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Do Institutions Matter For Economic Growth? The Case in Asia

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Do Institutions Matter For Economic Growth? The Case in Asia

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Abstract
Various phenomena in Asia, such as the Rohingya and the Middle East conflicts, require institutions to create an ideal environment for investors. Well-maintained political stability and economic freedom can encourage economic growth through investment, human capital, and technological developments. This paper aims to see the effect of political and economic institutions on economic growth. This paper uses panel data from developing Asian countries in 2009-2018 using the system GMM model. The results show that economic institutions have a positive and significant effect on economic growth. However, political institutions have no significant effect on economic growth. Based on these results, the role of institutions is essential, especially in maintaining corporate behavior in the market.

Keywords: Political Institution, Economic Institution, GMM System, Asia
JEL classification : E02, 010, O17

Introduction

Institutions are fundamental in economic growth as they facilitate policies that impact investment and human capital (Acemoglu, 2009). Institutions provide incentives in economic activities which impacts economic growth. Institutions also offer ideal conditions that can trigger various production factors such as capital investment, human capital, and innovation and technological development (Eslamloueyan & Jafari, 2018). Institutions' "rules of the game" provide constraints on individual behavior and influence economic activity through transaction costs (North, 1992). Besides affecting transaction costs, investment, human capital, and savings, institutions can influence other macroeconomic activities such as exports, imports, and foreign capital inflows by providing efficiency, especially in resource allocation, stability in property rights, and supporting freedom of choice.

The role of institutions in economic growth stems from differences in economic conditions in North and South Korea. North and South Korea gained independence from Japan at the same time and have similarities in various factors such as geographical and cultural conditions (Acemoglu, 2009). However, how the institutions regulate each country varies, resulting in different economic conditions where South Korea is more developed than North Korea. Another phenomenon regarding the role of institutions occurs in Norway and Venezuela, which shows how natural resources impact the two countries. Torvik (2016) shows that although both have abundant natural resources, it has affected the economy of both countries differently. Natural resources have encouraged Norway's economic growth,

while Venezuela is the opposite. One reason for this difference is the high role of political institutions in controlling resources by utilizing considerable political power. Other phenomena of how institutions affect the economy occurs in South Asia, with the effects of rampant corruption cases and weak property rights (Singh & Pradhan, 2020). Weak property rights cause low per capita income. Simply put, the institutional phenomenon can be seen through the 2016 Rohingya conflict, which peaked with a dispute between military forces and the Rohingya community (Burke, Williams, Barron, Jolliffe, & Carr, 2017). This phenomenon can be explained from an economic perspective; conflicts will affect incoming investment (in this study, investment is in the form of establishing branches of multinational companies or new companies) as the conflict between the government and the population becomes a double-edged sword for business, potentially reducing domestic investment (Miklian, 2019).

