# THE IMPACT OF IMPORT TAX LIBERALIZATION TOWARDS THE ECONOMIC GROWTH OF MALAYSIA



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FACULTY OF BUSINESS, ECONOMICS AND ACCOUNTANCY
UNIVERSITY MALAYSIA SABAH
2017

# THE IMPACT OF IMPORT TAX LIBERALIZATION TOWARDS THE ECONOMIC GROWTH OF MALAYSIA

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**THESIS SUBMITTED IN FULFILLMENT FOR THE DEGREE OF MASTER OF ECONOMICS**



**FACULTY OF BUSINESS, ECONOMICS AND ACCOUNTANCY**
**UNIVERSITY MALAYSIA SABAH**

**2017**

**UNIVERSITI MALAYSIA SABAH**

BORANG PENGESAHAN STATUS TESIS

JUDUL: **THE IMPACT OF IMPORT TAX LIBERALIZATION TOWARDS THE ECONOMIC GROWTH OF MALAYSIA**

IJAZAH: **MASTERS OF ECONOMICS (FINANCIAL ECONOMICS)**

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# DECLARATION

I hereby declare that the material in this thesis is my own except for quotations, equations, summaries and references, which have been duly acknowledged.

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# ACKNOWLEDGEMENT

First of all, I would like to express my appreciation and deepest gratitude to my supervisor Associate Professor Dr Caroline Geetha A/P B. Arokidasan for the support and guidance throughout this research. Her guidance in this research has led to the completion with success. I also would like to thank Dr Rafiq Idris, Dr James Alin, Dr Mori Kogid, and Associate Professor Dr Imbarine Bujang for sharing their opinions and suggestions with me in order to improve my writings. Besides that, I would to express my gratitude to my parents and friends for supporting me all the time until I complete this study.

Thank you.

Mohana Santheran

3rd September 2017

# ABSTRACT

This study examined the impact of import tax liberalization towards the economic growth of Malaysia from 1980 to 2013. Since Malaysia is a developing nation and aimed to achieve the vision 2020, the government intended to exempt import taxes in manufacturing sector. The import tax liberalization used as main independent variable proxied by import duties and the dependant variable economic growth was proxied by Gross Domestic Product (GDP) in line with other contributing factors like human capital investment, external debt, exchange rate, government spending on trade, and government policy. The study employed empirical methods like Ordinary Least Square estimates, Unit Root Test, Johansen Co-integration test, Granger Causality Test, ARCH test and others. Therefore, the result obtained from empirical test revealed that the import tax liberalization supported the economic growth in both long run and short run. Thus, it was recommended to increase the degree of import tax liberalization in order to enhance the economic growth of Malaysia.

**Keyword:** import tax liberalization, economic growth, Malaysia.

# ***ABSTRAK***

***KESAN PENGECUALIAN CUKAI IMPORT TERHADAP PERTUMBUHAN EKONOMI DI MALAYSIA***

*Kajian ini mengkaji kesan liberalisasi cukai import ke atas pertumbuhan ekonomi Malaysia dari tahun 1980 hingga 2013. Oleh sebab, Malaysia adalah sebuah negara membangun dan bertujuan untuk mencapai wawasan 2020, kerajaan berhasrat untuk mengecualikan cukai import dalam sektor pembuatan untuk meningkatkan pertumbuhan ekonomi. Pengecualian cukai import digunakan sebagai pembolehubah bebas utama diproksikan oleh duti import dan pembolehubah bersandar ialah pertumbuhan ekonomi yang diproksikan oleh Keluaran Dalam Negara Kasar (KDNK) selaras dengan faktor penyumbang lain seperti pelaburan modal insan, hutang luar negeri, kadar pertukaran, perbelanjaan kerajaan dalam perdagangan, dan dasar kerajaan. Kajian ini menggunakan kaedah empirikal seperti ujian regresi, ujian punca unit, ujian ko-integrasi Johansen, ujian penyebab Granger dan lain-lain. Oleh itu, keputusan yang diperolehi daripada ujian empirikal menunjukkan bahawa pengecualian cukai import menyokong pertumbuhan ekonomi dan mempunyai hubungan dalam jangka masa panjangdan jangka masa pendek. Oleh itu, dicadangkan supaya kerajaan Malaysia meningkatkan liberalisasi cukai import untuk meningkatkan pertumbuhan ekonomi Malaysia.*

