Federal Budget 2026-27

Budget Preview

10 May 2026

A pivotal period requires bold budget reform

In the 2026-27 Budget, Treasurer Jim Chalmers faces the daunting task of steering the economy through choppy waters while global trade routes are less predictable, supply chains more fragile, and households are stretched. The essential task of lifting productivity growth, which the Treasurer identified as a key ambition at last year's election, has become more pressing given the economy is being buffeted by yet another supply shock. The Middle East conflict is building on the challenges of the pandemic, trade disputes and the war in Ukraine.

Three ambitious reform packages have been promised by the Treasurer in his fifth budget. These are centered around savings; productivity and investment; and tax. As well, intergenerational fairness and supporting new housing have been identified by the Government as priorities. It all adds up to a big task, and certainly one that is possible. We welcome all positive policy changes but fear the reforms will not reach as far as they need to.

Thankfully, despite the current challenges, the Australian economy has continued to show resilience with relatively low unemployment and high commodity prices, which will likely lead to better-than-expected income and corporate tax collections. Data from the Department of Finance indicates that the deficit in FY26 will be much smaller than initially forecast. The year-to-March underlying cash deficit was $30.4 billion, approximately $17.0 billion smaller than forecast in the 2025-26 Mid-Year Economic and Fiscal Outlook (MYEFO) (which was published in December 2025). This gives the Government some flexibility with policy in the short term as new policies can be introduced without making the budget deficit worse.

But this flexibility is limited by the existing debt projections. At MYEFO, Australia's gross debt was projected to exceed $1 trillion in FY27, rising to more than $1.2 trillion by FY29. Higher interest rates and bond yields will lift the cost of issuance and refinancing even higher, increasing debt servicing pressures. Alongside persistent deficits, this risks undermining Australia's AAA rating and shifting a larger share of revenue toward interest payments rather than funding essential government services and investing in future priorities.

The impact of the Middle East conflict and subsequent rise in oil prices means Australia's inflation problem has only gotten worse from an already elevated level. Government spending, which is at a record high as a share of the economy, must avoid adding to inflation. We know some cost-of-living measures are planned but hope anything further is targeted only to those in need to avoid exacerbating the problem.

Our 2026 Budget wish list is largely consistent with our 2025 list, although with another shock having hit the economy this year, the urgency around reform has grown:

1. Do 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 invest and maximise productivity growth.

New spending outweighs savings, keeping fiscal pressure elevated

The Government has announced multiple policies worth tens of billions of dollars in recent months focused on defence, fuel security, housing and and cost-of-living relief for business and households impacted by the Middle East conflict.

Major spending policy and infrastructure announcements expected to be outlined in the Budget for implementation over the next four years include:

- $14 billion for extra defence spending, including drones and missile defence
- $10.7 billion fuel security package
- $3.8 billion for the Victorian Suburban Rail loop
- $3 billion for 5,000 new aged care beds and removing co-payments for key aged care services.
- $2.6 billion to cut the excise fuel tax and pause road user charges
- $2 billion for small scale infrastructure to enable housing development
- $1 billion in interest free loans for businesses impacted by higher fuel prices (as part of the National Reconstruction Fund)

'Off-balance sheet' spending (not counted as general government spending but still adding to gross debt) will increase, building on the record high levels of over $20 billion each year. New promises in this category include about $15 billion for defence spending in special government investment vehicles and joint ventures with private investors over the next 10 years, the $10.7 billion fuel security package and the Federal Government's portion of the $2 billion rescue package for heavy industry.

The Government has said it plans on $64 billion in gross savings measures, including reforming the National Disability Insurance Scheme (NDIS) although it is unclear over what period this figure relates.

Major announced savings over the next four years include:

- $35 billion from reforming the NDIS$10.7 billion fuel security package
- $5 billion in defence reprioritisations
- $3 billion from scrapping the private health insurance rebate for people aged over 65
- $2.7 billion in reduced external labour and non-wage spending

The announced reforms to the NDIS are critical to the scheme's sustainability and the overall budget position and are essential to return the NDIS to its originally intended size. In practice achieving the reforms is likely to be challenging. The Government is seeking to reduce the annual growth rate in the scheme's cost from over 10 per cent to just 2 per cent.

Importantly, the newly announced state administered Thriving Kids program will shift costs from the Commonwealth's NDIS to state and territory governments.

As we have consistently stated, recent government forecasts of the public sector wages bill have been unrealistically low. The Parliamentary Budget Office, in January, forecast that the Federal Government would need to cut 28,000 jobs over the next four years to meet its wage expense forecast. This is equivalent to $11.8 billion in savings. The Government has asked its departments and agencies to reduce their budgets by 5 per cent to help meet this target. It has also announced a round of voluntary redundancies for thousands of public servants.

