

E- Global Congress

Hosted online from Dubai, U. A. E., E - Conference.

Date: 30th May 2026

Website: <https://eglobalcongress.com/index.php/egc>

ISSN (E): 2836-3612

FISCAL SUSTAINABILITY AND NATIONAL CURRENCY STABILITY: AN ANALYSIS THROUGH THE LENS OF TAX INCENTIVE EFFICIENCY

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Abstract:

This research examines the critical nexus between fiscal sustainability and the stability of the national currency, specifically focusing on the efficiency of tax incentives. While tax incentives are often deployed as strategic tools to attract investment and stimulate growth, their mismanagement can lead to "fiscal erosion," widening budget deficits and destabilizing the exchange rate. By applying the "Fiscal-Monetary Nexus" framework, this study argues that inefficient tax expenditures fuel inflationary expectations and weaken the domestic currency. The paper provides a comparative analysis of incentive types and concludes with policy recommendations for aligning fiscal instruments with monetary stability goals.

Keywords: Fiscal Sustainability, Exchange Rate, Tax Incentives, Fiscal Deficit, Macroeconomic Balance, Tax Expenditures.

Introduction

In modern macroeconomics, fiscal sustainability is the primary anchor for monetary credibility. A government's ability to maintain a balanced fiscal stance is a prerequisite for public and investor confidence in the national currency. One of the most contentious instruments of fiscal policy is the granting of tax incentives. While intended to act as catalysts for economic development, these incentives often become "fiscal leakages" when they fail to generate incremental economic value.

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The central thesis of this paper is that inefficient tax incentives undermine fiscal health, which in turn exerts downward pressure on the national currency (devaluation). This occurs through the erosion of the tax base, necessitating either debt expansion or monetary financing, both of which are detrimental to currency value.

Literature Review

The theoretical discourse on the fiscal-monetary nexus explores how budgetary discipline serves as a fundamental anchor for currency credibility. The foundational framework is provided by Sargent and Wallace through their theory of "Unpleasant Monetarist Arithmetic." They argue that chronic fiscal deficits eventually lead to "Fiscal Dominance," a state where the central bank is forced to monetize government debt. This process inevitably triggers inflation and currency depreciation. Modern Fiscal Theory of the Price Level (FTPL), championed by Cochrane, further suggests that a currency's value is essentially the present value of the government's future primary surpluses; thus, fiscal instability directly erodes the exchange rate. Recent scholarship focuses on the impact of Tax Expenditures—revenue foregone through incentives. Tanzi and the IMF highlight the "Fiscal Erosion" hypothesis, where poorly targeted incentives shrink the tax base without generating proportional economic growth. In emerging markets, these incentives are often "redundant," meaning they fail to attract incremental investment while creating structural deficits that signal fiscal fragility to global markets.

The "Race to the Bottom" theory explores how aggressive tax incentives intended to attract FDI can backfire. Aizenman and the World Bank demonstrate that when fiscal sustainability is compromised for short-term investment gains, investors demand a higher Risk Premium. This is reflected in increased volatility of the Real Effective Exchange Rate (REER), as the lack of a robust fiscal anchor triggers capital flight.

Research Methodology

This study employs a deductive-analytical approach and fiscal gap analysis. The efficiency of tax incentives is evaluated based on three primary metrics:

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1. The Incremental Effect: Assessing whether the investment would have occurred in the absence of the incentive.
2. Revenue vs. Growth Ratio: Measuring the trade-off between foregone tax revenue and actual GDP growth.
3. Monetary Correlation: Analyzing the statistical link between fiscal deficit levels and the Real Effective Exchange Rate (REER).

Analysis and Discussion

The relationship between fiscal sustainability and currency stability is dynamic, operating through a complex array of institutional and market channels. This section analyzes the empirical and theoretical implications of tax incentive efficiency, demonstrating how "fiscal leakages" translate into monetary volatility[1].

At the heart of the analysis is the Fiscal-Monetary Nexus. When a government grants expansive tax incentives, it essentially chooses to sacrifice immediate revenue for the potential of future growth. However, when these incentives are "redundant"—meaning they are granted to sectors that would have invested regardless of the tax break—the result is a net loss in the national primary balance.

This fiscal gap triggers the following transmission mechanism:

1. Structural Deficit Expansion: Foregone revenue leads to an increased reliance on public borrowing.
2. Monetary Crowding Out: As the government competes for domestic credit to cover the deficit, interest rates rise, which can dampen private investment, counteracting the original intent of the tax incentive[2].
3. The Expectation Channel: International investors observe the shrinking tax base and anticipate future inflation or "debt monetization." This reduces the demand for the domestic currency in the forex market.

Not all tax incentives have a negative impact on currency stability. The efficiency depends on the Multiplier Effect of the incentive relative to the Tax Expenditure Cost[3].

