

The Wealthy World's Open-Economy from FDI Inflow Is a Real Thing: Malaysia's Experience

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Abstract Fiscal policy is one of the popular instruments used by government to provide balance to growth in the national economy and market. In Malaysia's context, fiscal policy is implemented using such as the annual budgets, Malaysia Plans, and multiple stimulus packages aimed at boosting Malaysia's economy especially during the recent lock down which has threatened to cause an economic crisis due to the Covid-19 pandemic. Additionally, one of the Malaysian Government's biggest spending using fiscal policy is its development expenditure, and tax is one of the largest contributions used to support this development expenditure. In order to attract investors to Malaysia, critical features such as benefits, facilities, and social welfare have been designed by decision-makers in each formulated policy. Initiatives such as inter-governmental forums, trade agreements and discussions are platforms that can be used to share and respond to economic problems. However, the existence of competition and foreign policy have become major challenges to the country's efforts to attract investors. Therefore, the aim of this study is to investigate the relationship between Malaysia's federal government development expenditure with foreign direct investment (FDI) inflow, as well as the country's openness towards investment. The two dimensions of asymmetric FDI inflow were analysed to see how they react to government expenditure from 1970 until 2019 using the Linear and

Nonlinear Autoregressive Distributed Lag method. Findings from the Nonlinear Autoregressive Distributed Lag Model (NARDL) model indicated that FDI has a positively significant effect on fiscal accumulation for development expenditure. In conclusion, increases in government expenditure increase FDI inflow into Malaysia in both the short- and long-run. Hence, government development expenditure behaviour represents accelerating economic growth in the Malaysian context, and it is proven to have a significant impact towards economic growth in the long-run. This study contributes to empirical literature on the relationship between federal government development expenditure and FDI inflow, particularly the effect of openness to investment into a developing country towards economic growth in the long-run.

Keywords Asymmetric, Competition, Investment, Economic Growth

1. Introduction

The "invisible hand" concept in the open market system is a metaphor introduced by economist Adam Smith to represent the role of the government. In this perspective,

the government plays the role as an arbitrator to provide balance to growth in both the national economy and the market. A popular instrument used by the government is fiscal policy. Malaysia has its annual budgets, Malaysia Plans, and stimulus packages as part of its fiscal policy used to boost the economy. When Malaysia went into lockdown due to the Covid-19 pandemic, the situation had posed the threat of an economic crisis. To combat this, the government introduced more than five stimulus packages: PRIHATIN, PENJANA, PERMAI, PEMERKASA, PEMERKASA PLUS, and PEMULIH as fiscal instruments implemented to recover the economy. RM530 billion were allocated for these packages. A government's spending on fiscal policy is divided into two categories: operating and development expenditures. Barro [3] stated that the impact of government spending may vary depending on the component of government expenditure that is under consideration. In the Shared Prosperity Vision 2030 which aims to establish and enlarge the business ecosystem and industry in Malaysia, fiscal sustainability is pursued through sustained government financing and strengthened investor confidence.

Taxes is one of the largest contributions to the government used to support development expenditure. The percentage of taxes imposed on personal income is different for individual residents or non-residents working in Malaysia and the corporate sector. However, in order to attract investors to Malaysia, critical features such as benefits, facilities, and social welfare have been placed in each policy by decision-makers. Lim, Shivee, and Woon [16] stated that among these features are attractive tax incentives, liberal equity policies, and the employment of expatriates. These features are included due to the competitive market nowadays. To increase the real income of the country and compete with other regions, development expenditure is crucial to boost growth. According to Chen, Lv, and Liu [6], the slow development of the financial sector has long been identified as one of the most binding constraints on economic growth, especially in developing countries.

Malaysia has implemented zero-based budgeting for its expenditures since 2019 in order to strengthen the federal government finances. This concept is developed based on the needs and abilities to implement without affecting government services to the society. Initiatives viewed as having a trickle-down effect from the government towards the society are mega projects such as the Klang Valley Mass Rapid Transit (MRT), Tun Razak Exchange, and the Pan Borneo Highway which are seen as national plans to accelerate economic growth and attract foreign investors. The government plans and implements mega projects in its annual budgets or Malaysia Plans. Katiman *et al.*[15] reported that socioeconomic impacts, increasing per-capita income, household occupation, and quality of life are some of the benefits that Iskandar Malaysia has provided as one of the country's mega projects.

