across 33 provinces in Indonesia over the period from 2012 to 2020. Using a dynamic panel data regression of the Generalized Method of Moments (GMM) within the path analysis framework, the study found that investment, political freedom, and democratic institutions have promoted Indonesia's economic growth, while civil freedom has deteriorated the economic growth of the country. In addition, investment has partially mediated the effect of the democracy indices on Indonesian economic growth. These results suggest the importance of providing more political freedom and democratic institutions and limiting civil freedom to promote investment and consequently boost economic growth.
Keywords: Democracy indices; investment; economic growth; regional development; Indonesia
JEL: C33; O43; O47; R10; R50

1. Introduction

The wealth and well-being of a citizen are primarily dictated by their democratic life, as democracy allows many things to be accomplished collectively, both economically and politically. A country's democracy and political stability are critical features that have a positive impact on its economic growth (Ahsan, Wang, 2015; Uddin et al., 2017; Zghidi,

[1] *N. Nuzulman, Ph.D Scholar in Economics, Faculty of Economic and Business, Universitas Syiah Kuala (USK) and Lecturer, Faculty of Economics, Universitas Muhammadiyah Aceh (UNMUHA), Indonesia, e-mail: nuzulman06@gmail.com.*
[2] *Raja Masbar, Professor, Faculty of Economic and Business, Universitas Syiah Kuala (USK), Indonesia, e-mail: raja.masbar@unsyiah.ac.id.*
[3] *B.S. Nazamuddin, Associate Professor, Faculty of Economic and Business, Universitas Syiah Kuala (USK), Indonesia, e-mail: nazamuddin@unsyiah.ac.id.*
[4] *M. Shabri Abd. Majid, Professor, Faculty of Economic and Business, Universitas Syiah Kuala (USK), Indonesia, e-mail: mshabri@unsyiah.ac.id (Corresponding author).*
[5] This paper should be cited as: *Nuzulman, N., Masbar, R., Nazamuddin, B. S., Majid, M. S. A. (2023). Does Democracy Matter for Economic Growth? Empirical Evidence from Indonesia. – Economic Studies (Ikonomicheski Izsledvania), 32(7), pp. 34-50.*

2017). Globally, all developed, underdeveloped, and developing countries, such as Indonesia, are continuing to make serious efforts to ensure political stability by providing a conducive democratic atmosphere nationwide as the basic requirement for boosting productive economic activities and attracting more investments that lead to economic growth. Building democratic conditions that are progressively leading to a better direction from time to time has been initiated by establishing a multi-party system in government administration, ensuring the independence of government institutions in carrying out public services, enhancing law enforcement, and providing large space to local government by Indonesia's central government through fiscal decentralization policies.

A good democracy provides the community with certain secured political rights. By safeguarding people's political rights in a certain region, a peaceful and safe environment for investment could also be established, which, in turn, has an impact on economic growth. Furthermore, good democratic treatment promotes good institutional aspects. Thus, a good institution ensures smooth administration and a lean business bureaucratic process and limits corrupt behaviour within the institution that, consequently, creates a conducive business environment and productive economic activities without any legal, security, or other administrative constraints.

The efforts of the Indonesian government to promote better political stability are indicated by an increasing trend in the democracy index during the last decade. The Central Statistics Agency of Indonesia (BPS – Statistics Indonesia, 2021) reported that the democracy index has been rising upwards, indicating better democratic progress since 2001 as the country started adopting a multi-party system and implementing broad fiscal decentralization. However, the overall trend of increasing the democracy index has been ineffective in boosting Indonesia's economic growth. For example, Indonesia's democracy index has increased from 62.72 in 2013 to 73.04 in 2014, but the national economic growth has declined from 6.16 per cent in 2013 to 5.21 per cent in 2014. Similarly, with the democracy index of 72.82 in 2015, the country's economic growth remained declined to 4.88 per cent during the year. Interestingly, when Indonesia's democracy index fell slightly to 70.09 in 2016, the national economic growth slightly grew to 5.03 per cent from the previous year. A similar phenomenon occurred during the 2017 to 2021 period, on average, Indonesia's economy has grown by 5.02 per cent, as the democracy index rose to 74.92.

The above figures indicate that the nature of the relationship between democracy and economic growth has been mixed, both positive and negative. The inconclusive nature of the democracy-economic growth nexus in Indonesia based on visual observations has been an interesting phenomenon to be further investigated. What is the directional relationship between democracy and economic growth in Indonesia? Does better democratic progress lead to the promotion or deterioration of Indonesia's economic growth? This issue is extremely important to be resolved as the different nature of the democracy-economic growth nexus provides different macroeconomic policy implications. This puzzle provides more motivation for our study to empirically discover the democracy-economic growth puzzle using a standardized econometric method over a longer study period from 2012 to 2022 and covering all 33 provinces in Indonesia, hoping to identify the exact relational nature between democracy and economic growth in the fifth largest populous emerging country of Indonesia.

Previous studies on the democracy-economic growth nexus documented that excellent democratic enforcement in an area or country has impacted investor admission and economic growth (Busse, 2003; Jensen, 2008; Moshi, Mwakatumbula, 2017). A strong democratic practice leads to increased national security and the enforcement of the rule of law. The assurance of legal certainty in a country encourages investors to invest since legal certainty is assured. Ray and Ray (2011) found a long-term causal relationship between economic growth and democracy in India. In addition, democracy, economic freedom, and political stability also have a positive impact on economic growth (Bashir, Xu, 2014; Ahsan, Wang, 2015; Vondrová, Fifeková, 2016; Zghidi, 2017; Uddin et al., 2017).

Some previous studies also found a significant relationship between democracy, investment, and economic growth (Zouhaier, Karim, 2012). The democratic regimes were able to reduce the risk of multinational investors, particularly through increased control over the executives (Jensen, 2008). Multinational corporations tend to invest in countries with low civil liberties but high political liberties. However, civil liberties are negatively related to foreign direct investment in 105 countries (Adam, Filippaios, 2007). Countries that promote the freedom of economic activity benefit more from the presence of multinational companies' investments (Azman-Saini et al., 2010) which, in turn, contributes positively to economic growth (Malikane, Chitambara, 2017).

