



# Shadow economy, corruption and public debt in Spain

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## Abstract

The aim of this paper is to study the relationship between the shadow economy and corruption as determinants of public debt in the Spanish Autonomous Communities. In addition, we construct a Corruption Perception Index for those regions. Our data constitute panel data for the period 2000–2012. The results show that the volume of the shadow economy has a significant and positive impact on regional public debt. Corruption also shows a direct and significant relationship with public debt in the Autonomous Communities, although its impact is lower than that of the shadow economy. We extract some implications for the public authorities.

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## 1. Introduction

The aim of this paper is to deepen the analysis of public debt in the Spanish Autonomous Communities from a new perspective, introducing the effects of the informal sector and corruption on regional public debt. To achieve this aim, we use an estimate of the regional shadow economy and build a Corruption Perception Index (CPI) for the Autonomous Communities that allows us to test our hypothesis.

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Our analysis is based on the importance of public debt as a main variable in the field of public finance. One of the most prevalent diagnoses among economists and analysts for the current financial crisis is that it is a debt crisis. There is a widespread perception that both public and private agents borrowed beyond their actual ability to pay. In the area of public finance, the high levels of debt have generated turbulence in the sovereign debt markets in several European countries, including Spain.

Similarly, in the context of the current crisis, concepts such as the shadow economy and corruption become more visible. In this sense, one of the phenomena that have contributed to the expansion and the origin of the crisis has been the existence of an ethical crisis. The size of the shadow economy is growing steadily over time, and public finance corruption cases are being revealed with increasing frequency.

This paper analyzes the relationship among the levels of public debt, the shadow economy and the perception of corruption in Spain. Specifically, given the important Spanish territorial component, the study focuses on corroborating this relationship in the different Autonomous Communities. In addition, we propose a CPI for the Autonomous Communities.

The results indicate that the shadow economy has a direct and significant relationship with the volume of regional public debt. The results are robust to different estimates for the underground economy in the Autonomous Communities. We corroborate the positive relationship between corruption and public debt. However, the results are not as robust as they are for the informal sector.

These findings have important policy implications for the economic authorities. Namely, the results indicate that the shadow economy and corruption are channels through which economic and political institutions may reduce public debt levels. Therefore, taking measures that attempt to reduce the levels of these two phenomena will decrease regional public debt, which is particularly significant in the context of the current financial crisis that is primarily a debt crisis.

The rest of the paper is organized as follows. In Section 2, we review the literature about the shadow economy, corruption and their relationship to public finances. Section 3 establishes the hypotheses to be tested. Section 4 presents the data and the methodology used in the analysis. Section 5 presents the primary results and implications obtained in the study. Finally, Section 6 provides the conclusions.

## **2. Literature review**

The aim of this article, which is to relate the public debt level with the shadow economy and corruption, is innovative and has rarely been addressed in previous studies. The following section is a review of the works done on these issues and their relationship to public finance.

### *2.1. The shadow economy and public finances*

The shadow economy has been and is being investigated by researchers and scholars in recent decades. The many studies that have focused on quantifying the volume of the shadow economy in different countries and regions are evidence of this interest (Giles, 1999; Orviská, Caplánová, Medved, & Hudson, 2006; Schneider, 2005; Tafenau, Herwartz, & Schneider, 2010). This area has been subject to growing interest because of the implications that the underground economy has for the public finances of a country or region. A proper approach to the shadow economy allows authorities to adopt economic policies that could be distorted if such an examination is not conducted properly. Similarly, many papers have analyzed, from a theoretical point of view, the

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