***Kata-kata kunci:****Pengecualiancukai import, pertumbuhanekonomi, Malaysia.*

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# LIST OF ABBREVIATIONS

| | | |
|---|---|---|
| **ADF** | - | Augmented Dickey Fuller |
| **AFTA** | - | ASEAN Free Trade Agreement |
| **ARCH** | - | AutoRegressive Conditional Heteroscedasticity |
| **ATIGA** | - | ASEAN Trade in Goods Agreement |
| **CEPT** | - | Common Effective Preferential Trade |
| **CIF** | - | Cost, Insurance and Freight |
| **ED** | - | External Debt |
| **EOI** | - | Export Oriented Industrial |
| **EXR** | - | Exchange rate |
| **FDI** | - | Foreign Direct Investment |
| **GATT** | - | General Agreement on Tariff and Trade |
| **GDP** | - | Gross Domestic Product |
| **GMM** | - | Generalized Methods of Moment |
| **GP** | - | Government Policy |
| **GS** | - | Government spending |
| **GST** | - | Goods and Services Tax |
| **GSTP** | - | Global System of Trade Preferences |
| **HCI** | - | Human Capital Investment |
| **IRF** | - | Impulse Response Function |
| **ISI** | - | Import Substitution Industrial |
| **ITL** | - | Import tax liberalization |
| **MSC** | - | Multimedia Super Corridor |
| **OLS** | - | Ordinary Least Square |
| **PP** | - | Phillips Perron |
| **RESET** | - | Regression Equation Specification Error Test |
| **VDA** | - | Variance Decomposition Analysis |
| **VECM** | - | Vector Error Correction Model |
| **WTO** | - | World Trade Organization |

# CHAPTER 1

# INTRODUCTION

## 1.1 Introduction

The international trade has always been the backbone to the development of developing country like Malaysia after independence. Undeniably, international trade also contributed to the Gross Domestic Product (GDP) and became one of major source of income to the nation. Through international trade, Malaysia was involved in both trade of goods and trade in services as well. Therefore, Malaysia has started to reduce its dependency on primary commodities and transformed to a competitive and dynamic industrializing nation through international trade after 1980's. According to the World Bank (2016), Malaysia as an upper middle income country had majorly dominated the production of raw materials like tin, rubber and so on.



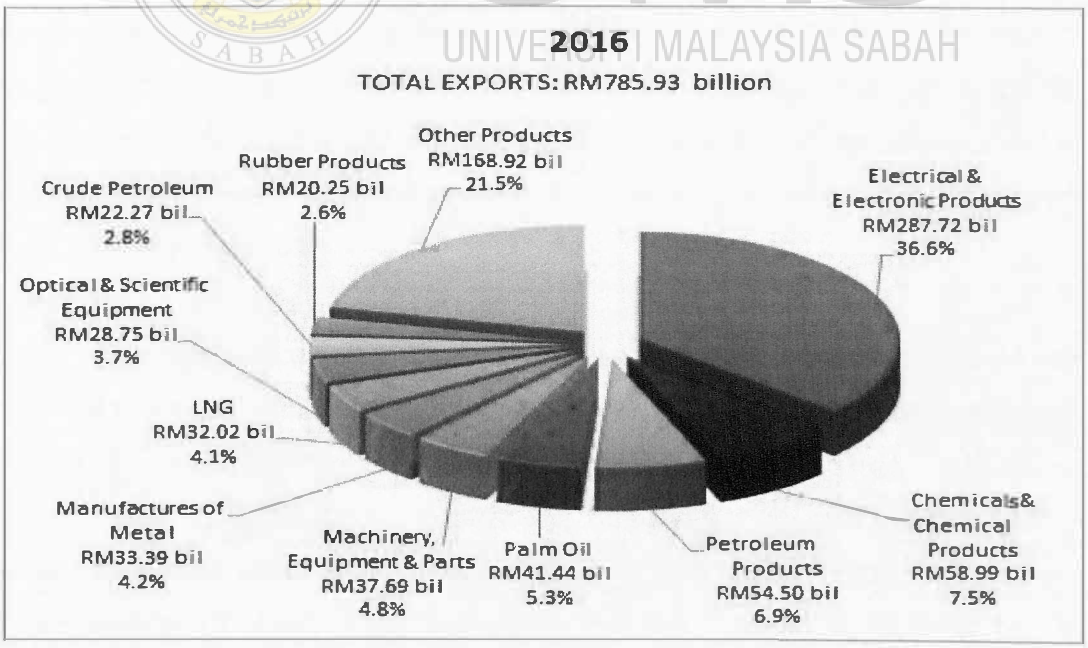


**Figure 1.1: Exports of Malaysia 2016.**

Source: Statistical Department of Malaysia (2016)

The major exports of Malaysia are electrical components and appliances, wood, plastics, animal fats, palm oil, and also natural gas. The major exports partner of Malaysia are the Asian countries, with the export of 70.5 per cent, followed by European countries at 10.8 per cent, North American countries at 10.6 per cent, and the least is African countries at 2.6 per cent. Malaysia's largest exported goods are the manufactured goods with the total worth of RM50.51 billion in 2016. In 2016, the commodity with the highest exports value in Malaysia was the machinery and transport equipment with the total value of RM 296,735 million.

