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The effect of good governance on the business cycles on Iran and OECD countries

Neda Jahanarai[1*], Roghayeh Abdolinejad[2], S. Abdolmajid Jalaee[3]
1. Master of Science in Economics, Shahid Bahonar University of Kerman, Iran.
2. Masters student of Science in Economics, Shahid Bahonar University of Kerman, Iran.
3. Professor and Dean of the Faculty of Management and Economics, Shahid Bahonar University of Kerman, Iran.

A B S T R A C T

This paper investigates the good governance effect on business cycles. As business cycles are related to economic growth, the model used in this paper is within the framework of apsis. The period under study is 1996-2014 for Iran and OECD countries. The model was estimated by Panel data. The results indicated that the government effectiveness index is more effective among the six good governance indicators. Improving the good governance indicators will result in the government increased efficiency and effectiveness; Consequently, the growth rate would be increased, as well. Also, improvement of these indicators can decline fluctuations. According to the relationship of the production positive growth rate (peaks) with economic prosperity and negative growth rate (Perigees) with depression, the improvement of good governance indicators can have an effective role in the control of the business cycles.

Keywords: Good Governance, Business Cycles, Panel Data.
Jel: G3, E32, C33.

INTRODUCTION

Since the beginning of economics, different ideas are presented from economists about the governance and public sector management. One of the most known this ideas is the paradigm of 'Traditional Governmental Administration' that bureaucracy is an inseparable part of it(Greener, 2012; Tabb, 2012). This was the main paradigm in the field of governmental sector management until the early 1980s, but with the appearance of its negative aspects in the same years in America and the UK, another paradigm of new governmental management was presented that its main slogan was privatization and government miniaturization. However, the purposes of this current thought in many countries, even its founder countries was not helpful and it soon became clear that this paradigm can't provide a fair and equitable well-being for citizens. Therefore, economists looked for other paradigms including 'New Public Services' and 'Good Governance'(Bhatta, 2015; Van Assche, Beunen, & Duineveld, 2013).

The business cycles explain the Changes in economic and commercial activities(Schumpeter, 2017). The economic boom is defined by words such as low unemployment

* . Corresponding Author: neda.jahanaray20@gmail.com

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rate, high economic growth and a great variety of goods associated with increased people welfare(Barr, 2012; McKinnon, 2010). Also, depression and crisis are defined by unemployment Exacerbate, life Pressure, the sharp decline in profits and increasing of bankruptcies(Roberts, 2016). In other words, the business cycles investigate the economic fluctuations around long-term trend path. It means that in a business cycle, in peak, the activities level is higher than the trend and in Perigee they are lower than trend (Arshad, Rizvi, & Ibrahim, 2014; Kose, Otrok, & Prasad, 2012; Samadi & Jalaie, 2004). Although the business cycles are very various in terms of domain, extent, territory and during of period, some of the economists like Lucas Jr (1977) believe all of them have many joint aspects and accordingly a comprehensive theory is represent for their analysis.

The objective the present study is to investigate the good governance and its indicators' impacts on the business cycles. The main question of this research is that do good governance and its components have a significant and positive impact on business cycles? The second part of the study investigates the empirical studies in this field and third part illustrate theoretical framework including the good governance concept and his effect channel on the business cycles. In the fourth part, the econometric model is explained and in the fifth and sixth parts, the model results and conclusions are presented.

THEORETICAL FRAMEWORK AND LITERATURE

When speaking business cycles, it's closed in mind sinusoidal-shape image with the regular repeating pattern. But in economics and other sciences, the cycling term refers to a more general concept. Maybe one of the best examples of cycles is the sunspot cycle that is variable with during of period under 10 to 20 years(Beaudry, Galizia, & Portier, 2017). But according to the views summary of scientists about cycles, it can explain by the following definition: the cycling word refers to reversible different periods from positive and negative movements that are often measurable exactly(Azariadis, 2018; Hill, Perri, & Fogli, 2015; Iacoviello, 2015). The business cycle definition also is compatible with this concept, but instead of "departure" refer to "deviation"; like Lucas that says business cycles are repeatable deviation of real GDP from the long-term trend (Ghaffari & Farhadi, 2016). The most important features of business cycles are volatility, persistence and co-movement(Anzoategui, Comin, Gertler, & Martinez, 2016). The volatility refers to the instability degree of a variable; indeed, the volatility is the variable tendency to the fluctuation. The variable high level of variability compared with the reference variable indicates time series power to create a cycle(Carsamer, 2015; Douglas, Huang, & Vetzal, 2016). But the important point is when the depression begins, the economy tends to constriction and this position will continue for one year or more. Also, in the boom, the economy tends to a distention which may continue for some time. The existence of such tendency during the depression or boob is called continuity.

