



OVERVIEW OF THE 2006/07 FEDERAL BUDGET

“Some Big Ideas and Positive Directions” (Heather Ridout, Chief Executive, Ai Group)

“This is a Budget which will build opportunity for the future.

“Now [that] the Australian Government is debt free in net terms ... We are saving over \$8 billion per annum in interest payments ... we can use those savings:

- *For a new program of investment;*
- *For a new comprehensive tax plan;*
- *To help Australian families;*
- *To assist older Australians; and*
- *To secure and defend our country....*

This is a Budget which will build opportunity for the future.”

The Hon Peter Costello, Federal Treasurer

Key Summary

The Federal Treasurer, the Hon Peter Costello, delivered his eleventh Federal Budget tonight (Tuesday 9 May 2006). The centerpiece of the Budget is a new program of investment, complemented by a new tax plan and assistance for Australian families and the aged.

For **business**, the reforms relate to two significant changes – enhanced depreciation arrangements and reform of small business taxation.

While Australia’s company tax rate is middle ranking by international comparison, most OECD countries offer much more generous depreciation arrangements which lower the effective marginal rate of taxation on investment. This was an essential argument which Ai Group highlighted in its report on ***Manufacturing Futures***.

In order to enhance Australia’s international competitiveness and in recognition of the more rapid uptake of new technology, the Government has moved to lift the depreciation rate on new plant and equipment (from 150%) to 200% diminishing value rate of eligible business assets acquired after tonight. This will be at a cost of \$3.7 billion over the next four years.

For **small business**, the Government has introduced changes to the Simplified Tax System to make it more attractive, aligning thresholds for small businesses to make it easier for them to understand their eligibility for various concessions, and simplifying and extending access to the small business capital gains tax concessions. These changes will provide benefits worth \$435 million to small business over the next four years.

For **individuals**, from 1 July 2006, the Government will reduce the marginal tax rates at the upper end of the income scale from 47% to 45%, and from 42% to 40%. This will give Australia four marginal tax rates of 15, 30, 40 and 45 cents.

In addition, the tax thresholds at which marginal rates cut in, are being lifted to \$25,000 for the 30 cent rate; \$75,000 for the 40 cent rate; and \$150,000 for the 45 cent rate. More than 80% of taxpayers will have a top marginal tax rate of 30 cents, and only 2% of taxpayers will pay the top marginal tax rate from 1 July this year.

For low income earners, the Low Income Tax Offset will increase from \$235 to \$600. It will phase out from \$25,000 to \$40,000. This means a low income earner will not pay tax until their annual income exceeds \$10,000.

In regard to **superannuation**, Australians aged 60 or over will from 1 July 2007 be exempt from any tax on their end benefits where these are paid from a taxed superannuation fund. There would be no tax on a lump sum. There would be no tax on a superannuation pension. As well, reasonable benefit and age-based limits would be abolished.

These reforms are complemented by further enhancements for **families and the elderly**. The Family Tax Benefit Part A income tax threshold will be lifted; access expanded to the Large Family Supplement; and removal of limits on the number of subsidized outside school hours and family day care places. For older Australians, the Utility Allowance has received a once-off injection of \$102.80 per household (to be paid by 30 June 2006); and the extension of eligibility.

The budget also provides for over \$3.0 billion additional expenditure for **infrastructure** investment on roads, rail, water, and health and medical research infrastructure.

Further details on these and other initiatives are outlined later in the document.

