GOVERNMENT EXPENDITURE AND ECONOMIC GROWTH IN MALAYSIA

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This project is submitted in partial fulfillment of the requirements for the degree of Bachelor of Economics with Honours (International Economics)

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Statement of Originality

The work described in this Final Year Project, entitled “Government expenditure and economic growth in Malaysia” is to the best of the author’s knowledge that the author except where due reference is made.

31 March 2006

Doris binti Arichat Enggoh
9990
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ABSTRACT

GOVERNMENT EXPENDITURE AND ECONOMIC GROWTH IN MALAYSIA

By

Doris binti Arichat Enggoh

The study set out to investigate the causality pattern between economic growth and government expenditure during period 1960 to 2004 in Malaysia. Furthermore, it indicates the research of long run equilibrium by using the Johansen’s cointegration procedures. In this research, the Granger causality technique is being adopted for two specifications of models: linear model and double logarithm model. In comparison to both results, it tends to support the Wagner’s law, which the government expenditure causes the economic growth in Malaysia. These empirical tests have shown that the economic growth is strongly endogenous for Malaysia.
ABSTRAK

PERBELANJAAN KERAJAAN DAN PERTUMBUHAN EKONOMI DI MALAYSIA

Oleh
Doris binti Arichat Enggoh

CHAPTER 1

INTRODUCTION

1.0 Overall introduction

Since the 1970s, Malaysia had achieved an impressive economic growth, which had continued to the 1990s by the average economic growth of 11.74%. The development process was not so smooth because Malaysia had experienced the colonialism (Pramanik, 1994), which had brought to the poverty and economic imbalances. In the improvement of these problems, the government had taken the initiatives by implementing the New Economic Policy (NEP) with the objectives of the eradication of poverty and the restructuring a multiracial society by removing the identification of economic functions with race to reduce the economic imbalances (Third Malaysia Plan 1976-1980, 1976).

Now, there are eight Malaysia plans have been completed. These plans are the formulation based on the government policies such as NEP and National Development Policy (NDP). In the early of Malaysia plans, it was focused on the mix plantation of agriculture industry rather than depended on the rubber plant only as the major resources. Structural transformation from agriculture to manufacturing industry began
during the Forth Malaysia Plan which was the beginning of the industrialization era. These changes had supported the NEP to increase the standard of living and economic development in Malaysia. Began the Sixth Malaysia Plan, the NDP had replaced the NEP and it emphasized on the development in infrastructure, education and health in rural and urban areas. The expansionary of services industries had brought to the rapid growth in Malaysia economic performance.

1.1 The economic growth and its pattern

![Figure 1: The annual growth rate of Malaysia’s Gross Domestic Product, 1966-2004](image)

Sources: International Financial Statistic Yearbook, various issues.

Based on the Figure 1, the annual growth rate of Gross Domestic Product, 1966-2004, Malaysia had a slow growth in the 1960s with the growth rate of gross domestic product (GDP) were below 5% and the growth had achieved 14.46% in the 1969. However, it
decreased to 4.52% in 1970 because the destabilization of the society through the May 1969 racial riots (Pramanik, 1994).

During 1970s, the economic growth rate was quite high, which was above 10% except for 1970, 1971, 1972 and 1975. Although the worldwide recession had impact on Malaysia economy during 1974/75 (Third Malaysia Plan 1976-1980, 1976) which the growth rate had achieved a negative sign of 2.3%, the government had success improved the economic growth by putting major efforts on expansionary of the modern sector industries, particularly in manufacturing. The rapid growth and structural transformation was also accompanied by the changes in employment structure and skills which brought to the urbanization in Malaysia (Fourth Malaysia Plan 1981-1985, 1981).

By the middle of 1980s, the economy experienced lower output growth and high unemployment. The stagnation in 1985 led to the export earnings was fragile due to the sharp decline in commodity prices and uncertainty recovery of the world economy. Aside from that, the large deficits in the public sector financial and high level of public debt had caused the resource constraints for the development process. Therefore, the strategies of increasing privatization by local and foreign investors and unrestrictive fiscal policies had been implemented. In the 1986, the economy began to recover which was led by the growth of export in manufacturing sector domestically and reduction of interest rate by the major developed countries helped to lower deficits (Fifth Malaysia Plan 1986-1990, 1986 and Sixth Malaysia Plan 1991-1995, 1991).
In the early of 1990s, the growths of GDP were more than 10% every year. It resulted from the increasing competitiveness of economy in term of private investment and price stability in the country. However, it faced supply constraints such as infrastructure inadequacies and labour shortage. Therefore, the productivity-driven strategy was taken by the government to increase the rate of innovation, skill development and managerial efficiency (Seventh Malaysia Plan 1996-2000, 1996). There was a through in 1998 as show in Figure 1. It was caused by the financial crisis in the Asian countries. Before the crisis, the growth was caused by the domestic demand especially in the private investment. During the crisis, the government had played the roles in the improvement of economic performance through fiscal and monetary policies. These led to the growth by 5.17% in GDP in the year 1999 (Eighth Malaysia Plan 2001-2005, 2001).

