Federal Budget 2011/12

10 May 2011

Hi ho, hi ho, it's off to work we go.....

highlights:

~ major change to Fringe Benefits Tax on cars
~ minor relief on excess superannuation contributions
~ enhanced tax concessions for small business
~ minimum pension payment relief continued but phasing out
~ changes to family tax benefits
~ activity is forecast to rebound in 2011-12 and 2012-13
~ market expectations are for two modest rate rises, totalling 0.50%, in the next 12 months

section one: what it means for financial planning

some relief from excess super contributions tax - refund option for contributions up to $10,000

The Government will provide persons who breach the concessional contributions cap by up to $10,000 with a one-off option to request that the excess contributions be refunded and assessed as income at their marginal rate of tax, rather than the excess concessional contributions tax rate of 31.5% (in addition to the 15% contributions tax).

This measure applies only to concessional contributions which include employer contributions (i.e. Superannuation Guarantee (SG) and salary sacrifice contributions, payment by employers of fund expenses such as life insurance premiums and administration costs) and personal contributions for which the taxpayer intends to claim a deduction. They also include notional taxed contributions for defined benefit interests and transfers of certain fund reserves.

This new refund option will apply from 1 July 2011 in respect of 2011-12 or later years, and only for the first year, commencing from 2011-12, in which a breach occurs. That is, it only applies to **first time breaches** from 1 July 2011.

You only get to use this "get out of jail free card" the first time you exceed the concessional contributions cap from 1 July 2011 and only if the excess is no more than $10,000. However, this may be easier said than done. Take the situation of a taxpayer who repeats the same error over a couple of financial years and due to the time lag between the Commissioner collecting and processing contributions data and notifying the taxpayer about a potential cap breach, it will be a couple of years before the taxpayer becomes aware of the problem. In this situation, the one-off nature of the measure will only provide partial relief.

The Government expects that this reform will help to reduce the number of occasions where the concessional contributions are exceeded, resulting in an excess contributions tax assessment. In particular, it will provide one-off relief in situations where excess concessional contributions up to $10,000 would flow through and also result in a breach of the non-concessional contributions cap triggering an effective tax rate of 93%.

This reform may benefit taxpayers with a marginal tax rate below the top marginal rate of 46.5% who inadvertently breach the concessional contributions cap by $10,000 or less for the first time.

This measure will NOT help taxpayers who inadvertently exceed the concessional contributions cap by more than $10,000 or for breaches before 1 July 2011 or for breaches of the non-concessional contributions cap. These people will need to apply to the Commissioner to disregard or reallocate the excess contributions.

no increase in the excess concessional contributions tax rate

There was no mention in the Budget of increasing the excess concessional contributions tax rate of 31.5% to take into account the flood levy. Thus, taxpayers on the top marginal rate may consider deliberately exceeding the concessional contributions cap to save 1% in tax in 2011-12, provided they do not also exceed the non-concessional contributions cap. The money will also remain in the superannuation system if they pay the excess concessional contributions tax personally.

higher concessional superannuation contributions cap for those 50 and over

The Government has confirmed that it will set the proposed higher concessional contributions cap at $25,000 above the general concessional cap for eligible individuals aged 50 and over with total

superannuation balances of less than $500,000. As a result, when the general concessional contributions cap increases with indexation from $25,000 to $30,000, the higher cap will increase by the same dollar amount.

This proposal to allow individuals aged 50 and over with total superannuation balances below $500,000 to continue making up to $50,000 per year in concessional contributions from 1 July 2012 was previously announced as part of the Government's response to the Henry Tax Report on 2 May 2010.

We are still waiting on a response from the Government to the consultation process commenced on 28th February. Further details are required on such issues as what is included in the account balance (i.e. income stream balances, prior withdrawals etc.), who determines assessment of eligibility to access the higher cap (i.e. ATO or self-assessment) and measurement date (i.e. 30 June one year or two years prior to year of contribution).

So, watch this space ...

it will cost more to run your own super fund

The self-managed superannuation fund (SMSF) annual supervisory levy is increasing from $150 to $180 with effect from the current (i.e. 2010-11) financial year.

This measure will assist in funding the implementation of the range of "Stronger Super" reforms to the SMSF sector. The package of SMSF reforms announced by the Government on 16 December 2010, are designed to improve the operation, efficiency and integrity of the SMSF sector.

minimum pension payment relief phasing out

The Government has begun to phase out the 50% pension drawdown relief that has been provided for the past three financial years.

The minimum annual pension payment requirements for account-based pensions, commonly known as allocated pensions, and market-linked (term allocated) pensions and annuities will be reduced by 25% for 2011-12. There will be no relief and it will return to normal in 2012-13.

