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

- Analyze the fiscal effects of Japanese corporate income tax cut
- Examine how fiscal revenue and welfare change with a corporate income tax cut in tradable and nontradable sectors
- Corporate income tax cut is financed by an increase in lump-sum tax or consumption tax
- Better welfare and fiscal results when corporate income tax cut is in the tradable sector
- Positive effects decrease when international borrowing becomes limited or consumers show habit formation

Abstract
The ongoing tax reform in Japan, particularly a corporate income tax cut financed by an increase in consumption tax, 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 the 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. The simulation results show that under conditions of unrestricted international borrowing and no consumption habit, a corporate income tax cut of 5% financed by an increase in consumption tax improves welfare by 0.53%. However, the positive effects of corporate income tax cuts decrease when international borrowing becomes limited or consumers show habit formation. In addition, we show that a corporate income tax cut in the tradable sector generates better welfare and fiscal consequences than a tax cut in the nontradable sector.

JEL Classification: E6
Keywords: corporate income tax; Japan; dynamic scoring; revenue neutral; tax reform
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