



Join us as we put
Labor's first budget
under the microscope.

Federal Budget Report 2008

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Introduction

The 2008 Federal Budget, the first Federal Labor Government budget in 13 years, has benefited from tax revenues created by the global resources boom. The Government has handed down a larger than expected \$21.7 billion surplus for 2008/09, representing a significant 1.8 per cent of GDP.

The surpluses arising from 2007/08 and 2008/09 will be used to create three 'nation building' funds, namely:

- Building Australia Fund (\$20b) for investment in national transport and communications infrastructure
- Education Investment Fund (\$11b) for capital expenditure in Australia's higher education institutions
- Health and Hospitals Fund (\$10b) to finance the renewal and refurbishment of the nation's hospitals and health facilities and fund major medical research projects.

These funds appear to be similar in concept to the Future Fund which was recently created to assist with the funding of future public servant superannuation and pension liabilities.

As expected, the Government has created expenditure savings by restricting access to certain welfare payments for higher income earners. Access to the baby bonus and Family Tax Benefit Part B will be restricted by applying means testing for people earning more than \$150,000 per year. The child care benefit is no longer available for families earning more than \$110,000 per year.

There is a lift in the child care tax rebate from 30 per cent to 50 per cent. The cap on the amount that can be paid will be lifted from \$4,354 to \$7,500 per child.

The news for lower income earners is positive, with income tax cuts from 1 July 2008 via changes in thresholds for the 30 per cent income tax rate (from \$30,001 to \$34,001), and an increase in the low income tax offset from \$750 to \$1,200. Taxpayers eligible for the full low income tax offset will not pay income tax until their annual income exceeds \$14,000 (up from \$11,000).

Additional tax cuts apply from 1 July 2009, with further reductions from 1 July 2010. No doubt all these changes, whilst popular, will not make it easier to do financial planning modelling!

Interestingly, salary sacrifice contributions will be included in the assessment of a range of government benefits such as family tax benefits, age pension and the super co-contribution, hence eliminating some existing strategies from 1 July 2009. So act now to ensure your clients benefit from these strategies.

Further tightening of eligibility for certain welfare payments will apply from 1 July 2009. Reportable fringe benefits, investment losses, and salary sacrifice contributions will be included in the definition of income to determine eligibility. This will reduce the effectiveness of some financial planning strategies.

The introduction of an education tax refund will allow, from 1 July 2008, eligible parents to claim a 50 per cent refund on eligible education expenses (but not school fees) for children undertaking primary or secondary school studies. The refund will be a maximum of \$375 for a primary school child and up to \$750 for a secondary school child each year. About 1.3 million families (with 2.7 million students) will be eligible for the education tax refund.

The pre-publicised increases in Medicare levy surcharge thresholds from \$50,000 to \$100,000 a year for singles and from \$100,000 to \$150,000 a year for members of a family apply from 1 July 2008.

The financial services industry, particularly funds management, will be pleased with the announcement of a reduction in withholding tax from 30 per cent to 7.5 per cent over three years for non-resident investors, adding potential for Australia to remain a potent player in the fast-growing Asian region. The First Home Savers Accounts should also benefit the financial services industry.

Less pleasing for certain financial services companies, advisers and clients will be the tightening of the extent of interest deductions on protected structured products effective from 7.30 pm AEST on 13th May 2008. Interest rates on capital protected borrowings above a rate of circa 9.5 per cent will not be deductible and will be considered capital, reducing the attractiveness of these products.

Further tax reform is likely, however the Government has re-confirmed its commitment to the tax free status of superannuation benefits for those aged 60 and over.

Overall, a well-balanced budget, limiting inflationary impacts of a strong economy, but also spending in the areas that a Labor Government would be expected to.....education, health, welfare and infrastructure.

Please note that the changes outlined in this summary are proposals only at this stage, and will not take effect until the passage of relevant legislation.

Taxation

Changes in personal income tax

Personal income tax rates and thresholds are proposed to change from 1 July 2008. The threshold at which the 30 per cent marginal rate begins to apply is proposed to be increased:

- from \$30,001 to \$34,001 from 1 July 2008
- from \$34,001 to \$35,001 from 1 July 2009, and
- from \$35,001 to \$37,001 from 1 July 2010.

In addition, the 40 per cent marginal tax rate will decrease to 38 per cent (from 1 July 2009) and to 37 per cent (from 1 July 2010).

The following table sets out the proposed rates and thresholds for resident taxpayers for the 2008/09, 2009/10 and 2010/11 and later years.

2008/09 financial year		2009/10 financial year		2010/11 financial year	
Taxable income \$	Tax rate %	Taxable income \$	Tax rate %	Taxable income \$	Tax rate %
0 – 6,000	0	0 – 6,000	0	0 – 6,000	0
6,001 – 34,000	15	6,001 – 35,000	15	6,001 – 37,000	15
34,001 – 80,000	30	35,001 – 80,000	30	37,001 – 80,000	30
80,001 – 180,000	40	80,001 – 180,000	38	80,001 – 180,000	37
Over 180,000	45	Over 180,000	45	Over 180,000	45

Different thresholds and rates of tax apply for non-residents.

