Economic Systems 37 (2013) 271–283

Contents lists available at SciVerse ScienceDirect

Economic Systems

journal homepage: www.elsevier.com/locate/ecosys

Economic integration and government revenue from financial repression

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ARTICLE INFO

Article history:
Received 28 October 2011
Received in revised form 4 October 2012
Accepted 24 October 2012

JEL classification:
F36
H63
P11

Keywords:
Financial repression
Globalization
Government debt

ABSTRACT

We study a relationship between economic openness via financial and trade integration and government revenue from financial repression. An implicit budgetary saving, the financial repression revenue, as measured by the stock of government domestic debt multiplied by the difference between effective foreign and domestic interest rate, has declined significantly from the 1980s into the 2000s across the upper-income, the middle-income, and the low-income developing countries. While we find that both the financial and trade openness have a negative association with the financial repression revenue in the panel of countries, the effect of financial openness is stronger and the empirical correlations depend on the quality of governmental and budgetary management.
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1. Introduction

The financial repression revenue is the 'easy-to-tax' revenue source of developing country governments, commonly used along with import/export tariffs and seigniorage. A channel of this implicit taxation relies on the imposition of governmental controls on international capital flows and domestic financial intermediaries, thereby increasing a wedge between the effective foreign rate and domestic rate of interest payments on public debt. Essentially, the resultant wedge between the foreign and domestic interest rates is a tax on financial transactions, providing in turn a subsidy or saving on interest liabilities to the government.

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http://dx.doi.org/10.1016/j.ecosys.2012.10.003

How prevalent is the government revenue from financial repression? In the 1970s, this revenue was as high as 39% of total revenue in Mexico and 22% in India; see Giovannini and De Melo (1993). Since the 1980s, the global economy has embraced policy reforms towards more trade and financial integration, liberalisation and stabilisation. These reforms have influenced a common fiscal denominator, in the process reducing the gap between the foreign and domestic interest rate, and hence the government revenue from financial repression. In Table 1 we offer an update of the financial repression revenue for the 1990s and 2000s. Notably, in the sample of 62 countries, the average of financial repression revenue to GDP is 4%, ranging, for instance, from 2.6% in Mexico to 6.2% in Argentina.

The mechanism in which economic integration affects revenue from financial repression is operating through the reduction of an existing gap between foreign and domestic interest rates. The theoretical argument for the association between economic integration and financial repression revenue suggests that financial openness is the main and direct channel. The financial openness enhances the mobility of resources and allows risk sharing between savers and investors across borders. This in turn should impose discipline on the fiscal and financial policies so that the ability of the public sector to borrow at artificially low interest rates domestically is constrained by the international capital markets that are now financially opened to the local savers and investors (Kletzer, 2004). Alternatively, trade channel may also be instrumental in reducing the financial repression revenue. Aizenman (2004, 2008) outlines a theoretical model accounting for a model accounting for the endogenous linkages between trade openness (i.e. declining tariffs and non-tariff barriers) and financial openness (i.e. lowering capital controls and increasing capital flows). In the model, greater trade openness increases the effective cost of fiscally enforcing import over-invoicing/export under-invoicing, the illicit capital movement that facilitates financial repression, which in turn reducing the usefulness of financial repression as an implicit tax and enhancing policy reform towards the financial openness.[1] The association between financial repression, trade and financial openness is therefore an empirical question that provides the hypothesis of our study.

This study adds to strand of literature that focuses on the intertwining of public finance and international factor movements. Earlier studies on the government revenue from financial repression in an international context include Reinhart and Sbrancia (2011), Kletzer (2004), Serven and Perry (2005), Demetriades and Luintel (1997), Dooley (1996), Giovannini and De Melo (1993), Cukierman et al. (1992), and Diaz Alejandro (1985). By and large, these studies document the extent of financial repression in the periods following the financial turbulences in the 1970s and prior to the 2000s in a small set of countries, some of which are country specific. For instance, Serven and Perry find in the case of Argentina that from the beginning of its major trade and financial opening in 1991 to macroeconomic collapse in 2002, the cost of refinancing public debt had been on the rise, with the implicit interest rate increased from 5% in 1993 to 8% in 2001, together with the steady growth of public debt stock further deteriorating repayment capacity of the Argentine government. Reinhart and Sbrancia find in that the financial repression is effective when accompanied by a steady rise of inflation during 1945–1980 for the advanced economies. Our study contributes to the literature by expanding both the countries and years coverage, measuring directly the financial repression revenue from several data sources, as well as formally testing the relationship between trade and financial openness, and the financial repression revenue in various specifications.

2. Estimation

The hypothesis of our testing is whether the ongoing economic integration has influenced the adjustment of financial repression revenue across countries. As shown in Aizenman (2004, 2008), in the presence of diminishing marginal efficacy of tax enforcement and costly tax collection, trade openness of countries that repress their financial system could lead to financial openness, thereby affecting the cost of servicing public debt liabilities and hence the use of financial repression as an

[1] This consideration remains an important one in the developing countries as, for instance, the cost of tax collection is 2.2 percent of total tax revenue in Argentina, 1.3 in Bolivia, 1.6 in Brazil, and 2.0 in Ecuador, whereas it is .9 in Spain and .4 in the US; see Singh et al., 2005. While these numbers are not that large, they are non trivial.

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