Figure 1.1 illustrating the components of total exports of Malaysia worth RM785.93 billion in 2016. It also shows that the electrical and electronic products (semiconductor, LED and solar) from the manufacturing sector was the largest export of Malaysia, which was about 33 per cent in 2016. The main reason for the demand of electrical and electronic products to increase in the global market was due to the globalization and high usage of mobile devices like smartphones, optoelectronic materials, tablets, embedded technologies and so on. Therefore, Malaysian government reduced the import taxes in the manufacturing sectors to cut the production cost and enjoy more profit since the demand of manufactured goods in the global market had increased. Meanwhile, the trade in service sectors comprised the sectors like financial, communication, transportation and shipping, engineering, constructions and distribution. The total export of services sectors of Malaysia in 2015 was approximately RM 765,417 million, meanwhile the import was about RM682,937 million.

According to Mcguire(2002),Malaysia was one of the most restricted market for services sectors such as the banking, maritime and distribution services, meanwhile professional and telecommunication services were regarded as the most discriminatory restricted market against the foreigners. Moreover, Mattoo (2001) study proved that openness in financial telecommunications sectors had positive impact towards the economic growth in the long run. Therefore, Malaysia had to reduce most of its trade barriers and restrictions in both goods and services and gradually adapt to the trade liberalization policies through Free Trade Agreements to increase the competitiveness level of Malaysia. According to the World Trade

Organization (WTO) Report in 2014, Malaysia had tremendous improvements in term of global growth by integrated in global value chains, the nation had created an environment ease to do business and attracted more Foreign Direct Investment (FDI).

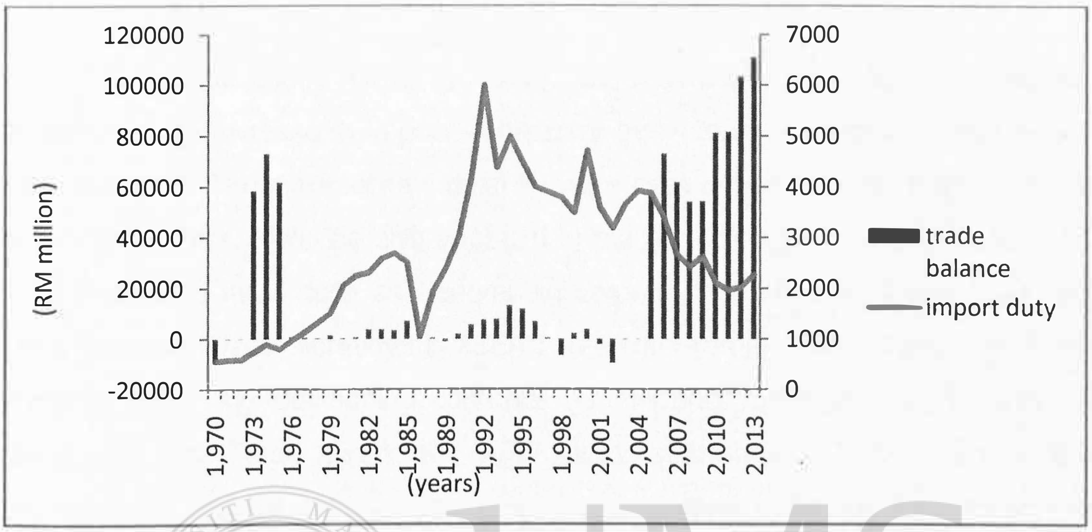


**Figure 1.2: Trade balance and import duty of Malaysia from 1971 to 2012.**
Source: Statistical Department of Malaysia (2016)

Historically, Malaysia adapted to a few numbers of trade restrictions change post-independence in 1957. The import substitution policy in industrialization was adapted from 1957 to 1969, and moderate tariff with direct restrictions on import was imposed in order to promote new investments in manufacturing industry. The main objective of the policy was to reduce the imports and unemployment rate, at the same time diversify the economy. In 1968 to 1980, the Export Oriented Industrial (EOI) strategy was introduced in order to create more employment opportunity through diversifying the manufacturing industry especially the exports of textiles and electronics.

