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CAN THE SHADOW ECONOMY UNDERMINE THE EFFECT OF POLITICAL STABILITY ON INFLATION? EMPIRICAL EVIDENCE

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This paper revisits the empirical relationship between political stability and inflation while explicitly accounting for the presence of the shadow economy. Using a large data set of 122 countries over the 1999 to 2007 period, we find that the well established negative correlation between political stability and inflation holds only if the size of the shadow economy remains modest; and it ceases to exist at higher levels of the size of the informal sector. This finding contributes to the existing literature on public finance that assigns special importance to political determinants of inflation. The results are robust against alternative specifications and satisfy the usual assumptions of a valid statistical inference.

JEL classification codes: O17, E52, H26, H27

Key words: political stability, informal sector or shadow economy, inflation, openness, tax revenue.

I. Introduction

The issue of inflation, particularly in developing countries, continues to attract the attention of economists as well as non-economists. Due to its strong political economy aspects, inflation requires a wider context to understand its determinants (Leeper

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2010). This study takes the view that one key variable which has not been sufficiently analyzed is the shadow economy.

The shadow economy refers to economic activities that would generally be taxable if they were to be reported to the authorities responsible for taxation and regulation (Schneider and Buehn 2013).[1] A large informal economy not only threatens the tax base but also has implications for stabilization policy. In these circumstances, a government that is uncertain about its revenue base is more likely to reach for short-term measures at the cost of policy consistency. The shadow economy influences monetary policy outcomes because it is associated with a larger demand for currency, and fiscal policy outcomes because of its impact on the size of the tax revenue. The existence of a shadow economy undermines policy outcomes even in the presence of political stability (Besley and Persson 2013; Buehn et al. 2015).

This line of reasoning leads to the conjecture that the systemic weaknesses entailed by a considerable shadow economy undermine the advantages of political stability. Do we have any evidence to support this conjecture? We empirically test the relationship between inflation, the shadow economy, and political stability. This is done in the context of a multivariate econometric model estimated using a large panel data set of 122 countries over the 1999 to 2007 period.

The findings of the study add a novel dimension to the relationship between political stability and inflation. The empirical evidence supports the hypotheses that political stability reduces inflation, and that it does so to a lesser extent in the presence of a large shadow sector. The estimates are robust to a variety of estimation procedures and also against alternative measures of macroeconomic and institutional indicators associated with inflation.

These findings are consistent with recent, as well as older literature on the political economy of inflation (for literature surveys see Fernandez-Albertos 2015; Alesina and Stella 2011). It is well known that political influences affect the credibility of the policy if agents rationally expect that policies will be time inconsistent. Similarly, seigniorage and political stability are related because less stable governments are more likely to pursue inflationary policies, especially those arising from fiscal profligacy and corruption.

[1] Within the literature there is often an overlap between the description of the term 'shadow economy' and other terms such as unofficial economy, underground economy, undeclared activities, informal economy, hidden economy, clandestine activities, black economy, which describe similar types of economic activity. For the purpose of this study it is worth noting that all of these terms involve income that is unreported and hence not taxed. There are numerous descriptions of the shadow economy. A broad definition of the shadow economy is found in Schneider (2012): "unreported income from the production of legal goods and services, either from monetary or barter transactions –and so includes all productive economic activities that would generally be taxable were they reported to the state (tax) authorities".