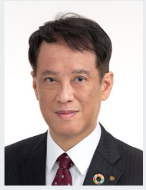
Economic Commentary (primary balance)

Importance of achieving a primary balance surplus is growing

- The primary balance of the central government's general account is already in surplus on an initial-budget basis
- Higher defense spending will raise the hurdle for achieving a primary surplus
- Rising interest payments will turn achieving a primary balance surplus from an end goal into an intermediate milestone
- A key focus will be the institutional design of bridge JGBs for crisis management and growth investment

Koji Hamada
81-3-5555-8791
kouji.hamada@daiwa.co.jp
Daiwa Securities Co. Ltd.



Conclusion

One factor behind the deficit in the central government's general-account primary balance (PB) was a decline in tax revenue. Recently, however, growth in tax revenue has accelerated, and the PB on an initial-budget basis turned to a surplus in FY26. The impact of supplementary budgets is also likely to diminish soon.
Looking ahead, however:

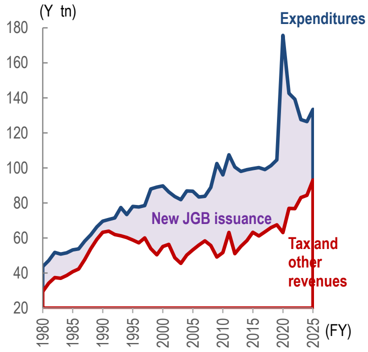
1. The hurdle for achieving and maintaining a PB surplus could rise owing to increases in defense spending and other expenditures.
2. Interest payments, which are excluded from the PB, will increase substantially. Achieving a PB surplus is therefore becoming more important, as it shifts from being the end goal of fiscal consolidation to an intermediate milestone toward ensuring fiscal sustainability.
3. For bridge JGBs used to finance crisis management and growth investment, attention will focus on their institutional design, including the details of the funding sources earmarked for redemption and the amount of funding required.

Following this report on the PB, we plan to publish reports on interest payments, the debt-to-GDP ratio, and the Domar condition.

(Reference) Overview of the analysis in this report

- We analyze the PB of the central government's general account on both an initial-budget basis and a post-supplementary-budget basis (i.e., the initial budget plus supplementary budgets). Although the PB is normally assessed on a settlement-basis, this approach enables us to decompose the respective contributions of the initial and supplementary budgets.
- "Expenditures minus tax and other revenues" equals new government bond issuance, while "(expenditures minus national debt service costs) minus tax and other revenues" equals the PB. We divide expenditures and tax and other revenues (including tax and non-tax revenues) into individual components and analyze the factors behind their increases or decreases.

Chart 1: Central Government General-account Expenditures, Tax and Other Revenues, and New JGB Issuance (post-supplementary-budget basis)



Source: MOF; compiled by Daiwa.

