Analysis of the Impact of Economic Factor and Institutional Quality on Economic Growth of APEC Member Countries

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Abstract

The Covid-19 pandemic has significantly impacted the economies of APEC member countries. This impact has been influenced by a paradigm shift in institutional quality. Although there were shift in institutions before the pandemic, it is suspected that the change in institutional paradigms has been more pronounced post-pandemic. Therefore, post-pandemic economic recovery must also prioritize institutional quality aspects. This study aims to analyze the influence of economic factors, including Foreign Direct Investment (FDI), Consumer Price Index (CPI), and taxes, as well as institutional quality factors, including the Voice and Accountability Index (VAA) and Rule of Law Index (RoL), on economic growth of APEC member countries from 2017-2022. The study employs panel data regression analysis using a fixed effect model approach, incorporating dummy variables to distinguish between the pre-and-post Covid-19 periods. The findings indicate that among both economic and institutional quality factors, only Foreign Direct Investment and Consumer Price Index show significant positive results both before and after the Covid-19 pandemic. Governments in APEC member countries need to open opportunities for Foreign Direct Investment and maintain the stability of goods and services post-pandemic to stimulate economic growth. Improving institutional quality post-Covid-19 is necessary to foster economic growth, which is expected to achieve economic growth in the future.

Key Words: *Economic Factor, Institutional Quality, Economic Growth, Panel Data Regression*

INTRODUCTION

Economic growth remains a crucial indicator of a country's development success. According to Kuznets (1973) as cited in Widianatasari et al., (2021) economic growth is defined as a country's ability to provide goods and services to meet the economic needs of its population over the long term. This capability, as per his view, evolves along with the ideological perspectives adopted, the quality and capability of a country's institution, and technological advancements. Mankiw, (1989)

posits that measure of country's economic growth is the increase in Gross Domestic Product (GDP), which reflects the income generated by individuals within an economic activity. Numerous factors contribute to a country's economic growth. Jhingan, (2011) identifies factors such as the availability of natural resources, the availability of human resources, and non-economic factors like institutional quality as significant influence on a country's economic growth.

Based on a country's income level, the World Development Indicator, 2006 (Hasan, 2022) classifies countries into three categories; low-income economies, middle-income economies, and high-income economies. However, according to Muttaqin, (2019), the United Nation does not always classify high-income countries loke Saudi Arabia, Qatar, Kuwait, and Brunei Darussalam as developed countries, but rather as developing ones. This classification is based on the fact these these countries's income levels heavily on a singe commodity, and thet have restively low standards of education and healthcare (Todaro & Smith, 2006).

The Indonesian Economic Report (2022) indicates that the economic growth rates of developed countries such as the United States, European Nation, and Japan did not exceed 3,5% during the period from 2022 to 2023. In contrast, global economic growth was estimated to reach only 2,3% in 2023, with projected decline to 2,9% in 2024. However, when examining the economic growth rates of emerging market countries, the average growth rate during the same period was recorded at over 6% (Bank Indonesia, 2022).

Over time, the countries within the Asia-pacific Economic Cooperation (APEC) have contributed approximately 62% of global economy and 48% of global trade (Li, 2023) However, following the COVID-19 pandemic crisis, both global economic and the economic growth of APEC countries experienced a downturn. Graph 1 illustrates the comparison between global economic growth and the economic growth APEC countries.

Table.1 Comparison of Global Economic Growth with APEC Member Countries 2015-2020

Year	Economic Growth (%)	
	World	APEC
2015	3,17	3,19
2016	2,83	3,1
2017	3,39	3,62
2018	3,37	3,39
2019	2,6	2,72
2020	-3,29	-3,55
Average	2,01	2,08
Average	2,01	2,08

Source: Bank Indonesia, 2022, data processed

Table 1 shows that before the COVID-19 pandemic, the economic growth rate of APEC member countries was higher than the global economic growth rate. However, during the pandemic, the economic growth rate of APEC member countries fell below the global economic growth rate. On average, the economic growth rate of APEC member countries has been higher than the global economic growth rate. Therefore, to improve the economic

conditions of APEC member countries post-pandemic, efforts are needed to boost economic growth by enhancing factors that influenced this growth.

