

Budget 2026

Defiant Treasurer ignoring RBA's warnings

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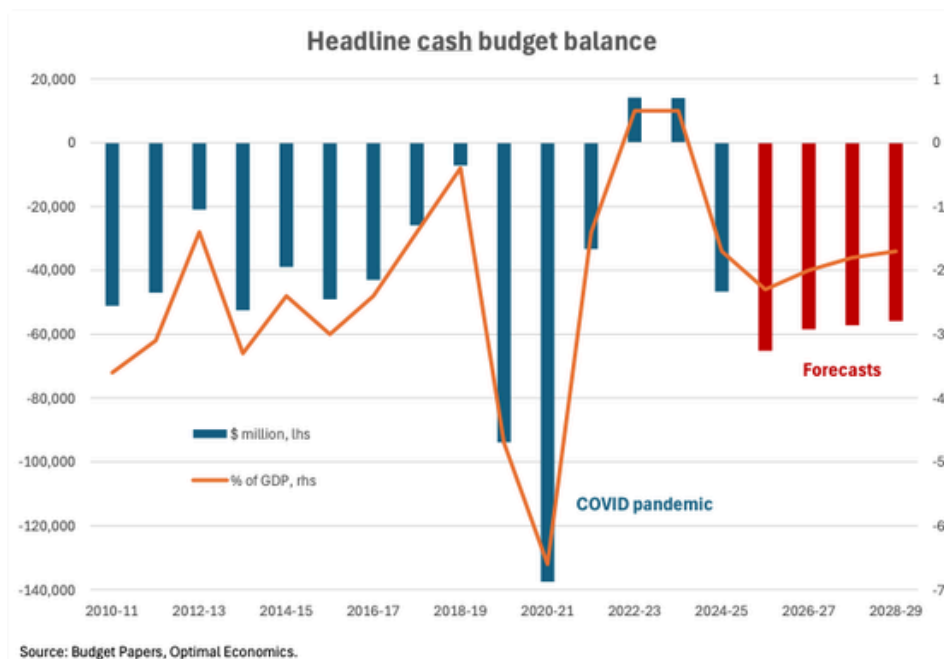
Budget
2026-27

Summary

Before delivering his fifth budget, Jim Chalmers said there were intersecting aims – addressing intergenerational inequity”; improving fairness; boosting resilience; and restoring trust with Australians struggling with a cost-of-living crisis. There were small steps on some of these, but insufficient ambition.

On fairness, the tax treatment of capital and wages will become more closely aligned (albeit through big tax hikes on investments) and, on generational equity, housing affordability may improve over time. As for resilience, we’re adding to the national fuel reserve, so that’s good.

But, on trust, the budget breaks solemn pre-election promises on negative gearing and capital gains tax, as well as the tax treatment of trusts. Also, the changes add significant complexity to an already fiendishly convoluted tax system. That’s bad.



Moreover, there was little in the budget to lift our flagging productivity and boost our sliding international competitiveness. In particular, the tax changes tonight are not tax reform – they are piecemeal, when substantial, whole of system reform desperately is needed. There was a deregulation package, but the measures are modest.

A lack of spending restraint means the budget will remain in persistent deficit for years to come as debt continues to rise. Outside some modest (promised) savings, where was the spending restraint and enhanced fiscal responsibility? The fiscal rules abandoned in 2022 did not return. They should have.

From an economic policy perspective, the budget is expansionary as the Reserve Bank Governor calls for restraint and as the supply side of the economy is constrained. Therefore, this budget will make inflation worse, not better. This means more interest rates hikes as fiscal and monetary policy pull firmly in opposite directions.

Accumulated deficits of nearly \$220 billion

Australia's still low unemployment rate and high terms of trade should be delivering substantial structural budget surpluses. Instead, the budget projects cumulative underlying budget deficits of \$122 billion over the forward estimates. The shortfalls sum to more than \$200 billion if the more appropriate headline cash balance is used, which includes ballooning "off-budget" spending.

Tonight, there were tax increases on housing, trusts and other capital investments and spending increases on defence, health, housing and infrastructure, alongside modest investment incentives for business. Much of the new spending is shovelled off budget as investment on the spurious assumption it will deliver returns to taxpayers ... some-day. There were small income tax cuts previously legislated and more untargeted cost-of-living relief for households.

