

Japan Viewpoint

Takaichi's fiscal policy: Options and key focus ahead

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Fiscal policy options up for debate

Following Sanae Takaichi's appointment as LDP president, the market expects the Japanese government to adopt expansionary fiscal policies; however, considerable uncertainty remains about the specifics of the policies up for debate, as well as the extent of the fiscal expansion. In this report, we draw on previous inter-party discussions and Takaichi's campaign promises to sum up the fiscal policy options that are on the table and where future discussions will focus.

Supplementary budget may edge up vs. FY24

Discussions on the FY25 supplementary budget, which will begin immediately after the new cabinet takes over, will likely focus on gasoline subsidies until the provisional gasoline tax is scrapped, local government grants, and investments in infrastructure and national security area. However, most of these (apart from gasoline tax subsidies) have been heavily funded in the past few years' budgets, and we therefore expect the FY25 supplementary budget to be only slightly larger than FY24's.

Bigger focus on tax reform discussion

Discussions on FY26 changes to Japan's tax system will likely focus on the Democratic Party for the People's (DPFP) calls for an increase in basic income tax deduction and the Japan Innovation Party's (JIP) demands for cuts to social insurance premiums. We also expect the debate on refundable tax credits to move ahead, but a conclusion is unlikely in the near term. We also expect discussions on raising defense spending and lowering the consumption tax to begin only in 2026.

Manageable impact from individual policies; combination could widen fiscal deficit

If only one of the fiscal measures is implemented or a few of them are implemented over time, we doubt that they would materially increase Japan's fiscal deficit, and would expect them to be offset by annual growth in tax revenues. However, the combination of these measures in a short period of time could widen the fiscal deficit. Key to watch is LDP leaders' and opposition parties' positions on fiscal spending from this autumn.

LDP: Liberal Democratic Party

CDP: Constitutional Democratic Party

JIP: Japan Innovation Party (Ishin)

DPP: Democratic Party For the People

Exhibit 1: Fiscal policy options up for debate from this autumn

Summary of fiscal policy measures that Japanese government is expected to discuss from this autumn

	Expected budget size	Expected time of implementation	LDP (Takaichi)	CDP	JIP	DPP
1) Scrap provisional gasoline tax	1.5tn	within 2025	✓	✓	✓	✓
2) Expand local government grants	~3tn	within 2025	✓	-	-	-
3) Increase basic income tax deduction	~7tn	FY2026?	✓	-	-	✓
4) Cut social insurance premiums	4-5tn	FY2026?	-	-	✓	-
5) Increase defense spending	6tn~	FY2027 onward	✓	-	-	-
6) Refundable tax credits	~5tn	takes multi years	✓	✓	✓	✓
7) Cut consumption tax	3-5tn	takes multi years	-	✓	✓	✓

Source: BofA Global Research, based on their election promises. * ✓ shows that the party pushes the policy measure.

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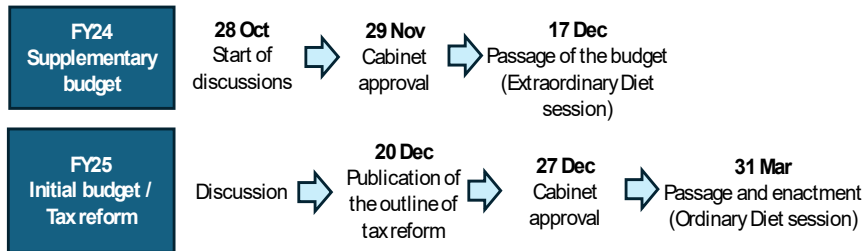
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Shift to procyclical fiscal policy, but scale unclear

Takaichi, who was elected LDP president on 4 October, is a well-known advocate of procyclical fiscal policy (see [Takaichi elected LDP president: Policy and market implications 05 October](#)). The market therefore expects a rise in government spending, but there is considerable uncertainty about which policies are likely to be implemented. We will be monitoring fiscal policy negotiations between the political parties, which will ramp up in earnest after the upcoming prime ministerial election (Exhibit 2)

Exhibit 2: Timeline of the fiscal debate in prior year

Inter-party fiscal policy negotiations will ramp up in earnest after the prime ministerial election



Source: BofA Global Research

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Policy options up for debate

Based on Takaichi's LDP leadership election promises and major opposition parties' policy platforms for the July Upper House election, we summarize below the fiscal policy options that are likely to feature in future discussions, and where the debate on them stands at this point (Exhibit 1).

