*Research article*

# The Impact of the Institution on Economic Growth: An Evidence from ASEAN

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**Abstract:** The ideal community life structure has a strong institutional level. Economists agree on the institution as an important factor in creating economic growth. The purpose of this study was to investigate the influence of institutional factors on economic growth in ASEAN. Institutional variables include political stability, voice and accountability, government effectiveness, regulatory quality, rule of law, and control of corruption, while economic variables include exports and imports. This study utilized panel data estimation on 10 countries in ASEAN during 2002-2018. The fixed effect model was the best estimation model. The findings show that there are three keys of institutions that had a significant influence on per capita GDP on ASEAN, namely voice and accountability, regulatory quality, and rule of law. If the institutional factors were weak, it would be detrimental to economic performance. It could be that if the institutional factors are weak, it will be detrimental to economic performance. The policy implication is that the synergy of all stakeholders needs to be improved for better institutional enforcement.

**Keywords**: institution, institutional economics, economic growth, ASEAN

**JEL Classification**: B15, B52, C23

**Abstrak:** Struktur kehidupan masyarakat yang ideal memiliki tingkat kelembagaan yang kuat. Para ekonom sepakat bahwa institusi merupakan faktor penting dalam menciptakan pertumbuhan ekonomi. Tujuan dari penelitian ini adalah untuk mengetahui pengaruh faktor institusional terhadap pertumbuhan ekonomi di ASEAN. Variabel kelembagaan meliputi stabilitas politik, suara dan akuntabilitas, efektivitas pemerintah, kualitas regulasi, supremasi hukum, dan pengendalian korupsi, sedangkan variabel ekonomi meliputi ekspor dan impor. Penelitian ini menggunakan data panel pada 10 negara di ASEAN selama tahun 2002-2018. Model fixed effect merupakan model estimasi terbaik. Temuan menunjukkan bahwa ada tiga kunci institusi yang memiliki pengaruh signifikan terhadap PDB per kapita di ASEAN, yaitu voice dan akuntabilitas, kualitas regulasi, dan supremasi hukum. Bisa jadi jika faktor kelembagaan lemah maka akan merugikan kinerja perekonomian. Implikasi kebijakannya, sinergi seluruh pemangku kepentingan perlu ditingkatkan untuk penegakan kelembagaan yang lebih baik.

**Kata kunci:** institusi, ekonomi institusi, pertumbuhan ekonomi, ASEAN

## 1. INTRODUCTION

Economic growth as one of the main indicators in the economy is not only determined by economic factors but also influenced by institutional factors. According to Ganau (2017); Henisz (2000); Khalil et al., (2007); Nawaz et al., (2014); Rodrik, (2004) stated that an agreement among economists that the institution is the key to economic growth. Richter (2005) stated that

institutional factors play an important role in encouraging economic performance. Ferrini (2012) mentioned the importance of institutional variables such as protection of property rights, effective law enforcement, and efficient bureaucracies. The strength of institutions in development can be demonstrated in the ability to balance governance, government, and private. The institutional indicators such as political stability can affect economic growth as explained by Hirschman (1994). Furthermore, Drury et al., (2006) emphasized the importance of the level of corruption and democracy for economic growth. The administration of the state with institutions encourages the effectiveness and equitable distribution of development.

New Institutional Economics (NIE) developed as a response to the market economy, where the institutional variable is the subject of economic development which has received attention from the World Bank and International Monetary Fund (Aron, 2000 and Przeworsky, 2004). The World Bank issued the data of 6 main institutional indicators which indicated the importance of institutional factors for a country. Based on these data, ASEAN countries face challenges in improving institutional quality to promote economic growth. Economic development and political stability occupy top priorities, both of which create investment in human capital and economic investment (Glaeser et al., 2004). NIE shows the need for law enforcement to reduce the irresponsibility of economic actors, create competitive markets, and equitable development (Richter, 2005). NIE can be applied at the micro and macro levels (national and international) to create economic growth and prosperity.