Based on the findings of multiple prior studies, we found that most of the previous studies solely measured democracy through civil freedoms, while only a few previous studies included institutional indices and political rights and their effect on economic growth. Furthermore, past studies only explored the effect of democracy on investment and economic growth directly. None of the previous studies empirically investigated the mediating impact of investment on the relationship between democracy and economic development. Additionally, many previous studies have mainly focused their analyses using aggregate data on developed and developing countries and none of them has focused its analysis on 33 provinces in Indonesia. Thus, this study intends to fill the existing gaps in the literature and provide new empirical evidence by empirically exploring the effect of democracy indices (i.e. civil freedom, political freedom, and democratic institutions) on investment and economic growth across 33 provinces in Indonesia. Thus, our study views the concept of democracy from the perspectives of civil, political, and institutional freedom. Comparing to the previous studies, we use a more holistic measurement for democracy in Indonesia as its practices and evaluation were commonly referred as the official government report covering three indices, namely: civil freedom, political freedom, and democratic institutions (Junaenah, 2015). In addition, considering the potential effect of democracy on economic growth through investment, thus this study empirically assesses the role of investment as the mediator of the democracy-economic growth nexus. However, the non-existence of other indices to fully reflect the practices of democracy in Indonesia, such as press freedom, electoral process and pluralism, functioning of government, political participation and political culture is viewed as one of the limitations of our study.

The findings of the study are hoped to shed some light for policy-makers on designing political macroeconomic stability to further prosper economic development through investment enhancement and good democratic practices. Additionally, the findings of the study are expected to enrich the existing literature on the nexus between democracy, investment, and economic growth from the perspective of the fifth largest emerging populous country Indonesia.

The rest of the study is structured in the following sections. Section 2 reviews the previous related literature on the investigated issue. Section 3 provides the research method as the basis for data analysis. Section 4 highlights the main findings and their discussion. Finally, Section 5 concludes the paper.

2. Literature Review

The nexus between democracy, investment, and economic growth has been investigated by several previous researchers using various econometric models. For example, by using the Vector Error Correction Model (ECM), Ray and Ray (2011) found a long-term causal relationship between economic growth and democracy in India. Democracy is documented to positively affect economic growth. Nomor and Iorember (2017) recorded a positive significant relationship between political stability and economic growth both in the long-term and short-term in Nigeria using the Autoregressive Distributed Lag Model (ARDL) technique. Meanwhile, by adopting the Generalized Method of Moments (GMM) and quantile regression models, Uddin et al. (2017) found political stability as the main determinant of economic growth across 120 developing countries.

Furthermore, using a panel data analysis (fixed effect model), Bashir and Xu (2014) and Ahsan and Wang (2015) found that economic freedom and political stability have a positive significant impact on the economic growth of 117 and 132 countries, respectively. A similar finding is found by Fabro and Aixalá (2012) for the case of 72 countries where economic freedom, civil liberties, and political rights have positive effects on economic growth based on a simultaneous equation model. Using a non-parametric approach, Vondrová and Fifeková (2016) found that economic freedom creates better conditions for improving economic performance in European countries. Zghidi (2017) found a significant positive effect of democracy and political stability on the economic growth of African countries using a Generalized Method of Moments (GMM) model. For the case of 12 transitional economies of the Commonwealth independent states' members, using a data panel analysis, Sandalcilar (2013) found that the political democracy effect on growth in transitional economies is indirectly through its impact on economic democracy.

Furthermore, using a dynamic panel data analysis, Zouhaier and Karim (2012) documented that democracy, investment, and civil liberties have a positive effect on the economic growth of 11 countries in the MENA region. Adam and Filippaios (2007) using the panel data analysis method through the random effects model found that multinational companies tend to invest in 105 countries with low civil liberties but with high political freedom, and civil liberties are negatively related to foreign direct investment. Using a probit regression model, Jensen (2008) documented that democratic regimes reduce the risk of multinational investors, particularly through increasing control over executives in 153 countries worldwide. Countries that promote the freedom of economic activity will benefit more from the presence of multinational companies (Azman-Saini et al., 2010).

Finally, in the study on eight Southern African countries using the GMM estimation, Malikane and Chitambara (2017) find strong democratic institutions as a vital driver of economic growth. Foreign investment that has a direct positive effect on economic growth was highly dependent on the level of democracy in the host countries. Durmaz (2017) found that an improvement in democracy positively impacted foreign direct investment in Turkey using an ARDL technique. Yusuf et al. (2020) found a significant effect of foreign direct investment in promoting the economic growth of the West African sub-region in the long run. Democracy is found to be insignificant for investment and economic growth both in the short-term and long-term. Political instability has an adverse impact on investment and economic growth.

The above-reviewed studies show mixed empirical evidence on democracy, investment, and economic growth nexus. Additionally, many of the previous studies on the issue have used aggregate data at the national level and none of them has focused its analysis using provincial data level in the context of the Indonesian economy. Using 33 provincial data in the Indonesian context, this study hopes to provide a new perspective on the democracy, investment, and economic growth nexus by considering the mediating effect of investment on the relationship between democracy and economic growth using a panel data analysis within the path analysis framework.

3. Research Methods

This study aims to examine the effect of democracy as measured by civil freedom, political freedom, and democratic institutions on investment and economic growth. It also attempts to explore the mediating effect of investment on the relationship between democracy and economic growth across 33 provinces in Indonesia from the period 2012 to 2020. To date, there are 34 provinces in Indonesia. As a newly established province on 25 October 2012, North Kalimantan was excluded from the study due to data unavailability during the study period. This study uses annual panel data, which combines data time series (9 years) and cross sections (33 provinces). The data used in this study is annual secondary data sourced from the official publications of the Central Statistics Agency of the Republic of Indonesia (BPS – Statistics Indonesia).

