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### The Moderating Effects of Exchange Rate on The Effects of Trade Liberalization to State Revenues From Tax and Welfare

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**Abstract:** Since the first period of modern economics development, economists have been launched trade liberalization, which at the period, the economists are often classified as the pioneers of classical economics assuming that liberalization is the essence of the economy. The research method used in this study was Library Research. Based on the analysis, it is known that there is a significant effect between trade liberalism towards the state income from tax and welfare directly or indirectly.

**Keywords:** Library Research, Economics Development, Research Method

#### INTRODUCTION

Since the first period of modern economics development, economists have been launched trade liberalization, which at the period, the economists are often classified as the pioneers of classical economics assuming that liberalization is the essence of the economy. In the opinion of the economists, trade between countries should be allowed freely with minimum government intervention, in the forms of tariffs and/or other restrictions. This is based on the argument that more free trade will provide greater benefits for both countries in trade and for the world in general, and increase greater prosperity than no trade. However, a development of economic theory supported by some empirical facts that give a different idea from the expectations of classical economic theory proves that not all predictions of classical economic thinkers is true.

Facts show that with the differences in the abundance of resources that become supporting components of competitiveness, other economists consider that trade liberalization has a negative potential because it encourages unfair market competition. Hence, a notion about the importance of the safeguards on domestic production and other interests from the international market pressures by imposing restrictions or trade barriers is emerged. However, the implementation of barriers or restrictions in this trade has two opposite

effects: on one side, this intervention can provide additional state revenue, but on the other side, it leads to the costs of inefficiency, ended with a decrease in the level of welfare.

From the different notions, theoretically it can be said that although the trade with barriers or restrictions is better than no trade, but free trade is much better than the trade with barriers. Indonesia is a developing country with an open economy, and it also ratified many cooperation agreements of economy and trade regionally and globally. However, liberalization pressure through various rules of cooperation agreements is not impossible to eventually collide with the internal policy and threaten the national interests that will have impacts on welfare.

The more open and integrated the trade among countries is driven by external factors, such as ratification bound on trade agreements among countries, regions, or even of global nature (Grace, 2003; Kariyasa, 2003). Feridhanusetyawan and Pangestu (2003) describe that in addition to be driven by regionalization occurred in the late 1980s until the mid-1990s (such as the establishment of AFTA and APEC), the external pressure of liberalization is also due to the bond on commitment to the Uruguay Round Agreement as part of a series of GATT Round (General Agreement on Tax and Tariff) which is then changed into a formal organization called WTO (World Trade Organization). AFTA and WTO agreements are binding, whereas the basic agreement of APEC (Asia Pacific Economic Cooperation) is voluntary. Nevertheless, the spirit brought by the three institutions is relatively similar, i.e. liberalization through the reduction in trade barriers (tariff and non-tariff).

Yet, in planning a program of liberalization, policy makers often face difficulties in predicting on state tax revenue, where it is generally caused by the uncertainty regarding the effects of trade liberalization and changes in the domestic exchange rate on the fiscal ability, in this case is the state tax revenue.

Therefore, the effect of trade liberalization on the domestic exchange rate of state revenues from tax and welfare level become a very important issue in practice. Thus, the study was conducted to determine the moderating effects on the effects of trade liberalization to state revenues from tax and welfare. The originality of the study is seen from the improvement of previous studies by using the moderating effects on the exchange rate on the effects of trade liberalization to state revenues from tax and welfare.

## **THEORETICAL BACKGROUND**

This section will discuss some theoretical and empirical reviews have been done by some previous researchers related to liberalization of international trade. Agbeyegbe, Terence D., Janet Stotsky, and Aseggedech Wolde Mariam (2006) have examined the relationship of liberalization of international trade, changes in exchange rate and state revenues from taxes in the countries of Sub-Saharan Africa during the period 1980-1996. They found that the sensitivity of the relationship between trade liberalization and tax revenue depends on the measure of the trade liberalization used, in which trade liberalization only has a positive effect on income tax revenue. Domestic exchange rate appreciation as the impact of trade liberalization leads to the overall tax revenue decline.