Also, co-movement means that the cyclic observed pattern in many economic sectors and macroeconomic variables moves more and less with product fluctuations simultaneously. That's meaning in a business cycle, the apsis step of mentioned variables have happened at a time. The co-movement analysis is determined by two views of rotation time and direction. According to the time, the variables can be leading, Simultaneous and backward. The leading variables are those which their departure change in turning points happens before the reference variable. Similarly, the Simultaneous occurs with GDP simultaneously and backward variable moves after the reference variable and also according to the direction are divided into three groups of direction agreeing, direction apposite and none-cyclic(Abdellatif, 2003; Cooray, 2009; Farzanegan, 2009).

Eventually, according to the business cycles descriptions, the economic growth can be considered as business cycles indicator.

Aguiar and Gopinath (2007) in their research indicate for some of developing countries trend and cycle nature of macroeconomic variables is different from developed countries. In other words, by comparison between Mexico and Canada, they have concluded random trend (not certain) plays a significant role in the simulation of movements and macroeconomic variables cycle fluctuations of Mexico. Mehrara and Asadian (2009) in their research to evaluate the impact of the good governance on the foreign direct investment for 15 middle-income countries (including Iran) between the years 1996-2005 used the panel data method based on fixed effects. The results represent that the average of good governance indicators and each of the indicators alone have a positive and quite significant impact on FDI. Ngobo and Fouda (2012) investigated the relationship between good governance and business. The hierarchical linear model results represent an improvement of good governance in countries currently with low levels of good governance ratings has greater positive effects on the firm profitability than a similar improvement in countries with relatively higher ratings of good governance. Golestani, Jogheini, and Khorasani (2012) has investigated the business cycles Synchronization between the OPEC. He by using panel data for the years 1994-2011 and random effect model has concluded that there is a correlation between the business cycles of member countries. But due to lack of homogeneous development degree, economy size and production structure of member countries the correlation hardness between their business cycles is not similar. Motefakker Azad, Asad Zadeh, and Garshasbi Fakhr (2013) in their research about good governance impact on GDP, investigate the information related to Iran and 74 countries in 2008. The results indicate that good governance has a positive and significant on GDP. Jalaee, Azizi, Zarei, and Mehrabi (2014) have explored the long-run trend components and disordered shocks from GDP and have investigated the agricultural sector in business cycles of Iran economy. Their results indicate that Iran economy during the period under study has passed five complete business cycle. Also, the vector error correction model results illustrate that agricultural sector has a significant and positive effect on GDP gap in long-term. Yilmazkuday (2014) has investigated the relationship between gasoline prices, transformation costs, and business cycles. The results show although in different papers standard shocks have significant effects on business cycles in long-term, supply shocks and gasoline demand play an important role in business cycles in short-term. Khan (2015) in his paper has tried to explore the relation between good governance and human development in developing countries, especially the South Asia countries. Regression analysis showed if South Asia can good governance indicators including voice and accountability, political stability, law role, regulatory quality and government effectiveness improve, he can has a significant progress toward human development.

METHODOLOGY

This research uses from Devarajan, Swaroop, and Zou (1996) model for investigation of the theoretical relation between good governance and economic growth. The governance effect on economic growth is divided into direct and indirect effects by the public expenditures combination (or governmental). (Devarajan et al.) classifies expenditures to efficient expenditures (capital) and inefficient expenditure (consumption). (Devarajan et al.) suppose that the expenditures combination and public costs which are exogenous are determined due to governmental policies. This model is adjusted as follows via Kagundu (2006). Also, (Kagundu) enters the governance as a factor that increases the efficiency via technology term to the production function. It is supposed that the expenditures combination and public costs depend on good governance.