Investment is a crucial component supporting economic growth alongside consumption, government expenditure, and net exports. Investment is a key factor in the accumulation of physical capital, thereby enhancing growth rates. According to Todaro & Smith, (2006), one of the most influential determinants of investment in boosting a country's economic growth is Foreign Direct Investment (FDI). As part of the economic globalization process, FDI facilitates international economic access and technological exchange between countries, leading to investment flows from one nation to another (Suharsih 2023). According to Anwar, (2016) countries compete to enhance their investment attractiveness, aiming to draw multinational companies to invest within their borders. The influx investment from multinational companies is expected to boost a country's FDI, contributing to national development through technology transfer, managerial expertise exchange, and asset transfers. Additionally, Febriana, (2014) states that FDI can create job opportunities ultimately reducing unemployment rates.

One key aspect to understand in order to increase FDI is a country's policies on attracting and managing incoming FDI. A stable and conducive investment and political climate is one of the factors that attract FDI inflows Alfaro et al., (2007). It is also clear that the quality of government services related to investment openness significantly influences FDI flows. If the services provided for investment openness are good, investors will be attracted to invest; otherwise, they will not. Based on this, it can be concluded that one effort to attract foreign investors through FDI is the organization and management of the quality of institutions in a country. In other words, good institutional quality that is friendly to investment in flows will automatically increase both local and foreign investment levels.

In new institutional economics theory, it is stated that institutions significantly impact a country's economic performance. Good institutions are expected to reduce transaction costs, uncertainty, and other forms of obstacles (Yustika, 2006). Similarly, Acemoglu et al., (2004) argue that economic growth is influenced by the quality of institutions, as good institutions enable the efficient allocation of a country's resources. To justify the level of FDI expected to enhance economic growth, Oktaviani et al., (2019) suggest that high-quality institutions can reduce transaction cost associated with incoming FDI, attract investments that increase productivity, and ensure investor security. Ramadhan (2019) argue that government performance and quality of its institution foster economic growth by establishing effective system. The aim of good governance is to manage a country resources more effectively, promoting sustainable economic development. Thus, good institutional quality and regulations, low corruption levels, and controlled political stability can potentially boost investment inflows into a country, helping to achieve growth targets (Widianatasari et al., 2021).

In addition to attracting FDI and improving institutional quality, another key strategy for government to enhance economic growth increasing tax revenue which ultimately boots government spending productivity. Tax revenue significantly influence a country's income level. Research by Adriansyah (2014), shows a positive correlation between taxes and economic growth. Similarly, Patrick et al (2013) previously noted that taxes derived from

international trade transactions can positively impact economic growth.

Based on the above discussion, it is crucial understand the economic growth rates in APEC member countries by further examining factors influencing them, including institutional quality, investment, taxes, and other potential factors, especially in the post-COVID-19 era. Therefore, FDI, presumed as development capital, institutional quality seen as a blend of government policies in managing economic performance, the level of tax revenue, and other economic factors are expected to affect the economic growth rates of APEC member countries. Thus, this study aims to; 1) analyze the impact of FDI on the economic growth of APEC member countries from 2017-2022; 2) analyze the influence of institutional quality, taxes, and inflation on APEC member countries from 2017 to 2022. These objectives will explore whether discrete factors such as COVID-19 have influenced economic growth from both institutional and economic perspectives.

LITERATURE REVIEW

Economic Growth and Institution

To accurately assess the rate of economic growth, its is essential to employ various comprehensive methodologies. Mankiw (1989), states that economic growth can be gauged by the increases in gross domestic product (GDP), which represent the total value of goods and services produced within a country by all economic units over a certain period. The economic growth rate achieved by a country is significantly affected by the economic political policies it adopts. This suggest that the quality of a country's institution and managerial practices plays a crucial role in shaping its economic development performance, as evidenced by the economic growth rate (Yustika 2006).

Todaro & Smith, (2006), further clarify that investment is a key driver of growth, capable of producing increasing returns to scale and thus contributing to income disparities among nations. This notion suggests that variations in investment levels across countries will lead to differing economic growth rates. Consequently, the theory emphasizes the government's role in offering public infrastructure, conducive environments, and regulatory frameworks to bolster investment. Increased investment, facilitated by government support, will eventually lead to capital accumulation, which turn will directly boost the economic growth rate.

