Explaining the nonlinearity of inflation and economic growth: The role of tax evasion

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Explaining the Nonlinearity of Inflation and Economic Growth: The Role of Tax Evasion

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Abstract

This paper incorporates tax evasion into a simple endogenous growth model with money in the utility function. Government in the economy finances its constant fraction of unproductive expenditures through taxing output, penalty revenues, and seigniorage. By endogenizing the individual decision of tax evasion, we show that the ratio of government tax revenues over output is not monotonously related to the tax rate, whereas economic growth is always decreasing in the tax rate. We then consider a scenario that the government first selects a growth rate of nominal money and then the tax rate is endogenously determined by the government budget constraint. Given this, our model finds a threshold level of inflation in which the inflation-growth nexus may be positive or negative for initial inflation below it, but is definitely negative for initial inflation over it. We also find that the negative relationship for initial inflation over this threshold level is convex. These conclusions are consistent with recent empirical studies.

Keywords: Tax Evasion, Seigniorage, Inflation, Economic Growth
JEL classification: E31, E44, E63, O16, O42

1. Intorduction

Recent empirical studies have confirmed a nonlinear relationship between inflation and economic growth - namely, the relationship may be positive or negative for low levels of inflation, but is definitely and significantly negative

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