In this paper, in addition to implemented adjustments, labour force enters for the first time to the production function. Also for investigating the relationship between good governance and economic growth, the production function is used. This function contains the basic characteristics of endogenous growth model such as key role, human capitals, its accumulation in the long-term growth rate and the removal of diminishing returns of capital. Per person production (y) in this model takes the form of a Cobb Douglas production function, composed of private capital (k), Labour (L), two types of government expenditures g_1 and g_2, and a composite efficiency-enhancing term, V, as expressed in equation (1) below:

$$Y = vf(K, L, g_1, g_2) \quad (1)$$

Where: $\alpha, \beta, \gamma, \lambda \geq 0; \alpha + \beta + \gamma + \lambda = 1$; and following Martinez and McNab (2005), we define $V = A\psi$ as a product of technology A, and a measure of good governance ψ. The parameters, α, β, λ and γ represent elasticities of output with respect to k, L, g_1 and g_2 respectively. We also follow Devarajan et al. (1996) in abstracting from issues of financing public spending by assuming that the government runs a balanced budget. That is,

$$Ty = g_1 + g_2 = g \quad (2)$$

Where g is total government spending per person, and τ is the tax rate. Let ϕ=ϕ (ψ) be the proportion of g spent on g_1, then:

$$g_1 = \varphi \quad , \quad g_2 = (1- \varphi)\, g \quad (3)$$

Where 0 <ϕ<1.

The problem of the representative individual (given the government's decision on τ, and φ) is to maximize lifetime utility:

$$u = \int_o^{00} u(c)e^{-pt}dt \qquad u' > 0 \quad , \quad u'' < 0 \quad (4)$$

$$k^0 = (1-\tau)y - c \quad (5)$$

Where c is consumption per person, k and y are as given in equation (1). In equation (4), $u(c)$ is the representative individual's instantaneous utility and ρ is the discount rate. A higher ρ implies that the individual values current consumption more than future consumption. Further, the first and second order derivatives of u (c) with respect to current consumption (in equation 4) imply that the marginal utility of current consumption is increasing at a decreasing rate.

The budget constraint in equation (5) indicates that, at any one time, the individual divides his/her disposable income between consumption and savings. Thus the rate of change in the capital stock (equal to savings in a closed economy) with respect to time (denoted by k^0) is simply the difference between disposable income ($(1-\tau)y$) and current consumption (c). Substituting equations (1) and (3) into (5) yields the following budget constraint:

$$k^* = (1-\tau)Vk^{\alpha}L^{\lambda}(\varphi g)^{\beta}\left((1-\varphi)g\right)^{\gamma} - c \quad (6)$$

Maximizing equation (4) subject to (6) yields the following (a derivative of c and k):

$$H = u(c)e^{-\rho t} + V\left\{(1-\tau)Vk^{\alpha}L^{\lambda}(\varphi g)^{\beta}\left((1-\varphi)g\right)^{\gamma} - c\right\} \quad (7)$$

$$\frac{dH}{dc} = u'(c)e^{-\rho t} - V = 0 \quad (8)$$

The derivative of equation (7) is shown in relation to k with V^0.

$$\frac{dH}{dk} = V(1-\tau)v\alpha k^{(\alpha-1)}L^{\lambda}\varphi^{\beta}(1-\varphi)^{\gamma}g^{(\beta+\gamma)} = -V^0 \quad (9)$$

The equation (8) is derived from the time (t).

$$u^{0\prime}(c)e^{-\rho t} - \rho\, e^{-\rho t}u'(c) = V^0 \quad (10)$$

By replacement (10) in (9) we will have:

$$e^{-\rho t}[u^{0\prime}(c) - \rho u'(c)] = -V(1-\tau)v\alpha k^{(\alpha-1)}L^{\lambda}\emptyset^{\beta}(1-\emptyset)^{\gamma}g^{(\beta+\gamma)} \quad (11)$$

By replacement V of equation (8) in (11), Equation (12) is obtained.

$$e^{-\rho t}[u^{0\prime}(c) - \rho u'(c)] = -u'(c)e^{-\rho t}\beta \quad (12)$$

In (12), $\beta = (1-\tau)v\alpha k^{(\alpha-1)}L^{\lambda}\emptyset^{\beta}(1-\emptyset)^{\gamma}g^{(\beta+\gamma)}$.