Ganau (2017) studied the relationship between institutional and economic growth in Africa, which showed that the bad institutional in Sub-Saharan African countries contributed to bad economic performance. Nawaz et al. (2014) used a panel data and found that the institutions in the developed countries compared are more significant than those in developing countries in Asia. A study carried out by Henisz (2000) found that the institution had a significant positive influence in 157 countries, in details, political stability is affected positively, in contrasts, executive turnover is proven as insignificant towards economic growth. It also indicates that political constrain gives positive impacts on economic growth.

Several studies explained the relationship and importance of institutions in economic activity. Glaeser et al. (2004) assert that economic growth is supported by human resources and social capital which will drive institutional quality effectively, thus increasing productivity and economic output. More interestingly, Haini (2019) discovers the important role of institutional quality which has positive impacts on ASEAN economic growth, so it is necessary to improve the institutional quality to further support economic development. Supporting these findings, Karimi & Daiari (2018) find out the positive influence of governance indicators such as accountability, political stability, terrorists eradication, regulations improvement, laws enforcement, and corruptions eradication on economic performance in several ASEAN countries.

North (1990) defined institutions as the rules of the game in a society or, more formally, are the humanly devised contraints that shape human interaction. Aron (2000); Azfar (2006); and Gunnarsson (1991) mentioned that NIE emerged as a reaction to dissatisfaction with the neoclassical theory. NIE is considered more feasible to apply in the real world because it considers assumptions, such as asymmetric information and transaction costs. Chang (2010) explained that the state is an institution of all institutions, the state plays an important role in enforcing institutions in growth. Jutting (2003) explained 4 institutional hierarchy: (1) informal values such as traditions, culture, and social norms; (2) protection of property rights and upholding justice; (3) institutions in business and economic activity; and (4) institutions in resource allocation. This hierarchy is highly relevant and forms the basis at the macro and micro levels. A strong institution facilitates the production, exchange, and distribution activities.

In economic theory, institutions play an important role in aggregate economic growth, institutions are an endogenous factor and the main determinant of public goods supply (Khalil et al., 2007). Acemoglu et al. (2005) described several important points for institutions as the determinant of economic growth: (1) institutions have a significant effect on investment, both economic investment and human capital investment; (2) the economic institution is endogenous, so it is important in making decisions for resource allocation and income distribution; (3) political stability

and security as a condition in every economic activity. This can be seen in the decisions of investors which are largely determined by domestic security and political conditions. Political instability greatly disrupts the continuity of the production, distribution, and consumption processes. Otherwise, Chang (2010) explained the relationship between economic development and institutions, such as increasing productivity that will create better institutions, creating transparency and accountability, and political stability. Therefore, to solve the development problem, institutional reform is needed.

**Table 1.** Institutional Hierarchy

| Level | Example | Frequency of change | Effect |
|---|---|---|---|
| Level 1 (social structure) | informal institutions: traditions, culture, social norms. | Long term, 102/103 years | Defining behavior. |
| Level 2 (rule) | Property rights and law enforcement. | 10 – 100 years | Defining all institutional environments. |
| Level 3 (play of the game) | Transaction costs on government and business. | 1 – 10 years | Organizational formation. |
| Level 4 (play) | Resource allocation rules (capital flow, trade flow, and social security systems). | Short term and continuous | Price and output adjustments. |

**Source:** Williamson (2000)

According to Acemoglu & Robinson (2008), the economic institution is a key factor that differentiates the level of welfare between countries. Therefore, institutional reform is needed to achieve optimal economic development. Welfare country tends to have good institutions. Otherwise, countries with low income have weak institutions that result in high transaction costs. Institutions are needed in allocating resources for efficient production processes and equitable development. Constantine (2017) stated that a high productivity country has efficient institutions, but in poor countries, institutions are still weak, causing high costs for law enforcement to implement bureaucracy such as public services. This is in line with a study by Khalil et al., (2007) where high economic growth requires reform of regulations, constitutional design, and institutions that strategically regulate the interactions of economic actors.