For those who can afford to take less than the normal minimum annual pension payment (i.e. those who are not reliant on the income they receive from their allocated pension, or whose living expenses are less than the minimum pension payment requirement), this measure continues to provide some assistance in recouping capital losses incurred as a result of the global financial crisis.

superannuation co-contribution indexation freeze extended

The Government is continuing to freeze the income thresholds for the co-contribution for an additional year.

In 2010-11, the Government provides a matching co-contribution of up to $1,000 for personal non-concessional contributions for people with incomes of up to $31,920 with the amount available phasing down for incomes up to $61,920. This measure will continue to freeze these thresholds at $31,920 and $61,920, respectively, into the 2012-13 financial year.

People on incomes less than $61,920 should not be deterred by this measure in making non-concessional contributions as it remains the best return on investment you can get.

SMSF trustee-director a parent or guardian of minor

The Government will amend the superannuation legislation so that where the trustee of a SMSF is a body corporate, a parent or guardian may be director of the body corporate in place of a member who is a minor.

superannuation on payslips

The Government will ensure that employees receive information on their payslips about the amount of superannuation actually paid into their account.

From 1 July 2012, employees and employers will also receive quarterly notification from their superannuation fund if regular payments cease.

changes to Family Tax Benefits

A higher rate of payment of Family Tax Benefit Part A (FTB A) will be available when eligible children remain in education or vocational training. FTB A will be increased by up to $4,200 pa for families with a teenage child aged 16 to 19 (per child). Currently, FTB A drops from $6,161 to $2,062 pa when a child turns age 16.

The change to FTB A may also give increased eligibility for FTB Part B (FTB B) and rent assistance. Eligible families could receive up to an additional $10,700 pa in a combination of FTB A and B and rent assistance.

The changes are aimed at encouraging families to ensure that children remain in education and enhance their long-term employment prospects.

FTB A is subject to a family income test. Generally, a family can have income up to approx $45,114 pa before FTB A reduces. The income cut off point for eligibility is determined by number of children and their ages and ranges from $101,191 pa to $162,949 pa. Generally, FTB B is available to sole-parent and single income families where the main income earner earns less than $150,000 pa.

'Income' for FTB is defined as 'adjusted taxable income' which includes taxable income, fringe benefits, add back of net investment losses, certain foreign income, tax free pensions and benefits (i.e. certain Centrelink payments) and reportable (i.e. voluntary) superannuation contributions.

In other changes, indexation pauses on several income thresholds for different benefits will continue for a further two years. These include the Baby Bonus, Paid Parental Leave, FTB A and B.

Higher Education Contribution Scheme (HECS) – reduction in discounts

From 1 January 2012, the Government will reduce the discounts currently available for payments made under HECS. Students who pay their student contribution upfront will have a reduced discount of 10% (previously 20%). Where the upfront payment option is not taken, a concessional loan through the Higher Education Loan Program (HELP) is still available. In addition, the bonus on lump sum repayments of $500 or more to reduce HELP debt will also reduce from the current 10% to 5%. As an example, a student making a $500 payment would currently have $550 deducted from their HELP debt. From 1 January 2012, this will reduce to $525.

increasing Medicare levy low income thresholds

From 1 July 2010, the income threshold before Medicare levy becomes payable is increasing to $18,839 for singles and $31,789 for families (previously $18,488 and $31,196 respectively). An additional amount of threshold of $2,919 applies for each dependent child or student. The threshold will increase to $30,439 for single pensioners below age pension age.

small business Capital Gains Tax (CGT) concessions

Effective for CGT events from 7.30 pm on 10 May 2011, the Government will legislate to ensure that assets of trusts will be included as connected entities for the purposes of assessing eligibility for the small business CGT concessions. Currently, some trusts seek to have their assets excluded from assessment on the basis that the trust assets are held for the benefit of others. This measure may also extend the small business CGT concessions to the trust assets where these are 'active' assets of the business.

winding back Fringe Benefits Tax (FBT) concession on cars

The Government has proposed abolishing the current tiered percentages in the statutory formula method for valuing car fringe benefits and replacing it with a set 20% rate regardless of distance travelled.

Cars which are provided as part of an employee's salary package are subject to FBT. There are two methods for valuing a car fringe benefit – the 'statutory formula' method and the 'operating cost' method. Salary packaging a car basically means that all finance payments, running and maintenance costs are paid from the employee's before-tax income, albeit with a varying FBT liability.