New taxation measures have been flagged as part of the reform package

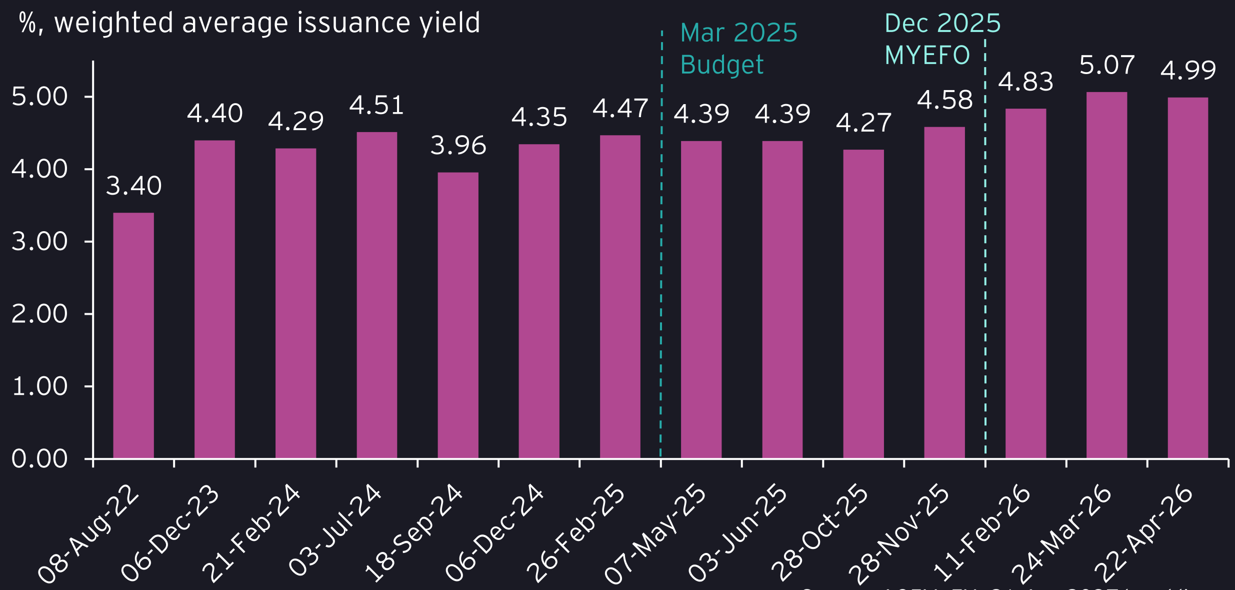
A new approach to taxing investor housing, assets and trusts, as well as retrospective taxes for foreign resident capital gains have been floated ahead of the Budget. There's also speculation that the Government will increase the research and development tax break. We consider this to be key step towards tax reform, but more needs to be done. Unless there is substantial change, Australia's corporate tax rate will remain well above the OECD average, and Australia will continue to rely heavily on corporate and income taxes for revenue.

Elevated government debt is a concern given higher interest rates

Net debt levels continue to grow and based on MYEFO forecasts, will reach over $754 billion by FY29. Debt issuance will reach over $1.2 trillion over the same period. The Australia 10-year government benchmark yield is now around 5 per cent, close to its highest level since 2011. With interest rates expected to rise further this will lead to an increase in the cost of new and refinanced debt. Based on MYEFO projections, the total interest cost on Federal Government debt was expected to reach $38.5 billion by FY29, which is equivalent to the cost of Medicare. In this Budget, that projection is expected to be higher.

