

2012-13 FEDERAL BUDGET PREVIEW

COMMONWEALTH BUDGET 2012-13 PREVIEW

4 MAY 2012

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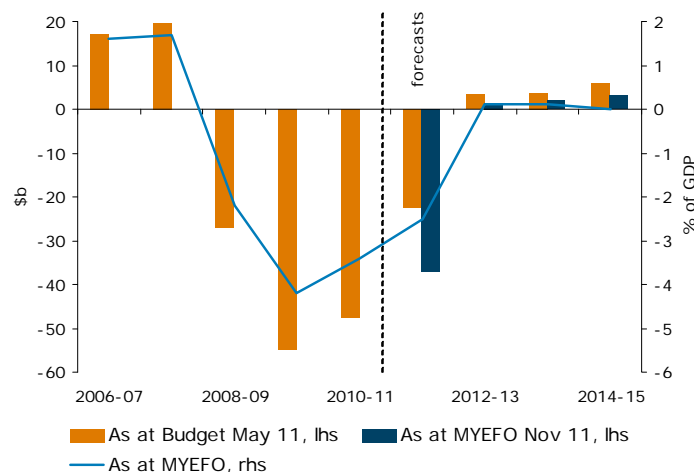
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- The Commonwealth budget will be handed down next Tuesday (8 May) at 7.30pm AEST. We expect the Government will forecast a small surplus in 2012-13 after some slippage in the 2011-12 deficit.
- Delivery of the surplus will be tough, but the final budget outcome is unlikely to phase markets given Australia's favourable fiscal fundamentals. Most market debate will be about how budget tightening will impact the RBA's thinking on monetary policy.
- We don't see the 2012-13 surplus target as quite the economic imperative the Government does, but agree the budget should be returned to surplus in the medium term to give the Government maximum flexibility to respond to shocks.
- The surplus target will reflect discretionary cuts to expenditure and delayed programs to offset downgraded revenue projections. There may also be some further spending brought forward from 2012-13 into 2011-12.
- Although the turnaround in the budget balance is projected to be the largest in Australia's history at 2.5-3ppts of GDP, the impact on economic growth is expected to be more moderate. ANZ estimates the likely change in government spending in 2012-13 will lead to around a 1ppt drag on growth in that year, although it is very difficult to be precise about this estimate and this is already largely factored into growth forecasts.
- The Government is clearly hoping fiscal consolidation will result in lower interest rates and downward pressure on the AUD. This fiscal strategy may provide some confidence benefits, but the net impact of fiscal tightening and lower interest rates, if they occur, will be broadly neutral for the economy.
- Our main concern, not knowing the full extent of cuts, is that the fiscal consolidation will be too hurried, and place additional pressure on the lacklustre non-mining economy.

FIGURE 1. UNDERLYING CASH BALANCE



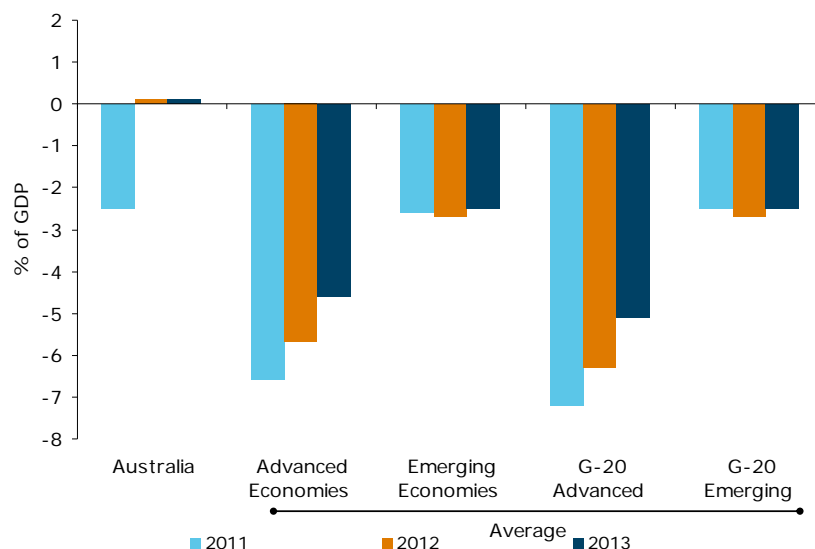
Sources: Treasury, ABS and ANZ

EXPECT A SURPLUS AND A SERMON ON FISCAL RESPONSIBILITY

The Budget papers will show the Government's aim to deliver a small surplus in 2012-13 remains on track after some slippage in the 2011-12 deficit. We expect the Budget projections for the early years will look similar to the Government's November 2011 mid-year projections, with a slightly bigger deficit in 2011-12 than the November forecast of AUD37.1bn (2.5% of GDP) and little change to the 2012-13 surplus forecast of AUD1.5bn (0.1% of GDP).

The pursuit of a surplus will mean Australia's fiscal policy is one of the most prudent in the world and this is a message the Treasurer will continue highlighting both domestically and abroad. Achieving a surplus in 2012-13 has been described by the Treasurer as the *"best defence in a changing global environment"*.

FIGURE 2. GENERAL GOVERNMENT BUDGET BALANCES, INTERNATIONAL COMPARISONS



Sources: IMF, MYEFO 2011-12 and ANZ

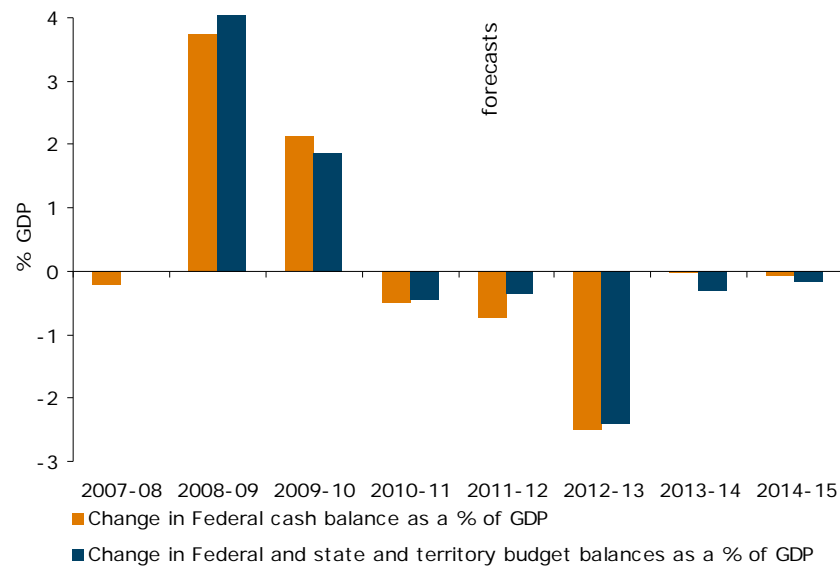
We do not see the accomplishment of a 2012-13 surplus as quite the economic imperative the Government does, but we agree with the need to return the budget to surplus in the medium term. This gives the Government flexibility to respond to shocks, as it did during the global financial crisis, without causing public debt to reach unmanageable levels. Australia has been very well served by running prudent fiscal policy over the course of the cycle for many years.

