

FINANCIAL REGULATION: BUDGET DEFICIT MANAGEMENT IN POST-INDEPENDENCE UZBEKISTAN

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ABSTRACT: *The paper aims to study the important macroeconomic financial regulation problems such as budget deficit management in post-independence years of Uzbekistan. The factors of budget deficit, the ways of its reduction and the financing mechanisms were studied using documentary analysis, economic and statistical methods of research. The research revealed that high level of centralized investments, negative effect of existed exchange regime, high subsidies for Pensions fund, compensation of agricultural losses due to bad weather conditions and geopolitical situation required voluminous expenses. At the same time, change in tax rules, sharp decline of the income base of enterprises reduced budget revenues in the studied period. The results of research can be used as a basis for further fundamental researchs and to improving public policy and increase the efficiency of measures of budget deficit management in emerging markets.*

KEYWORDS: regulation, deficit, budget, Uzbekistan, revenue, expenditure.

INTRODUCTION

In conventional literature, under stable state budget we understand performance of state budget without or with limited deficit (T.Malikov, 1996). In practice, having deficit in budget more than approved or for a long period makes public debt unmanageable and leads to hyperinflation (Kh.Jamalov,2000). These in turn limit public resources directed to social sphere with the negative consequences to the public welfare and increase poverty (V.Tanzi, 1993). Thus, with the transition economy from planned to liberal market the organizational mechanisms and principals are changed, and the importance of effective management of state budget is increased. The paper is devoted to study the ways of effective management of budget deficit in Uzbekistan between 1990-2001 years as an important macrieconomic issue in many transtation economies.

BACKGROUND OF THE STUDY & RESEARCH METHODOLOGY

Theoretical and practical aspects of management of budget deficit were studied by the following scholars such as M.Friedman (1992, 2000), J.Keyns (1973), C.McConnell, S.Brue & S.Flynn (2002), S.Fisher (1996) David C. (1995). The problems of budget deficit management in tranzation economies studied by L.Geiger (1996), (V.Tanzi, 1987), (N.Khaydarov, 2005), T.Malikov (1996), L.Drobozina (1999), V.Rodionova (1995), L.Shibsharova & A.Nabihuzhaev (1998), A.Smirnov(2000), C. Sharmini, Mecagni Mauro, & Offerdal Eric (1996) and etc.They point out that effectiveness of the government strategy and economic security is determined by financial system stability and efficiency of investments and innovations.

The Speeches of the Presedent of the Republic of Uzbekistan and the Laws approved in the Parliament, the Decrees of the Govenment and Central bank as practical and regulative basis as well as Worldbank and IMF reports were used for documentary analyses to evaluate the management of budget deficit.

The survey results of non-government organizations and recommendations of international organizations also used to perform this reseach.

ANALYSIS OF THEORITICAL ASPECTS

With transation to the market economy the new principals of budgeting was implemented in Uzbekistan. In contrast, to the soviet system budgeting, the new system is aimed to concentrate financial resources at the state budget and to finance socio-economic development, and at the same time to cut government support of inefficient state enterprises (EBRD, 1998). The important directions of state budget are financing of long-term investment projects for modernization of production facilities, creating new jobs and increasing social benefits. The new law about “Budetary system” creates legislative base for effective management of public funds and implimentations of new mechanisms, defines main principals and tasks.

A state budget as a government document estimates the anticipated government revenues and government expenditures for the ensuing financial year (V.Rodionova, 1995). Fiscal deficit is when a government's total expenditures exceed the revenue that it generates (excluding money from borrowings). Existence of different types of budget deficits (active, passive, structural, cyclical) and their impact to the economy were the hot topic of many debates among sientists (R.Roberto, 1995). Classical economists have traditionally advocated balanced government budgets (S.Arthur, 2003). Keynesians, on the other hand, believe that it is entirely legitimate and appropriate for governments to incur expenditure in excess of taxation revenues during periods of economic stagnation such as the Great Depression, which dominated economic life at the time he was developing and publicising his theories (Ph.Arestis, 1996).

In the transation economies the central banks play a very active role in mobilization of domestic and foreign exchange resources and their allocation to the public and private sectors (EBRD, 1998). Consequently, the central bank operations result in significant imbalances between revenues and expenditures, which usually referred to as *quasi-fiscal* deficits (V.Tanzi, 1993). In many cases, the deficits generated by central bank operations may become as larger than the deficits of the non-financial public sector (R.Roberto, 1995).

