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Balancing Industrial Policy and Fiscal Sustainability

― Selection and Combination of Policy Instruments for Sustained Support ―

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〈Summary〉

- Sustaining necessary investment requires clarity on the duration and form of industrial support, the conditions for review, the division of burdens between the public and private sectors, and future budgetary needs. With the submission of budget requests for FY2027 now complete, how to support the 17 strategic fields of Japan's Growth Strategy has become a central issue in budget formulation. The government has established a "Strong and Prosperous Japan" Investment Framework, and aims to expand private investment and supply capacity through support based on multi-year plans, thereby pursuing a more ambitious industrial policy.
- The selection and combination of policy instruments should reflect the factors that hinder investment and the stages of business development. The World Bank emphasizes choosing policy instruments according to government bandwidth, local market size, and fiscal space, and prioritizing public inputs such as basic infrastructure development. It also stresses discipline, i.e., reviewing support according to outcomes, and highlights the importance of withdrawing support. Meanwhile, Mazzucato and others present the idea of securing fiscal space by rethinking government procurement, returning profits from successful projects, and establishing institutions that support long-term investment. In Japan, too, while public inputs to correct market failures should be prioritized, it will be necessary to utilize not only subsidies, but also equity investment, loans, guarantees, public procurement, and regulatory and institutional reforms as appropriate. Additional fiscal burdens should be curtailed through the use of private-sector finance and recouped profits.

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◆ Putting these principles into practice requires policy outcomes and fiscal burdens to be assessed together. Expenditures with limited outcomes should be reduced or terminated, and the resources freed up, along with recouped profits, should be allocated to necessary investment. In doing so, policy outcomes and the recouping of public funds should be evaluated separately. Growth investment should emphasize productivity and value added, and crisis-management investment should emphasize the avoidance of losses from supply disruptions and other events. Decisions on whether support is required should not be made solely on the basis of profitability. At the same time, medium- to long-term fiscal projections that incorporate contributions to growth and tax revenue, as well as increases in additional expenditures and interest payments, will need to be updated regularly. Future increases in tax revenue and the recouping of investment should not be regarded as guaranteed, and assessments of individual projects and the fiscal outlook for the government as a whole should be reflected in budget formulation.

● **This is an English version of "産業政策と財政の持続可能性の両立 ― 持続的な支援に向けた政策手段の選択と組合せ ―" in JRI Research Focus (the original version is available at https://www.jri.co.jp/MediaLibrary/file/report/researchfocus/pdf/17027.pdf).**

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1. Introduction

In developed countries in recent years, industrial policy has once again been positioned at the center of economic policy. Behind this is heightened awareness of supply-chain vulnerabilities, stemming from the COVID-19 pandemic and geopolitical tensions. This has increased the need to secure essential goods and technologies in a stable manner. Similarly, in the areas of decarbonization and advanced-technology development, government support for investments that are difficult for firms to undertake alone is expanding (IMF [2025]).

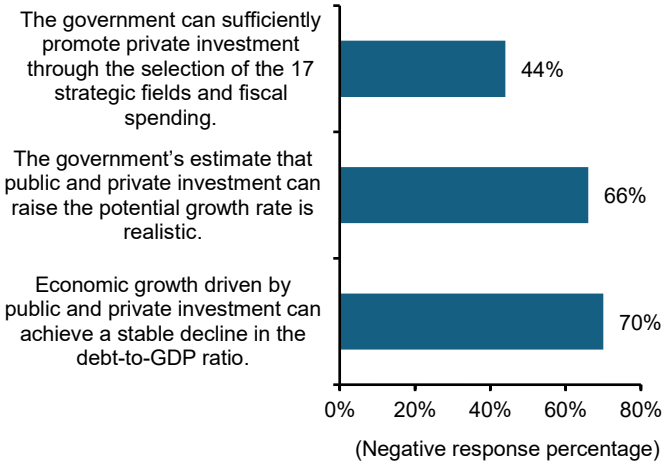
To support industrial policy over the long term, "fiscal space," i.e., the ability to secure necessary funding without undermining fiscal sustainability, is essential. An OECD [2026] comparison of 20 countries found that support through subsidies and tax-burden reductions increased from 2019 to 2023, and that many programs are long-standing, having been introduced in or before 2019. To prepare for long-term support, mechanisms that do not rely solely on additional fiscal burdens are required.

The Japanese government is seeking to advance an ambitious industrial policy by embedding substantial support, centered on economic security, in its growth strategy (Nogimori, Inoue, and Paterson [2026]). The strategy, which aims to strengthen supply capacity through public-private investment, is beginning to take shape in the FY2027 budget process. "Japan's Growth Strategy," approved by the Cabinet on July 21, projects cumulative public-private investment of over 370 trillion yen by FY2040 across 17 fields and 62 key products and technologies (Cabinet Secretariat [2026a]). In September, budget requests for the "Strong and Prosperous Japan" Investment Framework were announced, and the government indicated that it intends to scrutinize multi-year plans and predicted investment outcomes during the budget-formulation process (Ministry of Finance [2026b]).

Experts are divided as to the likely effectiveness of Japan's Growth Strategy. In a survey of economists by the Japan Center for Economic Research [2026], many respondents doubted that the strategy's expansion of public-private investment would raise potential growth and steadily reduce the debt ratio, as the government assumes (Figure 1). At the same time, even respondents who agreed with the government's estimate of the potential growth rate pointed to the need for continuous verification of the strategy's outcomes. Concerns have also been raised about implementation, including the impact of large-scale fiscal spending on fiscal sustainability (Armstrong and Urata [2026]).

