

Fiscal Discipline: The Prerequisite for “Responsible and Proactive Fiscal Policy” — Budgetary Reform, New Consolidation Indicators, and Strengthening Oversight Functions —

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<Summary>

- ◆ **The Fiscal Landscape:** The General Account Initial Budget for Fiscal Year (FY) 2026 has reached ¥122 trillion. While new government bond issuance has been maintained below the ¥30 trillion threshold for the second consecutive year, recent trends offer no guarantee against substantial mid-year expansions via Supplementary Budgets. The accelerating rise in interest rates is a clear manifestation of market vigilance regarding Japan’s fiscal management.

- ◆ **The Foundation of Market Confidence:** Maintaining market confidence is paramount. Demonstrating a steadfast commitment to Fiscal Consolidation is the baseline for national crisis management. The transition from "excessive austerity" to a "Responsible and Proactive Fiscal Policy" paradoxically demands even more rigorous fiscal discipline.

- ◆ **Key Proposals:**
 - (1) Budgetary Reform
Establish multi-year investment plans for 17 priority areas, prioritizing projects based on maturity and securing dedicated "slots" in the Initial Budget. This will enhance predictability and limit Supplementary Budgets to genuine, unforeseen global shocks or disasters.

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(2) Expenditure Reform

Conduct a thorough review of Special Taxation Measures and subsidies, eliminating those with low efficacy. Leverage regulatory and administrative reform to curb spending growth while protecting essential services.

(3) Strengthening Credibility

Set a hard ceiling on the total volume of new debt issuance through FY2030 as a new consolidation metric. Establish an Independent Fiscal Institution (IFI), ensuring its independence by requiring Diet approval for its leadership.

- This is a English version of “「責任ある積極財政」でこそ必要となる財政規律 — 予算制度改革、新たな健全化指標、評価・監視機能の強化 —” in JRI Research Focus (The original version is available at <https://www.jri.co.jp/MediaLibrary/file/report/viewpoint/pdf/16535.pdf>)

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1. Why "Responsible and Proactive Fiscal Policy" Demands Heightened Discipline

Public scrutiny of Japan's fiscal management has reached a critical juncture. Long-term debt (national and local) is projected to reach ¥1,335 trillion by the end of FY2025. Although the debt-to-GDP ratio is showing a marginal decline, it remains stubbornly close to 200%. Looking ahead, Japan faces a surge in mandatory spending driven by (1) social security costs for an aging population and (2) rising Debt Servicing Costs in an environment of increasing interest rates. Simultaneously, the government must secure funding for critical priorities: (3) raising defense spending to 2% of GDP, (4) free education initiatives, (5) tax burden relief, and (6) "crisis management and growth investments" for future prosperity.

While economic growth could yield tax revenue growth driven by nominal economic expansion and reduce the debt-to-GDP ratio by expanding the denominator, complacency is a luxury Japan cannot afford. Several structural headwinds—long-term demographic decline, fiscal rigidity caused by mandatory spending, and the necessity of maintaining "fiscal space" for security or disaster risks—mandate a relentless commitment to structural reform on both the revenue and expenditure sides.

The current administration has defined its economic compass as "Responsible and Proactive Fiscal Policy." For FY2026, the General Account Initial Budget stands at ¥122 trillion. Although new bond issuance is capped below ¥30 trillion for the second year, the Initial Budget has grown for the first time in five years. Furthermore, the FY2025 Supplementary Budget added approximately ¥12 trillion in new debt to the initial plan. Given the post-pandemic tendency toward massive Supplementary Budgets, there is no assurance that the FY2026 debt cap will hold. The recent acceleration in interest rate hikes serves as a warning shot from the markets regarding this fiscal trajectory.

The sustainable level of government debt is a moving target influenced by global market conditions. However, as the debt pile grows, the foundation of market trust becomes more fragile and prone to volatility. Implementing a framework for fiscal consolidation is not merely an accounting exercise; it is essential crisis management. To pivot from "excessive austerity" toward a truly "responsible and proactive" stance, the government must demonstrate a level of discipline that exceeds past standards.

