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## Foreign Direct Investment and Economic Growth in Indonesia: A Literature Review of Contribution Mechanisms and Effectiveness Factors

**Jancen Roland Patty**[1*]

[1] Department of Accounting, Politeknik Negeri Ambon, Ambon, Indonesia

[*] *Corresponding author: Jancen Roland Patty (yansenpatty@gmail.com)*

### Abstract

Economic growth is a fundamental indicator of national development because it reflects improvements in production capacity, income generation, and economic welfare. This study aims to analyze the relationship between foreign direct investment and economic growth in Indonesia, identify the contribution mechanisms of foreign direct investment in promoting economic growth, and examine the factors that determine the effectiveness of foreign direct investment based on previous empirical findings. This research employs a literature review method with a descriptive qualitative approach by analyzing relevant national and international journal articles related to foreign direct investment and economic growth. The findings indicate that foreign direct investment generally contributes positively to economic growth by increasing capital availability, improving productivity, strengthening technological capabilities, and supporting industrial transformation. However, the effectiveness of foreign direct investment depends on complementary factors, including human capital quality, institutional conditions, macroeconomic stability, and domestic industrial readiness. The study concludes that optimizing the role of foreign direct investment requires not only attracting foreign investment inflows but also strengthening domestic economic capabilities to achieve sustainable and inclusive growth.

### Keywords

Economic Growth, Foreign Direct Investment, Human Capital, Literature Review.

## 1. Introduction

Economic growth is widely recognized as one of the primary indicators of a country's development performance because it reflects the ability of an economy to expand the production of goods and services over time. Sustainable economic growth demonstrates that available resources are utilized more efficiently, leading to higher national income, greater employment opportunities, improved living standards, and stronger economic competitiveness. As economies continue to develop, increasing production capacity becomes essential to support long-term development and social welfare. Consequently, governments seek to maintain positive economic growth as an important measure of macroeconomic stability and national prosperity (Makki & Somwaru, 2004). Positive growth also creates a favorable business environment that attracts both domestic and international investors, thereby strengthening the productive sectors of the economy (Amdan & Sanjani, 2023).

Among various sources of investment, Foreign Direct Investment (FDI) has received considerable attention because it provides not only financial capital but also technological innovation, managerial expertise, and international market access. Unlike portfolio investment, FDI enables foreign firms to establish long-term business operations in host countries, facilitating technology transfer, productivity improvements, and human capital development. Through these channels, FDI is expected to increase production efficiency and stimulate sustainable economic growth. Previous studies have emphasized that FDI contributes to economic development by transferring capital, advanced technology, and organizational knowledge that enhance industrial competitiveness (Bintoro, 2022; Gandhi et al., 2022). Similarly, Djulius et al. (2019) found that foreign investment, together with domestic investment, supports manufacturing value added, which ultimately contributes to Indonesia's economic growth.

Recognizing the strategic role of FDI, the Indonesian government has introduced various policies to improve the investment climate, including deregulation, institutional reforms, and broader access to investment opportunities across economic sectors. These efforts aim to increase foreign capital inflows and accelerate national economic development. Nevertheless, fluctuations in FDI inflows continue to occur because investment decisions are influenced by macroeconomic conditions, institutional quality, exchange rate movements, globalization, and geopolitical uncertainty (Kartika & Ambya, 2023; Randa, 2023; Zaza et al., 2025). Moreover, the effectiveness of FDI in promoting economic growth depends on supporting factors such as human capital, trade openness, and economic policies (Islami et al., 2024; Ismail et al., 2025). These conditions indicate that attracting FDI alone may not automatically generate higher economic growth unless it is accompanied by an enabling economic environment.

Although numerous studies have examined the relationship between FDI and economic growth, the empirical evidence by Dewi and Sarfiah (2022), Gandhi et al. (2022), and Wang et al. (2022) remains inconclusive. Several studies reported that FDI positively influences economic growth because it enhances productivity and increases productive investment. In contrast, Sabir et al. (2019) and Islami et al. (2024) argued that the contribution of FDI depends on complementary factors, including institutional quality, macroeconomic stability, and the absorptive capacity of the host economy. Furthermore, previous studies by Bintoro (2022) and Randa (2023) have predominantly focused on identifying the determinants of FDI, while studies by Regina (2022) and Rahayu (2023) mainly examined factors affecting economic growth. However, relatively limited attention has been given to directly investigating the contribution of FDI to Indonesia's economic growth using recent economic conditions. This inconsistency in findings and the limited evidence for Indonesia constitute the research gap addressed in this study.