This paper examines how the selection and combination of policy instruments can create fiscal space for sustained industrial support. Drawing on the World Bank's framework for

Figure 1. Economists' Negative Assessment of Japan's Growth Strategy



Source: Prepared by JRI based on Japan Center for Economic Research [2026]
Note: 50 economists were surveyed from July 15 to 21, 2026. Total of "Disagree" and "Strongly Disagree."

selecting instruments under national conditions and enforcing withdrawal rules, and on Mazzucato and others' work on public procurement, profit recoupment, and institutional design, we consider budget allocation, public-private burden sharing, recovery of public funds, and expenditure review within Japan's institutional framework. Our central proposition is that policy outcomes and the recovery of public funds should be evaluated separately, with both assessments informing instrument choice and budget allocation.

2. The World Bank's perspective on fiscal considerations in industrial policy

A useful starting point is the World Bank's "Industrial Policy for Development: Approaches in the 21st Century," published in March 2026 (hereafter, "World Bank [2026]"). The report reflects both the global revival of industrial policy and a sharp increase in demand for policy advice from developing-country governments. It notes that 80% of World Bank country economists surveyed reported that client governments had sought their advice on how to use industrial policy more effectively. This attests to a revival of industrial policy, which had tended to be sidelined out of fear that it could lead to excessive government intervention (Ishikawa [2026]).

However, the World Bank does not endorse all aspects of this strengthening of industrial policy, and it should be noted that it is particularly critical of reliance on tariffs and subsidies (see Appendix 1). As described below, the World Bank presents a "feasibility framework" for industrial policy, which involves the selection of feasible policies based on economic fundamentals and other national characteristics, and advocates reconstituting industrial policy for the 21st century into a more precise and realistic policy system rather than a fiscal-expansion tool.

(1) Selecting feasible policies based on three national characteristics

The World Bank identifies three national characteristics that determine the feasibility of industrial policies: 1) government bandwidth (i.e., capacity to implement industrial policies), 2) local market size, and 3) fiscal space (Figure 2). 1) refers to administrative capacity to engage in continuous dialogue with firms and industries and to design and supervise policy. Actual classification is based on the Worldwide Governance Indicators for government effectiveness and administrative capacity. 2) refers to the size of the market in which firms can realize economies of scale, and classification uses nominal GDP as a proxy for local market size. 3) refers to the leeway to bear policy costs without sacrificing spending on social services, and is ascertained from indicators such as the tax-revenue-to-GDP ratio and the government-debt-to-GDP ratio. As Figure 2 shows, the more fully these three conditions are met, the broader the range of available policy instruments becomes, but the World Bank does not recommend strong intervention uniformly.

Figure 2. Typology of Feasible Industrial Policy Tools for Selected Combinations of Country Characteristics

Country characteristics			Feasible policies						Examples
Govern-ment band-width	Local market size	Fiscal space	Public inputs		Market incentives		Macroeconomic interventions		
Small	Small	Small	• **Industrial parks**		Commodity export ban		• Competitive exchange rate devaluation		•Mozambique •Madagascar •Cameroon
Small	Small	Large				• Export subsidy		• R&D tax credit	• Nepal • Kyrgyz Republic • Nicaragua
Small	Large	Small			• Commodity export ban • Technology transfer quid pro quo • Import tariff • Local content requirement				• Brazil • Nigeria • Bangladesh
Small	Large	Large				• Export subsidy		• R&D tax credit	• Uzbekistan • Belarus • Bulgaria
Large	Small	Small		• **Skills development** • **Market access assistance** • **Quality infrastructure**	Commodity export ban				• Senegal • Rwanda • Namibia
Large	Small	Large				• **Production subsidy** • **Specific innovation subsidy** • Export subsidy • Consumer demand subsidy		• R&D tax credit	• Georgia • Botswana • Latvia
Large	Large	Small			• Commodity export ban • Technology transfer quid pro quo • Import tariff • Local content requirement				•Indonesia •Japan •Philippines
Large	Large	Large				• **Production subsidy** • **Specific innovation subsidy** • Export subsidy • Public procurement • Consumer demand subsidy		• R&D tax credit	•India •China •United States

Source: JRI, based on Table 1.2 of World Bank [2026]

Japan is classified as "government bandwidth = large, local market size = large, fiscal space = small," and is recommended to prioritize public inputs that directly correct specific market failures, such as development of industrial parks and other infrastructure, as well as skill development, market access assistance, and the development of quality infrastructure (i.e., the establishment of standards and certification systems, testing facilities, and other foundations for verifying and ensuring product and process quality). Countries for which all the characteristics are judged as large, such as the U.S., India, and China, are considered able to employ a wide range of policy instruments, including subsidies.

(2) Prioritizing public inputs, treating subsidies as a last resort, and withdrawing support when necessary

The World Bank's focus is not support per se, but the prioritization and disciplined use of policy instruments. It first prioritizes relatively low-cost public inputs, such as government-provided industrial parks and other infrastructure, which can complement areas where market mechanisms alone are unlikely to deliver sufficient development or expansion. By contrast, market incentives such as subsidies and government procurement are positioned as a "last resort" when such public inputs alone do not yield sufficient outcomes. Because these instruments impose large fiscal burdens, the World Bank calls for them to be used cautiously.

Even more important is discipline applied after policy implementation, which is based on the premise that industrial policies can fail. Citing international political economist Dani Rodrik's argument that the question is "not whether a government can always pick winners—it should not even try—but whether it has the capacity to let the losers go," the World Bank stresses the importance of determining when and how to terminate industrial support.

In other words, the World Bank emphasizes that governments must continuously verify the achievements of firms, make support conditional, and withdraw it if outcomes do not improve. However, it also notes that ending support too early can undermine long-term benefits. Selecting policies according to government bandwidth, local market size, and fiscal space, and then, after implementation, deciding whether to continue, adjust, or withdraw based on outcomes, is central to the World Bank's recommended industrial policy approach. The Bank does not regard industrial policy in the 21st century as a rationale for excessive fiscal expansion.

3. New discussions on how to secure fiscal space

The World Bank's approach remains broadly conventional. Yet industrial policy today must address challenges such as decarbonization and economic security; implementing every potential measure would make fiscal costs difficult to contain.