ASEAN countries have unique characteristics with considerable economic growth in the world. The importance of institutional quality has existed in the old institutional economic theory, but with the advancement of time and industry, the roles and phenomena of institutional quality are getting less attention (Richter, 2005). To fill in this void, this study examines the influence of institutional factors in the form of 6 World Bank main institutional factors and macroeconomic factors on per capita GDP in ASEAN.

## 2. RESEARCH METHODS

### 2.1. Data

This study was carried out in ASEAN countries (Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei Darussalam, Laos, Cambodia, Vietnam, and Myanmar). This study used panel data estimation for the period 2002-2018 on economic variables and institutional variables. There are 6 main institutional indicators set by the World Bank namely: political stability, voice & accountability, government effectiveness, regulatory quality, rule of law, and control of corruption, and macroeconomic variables namely exports and imports. Political stability, voice & accountability, government effectiveness, regulatory quality, rule of law, and control of corruption ranges from approximately -2.5 (weak) to 2.5 (strong). This study used the data of imports of goods and services (% of GDP) and exports of goods and services (% of GDP) while the dependent variable was Per

capita GDP. A static estimation panel with the common effect model method, fixed-effect model, and random effect model was carried out to obtain the influence of institutions on economic growth.

**Table 2**. Definition of Operational Variable

| Data (variable) | Definition of Operational Variable | Data Source |
|---|---|---|
| Per capita GDP (GDPC) | The gross domestic product is divided by the mid-year population (constant 2010 US$). | World Bank |
| Exports of goods and services (EXS) | Exports of goods and services represent the value of all goods and other market services provided to the rest of the world (% of GDP). | World Bank |
| Imports of goods and services (IMP) | Imports of goods and services represent the value of all goods and other market services received from the rest of the world (% of GDP). | World Bank |
| Political stability (POL) | Level of political stability in a country | World Bank |
| Voice & Accountability (VA) | Freedom of speech and government responsibility (-2.5 to 2.5). | World Bank |
| Government effectiveness (GE) | Quality of bureaucracy and public services (-2.5 to 2.5). | World Bank |
| Regulatory quality (RQ) | Perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development (-2.5 to 2.5). | World Bank |
| Rule of law (RL) | The function of law in society (-2.5 to 2.5). | World Bank |
| Control of Corruption (CC) | Perceptions of public power for personal interest (-2.5 to 2.5). | World Bank |

### 2.2. The Model Specification

The research design is developed from Khalil et al. (2007); and Nawaz et al. (2014); Liu et al. (2018); and Ramadhan (2019) where there is a correlation between institutional quality and economic performance in the New Institutional Economy. Institutional quality as a determinant as found in poor countries indicates that low national income is accompanied by poor institutional quality. On the other hand, high national income is in line with good institutional quality (Liu et al., 2018).

$$GDPC_{it} = \beta_0 + \beta_1 EXS_{it} + \beta_2 IMP_{it} + \beta_3 POL_{it} + \beta_4 VA_{it} + \beta_5 GE_{it} + \beta_6 RQ_{it} + \beta_7 RL_{it} + \beta_8 CC_{it} + e_{it} \tag{1}$$

Where: GDPC is per capita GDP; EXS is exports of goods and services; IMP is imports of goods and services; POL is political stability; VA is voice & accountability; GE is government effectiveness; RQ is regulatory quality; RL is rule of law; CC is control of corruption; $\beta_0$ is constant-coefficient, $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7, \beta_8$ is parameters coefficient, and $e_{i,t}$ is error-term.

## 3. RESULTS AND DISCUSSION

The descriptive statistics of research data exhibit pieces of information such as means, the lowest value, the highest value, and standard deviations. Table 3 shows that Singapore has a more stable institution compared to other ASEAN countries. Commonly, ASEAN countries still have a high level of corruption and a low level of regulatory quality.