In this study, as an endogenous variable, economic growth is measured by the percentage change in Gross Regional Domestic Product (GRDP), namely the added value created from various economic activities across 33 provinces in Indonesia. Meanwhile, investment (mediating variable) is measured by a percentage change in total investment. As the exogenous variable, democracy is measured by three indices, namely: civil freedom, political freedom, and democratic institutions. Civil freedom is measured by the level the levels of freedom of assembly and association, freedom of opinion, freedom of belief, and freedom from discrimination. Political freedom is measured by the levels of the right to vote and be elected and the right to political participation in decision-making and government oversight in the form of an index. Finally, the democratic institutions are measured by the levels of free and fair elections, an independent judiciary, the role of the Regional House of Representatives, the role of political parties, and the role of the regional government bureaucracy in the form of the index (BPS – Statistics Indonesia, 2021). Thus, our study uses more holistic indices to measure democracy (i.e., civil freedom, political freedom, and democratic institutions) in Indonesia as its practical evaluation was commonly referred as the official government report. In addition, the three democracy indices used in the study to measure democracy are found to be the most comprehensive democracy measure available in the country, following the study by Junaenah (2015).

In this study, to examine the direct effect of democracy indices on investment and economic growth and the indirect effect of democracy indices on economic growth through investment, the dynamic panel data regression model of the Generalized Method of Moments (GMM) is utilized. Thus, to measure the direct effect of the democracy index on economic growth, the study estimates the following proposed equation:

$$INV_{it} = \beta_0 + \delta INV_{it-1} + \beta_{11}CF_{it} + \beta_{12}PF_{it} + \beta_{13}DI_{it} + \varepsilon_1 \quad (1)$$

$$EG_{it} = \beta_0 + \delta EG_{it-1} + \beta_{21}CF_{it} + \beta_{22}PF_{it} + \beta_{23}DI_{it} + \varepsilon_2 \quad (2)$$

Meanwhile, to measure the indirect or mediating effect of investment on the relationship between the democracy index and economic growth, the following equation is estimated:

$$EG_{it} = \beta_0 + \delta EG_{it-1} + \beta_{31}CF_{it} + \beta_{32}PF_{it} + \beta_{33}DI_{it} + \beta_{34}INV_{it} + \varepsilon_3 \quad (3)$$

where *INV* is the investment, *CF* is the civil freedom, *PF* is the political freedom, *DI* is the democratic institutions, *EG* is the economic growth, *i* is the cross-section Province *i* (*i* = 1,…, N), *t* is the time series of year t (*t* = 1,…, T), β_0 is a constant term, δ is the estimated value of the lag of dependent coefficient, β_{ii} are the estimated regressors, and ε_i are the error term.

The estimation of the GMM model requires several stages of testing to ensure the model is free from misspecification problems to produce valid and consistent results. The GMM model was also tested to be free from serial correlation on the error terms and instrument variables used (Majid, 2008; Majid, 2009). For this purpose, two stages of testing the GMM model were carried out in this study. First, testing the model specifications using the Arellano and Bond (1991) approach to ensure consistency of the estimates obtained from the GMM process. Second, testing the validity with Sargan (1980)'s specification test approach to ensure the estimation parameters are unbiased due to the inappropriate use of instrument variables in the model.

To test the hypothesis of the direct effect of democracy indices on investment and economic growth, the common t-test is used. On the other hand, to test the hypothesis of the indirect or mediating effect of investment on the relationship between democracy indices and economic growth, the study uses the Sobel t-test within Baron and Kenny (1986)'s framework. To estimate the Sobel t-value, the Preacher and Leonardelli (2010)'s Sobel t-test calculator is used.

4. Findings and Discussion

4.1. A Brief Overview of Democracy and Economy in Indonesia

Table 1 illustrates descriptive statistics of democracy indices, investment, and economic growth across 33 provinces in Indonesia over the period from 2012 to 2020. As observed from the table, on average, the democracy indices of civil freedom, political freedom, and democratic institutions were 82.42, 62.09, and 72.52, respectively. These figures showed civil freedom in a very good category, while political freedom and democratic institutions in a good category.

Table 1. Descriptive Statistics

	EG	INV	CF	PF	DI
Mean	4.5813	0.6030	82.4195	62.0947	72.5226
Maximum	21.76	28.61	98.44	86.52	93.98
Minimum	-20.13	-3.62	47.21	28.95	47.25
Std. Dev.	4.0359	2.5713	10.5931	11.9019	10.4593
Observations	297	297	297	297	297

Source: Secondary data, processed using the E-Views Software (2022).

The provinces of North Kalimantan, South Kalimantan, and West Nusa Tenggara recorded the highest civil freedom index (98.44) in 2016, political freedom index (86.52) in 2019, and democratic institutions index (93.98) in 2017. Meanwhile, the lowest civil freedom index (47.21) in 2014, political freedom index (28.95) in 2013, and democratic institutions index (47.25) in 2015 are recorded by the provinces of West Sumatera, Southeast Sulawesi, and Maluku, respectively.

In term of economic performance, the study recorded that, on average, the economic growth and investment growth was 4.58% and 0.60%. The highest economic growth of 21.76% was recorded by the province of West Nusa Tenggara in 2015, while the lowest value of -20.13% was recorded by the province of Papua in 2020. The highest investment growth rate of 28.610% was experienced by the Lampung province in 2012, while the lowest investment growth rate of -0.99% was also recorded by Lampung province in 2015.

The above figures show that the democracy indices, economic growth, and investment have varied across 33 provinces in Indonesia. An unequal level of democracy indices, economic growth, and investment, as indicated by the standard deviation values, should be a concern of the central government of Indonesia to design political economy policy ensuring just political and economic progress nationwide. Equal political and economic progress across the provinces is extremely important to maintain and enhance national stability and unity. The unified national constitutional and legal framework supposedly predetermines the similarity in the degree of democratization across the provinces in the country.

4.2. Generalized Method of Moments (GMM) Specifications

In this study, two models of GMM are estimated. The first model estimates the effect of democracy indices on investment, while the second model estimates the effects of democracy indices and investment on economic growth across 33 provinces in Indonesia over the period from 2012 to 2020. However, before presenting the findings of the GMM estimations, the study initially conducted the consistency (autocorrelation) and instrument validity of the models using the Arellano-Bond (1991) and Sargan (1980) techniques, respectively. The findings of the tests are reported in Table 2.