In Malaysia, the annual allocation by sector is different due to financial constraints and other political issues. According to Dreher, Sturm, and Ursprung [7], the government tends to reduce expenditures on transfers and subsidies because of globalisation. However, the Malaysian government has also improved and stabilized its annual budgets with other kinds of incentives. According to Chen *et al.* [6], there is less attention to the determinants of government expenditure composition. To fill this gap, our research focused on the short-run and long-run relationship between government spending and mobility policy in attracting investors to Malaysia. Charles [5] stated that the barrier to most incentive-based competitions is effectively intra-regional since much of real investment that national and sub-national governments compete for is investment that investors intend to locate in a particular region. The existence of competition and foreign policy has become a major challenge to the country in attracting investors. This paper contributes to the debate on development expenditure by addressing federal debt due to development made specifically to attract foreign investment. The authors studied whether there is a relationship between federal development expenditure in Malaysia with foreign direct investment inflow, as well as openness towards investment. The rest of the paper is organized as follows: Section 2 presents the relevant literature, Section 3 discusses the estimation and model of study, and the last section presents the overall discussion and policy implications.

2. Literature Review

Government expenditure's main contribution to a country's economic growth has been discussed and debated in various fields of literature. Government expenditure is a tool that can attract investment and develop certain places or sectors. Since 1970, the value of government expenditure has increased as shown in the annual budgets. The main aspect of a government expenditure is more towards generating and increasing a country's income in order to sustain economic growth. This is the reason why Malaysia has introduced its annual budgets and the long-term Malaysia Plans as tools to plan and determine the country's vision and mission. An earlier study by Solow (1956) showed how government spending has an impact towards economic growth, where in the long-run growth is exogenously driven by technical progress and assumes transitory effects of shocks to fiscal policy on economic growth. Barro [3] mentioned that the impact of government spending may vary depending on the component of government expenditure that is under consideration. Easterly and Rebelo [8] in their time series study found that public investment is consistently correlated to economic growth. Barro [3], on the other

hand, confirmed the detrimental effect of the public sector on economic growth.

Malaysia’s government expenditure has increased from only RM72.5 million in 1970 to RM45,962 million in 2016. Although the amount of the budget always fluctuates, the trendline is found to increase every year. In fact, ever since the implementation of the New Economic Model in 1970, Malaysia’s expenditure has been greater than 300%. Generally, infrastructure, education, social, and defense are the main aspects in a government’s expenditure as these factors are more likely to attract high FDI and income. However, the volume of development expenditure for Malaysia by share of GDP is only around 3.5% to 4.4% for the years of 2019-2021. The debate about government development expenditure has gained fresh prominence, with arguments by Gunby *et al.* [11] who posited that the growth in Chinese FDI was guided by public policy, with the reason being that the key elements in a policy affect the economy at the firm level.

The importance of saving and investing in supporting growth has been emphasised on by the Harrod-Domar model. The government’s investment helps boost economic growth and attract FDI. A number of authors have reported a contradicting relationship between FDIs and other sectors in the economy. Waqih *et al.* [23] stated that FDIs and CO₂ emissions in an empirical time series study portrayed an inverted-U relationship. Meanwhile, Munir and Ameer [18] reported that Pakistan’s economic growth and increase in FDI have increased CO₂ emissions. Gunby *et al.* [11] discovered evidence of FDI-related productivity spill-overs in China, and these spill-overs

have been of sufficient size to affect growth at the aggregate level.

Government debt is always debated on as the volume of debt affects economic growth in the long run. The crowding-out effect of government expenditure on debt has several potential elements. Feyzioğlu, Swaroop, and Zhu [9] showed that when governments receive foreign funding for education, they tend to cut back on their own spending in the sector. A study in China by Tang *et al.* [22] showed the importance of government spending in increasing intergenerational and improving equality. Meanwhile, evidence on government policy in expenditure have raised concerns about its distortionary effect on the market and other indicators of economic growth, especially in achieving the Shared Prosperity Vision 2030.

3. Methodology

In this section, the authors developed an econometric analysis on the nexus between economic growth, government development expenditure as well as foreign direct investment (FDI). All variables have been converted into a natural log form. The data were collected for various years from the Economic Planning Unit and the Ministry of Finance. We employed an empirical model based on the endogenous growth model of Barro, [3] which assumes the role of government public expenditure in order to generate outcomes that affect political stability, human capital, and market distortions.

