EMJ MS

EUROPEAN MULTIDISCIPLINARY JOURNAL OF MODERN SCIENCE

https://emjms.academicjournal.io/index.php/ Volume: 4

The Role of Fiscal Policy in Ensuring the Financial Stability of Uzbekistan

Ruziev Zafar Ikramovich, Tursunov Shukhrat Khamidovich

Associate Professor at the Department of Finance at the Karshi Engineering Economics Institute

Abstract: The definitions of the fiscal policy of the state are considered. The classification of types of fiscal policy given, the features of each type considered. The relationship between government spending and taxes and their impact on aggregate demand and, consequently, GNP (Gross National Product), employment and prices presented.

Keywords: fiscal policy, gross national product, government revenues and expenditures, aggregate demand and supply.

Modern fiscal policy determines the main directions for the use of the state's financial resources, methods of financing and the main sources of replenishment of the budget. Fiscal policy is a very powerful weapon. Some economists argue that it is, like the atomic bomb, too powerful a weapon to allow individuals and governments to play with, so it would be better if fiscal policy never came into play. Nevertheless, it is quite certain that in every country fiscal policy brought into play as soon as the country enters a state of crisis and instability. There is no other choice but to try to steer fiscal policy in a healthy direction rather than a harmful one. Any government always pursues some fiscal policy, whether it realizes it or not. The real question is whether this policy will be constructive or whether it will be unconscious and inconsistent.

The study of fiscal policy today is very relevant. Further socio-economic development in Uzbekistan largely depends on the state fiscal policy. One of the most important factors influencing the main macroeconomic parameters is the active use of fiscal instruments in the process of regulating the socio-economic proportions of territorial and sectoral development. The importance of government spending and taxes in ensuring macroeconomic stability is due to the ability consciously and purposefully determine their impact on economic processes.

One of the main factors hindering the growth of production activity in the conditions of the formation of capitalism in the Republic of Uzbekistan was an irrational fiscal policy. The tax burden imposed by the state was clearly excessive and did not allow production structures to conduct normal economic activities. Such fiscal pressure entailed a number of negative phenomena:

First, entrepreneurial activity turned out to be constrained.

Secondly, many cost-intensive industries, the most important and priority ones from a national standpoint automatically cut off from profitable areas of activity and began to stagnate. As a result, a kind of structural degradation of the Uzbekistan economy took place.

Thirdly, significant tax pressure by stimulating payment evasion and the development of the shadow sector of the economy exacerbated the country’s budgetary problems. Obviously, these problems were largely due to the unsatisfactory functioning of the fiscal mechanism of Uzbekistan.

There are a large number of definitions of fiscal policy in the literature, so it seems necessary to consider the main ones.

Under the fiscal policy of the state is understood the constant intervention of the state in economic processes and phenomena in order to regulate their course. In addition, the fiscal policy of the state is understood as a set of measures in the field of taxation aimed at forming the revenue side of the state budget, improving the efficiency of the functioning of the entire national economy, ensuring economic growth, employment and stability of money circulation.

Fiscal policy is a system for regulating the economy through changes in government spending, taxes, and the state budget in order to change real output and employment, control inflation, and accelerate economic growth. Fiscal policy both beneficially and quite painfully affect the stability of the national economy.

Fiscal policy – a set of financial measures of the state to regulate government spending and revenues to achieve certain socio-economic goals. The need for the development and systematic implementation of fiscal policy intensified, especially in the second half of the XX century, when state finances began to play a significant role in ensuring stable economic growth.

Fiscal policy as a way of financial regulation of the economy carried out with the help of powerful levers of taxation and government spending. In this regard, economic, two types of fiscal policy are distinguished: discretionary and automatic (non-discretionary).

Both discretionary and automatic fiscal policies play an important role in stabilization efforts, but neither is a panacea for all economic ills.

Discretionary policy refers to the deliberate manipulation of taxes and government spending in order to change real national output and employment, control inflation, and boost economic growth.

Depending on the state of the economy and the goals facing the government, fiscal policy can be stimulating (expansionary) and restraining (restrictive).

Stimulating fiscal policy carried out during a recession, depression, includes an increase in government spending, tax cuts and leads to a budget deficit.