Table 2. Findings of Consistency and Instrument Validity Tests

Arellano-Bond Test				Sargan Test
Model	Test Order	m-Statistic	Prob.	Prob.
Model 1 Dependent: Investment	AR(1)	-2.6436	0.0082	0.5556
	AR(2)	-1.3882	0.1651	
Model 2 Dependent: Economic growth	AR(1)	-3.3169	0.0009	0.2436
	AR(2)	1.8385	0.0660	

Source: Secondary data, processed using the E-Views Software (2022).

As observed in Table 2, the results of the Arellano-Bond AR1 for Model 1 and Model are found to be significant, implying the inconsistency of the estimated models due to the existence of autocorrelation in the first-order difference error. However, the results of Arellano-Bond AR2 are found to be insignificance at the 5% level for both Model 1 and Model 2. These findings show the consistency of the model due to the inexistence of autocorrelation in the second-order difference error. Thus, the findings show that the dynamic panel model to be estimated in the study has met the criteria for the best model. The last column of Table 3 shows the findings of Sargan (1980)'s specification tests for Model 1 and Model 2. The probability value of the Sargan test was greater than the 5% level, confirming the instrument validity of the estimated models. Thus, these findings show that the proposed estimated Model 1 and Model 2 in the study are consistent and valid.

4.3. Direct Effects of Democracy on Investment and Economic Growth

Having ensured the consistency and validity of the proposed Model 1 and Model 2 based on the Arellano-Bond (1991) and Sargan (1980) tests, the findings from the GMM estimations on the direct effects of democracy indices, namely civil freedom, political freedom, and democratic institutions on investment and economic growth across 33 provinces in Indonesia is, in turns, reported in Table 3.

Table 3. Direct Effect of Democracy Indices on Investment and Economic Growth

Model	Variable	Coefficient	t-Statistic	Prob.
Model 1 (Dependent: Investment)	INV(-1)	0.0700***	15.2035	0.0000
	CF	-0.0875***	-11.2074	0.0000
	PF	0.0793***	12.6404	0.0000
	DI	0.0106*	1.8030	0.0727
J-Stat. = 25.3340; Prob. (J-Stat.) = 0.5557; Instrument rank = 31				
Model 2 (Dependent: Economic Growth)	EG(-1)	0.3938***	22.7827	0.0000
	INV	0.9344***	8.7877	0.0000
	CF	-0.3286***	-54.6049	0.0000
	PF`	0.0802***	11.1110	0.0000
	DI	0.0475***	6.6804	0.0000
J-Stat. = 31.6938; Prob. (J-Stat.) = 0.2436; Instrument rank = 32				

*Note: * and *** show significance at the 10% and 1% levels, respectively.*
Source: Secondary data, processed using the E-Views Software (2022).

As illustrated in Table 3, the study finds that civil freedom negatively influenced both investment and economic growth with the estimated coefficients of -0.0875 and -0.3286 at the 1% significance level. These findings show that a unit improvement in the civil freedom index has led to a decline in investment and economic growth by 0.0875 and 0.3286 units, respectively. Civil freedom has caused a greater impact on investment as compared to economic growth. During the study period, the average civil freedom index across 33 provinces in Indonesia was considered higher amounting to 82.42 (Table 1), showing that Indonesian citizens have been freely involved and participated in many forms of assembly and association. As a result, a series of public demonstrations occurred nationwide in response to unfair government policies. The labour demonstration during the labour-day celebration on May 1 every year involving millions of labour forces across streets in the Indonesian major cities to protest the government policy of paying low minimum wage has caused national instability. Million Muslim citizens went to the streets protesting government policies, such as Muslim discrimination, a sharp increase in the price of cooking oil, the ratification of laws that weaken the Corruption Eradication Commission, ratification of the omnibus law that harms many parties in Indonesia and benefits foreign investors has adversely impacted economic activity in the country.

To overcome the above-mentioned demonstrations, the government has tended to impose strong measures which resulted in the fall of several protesters and some even being imprisoned. These demonstrations have been viewed by foreign investors as unfavourable conditions for foreign investors to invest in Indonesia. Consequently, the higher civil freedom index has caused a decline in investment. In addition, these unfavourable conditions caused by unmanaged civil freedom have also caused Indonesia's economic growth to decline during the study period. This finding is supported by a positive relationship between investment and economic growth across 33 provinces in Indonesia (Table 3). A decline in investment has been detrimental to the national economic growth, and vice versa, the findings similar to Malikane and Chitambara (2017) found a positive effect of foreign investment on economic growth in Southern Africa.

In addition, the increasing number of corruption cases in Indonesia and the complexity of the government bureaucracy have reduced investors' interest to invest their monies in Indonesia. The results of the Corruption Perception Index (CPI) survey in 2021, for example, Indonesia's CPI rose one point to 38 points from the previous year. Indonesia's CPI is still far from the global average CPI score of 43. This shows that the high level of corruption in Indonesia has been partly due to the abuse of public freedoms has had a negative impact on investment and economic growth in 33 provinces in Indonesia. The low level of education and democratic and political literacy of the Indonesian citizens has led to abuse of civil liberties by the state officials and bureaucrats involving in corrupt acts. For example, during the 2009-2022 period, the Financial Transaction Analysis Reporting Center (PPATK) reported that a number of 964 employees working at the Ministry of Finance Office were suspected of having improper assets through money laundering activities with a total value of IDR 349 trillion (Tempo.co., 2023). To carry out investment and business activities in Indonesia, investors and businessmen often have to pay various types of administrative fees and illegal levies, causing high production costs (Mandagie and Damayanti, 2023). Thus, the low investments and economic growth in most of developing countries that have low economic liberalization level, including Indonesia are associated with corruption (Saha et al., 2009;

Bazzaz et al., 2021; Li, Kumbhakar, 2022), which leads to low national economic growth. Some policy-makers and researchers believe that developing countries with a low level of citizens' education should adopt authoritarian regimes for promoting investment and economic development (Knutsen, 2012).

