# THE IMPACT OF IMPORT TAX LIBERALIZATION TOWARDS THE ECONOMIC COMPETITIVENESS OF MALAYSIA IN LONG RUN: A JOHANSEN CO-INTEGRATION APPROACH.

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**ABSTRACT**

*Trade liberalization strategies had been adapted by many developing countries since it has high rate of influence towards the growth and competitiveness of a nation. As one of the most promising and emerging market in the world, Malaysia also has embarked on the trade liberalization policies and strategies in order to sustain its past achievements and increase its competitiveness in the global economic arena. Therefore, this paper attempts to investigate how the exemption of import taxes in Malaysia could contribute to the nation's competitiveness in the long run using empirical analysis. This study employed annual time series data from 1980 to 2013 to analyze the long run relationship between the import taxes, external debt, government spending and the economic competitiveness of Malaysia. Empirical methods like unit root test and Johansen Co-integration test were majorly used to identify the existence of unit root problem and long run relationship between the variables tested. Based on the results of empirical analysis, it was inferred that both the import duties exemption and external debt showed a negative influence, meanwhile the government spending showed a positive influence towards economic competitiveness in the long run. It was concluded that the trade liberalization strategies would harm the competitiveness level of Malaysia in the long run. Therefore, it was not recommended for the nation to exempt import taxes in the long run.*

Keywords: Import tax liberalization, Economic competitiveness, Malaysia.

## 1. Introduction

International trade has been claimed as the backbone of development and stimulus to the competitiveness by many nations and by many renown economists. Initially, most of the countries emphasized on trade restrictions in order to protect their internal economic system. However, more nations adapted the trade liberalization policy to increase the competitiveness level in the global arena due to the emergence of globalization. Like any other country, Malaysia also actively engaged in many trade agreements to increase the competitiveness level and also to attain the status of high income nation.

Recently, the Malaysian government had decided to remove the import taxes for manufacturing industries in order to enhance its competitiveness level in the global arena. Since the trade taxes were one of the major sources of government's revenue, the question whether the import tax exemption would benefit Malaysia in the long run arises among the policymakers. Hence forth, an extensive analysis had to be conducted in order to study the relationship between the import duties and economic competitiveness in the long run.



Figure 1: Import duty of Malaysia from 1980 to 2013
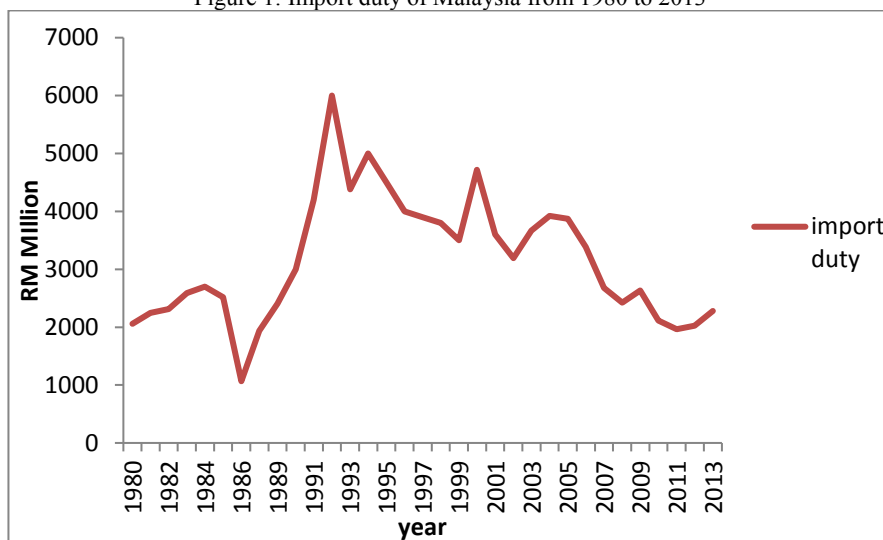
Sources: The Statistical Department of Malaysia