2. Challenges to Enhancing Fiscal Discipline

(1) Issues Relating to the Budget Compilation Process

① The Normalization of Massive Supplementary Budgets

In recent years, the recourse to large-scale Supplementary Budgets has become normalized, raising fundamental doubts about whether total annual fiscal expenditure is being effectively controlled. Under the current budget compilation process, the "Guidelines for Budget Requests," approved by the Cabinet in early August, sets the direction only for the General Account Initial Budget of the following fiscal year. Similarly, the "Basic Principles of Budget Compilation," finalized in early December, refers to the concept of a "15-month budget" (integrating the current year's supplementary and the following year's initial budgets), yet its substance remains overwhelmingly focused on the Initial Budget.

Furthermore, the "Economic and Fiscal Projections for Medium to Long Term" (hereafter "Medium-to-Long-Term Projections") released by the Cabinet Office in summer and winter provides a decade-long outlook based primarily on budgets already compiled at that stage.¹ Consequently, as autumn Supplementary Budgets become a fixture, the summer projections fail to account for them, and even the winter projections do not assume a Supplementary Budget for the following fiscal year.

This process rigorously suppresses total expenditure and New Government Bond Issuance in the Initial Budget. However, against a backdrop of structurally increasing social security costs due to an aging population, non-social security spending is inevitably squeezed. This creates a reactive pattern where such expenditures are subsequently "topped up" via Supplementary Budgets as a regular occurrence.²

The pitfalls of this reliance on Supplementary Budgets are manifold: shorter deliberation periods in the Diet and a lack of transparency regarding the breakdown of expenses by department, compounded by the uncertainty of multi-year continuity. In some cases, the scale of expansion is so significant that additional allocations far exceed the Initial Budget for certain items and departments.³ Ultimately, this calls into question the appropriateness of both the total scale and the allocation of fiscal spending when viewed in its entirety.

② The Impact of Rising Interest Rates and Inflation

The recent transition to a "world with interest rates" has led to an increase in Debt Servicing Costs. This rise, alongside growing social security obligations, risks inducing "fiscal rigidity" (budgetary inflexibility), which may further encourage the normalization of large Supplementary Budgets. As debt-servicing trends gain unprecedented importance in future fiscal management, it is essential to rigorously examine and debate the maturity structure of the debt stock—a topic hitherto largely neglected in policy discourse.

Furthermore, recent inflation is driving up the costs of providing administrative services. To prevent a real-term decline in the quality of public services, it is indispensable to reflect inflationary pressures in official prices (such as medical and nursing care fees), standard amounts for public systems, and procurement prices. Conversely, any real increase in public services — excluding the portion for price pass-throughs — must be carefully scrutinized for its validity. This requires a clear distinction between the impact of price hikes and real expenditure growth. At present, however, it remains difficult to discern these separate impacts on total expenditure, even within the "framework budgets" (multi-year spending frameworks) for healthcare, nursing care, and defense.

③ Securing Stable Investment Resources for the 17 Priority Areas

As fiscal rigidity intensifies and pressures non-social security resources, securing stable public and private investment resources for the "17 Priority Areas" (strategic sectors) for future growth remains a critical challenge. If such resources are haphazardly funded via annual Supplementary Budgets, it not only raises doubts about the efficient use of limited funds but also obscures multi-year expenditure trends and project progress, potentially

¹ However, some projections based on established plans, such as national resilience and defense capability strengthening, are incorporated.

² Since the COVID-19 pandemic, large supplementary budgets have continued even in "normal" times, with additional allocations exceeding ¥10 trillion annually since FY2023. Prior to the pandemic, such additions only exceeded ¥10 trillion twice: in FY2009 (post-Lehman shock) and FY2011 (post-Great East Japan Earthquake).

³ For example, in the FY2025 Ministry of Economy, Trade and Industry budget, the initial ¥0.85 trillion was increased to ¥3.06 trillion. Excluding Special Account transfers, the General Account portion rose from ¥0.35 trillion to ¥2.37 trillion—an addition of approximately ¥2 trillion.

detering private-sector investment.