Against this backdrop, attention has turned to Mariana Mazzucato, whose "mission-oriented approach" has strongly influenced industrial policy worldwide. Rather than treating government as a passive corrector of market failures, the approach casts it as an active market shaper that defines societal challenges and directs markets and innovation. Mazzucato's research was directly referenced in the mission design of "Horizon Europe," the European Union's funding program for the promotion of research and innovation, and has had a

major influence on the development of European industrial policy (Mazzucato [2018]). In Japan, too, the Ministry of Economy, Trade and Industry has cited Mazzucato's ideas and positioned industrial policy based on a "mission-oriented approach" at the center of a "new axis" of economic and industrial policy, presenting a policy stance of large-scale, long-term, planned government support (Ishikawa [2022]).

Mazzucato challenges the conventional practice of setting policy scale within predetermined fiscal constraints. In Mazzucato [2021], while referencing MMT (Modern Monetary Theory), she presents the argument that the spending constraints of a government issuing its own currency lie not in obtaining financing itself but in inflation and productive capacity. Even so, more proactive industrial support raises unavoidable questions about how spending should be evaluated, how returns should be recouped, and how support can be reconciled with long-term fiscal sustainability. Her work therefore helps fill gaps in earlier approaches. Below, we discuss (1) market formation through public procurement, (2) risk-return management through a portfolio approach, and (3) institutional design that supports long-term investment. Together, these ideas provide a basis for examining how proactive industrial support can be reconciled with long-term fiscal sustainability.

(1) Government-led market formation through the linking of missions and public procurement

Mazzucato, Spanó, and Wainwright [2025] present an approach for enhancing the effectiveness of limited fiscal spending by adopting a new approach to "public procurement." Their paper calls for governments to "actively shape and co-create markets" to address social challenges, and it positions public procurement as an important policy instrument. It proposes shifting away from conventional public procurement that prioritizes price and short-term efficiency, and instead adopting a "mission-oriented approach" to "public procurement" based on four ideas:

1) value is directional (emphasizes not the extent of growth, but the direction it takes),

2) value is dynamic (assessment should encompass such factors as long-term innovation, spillover effects, and learning),

3) value is co-created by the public and private sectors (stresses the importance of public-private cooperation), and

4) value is also created by a risk-taking public sector (the public sector should take risks, co-create innovation, and share in the rewards).

By linking missions determined by national and local governments, such as decarbonization, with public procurement, demand and market opportunities for new goods and services can be created, thereby crowding in private investment. The contention is that mission-oriented public investment is capable of generating more significant multiplier effects than generic government spending and of enhancing the economic and social outcomes delivered by existing fiscal resources.

(2) A portfolio approach to absorb losses with the returns from successful projects

Laplane and Mazzucato [2020], recognizing that not all projects receiving industrial support succeed, argue for the need to evaluate public investment not on the basis of individual projects but as a "portfolio." When government support fails, criticism that government capabilities are inadequate or that markets are being distorted intensifies. Meanwhile, many success stories do not attract attention as government successes and the profits accrue only to the private sector. To overcome these problems, the pair propose a mechanism whereby some of the upside returns from successful projects are channeled back to the public side in the form of equity, royalties, or profit-sharing, in order to compensate for losses from failed projects or to allow subsequent investments to be funded. This portfolio style of management, whereby the upside is used to cover the downside, offers greater stability in project support.

Furthermore, Mazzucato and Rodrik [2026] propose that public support for firms should not be provided unconditionally, but treated as a transaction in which the companies are required to act in line with public objectives in exchange for support. Conditions could include returning profits from successful projects, as mentioned above. This can prevent support that does not lead to outcomes or public value from continuing without purpose, and can also help curb fiscal burdens.

Laplane and Mazzucato [2020] discuss a case where the U.S. Department of Energy (DOE) provided support to the solar-power startup Solyndra and the EV manufacturer Tesla. Solyndra went bankrupt, and the government support it had received was subject to criticism, yet the support for Tesla proved successful. The pair point out that if the DOE had been able to obtain upside returns from Tesla in the form of equity or similar instruments, the Solyndra losses could have been covered many times over and the gains used to invest in the next promising project.

This portfolio approach differs from fiscal discipline focused on directly curtailing total expenditures. By re-purposing money earned from successful projects, it enables industrial policy to continue without complete reliance on additional fiscal burdens. In that sense, it can be viewed as one approach for mitigating fiscal costs associated with industrial support.

(3) Institutional design to support long-term investment required for industrial policy

In "Fiscal Space for Industrial Strategy,"[1] a conversation between Mazzucato and Nicolás Grau, Chile's former Minister of Economy and former Minister of Finance, the discussion focuses on how to create fiscal space for industrial policy, using Chile as an example (Mazzucato and Grau [2026]). Chile is described by Grau as a middle-income country with a small economy and a democratic system. Grau argues that fiscal space does not exist from the outset but has to be built. Specifically, he proposes:

1) treating science, technology, and innovation spending as capital investment,
2) utilizing off-budget mechanisms,
3) focusing on strategic social needs, and
4) focusing on investment in people as in-house state capacity (Figure 3).

[1] An online event hosted by IIPP, UCL on May 5, 2026. "Fiscal Space for Industrial Strategy: A Conversation between Mariana Mazzucato and Nicolás Grau" (https://www.ucl.ac.uk/bartlett/events/2026/may/fiscal-space-industrial-strategy-conversation-between-mariana-mazzucato-and-nicolas-grau).

These proposals call for institutional design that supports long-term investment through the treatment of innovation-related spending as investment and the utilization of off-budget public mechanisms. However, changing accounting treatment and funding channels does not eliminate fiscal burdens, and future burdens and risks still need to be managed.