In an atmosphere of high civil liberties, Peters (2005) and Shen and Williamson (2005) argued that democracy tends to be controlled by certain groups in government for special interests. For example, the new Law on Minerals and Coal (Minerba) which was promulgated on 10 June 2020, replacing Law Number 4 of 2009 has made oligarchy become a new threat for corruptors (Fernando et al., 2023). As a result, the policies produced by the government are not in favour of the interests of the wider community. The government policies benefit more big companies and banks in public affairs adversely influenced democracy (Tsakova, 2023). This will have an impact on reducing the amount of investment and slowing economic growth. Business sectors that provide great benefits to society and the country's economy are sacrificed to protect certain business sectors or to protect political interests by gaining votes during general elections.

Our finding is in line with the findings of previous studies. For example, Adam and Filippaios (2007) found that multinational corporations tend to invest in countries with low civil freedom but with high economic liberties. Thus, to attract more investment it is important to continuously promote the freedom of economic activity and trade openness to gain huge benefits from the presence of multinational companies (Azman-Saini et al., 2010; Zakaria, Ahmad, 2011). The negative effect of civil freedom on investment in Indonesia is partly due to the country's exports being dominated by natural resources (Asiedu, Lien, 2011).

Table 3 further reported that political freedom has promoted investment and economic growth in Indonesia with estimated coefficients of 0.0793 and 0.0802, respectively, at the 1% significance level. These empirical results show that an increase in the political freedom index by one unit has led to an increase in investment and economic growth by 0.0793 and 0.0802, respectively. The size of the effect of political freedom on investment and economic growth is found to be relatively similar. As viewed from Table 1, the political freedom index of Indonesia (62.0947) is considered in a moderate category. Since the Soeharto era (known as the new order) from 1966 to 1988 and the reform order from 1989 until 2021, political freedom in the country has significantly improved. The citizens have higher freedom in political activities, such as voting or being voted, including disabled people, a transparent voter list during elections, and a minimum quota of 30% for women sitting as members of the people's representatives at the provincial and national levels (Junaenah, 2015). An improvement in the political freedom of citizens across 33 provinces in Indonesia has promoted investment and national economic growth.

Our findings of the positive relationship between political freedom and investment and economic growth are supported by many previous studies. For example, Zouhaier and Karim (2012) found a positive effect of political freedom on economic growth across 11 countries in the Middle East and South Africa. Economic activities commonly develop rapidly in regions or countries that practice a more democratic political life to support economic growth (Sandalcilar, 2013). Thus, to encourage sustainable economic growth, it is necessary to uphold the political rights and ensure fair electoral democracy all levels of society (Fabro, Aixalá, 2012; Opoku, Acheampong, 2023).

Finally, as observed in Table 3, the study also found a positive effect of democratic institutions on investment and economic growth with the estimated coefficients of 0.0106 and 0.0475 at the 10% and 1% levels of significance, respectively. These results show that an increase in democratic institutions by one unit has led to an increase in investment and economic growth by 0.0106 and 0.0475, respectively. The effect of democratic institutions is found to be greater on economic growth as compared to investment. The presence of democratic institutions would support government macroeconomic policy to allocate sufficient budget for the lower-middle income groups' economic productive activities that promote national targeted economic growth. However, democracy only facilitates economic growth in countries that experience appropriate development due to their ability to create sustained economic growth-enhancing institutions (Sima, Huang, 2023).

After the fall of President Suharto on May 21, 1998, and the reform order started in Indonesia, democratic institutions underwent significant improvements in the country. These include the advancements in free and fair elections, the impartiality of General Elections Commissions both at the central and provincial levels in organizing and administering general elections, fairness in the counting of votes, the role of political parties, and the percentage of women in the stewardship of political parties (Junaenah, 2015). In addition, the role of regional government bureaucracy, and impartiality of civil servants in political activities of political parties in legislative general elections, and the role of an independent judiciary have also been continuously improved (Liddle, 2013). These improvements in the democratic institutions have attracted more investments and consequently contributed to higher economic growth.

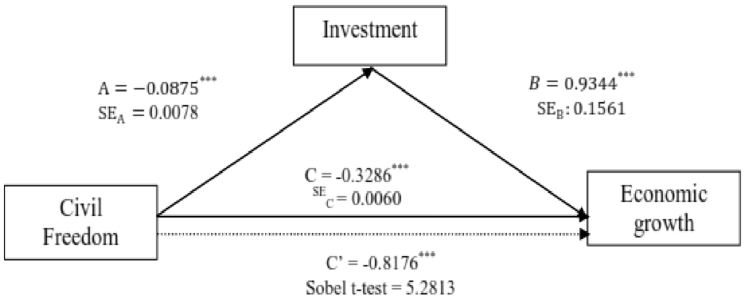
Furthermore, the existence of institutional improvements, especially service institutions related to investment greatly supports investment. A good institution's governance facilitates licensing arrangements for attracting more investment projects that, in turn, contribute to the promotion of economic growth. The positive impact of democratic institutions on investment and economic growth is supported by earlier studies (Busse, 2003; Salahodjaev, 2015; Huang, Ho, 2017; Moshi, Mwakatumbula, 2017). In his study, Busse (2003) found that the average investment by multinational companies is significantly higher in democratic countries with good institutions compared to the countries with poor governance of institutions. Countries with better democratic institutions have attracted more investments into their countries (Moshi, Mwakatumbula, 2017) and have boosted their economic growth (Salahodjaev, 2015). Finally, Huang and Ho (2021) also found a significant causal relationship between democratic government institutions and economic growth.

4.4. Investment as a Mediator of the Democracy – Economic Growth Relationship

Having discussed the direct effects of democracy indices (i.e. civil freedom, political freedom, and democratic institutions on investment and economic growth) in the earlier section, in this section, the study reports and discusses the mediating effects of investment on the democracy indices on economic growth. The Sobel t-test of Preacher and Leonardelli (2010) within Baron and Kenny (1986)'s framework is used to examine the significant mediating effect of investment on democracy-economic growth relationships. The findings of the mediating effects are illustrated in Figures 1, 2, and 3.

As observed from Figure 1, investment is found to have a negative significant mediator of the effect of civil freedom on economic growth at the 1% level. In this context, the investment acts as the partial mediator, implying both direct and indirect effects are active. Civil freedom has directly caused economic growth to decline and indirectly through investment. Unlimited civil freedom in the developing country of Indonesia has led to uncontrolled people's freedom and their involvement in anarchic actions that cause investors to be reluctant to invest in the country and, in turn, had caused a slowdown in economic growth.