The novelty of this research lies in its specific focus on evaluating the direct influence of FDI on Indonesia's economic growth by synthesizing recent theoretical and empirical developments concerning FDI and economic performance. Unlike previous studies that primarily investigated the determinants of FDI or analyzed multiple macroeconomic variables simultaneously, this study emphasizes the contribution of FDI as the main explanatory variable in supporting Indonesia's economic growth. By concentrating on this relationship, the study is expected to provide a clearer understanding of the economic significance of foreign investment and enrich the empirical literature concerning FDI-led growth in the Indonesian context. This study aims to analyze the relationship between FDI and economic growth in Indonesia, identify the contribution mechanisms of FDI in promoting economic growth, and examine the factors that determine the effectiveness of FDI in supporting sustainable economic development.

## 2. Literature Review

### 2.1. Economic Growth

Economic growth refers to the long-term increase in a country's capacity to produce goods and services, resulting in higher real national income and improved living standards. According to Kuznets (1973), economic growth is characterized by a sustained increase in per capita output accompanied by structural and technological transformations that improve production efficiency. Similarly, Ivic (2015) emphasized that economic growth reflects the expansion of productive capacity and serves as a fundamental prerequisite for economic development. The most widely used indicator of economic growth is the growth rate of Gross Domestic Product (GDP), particularly real GDP, because it measures changes in the value of goods and services produced within an economy after adjusting for inflation. An increase in real GDP indicates stronger economic performance and higher production capacity, whereas a decline suggests weaker economic activity and lower productive efficiency.

Various economic, institutional, and social factors influence economic growth. Capital accumulation, labor productivity, technological innovation, human capital development, investment, and macroeconomic stability are widely recognized as key determinants of sustainable economic growth (Batrancea et al., 2022; Harsono et al., 2023). In addition, research and development activities, renewable energy utilization, and foreign direct investment have become increasingly important drivers of long-term economic performance because they enhance productivity, technological progress, and production efficiency (Fang et al., 2022; Kanval et al., 2024). Strong economic growth is essential for national development because it increases employment opportunities, raises household income, reduces poverty, and strengthens fiscal capacity for public investment and social welfare programs. Therefore, maintaining sustainable economic growth remains a major policy objective for both developed and developing countries seeking inclusive and long-term economic prosperity (Samara et al., 2024).

### 2.2. Foreign Direct Investment

Foreign Direct Investment (FDI) refers to a long-term investment made by a foreign entity in a business located in another country to obtain a lasting interest and exercise significant managerial control. Unlike portfolio investment, FDI involves direct ownership and active participation in business operations, allowing investors to transfer financial capital, technology, managerial expertise, and production knowledge to the host country (Joo & Shawl, 2023). FDI generally takes several forms, including greenfield investment, mergers and acquisitions, and the expansion of existing foreign-owned enterprises. Danzman and Meunier (2023) explained that although these forms differ in their mode of market entry, they share the common objective of establishing sustainable business activities and strengthening productive capacity within the host economy. FDI has become one of the most important sources of external financing for developing countries seeking to accelerate industrialization and economic integration.

Several economic and institutional factors, including institutional quality, macroeconomic stability, financial development, market size, trade openness, and geopolitical conditions determine FDI inflows. Khan et al. (2024) found that countries with effective governance, transparent regulations, and stable economic environments are more likely to attract foreign investors because these conditions reduce investment risk and increase business confidence. Likewise, Nguyen (2022) argued that financial development enhances the ability of host countries to absorb foreign capital and maximize its economic contribution. Furthermore, Appiah et al. (2023) reported that FDI promotes capital accumulation, industrial development, employment creation, and productivity improvement, while Ganda (2022) emphasized that foreign investment also facilitates technological innovation and supports sustainable economic performance. Despite these advantages, Yu and Wang (2023) warned that FDI may generate challenges, including profit repatriation, environmental degradation, regional inequality, and vulnerability to geopolitical uncertainty. Therefore, governments should establish effective investment policies to maximize the developmental benefits of FDI while minimizing its potential risks.