Don't mention the war

The Treasurer blames the war in Iran for our latest economic troubles but, the flipside is there will be additional revenue coming the budget's way because of higher commodity prices and inflation. The war certainly has made Australia's economy weaker. But government spending growing too rapidly was the initial cause of our inflation problems. This budget provided little in mitigation in that respect.

The Treasurer claims to have banked \$64 billion of gross "savings", but we're still staring at a decade of projected deficits. The nation soon will pass the emblematic \$1 trillion mark of public debt. Spending as a share of GDP will remain at or near a forty-year high.

Main fiscal aggregates

	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	4-years to 2029-30
Headline cash balance (\$ billion)	-21.8	-47.9	-64.1	-54.3	-57.2	-41.0	-216.6
% of GDP	-0.8	-1.6	-2.1	-1.7	-1.7	-1.2	
Underlying cash balance (\$ billion)	-10.0	-28.3	-31.5	-31.0	-34.4	-25.2	-122.1
% of GDP	-0.4	-1.0	-1.0	-1.0	-1.0	-0.7	
Gross debt (\$ billion)	-28.6	982.0	1,051.0	1,120.0	1,193.0	1,249.0	
% of GDP	33.4	33.1	34.0	35.2	35.8	35.6	

Source: Budget Papers.

Treasurer ignoring the RBA's warning

Despite repeated warnings from the Reserve Bank, the Commonwealth Government (and the states) continue to pump money into an economy barely able to supply the goods and services in demand.

RBA Governor Michele Bullock said just last week that governments handing money to households makes the RBA's job of curbing inflation even more difficult. Loose fiscal policy will continue to stoke growth in the economy when the RBA is trying to cool it down.

Struggling households now will have extra money to spend, but the supply side of the economy is the same. The RBA's previous "narrow path" now is a tightrope. The war has unleashed a lethal wave of inflation through our constricted supply chains, much of which is yet to show up in measured inflation.

Australia had a worsening inflation problem before bombs started falling on Tehran. The RBA already was lifting the cash rate and will win this fight for supremacy in economic management by continuing to raise interest rates. This budget will make inflation worse and further interest rate hikes more likely than before.

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The fiscal metrics – focus on the headline balance

These days, when analysing the budget, it's important to focus on the headline cash balance, not the underlying balance the Treasurer favours. His preferred underlying cash balance excludes the ballooning off-budget spending shenanigans, like the National Reconstruction Fund (NRF), the Rewiring Australia Fund, the Housing Australia Fund (HAF) and others. But it is an incomplete and misleading measure.

Headline budget balance is the best measure

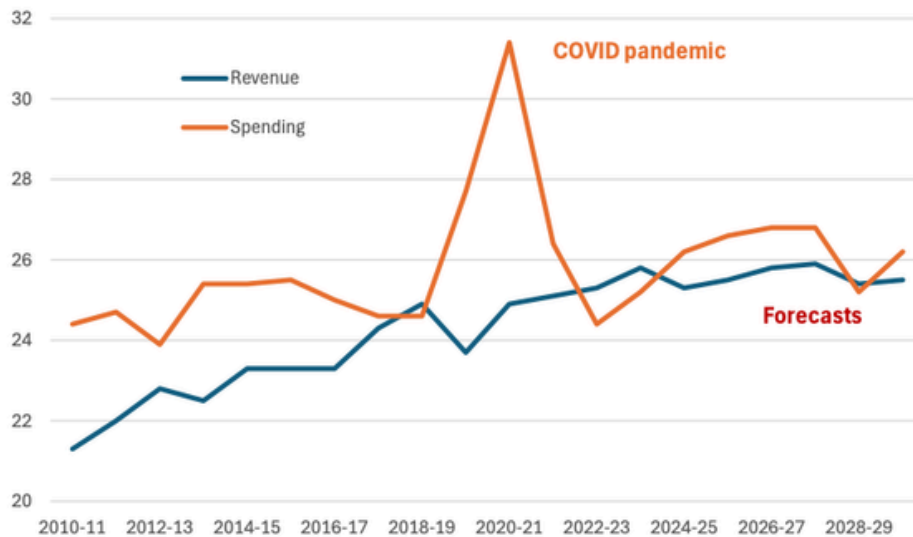
The headline cash balance (hidden in the tables at the back) includes the government's off-budget spending monuments. It is the best measure of the government's growing footprint on the economy.