Although the role of quasi-fiscal deficits has been recognized (see R.Anand & S.Van Wijnbergen, 1989; R.Cysne, 1990; Simonsen & Cysne, 1989; and The World Bank, 1988; M.Teijeiro, 1989 and etc.), there have been few attempts to integrate formally the accounts of the non-financial public sector and the central bank. This is surprising, since the distinction between nominal and real deficits is especially relevant to the central bank, given the financial nature of its operations.

The study shows that former soviet countries the budget trust funds operations and financing public expenditures by Development banks instead of state budget are also main sources of quasi-fiscal deficits (World Bank, 1999). Insufficient official statistics makes difficult manage or even measure this type of deficit in many countries with transition economy (EBRD, 1998).

In research we seek to contribute to the literature on fiscal and quasi-fiscal deficits in several ways. First, we studied in detail the interactions between the government and central bank accounts and gave definition. Second, we analyzed the problem of foreign exchange losses in the central bank, including the reasons for their accumulation and the conditions under which these losses may be monetized in the case of Uzbekistan. Third, we examined some important policy issues related to the problem of quasi-fiscal deficits and develop recommendations to manage it. Finally, we discussed the theoretical and practical problems that were encountered in the measurement of central bank and consolidated public sector deficits, and develop alternative methods to measure those deficits from below the line.

The study classifies management of state budget in three groups: *yearly balanced budget, cyclically balanced budget and functional finance*. Balanced budgets and the associated topic of budget deficits are a contentious point within academic economics and within politics. The mainstream economic view is that having a balanced budget in every year is not desirable, with budget deficits in lean times being desirable. Most economists have also agreed that a balanced budget would decrease interest rates, increase savings and investment, shrink trade deficits and help the economy grow faster in the longer term (S.Arthur, 2003).

A cyclically balanced budget is a budget that is not necessarily balanced year-to-year, but is balanced over the economic cycle, running a surplus in boom years and having a deficit in lean years, with these offsetting over time (A.Lusse, 1999). Managers of public resources can achieve balance by increasing taxation or decreasing public expenditure. Consequently, both these measures limit general demand and accelerate inflation rate. In boom year's, according to this theory government should eliminate profit and to achieve this it should decrease taxation or increase expenditure, or do both at the same time which in a result leads to higher rate of inflation. The small profit after slight increase in GDP may not be enough to cover huge deficits which accumulated after long crisis. Thus, even at the high point of the business cycle when revenues are high the country's economy may still be in deficit.

Functional finance is an economic theory proposed by A.Lerner (1943), based on effective demand principles and chartalism. It states that government should finance itself to meet explicit goals, such as taming the business cycle, achieving full employment, ensuring growth, and low inflation.

The main idea is not to balance budgets but achieving balance of whole economy. According to this theory yearly or cyclical balance of state budget is not very important. The effective management should aim to balance the economy by reducing rates of inflation and increasing employment. Achieving this balance may increase public debt, but the deficit and public debt are not very important issues comparing to

inflation and long term economic recessions.

The analysis of these theories result that in many countries the idea of functional finance is prevailing and we recommend taking into account this in Uzbekistan at managing budget deficits.

REGULATION PLOCY ANALYSIS OF BUDGET DEFICIT IN UZBEKISTAN

The research of management of budget deficit focuses to the study factors of budget deficit and analysis of its current state, the methods of financing of budget deficit and the ways of its reduction.

The budget deficit factors and the empirical analysis of these factors start from the last years of former Soviet Union. The results show that the radical drop of oil prices in foreign markets, the increased of capital investments to accelerate economic growth, emergency costs of recovering earthquakes in Armenia and the disaster of Chernobil nuclear station were the main factors (G.Trofimov, 2000).

Comparative research of management of budget deficit in Uzbekistan, Kazakhstan, Russia and US was conducted to develop scientific conclusions. For instance, the positive achievement of reforms held in Kazakhstan lead the country in top 5 on attraction of foreign investments (per capita) among countries in Eastern Europe and CIS. The countries taxation system is one of the most liberal consisting only from 11 types of taxes instead of old 45 (Kazakh University Bulletin, 1998).

The positive experience of restructuring of external debt Russia was studied A.Smironov (2000). The main factors to increase of budget deficit in Russia were studied and conclusions made on the bases of conducted analysis of problems of financing budget deficit. The rich experience of management of budget deficit in different business cycles was studied in the case US (Congressional Budget Office, 1989). Among other problems the internal and external debt service payments shown as increasing burden to the state budget. Further the impact of this situation to capital markets also was considered in the study.

