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Unmasking the Economic Traps: How Corruption, Political Instability, and Public Debt Stall Growth in South Asia – A Panel Study

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Abstract

This paper aims to investigate effects of corruption, political stability, trade, inflation rate, and government public debt on economic growth in major South Asian nations during 2001-2022.The present study has used Generalized Method of Moments (GMM) for analyzing panel data. The results therefore show that corruption and public debt both negatively affect economic growth as concluded in previous analysis that portray corruption as having positive impacts on the efficiency of governance and institutions. Government stability also show a strong negative relationship with growth keeping aside from the fact that stability is very essential when it comes to political stability. On the other hand, import and export have positive impact that lead to growth through enhancing trade openness and the markets. This macro economical aspect pulls down growth and is probably driven by inflation. It awards more importance to institutions, governance and political stability key ingredients that are necessary for a sustainable economic development in South Asia region. That is why, these results show that for the development of sustainable growth, institutional changes designed to enhance the quality of institutions and combat corruption are required.

Keywords: *Panel Data, South Asia, GMM, Economic Growth, Corruption, Political instability*

Introduction

Political instability has been directly associated with the economic condition of a country. Stability is important because when a government is unstable it creates an atmosphere of

uncertainty and this deters investment and slows down economic growth. Investors start to avoid risk due to the uncertainty of government policy and this leads to the slowdown of industrialization, less employment. Political parties in South Asian democracies have their sights set on the next four to five-year term, which is why they often invest in things like infrastructure (which is easier to channel towards personal gain) rather than education or healthcare, for instance. These short term goals and objectives hamper the achievement of long term sustainable development. This also leads to a cycle in the political system. With the slowdown in economic growth, governments become prone to failure which in turn worsens the situation. Aisen and Veiga (2013) noted that political instability is inversely related to economic growth. Thus, in politically unstable countries, economic inefficiencies increase because resources are not allocated efficiently thus resulting to a poor government performance and a general negative economic change. Moreover, in politically unstable countries, institutions are dependency of political actors and bureaucracy, and therefore lack autonomy. This lack of autonomy hampers the needed change and accountability and thus fosters corruption. Corrupt governance leads to the misallocation of resources from social sector projects to projects that lined the pockets of the corrupt, worsening social imbalance.

Corruption exists in countries with poor institutional frameworks and is observable throughout the society. Political corruption in particular, has direct adverse impact on economic development since public funds are embezzled. The author notes that leaders often tend to fund projects, which allow for bribery, like construction of highways or buildings, rather than spending money on people's health or education, which is essential for sustainable development (Mauro, 1998). According to the literature, corruption has a negative effect not only on the economic development but also on income distribution. Due to corruption, in some countries, the levels of income inequality are high because a few people hold most of the wealth. Corruption also expands the shadow economy, which leads to more black money in circulation and thus skewing the economists' figures. Mo (2001) and Gyimah-Brempong (2002) have established that corruption decreases economic growth by 0.72% for every 1% increase in corruption. More specifically, South Asian nations are ridden with institutional corruption that limits their development and increases political risks. For instance, in Pakistan and Bangladesh, corruption has denied the poor a better life and hindered the generation of opportunities. Nonetheless, there are economies with robust institutional settings such as China; they are capable of reducing the adverse impacts of corruption to some extent though the problem is not entirely contained within these economies. Other findings also show that corruption has a direct impact on political instability thus strengthening the correlation between these two variables.

It is no longer a rarity for developing economies such as those in South Asia to face public debt. The countries in the region have thus shifted their focus towards the international financial institutions like the IMF and the World Bank to handle fiscal deficits. Public debt, however, has different impacts on growth since the funds can be used in different ways and may also be affected by corruption. Despite the fact that debt as such is not dangerous, issues occur when the borrowed money is spent inefficiently, which is often linked to corruption. Kim et al. (2017) included corruption as another variable to capture the impact between public debt and economic growth. They discovered that corruption can greatly change the effect of debt on growth. For instance, in the most corrupt countries, debt financed initiatives may not have any positive impact on growth because the resources are channeled to the private gain and not to the public utilities. In South Asia, the public debt results in a vicious circle, which is generally known as 'debt trap'. This is

further compounded by corruption which merely worsens the mismanagement of debt resources. Consequently, these countries cannot attain sustainable growth, and most of the borrowed capital does not produce lasting economic returns (Ouhibi et al., 2017). Nevertheless, there are examples of positive impact of debt in countries with better institutions such as Egypt and South Africa. In some countries, public debt has been utilized in funding large number of developmental projects including infrastructural and industrial development that has boosted the economy. This indicates that the role of public debt in growth is very sensitive to the condition of governance.

