

BUDGETARY DISCIPLINE OF THE TURKISH REPUBLIC OF NORTHERN CYPRUS (TRNC) IN THE LIGHT OF EMU MAASTRICHT CRITERIA

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-Abstract-

As it is widely known, economic measures mainly, aim to achieve sustainability requiring macro-economic stability. Moreover, budgetary discipline should exist to have macro-stability. Eventually, it is acknowledged that budgetary discipline is an indispensable element of sustainability. In this regard, European Union (EU) requires countries to budgetary discipline as a prerequisite of functioning within Eurozone. Maastricht Criteria must be fulfilled in order to qualify for Eurozone membership consists of elements of budgetary discipline. These are; Budget Deficit: Budget Deficit must not exceed 3% of GDP; and National Debt: Government Debt must not exceed 60% of GDP.

Turkish Cypriot authorities are currently implementing “Program for the Future Adoption of the Acquis” (PFAA) in order to fulfill the relevant economic and political criteria as the preconditions for EU accession. Despite the implementation of this Program, the potential of TRNC to fulfill the convergence criteria in order to qualify for Eurozone membership is yet not satisfactory.

When the convergence criteria of fiscal discipline is considered, it is clear that the position of TRNC is worst than Greece. The ratio of Budget Deficit of TRNC to

GDP is 16 % in 2009 while this ratio of Greece is 12.7 % for the same year. Turkey's donors finance this deficit even though specified percentage is officially recorded as credit. Thus, there is no payment of debt stock declared by TC authorities and demanded by authorities of Turkey. This shows that TRNC has potential debt burden seriously jeopardizing budgetary discipline.

In addition to absolute figures of TRNC budget, there are other crucial factors negatively influencing budgetary discipline. These are primarily tax, budget revenue and expenditures elasticities in addition to issues of public expenditure management system consisting of institutional framework, fiscal framework, budget preparation process, budget execution and monitoring, accounting and reporting, financial control, procurement systems, allocative efficiency, technical efficiency and transparency and accountability.

Key Words: *Budgetary Discipline, TRNC, EMU, Maastricht criteria*

JEL Classification: *E62, H2, H6, M4*

1. INTRODUCTION

Authorities seek to create maximum positive effect on the economy by pursuing fiscal policies to ensure rational allocation of resources based on macro-targets. Theoretically, fiscal policy must meet the basic functions of ensuring fiscal discipline, allocation of public resources according to strategic priorities set and production of public goods and services at least cost (Günay, 2007, p. 5). One of the basic indicators of the sustainability of fiscal policy over the medium term, is sustainable budget deficit, or financeable deficit (Günay, 2007, p. 58). Economic sustainability depends on the sustainability of budget policies (Göktaş, 2008, p. 45).

Economic theory sees sustainability of the public financial position as "deficits which do not entail ever-increasing shares of debt and money to income" (Easterly *et al.*, 1994). Such a definition does not only refer to a country's *ability to pay* (solvency) but also its *willingness* to meet its debt obligations. Alternatively, fiscal sustainability can be defined as the government's ability to maintain fiscal and monetary policies without becoming insolvent while solvency refers to the government's ability to service its debt obligations without explicitly defaulting on them. Fiscal sustainability is a concept, closely linked to the concept of solvency (IMF and World Bank, 2006). Fiscal policy is unsustainable if the

present and prospective fiscal stance results in a persistent and rapid increase in the public debt-to- GDP ratio. The size and growth rate of the debt-to-GDP ratio therefore is a key indicator of fiscal sustainability. High debt ratios can eventually become unsustainable. As the creditors realizes that the higher debt servicing costs will make it more difficult for the government to meet its budget constraint and this would require difficult fiscal adjustment, which will increase the risk of monetizing the deficit or debt default (Spilimbergo *et al.*, 2008; IMF and World Bank, 2006). Effective fiscal policy should integrate with the policy of macroeconomic stability and solvency considerations (Sharma, 2009, p. 5).

The European Union and the European Central Bank (ECB) have adopted a comprehensive package of measures to stabilize financial markets and support the adjustment of European economies. The European Union has also committed to accelerating structural reforms, strengthen fiscal discipline, and establish a permanent crisis resolution framework (Debrun and Mathisen, 2010).