By simplifying the relation (12), the following relation (13) is obtained.

$$[u^{\cdot\prime}(c) - pu'(c)] = -u'(c)\beta \Rightarrow \frac{u^{\cdot\prime}(c)}{u'(c)} = \rho - \beta \quad (13)$$

Assuming the following:

$$u(c) = \frac{c^{1-\sigma}-1}{1-\sigma} \quad (14)$$

$$u' = c^{-\sigma} \quad , \quad u'' = -\sigma \times c^{-\sigma-1} \quad (15)$$

$$u^{\cdot\prime} = \frac{du'}{dc} \times \frac{dc}{dt} = u''c^{\cdot} \quad (16)$$

By replacing (15) and (16) in (13) we will have.

$$\frac{-\sigma \times c^{-\sigma-1}c^{0}}{c^{-}} = \frac{-\sigma \times c^{0}}{c} = \rho - \beta$$

$$\frac{c^{0}}{c} = \frac{\beta-\rho}{\sigma} \quad (17)$$

$$\beta = (1-\tau)v\alpha k^{(\alpha-1)}L^{\lambda}\emptyset^{\beta}(1-\emptyset)^{\gamma}g^{(\beta+\gamma)}.$$

$$\mu = \frac{c^{0}}{c} = \frac{(1-\tau)v\alpha k^{(\alpha-1)}L^{\lambda}\emptyset^{\beta}(1-\emptyset)^{\gamma}g^{(\beta+\gamma)}-\rho}{\sigma} \quad (18)$$

Equation (18) reflects the long-term consumption growth rate associated with sustainable (long-run) economic growth. In this equation, the economic growth rate is a function of efficiency V, which includes technology and good governance, k private investment including physical and human capital, L labour, τ tax rate, g government expenditures. Other expressions are the parameters of the equation. It should be noted that indicators showing technical knowledge and technology were not available for most surveyed countries and this variable was excluded from the model. Thus, according to theoretical foundations and the intended model, the final model for estimation is defined as follows:

$$GGDP = \beta_0 + \beta_1 GC_{it} + \beta_2 T_{it} + \beta_3 INF_{it} + \beta_4 EXOIL_{it}(EX_{it}) + \beta_5 SP_{it} + \beta_6 K_{it} + \beta_7 L_{it} + \beta_8 L_{it} + \beta_9 GI_{it} + U_{it} \quad (19)$$

In this study, GGDP: The growth rate of gross domestics' product (GDP) to constant prices. GC: The government final consumption expenditure to constant prices. T: Tax revenues of the government. INF: Inflation to constant prices. EXOIL: Oil export share of GDP. EX: The share of exports of goods and services of GDP. SP & SS: Primary and secondary school enrolment ratio of the total. K: The share of gross domestic fixed capital from GDP as physical capital stock. L: Labour's share of the active population as an indicator of the labour force. GI: Good governance quality index & U: error. Data for all variables are collected from the World Bank and the period under study in this research is 1996-2014 for Iran and OECD member countries. GI or good governance index is composed of 6 indices and the simple average of good governance indicators data is used. Based on percent rating, data have been extracted from the World Bank. Since the data related to the years 1997, 1999 & 2001 were not available, so the data relevant to these years were made using data building formula by the software EXCEL and most variables have been used in logarithmic mode. Also for showing Institutional Quality Index in this study, in addition to GI, the impact of all six indices of good governance are investigated and GOE shows government

effectiveness index, COC shows corruption control index, VOA shows voice and accountability indicator, POS shows political stability, RQ shows rules and regulations quality index & ROL shows rule of law index. Surveyed countries of this study consist of Iran and OECD member countries that are as follows: Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, England, America, South Korea, Italy, New Zealand, Finland, Australia, Czech Republic, Hungary, Poland and Slovak Republic. Also in this research, Hodrick-Prescott filter is used for apsis points. Therefore, instead of the dependent variable of GDP growth rate, for studying business cycles, apsis points are used to better illustrate the effects of business cycles on good governance indices.