In the early millennium years, there is a negative sign of growth by 2.42% in 2001. It was caused by the instability of world economy after the incident of September 11th 2001. However, in the later years, Malaysia was in sustaining growth in which there were low inflation and unemployment rate. Besides that, the government began to realize the opportunities and challenges from global competition in which efforts will need to be intensified to improve knowledge management, accumulate new skills and change mindsets (Mid-term Review of the Eighth Malaysia Plan 2001-2005, 2003) for future development.
1.2 The component of government financing

There are two main components in the government financing: government revenue and government expenditure. In Malaysia, the government revenue is based on the taxes collection, which can be divided into direct taxes and indirect taxes. The direct taxes are the taxes towards the incomes of the companies, individuals and petroleum and its royalties. Meanwhile, the indirect taxes are including the export and import duties and other types of taxes.

McCandless (1991) defined the government expenditure as all of the products of the economy that goes to the government such as the government purchases of goods as well as the salaries of government employees, which are independent of the government’s collection of taxes. There are two subcomponents of the Malaysia’s government expenditure: operating expenditure and development expenditure. Operating expenditure is the expenditure based on the five years Malaysia plans progression. The expenditures by long term policies such as NEP and NDP are called development expenditure.

Both of the components play a significant role in the fiscal policy of a country. According to McCandless (1991), fiscal policy is the changes in taxes or government expenditures and can result in changes in the money stock or the quantity of government bonds. A deficit is happened when the government expenditure is exceeding the government revenue. Meanwhile, if the government revenue is more than government
expenditure is called surplus. Therefore, it is important in financing the government budget for the development of the country.

1.3 The trend of government expenditure in Malaysia

Figure 2: The annual growth rate of Malaysia’s government expenditure, 1966-2004

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual growth rate of government expenditure</th>
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<tbody>
<tr>
<td>1966</td>
<td>-30.00%</td>
</tr>
<tr>
<td>1969</td>
<td>-20.00%</td>
</tr>
<tr>
<td>1972</td>
<td>-10.00%</td>
</tr>
<tr>
<td>1975</td>
<td>0.00%</td>
</tr>
<tr>
<td>1978</td>
<td>10.00%</td>
</tr>
<tr>
<td>1981</td>
<td>20.00%</td>
</tr>
<tr>
<td>1984</td>
<td>30.00%</td>
</tr>
<tr>
<td>1987</td>
<td>40.00%</td>
</tr>
<tr>
<td>1990</td>
<td>50.00%</td>
</tr>
<tr>
<td>1993</td>
<td>60.00%</td>
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</tbody>
</table>

Sources: International Financial Statistic Yearbook, various issues.

Figure 2 shows the annual growth rate of the government expenditure for Malaysia from 1966 to 2004. During 1960s, based on Figure 2, the growth rate of the government expenditure is less than 10% and government also had reduced the expenditure by 0.69% in 1968. In these moments, government expenditure had acted as stabilizing that influences on aggregate demand and output (Rao, 1980).
In 1970s, there is a wave of growth in government expenditure in Malaysia. During the decade, most of the funds used to reduce the wide economic and social imbalances existing among the races, with the view to reduce the incidence of poverty and restructuring of society. The expenditure focused on building up the infrastructures and expanding the supply of skilled manpower especially in less developed states (Third Malaysia Plan 1976-1980, 1976). Therefore, the allocations of the expenditures are more on land development and education to improve the quality of life and expansionary of Malaysia’s economy.

Based on Figure 2, the expenditure growth rate is 47.44% in 1980 and there was a drastic shortfall in the growth of government expenditure by negative sign of 3.25% in 1982. In the year range of 1982 to 1987, the growth rate was less than 3%. This expenditure limitation, especially in the light of emerging resource constraints is followed by the 1985/86 recession (Fifth Malaysia Plan 1986-1990, 1986). However, the rapid economic recovery since 1988 led the government took a faster action by increasing the expenses for the Malaysia’s development.