This paper demonstrates how corruption, political instability, and public debt jointly determine the economic growth paths of the South Asian nations. Political instability and corruption are in a vicious cycle where each one enhances the other and hampers political and economic performance. While public debt is an important instrument for development, it turns into a curse when corruption is evident. The study finds that South Asian countries must enhance their institutional capacity, fight corruption and maintain stable political environment to support sustainable growth. However, more can still be done to improve economic results by lifting trade restrictions and optimizing the usage of public debt. These factors make it clear that it is important to implement the necessary reforms to promote and enhance the principles of openness and accountability so that sustainable economic development can be pursued in the region.

Literature Review

The economic growth is a multifaceted process, which does not have any one factor that would directly determine the economic elevation or the decline of a particular country. Prior research on the subject have analyzed several antecedents of economic development and their causal relationships among diverse countries via a panel data approach. Of these factors, corruption, public debt, shadow economy, political instability, trade openness has been a sign of significant economic performance.

Corruption and Economic Growth

There is a clear evidence of the general negative impact of corruption on the growth of the economy. According to Henri (2018), public debt is caused by corruption and subsequently leads to decline in the economy, but it appears that spending is an effective way to reduce the debt. Dokas et al., (2023) & Cooray et al. (2017) agreed that corruption is interrelated with the shadow economy. Their study, which focuses on how weak institutions facilitate unofficial economy, points out that corruption and shadow economy are forms of reciprocation lowering the tax revenue and increasing domestic and foreign debts. This emphasizes the importance of institution changes regarding public debt and economic volatility. Kim et al. (2017) continued this line of thought by analyzing the link between corruption, public debt and economic development of 77 countries. Based on OLS and GMM techniques, the authors find out that public debt is not harmful per se specially if utilized for its proper uses and within publicly unclouded system. But in corrupting states, public debt is inefficient utilized and therefore produces negative effects. Benfratello et al. (2015) also note that corruption leads to growth in public debt both through a direct and an indirect path. In extension, their study on the 166 nations suggests that coherent polices are required for the viable management of public resources and the funding of such endeavors. Mauro (1998) examines the net effect of corruption, especially at the political level on the corruption of government expenditure on social necessary sectors such as education and health. When corrupt officials are spending our money, the latest research of 100 countries shows that corrupt governments spend more on large projects where they can steal more and less on public goods like schools and hospitals. In light of these findings the study concludes that the

fight against corruption especially in the management of public expenditure is essential for sustainable economic development of a country. The shadow economy which is associated with corruption also causes its own vices affecting the steadiness of an economy. Gonzalez-Fernandez and Velasco (2014) and Mudassaar (2019) consider this effect of the shadow economy, education and corruption on public debt with the help of panel data of Spain. They discover that the shadow economy exerts a positive influence on public debt, a role that corruption reinforces. The results also reveal that the size of corruption and the general public indebtedness increases with the size of the shadow sector; therefore, reducing the monetary value of the shadow sector is crucial for combating corruption and stabilizing public debt and for accelerating economic growth.

Political Instability and Economic Growth

Another factor that cause a problem towards economic growth is political instability. Alesina et al., (1996) and Sheikh & Mustafa, (2018) in their respective studies on how political instability influences per capita GDP, the countries with unstable governments experience higher tendency to collapsed if their respective economic growth is poor. These studies stresses on the consequence of political instability by revealing the way it influences productivity and human capital formation universally and proposes that such problems should be handled systematically. To this effect, Aisen and Veiga (2013) & Ezeador (2024) also take this further by highlighting corruption as a determinant of political instability. Their study establishes that one percent improvement in corruption reduces economic growth by 0.72 percent. Several factors trigger this decline including; badly protected, poor, and heavily disputing institutions, inefficient judiciary systems, and inconsistent income levels. According to the authors, corruption especially in bureaucratic structures have to be eradicated for effective political stability and economic development.