Fiscal Balance

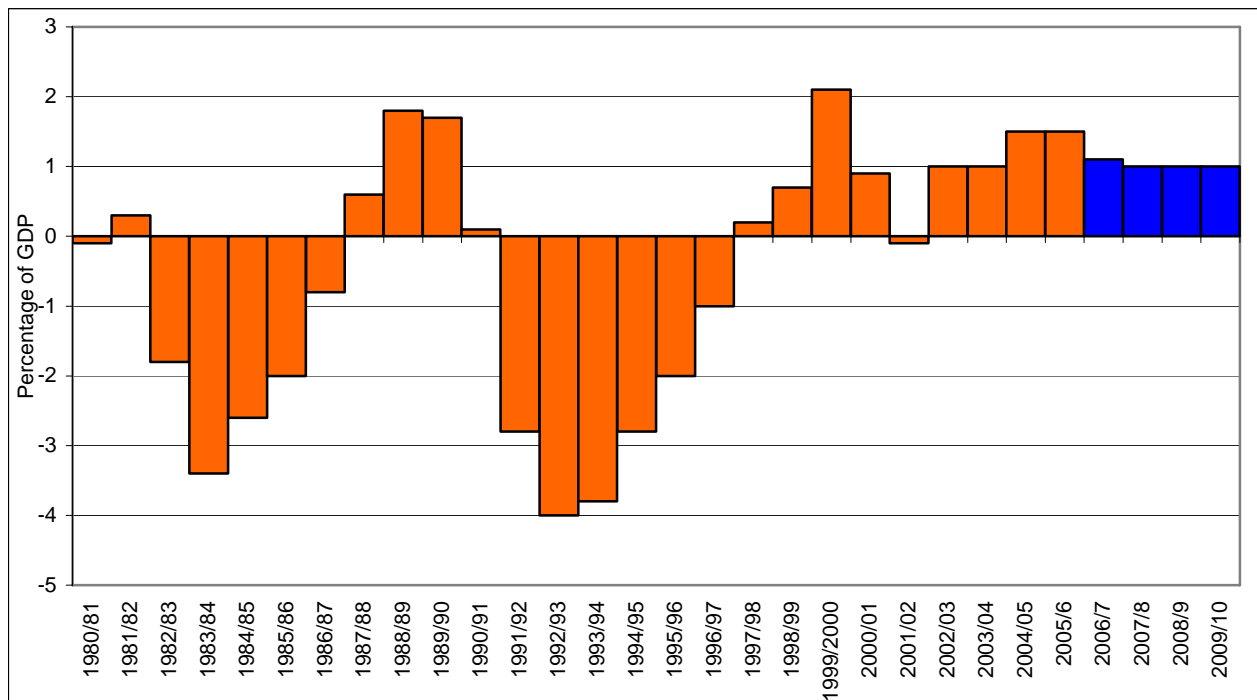
The Government has budgeted for an underlying cash surplus of \$10.8 billion, \$1.1 billion higher than forecasted in the Mid Year Economic and Fiscal Outlook (released in December last year). This is in contrast to last year's estimated surplus of \$14.8 billion.

In accrual terms, the 2006/7 fiscal balance is a surplus of \$10.3 billion, lower by \$5.7 billion than the fiscal balance in 2005/6.

The underlying cash balance is projected to be \$12.0 billion in 2009/10.

Total revenue is expected to rise by 3.9% (from \$222.9 billion to \$231.7 billion), while total expenditure is set to rise from \$206 billion to \$219.7 billion). The vast bulk of the \$8.8 billion increase in revenue is expected to come from income taxation (from individuals, companies and superannuation). Company tax collections are expected to contribute around \$6.4 billion in additional revenue and are expected to yield over \$56.7 billion in 2006/7, even after taking account of the changes to depreciation allowances (a reduction of \$0.5 billion in 2006/07) and fringe benefit tax (a reduction of \$0.26 billion).

Chart 1 Underlying cash balance



Ai Group Assessment

The Budget will be good for business and makes important headway into some of the key issues facing Australia. It is a positive Budget that makes solid progress on the big domestic policy goals of participation, national saving and competitiveness.

These policy goals will be stimulated by the mix of income tax changes; the decisive plan to overhaul and simplify our superannuation system; the depreciation measures and the changes to the Simplified Tax System for small business.

The income tax changes announced by the Government follow on the recommendation of Ai Group to give emphasis to reducing the impact of marginal tax rates on low and middle income earners. The reductions in the higher tax rates will also boost incentives to work, save and invest.

Ai Group has also campaigned hard to remove the multiple layers of tax on superannuation. The budget proposals will deliver on this objective and will also assist in simplifying the superannuation system.

The change in depreciation arrangements for business assets will bring tax deductions much closer into line with business realities. This measure will provide a spur to capital investment at a time when Australian industry is looking to upgrade its production processes and develop new products.

While the venture capital changes are welcome, it is disappointing that more progress has not been made on the big nation-building goals of skills and innovation. The initiatives to increase expenditure on road and rail infrastructure will add to national capacity although these measures are not sufficient in addressing the need for better planning and co-ordination.