The surplus forecast will be achieved by the Government making further discretionary cuts to expenditure in this budget to offset further downgraded revenue projections, predominantly due to lower company and capital gains tax collections. The Government may also shift some expenditure between years, in addition to moves already known at November, to achieve the surplus.

LARGEST FISCAL TURNAROUND IN AUSTRALIA'S HISTORY

The mid-year update in November 2011 suggested the turnaround in the budget balance will be equivalent to around 2.5% of GDP in 2012-13 and, if our expectations of a larger deficit in 2011-12 prove correct, this could easily move out towards 3% of GDP. Adding in the budget projections from the states and territories (which are the recipients of significant Commonwealth funding) reduces the size of "total government" budget turnaround slightly (see Figure 3).

FIGURE 3. TURNAROUND IN BUDGET BALANCE



Sources: Mid-year budget updates from the Commonwealth and states and territories and ANZ

WHAT DOES THE BUDGET MEAN FOR ECONOMIC GROWTH?

This is the key question for markets. The actual impact on the economy will not be as extreme as the forecast turnaround in the budget balance suggests. The budget figures reflect accounting principles, and not the *economic* effect.

We estimate that discretionary fiscal tightening will likely lower the government contribution to growth by around 1ppts in 2012-13 compared to 2011-12, although it is difficult to be precise about this estimate.

There are a few reasons why this estimate of the economic impact is much lower than the turnaround in the budget balance might imply. Firstly, we expect most of the economic impact of discretionary fiscal tightening to be felt through direct public demand (that is, government spending on goods and services and investment) and indirectly through grant payments to households and others.

The budget bottom line, however, is affected not just by the level of direct spending but also a range of other factors, including tax revenue, interest payments, dividend income, etc. Most of these do not have a direct economic impact.

Most of the improvement in the budget balance is through revenue growth, rather than discretionary spending cuts. Increases in tax revenue in 2012-13 are expected to be equivalent to 2½% of GDP. In broad terms, therefore, the November MYEFO budget is brought from 'deficit' to 'balance' simply through broadly flat growth in

government spending in 2012-13. This of itself implies a much more muted economic impact than the turnaround in the budget balance of 2½-3% of GDP suggests.

Further, this revenue growth appears to mainly reflect momentum in the economy, rather than policy changes to the tax system. It will therefore have little impact on business or consumer spending decisions and hence economic growth. (New taxes on business, such as the mining tax and carbon tax, may or may not have a meaningful impact on business investment decisions in the medium term, but we would not expect a significant response in 2012-13.)

Secondly, in estimating the likely economic impact, timing issues must be considered. In the mid-year budget update, the Government brought forward several large payments which lifted 2011-12 cash expenditure while lowering 2012-13 expenditure. But this financial exercise won't necessarily translate into a bring-forward of economic activity from 2012-13 into 2011-12. For example:

- almost AUD1.4bn of lump sum payments to compensate pensioners and other income support recipients for the Clean Energy Future package (carbon tax) will be paid in May and June 2012 and clearly some of that will be spent after 1 July;
- highly emissions-intensive coal-fired generators will be paid AUD1bn in 2011-12 as part of the Clean Energy Future package, but affected businesses will not have to buy carbon permits until after 1 July;
- natural disaster relief payments of AUD2.3bn were paid up front in 2011-12, even though there was no requirement for the Government to front-load these; and
- around AUD1.4bn of funding to the states for National Building infrastructure projects was brought into 2011-12 from 2012-13.

The economic activity associated with these cash payments will flow well into 2012-13 or later as state government, household and business recipients spend them. In the upcoming budget, we expect there will be more cheques posted before 30 June and more shuffling between the two years to assist in achieving a 2012-13 surplus.

In addition to the examples above, there are other expenditure lines that appear to shift spending into 2011-12. Although we do not have enough information to interrogate these further, we suspect they overstate the effect of fiscal tightening on growth in 2012-13.

- For instance, supply of goods and services (a very large category) and 'other' current grants appear very lumpy and have large impacts on the implied economic impact of the budget. Grants, in particular, are relatively easier to shift between years.

Supporting this suspicion is the fact that government spending projections do not match (when translated into an implied economic impact) recent public demand data or what we, or the Treasury, expect in 2011-12.

- The contribution to GDP growth by the Commonwealth government, taking the November budget numbers at face value, is 0.5ppts in 2011-12. Adding in the state and territory governments takes this to 0.9ppts. This compares to the actual public contribution to growth (including local government) in the previous year of 0.5ppts. The largest contribution from public demand to growth in recent history was 0.8ppts in 1998-99. We do not expect government spending to increase sharply in 2011-12 as is suggested by the budget spending projections (and indeed the Government's November economic forecasts predict growth in public demand to halve to 1.25% in 2011-12.)

Necessarily, our detailed budget analysis has been based on the November mid-year update. In next week's Budget, we expect that the 2011-12 deficit will widen by around AUD5bn, based on the Treasurer's announcement that revenues for the following two years have been downgraded by that amount. To retain a surplus in 2012-13 would therefore require spending cuts of around AUD5bn (assuming no tax rises).

