Tax evasion impacts country credit ratings and lending costs, says new study

January 19 2016

High levels of tax evasion are linked to higher interest rates and can be a predictor of a country's credit risk, according to a new study led by the University of East Anglia (UEA).

Researchers investigated the controversial role of the 'informal' or 'shadow' sector—activities that are not officially registered but do make an economic contribution—in the economies of 64 countries in the run-up to the current Eurozone crisis.

For the first time they focused on the impact the informal sector, which is directly linked to tax evasion, has on sovereign debt markets. They found that it has significant adverse effects on country credit ratings and lending costs. These results do not change with respect to the stage of economic development of a country.

Countries such as Switzerland, the United States, Luxemburg, Austria and Japan that had the smallest levels of informal economic activity—averaging between 8% and 11% of Gross Domestic Product (GDP)—faced low lending costs, under about 4%. In countries such as Panama, Peru, Uruguay, Honduras and Sri Lanka, where around half of the economy was untaxed, country lending costs were much higher and ranged between 7% and 10%. In comparison, the United Kingdom's informal sector averaged at 12.4% of GDP, while its interest rate was 4.5%.

There was a wide variation in the level of the informal economy, even within developed countries. Those with the largest informal sector among member countries of the Organisation for Economic Co-operation and Development (OECD) studied were Greece (26.86%), Italy (26.96%), Portugal (23.12%) and Spain (22.38%), all of which had around a quarter of economic activity untaxed and faced severe problems during the recent Eurozone debt crisis.

Publishing their findings today in the *European Journal of Operational Research*, the authors suggest that trying to reduce the amount of tax evasion in financially challenged countries is likely to help in relaxing credit risks and cutting lending costs. The study is particularly important given that previous research has not been able to show clearly if the informal economy has an overall positive or negative influence on economic activity and growth.

The research was led by Raphael Markellos, professor of finance at UEA's Norwich Business School, working with Dr Dimitris Psychoyios from the University of Piraeus in Greece, and Prof Friedrich Schneider, a leading authority on shadow economies and tax evasion at Johannes Kepler University, Austria. They analysed country-specific financial data and other variables, such as inflation and unemployment rates, GDP, tax revenue and public debt, for the years 2003-2007.

In addition to the implications for government debt, the study also highlights that countries with a higher shadow economy face adverse general conditions with respect to balance of payments, deficit, inflation, unemployment, tax revenues, and Research & Development spend, as well as competitiveness, economic freedom, corruption and human development, for example in relation to life expectancy and education.

Prof Markellos said: "Given the ongoing sovereign debt crisis in Europe, any new findings about the drivers of country credit ratings and costs of debt are particularly valuable. Tax evasion harms the ability of a country to raise cheap debt in the international financial markets. This in turn can have damaging effects across the economy, including public spend and services, corporate investments, jobs, price levels, availability and cost of mortgages and consumer debt.

"In modern economies, everything is strongly related to the creditworthiness of the country you live in. If someone is not paying taxes, they are not only free-riding on public services but they are ultimately hurting the credit score of others."

Prof Schneider added: "Those countries involved in the debt crisis in recent years have all had a high level of tax evasion, suggesting that this is likely to be part of the problem and of the solution. However, we should not ignore the possibility that stamping out tax evasion may also have negative side-effects for vulnerable parts of society and the economy, especially during times of crisis."

'Sovereign debt markets in light of the shadow economy', Raphael Markellos, Dimitris Psychoyios and Friedrich Schneider, is published in the *European Journal of Operational Research*.

More information: Sovereign debt markets in light of the shadow economy, *European Journal of Operational Research*, 2016.

Provided by University of East Anglia