The conducted comparative study of foreign experience allows evaluate the management of budget deficit in Uzbekistan dividing in some periods. The figure-1 presents the general factors of budget deficit which are common for many countries. The analysis show that high rate of deficit in 1991-1996 was the results of the increase of expenditures because of the following factors:

- High demographic growth and unemployment increased the sizes of social benefits (UNDP, 1996);
- Increased budget subsidies directed to compensate the difference of internal and external import products to social support of population (EBRD, 1998);
- New expenditures associated with the creation of new defence system after independence was occurred (UNDP, 1999).

The following factors led to budget revenues fall:

- Same as the other Central Asian countries Uzbekistan was dependant on dotations in the size of 19.5 % of GDP from Central government (at the expense of provision of

mining and agriculture raw materials to other Republics of USSR) and discontinuance which was catastrophic to the economy (L.Shibsharova, A.Nabikhujaev, 1998);

- The change in taxation system with disclaim of confiscation system of unused revenues of state enterprises resulted to considerably decrease of state budget revenues (N.Khaydarov, 2005);
- Reduction of company revenues because of disconnection mutual relations after brokndown of former USSR resulted to decrease the tax base.

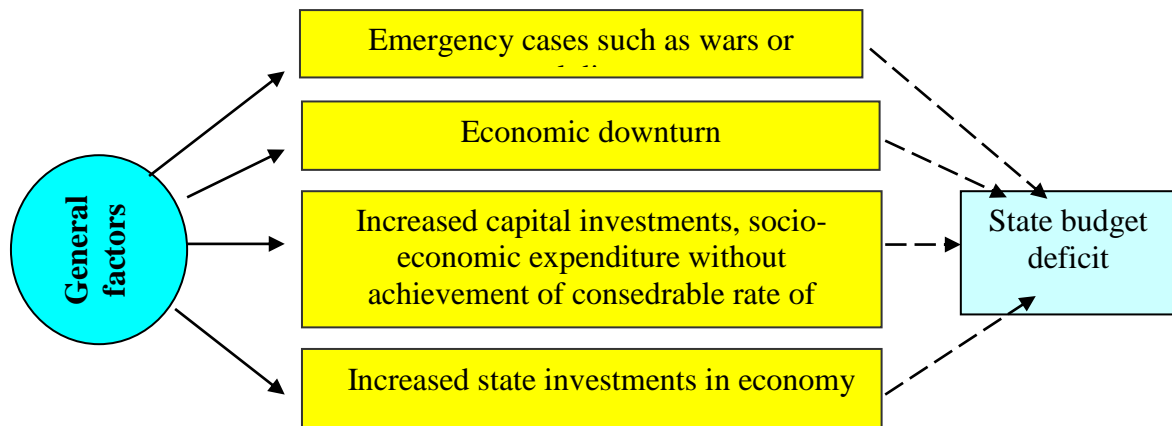


Figure-1. **The factors influencing budget deficit.**

The sources: Prepared by the authors as the result of research

The main factors of budget deficit in that period were high volume of central investments, subsidies to Pension fund, reduction of budget revenues due to currency volatility, compensation farmers' loss from drought, and increase of defence costs due to regional security challenges.

The research reveals that the problem of deficit should be tackled by complex measures. The practice shows that the measuring the sizes by mathematical formulas and trying to achieve them not always effective way at management of deficit. For instance, the reduction of sizes of deficit from 3.5 % of GDP in 1985 to 1.2 % of GDP in 1989 in the countries of Organization for Security and Co-operation in Europe not only resulted increasing of unemployment but also made difficult of achieving the goals of the demographic programmes. Further, the GDP growth rate fell from 3-4 % in 1985-1989 to 2% in 1989-1993 (K.Messere, 1998).

The research reveals that in 1996 the government of Uzbekistan consolidates state budget (state budget includes 4 different budget trust funds such as state Pension fund, Road construction fund, Social benefit (for unemployed) fund, and Privatization fund) and it increases the efficiency of management of public finance which in turn combined with growth in GDP the sizes of deficit is dramatically declined (figure-2).

