Japan Q&A: there is ample funding for the VAT cuts supporting Sanaenomics

- **How would the VAT cuts be funded?**
- **How does Sanaenomics differ from Abenomics?**

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Question 1:* *How would the VAT cuts be funded?

Our view: the revenue loss from the VAT cuts on food starting in FY27 could be fully covered by (1) revenue increases accompanying economic growth and (2) revenue exceeding the estimates in the initial budget.

Looking at the combined total of tax and non-tax revenue (including payments from the BoJ and surpluses in special accounts) recorded in the government's initial budgets since FY24, together with the YoY changes, shows that the total increases every year through FY27, for which Cabinet Office projections are applied, except in FY24, when the fixed-amount tax cuts introduced to address rising prices lowered the tax revenue estimate. The increases amount to JPY9.4trn in FY25, JPY6.2trn in FY26 and JPY6.1trn in FY27 (Cabinet Office projections are applied for FY27 because the budget has yet to be formulated).

These revenue increases are supported by nominal GDP expansion. As nominal GDP reflects not only the expansion of real economic activity but also rising prices, an increase in nominal GDP would raise consumption expenditure, corporate profits and employee compensation in nominal terms, thereby boosting revenue from VAT, corporate tax and income tax. In other words, tax revenue would increase naturally as nominal GDP expands, even without tax increases such as higher tax rates.

Nominal GDP increased by 4.3% in FY25 and, according to Cabinet Office projections, is expected to increase by 3.0% in FY26 and 3.9% in FY27. Continued nominal GDP expansion would increase tax revenue, generating additional revenue for the government. When considering funding for VAT cuts, it is essential to adopt a dynamic perspective in which future tax revenue increases through economic growth, rather than a static perspective that assumes current tax revenue would remain unchanged.

As economic growth, corporate profits, wages and prices change from the assumptions underlying the initial budget, both revenue and expenditure can exceed or fall short of their estimates in the final accounts after the fiscal year ends. In particular, tax revenue has repeatedly exceeded initial budget estimates by a substantial margin in recent years. The combined total of tax and non-tax revenue in the initial budget was JPY77.1trn in FY24 and JPY86.6trn in FY25. In the final accounts, however, the totals were JPY86.2trn and JPY95.0trn, exceeding the initial budget estimates by JPY9.1trn in FY24 and JPY8.4trn in FY25. In both years, the revenue upside in just one year approached the approximately JPY10trn required to fund the VAT cuts over two years.

One reason for such substantial upside surprises is that the government estimates tax revenue very cautiously. The indicator showing the multiple at which tax revenue grows relative to nominal economic growth is called "tax revenue elasticity". For example, a tax revenue elasticity of 2 means that tax revenue increases by 2% when nominal GDP increases by 1%. The Ministry of Finance assumes a tax revenue elasticity of 1.2 in its revenue estimates. In practice, however, tax revenue elasticity was 2.8 in FY25 and has averaged 1.8 since FY21, substantially exceeding the assumption.

Although tax revenue growth was restrained in some years by special factors, such as the spread of Covid-19 and the fixed-amount tax cuts in FY24, tax revenue in recent years can be said to have responded more strongly to nominal GDP

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expansion than the government assumed. Given this trend, tax revenue would also be highly likely to exceed initial budget estimates by a reasonable margin in FY26 and FY27, when the VAT cuts would begin, unless a major economic shock occurs. In other words, in addition to the revenue increases recorded in the government's initial budget, further funding could be generated as actual tax revenue exceeds the estimates.

Adding together (1) revenue increases accompanying economic growth and (2) revenue exceeding initial budget estimates gives JPY7.5trn in FY24 and JPY17.8trn in FY25. Applying the average revenue upside in FY24 and FY25 to FY26 and FY27 gives totals, including revenue increases accompanying economic growth, of JPY14.9trn and JPY14.8trn, respectively. These amounts substantially exceed the approximately JPY5trn per year, or JPY10trn over two years, required to fund the VAT cuts. Taking into account annual revenue increases from economic growth, together with the scope for upside surprises arising from the government's cautious tax revenue estimates, securing funding for the VAT cuts would be entirely possible. In addition, higher-than-expected surpluses arising from the multiple rounds of JPY-buying foreign exchange intervention could also be included as transfers from the Foreign Exchange Fund Special Account to the general account budget. The argument that VAT cuts necessarily require tax increases or spending cuts overlooks the effect of economic growth in increasing tax revenue.