From a Keynesian standpoint, taxes play a crucial role in determining government spending levels. It is particularly noteworthy that Keynesians believes tax reductions for lower-income groups can boost aggregate income and thus drive economic growth. This concept consistent with supply-side theory, which argues that lowering individual income taxes will promote increased investment and productions, leading to enhanced economic growth. Similarly, the optimal tax theory emphasizes the need to establish an optimal tax rate for both residents and investors. This optimal rate should generate adequate government revenue without impeding economic growth (Patrick,2013).

Inflation, viewed as an external factor, is significant in shaping a nation's economic growth trajectory. Typically, low inflation rates are believed to foster robust economic growth. This belief stems from the idea that lowest process encourages greater consumption of goods and services, thereby stimulating economic activity. On the contrary, elevated inflation, evidenced by escalating process of good and services, tent to dampen consumer spending, potentially leading to economic downturns. Furthermore, hight inflation levels can introduce uncertainty, which might hinder investment. To maintain inflation at desirable levels, it is essential to uphold balanced and effective structural elements such as institutional quality, productivity, and market stability (Oktaviani et al., 2019).

Furthermore, Acemoglu et al., (2004), argue that variations in institutional quality within a country significantly impact its prosperity. High-quality institutions create stable structures, ensure asset ownership, provide legal certainty, enhance security, and reduce market uncertainties. A central aspect of this theory is the guarantee of property rights, which implies that economic activities can proceed smoothly and securely only when ownership right are well defined. Consequently, the theory concludes that superior institutional quality fosters efficiency and productivity, leading to the rapid accumulation of capital, achieving desired economic growth targets, and ultimately improving societal welfare. Harutyunyan, Bagrat&Valadbigi (2012) also posits that the quality of institutions is intrinsically linked to the rule of law, meaning the equitable enforcement of legal regulations for all involved parties. This suggests that legal certainty, as manifested through robust legal institutions, foresters public trust and is anticipated to boost economic growth.

METHODOLOGY AND DATA

This study utilizes a descriptive quantitative approach with a panel data model. These research covers 21 APEC member countries over the period from 2017 to 2022. Data is sourced from the World Bank, including economic indicators (economic growth, FDI, taxes, and inflation) as well as non-economic indicators (voice and accountability and rule of law). The data analysis method utilizes is panel data regression with a fixed effect model approach. To ensure the accuracy of the interpreted data, it must first undergo and pass classical assumption test, including: 1) the autocorrelation test; 2) the multicollinearity; 3) the heteroskedasticity test. Employing panel data methods allows for more accurate parameter estimates, reduce selection bias, and models both fixed and random effect. This study utilizes panel data analysis to achieve a deeper and more relevant understanding of the determinants of economic growth and their impact on the unemployment rate in APEC member countries.

The research model speciation involves incorporating both economic and non-economic factors. This approach consistent with the studies by Yusuf (2018), and Widianatasari et al., (2021). A dummy variable is included to account for the periods before and after the COVID-19 pandemic. The purpose of this dummy variable is to identify significant differences in the regression result of the independent and dependent variables before and after the pandemic. The equation model used in this study is as follows:

$$EG_{it} = \beta_0 + \beta_1 lnFDI_{it} + \beta_2 lnCPI_{it} + \beta_3 lnTAX_{it} + \beta_4 lnVAA_{it} + \beta_5 lnRoL_{it} + \beta_6 DV_t + \varepsilon_{it}$$

In this study, do the economic and non-economic factors has to impact the economic growth (EG) in APEC member countries. Economic factors such as FDI is refer to foreign direct investment, CPI as consumer price index, and TAX is referred to taxes. Then, non-economic factor such as VAA is refer to voice and accountability, and RoL as rule of law in all APEC member countries. To standardize the units of each variable, the econometric equation must transform into its natural logarithm form. Before this transformation, since natural logarithms.

