

C onsumption tax pause would be ill-advised

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Executive Summary



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The LDP is seeking to suspend the consumption tax on food and beverages for two years. Such a tax pause would do little to stimulate the economy or bolster living standards. Other drawbacks include a lengthy implementation lag, funding constraints and a risk of undermining confidence in social security programs' fiscal sustainability. Refundable tax credits, a more potent approach to mitigating inflation, should be prioritized over a consumption tax pause.

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Consumption tax pause would not deliver much economic stimulus

Japan's Liberal Democratic Party (LDP) scored a stunning landslide victory in the 8 February Lower House election under the leadership of Prime Minister Sanae Takaichi. During the election campaign, the LDP pledged to fast-track a two-year suspension of the 8% consumption tax on food and beverages. The LDP began discussing such a consumption tax moratorium at the National Council on Social Security's recent inaugural meeting, to which even opposition parties were invited. With middle- and low-income households feeling pinched by Japan's historic inflation of recent years, it was only a matter of time before politicians addressed this issue as a priority.

However, the anti-inflationary tax pause's stimulus effect on real GDP is estimated at a mere +0.22% over one year. The pause would reduce a four-person household's annual food bill by only about ¥67,000, not enough to adequately support middle- and low-income households' standard of living.

To protect middle- and low-income households from inflation, Japan urgently needs tax and social security reforms that offer flexible adaptability to changes in environment. One reform that could fully meet this need is refundable tax credits, an idea that the Takaichi Government is commendably pursuing as the centerpiece of its anti-inflation policy agenda. However, because the tax credits will take a while to implement, the government is pursuing the consumption tax pause as an interim measure.

Drawbacks of consumption tax pause as interim measure

However, the proposed consumption tax pause has serious drawbacks as an interim measure. Based on the timelines of previous changes in the consumption tax rate, the consumption tax pause would likely require some 18 months of pre-implementation preparations (e.g., for retailers to update their point-of-sales systems) once the Diet has passed the requisite legislation. The pause would likely not take effect until two years from now. The inflation rate and real wage growth rate are hard to forecast so far in advance. There is no assurance that inflation will still be elevated in two years.

Meanwhile, PM Takaichi has indicated she intends to fund the consumption tax pause at ¥5tn per year without resorting to issuance of deficit JGBs. She mentioned three potential funding sources: nontax revenues, subsidy cuts and discontinuation of special tax incentives. However, nontax revenues such as BOJ remittances to the National Treasury and proceeds from government asset sales are already committed to funding other budgeted expenditures. They cannot properly be treated as a new funding source. Corporate subsidies and special tax incentives currently total an estimated ¥8tn per year. Scaling them back by ¥5tn to fund the consumption tax pause is unlikely to be politically feasible.

Financial markets are concerned that the government may move forward with the consumption tax pause without being able to fully fund it, resulting in further fiscal deterioration. In such an event, confidence in Japan's fiscal policy and currency would likely diminish, leading to yen depreciation and a JGB market drawdown (rise in long-term interest rates). Higher long-term rates and inflation driven by yen depreciation would eventually crimp the public's standard of living. In other words, a policy intended to bolster the public's standard of living may perversely end up doing the opposite.

Consumption tax pause may also impair confidence in social safety net

Even if the government is able to fully fund the consumption tax pause, the resultant loss of consumption tax revenue would be problematic because the consumption tax is designated as social security programs' predominant funding source. In the government's proposed FY26 budget, national social security expenditures were budgeted at ¥39.1tn while the national government's share of

consumption tax revenue was budgeted at ¥26.7tn, more than ¥12tn below social security spending. If consumption tax revenue is reduced when it actually needs to be increased to support social security programs, problems could ensue.

The consumption tax is not an earmarked tax, meaning that consumption tax revenue is not statutorily restricted to being used for a designated purpose. As a result, social security expenditures are not automatically reduced if consumption tax revenue decreases. However, a reduction in consumption tax revenue, the primary source of funding for social security programs, could cause the public to worry that social security programs may someday become unsustainable or have to substantially reduce (e.g., pension) benefits. If so, mounting anxiety among the public could adversely affect consumption activity.

One reason that the consumption tax was designated as the main funding source for social security is that consumption tax receipts are less variable than corporate or individual income tax receipts and therefore a more stable funding source for social security expenditures projected to steadily grow year after year. Another reason is the belief that social security programs merit broad intergenerational support as pillars of the welfare state. If the government goes ahead with a big consumption tax cut, social security expenditures would likely have to be increasingly funded by other taxes, such as corporate or individual income taxes. Shifting the social security funding burden onto businesses would not be appropriate. If the funding gap created by a consumption tax pause were to be plugged solely by individual income taxes, working-age generations may end up overburdened tax-wise.

Anti-inflation policy should combine tax and social security reforms

The proposed consumption tax pause seems ill-advised given its numerous drawbacks and limited stimulus effect as discussed above. Japanese households, particularly those in the middle- and low-income groups, have been hard hit by the historic inflation of the past several years. The crux of the problem is that Japanese institutions such as the tax code, social security programs and wage setting mechanisms have failed to flexibly adapt to the inflationary environment. Such institutions should promptly be reformed drastically. One promising reform, which happens to be supported by most Japanese political parties, is implementation of refundable tax credits. Refundable tax credits would be a flexible means of

bolstering middle- and low-income households' standard of living and protecting their real incomes from future changes in the environment such as consumer price volatility.

In light of such, the government should prioritize refundable tax credits over a consumption tax pause to combat inflation more effectively. In fact, the National Council on Social Security, invitees to which include opposition parties in favor of refundable tax credits, may be inclined to give precedence to refundable tax credits over a consumption tax pause on its discussion agenda. If an interim anti-inflation measure is needed until refundable tax credits are implemented, cash benefits targeted exclusively at low-income households would be more appropriate than a consumption tax pause.

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