In 1960's, the effective rate of protection increased about twenty five per cent and to seventy per cent in early 1980's. However, the protection tariff rate declined to below thirty per cent in late 1980's, and where the drop was explained that the industries that was sensitive to politics would make profits through high tariff rate. In 1981, the second phase of Import Substitution Industrial (ISI) comprised the objective of creating linkage in manufacturing industry and reducing the import of intermediate and capital goods. In 1990, the nation adopted to knowledge economy which emphasized on moving towards higher skilled and knowledge intensive economy. Thus, the Multimedia Super Corridor (MSC) was established in 1996 in order to promote the knowledge based economy.

During economic crisis in 1998, the automobile industries in Malaysia experienced an increase in import in order to minimise the effect of crisis on local manufacturers. The automobile industries were heavily protected by both tariff and non-tariff barriers. Malaysia also engaged in many trade agreements to control the tariff protection rates such as General Agreement on Tariff and Trade (GATT) in 1957, Bilateral Trade Agreement, ASEAN free trade area, Global System of Trade Preferences among Developing countries (GSTP) and others as well. Meanwhile, the ASEAN Free Trade Agreement (AFTA) was established in 1992 as a collective effort of the original six member countries (including Malaysia) to eliminate or reduce the tariff rate in trade of goods through the Common Effective Preferential Tariff (CEPT).



The main objective of CEPT was to remove the barriers among intra-ASEAN and increase the competitive edge as production base in world market. Zero to five per cent of tariff was reduced for processed agricultural products, manufactured goods and the non-tax barriers and quantitative restrictions for imports was removed too. In 2010, the AFTA-CEPT was replaced by ASEAN Trade in Goods Agreement (ATIGA). The main objective of ATIGA was to establish an integrated market and free flow of goods among ASEAN Economic Community (AEC) by 2015. By joining AEC, ASEAN member countries got involved into the worldwide economy. Through various "ASEAN+1" commerce concurrences with the People's Republic of China, Japan, the Republic of Korea, Australia, New Zealand and India, ASEAN were all around situated at the focal point of worldwide supply chains. Hence, it created a solid trade joints and links with the major provincial economies, which took into account the formation of worthy business opportunities.

Besides, Malaysia also focused on trade in services through the liberalization of services sub-sectors substantially. The trade liberalization in services sector was actually to reform the regulations that restrict the trade in order to enhance the national welfare. High restriction on service sector, eventually reduced the efficiency since it limited the ability to specialize in service sectors that have comparative advantage. Therefore, starting 2009 the Malaysian government liberalized twenty eight sub-sectors like computer and related services, health services, tourism, support and auxiliary transport services, rental and leasing without operator, business, sporting and recreations, and transport services. In 2012, Malaysian government once again liberalized eighteen sub-sectors under main sectors like telecommunication, healthcare, professional services, environmental services, distributive trade, education and courier services.

After the tax liberalization being applied in most of the sectors, Malaysia still imposed high tax barriers and non-tax barrier on few other goods and sectors. Since Malaysia is an Islamic nation, the alcohol manufacturing sectors are mostly centred in the east Malaysia (less Muslim people). Malaysia imposed 15 per cent tax on alcohol, which was the third highest in the world after Norway and Singapore. Moreover, wine, pork, poultry also charged with high effective tariff and subject to Goods and Services Tax (GST) in Malaysia. However, Malaysia was re-considering about reducing the tax rate for alcohols after joining TPPA to increase the liberalization of trade with member countries.

Since Malaysia was engaged in all these agreements since 1992 to 2015 and started to remove its trade barriers, the economic growth of the nation had increased gradually from year to year. The removal of trade taxes and barriers through the trade agreements, was proven to be supportive to the nation's growth and made it highly competitive in the contemporary world. Moreover, the government's aim to exempt taxes for manufacturing sectors (equipment, packaging products, machinery, raw materials and etc) recently caused many debates and question to arise on its impact towards the economic growth of Malaysia. Hence, this study aimed to find the impact of import tax liberalization (proxied by the import duties of Malaysia) followed by the conditions of variables like external debt, human capital investment, government policy, exchange rate and government spending on trade towards the economic growth (proxied by GDP) of Malaysia.