Low income tax offset

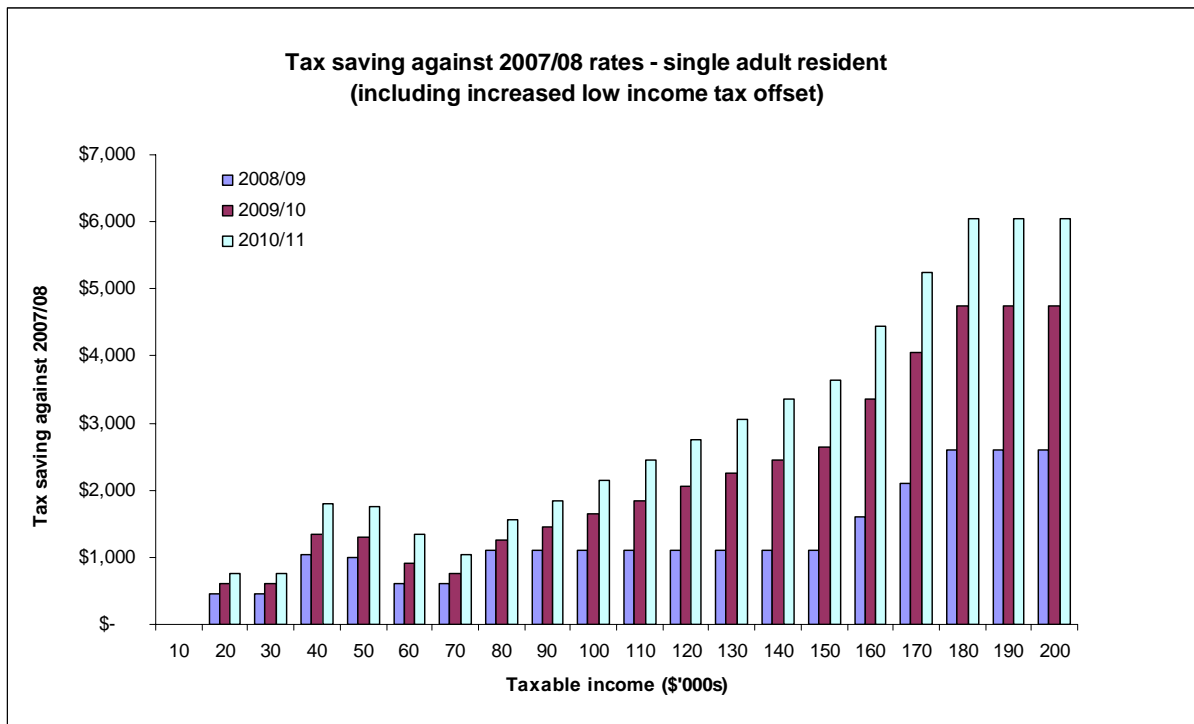
The low income tax offset will increase as follows:

- from \$750 to \$1,200 per year from 1 July 2008
- from \$1,200 to \$1,350 per year from 1 July 2009, and
- from \$1,350 to \$1,500 per year from 1 July 2010.

The threshold at which the offset begins to phase out will remain at \$30,000. Those eligible for the full low income tax offset will have an effective tax free threshold of \$14,000 in 2008/09, \$15,000 in 2009/10 and \$16,000 in 2010/11.

In 2008/09, those eligible for the full low income tax offset will not pay tax until their annual income exceeds \$14,000 (currently \$11,000), with some offset able to be claimed up to an income of \$60,000, currently \$48,750.

New PAYG withholding schedules will deliver half of the benefit of the low income tax offset to low and average income earners through their regular pay, rather than requiring these salary and wage earners to wait for a lump sum refund following assessment of their income tax return.



Senior Australians

Senior Australians eligible for the senior Australians tax offset currently pay no tax up to an annual income of \$25,867 for singles and \$43,360 for couples, depending on the income earned by each member of the couple. The effect of the tax changes is to lift these income levels from 1 July 2008 to \$28,867 for singles and \$24,680 each (\$49,360 combined) for members of a couple.

The Medicare levy low income threshold will also increase to ensure that Medicare levy is not payable by senior Australians until income tax is payable.

Medicare levy low income thresholds

From 1 July 2007, the Medicare levy low income thresholds will increase to \$17,309 for individuals and \$29,207 for individuals in families. The additional threshold for each dependant student or child will increase to \$2,682.

Pensioners below age pension age will have an increased Medicare levy threshold of \$22,922 from 1 July 2007, ensuring they do not pay Medicare levy if they are not liable for income tax.

Medicare levy surcharge thresholds

For the first time since Medicare levy surcharge was introduced on 1 July 1997, the thresholds will increase with effect from 1 July 2008, as follows:

- from \$50,000 to \$100,000 for singles, and
- from \$100,000 to \$150,000 for those who are members of a family.

