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Takaichi's Fiscal Policy in 15 Questions
— A Preview of Japan's Basic Policy 2026

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Summary

Discussions are under way toward the 2026 Basic Policy on Economic and Fiscal Management and Reform, known in Japanese as the "Honebuto no Hoshin." As the first Basic Policy since the inauguration of the Takaichi administration, it will be critical for assessing the substance of Prime Minister Takaichi's signature economic and fiscal agenda: "responsible, proactive fiscal policy." Market attention is high, and depending on the content, interest rates and the yen could well move. Drawing on what has already been made public, this report sets out the key fiscal-policy points and the author's views in Q&A format.

Note that the report includes the author's inferences based on materials published to date by the Council on Economic and Fiscal Policy (CEFP); the actual content of the Basic Policy and the subsequent budget formulation guidelines will only be revealed in due course.

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Q1. How will fiscal policy change under the Basic Policy?

At the April meeting of the CEFP, five "basic principles" for fiscal management were presented. The following is based on the original document.

(1) Position a stable decline in the debt-to-GDP ratio as the core target of fiscal management
 - The primary balance will be monitored with a view to lowering the debt-to-GDP ratio.
(2) Shift to budget formulation that appropriately reflects prices and wages and is commensurate with stronger growth potential and an expanding nominal economy
 - Ensure that increases in prices and wages are properly reflected in budget formulation.
(3) Create a "new investment framework" for crisis-management and growth investment

- Manage crisis-management and growth investment within a "new investment framework," separate from regular expenditures, so that it can be implemented with predictability.
- Funding is to be managed flexibly, consistent with the medium-term debt path, after scrutinizing the fiscal space available even while the debt-to-GDP ratio is steadily being reduced.
- Investment in fields deemed particularly critical to economic security will be managed separately, with funding secured over multiple years; the portion financed by "bridge bonds" (tsunagi kokusai, bonds backed by earmarked redemption funding) will be excluded from indicators such as the debt-to-GDP ratio.

(4) End the reliance on supplementary budgets; book permanent programs in the initial budget
- Limit supplementary budgets to genuinely urgent items; as a rule, fund permanent programs through the initial budget.

(5) Prepare for uncertainty and secure market confidence through stronger communication
- Secure the necessary fiscal response to recessions and external shocks; incorporate uncertainty over growth rates, interest rates, etc., drawing on the SDSA approach; monitor multiple fiscal indicators.

Q2. What does it mean to make the debt-to-GDP ratio the core target?

Japan's fiscal targets to date have been, first, achieving a primary surplus and, second, a stable decline in the debt-to-GDP ratio. Making the debt ratio the core target shifts the focus from flow (the single-year fiscal balance) to stock (outstanding debt), reversing the previous hierarchy in which the flow target ranked above the stock target. Freed from a single-year primary balance constraint, fiscal management becomes more flexible and responsive to circumstances.

Because the ratio is "divided by GDP — so growth brings it down," many critics view the change as growth-biased and permissive of fiscal expansion. That criticism, however, reflects an economic environment in which growth far exceeded interest rates. In today's environment of rising rates, lowering the debt-to-GDP ratio also requires close attention to growing interest payments.

Moreover, fiscal indicators including the primary balance have in fact been narrowing their deficits in recent years, and a successor target standard is becoming necessary. As the flip side of the criticism above, much commentary presumes that the primary balance is the discipline-oriented metric. But the primary balance is defined on expenditure excluding interest payments, and therefore takes no account of the rise in interest costs that accompanies higher rates. In that respect it has its own shortcomings as a fiscal anchor in a "world with interest rates."

Q3. What is a budget that reflects rising prices and wages?

The key is the "spending benchmark" (meyasu) that has governed budget formulation. Established in the 2015 Economic and Fiscal Revitalization Plan as the budgeting standard for achieving the primary-balance target, it held growth in expenditures to roughly the increase attributable to population aging in social security. Despite its soft-sounding name, the "benchmark" was adhered to in actual budget formulation and functioned as a ceiling on spending.