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Question 2: ***How does Sanaenomics differ from Abenomics?***

Our view: the Takaichi administration's economic policy direction is entirely different from Abenomics. In contrast to the large-scale monetary easing under Abenomics, monetary policy under the Takaichi administration is moving towards interest rate increases. Fiscal policy also places greater emphasis on expanding future supply capacity through strategic investment than on simply adding to aggregate demand. The growth strategy likewise responds to the transition towards an era of intense global competition in industrial policy involving large-scale, long-term fiscal spending through public-private collaboration, rather than pursuing an efficiency-focused, neoliberal approach.

In her policy speech to the ordinary Diet session, PM Sanae Takaichi clearly indicated that Sanaenomics is about expanding investment. She attributes past economic stagnation to insufficient domestic investment by the public and private sectors rather than deteriorating demographics. The Takaichi administration's policy is to transition to a "growth-oriented economy" and achieve a "strong economy" through strategic investment involving public-private collaboration. The administration intends not to hesitate over expenditure needed to decisively implement policies required today, including investment that would generate future economic growth, focusing on strategic sectors and cross-sectoral challenges. Although the global economy is experiencing inflation, Japan, where domestic demand remains weak, has greater scope to expand investment than other countries with stronger domestic demand and greater inflation concerns. Japan can therefore be said to be in an advantageous position to win the global competition in strategic investment. The expansion of supply capacity through investment would also help stabilise inflation.

There remain deeply entrenched views that Sanaenomics, which seeks to expand supply capacity through strategic investment, focuses on expanding demand through handouts, as well as concerns that "responsible expansionary fiscal policy" would generate fiscal anxiety, driving up interest rates and weakening the currency. These arguments mainly take the following forms. "Amid high prices, JPY depreciation, high interest rates and Middle East risks, expansionary fiscal policy would lead to an excessive increase in interest payments"; "the BoJ is behind the curve in raising interest rates, and rate increases are also necessary to correct JPY depreciation"; "VAT cuts are populism, and handouts would lead to a short-lived administration"; "as rising interest rates could worsen the debt-to-GDP ratio again, now is the time to pursue fiscal consolidation"; "a primary balance surplus should remain the objective to maintain fiscal credibility"; and "Sanaenomics has a strong emphasis on government-led industrial policy and is mercantilist and outdated".

Sanaenomics aims to expand supply capacity and restore the economy and national strength by increasing domestic investment through public-private

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collaboration supported by expansionary fiscal policy. The domestic capital expenditure cycle is currently still improving as expansionary fiscal policy has begun to expand the economy. The aim is to strengthen the capital expenditure cycle further through strategic investment involving public-private collaboration, restore the corporate sector from an abnormal savings surplus (insufficient investment) to a normal position in which investment exceeds savings, and escape economic stagnation completely. While the capital expenditure cycle is improving, expectations of greater future supply capacity would persist, preventing the risk of extreme JPY selling. This is because extreme currency selling arises from risks of damage to future supply capacity and dependence on overseas supply.

Investment expansion would boost demand and raise the output gap in the short term, creating a high-pressure economy. However, the subsequent expansion of supply capacity would help stabilise inflation, raise potential growth and increase real wages through higher labour productivity. In the meantime, households would receive support through time-limited fiscal assistance, including VAT cuts, which would by no means constitute handouts. Economic policy management based on a low-pressure economy using a 0% output gap as its benchmark would be reconsidered to raise corporate growth and earnings expectations. As investment constitutes demand in the short term, a high-pressure economic policy that creates room for the output gap to rise is important. It is necessary to distinguish clearly between cost-push inflation from higher import prices and demand-pull inflation from increases in the output gap and net domestic fund demand, and to avoid undermining the momentum for investment expansion through premature fiscal and monetary tightening. If premature BoJ rate increases were to derail the capital expenditure cycle, the resulting risk of damage to future supply capacity would create a risk of stronger JPY depreciation pressure over the medium to long term.