Dependency offsets

From 1 July 2008, an income threshold of \$150,000 will be introduced to determine eligibility for the following tax dependency offsets:

- Dependent Spouse
- Housekeeper
- Child Housekeeper
- Parent/Parent-in-law, and
- Invalid Relative tax offsets.

From 1 July 2009, the definition of income for these offsets will be aligned with that applying to family assistance payments. The income threshold of \$150,000 will be indexed from 1 July 2009.

Entrepreneurs' tax offset

Currently, the entrepreneurs' tax offset (ETO) is claimed by many taxpayers for whom business is not a primary source of income and who have other, more significant, forms of income. The ETO provides a 25 per cent tax offset on the income tax liability of small businesses that have an annual turnover of \$75,000 or less, phasing out from a turnover of \$50,000.

The Government will apply a family income test to the eligibility criteria for the ETO. The family income test will restrict access to the ETO for businesses with high alternative sources of household income. The family income test will further limit access to the ETO by restricting eligibility for singles from \$70,000 and families from \$120,000 adjusted taxable income per year.

Fringe benefits tax - exemption for certain work-related items

The current fringe benefit tax (FBT) exemption for work-related items such as laptop computers, personal digital assistants and tools of trade will only apply where the item is primarily used for work purposes. In addition, the FBT exemption will generally be limited to one item of each type per employee per year.

Where the FBT exemption continues to apply for an item, depreciation deductions will be denied. These measures apply to items purchased after 7.30 pm (AEST) on 13 May 2008. For items purchased before that time, depreciation deductions will be denied from 1 July 2008.

Fringe benefits tax - jointly held assets

FBT legislation will be amended to ensure that the full value of a benefit provided to both an employee and an associate in relation to a jointly held asset will be subject to FBT. Income and deductions arising from such jointly held assets will be allocated with regard to the joint owners' legal interests. Salary sacrifice arrangements entered into prior to 7.30 pm (AEST) 13 May 2008 will retain their current treatment until the end of the current FBT year, ie 31 March 2009.

Fringe benefits tax - meal cards

Employees enjoying salary sacrifice meal card arrangements will no longer receive the FBT exemption that allows the purchase of meals out of pre-tax income. Existing balances on meal cards as at 7.30 pm (AEST) on 13 May 2008 will remain eligible for the FBT exemption, if used up by 31 March 2009. Any addition to existing balances after 7.30 pm (AEST) on 13 May 2008 will be subject to FBT. The measure will not affect subsidised canteens that are provided to all staff and that are not part of a salary sacrifice arrangement.

Non-resident withholding tax

Withholding tax on distributions of Australian sourced income from Australian managed investment trusts, (except dividends, interest and royalties), paid to certain non-residents, will be reduced from 1 July 2008. Individuals that are tax

resident of jurisdictions with which Australia has effective exchange of information arrangements (to be specified in regulations) will have the following withholding tax rates:

- 22.5 per cent for 2008/09 (non-final rate, with ability to claim deductions for expenses relating to these payments)
- 15 per cent final rate for 2009/10, and
- 7.5 per cent final rate for 2010/11 and later income years.

Other non-residents will remain subject to the 30 per cent final withholding tax rate.

Luxury car tax

From 1 July 2008, the luxury car tax will increase from 25 per cent to 33 per cent. The current luxury car tax threshold of \$57,123 will remain the same.

Capital gains tax - extension to small business tax concessions

The concessions will be broadened to cover taxpayers with a CGT asset used in a business by a related entity and to cover partners owning a CGT asset used in the partnership business, effective 1 July 2007. Currently, for partnerships, the small business entity test requires the taxpayer making a capital gain to be a partner in the partnership and for the asset to be an asset of the partnership.

Employee share schemes – removal of double taxation

Relief from double taxation that applies to some employee share schemes (ESS) that use employee share trusts will be provided effective from 7.30 pm (AEST) 13 May 2008. Currently, capital gains made by the trustee while the shares are held in the trust are also assessable to the employee (if acquired through exercising rights), either under ESS provisions or later as a capital gain.

Capital protected borrowings

A new benchmark interest rate will be used to determine the maximum interest expense for capital protected borrowings. For arrangements entered into from 7.30 pm (AEST) 13 May 2008, any interest expense on a capital protected borrowing in excess of the Reserve Bank of Australia's indicator rate for variable home loans will be treated as the cost of capital protection and not deductible.

Existing arrangements will be taxed under the current law (prior to proposed amendment) for five years or the life of the product, whichever is shorter.

The effect of this change is to reduce the attractiveness of these products.

Family trust limitations

The definition of 'family' for the family trust election rules will change, limiting lineal descendants to children or grandchildren of the test individual or their spouse. In addition, family trusts will not be able to vary the test individual other than in relation to family breakdown. These measures are effective from 1 July 2008.