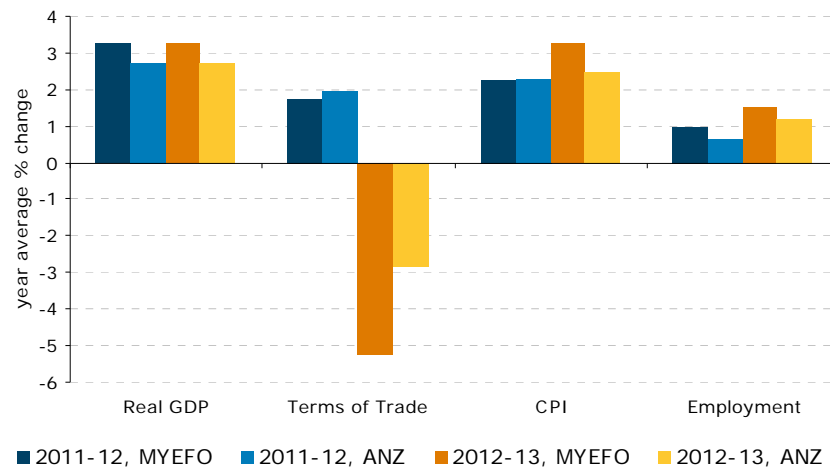
Taking the Government's November MYEFO projections and state spending plans at face value, and including our estimate of further fiscal tightening in the upcoming budget, we derive an estimated drag on growth from commonwealth and state fiscal tightening of around 1½ppts in 2012-13. For the reasons discussed above, though, we think this overstates the real economic impact. The likely economic impact may be a drag of around 1ppts from growth, although it is difficult to be precise about this estimate and there remains risks that it is smaller.

- We have been relatively conservative in estimating how much 'smoothing' between years of some budget numbers is necessary to reflect the timing of actual economic activity.
- There may be some revenue-raising policies announced that have little direct economic impact (such as reductions in R&D concessions if these do not lead to significant falls in private sector R&D spending).
- Some spending cuts announced in the budget may not have a direct Australian economic impact (such as cuts to foreign aid).
- Movement of state funding out of 2012-13 (and into 2011-12) may not be fully reflected in lower spending by the states next year. The Northern Territory 2012-13 budget tabled this week noted that its surplus operating balance for 2011-12 *"is the result of additional Commonwealth revenue that will be provided this year, but will not be spent until future years"*.

Of course, if spending cuts are significantly higher than our AUD5bn estimate, this would increase the estimated drag on the economy.

We will also be watching for any signs that Treasury has adjusted its economic forecasts higher in 2012-13 to assist the Government to deliver a surplus. However, we don't expect that this will be the case. Media reports suggest the budget will forecast growth around trend in 2012-13 which appears credible. We do see some downside risk to this based on our own moderately lower forecast. Treasury is likely to revise down its inflation forecast for 2012-13 and we see downside risk to its employment growth forecast compared to its November 2011 estimate (see Figure 4). This would translate to downside risk to its revenue projections.

FIGURE 4. TREASURY'S NOVEMBER 2011 MYEFO VS ANZ ECONOMIC FORECASTS



Sources: Commonwealth Treasury and ANZ

GOVERNMENT'S WISH LIST: LOWER INTEREST RATES, LOWER AUD

The Government is clearly hoping that fiscal consolidation will result in lower interest rates and downward pressure on the AUD. Indeed, the Treasurer suggested the Government's fiscal strategy contributed to Tuesday's decision by the Reserve Bank to cut the cash rate by 50bps: *"The fact is that these rate cuts would not have been possible if it wasn't for our disciplined fiscal strategy. It's provided the room for the Reserve Bank to deploy monetary policy to assist those sectors of the economy that are not as strong as others. That is a very good example of the way in which fiscal and monetary policy can work together."*

In our view, this is a plausible argument. Fiscal tightening, if substantial will lower demand and inflationary pressure in the economy. (However, as explained above, it will be important to estimate the extent to which the change in the budget balance forecast actually flows through to restraining the economy). The Reserve Bank will of course need to take account of in its settings of monetary policy. But monetary policy and fiscal policy working together in this way will largely have a neutral effect on the economy and will not necessarily lift the weaker sectors. Policy would merely be taking with one (fiscal) hand and giving with the other (monetary) one.

That said, the Government's persistence in running a credible medium-term approach to fiscal policy should reinforce confidence benefits, especially from overseas investors.

The budget assumes interest rates will move in line with market pricing, which currently suggests another 75bps of cash rate cuts by the end of this year. These expectations in part reflect ongoing concerns about the European debt situation and its possible flow on effects to Australia. The budget forecasts are therefore only slightly out of step with most market economists' forecasts for 25–50bps of rate cuts over this period, including ours.

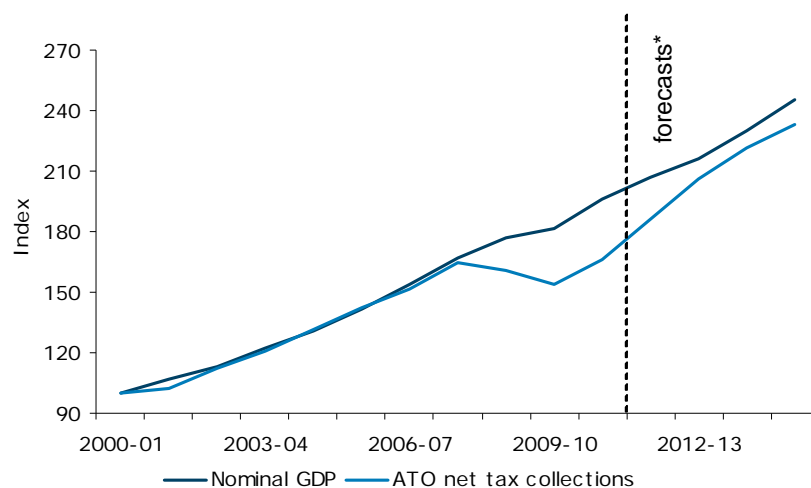
Despite the Government's hope that its policy will exert downward pressure on the AUD, in the budget papers the AUD is usually assumed to remain steady at the current rate. We do not expect the budget to put significant downward pressure on the AUD: it has settled above 1.02 despite Tuesday's 50bps of rate cuts, another 75bps of rate cuts priced in the market and current expectations that the Government will continue to project a 2012-13 surplus.

REVENUE DOWNGRADES: WHY HAVE REVENUES BEEN SO WEAK IN A MINING BOOM?

The Government has already flagged that revenue projections made in November's mid-year budget review will be downgraded in next week's budget, largely due to lower company and capital gains tax revenue. The bout of financial market instability in Q4 2011, coupled with a still elevated AUD, contributed to a 6.5% fall in company profits in that quarter.

More generally, revenue growth is likely to be subdued in the next few years compared to the boom years leading up to 2007-08. Indeed, tax receipts have not kept pace with nominal GDP growth over the period since the GFC (see Figure 5). According to the Treasurer, since the GFC (2008-09) there have been AUD140bn in revenue downgrades over the five years to 2012-13. Slower growth in revenues is partly due to structural changes in the economy, including the high AUD, as well as the lingering effects of the GFC including carried forward capital gains tax losses.