## 3. Methods

This study employed a literature review method with a descriptive qualitative approach to analyze the impact of FDI on economic growth in Indonesia. This research design was selected because the study aimed to identify, evaluate, and synthesize previous empirical findings regarding the contribution of FDI to economic growth rather than testing causal relationships using primary data. Through a literature review approach, this study examines how FDI contributes to economic performance through various mechanisms, including capital accumulation, technology transfer, employment creation, export expansion, and productivity improvement. Furthermore, this approach enables the identification of factors that influence the effectiveness of FDI in supporting economic growth, such as human capital quality, institutional conditions, macroeconomic stability, and domestic industrial readiness.

The population of this study consisted of scientific publications discussing the relationship between FDI and economic growth. The reviewed sources included national and international journal articles, academic publications, and other relevant scientific references related to investment and economic development. The literature selection was based on several inclusion criteria, including, studies discussing FDI and economic growth, studies providing empirical or theoretical explanations regarding the role of FDI in economic development, publications from credible academic sources, and studies relevant to Indonesia or developing countries with similar economic characteristics. Publications that were unrelated to the research topic, duplicate studies, and sources without sufficient academic information were excluded from the review process.

Data collection was conducted using a documentation method by gathering relevant secondary data from academic databases and digital libraries. The literature search was performed using keywords such as “Foreign Direct Investment”, “FDI”, “economic growth”, “investment”, and “Indonesia”. Relevant studies were obtained from academic platforms, including Google Scholar, Scopus, ScienceDirect, SpringerLink, Taylor & Francis Online, Emerald Insight, and other reputable sources. After the identification process, the selected studies were reviewed for relevance to the research objectives, methodological clarity, and contribution to understanding the relationship between FDI and economic growth.

The collected data were analyzed using descriptive qualitative content analysis. The analysis process involved identifying the main findings, comparing results across studies, and synthesizing the evidence into several thematic categories. The first theme focused on the relationship between FDI and economic growth, including empirical evidence regarding the positive or conditional effects of FDI. The second theme examined the impacts of FDI on economic growth through capital formation, technology transfer, employment opportunities, exports, and industrial development. The third theme analyzed the factors determining the effectiveness of FDI, including human resources quality, institutional quality, macroeconomic stability, and domestic industrial structure. Through this analytical process, the study developed a comprehensive understanding of the role of FDI in promoting economic growth in Indonesia.

## 4. Results

### 4.1. Relationship between Foreign Direct Investment and Economic Growth

The synthesis of previous studies indicates that FDI generally has a positive relationship with economic growth, particularly in developing countries. The reviewed literature shows that FDI contributes to economic growth by increasing capital availability, expanding productive capacity, improving technological capabilities, and strengthening industrial development. However, the magnitude of its contribution varies across countries depending on economic conditions, institutional quality, and the capacity of domestic sectors to absorb foreign investment. Several studies emphasize that FDI should not be viewed merely as an external source of capital, but also as a mechanism that facilitates productivity improvement and long-term economic transformation (Wang et al., 2022; Joo & Shawl, 2023; Kurniawan et al., 2025).

Empirical evidence from Indonesia consistently demonstrates a positive contribution of FDI to economic growth. Dewi and Sarfiah (2022) found that FDI had a positive and significant effect on Indonesia's economic growth during the period 1990–2020, with a significance value of 0.0024 and a long-term coefficient of 0.083180. Similarly, Kartika and Ambya (2023) revealed that increasing FDI inflows contributes to higher economic growth by stimulating domestic production activities. These findings are supported by Gandhi et al. (2022), who showed that FDI plays an important role in promoting economic growth through capital formation and productivity improvement, although the magnitude of its impact differs between Indonesia and Singapore due to differences in economic structures and investment environments.