Table 1. Malaysia’s Development Expenditure

Sector	RM Million			Change (%)			Share (%)		
	2019	2020	2021	2019	2020	2021	2019	2020	2021
Economic	31,300	28,525	38,887	-13.3	-8.9	36.3	57.8	57.1	56.4
Social	14,484	13,058	18,369	12.5	-9.8	40.7	26.7	26.1	26.7
Security	5,614	5,557	7,780	13.9	-1.0	40.0	10.4	11.1	11.2
General Administration	2,775	2,860	3,964	26.7	3.1	38.6	5.1	5.7	5.7
Share of GDP (%)	3.6	3.5	4.4						

Source: [19]

Table 2. Summary of Selected Variables

Variables	Short Form	Measurements	Sources
Government development expenditure	EXP	RM Billion	Ministry of Finance Malaysia
Economic Growth	GDP	GDP Per capita (Current USD)	World Development Indicator (WDI)
Foreign Direct Investment in Flow	FDI	Percentage of GDP (Current USD)	World Development Indicator (WDI)
Trade Openness	TROP	Ratio of total trade (exports plus imports) in GDP,	World Development Indicator (WDI)

Source: Authors’ compilation

In our basic model for analysis, government development expenditure (G_{EXPT}), Gross Domestic Product (GDP) per-capita (GDP_{PCt}), foreign direct investment inflow (FDI_{IFt}), and trade openness (TRO_{POPt}) are the proxies by import and export to be divided by total GDP. Intercept is represented by C and residual by U_t . Hence, the simple OLS-three variable model takes the following form:

$$G_{EXPT} = C + \beta_1 GDP_{PCt} + \beta_2 FDI_{IFt} + \beta_3 TRO_{POPt} + U_t \quad (1)$$

Next is the three-step econometric procedure, ARDL. First, a time series unit root test was applied for the stationary test. The stationary test was done on each variable to avoid spurious regression problems since the OLS minimizes the summed squared residuals and the regression estimation is sensitive to residuals from large data. Taasim and Yusoff [21] stated that time series data is stationary if its mean and variance are constant over time. Granger and Yoon [12] reported that in order to test the existence of a long-run relationship, an EC model should be estimated with the lagged residual. A bounds testing procedure can be used to draw conclusive inference without knowing whether the variables are integrated of order zero or one, $I(0)$ or $I(1)$, respectively as put by Pesaran, Shin, and Smith [14] and Pesaran and Shin [13].

$$\Delta y_t = c_0 + \gamma \hat{v}_{t-1} + \sum_{i=1}^{p-1} \varphi_{yi} \Delta y_{t-i} + \sum_{i=0}^{q-1} \varphi'_{xi} \Delta x_{t-i} + \mu_t$$

$$- 1 \leq \gamma < 0 \quad (2)$$

The long-run relationship is expressed as Equation 4, where y_t represents the development expenditure of the government. Ak, Kirca, and Altintaş [1] stated that μ_t is a vector of deterministic regressors (trends, season, and other exogenous variables). When the development expenditure and FDI are nonlinear (asymmetric), Shin *et al.* [20] proposed the NARDL model as positive and negative partial sums. Asymmetric cointegration is implied if the time series is noted to have cointegration using their positive and negative components, as posited by Granger and Yoon [12]. Shin *et al.* [20] proposed the nonlinear ARDL cointegration approach (NARDL) as an asymmetric extension to the well-known ARDL model of Pesaran and Shin [13] and Pesaran *et al.* [14].

$$\Delta y_t = c_0 + \beta_1 FDI_t^+ + \beta_2 FDI_t^- + \beta_3 GDP_{PCt} + \beta_4 TD_t + \varepsilon_t \quad (3)$$

The values of FDI_t^+ and FDI_t^- are the partial sums of

the positive and negative in the foreign direct investment inflow.

$$FDI_t^+ = \sum_{i=1}^t \Delta FDI_i^+ = \sum_{i=1}^t \max(\Delta FDI_i, 0)$$

$$\text{and } FDI_t^- = \sum_{i=1}^t \Delta FDI_i^- = \sum_{i=1}^t \max(\Delta FDI_i, 0) \quad (4)$$

After the model obtained the optimum lags, a cointegration bound testing was applied as in Pesaran *et al.* [14] to identify the presence of cointegration variables. To identify the presence of asymmetry, analysis using the Wald test was employed for the long-run. The existence of a long-run/cointegrating relationship can be tested based on the EC representation (Ahad and Dar, [2]). These techniques are only applicable when the data series are integrated at the same level, i.e., $I(0)$ or $I(1)$.