The problem is that this standard did not assume inflation. With budgets effectively held flat in nominal terms outside of aging-related increases, spending on existing programs was left unadjusted even as prices turned upward, and erosion in real terms set in. The author has compared general expenditures in initial budgets from FY2021 through FY2026 — adjusted to exclude special factors such as the increases attributable to aging, the defense build-up and childcare-related spending — against a path keeping pace with consumer-price inflation. The gap amounts to roughly JPY 5.3 trillion, which corresponds to the real-terms erosion attributable to inflation not being reflected in spending.

A budget that reflects prices and wages is therefore primarily about raising expenditures in line with inflation so as to stem this erosion of spending in real terms. Put differently, it is a measure to stop inflation from automatically delivering real spending cuts.

Q4. Is inflation indexation only a spending-side issue?

No — there is also unaddressed inflation adjustment on the revenue (tax) side, most notably bracket creep. Bracket creep refers to the phenomenon whereby, even with statutory tax rates unchanged, taxpayers' real burdens rise automatically because tax bracket thresholds and deduction amounts are left fixed while prices climb. In the author's report "Estimating the 'Hidden Tax Increase' from Bracket Creep" (May 8, 2026), the failure to adjust for inflation between 2019 and 2025 is estimated to amount to a tax increase of roughly JPY 1.9 trillion per year at present.

In a non-inflationary economy there was little need to adjust nominal amounts and thresholds. Under inflation, however, many of them act as automatic fiscal tightening, through real-terms spending restraint and bracket creep. This, indeed, is one of the reasons the primary balance and the fiscal balance have improved (deficits have narrowed) in recent years.

Q5. What is the "new investment framework"?

It is a mechanism that separates crisis-management and growth investment from regular expenditures and manages it within a distinct envelope, so that it can be implemented predictably over multiple years. As for funding, the stated approach is to scrutinize the fiscal space available even while the debt-to-GDP ratio is steadily being reduced, and to manage it flexibly in a manner consistent with the medium-term debt path. Rather than securing funding through new tax increases or spending cuts, the image is one of permitting fiscal outlays within the range over which the debt ratio still declines, and conducting crisis-management and growth investment within that fiscal space.

In addition, investment in fields deemed particularly critical to economic security is to be managed in a separate account, and the portion financed by bridge bonds is to be excluded from indicators such as the debt-to-GDP ratio. Depending on how the boundary of "fields particularly critical to economic security" is drawn, this could in practice become a loophole for spending expansion. A sense of balance will be needed — for instance, monitoring in parallel the baseline fiscal indicators that include these items.

Q6. What does "ending the reliance on supplementary budgets" mean?

It means correcting the practice whereby even permanent, structural programs have been funded through annual supplementary budgets, and booking them in the initial budget instead. Especially since the pandemic, large supplementary budgets became the norm and recurrent spending continued to be placed in them. With key programs concentrated in supplementary budgets whose size and content change every year, the predictability of both policy and the fiscal position deteriorated. Allocating necessary programs in the initial budget from the outset is a rational reform quite apart from fiscal-discipline considerations. Indeed, the Public Finance Act itself restricts additional expenditures via supplementary budgets to items such as "expenses that have become particularly urgent owing to circumstances arising after the budget was formulated." The new policy is also in keeping with that original intent.

Q7. Was past budget formulation really "excessively austerity-minded"?

Prime Minister Takaichi has characterized Japan's past fiscal management as "excessively austerity-oriented." Many find it jarring to call Japan — with its massive public debt and its routine of large supplementary budgets — "austere." The author considers the characterization half right and half wrong.

It is right in that, as seen above, the absence of inflation adjustment on both the spending and the revenue side has acted as automatic tightening. On the spending side, under a benchmark designed in the deflation era, budgets remained nominally flat outside aging-related increases. On the revenue side, bracket creep arose from tax thresholds left unadjusted for inflation. Compared with countries whose systems index spending and tax parameters to prices, the view that Japan's budget formulation has been austere can be sustained. The recent improvement in the primary balance also rests on this "automatic austerity."

