



# An Analysis of the Causal Relationships between Economic Development, Good Governance and Political Stability in Malaysia

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Globally it has been accepted that good governance through effective government institutions, and political stability, have a positive impact on the economic growth and development of a country. The primary objective of this paper was to analyse the causal relationships for Malaysia, between economic development measured as GDP per capita and predicting variables including effective governance, government spending, corruption control and political stability. A quantitative econometric modelling methodology was utilized for the determination of long and short-run relationships using an ARDL model. The results indicated that no long-run existed between the variables, but in the short-run, government spending and political stability had significant impacts on economic development. Also, the results from the short-run Toda and Yamamoto causality analysis, indicated that all the predicting variables caused changes in GDP per capita, while none of the variables caused changes in effective governance. Government spending is caused by effective governance, and political stability, while corruption control, and effective governance cause political stability. The results of this study, as well as the empirical review, indicate that economic development is caused and driven by quality institutions via effective government, sustainable government spending, corruption control and political stability. Government policy should therefore keep this in mind in policy formulation.

**Key words:** *economic development, econometric analysis, good governance, malaysia, political stability.*



## Introduction

“Institutions are the underlying determinant of the long-run performance of economies” (North, 1990). Well performing government systems, with quality institutions, may attract more investment. This could lead to economic growth by minimizing “red tape” regulations and ensuring the protection of the pillars of democracy such as protection of property rights. According to Dellepiane-Avellaneda (2010) there is consensus that good effective governance is a pre-requisite for economic development, leading to sustained improvements in the general living standards in a specific country. Weaver (2010) agrees and states that good governance is a “necessity” for development, in fact he further states “no good governance, no development”. The primary objective of this research is to analyze the causal relationships between economic development, good governance and political stability in Malaysia. Effective government and quality public institutions play critical roles in economic growth and development (World Bank, 2000). Furthermore, effective government is a critical component of political stability (Abdellatif, 2003; Grindle, 2007; Ramuhulu & Chiranga 2018). Effective government is required to at least have fiscal discipline, focus on a decentralized system of governance, be responsible in the provision in the needs of the people and lastly, ensure policy certainty for growth and development (Andrews, 2008).

Literature within the research paradigm indicates limited analysis of the relationships between development, effective governance, corruption and political stability in recent years, although overall, a large volume of research with empirical results exist. The mixture of variables included in this study and analyzed in a time series econometric model, has not been the focus of many studies and indicates a gap in the research. Malaysia has been selected as the study region due to the relatively high growth rate of the country over the last twenty years and the overall improvement in socio-economic indicators. Malaysia is classified by the UN as an upper-middle income developing country (UN, 2017). Over the last four decades, Malaysia has achieved rapid and inclusive growth with real GDP growth averaging at 6.4% since 1970. The Malaysian economy has become more diversified, open and modern. The economy has also proven to be more resilient in the face of external shocks. The 11<sup>th</sup> Malaysia development plan (2016 to 2020) has its focus on inclusiveness (Koen, et al. 2017; Raza, et.al 2018). Table 1 below is a summary of some of the most important socio-economic indicators for Malaysia. Most of the indicators indicate a significant improvement of the economy and the general environment in Malaysia. For example, income inequality has improved, HDI has moved above the 0.8 level and life expectancy has moved to above 75 years on average. Socio-economic development indexes have also improved at a rapid pace for example, the Economic Freedom Index lists Malaysia

as 22<sup>nd</sup> in the world, 23<sup>rd</sup> in terms of the Global Competitiveness Index and 46<sup>st</sup> in terms of the Happy Planet Index. Malaysia has a score of 47 out of 100 in the Global Corruption Control Index, 0.84 out of 2.5 for the Effective Governance Index and a low score of 0.16 out of 2.5 in the Political Stability Index. The country has however moved backwards regarding the Global Entrepreneurship Index (from 43 in 2012 to 32.7 in 2017).