Panel data testing has many advantages and there is no need for classical assumption testing (Gujarati, 2003). Moreover, the advantages of panel data are having a large degree of freedom, avoiding multicollinearity problems, and having extensive data coverage. The following shows the

classical assumption testing. The multicollinearity test aims to test whether the regression model correlates with the independent variables or not. From the test results, most of the correlation coefficient is less than 0.8. Therefore, it can be concluded that the research model is free from multicollinearity problems.

**Table 3.** Descriptive Statistics of Data

| Variables | GDPC | EXS | IMP | POL | VA | GE | RQ | RL | CC |
|---|---|---|---|---|---|---|---|---|---|
| Mean | 10724.50 | 66.43 | 61.00 | -0.18 | -0.75 | 0.10 | -0.05 | -0.22 | -0.28 |
| Std. Dev. | 15915.78 | 51.40 | 44.14 | 0.94 | 0.68 | 1.02 | 1.03 | 0.90 | 1.01 |
| Min | 417.98 | 0.10 | 0.06 | -2.09 | -2.23 | -1.62 | -2.34 | -1.74 | -1.67 |
| Max | 59073.49 | 228.99 | 208.33 | 1.62 | 0.32 | 2.44 | 2.26 | 1.84 | 2.33 |
| Obs. | 168 | 168 | 168 | 168 | 168 | 168 | 168 | 168 | 168 |
| Correlation between independent variable | | | | | | | | | |
| EXS | | 1.000 | - | - | - | - | - | - | - |
| IMP | | 0.963 | 1.000 | - | - | - | - | - | - |
| POL | | 0.676 | 0.586 | 1.000 | - | - | - | - | - |
| VA | | 0.343 | 0.280 | 0.012 | 1.000 | - | - | - | - |
| GE | | 0.829 | 0.710 | 0.655 | 0.600 | 1.000 | - | - | - |
| RQ | | 0.801 | 0.683 | 0.652 | 0.669 | 0.953 | 1.000 | - | - |
| RL | | 0.846 | 0.727 | 0.703 | 0.560 | 0.982 | 0.950 | 1.000 | - |
| CC | | 0.871 | 0.761 | 0.706 | 0.521 | 0.944 | 0.922 | 0.964 | 1.000 |

**Source:** Secondary data processed

The unit root test was carried out to analyze the data stationary level. This study used the Augmented Dickey-Fuller (ADF) test and Philips-Perron (PP) test. Table 4 describes the results of the ADF test that per capita GDP, import, and control of corruption were stationary at the first difference *I*(1). Otherwise, export, political stability, voice and accountability, government effectiveness, regulatory quality, and rule of law were stationary at Level *I*(0) and the first difference *I*(1).

**Table 4.** Stationarity of Data

| Variable | Augmented Dickey-Fuller (ADF-test) | | | | Phillips-Perron (PP-test) | |
|---|---|---|---|---|---|---|
| | Level | | 1st Difference | | Level | |
| GDPC | 0.955 | 17.288 | 41.625 | 32.597 | 1.0037 | 28.282 |
| | (1.000) | (0.634) | (0.003)*** | (0.037)** | (1.000) | (0.102) |
| EXS | 65.865 | 26.761 | 65.865 | 49.319 | 19.189 | 115.706 |
| | (0.000)*** | (0.142) | (0.000)*** | (0.000)*** | (0.509) | (0.000)*** |
| IMP | 15.523 | 26.991 | 58.887 | 45.369 | 16.169 | 34.446 |
| | (0.745) | (0.135) | (0.000)*** | (0.001)*** | (0.706) | (0.023)*** |
| POL | 43.462 | 73.694 | 36.506 | 62.617 | 40.390 | 58.864 |
| | (0.001)*** | (0.000)*** | (0.013)*** | (0.000)*** | (0.004)*** | (0.000)*** |
| VA | 24.310 | 62.126 | 23.278 | 39.541 | 23.404 | 23.489 |
| | (0.229) | (0.000)*** | (0.275) | (0.005)*** | (0.269) | (0.265) |
| GE | 13.3449 | 72.111 | 25.468 | 53.625 | 14.851 | 32.091 |
| | (0.8621) | (0.000)*** | (0.184) | (0.000)*** | ( 0.784) | (0.042)*** |
| RQ | 13.864 | 55.470 | 19.812 | 33.538 | 21.647 | 28.327 |
| | (0.8373) | (0.000)*** | ( 0.469) | (0.029)*** | ( 0.359) | (0.101) |
| RL | 15.481 | 13.411 | 53.308 | 43.640 | 25.611 | 36.669 |
| | (0.7483) | (0.859) | (0.000)*** | (0.001)*** | (0.179) | (0.012)*** |
| CC | 14.2202 | 18.229 | 43.003 | 23.333 | 17.732 | 21.817 |
| | (0.8192) | (0.572) | (0.002)*** | (0.272) | (0.605) | (0.350) |

