Federal Budget 2025-26

Budget Preview

23 March 2025

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Fiscal discipline and pro-productivity reforms needed

Fiscal discipline and a plan for productivity-enhancing reform should be front and centre in the 2025-26 Budget as inflation risks persist while the hostile and ever-changing global trading environment, plus known challenges threaten Australia's growth prospects.

But already, tens of billions of dollars have been promised for new programs and infrastructure in the lead up to the 2025 election. There have been indiscriminate policies to lower expenses for all households, with more expected. Easing cost of living problems is still the main focus for politicians – as it has been for the past two to three years. The level of prices is causing stress for households, even though headline inflation has eased to a reasonable level.

But it is not Australia's only challenge and so we repeat our Budget wish list again in 2025:

1. Not add to spending, unless offsetting it elsewhere
2. Change existing policy to lower spending and find new revenue that will persist over time
3. Put in place reforms to assist the private sector to maximise productivity growth.

Our concerns are based on structural expenditure forecasts exceeding revenue for another decade, even though (at least for the moment) the economy is forecast to continue growing, with relatively low unemployment, high commodity prices and a competitive Australian dollar. The Treasurer has noted that even though there will be (smallish) revenue upgrades in the Budget and some of the election promises had already been provisioned for, fiscal deficits are to be expected for some years. This means current policy settings will cause our debt burden to grow even if we avoid bad times, and if we don't, there is no fiscal buffer to deal with downside scenarios, which means the debt and interest burden grow further.

The underlying cash balance projections made at the time of the December mid-year economic review, which Treasurer Chalmers said last week would remain mostly unchanged, were for a deficit of around $27 billion this financial year and $47 billion next year. Under that scenario, net debt rises to over $700 billion by mid-2028 (from $540 billion this year) and there is a near doubling in the interest rate bill to over $27 billion by 2027-28.

Personal income and company tax receipts decline as a share of total receipts due to the personal income tax cuts this year but return to their upward trajectory again from July.

Successful businesses given the most supportive and competitive backdrop could be a significant part of Australia's armoury as we deal with the tail end problems of high inflation, geopolitical strife, a trade war, climate change and aging. The Budget is an opportunity to kick off further productivity enhancing (including tax) reform, which could be carried into the next term of government.

New election policy promises will add to the Government expenditure

The Government has announced multiple policies worth tens of billions of dollars in recent months focused on health care, cost of living relief and infrastructure as it prepares the 2025-26 Budget ahead of the pending election. The Treasurer has noted that funding for some of its policies has already been provided for in previous budget updates.

Major policy and infrastructure announcements include:

- $8.5 billion for Medicare for:
  - bulk-billed GP visits;
  - Nursing scholarships; and
  - More doctors.
- $7.2 billion for Queensland's Bruce Highway
- $3.5 billion for Victorian and South Australian public schools over the next 10 years
- $3.3 billion for new road and rail projects in Victoria
- $2 billion for green aluminum production credits
- $1.8 billion in cost-of-living relief in the form of electricity rebates
- $1.7 billion to fund public hospitals and health services, including $573 million for women's health
- $1 billion for various housing projects across three states
- $627 million for an apprentice incentive program ($10,000 bonuses for apprentices)
- $690 million to cap PBS medicines at $25 a script

As well, the Treasurer said there will be provisions made for election promises that the Government will announce once the campaign has launched and $1.2 billion has been allocated for natural disaster relief following cyclone Alfred.

'Off-balance sheet' spending (not counted as general government spending but which still adds to gross debt) will also increase, building on the record high levels of over $20 billion each year. New promises include the federal government's part of the $2.4 billion rescue package for Whyalla steelworks, $2 billion for the Clean Energy Finance Corporation, $500 million for the Green Iron Investment Fund and $3 billion for NBN upgrades.

Given changes in the global security and trading environment, additional spending will also likely be made in defence, plus an extension of the Future Made in Australia policies seems likely.