By adopting a model that has been used by Agbeyegbe, Terence D., Janet Stotsky, and AseggedechWoldeMariam (2006), the researcher tried to do a similar study in Indonesia. The difference from the previous studies is very significant, that this study tried to see the effects of trade liberalization and macroeconomic variables to tax revenues and welfare simultaneously.

## **Trade Liberalization and Tax Revenues**

The purpose of the liberalization policy is trade policy taken by a country that reflects the movement towards a more neutral, liberal, or open direction. Particularly, a change to a more neutral direction includes incentive (average) unification among the trade sectors. The regime of a policy is considered implementing a liberalization policy when the level of intervention is overall increasing. In addition, a liberal policy can also be marked by the more important of the role of trade in the economy. Liberalization policy can be achieved through several ways, such as a reduction in trade barriers or the implementation of export subsidies (Santos-Paulino, 2005).

The studies conducted by Krueger (1978) and Bhagwati (1978) were the first organized studies to formalize the classification of policy. They interpreted the trade liberalization policy as a policy that reduces the bias level of anti-export that focuses on reducing import license premium (PR). The orientation of trade policy of a country is measured by the level of applicable protection structures and incentive systems.

Generally, the first step towards the liberalization of international trade is changing the international trade policy from limiting the number of import or also called import quota into import taxes or import tariffs. This would result in a state revenue from trade taxes, in which the amount of the tax revenues is highly dependent on the import tax rate itself and changes in the value of imports in reaction to the liberalization measure.

Tax collection by each state can be performed in several ways. However, it is impossible to equate the effects of trade liberalization and changes in some macroeconomic variables to state revenues without considering the structure of different components of revenues and the contribution of each different component of revenues to total state revenue. In addition, the components of tax revenue interact by reinforcing or covering changes of one to another.

Generally, in developing countries, tax revenues contribute the most to total state revenues, except in several countries that have high level of natural resources production, so that non-tax revenues become more dominant.

Furthermore, the taxation system includes various types of taxes, which can be divided into three general categories, namely: income and profit tax, goods and services tax and international trade tax. Individual and corporate income taxes are generally the major components of income and profit tax, although sometimes there may be separation of income tax from capital. Meanwhile, a major component from goods and services tax is sales tax.

## **Trade Liberalization and Welfare**

Free and open world trading system requires the elimination of all forms of intervention, because it could distort the market. Furthermore, despite the rejection of the reduction in intervention is often done with an excuse to create a “fair” trade, this kind of excuse often makes the trade unfair instead. This is due to the differences in the ability to reduce production costs which will determine the competitiveness of trading nations, particularly for the trader classified as a small country. In addition, the small countries do not have the abilities to influence the international market prices, both monopoly and monopsony, so that the trade interventions made are unable to improve the welfare of the country entirely.

In concept, the elimination of the various forms of interventions and barriers makes the implementation of trade liberalization increase greater volume of trade (exports and imports), so that the value added created will also be higher. The conditions will further trigger the growth of the world economy. To determine the benefits or advantages of increasingly open trade or commonly known as liberal trade, a common measure used is welfare (Ilham, 2003). An analysis to the changes in the level of welfare as a result of trade or implementation of instruments of trade liberalization can be done using the concepts of consumer surplus and producer surplus.

Trade liberalization will lead to increased consumer surplus (because the consumer can benefit imported goods at cheaper prices, and the goods that can be consumed are also more varied) and decreased producer surplus, accompanied by the loss of state revenue from trade taxes. However, the partial loss of producer surplus and trade tax revenue of the government is still relatively small, compared to the benefits benefited by the consumer. Therefore, trade liberalization will lead to the distribution of profits from producers and the government to consumers which eventually will improve welfare.