RESULT AND DISCUSSION

Descriptive Analysis

The economic growth targets are affected by a combination of economic and non-economic elements. As discussed earlier, the economic factors under examination encompass FDI, taxation, and inflation. Concurrently, non-economic factors such as voice and accountability, along with the rule of law, are also taken into account. Figure 1 graphically presents the evolution of these indicators across APEC member nations spanning the period from 2017 to 2022, aiming to offer a clear descriptive overview of economic trends. Then, when examining the inflation rate both before and after the COVID-19 pandemic, it is noted that it did not exhibit negative growth. This can be observed in the following Figure 2. Apart from economic indicators, other factors anticipated to impact economic growth concerning institutional quality include voice and accountability (VAA) and rule of law (RoL). Figure 3 depicts the average trends of VAA and RoL indices across APEC member countries from 2017 to 2022.

Based on Figure 1, it can be observed that in 2018, both the average FDI growth and tax revenues experienced significant declines. However, a different trend emerged in 2019, with both FDI and tax revenues showing increases, though these were not sufficiently significant. As daily COVID-19 cases began rise in 2020, FDI growth and tax revenues contracted notably. In 2021, as an initial step towards economic recovery, FDI growth responded to various policies implemented by APEC member countries, showing a significant increase, where tax revenues did non. The emergence of new COVID-19 variants led to another contraction in FDI growth in 2022, although tax revenues recorded a slight increase, albeit not significant. According to Figure 2, the year 2020 marked the period with the lowest inflation rate 1,89% during the analysis. This decline in inflation was attributed to the overall weak economic growth across APEC nations, reflecting subdued economic activity and reduced flow of goods and services. Nevertheless, government policies implemented by APEC countries began to stimulate economic recovery, evident in rising inflation rates from 2021 to 2022. According to Figure 3, the VAA index values for APEC member countries have shown an upward trajectory, increasing from 3,59 in 2017 to 3,66 in 2022. This suggests an overall enhancement in societal participation, civic engagement, and media accessibility across this nation. Similarly, the RoL index has also shown slight increase, rising from 3,15 in 2017 to 3,16 in 2022. This upward trend indicates that most APEC member countries have implemented and maintained effective legal systems.

Panel Model Selection

According to Gede & Sunengsih (2019), as referenced in Faisal&Diartho (2020), panel data regression involves analysing data that combines cross-sectional and time series data to examine relationships between dependent and independent variables. In this study, the fixed effect model (FEM) was chosen for estimation, based on prior test including the Chow-test and Hausman-test. The Chow-test helped determine whether to use the common effect model or the fixed effect model; if the Cross-section- F probability was less than 0,05%, the fixed effect model was s selected, followed by the Hausman-test. If the Cross-section F probability exceeded 0,05, the common effect model was chosen, followed by the Langrangian multiple-test. The result of the Chow test conducted in this study are presented in Table 2.

Table 2. *Chow-Test*

Effect Test	Statistic	d.f.	Probability
Cross-section F	2,340635	(18,89)	0,0046

Source: Author data processed

From Table 2, it is evident that the Cross-section F probability is 0,0046, indicating a value below 0,05. Consequently, the fixed effect model was selected, and the next step involves conducting a Hausman-test to compare it with the random effect model. The finding of the Hausman-test conducted in this research are detailed in Table 3.

Table.3 *Hausman-Test*

Effect Test	Statistic	d.f.	Probability
Cross-section F	17,4289	6	0,0078

Source: Author data processed

According to table 3, the Cross-section F probability is 0,0078, indicating a value below 0,05. Thus, the fixed effects model was selected. Before interpreting the data, it is crucial to ensure they meet classical assumptions. Given the use of the fixed effects model for estimation, classical assumption testing is restricted to assessing heteroskedasticity and multicollinearity (Kuncoro, 2003).

In fixed effect model panel data regression, it is essential to conduct two classical assumptions; heteroskedasticity and multicollinearity. As per Ghozali (2018), the heteroskedasticity test aims to assess whether there is uniformity in variance among residuals across observations, ensuring homoscedastic data. Meanwhile, the multicollinearity test examines potential correlation among the independent variables employed in the model. Tolerance for data correlations is acceptable if the Variance Inflation Factors (VIF) values are below 10 or 0,85. Then, Heteroskedasticity testing in this study utilizes the Glejser-test., which regress the absolute residuals of independent variables against their dependent variable. A regression model is deemed free from heteroskedasticity if the probability of the residuals of independent variables against the dependent variable exceeds the error tolerance level (probability of independent variable exceed 0,05). Table 4 indicates that the residual probability for each independent variable exceed 0,05, indicating the absence of heteroskedasticity in the data. The result of the Glejser heteroskedasticity test are displayed in Table 4. Following this, the analysis will focus on assessing the correlation between each variable using the multicollinearity test. According to Table 5, all corelation coefficients among the variables are below 0,85. This suggest that there is no issue of multicollinearity in the data used.

