Japan Q&A: tax cuts vs cash transfers: how will funding be secured?

- **What do you think of opposition parties' proposals focusing on cash transfers as an alternative to a VAT cut?**
- **Is there no need to worry about funding for the VAT cut?**
- **What is supporting the increase in government revenue?**
- **What is behind such large upward surprises in tax revenue?**
- **Where do you think the annual income threshold should be set for income-linked cash transfers?**



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Question 1: *The VAT reduction bill has become the main focus of the current Diet session. Its main pillars are to lower the 8% VAT rate on food and beverages to 1% for a limited period of two years from next April, while also introducing a new income-linked cash transfer scheme. In response, Komeito is calling for payments of approximately JPY80,000 per person over two years. The Democratic Party for the People proposes raising the resident tax allowance to JPY1.78mn, reducing taxes by approximately JPY50,000 per person annually. For those earning JPY1.78m or less annually who would not benefit from the tax cut, it proposes easing their burden through cash transfers. The Democratic Reform Association argues that a uniform payment of JPY40,000 per person should be provided, followed by the introduction of income-linked transfers. What do you think of opposition parties' counterproposals focusing on cash transfers?*

Our view: it looks as though opposition parties are taking positions that differ from the administration's policy in order to criticise it. In the previous Lower House election, most opposition parties advocated lowering the VAT rate. In the past, many opposition parties criticised cash transfers as inefficient handouts. In her policy speech to the current Diet session, PM Sanae Takaichi candidly pointed out: "It is essential to stimulate domestic investment, raise Japan's potential growth rate and sustain wage increases that outpace rising prices. However, it will take some time for sustained real wage growth to become firmly established". Rising food prices are pushing up inflation and placing a burden on the public. To ease the burden on households during this "period of time", her approach is correct: "We would like to reduce the tax burden on food and beverages, which are most closely connected to everyday life, and also provide income-based support payments to give households a little more 'breathing room'".

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Question 2: *One of the centrepieces of the Takaichi administration's expansionary fiscal policy is the VAT cut on food. However, PM Takaichi has not specified how the approximately JPY5trn in annual funding would be secured or how the new cash transfer scheme would be designed. This has fuelled concerns in the business community. Is there no need to worry about funding?*

Our view: there is ample funding. Tax revenue is increasing at a pace of approximately JPY6trn annually. Moreover, the Ministry of Finance has a bad habit of underestimating tax revenue, with underestimates amounting to approximately JPY9trn in recent years. These two sources alone amount to approximately JPY15trn. Furthermore, transferring realised gains from foreign exchange intervention to the general account would generate a surplus of several trillion JPY. Some argue that realised gains from foreign exchange intervention are small because they are calculated relative to exchange rate levels two months earlier. However, this comparison is merely based on the Ministry of Finance's internal rules. The foreign currency was actually purchased during earlier periods of JPY

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strength, so it would not be difficult to change the internal rules and transfer substantial realised gains to the general account.

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Question 3: *You have explained that government revenue is exceeding the estimates in the initial budget. What is supporting this increase in revenue?*

Our view: nominal GDP, which measures the size of the economy, had long grown at less than 1%, leaving the Japanese economy unable to expand. Consequently, tax revenue did not expand either. Against this backdrop, the former Democratic Party of Japan administration, which prioritised fiscal consolidation, introduced a funding rule in 2011 requiring new funding sources for all additional expenditure and tax cuts. This rigid rule, which does not reflect standard thinking internationally, has made it seem normal that funding must always be discussed whenever a policy is implemented. The standard approach is not to tie discretionary spending, which rises or falls through the budget process, to specific funding sources. Implementation is determined by whether a policy is necessary, rather than whether funding is available. Nominal GDP is now continuing to grow at between 3% and 4%. As a result, tax revenue has also increased substantially. Tax revenue is rising excessively relative to households' heavy living costs, so it is right to return excessive tax collections to the public through tax cuts.

