

# Daiwa's View

## Policy choices regarding consumption tax cut on food

- Choices under time and institutional constraints, decaying effect on prices, fiscal constraints, and exit problem

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### Media reports: Shift toward the “1%” option

*Nikkei* reported that the government is making final adjustments centered on a plan to set the consumption tax rate on food to 1% from April 2027, with the possibility that a decision by the Prime Minister is possible in June. As a practical point, it has been noted that the period required to modify cash register systems would be around five to six months if the rate were set at 1%, whereas a 0% rate would require up to about one year. Related legislation is expected to be submitted to the extraordinary Diet session in the autumn.

This is also consistent with other recent reports, and similar discussions have already appeared in multiple media outlets since last week (*Kyodo News*, *Asahi Shimbun*, *Yomiuri Shimbun*, etc.). This latest report is less new information and more an indication that the government is in the final phase of a process where, out of the coexisting options of “0%” and “1%,” the decision is leaning towards “1%” based on feasibility.

From an institutional perspective, a zero-tax rate would fall outside the existing framework of the consumption tax and therefore require exceptional processing, imposing a heavy burden in terms of system modifications. In contrast, a reduction to 1% could be handled as an extension of existing tax-rate change procedures. This difference results in a substantial gap in the implementation period that is institutionally permissible. Consequently, in prioritizing the early implementation of the tax cut, the 1% plan was politically judged to be more realistic.

Meanwhile, a gap remains with the campaign pledge. Therefore, in light of the fact that a zero tax rate on food had been advocated, a proposal to make it “effectively zero” through subsidies and other measures is being considered simultaneously. This is an attempt to maintain institutional simplicity while also ensuring policy consistency.

### Impact on prices: Divergence between theoretical and realized values

A cut in the consumption tax rate on food would mechanically act to push down consumer prices. It is estimated that a 0% rate would lower core CPI by roughly 1.5ppt, while even a 1% rate would lower it by around 1.3ppt.

However, this downward impact would not necessarily be fully realized. First, there is the issue of the price pass-through rate. Overseas examples of VAT cuts confirm a tendency that the tax cut is not fully reflected in prices, with part of the benefit remaining on the corporate side. If the pass-through rate were, for example, around 70%, the price reduction would be limited to just over 1%.

Second, there is also the effect of costs associated with institutional responses, in addition to the current price environment. Currently, companies are continuing price revisions in response to rising costs, leading to higher base prices. Under these circumstances, price cuts due to the tax cut and hikes in base prices would occur simultaneously, meaning that the eventual decline in final selling prices would be further diminished.

In fact, the National Council on Social Security pointed out the “possibility that base prices themselves will rise partly due to the pass-through of system upgrade costs, and prices may not fall as much as expected.” A temporary consumption tax cut would require system modifications both when the tax cut is introduced and when the tax rate is restored. If these costs are included into prices, the price level after the tax cut ends could become higher than the level that would have prevailed in the absence of the tax cut.

Third, the temporary nature of the policy has an impact. A two-year tax cut is unlikely to be viewed as an increase in permanent income and will be perceived by households as a temporary relief measure. In this case, much of the increased income is likely to go into savings rather than consumption, limiting the ripple effect on spending. This means the tax cut is less a policy to directly boost consumption and more akin to a temporary adjustment of real income through price changes. Without an increase in permanent income, its effect on boosting the underlying trend of consumption is limited.

### **Fiscal constraints: Scale of Y4.4tn (or Y5tn if effectively 0%) and the maintenance of apparent discipline**

Even if the tax rate is set at 1%, the scale of the tax reduction for both national and local governments combined is estimated to reach about Y4.4tn annually. At 0%, it would be on the scale of Y5tn. While there is a difference between the two, they are both large-scale fiscal measures.