### **Previous Studies**

Liberalization of international trade will eventually lead to a reduction in import taxes, and will further affect state revenue from international trade taxes (Ebrill, Stotsky, and Gropp, 1999 discussed this). The relationship between the liberalization of international trade and tax revenue including domestic tax is uncertain and depends on several factors, including the structure of tax systems adopted by the countries and the ability of the tax administration (Ebrill et al., 1999; Keen & Ligthart, 2002). Generally, trade liberalization is accompanied by a value-added tax (VAT) or significant domestic tax policy changes.

Changes in the macro-economic variables also affect state revenues from taxes. Tanzi (1989) suggested several broad hypotheses on the relationship among various macro-economic variables, including inflation and exchange rate, with state revenues from taxes. He found that there was a negative relationship between state revenues from taxes and the real exchange rate of the domestic currency. He agreed that overvaluation has a direct effect by pressing the import and export measured in domestic currency. It lowers the tax revenues of international trade and sales taxes, which are usually drawn from the consumption of domestic and imported goods.

Khattry and Mohan Rao (2002) also investigated this topic by using panel data from 80 industrialized countries, during the period 1970-1998. Using a fixed effect regression framework, they found that the liberalization of international trade is negatively related to total tax revenues and international trade tax revenues, but they also found that there was no significant relationship between the domestic exchange rate and international trade tax revenues. They also found that the countries generally had reduced their measure to the tax rates to maximize the revenues, in which shows that the reduction in import tariffs will reduce international trade tax revenues.

Furthermore, Adam, Bevan, and Chambas (2001) examined the relationship among tax revenue, exchange rate, and trade openness in Sub-Saharan Africa by using General Method of Moments (GMM) estimation of dynamic panel. The weakness of this study is the observation time period that is too short to fully capture the dynamic effect. In addition, although trade liberalization is not the focus of their study, but they proxied trade liberalization with openness variable. They concluded that openness would increase

the tax revenues overall in CFA franc countries, while it only gave a small effect on the non-CFA franc countries, although the proceeds of revenues partially emphasized that openness will increase trade taxes revenues and lower goods and services taxes.

Tovar, Jorge Andres (2004) investigated the effects of welfare from trade liberalization through the exchange rate by using the case study at the car industry in Columbia. He found that trade liberalization characterized by decreasing import taxes on cars with an average of 38 percent caused price-cost margins reduced to about 23 percent for domestic cars as a result of increased competition in the country and reduction in production costs due to increasing level of efficiency. However, the market structure has not changed. Furthermore, it led to increased consumer welfare because the monetary gains benefited by consumers as a result of the decrease in the domestic price level and the increasing variety of goods they can consume.

Furthermore, Acharya, S. and S. Cohen (2008) examined some of the latest findings by using general equilibrium models that measure the impact of trade liberalization on household welfare. They made modifications in the standard neo-classical model and applying it to the characteristics of the rural economy in the South Asian where there are only few studies on policy models. Furthermore, they concluded that a combination of liberalization of imports and exports would have an impact on high economic growth, but the pattern of income distribution did not switch and stand for the poor. Compared to a fixed exchange rate system, trade liberalization with a flexible exchange rate system can have a negative impact because the domestic currency can experience quite large appreciation, and eliminate comparative advantage. They also found that the external reforms implemented one by one will provide better economic impact than if they are implemented simultaneously.

## RESEARCH METHODS

The research method used in this study was Library Research, as a form of research that utilized available means of library in the forms of books, journals, data, and other empirical studies. These materials can be obtained from the library directly or via the internet. The data used in this study were secondary data obtained from various data sources, such as the International Financial Statistics of the IMF, World Bank, Bank Indonesia reports, Central Bureau of Statistics, and other sources. All data used in this study were the annual data for each variable of study from 1986 until 2007.

