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Taxation, corruption and the exchange rate regime

Carsten Hefeker *

University of Siegen, Department of Economics, Hoelderlinstrasse 3, 57068 Siegen, Germany
HWWI, Hamburg, Germany
CESifo, Munich, Germany

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The paper analyzes the relation between institutional quality, such as corruption, in a country and its monetary regime. It is shown that a credibly fixed exchange rate to a low inflation country, like a currency board, can reduce corruption and improve the fiscal system. A monetary union, however, has ambiguous effects. I find that there is convergence between countries with regard to the level of corruption.

1. Introduction

Empirical evidence shows a significant contrast concerning the choice of exchange rate regimes by industrialized and developing countries, with emerging markets falling somewhat in between. Whereas industrial countries (with the exception of the member states of the European Union) mostly tend to have floating exchange rates, developing and transition countries often choose fixed exchange rates, at least de facto if not de jure (Calvo and Reinhart, 2002; Reinhart and Rogoff, 2004; Levy-Yeyati and Sturzenegger, 2005). Arguments explaining this difference include the lower credibility of the monetary regime, the shallowness of financial markets, the openness of the country, and the existence of a dominant trading partner or a former colonial tie (for a survey of the arguments, see Rogoff et al., 2004; Meissner and Oomes, 2009). Another dimension in which these countries tend to differ is the amount of corruption and the quality of institutions and governance.[1] Although industrial countries are not immune to these problems, they are clearly more prevalent in developing and transition countries as indices developed by Transparency International (2008) or the World Bank (Kaufmann et al., 2008) show.

* Address: University of Siegen, Department of Economics, Hoelderlinstrasse 3, 57068 Siegen, Germany. Tel.: +49 271 740 3184; fax: +49 271 740 4042.
E-mail address: carsten.hefeker@uni-siegen.de

[1] Corruption is only one indicator of bad institutions, and indices show a high correlation of corruption with other indicators of deficient institutional quality.

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In this paper I aim to explore the connection between institutional quality, the fiscal system, and the choice of the exchange rate regime. This connection is important for countries in which monetary policy is dominated by fiscal policy and plays an important role in financing the public budget (Cukierman et al., 1992; Crowe, 2006; Catao and Terrones, 2005), where de-facto independence of central banks is often not given (Acemoglu et al., 2008), and where corruption and rent-seeking are prevalent phenomena that go hand in hand with high rates of inflation and ambitious government spending (Al-Marhubi, 2000; Ades and Di Tella, 1999; Blackburn et al., 2008).

The model developed in this paper captures these phenomena and is hence relevant for countries in Africa, the Middle East, Central Asia or the Caucasus. Many of these countries have considerable amounts of natural resources such as oil or gas, are plagued by widespread corruption and weak institutional capacities, and highly distortive and regressive tax systems.

At the same time, monetary policy institutions are not very credible and for this and other reasons, some of these countries consider forming a monetary union, such as in West Africa (Masson and Pattillo, 2005), the Gulf Region (Sturm and Siegfried, 2005), or in the former Soviet Union (Chaplygin et al., 2006).[2] Alternatively, some countries have chosen (or are considering) a unilateral peg to a low inflation anchor currency or the introduction of a foreign currency as a means of payment (see Kenen and Meade, 2008 for examples).

The present paper considers the options of monetary autonomy, a hard peg, or a full monetary union and discusses the implications of a move from one regime to another for institutional quality. I find that a peg to a high inflation country, or a monetary union with such a country, would lower institutional quality in the pegging country. This is because the more seigniorage revenue a country obtains, the less incentive it has to fight against corruption and looting of the budget. A unilateral peg to a low inflation country instead would force fiscal discipline on the pegging country and thus lead the government to fight harder against corruption. However, lower seigniorage also implies higher taxes and can have negative output effects. Governments thus face a trade-off between higher institutional quality with lower inflation versus higher taxes with lower output and government spending.

The paper is structured as follows. Section 2 relates to the literature, while Section 3 develops a theoretical model that analyzes the relation between fiscal policy, corruption and inflation. Sections 4–6 look at monetary independence, a tight peg, and a monetary union respectively. Section 7 concludes.

2. The literature

The paper is related to three issues so far discussed separately in the literature. One aspect is the connection between fiscal policy and inflation. A well established theory considers inflation and seigniorage revenue as an integral part of an optimal fiscal policy mix (Phelps, 1973; Vegh, 1989, or Fischer et al., 2002 for a survey). Trying to minimize the welfare costs of distortionary taxation seigniorage is deliberately employed as one source of taxation, in particular when fiscal shocks have to be accounted for (Click, 1998). While this theory is a general one, empirical evidence clearly shows that the dominance of monetary policy by fiscal policy is only relevant for developing countries and not for industrial or middle income countries (Catao and Terrones, 2005). It is particularly relevant for countries with bad institutions and low political and social stability (Aisen and Vega, 2008).

Clearly, inflation and thus fiscal policy should have an influence on the choice and stability of the exchange rate regime (De Kock and Grilli, 1993; Tornell and Velasco, 2000). De Kock and Grilli (1993) in a direct extension of the arguments above argue that fixed exchange rates should collapse when fiscal shocks hit that require a increase in spending, whereas Tornell and Velasco (2000) argue that flexible rates impose more fiscal discipline because fixed rates shift the costs of deficits into the future and thus induce reckless fiscal policy.

This literature overlooks a second aspect of fiscal policy, that is, the question of corruption or leakages from fiscal revenue (for a survey, see Aidt, 2003). In particular many transition economies and developing countries have a fundamental problem of corruption affecting fiscal revenues, and this, again, is especially the case for resource rich countries (Ades and Di Tella, 1999; Blackburn et al., 2008; van der Ploeg, 2006). A closely related literature discusses the influence of interest groups on fiscal policy, arguing that powerful interest groups tend to overspend revenues (Lane and Tornell, 1996). This effect arises because uncoordinated interest groups do not take into account the external effects of their behavior and thus overuse a given resource. Building on that literature, I ask whether a particular exchange rate regime could induce governments to be less tolerant with corruption or other forms of appropriation of fiscal resources.

Finally, there exits a voluminous literature on the connection between monetary policy and institutional quality. This literature, starting with Rogoff (1985), usually focuses on the institutional independence of the central bank or other institutional solutions that lead to a low rate of inflation (see Cukierman, 1992 or Siklos, 2002). Again, there is evidence that countries with low institutional quality, and in particular with corruption and wide spread rent-seeking, often have a poor monetary policy record (Al-Marhubi, 2000).

Most closely related to this paper is recent work by Huang and Wei (2006) who also explore the connection between institutional quality and monetary policy but with a different focus. They analyze the question of the optimal monetary regime more broadly and include the possibility of appointing an independent and conservative central banker. Given deficits

[2] There is also discussion about monetary union in Asia or Latin America although plans are much less advanced there (see Kenen and Meade, 2008).