**Table 1:** Key indicators: Malaysia

Indicator	2012	2017
Gini Index (a value closer to 0 indicates income equality)	42.5	41.0
HDI (values between 0 and 1)	0.775	0.802
Population (growth in brackets)	29.17	31.62
Life expectancy	74.6	75.3
Youth unemployment	10.11	10.85
Economic Freedom Index (values between 0 and 100)	66.4 (54)	74 (22)
Global Competitiveness Index (values between 0 and 10)	5.06 (25)	5.17 (23)
Happy Planet Index (values between 0 and 100)	40.4 (50)	30.3 (46)
Global Entrepreneurship Index (values between 0 and 100)	43.0	32.7
Global Corruption Index (values between 0 and 100 with a higher value indicating lower levels of corruption)	49	47
Global Efficient Government Index (values between 0 and 100)	0.92	0.84
Global Political Stability Index (values between -2.5 and 2.5)	-0.01	0.16

**Source:** (CIA, 2017; NationMaster, 2017; United Nations, 2017; World Bank, 2016).

**Note:** \* Indicates global ranking in brackets where applicable.

## Literature Review

From a theoretical point of view, many perspectives are linked to the focus of the research. The theoretical foundation is based on the functionalist approach which includes an objective analysis of a research question using quantitative data analysis based on specific theory (Teddle & Tashakkori, 2009). The Keynesian economic theory analyzes the role of government intervention in the economy. The theory states that the economy will in some cases not return back to equilibrium without some government intervention (Gillis, Perkins, Roemer & Snodgrass, 1992). The extent and quality of government intervention through institutions has an impact on economic growth and development (Rodrik, 2000; Barro, 1979). Another theoretical angle to the research within the economic development and governance paradigm is the “Big Push” theory as developed by Rosenstein-Rodan. This theory states that government plays an important role in the coordination of role players in the economy



through good governance, leadership and policy certainty based on a shared and accepted national development vision (Rosenstein-Rodan, 1943; Raudino, 2016).

Kaufmann *et al.* (2007) state that good governance requires only limited government intervention, providing support towards growth and development in social and developmental factors. In the research, the characteristics of good and effective government have been listed many times and could include the following: limited government interventions (Sutopo & Siddi, 2018); formal structures with roles and functions; quality non-political officials; effective implementation of policy and service delivery; fiscal discipline; red-tape reduction processes; pro-business; and decentralized and participatory governance (Meyer & Meyer, 2016). Nash *et al.* (2006) formulated a set of criteria for institutional success. Factors of importance include stable macro-economic policy including debt and fiscal stability; secure property rights; strength in budget control; quality in overall governance; accountability; prevention of corruption; creation of an enabling environment for business development; and social protection. In addition, one can also mention a significant positive relationship between education and economic growth (Karacor *et al.*, 2018).

With regards to empirical results from similar and previous studies, a large volume of results are available in the literature. Economists mostly achieve consensus in that good governance is one of the most critical factors in predicting the economic performance of economies (Khan, 2007). Méon and Weill (2005) found that effective governance has a positive impact on economic growth and development; and quality institutions are of significant importance in driving economic output and income. Their study included 62 developed and developing countries and included macro-economic data and governance data such as effective governance and rule of law. They also concluded that poor governance is usually linked to lower levels of economic efficiency. Liu, Tang, Zhou, & Liang (2018) completed a panel data analysis for China, investigating the impact of governance quality on economic growth for the period from 2001 to 2015. The results indicate a positive relationship between the two variables. The authors recommended that the quality of local governance should be improved and human capital must also receive attention.

Olson *et al.* (2000) also had similar results, and Máté (2015) recommend to support high-skilled employment branches if this directly affects the economic demand structure. Knack & Keefer (1995) found that good governance is also an important factor to drive investment, eventually leading to economic growth. Mira and Hammadache (2017) also found a significant relationship between economic growth and effective governance as well as political stability. Chong and Calderon (2000), found bi-directional causality exists between quality institutions and economic growth. This finding is supported by Levine (1997); Evans and Rauch (2000); and Cooray (2009). Kaufman and Kraay (2002), posit that good



governance is crucial for economic growth and in fact causes economic growth. Kurtz and Schrank (2007) state that effective government could only be achieved by means of effective public management and economic growth can lead to more effective government. Abizadeh, Yousefi (1998) reflect that a large ineffective public sector, can have a negative impact on economic growth and the size of government and interventions should be limited. Moreover, Sadaf *et al.* (2018) claim that an increased level of controlled corruption and political stability might reduce the number of fraud cases, while efficacy and independent governance services with a higher freedom of expression seemed to increase them.

With regards to the relationship between political stability and economic growth, Barro (1991) confirmed that political instability has a significant negative impact on good governance and economic growth. Feng (1997) analysed the relationship between democracy, political stability and economic growth with data from 96 countries from 1960 to 1980 by means of a three stage OLS econometric analysis. The results found that democracy has a positive but indirect effect on economic growth in the short-run and that economic growth tends to have a positive impact on democracy. It was also found that political instability has a negative impact on economic growth. According to Feng (1997), rapid economic growth is possible if a stable government with a stable political system exist with quality institutions. Within this paradigm, democracy is most likely to assist in the provision of favourable conditions.