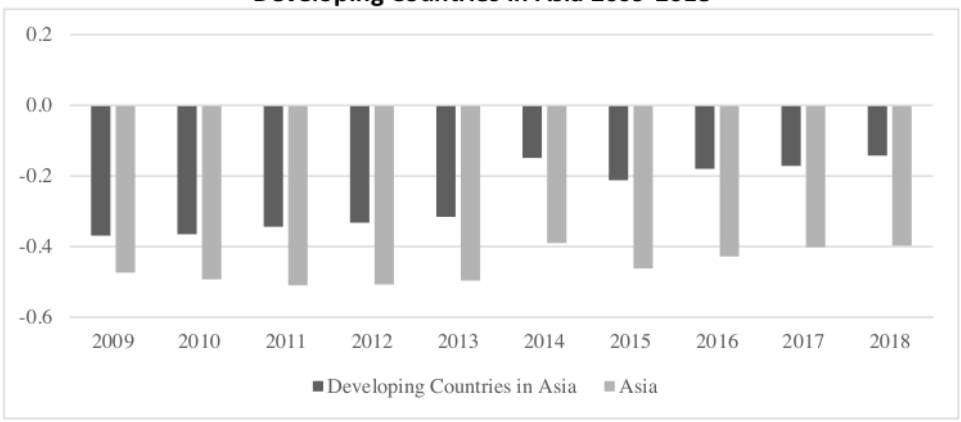
Another significant area with prominent institutional effect is in the Middle East, such as Iraq. Idris (2018) argues that the economic impact arising from the prolonged conflict is caused by the failure of Iraqi institutions to manage the country's potential natural resources, namely oil. Petroleum cannot be adequately utilized by the government, which prevents these natural resources from increasing the quality of human capital; the government has also failed to diversify its policies regarding natural resources, thus reducing opportunities to increase investment and employment. The Iraqi economy, which treats oil as the primary commodity and acts as a source of capital and consumption, requires institutions to play a crucial role in determining economic growth (Yousif, 2016). Other developing countries in Asia also experience similar problems as they tend to have weak institutions due to excessive intervention in the market, resulting in inefficiency and the potential for rent-seeking practices (Khan, 2018). Doğanay & Değer (2021) stated that economic growth in developing countries is highly dependent on the quality of institutions in terms of effectiveness and efficiency of regulations.

Acemoglu (2009) states that institutions are divided into two types, namely political and economic. Uddin, Ali, & Masih (2020) noted that political and economic institutions are measured by political stability and economic freedom. Political stability affects economic growth because imbalances in the political world will lead to failure to manage or utilize political power, manipulation in the judiciary, and hinders an investor from making efficiency in technology (Olaoye & Aderajo, 2020). Thus, weak institutions will impact low investment growth and reduce economic growth (Wanjuu & Roux, 2017). In this case, the quality of political institutions is measured using political stability and the absence of violence.

Political stability and the absence of violence are valued between -2.5 to +2.5. The greater the value, the better the level of political stability in the country and vice versa. Kaufmann & Mastruzzi (2008) explained that world trends are illegible as the world average is assumed to be 0. Meanwhile, the Asian average in 2018 was -0.39, and the developing countries in Asia have a score of -0.14 points. Asia's negative value is caused by various conflicts, especially those originating at the domestic level. Erlangga (2018) stated that

Hoh (2019) also mentioned that the Middle East conflict increases political instability, thereby increasing risk for investors (especially China) in investing in the region, which will impact economic growth. Figure 1 is a measure of the quality of political institutions.

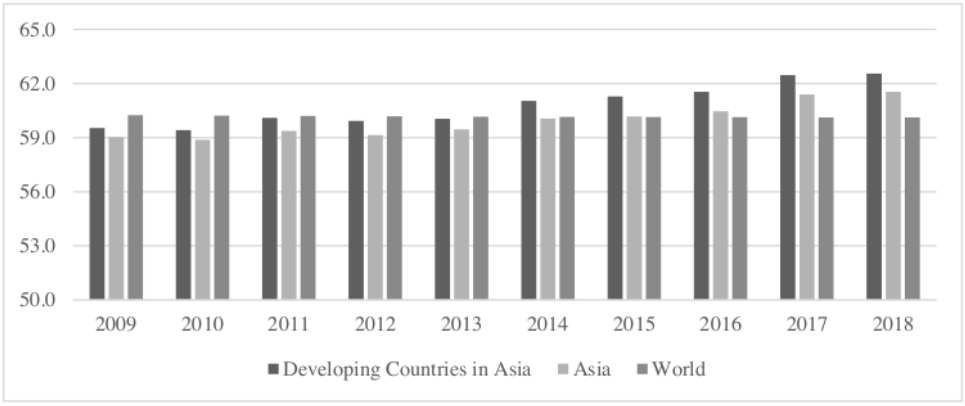
Figure 1 Political Stability and Absence of Violence in Developing Countries in Asia 2009-2018



Source: *The Worldwide Governance Indicators* (WGI) 2009-2018, processed data

Economic institutions assist policy regulations, both in the form of property rights and economic freedom. This indirectly provides incentives to individuals who invest primarily in the technology development sector and production efficiency. Haini (2019) stated that economic institutions can cut information and transaction costs which helps avoid market failures and maintain market stability. It also ensures that the allocation of limited resources can be utilized efficiently to avoid exploitation by certain parties. Figure 2 is a measure of the quality of economic institutions based on the economic freedom index.