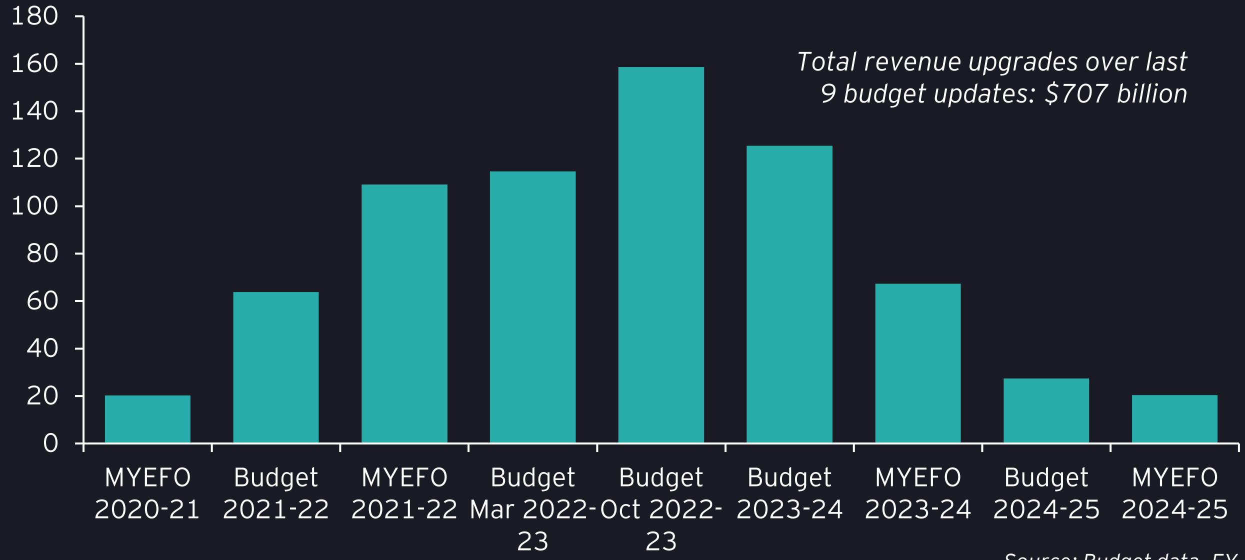
Economic conditions could lead to another short-term revenue bump

The ongoing strength of the jobs market, coupled with population growth, above-forecast commodity prices, a weaker Australian dollar, and ongoing inflation will likely lead to upward revisions to revenue. The Treasurer said this bump will be smaller than it has been in each of the post pandemic budget updates.

In 2024-25 however, which Treasury last forecast at 1¾ per cent, the impact of cyclone Alfred is likely to take a ¼ percentage point off GDP (in the March quarter). This could be offset with a small upward revision to real GDP growth in 2025-26, forecast at 2¼ per cent at MYEFO, as household consumption recovers and monetary policy conditions become less restrictive. Nominal GDP though, which is more reflective of revenue growth and crucial for the budget numbers, is likely to be broadly unchanged at 3½ per cent in 2025-26.

Headline inflation forecasts are likely to be revised a little lower, given the last forecast for 2024-25 and 2025-26 was 2¾ per cent in MYEFO and the latest quarterly CPI read was 2.4 per cent over the year to December. Also, the continuation of electricity rebates will add downward pressure to headline inflation. But as we have witnessed over the past year, this doesn't help bring underlying inflationary pressures down across the economy.

Total revenue upgrades over four year budget horizon
$ billion



Source: Budget data, EY

Although there may be adjustments to the near-term growth outlook, the post-pandemic upside revenue surprises of recent years are unlikely to continue. The boost from strong commodity prices will fall as China's structural slowdown takes hold. The Australian dollar’s depreciation is not expected to continue, and together these mean export income and resource company's profits are less likely to surprise on the upside and push up corporate tax. Downside risks to growth from the trade war, geopolitical strife, climate change management, natural disasters and an aging population also add downside risks to the budget outlook.