It is wrong, however, in that it disregards how the suppressed amounts were released through large supplementary budgets. While initial budgets were squeezed, large new programs were booked in supplementary budgets beyond the reach of the spending ceiling, and fiscal management was hardly restrained in terms of total expenditures. The reality, in short, was an imbalance between overly strict initial budgets and overly loose supplementary budgets. The current overhaul is better understood not as a turn from austerity to expansion, but as a correction of that imbalance. That is precisely why it matters whether the expansion of the initial budget (the new investment framework and inflation indexation) is accompanied by a corresponding shrinking of supplementary budgets.

Q8. Will fiscal policy turn expansionary?

Ms. Takaichi's original policy leanings were strongly expansionary. With the recent rise in interest rates and ongoing inflation, however, she now appears to be keeping her distance from quantitative expansion of spending. In explaining the recent supplementary budget responding to the deterioration in the Iran situation, the government put its restraint in bond issuance front and center, emphasizing fiscal discipline.

Moreover, as noted above, the debt-to-GDP ratio is an indicator that worsens as interest rates rise. With its decline serving as the fiscal target, the framework makes explicit a structure in which higher interest rates shrink the remaining fiscal space. If expansionary fiscal management were to push rates up, that very rise in rates would eat into the fiscal space — a framework that can be read as having discipline built in, with rising interest rates likely to act as the brake.

Q9. Will the FY2027 initial budget swell?

It is likely to expand. Under the "from supplementary to initial" policy, however, expansion of the initial budget should be the mirror image of smaller supplementary budgets. What matters is whether the now-customary year-end supplementary budget is compiled at all this year — and, if it is, whether its size is

rigorously restrained.

If the outcome is "a larger initial budget with supplementary budgets maintained as usual," the reform loses its meaning, and a bond market that is becoming increasingly sensitive to fiscal developments would likely react. Whether total expenditures and new bond issuance across the initial and supplementary budgets combined are restrained will be the yardstick for assessing fiscal discipline.

Q10. What happens to social security spending?

Restraint is likely to continue. The CEFP has assessed the existing framework for containing social security spending as having "functioned as a degree of fiscal discipline," and stated that even while appropriately reflecting price and wage increases, Japan "needs to continue reform efforts on benefits and burdens and work to secure the sustainability of the system." Concrete reform items are already listed: cost-sharing based on ability to pay irrespective of age (reviewing out-of-pocket shares for medical and long-term care), revisiting the definition of "elderly," and measures concerning minor, routinely used medicines and medical services.

Behind this lies the Takaichi administration's policy of "stopping, and then lowering, the rise in social insurance premium rates borne by the working-age population." Nominal growth in spending will be tolerated to a degree as prices and wages are reflected in medical fee schedules and the like, but the framework assumes that efficiency efforts in real terms will continue.

As a result, the expenditure structure is likely to take the shape of "restraint in social security plus expansion in non-social-security areas (crisis-management and growth investment, etc.)." Whereas the old spending benchmark used social security (with only aging-related growth permitted) as the axis for binding total expenditures, under the new framework the axis of restraint remains on social security while non-social-security areas gain room to expand through the new investment framework. Whether social security efficiency gains proceed as planned will therefore determine the funding of the investment framework — and, by extension, the discipline of the public finances as a whole.

Q11. How does this relate to rising interest payments?

The trajectory of the debt-to-GDP ratio is governed by the relationship between the interest rate (r) and the nominal growth rate (g). The ratio tends to decline while nominal GDP growth exceeds the interest rate; once

rates catch up with growth, declines become harder to achieve and a degree of primary surplus becomes necessary.