The success and continuation of a regime is closely related to economic growth. Ades and Chua (1997), in a study of 10 developing countries, with a data set from 1960 to 1985, found that political instability has a strong negative impact on economic development in a country. They found two channels through which this impact occurs namely through the disruption of trade and increased budgeting for military expenditure. This instability also has an impact on surrounding countries. Also from an economic point of view, various research findings confirmed this negative relationship and that for example: instability leads to higher inflation (Aisen & Veiga, 2008); instability leads to higher levels of government debt (Ozler & Tabellini, 1991); and leads to less investment (Alesina & Perotti, 1996; Oláh *et al.*, 2019). Fatah, Othman and Abdullah (2012) investigated the relationships between economic growth, political freedom and HDI in Asian countries including Malaysia using data from 1980 to 2005 using the least square quantitative method. The findings include that political freedom and civil liberty have a positive impact on economic growth.

Alesina, Ozler, Roubini and Swagel (1996) found that in countries where relative high levels of political instability exist, those countries usually have lower levels of good governance and economic growth. Political instability could also be a push-factor for investment, which is



needed for growth (Fosu, 2001); and political instability can also lead to increased policy uncertainty which also negatively impacts on investment (Rodrik, 1991). Political instability can also lead to more opportunities for corrupt activities (Shleifer & Vishny, 1993). Lastly, the lack of a democratic government, with the existence of high levels of corruption and political instability, could lead to poor governance, and eventually poor economic performance (Rose-Ackerman & Palifka, 2016).

Regarding the relationship between corruption control and economic growth and development, empirical results have also confirmed that the existence of corruption is in most cases associated with poor governance and related low levels of economic growth (Friedman et al., 1999; Mauro, 1995; Rabeea *et al.*, 2018). Corruption can be defined as an activity that is used to the benefit of individuals including aspects such as bribery, nepotism, and theft of public resources (Drury *et al.*, 2006). Negin, Rashid and Nikopour, (2010) analysed the Granger causality between corruption and poverty levels or economic development using a dynamic panel system based on a sample of 97 developing countries during 1997 to 2006. The empirical findings confirm that corruption and poverty have a bi-directional causality. Corruption is a barrier to successful poverty eradication and could destroy efforts by developing countries to alleviate poverty. Corruption delays and slow down economic growth. An integrated strategy of good governance is required to reduce poverty and to fight corruption.

The researchers make the following recommendations to reduce corruption: The promotion of inclusiveness of all citizens in the political, economic and social processes; promoting lawfulness and rule of law; promoting accountability of government to take responsibility for actions. Dincer and Gunalp, (2008) analysed the relationship between corruption, income inequality, poverty and economic growth. They found that higher and increasing levels of corruption lead to increases in income inequality, and higher levels of poverty, while it has a negative impact on economic growth and development. Setayesh and Daryaei, (2017) analysed eight Islamic countries from 2005 to 2014 and their results indicate a significant positive relationship between effective corruption control and economic growth. The impact of high levels of corruption could also negatively impact on the effectiveness of government (Mauro, 1997), and has a limiting negative impact on economic growth (Meyer, Meyer & Molefe, 2016). Aidt (2009) also found that economic growth led to less corruption. The existence of law and order, protection of property rights and policy certainty also attracts growth and investment (Knack & Keefer, 1995). This finding is confirmed by Aguilera and Cuervo-Cazurra, (2004) who indicate that good governance is possible when all components of law and order exist which include property rights and civil rights.

## Methodology

The methodology used in the study regarding the empirical section is quantitative in nature and has its focus on Malaysia as one of the leading economies in Asia. The study has as its primary objective to analyse the relationships between GDP per capita as the dependent variable, representing level of economic development and independent variables such as effective governance, government spending, corruption and political stability. The study also analysed the causal relationships between all the variables included in the study see Table 2 below. Annual data from 1996 to 2017 were utilized and all variables were converted to natural logarithms. Table 2 provides a summary of the variables included in the study. The Worldwide Governance Indicators (WGI) by the World Bank (2018) forms the basis for the data set.