Mazzucato and others extend mission-oriented industrial policy beyond proactive support to include 1) rethinking government procurement and developing mechanisms that induce investment, 2) recouping returns from successful projects and absorbing losses from failures, and 3) designing institutions to support long-term investment. Together, these show how fiscal space for industrial policy can be created without losing sight of fiscal sustainability.

Figure 3. Four Agendas for Creating Fiscal Space

1. Treat STI (Science, Technology, and Innovation) spending as capital investment	
	Recommend applying the budget office's existing treatment of capital investment to STI spending Propose treating STI spending as capital investment, although its impact on future fiscal revenue is difficult to project accurately.
2. Utilize off-budget mechanisms	
	Insulate STI investment from short-term fiscal pressures. Examples include concessions in public works (where the government determines the investment target and uses private financing).
3. Focus on strategic social needs	
	Restrain fiscal burdens through innovation (e.g., emergency room bed optimization in the healthcare sector). Coordinate innovation efforts across all public services and social ministries.
4. Focus on investment in people as in-house state capacity	
	A lack of knowledge and capacity within government limits industrial policy capacity. Prioritize investment in people (in-house state capacity) over subsidies.

Source: JRI, based on "Fiscal Space for Industrial Strategy: A Conversation between Mariana Mazzucato and Nicolás Grau" hosted by UCL IIPP.

4. Designing sustainable support for industrial policy under fiscal constraints

Effective industrial policy requires support instruments tailored to individual projects and national conditions, while containing fiscal costs. Subsidies alone may not be sufficient to resolve workforce shortages, and R&D and mass production require different forms of finance. The framework below draws on the World Bank's emphasis on instrument choice and withdrawal discipline (i.e., prioritization of support) and on Mazzucato's proposals for market formation through public procurement and the recycling of returns from successful projects (i.e., creation of fiscal space). We then set out how to reconcile support priorities with the reuse of public funds.

Three perspectives are central to prioritization:

(1) Determining desired outcomes according to policy objectives

Industrial policy has diverse objectives, which include productivity improvement and economic growth, security, decarbonization, job creation, and regional revitalization. For projects with multiple objectives, it is necessary to distinguish between primary and secondary objectives and to clarify at the outset what must be achieved for the project to be judged successful.

(2) Selecting policy instruments to reflect factors that hinder investment

Policy instruments should not be chosen solely for administrative convenience. Selection should instead reflect the constraints holding back investment. When infrastructure or human resources are lacking, public inputs are appropriate; when research outcomes spill over to other firms, making it difficult for the firm undertaking the research to recoup its costs, subsidies or commissioned research may be warranted.

And when multiple factors are in play, instruments should be combined. If uncertainty in technology development sits alongside insufficient initial demand, expanding loan programs alone will be inadequate. In the case of products/services expected to be used by national or local governments, for example, support could be combined with public procurement, providing a clearer prospect of purchase once the products/services are developed.

(3) Reviewing the nature of support in line with project progress and strictly applying rules for withdrawal

Support must extend beyond technology development to demand creation and the financing needed for mass production. The European Commission describes two "valleys of death": the "startup" stage of turning research outcomes into products and the "scaleup" stage of expanding scale after commercialization (European Commission [2025], Figure 4). Reflecting the discussion by the IMF [2024], subsidies and commissioned research should be used for R&D and prototyping, while the combination of public procurement and equity investment should be used for pilot testing and market formation. At the mass-production and expansion stages,

once sales and repayment prospects become clearer, greater weight should be placed on loans, guarantees, and co-financing with the private sector. Finally, once a revenue base is established, policymakers should decide whether public support remains necessary.

However, reviews of support should not be conducted mechanically. Rather, decisions on whether to continue should be based on the achievement of intermediate targets. When prospects for commercialization do not materialize, "enforcing strict discipline for the withdrawal of support" (i.e., reduction, suspension, or early termination of support according to predetermined criteria) is essential. On the other hand, after commercialization, if research outcomes are spilling over to other firms or security needs remain, combining subsidies with financial support may be considered. Such review of support based on clear criteria will help to curb the expansion of fiscal burdens.

Furthermore, for the "creation of fiscal space," the following will be important:

(4) Clarifying public-private risk-return sharing and curtailing fiscal burdens through redistribution of upside gains

First, in industrial support, governments need to avoid taking extreme risks that could greatly expand fiscal burdens. Even when a government assumes risks that would be difficult for the private sector to bear, the firms and financial institutions must still retain some of the risk burden. If the government were to bear all losses, there would be a danger that the firms and financial institutions would not sufficiently scrutinize profitability or risk. It is necessary to determine in advance the scope of losses that the government will bear if the project fails and the rewards it will reap if the project succeeds, and also to estimate the government burden in cases where recouping of equity investment or lending falls short of expectations and in cases where guarantee payments arise.

Verification of "additionality" (i.e., whether the investment would not have been made without government support) is also essential. If the same investment would be made even without support, public funds may simply substitute for costs that the private sector would otherwise bear. Attention to "opportunity cost" (i.e., comparison with the outcomes of allocating the same budget, human resources, and capital to other uses) is also required.