Proponents of the fiscal criteria argue that countries have typical structural characteristics and that each country must therefore have produced evidence *before* joining monetary union (EMU) that it is capable of maintaining financial discipline. To ensure the sustainable convergence required for economic achievement and monetary union (EMU), the Treaty sets four convergence criteria, to be reached by each Member State before participating in the third stage of EMU, and hence before adopting the euro. Compliance is checked based on reports produced by the Commission and the European Central Bank (ECB). One of the four convergence criteria is related to budgetary discipline stating that “the ratio of government deficit to gross domestic product (GDP) must not exceed 3% and the ratio of government debt to GDP must not exceed 60%” (Engin and Yeşiltepe, 2009, pp 15-16; Kocenda *et al.*, 2008, p. 7). The criteria relating to government deficit and government debt must continue to be met after the start of the third stage of EMU (1 January 1999). To this end, a stability pact was adopted at the Amsterdam European Council in June 1997 and enables the members of the Euro-zone to coordinate national government budget policies and avoid excessive government budget deficits (Europa Glossary, 2011).

In order to achieve budgetary discipline fiscal principles of taxation should also be cited. The fiscal principles of taxation may be examined under two headings: fiscal soundness and elasticity. By fiscal soundness, we mean that in a good tax system, tax revenues should be able to meet public expenditures and deficits

should not be experienced in the government budget. By elasticity, we mean that tax yield should be elastic (Batirel and Güner, 1994, p.61). Tax systems have been revamped and restructured with the objective of maximizing tax revenues from the reform process. In this regard, tax elasticity - the responsiveness of tax revenues to income at a given rate structure constitutes an important ingredient of a tax system. An elastic tax system is one in which tax revenues rise proportionately faster than income as income increases. Such a tax system becomes desirable for developing countries in order to provide resources for government expenditures, both for consumption purposes and for financing capital formation. Apart from the need to mobilize resources for revenue purposes, a study of tax elasticity is also important for revenue forecasting purposes, analyzing the automatic stabilizing properties of a tax system and for examining the progressivity of a tax system. Therefore, an examination of tax elasticity is crucial for tax policy formulation (Indraratna, 1991, pp. 73-74).

Finally, the importance of public expenditure management for the budgetary discipline should be stated. All governments have to: collect resources from the economy, in a sufficient and appropriate manner; and allocate and use those resources responsively, efficiently and effectively. The national budget is the main instrument through which these transactions are planned and carried out (Todorović and Djordjević, 2009, p. 282). The prerequisite of a good financial performance can be covered through a good institutional arrangement during budgeting (Shah and Von Hagen, 2007, p.48). Public expenditure management (PEM) is one instrument of government policy. Public expenditure management is a basic means of government policy distributing and utilizing sources productively, effectively and sensitively (Allen and Tommasi, 2001, p.19). The basic goals (principles) of public expenditure management are accomplishing macro financial discipline, strategic priorities (productive source allocation) and functional application (technical productivity). All three goals are in very strong interaction (World Bank, 1998, p.3) both theoretically and practically. These three objectives are complementary and interdependent. Without fiscal discipline, it is impossible to achieve effective prioritization and implementation of policy priorities and programmes. A set of "baseline" criteria that set out the essential requirements of a well-functioning public management system covering both EU funds and national resources provided through the budget are: a) Institutional framework. b) Medium-term fiscal framework that complies with certain methodological principles and standards, c) Budget preparation process, d) Budget execution and monitoring, e) Accounting and reporting, f) Financial

control, g) Procurement systems, and h) Budget management of EU Funds (Todorović and Djordjević, 2009, pp. 285-287). The budgeting institutional and budgeting period execute some significant basic functions. These functions are; allocation priorities of public sources; planning for succeeding political goals; providing financial control of the rules and harmonious input; providing managerial function with financial savings; and providing confidence of taxpayers through honesty and accountability (Shah and Von Hagen, 2007, p.27).

Integrated policy, planning and budgeting are fundamental for expenditure programs that are driven by policy priorities and disciplined by budget realities. The challenge is to manage the tension between "needs" and "availabilities" more effectively. A medium-term approach provides such a linking framework and facilitates the management of the tension between policy and budget realities to reduce pressure throughout the whole budget cycle. In this respect, linking policy, planning and budgeting in the planning and resource management cycle consists of essential elements of;

- 1-REVIEW POLICY (Review the previous planning and implementation period);
- 2- SET POLICY AND UNDERTAKE PLANNING ACTIVITY (Establish resource framework, set out objectives, policies, strategies and expenditure priorities);
- 3- MOBILIZE AND ALLOCATE RESOURCES (Prepare Budget);
- 4-IMPLEMENT PLANNED ACTIVITIES (Collect revenues, release funds, deploy personnel, undertake activities);
- 5- MONITOR activities and ACCOUNT for expenditure; and
- 6-EVALUATE and AUDIT Policy activities' effectiveness and feed the results into future plans (World Bank, 1998, p.32).

