Tax reform in Japan: Is it welfare-enhancing? *

Yoonseok Choi**
Sungkyunkwan University

Hideaki Hirata***
Hosei University

Sunghyun Kim****
Sungkyunkwan University

Abstract

The ongoing tax reform in Japan, in particular a corporate income tax cut financed by an increase in VAT, is expected to bring positive effects on investment and output. However, the overall effects on government fiscal balance and welfare can be ambiguous depending on dynamic responses of macroeconomic variables to changes in tax rates. This paper aims to provide quantitative forecasts of Japanese tax reform on welfare and fiscal balance using a small open two-sector dynamic general equilibrium model calibrated to the Japanese economy. Simulation results show that under unrestricted international borrowing and lending and no habit, a corporate income tax cut of 2.5% financed by an increase in VAT improves welfare by 0.12%. However, positive effects of corporate income tax cut disappear when international borrowing becomes limited or consumers show habit formation.

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** Department of Economics, Sungkyunkwan University, Seoul, Korea. E-mail: yoonchoi3@skku.edu.
*** Department of Business Administration, Hosei University. E-mail: h-hirata@hosei.ac.jp.
**** Corresponding Author. Department of Economics, Sungkyunkwan University, Seoul, Korea. Tel: 82-2-760-0421, E-mail: shenrykim@skku.edu.