FIGURE 5. RELATIONSHIP BETWEEN NOMINAL GDP AND TAX COLLECTIONS

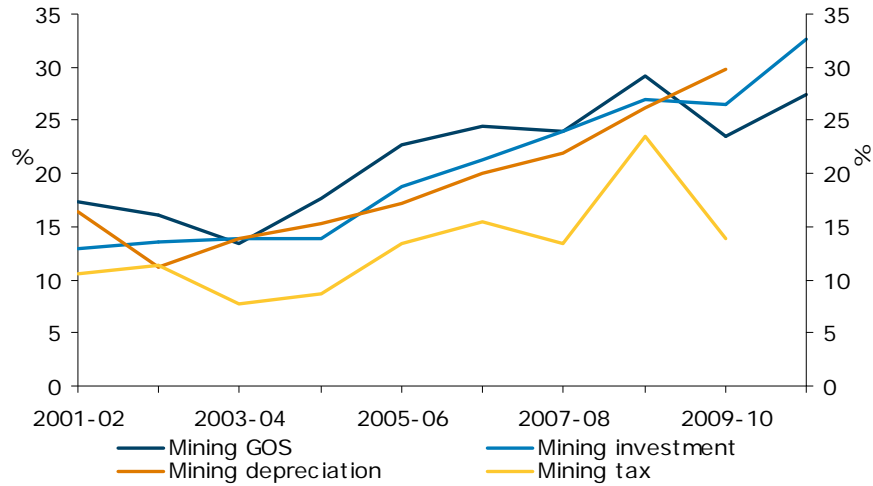


Sources: Commonwealth Treasury, ATO and ANZ

*Forecasts of nominal GDP are ANZ's and forecasts of tax collections are based on growth rate of Treasury forecasts of tax receipts in MYEFO, November 2011

Structural change has affected the composition of growth in company profits, and this changing composition is dampening growth in tax revenue. The mining sector is generating about one quarter of the economy's profits, but only providing around 14% of company tax receipts. This is because very high levels of mining investment are leading to large depreciation deductions, lowering miners' tax liabilities.

FIGURE 6. MINING SECTOR'S SHARE OF PROFITS, DEPRECIATION, INVESTMENT AND TAX

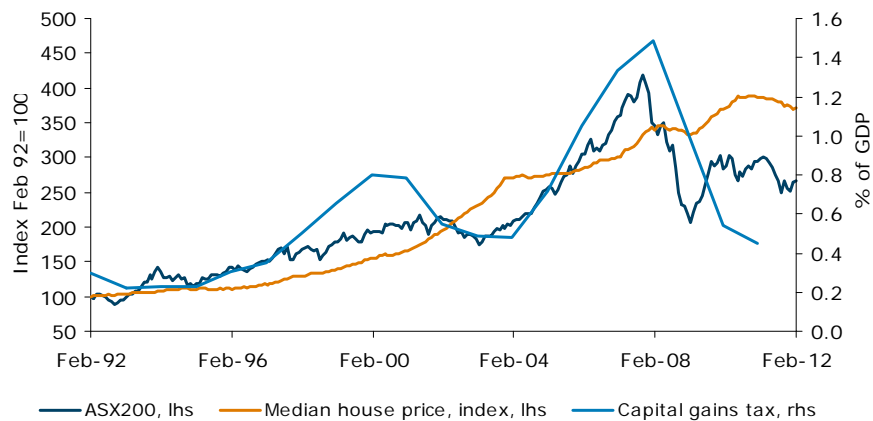


Sources: Commonwealth Treasury and ANZ

Throughout the economy, tax contributions as a share of profits have fallen below the average of the past decade. This is because growth has been strongest in low average tax paying sectors (mining and transport and utilities), while growth has been weaker in high average tax paying sectors (retail, manufacturing and construction) due to cautious consumer spending, retail discounting, the high AUD, and subdued conditions for dwelling and commercial construction.

Capital gains tax receipts have also declined as a share of GDP. Falls in equity prices during the GFC have created a large stock of losses that will require significant future asset price gains before tax will be payable. House prices have also weakened over the past year or so.

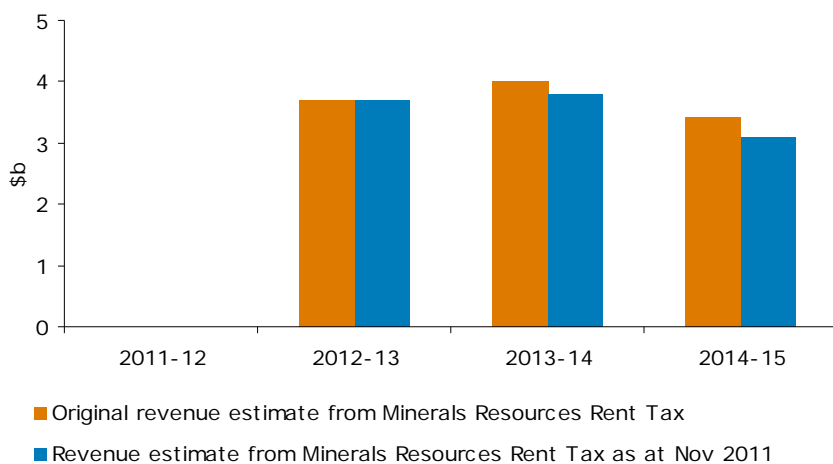
FIGURE 7. CAPITAL GAINS TAX AND EQUITY AND HOUSING MARKET PERFORMANCE



Sources: Commonwealth Treasury, Residex and ANZ

Estimates of the revenue to be generated by the Minerals Resources Rent Tax, which begins on 1 July, may also be revised down in the budget. In November, the tax was assumed to generate AUD10.6bn over the three years to 2014-15, having been revised down from the AUD11.1bn figure in the legislation. The revenue estimate is likely to be lower again due to changes in commodity prices, revised production volumes and state royalties, which the Commonwealth must credit to the companies paying the tax.