The government is considering a plan to manage the tax cut within a scope that does not increase the amount of new JGB issuance from the previous fiscal year. This plan is based on two premises. First, the government will contain spending growth by not compiling a supplementary budget. Second, the tax cut can be absorbed by fiscal “leeway,” including higher-than-expected tax revenues. It has also been suggested that explicitly stating that the total amount of new JGB issuance will not be increased from FY27 onward would make it easier to gain market understanding.

What is important here is how fiscal discipline is assessed. In a y/y comparison, it can be framed as “not increasing,” but when comparing a scenario with the tax cut to one without it, fiscal policy has been expanded. The evaluation of the same measure differs depending on these two perspectives.

Furthermore, given the institutional timing, the full impact of the tax reduction may not be reflected in FY27 tax revenues. If implemented in April, the new tax rate will only apply to corporate tax payments for a portion of the year, so the first-year decline in tax revenues would appear smaller. This aspect makes the fiscal impact seem temporarily mitigated.

This method of securing funds based on such “leeway” implicitly assumes that tax revenue growth will continue, and it contains uncertainties dependent on the economy and external environment. Moreover, other spending pressures, such as defense spending and growth investments, coexist, limiting the room to permanently absorb the tax cut.

### **Exit problem: Risk of not being able to restore the tax rate in two years**

This policy is being discussed as a two-year temporary measure, but the key issue is whether it can actually be ended. LDP Secretary-General Shunichi Suzuki has stated that the consumption tax is a core tax, and if it is reduced and cannot be restored, it will have a major impact on public finances, pointing out the importance of gaining the understanding of the market and the public. This statement indicates that the ability to end the policy, rather than its implementation, will determine its sustainability.

Similar to past energy subsidies, burden-reduction measures tend to become difficult to abolish once introduced. Restoring the consumption tax rate is perceived as a tax hike by households, creating a political burden at the time of termination.

Although a deadline is set in the policy design, if the consumption tax cut is implemented from April 2027 as per the administration's plan, a decision on whether to continue the tax cut will have to be made again by the end of 2028. Considering the Upper House election scheduled for the summer of 2028, a re-evaluation will be necessary around that time, and the political hurdles will be extremely high. If it is continued, the fiscal resource problem would re-emerge; if it is ended, consumption and prices would move in the opposite direction.

Furthermore, given that this consumption tax reduction is positioned as a stopgap measure until a permanent benefit (refundable tax credit program) can be realized, we can assume that the benefit will also require a similar scale of fiscal cost.

In terms of price formation, it has been pointed out that price pass-through may be stronger when taxes are raised than when they are cut. In that case, it cannot be ruled out that the price level after the tax cut ends could become higher than it was before the tax cut.

### **Implications: Front-loaded burden relief and deferred burden of adjustment**

Based on the above, the consumption tax cut on food has a stronger character as broad-based household support against rising prices than as an economic stimulus measure. At the same time, it is positioned as a temporary measure premised on a transition to the refundable tax credit program. From an institutional perspective, this tax cut is an intermediate step toward shifting to a redistributive policy.

On the other hand, while a consumption tax cut as a broad-based price adjustment does function as household support, it is not necessarily efficient from the standpoint of redistribution according to income brackets. However, this assessment is conditioned on the facts that the price-lowering effect is temporary, the funding source is not permanent, and friction will arise when the measure ends.

The current consumption tax cut plan is therefore simultaneously constrained by institutional, funding, and political factors. A zero tax rate requires time to implement, and even a 1% rate entails a fiscal burden of ¥4tn-5tn annually. In addition, once the tax cut ends, burdens would increase once again. If that burden increase is politically avoided, the burden would effectively be recouped through changes in markets (forex rates and interest rates) and fundamentals (prices).

The convergence toward the "1% plan" is the result of prioritizing institutional and time constraints. Meanwhile, the issues of funding and exit remain unresolved, and whether the policy continues will depend on future institutional design. In the short term, the measure is expected to alleviate household burdens caused by rising prices, but in the medium term, a review of fiscal management and the redistribution system will become unavoidable.

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