In the years of 1990 to 1997, it was the golden age of Malaysian economic growth. Due to the Figure 2, the growth of the government expenditure from 1990 to 1993 was more than 9%, in 1994 to 1995 had negative sign of growth more than 10%, but a robust growth of government expenditure by 19.94%. This shown that the government took the action to reduce the expenditure when there was stability of the Malaysian economic growth by 1994 because of the rapid development and
urbanization. However, there was a slowdown phase during 1997 to 1999 with the growth of government expenditure less than 5% due to the 1997 of financial crisis. In recovering the market confidence, the government had increased the interest rates and tightens the fiscal policy (Eighth Malaysia Plan 2001-2005, 2001).

There were large different between GDP and government expenditure in 2000 and 2001, which were by 6.58% and 15.17%. This might be because of Malaysia was in the process of recovery from the financial crisis during 1997 and the incident of September 11th 2001 led to the instability of world economy. In the following years, there was a lower growth of government expenditure, which was less than 10%. However, based on Figure 2, a drastic growth by 21.37% in the year of 2004 can be the reason to achieve the Malaysia objective in term of economic and social sustainability.

1.4 Problem statement

With respect to the rapid growth from agriculture sector to industrial sector to the recent information technology and biodiversity industry, the Malaysian government had successfully transformed Malaysia to be one of the respective developing nations in the late 20th century. These transformations are supported by various implementations of government expenditure programs such as spending on infrastructures, capital goods and investment which benefits the society and the businesses. These benefits will
stimulate the economic performance. From this scenario, there interrelationship exists between government expenditure and economic growth in Malaysia.

Based on the Wagner’s law, the government spending is endogenous variable while the exogenous variable is the growth of the national income (Wagner, 1890). Contrary, Keynesian thesis stated that the government expenditure is an exogenous factor that can influence growth (Keynes, 1936).

Apart from that, the cointegration explains how a set of economic variables behaves in the long run equilibrium (Wing, 2005). In long run, government will spend most of the revenue on economic sector and social sector such as education and training, health and land development. Moreover, in developing economies, there is a larger segment of the population live in poverty. By conducting these government programmes, it will reduced unemployment and increased the standard of living of the Malaysian household and led to the economic growth.

1.5 Objectives of the study

The purpose or general objective of the study is to investigate the relationship of the economic growth based on GDP and the government expenditure in Malaysia.

The specific objectives are as follow:
To test the existence of long run relationship between government expenditure and the economic growth.

To identify the endogenous and exogenous variables between the economic growth and government expenditure in Malaysia.

To investigate the causality pattern of the growth in GDP and government expenditure in Malaysia.

1.6 **Significance of the study**

From the study, it might benefit the government in the decision making process for the government budget. The right decision for the fiscal policy which related to government revenue and government expenditure might bring to the budget surplus rather than deficits.

Besides that, it also might benefit the potential investors to respond and make investment in Malaysia based on the government action towards its policy for its future planning. The study might be able to clearly show either it will making profits for the investors and businesses in Malaysia.
The study also can help the future researchers to do the further study that is related to this research by showing the relevant development and growth in Malaysia depends on the government policies or vice versa.

### 1.7 Theoretical framework

From the diagram above, the government expenditure is an exogenous factor or independent variable that will affect the economic growth. Therefore, the economic growth is a dependent variable or endogenous factor as simply describe in the diagram. This diagram is supported by the Keynesian model based on the equation 1 below:

\[
Y = C + I + G + (X - IM) 
\]

\[(1)\]

Where, 

- \(Y\) = total output
- \(C\) = personal consumption expenditure or consumption
- \(I\) = gross private domestic investment or investment
- \(G\) = government purchases of goods and services or government expenditure
\[ X = \text{export of goods and services} \]
\[ IM = \text{import of goods and services} \]

According to Marin (1992) based on Keynesian view, an increase in one of the components of desired expenditure such as government expenditure will lead to an increase in output. He also stated that the changes in the government expenditure are considered to be solely a result of government decisions in the standard Keynesian model. According to Barro (1990) theoretical prediction, the increases in the government expenditure will raise the growth rate and reverse after a point showing the optimum value of expenditure.

The second diagram shows that the government expenditure is influenced by the economic growth. This is based on the Wagner’s law which was also one of the classical theories. Wagner’s law viewed that public expenditure plays no role in economic growth or not a cause of growth in national income. Hence, a raise in per capita income will increase the public sector expenditure to meet the increased protective, administrative and educational functions of the state (Tang, 2002). It can be shown as follows:

\[ GE = f(GDP) \]  \hspace{1cm} (2)