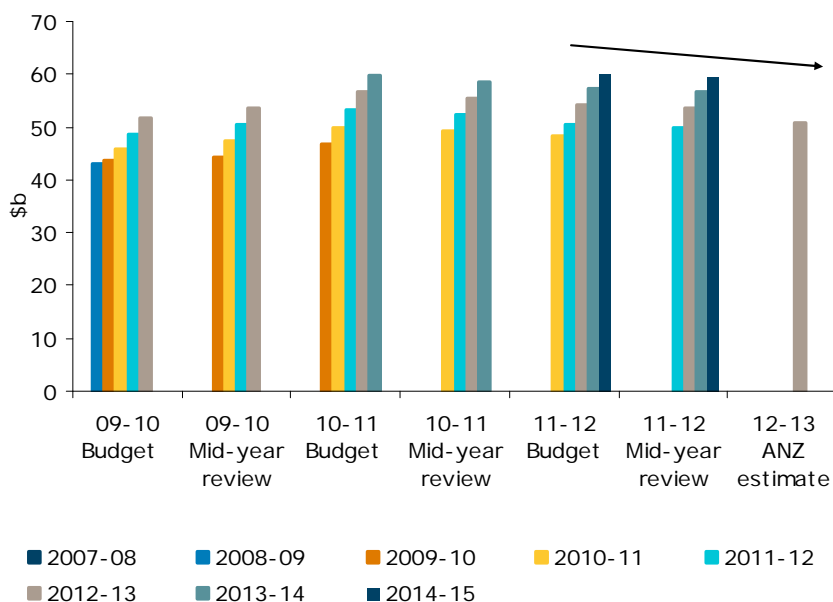
FIGURE 8. REVENUE ESTIMATES OF MINERALS RESOURCES RENT TAX



Sources: The Senate Economics Legislation Committee Minerals Resource Rent Tax Bill 2011 [Provisions] and related bills report, March 2012 and ANZ

Subdued domestic spending on taxable goods and services, and signs of deflation in many market prices (evident in the Q1 CPI release) are also dampening the indirect tax take (see Figure 9). This does not affect the Commonwealth directly as state and territory governments share 100% of the GST tax take.

FIGURE 9. GST REVENUE PROJECTIONS AND REVISIONS

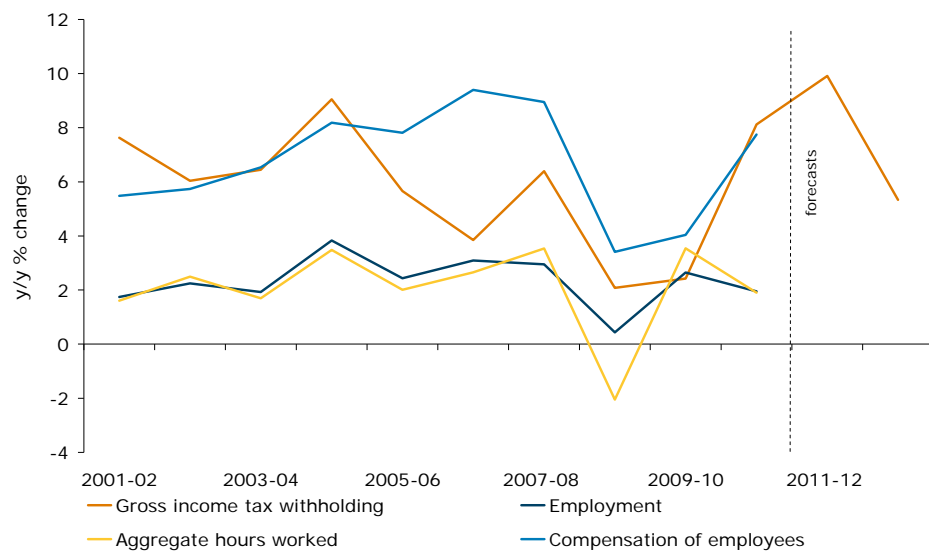


Sources: Commonwealth budget papers and ANZ

The Victorian Budget released this week showed the GST take for Victoria has been downgraded by AUD635m in 2012-13 alone, due to downward revisions to the national pool. Extrapolating this figure based on the shares of GST pool determined by the Commonwealth Grants Commission, suggests the total pool for 2012-13 will be AUD50.8bn, or AUD2.8bn lower than estimated in November 2011.

The exception to this general trend of subdued revenue growth appears to be personal income tax receipts. Monthly data suggest that, to date, these have held up well despite the softness in employment growth. Wage growth has remained solid and structural change in the economy is shifting the composition of jobs towards full-time, higher-paying roles.

FIGURE 10. GROSS INCOME TAX WITHHOLDING AND LABOUR MARKET PERFORMANCE

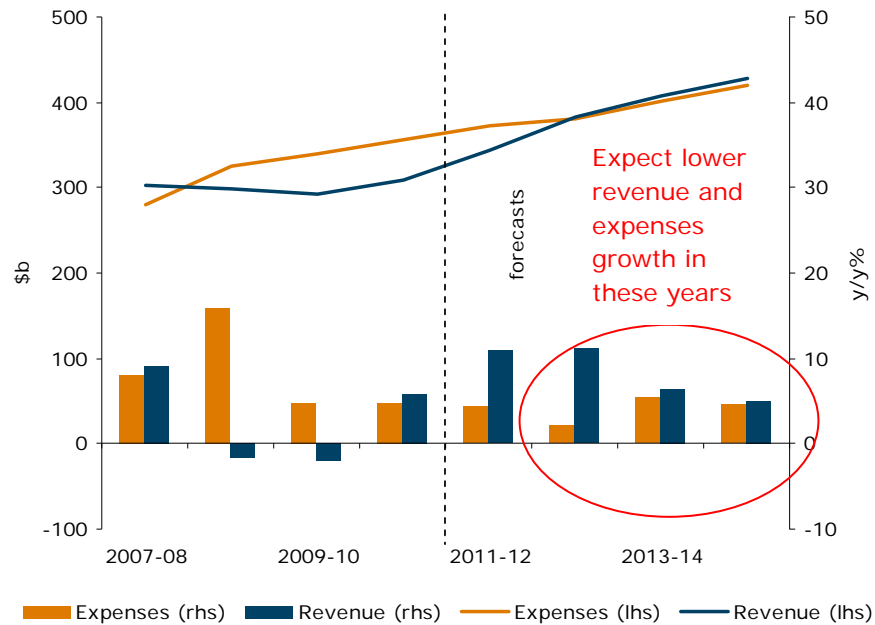


Sources: Commonwealth budget papers, ABS and ANZ

EXPENDITURE CUTS TO OFFSET FALLING REVENUES

As noted above, we still expect a surplus to be forecast in 2012-13, with discretionary cuts to expenditure to offset lower revenue projections. Figure 11 shows the projections for revenue and expenditure as at the mid-year review in November 2011. We expect both revenue and expenditure growth forecasts to look softer from 2012-13 in the upcoming budget.