④ Short-term Technical Maneuvers and the Deferral of Stable Funding

During the annual budget compilation, the government frequently resorts to ad-hoc, short-term technical transfers between accounts (inter-account transfers) to suppress the deficit in the General Account.⁴ However, the focus of restraint should properly be on the consolidated deficit and debt stock of both the national (General and Special Accounts) and local governments.

Simultaneously, stable funding for many recently expanded policies remains unconfirmed. For instance, much of the defense spending hike relies on Settlement Surpluses and non-tax revenues, which are inherently unstable. Regarding free compulsory education, significant amounts remain under "continuous review," alongside funding related to the abolition of the provisional tax rate on gasoline. Future discussions on "consumption tax cuts" or "refundable tax credits" also lack designated funding; these require deliberate consultation within the "National Council on Social Security Reform."

(2) Challenges Regarding Mid-to-Long-term Consolidation Plans and Verification

① Uncertainty of Stable Debt-to-GDP Reduction Targets

Regarding mid-to-long-term Fiscal Consolidation targets, the focus has historically been on (i) achieving a Primary Balance (PB) surplus for the national and local governments, and (ii) a subsequent stable reduction of the debt-to-GDP ratio. Under the Takaichi Administration, the goal is to "keep the growth rate of debt within the growth rate of the economy and stably reduce the government debt-to-GDP ratio."⁵

However, it must be noted that it is extremely difficult for the government to control private sector activity, which accounts for roughly 75% of nominal GDP. Furthermore, should the economy deteriorate, the continued application of this rule could inadvertently exacerbate the downturn. There is a risk that the rule itself could become a mere formality if it is too easily relaxed under political pressure.

② Future Impact of Fiscal Spending and Tax Reforms

It is imperative to demonstrate that annual fiscal management aligns with fiscal consolidation targets. Simultaneously, the government is required to provide a comprehensive and objective outlook on the impact on future economic growth, tax revenue, and the lives of citizens. This includes (i) the impact of growth investments on future economic expansion and revenue, and (ii) the potential "crowding out" effect, where fiscal deficits impact future private investment through interest rate fluctuations.

⁴ In the FY2026 budget, ¥0.7 trillion of the debt balance in the Local Allocation Tax Special Account was transferred to the General Account, while the transfer from the General Account to the Special Account was reduced by the same amount, thereby suppressing new bond issuance. (Doi, Takeo. "Proactive yet Restrained in Bonds: The Deep Strategy of the Ministry of Finance," *Toyo Keizai Online*, Dec 27, 2025).

⁵ Policy Speech by Prime Minister Takaichi to the 221st Session of the Diet (Cabinet Decision, Feb 20, 2026).

3. Measures for Strengthening Fiscal Discipline

To pursue a "Responsible and Proactive Fiscal Policy" while maintaining market confidence, the government must simultaneously strengthen fiscal discipline through the following three initiatives.

(1) Budgetary System Reform: Multi-year Appropriations and Prioritization

① Multi-year Investment Plans

For the 17 priority areas of "Crisis Management and Growth Investment," a multi-year budgeting system should be introduced. After formulating a five-year "Public-Private Multi-year Investment Plan," the government should set a multi-year expenditure framework for the public burden — encompassing the General Account, Fiscal Investment and Loan Program (FILP), Special Accounts, and government guarantees—and secure this as a dedicated "slot" within the Initial Budget. Progress and outcomes, including regulatory reforms, must be verified annually by a third-party committee.

② Prioritization

To avoid indiscriminate spending, prioritization must be applied based on the maturity of investment plans and the strength of private-sector commitment. Furthermore, stable funding sources that do not rely on Deficit-financing Bonds must be secured—following the precedents of the "GX" Economy Transition Bonds.⁶

③ Restricting Supplementary Budgets

This mechanism will enhance predictability, allowing Supplementary Budgets to be strictly limited to responding to unforeseen global economic shocks or large-scale disasters.

