



Faculty of Economics and Business

**THE STUDY RELATIONSHIP OF GOVERNMENT SPENDING
AND ECONOMIC GROWTH IN MALAYSIA: EVIDENCE
BASED ON DEVELOPMENT EXPENDITURE**

Wong Siaw Wei

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WONG SLAW WEI

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Statement of Originality

The work described in this Final Year Project, entitled
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Wong Siaw Wei
20265

ABSTRACT

THE STUDY RELATIONSHIP OF GOVERNMENT SPENDING AND ECONOMIC GROWTH IN MALAYSIA: EVIDENCE BASED ON DEVELOPMENT EXPENDITURE

By

Wong Siaw Wei

The study aims to estimate the relationship between government spending and economic growth in Malaysia for 38 years, which covers the period 1970 to 2008. The investigation is conducted by utilizing time series econometric techniques. The Augmented Dickey Fuller (ADF) unit root test results suggest that the variables are either integrated of order zero, $I(0)$ or order one $I(1)$. Besides, the Auto-regressive distribution lag (ARDL) model is applied to investigate the long run relationship between government spending and economic growth. Furthermore, the empirical result obtained from the execution of Granger causality test reveals a unidirectional causality running from government spending on agriculture and rural development to gross domestic product which supports the Keynesian hypothesis and unidirectional causality from gross domestic product to government spending on transportation as well as defence and security which support the Wagner's hypothesis in the case of Malaysia.

ABSTRAK

KAJIAN HUBUNGAN TERHADAP PERBELANJAAN KERAJAAN DAN PERTUMBUHAN EKONOMI DARI MALAYSIA: BUKTI BERDASARKAN PERBELANJAAN PERTUBUMBUHAN

Oleh

Wong Siaw Wei

Kajian ini bertujuan untuk mengkaji hubungan penyebab antara perbelanjaan kerajaan dan pertumbuhan ekonomi di Malaysia dalam tempoh 38 tahun dari tahun 1970 sehingga tahun 2008. Penyelidikan dijalankan dengan menggunakan ekonometrik siri masa. Keputusan empirikal yang diperolehi melalui teknik ujian Augmented Dickey Fuller (ADF) menunjukkan bahawa kesemua data adalah stabil dalam $I(0)$ dan $I(1)$. Manakala, kaedah Autoregressive Distribution Lag (ARDL) akan digunakan untuk mengkaji kewujudan hubungan dalam jangka masa panjang antara perbelanjaan kerajaan dan pertumbuhan ekonomi. Selain itu, ujian Granger telah membuktikan bahawa terdapat hubungan satu hala dari perbelanjaan kerajaan di pertanian dan pembangunan luar bandar kepada pertumbuhan ekonomi yang menyokong hukum Keynesian hipotesis manakala hubungan satu hala dari pertumbuhan ekonomi kepada perbelanjaan kerajaan di pengangkutan dan pertahanan dan keselamatan yang menyokong hukum Wagner hipotesis di Malaysia.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

Malaysia is a small and open economy which has middle income country. Malaysia is a country on the move. Today, Malaysia becomes an export-driven economy which accelerates one's step by high technology, knowledge-based and capital-intensive industries. Malaysia's economy achieves successes in economic development because of economy transformation in an effective public policy. The role of the policy not only can increase the economic growth but also can achieve the goal in the different development stages (Nabulsi, 2001). Thus, government plays an important role in economic development.

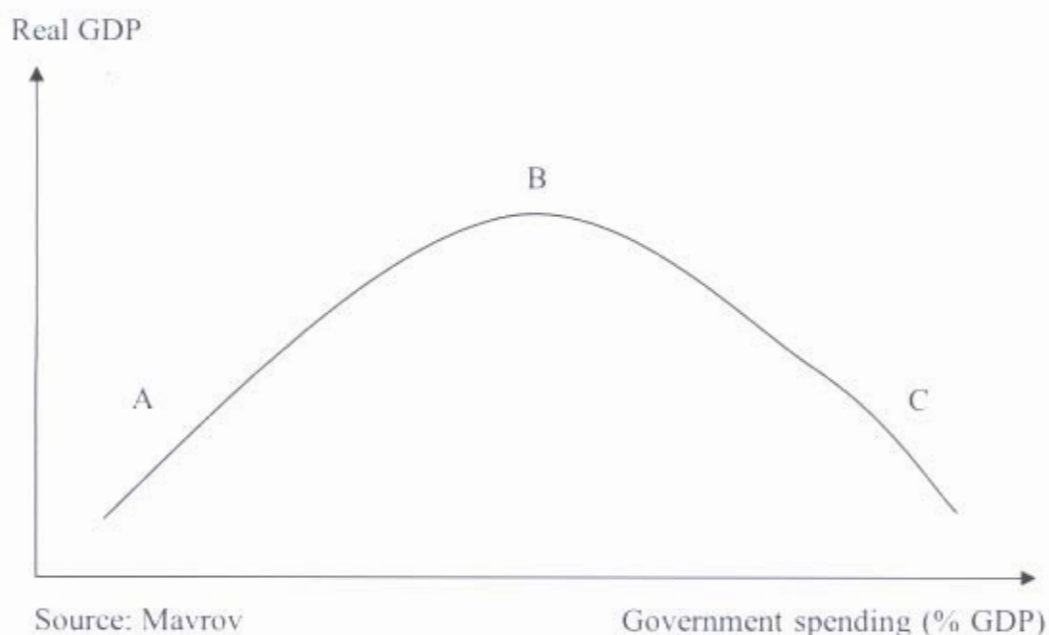
Recently, Malaysia economy faced downturn because of the deceleration of the US economy. In addition, because of the inflation in Malaysia, the prices of the commodity goods increase directly. This situation affect Malaysia's GDP growth decreases to 3.5 percent in 2009 if compare 4.6 percent in 2008 (International Monetary Fund, World Economic Outlook Database, 2009). Therefore, there are two schools of thought from Keynesian and Wagner's Law. These two schools of thought are to test relationship between government spending and economic growth whether