FIGURE 11. COMMONWEALTH REVENUE AND EXPENDITURE AS AT NOVEMBER 2011

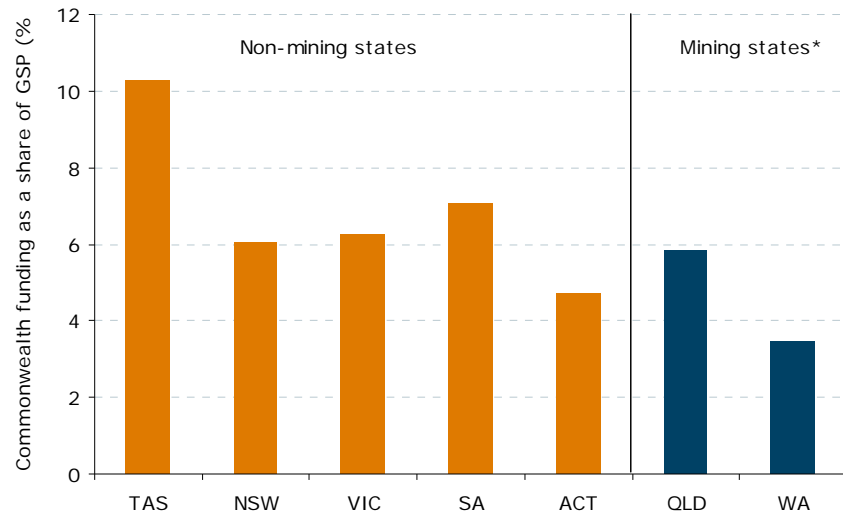


Sources: Commonwealth budget papers, ABS and ANZ

In our view, the discretionary expenditure cuts should be implemented in such a way as to minimise near-term weakening of domestic demand, especially in those regions and sectors already under pressure. Budget leaks suggest this will largely be the case. With this in mind, we would also be looking for the Government to be supporting and not hindering, structural change in the economy and therefore not simply “protecting” the sectors that are suffering due to current economic dynamics.

If we use Commonwealth funding to the states as a proxy for how Government funding is redistributed throughout the economy, the focus on the non-mining states suggests the current flow of funding is broadly appropriate (see Figure 12). We suggest that this pattern should not be reversed in the budget and see some scope for the Government to further rebalance demand given the Australian economy is operating very much at “two speeds”. While monetary policy can only set an interest rate for the entire economy, fiscal policy can be more nuanced and help smooth the impact of the structural transition that is underway, and share the benefits of the commodities boom more broadly.

FIGURE 12. COMMONWEALTH FUNDING TO THE STATES AND TERRITORIES



Sources: Commonwealth budget papers ANZ, various state and territory budget papers, ABS and ANZ

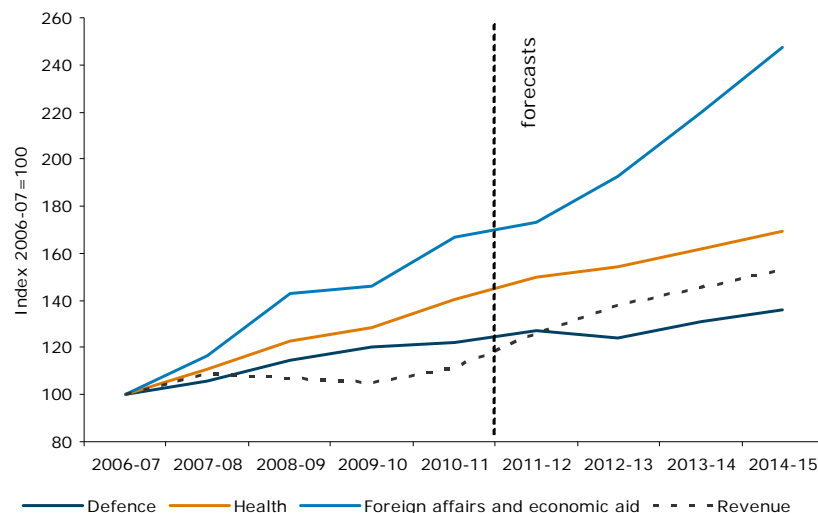
*Northern Territory has been excluded for graphical presentation purposes, its share is 17%.

BUDGET POLICY LEAKS AND PRE-ANNOUNCEMENTS

PUBLIC SECTOR SPENDING CUTS

Budget leaks and announcements have suggested downward revisions to the defence, health and foreign affairs budgets. The announced withdrawal of troops from Afghanistan, delays in the United States Joint Strike Fighter program, and cancelling an order for self-propelled artillery pieces will result in significant savings in the defence budget. The foreshadowed cuts to health and foreign affairs are in the context of significant recent and projected growth in these portfolios (see Figure 13).

FIGURE 13. PROJECTED GROWTH IN DEFENCE, HEALTH AND FOREIGN AID BUDGETS VS TOTAL GOVERNMENT REVENUE



Sources: ABS, ANZ, MYEFO 2011-12

BUSINESS AND SUPERANNUATION

We also expect expenditure cuts in the budget to come from reductions in business and superannuation tax breaks. There may also be delays or cancellations of programs scheduled to begin in 2012-13. The Treasurer has pointed out that the mining sector is paying a smaller share of taxes than its share of company profits and so further measures to remove tax breaks in this sector are expected. Budget leaks suggest the following may be vulnerable:

- immediate deductibility of expenditure on exploration or prospecting for mining and quarrying;
- accelerated depreciation for mining, petroleum or quarrying operations; and
- immediate deductibility of overburden (ie dirt above new mining sites) removal.

Other business tax breaks that may be downsized include:

- research and development concessions;
- FBT exemptions for living away from home (especially for executives); and
- superannuation tax breaks for high income earners.

Others leaks have suggested:

- environmental subsidies could be cut or reduced given the carbon pricing scheme is now entrenched in legislation; and
- further savings from drug companies under the Pharmaceutical Benefits scheme.

However, there will be some wins for business. The Government has announced that superannuation funds planning to merge will be able to carry forward losses rather than crystallise those losses, giving these funds an effective tax break and incentive to merge.