1) Scrap provisional gasoline tax

The ruling and major opposition parties are likely to agree on scrapping the provisional gasoline tax within 2025, resulting in an annual tax cut of ¥1.5tn (0.2% of GDP; see [Another tax cut: Rising chance of gasoline tax cut from Apr '26 17 July](#)). However, the ruling coalition and opposition disagree about how to offset the resulting decline in tax revenue, with the LDP aiming to secure funding by raising corporate tax, taxation on financial income, and automobile taxes. Tax reforms would likely take effect from April 2026, but Takaichi has indicated her intention of using subsidies to lower prices until March, suggesting that the subsidies will likely be included in the supplementary budget.

2) Expand local government grants

Takaichi has advocated expanding local government grants to immediately address inflation. Depending on region, these could be used for SME or farming sector subsidies or to fund cash transfers to low-income households. While the amount involved is unclear, we estimate around ¥3tn (0.5% of GDP) based on the LDP's pledges during the Upper House campaign. However, the FY24 supplementary budget under the Ishiba administration also included ¥1.7tn for this item, and only the excess versus this figure would represent additional fiscal spending.

3) Increase basic income tax deduction

The DPFP has for some time advocated increasing the basic income tax deduction, and discussed it with the LDP-Komeito coalition during last year's budget negotiations (see [Fiscal policy debates deadlocked under minority government 23 December 2024](#)). In December 2024, the coalition and DPFP agreed to raise the annual income barrier, a policy which Takaichi also supports.

Last year, the DPFP argued for a ¥7.6tn tax cut (1.2% of GDP), but the actual figure was ultimately only around ¥1.2tn (see [Amended FY25 budget should not require more JGB issuance 27 February](#)). The DPFP is likely to advocate a similar figure in 2025, and the focus will be how much of the implied additional ¥6.4tn cut (1.0% of GDP) the LDP is prepared to accept.



4) Cut social insurance premiums

The JIP is pushing for cuts to social insurance payments, and has cited agreement on this and its "vision for the second capital" (in which Osaka would supplement Tokyo as Japan's second city) as conditions for joining the LDP-Komeito coalition. In its Upper House election manifesto, the JIP claimed that social insurance reforms could reduce annual healthcare costs by ¥4tn, which it would use to fund cuts in working households' social insurance premiums. The additional fiscal cost would depend on how much medical costs fell, but assuming the government targeted only a reduction in social insurance premiums, this would reduce tax revenue by up to ¥4tn (0.6% of GDP).

5) Increase defense spending

The US is demanding that Japan increase its defense spending from the current 2% of GDP to 3%, and Takaichi has also indicated that she favors spending more on defense (a 1ppt increase would equate to ¥6.4tn). However, we think discussions on increasing spending are unlikely to make much headway during this year's budget discussions. Given the ongoing Defense Buildup Program for the five years through FY27, we doubt that any discussions on moving up an increase in spending will take place until autumn 2026 at the earliest (see [Defense spending back in spotlight 10 March](#)). Meanwhile, the government already plans to raise the corporate tax rate by 4ppt from April 2026 to fund the previous increase in defense spending.

6) Refundable tax credits

Refundable tax credits were the main pillars of Takaichi's leadership campaign promises, but they were already part of the Constitutional Democratic Party of Japan's (CDP) platform in the Upper House race and the subject of recent discussions between the LDP-Komeito coalition and CDP. The CDP's most recent proposal is budgeted at roughly ¥3.6tn (0.6% of GDP). However, we think it would take at least a few years to structure the scheme, and Takaichi has also stated that it will not be possible to implement it in 2025-26. We expect deliberations to continue, but see an impact on the fiscal balance as unlikely over the next several years.

7) Cut consumption tax

All the major opposition parties included consumption tax cuts in their Upper House election promises and Takaichi also advocated them in May, but she took a more cautious position during the LDP leadership race on the grounds that a cut would have little immediate effect. Eliminating the consumption tax only for food would reduce tax revenue by ¥2tn-5tn (0.3-0.8% of GDP), but we see a full-blown debate on the subject as part of this autumn's tax system negotiations as unlikely (see [Consumption tax cut FAQs: Easier said than done 28 May](#)). Major opposition parties have also recently toned down their rhetoric on consumption tax cuts.