The literature also highlights that the relationship between FDI and economic growth is not always automatic but depends on complementary economic factors. Djulius et al. (2019) found that the interaction between FDI and domestic investment positively affects manufacturing industry value added in Indonesia, indicating that foreign investment generates greater economic benefits when supported by strong domestic industrial linkages. Similar findings were reported by Appiah et al. (2023), who demonstrated that FDI contributes to industrial development by improving capital accumulation and production capacity. Furthermore, Nguyen (2022) emphasized that financial development strengthens the ability of host countries to utilize FDI effectively, while Islami et al. (2024) highlighted the importance of human capital in maximizing the growth-enhancing effects of foreign investment.

Although most reviewed studies confirm the positive role of FDI, several studies suggest that its contribution depends on the quality of the investment environment. Bintoro (2022) and Randa (2023) showed that FDI inflows in Indonesia are influenced by macroeconomic and structural factors, indicating that economic stability and favorable investment conditions are important prerequisites for attracting sustainable foreign investment. Moreover, Wang et al. (2022) argued that FDI may generate both complementary and competitive effects on domestic investment depending on the characteristics of the host economy. Therefore, the literature synthesis suggests that FDI has a significant potential to promote economic growth in Indonesia, but its effectiveness depends on the interaction between foreign capital inflows and domestic economic capabilities.

### 4.2. The Contribution of Foreign Direct Investment to Economic Growth

The synthesis of previous studies reveals that FDI contributes to economic growth through several important mechanisms, including capital formation, technology transfer, employment creation, export expansion, and industrial development. The reviewed literature indicates that the economic benefits of FDI are not limited to additional financial resources but also involve broader improvements in production capacity, competitiveness, and economic transformation. Therefore, FDI acts as a catalyst that strengthens both short-term economic activities and long-term development processes (Ganda, 2022).

First, FDI contributes to economic growth through capital formation and increased economic financing. The inflow of foreign capital provides additional financial resources for developing countries to overcome domestic capital limitations and support productive investment activities. Dewi and Sarfiah (2022) found that FDI positively influences economic growth in Indonesia because foreign investment increases the availability of capital for economic activities and strengthens domestic production capacity. Similarly, Wang et al. (2022) explained that FDI can complement domestic investment by stimulating capital accumulation and expanding productive sectors. However, the effectiveness of capital inflows depends on the ability of the host economy to integrate foreign investment with domestic economic activities.

Second, FDI contributes to economic growth through technology and knowledge transfer. Multinational companies often bring advanced technologies, modern production systems, and managerial knowledge that can improve productivity in host countries. Ganda (2022) emphasized that FDI is closely associated with technological innovation because foreign investors facilitate the diffusion of knowledge and production techniques. This finding is supported by Ismail et al. (2025), who highlighted that technology transfer from foreign companies enhances domestic industrial efficiency and strengthens global competitiveness. Thus, the presence of foreign firms can accelerate technological upgrading and improve the productivity of local industries.

Third, FDI supports economic growth through employment creation and human capital development. Foreign companies generate new employment opportunities, particularly in manufacturing, services, and other productive sectors. In addition, foreign firms often provide training programs that improve workers' skills and capabilities. Islami et al. (2024) found that human capital plays an important role in strengthening the impact of FDI on economic growth because a skilled workforce increases the ability of domestic economies to absorb foreign technologies and managerial practices. Therefore, the contribution of FDI to employment is not only reflected in the quantity of jobs created but also in improvements in workforce quality.

Fourth, FDI contributes to export expansion and international market integration. Foreign companies generally have wider access to global markets, allowing host countries to increase export capacity and participate in international production networks. Kurniawan et al. (2025) demonstrated that FDI, together with trade openness, contributes to economic growth by strengthening international economic activities. Similarly, Ismail et al. (2025) explained that foreign investment, particularly in export-oriented industries, can improve trade performance by increasing production capacity and expanding market access.

Fifth, FDI promotes industrial development through stronger linkages between foreign and domestic sectors. The presence of foreign companies can generate multiplier effects by increasing demand for local suppliers, supporting related industries, and improving industrial competitiveness. Djulius et al. (2019) found that the interaction between FDI and domestic investment positively affects manufacturing industry value added in Indonesia, indicating that foreign investment creates greater economic benefits when supported by strong domestic industrial networks. Furthermore, Appiah et al. (2023) confirmed that FDI contributes to industrial development by improving productivity, capital accumulation, and economic capacity. The literature synthesis indicates that FDI contributes to economic growth through multiple interconnected channels. However, the magnitude of these contributions depends on complementary factors, including institutional quality, human capital capacity, macroeconomic stability, and the readiness of domestic industries to utilize foreign investment effectively.