Public Debt and Economic Growth

Over the years, much attention has been paid to the link between the public debt level and economic growth, mainly under conditions of corruption and political instability. Heimberger, (2023) & Alesina and Tabellini (1989) observe that countries with facilities of institutional quality, lower private capital formation, and which are not capable of attracting foreign capital fund form higher level of debt which is deleterious to economic growth. The authors highlight the political motivation for borrowing, especially in the LDCs, and the resulting impact of the public. Ondo (2017) examines corruption as a growing factor of Central African countries, particularly if there is a positive or negative linear correlation between corruption and economic growth for the 2005–2015 period using a panel data. The present research also indicates that corruption has a direct positive correlation with economic development in these countries, meaning that corruption may act more of a survival strategy given the prevailing institutional setting. Nonetheless, global literature clearly exhibits that corruption when analyzed alongside the higher level of public debt significantly deteriorates the long term economic stability and growth.

Trade Openness and Economic Growth

There are three components of trade openness that has received significant attention in the literature on economic development: Trade intensity. Malefane and Odhiambo (2018) & Kong et al. (2021) explore a relationship between trade openness and economic growth in the South Asian economy and apply the ARDL model with four indicators. According to their work, the earliest essay in this volume concludes that trade openness has had positive effects in poverty reduction and provision of employment opportunities though it exercises a negative impact on income

disparity. According to the authors, trade integration and especially with the developed countries, can stimulate activities and productivity in the economy, while protectionism negatively affects the growth of economic productivity in the long run.

Summing up literature, number of aspects, which show the fact of economies' growth, has been defined, emerging such factors as corruption, political instability, shadow economies, public debt, and trade openness. Corruption in specific, has a dynamic negative effect on economic growth, public debt and institutional governance. These challenges are compounded by political instability especially in developing countries with less political institution endowment. And it was incumbent upon these countries to address these matters of institutional quality, public accountability and trade liberalization in order to focus on lasting economic change and development.

Model, Data and Methods

In order to determine impact of corruption on the relationship between public debt and economic growth, we have used a model which can be defined as;

$$\Delta y_{it} = \beta 0 log(y_{it}) + \beta 1 log(Debt_{it}) + \beta 2 Corruption_{it} + \beta 3 log(Debt) \times (Corruption) + Z'X + \rho + \tau + \varepsilon$$

Here i = country i = 5 (Bangladesh, China, India, Pakistan and Sri lanka) & t = time period = 2001-2017. Y is the economic growth (GDP per capita) which is dependent variable while the rest variables adopted includes Corruption, political stability, inflation, public debt, trade and final error term is incorporated.

These variables are expressed above; how much each of these variables contributes to influencing the growth that the above equation depicts is not the same for all the countries involved. As with the situation in corruption, the case is more the country has corruption the more public debt declines the economic growth it can be in this vice versa in less corrupt nations (Woo & Kumar, 2015). CPI index scoring is applied to proportional the corruption level, the scale of CPI index is ranging from 0 to 10, where near to 0 meaning the country is highly corrupted and high score means the country is less corrupted. Given the current research, the impact on the economic growth may be positive in less corrupt countries with regard to public debt effect. The relationship of public debt with economic growth has been defined and well understood but corruption equally impacts the economic growth directly so there is need to focus on the direct impact only. Nevertheless, in which direction the effects went is uncertain. Public officials are said to use arbitrary power and set barriers and collect bribe (Myrdal, 1968). Shleifer & Vishny, 1999 also holds that when there are more restrictions and implied and cost of corruption rises then, economic growth is slow down some studies about it show the positive effects of corruption on growth for certain circumstances such as when eliminating the time for waiting; one is able to start a project. For this research study the data of 5 countries (Bangladesh, China, India, Pakistan and Sri lanka) from 2001-2017 is gathered and variables like Economic growth (GDP per capita) which is dependent variable and the independent variables are: Corruption, Political stability, Trade openness, Inflation and Public debt are used. Secondary data is used and collected from different sources and all the data is taken in percentage of GDP except for Corruption Perception Index whose data is taken from Transparency International and for rest variables the data is obtained from either WDI of World Bank or WEO of IMF and finally political stability data is taken from Global economy which is in index form. As shown in the table 1. Other variables need to be controlled effecting the economic growth for which we used standard specification; other variables taken are Inflation, Public debt, political stability and trade from the time period (2001-

2022). Taken the data for these variables as a percentage of GDP and for corruption we use CPI (International Transparency) data scores from 0-10, and use GMM panel regression.