Figure 1. Investment as a Mediator of the Civil Freedom – Economic Growth Relationship

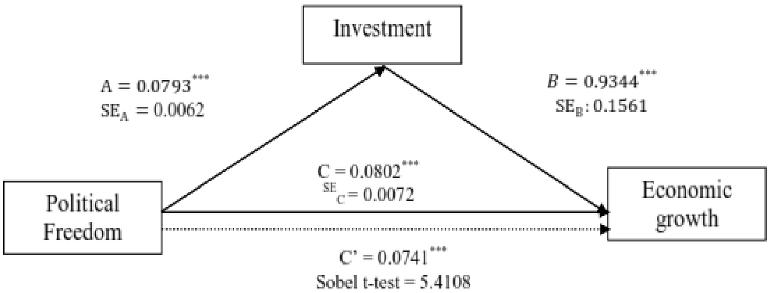


Source: Secondary data, processed using the E-Views Software (2022).

Our findings show that a decline in investment has been detrimental to national economic growth (Malikane, Chitambara, 2017; Dewi et al., 2018; Majid et al., 2019). The investment in the developing country of Indonesia that is associated with corruption (Bazzaz et al., 2021) has led to low national economic growth. In the atmosphere of high civil liberties, Indonesia's democracy is tended to be controlled by certain government groups for special interests (Li, Resnick, 2003) by designing macroeconomic policies in their favour. Economic sectors that significantly contribute to the promotion of economic growth are sacrificed to protect their business entities and their political interests. These, consequently, have negatively impacted the decline in investment and economic growth, similar findings to the previous studies by Azman-Saini et al. (2010), Asiedu and Lien (2011), and Mohsin et al. (2021).

Next, Figure 2 reports the mediating effect of investment on the relationships between political freedom and economic growth. As observed in Figure 2, the investment is found to have a positive significant mediating effect on political freedom and economic growth at the 1% level. The investment acts as the positive partial mediator of the political freedom and economic growth relationships. This is simply due to the positive significant direct effect of political freedom on economic growth and the positive significant indirect effect of political freedom on economic growth through investment. These findings show the importance of promoting political freedom to directly promote economic growth and indirect through enhancing investment.

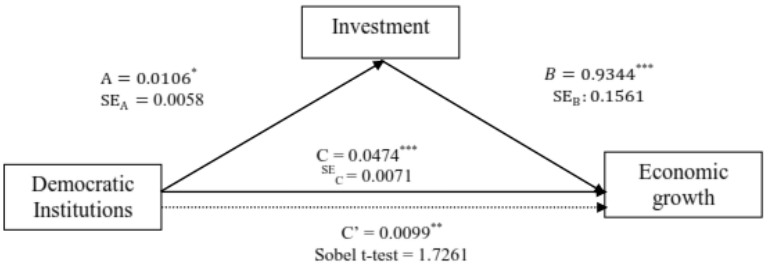
Figure 2. Investment as a Mediator of the Political Freedom – Economic Growth Relationship



Source: Secondary data, processed using the E-Views Software (2022).

Since the new order (1966-1988) and reform order (1989 until to date) era, the political freedom in Indonesia has continuously improved. Better political freedom across 33 provinces in Indonesia has enhanced investment and promoted national economic growth. Our findings are in harmony with previous studies. For instance, Zouhaier and Karim (2012) found a positive contribution of political freedom to the economic growth of 11 Middle Eastern and South African countries. Practising a more democratic political life and upholding political rights within all dimensions of society would promote sustainable economic growth (Fabro, Aixalá, 2012; Sandalcilar, 2013).

Figure 3. Investment as a Mediator of the Democratic Institutions – Economic Growth Relationship



Source: Secondary data, processed using the E-Views Software (2022).

Finally, Figure 3 reports the mediating effect of investment on the relationships between democratic institutions and economic growth. As illustrated in Figure 3, investment is found as a positive significant mediator of the relationships between political freedom and economic growth at the 5% level. This is confirmed by the existence of a positive significant direct effect of democratic institutions on economic growth and the positive significant indirect effect of democratic institutions on economic growth via investment. These findings show that any efforts to promote Indonesia's economic growth could be done directly by enhancing democratic institutions or indirectly through enhancing investment. The ongoing improvements in the practices of democratic institutions since 1998's new order in Indonesia should be supported by strengthening existing regulations to ensure free and fair elections, an active role of political parties and women's representativeness in the stewardship of political parties, a good regional government bureaucracy, and the presence of an independent judiciary system.

Overall, our findings on the significant mediating effect of investment on the relationships between democracy indices (i.e., civil freedom, political freedom, and democratic institutions) and economic growth are supported by the previous studies of Bozkurt et al. (2018) and Nosier and El-Karamani (2018). Democracy has a significant effect on economic growth both directly and indirectly through investment as the mediator. Our findings suggest that to further promote economic growth, Indonesia's government needs to limit and control civil freedom. The government should also continuously improve political freedom, control the oligarchic political system, and enhance democratic institutions. A continuous improvement in democracy through good government governance practices is believed as one of the strategic ways to enhance investment and national economic growth.

5. Conclusion

This study empirically examined the mediating effect of investment on the relationship between democracy indices (i.e. civil freedom, political freedom, and democratic institutions) and economic growth across 33 provinces in Indonesia over the period from 2012 to 2020. Using the GMM estimation within the path analysis framework, the study documented the positive significant effects of political freedom, democratic institutions, and that investment on Indonesia’s economic growth. Meanwhile, civil freedom is recorded to deteriorate the economic growth of the country. Indirectly, the study found that investment has partially mediated the effect of the democracy indices on Indonesia’s economic growth.

Our empirical findings suggest the importance of enhancing political freedom and democratic institutions and limiting civil freedom to attract more investment that consequently promotes national economic growth. To further promote economic growth, Indonesia's government needs to limit and control civil freedom, improve political freedom, control the oligarchic political system, and enhance democratic institutions. Practising good government governance principles in democracy is necessary for enhancing investment and national economic growth.