Figure 2 Economic Freedom Index of Developing Countries in Asia 2009-2018



Source: *The Heritage Foundation 2009-2018*, processed data

Figure 2 shows the average quality of economic institutions in Asian countries. The average index value of developing countries in Asia in 2018 was 62.55, higher than the Asian average of 61.54 and the world average of 60.12. The Heritage Foundation (2018) stated that countries with points above 50 are classified as countries with freedom in economic activity. Zhao, Madni, Anwar, & Zahra (2021) stated that when a region in Asia has economic freedom, it will encourage markets to function efficiently, thereby increasing trust, especially in companies, reducing uncertainty, and creating high levels of economic growth. In addition, these regions also encourage people to innovate and improve the economy due to low barriers to enter and exit from the market. Improving the quality of institutions, especially economic institutions in Asia, is needed to control economic freedom, especially regulation and efficiency, and also provide an ideal environment for investors. Nadeem, Jun, Akhtar, Dong, & Niazi (2019) further stated that South Asia is opening up the economy and is continually trying to increase economic freedom between regions in the area.

Past studies have tried to examine the influence of institutions on economic growth using various measures. Nawaz (2015) used indicators from The International Country Risk Guide (ICRG), while Singh & Pradhan (2020) used indicators from the World Governance Indicator (WGI). Both studies found that, in general, institutions significantly affect economic growth. Other studies have tried to focus on institutions based on types. M. A. Uddin et al. (2020) focused on three types of institutions: political, economic, and financial institutions. The research is based on Aisen & Veiga (2013), which analyzed the quality of institutions through economic openness and political instability. Meanwhile, Haini (2019) divides institutions into two, namely political and economic institutions. These studies found that each institution significantly affected economic growth. However, other studies showed different results. Aslam (2020) did not find that institutions have a significant effect on economic growth, however, the study showed otherwise after inputting macroeconomic variables such as inflation, economic openness, and human capital. Xu et al. (2021) did not find a significant effect on several institutional indicators, namely voice and accountability, regulatory quality, and political stability on economic growth.

Empirical studies show potential factors affecting the institutional performance of developing countries in Asia, such as trade wars, technological advances, and conflicts such as the Rohingya and the Middle East, which may hamper the economic sector. Thus, research on institutions does not always have a consistent result with differing results based on the types of institutions studied. Therefore, this study aims to look at the role of political and economic institutions on the economic growth of developing countries in Asia. This research contributes important empirical results regarding the effect of institutions and economic growth from developing countries in Asia.

Research Method

Institutions in this study were measured based on political and economic institutions. Economic growth is measured using per capita income with a constant value in 2010. This

study focuses on developing countries in Asia, referring to previous research, where developing countries in Asia tend to have weak institutional conditions and are prone to rent-seeking practices (Khan, 2018). In addition, the selection of developing countries is based on research by Doğanay & Değer (2021), which says that economic growth in developing countries is highly dependent on the quality of institutions, especially the quality of regulations.

The Asian developing countries selected in this study were based on the classification of the United Nations Department of Economic and Social Affairs (2021), which consisted of Bahrain, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, Hong Kong, India, Indonesia, Iran, Israel, Jordan, Kiribati, Laos, Lebanon, Malaysia, Maldives, Mongolia, Myanmar, Nepal, Oman, Pakistan, Philippines, South Korea, Saudi Arabia, Singapore, Sri Lanka, Thailand, Turkey, United Arab Emirates, Vanuatu, and Vietnam.