Panel Data Regression with Fixed Effect Model Approach

The interpretation of the regression data using the fixed effect model, which has been confirmed to meet classical assumptions, is detailed in Table 6. According to table 6, the dummy variable (DV) probability is 0,000, indicating distinct values between pre-COVID-19 and post-COVID-19 periods, where 1 represent before and 0 after the pandemic. The positive DV coefficient implies that economic and non-economic conditions were generally better before the pandemic than after the pandemic. A parallel decline is evident in the economic growth of APEC member countries.

Upon analysing the probability values of each independent variable, it is evident that only three variables have probabilities less than 0,05; FDI, CPI, and VAA, with coefficient 1,9485; 22,811, and 2,750 respectively. This indicates that a 1% increase in FDI (representing investment levels) leads to a 1,94% increase in economic growth. Similarly, a 1% rise in CPI result in a 22% growth in economic output. Additionally, a 1% increase in VAA corresponds to 2,75% increase in economic growth. There finding align with a previous research by Daniele & Marani, (2006) and Widianatasari et al., (2021), which highlighted the significant positive impact of, FDI, CPI, and VAA on economic growth.

Furthermore, based on the F-statistic probability value of 0.0003, it can be concluded that all the variables used can explain the estimation model simultaneously. Meanwhile, the coefficient of determination value of 0.5029 indicates that the variation in the independent variables can explain 50.29% of the dependent variable, while the remainder is explained by other variables not included in the model. This finding is consistent with research conducted by Yusuf (2018) and Windianatasari (2021), where the combination of economic and non-economic variables in the model effectively explains the variation in the dependent variable, namely economic growth.

Moreover, considering the F-statistic probability value of 0.0003, it is evident that all variables used collectively explain the estimation model. The coefficient of determination, 0.5029, indicates that the independent variables account for 50.29% of the variation in the dependent variable, with the remainder attributed to unaccounted variables. This aligns with findings from Yusuf (2018) and Widianatasari et al., (2021), highlighting that both economic and non-economic variables in tandem explain variations in the dependent variable, economic growth.

CONCLUSSION

Based on the analysis conducted, it is evident that economic factors such as FDI, CPI, and VAA exert significant positive effect in economic growth in APEC member countries, both pre-and- post-COVID19 pandemic periods. These factors directly influence economic growth through their impact on invest and the volatility of goods and services, particularly evident in the aftermath of the pandemic when economic activities slowed down substantially. Conversely, tax policy dies not exhibit significant influence on economic growth, indicating that the economy recovery of APEC member counties post-COVID-19 has not been robust enough to yield substantial economic growth from tax revenues. Moreover, the non-economic factor, is rule of law show no significant impact on economic growth, suggesting that institutional improvements in APEC countries affect economic growth only over the long term, given the lengthy process required to overhaul and regulate institutional quality.

Based on the study's finding, the researcher proposes several recommendations. Firstly, concerning economic factors, it is essential for government in APEC member countries to prioritize attracting investment, particularly FDI, post COVID-19. This can be achieved by enhancing the investment climate through streamlined process, faster permit issuance, and fair tax policies. Additionally, sustaining the volatility of goods and services is crucial as it significantly contributes to economic growth. Supporting consumer consumption with subsidies for essential goods is one viable approach.

Secondly, government should address tax policies, pivotal for nation revenue, by considering the ability of both the public and business to pay taxes post-COVID-19. Given the ongoing recovery, tax relief and amnesties could help stimulate economic growth by easing financial burdens.