**Note:** ***, ** and * denote significant levels at 1%, 5% and 10%, respectively
**Source:** Secondary data processed

Heteroscedasticity test is used to find out whether there is an inequality of residual variants or not in the regression model. Based on the heteroscedasticity test, the probability value of the independent variables is more than the level of significant at 0.05, so that it is free from

heteroscedasticity problems. It is only an import variable and a political stability which have a probability of less than the level of significant at 0.05. Panel data testing using the fixed effect methods does not require the data to be free from autocorrelation problems so that the autocorrelation problems can be ignored.

The testing of the research model was carried out through pooled OLS methods, fixed effects, and random effects. The results of Chow and Hausman tests discover that the probability of these tests is both under the p-value of 5 percent. Thus, the best model for estimation is the fixed-effect model.

**Table 5.** Empirical Result of Panel Data Regression

| Dependent variable = GDPC | | | |
|---|---|---|---|
| Variable | Pooled OLS | Fixed Effects | Random Effects |
| Constant | 105.714 (0.084)*** | 73.972 (0.108) *** | 50.291 (0.161) *** |
| EXS | 6.048 (0.002) *** | -0.031 (0.002) | 1.016 (0.002) |
| IMP | -12.540 (0.002)*** | 0.262 (0.002) | -1.088 (0.002) |
| POL | -1.814 (0.044)* | 0.145 (0.047) | -0.418 (0.045) |
| VA | -4.573 (0.064)*** | -4.519 (0.080) *** | -0.350 (0.075) *** |
| GE | 1.371 (0.113) | 0.590 (0.107) | 1.4366 (0.101) |
| RQ | 5.749 (0.086)*** | 7.114 (0.090) *** | 7.105 (0.088) *** |
| RL | 3.716 (0.152)*** | 5.048 (0.122) *** | 5.342 (0.121) *** |
| CC | 6.841 (0.082)*** | -1.467 (0.103) | -0.986 (0.099) |
| Summary | | | |
| Observations | 168 | 168 | 168 |
| Adj. $R^2$: | 0.9673 | 0.9879 | 0.6246 |
| F-stat | 619.982 | 805.166 | 35.744 |
| Chow-test | | 31.091 (0.000) | |
| Hausman-test | | | 18. 794 (0.000) |
| Diagnostic tests | | | |
| Heteroscedasticity | | 6.392 (0.000) | |
| Autocorrelation | | 679.831 (0.000) | |

Note: () denotes standard error; ***, ** and * denote significant levels at 1%, 5% and 10%, respectively
Source: Author's estimation