government spending is consequence of a growing economy or vice versa (Tang, 2001).

According to the Ninth Malaysia Plan, 2006-2020, the aim of this plan is to shift the economy up to the value chain which is increase in productivity, competitiveness and value add to build up the activities in agriculture, manufacturing and services sectors. (Ninth Malaysia Plan, 2006-2020). Thus, the study of the relationship between government spending and economic growth is to find the results regarding the growth impact of different types of sector spending.

Based on the Mavrov (2007) economic theory provides the different ways and instrument to estimate the role of the government spending in the economic process. The relationship between government spending and economic growth rate can be used the Armev Curve as one of the instrument to estimated government spending in order to advance economic development or restrict economic growth. This instrument of the Armev curve is based on the fundamental law of diminishing return.

Figure 1: Armeiy Curve



Diminishing marginal product is the property whereby the marginal product of an input decreases as quantity of the input increases. Based on the Figure 1 shows that the relationship between government spending and real gross domestic product. At the beginning which is at the point A, result that if that country without government spending, it will produce at a lower output. If the government expenditure increases, it will increase the gross domestic product. However, when government spending increases to a certain level which is at the point B, it shows that government spending is at a maximum growth rate. After this point, to take one step ahead rises of government spending, it will decrease the nation output. This situation will slow down the economic growth rate. Thus, at the point B and C represented that take one step further increase government spending, it will decrease the growth rate (Mavrov, 2007).

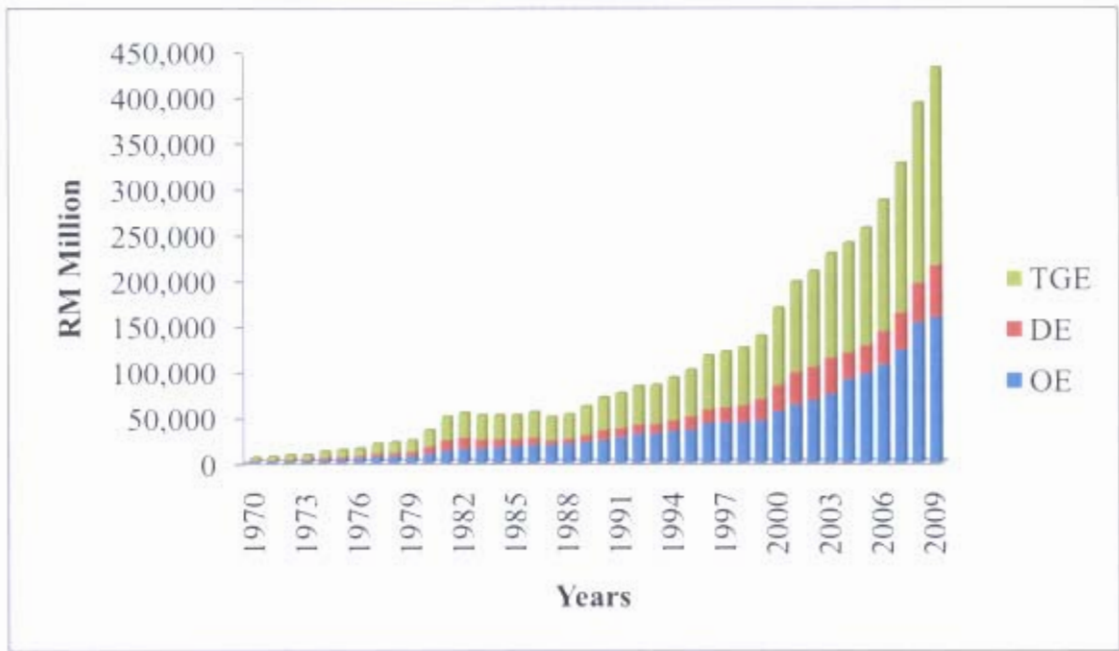
1.2 Definition

1.2.1 Government spending

Government spending can be defined as the sum of federal government and state and the local government bought a value of goods and services. Government spending can be collected through taxes, public debt, money emission, and also international aid (Piana, 2001). It can also be categories into government consumption, government investment and also transfer payments (Barro and Grilli, 1994).