The Government intends to reduce the scope for family trusts to utilise losses however no detail is yet available.

Comprehensive enquiry into the tax system

The Government will conduct a comprehensive review of Australia's tax system. The review will encompass Australian Government and State taxes, and will consider:

- the balance of taxes on work, investment and consumption and the role for environmental taxes
- further enhancements to the tax and transfer system facing individuals, families and retirees

- the taxation of savings, assets and investments, including the role and structure of company taxation
- the taxation of consumption and property and other state taxes
- simplifying the tax system, including the interactions between federal, state and local government taxes, and
- interrelationships between the elements of the tax system, as well as the proposed emission trading system.

The review will reflect the Government's policy not to increase the rate or broaden the base of the goods and services tax (GST); preserve tax-free superannuation payments for individuals aged 60 and over; and the Government's announced aspirational goals for personal income tax.

The Government has set an aspirational tax goal over six years for a personal income tax system which reduces the number of rates from four to three with a personal income tax scale of 15 per cent, 30 per cent and 40 per cent. The effective tax free threshold for those eligible for the low income tax offset will also increase to \$20,000 by 2012/13, through an increase in the value of the offset.

Political donations – removal of tax deductions

From 1 July 2008, gifts and contributions made by individuals or businesses to political parties, members and candidates will no longer be tax deductible.

Superannuation

Establishment of a superannuation clearing house

Funding will be provided over three years to set up an optional superannuation clearing house facility to reduce the burden on businesses.

Where employees can choose their own superannuation fund from the many hundreds available, an employer may be required to pay superannuation into a large number of different funds. A superannuation clearing house will allow an employer to pay their contributions to a single location. The clearing house will then distribute contributions to the relevant superannuation funds as selected by the employees.

Businesses that use the clearing house facility will have their legal obligation to make superannuation contributions discharged when payment of the correct amount is made to the clearing house.

Tax-free lump sums for individuals with a terminal medical condition

The measure allowing payment of tax-free lump sum superannuation benefits to those individuals diagnosed with a terminal medical condition has been confirmed and backdated to be effective from 1 July 2007.

Payment of temporary residents' superannuation to the Australian Government

It is proposed that future superannuation contributions and existing balances of temporary residents will be paid to the Government. It will allow employers to pay temporary residents' superannuation contributions to a superannuation fund or directly to the Australian Taxation Office (ATO). Each year, the ATO and the Department of Immigration and Citizenship will use data matching to identify super funds holding balances for temporary residents. The funds will be notified by the ATO and will be required to transfer those balances.

The start date for the payment of temporary residents' superannuation to the Australian Government has been deferred to the date of Royal Assent (expected before the end of 2008). The deferral will allow consultation on administrative and legislative design features of this policy.

Social security

Changes to income definitions

From 1 July 2009, salary sacrifice contributions will be included in an expanded definition of 'income' used to determine eligibility for government support, including:

- income support payments for people below Age Pension age
- family assistance
- child support
- superannuation co-contributions, and
- financial and retirement savings assistance delivered through the tax system.

From 1 July 2009, the definitions of adjusted taxable income will be expanded to include net financial investment losses, whereas currently only net rental property losses are included for some definitions. Net financial investment losses and net rental property losses will be counted for the following programs:

- family assistance
- some parental income tests
- the Commonwealth Seniors Health Card
- child support
- Higher Education Loan Program repayment obligations
- Senior Australians tax offset
- Medicare levy surcharge, and
- dependency tax offsets.

From 1 July 2009, the definitions of taxable income for the senior Australians and pensioner tax offsets will include reportable fringe benefits. For eligibility for the dependency tax offsets, the dependant's income will also include reportable fringe benefits.

Certain financial planning strategies will no longer be as effective when these changes are implemented.

Commonwealth Seniors Health Card - adjusted taxable income test

The Commonwealth Seniors Health Card provides a range of benefits to people who do not qualify for the Age Pension but have an adjusted taxable income of less than \$50,000 (for singles) or \$80,000 (for couples combined). From 1 July 2009, the Government will change the Commonwealth Seniors Health Card income test to include gross income from superannuation income streams from a taxed source and include income that is salary sacrificed to superannuation in the income assessment.

This measure will ensure that, in applying the existing income test, all income received by seniors, whether from superannuation or another source such as a managed fund or interest from a bank account, is treated in the same way.

Bonus payments for carers

A one-off tax-free lump sum payment to eligible carers will be paid as follows:

- a payment of \$1,000 will be made to carers who receive Carer Payment and Department of Veterans' Affairs (DVA) Carer Service Pensions

- recipients of Carer Allowance will receive a payment of \$600 for each eligible person in their care, and
- recipients of Carer Allowance who also receive Wife Pension or the DVA Partner Service Pension will receive a payment of \$1,000.

These payments will be made to the majority of eligible carers by 30 June 2008.