The statutory formula provides a percentage based on a range of kilometres travelled in a FBT year. This percentage is applied to the car's purchase cost and the result is the car's value for FBT purposes. The statutory formula does not distinguish between business and private use, so eligible employees are effectively getting a tax subsidy even for private travel. The statutory formula method is simpler and is by far the most common valuation method, however has long been criticised because it is structured such that the more kilometres driven in a year the less FBT is paid, as shown in the table below. This has promoted undesirable outcomes where employees may deliberately drive more to ensure they get over the next threshold to be able to decrease their FBT liability.

The new flat rate will commence for new packaging arrangements for those travelling less than 25,000 kms pa from 7.30pm on 10 May 2011. For those travelling in excess of 25,000kms pa, the flat rate will progressively phase in for new packaging contracts from Budget night and will be completed for new contracts from 1 April 2014.

The following table shows current FBT costs on two representative vehicles over distances shown. The proposed flat rate is shown in **bold** with the saving or additional cost shown alongside. Other running and maintenance costs are not shown as these will not be affected by the proposed change. The table does not show any of the progressive shade in rates, only the proposed final situation from 1 April 2014.

Car Fringe Benefits – FBT under Statutory Formula

kilometres travelled (pa)	%	FBT on vehicle value $35,000	net saving (extra cost) pa	FBT on vehicle value $57,000	net saving (extra cost) pa
< 15,000	26	$8,737	$2,106	$14,228	$3,283
15,000 – 24,999	**20**	**$6,721**	–	**$10,945**	–
25,000 – 40,000	11	$3,696	($3,025)	$6,020	($4,925)
> 40,000	7	$2,352	($4,369)	$3,831	($7,114)

source: ipac securities

As an example, an employee with a $35,000 car driving less than 15,000kms pa would currently have a FBT cost of $8,737 pa. This drops to $6,721 under the proposed change, a saving of $2,106 pa. Between 15,000 and 25,000kms pa there will be no change. If driving more than 25,000kms pa he will have an additional FBT cost of $3,025.

Our rule-of-thumb has previously been that if you need vehicle finance and will drive more than 15,000kms pa then you should consider packaging the car. The proposed change does not alter this view. It will actually make packaging a car benefit more attractive for those who drive relatively less, maybe another unintended outcome!

Those currently driving high levels of kilometres will still have the option of using the 'operating cost' method of valuing the fringe benefit. Under this method, business use is excluded from the FBT calculation. The proportion of business use is established by use of a log book for all journeys in a specified period.

For those who have a relatively high proportion of business use, packaging the car does not always give the best outcome when compared with private ownership and claiming the car running and finance expenses as a tax deduction. This comparison remains necessary under the proposed changes.

phase-out of Dependent Spouse Tax Offset (DSTO)

The Government will phase-out the DSTO for those taxpayers with a dependent spouse born after 1 July 1971 (i.e. less than age 40). This measure is aimed at increasing work force participation. The DSTO is currently available to a taxpayer who earns less than $150,000 pa (in 2010-11) and contributes to the support of the spouse and neither is eligible for FTB B. The maximum rebate is $2,286 in 2010-11 when the dependent spouse has income less than $282 and cuts out when the dependent spouse's income level reaches $9,426. Those with an invalid or permanently disabled spouse, supporting a carer or eligible for zone rebates are not included in this measure.

extended 'bring-forward' of Low Income Tax Offset ('LITO')

LITO is a tax offset (refund) of up to $1,500 pa, it effectively gives certain low income earners a tax-free threshold of $16,000 in 2010-11. LITO is currently paid half as a reduction of PAYG tax and half as a lump sum refund following lodgement of the individual's tax return. From 1 July 2011, the Government proposes to increase the 50% PAYG portion to 70%. The full LITO refund of $1,500 is available to those with taxable income of up to $30,000 and shades out above this amount until a cut-off threshold of $67,500 is reached. Someone eligible for the full amount of LITO would receive an

extra $300 throughout the year (approx $11.54 per fortnight) in exchange for a reduced tax refund at the end of the year.

This measure is designed to increase regular cashflow for low income earners at a time when living costs are expected to rise.

minors no longer eligible for LITO on unearned income

From 1 July 2011, minors will no longer be eligible for the LITO on unearned income (e.g. income from investments, trust distributions). Minors are generally subject to punitive rates of tax on their unearned income as a measure to prevent income splitting in families. Marginal tax rates for unearned income of a minor can be as high as 66%, however LITO gives those under age 18 a tax-free threshold of $3,333. Removal of eligibility for LITO will mean that the tax-free threshold for a minor reduces to just $416. Above this level a tax rate of 66% will apply to income of $1,307 and if income exceeds this amount a flat rate of 45% applies to all unearned income of the minor.