To analyze the relationship between economic growth and other variables this study used Generalized Method of Moments (GMM), which is basically generic method for estimating the parameters in statistical models. The moment conditions are used to function the models parameter and its data, in such a way that their expectation is zero when the value of parameter is true it is also a dynamic Panel data estimator. GMM well documented to controls the endogeneity of the lagged variable in a dynamic panel model when there is problem of correlation between the explanatory variable and the error term in a model. It also controls the omitted variables biasness and unobserved panel heterogeneity, also controls the measurement errors.

Table 1 Variables and data sources

Variable Name	Definition	Source
GDP Per Capita	Log of real GDP per capita	WDI of World Bank
CPI	CORRUPTION PERCEPTIONS INDEX published by Transparency International: the score has been rescaled From 0-100	Transparency International
Inflation	End of period consumer price Index	IMF WEO data
Political stability	Ranges from -2.5 to +2.5 less means politically instability	Global economy
Trade Openness	Sum of export and import as a percentage of GDP	WDI of World Bank
Public Debt	The ratio of public debt to GDP. Debt is general government's gross debt.	IMF WEO data

Arellano & Bover (1995) and Blundell & Bond (1998) Corrects endogeneity problem by introducing more instruments to improve the efficiency dramatically and Transforms the instruments so that they become uncorrelated (exogenous) with the fixed effects. It builds a system of two equations: the original and the transformed one. Uses orthogonal deviations – Instead of subtracting previous equation from the contemporaneous one, it subtracts the average value of all future available observations of a variables, no matter how many gaps, it is computable for all observations expect the last for each individual, so it minimizes the data loss. Dynamic Panel models is designed for situations where there is Small T and large N panels, also the variables that are independent and not strictly exogenous, means that they are correlated with past and possibly current realizations of error term also known as endogeneity.

Difference GMM model:

$$\text{Initial Model: } lny_{it} = \emptyset lnY_{it-1} + BX_{it} + (n_i + \epsilon_{it}) \dots (1)$$

$$\text{Transformed model: } \Delta lny_{it} = \emptyset \Delta lnY_{it-1} + B\Delta X_{it} + \Delta\epsilon_{it} \dots . (2)$$

By transforming the repressors through first differencing the fixed effect is removed, as is does not change with time but the problem of endogeneity remains. From 2 , the model becomes

$$\Delta \boldsymbol{u_{it}} = \Delta \boldsymbol{ni} + \Delta\, \boldsymbol{\epsilon_{it}} \dots \dots \dots (\mathbf{3})$$

Fixed effects which are unobserved no longer enter the equation because they assumed to be constant between periods. Also the first differenced lagged dependent variable is instrumented with its past levels and then changes in the dependent variable are assumed to represent by equation 2.

System GMM model:

Initial Model:$lny_{it} = \emptyset lnY_{it-1} + BX_{it} + (n_i + \epsilon_{it}) \ldots$ (4)

Assume equation 1 is a random walk model and Y is persistent. Application of the difference GMM estimators yield both a biased and inefficient estimate of φ in finite samples, and this is particularly acute when T is short.

System GMM is applicable if one equation is expressed in levels of form with first differences as instruments and when the second is expressed in first differenced from with levels as instruments. This approach involves use of a greater number of moment conditions but Monte Carlo evidence suggests that when T is short and the dependent variable persistent, there are gains in precision and the small sample bias is reduced. It is also applicable in the presence of heteroscedasticity and serial correlation a two-step system GMM estimator should be used exploiting a weighting matrix using residual from the first step. However, in finite samples such standard errors tend to be downward biased and the conventional approach by practitioners in such circumstances is to use what is known as the Windmeijer adjustment to correct for such small sample bias.