More needs to be done to address the structural budget deficit

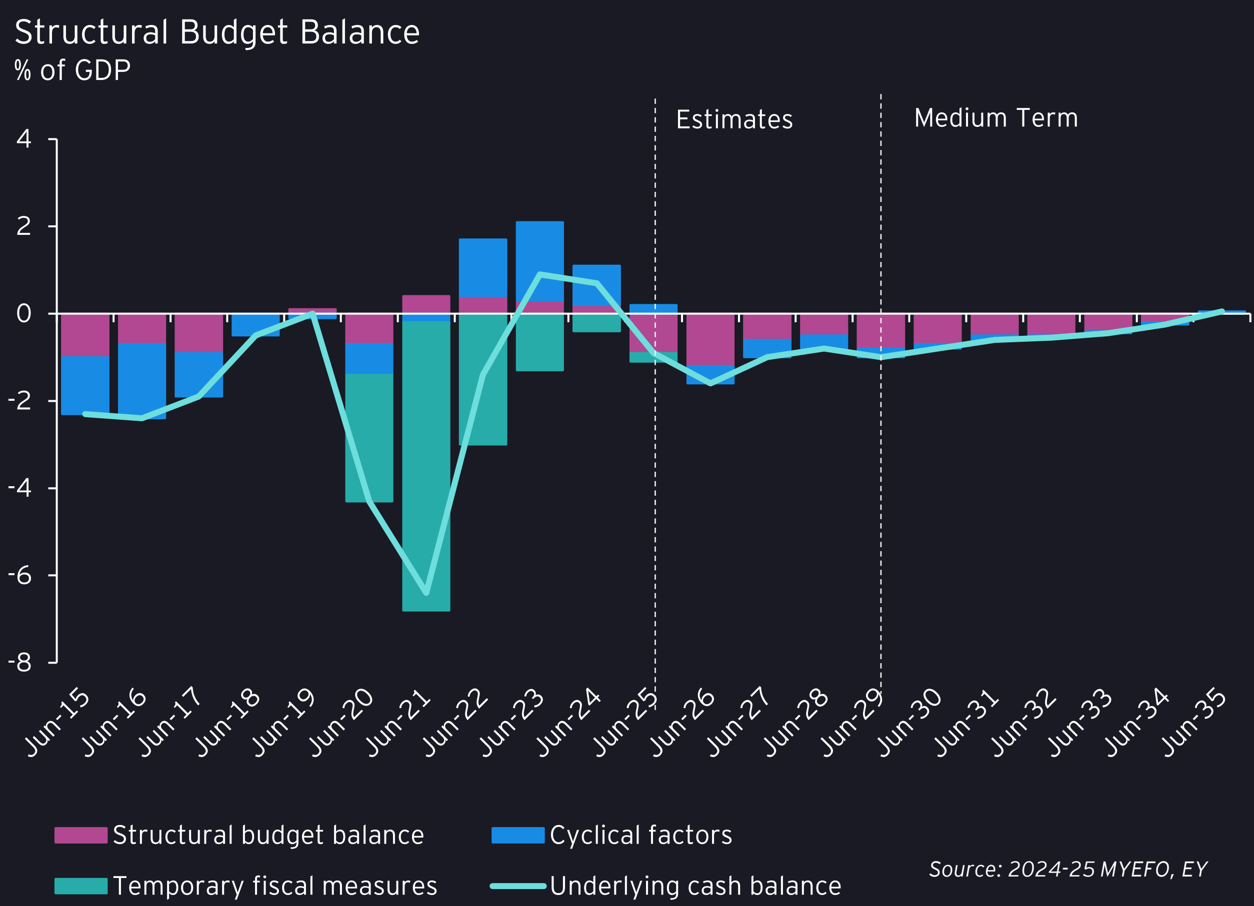
When temporary cyclical factors like high commodity prices or lower than normal unemployment is removed from revenue and expense projections, we are left with the structural budget position. This measure helps us better understand how government policy dictates revenues and expenses. If revenue and expenses align, this is considered a sustainable budget position as the structural budget is closer to balance. This is key in bringing debt down and ensuring there is fiscal space to help the economy deal with future shocks.