This measure could have an adverse impact on those families where minors own investments such as shares or bank accounts whether directly or through a parent/trustee.

Existing exceptions to unearned income, such as income from a deceased estate or child maintenance trust, will continue to apply. Excepted minors (e.g. orphans or disabled) will continue to be exempt from this change.

no tax deductions against Government assistance payments

A High Court decision in 2010 allowed a student receiving Youth Allowance to claim education costs as a tax deduction. This forced the Australian Taxation Office to allow deductions to potentially thousands of students in the years from 2006-07 to 2010-11. The Government will legislate to prevent deductions being claimed against all Government assistance payments from 1 July 2011. This timing is consistent with the Government's pledge not to make the legislation retrospective.

extension of Education Tax Offset (ETO)

From 1 July 2011, expenses eligible to qualify for the ETO will be extended to include school uniforms.

The ETO is a refundable tax offset that reimburses parents for the cost of certain educational expenses. The maximum offset that can be claimed is 50% of the relevant limit. In 2010-11, the relevant limits are $1,588 per secondary school student (maximum tax refund $794) and a limit of $794 per primary school student (maximum tax refund of $397). The family must be eligible for FTB A and only certain educational expenses (including computers and associated software) are eligible. Please refer to www.ato.gov.au for further information.

30% Private Health Insurance rebate means test revisited

Although not announced in the Budget, Thomson Reuters reported that the Government plans to re-introduce legislation to means test the private health insurance rebate. This legislation was originally introduced in 2009 but defeated in 2010.

new instant tax write-off on new vehicles purchased by small business

An up-front tax write-off of the first $5,000 of the cost of a new vehicle purchased by qualifying small business will apply from 2012-13. This is in addition to write-off (depreciation) rates for small

business to be introduced from 2012-13. The $5,000 instant write-off will result in lower deductions in following years.

From 2012-13, the proposed write-off rates are immediate write-off of all assets valued at less than $1,000 and a standard depreciation rate of 30% for all other assets (except buildings) in a single depreciation pool. In addition, company tax rate is proposed to drop to 29% (from current 30%) in 2012-13.

The instant tax write-off will be available to all small businesses including sole traders, partnerships, trusts and companies. A small business is broadly defined in the Tax Act as one whose aggregated turnover in the previous and current year is less than $2 million ('turnover' is broadly gross income of the business, excluding GST, 'aggregated' turnover can include turnover of affiliates of the small business).

The tax write-off on new vehicle purchases will replace the existing Entrepreneur's Tax Offset which will be abolished due to poor targeting and high compliance costs (resulting in a low take up rate).

free 'set-top boxes' for pensioners

With the move to digital TV and the shutdown of the existing analogue network which is due to occur by December 2013, the Government will provide support to certain low income households to assist with the change. This support will consist of free supply and installation of a high definition set-top box to the pensioner's existing analogue TV. Those eligible for the free supply and installation will include those who qualify for the full rate of Age Pension, Disability Support Pension, Carer Payment and (War) Service Age Pension.

The program is expected to begin in January 2012 and benefit up to 750,000 households.

matters unresolved from the 2010 Federal Budget

Several initiatives announced in the 2010 Budget and following release of the Henry Report remain unresolved. These include:

- the Mining Tax (re-named Minerals Resource Rent Tax);
- standard personal tax deductions (initially $500, rising to $1,000);
- increase in SG age from current age 70 to age 75;
- phased increase in the SG obligation from current 9% of salary/wages to 12% to commence from July 2013;
- introduction of a Government super contribution to subsidise super contributions tax of low income earners; and
- phased reduction of the company tax rate from 30% to 28% commencing from July 2014.

section two: what it means for the economy

- **activity is forecast to rebound in 2011-12 and 2012-13 after the natural disasters that impacted GDP growth for 2010-11.**
- **the forecast deficit for 2011-2012 is $49.4 billion, up on the estimate last year. The Budget is still forecast to have a surplus in 2012-13.**
- **new spending initiatives are modest and specifically targeted to encourage labour market participation.**
- **the Budget is set against the backdrop of a world economy that continues to recover post the GFC.**

budget economic forecasts

indicator	estimate 2010-11	forecast 2011-12	projection 2012-13
Real GDP (%)	2.25	4.00	3.75
Employment (%)	2.75	1.75	1.75
Unemployment rate (%)	5.00	4.75	4.50
Inflation (%)	3.25	2.75	3.00
Wage price index (%)	4.00	4.00	4.25
Current account deficit (% of GDP)	-2.00	-4.00	-5.25
Budget cash surplus/deficit ($ billion)	-49.4	-22.6	3.50

source: 2011-12 Budget Papers, Statement Nos. 1, 2 and 3

new political landscape and natural disasters

In last year's Federal Budget, the Government articulated a medium-term strategy to return the Budget to surplus in 2012-13. The plan involved capping real spending growth to 2.0% per annum, the removal of various tax concessions and reliance on booming tax receipts in future years flowing from strong commodity prices and firm economic growth. Much has changed.

