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Higher levels of tax evasion in a corrupt economy, encourage policy making that hinders the functioning of private financial markets

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When amplified levels of corruption and reduced penalties for illegal behaviour encourage greater levels of tax evasion, the policy response will exacerbate measures that constrain the functioning of private-sector financial markets.

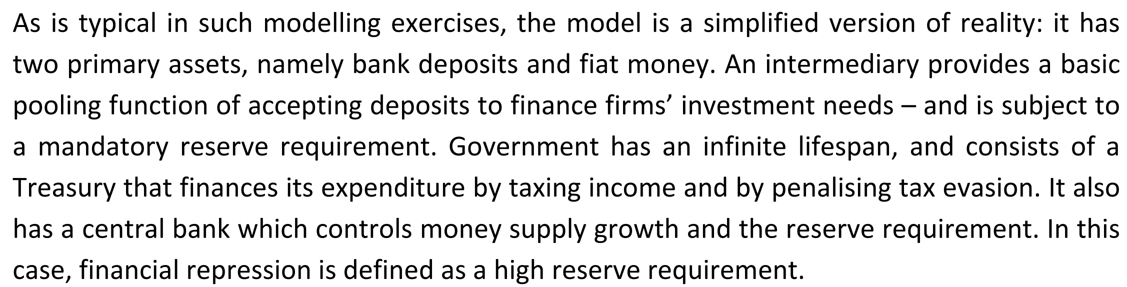
In the ERSA working paper "Tax evasion and financial repression: a reconsideration using endogenous growth models" (Working Paper No. 81), Rangan Gupta and Emmanuel Ziramba scrutinise the relationship between tax evasion and financial repression – a set of restrictions that inhibit financial market efficiency – with a view to establishing whether financial repression can be explained by tax evasion.

They conclude that the nature of this relationship depends on what causes the higher levels of tax evasion: when the cause of tax evasion is increased corruption or a lower penalty rate, one can indeed expect financial repression to intensify. However, if tax evasion rises because of a higher tax rate, the severity of financial repression eases.

It is the first study of its kind to treat tax evasion as endogenous – that is, to assume that this behaviour by economic agents is a decision affected not only by the structural parameters of the economy, but also by the policy decisions of the government. Previous studies have treated tax evasion as behaviour that is unaffected by the structure of the economy and policy action.

In line with literature, financial repression is defined as a set of legal restrictions imposed by government that prevent financial intermediaries from functioning at full capacity. It is characterised by a banking sector which is forced to hold government bonds and cash through a high reserve requirement, to enable the government to finance its deficit at low cost. At the same time, high interest rate ceilings are imposed, credit allocation is regulated and the development of private financial markets is discouraged.

Gupta and Ziramba's analysis is based on two dynamic, endogenous, general equilibrium models, with overlapping generations, using data for Greece, Italy, Portugal and Spain. Though the choice of countries is motivated by data availability, these economies have a history of tax evasion, high inflation and hefty reserve requirements.



As is typical in such modelling exercises, the model is a simplified version of reality: it has two primary assets, namely bank deposits and fiat money. An intermediary provides a basic pooling function of accepting deposits to finance firms' investment needs – and is subject to a mandatory reserve requirement. Government has an infinite lifespan, and consists of a Treasury that finances its expenditure by taxing income and by penalising tax evasion. It also has a central bank which controls money supply growth and the reserve requirement. In this case, financial repression is defined as a high reserve requirement.

An optimal level of tax evasion is the point of consumer optimisation, derived from the parameters and policy variables within the model.

When put into action, the model suggests that higher levels of tax evasion, when caused by reduced penalty rates or more pervasive corruption, creates a policy response in the form of more onerous reserve requirements and a rise in money supply growth. But it also shows that tax evading behaviour that is prompted by a hike in tax rates results in a drop in reserve requirements and in money supply growth.

The findings hold regardless of whether the economy shows positive or zero growth.