The Purpose of Tax Policy: Economic Growth

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The purpose of taxation is to provide adequate revenues that governments need for necessary functions to promote economic development and social progress. But how do governments determine the levels of taxation that best meet their needs?

This article posits that the purpose of tax policy should be to drive economic growth. *Investment* leads to *employment*, which leads to *taxation*, which leads to *development*. Increases in revenues thus depend on profitable businesses employing workers and on investors placing funds into those businesses or starting new businesses. In virtually all circumstances, economic growth is a prerequisite for revenue growth.

Too often, discussions on tax policy miss this most important element. Rather than simply adjusting tax rates in response to economic conditions (or worse, to favor certain types of economic activity over others), a focus on growth shifts policymakers' goal: to design a tax system to promote economic growth that *itself* drives higher revenue.

China, has been the world's most prominent example of rapid economic growth and eradication of poverty. Other nations seek to follow this path, but they need assistance and encouragement to stay the course even in difficult times with demanding fiscal pressures.

Indeed, other countries around the world including Bangladesh, Ethiopia, Mongolia and Vietnam have enjoyed regular and sustained GDP growth. Still others, including Indonesia and Kenya, have taken bold steps in developing broader growth strategies, including diversifying the economy and moving up the value chain.

Now, all nations must look for strategies to build growth. To this end, investments in physical and social infrastructure (such as education, healthcare and gender equality) contribute strongly to growth. Frequently, however, they are necessary but not sufficient conditions if governments also make other policy choices without considering the effect on growth and a country's overall fiscal posture.

Policymakers must consider how to design incentives that encourage productive investment while avoiding distortions. Governments should understand how tax policy influences investors' decisions. Businesses generally favor broad-based and easily administered taxes. Unpredictability or uncertainty in a tax regime can deter investment, underscoring the importance of clarity and stability to maintain investor confidence.

Some, however, actually argue against growth and even for "degrowth." (Marquis, 2024; Saito, 2024). It ignores the plight of the poor, who need growth to lift them from poverty. And reducing growth will lower revenues that governments need to meet fiscal and societal challenges. While governments should easily dismiss calls for degrowth, economists continue to debate strategies to achieve growth.

Tax policy must play a part in developing a strategy for economic growth. For many countries, a structural transformation of tax policy must accompany implementation of a strategy for growth. In short, a wise system of taxation built with an emphasis on growth can attract significant foreign investment, while an inefficient or ineffective tax system as well as unwise economic policy can hold a country back from achieving its full potential.

Tax systems should therefore be designed to promote economic growth regardless of the revenue mix. This is true no matter what strategy a country has developed for economic growth, for instance export-led manufacturing country as in Korea and other East Asian countries, a focus on increasing domestic demand as in Indonesia, Thailand, and other developing countries, or highlighting specific economic sectors such as extractive industries or tourism.

What factors contribute to a tax system designed to promote economic growth?

Tax policy is not merely a question of determining tax rates. Excessively high tax rates discourage both domestic and foreign investment; excessively low tax rates mean that governments miss opportunities for revenue that can promote development. Setting tax rates appropriately depends on domestic circumstances. Rather, the more significant question is how a

tax *system* is designed and the goals it seeks. Poor or corrupt tax administration, for instance, discourages foreign investment as surely as high tax rates do.

As a series of general principles, tax systems that promote economic growth are systems that are *fair* to all taxpayers; *predictable* in their effects to drive investment and ensure both domestic and foreign taxpayers understand their obligations; *understandable* to promote very high levels of compliance; and *simple* for revenue authorities to administer, to reduce opportunities for corruption and support fairness and predictability in the overall system.

Without question, developing countries should seek to close the "tax gap" in building a system that is fair to all taxpayers and repositioning it for growth. But by definition, if private market financing is declining, a system that should attract investment is not functioning as it should. Capital goes where it can seek higher returns. National governments, therefore, are far better advised to address ways to increase the attractiveness of their own domestic economies, including their tax systems, to encourage investment , rather than simply to raise tax rates in the unlikely expectation that revenues will increase.

In all this, the work of the Belt and Road Initiative Tax Administration Cooperation Mechanism (BRITACOM) is essential as a cooperative mechanism, in which consultation and discussion will help nations develop wise tax policy to promote sustainable growth based on increased foreign and domestic investment. BRITACOM also helps countries modernize their tax systems and optimize them for growth. The International Tax and Investment Center (ITIC) is proud to be one of the select non-governmental organizations invited to actively participate in the workings of the BRITACOM.

There is simply no way to achieve the Sustainable Development Goals without real, sustained economic growth that lifts people out of poverty, increases gender equality, builds national

education and health systems, provides funding for addressing climate change, and underpins strong domestic fiscal systems.

Just as tax policy is essential to economic growth, economic growth is the fundamental purpose of tax policy. Policymakers and the private sector must build a strategy for growth in partnership with tax authorities and continually ask whether a specific regulation or tax policy will promote or discourage economic growth.

Endnotes

This article is based on remarks presented at the Fifth BRITACOF in Hong Kong on 24 September 2024. It is excerpted from a longer article that will appear in the *Belt and Road Initiative Tax Journal* (BRITJ *)*, 2024 2nd issue.

Marquis C. (2024). In defense of degrowth, *Harvard Business Review*.

Saito K. (2024). Slow Down: The Degrowth Manifesto.