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Question 4: *So tax revenue naturally increases as nominal GDP expands. What, then, is behind such large upward surprises in tax revenue?*

Our view: the Ministry of Finance assumes that a 1% increase in nominal GDP leads to a 1.2% increase in tax revenue. This is called tax revenue elasticity. However, actual tax revenue elasticity is estimated to be around 2.5. This gap is the source of the persistent underestimation problem. Given national and economic security concerns and intense global competition in industrial policy, Japan's economic situation is critical. Unless it expands investment and creates a "strong economy", defeat is inevitable. The debate over whether or not to invest is already outdated. We are at a stage where the public must come together to devise investment strategies that would create a "strong economy". At the October Growth Strategy Council meeting, I highlighted the problem that persistent underestimation of tax revenue is constraining the scope for policy action. This is because we must make full use of the power of policy and create a "strong economy" as soon as possible by expanding investment.

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Question 5: *Regarding eligibility for the income-linked transfers she aims to introduce from the next fiscal year, PM Sanae Takaichi has said that annual incomes of JPY1m to JPY3.5m provide "one reference point". The support payments scheduled to be introduced alongside the tax cut constitute a new scheme that would provide income-based cash transfers to "low- and middle-income workers" facing heavy tax and social insurance contribution burdens. However, the government has not indicated who would receive payments or how much they would receive. PM Takaichi has previously explained that similar schemes overseas cover around 30% of workers, which would translate into approximately 20m people in Japan. Where do you think the annual income threshold should be set for income-linked cash transfers?*

Our view: the administration's original intention for the VAT rate on food was to reduce it from 8% to 0%, rather than to 1%. However, it settled on 1% in consideration of the time available to adapt cash register systems. Had the National Council on Social Security accelerated its discussions, a reduction to 0% would likely have been possible. In practice, various forms of resistance prolonged the discussions and prevented a conclusion, leaving PM Takaichi to decide on the reduction in early August. In our view, it is reasonable to determine the coverage of cash transfers equivalent to the remaining 1% by comparing similar schemes overseas. This VAT rate reduction provides an opportunity to invest in more flexible cash register systems. VAT is described as a stable source of revenue, but this is precisely the problem: because revenue does not change significantly with economic conditions, it ends up destabilising the economy. This reduction would be an important first step towards reviewing the VAT rate flexibly in light of economic conditions to alleviate this problem.

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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

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

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Takuji Aida is a member of the Japan Growth Strategy Council

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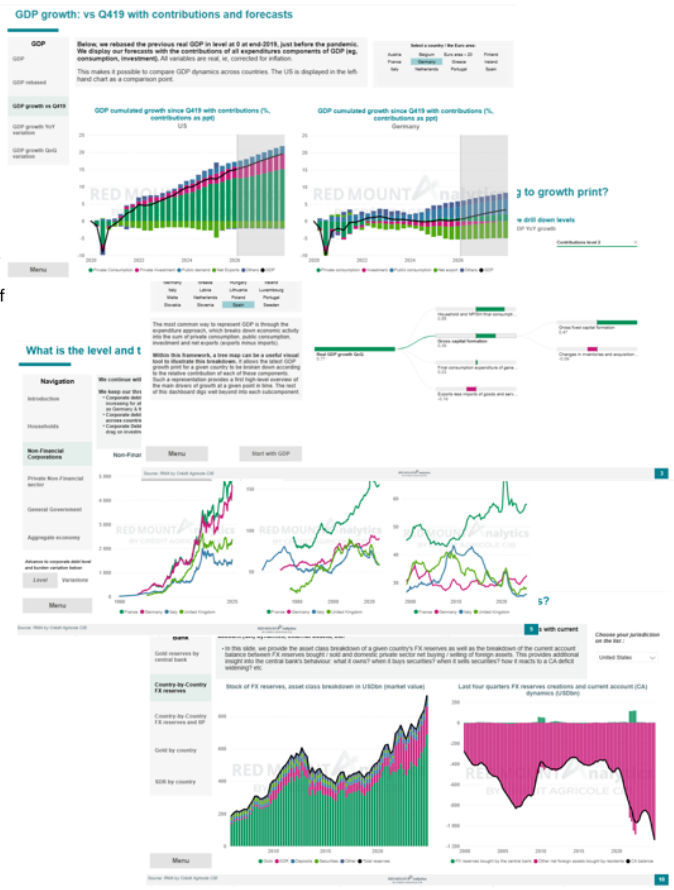
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