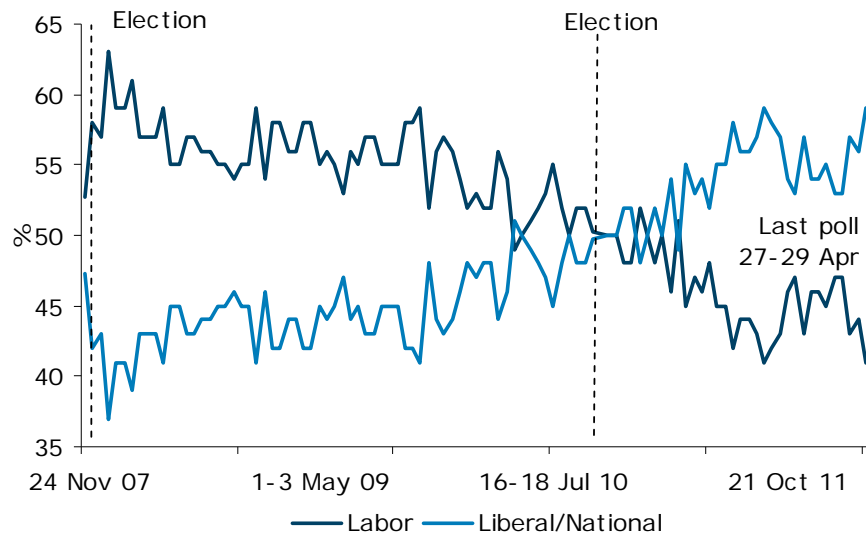
The Government is also considering a proposal from the Business Tax Working Group to allow past business losses to be offset against profits for tax purposes. Other suggestions for business tax reform from this Group are likely to be flagged, but not committed to, in the 2012-13 budget.

HOUSEHOLDS

Expenditure cuts affecting the household sector will be more modest and there will also be some new spending measures. The general theme is likely to be removing untargeted welfare programs put in place during the boom Howard-Costello years.

As the Government finalises these measures, it will be sensitive to the low level of consumer sentiment. Also, the Australian Labor Party's opinion poll results have been very poor, even amongst its traditional followers, and so it is working from a delicate voter support base (see Figure 14).

FIGURE 14. NEWSPOLL – TWO PARTY PREFERRED



Sources: Newspoll and ANZ

Note: the dates on the x-axis of poll chart are not uniformly spread due to irregular timing of these polls.

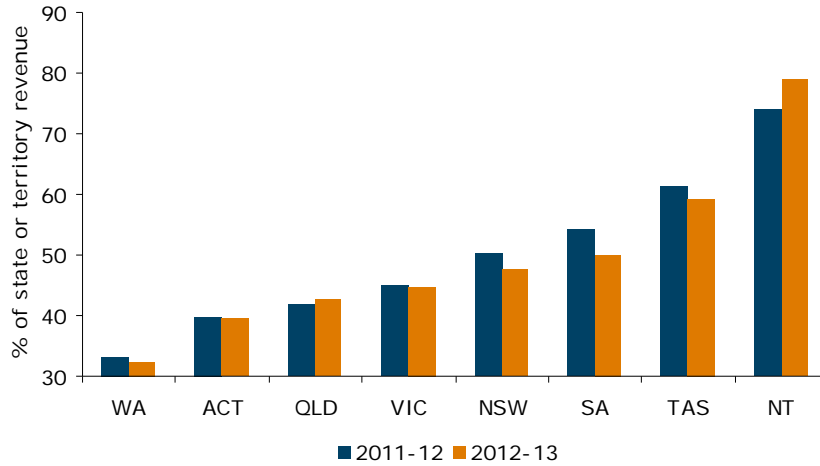
Budget leaks or announcements regarding the household sector have suggested:

- further tightening up of untargeted welfare policies put in place during more prosperous times, especially where those benefits incorporate disincentives to work or save;
- tightening up the Medicare safety net which means a reduction in payments for doctors. The increased costs may be passed on to households;
- further delay in implementation of the 50% tax discount for interest income;
- an Aged Care package has been released which will means-test Home Care packages and residential aged care. There will be an increase in the number of Aged Care Home Care Packages and an increase in the maximum supplement the Government pays to aged care providers, which is expected to boost and improve residential aged care places. There will also be AUD1.2bn for aged care workers and AUD268.4m for dementia sufferers; and
- introduction of a national disability insurance scheme from 2013-14.

IMPLICATIONS FOR THE STATES AND TERRITORIES

Revenue redistributed from the Commonwealth to most states and territories is expected to fall in 2012-13 relative to 2011-12 (see Figure 15). These reductions are likely to be more significant following the 2012-13 budget, in part due to downward revisions to the national GST pool.

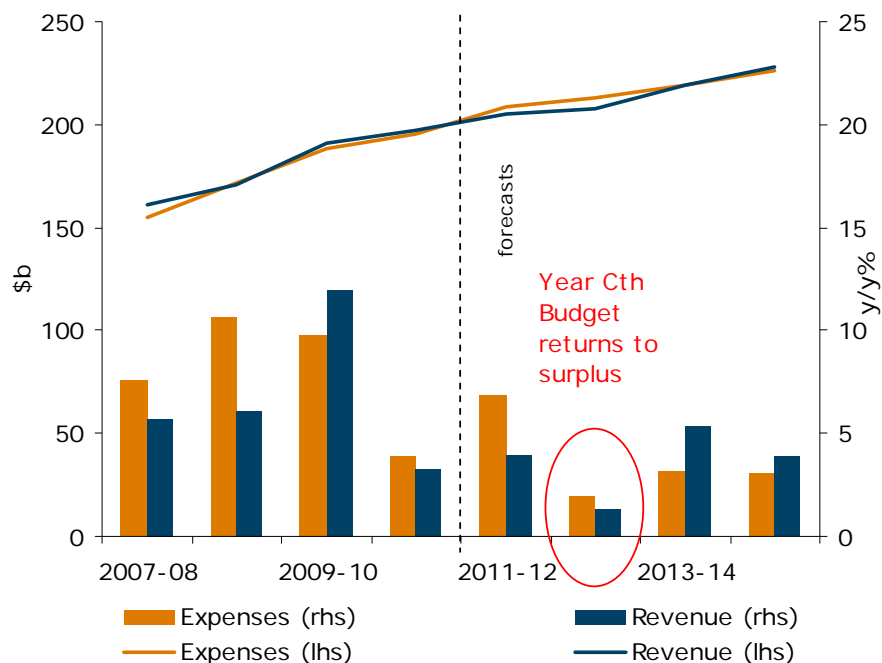
FIGURE 15. SHARE OF STATE AND TERRITORY REVENUE FROM THE COMMONWEALTH, AS AT NOVEMBER 2011



Sources: Various state and territory budget papers, Commonwealth budget papers and ANZ

In response, and to reflect downward revisions to their own revenue sources, states and territories are collectively planning to also slow expenditure (see Figure 16). More discretionary cuts are likely after the Commonwealth budget reveals the full extent of further changes. Maintaining fiscal balances over the cycle, keeping debt at manageable levels and maintaining or improving credit ratings remains a fiscal priority for most.