The government's preference for concealing massive spending "off budget" means the headline deficit is substantially larger than the underlying deficit. But all this additional spending is sloshing around – the economy doesn't care which side of the budget it comes from!

The headline cash deficit for 2026-27 will be a whopping \$64.1 billion (2.1% of GDP). This will be a significant deterioration on the \$47.9 billion deficit expected for the current year ended June 2026. There's been some improvement since last December's MYEFO update, thanks to the war and some savings, but not enough to close the imbalance.

Instead of curbing its instincts to spend money into any crisis, the government chose the alternative path, ramping up its spending footprint. Sadly, the fiscal rules did not return. Rules like a spending cap as a share of GDP, public debt targets and restrictions on real growth in spending are critical guardrails and would help deliver fiscal sustainability.

Spending and revenue - % of GDP



Source: Budget Papers, Optimal Economics.

Debt approaching \$1 trillion

With the Government projecting budget deficits for a decade, Australia’s debt pile will continue to grow. Some near-term refinancing fun and games will keep the balance below \$1 trillion for a while but will not be enough to hold back the debt tide. Our national debt will equate to 40% of GDP before too long.

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The economy – echoes of 1970s-style stagflation

The budget projects sluggish growth in the economy of just 1.75% in the year ended June 2027 and only modest improvement in 2027-28. The economy cannot grow much faster than this because it already is bumping up against capacity constraints. As the RBA Governor said last week, we have “a supply problem”.

Treasury’s economic forecasts are more optimistic than those of the RBA. The Treasury forecasts that inflation will peak this year and start trending down. This, though, assumes an early end to the war in Iran, but no one has a clue how that will happen, including President Trump. The clear risk is that the war persists and inflation doesn’t come down. That would mean even more hikes in interest rates.

Economic forecasts

	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Real GDP growth, % change	1.30	2.25	1.75	2.25	2.50	2.50
Employment, % change	2.10	1.50	1.50	1.75	1.75	1.75
Unemployment rate, %	4.20	4.25	4.50	4.50	4.50	4.25
Inflation, % change	2.10	5.00	2.50	2.50	2.50	2.50

Source: Budget Papers.

The budget also assumes that unemployment rises from here. So, we will suffer an unhappy confluence of rising joblessness and elevated inflation. It's not the stagflation of the 1970s, but there definitely are echoes.

Productivity assumed unchanged

Surprisingly, the budget left the long run productivity assumption steady at 1.2%, despite no productivity growth since 2016. That's heroic. The RBA last week was more brutal (and, arguably, more honest), by assuming there will be no productivity growth at all in the near term.

This is disastrous. We have "a supply problem" because of our lousy productivity that keeps getting worse. Productivity will keep deteriorating until governments undertake genuine reform in areas like industrial relations, tax and energy policy.

Then, of course, there's the worsening thicket of regulation and red and green tape strangling business. These are "hairballs" making growing the economy and creating jobs much more difficult than it should be. Remember, productivity is the only thing that drives living standards over time.

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Revenue measures – rebooting the 2019 playbook

The budget included tax increases the Treasurer describes as "tax reform". But to qualify as genuine reform, the whole tax system should be refreshed, rather than piecemeal changes. Also, any tax changes should boost productivity and enhance economic growth, enhance fairness, improve the efficiency of tax collection, and ease the compliance burden. The tax changes announced tonight fail this test.

Meanwhile, bracket creep continues to play a major role in lifting tax collections by raising average tax rates as personal incomes rise. One option to curb this "thief in the night" is to index the tax thresholds to inflation, but the Treasurer declined to do so. Instead, as things stand, higher inflation will accelerate bracket creep.

Main revenue/tax measures

The budget's main revenue measures were:

For individuals:

- A small tax break via an earned income offset of \$200-\$300 for anyone earning a wage and paying tax;
- Abolition of the 50% capital gains tax discount that has prevailed since 1999. Instead, nominal capital gains will be adjusted for inflation, as per the pre-1999 regime. The effect is a tax hike for all investments except those “grand-personed”¹ from before Budget night.
- Restrictions on negative gearing, which is another effective tax hike. From tonight, the tax treatment will be reserved only for newly-built housing, with existing investments left untouched. There is a 12-month grace period before the changes apply (from 1 July 2027).
- Imposition of a 30% tax on all distributions from discretionary trusts from 2028 to align the tax treatment with companies. The exceptions are for farmers and small businesses;
- EV tax benefits phased down for vehicles costing over \$75,000, from 2027; and
- Funding for the \$2.9 billion fuel excise cut announced as the Iran war escalated.

