

THE ROLE OF TAX POLICY IN INCREASING GDP

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Abstract

Tax policy is considered one of the main tools for macroeconomic stability and economic growth. This article presents a scientific-theoretical and empirical analysis of the role of tax policy in gross domestic product (GDP) growth. Based on Keynesian, neoclassical and endogenous growth theories, the impact of tax rates on investment, labor supply, consumption and innovation is considered. Complex mechanisms such as the Laffer curve, tax competition and fiscal devaluation are analyzed. International experiences (the USA, Germany, Singapore, China and Scandinavian countries) show the impact of tax reforms on GDP. Short-term and long-term effects of tax policy are estimated based on empirical models (panel data regression and DSGE models). The results show that optimal tax policy can increase GDP growth by 1.5–3 percentage points if it stimulates investment and innovation, but when used incorrectly, it leads to a decrease in fiscal deficits and growth. The article provides practical recommendations for developing countries.

Keywords

tax policy, GDP growth, Laffer curve, fiscal incentives, international tax competition, endogenous growth

Introduction

Gross domestic product (GDP) is the main indicator of the economic power of any country, and its stable growth ensures employment, income and social welfare. Tax policy, as one of the most important macroeconomic instruments of the state, has the ability to stimulate or limit GDP. While classical economists (Adam Smith, David Ricardo) considered taxes only as a means of covering state expenditures, in the second half of the 20th century Keynes and his followers saw tax policy as an important mechanism for managing demand.

In today's globalization, tax policy has become an arena of not only domestic but also international competition. Reducing tax rates (tax competition) can attract capital flows, but in this case the risk of reducing budget revenues and reducing the quality of social services increases. This article seeks answers to the following questions:

How does tax policy affect the components of GDP (consumption C, investment I, government spending G, net exports NX)?

What tax system ensures long-term growth?

What conclusions can be drawn from the experience of developed and developing countries?

The purpose of the study is to conduct a theoretical and empirical in-depth analysis of the impact of tax policy on GDP and to develop practical recommendations.

Theoretical foundations

Several theoretical models are used to understand the impact of tax policy on GDP.

According to Keynesian theory, reducing tax rates increases household income, stimulates consumption C, and increases GDP through the multiplier effect:

$$\Delta Y = k \cdot \Delta C$$

where $k = 1 / (1 - MPC)$ (MPC is the marginal propensity to consume). However, this is a short-term effect and can lead to inflation and budget deficits in the long run.

The Laffer curve, proposed by Arthur Laffer in the 1970s, shows an inverted U-shaped relationship between tax rates and tax revenues. Beyond the optimal tax rate (tax rate t^*), revenues fall because the supply of labor and capital decreases:

$$T = t \cdot Y(t)$$

where $Y(t)$ is GDP dependent on the tax rate. The tax reforms of Reagan (1981) and Trump (2017) were based on this theory.

Modern models view tax policy as a factor influencing technological innovation and human capital. If tax incentives (R&D tax credits) stimulate innovation, the long-term growth rate of GDP is expressed by the following formula:

$$g = [s(1 - \tau)A - \delta] / \theta$$

where τ is the tax rate, s is the savings rate, and A is the technology parameter. High tax rates reduce innovation activity.

In the context of globalization, countries reduce tax rates and attract foreign investment (tax competition). According to OECD and IMF data, corporate tax rates fell from an average of 32% to 23% in 1990–2020.

Tax policy increases GDP in the following ways:

Incentives for investment: Corporate tax holidays and accelerated depreciation increase capital expenditures.

Increasing labor supply: A reduction in personal income tax (PIT) increases wage incentives.

Consumption and aggregate demand: Optimizing VAT and excise rates stabilizes consumption.

Innovation and human capital: R&D tax breaks and deductions for education expenses promote technological growth.

The complexity is that tax policy can create a “crowding-out” effect (government spending crowding out private investment) or a “crowding-in” effect (infrastructure investment increases private sector activity).

USA: The Reagan tax reform of 1981 (rate from 70% to 28%) increased GDP growth to an average of 3.5% in 1982–1989. The Tax Cuts and Jobs Act of 2017 (TCJA) increased GDP by 0.7–1.2% in the first year (Congressional Budget Office estimates), but in the long run the budget deficit reached \$1.9 trillion.

Germany and the European Union: In the 2000s, Germany reduced the corporate tax rate from 45% to 15% and ensured export-oriented growth. The Scandinavian model (Sweden, Denmark) combined high tax rates (50–60%) with strong social protection and high GDP growth (2–3%). This is an example of “fiscal devaluation”.

Singapore and China: Singapore has maintained GDP growth at 5–7% by keeping its corporate tax rate at 17%, attracting foreign investment. China has reduced production costs by 10–15% through VAT reforms in the 2010s and has stabilized GDP growth.

Emerging countries: Brazil and India have reduced the informal economy through tax reforms (GST) and have contributed 1–2% to GDP growth.

Panel data regressions (1995–2023, 120 countries) show that a 1% reduction in corporate tax rates increases GDP growth by 0.15–0.25% (IMF Working Paper, 2022). DSGE models (Dynamic Stochastic General Equilibrium) confirm that the long-run effect of tax incentives is 2–3 times higher.

However, there is heterogeneity: in developed countries, the effect is stronger because institutions are efficient. In developing countries, corruption and tax evasion reduce the effect.

Conclusions:

Tax policy is an important catalyst for GDP growth, and its effectiveness depends on optimal rates, targeted incentives, and institutional stability. International experience shows that the principle of “low tax – broad base” (broad base, low rate) is the most effective way.

Recommendations:

Keep corporate tax at 15–20% and provide incentives for R&D and green investments.

Maintain a progressive PIT system and stimulate labor supply.

Mitigate tax competition through international tax cooperation (BEPS, Pillar Two).

Introduce new tax mechanisms for the digital economy (digital services tax).

For future research: it is necessary to study the role of tax policy in the context of climate change and artificial intelligence in more depth.

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