As Ai Group showed in our recent report *Manufacturing Futures*, investments in skills, innovation and infrastructure are required to build the competitiveness of Australian business and to assist in rebalancing the economy as the current minerals boom begins to fade.

Key Economic Parameters

The Treasurer expects **gross domestic product** (GDP) to lift from a year average of 2.5% in 2005/6 to 3.25% in 2006/7. After easing sharply in 2005/6 (to 2.75%), the growth in **household consumption** is expected rise to 3.0% in the next financial year.

Inflation is expected to moderate slightly from 3.0% in 2005/6 to 2.75% in 2006/7, well within the Reserve Bank of Australia's target range of 2-3%. **Unit wage costs** however are expected to remain unchanged at 4.0%.

Employment growth is expected to fall to 1.0% (down from 2.0% in 2005/6). The **unemployment rate** is forecast to continue to remain unchanged at 5.25% in 2006/7.

Australia's **export** performance is anticipated to improve significantly, from 2% growth in goods and services exports in the current year to 7% growth in 2006/7. It should however be noted a similar forecast in last year's budget failed to materialise. **Imported goods and services**, are anticipated to grow by 7% in 2006/7 compared with a 6% growth figure in 2005/6.

The **current account deficit** is expected to deteriorate from \$56.25 billion to \$62.5 billion over the next financial year. This represents a rise in the current account deficit from 6.0% to 6.25% of GDP.

Private investment growth is expected to be lower than in 2006/7. Investment in **dwellings** is expected to fall by 1% in 2006/7 compared to a fall of 3% in the previous year. Investment in new **machinery and equipment** is expected to rise by 9% in the year ahead (compared with a 16% rise in 2005/6). The rate of growth in new investment in **non-dwelling construction** is expected to fall from 14% to 6% over the coming financial year.

In terms of the world environment, the **United States** growth forecasts remains unchanged on last year at 3.5% in 2006. Growth in the **Japanese economy** is expected to improve from 2.7% in 2005 to 3.0% in 2006. **Chinese** growth is anticipated to abate slightly from a rate of 9.9% to 9.75% in 2006. Growth among other **East Asia** countries is expected to rise marginally from 5.0% to 5.25% over the course of 2006. In the **Euro area**, GDP growth is expected to also improve from 1.4% in 2004 to 1.75% in 2006.

Review of Main Initiatives Affecting Business

Tax Changes

Personal income tax

The Government has made several changes to the personal income tax scale to take effect from 1 July 2006. These changes come on top of changes already due to take effect from 1 July this year as announced by the Government in last year's budget. The changes to personal income tax scales are summarised below (with changes highlighted in bold).

Personal Income Tax Scales

2005-06 Scale	Previously announced 2006-07 Scale	Newly announced 2006-07 Scale
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Incomes (\$)	Tax rate (%)	Incomes (\$)	Tax rate (%)	Incomes (\$)	Tax rate (%)
0 to 6,000	0	0 to 6,000	0	0 to 6,000	0
6001 to 21,600	15	6001 to 21,600	15	6001 to 25,600	15
26,001 to 63,000	30	26,001 to 70,000	30	25,001 to 75,000	30
63,001 to 95,000	42	70,001 to 125,000	42	75,001 to 150,000	40
95,001+	47	125,001+	47	150,001+	45

In addition the Government announced a large increase in the Low Income Tax Offset from its present level of \$235 to \$600 from 1 July 2006. The threshold at which the offset begins to phase out will also rise from \$21,600 to \$25,000.

The impacts at different income levels of the cumulative changes in tax arrangements that will take effect from 1 July 2006 are set out below.

Income	Tax cut		Reduction in tax paid	Change in disposable income
	\$ per year	\$ per year	\$ per week	%
10,000	364.85		7.00	100.0%
25,000	1,010.66		19.38	31.0%
40,000	509.89		9.78	6.5%
50,000	509.85		9.78	4.7%
75,000	1,949.73		37.39	9.8%
100,000	2,699.78		51.78	8.8%
125,000	4,449.78		85.34	10.5%
150,000	6,199.78		118.91	11.5%

Changes to Superannuation

The Government proposes to remove the current highly complex tax arrangements and rules that apply to superannuation benefits.

Under the plan, Australians aged 60 and over who have already paid tax on their superannuation contributions and earnings would not pay tax on their superannuation benefits from 1 July 2007.