For estimation models used in this study is a model of simultaneous equations (Simultaneous Equation Model) based variance is known as a method WarpPLS.0. Model By Engaging Moderation (Hypothesis 1-5).

$$Y1 = \gamma_1 X + \gamma_2 M + \gamma_3 X*M + \epsilon_i$$
$$Y2 = \gamma_4 X + \gamma_5 M + \gamma_6 X*M + \beta_1 Y1 + \epsilon_i$$

where

Y1 = Nation Income from tax

Y2 = Prosperity

X = Trade Liberalization

M = Exchange Rate

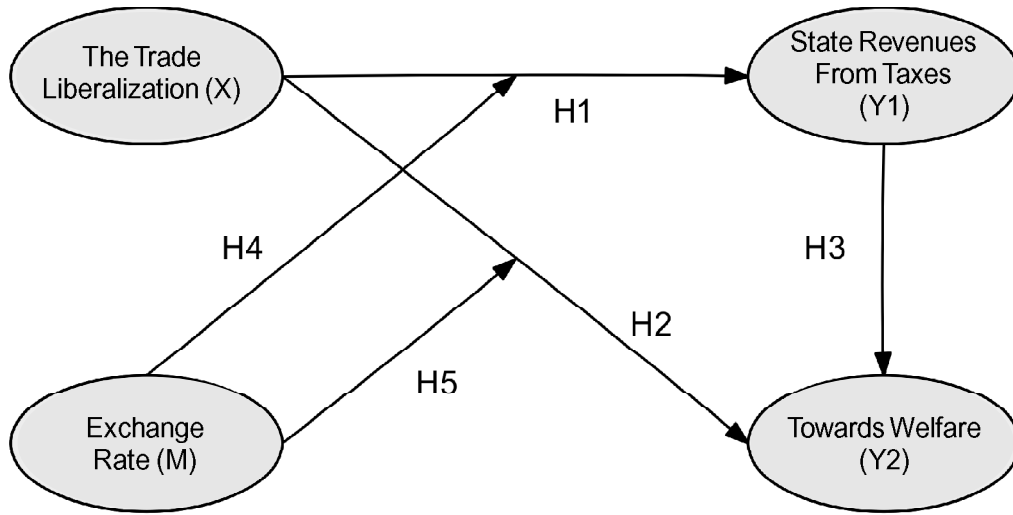


Figure 1: Conceptual Framework

## RESULT AND DISCUSSION

### Goodness of Fit

The model in this study is said to be fit if supported by empirical data. As it is known that the Goodness of Fit the structural model in the form of SEM-relevance predictive value( $Q^2$ ) which is calculated based on the value of  $R^2$  each endogenous variable. Rated R for each dependent variable can be seen in Table 1.

Table 1  
R-Square Dependent Variable

Variable	R-Square
Agricultural Productivity	0.759
Prosperity	0.652
Predictive-relevance ( $Q^2$ )	0.916

Source: Outcome WarpPLS, 2016

Based on Table 1 it can be seen that the value of Predictive-relevance ( $Q^2$ ) of 0.916 or 91.6%. This means that the model can be explained by variables associated by 91.6% while the remaining 8.4% is explained by other variables outside the model.