For business:

- An instant asset write-off of \$20,000 for businesses that turn over less than \$10 million to be made permanent; and
- A more generous R&D tax credit worth \$400 million.

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Expenditure – biggest share of GDP in four decades

The budget sees spending growing faster than the economy, with average real growth around 2% out to 2029-30. This is even after the claimed “savings” are banked. The “Table of Truth” in the budget, which explains policy and parameter variations, shows spending more than \$18 billion higher in 2026-27 alone.

Main spending measures

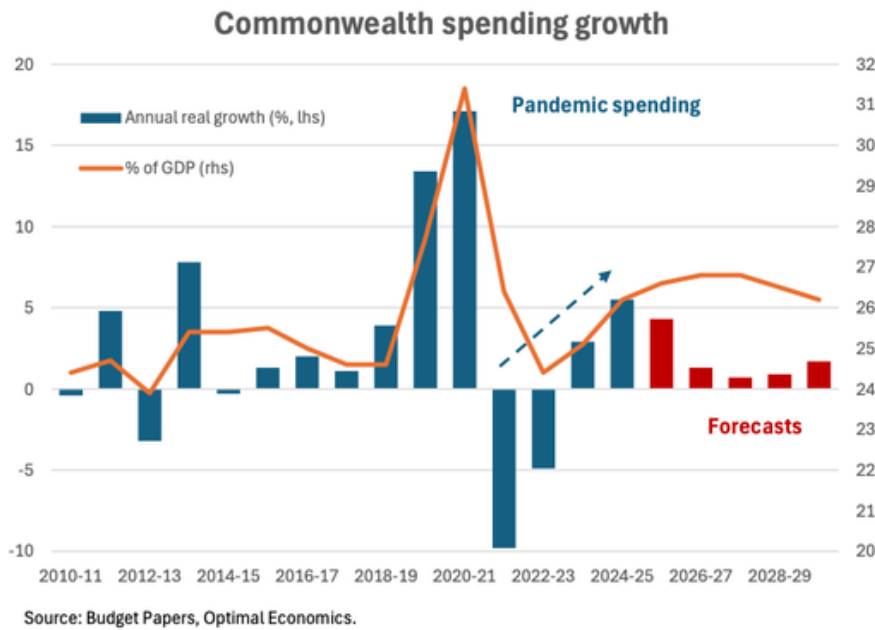
The budget's main expenditure measures were:

- Gross “savings” of \$64 billion have been baked into the forward estimates – more than half of this is bringing the NDIS back under control. The means to do so, however, have not been specified. Other savings include a \$2.7 billion reduction in the use of consultants and \$3 billion from paring back the private health rebate for people aged over 65.

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[1] According to the Greens.

New spending on:

- Another \$2.4 billion of untargeted cost of living relief for households affected by the war in Iran;
- Defence - \$14 billion of additional spending as part of a long-term commitment to lift defence spending to 2% of GDP;
- \$10.7 billion to lift diesel and jet fuel security to 50 days, from the current 30 days;
- \$2 billion to help connect water and sewerage for housing developments; and
- More funding for the Suburban Rail Loop in Melbourne – another \$3.8 billion committed on top of previous promises.



Other budget announcements

Migration targets

The budget papers include an assumption that net overseas migration will be 225,000 people by 2028-29, compared to 305,000 last year. The government also plans a shift in the points system in favour of more skilled migrants.

A deregulation package

The government announced a cut the cost of regulation by \$10 billion per year. The measures include streamlining commercial zoning and planning and removing barriers to modern construction methods and non-standard builds, like modular houses.

Disclaimer

This material has been prepared by Stephen Walters, Principal and Chief Economist of Optimal Economics Pty Ltd (A.C.N. 689 640 453 with a registered address of Level 8, 70 Pitt Street, Sydney, 2000).

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