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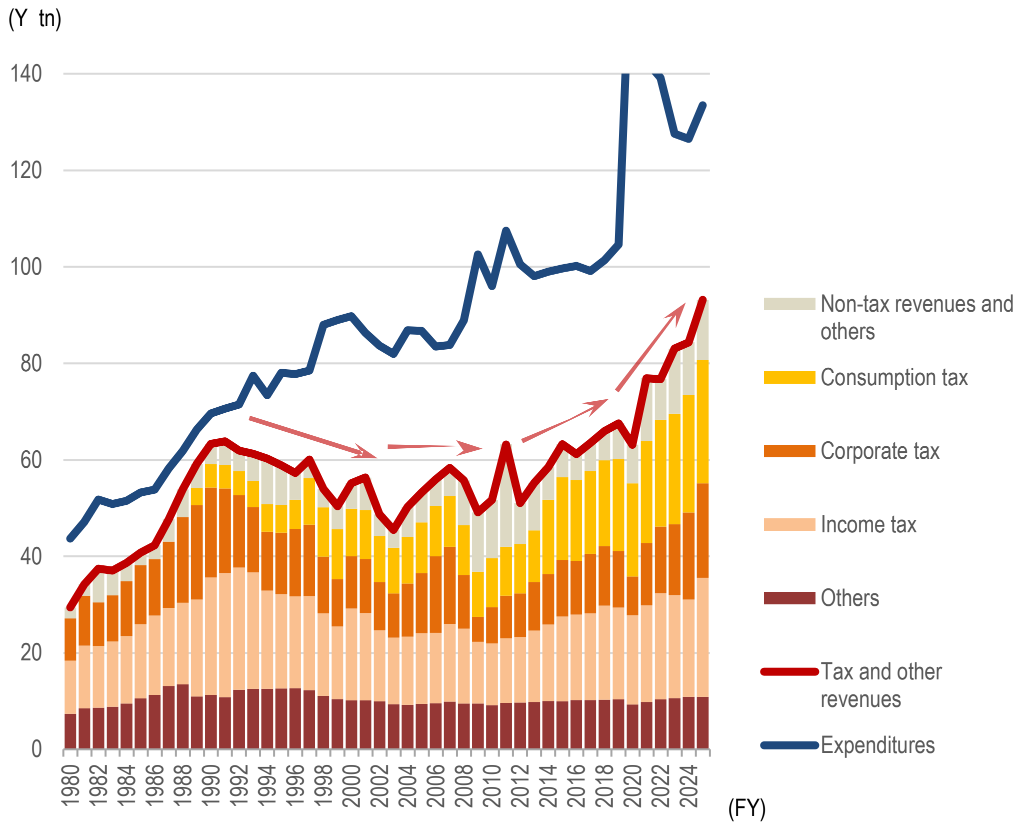
Tax revenue has shifted from a downward to an upward trend, with growth accelerating recently

Tax and other revenues declined throughout the 1990s, causing the lower jaw of the "crocodile's mouth" to fall and the mouth to open. However, the decline came to a halt in the 2000s, and tax and other revenues began rising in the 2010s. Their growth has accelerated in the 2020s (Chart 2).

Chart 2: Trends in Central Government General-account Tax and Other Revenues (post-supplementary-budget basis)



Period	Major economic developments	Impact on tax revenue
1990s–early 2000s	Collapse of the asset-price bubble and Japan's financial crisis	Individual income tax and corporate income tax revenues shifted to a declining trend
Early 2000s	The *Izanami* economic expansion (the longest postwar expansion)	Individual income tax and corporate income tax revenues temporarily bottomed out
Late 2000s	The global financial crisis (Lehman shock)	Individual income tax and corporate income tax revenues declined again
2010s	The Abenomics-driven economic expansion	Corporate income tax and individual income tax revenues shifted to an upward trend
2010s	Two increases in the consumption tax rate	Consumption tax revenue increased markedly
2020s	Import-driven inflation amid surging global commodity prices and yen depreciation Strong corporate earnings and a shift toward wage hikes	Growth in consumption tax, individual income tax, and corporate income tax revenues accelerated

Source: MOF; compiled by Daiwa.

PB turned to a surplus in FY26 initial budget

A simple method for calculating the PB is as follows: “tax and other revenues − (expenditures − national debt service costs).” In the initial budget, “expenditures − national debt service costs” has increased at a steady pace. Almost all of this increase can be explained by the rise in social security expenditures alone (Chart 3: social security expenditures on an initial-budget basis). Tax and other revenues began rising after declining for more than a decade.

As a result, tax and other revenues exceeded “expenditures − national debt service costs” in FY26, producing the first PB surplus in 28 years (the arrow and red-circled area in Chart 3).