People who receive superannuation benefits that have not previously attracted tax would still pay tax on their benefits under new tests.

The removal of tax on benefits is expected to improve the incentives for people to work part-time without imposing higher tax on their superannuation income.

Under the proposal people could still access their superannuation benefits before age 60, although they would be taxed on their benefits.

The plan also abolishes reasonable benefit limits (RBLs); introduces new streamlined rules for contributions; and gives individuals greater flexibility over their use of superannuation.

Related to the superannuation reform there would also be reform of the pension assets test. The current taper rate of \$3 is a large disincentive to save for retirement and would remove this barrier to retirement saving. This measure would be offset by removing the 50% assets test exemption for complying superannuation income streams. The removal of this exemption would introduce some complexity into the new arrangements because income streams purchased before 2007 would still be 50% exempt and a 100% exemption would apply to income streams purchased before 2004.

The Government intends to consult over the design of the new superannuation arrangements in time for their introduction in 2007.

Red Tape Reduction

When the Government released its initial response to the report of the Regulation Taskforce it announced several measures which also appear in the Budget. These include the reduction in the incorporation fee from \$800 to \$400 (at a cost of \$216 million over four years); increasing the reportable fringe benefits exclusion threshold from \$1,000 to \$2,000 from 1 April 2007; and an increase in the minor benefits exemption threshold from \$100 to \$300 from 1 April 2007.

Fringe Benefit Tax

The Fringe Benefit Tax Rate will be reduced from 48.5% to 46.5%, effective from 1 April 2006. These changes will ensure that the FBT rate aligns with the top personal income tax rate. This will represent a cost of \$260 million in 2006/07.

As well, the in-house tax free fringe benefit tax-free threshold will rise from \$500 to \$1,000 from 1 April 2007.

Uniform Capital Allowance – diminished value rate

The rate of depreciation for eligible assets will rise from 150% to 200% on and after 10 May 2006.

Currently, a taxpayer can use either the diminishing value or the prime cost (straight-line) method for depreciating assets. The diminishing value method uses a fixed proportion (determined by the diminishing value rate and the effective life) of the asset's

written down value to establish its annual decline in value. This reflects the fact that asset value can decline more rapidly in the initial years in which the asset is held. Under the prime cost method, the asset is written off in equal instalments over the asset's effective life. Generally, a taxpayer can choose between the two methods.

The current 150% diminishing value rate does not fully reflect the true change in value of many depreciating assets. This results in depreciation rates that are generally too low for most plant and equipment. By increasing the diminishing value rate to 200%, this measure will ensure that tax depreciation rates more closely align with economic depreciation.

This change is estimated to cost \$500 million in 2006/07, rising to \$1.2 billion in 2009/10.

Infrastructure

The budget also provides for over \$3.0 billion additional expenditure for **infrastructure** investment on roads, rail, water, and health and medical research infrastructure.

The main initiatives include, an additional \$2.3 billion under the **AusLink** for Australia's key highway and rail network, including:

- \$800 million this year to accelerate duplication of the Hume Highway, bring forward completion from 2012 to 2009.
- \$220 million to accelerate works to improve the safety of the Bruce Highway between Townsville and Cairns, and an extra \$48 million to the Tully flood works project.
- \$323 million for the Great Northern, Great Eastern and Eyre Highways in Western Australia
- \$160 million for the Pacific Highway in New South Wales.
- \$100 million for the Sturt Highway in South Australia.
- \$60 million for the East Tamar Highway in Tasmania and
- \$30 million for the Victoria Highway in the Northern Territory

At the local level, the **Roads to Recovery** program will receive an additional \$307.5 million to local councils this year - before 30 June - so councils can double next year's level of construction.

The **Road User Charge** for heavy vehicles currently stands at 19.6 cents per litre. The Government will not proceed with an anticipated increase in this charge which was to have come into effect on 1 July 2006. This is a saving to the road industry of \$1.2 billion over the forward estimates.

In terms of **Water Infrastructure**, the Government is committing an additional \$500 million to restoring the health of the Murray River system. The money will be used to

undertake a range of capital works and improvements to protect the resources of the basin and enhance environmental flows.