Furthermore, government spending can divided into two components which are operating and development expenditure. Economic development of Malaysia is one of the rapid and regular in global economic. Each of the sectors contributed to Malaysia GDP with a different result. There are four sectors in development expenditure which are economic, social security and general administration sectors. The major are economic and social sectors. Operating expenditure is based on the five years Malaysia Plan. However the long run policies are support by the development expenditure (Economic Planning Unit, 2009).

Figure 2: The Trend of Malaysia’s Government Expenditure, 1970-2008



Source: Ministry of Finance Department of Statistics, Malaysia

Figure 2 show the trend of Malaysia’s government expenditure from year 1970 till year 2008 based on the development. Based on the movement of the figure, Malaysia’s government expenditure was in the increasing trend but at a slow movement. During 1971-1990, Malaysia government was implemented New Economic Policy (NEP) to eradicate poverty and restructure the society.

This is because the imbalances of economic and social achievement among races which is stated in National Economy policy that affect the government concern to inject into the funds to reduce the poverty and restructure society (Economic Planning Unit, 2009). Thus, Malaysia economy further increase, government also

take part to expands parallel with the agenda to motivate economic activity and to attain sustainable economic growth.

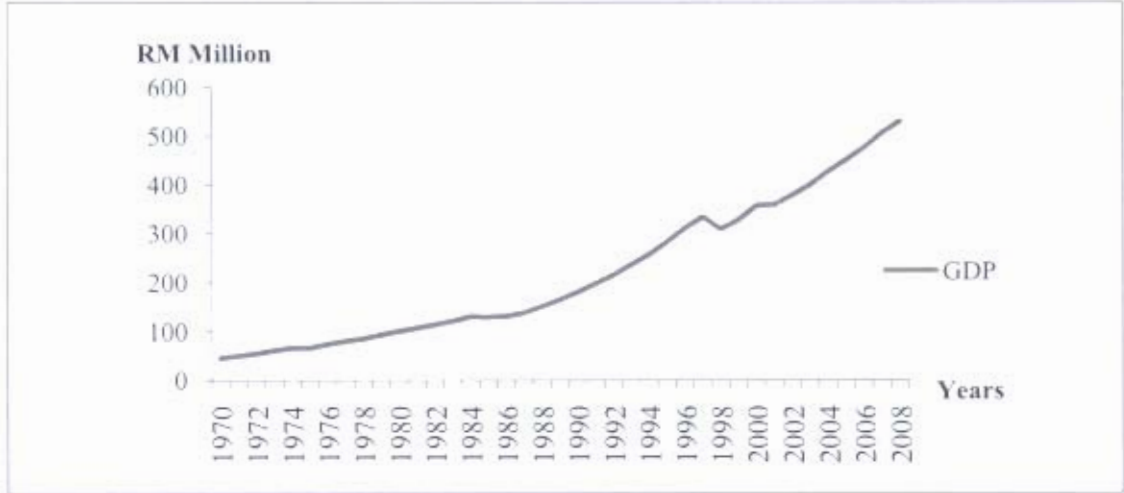
But, the government expenditure experienced a downward trend in year 1983 which decrease by RM25, 794 million if compare with RM27, 407 million in year 1982 because of the limitation of the resource. In 1985 and 1986, the effect of economic recession makes the decreasing trend of government expenditure to RM24, 926 million in 1987 with a negative sign of 9.7 percent. However, it was successfully to overcome the negative growth of government expenditure in 1988 by the adjustment efforts undertaken by government to stimulate the economic development. From the period of recovery, government spending has increase sharply in 1988 with a positive sign of 26443 million (Economic Planning Unit, 2009).

According to the figure above, due to the Asian financial crisis, Malaysian government expenditure faced a decreasing trend from 1997 to 1999. However, the negative growth of government expenditure required government to pursue the fiscal policy to improve, increase competitiveness and efficiency in the economic activity. Hence, it can view that from the period 1988 until 2009, Malaysia's government spending has grown drastically (Economic Planning Unit, 2009).