Based on the Figure 1, an increasing trend could be observed in import duties of Malaysia from 1980 to 2013. The increasing trend observed from 1980 was followed by a sharp declination in the mid of 80's, yet it gradually increased and reached the peak

in 1990's. After 1990's the decreasing trend could be observed in the statistic of import duties of Malaysia. Figure 1 proved that Malaysia had gradually reduced its trade barrier after 1990's once it started engaged in many trade policies. Moreover, the World Trade Organization (1997) stated that Malaysia had a great improvement in term of global competitiveness after reduced half of its trade restrictions and adapted a few numbers of trade reformation policies such as the General Agreement on Tariff and Trade (GATT), ASEAN free trade area, Global System of Trade Preferences among Developing countries (GSTP) and others.

Theoretically, Smith (1776) has supported the practice of free trade system in economic system. According to Smith (1776), the removal of trade restriction and barriers would lead to the expansion of market and reduce the domestic firm's market power as well. Besides that, Krugman (2011) also emphasized that, the expansion of international trade led to the economics of scale and great increase in production outputs. However, Regina (2012) argued about the commercial risk of adapting a free trade system. When foreign country's product is more appealing than own country product, it would lead to local market failure since most of the consumers prefer appealing products. Moreover, trade liberalizations and its impact towards growth of a nation has been extensively analysed and proven theoretically and empirically by previous literatures like Ahmed and Dutta (2006), Olufemi (2004), Bhasin and Annim (2005).

Practically, the import tax liberalization would benefit the local consumers since they could enjoy variety of imported goods at lower price after the tax been exempted. Besides that, the cost per unit for the local manufacturers using the imported goods as raw material would decrease as well. This would lower the cost of production for domestic manufacturers. Cheaper products would improve the net exports and attract more buyers in local and global market too. Eventually, the import tax liberalization would increase the competition in domestic market and reduce the monopoly power of local giants. It would enhance the effectiveness and competitiveness of domestic market as well.

On the other hand, the negative effects of import tax liberalization would be the deficit in the balance of payment. Balance of payment is the transaction between a country and rest of the world. Thus, the current account might become deficit (import more than export) if the import taxes are exempted but the capital account would be a surplus through the increase of Foreign Direct Investment (FDI) flow into the nation. If the import tax were exempted the cost of doing business in Malaysia would become cheaper and will attract more foreign companies to start their business in Malaysia. Moreover, FDI would increase through sharing of skills, job opportunities, expertise and so on which led to human capital improvements as well. Consequently, there is a high tendency for the dumping of foreign goods in local markets at cheaper price which would cause huge losses to the local manufacturers and infant industries. However, the Malaysian government still could overcome it through anti-dumping laws.

In conclusion, the above examples exhibits strong evidences that import tax liberalization has both benefit and harm to the practising nations. Since the main objective of the study was to analyse whether the import duties exemption increased the economic competitiveness of Malaysia in the long run and due to the decision of Malaysian government to remove the import taxes, this study would be extended by conducting an empirical analysis. Thus, the organization of the study would be as follow. The next section would be the literature review followed by the methodology in section three. Section four would present the empirical results, meanwhile the conclusion are presented in section five.

## 2. Literature Review

Saaed and Hussain (2015) analysed the relationship between the trade openness, financial development and economic growth of Kuwait by employing empirical methods such as the Co-integration Test, Vector Autoregressive (VAR) model with Granger Causality Test. Besides, Githanga (2014) has attempted to investigate the relationship between the trade intensity and barriers towards the economic growth in Kenya. The results of empirical methods revealed that trade openness had negative impact towards economic growth of Kenya. The results obtained indicated the presence of positive and significant relationship between the variables tested.