Consider Fig. 1, where we assume that a sharp decline in investment spending has led to a shift taken together demand curve in the economy from AD1 to AD2. Perhaps the prospects for profits from investment projects have become vaguer, so investment spending and aggregate demand have fallen significantly. As a result, real GDP decreased from 505 billion s. – a value close to the level of production at full employment – up to 485 billion s. This is a drop in real production by 20 billion s. accompanied by an increase in unemployment, since less labor is required to produce a smaller volume of output.

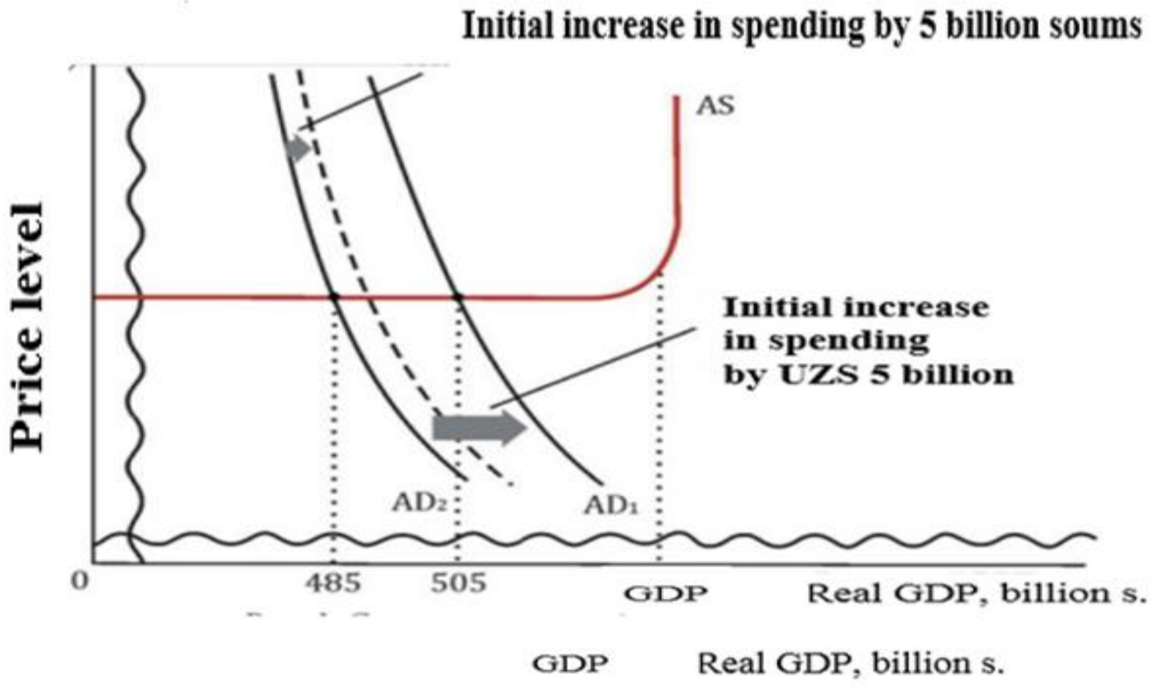

Fig. 1. Stimulating fiscal policy

Such an economy is in a recession phase with accompanying cyclical unemployment. What should the government do under these circumstances? It has three main fiscal policy options:

1) Increase in government spending;

2) Tax cuts;

3) A combination of the first two options. If the federal budget is balanced, then fiscal policy during a recession should be aimed at creating a budget deficit, that is, at an excess of government spending over tax revenues.

1. *Increase in government spending*. Ceteris paribus, an increase in government spending will shift the aggregate demand curve to the right, as shown in Fig.1, – from AD_2 to AD_1. To understand why this is happening, assume that the government allocates an additional UZS 5billion to build roads, satellite communications systems, etc. to ease the downturn. We represent this additional UZS 5billion in government spending as a horizontal line between AD_2 and the dashed downward line to the right of AD_2. At any price level, the real volume of the manufactured product, for which demand presented (demand value), becomes 5billion soums more than before the increase in government spending.