## 1.2 Background of Study

Trade liberalization or trade barriers removal was proven to be supportive to the economic growth theoretically and empirically by Baharom, Habibullah and Royfaizal (2008), Hasvenda and Fadhlin (2014) and others. Based on the classical theory of absolute advantage in trade by Smith (1776), free trade was believed to reduce the market power and increase the productivity level and income of a nation. Milton and Friedman (1980) believed that free trade system would increase the economic growth, standard of living and job opportunities in a country since free environment without barriers lead to higher specialization and trade based on own production capabilities. Bhagwati and Srinivasan (2002), stated that high protectionism constrained the marginal efficiency of capital in a nation and high openness led to integrated world economy.

However, developing nations like Malaysia had to shelter their economic system from the external threats through imposition of restrictions and barriers. Moreover, Regina (2012) emphasized on the risks involved in free trade such as the risk of unpredictable fluctuations of currency rate, transportation risk, commercial risk and others. Important reasons for the imposition of trade barriers was to protect the domestic producers, avoid dumping of foreign products in domestic markets and reduce the dependency on other countries due to Malaysia's status as a developing nation and open economy that highly depends on income generated through exports of goods and services. The purpose of the study was to ascertain the role of import duties liberalization in enhancing the economic growth of Malaysia.

In general, there are two types of restrictions in trade, the tax base and non-tax base. Tax base restrictions are import tariff, export tariff and others, meanwhile the non-tax base are import quota, import license, local content requirements, embargoes, fees and so on. In Malaysia, non-base restrictions are applied on automobile manufacturing industries, liquor, cigarettes, tobacco and others. The Malaysian government also imposed import licensing on arms, explosives, drugs, chemicals, and other goods, where all these non-tax restrictions are applied based on the agreements and policies signed by the government. For Malaysia, the import duty and taxes are due when the private individual or even a commercial entity imported goods inside the country. The valuation methods commonly used are the cost, insurance and freight (CIF) method and in some circumstances based on the quantity (volume or weight). In Malaysia, the average applied tariff for industrial goods are about 6.1 per cent. Besides that, goods like alcohol, wine and pork are charged with high specific duties and also subject to Good and Service Tax (GST) at the standard rate of 6 per cent.

Due to globalization, many emerging economics like China, Indonesia and India had to attract more foreign direct investment into their country by removing trade barriers in order to increase the economic growth through surplus in trade balance. They would be able to produce goods with their skilled but cheap labor. Moreover, those countries had a large population size that created a ready market for the products that they produced. Malaysia faced a lot of challenges in attracting Foreign Direct Investment (FDI) since the late 1980's. This means the Malaysian government had to remove protectionism such as the restrictions and barriers to attract more Foreign Direct Investment to increase export.



Important reasons for the import taxes being levied are to protect the domestic producers, avoid dumping of foreign products in domestic markets and reduce the dependency on other country. For the case of Malaysia, the nation was an open economy that highly depends on income generated through exports of goods and services. Besides the income generated through export, the foreign direct investment was also another important variable to produce goods and services and generate more job opportunities in Malaysia.

However, the multinational corporations that operated in Malaysia would transfer the incomes generated through the investment to their origin country. This caused a big deficit in the current account of Malaysia that showed the net exports value of goods and services in balance of payment. Meanwhile, the balance of payment was the summary of transaction between a country with the rest of the world. It consists of the current account, capital account and the official financing. If export was more than import, then it was a surplus in current account. Meanwhile, if the import was higher than export, it would be a deficit. If deficit takes place in the current account, the Malaysian economic system would be facing a debt in its external economics. Therefore, the debt could be covered using the capital account.

Capital account deals with short term capital and long term capital. Short term capital consisted of saving and investment. In Malaysia, savings were only 42 per cent of the GDP meanwhile investments were 46 percent. It formed a saving investment gap that can only be covered by long term capital. Long term capital consists of inflow and outflow of foreign direct investment. Up to date Malaysia strongly depends on the foreign direct investment to cover the debt in the current account and the short term capital. With the strong inflow of foreign direct investment, Malaysia would be able to have a strong reserve in the official financing and did not borrow from IMF for balancing its balance of payment.



Since Malaysia had engaged in free trade policies of the World Trade Organization and the ASEAN Economic Community, all forms of trade barriers would be removed. This means, Malaysia ought to be able to sustain the growth in the world market without the protection. Thus, this study highlighted the impact of import tax liberalization towards the economic growth of Malaysia together with other contributing factors.

## 1.3 Problem Statement

The Federal Manufacturers Association of Malaysia found that the percentage of profit from manufacturing sector could be increased if the cost of doing business in Malaysia can be reduced. Manufacturing sector contributed about 30 to 40 per cent of the GDP of Malaysia and one of the major contributor to the nation. Therefore, the Malaysian government exempted the tax for wide range of raw material or direct inputs of manufacturing sectors for the materials that were not