4. Empirical Results

The authors' focus in this section is to identify the stationarity of the time series and the data integration at $I(1)$ for all variables involved. Annual data from 1970 to 2017 were employed in the analysis. Table 3 represents the descriptive statistics of the 46 observations. Based on the statistics, FDI (dfdi) has the highest ranking for mean and standard deviation at 9.390 and 0.546, respectively. The trade openness (dtrop) variable has the lowest values for mean and standard deviation.

Table 3. Summary of Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
dexpg	46	4.194	0.427	3.274	4.734
dgdg	46	3.565	0.344	2.883	4.058
dtrop	46	0.156	0.119	-0.043	0.343
dfdi	46	9.390	0.546	8.059	10.179

Before ARDL and NARDL were employed in the analysis, the Augmented Dickey Fulley (ADF) and Philips-Perron (PP) analyses were first conducted to examine the time series properties of the variables and to compute the unit root statistics. A nonstationary series has one or more basic properties that do change over time. The results are shown in Table 4. Since the test results show that a number of variables are significant $I(1)$, the analysis then proceeded to the bound testing procedure. The null hypothesis is accepted if the value of the t-statistic is more than the t-critical.

Table 4. Unit Root Test (Constant and Trend)

Variables	Level				1 st Difference			
	ADF		PP		ADF		PP	
	Constant	Constant and Trend	Constant	Constant and Trend	Constant	Constant and Trend	Constant	Constant and Trend
dexpg	-1.738	-3.054	-1.874	-2.165	-4.631*	-4.676*	-4.497*	-4.509*
dgdg	-1.412	-3.928	-1.379	-2.399	-4.263*	-4.181**	-5.448*	-5.578*
dtrop	-2.756	-0.500	-1.409	-0.029	-4.209*	-4.961*	-4.158*	-4.863*
dfdi	-3.102	-5.465	-2.854	-5.466	-7.425*	-7.342*	-20.24*	-20.92*

*Significant at 1%; **Significant at 5%

To ensure that the model estimates are not spurious, we applied traditional methods of estimating unit root such as the Augmented Dickey-Fuller test (ADF, 1979) and the Philip-Perron (PP, 1990) test. Taking the first difference is enough to convert a nonstationary series into stationary. For Table 4, the null hypothesis of the ADF and PP tests is unit root at level 1% and 5%. This test is to verify the stationary of variables. Possible asymmetric effects of government development expenditure on gross domestic product was analysed using the NARDL technique which decomposed the GOV rate series into two parts: (1) partial sum of positive change in GOV rate denoted by GOV⁺, and (2) partial sum of negative rate denoted by GOV⁻. When both of GOVs were included as separate regressors in the model, the following model was developed:

$$GDP_t = C + \alpha_0 GDP_{t-1} + \alpha_1 GOV_{t-1}^+ + \alpha_2 GOV_{t-1}^- + \alpha_1 FDI_{t-1}^+ + \alpha_2 FDI_{t-1}^- + U_t \quad (5)$$

Equation 2 is the ARDL model proposed by Pesaran *et al.* [14], and the final model is asymmetric as shown below in the general form of the NARDL (Nonlinear Autoregressive Distributed Lag Model):

$$\Delta GDP_t = \alpha + \beta_0 GDP_{t-1} + \beta_a GDP_{t-1} + \beta_1 \theta^+ GOV_t^+ + \beta_2 \theta^- GOV_t^- + \sum_{j=1}^{p-1} \varphi_j \Delta GDP_{t-j} + \sum_{j=0}^q (\pi_j^+ \Delta GOV_{t-j}^+ + (\pi_j^- \Delta GOV_{t-j}^-)) + e_t \text{ for } j = 1, \dots, q \quad (6)$$

Where $\theta^+ = p\beta^+$ and $\theta^- = p\beta^-$
 ρ and q are lag orders, and both

$$\alpha_1 = -\frac{\beta_1}{\beta_0} \text{ and } \alpha_2 = -\frac{\beta_2}{\beta_0}$$

are the aforementioned long-run impacts of increasing foreign direct investment and reducing foreign direct investment on remittances, respectively. For data with negative signs for foreign direct investment, the authors transformed them to positive values using the procedure proposed by Busse and Hefeker [4]. Foreign direct investments are the most ideal form of capital inflows to emerging and developing countries because they are less susceptible to crises and sudden stops, as mentioned by Busse and Hefeker, [4].