Rule of Thumb given by Bond & Windmeijer (2002) states that the dynamic model initially must be estimated by polled OLS and LSDV approach (i.e. using the "within" or fixed effect approach) and the pooled OLS estimate for φ should be taken as upper bound estimate, while the corresponding fixed effects estimate should be considered as a lower-bound estimate. Secondly if the difference GMM that is estimated, if close to fixed effect estimate or below it, means that the former estimate is biased downward because of weak instrumentation and it is preferred to use system GMM instead Also use system GMM if variable exhibits a random walk (persistent).

Results and Analysis

Table 2 represents the results from the Generalized Method of Moments (GMM) estimation The implication from the foregoing analysis is that the GMM estimation results contained in Table 2 add to the understanding of the interactive effects between trade openness, political stability, public debt, inflation, and economic growth. The result depicted shows that the proposed model has an adequate fit based on the coefficient of determination (R-squared) of 0.814 and the adjusted coefficient of determination of 0.777 which means that 81.4% of the variability in economic growth is explained by the independent variables in the proposed model.

Trade openness have coefficient of 0.029 and is significant at 1% level which implies that increase in trade openness is beneficial to economic growth. This agrees with the idea suggesting that opening up more to the international markets helps in creating a flow of goods, service, capital and technology which enhances productivity and growth. Trade openness provides the opportunities of the nature in which different economies can focus in given production sectors that would be most advantageously served to figure improvements in efficiency and innovation (Kumari 2023; Usman et al., 2021). This result confirms the observations made in numerous papers that place particular significance on trade as one of the main factors that define growth, particularly in the context of developing nations (Chang et al., 2009). With reference to the Pakistan case, increased Integration may help to overcome the domestic factors of production hurdles and increase growth.

The coefficient for political stability is negative (-0.128) and highly significant (p=0.000), This is because, political instability is likely to retard any economic growth process. Instability in the political system may discourage investors, create uncertainty, and deters the desired economic

activities that define growth (Ezeador, 2024; Alesina et al. 1996). In the circumstances of unstable political environment common for developing countries such as Pakistan too often changes in the government, civil unrest and weak governance can hamper investors' confidence and slow down progress in the sphere of economic reforms thus resulting in poor economic performance. In particularly, political stability is related to increased and improved quality of institutions, effectiveness in terms of implementing contract and established economic policies all of which are beneficial for business (Acemoglu Johnson and Robinson 2001). Thus, the negative impact of political instability highlights the need for strengthening political institutions and governance structures in Pakistan.

The negative coefficient for public debt (-0.032, p=0.019) suggests that increasing public debt has a detrimental effect on economic growth. This finding is consistent with the literature, which argues that high levels of public debt can crowd out private investment, increase the cost of borrowing, and lead to unsustainable fiscal policies (Anh & Thi, 2024; Devarajan et al., 2021). When public debt reaches critical levels, governments may resort to austerity measures or cut back on productive investments in infrastructure, education, and health, all of which are vital for long-term growth. For Pakistan, where public debt levels have been increasing, this result emphasizes the need for sound fiscal management to avoid the adverse consequences of debt accumulation. High public debt could also lead to external vulnerabilities, making the country more susceptible to economic shocks.

Table 2: Results of GMM

Variable	Coefficient	Std. Error	T-Statistic	Prob.
TRADE	0.029	0.008	3.404	0.001
PS	-0.128	0.041	-3.075	0.000
PDEBT	-0.032	0.013	-2.379	0.019
INF	-0.089	0.021	-4.177	0.000
CPI	0.568	0.312	1.818	0.072
C	5.323	1.439	3.698	0.000
R-squared	0.814	Adjusted R-squared		0.777
Durbin-Watson stat	1.998	J-statistic		79.00
Instrument rank	7	Prob(J-statistic)		0.000

Source: Author's own calculations

The coefficient for the inflation variable is negative (-0.089) and very significant at (p=0.000) level showing that inflation significantly inhibits economic growth. Inflation leads to an indication of erratic movement of price levels in the future, reduces the worth of consumer's money, may give out wrong signals for investment decisions. Furthermore, inflation tends to indicate the existence of macroeconomic imbalance, and thereby destabilisation and hindrance to growth (Fischer, 1993). This discovery has maker great insights to the perceptions that addressing inflations is a key component in attaining sound economic growth. In general, Agnloparities are less threatening for the communities and the business and thus, are good to sustain the long term.

