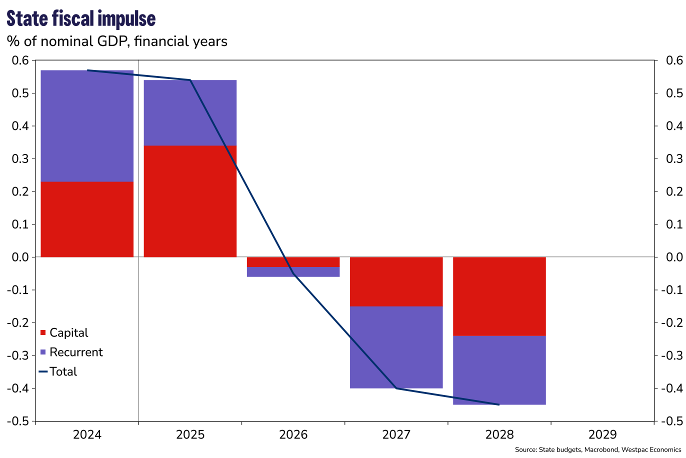
27 June 2025

AUSTRALIAN FISCAL UPDATE BULLETIN

National fiscal impulse to be flat in 2026FY. Net interest repayments to reach 2.2% of GDP.

Key points

- States ramped up spending in recent years to provide cost of living support and invest in the infrastructure and services required to cater for the growing population. This was largely financed by debt, with the rising interest burden now requiring a return to fiscal discipline.
- Recent state budgets suggest that the ramp up in spending has come to an end. Revenues are expected to pick-up alongside the forecast recovery in the economy.
- This will significantly reduce the state fiscal impulse to flat in the 2026FY - down from an annual average of 0.5% of GDP over the two years to 2025FY. Even with Federal spending, the impulse is only marginally positive in FY26.



- Based on current fiscal trajectory, net interest on state debt will surge to 1.0% of GDP by the 2028FY. Including Federal debt, net interest will surge to around 2.2% of GDP by the 2028FY – the highest since at least the early 2000s and much higher than the pre pandemic average of 0.6% of GDP.

Learning the laws of compound interest

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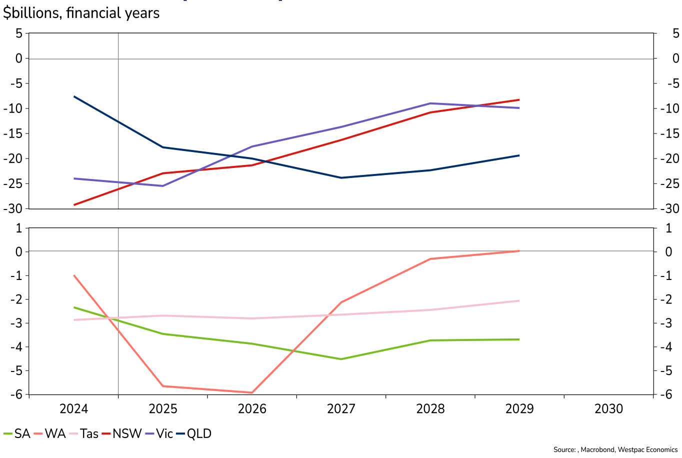
The expansion in public demand has driven much of the economic growth and employment gains over the past two years (around 80% of total growth in the economy and more than 95% of the total increase in hours worked). Through increased infrastructure investment, spending on public services (including wage increases), and cost of living measures states have contributed significantly to this expansion. Over the two years to FY2025, recurrent expenses across the states have grown by around 16%, with infrastructure investment growing a massive 32% over the same period.

Looking more broadly at the fiscal impulse, which measures how the change in net government spending is contributing to growth in demand and wider economic activity, states have contributed an annual average of 0.5% of GDP over the two years to 2025FY – roughly 35% of the total fiscal impulse.

With budget season come and gone for another year, the refreshed fiscal outlook suggests that states will be much less supportive for growth going forward – recurrent expenses are forecast to grow by around 5% over the next two years, with investment in infrastructure essentially flat in nominal terms over the same period.

At the same time, states are expecting revenues to grow more strongly as economic growth is forecast to pick up. This combination of slowing payments, and rising receipts, reduces the combined state fiscal impulse.