Table 5. ARDL Long-Run and Short-Run Estimation Results (2,0,0,0)

Variable	Long-Run Estimation			
	Coefficient	Std Error	t-stat	Prob.
c	0.29	0.15	2.02	0.05
dgdg	0.28	0.11	2.61	0.01
dtrop	0.03	0.02	1.91	0.06
dfdi	-0.09	0.08	-1.14	0.26
Short-Run Estimation				
c	0.29	0.15	2.02	0.05
dgdg	0.94	0.18	5.28	0.00
dtrop	0.09	0.05	1.99	0.05
dfdi	-0.29	0.25	-1.19	0.24
ect(-1)	0.39	0.14	2.79	0.00
AIC (lag)	-17.851 (2)			
F-stat	248.650			
Prob > F	0.000			
R-squared	0.971			
Root MSE	0.017			

*Significant at 1%

In the first step, the authors employed the ARDL analysis to capture the long-run and short-run estimations for the model. The table above shows the results with the selected optimal maximum lag order by the Akaike Information Criteria (AIC). The short-run estimations were obtained from the ECM equation using the AIC with estimation error correction model and long-run estimations. Table 5 shows that all variables are significant in the long-run and short-run, excluding the foreign direct investment with the negative sign. The value of ECT (-1) is positive and significant at level 1%, indicating that at least one direction exists, therefore proving a causal relationship.

$$\Delta \ln GEXP_t = \mu + \sum_{i=1}^p \gamma_i \Delta \ln GDP_{t-i} + \sum_{j=1}^p \gamma_j \Delta \ln TRO_{j-i} + \sum_{k=1}^p \gamma_k \Delta \ln FDI_{k-i} + vecm_{t-1} + \mu_t \quad (7)$$

The estimated gross domestic product has a high significance of 1% in both the short-run and long-run relationships. However, in two periods of time, foreign direct investment was found to be negative and not significant. Frimpong and Oteng [10] reported in a study in Ghana that FDI inflows have failed to generate the necessary linkages to the wider economy that are needed for the anticipated economic growth. Unlike ARDL, the formulation of NARDL allows for potential asymmetric effects of positive and negative changes in explanatory variables on the dependent variable.

Table 6. Asymmetric Estimation of Government Expenditure-Foreign Direct Investment

Variable	Coefficient	Std Error	t-stat	Prob.
$dexp_{t-1}$	-0.181	0.072	-2.52	0.016
$d\text{fdi}_{t-1}^+$	0.189	0.129	1.47	0.150
$d\text{fdi}_{t-1}^-$	0.163	0.139	1.16	0.252
$\Delta dexp_{t-1}$	0.259	0.141	1.85	0.072
Δfdi_t^+	0.672	0.227	2.96	0.006
$\Delta \text{fdi}_{t-2}^+$	-0.045	0.083	-0.55	0.587
Δfdi_t^-	-0.131	0.086	-1.52	0.138
$\Delta \text{fdi}_{t-1}^-$	0.482	0.257	1.88	0.068
Const	0.241	0.093	2.60	0.013
		F-stat	P>F	
L_{fdi^+}	1.049	4.399	0.043	
L_{fdi^-}	-0.902	2.039	0.162	
			P-value	
Portmanteau test			0.3492	
Breusch/Pagan heteroskedasticity			0.8068	
Ramsey Reset test (F)			0.9001	
Jarque-Bera test on normality			0.5480	
F-statistic				

Referring to Shin [20], the authors employed the NARDL to identify the relationship between development expenditure and foreign direct investment inflow. The techniques used were the interaction of both positive and negative shocks, as well as the interaction between the explanatory variable and the dependent variables in the long-run equilibrium. The results of the analysis are shown in the table below, with L^{fdi^+} and L^{fdi^-} denoting the coefficient for foreign direct investment with asymmetric estimations in the positive and negative. Table 6 shows that the NARDL captures the asymmetries in the responses of government expenditure towards changes in foreign direct investment inflow. The long-run and short-run relationships were tested using the F-test as the significance is at 0.05. The test indicated that the results are asymmetric for the long-run. The results show that when government expenditure increases by 1%, foreign direct investment inflow increases by 1.05%.