Furthermore, the research period 2009-2018 was selected as the research period to see changes in the quality of institutions when specific phenomena occurred, such as the trade war in 2018, technological progress, the 2016 Rohingya conflict, and the Middle East conflict. In addition, when analyzing the impact of the 2008 U.S. subprime mortgage crisis, Kim, Kim, & Lee (2015) argued that the spillover effect caused by the subprime mortgage crisis could affect Asia, especially concerning dollar liquidity from the foreign exchange market.

The economic growth dependent variable is measured using the natural logarithm of per capita income based on the US$ 2010 constant prices obtained from the World Bank (Aslam, 2020). Economic institutions are measured using the Economic freedom index obtained from The Heritage Foundation as used in previous research (Alhassan & Kilishi, 2019; M. A. Uddin et al., 2020) with four main pillars: the rule of law (legal conditions in a country), government size (government size and behavior), regulatory efficiency (effectiveness of law in a country) and open market (barriers to economic activity) where the overall value of the four pillars is used to see the market freedom in a country; the greater an individual's freedom when conducting economic activities, the greater the level of investment, per capita income, and economic growth of a country (The Heritage Foundation, 2021).

Meanwhile, political institutions refer to previous research (M. A. Uddin et al., 2020; Benayed, 2020; Mahaini, Noordin, & Mohamad, 2019) using political stability and the absence of violence variables, including violence with political motives and terrorism, which was obtained from the World Governance Indicator (WGI) to identify political stability (Kaufmann, Kraay, & Mastruzzi, 2010). Other variables believed to affect economic growth are obtained from the World Bank, such as investment using the gross capital formation measure (Alexiou, Vogiazas, & Solovev, 2019). Foreign investment is used to measure foreign investment inflow (Olaoye & Aderajo, 2020). Inflation is calculated using the consumer price index (Saha & Zhang, 2017). Finally, population growth is measured using the percentage growth per year (Shchegolev & Hayat, 2018).

The methodology used in this research is the generalized method of moments (GMM). Roodman (2009) states that this method is suitable when the model is assumed to have

endogeneity problems and other classical assumption problems such as heteroscedasticity and autocorrelation, especially when the first lag of the dependent variable is included as the independent variable. Furthermore, this method is suitable when samples are larger than the time period (N>T). In addition, the use of dynamic panel data is carried out because current economic growth tends to be influenced by past economic growth (A. Uddin, Ali, & Masih, 2017). For this reason, it is necessary to add an independent variable in the form of a lag from the dependent variable (y_{t-1}). The use of dependent variable lag as an independent variable can correlate with error so that regression using pooled least squares, random effects, and fixed effects gives inconsistent results (Aisen & Veiga, 2013). Finally, dynamic panels can also overcome the possible endogeneity problems that exist in the model (Connolly & Li, 2016).

Acemoglu (2009) states an endogeneity problem in the relationship between institutions and economic growth. This is explained in a study conducted by A. Uddin et al. (2017), where the variables of political stability and the absence of violence have endogeneity problems because political instability will lead to reduced investment activities and hamper economic growth. Meanwhile, stunted economic growth can increase political instability, causing the collapse of the government and political unrest.

This research model adopts the model from M. A. Uddin et al. (2020), especially in determining the size of political and economic institutions. However, control variables and sample differences were modified as this study uses annual data from developing countries in Asia. Thus, the econometric model in this study is as follows:

$$lnY_{it} = \beta_1 lnY_{t-1} + \beta_2 pol\_ins_{it} + \beta_3 econ\_ins_{it} + \beta_i X_{it} + \theta_t + \delta_i + u_{it} \quad (1)$$

where lnY is the logarithm of per capita income, lnY_{t-1} is the logarithm of the country's previous per capita income, pol_ins is the political stability and the absence of violence as a measure of political institutions, $econ\_ins$ is the economic freedom index as a measure of economic institutions, X is the control variable consisting of investment, foreign investment, inflation, and population growth, δ_i is country-specific fixed effects, θ_t is the time fixed effects, and $_{it}$ is country i, year t and u_{it} is the error term.