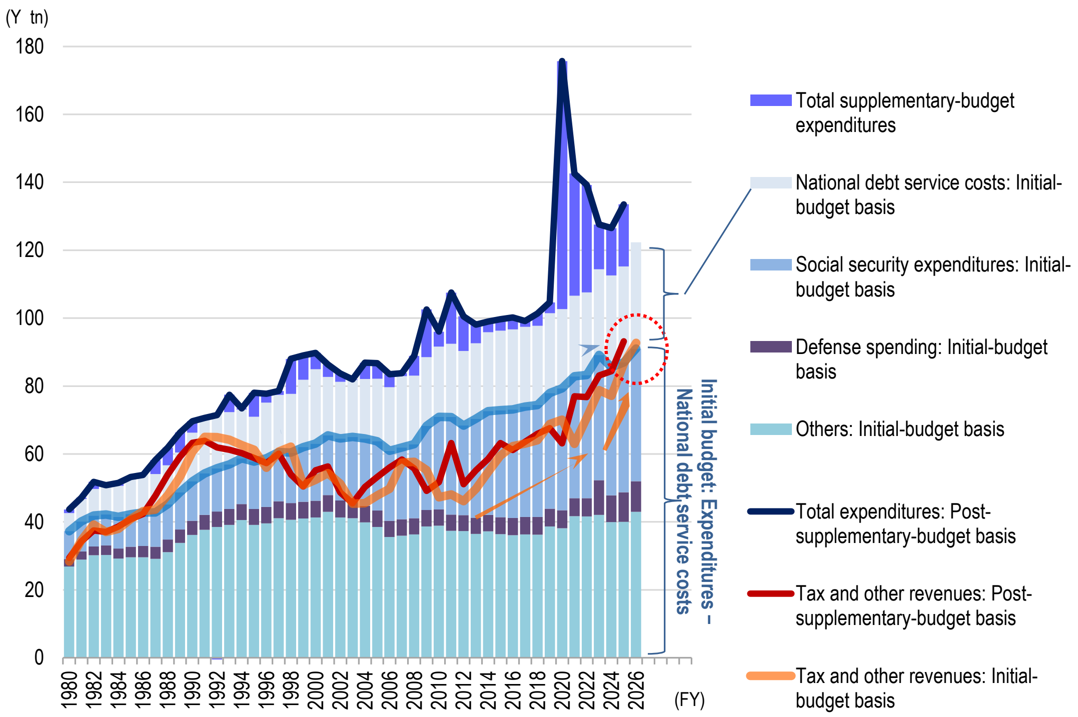
Although this applies only to the PB on an initial-budget basis, the government has already achieved, in flow terms, its longstanding fiscal-consolidation target.

Higher defense spending will raise the hurdle for achieving a PB surplus

Looking ahead, however, growth in “expenditures − national debt service costs” is likely to accelerate, potentially raising the hurdle for achieving a PB surplus.

Defense spending, in particular, began increasing in FY23, and the annual increases are highly likely to become larger from FY27 (Chart 3: defense spending on an initial-budget basis).

Chart 3: Trends in Central Government General-account Expenditures (post-supplementary-budget basis)



Source: MOF; compiled by Daiwa.

Achieving a PB surplus has become an intermediate milestone toward ensuring fiscal sustainability

The PB is the difference between “expenditures − national debt service costs” and tax and other revenues. New government bond issuance is the difference between expenditures and tax and other revenues. National debt service costs do not affect the PB, but they do affect the amount of new government bond issuance. If national debt service costs increase substantially and the increase exceeds the improvement in the PB, new government bond issuance will rise.

National debt service costs have increased over the long term (Chart 3: national debt service costs on an initial-budget basis). This is because principal redemption costs have risen in line with the outstanding amount of government debt. Moreover, the pace of increase will accelerate going forward, as interest payments, in addition to principal redemption costs, have begun to rise. Achieving a PB surplus has therefore shifted from being the end goal of fiscal consolidation to an intermediate milestone toward ensuring fiscal sustainability, making it increasingly important.

The Basic Policy on Economic and Fiscal Management and Reform 2026 states that “the stable reduction of the ratio of the combined outstanding debt of the central and local governments to GDP shall be positioned as the core objective of fiscal management.”

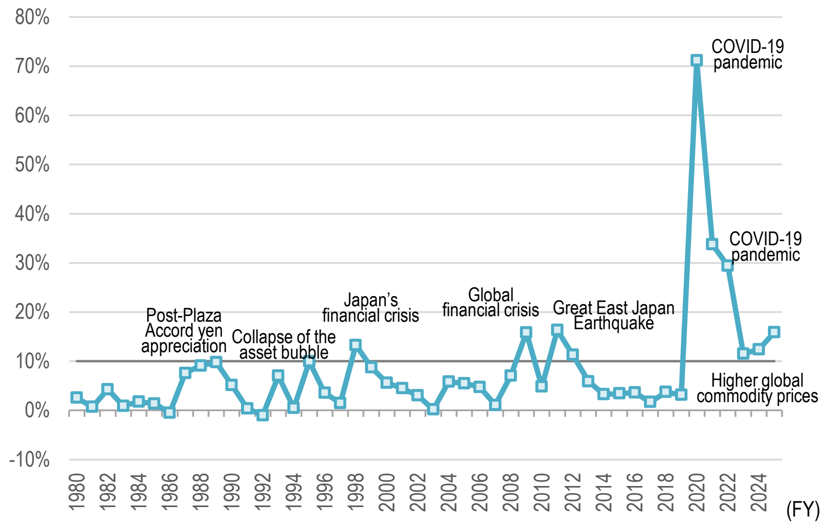
This is followed, however, by the statement that “fiscal management shall be assessed in light of the fiscal balance after taking account of the PB and net interest payments.” If the amount of new government bond issuance comes to be determined by taking both the PB and net interest payments into account, this could help alleviate fiscal concerns.