The new global trend in economic policy is to strengthen national capabilities by expanding strategic domestic investment through stronger public-private collaboration. It is important to incorporate this shift into the government's macroeconomic strategy. Fiscal consolidation policies, such as the primary balance surplus target, were compatible with neoliberalism because they reduced government involvement. Even for strategic investment that generates future growth and income, the primary balance surplus target imposes a constraint requiring investment to remain within tax revenue. If there were flexibility to maintain a certain fiscal deficit, government bonds could be issued for strategic investment while keeping current expenditure, excluding debt redemption and investment expenditure, within tax revenue. The criterion for deciding whether to undertake strategic investment would be whether it leaves future generations with benefits exceeding the interest burden on government bonds, rather than whether funding is available. Amid intense global competition in strategic investment through public-private collaboration, Japan would lose and see its national strength decline if it alone competed with unnecessary constraints. There has been insufficient recognition that the US, which Japan has treated as a model for structural reform, has not simply pursued neoliberal policies, but has had a strong form of public-private collaboration through defence demand. Moderate fiscal spending, implemented while monitoring fiscal indicators, such as keeping net domestic fund demand (the corporate savings rate + the fiscal balance) within -5% of GDP, would be far removed from unrestrained fiscal expansion.

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Fig 1. Increase in tax revenue and non-tax revenue due to economic growth

	FY24 initial budget	FY25 initial budget	FY26 initial budget	FY27 initial budget (Cabinet Office estimate)
Initial budget revenue (tax revenue + non-tax revenue) (JPYtrn)	77.1	86.6	92.7	98.8
Year change in initial budget revenue (JPYtrn)	-1.6	9.4	6.2	6.1

Source: Cabinet Office, MoF, Crédit Agricole CIB

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Fig 2. Upside deviation in tax revenue and non-tax revenue from the initial budget to the final settlement

	FY24		FY25		Average
	Initial	Settlement	Initial	Settlement	
Revenue (tax revenue + non-tax revenue) (JPYtrn)	77.1	86.2	86.6	95.0	
Revenue outperformance from initial budget to settlements (JPYtrn)	9.1		8.4		8.8

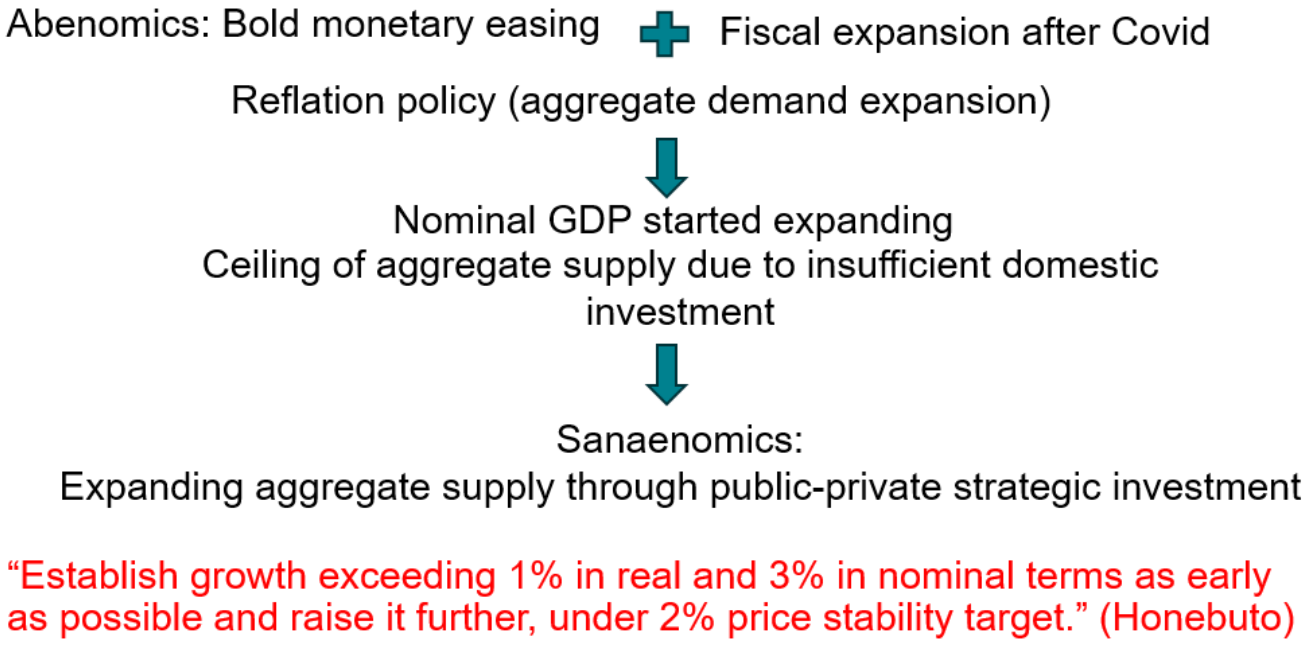
Source: MoF, Crédit Agricole CIB

Fig 3. The magnitude of increase in tax revenue and non-tax revenue due to economic growth and tax revenue outperformance