RESULT

For testing variables, their stationary process should firstly be tested. The null hypothesis in unit root test is combined data of Levin, Lin & Chu and according to results, it could be concluded that with the possibility of 90%, the null hypothesis is rejected in all variables and it shows their stationary process in the level and so using combined data method is approved. Therefore, for investigating the relationship between variables, simple panel method can be applied. To estimate the pattern through a simple panel, we should determine if data have stable effects or random effects. So three steps should be implemented. The first step is Chow test, the null hypothesis in this test is the existence of compiled data and its alternative hypothesis is fixed effects. If the obtained amount of t statistic if higher than the number in the table, so the null hypothesis is rejected and the existence of fixed effects is approved. In the second step, Breusch-Pagan test is done. The null hypothesis of this test is the existence of compiled data and its alternative hypothesis is the existence of random effects. If the resulting probability of this test is less than the determined margin of error, so the null hypothesis is rejected and the existence of random effects is approved. The third step is Hausman test. This test is done for the selection between fixed effects and random effects. The software Statal13 has done the estimation of the model and results are presented in Appendix document. As it can be concluded from results, the model is estimated through the simple bilateral panel with fixed and random effects. The results of model estimation are shown in tables 1 to 4.

Table 1. Final Results

	Model Estimation with GI Governance Index	Model Estimation with COC Governance Index	Model Estimation with GOE Governance Index	Model Estimation with POS Governance Index
GC	-0.0055	-0.0094	0076/0-	0084/0-
INF	-0.0005*	-0.0003*	-0.0004*	-0.0003*
EXOIL	-0.0001	0.0004	0.0002	-0.003*
EX	0.0073*	0.0071*	0.0073*	0.0085*
SP	-0.0454*	-0.0375	-0.0413*	-0.0453*
SS	-0.001	-0.0029	-0.0007	-0.0058
K	0.0146*	0.014*	0.0142*	0.0162*
L	-0.0362	-0.046	-0.0333	-0.0462
T	-0.0033	-0.0028	-0.0025	-0.0052
GI	-0.0231*	-	-	-
GOE	-	-	-0.0273*	-
COC	-	-0.0166*	-	-
POS	-	-	-	-0.0124*

Source: Calculations research, all numbers are significant at the 90% level.

Table 2. Final Results

	Model Estimation with ROL	Model Estimation with VOA	Model Estimation with RQ

	Governance Index	Governance Index	Governance Index
GC	-0.0066	-0.0037	-0.0048
INF	-0.0005*	-0.0005*	-0.0004*
EXOIL	-0.0001	-0.0001	0.0003
EX	0.0071*	0.0066*	0.0063*
SP	-0.045*	-0.0479*	-0.0433*
SS	0.0008	0.0041	-0.0044
K	0.0151*	0.0145*	0.0124*
L	-0.052	-0.0425	-0.0036
T	-0.0025	-0.0042	-0.004
RQ	-	-	-0.0111*
VOA	-	-0.0171*	-
ROL	-0.0269*	-	-

Source: Calculations research, all numbers are significant at the 90% level.

Table 3. Final Results

	Model Estimation with GI Governance Index	Model Estimation with COC Governance Index	Model Estimation with GOE Governance Index	Model Estimation with POS Governance Index
GC	-0.0152*	-0.0123	-0.0147*	-0.0132*
INF	-0.0001	-0.0004	-0.0001	-0.0002
EXOIL	0.0004	0.0009	0.0003	0.0002
EX	-0.0001	-0.002	-0.0003	-0.0008
SP	-0.0144	-0.0298	-0.0163	-0.0129
SS	0.0042	0.0103	0.0047	0.0051
K	0.0241*	0.0292*	0.0244*	0.0239*
L	-0.0896*	-0.0784	-0.0889*	-0.0833
T	0.0034	0.0030	0.0027	0.0047
GI	0.0154*	-	-	-
GOE	-	-	0.0194*	-
COC	-	0123/0	-	-
POS	-	-	-	0.0088*

Source: Calculations research, all numbers are significant at the 90% level.