**Table 2:** Summary of variables includes in study

Name of variable	Abbreviation for variable	Data source	Detail description
GDP per capita (in \$)	LGDPCAP	The World Bank (2018)	GDP per capita is the gross domestic product divided by the total population. In this study used as dependent variable representing economic development.
Effective Governance Index (part of good governance)	LEFFGOV	The World Bank (2018), Worldwide Governance Indicators (WGI)	Indicates of the quality of service delivery, civil service performance, policy formulation and implementation (values between -2.5 to +2.5).
Government spending (in Billion \$)	LGOVSPEND	The World Bank (2018)	Indicates total government spending per annum.
Corruption Control Index	LCORRUPTC	The World Bank (2018), Worldwide Governance Indicators (WGI)	Indicates the level to which public power is exercised for private gain, as well as "capture" of the state (values between -2.5 to +2.5).
Political	LPOLSTAB	The World	Including the absence of violence



Stability Index		Bank (2018), Worldwide Governance Indicators (WGI)	and terrorism, and measures the likelihood of political instability (values between -2.5 to +2.5).
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The analysis of the data was completed using Eviews 9 software. The model selection for the analysis was based on a stationarity test for all variables included in the study. Due to the mixed nature of the unit root tests, an Autoregressive Distributed Lag model (ARDL), as developed by Pesaran and Shin, (1996) and amended by Pesaran, Shin and Smith (2001) was selected and utilised. This model as selected is the most suitable model in this case and was the most suitable also taking into account the limited number of observations that are available for most of the variables (22 annual observations). Equation (1) was formulated to analyse the relationship between the variables:

$$\Delta LGDPCAP = f (\Delta LEFFGOV + \Delta LGOVSPEND + LCORRUPTC + \Delta LPOLSTAB) \dots\dots\dots(1)$$

The empirical analysis included the following steps in the process. A descriptive statistical analysis were completed followed by the testing for the level of stationarity by means of unit root tests where a mixture of stationarity of the variables was confirmed, a Bounds test was performed to test for any long-run relationships between variables. The test compares the F-statistic and the critical values for the lower and upper bounds from the Pesaran *et al.* (2001) table. The next step in the process, after it was confirmed that the value of F-statistic was indeed higher than both the lower and upper bounds values at a 5% significance level, an ARDL cointegration test for both long and short run were estimated. Consequent to this analysis a Todo Yamamoto causality test was also conducted to determine the direction of causality between all the variables. Additionally, a number of diagnostic tests, i.e. serial correlation, heteroscedasticity, normality and stability, were performed.

**Results and Discussion**

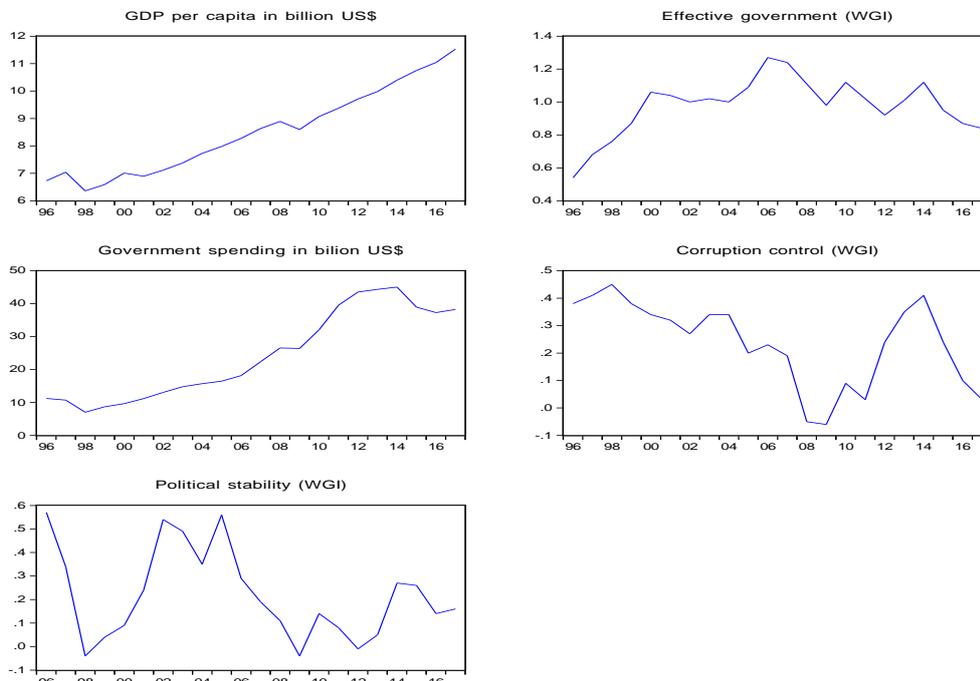
This section provides details of the results of the estimation of the model and discussion of results, linked to previous empirical results. Table 3 below is a summary of the descriptive statistics for all the variables, while figure 1 below indicates the trends graphically per variable. All of the variables included in the model are normally distributed with the probability value above the critical significant levels of 0.05. GDP per capita has shown a steady increase over the time period (1996-2017) with periods of recession in 1997-1998,

