Does The Size of Shadow Economy Matter for Financial Development?

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Abstract

Role of financial sector has been hotly debated issue in the literature which evolved over the years from the financial sector policies in the 1970s to contribution of financial development to economic growth within the endogenous growth theories in the 1980s to determinants of level of financial development in the late 2000s. The empirical researches have tried to investigate the impacts of a variety of macroeconomic indicators on financial development. However there is a very limited works that look at the role of shadow economy on financial development. It is expected that size of shadow economy is inversely related to financial development, especially in the developing or least developed countries.

This paper, therefore, tries to empirically examine the impact of the shadow economy on financial development by controlling the traditional determinants for the countries that has been subject of Schneider (2010 and 2015). In other words, by using the data of shadow economy calculated by Schneider, this paper detects whether size of the shadow economy matters for financial development. Econometric analysis will be carried out by using the modern estimation techniques, namely panel unit root and cointegration analysis.

Key Words: Shadow Economy, Financial Development, Unit Roots, Cointegration.