Incorporating supplementary-budget expenditures into the initial budget could also raise the hurdle for achieving a PB surplus, depending on their scale

The Japanese economy has long been hit by a succession of shocks, prompting repeated fiscal stimulus. In general-account expenditures, supplementary budgets appear as humps or spikes (Chart 3: total supplementary-budget expenditures).

Looking back at the major shocks of the past, supplementary-budget expenditures exceeded 10% of initial-budget expenditures. In FY20, during the COVID-19 pandemic, the ratio was exceptionally high at more than 70%. Spending on subsequent measures to address rising prices also exceeded 10% (Chart 4).

Chart 4: Ratio of Supplementary-Budget Expenditures to Central Government General-account Initial-budget Expenditures



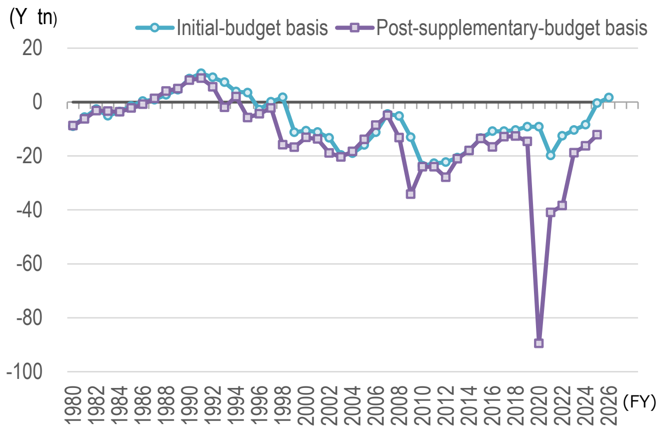
Source: MOF; compiled by Daiwa.

Although the PB on an initial-budget basis turned to a surplus in FY26, improvement in the PB on a post-supplementary-budget basis has lagged (Chart 5). This reflects the large-scale fiscal measures implemented in response to the COVID-19 pandemic and rising prices.

If the FY26 supplementary budget remains small, the PB on a post-supplementary-budget basis should improve substantially, catching up with the PB on an initial-budget basis. As supplementary-budget expenditures may, in principle, be carried forward only to the following fiscal year, an improvement can also be expected in the FY27 PB on a settlement basis.

On the other hand, the process of incorporating supplementary-budget expenditures into the initial budget will begin in FY27. If the amount incorporated into the initial budget exceeds the level normally seen in non-crisis periods, the PB on an initial-budget basis could reverse course and return to deficit.

Chart 5: Central Government General-account PB on Initial-budget and Post-supplementary-budget Bases



Source: MOF; compiled by Daiwa.

Attention will focus on the institutional design of bridge JGBs for crisis management and growth investment

Crisis management and growth investment will be managed through special accounts and financed by bridge JGBs. The current direction is for these bridge JGBs to be excluded from the PB and the debt-to-GDP ratio.

Bridge JGBs are issued as interim financing until stable funding becomes available, provided that a stable future funding source has been secured in advance through legislation. If proceeds from the sale of government-held shares or other non-tax revenues are used as funding sources, this would create competition for resources with the general account and other special accounts.

Moreover, the larger the amount issued each fiscal year and the longer the issuance period, the greater the amount of funding required for redemption.

As these bonds will be managed separately, attention will focus on their institutional design, including ensuring consistency across the government as a whole, the composition of the funding sources earmarked for redemption, and the amount of funding required.

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