Current situation and trends in the world regarding public expenditure and control system are multi-year budgeting system, strategic planning, performance based budgeting, internal control, external control, accounting system and external auditing (DPT, 2006, pp. 13-22).

In the light of the conceptual framework above the focus of this study is to examine the budgetary discipline of TRNC.

2. BUDGETARY DISCIPLINE OF TRNC

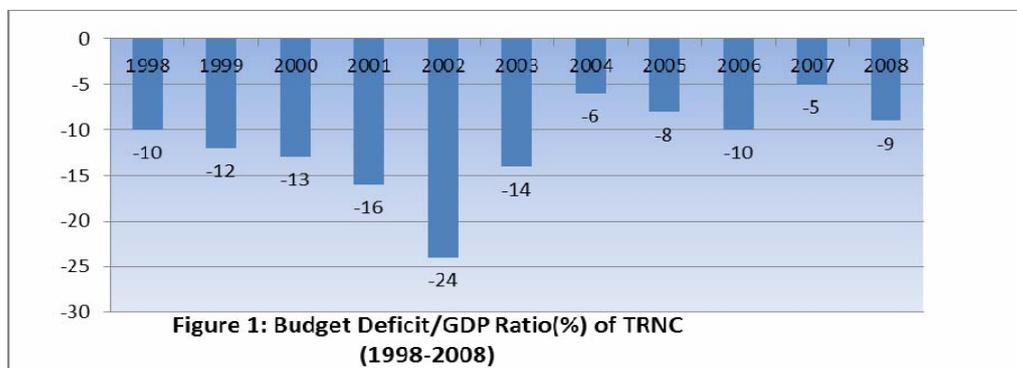
In this study both quantitative and qualitative approaches will be used in examining the budgetary discipline of TRNC. Quantitative approach mainly depends on EMU Maastricht criteria in addition to the concepts of tax elasticity and direct/indirect taxation. Qualitative approach is solely devoted to public expenditure management.

2.1. Quantitative Approach

Quantitative approach of budgetary discipline will consist of EMU Maastricht criteria, tax elasticity and direct/indirect taxation as follows.

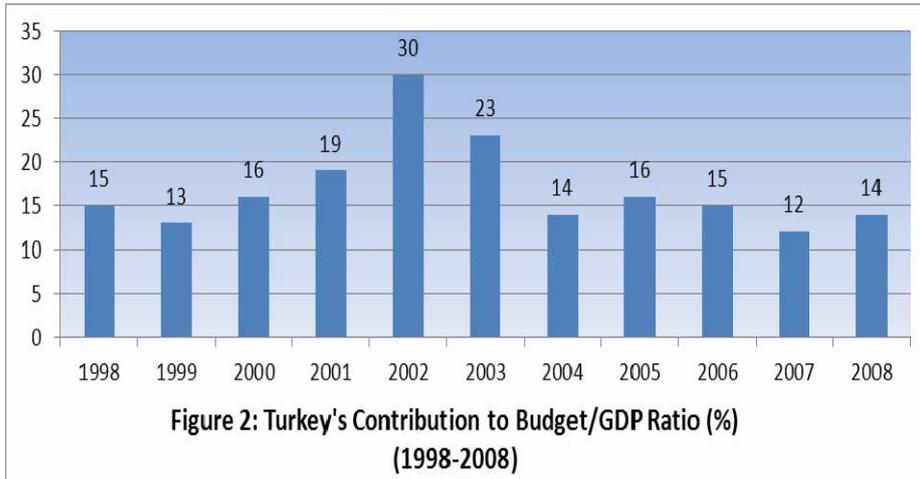
2.1.1 EMU Maastricht Criteria of Budgetary Discipline

As cited in the introductory part, one of the EMU Maastricht criteria is related to budgetary discipline stating, “The ratio of government deficit to gross domestic product must not exceed 3% and the ratio of government debt to gross domestic product must not exceed 60%”. So, TRNC’s potential of budgetary discipline will be evaluated against the benchmark of EMU Maastricht criteria. The ratio of budget deficit to GDP for TRNC is shown in Figure 1. As of the 2008, budget deficit exceed the EMU limits by 6 percent. However, when budget deficit is compared with the deficit in 2002, it barely showed a favorable decrease as from -24 percent to -9 percent.