The baton of political leadership has passed to a new Prime Minister and the Federal Government was only returned to power with the support of the Greens and Independents. The result is a more difficult policy climate when framing the Budget strategy. There is a large number of competing stakeholders to be satisfied to ensure safe passage of the legislation through Parliament.

At the same time, the medium-term deficit reduction plan has been unsettled by a number of surprises, including the strong $A which has weakened company tax receipts and a series of natural disasters across the country that has temporarily disrupted economic activity (and revenue collections) and made extra calls on government spending.

Weaker than expected asset markets have led to lower than expected capital gains tax collections. These factors have seen the forecast deficit for 2010-11 increase from $40.8 billion at the time of last year's Budget to an estimated $49.4 billion.

Modifications to the Mineral Resources Rent Tax have reduced expected tax revenue for future years. Macroeconomic challenges have also increased. Risks to inflation have increased as the economy pushes toward its capacity limits. As the mining sector continues to boom, large calls are to be made on Australia's productive resources in the years ahead. The Government expects the unemployment rate to fall to 4.75% over the next year, very close to a rate associated with full employment. In this environment, there is an increased possibility of uncomfortably high wages growth.

the economic priorities of this Budget

- deliver on a key promise to return the Budget to a surplus in 2012-13 ($3.5 billion)
- limit Federal Government spending to "make room" for increased business investment in mining and infrastructure spending in a number of states (Queensland, NSW and Victoria)
- undertake measures to improve labour supply
- contribute to the overall tightening of economic policy to reduce inflation risks.

The Government remains committed to cap spending at a 2.0% real growth rate (after inflation) with announced measures likely to produce an average rise in real spending of 1.0%. Most new savings measures have already been announced and are spread widely across business, government and household sectors to limit the pain and political risk. In particular, reforms to the welfare system are being made to encourage labour market participation whilst "middle class" welfare eligibility criteria are being tightened, in part, to fund the labour market participation measures.

global growth continues to recover

The Budget is set against the backdrop of a world economy where moderate growth is expected to continue. It is framed on forecasts that global activity advances by 4.25% in both 2011 and 2012. The recovery of global growth is supportive of the Australian economy and exports.

The Government is forecasting that real GDP in Australia will increase by 4.00% in 2011-12 and by a further 3.75% in 2012-13. Real GDP will rebound after the natural disasters that will impact on the growth outcome for 2010-11, now expected to be 2.25%.

This firm growth profile can be expected to deliver stronger growth in corporate taxes beyond the next year, notwithstanding the short-fall on estimates in the current year. Bracket creep and expected employment growth should also raise pay-as-you-go tax collection. If this scenario is realised, then it is expected to contribute to a marked turnaround in the Budget position in coming years. Such an outcome ensures that Australia should preserve its Aaa sovereign credit rating.

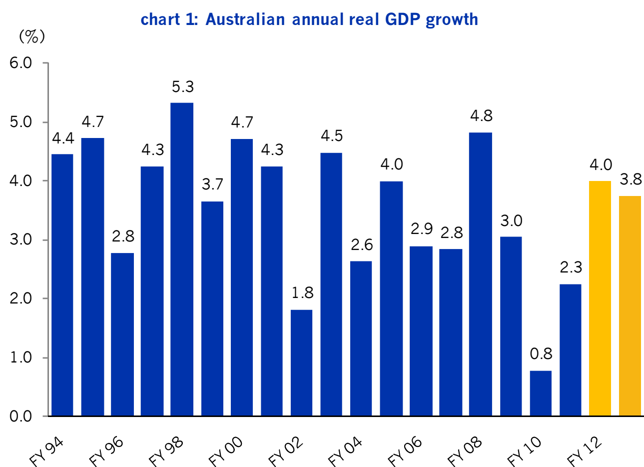
Inflation, measured by the CPI, is forecast to increase by 2.75% in 2011-12 after an expected rise of 3.25% in 2010-11. Underlying inflation is forecast to edge higher, due to firmer wages growth, notwithstanding the effects of a stronger $A. This is an area where the Reserve Bank of Australia (RBA) has recently sharpened its focus. The Government's forecasts are a little lower than the RBA.

The Budget strategy is, by and large, consistent with economic policy needs. However, it could be argued that an opportunity has been missed, particularly in the first year of a new government when the hard measures are traditionally taken, to effect a speedier consolidation in the net Budget position. This is where the political dynamic could be acting as a constraint.

