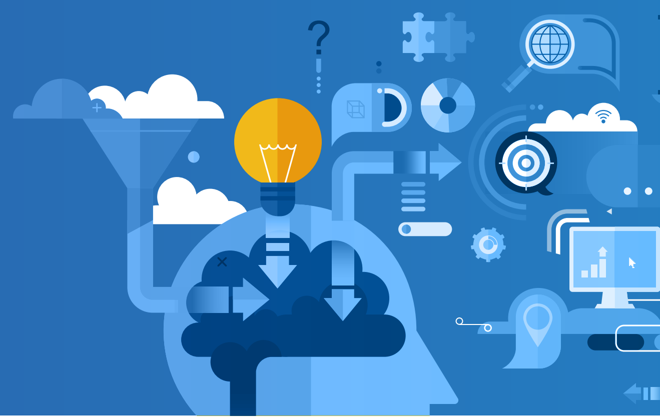
RESEARCH INSIGHTS



IDB

When Fiscal Adjustments Must Be Made, Do Voters Care Which Policy Is Used?

- **Fiscal adjustments, aimed at resolving imbalances that can lead to an economic crisis, have a high political cost in Latin America and the Caribbean.**
- **Fiscal consolidations in the region generally focuses on raising indirect taxes, such as the value added tax (VAT), which are relatively easy to collect. Experimental evidence, however, indicates that citizens would prefer to reduce public spending rather than increase taxes.**
- **The countries of Latin America and the Caribbean must invest in fiscal tools that give them more room to maneuver in times of economic crisis and thus reduce negative impacts on electoral results.**

CONTEXT

Fiscal adjustments or consolidations may affect electoral outcomes (voters usually dislike tax hikes or cuts to public programs), but this does not always occur. The impact varies according to country, the timing of the adjustment, and the tools used. Notably, developed countries can undertake countercyclical fiscal policy through a variety of measures involving spending and direct taxation. However, governments in Latin America and the Caribbean have relatively few options and are likely to increase indirect taxes, which can immediately generate significant revenues for the government. These taxes, however, affect large segments of the population and are rarely progressive, which reduces their popularity and affects electoral outcomes.

PROJECT

We test the effects of fiscal consolidations on political outcomes by evaluating sharp changes in government, namely, whether they cause changes in the ideology of the ruling party. The following aspects of consolidations were considered: i) whether they occurred during the term in office preceding the election, ii) their size in relation to GDP, iii) whether they represented more than 50 percent of total budgetary impact in a given year, and iv) whether they involved cutting spending or increasing taxes. This analysis was complemented with survey data from more than 6,000 people in seven Latin American and Caribbean capitals and an experiment testing those preferences.

RESULTS

Compared to voters in OECD countries who do not seem to react much politically to fiscal consolidations, voters in Latin America and the Caribbean are more likely to vote against the government and change ideological orientation following the implementation of fiscal consolidations. Compared to a government that does not make fiscal adjustments, the probability of a change of government in a Latin American country triples when that country implements ambitious adjustment programs (in terms of GDP size). This differential result across regions, though, may not be independent of the set of tools used for that consolidation. It should be noted that fiscal consolidations in the region are mostly based on tax increases, mainly by raising tax rates and indirect taxes like VAT, which affect large segments of the population. Moreover, these policies are often implemented when politicians have no choice but to make the adjustment due to an economic crisis, which amplifies the multiplier effects of fiscal contractions. As can be observed in the figure, the likelihood of a change in government and the switch to a party with an opposing ideology grows rapidly when the consolidation is tax based as the size of the consolidation increases.

At the micro level, according to the experimental evidence, voters are more likely to prefer spending-based fiscal consolidations than taxes, and that opposition to tax increases is more prevalent among the most vulnerable. This suggests that governments in the region are more likely to lose elections if they raise taxes.