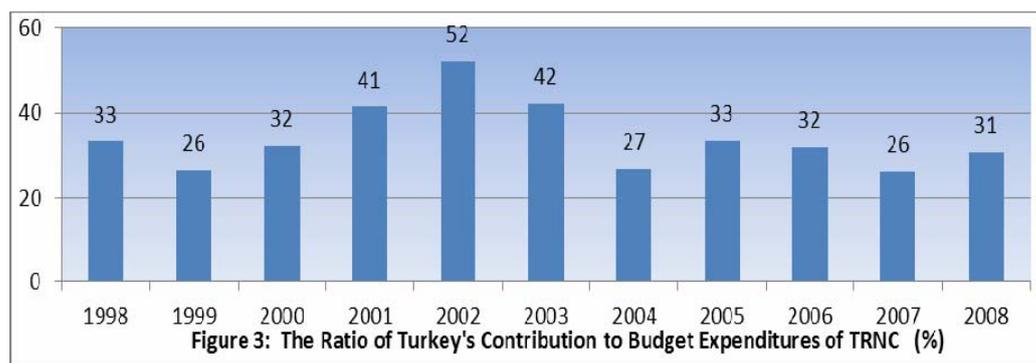
Source: SPO (2010), *Economic and Social Indicators*, State Planning Organization, Follow Up and Coordination Department, Nicosia, <http://www.devplan.org/>, January 24, 2011

From the financial point of view, it should be clearly stated that budget deficit figures above are misleading. Because Turkey's grant aid is recorded as budget revenue, real leverage factor of TRNC budget is greater than one reported. Because of this nature of TRNC budget, budgetary discipline can be examined by considering the total contribution of Turkey to TRNC budget. As seen in figure 2, the ratio of Turkey's budget contribution to GDP is 14 percent. Even though there is a remarkable decrease from 2002 to 2008, this is evidently potential threat to the budgetary discipline in the absence of Turkey.



Source: SPO (2010), *Economic and Social Indicators*, State Planning Organization, Follow Up And Coordination Department, Nicosia, <http://www.devplan.org/>, January 24, 2011

Importance of Turkey for the economic existence of TRNC is also shown in Figure 3. As can be understood, Turkey finances 31 percent of budget expenditures. In other words, one of every three Turkish Liras spent from TRNC budget is provided by Turkey.

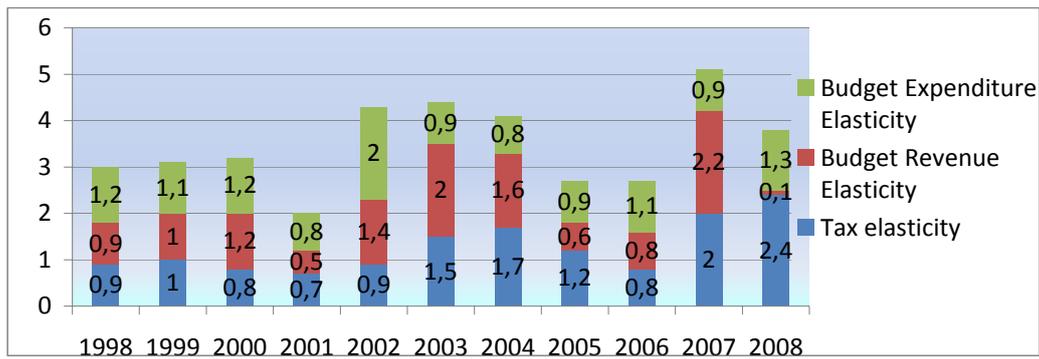


As stated above all deficits of TRNC are financed by Turkey either in the form of donors or credits, which are not practically paid and eventually erased by state authorities of Turkey. However, total contributions of Turkey to TRNC have opportunity cost that needs to be taken into account in economic terms. Because of this opportunity cost, we should specify Debt stock/GDP ratio of TRNC in order to check if it complies with EMU Maastricht Criteria. As the end of 2008 from the year of 1977, potential debt stock/GDP ratio of TRNC excluding time value of money is calculated approximately as **79 percent**. This ratio signals a potential danger for TRNC since even absolute figures exceed 60 %.