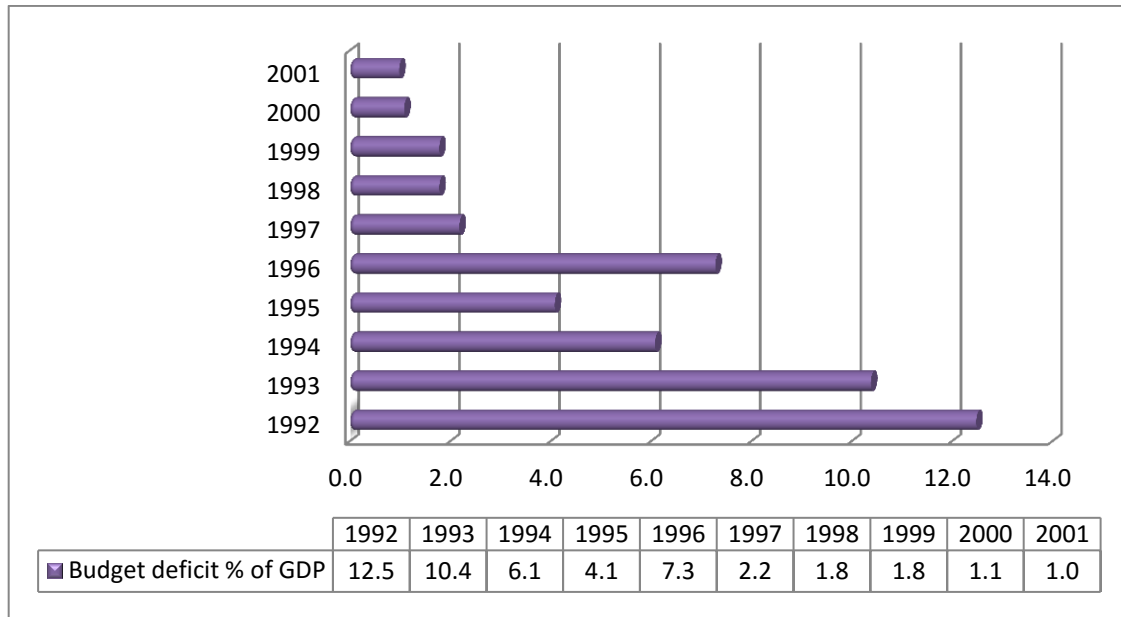


Figure-2. The budget deficit in the Republic of Uzbekistan

The sources: Prepared by the authors according to the data of the Ministry of Finance and the Worldbank

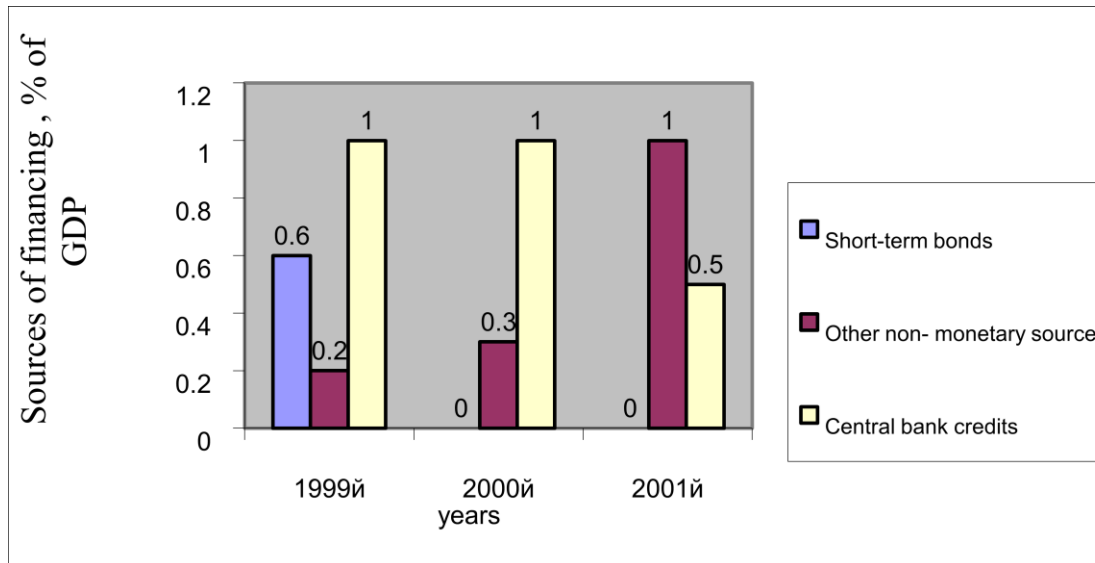
The research analysis the sources of financing of budget deficit and divided into two main groups (monetary and debt):

- The central bank credits or monetization of fiscal deficits (monetary financing);
- Commercial bank credits (debt financing);
- Credits from non bank institutions (debt financing);
- Use of surrency reserves or external debt;
- Privatization or other noninflation sources.