Result and Discussion

Table 1 shows that economic growth- measured by GDP per capita- averages $11,178.82 per year, with the lowest of $567.90 per year and the highest of $59,260.57 per year. Political institutions have an average of -0.25 points, with the lowest score of -2.81 points and the highest of 1.61 points. A negative value indicates that the level of political stability in the Asian developing countries is not sufficient.

Economic institutions have an average score of 60.80 points, which indicates that developing countries in Asia have an open economy. The lowest score was 36.7 points, and the highest was 90.2 points. Investment is measured using a gross capital formation with an average of 29.21%, the lowest figure is 14.12%, and the highest is 69.48%. The foreign investment variable has an average of 5.19%, with the lowest value of -37.15% and the highest of 58.51%. The inflation variable has an average of 4.28%, the lowest value is -

3.89%, and the highest is 36.60%. Finally, population growth has an average of 1.78%, with the lowest rate of -0.26% and the highest of 11.04%.

Table 1 General Description of Research Variables

Variable	Mean	Standard Deviation	Min	Max
GDP per Capita	11,178.82	13,406.63	567.90	59,260.57
Political Institution	-0.25	0.98	-2.81	1.61
Economic Institution	60.80	10.79	36.7	90.2
Investment	29.21	8.87	14.12	69.48
Foreign investment	5.19	8.24	-37.15	58.51
Inflation	4.28	4.37	-3.89	36.60
Population growth	1.78	1.49	-0.26	11.04

Source: STATA 13 Processed

The estimation results of the system GMM estimator model (SYS-GMM) aim to overcome the model's endogeneity problem. In addition, classical assumption problems such as autocorrelation and heteroscedasticity in the model are overcome by using robust standard error in the regression stage. Regression is done by comparing pooled least square, random effect, fixed effect, first difference GMM, and System GMM. The use of dynamic panel data where there is a first lag variable from the dependent variable (y_{t-1}) as an independent variable will give biased results if processed using the pooled least square, random effect, and fixed effect method due to autocorrelation between (y_{t-1}) and the unobserved fixed effect (Aisen & Veiga, 2013; Han & Phillips, 2006; Muhammad, Islam, & Marashdeh, 2015). Thus, the SYS-GMM method can be used to avoid autocorrelation and endogeneity problems in the model.

According to Bond et al. (2001) and Roodman (2009), instrumental variables are used to overcome endogeneity problems by treating the second lag of endogenous variables as instruments, while exogenous variables can use equations at the level as there is no correlation to error. This study refers to A. Uddin et al. (2017) and Aisen & Veiga (2013), where the second lag of the dependent variable and the independent variable becomes the instrument in the first derivative equation. In comparison, the first lag of the variable is used as an instrument in the equation at the level. Then, the level of the exogenous variable can be used as an instrument.

Economic institutions have a positive and significant influence at a significance level of 5% with a coefficient value of 0.0042. This means that every 1 point increase in the Economic Institution will increase economic growth by 0.42%, *cateris paribus*. This result is in line with previous research, which showed positive and significant economic growth results in South Asia (Nadeem, Jun, Akhtar, Dong, & Niazi, 2019). Another study with similar results was conducted by Uddin et al. (2020), using the economic freedom index to measure the economic institution. The security provided by economic institutions in maintaining stability, especially property rights, will increase domestic investment. Regulations

regarding property rights will encourage companies to research to obtain efficient technology. In addition, with policies regulating property rights, individuals will obtain incentives from investment as new companies will bring forward more efficient technology (Acemoglu, 2009). In addition to the property rights policy, economic institutions can open the economy, triggering investment in foreign capital. Imitiaz & Bashir (2017) say that economic freedom will make it easier for foreign investors to channel funds into the country with low barriers from the government, especially for entering and exiting the market, reducing transaction costs and information asymmetry in the South Asian region. Research on the importance of economic institutions was also stated by Wanjuu & Roux (2017) and Hussain & Haque (2016), where economic institutions have a positive and significant effect on economic growth.

