

2006 BUDGET: WAITING FOR 2007

Based on optimistic macroeconomic assumptions (expected growth of 1.5 to 2% in 2005 and 2 to 2.5% in 2006, compared to our forecasts of 1.5% and 1.8% respectively), the government's finance bill for 2004 (projet de loi de finances or PLF) forecasts a fall in the public deficit to 2.9% of GDP, thanks to the moderation of spending increases and the stabilisation of the social security deficit.

Nevertheless, the public deficit should rise to just over 3% of GDP, due to fiscal and social security shortfalls, and higher than predicted social security spending. It is highly likely that some budget appropriations will need to be frozen over the course of the year.

In the absence of any in-depth reform of the public sector, balancing the 2007 budget will be an extremely difficult task given the measures recently announced (EUR 3.5 billion reduction in marginal income tax receipts due to reforms in the tax brackets, EUR -1.4 billion due to the capping of the business tax at 3.5% of value added, EUR -0.5 billion due to the increase in the prime d'emploi or tax credit), and bearing in mind that 2006's budget includes substantial windfalls.

Main features of the 2006 budget

The public deficit was reduced to 3% of GDP in 2005 due in part to the one-off adjustment paid by EDF-GDF, and should come out at 2.9% of GDP according to budget assumptions. This ambitious reduction (0.6% excluding "EDF payment") will be achieved through the stabilisation of the budget deficit and a reduction in the social security deficit: the latter fell sharply in 2005 due to the one-off adjustment and the implementation of health service reforms, and should stabilise at 0.2% of GDP. This improvement is the result of a further increase in social security contributions, the income from another one-off payment from La Poste (EUR 2 billion, or 0.1% of GDP) and the increasing impact of social security reforms. The overall social security deficit (*Régime Général*) should fall from EUR 11.9 billion this year to EUR 8.9 billion next year, with all the divisions posting a negative balance (the deficit in healthcare should be reduced from EUR 8.3 billion to EUR 6.1 billion). Local authorities should remain in deficit, while the ODAC (other central government agencies) should see their surpluses decline.

% OF GDP	2005	2006	% OF GDP	2005	2006
Public balance	-3.0	-2.9	ODAC (other central government agencies)	0.6	0.2
Of which :			Local authorities	-0.1	-0.1
Government	-3.3	-2.8	Total tax burden	43.9	44.0
Social security	-0.2	-0.2			

Public spending should be kept more or less under control

The 2005 budget is first and foremost based on controlling public spending: the latter should increase by 1.6% following an increase of 1.7% in 2005, driven by local authority spending (+3.1%) and social security spending (+0.7%). Meanwhile, government spending should be kept stable for the fourth year running¹. This relative control of expenditure (a decrease from 53.8% of GDP to 53.6%) will enable the structural deficit to be reduced by 0.5% of GDP, excluding the effects of one-off payments and the financing of EUR 0.8 billion in tax reductions principally aimed at households (including an increase in the *prime pour l'emploi* of EUR 0.5 billion), along with EUR 3.9 billion of tax reductions voted in 2002 and 2005 (continuing reductions in charges, cancellation of Juppé's additional corporate tax, and exoneration of the business tax on new investment). The 2006 budget lays the foundations for tax reforms by introducing a "tax shield", capping tax benefits and revising the income tax regime for 2006 earnings as well as the *prime pour l'emploi*.

The ministries given priority in 2005 will continue to top the list in 2006: EUR 1.6 billion extra will be awarded to defence, justice and the home office, whilst the respective budgets for the 'back to work' programme and research should be EUR 3.7 billion and EUR 1 billion. These payments will be funded by budget reallocation and the freezing of new hires to replace retiring civil service employees (only 5,100 redundancies are planned out of a total of 72,000 departures, as opposed to the 7,392 listed in the 2005 budget; only a long-term policy

¹ In fact, this standard is only formally respected by transferring rapidly rising expenditures and receipts to various bodies, or by charging spending against tax revenues.

of productivity gains will generate any substantial and sustainable savings). In addition, growth in income tax receipts is expected to slow (EUR +12.6 billion compared to EUR +17.8 billion in 2005), while EU and local authority contributions are expected to rise by 1% of GDP. Non-tax receipts should increase (EUR +1.7 billion on a like-for-like basis, despite the freeze on contributions to the Social Security Debt Repayment fund or CADES), due to a sharp rise in income from dividends and the tapping of 'dormant reserves': however, these sources of income are non-recurring...

Moderate risks of tax shortfalls

The planned increase in budget appropriations does not seem unreasonable, even if around EUR 4 billion of appropriations have been cancelled, in line with 2005, and corrective regulation measures will need to be put in place to make up for insufficient allocations.

The government has been relatively cautious in its forecasts for tax receipts. However, the budget still assumes elasticity of 1.2 in underlying tax receipts (i.e. under constant legal conditions), after 1.4 in 2005. This seems optimistic given the mediocre growth outlook for 2005-2006. Based on our (slightly less favourable) growth scenario, and adopting the government's assumptions for elasticity, the tax shortfall will amount to EUR 1.2 billion (0.5% of EUR 257.7 billion). The potential level of shortfalls can also be calculated using estimated changes in the tax base for each tax. The growth forecast for household disposable income is very similar in both projections for 2005, giving roughly the same estimates for income tax in 2006. The budget rightly highlights the pressure on corporate margins in 2005; the slight underestimation of this decline could lead to a corporate tax shortfall of between EUR 0.5 billion and EUR 1 billion. Finally, the increase in the VAT tax base could be 0.4pt lower than predicted, giving a tax shortfall of some EUR 0.5 billion. In conclusion, the shortfall in taxes should be modest, coming out somewhere between EUR 1 billion and EUR 1.5 billion.

A bigger risk for social security

In contrast, the forecast for the social security deficit seems ambitious. Despite measures to support employment, job creations in 2006 should be below those forecast in the budget, which will in turn knock half a percentage point off wage growth. This gap will produce a shortfall in social security payments of around EUR 2 billion (0.6% of a tax base equivalent to around 20% of GDP). In addition, extra payments of EUR 3.2 billion are planned. As well as this, the ONDAM (target for national health insurance expenditure) growth prediction (+2.5% in value) seems ambitious, even given the new corrective measures: 2005 saw a marked slowdown (growth was 3.2% rather than the forecast 3.8%), but this is probably a temporary phenomenon often observed following new reforms. ONDAM growth is more likely to stabilise at around the current level, representing an additional cost of EUR 1.8 billion. Therefore, the public deficit could reach 3.2%, once again exceeding the 3% limit...

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