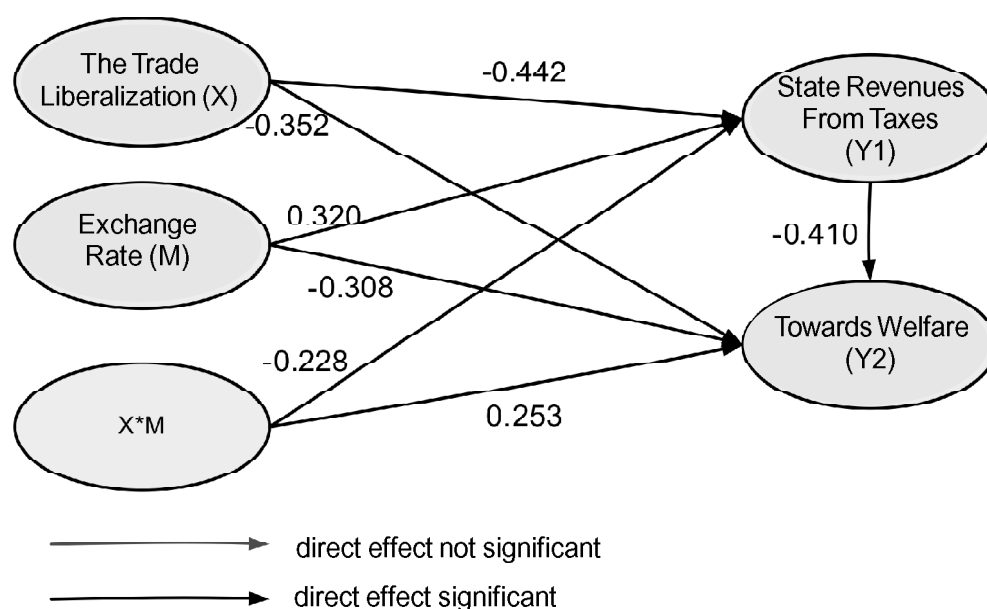
### SEM Analysis

The second part of SEM analysis is the interpretation of structural models or structural models. Structural model presents the relationship between the study variables coefficient structural model of stating the magnitude relationship between one variable against another variable. There is significant influence between variables to one another variable, if the value of P-value of  $< 0.05$ . There are two influences in this research is the direct effect (direct effect), as well as the interaction effect (moderator effect). The results of the analysis are summarized in Table 3 and Figure 2.

**Table 2**  
**SEM Structural Model: Direct Effect**

No	Relation	Coefficient	P-value	Explanation
1	X towards Y1	-0.442	< 0.001	Significant
2	M towards Y1	0.320	< 0.001	Significant
3	X towards Y2	-0.352	< 0.001	Significant
4	M towards Y2	-0.308	< 0.001	Significant
5	X_M towards Y1	-0.228	< 0.001	Significant
6	X_M towards Y2	0.253	< 0.001	Significant
7	Y1 towards Y2	-0.410	< 0.001	Significant

Source: Primer Data be treated, 2016

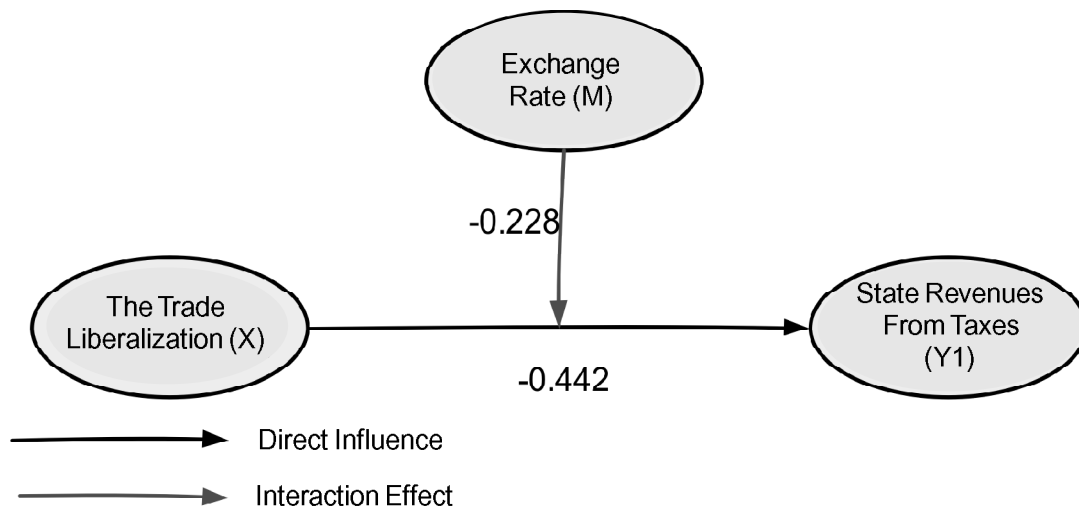


**Figure 2: SEM Structural Model: Direct Effect**

Based on Table 3 and Figure 2, can be served inner testing results the following models:

1. Testing the direct influence of trade liberalism (X) towards state revenues from taxes (Y1), the structural coefficient values obtained at -0442, with a p-value of < 0.001 (p.value< 0.05), then there is a significant direct effect between Liberalism trade (X) towards state revenues from taxes (Y1). Given the structural coefficient is negative, indicating that their relationship is directly inverted. That is, the higher the trading Liberalism (X), will lead to the decline in state revenues from taxes (Y1).
2. Testing the direct influence of exchange rate (M) towards state revenues from taxes (Y1), the value of the structural coefficient of 0.320, with a p-value of < 0.001. Because p-value < 0.05, then there is a significant direct effect between exchange rate (M) towards state revenues from taxes (Y). Given the structural coefficient is positive, indicating that the relationship positive. That is, the higher the exchange rate (M1), will affect the higher state revenues from taxes (Y).

3. Testing the direct influence of trade liberalism (X) towards welfare (Y2), the structural coefficient values obtained at -0352, with a p-value of  $< 0.001$  ( $p\text{-value} < 0.05$ ), then there is a significant direct effect between Liberalism trade (X) towards welfare (Y2). Given the structural coefficient is negative, indicating that their relationship is directly opposite. That is, the higher the trading Liberalism (X), will result in the decline Welfare (Y2).
4. Testing the direct influence of exchange rate (M) towards welfare (Y2), the structural coefficient values obtained at -0308, with a p-value of  $< 0.001$ . Because  $p\text{-value} < 0.05$ , then there is a significant direct effect between exchange rate (M) towards welfare (Y2). Given the structural coefficient is negative, indicating that their relationship is inversely proportional. That is, the higher the exchange rate (M), will affect more the low Welfare (Y2).
5. Testing the direct influence of state revenues from taxes (Y1) towards welfare (Y2), the structural coefficient values obtained at -0410, with a p-value of  $< 0.001$ . Because  $p\text{-value} < 0.05$ , then there is a significant direct effect between state revenues from taxes (Y1) towards welfare (Y2). Given the structural coefficient is negative, indicating that their relationship is inversely proportional. That is, the higher the value of state revenues from taxes (Y1), will affect more the low Welfare (Y).