Table 5 confirms the estimation results that the best model is the fixed effect model (FEM) which can be seen from the significant results of Chow and Hausman tests. Based on the FEM estimation results, it is proven that voice and accountability have significant negative effects on GDP. Interestingly, regulatory quality and rule of law significantly positively affects the economic growth in ASEAN. This is in accordance with the institutional quality theory expressed by North (1990) regarding institutional quality as the main driving factor for economic growth asserting that good institutional quality reduces asymmetric information and creates efficiency. The condition of regulatory quality and rule of law in ASEAN is various according to the condition of each country. However, these results indicate that regulatory and rule improvements have been done. This finding is in accordance with Nirola and Sahu (2019) who discover the positive impacts of institutional

quality improvement such as governance on economic growth in India. According to the results of FEM, exports and imports are surprisingly proven as insignificant. This is in accordance with the results obtained by Chetthamrongchai, Jermsittiparsert, and Saengchai (2020) which identify ASEAN exports as uncompetitive resulting in institutional quality improvements such as government effectiveness and corruption control are needed to make ASEAN trade better in global competition. The estimation of FEM also confirms that political stability is not significant. It is different from the findings of Ramadhan (2019) which confirm the strong influence of political stability on Indonesia's economic output. Ferrini (2012) describes the roles of institutional quality in driving the economy through transaction cost, clarity of investment return, effective management, and conducive social environment. Using static and dynamic panel data models, Nawaz et al. (2014) found that institutions played an important role in Asia, but the impact of the institutions on economic growth varied from country to country, also rule of law played an important role in economic growth in developing Asian countries.

Ramadhan (2019) found that government performance and institutional quality are proven to encourage the economic growth of Indonesia. However, Yildirima & GokalPb (2016) found that political stability had a negative influence on economic growth in developing countries. Surprisingly, based on the results, government effectiveness and control of corruption did not influence economic growth in ASEAN countries, although, in the common effect model, control of corruption influenced economic growth. Yildirima & GokalPb (2016) found several institutional variables such as judiciary independence, civil freedoms, and political stability had a negative influence on the macroeconomic performance of developing countries. Masron & Abdullah (2010) explained the need to improve institutional factors to invite foreign investment to ASEAN. In general, NIE provides solutions by strengthening institutions and maintaining political stability and legal institutions so as not to cause high transaction costs, moral hazard, and asymmetric information to create sustainable economic development (Azfar, 2006).

Institutional reinforcement has a strategic position to promote the development and the nation's competitiveness. ASEAN which is in the strategic position of trade, tourism, and global politics has big chances for institutional reinforcement to provide excellent services not only for domestic residents but also foreign investors. As an example, Indonesia has a procedure for the business establishment that still takes a long time. Of course, it becomes an obstacle for investors. It is different from Singapore which is very strong on institutional sides resulting in services obtained by its citizens and foreign investors which are excellent and boost productivity. The relevance and application of institutional reinforcement are essential as corrective solutions in all fields, especially in economic activities which are very much determined by positions between economic actors. Several economists argue that institution is an answer to catching up. A strong institution has a positive correlation with good income.

## 4. CONCLUSIONS

Institutions are the important aspects for managing public life, such as social, education, business, and bureaucracy. Several studies proved that better institutions occur in developed countries, while weak institutions occur in poor countries. An institution should be fundamental to economic performance. Based on the results, there was a significant influence of institutional factors on economic growth in ASEAN. Voice & accountability, regulatory quality, and rule of law play an important role and has a significant influence in encouraging economic growth in ASEAN. This condition shows that not all institutional indicators have functioned properly and played a role in economic stability in ASEAN. Therefore, it requires institutional improvement from all stakeholders, government and private cooperation, and its application from the micro to macro levels. Furthermore, the Indonesian government should improve services to society by strengthening domestic institutions and optimizing coordination with other countries in the ASEAN region. This study is still limited to estimating macro institutional factors, it has not included institutional factors in a micro perspective and has not estimated more economic factors. Policy implications that can be provided are institutional as a solution for improving the life of ASEAN

people to achieve equitable development. All ASEAN member countries are suggested to apply government effectiveness through simplification of administrative lines and efficiently use the time to encourage public accountability in addition to clarifying and reinforcing regulatory quality as well as implementing and strengthening rule of law to support political stability. A policy recommendations that is also very important is controlling the level of corruption.

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