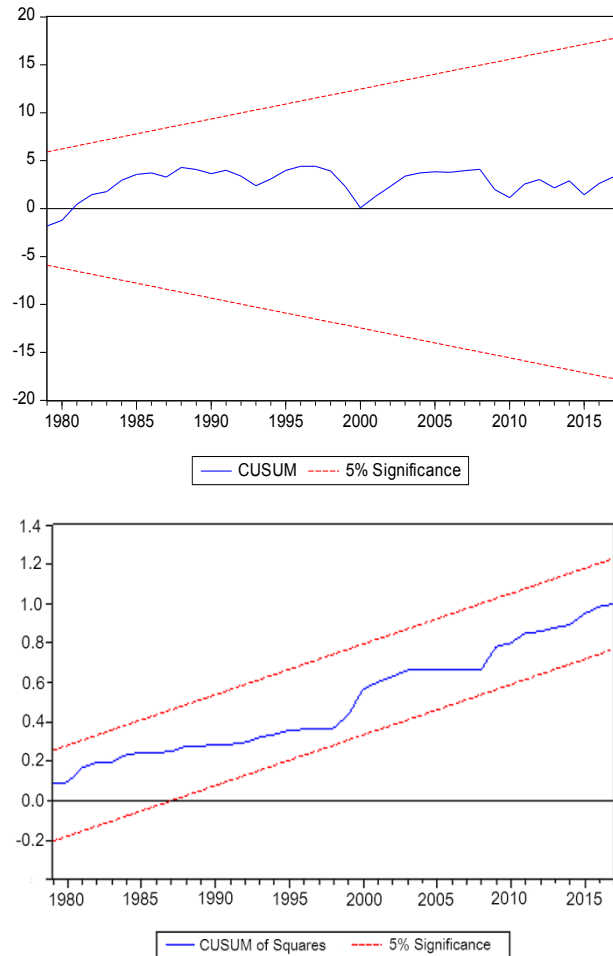


Figure 1. CUSUM and CUSUM of Squares

However, when government expenditure decreases, foreign direct investment also decreases by 0.9%. This study performed four types of diagnostic tests. From the table, all model diagnostics have been found to be insignificant, thus it can be concluded that there is no autocorrelation, heteroscedasticity, misspecification, and non-normality. The next step is to test the structural stability of the model. We employed the CUSUM and CUSUM squares. From the results, the CUSUM and CUSUM squares indicated that the confidence level is within 5%. The authors can therefore conclude that the model has no structural instability in its residuals.

5. Concluding Remarks

The current study aims at determining how Malaysia's fiscal policy measures interact with foreign direct investment. Malaysia is listed as one of the most conducive countries for foreign investments with the implementation of an investor-friendly environment. The major contributors to foreign direct investment in Malaysia for the period of 2017 to 2019 are the equity sector as well as investment in the stock market [17]. The

authors used the empirical approach to test the short-run and long-run nonlinearities simultaneously through positive and negative partial sum decompositions of the explanatory variable. The test indicated that FDI is significant with positive interaction on fiscal accumulation for development expenditure. It is interesting to note that for both the analysis models, the autoregressive distributed lag and asymmetric model showed similar effects. These factors may explain why FDI inflow is affected when the government decreases its volume of allocation on development expenditure. As foreign investors have the opportunity to invest in other countries, the Malaysian government should thus consider allocating an amount of development expenditure in its annual budgets. There are several opportunities for Malaysia to lead as a hub of foreign investments, especially during this pandemic-caused economic crisis. Promotion by the Malaysian Investment Development Authority (MIDA), stable economic performance, pursuance of government projects with high impact especially mega projects, and tax benefits are some of the attractions needed for FDI inflow.

As a recommendation, the share of GDP for development expenditure should be increased to 5% of the annual GDP as a show of confidence and to attract investors. As shown in Table 1, the share of GDP for development expenditure is less than 5%. The findings have proven the significant impact of development expenditure towards economic growth in the long-run. The smaller amount of GDP allocated to development expenditure compared to the operating expenditure of more than 15% of the GDP should be reconsidered in order to attract new investors.

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