



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



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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.

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1. Introduction

Japan has been implementing a series of tax reforms since launching Prime Minister Shinzo Abe's administration in 2012. Two main objectives of Japanese tax reform are improving growth and restoring fiscal balance, especially with the impending explosion in social security spending due to the aging population. The main direction of tax reform is to lower a corporate income tax, which is expected to boost corporate profitability and promote inward investment from the rest of the world, thereby bolstering economic growth. The Japanese government plans to finance the lost tax revenue from corporate income tax cuts by increasing the consumption tax rate. Currently, the Japanese tax structure shows that the consumption tax rate is too low and that the corporate income tax rate is too high compared to other countries (see Figs. 1 and 2). The Abe administration has committed itself to lowering the effective corporate income tax

rate from 34.6% to below 30% and increasing the consumption tax rate to from 5% to 10%.¹

How much of a positive effect can this tax reform generate for investment and output? How will fiscal revenue and welfare respond to this tax reform over time? These are important questions to answer in order to successfully implement a tax reform program in Japan. This paper aims to provide quantitative estimates of the impact of potential Japanese tax reform on the welfare and fiscal budget balance using a small open two-sector (tradable and nontradable sector) dynamic general equilibrium model. Because the Japanese economy is open to international borrowing and lending with a large trade sector, it is important to incorporate these features into the model. The baseline model is similar to the one used in Choi and Kim (2016), who use

¹ In 1989, the Japanese government introduced a 3% consumption tax rate with a significant reduction in corporate tax and income tax. In 1997, the consumption tax rate was raised to 5% with an advanced implementation of a tax cut for three subsequent years. Unlike the 1989 tax hike, the 1997 tax hike significantly lowered consumption partly due to financial crisis in Japan and Asia (Hirata and Otsu, 2016). In April 2014, it was raised to 8%, and a fiscal stimulus of 5 trillion yen was implemented to mitigate the short-term negative impact of the hike, but again consumption was dampened sharply. The Abe administration, thus, has struggled to increase the rate from 8% to 10%.

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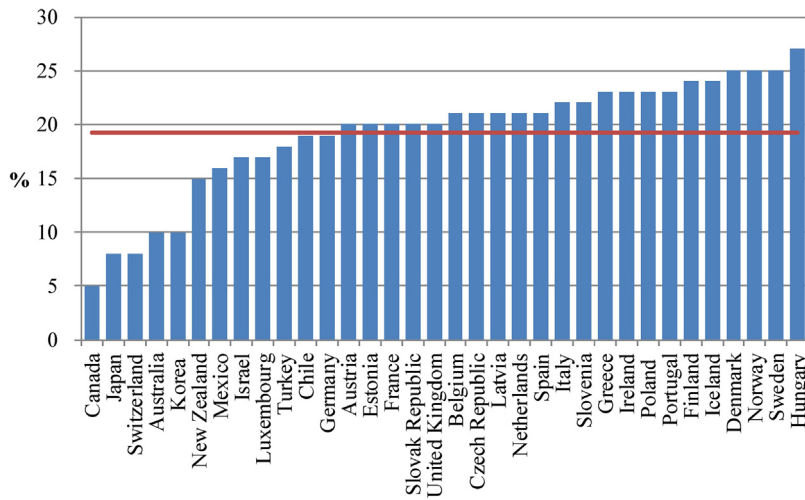


Fig. 1. Value added and sales tax rates.
 Note: The rates are applicable on 1 January 2016.
 Source: OECD, Tax Database.

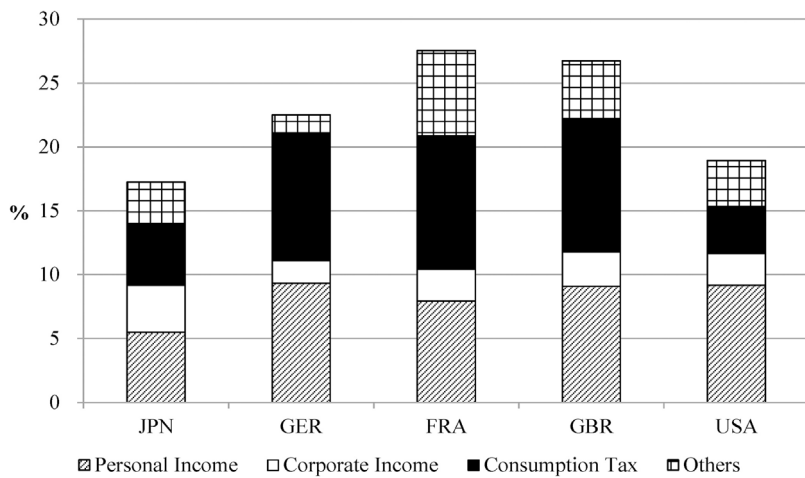


Fig. 2. Tax revenue by sources.
 Notes: Y-axis denotes % of GDP in 2012. Each item corresponds to the source of tax revenue in 2014. Social Security is excluded.
 Source: OECD, Revenue Statistics 2014.

dynamic scoring to estimate fiscal consequences of tax policies in Korea.²

In general, a tax reform involving a corporate income tax cut financed by an increase in consumption tax enhances welfare (e.g., Kim and Kose, 2014; Mendoza and Tesar, 1998).³ An increase in the consumption tax rate is likely to be less distortionary than other sources for fiscal revenue, such as income tax (IMF, 2011, 2013).⁴ Some studies in dynamic scoring show that corporate income tax can be self-financing, especially in open economies and in the

long-run (e.g., Choi and Kim, 2016).⁵ Therefore, the overall effects of a corporate income tax cut on fiscal balance may not be as bad as previously estimated. Exact quantitative forecasts depend on the structure of the model and the parameter values used for model simulation.

The dynamic scoring method employed in this paper has been widely used to measure the dynamic revenue effects of tax reform in recent studies. Using a simple neoclassical growth model, Mankiw and Weinzierl (2006) find that the long-run feedback

² The model used in this paper has more realistic features such as habit formation compared to the model in Choi and Kim (2016).

³ Heer and Trede (2003) also constructed a dynamic general equilibrium model for Germany and found that a consumption tax that replaces an income tax has only a small impact on labor income distribution but positive effects on employment and long-run welfare levels.

⁴ Unlike capital income tax, consumption tax does not distort household saving decisions, investment decisions or trade, and a part of the burden of an increase in tax rate falls on spending financed by past savings, which is completely distortion free because past decisions cannot be changed.

⁵ Dynamic scoring calculates the revenue effects of a proposed tax policy by using dynamic macroeconomic models, in which a change in tax rate generates feedback to tax revenue through changes in the tax base over time. For example, a tax cut in capital income (or other distortionary taxes) tends to reduce tax revenue on impact but increases the tax base (and tax revenue) over time because a tax reduction in capital income enhances economic activities such as investment. The first effect of a tax cut is called static scoring, and the second effect (related to an increase in the tax base) is called the feedback (dynamic) effect. Compared to dynamic scoring, static scoring tends to overestimate the fiscal revenue loss from a tax cut as it disregards changes in the tax base.

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