Lastly, focusing on institutional quality, government should embark on long-term reforms, such as regulatory enhancements, media transparency, civic participation in governance, and freedom association. These steps are crucial for ensuring institutional factors contribute effectively to economic growth in the future.
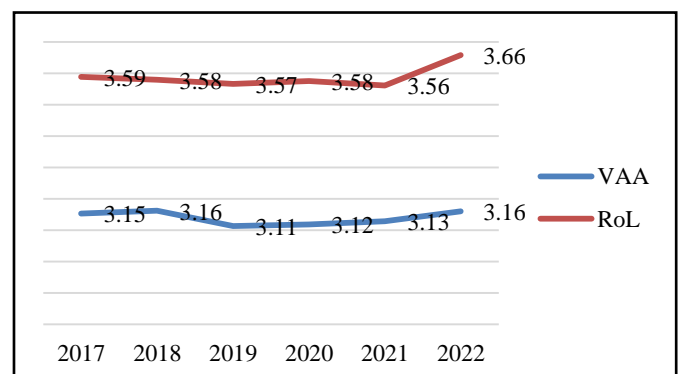
APPENDIX
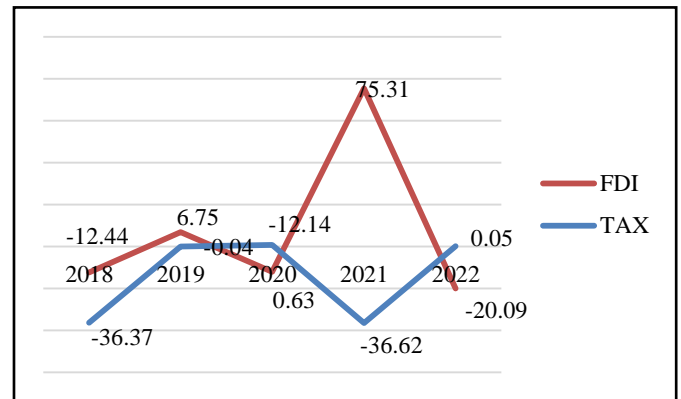
Source: World Bank 2023, data processed

Figure 1. The Average of Growth of FDI and Tax of APEC Member Countries 2018-2022
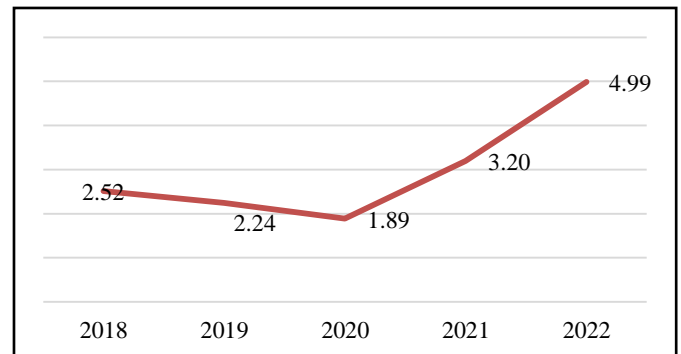
Source: World Bank 2023, data processed

Figure 2. The Average of Inflation of APEC Member Countries 2018-2022

Source: World Bank 2023, data processed

Figure 3. The Average of VAA and RoL of APEC Member Countries 2018-2022

Table 4. Heteroskedasticity Test

Variable	Probability
LVAA	0,1710
LROL	0,5692
LFDI	0,9091
LCPI	0,2337
LTAX	0,7491

Source: Author data processed

Table 5. Multicollinearity Test

	LVAA	LROL	LFDI	LCPI	LTAX
LVAA	1.000000	0.542993	0.026813	0.317134	0.173450
LROL	0.542993	1.000000	0.286610	0.657458	0.132154
LFDI	0.026813	0.286610	1.000000	0.039507	0.197513
LCPI	0.317134	0.657458	0.039507	1.000000	0.096351
LTAX	0.173450	0.132154	0.197513	0.096351	1.000000

Source: Author data processe

Table 6. Estimation Result with Fixed Effect Model Approach

Variable	Coefficient	t-statistic	Probability
Constanta	-163,1895	-3,8302	0,0002
Voice and Accountability	2,7507	0,3288	0,0074
Rule of Law	0,2041	0,0209	0,9833
Foreign Direct Investment	1,9845	3,7579	0,0003
Consumer Price Index	22,8119	2,9334	0,0043
Tax	0,1004	0,1995	0,8423
DV	3,3002	4,8239	0,0000
R-squared	0,5029		
F-Statistic	3,7522		
Prob (F-statistic)	0,00003		

Source: Author data processed

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