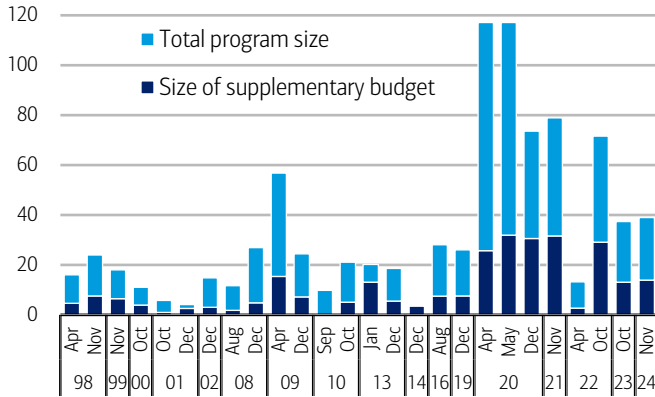
Near-term focus: Supplementary budget could edge up

Discussions on the FY25 supplementary budget will begin immediately after a new PM is elected; we expect it to mainly feature gasoline tax subsidies and an increase in local government grants. As per budgets through last year, we think another main component will be investments in infrastructure and the area of national security (including semiconductors). However, most of these (apart from gasoline tax subsidies) have been heavily funded in the past few years' budgets. Despite considerable uncertainty at this point, we therefore expect the FY25 supplementary budget to be only slightly larger than FY24's ¥13.9tn (for the general account).



Exhibit 3: Past economic stimulus measures (¥tn)

The size of FY24 supplementary budget was ¥13.9tn



Source: BofA Merrill Lynch Global Research, CAO, MoF, Nikkei QUICK

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Exhibit 4: Expenditure breakdown of FY24 supplementary budget

Local government grants, and investments in infrastructure and the national security field were also heavily funded in prior year's supplementary budget

Expenditure breakdown	Budget size (¥tn)
1) Growth strategy	5.8
- Building environment for wage growth	0.9
- Regional revitalization	1.8
(of which local government grants)	0.8
- Industry promotion	3.0
2) Anti-inflation measures	3.4
- Local government grants	1.1
- Energy subsidies (electricity, gas, gasoline)	1.4
3) Securing safety	4.8
- Restoring from disasters	0.7
- Infrastructure investment	2.0
- Diplomatic policy, national security	1.4
Total	13.9

Source: BofA Global Research, Cabinet Office

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Bigger focus is tax reform debate

FY26 tax system reforms and inter-party discussions on Japan's longer-term tax regime will be more important in gauging the scale of procyclical fiscal policy under Takaichi's leadership. With the ruling coalition continuing to govern as a minority, the key factor in the fiscal balance outlook from FY26 will be to what extent it accepts the DPPF's proposal to lift the basic income tax deduction (which would reduce tax revenue by up to ¥7tn) and/or the JIP's proposed reduction in social insurance premiums (up to ¥4tn).

Elsewhere, refundable tax credits and higher defense spending would have a major impact if implemented, but we see the debate as unlikely to make much headway over the next six months and expect little immediate fiscal impact.

Manageable impact from individual policies; package would widen fiscal deficit

If the government were to go ahead with the maximum proposed increase in the basic income tax deduction without securing offsetting sources of funding, we estimate a roughly 1ppt increase in the annual budget deficit as a percentage of GDP (1.2ppt including the gasoline tax cut). The IMF's fiscal balance forecast (as of April) posits an increase in deficit from 3.1% of GDP now to around 4.3% in 2026 (Exhibit 5).

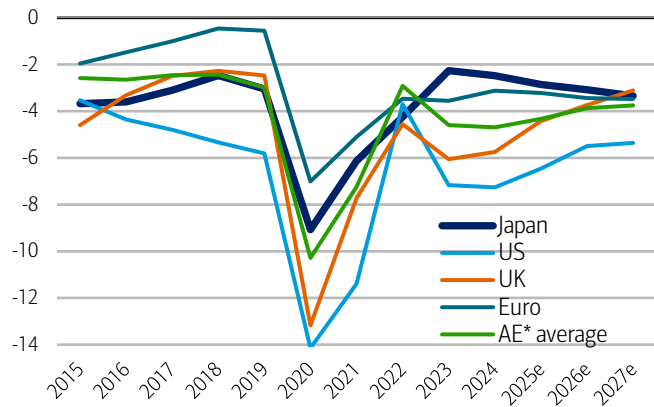
However, this would not make Japan an outlier versus other major developed nations that are adopting increasingly procyclical fiscal policy. Japan's tax revenues from consumption, income, and corporate taxes have risen over the past several years due to inflation, wage hikes, and the boost to corporate earnings from the weaker yen, increasing overall government tax receipts by around ¥3tn on average per year. If any of the above multi-trillion yen tax cuts or fiscal policy measures were implemented individually or over time, growth in tax revenue over the next several years (assuming inflation continues) would offset most of the negative impact on government finances.