This study only focuses its analysis on the effects of democracy indices on economic growth through the investment channel across 33 provinces in Indonesia from 2012 to 2020 period. To provide more comprehensive findings on the role of democracy in the economy, future studies might explore the effects of democracy on economic growth through different macroeconomic channels. Future studies could also explore the effect of democracy on various economic performance indicators, such as poverty, income disparity, price stability, unemployment, etc. to enrich the existing empirical findings. In addition, to provide more comprehensive empirical evidences on the effect of democracy on the national economic welfare, future studies are hoped to use more holistic indicators to measure democracy and economic welfare. For instances, future might use an electoral process and pluralism, civil liberties, functioning of government, political participation and political culture as the democracy indicators and use human and social development indices, instead of the real gross domestic product to measure economic welfare.

References

Ahsan, A. Q. T., Wang, M. (2015). Democracy, regime stability and economic growth: A cross country dynamic panel data analysis. – Democracy, 6(12), pp. 23-44. Available at: https://core.ac.uk/download/pdf/234647092.pdf.

Arellano, M., Bond, S. (1991). Some tests of specification for panel data: Monte Carlo evidence and an application to employment equations. – The Review of Economic Studies, 58(2), pp. 277-297. https://doi.org/10.2307/2297968.

Asiedu, E., Lien, D. (2011). Democracy, foreign direct investment and natural resources. – Journal of International Economics, 84(1), pp. 99-111. https://doi.org/10.1016/j.jinteco.2010.12.001.

Azman-Saini, W. N. W., Baharumshah, A. Z., Law, S. H. (2010). Foreign direct investment, economic freedom and economic growth: International evidence. – Economic Modelling, 27(5), pp. 1079-1089. https://doi.org/10.1016/j.econmod.2010.04.001.

Baron, R. M., Kenny, D. A. (1986). The moderator–mediator variable distinction in social psychological research: Conceptual, strategic, and statistical considerations. – Journal of Personality and Social Psychology, 51(6), pp. 1173-1182. https://doi.org/10.1037/0022-3514.51.6.1173.

Bashir, M. F., Xu, C. (2014). Impact of political freedom, economic freedom and political stability on economic growth. – Journal of Economics and Sustainable Development, 5(22), pp. 59-67. Available at: https://core.ac.uk/download/pdf/234646637.pdf.

Bazzaz, N. H. S., Ahmed, S. A., Saeed, Y. J. (2021). Evaluating the effect of improvement of democracy index on economic growth: A study of a selected sample of developing countries. – Review of International Geographical Education Online, 11(5), pp. 3583-3591.

Bozkurt, E., Altiner A., Yılmaz Toktaş. (2018). Democracy and economic growth: Evidence from emerging market economies. – Turkish Studies: Economics, Finance and Politics, 13(14), pp. 15-32. http://dx.doi.org/10.7827/TurkishStudies.13477.

BPS – Statistics Indonesia (2022). Indonesian Democracy Index. Jakarta: BPS.

Busse, M. (2003). Democracy and FDI. – Discussion Paper Series 26260, Hamburg Institute of International Economics. http://dx.doi.org/10.2139/ssrn.384480.

Dewi, S., Majid, M. S. A., Aliasuddin., Kassim, S. (2018). Dynamics of financial development, economic growth, and poverty alleviation: The Indonesian experience. – South East European Journal of Economics and Business, 13(1), pp. 17-30. https://doi.org/10.2478/jeb-2018-0002.

Durmaz, N. (2017). Foreign direct investments, democracy, and economic growth in Turkey. – International Journal of Social Economics, 44(2), pp. 232-252. https://doi.org/10.1108/IJSE-01-2015-0015.

Fabro, G., Aixalá, J. (2012). Direct and indirect effects of economic and political freedom on economic growth. – Journal of Economic Issues, 46(4), pp. 1059-1080. https://doi.org/10.2753/JEI0021-3624460411.

Fernando, Z. J., Illahi, B. K., Putra, Y. S., Gusri, I. (2023). Deep anti-corruption blueprint mining, mineral, and coal sector in Indonesia. – Cogent Social Sciences, 9(1), p. 2187737. https://doi.org/10.1080/23311886.2023.2187737.

Huang, C. J., Ho, Y. H. (2017). Governance and economic growth in Asia. – The North American Journal of Economics and Finance, 39, pp. 260-272. https://doi.org/10.1016/j.najef.2016.10.010.

Huang, C. J., Ho, Y. H. (2021). The impact of governance on economic growth in Malaysia. – The International Journal of the Malay World and Civilization, 9(1), pp. 3-9. https://doi.org/10.17576/jatma-2021-0901-01.

Jensen, N. (2008). Political risk, democratic institutions, and foreign direct investment. – The Journal of Politics, 70(4), pp. 1040-1052. https://doi.org/10.1017/S0022381608081048.

Junaenah, I. (2015). Indonesia Democracy Index (IDI): the effort to encourage democratic provincial government. – International Journal of Social Science and Humanity, 5(5), p. 466. Available at: http://www.ijssh.org/papers/501-V10026.pdf.

Knutsen, C. H. (2012). Democracy and economic growth: A survey of arguments and results. – International Area Studies Review, 15(4), pp. 393-415. https://doi.org/10.1177/2233865912455268.

Li, M., Kumbhakar, S. C. (2022). Do institutions matter for economic growth?. – International Review of Economics, 69(4), pp. 465-485. https://doi.org/10.1007/s12232-022-00400-9.

Li, Q., Resnick, A. (2003). Reversal of fortunes: Democratic institutions and foreign direct investment inflows to developing countries. – International organization, 57(1), pp. 175-211. https://doi.org/10.1017/S0020818303571077.

Liddle, R. W. (2013). Improving the quality of democracy in Indonesia: Toward a theory of action. – Indonesia, (96), pp. 59-80. https://doi.org/10.5728/indonesia.96.0057.

Majid, M. S. A., Dewi, S., Aliasuddin., Kassim, S. (2019). Does financial development reduce poverty? Empirical evidence from Indonesia. – Journal of Knowledge Economy, 10(3), pp. 1019-1036. https://doi.org/10.1007/s13132-017-0509-6.