Table 2 Estimation Results of PLS, RE, FE, DIFF-GMM and SYS-GMM

Variable	PLS	Random Effect	Fixed Effect	DIFF-GMM	SYS-GMM
LnY_{t-1}	0.9912***	0.9864***	0.9118***	0.9561***	0.9618***
	(0.0023)	(0.0035)	(0.0182)	(0.1271)	(0.0112)
Political Institution	- 0.0064***	- 0.0062*	0.0086	0.0089	- 0.0065
	(0.0018)	(0.0032)	(0.0057)	(0.0581)	(0.0182)
Economic Institution	0.0002	0.0004	0.0014	0.0053	0.0042**
	(0.0003)	(0.0003)	(0.0005)	(0.0029)	(0.0016)
Investment	0.0012***	0.0015***	0.0017***	0.0004	0.0020**
	(0.0001)	(0.0002)	(0.0004)	(0.0012)	(0.0007)
Foreign Investment	0.0008***	0.0009***	0.0007***	0.0010	0.0001
	(0.0002)	(0.0002)	(0.0002)	(0.0007)	(0.0005)
Inflation	-0.0014**	-0.0017***	-0.0021***	-0.0016	-0.0066***
	(0.0006)	(0.0004)	(0.0006)	(0.0023)	(0.0023)
Population Growth	-0.0108***	-0.0088***	-0.0081***	-0.0145***	-0.0161***
	(0.0010)	(0.0014)	(0.0023)	(0.0045)	(0.0027)
Groups				33	33
Instruments				28	25
AR (1)				0.041	0.040
AR (2)				0.071	0.139
Hansen J Stat.				0.760	0.991

*** significant in 1%, ** significant in 5%, * significant in 10%. The value in brackets is the robust standard error. The second lag is used as an instrument in the first difference equation. The first lag is used as an instrument in the equation at the level (Aisen & Veiga, 2013; A. Uddin et al., 2017).

Political institutions have no significant effect on economic growth. Similar results were found in the study of Xu et al. (2021) in Asia, which found that political stability and the absence of violence had no significant effect on economic growth. He stated that this result occurred from obstacles to institutional performance in Asian countries due to the

fragile political conditions. Similar results were found in the study of Gnangoin, Du, Assamoi, Edjoukou, & Kassi (2019) in Asia. In addition, it has a negative effect, similar to the research of Doğanay & Değer (2021) and Shchegolev & Hayat (2018), where this occurs due to the unequal distribution of political power in the institutional structure where one group has greater control and tends to trigger the practice of rent-seeking. Another study with negative results was found in Zhuo, Musaad O, Muhammad, & Khan (2020). More details can be seen in Table 2. below.

Economic growth last year affected the current economic growth positively and significantly at the level of 1% with a coefficient of 0.9618, similar to the research conducted by Aslam (2020). The lag coefficient of the dependent variable, which is less than 1 ($|\rho| < 1$), indicates that the model is stationary (Gujarati & Porter, 2009). Other studies state that the lag of the dependent variable is significant, indicating that there is a convergence where countries with lower per capita incomes have higher economic growth to catch up with the economic conditions of developed countries that have reached steady-state conditions (Haini, 2019; Muhammad et al., 2015).

As measured by gross capital formation, investment has a positive and significant effect at a significance level of 5% with a coefficient of 0.0020. This means that every 1% increase in investment will increase economic growth by 0.20%, *cateris paribus*. These results follow the research conducted by Alexiou et al. (2019) and Shchegolev & Hayat (2018) and Shchegolev & Hayat (2018) where the accumulation of physical capital will increase economic growth. In addition, research by M. A. Uddin et al. (2020) in developing countries also found a positive and significant effect. Mankiw (2010) explains this through the production function where physical capital accumulation will encourage economic growth.