2001-2002 and during the financial crisis (2008-2009). The Effective Governance Index over the period, had a mean value of 0.98 with a maximum value of 1.27 and a minimum value of 0.54. Overall effective governance improved from 1996 to 2000, but has since been unstable with a general negative trend. Government spending has since 1998 shown a steady increase up to 2013, but has since then shown a decreasing trend. The Corruption Control Index had a mean value of 0.24 over the time period with a maximum value of 0.45 in 1998 and a minimum value of -0.06 in 2009 during the financial crises. The current trend since 2013 has been negative with decreasing levels of corruption control. Lastly the Political Stability Index had an mean value of 0.22 with a maximum value of 0.57. The index had its lowest points during recessions in 1997-1999 and between 2007-2010. The index is currently indicating a positive trend.

**Table 3:** Descriptive statistics

<b>Statistical Component</b>	<b>GDP per capita (In US\$)</b>	<b>Effective Governance Index (between -2.5 and +2.5)</b>	<b>Government spending (In Billion US\$)</b>	<b>Corruption Control Index (between -2.5 and +2.5)</b>	<b>Political Stability Index (between -2.5 and +2.5)</b>
<b>Mean</b>	8.504	0.977	24.134	0.238	0.219
<b>Maximum</b>	11.520	1.270	45.030	0.450	0.570
<b>Minimum</b>	6.361	0.540	7.050	-0.060	-0.040
<b>Std. Dev.</b>	1.564	0.170	13.378	0.154	0.191
<b>Jarque-Bera</b>	1.524	2.085	2.327	1.871	1.571
<b>Prob.</b>	0.467	0.358	0.312	0.392	0.456
<b>Observations</b>	22	22	22	22	22

**Figure 1.** Trends for all variables



Unit root tests are important econometric tests in the process of selection of the specific model in testing for stationarity. The tests were conducted by using the Augmented Dickey-Fuller (ADF) test. The results of the test are presented in Table 4 below. The results show that all variables passed the unit root test at either levels  $I(0)$  or at 1<sup>st</sup> difference  $I(1)$ . Therefore the ARDL model could be estimated as it was designed to be used in the case where there is a mixture of variables.

**Table 4:** Unit root tests

Variables	Stationarity		Result
	ADF levels $I(0)$	ADF 1 <sup>st</sup> difference $I(1)$	
LGDP CAP	0.9850	0.0004*	$I(1)$
LEFFGOV	0.0109*	0.0315*	$I(0)$
LGOVSPEND	0.8094	0.0140*	$I(1)$
LCORRUPTC	0.2263	0.0026*	$I(1)$
LPOLSTAB	0.0187*	0.0001*	$I(0)$

**Note:** \*denotes the rejection of the null hypothesis of unit root at the 5% level of significance.

Lag length selection is important to avoid spurious rejection or acceptance of estimated results as well as the power of rejection of hypothesis. The lag length for the model was estimated and all selection criteria selected using the Akaike information criterion.

Both the Schwarz information criterion and the Hannan-Quinn information criterion, and all criteria indicated a lag structure of 1. Table 5 below details the ARDL Bounds test for the selected model. The table indicates the estimated F-stats with the relevant lower and upper bound values as formulated by Pesaran *et al.* (2001). The result of the test indicates that the F-stat is lower than the lower bound value of 2.86, at the 5 percent significance value. For this reason, the null hypothesis of no cointegration between the variables could not be rejected in this case. Therefore, it could be concluded that there is no long-run relationship between the variables included in the model.

**Table 5:** ARDL Bounds test for cointegration

Test statistic	value	k
<b>F-statistic</b>	<b>2.5616</b>	<b>4</b>
<b>Critical value bounds</b>		
<b>Significance</b>	<b>Lower bound</b>	<b>Upper bound</b>
10%	2.45	3.52
5%	2.86	4.01
2.5%	3.25	4.49
1%	3.74	5.06

Table 6 below indicates the short-run results of the estimation. This analysis indicates the short-run relationships between the independent variables (effective governance; government spending; corruption control; and political stability) and the dependent variable namely GDP per capita. The results show that government spending and political stability significantly effects GDP per capita. Similar results were also confirmed by Weaver, (2010) and Rose-Ackerman & Palifka, (2016). However, in the short-run, effective governance and corruption control do not significantly impact on GDP per capita.