	FY24	FY25	FY26	FY27
Revenue sources (tax revenue increase from growth and revenue outperformance, JPYtrn)	7.5	17.8	14.9	14.8

Source: Cabinet Office, MoF, Crédit Agricole CIB

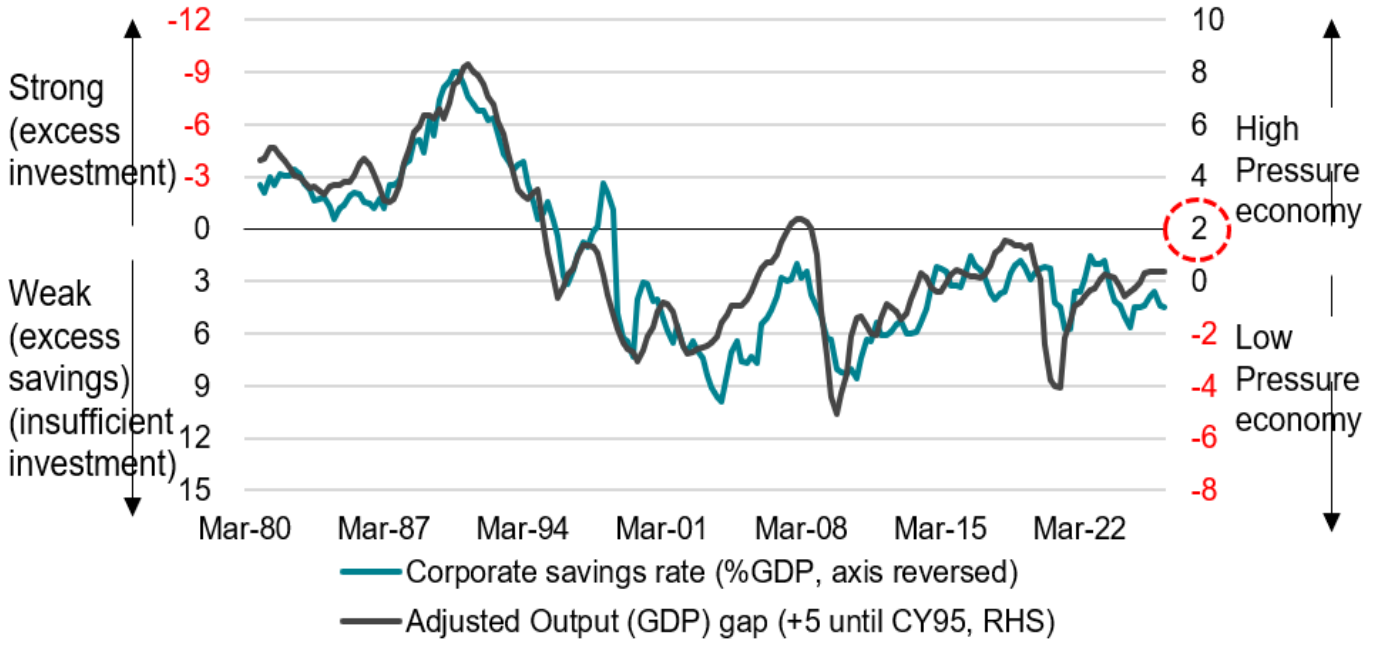
Fig 4. Transition from reflation to Sanaenomics