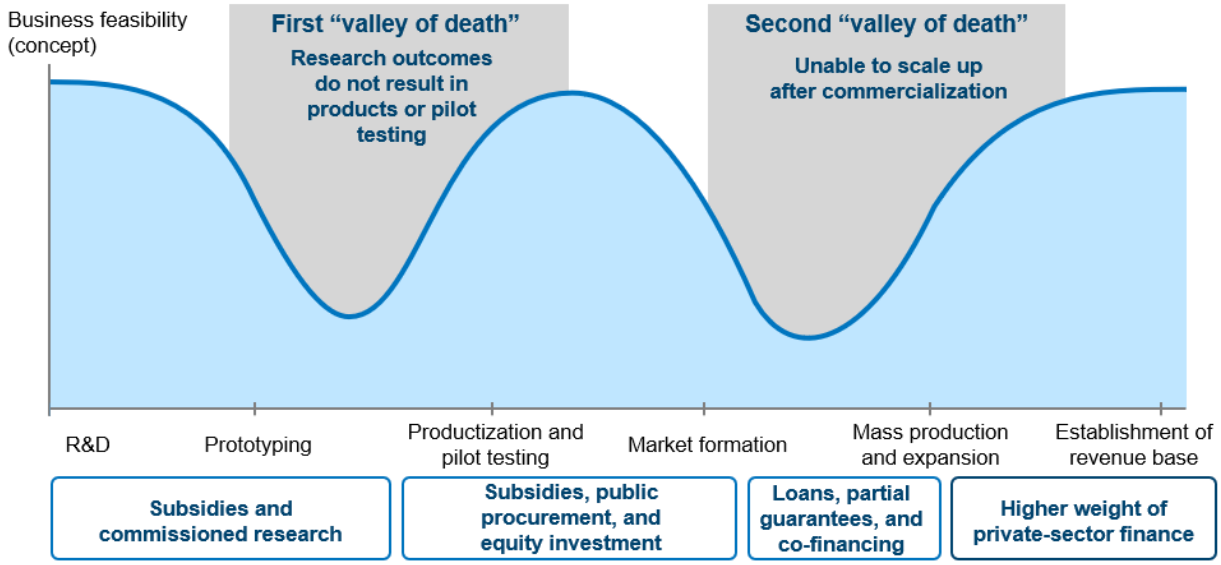
Support outcomes must be captured not only for supported firms but for the entire economy. In a model-based analysis of major developed countries conducted by the IMF [2025], even when total subsidy amounts were the same, results differed between targeted support for industries where efficiency increases with production expansion and uniform subsidies across all industries. In the latter case, overall economic productivity declined slightly. Although this result was derived from a model, not the measurement of actual policy outcomes, it indicates the need to determine the allocation of support while considering impacts on other industries.

Policy outcomes and the recovery of public funds should be evaluated separately. Productivity gains and reduced supply-disruption risk cannot be measured by dividends or repayments alone. For projects expected to generate revenue, the likelihood of recovering equity investments or loans should be assessed, and the reasonableness of the public burden should be judged in relation to the potential policy outcomes. The results of this process can be used to review the risk-return characteristics of the overall portfolio and to adjust support allocation. In particular, for projects expected to generate large upside gains when successful, the government

should not rely on subsidies alone. It should capture returns through equity, royalty contracts, or profit-sharing. Reinvesting financial returns from successful projects, within institutional limits, can create a sustainable mechanism that helps offset losses from failed projects.

It is also important to incorporate a "mission-oriented approach," i.e., to position the resolution of social challenges as a guiding principle, and to link missions determined by national and local governments, such as decarbonization, with public procurement. By doing so, demand and market opportunities for new goods and services will be created, and this can be expected to draw in investment from the private sector. In addition to helping the individual firms receiving the investment to grow, this could also contribute to curtailing medium- to long-term fiscal burdens by spurring innovation creation. Furthermore, it is necessary to examine approaches for generating medium- to long-term fiscal space. These could include institutional measures that support long-term investment, such as treating innovation-related spending as capital investment and utilizing off-budget mechanisms.

Figure 4. Two "Valleys of Death" and Focus of Support according to Stage of Business Development



Sources: Prepared by JRI based on European Commission [2025], IMF [2024], etc.
Note: The curve is a schematic illustration of the two "valleys of death" and does not represent the amount of private-sector money supplied. The correspondence between support instruments and stages is highlighted and exemplified in this paper.

5. Implications for Japan: how to secure fiscal space to support industrial policy

Sustaining industrial policy requires not only the necessary budget but also institutional arrangements covering the methods of allocating the budget across fields, the degree to which the public and private sectors should share burdens, and the ways of handling public funds that can be recouped. Drawing on Japan's Growth Strategy and the Public-Private Investment Roadmap, we examine approaches for securing fiscal space from four perspectives: (1) budget allocation and fund recouping, (2) budgetary and financial instruments, (3) public procurement and regulatory reform, and (4) evaluation and reallocation.

(1) Reviewing budget allocation across the 17 fields and using recouped profits to curtail fiscal burdens

The 17 fields should be viewed as a whole (i.e., as a portfolio), and budgets should be allocated based on policy necessity, the time it will take for outcomes to appear, and the prospects for recouping the public funds. Japan's Growth Strategy calls for the combination of current revenue sources, future profit drivers, and seeds of future growth. With growth investment, it is difficult to recoup the cost of basic research directly, but with crisis-management investment, the production and sale of critical minerals may generate revenue. It is important to separate policy objectives from prospects for recouping funds, and not determine allocation solely on the basis of short-term profitability (Figure 5).

In budget allocation, public inputs that remove obstacles to investment that are faced by multiple firms should also be emphasized. The Public-Private Investment Roadmap states that support could be provided for the establishment of shared infrastructure that individual firms would find difficult to build on their own. For example, there could be shared use of testing equipment (Cabinet Secretariat [2026b]).

For projects expected to generate revenue, the government should also receive dividends or earn capital gains to curb additional fiscal burdens. A mechanism is needed to use returns from recoverable support to finance subsequent necessary investment, including support that is not itself expected to yield direct returns. Profits should be treated differently depending on the institutional arrangement. In some cases, they can be directed immediately to the next investment, while in others they must first be returned to the fund-establishing entity or the national government, as in the case of so-called "revenue remittance" from funds. At the budget-formulation stage, funds returned to the national government should be allocated according to policy priorities.

In annual budget formulation, regardless of whether funds are in the general account or special accounts, the policy outcomes and burden on the national treasury of each measure should be compared to determine priorities and scale of support. The "Strong and Prosperous Japan" Investment Framework is divided into portions recorded in the general account and portions for investments important to economic security, with the latter separately managed in special accounts. The Ministry of Finance states that it will scrutinize both. Multi-year support plans must present the duration and the nature of support and the conditions for review, as well as future funding needs and projections of fiscal burdens in future years. Future increases in tax revenue and the recouping of investment should not be regarded as definite financial resources, and the scale of support should be determined within the context of the overall budget.

