RESEARCH INSIGHTS

IDB

How Do Economic Crises Affect Reforms to Fiscal Rules in Latin America?

Economic crises may favor reforms in fiscal rules, either because they increase the cost of maintaining fiscal imbalances or because these imbalances are behind the origin of the crises.

Banking crises would not necessarily explain fiscal reforms in some democratic governments in the region.

Financial crises favor reforms the longer the crisis extends over time. If the crisis turns into a sovereign debt crisis, fiscal reforms are much more likely.

CONTEXT

Fiscal problems in the region largely result from the common pool resource (CPR) problem, whereby politicians and policymakers have incentives to secure resources for their voters or the sectors they represent but without internalizing the impact of their decisions on the country's public finances. This problem can be addressed by establishing or modifying fiscal rules, procedural rules, and transparency rules. Crises can favor such reforms by highlighting imbalances of power and flaws in how the current system operates. Crises can also increase the cost of the status quo, requiring changes to increase the credibility needed to address a country's problems.

PROJECT

This study compiled data on fiscal reforms and crises for the period 1990-2005 for 17 Latin American countries and examined them in relation to three groups of variables. The political variables control for the intensity of the common pool problem, and the government capacity variables control for the government's ability to use alternative policies to control spending and to manage economic crises. The history of reforms makes it possible to control for the country's ability to pass reforms but also restricts the scope for reforms if some fiscal rules have already been introduced.

Key Concept

BANKING CRISIS

A situation in which one or more banks in a country or region suffer serious liquidity and solvency problems at the same time.

RESULTS

The probability of reform is affected by crises, but different types of crises have different effects, as shown in the figure below. Banking reforms, for instance, reduce the likelihood of carrying out a reform of fiscal institutions. This could be because the government is preoccupied with problems that are not necessarily or primarily fiscal, or because there is simply not the same pressure on state budgets. Fiscal or debt crises, however, do increase the likelihood of reforms. Moreover, if a debt crisis occurs at the same time as a banking crisis, then the negative effect of the banking crisis disappears. These results indicate that banking crises initially have a strongly negative impact on fiscal reforms, and that there are no reforms when the crisis remains a banking crisis. If this banking crisis turns into a sovereign debt crisis, the probability of fiscal reform increases. This is because the obligation to pay off debt by increasing interest payments on external debt as a percentage of exports intensifies the pressure for fiscal reforms. In addition, the interest variable of the external debt is significant. This reinforces the conclusion that fiscal pressure is most important in triggering tax reforms. Interestingly, crises in other countries in the region increase the likelihood of reforms in each country, particularly when crises occur in larger economies.

Key Concept

REFORMS TO FISCAL RULES

The introduction of institutional reforms aimed at reducing the size of the common pool resources problem, and with it the growth of deficits and debt.

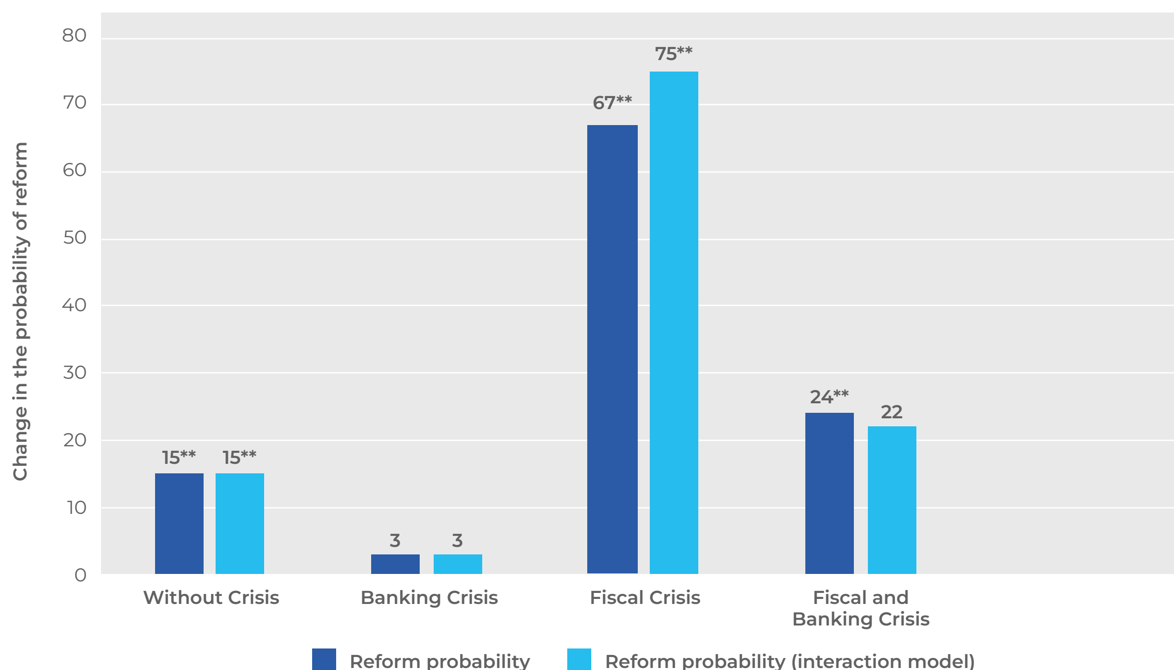
POLICY IMPLICATIONS

Fiscal crises are catalyst for reforms in fiscal institutions. While improving the fiscal institutional framework ex ante would reduce the chance of crises, governments seldom follow through unless it is deemed urgent. The overall relationship between crises and reform, however, is more complex than originally envisaged. Banking crises, while also generating a quick demand for liquidity, do not create the same incentives for institutional fiscal reforms. It seems possible that, when a Latin American country is in a banking crisis, the fiscal pressure to find more money in the shortest possible time restricts the government's ability to initiate fiscal reforms. This urgent need clearly overrides the demand to signal to international markets that the country will be solvent in the future (which a debt crisis and its subsequent renegotiations need). The relationship to debt and fiscal crises provides an important lesson. First, reforms generally occur during the crisis year. Second, crises in other countries can be a good time to catalyze reforms.

IDB RESEARCH ON TAX REFORMS

This document is part of the IDB's research on the political economy factors behind broad tax and fiscal reforms. Since restoring and maintaining fiscal discipline is essential to ensuring sustainable growth in the countries of the region, understanding the political environment facilitating fiscal discipline is critical.

Figure 1. Likelihood of Fiscal Reform in Latin America



Note: * p<0.10, ** p<0.05, *** p<0.01.

Key Concept

COMMON POOL RESOURCES (CPR) PROBLEM

When stakeholders are only concerned with their decisions' spending and revenue implications for their constituencies but do not internalize the impact of their decisions on a country's finances.

FULL STUDY

Hallerberg, Mark, and Carlos Scartascini. 2015. "When Do Governments Improve Fiscal Institutions?: Lessons from Financial Crisis and Fiscal Reform in Latin America." *Economía* 16 (1): 41–76.

This study has also been published as an IDB Working Paper.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

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