2.1.2 Tax revenue elasticities

As cited above an elastic tax system is one in which tax revenues rise proportionately faster than income as income increases. Such a tax system becomes desirable for developing countries in order to provide resources for government expenditures, both for consumption purposes and for financing capital formation. In this regard, budget elasticities indicated in Figure 4 do not reveal satisfactory results. Even though tax elasticities between 2003 and 2008 except 2006 are greater than 1, budget revenue elasticities except 2007 unfortunately are less than 1 during the recent years. On the other hand, budget expenditure elasticities except 2007 are unfavorably greater than 1 in recent years. Eventually, this figures lead to detorated state budget.

Figure 4: Budget Elasticities of TRNC (1998-2008)

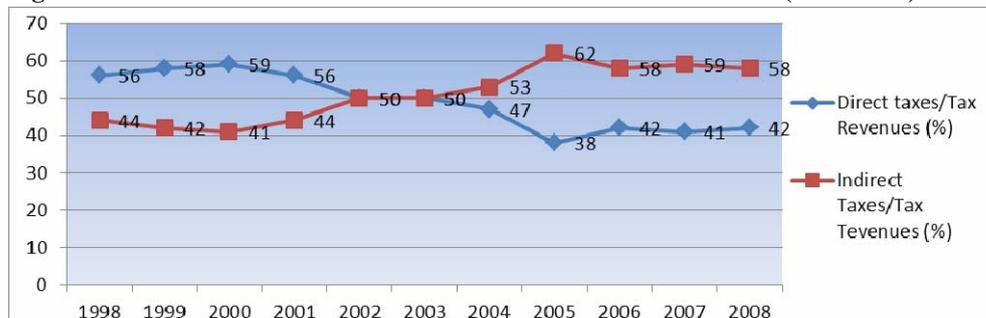


Source: SPO (2010), *Economic and Social Indicators*, State Planning Organization, Follow Up And Coordination Department, Nicosia, <http://www.devplan.org/>, January 24, 2011

2.1.3 The Ratios of Direct tax and Indirect tax

An important dimension of sustainable state budget is tax equity and hence social justice. The share of direct tax in total tax revenue is widely used indicator of tax equity necessitating vertical and horizontal equity. Such that decrease in the ratio of direct taxes to total tax revenue will have negative impact on tax equity. As seen in Figure 5, the trend of direct and indirect nature of taxation in TRNC adversely changes after 2003. After this year, the ratio of direct tax became less than that of indirect tax. This structure will naturally have negative effect on tax equity. The continuation of this trend inevitably increase unrecorded economy and hence the sustainability of state budget.

Figure 5: The Ratios of Direct and Indirect Taxes to Tax Revenues (1998-2008)



Source: SPO (2010), *Economic and Social Indicators*, State Planning Organization, Follow Up And Coordination Department, Nicosia, <http://www.devplan.org/>, January 24, 2011

2.2 Qualitative Approach

Negative appearance of TRNC budget as evidenced by the figure above is the result of technical and administrative nature of the budget. Contrary to the theory, there is no structural and sequential link between economic targets, planning, program, and budgeting. In the absence of up-to-date and reliable economic and social indicators; estimates and targets, plans and programs state budgets are prepared in TRNC. Furthermore, other essential elements of budgetary discipline are also missing in TRNC. Strategic planning are performance based budgeting are not implemented. When these are combined with the absence of insufficient transparency and accountability, internal control and performance auditing become almost impossible in achieving technical and allocative efficiency and henceforth-budgetary discipline.

3. CONCLUSION

In the light of the above findings it should be pointed out that, budgetary discipline is not only important for meeting state expenditures but also macro-economic stability and henceforth for the economic sustainability. Unfortunately, state budget figures of TRNC show that budget of TRNC is potentially bankrupt. State budget seriously exceeding the limits of EU Maastricht criteria is not able to meet current obligations without the existence of Turkey's leverage factor. Furthermore, budget elasticities and tax equity indicators signal other obstacles jeopardizing the budgetary discipline of TRNC.

As a conclusive remark, it can be said clearly that negative appearance of TRNC state budget is the result of bad public expenditure management. The cornerstones public expenditure management such as sequential budgeting process that are planning, programming and budgeting; accountability, transparency, allocative and technical efficiency, strategic planning, performance budgeting, efficient internal control and performance auditing have not been institutionalized yet to assure quality of budgetary management for achieving the intended budgetary discipline.

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