### 4.3. Factors Determining the Effectiveness of Foreign Direct Investment

The synthesis of previous studies indicates that FDI's contribution of FDI to economic growth is determined not only by the amount of foreign capital inflows but also by the host country's economic and institutional conditions of the host country. The reviewed literature demonstrates that the effectiveness of FDI depends on several complementary factors, including human capital quality, institutional and regulatory conditions, macroeconomic stability, and domestic industrial readiness. These factors determine the ability of a country to absorb, utilize, and transform foreign investment into sustainable economic growth (Randa, 2023).

First, human capital quality is identified as an important factor influencing the effectiveness of FDI. The reviewed studies show that countries with higher levels of education, skills, and workforce productivity are better able to absorb foreign technologies, managerial knowledge, and production practices introduced by multinational companies. Islami et al. (2024) found that human capital strengthens the relationship between FDI and economic growth because skilled workers improve the capacity of domestic industries to utilize foreign investment effectively. Similarly, Kanval et al. (2024) emphasized that human capital formation enables countries to maximize the benefits of FDI by supporting technological adoption and improving productivity. These findings suggest that foreign investment will generate greater economic benefits when supported by adequate workforce capabilities.

Second, institutional quality and regulatory conditions play a critical role in determining investment effectiveness. The literature indicates that strong institutions, transparent regulations, and effective governance create a more attractive investment environment by reducing uncertainty and operational risks for foreign investors. Sabir et al. (2019) demonstrated that institutional quality has a significant relationship with FDI inflows, as countries with stronger institutional frameworks tend to attract more sustainable foreign investment. Similarly, Khan et al. (2024) found that regulatory quality and governance stability increase investor confidence and enhance the economic contribution of FDI. Therefore, institutional improvement is necessary to ensure that foreign investment generates long-term economic benefits rather than only temporary capital inflows.

Third, macroeconomic stability is an essential condition for maximizing the contribution of FDI to economic growth. Stable inflation, predictable exchange rates, and consistent fiscal and monetary policies reduce investment uncertainty and encourage long-term foreign investment decisions. Randa (2023) found that macroeconomic variables significantly influence FDI inflows in Indonesia, indicating that economic stability is an important consideration for foreign investors. In addition, Zaza et al. (2025) highlighted that geopolitical uncertainty can negatively affect FDI decisions because increased risk reduces investor confidence. These findings suggest that maintaining economic stability is crucial for ensuring sustainable foreign capital inflows.

Fourth, the readiness of domestic industrial structures determines how effectively FDI contributes to economic development. The literature reveals that FDI creates stronger economic impacts when foreign companies are integrated with domestic industries through supply chains, production networks, and business linkages. Djulius et al. (2019) found that the interaction between FDI and domestic investment positively affects manufacturing industry value added in Indonesia, demonstrating that foreign investment generates broader benefits when supported by strong domestic industrial capabilities. Furthermore, Appiah et al. (2023) showed that FDI contributes to industrial development by improving production capacity and strengthening economic activities in related sectors. The literature synthesis demonstrates that FDI does not automatically lead to higher economic growth. Instead, its effectiveness depends on the interaction between foreign investment and domestic supporting conditions. Countries with stronger human capital, reliable institutions, stable macroeconomic conditions, and developed industrial structures are better able of convert FDI inflows into sustainable economic growth.

## 5. Discussion

The results of this literature review indicate that FDI plays an important role in supporting economic growth in Indonesia through several interconnected mechanisms, including capital accumulation, technology transfer, employment creation, export expansion, and industrial development. The findings confirm the theoretical perspective that FDI is not merely an external source of financing but also a channel for transferring productive resources that can improve economic capacity. This finding is consistent with Dewi and Sarfiah (2022), who found that FDI has a positive and significant effect on economic growth in Indonesia, indicating that foreign capital inflows contribute to strengthening productive activities. Similarly, Gandhi et al. (2022) explained that FDI contributes to economic growth by increasing capital availability and supporting improvements in production efficiency. Therefore, the contribution of FDI to economic growth is not only reflected in additional investment value but also in its ability to stimulate broader economic transformation.