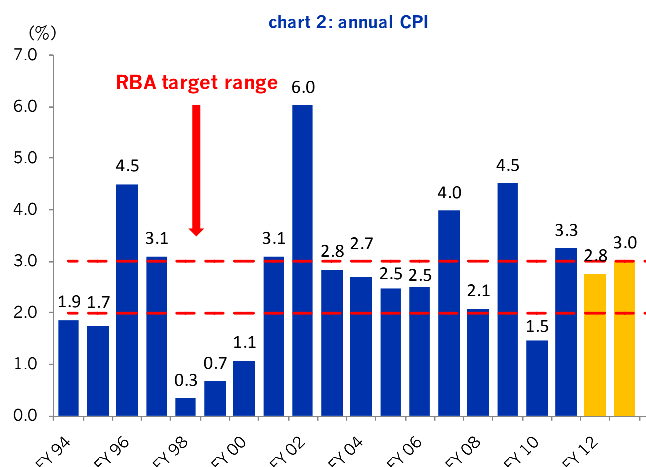
Whilst considerable attention is focused on the Budget bottom-line and the speed at which the deficit is erased, it is also worth remembering that Australia's overall Budget is in very sound shape. In 2011-12, the deficit as a percentage of GDP is expected to decline to 1.5%. This compares with deficits of 5%-10% in most other large advanced economies. Australia, similar to countries across much of Asia, is in a highly enviable position.

The Budget was framed to respond to the challenges posed by the rising inflation risk and the need to boost the economy's productive capacity to avoid production bottlenecks. Another key influence is that the Australian community has been conditioned to have a strong aversion to government debt. These are challenges that the economies in Europe, Japan and the US could only wish to have.

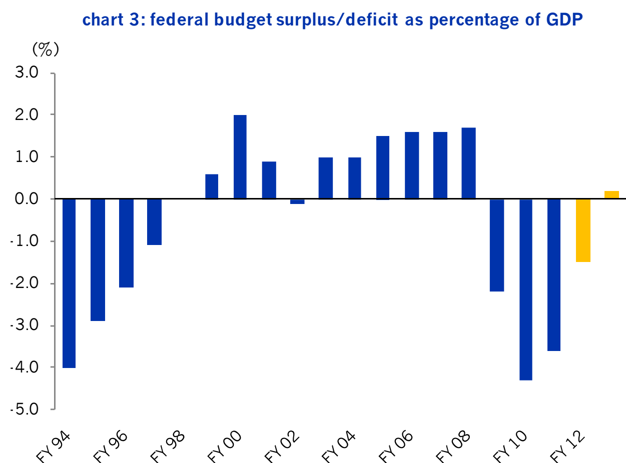
the economic story of the Budget in four charts



Growth expected to advance in 2011-12 after being impacted by natural disasters in 2010-11.



Rising input cost pressures risk compromising the RBA's 2-3% inflation target.



Government on track to meet promise of a budget surplus by 2012-13.

Unemployment continues to fall, with the economy running at close to capacity.

section three: what it means for your investments

- **The RBA has clearly communicated its view that further tightening of monetary policy is likely to be required to manage inflation. The Budget will not have altered this view. Market expectations are for two modest rate rises, totalling 0.50%, in the next 12 months.**

- **Australian bonds will remain attractive to international investors, particularly with our high interest rates and low public sector debt. By retaining the highest Aaa sovereign debt rating we can access credit markets on the most favourable terms.**

- **The Australian dollar is likely to remain higher than its long-term average in the period ahead. ipac's medium-term outlook is for the Australian Dollar to eventually move downwards as additional supply reduces commodity prices and interest rates rise in other developed economies.**

- **Equity market valuations, judged relative to longer-term averages, suggest that investors remain concerned about the outlook for companies operating in the domestic economy. If the Budget growth and inflation forecasts are realised it creates the potential for a favourable re-rating of the share price of these businesses.**

Budget outlook consistent with market expectations

The Government's economic outlook confirmed that activity is expected to accelerate to an above trend rate after temporarily stalling due to natural disasters. Large divergences in the performance of different sectors is likely to remain. Mining is expected to be very strong as export volumes and commodity prices remain high. However difficulties will persist in non-resource export sectors, import competing industries and the retail sector due to $A strength and subdued consumer demand.