FIGURE 16. CONSOLIDATED STATE AND TERRITORY REVENUES AND EXPENSES

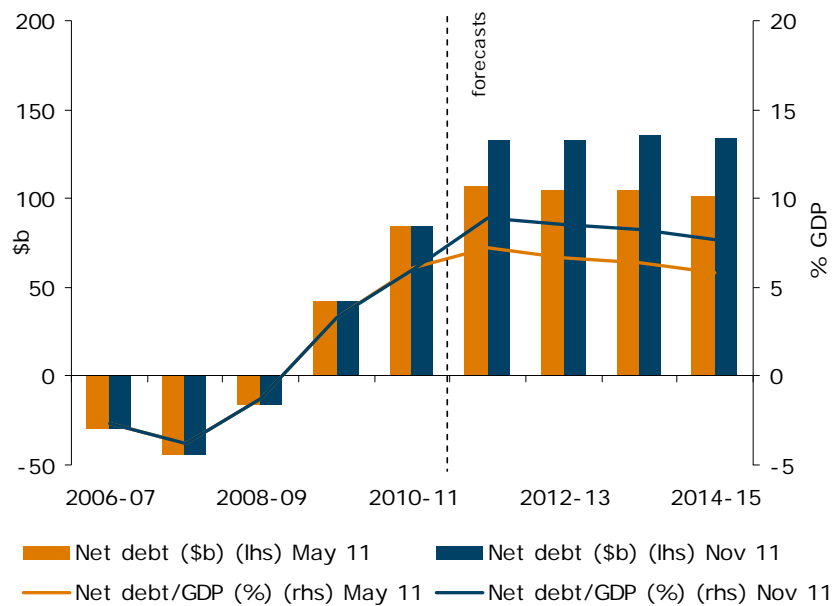


Sources: Various State and Territory Budget Papers and ANZ

NET DEBT AND COMMONWEALTH GOVERNMENT SECURITIES

We expect public net debt to remain contained and at a relatively low level (around 5–10% of GDP; see Figure 17). This is low by international standards and in part why Australia maintains an enviable stable “AAA” credit rating.

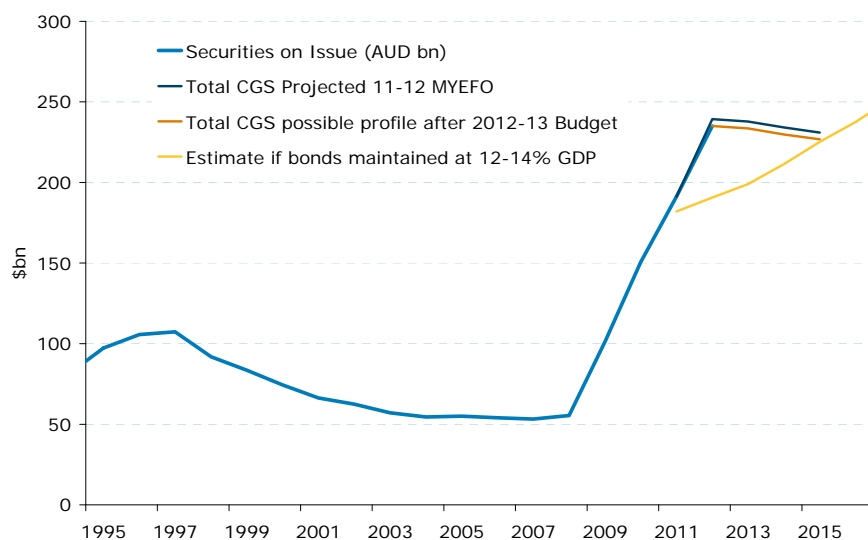
FIGURE 17. COMMONWEALTH NET DEBT



Sources: Various Commonwealth budget papers and ANZ

The Government’s commitment to return the budget to surplus means the stock of Commonwealth Government Securities will be broadly unchanged next financial year (see Figure 18).

FIGURE 18. COMMONWEALTH GOVERNMENT SECURITIES ON ISSUE



Sources: AOFM and ANZ

The Australian Office of Financial Management (AOFM) is on course to issue around AUD53bn of fixed rate bonds in the current financial year. This should drop to something around AUD30–35bn of gross issuance in 2012-13.

The AOFM will need to cover AUD27bn of maturing bonds (the 15 November and 15 May maturities) plus any additional issuance to cover other borrowings such as infrastructure needs under the NBN project and support for the Treasury Capital Indexed bond market. The AOFM obviously retains discretion on the exact mix of funding and has pledged to keep (shorter-dated) Treasury Notes on issue above AUD10bn. Current T-Notes on issue total AUD14.6bn.

The pace of CGS issuance has already declined. The AOFM has so far issued just over AUD46bn of fixed rate bonds in the current financial year. If there is one bond auction each week of typical size around AUD700m for the remaining 10 weeks of the financial year then total issuance will just reach the AUD53bn target. The AOFM had previously held two bonds tenders a week until the start of April. This should underline the “scarcity value” of AAA-rated CGS at a time when around 75% of the market is owned by overseas investors (in face value terms). The global shortage of true AAA investments is likely to see this percentage maintained at very high levels, if not rise further. This is likely to contribute to keeping bond yields exceptionally low.

As at 27 April 2012, current fixed rate bonds on issue total AUD196bn with Indexed Bonds currently at AUD15.8bn. Assuming T-Notes on issue hold around AUD15bn then we can project that total CGS on issue will rise to around AUD235bn from AUD228bn at present, and then stabilise around this level as long as the Government maintains fiscal discipline. The profile on Figure 18 shows a slight downward bias due to the assumption of modest surpluses in coming years, but we are more likely to see the numbers go sideways.

The Treasury provided some guidance in last year’s budget papers regarding the maintenance of a deep and liquid bond market (around 12–14% of GDP) considering forward estimates of modest surpluses. Current levels are above this target, but it will rise over time with growth in GDP. We do not expect to see further detailed guidance in this budget.

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