Michael (2013) investigated the trade liberalization's effect towards the economic system of Ghana through Autoregressive Distributed Lag (ARDL). The study concluded that the effect of trade openness was inconsistent both in the short and long run towards the economic growth in Ghana. Liargovas and Konstantinos (2012) studied the relationship between the trade openness and foreign direct investments using the sample of 36 developing countries. The results obtained from the study revealed that trade openness had positive long run relationship towards foreign direct investment. Besides that, Hur and Cheolbeom (2012) investigated the impact of free trade agreement towards the output growth of ninety developed and developing countries from 1958 to 2003. The findings of the research suggested that free trade agreement had insignificant relationship in the short run, but turns out to be a positive relationship in the long run.

Tash and Sheidaei (2012) studied the relationship between trade liberalization, financial development and economic growth in Iran from 1966 to 2010.The empirical results showed a positive long run relationship between the trade liberalization, financial development, and economic growth of Iran. Research conducted by Yavari and Mohseni (2012), Onafowara and Owoye (1998) showed a positive correlation between trade openness and economic growth in the long run. Iftikhar (2012) also investigated the trade liberalization policy in Bangladesh and its impact towards economic by employing empirical methods like Unit Root Test, co-integration, Granger causality, and Error Correction Model. The results explained that the trade openness contributed positively to economic growth and led increased industry's performance. Thus, it was concluded that Kuwait needs trade linearization instead of trade liberalization to enhance its economy.

Chaudhry, Malik and Faridi (2010) revealed that the trade openness and human capital contribute to both short and long run growth in Pakistan using empirical methods like co-integration test, Error Correction Model and Granger Causality Test. Adebiyi (2006) attempted to study the impact of trade openness towards economic growth in Nigeria using the Vector Auto regression methods. The results suggested a positive relationship between the trade openness and economic growth. Meanwhile, Olufemi (2004) attempted to study the relationship between the trade openness variable and the economic growth of Nigeria using econometrical methods like Unit Root Test, Granger Causality Test, Co-integration Test, and Error Correction Test. It was concluded that Nigerian economy has to be moderate in trade liberalization due to its weak nature in absorbing negative shock from external trade.

Sinha and Sinha(1999) attempted to analyse the impact of trade openness for 124 countries towards the economic growth. The results obtained showed a positive and significant relationship between the trade openness and growth. Edward (1992) examined the relationship between trade liberalization and economic growth for 30 developing countries using the OLS method. The results revealed that open trade policies help to increase the growth faster. Thomas and Nash (1991) identified that trade policy changes and reformations led to increase in economic growth for selected developing nations test.

## 3. METHODOLOGY

The study tried to find the long run relationship between import tax liberalization and economic competitiveness. Therefore the unit root test (Augmented Dickey Fuller) was used to identify the unit root problem and Johansen Co-integration technique was employed to find the long run relationship between the variables tested. The research framework and variables were adapted from Hossain and Mitra (2013) and Olufemi (2004) in order to establish a long run relationship between variables using Co-integration test.

The explanatory variables included were the import tax liberalization (IT), external debt (ED), and government spending on trade (GS). In this study Gross Domestic Product (GDP) was used to represent the economic competitiveness(Y), meanwhile import tax liberalization (IT) was proxied by import duties. Besides, the external debt(ED) used the external debt of Malaysia value and government spending (GS) used government spending on trade and industry as proxy. The model specification was as follow:

$$\Delta LOG(Y) = \beta 0 + \beta 1\ LOG\ (IT) + \beta 2\ LOG(ED) + \beta 3\ LOG\ (GS) + \varepsilon$$
Y: economic competitiveness
IT: Import tax liberalization
ED: external debt
GS: government spending

## 4. INTERPRETATION OF RESULTS

**Table 4(a): The results of Unit Root Test**

| Augmented Dickey Fuller | | |
|---|---|---|
| | **level** | **First Difference** |
| **Log(Y)** | -0.23 | -5.71*** |
| **Log(IT)** | -1.92 | -6.35*** |
| **Log(GS)** | -1.51 | -7.51*** |
| **Log(ED)** | -1.06 | -7.57*** |

Note: ***was significant at 1%, **significant at 5%,*significant at 10%

The ADF test results proved that the all variables tested were not stationary at level, since the p-value for all variables were greater at MacKinnon's one and five percent critical values. Thus, it was concluded that all the variables were stationary only at first difference and none were stationary at level form.