Interest rates on government debt

%, weighted average issuance yield



Source: AOFM, EY, 21-Apr-2037 bond line

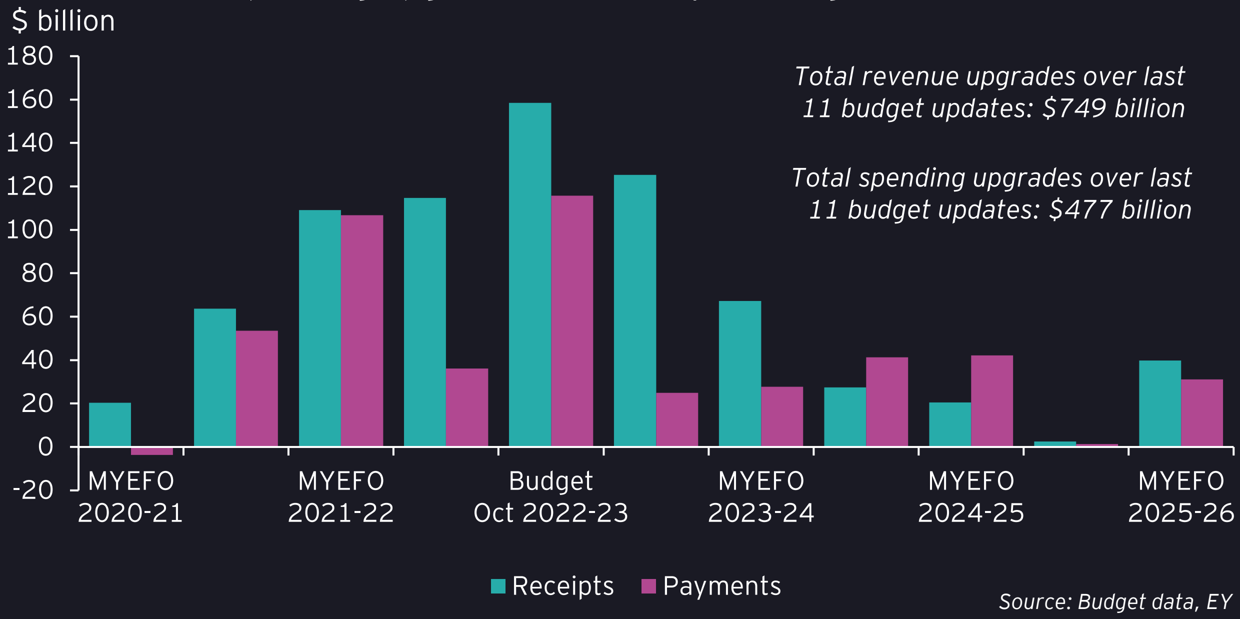
Economic conditions are likely to deteriorate, partially offsetting the short-term revenue increase from higher commodity prices

The recent resilience of the jobs market, coupled with population growth, higher commodity prices, and persistent inflation, will likely lead to upward revisions to revenue for 2025-26.

But economic conditions are likely to deteriorate as growth slows in an environment of elevated geopolitical and economic uncertainty and rising interest rates. Treasury last forecast real GDP growth at 2¼ per cent, an improvement from 1.4 per cent in 2024-25. This is likely to be revised down in 2026-27, as households feel the impact of rising inflation and oil prices and more restrictive monetary policy conditions. Nominal GDP, which is more reflective of revenue growth and crucial for the budget numbers, is also likely to be revised down from the MYEFO forecast of 5¼ per cent in 2025-26.

Headline inflation forecasts are likely to be revised much higher given the reacceleration in domestic inflation at the end of 2025 and the rise in global oil prices from the Middle East conflict from March 2026. The last forecast for 2025-26 and 2026-27 was 3¾ and 2¾ per cent in MYEFO and the latest quarterly CPI read was 4.1 per cent over the year to March. Treasury modelling ahead of Budget has indicated that inflation could be over 5 per cent this year if increases in oil prices are sustained.

Total revenue/spending upgrades over four year budget horizon



Source: Budget data, EY

Downside risks to growth and even stagflation due to the current supply shock are possible. Fiscal management is expected to become more difficult as revenue surprises dry up and a weaker labour market raises demand for household income support.

The Government will also be under pressure to continue with cost-of-living relief for households and businesses if the current conflict further damages activity and pushes inflation higher than current forecasts.

More needs to be done to address the structural budget deficit

When temporary cyclical factors like high commodity prices or lower than normal unemployment are 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, it's considered a sustainable budget position as the structural budget is closer to balance. This is key to reducing debt and ensuring there is fiscal space to help the economy deal with future shocks.

