Economic Update 23 July 2025

Fiscal policy in neutral

Key points

- Combined Federal and state fiscal policy settings for 2025-26 are broadly neutral, a step down from the fiscal stimulus seen in 2024-25.
- Budget forecasts suggest that fiscal policy could turn contractionary in 2026-27, but this is being driven by what looks like an implausible slow down (to near zero) in state spending growth. It is likely that future policy decisions will add to spending (and the deficit).
- State budget projections point to state infrastructure programs peaking in 2025-26. However, the trend has been for the size of state programs to be revised up, and the peak year pushed out, although there are signs governments have become more conscious of the need to prioritise projects and to contain costs.
- The move from fiscal stimulus to more neutral settings in 2025-26 reinforces our view that the appropriate path for monetary policy is for it to move to around neutral. We expect the RBA to make three further 25bp cuts, taking the cash rate back to 3.1%.

The States matter

With all the state and territory ('state' hereafter) budgets for 2025-26 now released, we present a more complete assessment of likely fiscal policy settings for the 2025-26 financial year.

State spending makes up around 32-48%[1] of combined state & federal spending. In the national accounts the state & local government share of public final demand is even larger, at almost 60%, recognising their primary role as service and infrastructure providers (whereas the Commonwealth has a larger role in income transfers).

A recap – Commonwealth Budget

Our assessment at the time of the Commonwealth's 2025-26 Budget in March was that the stance of Federal fiscal policy was set to be broadly neutral in 2025-26, with the prospect of it turning contractionary in 2026-27. This was a reversal from the fiscal stimulus seen in 2024-25.

This conclusion was based on estimates of the general government (GG) structural budget balance. Structural balance estimates decompose the budget balance between structural and cyclical components. This is based on model estimates and so can be sensitive to model specification.

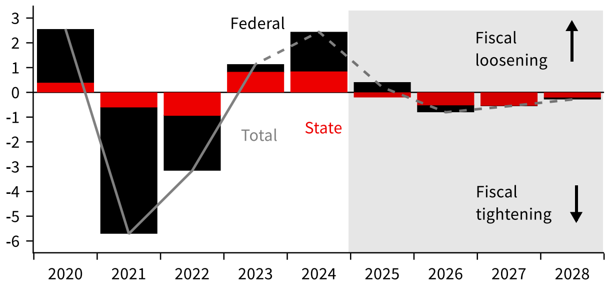
A simpler metric is to look at the change in the budget balance – with a larger (smaller) deficit implying fiscal stimulus (contraction). Doing this leads to a similar conclusion. While there was a projected increase in the underlying cash deficit in 2025-26 (as a % GDP), it was only small (+0.5ppt) and much less than in 2024-25 (+1.6ppt).

Adding in the States

To assess the impact of the states, as structural balance estimates are not readily available, we only look at changes in the underlying cash balance.

We also focus on the total non-financial public sector (NFPS), which is made up of the GG and the public-non-financial corporations (NFC) sectors - the latter are more important at the state level.

Fiscal impulse - based on cash balance (% GDP)



Source: National Australia Bank, Australian Department of the Treasury, Macrobond. Federal NFPS forecasts extended using General govt. growth rates. Impulse = -(change in underlying cash balance) x-axis shows first year of the financial year (2025 represents FY 2025-26)

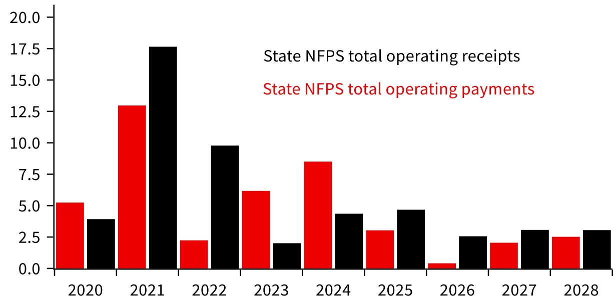
For 2025-26, the combined Federal and state government fiscal impulse is close to zero, with a small increase in the Federal deficit offset by a small decrease at the state level. While any measure of the fiscal impulse has limitations, fiscal policy will be far less supportive of demand growth in the economy in 2025-26 compared to 2024-25 at both the Federal and state levels. This is consistent with our forecast that private demand is expected to be a stronger driver of overall GDP growth in the next year or so.

At first glance, the estimates also suggest that fiscal policy will be contractionary in 2026-27. **However, we don't place much weight on this.** The main driver of the expected improvement in the budget balance in 2026-27 is near zero state spending growth, with a small rise in operating payments and a fall in non-financial asset

[1] Depending on whether Commonwealth grants to the states are treated as spending by the Commonwealth or states.

investment. This implies a large fall in real, per capita, operating spending, which appears implausible (and historically unusual) absent an urgent need to repair state budget positions.

State NFPS payments and receipts (% change)

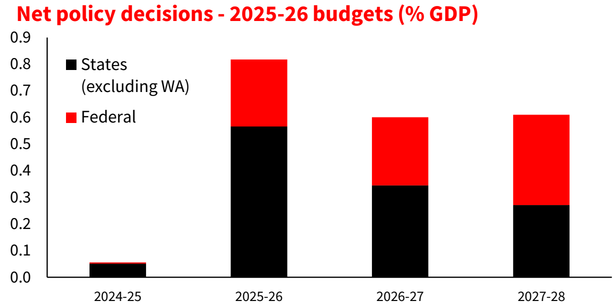


Source: National Australia Bank, Macrobond
x-axis shows first year of the financial year (2025 represents FY 2025-26)

In this light it is worth looking at the net cost of new announcements in the various 2025-26 budgets. This also provides an indication of how the fiscal stance has *changed from what was known pre-budget*.