Majid, M. S. A., Meera, A. K. M., Omar, M. A. (2008). Interdependence of ASEAN-5 stock markets from the US and Japan. – Global Economic Review, 37(2), pp. 201-225. https://doi.org/10.1080/12265080802021201.

Majid, M. S. A., Meera, A. K. M., Omar, M. A, Aziz, H. A. (2009). Dynamic linkages among ASEAN-5 emerging stock markets. – International Journal of Emerging Markets, 4(2), pp. 160-184. https://doi.org/10.1108/17468800910945783.

Malikane, C., Chitambara, P. (2017). Foreign direct investment, democracy and economic growth in southern Africa. – African Development Review, 29(1), pp. 92-102. https://doi.org/10.1111/1467-8268.12242.

Mandagie, M. N. N., Damayanti, A. (2023). Corruption in Indonesian reformed era: Cases of bribery and gratification in bureaucracy. – Law and Political Sciences, 4(1), pp. 1-14. Available at http://www.amcs-press.com/index.php/ijalps/article/view/387.

Moshi, G. C., Mwakatumbula, H. J. (2017). Effects of political stability and sector regulations on investments in African mobile markets. – Telecommunications Policy, 41(7-8), pp. 651-661. https://doi.org/10.1016/j.telpol.2017.07.005.

Mohsin, M., Ullah, H., Iqbal, N., Iqbal, W., Taghizadeh-Hesary, F. (2021). How external debt led to economic growth in South Asia: A policy perspective analysis from quantile regression. – Economic Analysis and Policy, 72, pp. 423-437. https://doi.org/10.1016/j.eap.2021.09.012.

Nomor, T. D., Iorember, P. T. (2017). Political stability and economic growth in Nigeria. – IOSR Journal of Economics and Finance (IOSR-JEF), 8(2), pp. 45-53. https://doi.org/10.9790/5933-0802034553.

Nosier, S., El-Karamani, A. (2018). The indirect effect of democracy on economic growth in the MENA region (1990-2015). – Economies, 6(4), p. 61. https://doi.org/10.3390/economies6040061.

Opoku, E. E. O., Acheampong, A. O. (2023). Energy justice and economic growth: Does democracy matter?. – Journal of Policy Modeling. 45(1), pp. 160-1861. https://doi.org/10.1016/j.jpolmod.2023.01.005.

Peters, B. G. (2005). Governance and public bureaucracy: New forms of democracy or new forms of control?. – Foro Internacional, 45(4), pp. 585-598. https://doi.org/10.1080/23276665.2004.10779282.

Preacher, K. J., Leonardelli, G. J. (2010). Calculation for the Sobel Test: An Interactive Calculation Tool for Mediation Tests [Online software]. http://www.people.ku.edu/~preacher/sobel/sobel.htm.

Ray, S., Ray, I. A. (2011). Regional analysis on the relationship between economic growth and democracy: Evidence from India. – Afro Asian Journal of Social Sciences, 2(2.3), pp. 1-24. Available at: http://onlineresearchjournals.com/aajoss/art/66.pdf.

Saha, S., Gounder, R., Su, J. J. (2009). The interaction effect of economic freedom and democracy on corruption: A panel cross-country analysis. – Economics Letters, 105(2), pp. 173-176. http://dx.doi.org/10.1590/0034-761220190165x.

Salahodjaev, R. (2015). Democracy and economic growth: The role of intelligence in cross-country regressions. – Intelligence, 50, pp. 228-234. https://doi.org/10.1016/j.intell.2015.04.013.

Sandalcilar, A. (2013). Democracy and growth: evidence from transition economies. – American International Journal of Contemporary Research, 3(1), pp. 63-75. Available at: http://www.aijcrnet.com/journals/Vol_3_No_1_January_2013/8.pdf.

Sargan, J. D. (1980). Some tests of dynamic specification for a single equation. – Econometrica: Journal of the Econometric Society, pp. 879-897. https://doi.org/10.2307/1912938.

Shen, C., Williamson, J. B. (2005). Corruption, democracy, economic freedom, and state strength: A cross-national analysis. – International Journal of Comparative Sociology, 46(4), pp. 327-345. https://doi.org/10.1177/0020715205059206.

Sima, D., Huang, F. (2023). Is democracy good for growth?—Development at political transition time matters. – European Journal of Political Economy, 102355. https://doi.org/10.1016/j.ejpoleco.2022.102355.

Tempo.co. (2023). PPATK: Rp300tn Suspicious Transaction at Finance Ministry Not from Corruption. Available at https://en.tempo.co/read/1702552/ppatk-rp300tn-suspicious-transaction-at-finance-ministry-not-from-corruption.

Tsakova, I. (2023). Consequences of global firm domination in the post-democratic European Union (and its member states). – Economic Studies (Ikonomicheski Izsledvania), 32(2), pp. 42-58.

Uddin, M. A., Ali, M. H., Masih, M. (2017). Political stability and growth: An application of dynamic GMM and quantile regression. – Economic Modelling, 64, pp. 610-625. https://doi.org/10.1016/j.econmod.2017.04.028.

Vondrová, A., Fifeková, E. (2016). Impact of economic freedom on economic development: A nonparametric approach to evaluation. – European Scientific Journal, 12, pp. 218-226. https://doi.org/10.19044/esj.2016.v12n10p%25p.

Yusuf, H. A., Shittu, W. O., Akanbi, S. B., Umar, H. M., Abdulrahman, I. A. (2020). The role of foreign direct investment, financial development, democracy and political (in) stability on economic growth in West Africa. – International Trade, Politics and Development, 4(1), pp. 27-46. https://doi.org/10.1108/ITPD-01-2020-0002.

Zakaria, M., Ahmad, E. (2011). Openness and democracy: Some evidence from Pakistan. – Economic Studies (Ikonomicheski Izsledvania), 11(1), pp. 175-185.

Zghidi, N. (2017). Do political stability and democracy increase national growth? Evidence from African countries using the GMM method. – Journal of Global Economics, 5(1), p. 242. https://doi.org/10.4172/2375-4389.1000242.

Zouhaier, H., Karim, K. M. (2012). Democracy, investment and economic growth. – International Journal of Economics and Financial Issues, 2(3), pp. 233-240. Available at: https://dergipark.org.tr/en/download/article-file/362689.