Table 4. Final Results

	Model Estimation with ROL Governance Index	Model Estimation with VOA Governance Index	Model Estimation with RQ Governance Index
GC	-0.0134*	-0.0164*	-0.017*
INF	-0.0002	-0.0009	-0.0008
EXOIL	0.0002	0.0005	0.0006
EX	0.0002	0.0004	0.0007
SP	-0.0185	-0.0138	-0.014
SS	0.0064	0.0049	0.0045
K	0.0245*	*0.0245	0.0255*
L	-0.0901*	-0.0902*	-0.1137*
T	0.0039	0.0040	0.0036
RQ	-	-	0.0097*
VOA	-	0.0117*	-
ROL	0.0072	-	-

Source: Calculations research, all numbers are significant at the 90% level.

The obtained results from model estimation in the country of Iran and member countries of OECD show that government effectiveness index (GOE), corruption control index (COC), political stability index (POS), voice and accountability index (VOA), rules and regulations quality

index (RQ), rule of law index (ROL) and the index of average have negative and significant impact on high points of economic growth while government effectiveness index (GOE), political stability index (POS), voice and accountability index (VOA), rules and regulations quality index (RQ) and the index of average have positive and significant impact on low points of economic growth and other indices such as corruption control index (COC) and rule of law index (ROL) have no significant impact on low points of economic growth. Among six indices of good governance, the government effectiveness index had the most effect on low points of economic growth.

Government final consumption expenditure has a negative effect on low points of economic growth and this shows that economic and social infrastructure reforms should be taken into consideration. According to government economics in Iran, the government does a large part of the physical investment and a large part of the human capital is working in this sector. Therefore, any increase in these sectors means the growth of government and its spending and this fact has a negative effect on the growth rate due to the inefficiency of the public sector and the reduction of incentive of the private sector and in applied models, this variable has negative and meaningless impact on high points of economic growth. Tax revenue has a meaningless impact in both cases studied. This variable has a negative and significant effect due to the high inflation rate in OECD member countries and Iran. Oil exports have a positive and meaningless impact but exports of goods and services have a positive and significant impact on high points of economic growth and meaningless impact on low points. Physical capital stock in all estimated equations has a positive and significant impact and labour force in investigated models is meaningless in high points of economic growth and has a negative and significant impact on low points. Also human capital during the primary period has a negative and significant impact in high points and it's meaningless in low points and during secondary periods, human capitals had a meaningless impact in both cases studied.

CONCLUSION

The objective of this study is to investigate the effect of good governance indices on business cycles in Iran and OECD member countries for the period of 1996-2014. The results show that the indices of government effectiveness, control of corruption, political stability, voice and accountability, quality of rules and regulations, rule of low and average index have negative and significant impact on high points of economic growth while the indices of government effectiveness, political stability, voice and accountability, rules and regulations quality and average index have positive and significant impact on low points of economic growth and among six indices of good governance, government effectiveness index has the most effect on low points of economic growth. Government final consumption expenditure has a negative effect on low points. This variable has a negative and significant effect due to the high inflation rate in OECD member countries and Iran. And between two studied exports, the export of goods and services has a positive and significant impact on high points of economic growth. Physical capital stock in all estimated equations has a positive and significant impact and the labour force has a negative and significant impact on low points of economic growth. Also human capital during the primary period has a negative and significant impact on high points.

As mentioned, by improving the indices of good governance, the growth rate will be higher. According to the results of the model, when the private sector is smaller, the effect of the variables of the model is more negative on business cycles. Since the indices of good governance don't seek to make government bigger or smaller, so by creating political openness and free economic space for the activity of private sector in addition to the efficiency and effectiveness of government and

also by enhancing the indices of good governance, it will be possible to increase the efficiency and effectiveness of the government and raise the growth rate. When the governments are selected more freely, the participation of the people and performance of governments will be improved. When there is more control on corruption, labour productivity will be increased and human capital will be enhanced. The rule of law and the quality of regulations can have a positive effect on growth rate through the removal of unnecessary regulations. This issue is effective on the state budget and business openness through tariffs and tax laws and its improvement will result in economic growth. Since the positive rate of production growth and high points of economic growth will result in economic boom and the negative rate of these elements will result in economic depression, so the enhancement of good governance indices can be effective on the reduction of economic recession periods and shortening these periods. Also, the enhancement of these indices can provide the stability of economic growth and the reduction of its volatilities.

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