Seniors bonus payment

People receiving the following payments on or before 13 May 2008 will be entitled to a one-off bonus of \$500:

- Age pensioners and other income support recipients who are of Age or Service Pension age
- Seniors concession allowance
- Mature Age Allowance
- Widow Allowance
- Partner Allowance
- Wife Pension, and
- Widow B Pension.

To be eligible, the recipient must be in Australia or temporarily absent for no more than 13 weeks. The bonus is tax free and will not be treated as income for social security purposes. The payment of this bonus is expected to be made by the end of June 2008.

Utilities allowance

Utilities allowance is paid to eligible income support recipients to assist with the payment of household expenses. The utilities allowance has been increased from \$107.20 to \$500 per year from March 2008 and will be paid quarterly. Furthermore, the utilities allowance has now been extended to Carer Payment and Disability Support Pension recipients.

Seniors concession allowance

Seniors concession allowance is paid to eligible Commonwealth Seniors Health Card holders and eligible Gold Card holders who are not eligible for utilities allowance. The seniors concession allowance has been increased from \$218 to \$500 per year from March 2008 and will be paid quarterly.

Telephone Allowance

The Telephone Allowance has been increased from \$88 to \$132 from March 2008 for those with an internet connection.

Retention of concession cards while overseas

The Government will cease the automatic cancellation of concession cards for temporary absences from Australia. Under this measure, concession cards will remain current during a cardholder's temporary absence from Australia of 13 weeks or less.

New eligibility criteria for Carer Payment

Many parents caring for a child under 16 years of age will be eligible for fortnightly Carer Payments after an overhaul of the eligibility and assessment for Carer Payment (child). The changes, which are proposed to come into effect from 1 July 2009, will include:

- a new assessment process that is based on the amount of care required, and
- more generous arrangements for carers of children in hospital and those with a terminal illness so that they can keep their Carer Payment and/or Allowance while their child is in hospital.

Families

Baby bonus

The baby bonus will increase to \$5,000 from 1 July 2008. The amount of the baby bonus will be indexed annually on 1 July of each year. From 1 January 2009, a family means test of \$150,000 will be introduced, meaning that high income earning families will no longer be eligible for the bonus. The means test will be based on the family's income in the six months following the birth of their child on a pro rata annual basis equivalent to \$75,000 over that six-month period. For all eligible births after 1 January 2009, the baby bonus will be paid in 13 fortnightly instalments of approximately \$385.

The baby bonus will be extended to families with newly adopted children aged from two years to 16 years, from 1 January 2009.

Income testing of Family Tax Benefit Part B

Family Tax Benefit (FTB) Part B will only be paid to families where the primary income earner has an adjusted taxable income of \$150,000 or less per year. Adjusted taxable income includes taxable income, plus other amounts that reflect a person's financial means, such as net rental property losses and tax free pensions or benefits.

FTB will no longer be paid through the tax system. Centrelink and Medicare will continue to provide payment by fortnightly instalment or annual lump sum.

Education tax refund

The introduction of an education tax refund will allow eligible parents to claim a 50 per cent refund on eligible education expenses for children undertaking primary or secondary school studies. The refundable tax offset will apply to expenses from 1 July 2008 and will be a maximum of \$375 for a primary school child and up to \$750 for a secondary school child each year. This covers costs of education, but not school fees. About 1.3 million families (with 2.7 million students) will be eligible for the education tax refund.

Increased child care rebate

The Child Care tax rebate will be increased from 30 per cent to 50 per cent. The rebate will be paid quarterly to give parents assistance closer to when they incur out-of-pocket expenses. Furthermore, the cap on the amount that can be paid will be lifted to \$7,500 per child, which is an increase of \$3,146.

Child Care Benefit – removal of the minimum rate

The Government will strengthen the income testing arrangements for Child Care Benefit, and improve the targeting of Government assistance, by abolishing the Child Care Benefit minimum rate from the first Monday in July 2008.

Families currently using approved care have the hourly rate of Child Care Benefit reduced over certain income ranges down to a minimum rate of Child Care Benefit. This measure will have the effect of reducing the minimum rate of Child Care Benefit to zero. As a result, families with higher incomes (over \$110,000 per annum) will no longer receive any Child Care Benefit.

First Home Saver Accounts – outcomes of consultation

Eligible individuals will be able to contribute into a First Home Saver Account to assist them to save a larger deposit for their first home. A Government contribution of 17 per cent will be paid on the first \$5,000 (indexed). Personal contributions will be able to be made to the account until the balance reaches \$75,000 (indexed). Earnings on the account will be concessionaly taxed at 15 per cent. Tax-free withdrawals from the account to purchase or build a first home in which to live can only be made after contributions of at least \$1,000 have been made in at least four separate financial years.

The major changes to the scheme include:

- removing the requirement for individuals to make a \$1,000 contribution to open an account
- replacing the \$10,000 annual contribution cap with an overall contribution cap of \$75,000 (indexed)
- clarifying that the four-year rule for tax-free withdrawals operates on a financial year basis, and
- allowing a 14-day cooling off period for individuals to change their mind about their account.