Inflation has a negative and significant effect with a significance level of 1% with a coefficient of 0.0066. This means that every 1% increase in inflation will reduce economic growth by 0.66%, *cateris paribus*. Similar results were obtained in the research of Aisen & Veiga (2013) and Muhammad et al. (2015), where inflation will hamper economic growth. Imam & Kpodar (2016) found similar results; high inflation results in changes in the price level. If it changes erratically, it will reduce efficiency and productivity levels. Mankiw (2010) further states that inflation levels can reduce people's purchasing power, thus reducing consumption levels and ultimately hampering economic growth.

Population Growth has a negative and significant effect on economic growth at a significance level of 1% with a coefficient of 0.0161. That means that an increase in the economic growth of 1% will reduce economic growth by 1.61%, *cateris paribus*. Similar results were obtained in the research of Aisen & Veiga (2013), Zghidi et al. (2016) and Aslam, (2020), where population growth tends to reduce per capita income. This follows Solow's theory, where population growth will reduce output and per capita income (Mankiw, 2010). Finally, there was no significant effect on foreign investment similar to the research of M. A. Uddin & Masih (2016); Rahman, Rana, & Barua (2019) and Olaoye & Aderajo (2020), where various factors such as unstable political conditions, inefficiency of institutional performance and lack of property rights protection will prevent the entry of foreign capital.

In addition, the incoming foreign capital cannot be utilized properly, especially in developing the productive sector.

Robustness Check

This study also examines the consistency (robustness check) of the key variables, namely the political and economic institutions. The test compares two regression models in the System GMM method, where the first model does not have control variables and the second model has control variables. Table 3 shows that the economic institution consistently influences economic growth positively and significantly, both before adding the control variable and after adding the control variable.

Table 3 Estimation Results of SYS-GMM

Variable	SYS-GMM	
	(1)	(2)
Ln (GDP Per Kapita $_{t-1}$)	0.9402***	0.9618***
	(0.0196)	(0.0112)
Political Institution	0.0137	- 0.0065
	(0.0227)	(0.0182)
Economic Institution	0.0045*	0.0042**
	(0.0026)	(0.0016)
Investment	-	0.0020**
		(0.0007)
Foreign Investment	-	0.0001
		(0.0005)
Inflation	-	- 0.0066***
		(0.0023)
Population Growth	-	- 0.0161***
		(0.0027)

*** significant in 1%, ** significant in 5%, * significant in 10%. The value in brackets is the robust standard error. The second lag is used as an instrument in the first difference equation. The first lag is used as an instrument in the equation at the level (Aisen & Veiga, 2013; A. Uddin et al., 2017)

Conclusion

The discussion above concluded that the quality of the economic institution has a positive and significant effect on economic growth in Asia. Economic freedom provides convenience, especially when entering and exiting the market- thus increasing the interest of investors towards the countries. This economic freedom is supported by property rights policies that can guarantee investors' assets, thereby triggering technological progress and increasing human capital. Finally, the combination of these policies will boost domestic productivity, followed by an increase in economic growth. Meanwhile, this study did not find a significant influence from political institutions. This can happen if political power is

not well distributed and concentrated in one group; thus, political stability will be followed by increased rent-seeking practices.

However, this study is limited by not having exclusive access to specific institutional indicators at certain institutions, especially when determining political institutions with diverse sizes, methods and sources. Various studies have only looked at the influence of institutions in general. A complete explanation and example of institutions, in general, can be seen in the research of Singh & Pradhan (2020), Aslam (2020), and Nawaz (2015).

As summarised, economic institutions have a significant influence on economic growth as it assists in the maintaining and controlling the activities of emerging markets in Asia. Good institutions are a must to control fraud in market activities such as monopolistic practices and rent-seeking. In addition, economic freedom is an essential factor in attracting investment into the country to have a spillover effect on technological developments and human capital.

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