The study reveals that budget deficit during 1991-1995 years in Uzbekistan financed through monetization of fiscal deficits (The Ministry of Finance, 1996). During the years of transation there were not stable non inflantionary sources. The practice of financing deficit by external sources began in 1992 and generated 30.0 mln UzS and this source increased in 1995 to 4918,0 mln UzS. In 1993 10.0 mln UzS was generated through privatization state assets and it was increased to 2467.0 mln UzS in 1995 (IMF, Ministry of Finance, 1996). With the start of issuance and selling 829.0 mln UzS of short term bonds in 1996 non inflantionary sources of deficit financing were strengthen. The analysis of bond market show that in short period the sizes of bondmarket increased in tenfold. With reduction of deficits in budget in1997-1998gave an opportunity to decrease monetary financing in 1.3% and 1.6 % of GDP accordingly. Consequently, this resulted stabilize of consumer prices and value of national currency.

As we can see from figure-3 the Central bank credits was the main source of financing of deficit (1% of GDP) and short-term bonds provides 0.6 % of GDP non monetary source of financing in 1999. Further, in 2000 the budget deficit of 1.0% of GDP was planned to finance by Central bank credits and non monetary sources were 0.3% of

GDP. Starting from 2001 the Central bank financing decreased to cut inflation.



The sources: The Ministry of Finance of the Republic of Uzbekistan statistics.

The study shows that central bank credits remain one of main sources of financing deficits in budget (figure-3). In our opinion, this will lead to high inflation and inflation expectations. The reason why short term bonds were not sold in 2001 was that yield on bonds was below than inflation rates. The study revealed that speed of privatization was slow in those years and it negatively affect to provision non inflationary sources of deficit finance in Uzbekistan.

The research results show that short-term bonds became of one main sources of budget deficit financing in CIS countries including Uzbekistan (Review of Financial sector of Uzbekistan, 2000). The service payments for these bonds pays from the money accumulated from the new bond issuance. This situation in turn can build short term pyramid of bonds. The results of analysis reveal bond growth rate is much higher of GDP growth rate as well as budget revenue and monetization rate.

In our opinion, to prevent the increased debt problem, the bonds should be accounted as internal government debt and yearly payments for the services should be planned in state budget. At the issuance of new bonds the sizes should be planned by every month taking into account the dynamics of credit resources and monetization rate in economy. The results of the study of foreign experience show that financing of budget deficit through non-inflationary sources should be preferred option comparing to central bank credits or money market loans.

CONCLUSION

The research results show that the following factors should be managed effectively to decrease budget expenditures:

- Cessation of dotations to ineffective state companies in energy sector, agriculture, industry and transport and freed resources could be directed to improve infrastructure

and social services;

- Acceleration of privatization to solve two problems at the same time: on one hand it reduces the number of ineffective state enterprises which is dependent on budget subsidies and secondly, the money received from the privatization could be used to finance budget deficit;
- The reduction of defence expenditures is the main sources of redirection these resources to social sector in many countries. The defense expenditures did not exist in Uzbekistan till 1991. However, the defense expenditures in 1992 was 2.5 and increased to 3.3 of GDP in 1993 (UNDP, 1999). From 1993 these expenditures mixed with other expenditures and not presented separately which made impossible providing analysis. According to international measures defense expenditures in developing countries are around 5% of GDP (where in developed countries are around 2.5% of GDP) (World Bank, 1999). The defense expenditures in all Central Asian countries were below of international measures and those not allow further reduction (UNDP, 1999);
- Some expenditure in healthcare sector remained higher than even the expenditures in developed countries. For instance, these occurred due to high number of doctors and more bed numbers in hospitals in the account per 1000 people (TASIS, 2000);
- As in other Central Asian countries, the proportion of pupil-teacher was less than other developed countries. The demographic situation needs to be taken into account in planning of future expenditures in education;
- Uzbekistan was one of the poorest republics in the former USSR and in the years of independence the government tried to cut poverty. However according to international organizations the poverty rate was around 35% of population in the studied period which shows that there was no room to cut social support expenditures (World Bank, 1999);
- The reduction of state investments step by step and creating favorable investment climate for private sector would give opportunities to cut deficit.

Except aforementioned factors the long- term deficit in Pension fund and problems in foreign currency policy were main factors of state budget deficit and needs another reaserch.

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