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Tax evasion and financial repression

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Abstract

Using a simple overlapping generations framework, calibrated to four Southern European countries, we analyze the relationship between tax evasion, determined endogenously, and financial repression. We show that higher degree of tax evasion within a country, resulting from a higher level of corruption and a lower penalty rate, yields higher degrees of financial repression as a social optimum. However, a higher degree of tax evasion, due to a lower tax rate, reduces the severity of the financial restriction.

JEL classification: E26; E63

Keywords: Underground economy; Tax evasion; Macroeconomic policy

1. Introduction

Using a simple overlapping generations framework, we analyze the relationship between tax evasion, determined endogenously, and financial repression. We follow Drazen (1989), Bacchetta and Caminal (1992), Haslag and Hein (1995), Espinosa and Yip (1996), Haslag (1998), Haslag and Young (1998) and Haslag and Koo (1999), in defining financial repression through an obligatory "high" reserve deposit ratio requirement. The study attempts to assay whether there exists a plausible explanation as to why the reserve requirements in some economies are higher than others. Specifically, we analyze whether the "high" reserve requirements are a fall out of a welfare maximizing decision of the government, in an economy characterized by tax evasion.

Note, financial repression can be broadly defined as a set of government legal restrictions, like interest rate ceilings, compulsory credit allocation and high reserve requirements, that generally prevent the financial intermediaries from functioning at their full capacity level. However, given

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the wave of interest rate deregulation in the 1980s, and removal credit ceiling some years earlier, the major form of financial repression is currently via obligatory reserve requirements.[1] As Espinosa and Yip (1996) points out the concern is not whether financial repression is prevalent but the associated degree to which an economy is repressed, since developed or developing economies both resort to such restrictive policies.

Now the pertinent question here is—Why, if at all, would a government want to repress the financial system? This seems paradoxical, especially when one takes into account the well documented importance of the financial intermediation process on economic activity, mainly via the finance-growth nexus.[2] Besides, the fact that "high" cash reserve requirements enhances the size of the implicit tax base and, hence, is lucrative for the government to repress the financial system, an alternative line of thought is derived from the works of Cukierman, Edwards, and Tabellini (1992) and Giovanni and De Melo (1993). Both these studies suggested that, countries with an inefficient tax systems would be more oriented towards the repression of the financial sector. Roubini and Sala-i-Martin (1995) addresses this issue in a formal fashion, using an endogenous growth framework. They indicated that, governments subjected to large tax evasion will "choose to increase seigniorage by repressing the financial sector and increasing the inflation rates."

However, Gupta (2005, 2006), using a pure-exchange- and a production-economy in an overlapping generations framework, calibrated to Southern European economies, showed that higher tax evasion would cause a benevolent social planner to optimally increase the tax rates, when implicit taxation is also available as a source of revenue. The optimal reserve requirements, however, continued to be at zero, implying the inability of tax evasion to explain financial repression. Similar results have also been obtained by Holman and Neanidis (2006) in the context of an open economy, characterized by both tax evasion and currency substitution.

However, all the above mentioned theoretical analyses, suffer from a serious problem, in the sense, that they treat tax evasion as exogenous. The optimal degree of tax evasion is a behavioral decision made by the agents of the economy, and is likely to be affected by not only the structural parameters of the economy, but also the policy decisions of the government. In such a situation, all these models, essentially suffer from the "Lucas Critique" in some ways. Specifically, all the above studies, look at the optimal policy decisions of the government following an increase in the exogenous rate of tax evasion, without specifying what is causing the change in the degree of evasion in the first place. Under such circumstances, the optimal choices made by the government, following an exogenous increase in the degree of tax evasion, is likely to be non-optimal, simply because, the degree of tax evasion, following such policy choices, would have changed the actual level of the tax evasion further, once we treat tax evasion as endogenous. What this implies is that once we determine which policy parameters, besides the structural parameters, are affecting the degree of tax evasion, they cannot be available to the government for use, to respond optimally to a change in tax evasion. Moreover, once we endogenize the process of tax evasion, it is likely that optimal policy decisions made by the government with regard to the policy instruments available, might vary depending on which factor is driving the change in the degree of evasion.

This paper, thus, extends the work of Roubini and Sala-i-Martin (1995), Gupta (2005, 2006) and Holman and Neanidis (2006), by, first, providing the microeconomic foundations to the process of tax evasion, along the lines of Atolia (2003), Chen (2003) and Arana (2004), and second, by analyzing how a welfare maximizing social planner will respond to, in terms of its available policy

[1] See Demirgüç-Kunt and Detragiache (2000) for further details.

[2] See Roubini and Sala-i-Martin (1992), and the references cited there in.