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A growth model of inflation, tax evasion, and financial repression

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Abstract

This paper studies the relation between policies of financial repression, inflation rates, and long-term growth. We set up a model which shows that governments might want to repress the financial sector because this sector is an 'easy' source of resources for the public budget (the inflation tax). To the extent that the financial sector increases the efficiency of the allocation of savings to productive investment, the choice of the degree of financial development will have real effects on the growth rate of the economy. In countries where tax evasion is large the government will optimally choose to repress the financial sector in order to increase seigniorage taxation. This policy will then reduce the efficiency of the financial sector, increase the costs of intermediation, reduce the amount of investment, and reduce the growth rate of the economy. Financial repression will therefore be associated with high tax evasion, low growth, and high inflation.

Key words: Financial repression; Growth; Inflation

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1. Introduction

This paper explores some reasons behind the existence of financial repression and its economic consequences. It is widely recognized that financial markets

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and financial intermediation are important determinants of the economic performance of a nation.[1] Many governments in history, however, have introduced a whole host of laws, regulations, taxes, restrictions, and controls on the behavior of financial intermediaries together with restrictions on the development and introduction of new financial instruments and markets.

Before the 1970s, many economists favored policies of financial repression on several grounds. First, it was argued that the government needed to impose anti-usury laws thereby intervening in the free determination of interest rates. Second, strict control and regulation of the banking system was said to give the monetary authorities a better control over the money supply. Third, it was thought that governments knew better than markets and private banks what the optimal allocation of savings was or what kind of investments were more or less desirable from a social perspective. Fourth, financial repression was identified with interest rates below market rates, which reduced the costs of servicing government debts.

Some of the recent growth literature deals with the theoretical links between financial intermediation and growth along two lines: (1) it analyzes how financial intermediation affects economic growth, and (2) it studies how economic growth might itself affect the evolution and growth of financial intermediation.[2] Some of the papers exploring the first link study the effects of policies of repression of the financial system (in the form of taxes, restrictions, and regulations of various sorts) on the rate of economic growth. The main implication of these papers is that policies of repression of the financial sector lead to a reduction in the rate of growth of the economy.

From the empirical side, there is a large body of evidence showing that financial repression leads to low growth rates.[3] Then, an important question is the following: if both theory and evidence suggest that financial repression policies have adverse effects on growth, why do some governments choose to follow such policies? This is one of the key issues that will be addressed in this paper.

The second (and related) question we ask in this paper is why inflation seems to be negatively correlated with growth in a cross-section of countries. A number of recent empirical studies use the Summers and Heston (1988) data set to

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[1] For example, the 1989 issue of the World Bank's *World Development Report* was entirely devoted to the role of financial markets and intermediation for the process of economic growth. See also the seminal contributions of Goldsmith (1969), McKinnon (1973), and Shaw (1973).

[2] See Greenwood and Jovanovic (1990), Bencivenga and Smith (1991), Levine (1990, 1991a), De Gregorio (1993), and Greenwald and Stiglitz (1989).

[3] See Fry (1988), World Bank (1989), Gelb (1989), King and Levine (1993a,b,c), Levine (1991b), De Gregorio (1992), and Roubini and Sala-i-Martin (1991, 1992). We survey this literature in Section 3.2 below, where we present evidence on the channels of influence stressed in our model.