1.2.2 Gross Domestic Product (GDP)

Gross Domestic Product (GDP) can measure total expenditure on the final goods and services produced within a nation during a fixed period of time. There are four categories of spending which are consumption, investment, government expenditure and net exports. Besides that, GDP divided into 2 categories which are nominal GDP and real GDP. Nominal GDP is GDP measured the current prices we pay for things. Nominal GDP includes all the components of GDP valued at their current prices. Real GDP uses constant base-year prices to value the economies production of goods and services (Maurice Levi, 1994).

Figure 3: The Trend of Malaysia Gross Domestic Product, 1970-2008



Source: International Monetary Fund, World Economic Outlook Database, 2009

The figure 3 shows that the trend of Malaysia Gross Domestic Product (GDP) from 1970-2008. According to the trend, from year 1970 Malaysia's Gross Domestic product (GDP) was continue increase until 1984. However, Malaysia economy was starting decline to RM128, 957 million in 1985, which decrease RM 1139 million or 0.8 percent if compare with 1984. It is because Malaysia facing the economic recession in 1985 and influence the lower output growth, increase unemployment, reduced investment and limited the growth in international trade.

However, it is increases again to RM 130,443 million in 1986, which increase by RM 1486 million or 1.2 percent. The economy was recovery based on the growth of export in manufacturing sectors domestically. It helped to reduce the budget deficit and increase the rate of growth of the economy (The Fifth Malaysia Plan, 1986-1990).

After Malaysia overcome the economy recession, Malaysia economy increase steadily from 1987- 1997 which is RM 137,472 million to RM 333,516 million. However, in the year 1998, Asian financial crisis affected the Malaysia's economy and economic growth decline. The Gross Domestic Product has been decrease to RM 308,972 million with a negative 7.36 percent (International Monetary Fund, World Economic Outlook Database, 2009). Thus, in order to recovery for the crisis, Malaysian government has been implemented the policy which are fiscal and monetary policies to improvement the economic performance. In 1999, it leads to the

growth by 6.14 percent in GDP (International Monetary Fund, World Economic Outlook Database, 2009).

After recovery for the crisis, Malaysian economy continues increasing from 1999 to 2000. However, the economy was at a slow movement in 2001 which is RM 358,246 million if compare to 2000 RM 356,397 million. There is just growth by 0.52 percent in 2001. After that period, Malaysian economy continues began increase steadily in the following years.

1.3 Background of Malaysia

Prior independence in 1957, Malaysian was predominantly a producer of primary commodities such as rubber and tin. The government was employed import substitution manufacturing industries to promote industrial development. Since independence in 1970, due to the economic diversification, coupled with deregulation and liberalization of the financial system has helped transforming the country into a middle-income emerging multi-sector market. Malaysia has been transformed economy from dependence on export of raw materials to expansion in manufacturing and encourages promoting foreign direct investment in order to expansion the economic growth (Economic Planning Unit, 2009).

In addition, Malaysia government had implemented a planning horizon which consists of long-term planning, medium-term planning, and short-term planning. In the long-term planning, it consists of Vision 2020, (1991-2020), First Outline Perspective Plan (OPP1), 1997-1990, Second Outline Perspective Plan (OPP2), 1991-2000 and Third Outline Perspectives Plan (OPP3), 2001-2010. Besides that, the medium-term planning included a five year development plan like Ninth Malaysia Plan, 2006-2010 and Mid-term review (MTR) of the five year plans. Lastly, the short-term planning is included the annual budget (Economic Planning Unit, 2009).

The First Outline Perspective Plan (OPP1), 1971-1990 was based on New Economic Policy (NEP) with the objectives to eradicate poverty and restructure the

economy. The objectives are to creation of employment opportunities increases productivity and correct economic imbalance. Besides that, Malaysia government plays an important role in achieving Vision 2020. Hence, the Second Outline Perspective Plan (OPP2), 1991-2000 was implemented which is National Development Policy (NDP).

These plans are continues of National Economy Policy (NEP) in order to balance development by balanced economic growth. The objectives of this plan are to strike optimum balance between goals of economic growth and equity and reduce social, economic inequality and improve human resource development .In the mid 1997, the Asian Financial crisis, it causes the high unemployment, poverty increase and companies bankruptcies (Economic Planning Unit, 2009).

Thus, the Third Outline Perspective Plan (OPP3), 2001-2010 was based on the policy which is National Vision Policy (NVP) was implemented. The aim of NVP is to establishing a progressive and prosperous nationality Malaysia at least 30 percent Bumiputera participation in 2010. Lastly, objectives of Vision 2020, (1991-2020) is to become a fully developed nation and industrialized country (Economic Planning Unit, 2009).

Up to today, Ninth Malaysia Plan shows the first five-year blueprint of the National Mission. The aim of this policy was provide a better standard living for the