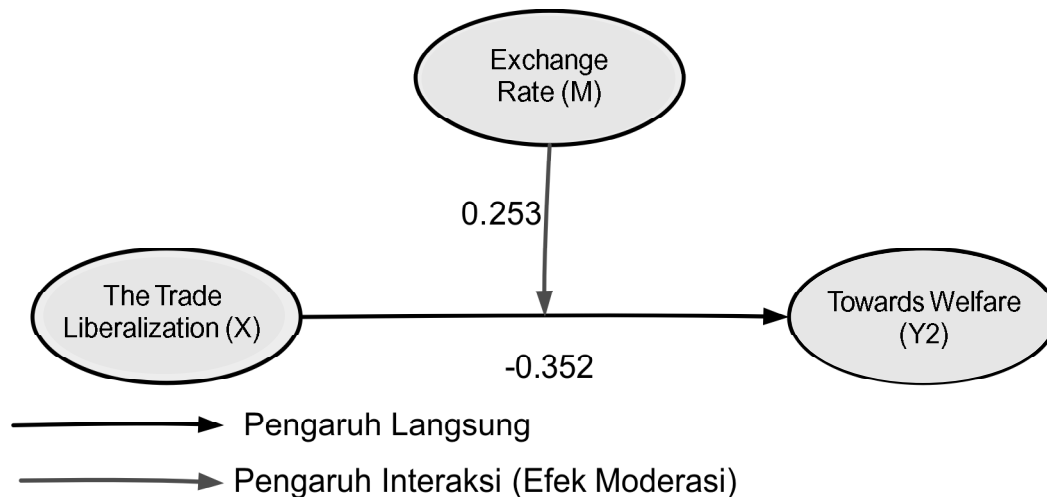


**Figure 3: Moderation Effects on Effect of exchange rate towards trade liberalization of state revenues from taxes**

SEM analysis results obtained interaction coefficient of -0228, and P of  $< 0.001$ . Because the P value of  $< 0.05$  indicates the exchange rate is a variable moderator between the effect of trade liberalism (X) towards state revenues from taxes (Y1). Because of the direct influence and interaction effects are equally significant impact towards state revenues from taxes (Y1) then the variable exchange rate quasi moderator (moderator false). While the value of the coefficient of the interaction effect is negative then the variable exchange rate (M) is said to be weakening. That is, the higher the exchange rate (M), affect more the low influence of trade liberalism (X) towards state revenues from taxes (Y).

SEM analysis results obtained interaction coefficient for 0253, and a P of  $< 0.001$ . Because the P value of  $< 0.05$  indicates the exchange rate is a variable moderator between the effect of trade liberalism





**Figure 4: Moderation Effects on Effect of exchange rate towards trade liberalization Welfare**

(X) towards welfare (Y2). Because of the direct influence and interaction effects are equally significant influence towards Welfare (Y2), the variable rate quasi moderator (moderator false). While the value of the coefficient of the interaction effect is positive, then the variable exchange rate (M) is said to be strengthening. That is, the higher the exchange rate (M), affects the increasing influence of liberalism Trade (X) towards welfare (Y2).

## DISCUSSION

The results of the analysis stated that trade liberalization directly has negative and significant effects to state revenues. It is hypothesized that the higher the degree of trade liberalization, will lead to the elimination of some state revenue from taxes, particularly trade taxes. Therefore, according to the empirical results that support the hypotheses, the direct effect of trade liberalization will reduce state revenues from taxes, particularly trade taxes.

This finding is consistent with the results from the study of Khattry and Mohan Rao (2002) that were also investigated this topic by using panel data from 80 industrialized countries, during the period 1970-1998. Using a fixed effect regression framework, they found that the liberalization of international trade is negatively related to total tax revenues and international trade tax revenues, but they also found that there was no significant relationship between the domestic exchange rate and international trade tax revenues. They also found that the countries generally had reduced their measure to the tax rates to maximize the revenues, in which shows that the reduction in import tariffs will reduce international trade tax revenues.

In addition, according to Weisbrot, Mark and Dean Baker (2002), who examined the relative impact of trade liberalization in developing countries, they found that there was a cost to be borne by the developing countries by liberalizing their trade that is often neglected, i.e. government revenue will be reduced.

The direct effect of trade liberalization that would reduce state revenues from taxes, particularly trade tax, will be responded positively by the enhancement of the government creativity to explore other sources of tax revenue that are more potential. However, of course, the conditions or criteria that must be met by a tax object to be a good tax should be considered.

Yet, since the tax base is in nominal income and not on real income, the state revenues will increase, particularly from income tax. This thing is less recognized by the government, which in the conditions of declining real income, the tax payment will be the tax burden.

This is consistent to the results of a study conducted by Ebrill et al., (1999), which examined two complementary models of the determinants of imports and international trade tax revenues by using panel data from 27 countries from Africa, Asia, and the Western Hemisphere, with a time period from 1980 to 1995. By using an instrumental regression framework and fixed effects, they concluded that the tariff changes did not always cause trade tax revenue declined. They found that, in both models, the depreciation of the exchange rate significantly related to the increase in trade tax revenue.