The greatest risk is that the government opts to bring in several of these policy options in a short space of time, resulting in a drastic increase in budget deficit as tax revenue growth fails to offset the impact. While we do not see this as a significant risk at this point, we will be watching LDP leaders' and opposition parties' positions on fiscal spending from this autumn.



Exhibit 5: Fiscal balance (% of GDP, IMF estimate)

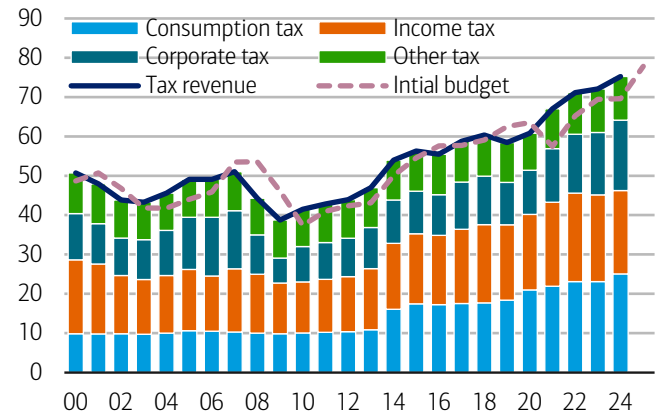
Japan's fiscal deficit has recently been contained relative to other DMs



Source: BofA Global Research, IMF Fiscal Monitor in April 2025 *Advanced Economies
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Exhibit 6: Central government's tax revenue (JPYtn, FY)

Government tax revenue has increased by around ¥3tn on average per year



Source: BofA Global Research, MoF
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Exhibit 7: Takaichi's policy proposals and key comments

She advocates an expansionary fiscal stance and stronger efforts in national security, while remaining cautious about BoJ's rate hikes

Policy area	Main proposals
Fiscal policy/tax cuts	"Responsibly aggressive" fiscal policy, will issue deficit-financing bonds if necessary Scrap provisional gasoline/diesel taxes Consider "tax deduction with cash transfers" Supports raising "annual income barrier" (=minimum income subject to income tax) Not rule out consumption tax cut on food, but prioritizing other policies given lack of immediate implementation Expand cash transfer to local governments to support households
Monetary policy	Government responsible for fiscal and monetary policy while BoJ decides monetary policy measures Close dialogue with BoJ aimed at "demand-pull" rather than "cost-push" inflation
Industrial policy	Expand tax incentives/subsidies to protect SMEs/small business owners, encourage wage hikes/capex Aggressively invest in growth areas essential to economic security Make start-up tax cuts permanent
Energy policy	Restart nuclear power plants Quickly introduce innovative next-generation reactors/fusion reactors
Foreign policy	Comply with Japan-US agreement, continue robust debate on investments in US Enhance US-Japan relation, stronger relationships with Korea, Australia and Philippines, expand CPTPP membership
Defense/national security	No specific defense spending targets (as % of GDP) at this point Will revise Japan's national security/defense strategy and defense buildup program Develop technology/personnel capable of responding to sophisticated cyberattacks Establish "national intelligence agency", begin work on anti-espionage law Strengthen food security, promote agricultural/food exports Develop backup for Tokyo's crisis management functions
Social security policy	Support for generation affected by 1990s-2000s job market "ice age" Support for low-income households Earlier revision of medical/nursing care fees to reflect inflation/wage hikes
Policy on foreign nationals	Stricter controls on foreign investment in Japan Strengthen centralized administrative function to respond to issues involving foreign nationals Step up response to visa overstayers, consider restrictions on land purchases
Party politics	Keen to expand coalition to include parties that share same basic views Opposes dissolving Lower House in near future Involvement in political funding issue will not affect choice of cabinet members

Source: LDP, media reports



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