

THE 2005 BUDGET DESTABILISED BY OIL PRICES

- According to the “*projet de loi de finances*”, or PLF 2005 (the Finance Bill 2005), the public deficit should drop below 3 % of GDP next year, to 2.9 %, assisted by a moderation in spending (both state and social security), a rise in welfare contributions and the “EDF payment”.
- Although it was appropriate at the time of writing, the macroeconomic environment on which the 2005 draft budget is based is currently being threatened by persistently high oil prices (volume growth at 2.5 % in 2004 and 2005, compared with our forecasts of 2.4 % and 1.8 % respectively). Tax and social security revenues will probably be lower than expected, while spending on healthcare is likely to exceed projections. On balance, the public deficit will probably marginally exceed 3 % of GDP.

Characteristics of the 2005 Finance Bill

Estimated at 3.6 % of GDP this year, the public deficit should fall to 2.9 % next year, according to the 2005 draft budget. This 0.7 point reduction is to come from a temporary measure, the payment of EUR 7.7 billion — i.e. 0.4 points of GDP — by EDF-GDF to the CNAV (state old-age insurance fund) for the integration of their pension scheme into the general pension regime (to be booked in 2005 during the transfer of pension liabilities) and by the stabilisation in volume terms of government spending. The social security accounts will remain in deficit, but will improve slightly: after reaching a record level in 2004 (EUR 14 billion, 13.2 billion of which was spent on the healthcare sector alone), the social security deficit is expected to drop to 8 billion, partly due to the reform of the healthcare sector, while UNEDIC (state organisation that manages unemployment benefit schemes) will continue to benefit from the recovery plan initiated in December 2002.

As % of GDP	2004	2005	As % of GDP	2004	2005
Public deficit	-3.6	-2.9	ODAC (various central government agencies)	0.4	0.7*
of which:			Local governments	0.0	0.0
State	-3.2	-3.0	Mandatory contributions	43.6	43.7
Social sec. accounts	-0.8	-0.6			

* including the EDF-GDF payment

Public spending is expected to increase by 1.6 % in volume terms, driven by local governments (+2.9 %) and social security administrations (+1.8 %). Because some government expenses are unavoidable (the cost of public debt represents 14.5 % of budgetary expenditure, pensions and salaries represent 39.8 %) and the budgets of certain key ministries (Defence and Employment in particular) were revised upwards, there are plans to increase loan rescheduling and to cut back on the replacement of retiring staff. This management lever, the effects of which would be spread out over the long-term and which would facilitate government reform, is once again being underexploited, as demonstrated by the fact that only 7,188 net job cuts have been announced out of around 60,000 retirements.

By lowering the weight of public expenditure from 54 % of GDP to 53.6 %, this would create room for manoeuvre and lead to:

1) a small reduction in the structural deficit (-0.6 points of GDP, 0.4 points of which would stem from the EDF-GDF payment, following a 0.5 point reduction in 2004); 2) EUR 1.07 billion in corporate tax cuts (EUR 0.5 billion of which relating to the two-year phase out of the 10 % surtax on corporate income tax; EUR 0.4 billion relating to efforts to stem relocations) and 0.885 billion in tax cuts for households (EUR 0.6 billion reduction in inheritance tax and increase in the employment subsidy). However, the mandatory contributions rate is expected to edge up from 43.6 % to 43.7 % of GDP due to the delayed effects of the economic recovery on income and corporate tax and, in particular, levies linked to social security reform and to the abolition of a public holiday (around EUR 1.6 billion for businesses; around EUR 2.2 billion for households, to which can be added EUR 1.1 billion relating to the broadening of the civil service pension contributions base).

Moderate risk of a drop in tax revenues

A stabilisation of budgetary expenditure in volume terms does not

seem impossible, although it seems likely that, as in previous years, corrective measures will be taken, such as the booking of temporary credit reserves.

When assessing tax revenues, it is useful to look at trend revenue elasticity (with unchanged legislation) to nominal GDP, which changes with the economic cycle and is equal to 1 on average. High in 2004 (at 1.2, after 0.1 in 2003), as is normal during recovery periods, it is forecast to reach 1.4 in 2005, which is an optimistic assumption for a second year of recovery and which does not factor in the anticipated slowdown in activity. Even so, if we apply this hypothesis to our less favourable growth scenario (nominal GDP growth of 3.1 % versus a forecast of 4.3 % in the PLF 2005), the drop in tax revenues exceeds EUR 4 billion (1.7 % of 252 billion), i.e. one quarter of a GDP point.

However, the impact on tax revenues the same year as a downturn in growth is generally limited, and it seems preferable to maintain a consistent approach for analysing changes in the tax bases of each major tax type. The improvement in household disposable income in 2004 is almost the same in both forecasts, which leads to the same changes in income tax in 2005. Similarly, the significant projections concerning corporate income tax indicated in the PLF 2005, i.e. a 14.4 % increase in net revenues, appear plausible. Indeed, uncertainty reigns strongly here due to the way in which this tax is recovered and the difficulty in determining the amount of taxable income from macroeconomic profit indicators, EBIDTA in particular. Nevertheless, there has been a marked improvement in corporate financial situations in 2004. However, VAT tax bases are likely to increase at a pace 0.7 points slower than projected in the PLF 2005, resulting in a tax revenue loss of around EUR 900 million. This is a low estimate because the impact of a slowdown in volume consumption on VAT revenues is, in fact, more than proportional due to the relative sluggishness of low-tax expenditure, whereas the purchase of manufactured goods, durable goods in particular, is more volatile. Furthermore, the rise in oil prices will lead to a drop in the volume consumption of oil products and a fall in revenues from domestic tax on oil products (the VAT effect having been taken into account in the taxable base estimate). On balance, the loss of tax revenue could exceed EUR 1 billion.

Social security accounts pose a greater risk

The PLF 2005 assumes relatively optimistic growth in employment and wages (+3.6 % in value terms). Based on our estimates of an increase in wages, the drop in social security revenue could reach around EUR 1.5 billion (i.e. 0.4 points of a taxable base, exceeding 20 % of GDP). Regarding social security spending, ONDAM's target growth (+3.2 % in value terms) seems ambitious given the trend observed since its creation (only the first target in 1987 has been met), despite a marked slowdown at the year-end (probably to below 5 % in 2004, versus a target of 4 %, after rising 6.9 % in 2003). A target overshoot by around a half percentage point (i.e. 0.7 billion) seems likely, although the newly created emergency committee will be there to implement restrictive measures in the event of a severe overshoot.

All in all, at 3.1 % of GDP, the public deficit could slightly exceed the 3 % threshold, even including the EDF-GDF payment.

Caroline de TINGUY – 33 (0)1 42 14 93 49

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