POLICY IMPLICATIONS

The results obtained suggest that investments should be made in the fiscal capacity of LAC countries, as they could be useful for broadening the set of policy tools available to governments. Having a range of effective fiscal tools other than indirect taxes allows politicians to fine-tune fiscal consolidations and avoid major negative electoral repercussions. In addition, those tools would allow for countercyclical fiscal policies and thus serve as automatic stabilizers that are triggered during times of growth and provide room to maneuver during recessions. Developed countries already have such tools at their disposal, and developing countries need to invest in them. Unfortunately, governmental capabilities do not evolve overnight, and they cannot be built by decree by drafting an institutional reform law; rather, they are the result of the actions of the country's main political actors over time.

IDB RESEARCH ON GOVERNMENTAL CAPABILITIES

At the IDB, we understand that countries need governmental capabilities to achieve public policies that promote sustainable and inclusive growth. Therefore, we have developed an extensive knowledge agenda on the causes and consequences of low governance capabilities and on the reforms needed to increase them.

Key Concept

FISCAL CONSOLIDATION

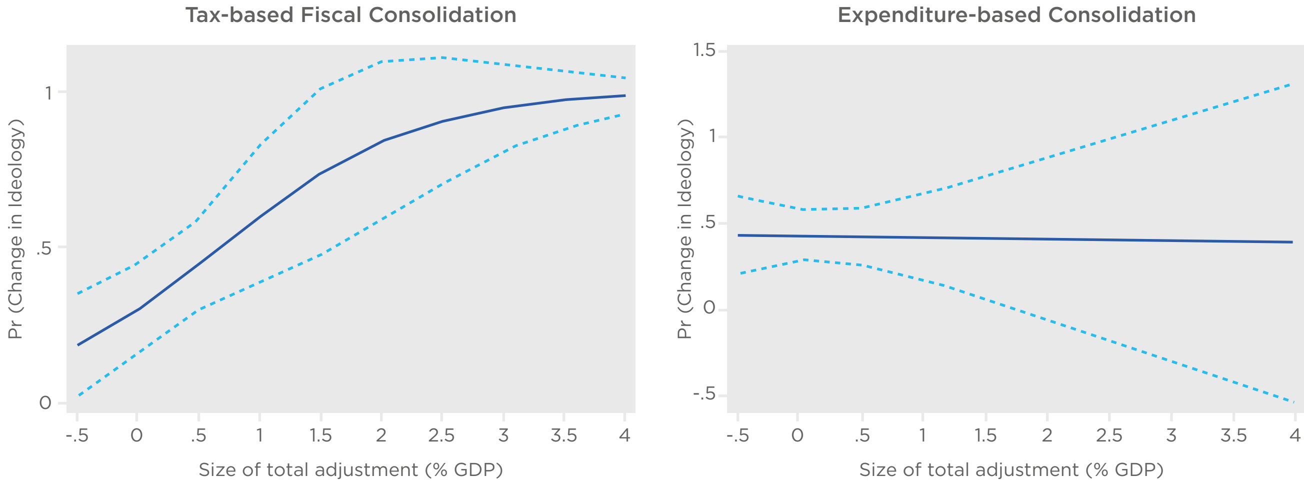
A government policy that aims to reduce deficits and debt accumulation by increasing taxes and/or reducing public spending.

Key Concept

ECONOMIC CYCLE

Phases of recession and expansion through which an economy passes and that occur in order until the end of the cycle, when it begins again.

Figure 1. Probability of Political Turnover by Type of Fiscal Consolidation



Key Concept

DIRECT (INDIRECT) TAX

A direct tax, such as income tax, is levied on the income or profits of the person who pays it, rather than on goods or services. Indirect taxes are levied on goods and services, not individual payers.

FULL STUDY

Ardanaz, Martín, Mark Hallerberg, and Carlos Scartascini. 2020. "Fiscal Consolidations and Electoral Outcomes in Emerging Economies: Does the Policy Mix Matter? Macro and Micro Level Evidence from Latin America." *European Journal of Political Economy* 64 (September): 101918.

This study also appeared as an IDB Working Paper.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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