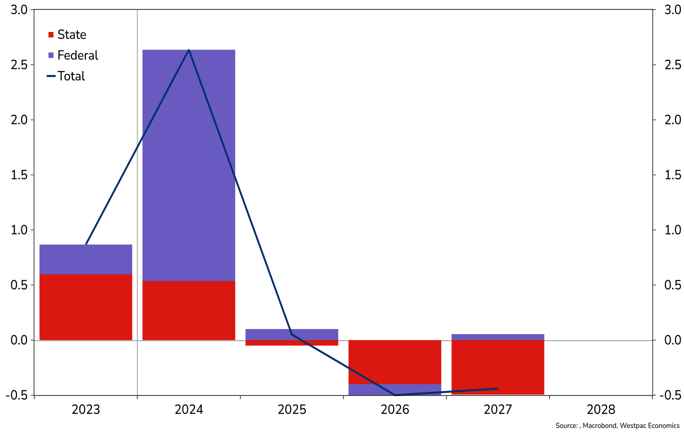
State fiscal balances expected to improve
$billions, financial years



There are risks, however. The expected pickup in revenue might not materialise, particularly given Westpac Economics expects the recovery to be more sluggish than state forecasts (see the discussion on the outlook). As such, we think the impulse will be flat in the 2026FY. This is in comparison to the unadjusted outlooks presented in the recent 2025 budgets, which suggest state public demand will detract from growth.

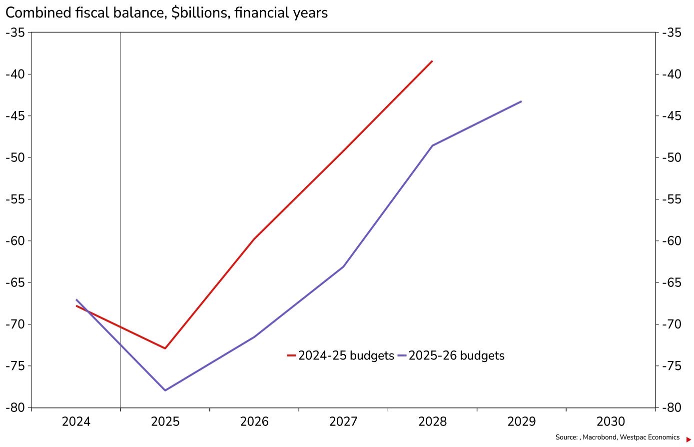
Combined with Federal spending, the total fiscal impulse is expected to be marginally positive in the 2026FY – well down on the impulse of 2.5% of GDP in 2025FY.

Total fiscal impulse
% of nominal GDP, financial years



Downside risks to the fiscal outlook were partly realised in the most recent round of budget updates, with most states downgrading their near-term outlook due to near-term revenue downgrades (for example NSW and Queensland), higher labour and other costs (NSW, South Australia and Queensland), new government decisions (all the states), and support for households and businesses impacted by the recent natural disasters (NSW and Queensland). As these near-term headwinds fade, states are expecting an improvement in their fiscal positions.

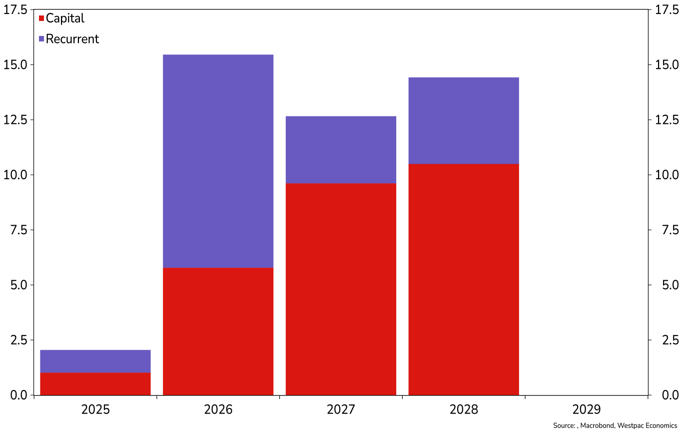
State fiscal balances deteriorated
Combined fiscal balance, $billions, financial years



Unlike the budget rounds coming out of covid, there has been a clear shift away from providing near term cost of living relief. Only Victoria and Queensland are providing electricity rebates, and here it's to low-income households rather than across the board. Instead, states have focused on increasing funding for critical public services, supporting first home buyers, increasing the supply of housing by helping to shore-up funding for developers, and setting up processes and bodies to fast-track large investment approvals. NSW's efforts in these areas are particularly notable and if implemented, will likely sway momentum in the right direction. The net fiscal impact of new measures is around $17bn across the four years to 2027FY, with $9.5bn in 2025-26.