With the economy expected to push towards its speed limit, there is an increased potential for capacity constraints to emerge as significant infrastructure investment gets underway. Unless economic policy is carefully managed, there is a risk that inflation will move beyond the upper bound of the RBA's preferred 2-3% target band in coming years.

cash rates likely to rise modestly

Budget measures to boost the productive potential of the economy and reduce cost pressures by encouraging labour market participation have a medium-term focus. Whilst such reform is important, it is unlikely to impact monetary policy in the year ahead.

Last week, the RBA released its quarterly Statement on Monetary Policy. The RBA's economic outlook is broadly similar to that of the Government, pointing to above trend growth over the next few years, declining unemployment and inflation rising to the top of its target band in the near term. The RBA has clearly communicated its view that further tightening of monetary policy is likely to be required to manage inflation. The Budget will not alter this assessment.

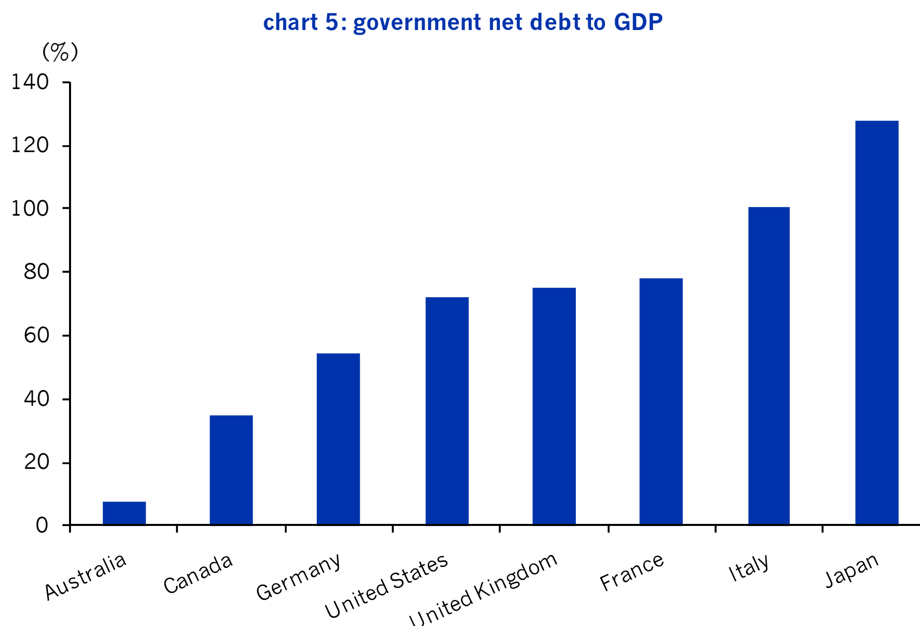
Current market thinking suggests the potential for two modest interest rate rises, totalling 0.50%, in the next year. This view is consistent with the Federal Government and RBA outlooks.

fixed interest in Australia remains attractive to global investors

The path back to a balanced Budget and prospective surpluses in future years is not unexpected. This objective has been well communicated to markets.

The Australian economy is one of the few in the developed world where public sector debt levels are not an issue, as shown in the chart below. Barring unexpected developments, the Budget maintains the discipline of quickly restoring a strong public sector balance sheet. In this environment, international investors will continue to look upon Australia as a safe place to invest in sovereign debt.

chart 5: government net debt to GDP



source: International Monetary Fund (IMF)

The Budget debt reduction strategy will help Australia retain the highest (Aaa) sovereign debt rating from major ratings agencies. This stands in marked contrast to developments in a number of other major economies. Some of these economies have experienced ratings downgrades. In the case of the US and Japan – the world's two largest advanced economies – these economies have been placed on negative watch due to persisting high debt levels or lack of clarity over plans to restore health to public sector finances.

Preservation of the highest rating not only contributes to Australia's "safe haven" status but also provides access to credit markets on the most favourable terms. This is particularly important when the global supply of sovereign debt is still growing quickly in response to persisting large budget deficits in most developed economies and where inflation is showing signs of ticking up from its current low base.

The economic outlook underpinning the Budget – stronger growth, potentially higher inflation and upside risk to cash rates – is not one that typically sits comfortably with bond rate declines. However, the investment climate has been well anticipated by capital markets. But, further unexpected rises in any of these areas could remain a point of concern for bond markets over the medium-term.

the $A dollar expected to remain at elevated levels for some time

The Budget is unlikely to have a material impact on currency market dynamics. The $A has risen markedly over the past year particularly in recent months. Three factors have driven the rise:

~ commodity price strength that continues to boost the terms of trade

~ expectations that cash rates will rise sooner in Australia than in other developed economies

~ re-alignment of the $US against virtually all other major currencies with expectations that the US Federal Reserve will maintain highly accommodative monetary policy settings for an extended period.