After budget formulation, medium- to long-term checks should be conducted on the degree to which investments are boosting economic growth and tax revenue and the extent of additional spending and increased interest payments. Using the Cabinet Office's medium- to long-term projections, which are updated at the beginning of the year to reflect the government's draft budget, the Council on Economic and Fiscal Policy should confirm whether projections for the primary balance (i.e., the fiscal balance when interest payments are excluded) and the debt ratio (i.e., the government-debt-to-GDP ratio) with additional spending factored in are consistent with the government's fiscal targets, including in the event of slower growth or higher interest rates than anticipated. The Council's findings should be reflected in the next Basic Policy for Economic and Fiscal

Management and Reform, and in reviews of the "Medium- to Long-Term Economic and Fiscal Plan," as well as during the formulation of the next budget.

Figure 5. Examples of Support Decisions Distinguishing Policy Objectives from the Recovery of Public Funds

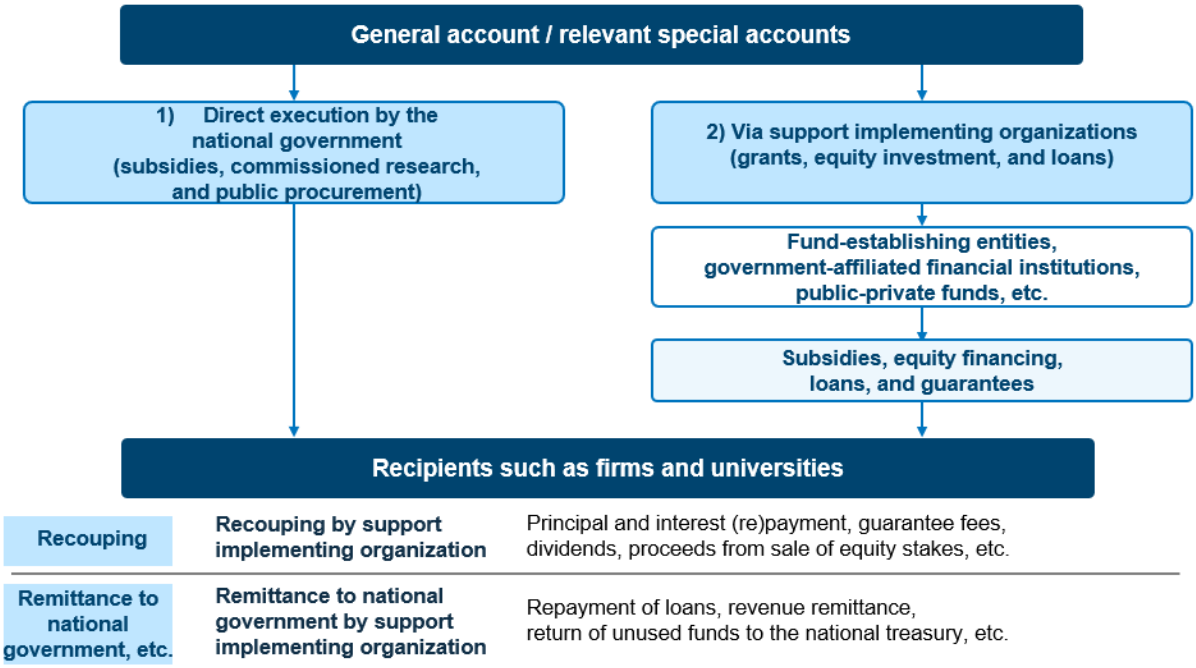
Policy objectives and main evaluation targets	Support unlikely to result in direct recouping of public funds	Support expected to result in recouping of public funds
Strengthening growth capacity (productivity and value added)	**Subsidies for and commissioning of basic research** Evaluate research results and knowledge spillover	**Equity investment and loans for commercialization and mass production** Evaluate policy outcomes and prospects for recouping
Preparing for crises (avoiding losses from supply disruptions, etc.)	**Procurement and maintenance of naval vessels for the Self-Defense Forces** Evaluate securing of required functions and capabilities	**Equity investment and loans for production of critical minerals** Evaluate contribution to stable supply and prospects for recouping
Actions in both support cases	With all forms of support, compare policy outcomes and national burdens. For equity investment and loans, assess any shortfall in recovery; for guarantees, check the fiscal burden if guarantees are called.	
Repurposing of funds	**Return upside gains to the public sector → reinvest and allocate budgets according to institutional arrangements** **→ To subsequent necessary investment (including support unlikely to result in direct recouping)**	

Source: Prepared by JRI
Note: Examples of support. Even within the same field, both columns may be combined. Recouping refers to repayments, dividends, etc. to the public sector (excluding increases in corporate sales or tax revenue). Recouping and reinvestment depend on contracts and institutional arrangements.

(2) Differentiating between budget and financial instruments and curtailing excessive reliance on subsidies

With multi-year support, it is important to allow firms to envisage future support, while also allocating budgets according to actual progress. In line with its policy of providing for ongoing measures in its initial budget, the government has indicated that it will present multi-year projections by drawing up investment plans and making multi-year government expenditure commitments. Multi-year government expenditure commitments allow contracts involving future payments within the limits approved by the Diet, with actual payments included in each fiscal year's budget. Funding channels for industrial support can be broadly divided into cases where the national government directly provides subsidies, commissions research, or performs public procurement through the general account or relevant special accounts, and cases where fund-establishing entities, government-affiliated financial institutions, or public-private funds that receive grants, equity investment, or loans provide subsidies, equity financing, loans, or guarantees (Ministry of Finance [2025], Ministry of Finance [2026a], Figure 6). For R&D, where the timing of expenditures is more variable, funds (in the sense of funding vehicles) should also be considered as an option, and necessary amounts should be allocated according to progress and funding needs to avoid the excessive provision of money.