The structural budget position (according to MYEFO estimates) is projected to be in deficit from 2024-25, peaking at 1.2 per cent of GDP in 2025-26 – broadly in line with the 2024-25 Budget. It is projected to improve gradually but remain in deficit until 2034-35. This is driven by spending pressures from aged care, medical benefits, defence, health, the NDIS and interest payments.

To make improvements to the structural budget, policy changes that lift revenue and/or lower expenditure are needed. There may be some potential to implement cost savings by using AI and digital technologies to provide more efficient back-office services. Some savings could also be made by running government services through a contestability lens, asking whether they should be provided by the public sector at all.

The biggest improvement though could come from better allocation of labour and capital which would lift productivity growth, allowing the economy to grow faster. Labour productivity fell by 1.2 per cent in the year to the December quarter of 2024, a poor outcome. This is likely to turn around somewhat and the MYEFO assumption is for long run annual productivity growth of 1.2 per cent (as it was in the 2024-25 Budget).

As highlighted in the 2021 Intergenerational Report, if productivity growth rose to its 30 year long run average rate (to 2018-19) of 1.5 per cent, the structural budget deficit could eventually close as real and nominal GDP would be higher, and the underlying cash balance would be lower.



Source: 2024-25 MYEFO, EY

A better tax system would lift productivity growth and assist fiscal repair

A better tax system would go a long way towards achieving the goal of higher productivity growth, although not without some politically challenging disruption.

Tax reform would ideally start from a blank page. It would be long-term and bi-partisan with the support of all state and territory governments. It would be designed on the principles of fairness, efficiency, simplicity, sustainability and coherence. It would lower the proportion of tax directly sourced from income, and increase that from indirect sources like consumption, and it would lower the economic cost of raising revenue.

Recognising the political realities, the second-best option would be a "package" that reforms part of the tax system. Increasing the GST rate to 20 per cent – which would be just over the OECD country average of 19.3 per cent – while retaining the exemptions would generate an extra $80 billion every year. Eliminating the exemptions as well would generate an extra $132 billion. Some of the proceeds could be used to compensate low-income households. Importantly this would mean the foundations of a tax collection model, with less reliance on personal and business income, would be in place.

Failing that, a third solution would be very targeted tax incentives for sectors, industries or regions to achieve policy goals. Investment allowances – such as an extra 20 per cent depreciation deduction – and full expensing and enhanced research and development (R & D) tax incentives would encourage incremental business investment. This would attract foreign capital and deepen the capital base. Capital deepening allows workers to be more productive. Had it not been for the capital deepening that occurred over the 10 years to 2023-24, GDP would have been lower by about $70 billion per year.

Company taxes are being lowered internationally to raise competitiveness. The US Government has floated a concessional corporate tax rate of 15 per cent for companies that make products in the US. Singapore has incentives that encourage companies to set up or expand their headquarter activities there, offering a concessional tax rate of 5, 10 or 15 per cent on qualifying income.

In Australia, over the past 5-10 years, tax integrity measures have broadened, not narrowed, the corporate tax base. Australia's regime ranks poorly for the burden it imposes on companies. Australia (both federal and state) raises 62 per cent of its taxes from personal and corporate income. The OECD country average is 36 per cent. For the federal government alone, this is 75 per cent. Inherent in our systems are disincentives to earn income – the exact opposite of what we need.

Cherelle Murphy | EY Regional Chief Economist, Oceania
23 March 2025

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