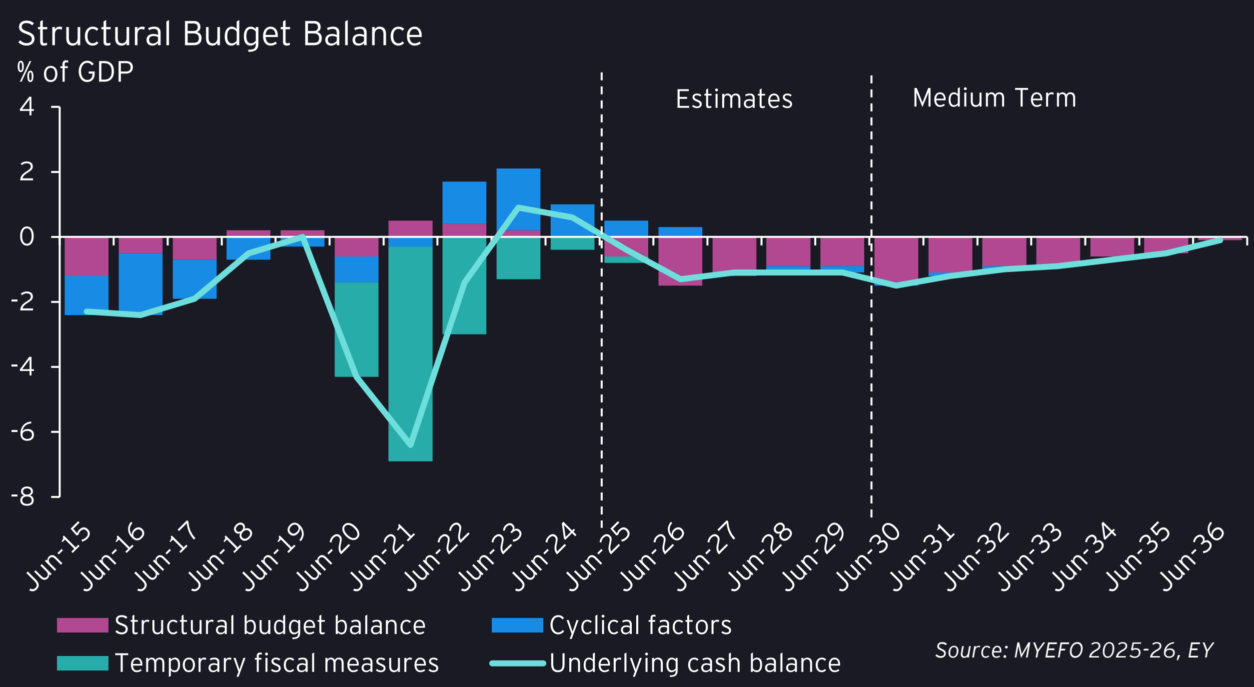
The structural budget position, based on MYEFO estimates, improved a little in the near term compared to the 2025-26 Budget, but is projected to remain in deficit from 2024-25 to 2035-36, deteriorating to -1.3 per cent of GDP in 2025-26. It is projected to remain relatively steady, before deteriorating again to -1.5 per cent of GDP in 2029-30. This is driven by spending pressures from aged care, medical benefits, defence, health, the NDIS, and interest payments.

The announced reforms to the NDIS should improve the structural budget position. But further policy changes that lift revenue and lower expenditure are needed. In practice, these structural changes will be challenging due to elevated inflation and the extent of change needed.

AI and digital technologies may enable the Government to achieve cost savings while encouraging higher economic growth to help lift government revenue. The Government must work with businesses to ensure the development of these technologies in the public service itself.

An improvement in productivity growth and better allocation of labour and capital, would allow the economy to grow faster, offset strong labour cost growth and inflationary pressures, and improve the underlying budget position. Labour productivity growth recovered mildly to 1 per cent in the year to the December quarter of 2025, a little above the Reserve Bank's productivity assumption of 0.7 per cent and close to the MYEFO assumption for long run annual productivity growth of 1.2 per cent (as it was in the 2025-26 Budget).

As highlighted in the 2023 Intergenerational Report, if productivity growth rose to its 20 year long run average rate of 1.2 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: MYEFO 2025-26, EY

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

The Government has already legislated income tax cuts of $5 a week which will start on 1 July with a further $5 one year later. However, their impact on real household incomes has been more than offset by elevated inflation.

A better tax system would go a long way towards achieving higher productivity growth. Ideally, tax reform would lower the proportion of tax directly sourced from income and earnings, and increase taxes from indirect sources like consumption. It would also lower the economic cost of raising revenue.

The Government has indicated that it may make changes to the capital gains tax and negative gearing in response to concerns around housing supply and intergenerational equity.

Proposed changes to the foreign resident capital gains tax regime are concerning because they are applied retrospectively. The plan would impose a 30 per cent tax on sales of land related assets including wind, solar and battery projects and would be applied back to 2006. While it is a tempting revenue-raising measure given current budget pressures, it risks undermining certainty and deterring investment.

A flagged positive change is the research and development tax break, which should drive greater investment and innovation. As we have previously advocated, fully removing the cap on the research and development expenses that can be claimed and introducing a commercialisation incentive could enhance Australia's attractiveness as an investment destination.

As a share of GDP, business investment in Australia remains too low at 12.3 per cent. That is below the 20-year pre-pandemic average of 14.6 per cent. Taxation changes which encourage greater investment and research and development are critical to growing Australia's economy. Such changes would also attract foreign capital and deepen the capital base.

Cherelle Murphy | EY Regional Chief Economist, Oceania
10 May 2026

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