However, the aggregate demand curve shifts to the right, to AD_1, i.e., demand increases by more than 5billion sums of additional government spending. This is because the multiplier effect multiplies the initial change in demand with each successive cycle of new consumer spending. If the marginal propensity to consume (MPC) in the economy is 0.75, then the simple multiplier is four. The aggregate demand curve shifts to the right by a distance 4 times the length of the segment, which represents an increase in government spending by UZS 5billion. This increase in aggregate demand occurs within the horizontal segment of the aggregate supply curve, so the multiplier is in full force and real output quadruples. Note that real output jumped to 505 billion rubles, that is, increased by 20billion soums compared to the level of 485 billion soums observed during the recession. Simultaneously, unemployment is falling as firms re-hire workers laid off during the downturn.

2. *Tax cuts*. There is also an alternative way: in order for the aggregate demand curve to shift to the right from AD_2 to AD_1, the government can cut taxes. Suppose the government cut personal income tax by UZS6.67 billion, resulting in an increase in disposable income by the same amount. Consumption will increase by UZS 5 billion (= MPC 0.75 • UZS 6.67 billion) and savings will increase by UZS 1.67 billion (= GNP 0.25 • UZS 6.67 billion).

In this case, the horizontal segment between AD_2 and the dashed downward line in Fig. 1 represents the original increase in consumer spending, equal to 5 billion rubles. Again, we are talking about the "initial" or "original" increase in consumer spending, because due to the multiplier effect, it increases in subsequent spending cycles. The aggregate demand curve will shift to the right by four times the initial increase in consumption of 5 billion UZS due to tax cuts. Real GDP will increase by 20 billion soums – from 485 billion soums to 505 billion soums, which means that the multiplier is four. Employment will increase accordingly.

For the same shift of the aggregate demand curve to the right, it is necessary to reduce taxes by a greater amount than to increase government spending. This is because some portion of the tax cut causes an increase in savings rather than consumption. To increase initial consumption by a certain amount, the government must cut taxes by more than that amount. With a MPC equal to 0.75, for a future increase in consumption by 5 billion rubles. 6.67 billion rubles should reduce taxes, since 1.67 billion rubles goes to savings (rather than consumption). If the MPC were, say, 0.6, then for an initial increase in consumption by 5 billion rubles. Taxes should have been cut by 8.33 billion soums. The smaller the MPC, the more tax cuts are required to achieve a certain increase in consumption and a certain shift taken together demand curve.

3. *A combination of increased government spending and tax cuts*. The government can simultaneously increase government spending and cut taxes to generate the desired initial increase in spending and ultimately increase aggregate demand and real GDP. In the economy shown in Fig. 1, the state could increase its spending by UZS 1.25 billion and at the same time reduce taxes by UZS 5 billion. This combination will lead to the desired result – an initial increase in costs by 5 billion soums.

A contractionary fiscal policy carried out during a boom and inflation period includes cutting government spending, raising taxes, and leading to a surplus in the state budget. Fig.2 draws attention to the vertical segment of the aggregate supply curve. First, suppose that a shift taken together demand curve from AD_3 to AD_4, on the vertical segment of the aggregate supply curve, raised the price level from P_3 to P_4. This increase in aggregate demand could for example, be the result of a sharp increase in investment spending or net exports. If the government is going to control inflation, then its fiscal measures must be very different from those it used to fight the recession. In such a case, the government can:

1) Reduce public spending;

2) Raise taxes;

3) Use the first two options in combination.