Furthermore, the results also showed that trade liberalization has a negative and significant effect to the welfare both directly and indirectly. It is hypothesized that the effect of trade liberalization to the welfare is positive, indicated by the lack of unequal distribution of income, but the results of the analysis showed that the trade liberalization has a negative and significant effect to the welfare, proxied with unequal distribution of income, which means that the lower the unequal distribution of income, the more the people will be happy and prosperous.

Theoretically and supported by some of the results of previous findings that the higher the degree of trade liberalization of a country, the higher the competition in the country that will eventually drive every industry to improve efficiency by reallocating resources to the sectors according to the comparative advantages, so that the costs of inefficiency resulting in low welfare can be eliminated.

Furthermore, it is emphasized with the Stolper-Samuelson theorem which predicts that trade liberalization will shift income from the factors of rare production (indicated by the high prices of the production factors) to the abundant factors of production (indicated by the low prices of the production factors) in a country. This means that the developing countries which have relatively abundant labors (measured by the relatively low wages to other production factors), predicted that trade liberalization will raise the level of wages in the country relatively to other production factors, and this is due to the increase in labor productivity as increasing degree of trade liberalization, so that the income distribution will eventually be better.

According to Davis (1996), the policy of trade liberalization for developing countries is carried out to gain two benefits promised. First, that the policy of trade liberalization will increase the aggregate income of the country. Second, the policy of trade liberalization pledged the consequences of more equitable income distribution internally. However, this study found the opposite, where the policy of trade liberalization simultaneously will cause higher unequal income distribution, resulting in a decrease in economic welfare.

On one hand, this is caused by the depreciation in the domestic exchange rate as the impact of the policy of trade liberalization that would increase the national income. Yet, on the other hand, there is a positive response on the trade liberalization that occurred in domestic inflation level, causing a reduction in real purchasing power of the community. Therefore, it will reduce aggregate demand in the country, resulting in a decrease in economic growth in Indonesia.

This finding is consistent with results from the study of Amang and Sawit (1997), which warned that the impact of free trade is quite serious for Indonesia, not only about economics but also non-economic

fields. Rapidly and excessively movement of production factors such as labor, land, capital and within a relatively short period from agriculture and services sectors to manufacturing sector as a result of trade liberalization policies, would create new problems that are more difficult and expensive to handle. Urban infrastructure adequate to accommodate rapid urbanization is almost impossible to build, so that there would be problems such as squalor and poverty in cities, urban congestion, lack of shelter, insufficiency of parks, lack of clean water (in quality and quantity), deterioration of the environment and rising crime. In addition, the income distribution of the people will be more unequal.

In addition, Acharya, S. and S. Cohen (2008) have also examined some of the latest findings by using general equilibrium models that measure the impact of trade liberalization on household welfare. They made modifications in the standard neo-classical model and applying it to the characteristics of the rural economy in the South Asian where there are only few studies on policy models. Furthermore, they concluded that a combination of liberalization of imports and exports would have an impact on high economic growth, but the pattern of income distribution did not switch and stand for the poor.

## CONCLUSIONS AND RECCOMENDATIONS

Based on the analysis, it is known that there is a significant effect between trade liberalism towards the state income from tax and welfare directly or indirectly. On the other hand, also found that the variable rate is a variable moderator between the effect of trade liberalism towards the state income from tax and welfare quasi moderator.

Minimizing the negative effects of liberalization to economic growth and income distribution (welfare) can be done by increasing the competitiveness of Indonesian exports in the international market, among others through the creation of a conducive investment climate by maintaining macroeconomic stability and reducing high economic costs, such as complicated bureaucracy and levies which lead to a greater cost; maintaining the stability of domestic inflation, among others with the monetary policy, such as inflation targeting policy; improving productivity and efficiency of the use of the factors of production that are relatively abundant and cheap in Indonesia, in this case is labor, through education and training of human resources; developing products from each region with high competitiveness through the regional core competence-based products development.

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