The Commonwealth and most states (WA the exception) publish a reconciliation of the change in the budget position (from the half-year budget update). This reconciliation shows how much of the change in the budget is due to policy decisions as opposed to changes in 'parameters'. An example of a policy change is a decision to lower tax rates. Examples of parameter changes include estimated tax receipts and program costs being revised higher because (respectively) employment and program take-up is higher than previously forecast.

Net policy decisions - 2025-26 budgets (% GDP)



Note: Federal decisions are for the GG sector (including capex), state estimates are for operating activities, and sector coverage varies (generally GG).

Net new policy decisions announced in the federal and state 2025-26 budgets increased budget deficits at both the state and Federal levels. New policy decisions at a state level (ex WA) were roughly double the magnitude of Commonwealth net new policy.

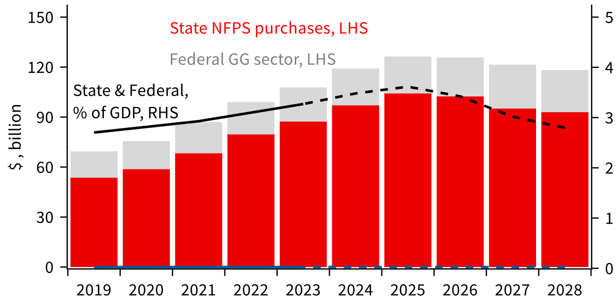
In short, with one budget and two half-year updates before the end of 2026-27, a lot can still change. Moreover, parameter variations can be substantial. State GSP growth forecasts imply a modestly higher level of Australian GDP growth than we expect, which suggests some risk of higher than expected budget deficits. (That said, the overall revenue estimates do not appear high and at least some budget assumptions are conservative, including assumed commodity prices in the Commonwealth and WA budgets, but less so in the case of the Qld Budget).

Infrastructure programs

The states are the major providers of public infrastructure. Because of capacity issues in the construction sector, the size of state infrastructure programs has competed for resources with private investment – for example, anecdotal reports suggest that competition for labour and materials has impacted residential construction activity. The Commonwealth also has a still sizable, if smaller capital program (outside of grants to the states), but with a different mix – defence investment is expected to be 80% of total investment this year.

The 2025-26 budget papers suggest that state and Commonwealth infrastructure programs will peak in 2025-26 before beginning to ease. This would open the way for an easing in construction cost pressures and an alleviation of supply constraints in other parts of the economy from 2026-27.

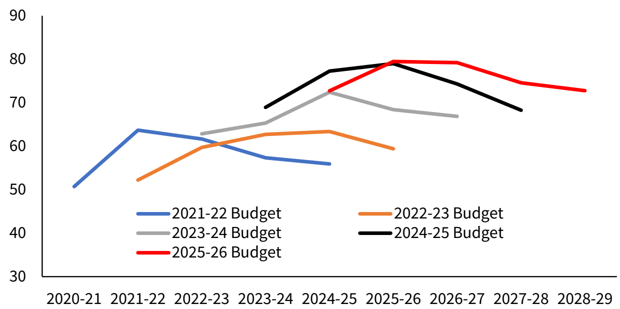
Purchases of non-financial assets (% GDP)



Source: National Australia Bank, Australian Department of the Treasury, Macrobond
x-axis shows first year of the financial year (2025 represents FY 2025-26)

However, this is by no means guaranteed. Looking at the three largest states, while an earlier peak in infrastructure investment has been projected in previous budgets, **infrastructure spending estimates have tended to be revised higher and the peak year moved out.** This likely reflects a combination of project delays, higher than expected costs and policy decisions to expand the scope of current projects or to take on additional projects.

NFPS purchases of non-financial assets ($b) - NSW, Vic., Qld



A more optimistic take is that capacity constraints and the need to contain cost pressures have become more front of mind with a greater focus on prioritisation. In 2023, following a review of the Infrastructure Investment Program (a program focussed on transport infrastructure through grants to the states) the Federal Government withdrew funding for 50 projects while providing additional funding to other projects (with the total 10 year spending envelope unchanged).

Implications

As the state budgets confirm our previous assessment of fiscal policy, there are no major implications for our forecasts. These incorporate an expectation that public final demand growth over 2025 and 2026 will not be as strong as recent years but remain at a solid level, a view which is consistent with the projected slowdown in spending growth by the Federal and state governments in 2025-26.

With inflation expected to settle at around 2.5% in underlying terms and global growth facing headwinds, **the change in the fiscal stance from stimulus in 2024-25 to neutral in 2025-26 reinforces our view that the appropriate path for monetary policy is for it to move from its current modestly restrictive level back towards neutral. This should deliver consistency across the key arms of economic policy.** We expect the RBA to make three further 25bp cuts by February 2026, taking the cash rate back to 3.1%**.**

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