In the shorter-term, the potential that Australian cash rates will rise before other developed nations could provide shorter-term support for the currency. Interestingly, in the emerging new economic order Australian, Chinese and Indian monetary policies are tightening at broadly the same time. Commodity prices should remain firm in the short-term, especially under the influence of recent supply disruptions, another factor keeping the $A high.

Over the medium-term, the $A is not generally expected to maintain current levels against other currencies, particularly the $US. Increases in global capacity are expected to come on-stream in the next few years and this should lead to gradual decline in the terms of trade. That said, barring unforeseen events, the terms of trade is likely to settle at higher levels relative to historical averages.

At some point, the US will also need to start contemplating the pathway to monetary policy normalisation. This is not yet on the radar but will be a function of the profile of US economic growth and trends in unemployment. This factor also supports the view that the $A will decline over the medium term.

In the meantime, the high value of the $A is resulting in large divergence of business performance across different sectors. The evidence that the strong $A is now exerting a major impact on the competitiveness of Australian business is evidenced by the internet shopping boom, the significant rise in Australians travelling overseas, the plethora of major overseas rock acts touring the country and the difficulties confronting Australian tourism and the education services sector in attracting foreign visitors and students respectively.

potential for re-rating of companies operating in the domestic economy

The economic outlook underpinning the Budget brings different challenges for different sectors of Australian business.

The mining sector continues to enjoy strong demand and a favourable pricing climate. Massive expansion of capacity should ensure strong volume growth into the medium-term. These activities have had a direct impact on the $A. Mining sector profitability has been largely insulated from the adverse effects of the rising $A through offsetting commodity price gains. Many other segments of the Australian economy should benefit from the multiplier effects as the income generated from mining and related new investment activity is spent. However, specific sectors that are either exposed to import competition or operate in non-commodity export markets may continue to be challenged at a time when spare capacity in the economy could become more limited.

Equity market valuations, judged relative to longer-term averages, suggest that investors remain concerned about the outlook for companies operating in the domestic economy. If the Budget growth and inflation forecasts are realised it creates the potential for a favourable re-rating of the share prices of these businesses.

In addition, there are a number of specific features of the Budget that have consequences for the Australian equity market.

The Budget has been silent on the design and implications of the proposed Carbon Tax. This is still a source of considerable uncertainty for equity investors. There may be reticence in some sectors to proceed with business and investment plans until there is clarity on this issue.

With the Government having articulated the need to enhance the labour supply in an economy that is close to full employment, equity investors may query whether enough has been done in the Budget to alleviate potential upward pressures on input costs.

The measures adopted to boost labour force participation and to wind back government spending to make room for surging investment are sensible. Reforms to expand the nation's productive potential should be supportive to the corporate operating environment. However, the main benefits can be expected to flow in the medium-term and are therefore unlikely to have a meaningful impact on containing shorter-term cost pressures.

We have recently witnessed the impact of some of these pressures with margins being compressed in some industries (retailing, steel) and analysts downgrading profit forecasts on the back of these developments. Comments from the RBA suggest it is acutely aware of the risks flowing from higher input costs.

The healthcare budget is being refocussed with greater assistance being provided in some areas of critical need. However, Budget measures to tighten funding of pathology services will have negative implications for certain healthcare companies. By the same token, the measures have generally been well telegraphed to markets and clarity on government policy with respect to these services may create a firmer base for companies to plan future business models.

The retailing sector has been adversely impacted by a combination of margin pressure, as a result of a rising $A, weakening housing investment and rising household savings with consumers showing a desire to reduce debt. If Budget economic forecasts are realised and a strong labour market continues to drive unemployment lower, there could be something of a silver lining for the sector should the savings rate reduce on the back of improving consumer sentiment.

To support infrastructure investment, the Government has decided to provide additional tax incentives. These actions could contribute to an increase in attractive investment opportunities in this area.

Finally, the Government has confirmed its intention to cut the company tax rate from 30% to 29% in 2013-14 and then to 28% from 2014-15, when the Budget balance should be firmly back in surplus. This initiative is a positive for corporate profitability and cash flow, albeit at the margin.

financial advice

We encourage you to seek expert advice from your financial adviser, as now more than ever there is a need for sound financial advice.

You adviser can work with you to explore ways you may benefit from new opportunities or changes needed as a result of this year's budget helping you to make the right choices with your money.

ipac, a leading financial advisory firm, has been helping people get the most out of their money and their lives for more than 25 years, and we can help you too.

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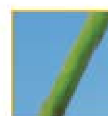

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The information provided in this report is current at the release of the 2011/12 Federal Budget on Tuesday 10 May 2011 and is subject to change and future legislation.