The key point is the time lag before market interest rates feed through to actual interest payments. Most of the outstanding government debt consists of bonds issued in the low-rate era, which carry their old low coupons until redemption. Hence, even as market rates rise, the effective interest rate on the debt stock as a whole (the weighted-average interest rate on JGBs) remains low. This is merely a "bonus period" that lasts until refinancing runs its course. As low-rate debt is progressively rolled over into higher-rate debt, the effective rate will ratchet up in stages.

The current decline in the debt-to-GDP ratio is thus partly supported by a tailwind that will eventually fade. The question is whether medium-term fiscal plans can be designed in anticipation of the phase in which the effective rate catches up with the growth rate and the ratio becomes harder to bring down. That is where the new target of "a stable decline in the debt-to-GDP ratio" will face its real test.

Q12. What is SDSA?

SDSA stands for Stochastic Debt Sustainability Analysis — a simulation framework for discussing fiscal sustainability in probabilistic rather than deterministic terms. Olivier Blanchard, former chief economist of the IMF, introduced it as an analytical tool for fiscal sustainability when he took part in the CEFP discussions.

The Cabinet Office's Medium- to Long-Term Economic and Fiscal Projections are "point" forecasts built on preset assumptions (growth rates, interest rates, etc.), with no explicit probability attached to any given scenario. SDSA, by contrast, applies stochastic shocks to variables such as growth and interest rates, simulates a large number of paths, and captures the outlook for the debt-to-GDP ratio as a probability distribution — a "surface" rather than a point — making the width of uncertainty visible. If introduced, it would change the terms of debate: from "can the fiscal target be met?" to "with what probability can it be met?"; and from "is the baseline scenario safe or dangerous?" to "how large a fiscal buffer is needed to keep debt from exploding with a given probability?"

One caveat deserves attention: SDSA, too, cannot eliminate analyst discretion. Results such as the probability of debt explosion vary greatly depending on which data are used to estimate the shock distributions and the correlations among variables, and on how fiscal policy is assumed to respond to shocks. It is no less assumption-dependent than the existing projections — if anything, the number of assumptions to

be made increases. What will matter is whether it is operated in a way that allows the validity of those assumptions to be scrutinized openly.

Q13. What about a consumption tax cut or refundable tax credits?

These may connect to the funding debate. As discussed above, the fiscal target will likely treat the room consistent with a declining debt-to-GDP ratio as "fiscal space," tolerating spending increases within it. The specific size of that space is unclear at this stage (it depends on the economic assumptions), but one could conceive of a consumption tax cut or refundable tax credits being framed as fitting within that space. Naturally, if the space is devoted to such measures, the amount available for crisis-management and growth investment shrinks accordingly.

Q14. What is the connection with Japan's version of DOGE?

Japan's DOGE is a politically led screening of existing measures — special tax measures, subsidies, government funds — aimed at abolishing or scaling back those with low policy effectiveness. "Responsible, proactive fiscal policy" is constructed as strategic fiscal deployment built on top of administrative and fiscal reform.

The review work has been in full swing since spring 2026; its results are to be reflected in the Basic Policy and then fully incorporated into the FY2027 budget and tax reform. Against the accelerator of the "new investment framework," how much braking power the spending-reform record can demonstrate will be important for the credibility of fiscal discipline.

Q15. Once again — what should we watch for in the upcoming Basic Policy?

What matters is whether the government can dilute the impression of quantitative expansion and demonstrate that this is a "from quantity to quality" transformation of fiscal policy. Three passages deserve particular attention: (1) under the "from supplementary to initial" policy, how strongly the shrinking of supplementary budgets is written into the text; (2) how concretely the size and funding of the "new investment framework" are to be set; and (3) to what extent the medium-term fiscal management plan takes account of future increases in interest payments.

The Takaichi administration's fiscal stance is often seen as one-dimensionally expansionary, but the individual policies on the table include genuine corrections of long-standing distortions in Japan's budget formulation. The real question is the effectiveness of the mechanisms that discipline them — and the bond market's verdict may well turn on how the Basic Policy is written.

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