Daiwa's Economic View

JIP to work with LDP outside of cabinet, avoid expanding supplementary budget

- Takaichi administration assured as Japan Innovation Party (JIP) to cooperate with LDP outside of cabinet
- Challenges include stabilizing policy cooperation outside of cabinet, securing Upper/Lower House majorities
- LDP-JIP coalition to diminish risk of bigger FY25 supplementary budget
- Focus to shift to securing majorities, increasing initial FY26 budget as demanded by JIP

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The LDP and Japan Innovation Party (JIP) have agreed to form a coalition with JIP participating outside of the cabinet, ensuring the launch of an administration led by Sanae Takaichi. Challenges remain regarding the stability of policy cooperation outside of the cabinet, as well as securing majorities in both houses of the Diet. However, the risk of a bigger supplementary budget for FY25 due to this coalition is small. The focus will now turn to securing a majority through alliances with smaller parties, as well as whether the initial FY26 budget will further increase based on JIP demands.

Coalition talks likely to conclude with JIP providing support outside of cabinet

The LDP and JIP are expected to sign an agreement on the afternoon 20 October, following coalition talks, with the JIP to provide cooperation outside of the cabinet. This makes the launch of a Takaichi administration all but certain. As such, the risk of important bills, including those related to the budget, as well as no-confidence motions against the cabinet being passed solely by the opposition parties will remain limited for now.

The LDP has been seeking cabinet cooperation from JIP (involving participation of senior political appointees from JIP). However, the JIP wants to cooperate on policies without joining the cabinet (support from outside of cabinet).

Ties between ruling parties are weaker when one party works outside of the cabinet, leaving concerns about the stability of policy coordination among the ruling parties. Parties cooperating outside of the cabinet are not required to participate in cabinet decisions on budget proposals and bills. As such, they have no obligation to support such actions. The threshold for dissolving a coalition is also low.

However, the LDP plans to have JIP's Diet Affairs Chief Takashi Endo serve concurrently as an assistant to the prime minister to facilitate communication between the two parties. It has also been reported that the LDP and JIP have reached a coalition government agreement and JIP will participate in the preliminary review of bills submitted by the government. With this arrangement, even if JIP cooperates from outside of the cabinet, the risk of JIP opposition after bills are submitted to the Diet becomes smaller.

Moreover, the LDP and JIP alone fall just short of a majority in both houses of the Diet, leaving the risk that budget proposals and bills could be rejected or that demands from other parties might have to be accommodated. However, forming parliamentary groups with minority parties could reduce those risks. The LDP formed a parliamentary group in the Upper House on 15 October that included the sole member of the NHK Party. A parliamentary group entails looser connections between parties than a coalition, but they essentially vote together in the Diet. The LDP's future outreach to minority parties should attract attention.

LDP-JIP coalition seems likely to avoid increasing scale of supplementary budget

Even if the JIP agrees to work with the LDP outside of the cabinet, there is little concern about any additional expansion of economic measure component of FY25 supplementary budget. It appears the impact will be limited to fiscal expansion under a Takaichi administration.

During the coalition talks, JIP called on the LDP to adopt 12 policy areas. Of these 12 areas, only the abolition of the provisional gasoline tax rate and measures to combat high prices are relevant to the FY25 supplementary budget. These two measures would very likely be implemented even under an LDP-only government. As such, the supplementary budget assumption at the time of Takaichi's appointment as new prime minister will remain unchanged (economic stimulus measures of Y16-18tn, calendar-based market issuance that is flat or up only a few trillion yen [see *our 6 Oct 2025 Daiwa's Economic View "Fiscal policy of new Takaichi administration and its impact on JGB market"*]).

On 17 October, the LDP informed the Constitutional Democratic Party of Japan that, if Takaichi becomes prime minister, a draft FY25 supplementary budget bill would likely be submitted to the Diet around early December. The cabinet decision on the supplementary budget and the revision to the JGB issuance plan will likely take place around early December.

Initial FY26 budget if coalition increases expenses

If an LDP/JIP coalition leads to fiscal expansion, that would impact the initial budget for FY26, but the impact is expected to be limited at this juncture.

Among the 12 items that JIP requested from the LDP, the full implementation of tuition-free high school education could be the primary factor impacting the initial FY26 budget. According to JIP, the required budget for that initiative is estimated at Y600bn. The scale of the free elementary school lunch program is unclear, but it may be comparable to the free high school program.

The key issue is the proposal to lower the food consumption tax to 0% for two years. If realized, that proposal would require an annual funding source of Y4.0~5.0tn. However, considering the preparation period required by businesses, implementation starting in April 2026 would be difficult. If the preparation period is six months starting in October, the required funding for FY26 would be halved. Also, in the first place, cutting the consumption tax was not a high priority among the JIP demands. Given that the proposal lacks immediate effectiveness as an inflation countermeasure, it could not be implemented.

Also, while LDP President Takaichi is also supportive of tax credits with cash transfers, that would require income verification and so would likely take two to three years to implement. Many have pointed out that social security reforms are difficult and JIP wants to reduce social insurance premiums by the amount saved through healthcare cost reductions. At this juncture, that is not expected to lead to increased issuance of JGBs.

We should note that uncertainty remains regarding future negotiations with the JIP, as well as negotiations with other parties needed to secure a majority.

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