Figure 6. Main Funding Channels Supporting Industrial Policy and Recouping/Remittance



Sources: Prepared by JRI based on Ministry of Finance [2025, 2026a] and Administrative Reform Promotion Council [2026]
Note: Actual funding channels differ depending on the system and project. Even in direct execution, subsidy repayment or revenue remittance may occur depending on the system and conditions.

Funds allow for long-term support but need to be managed to prevent the unnecessary retention of money. The July 2026 review indicated that while the rule limiting new budget allocations to funds to approximately three years would not be applied, opportunities to assess progress and outcomes every one to three years and decide on subsequent support would always be provided (Administrative Reform Promotion Council [2026]). "Revenue remittance," in which a portion of the profits generated from support is returned to the fund-establishing entity or the national government, is also established as a general rule. It will be important to put in place mechanisms for returning unused money to the national treasury and avoiding unnecessary additional injections.

Regarding support for firms, based on discussions by the Fiscal System Council [2026], equity investment and loans should be combined according to project stage and prospects for recouping the money, and subsidies or commissioned research should not be the only forms of funding. A June 2026 news release from Rapidus presents plans for commissioned research funded by NEDO (New Energy and Industrial Technology Development Organization), equity investment from the government through the IPA (Information-Technology Promotion Agency, Japan), and equity financing and loans ahead of mass production (Rapidus [2026]). Commissioned research is expenditure aimed at technological outcomes, while equity investments and loans are expected to be recouped through dividends, capital gains, and repayment. When deciding on additional support, the assessment of prospects for outcomes and recouping should reflect these differences.

Financial support should share risk between the public and private sectors, with public funds used to crowd in private capital. After clarifying the scope of the government burden, coordinated lending by government-affiliated and private-sector financial institutions, as well as guarantees whereby the public sector would bear a portion of losses, should be utilized. As projects progress and prospects for revenue and repayment become

clearer, the weight of private-sector finance should be increased. It will be necessary to gauge not only how much private capital has been drawn in but also the burden on the government if loans cannot be repaid in full or guarantee payments arise.

Public-private funds should be evaluated not only in terms of individual projects but also as to whether revenues and expenditures balance over the entire investment period (Appendix 2). The "Guidelines for the Operation of Public-Private Funds," decided at a meeting of the relevant ministers in 2013, call for balancing the need to take necessary risks in individual projects for the policy objective with safeguarding principal (invested capital) at the fund level (Board of Audit of Japan [2025]). Performance in recouping and updated projections of when and how much can be recouped must be used to determine the need for additional equity injections and to inform decisions on investment allocation.

(3) Combining public procurement and regulatory reform to enhance the effectiveness of fiscal spending

Public procurement should be used to link the purchase of goods and services needed by government organizations with R&D support, thereby connecting fiscal spending to the practical application of research results. The Public-Private Investment Roadmap for disaster-management technologies identifies unclear functional and performance requirements at the operational level as an issue and calls for the use of public procurement (Cabinet Secretariat [2026b]). It will be important to apply disaster-response knowledge to development and pilot testing and to link this to the introduction of necessary products, thereby translating spending on R&D to actual improvements in disaster-prevention capabilities.

The organizations responsible for development support and the organizations responsible for procurement should share information at an early stage regarding intended use, required performance, and procurement methods, and design a single flow from pilot testing to purchase. For projects where specifications have not yet been finalized, technical proposals should be solicited using the government's "Startup Technical Proposal Evaluation Method," and specifications and planned prices should be determined following reviews and price negotiations, after which contracts should be signed. Outcomes from R&D conducted via the SBIR (Small/Startup Business Innovation Research) Program[2] may lead to purchases under discretionary contracts when prescribed requirements, such as publication of final evaluation results, are met (Cabinet Office [2025]). It will be important to ensure competitiveness and transparency and to compare purchase prices, other costs such as those incurred for maintenance and operation, and performance, in order to secure the required functionality with a smaller fiscal burden.

When regulations or licensing procedures hinder commercialization, just increasing subsidies is unlikely to advance investment. Institutional reforms and development-and-introduction support, which are included in the Public-Private Investment Roadmap, should be advanced together, ensuring safety while preventing delays in commercialization and prolonged support.

[2] The SBIR (Small/Startup Business Innovation Research) Program is a scheme that aims to promote innovation and create unicorns through the provision of consistent support from government departments from the early stages of R&D through to government procurement and civilian use.

(4) Verifying policy outcomes and fiscal burdens and linking them to budget review and reallocation

Expenditure reviews should assess whether policy outcomes justify their costs and guide the reallocation of resources toward necessary investment. Growth investment should emphasize productivity and value added, and crisis-management investment should emphasize the avoidance of losses from supply disruptions and other events. Reviews should assess both fiscal burdens and the additional outcomes attributable to support.

Expenditure amounts or the completion of facilities should not be treated as policy outcomes in themselves. Decisions on additional support for mass production by Rapidus, and the amount of such support, should be made after assessing prospects for business viability, as gauged from projected customer demand and manufacturing costs. Meanwhile, the roadmap for naval vessels includes the establishment of domestic production and maintenance systems and the promotion of equipment transfer, but does not mention estimated economic spillover effects (Cabinet Secretariat [2026b]). Support for naval vessels should be allocated in line with policy objectives, and based on an assessment of how much construction and repair capacity can be secured and at what cost. It is also worth considering a mechanism for returning profits earned from equipment transfer to the government side and, within institutional limits, allocating them to subsequent necessary investment, such as maintaining and strengthening supply capacity.

To use evaluation to improve budgeting, the ministries overseeing support and the organizations providing it should determine the required data and evaluation methods at the outset. Human resources capable of analyzing technology, business feasibility, and policy outcomes should be secured and developed, and EBPM (evidence-based policy making) must be employed consistently from outcome verification through to expenditure review.

