Daiwa Securities

# Daiwa's Economic View

## Consumption tax cut: Can market confidence be secured without a permanent funding source?

- The tax cut is already priced in; the market is focused on permanent funding

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On the evening of July 30, Prime Minister Sanae Takaichi formally announced to reporters at the prime minister's office that the consumption tax rate on food and beverages would be reduced from 8% to 1% for a limited period of two years beginning in April 2027. She also indicated her intention to provide income-linked benefits equivalent to one percentage point of the consumption tax, effectively reducing the consumption tax burden on food to zero for low- and middle-income households. The government and ruling parties plan to formally approve the policy in early August, formulate a broad policy framework in September, and submit the relevant legislation to an extraordinary session of the Diet in the autumn. The measure is positioned as a bridge to the full-scale introduction of a refundable tax credit program planned for FY29.

The decision itself was broadly in line with expectations and therefore came as no major surprise to the market. Since the House of Representatives election, the Takaichi administration has consistently advocated a reduction in the consumption tax on food as a long-held policy objective, and a similar approach has been discussed by the National Council on Social Security. The implementation of the tax cut itself appears to have been largely priced into the yen interest rate market. The market's focus is not on whether the tax cut will be implemented, but on how it will be funded.

PM Takaichi reiterated that the necessary funding would be secured "without relying on special deficit-financing bonds, in a manner that maintains market confidence." She also explained, "Regarding non-tax revenues, which were around Y9.0tn, we will meet the necessary fiscal needs through a comprehensive review of special tax measures and subsidies, the use of payments from sources such as the Foreign Exchange Fund Special Account (FEFSA), and further efforts to secure revenues from all special accounts and funds."

That said, this explanation has been repeated for some time and does not constitute new information. The prime minister has previously stated that the government would not rely on deficit-financing bonds, but discussions at the National Council have yet to produce a comprehensive picture of the specific funding sources. At the latest press conference, she again indicated that funding would be sought through reviews of special tax measures and subsidies, payments from the FEFSA, and the utilization of special accounts and government funds. However, she did not clarify how much revenue would be secured from each source.

Achieving the "effective zero" tax rate through the combination of lowering the consumption tax rate on food to 1% and providing benefits is estimated to require an annual funding source of approximately Y5tn. Potential funding sources reportedly under consideration include higher-than-expected tax revenue and the use of resources from the FEFSA, but neither constitutes a permanent funding source. Tax revenue growth depends heavily on economic conditions, including nominal economic growth and rising equity prices, and is therefore vulnerable to cyclical fluctuations. Resources from the FEFSA and other non-tax revenues are also already allocated to other purposes, making it unclear how consistently and reliably they can be utilized. What the market wants to see is not merely a policy commitment to refrain from issuing deficit-financing bonds, but a clear picture of the permanent funding sources that would make such issuance unnecessary.

Under the proposed framework, the relevant legislation is not expected to include an economic escape clause. By omitting such a clause, the government and ruling coalition appear eager to clearly demonstrate their intention to return the tax rate to 8% in April 2029. PM Takaichi has also stated, "In two years, I will take responsibility for ensuring that the tax rate is restored to its original level." However, the market is generally aware of both the implementation of the tax cut and the difficulty of restoring the rate. Although the presence or absence of an economic escape clause is an important issue in the design of the framework, the market is more focused on the specific funding arrangements that will support the tax cut and the subsequent benefit program than on the government's stated intention to restore the tax rate.

Indeed, Liberal Democratic Party Secretary-General Shunichi Suzuki has said that "It is not the case that we have no concrete prospects at all," while also explaining that "the details will be presented based on the expectation that the necessary funding can be secured from a variety of sources, including higher-than-expected overall tax revenue." At present, the government could therefore be viewed as doing little more than listing possible funding sources, rather than presenting concrete funding plans.

The market is particularly focused on what the government means by "increased tax revenue." If the natural increase in tax revenue generated by nominal GDP growth and rising equity prices is positioned as the principal funding source, this would mean using revenue that is sensitive to the economic cycle to finance what could become permanent expenditures and/or tax cuts. If such an intention becomes clear through future statements by the prime minister or other government officials, concerns about fiscal discipline could re-emerge in the JGB market. While the decision to reduce the consumption tax itself appears to have been largely priced into the interest rate market, the market may reassess the policy depending on the government's explanation of the funding arrangements.

Moreover, the funding issue extends beyond the tax cut. Higher tax revenue and non-tax revenue would be required to finance not only the consumption tax cut, but also growth investment, defense spending, and social security-related expenditure. With respect to higher tax revenue and additional non-tax revenue, the *Nikkei* has pointed out that "the consumption tax cut and other policies are competing for the same funding sources." The government's funding needs for growth investment and the strengthening of defense capabilities are also expected to increase. A senior Ministry of Finance official has stated: "It is no longer meaningful to discuss individual policies and their respective funding sources separately. We can only evaluate the final outcome by considering expenditures and revenues together and assessing the ultimate extent to which JGB issuance can be contained."

The schedule going forward is now relatively clear. The government and ruling parties are expected to formally approve the policy in early August, finalize the broad framework of the program in September, and submit the relevant legislation to an extraordinary session of the Diet in the autumn. Work will subsequently proceed on designing the refundable tax credit system ahead of its full-scale introduction in FY29. The focus of the government's dialogue with the market is therefore likely to shift from the merits of the tax cut itself to the question of how it will be funded.

PM Takaichi repeatedly referred to "market confidence" in her latest remarks. She has opted not to include an economic escape clause and has made clear her intention to restore the tax rate. However, both the implementation of the tax cut and the difficulty of restoring the tax rate appear to have been largely priced into the market. The key issue is not the tax cut itself, but the extent to which the government can provide specific details on the permanent funding sources that will support both the tax cut and the new benefit program. From the government's policy decision in August through the extraordinary Diet session in the autumn, the market will be looking closely for greater clarity on this point.

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