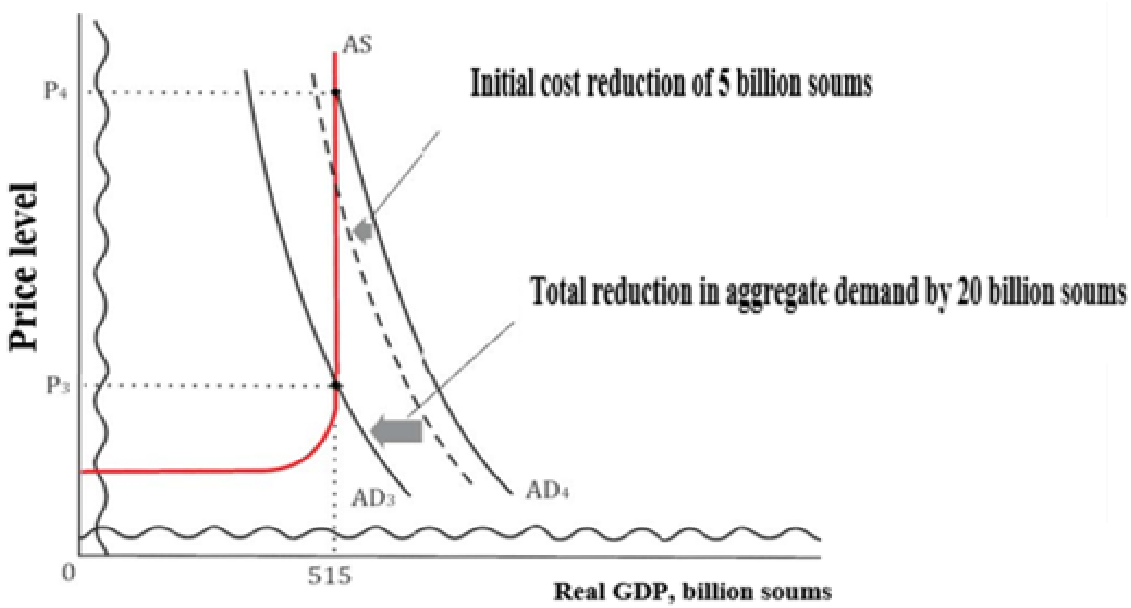

Fig. 2. Contractionary fiscal policy

When the economy faces demand-pull inflation, fiscal policy should aim to create a fiscal surplus, i.e., an excess of tax revenues over government spending.

1. Reducing government spending. The government can cut its spending to slow down or eliminate inflation, as shown in Fig. 2, where the horizontal line between AD_4 and the dotted line indicates a reduction in government spending by 5 billion soums. This decrease in spending will shift the aggregate demand curve to the left from AD_4 to AD_3 if the multiplier process is completed. If prices have downward flexibility, they will return to the P_3 level, i.e., to the level before the start of inflation. The real volume of production will remain at the level of maximum production capacity – 515 billion soums.

In the real economy, prices are "resistant" to falling, so that in order to contain inflation, it is necessary to prevent the rise in the price level, and not try to reduce them to the previous level. Demand-pull inflation usually shifts the aggregate demand curve to the right. Therefore, the goal of fiscal policy is to stop these shifts, and not to restore the previous, lower price level. However, Fig. 2 reveals the basic principle that government-spending cuts can contain demand-pull inflation.

2. Raising taxes. Just as a government cuts taxes to increase consumer spending, it can raise taxes to reduce consumer spending. If the MPC in the economy is 0.75, as in Fig. 2, the government should raise taxes by 6.67 billion soums to reduce consumption by 5 billion soums. With a tax increase of UZS6.67billion, savings would fall by UZS1.67 billion (MPC 0.25 • UZS6.67 billion), and this reduction in savings is by definition not a decrease in spending. However, raising taxes by 6.67 billion soums will reduce consumer spending by 5 billion soums (MPC 0.75 • 6.67 billion soums), which is expressed by the segment between the AD_4 curve and the dotted line to the left of it. Due to the multiplier effect, aggregate demand will shift to the left by UZS 20 billion at any price level (multiplier (equal to 4) • UZS 5 billion), and the price level will fall from P_4 to P_3. This will ensure control of demand inflation.

3. A combination of government spending cuts and tax increases. To reduce aggregate

demand and control inflation, the government may resort to a combination of cutting government spending and raising taxes.

In the short term, these measures reduce demand-pull inflation at the cost of rising unemployment and a decline in production.

In the longer term, a growing tax wedge can serve as the basis for a decline in aggregate supply and the deployment of a stagflation mechanism (a recession, or a significant slowdown in economic development), especially when government spending is cut proportionally across all budget items and priorities are not created in favor of public investment in labor market infrastructure.

Thus, in the conduct of fiscal policy, the emphasis can be placed either on maneuvering spending or on changing taxes. The choice of fiscal policy instrument depends on the general course pursued by the government. If this is a “liberal” course, involving the state’s broad participation in the regulation of a mixed economy, then preference is given to government spending; if a “conservative” course is pursued, focused on narrowing the role of the state and creating a purely market mechanism, then tax changes are more widely used in order to stabilize the economy.

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