**Table 4(b): Unrestricted Cointegration Rank Test**

| Lag interval (first difference) :1 to 1 | | | | |
|---|---|---|---|---|
| **Hypothesized No. of CE(s)** | **Trace statistics** | **Prob **** | **Max Eigen statistics** | **Prob **** |
| None * | 153.73* | 0.0003 | 60.29* | 0.0009 |
| At most 1 | 93.44 | 0.0715 | 32.74 | 0.2641 |

| At most 2 | 60.70 | 0.2147 | 23.61 | 0.4843 |
| At most 3 | 37.09 | 0.3436 | 17.22 | 0.5613 |

\* denoted rejection of the hypothesis at the 0.05 level
\*\*MacKinnon-Haug-Michelis (1999) p-values

Table 4(b) revealed the result of Trace and Maximum Eigen Value Test results. Before conducting the Johansen Co-Integration test, the VAR model were conducted to select the optimal length. Based on the smallest or minimum AIC value, lag one was selected as the most optimal lag. The test indicated the presence of one co-integrating equations at 0.05 or five per cent significance level. Since there was at least one co-integrating equation, the null hypothesis was rejected. There was a long run relationship between the dependant and independent variable.

**Table 4.4 (c): Normalized Co-integrating Coefficients Result**

| LOG(Y) | LOG(IT) | LOG(ED) | LOG(GS) |
|---|---|---|---|
| 1.000000 | -0.317 (0.15634) | -1.575 (0.20618) | 2.225 (0.06893) |

The coefficient of co-integrating equation showed a negative relationship between the import tax liberalization and economic competitiveness in long run. Meanwhile, the external debt and government spending revealed a positive relationship with economic competitiveness. These results have negated the findings of Tash and Sheidaei (2012). The coefficient of Log (IT) indicated that, one per cent increase in Log (IT) would cause the Log(Y) to decline by 0.317 per cent. Meanwhile, one per cent increase of Log(ED) would cause Log(Y) to drop by 1.575 per cent. Import tax liberalization and external debt had a negative relationship with economic competitiveness in the long run. However, government spending had a positive relationship with the dependant variable. When the Log (GS) increase by one per cent, the Log(Y) also increased by 2.225 per cent in the long. All the variables rejected the null hypothesis at 5 per cent significant level.

**5. Summary And Conclusion**
The study began by examining the existence of long run relationship between the import tax liberalization towards the economic competitiveness of Malaysia from 1980 to 2013. Based on the empirical results obtained, it was proven that there was a long run relationship between the dependant and the independent variables tested. The Johansen Co-integration test showed a negative relationship between the import tax liberalization and competitiveness of Malaysia's economy in the long run. The findings obtained in this study have negated the findings of Yavari and Mohseni (2012) that showed a positive relationship between the trade liberalization and growth of the nation.

As a developing nation, Malaysia would not be able to fully benefit through import tax removal (liberalization) in the long run since it still need to protect the infant industries. Infant industries still need to be sheltered since they are not strong enough to compete with the giants like China and Taiwan where they are able to produce goods at cheaper price than Malaysia. Besides, it could have possibly shown a negative result due to the loss of government revenue and higher value of import than export which might lead to the negative trade balance as well.

Moreover, Malaysia ought to focus more on the government spending instead of exempting the trade taxes. Theoretically, government spending is an injection to the economic system and clearly would be able to boost up the national income. Meanwhile, external debt was clearly harmful for a nation's competitiveness level and its ability to manage the crisis.

Hence, the main objective of the study was fulfilled as the empirical results clearly revealed that the import tax removal or liberalization would harm the economic competitiveness of Malaysia in the long run. However, this study only employed annual time series from 1980 to 2013 to test the long run relationship between dependent and independent variables only due to the limited availability of data. So, it was recommended for the future researchers to include longer time series data for more accurate results. In a nut shell, Malaysia is not recommended to exempt import taxes for the long run.

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