The positive relationship between FDI and economic growth identified in this study also highlights the importance of capital formation as one of the main pathways through which foreign investment influences economic performance. The reviewed studies suggest that FDI helps overcome domestic capital limitations by providing additional financial resources for productive sectors. However, the effectiveness of foreign capital depends on the ability of the host economy to integrate FDI with domestic economic activities. Wang et al. (2022) emphasized that FDI can complement domestic investment by encouraging capital accumulation and expanding production capacity, although excessive dependence on foreign investment may create challenges if domestic industries are unable to compete. This finding is supported by Djulius et al. (2019), who demonstrated that the interaction between FDI and domestic investment strengthens manufacturing value added in Indonesia. Thus, the economic benefits of FDI are maximized when foreign capital is supported by strong domestic economic structures.

Furthermore, the findings show that technology transfer and knowledge diffusion are important mechanisms explaining how FDI contributes to long-term economic growth. Foreign companies generally introduce advanced technologies, managerial practices, and production systems that can improve domestic productivity. However, the ability to absorb these benefits depends on the quality of human resources and technological readiness in the host country. Islami et al. (2024) found that human capital strengthens the role of FDI in promoting economic growth because skilled workers are better able to utilize foreign technologies and managerial knowledge. In line with this argument, Ganda (2022) highlighted that FDI contributes to technological innovation and productivity improvement, suggesting that countries with stronger absorptive capacity can obtain greater economic benefits from foreign investment.

The discussion also reveals that the impact of FDI on economic growth is influenced by institutional quality, macroeconomic stability, and investment conditions. Although FDI provides significant economic opportunities, foreign investors consider regulatory certainty, governance quality, and economic stability when making investment decisions. Sabir et al. (2019) found that institutional quality has a significant influence on FDI inflows because effective institutions reduce investment risks and increase investor confidence. Similarly, Randa (2023) demonstrated that macroeconomic factors affect FDI attractiveness in Indonesia, indicating that stable economic conditions are essential for maintaining sustainable foreign investment. These findings imply that policies aimed only at increasing FDI inflows are insufficient without improvements in institutional capacity and macroeconomic management.

The results indicate that the contribution of FDI to economic growth is strongly related to the readiness of domestic industrial structures. FDI generates greater economic spillovers when foreign firms are connected with local suppliers, domestic industries, and export networks. Appiah et al. (2023) found that FDI supports industrial development by improving productivity and strengthening economic activities in related sectors. Likewise, Ismail et al. (2025) emphasized that FDI can enhance competitiveness, expand exports, and create employment opportunities through integration with global markets. Therefore, the findings of this review suggest that Indonesia should focus not only on attracting foreign investment but also on improving domestic capabilities to ensure that FDI generates sustainable and inclusive economic growth.

## 6. Conclusion

This literature review concludes that FDI has a positive contribution to economic growth in Indonesia through several mechanisms, including capital formation, technology transfer, employment creation, export expansion, and industrial development. However, the impact of FDI is not determined solely by the amount of foreign capital inflows but also depends on supporting conditions, such as human capital quality, institutional effectiveness, macroeconomic stability, and domestic industrial readiness. These findings imply that policymakers should not only focus on attracting foreign investors but also strengthen domestic capabilities to maximize the long-term benefits of FDI. Improving workforce skills, regulatory quality, and industrial competitiveness is essential to ensure that FDI contributes to sustainable and inclusive economic growth.

This study has several limitations. As a literature review, the analysis relies on secondary data from previous studies, which limits the ability to directly measure the current magnitude of FDI's impact on Indonesia's economic growth. In addition, differences in research methods, periods, and economic contexts among previous studies may influence the consistency of findings. Future research is recommended to conduct empirical analyses using updated macroeconomic data and more comprehensive models by incorporating moderating factors, such as institutional quality, human capital, technological readiness, and industrial capacity. Such studies can provide deeper insights into the conditions under which FDI generates optimal contributions to Indonesia's long-term economic development.

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