Source: Crédit Agricole CIB

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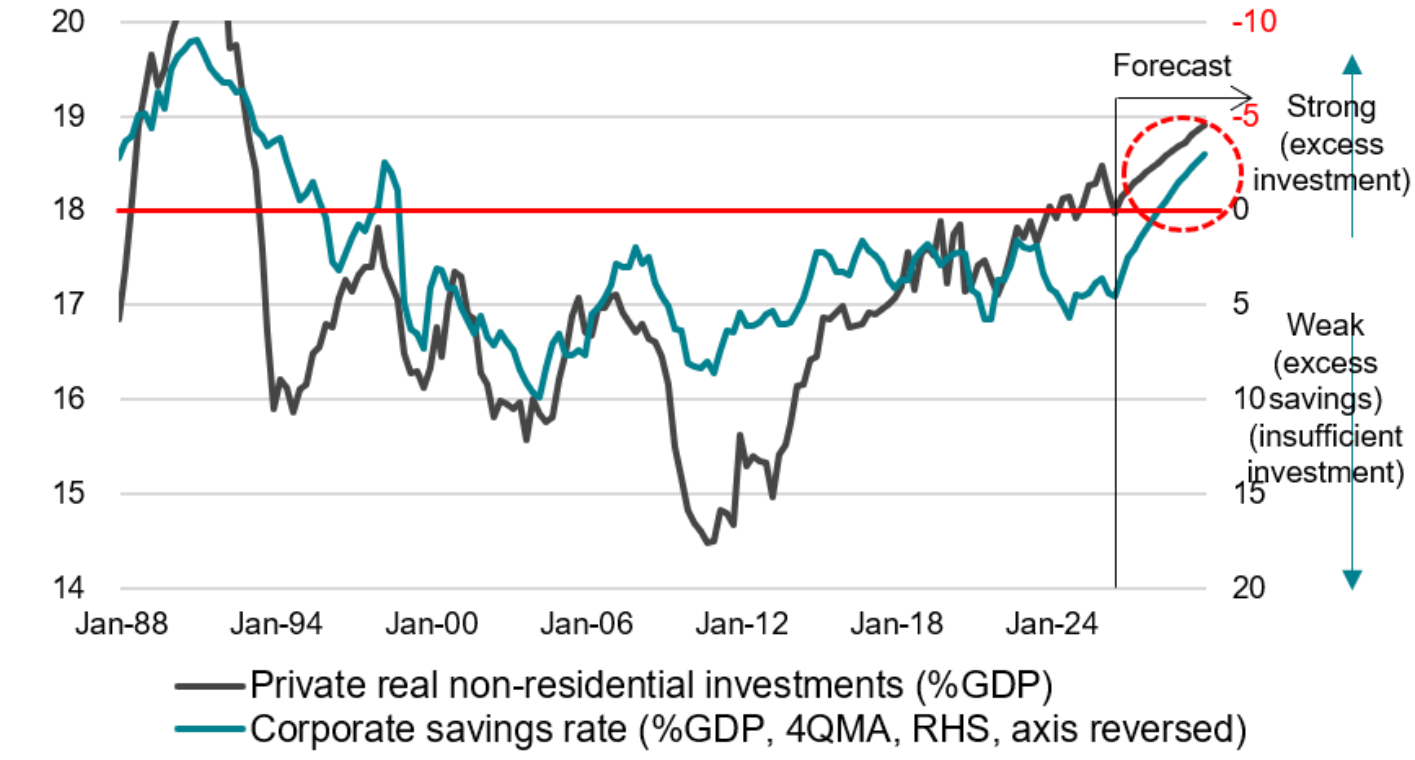
Fig 5. Corporate savings rate and output gap



Due to the revision of the GDP standard, the output gap before 1995, including the financial bubble period, is adjusted by +5