Surprisingly, the CPI has a positive coefficient whereby the anti-corruption level is high (= 0.568), which has a marginal significance level of 0.072. While the CPI is most frequently utilized in the form of perceived corruption, in this case, the positive association can speak of an entirely separate

process. If perceived corruption levels go up, then levels of economic growth could be high if corruption is reduced because it foments institutional efficiency (Abotsi & Ampah, 2024). However, such relationship could not gain strong statistical significance, meaning that this relationship was not very stable. Presumably, other factors that include institutional quality or governance reforms are possibly distorting the overall effect of CPI on growth (Haque & Kneller, 2008). The constant term is positive (C= 5.323); tests is significant at p = 0.000 level and it represent the base growth rate when all the independent variables are controlled. As a result, several growth promoting factors are there outside the mentioned model that affect positively on the economic growth of Pakistan.

The R-squared (0.814) and Adjusted R-squared (0.777) imply that a greater part of the pattern of economic growth is explained by the formulated model. Moreover, there is no sign of the first order autocorrelation as the Durbin-Watson statistic equals 1.998, a value near to 2 improving the reliability of the results. The p > F test probability of 0.000 with the J-statistic of 79.00 shows that the instruments used in the GMM estimation are endogenous. This is important because weak instruments could bias the estimates and reduce the reliability of the results (Baum, Schaffer, & Stillman, 2003).

Conclusion and Policy Recommendation

This study investigated different possible factors that can actually has a strong impact on Economic growth for this we have chosen five South Asian countries and collected Data from 2001-2022, we see each variable does effect the growth either in a positive or negative manner, from different studies and literature we have seen that corruption has a negative impact on growth and harm the economy and mostly corruption is more in the developing countries where Government officials are corrupt, corruption is at high level and effect the growth directly or indirectly, it does not only effect growth and development but income inequality is more in the countries where the problem of corruption is more because tax payer are in small proportion and these taxes also goes into bribe and not spent on general public and betterment of institutions and poor class of the economy suffer more, some of the studies also concluded that corruption can enhance the growth in a way that it reduces the time for waiting in queue and rich have money work for them so that they can invest in the economy and start any project which generates employment, but in the long run it is harmful for any state.

Political instability also play its part where there is corruption, the more country is politically instable the less will be the growth as shown from the results it also have a negative relation with growth, instability is taken as that how many times government collapse, we have taken the stability index of these five countries and analyzed the results and conclude that when instability arises the investment declined because people are not sure that what will happen after wards and there is a situation of uncertainty and the foreign investment also declined and this all creates a panic situation and black money is in large amount and people make money by unfair means, this all situation lead to take large amount of debts which is also not been utilized in fair means and developing countries comes under debt trap because the political parties only focuses for the short term and work for their personal interests rather than to work for the betterment of state, debt itself is not a bad thing but if it is used for the purpose it is taken, but it is the one of the biggest problem of developing states, that debt goes into bribe or taken to fix the BOP problem. These all things are interlinked with one another it is not the case that not only one thing is effecting the

growth and also the basic objective of our paper is to see the effect cause by each variable, as more corruption leads to more political instability and more internal and external debt raises, which than results in more inflation and poor of the economy suffers and then devaluation of your currency lead to effect the trade which is the main factor which enhances the growth and these developing countries are always in trade deficient because they import in large quantity finished goods and export in small proportion which are also unfinished products so the problem of Balance of Payment arises for which these countries take loans from IMF and World Bank.

The findings of this study provide significant policy implications for Pakistan's economic growth. Trade openness emerges as a vital driver of growth, underscoring the need for policies that enhance Pakistan's integration into global markets. Reducing tariffs, enhancing export competitiveness, and improving trade logistics could further harness the benefits of trade. On the other hand, political instability and public debt present serious challenges to growth. Improving political stability through stronger governance, rule of law, and transparent policymaking is crucial for maintaining investor confidence and fostering a stable economic environment. Additionally, fiscal reforms aimed at reducing the debt burden, such as enhancing tax collection efficiency and cutting non-productive expenditures, would alleviate the negative effects of public debt on growth. The negative impact of inflation further stresses the need for a sound macroeconomic framework. The central bank should focus on price stability while promoting policies that support growth. Controlling corruption through strict legal policies and stabilizing the exchange rate would contribute to a more stable economic environment.

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