④ Transparency

To ensure the "Guidelines for Budget Requests" are reflected in actual spending, the government should disclose the post-initial expenditure profile and the total expenditure profile (including supplementary additions) using the categories established in the Guidelines.⁷⁸

⑤ Inflation Adjustment

The impact of inflation on official prices should be continuously surveyed by the "Office for the Review of Special Taxation Measures and Subsidies" (established in November 2025) and reflected in the budget.

⁶ "GX" (Green Transformation) aims for over ¥150 trillion in public-private investment, with ¥20 trillion in "GX" Economy Transition Bonds to be redeemed by 2050 via carbon pricing. The AI/Semiconductor framework targets over ¥50 trillion in investment, with ¥10 trillion in public support funded by FILP, GX bonds, and Special Account bonds.

⁷ For the FY2026 budget: Pensions/Healthcare, Defense buildup, Discretionary spending, Mandatory spending, Local allocation tax, and Debt servicing.

⁸ Improving fiscal statistics to allow easy comparison between initial and supplementary budgets is also essential.

⑥ Fiscal Integrity

The government must abandon short-term technical transfers between accounts and commit fully to securing stable, long-term funding.

(2) Thorough Expenditure Reform

In addition to a rigorous review and reduction of ineffective Special Taxation Measures and subsidies, the government should reorganize the delivery of administrative services. Maintaining essential services while containing spending growth requires advancing regulatory and administrative reforms, including the digitalization of government (ICT), the utilization of private companies and NPOs, and the "regionalization" of services beyond traditional municipal borders to achieve economies of scale.

(3) Strengthening Credibility: Debt Caps and Enhanced Oversight

① New Debt Issuance Caps

Given the surge in Debt Servicing Costs, the government should set—and update annually—a new fiscal consolidation indicator: a multi-year ceiling on the total volume of New Government Bond Issuance through FY2030 (excluding emergency responses).⁹

② Enhanced Projections

The "Medium-to-Long-Term Projections" should highlight this new indicator and provide outlooks for both upside and downside growth scenarios.

③ Independent Fiscal Institution (IFI)

Japan must join the 29 other OECD nations that have established IFIs.¹⁰ As a first step, the government should "pre-emptively" apply IFI functions by establishing a third-party committee to evaluate investment plans and having the Council on Economic and Fiscal Policy (CEFP) provide robust recommendations based on debt sustainability analyses. As a subsequent step, a formal Independent Fiscal Institution should be established. Models include the legislative branch model (e.g., U.S., Canada)¹¹ or the executive branch model (e.g., U.K., France).¹² While domestic proposals often favor the House of Councilors¹³, an executive-led model is also a viable option. To ensure impartiality, the head of the IFI should be subject to Diet approval.¹⁴

⁹ This should account for the redemption pace of government debt. By considering the relationship between interest rates and nominal growth ($r > g$ or $r < g$), the required PB surplus or acceptable PB deficit over multiple years can also be calculated.

¹⁰ According to data from the OECD's 2021 survey, 29 out of 38 member countries have established an IFI to provide objective evaluations of fiscal management.

¹¹ Legislative IFIs ensure independence from the executive, allowing for cost estimation of opposition policies, though they risk entanglement in partisan conflict.

¹² Executive IFIs can easily reflect evaluations in budget compilation but risk "optimism bias" if independence is not secured.

¹³ For instance, the Japan Association of Corporate Executives (Keizai Doyukai) [2019], in its report titled "Establish an Independent Fiscal Institution for Future Generations—Toward Building a Society that Views the Future from Multiple Perspectives—", proposed the establishment of an "Economic and Fiscal Projections and Validation Committee (tentative name)" under the House of Councilors. This committee would be tasked with providing medium-term economic, fiscal, and social security projections, as well as validating compliance with fiscal targets and rules.

¹⁴ In the U.K., the Chair of the Office for Budget Responsibility (OBR) is appointed by the Chancellor with the consent of the Treasury Select Committee. In France, the High Council of Public Finance (HCFP) ensures independence through diverse appointments by the heads of both houses of Parliament and the Court of Audit.