Finally, in regard to **Health and Medical Research Infrastructure**, the Government has announced new funding of \$235 million for the provision of physical infrastructure. This will fund new infrastructure at facilities such as the Howard Florey Institute (\$37 million), the Garvan and Victor Chang Institutes (\$14 million), and the Murdoch Children's Research Institute (\$10 million). All up this new investment in scientific infrastructure amounts to around \$806 million over five years.

Venture Capital

The Government will introduce a new investment vehicle called an early stage venture capital limited partnership (ESVCLP) which will, from 1 July 2006, progressively replace the existing pooled development funds (PDF) arrangements. The Government will also make changes to the existing venture capital limited partnership (VCLP) regime.

Investors in innovative small companies will be able to invest free of income and capital gains tax under the changes to venture capital rules announced tonight.

Also for the first time, fund managers under the program will be able to invest in companies that are not headquartered in Australia, allowing venture capitalist to invest Australian funds offshore. This is in recognition of Australian companies move some or all of their operations offshore (and consistent with the approach articulated in Ai Group's *Manufacturing Futures*).

The Government expects the program to leverage an additional \$200 million in matching capital from the private sector into early-stage venture capital, a doubling of the existing Innovation Investment Fund.

The Fund has helped to create 60 start-up companies since 1998.

Skilled Migration and Visa

The Government will implement changes to the general skilled migration program to place greater importance on English language proficiency and skilled work experience. This will include an increase in base English language requirements, the allocation of additional points to applicants who achieve high levels of English, and a greater emphasis on skilled work experience in the points test. To allow time for applicants to obtain work experience, the Graduate Skilled (temporary) visa will be extended from 6 to 18 months. These changes will commence on 1 July 2007.

The Government will expand the current work and holiday visa arrangements. This will allow persons from additional countries to apply for work and holiday visas. A

new visa class will also be created which will extend post-qualification work experience opportunities to overseas students who have completed post-secondary studies in Australia. In addition, a temporary working visa will be formulated to attract graduates of prestigious overseas universities to work in Australia. These initiatives will lead to additional revenue through visa fees of \$24.6 million over four years.

Apprenticeships

The Government will provide an additional \$106.7 million over four years for New Apprenticeships Centres to deliver payments under the New Apprenticeships Incentives program and provide information and resources to employers and new apprentices.

The additional funding is to meet anticipated increases in the costs of providing existing services, as well as providing for service enhancements to increase the retention and completions rates of new apprentices. Service enhancements include increased contact by New Apprenticeships Centres with new apprentices and their employers and increased responsibility to intervene where there is a risk a new apprenticeship will not be completed.

Invest Australia

The Government will provide funding of \$72.9 million over four years to continue and expand the operations of Invest Australia. Invest Australia promotes and facilitates foreign direct investment into Australia. This funding will provide for the establishment of new Invest Australia offices in India and the United Arab Emirates, and allow for the expansion of staff, especially overseas.

Global Supply Chain Management

The Government will provide an additional \$4.2 million over four years to expand the Supplier Access to Major Projects (SAMP) program. This funding will assist small and medium-sized Australian businesses to access international supply chains. The Department of Industry, Tourism and Resources will also have an increased role in facilitating access to new global markets and partners.

Wine Tax Equalisation

The Government will enhance the wine equalisation tax (WET) producer rebate scheme, with effect from 1 July 2006 (at a cost of \$25 million in 2006/07)

Currently, the WET producer rebate scheme provides a WET rebate of up to \$290,000 to each wine producer (or group of producers) each financial year. From 1 July 2006, each wine producer (or group of producers) will be able to claim an increased maximum rebateable amount of \$500,000 each financial year.

The enhanced assistance will effectively exempt up to around \$1.7 million of domestic wholesale wine sales from WET each year per wine producer (or group of producers), compared to \$1 million a year under the current scheme.

Defence

The Government will extend its commitment to increase Defence spending by three per cent real growth from 2011-12 to 2015-16. This extension provides an additional \$10.7 billion for Defence over this period, building upon the Government's previous commitment in 2000 to increase defence spending by three percent real growth up to 2010-11. The Defence budget will grow from \$12.6 billion in 2000-01 to \$26.7 billion by 2015-16. The 2006-07 Budget also provides for a number of additional measures, including \$1.9 billion to acquire a new heavy airlift capability (C-17 aircraft); \$623 million for Defence operations; and \$300 million over eight years to modernise propellant manufacturing at the explosives and propellant facility at Mulwala NSW.