Source: BoJ, Cabinet Office, Crédit Agricole CIB

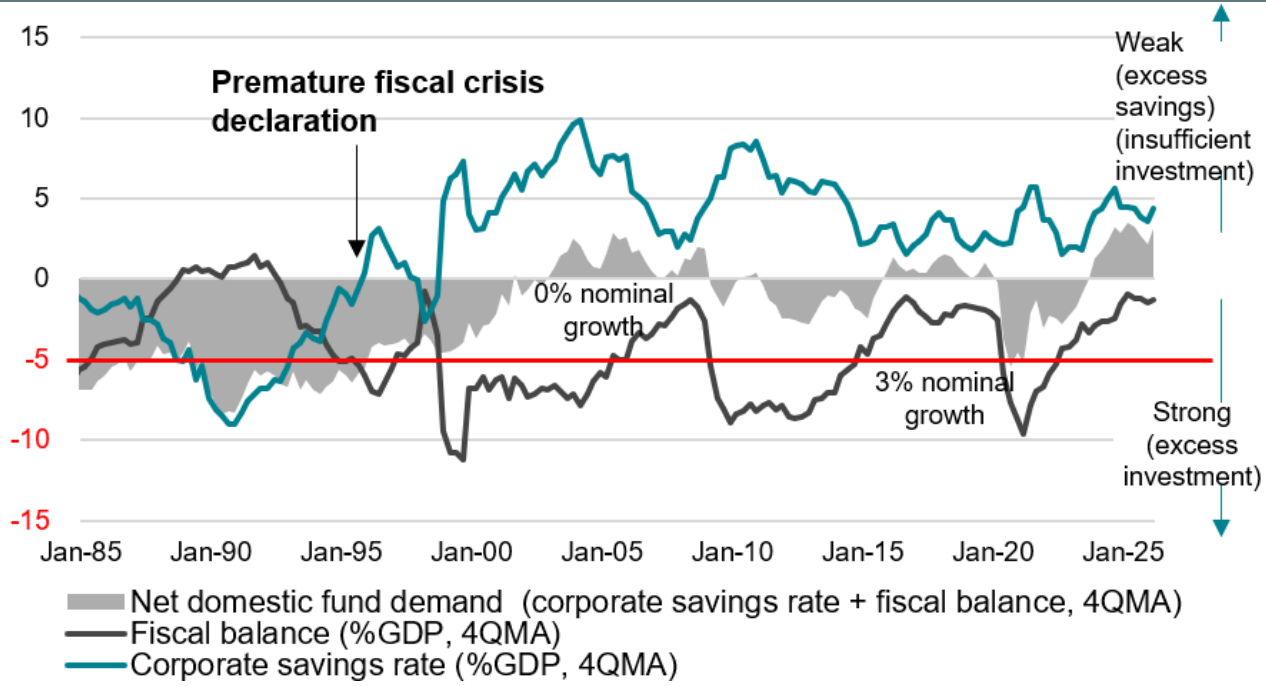
Fig 6. Corporate savings rate and private domestic capex cycle



Source: Cabinet Office, BoJ, Crédit Agricole CIB

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Fig 7. Net domestic fund demand (corporate savings rate + fiscal balance)



Source: Cabinet Office, BoJ, Crédit Agricole CIB

Note: Takuji Aida is a member of the Japan Growth Strategy Council. The content is a personal opinion and does not necessarily reflect the government's view.

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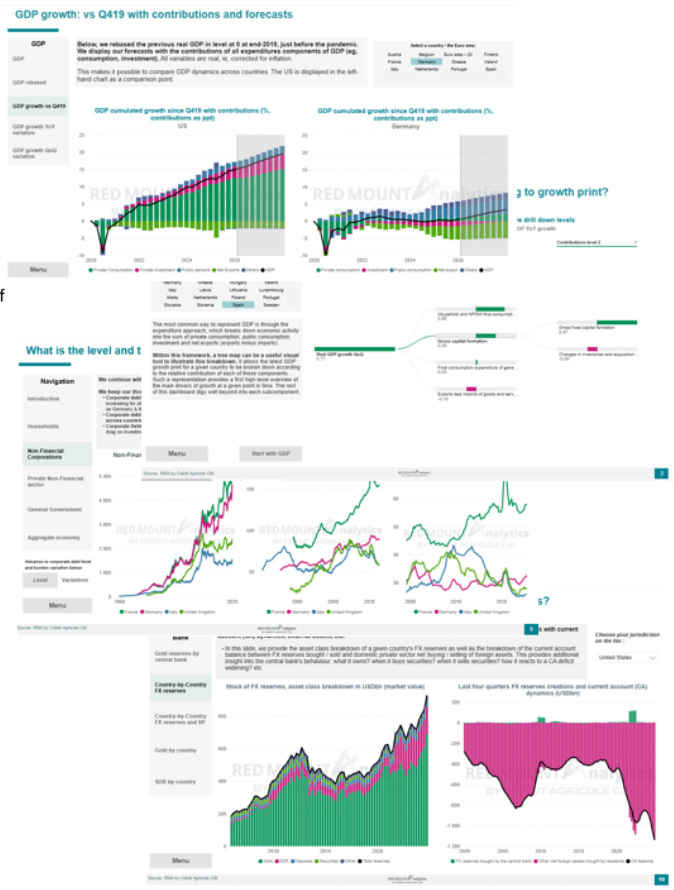
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