Combined measures impact

$billions, financial years



The capital budget across the states also saw a lift, however, the days of large-scale megaprojects have gone in NSW and Victoria but for Queensland, Olympics-related projects are still going ahead.

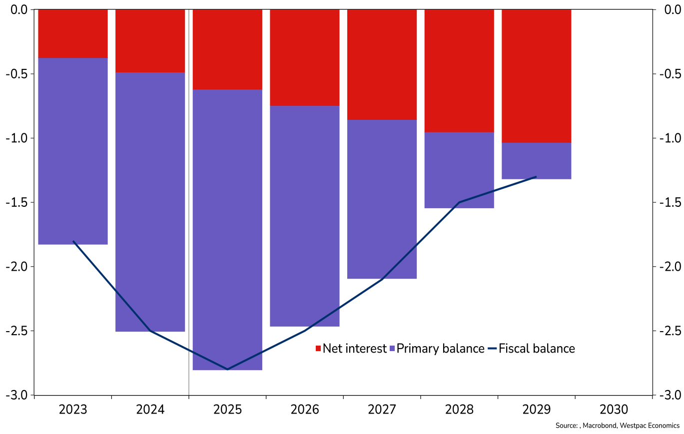
In the near-term, cost overruns and adjustments or extensions to existing projects underpin the higher expected outlays – around $5bn in the 2026FY. This picks up in the outer years of the forwards (around $10bn in 2027FY) with the majority driven by Olympics-related projects in Queensland and as NSW and Victoria look to ramp up investment in health and education infrastructure to cater for the growing population.

The question is: will states have the fiscal space to increase spending if the economy needs support? In our view the space is quite limited. Based on the current fiscal trajectory, net interest will surge to 1% of GDP by the 2028FY – the highest since at least the early 2000s and much higher than the pre pandemic average of 0.3% of GDP.

Indeed, by the end of the forwards the states will be borrowing just to pay for their interest expenses. This also means there is less scope for state governments to respond to adverse economic shocks. As such, the Federal government, which is less fiscally constrained, may need to play a more prominent role.

State fiscal balances by components

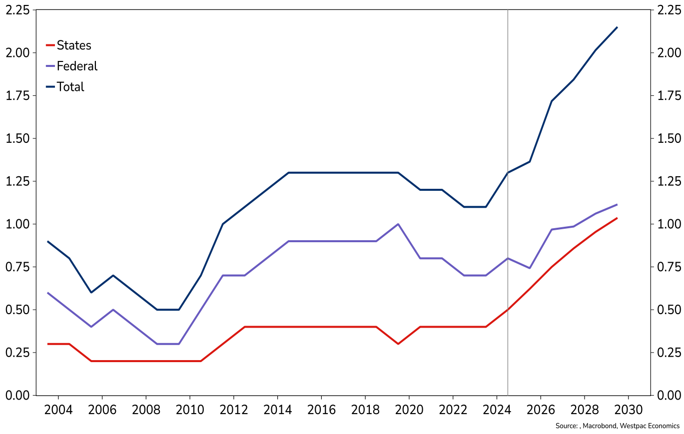
% of nominal GDP, financial years



Including Federal debt, net interest will surge to around 2.2% of GDP by the 2028FY – the highest since at least the early 2000s and much higher than the pre pandemic average of 0.6% of GDP.

Net interest repayments

% of nominal GDP, financial years



What does this mean for the economic outlook

A key risk to the outlook we have been talking about is a 'shaky handover,' where the recovery in the private sector is unable to fully offset the slowdown in public demand, and a period of sluggish economic growth ensues.

State budgets confirmed there's not much upside to public demand when it comes to the states, making the private recovery all the more important.

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