The commencement date of the scheme has been delayed until 1 October 2008 to enable account providers more time to develop products. The delay does not affect individuals as they are still entitled to a Government contribution on the first \$5,000 of personal contributions in 2008/09.

Same sex couples and their children

The Government will prospectively remove differential treatment of same-sex couples and their children from Commonwealth laws in the areas of Australian Government (defined benefit) superannuation schemes, social security, veterans' entitlements, workplace relations, workers' compensation, taxation, health (including Medicare, pharmaceutical benefits and hearing services) and immigration and citizenship.

Veterans

Income Support Supplement - extend eligibility

The Government will extend eligibility for the Income Support Supplement to all War Widow and War Widower pension recipients without children, regardless of age. Previously these War Widow(er)s were only eligible when they reached the qualifying age for Income Support Supplement. This measure will commence from 1 July 2008.

Automatic granting of War Widows' Pension

The Government will extend the automatic granting of the War Widows' Pension to the widow(er)s of veterans who were in receipt of the Temporarily Totally Incapacitated Special Rate and Intermediate Rate of Disability Pension at the time of the veteran's death. This measure will bring these widow(er)s into line with arrangements that currently apply to the widow(er)s of Extreme Disablement Adjustment and Totally and Permanently Incapacitated disability pensioners.

Backdating of Widows' Pension

The payment of a Widows' Benefit can be backdated to 1 July 2003 where Defence Force Retirement and Death Benefits pensioners commenced a marital relationship after 60, but died within five years of the relationship commencing.

For more details on any of the above information and the implications for your clients, please contact the AXA Technical Services team on 1800 644 644 or email axatechservices@axa.com.au.

This article is based on our interpretation of information available at the time of publication 13 May 2008 and has been prepared to provide you with general information only. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information.

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what it means for the economy

The Government is forecasting a combination of below trend growth and higher inflation over the next year.

- ~ Australian growth is expected to slow to 2.75% in 2008-09 from 3.5% in 2007-08 (ref Chart 1). The slowdown is driven by moderating private and public sector demand and weaker net exports. The income generated from an expected 16% rise in Australia's terms of trade due to soaring commodity prices is expected to cushion the economy from the effects of more noticeable slowdown in the US, Japan and Europe. For the 3 years from 2009-10, Australia's growth is projected to be 3%.
- ~ Inflation, which increased by 4.2% over the year to March 2008, is forecast to rise by 3.5% in 2008-09, easing back to 3.25% by June 2009 (ref Chart 2). Budget projections assume inflation could fall back to the middle of the 2-3% band targeted by the Reserve Bank of Australia (RBA) in 2009-10.
- ~ The unemployment rate reached a 33 year low of 4.0% in February 2008, significantly lower than the 5.0% rate forecast in last year's Budget. Labour market tightness and anecdotes of rising skilled labour shortages run the risk of adding to wages pressures although the Government expects a weaker labour market to contain wages growth to rates experienced in recent times. The unemployment rate is forecast to rise to 4.75% by June 2009. Pockets of labour market tightness, particularly in resource related areas, are expected to persist.
- ~ Business investment has been supported by high corporate profits over the past year. The Government is forecasting that investment will remain firm in 2008-09, partly as a consequence of existing capacity constraints. However, higher interest rates, tighter credit conditions and uncertainty in global markets are expected to have more of a dampening effect as the year progresses.
- ~ Australia's current account deficit is expected to narrow to 5% of GDP in 2008-09 under the influence of a strong rise in the terms of trade which is forecast to produce a small trade surplus.
- ~ The Australian Dollar has risen 13.2% against the US Dollar and remained relatively unchanged against the Yen and Euro over the year to 30 April 2008. The Budget measures are unlikely to have an immediate impact on the Australian Dollar, which continues to be supported by the strong terms of trade and attractive yields in interest rate markets.
- ~ In a world of increased uncertainty, international investors should gain comfort from Australia's large Commonwealth fiscal surpluses. It is planned to use these surpluses to establish three funds that will support long-term infrastructure investments in education, health, transport and communications. This will enhance the economy's growth potential over the medium to long-term.

budget economic forecasts

Indicator	Estimate 2007-08	Forecast 2008-09	Projection 2009-10	Projection 2010-11
Real GDP (%)	3.5	2.75	3.0	3.0
Employment (%)	2.5	1.25	1.25	1.25
Unemployment rate (%)	4.25	4.5	-	-
Inflation (%)	4	3.25	2.5	2.5
Wage price index (%)	4.25	4.25	4	4
Current account deficit (% of GDP)	6.25	5.0	-	-
Budget cash surplus/deficit (\$A billion)	16.8	21.7	19.7	19.0

source: 2008-09 Budget Papers, Statement Nos. 1, 2 and 3

Chart 1:

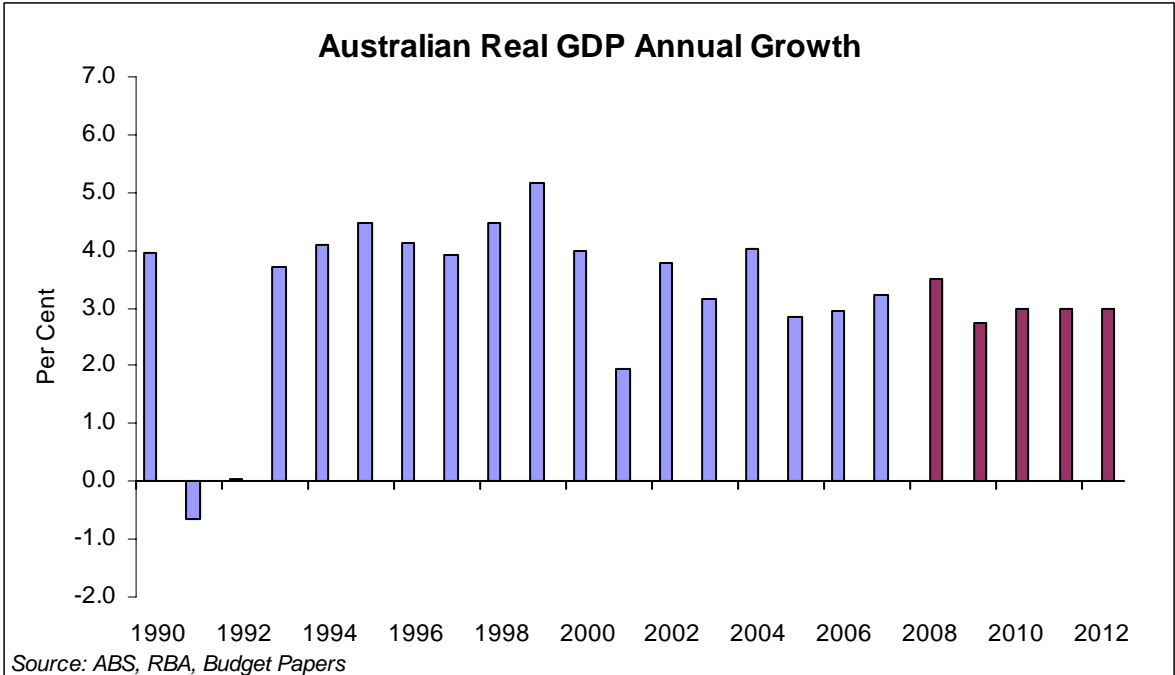
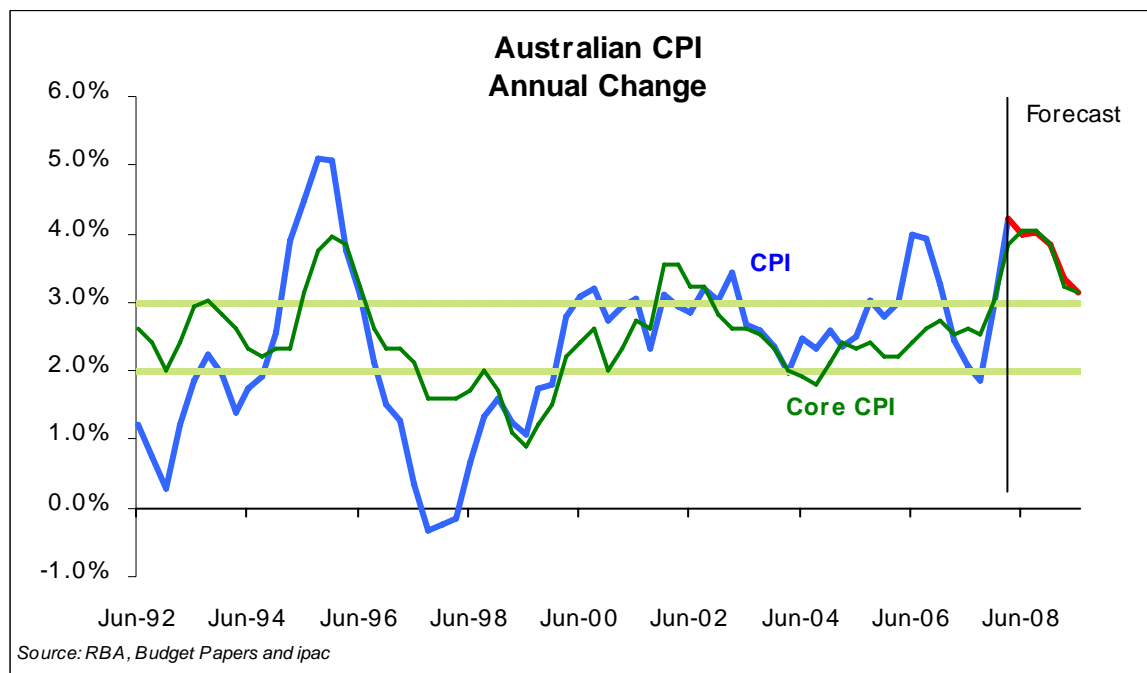