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Table 1: Matrix of Fiscal-Monetary Impact by Incentive Type

Incentive Category	Fiscal Cost	Multiplier Effect	Currency Stability Impact
Targeted Export Subsidies	Moderate	High (FX Inflow)	Stabilizing: Boosts foreign reserves and demand for local currency.
R&D / High-Tech Credits	Low	High (Productivity)	Positive: Enhances long-term economic competitiveness.
General Corporate Waivers	High	Low (Redundancy)	Destabilizing: Erodes the tax base without structural growth.
Import Duty Exemptions	Moderate	Variable	Neutral/Negative: May worsen the Trade Balance if not tied to production.

In the context of developing economies, many governments operate on the "wrong side" of the Laffer Curve when it comes to incentives. By offering excessive tax holidays, they reach a point of diminishing returns. The analysis shows that when the Tax-to-GDP ratio falls below the 15% threshold (as identified by the IMF), the state loses its ability to perform basic stabilization functions[4].

In such scenarios, the national currency loses its "Fiscal Anchor." Without a credible plan to replenish the treasury, the currency becomes speculative, and its value becomes highly sensitive to external shocks and capital flight. The discussion now shifts toward a modern solution: Algorithmic Fiscal Monitoring. In a digitized economy, tax incentives should not be static legal provisions but dynamic, data-driven tools.

- **Performance-Linked Incentives:** By integrating tax systems with real-time industrial data, incentives can be programmed to "switch off" if the recipient fails to meet export or employment quotas.
- **Fiscal Buffer Requirement:** To maintain currency stability, the cost of tax incentives should be hedged by a "Fiscal Buffer"—a reserve fund that



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ensures that even if tax revenues fall, the central bank is not forced into debt monetization[5].

Finally, the analysis emphasizes the role of Institutional Credibility. Currency stability is as much about perception as it is about math. When tax incentives are granted through non-transparent, discretionary processes, it signals institutional weakness. This increases the "Country Risk Premium," leading to a higher cost of sovereign debt and persistent pressure on the exchange rate. Conversely, a transparent, efficiency-based incentive framework acts as a signal of fiscal maturity, attracting high-quality FDI that supports, rather than undermines, the national currency[6].

Conclusion

The investigation into the nexus between fiscal sustainability and national currency stability reveals that the efficiency of tax incentives is not merely a budgetary concern but a fundamental determinant of monetary credibility. This research has demonstrated that when tax incentives are redundant or poorly targeted, they catalyze a process of "fiscal erosion," which inevitably compromises the central bank's ability to maintain a stable exchange rate. The "Unpleasant Monetarist Arithmetic" remains a potent reality; without a robust tax base to anchor the economy, the national currency becomes susceptible to inflationary pressures and speculative volatility.

Ultimately, the study finds that while strategic incentives can bolster foreign exchange reserves—particularly in export-oriented sectors—general and non-transparent waivers create a structural fiscal void. This void increases the country's risk premium, triggers capital flight, and diminishes the sovereign "fiscal anchor" necessary for long-term currency resilience.

To align fiscal instruments with the objective of currency stability, the following strategic policy shifts are recommended:

- **Institutionalization of "Performance-Based" Incentives:** Governments should transition from unconditional tax holidays to conditional credits. Tax benefits must be contractually tied to verifiable Key Performance Indicators (KPIs), such as net foreign exchange earnings or high-tech job creation, ensuring a positive net impact on the balance of payments.
- **Mandatory "Sunset" Provisions and Audits:** All tax incentive legislation should include a mandatory expiration clause (Sunset Provision). Rigorous

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cost-benefit analyses must be conducted every 3–5 years to determine if the incentive is generating incremental growth or merely serving as a windfall for existing entities.

- **Integrated Fiscal-Monetary Reporting:** To mitigate the risks of "Fiscal Dominance," tax expenditures should be transparently reported in annual budgets. This allows the Central Bank to adjust monetary targets and interest rate paths in anticipation of revenue shortfalls, thereby protecting the exchange rate from unexpected shocks.
- **The 15% Tax-to-GDP Floor:** Emerging economies should prioritize broadening the tax base to maintain a Tax-to-GDP ratio of at least 15%. Maintaining this threshold is essential for the state to provide the infrastructure and stability that high-quality investors value more than nominal tax breaks.
- **Digitalization of Tax Governance:** Implementing real-time digital monitoring systems for firms receiving incentives can reduce "leakage" and tax evasion. Data-driven fiscal oversight ensures that the fiscal sacrifice of the state results in a tangible increase in economic complexity and currency strength.

In conclusion, the stability of a national currency is the reflection of the state's fiscal health. In an increasingly competitive global economy, the temptation to offer expansive tax incentives must be balanced against the imperative of maintaining a solvent and credible treasury. By shifting from a volume-based to an efficiency-based incentive framework, nations can foster an environment where fiscal policy supports, rather than undermines, the enduring value of the national currency.

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