Expenditures with limited outcomes should be reduced or terminated, and the resources released should be reallocated to high-priority investments with strong expected outcomes. Judgments should consider the time required for results to appear, future outcomes, and additional burdens, and projects should not be terminated solely because short-term targets could not be achieved. When outcomes can be improved by changing policy instruments, their combination should be revised, and evaluations of individual projects and assessments of the government's overall fiscal resources and burdens should inform subsequent budgets.

6. Conclusion

Sustaining industrial policy requires both discipline in prioritization and withdrawal and sufficient fiscal space for support. This calls for a combination of budget reallocation, private capital crowded in by public funds, and returns recouped from successful projects. The government should provide a predictable support framework so that firms can undertake long-term investments, while managing future burdens if recoveries or policy outcomes fall short of expectations. In addition, Japan's Growth Strategy states that "regarding assets held by the public sector, including the Foreign Exchange Fund Special Account, we will examine the feasibility of improving their management and making effective use of them, while taking into account the purposes for which they are held." However, limits to the use of the Foreign Exchange Fund Special Account have been

pointed out (Makita [2026]), and the amount of returns that can be earned from managing public assets is highly uncertain. It should also be noted that using such financial resources for industrial support may create problems in terms of policy sustainability.

To make "responsible and proactive public finances" a reality, the government must neither postpone investment needed to strengthen supply capacity nor defer verification of policy outcomes, financing, and fiscal burdens (Inoue [2026]). Based on a discussion of the importance of "prioritization of support" (i.e., ensuring strictness in prioritization and withdrawal) and the "creation of fiscal space" (i.e., recouping and re-purposing gains from successful projects), this paper has presented approaches for managing medium- to long-term fiscal burdens while enhancing policy outcomes in Japan's industrial policy. The objective is not across-the-board spending cuts, but to review low-impact expenditures, redirect resources to necessary investment, and use recovered funds to create capacity for the next round of investment.

Appendix 1: Background to the World Bank's reassessment of industrial policy

The World Bank's basic stance toward industrial policy is orthodox: "industrial policy that fixes market failures can be expected to boost growth and benefit society as a whole." However, it also acknowledges that concerns about industrial policy exist, and gives three reasons for such concerns. First, benefits are difficult to quantify. It is hard to accurately measure the economic benefits of addressing market problems through government intervention by comparing them with policy costs. Second, there are political risks, as interest groups and political pressure can lead to the selection of policies that excessively benefit certain firms or industries (i.e., government failure). Third, other countries can be adversely affected and compete with each other through subsidies. Domestic industrial support by large countries can have spillover effects on firms and workers in other countries, and distort the international competitive landscape.

However, the World Bank also acknowledges moves to revisit industrial policy and points to three environmental shifts as being behind this (Figure 7). To begin with, 1) the human resources and capabilities available to governments have improved. Amid rising education levels globally, the talent that governments can make use of has seen substantial improvement. Next, 2) the political environment has improved. In many countries, the political scene has shifted toward support for development goals, and improvements in areas such as macroeconomic stability, economic growth, and health have also been observed. Finally, 3) economies have shifted to being open rather than closed. Most countries today have economies that are open to international trade and investment, and this has made limited and efficient industrial policy centered on public inputs possible. These are environmental shifts unique to the 21st century, and while concerns remain, the World Bank is encouraging the reconsideration of industrial policy. In doing so, as noted above, it recommends that decision-making by national governments adhere to the following order: 1) emphasize institutions and fundamentals that make implementation possible, 2) prioritize low-cost public inputs that are difficult for markets alone to provide, 3) consider market incentives as a last resort, and 4) exercise caution with macroeconomic interventions.

Figure 7. World Bank's Concerns Regarding Industrial Policy and Recent Environmental Changes

Three Factors of Concern in Implementing Industrial Policy
Difficulty of measuring benefits
Political risk (government failure)
Negative spillovers to other countries and subsidy races

Three Environmental Changes Prompting a Reassessment of Industrial Policy
Improvements in available human resources and government capabilities
Improvements in the political environment
Shift from closed economies to open economies
Four-Step Government Decision-Making Sequence Required in the New Environment
Prioritize institutions and foundational conditions that enable implementation
Select low-cost public inputs that are unlikely to be provided by markets alone
Utilize market incentives only when public inputs are insufficient
Exercise caution with macroeconomic interventions

Source: JRI, based on World Bank [2026]

Appendix 2: How to view public-private funds

The success or failure of public-private funds cannot be judged solely on the basis of initial investment losses. Operating expenses are incurred upfront, and it takes time for investees to grow and for profits to be realized through, for example, the sale of equity. This pattern, whereby losses occur early and profits improve later through the recouping of investment, is called the "J-curve" (Amatatsu [2021]).

However, even when evaluating outcomes over the long term, plans and actual results need to be checked regularly. According to the Ministry of Economy, Trade and Industry (METI) and the Cool Japan Fund [2026], cumulative losses at the Cool Japan Fund at the end of FY2025 had amounted to 54 billion yen. The goal of keeping losses below 42.6 billion yen, set during the November 2022 management review, had not been achieved. In July 2026, METI indicated that, with a view to examining specific paths toward integration with another institution or abolition, it would review institutional factors, the projects the fund has invested in, and the fund's organization and management, and compile its findings by the end of the year.

Decisions on additional investment should be made based on whether policy outcomes and returns commensurate with the amount invested can be expected. Even if they are currently loss-making, there may be space for continued support for projects with prospects for delivering results in the future. However, in the case of projects where such prospects have diminished, the reduction or suspension of additional investment will need to be considered. Mitsusada and Kawakita [2022] point out that if, in an effort to quickly eliminate past losses, investment is expanded without sufficiently assessing profitability, losses may swell further.

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