Chart 2:



what it means for markets

monetary policy and cash rates

- ~ In its Quarterly Statement of Monetary Policy on 8 May, the RBA stated that domestic demand will need to slow significantly if inflation is to track back towards its target range of 2-3%. There are signs this is starting to occur, and budget measures to contain growth in government spending will contribute to this process, albeit moderately. In addition, the Government has identified A\$7.3 billion in savings over the year ahead to broadly offset the stimulatory impact of its new spending decisions.
- ~ The Federal government's inflation forecasts are slightly lower than those published by the RBA. The RBA expects annual CPI inflation to remain slightly above 4% throughout 2008 before gradually declining through 2009. The annual inflation rate is not forecast to move back inside the 2-3% medium-term target band before 2010. In contrast, government economic projections assume inflation will average 2.5% in 2009-10.

- ~ The task of setting budget and monetary policies has been complicated by recent liquidity strains in global financial markets, particularly credit markets, and the considerable uncertainties surrounding the outlook for global and Australian growth. Sentiment is still fragile but the declining threat to growth is allowing the RBA to refocus on the fight against inflation. Expectations for a further boost to incomes from the strong rise in the terms of trade, and slow progress in moderating inflation suggest the RBA is likely to maintain its current restrictive monetary policy for an extended period.

fixed interest

- ~ Fixed interest markets tend to warm to slowing growth but fear the risk of higher than expected inflation. Consequently, the economic outlook contains mixed messages for the domestic fixed interest market.
- ~ To a large extent, the fixed interest markets have discounted the Government's economic outlook with the Budget economic assumptions broadly in line with the market consensus. The prospect of higher inflation in the short-term and the maintenance of restrictive monetary policy settings should underpin short term bond rates.
- ~ Long-term rates are subject to a broader set of factors, being more influenced by inflationary expectations and developments in global capital markets. Consequently, the outlook for longer-dated bonds remains more uncertain and the near-term impact of the Budget should be minimal. A potential tug of war between higher inflation and slower growth suggest the potential for volatile but rather directionless market conditions.
- ~ Large budget surpluses mean that new bond issuance is only undertaken to maintain an active treasury bond market. With A\$5.1 billion of bonds due to mature in 2008-09, a modest issue of A\$5.3 billion of new bonds is expected to maintain a stable supply of government debt.
- ~ Whilst the impact of the Budget on fixed interest markets is expected to be limited, the recent sharp widening in credit spreads as a consequence of the re-pricing of risk in financial markets, appears to once again be offering some potentially interesting investment opportunities, particularly for shorter dated securities. Spreads on most fixed interest securities are now well above historic averages.

shares

- ~ Typically, the performance of shares has been more constrained when inflation is rising. On this occasion, however, shares seem better placed to withstand increases in inflation, as long as it is not extreme and does not become embedded. Provided any increases can be quarantined from feeding into stronger wages growth, corporate margins should be able to withstand the risk of inflation. The more serious challenge to margins is if the slow-down in demand and activity growth ends up being more severe than currently anticipated.

- ~ The economic outlook underpinning the Budget presents different challenges for various sectors of the Australian share market. With the RBA focused on slowing domestic demand, interest rate sensitive sectors more heavily exposed to the domestic economy seem more likely to be adversely affected. At the other extreme, materials and energy company earnings appear to be strongly underpinned by high commodity prices and may provide something akin to an inflation hedge. Companies delivering sustainable, more predictable, earnings streams may also be better positioned in the current climate.
- ~ The planned transfer of the bulk of the 2007-08 and 2008-09 budget surpluses to three new funds - the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund - will provide a significant boost to the financing of Australia's long-term infrastructure needs in the transport, communications, education and health sectors. The Government initially expects to allocate A\$40 billion to these funds and make contributions from future surpluses. While of no immediate impact to markets, it should provide longer-term support to industries in the building and construction, communications and engineering sectors and may be of longer-term benefit to companies with particular expertise in managing infrastructure projects.
- ~ A combination of capacity constraints, slowing demand, rising inflation and a restrictive monetary policy presents a more challenging business environment. Share markets are likely to experience noticeable volatility in the year ahead as fiscal and monetary policies work towards a more sustainable, non inflationary, growth path. Following the sharp price declines experienced by the Australian share market in the first quarter of 2008, valuations are quite reasonable and appear to be making some allowance for an extra degree of downside earnings risk beyond that currently forecast by the market consensus.

property

- ~ Overall, the budget should have little material impact on the performance of listed property.
- ~ Following pronounced weakness in the listed property sector in the December and March quarters, property valuations now appear more reasonable. There are early signs that listed property trust market conditions are beginning to normalise, and the sector appears to be looking for opportunities to reduce gearing in response to the difficulties encountered by the more highly leveraged managers.

Important information

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