**Table 6:** Short-run results

Variable	Coefficient	Std. Error	t-Stat	Prob.
D(LEFFGOV)	0.0368	0.0617	0.5955	0.5617
D(LGOVSPEND)	0.1579	0.0439	3.5960	0.0033*
D(LCORRUPTC)	0.0075	0.0061	0.1192	0.9069
D(LPOLSTAB)	0.0151	0.0052	2.9151	0.0121*

**Note:** \*denotes the rejection of the null hypothesis of unit root at the 5% level of significance.

Table 7 below provides a summary of the causality results indicating short-run causal relationships between variables. The empirical results of the Causality tests are based on the Toda and Yamamoto (1995) methodology. This method is used in cases where a mixture of variables exists regarding stationarity. The results indicate strong causality between most of the variables with the original dependent variable, GDP per capita, being affected and caused to change by all the independent variables. In their studies, Khan, (2007); Liu, Tang, Zhou, & Liang (2018) and Kurtz & Schrank (2007). Bi-directional causality also exists between GDP per capita and corruption control as was also confirmed by Aidt (2009). In addition, effective governance also causes government spending, corruption control and political stability (only at 10% significance). These findings are confirmed by Setayesh and Daryaei, (2017). Bi-directional causal relationships also exist between government spending and corruption control and between corruption control and political stability; while government spending and political stability also have a bi-directional causal relationship.

**Table 7:** Toda-Yamamoto Causality Test results: P-values for probability

Causality variable	Dependent variable				
	GDP per capita	Effective governance	Government spending	Corruption control	Political stability
<b>GDP per capita</b>	_____	0.1226	0.1492	0.0002*	0.1149
<b>Effective governance</b>	0.0258*	_____	0.0269*	0.0133*	0.0653**
<b>Government spending</b>	0.0035*	0.1497	_____	0.0019*	0.0910**
<b>Corruption control</b>	0.0358*	0.3957	0.0159*	_____	0.0022*
<b>Political stability</b>	0.0054*	0.1364	0.0085*	0.0001*	_____

**Note:** \*rejection of null hypothesis at 5% level of significance and \*\* rejection at 10% level.

In order to determine the robustness and stability of the model, the required tests were performed. Residual diagnostic tests were performed including the Breusch-Godfrey LM Test for serial correlation with a p-value of 0.2316, the Breusch-Pagan-Godfrey Test was estimated to test for heteroscedasticity amongst the variables with a p-value of 0.7779 and the Jarque-Bera Test was performed to test for normal distribution with a probability of 0.2613. The results revealed that for the series as used, the residuals are not auto-correlated, the series was homoscedastic and also normally distributed. Lastly, the CUSUM test was applied to assess parameter stability and test results indicates stability for the model. This indicates that the findings are trustworthy.



## Conclusion

The comprehensive empirical analysis that underpins this study confirms the significant relationships between the variables investigated. The literature indicates the importance of good governance and quality institutions for growth and development. The main objective of this study was to determine the impact of effective government, corruption control and political stability on GDP per capita as proxy for economic development by means the use of an econometric model. The results indicate that while no relationships amongst the variables exist in the long-run, in the short-run, independent variables such as government spending and political stability, are significant predictors of GDP per capita, while effective government and corruption control do not significantly impact on economic development. The results further indicate strong uni-directional causality flowing from the independent variables having an impact on economic development, with bi-directional causality between economic development and corruption control. Further bi-directional causality also exists between government spending and corruption control, also between corruption control and political stability and lastly also between government spending and political stability. The implication of the study as that strong and quality public institutions play a significant role in economic growth and development. Also of importance is the finding that corruption control and political stability have positive impacts on economic growth and development. The limitation of the study is that due to availability of data, the time frame of the study initiated from 1996.

Future research could include comparative studies between different developed and developing countries. Government should play a critical role in the coordination of all role players in the economy by means of vision and leadership and as such, effective policy implementation is also of importance for growth and development. Accountability, decentralized decision making, fiscal stability and the creation of an enabling environment of the private sector to succeed are also required. Best practice factors for further success include limited government intervention in the economy and the limitation of the size of government. Lastly and in conclusion, it was confirmed by means of the results of the study, that good governance, effective government spending, corruption control and political stability are requirements for growth and development.

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