

2007 BUDGET: PROGRESS ON EXPENDITURE CONTROL

€# The 2007 budget bill is based on a mildly optimistic economic scenario (growth of 2-2.5% versus 1.9% in our scenario) and assumes a reduction in the government deficit down to 2.5% of GDP. Expenditure control coupled with a spontaneous jump in tax receipts should, in addition, allow the government to finance substantial tax benefits. As in 2006, special measures are forecast to cut government debt by one percentage point of GDP.

€# Our own macroeconomic assumptions and more cautious social security spending forecasts imply a slightly larger government deficit (2.8% of GDP), undoubtedly leaving France within the Maastricht deficit criteria for another fiscal year. The debt/GDP ratio looks set to stabilise spontaneously significantly above the 60% threshold. That said, a mini-budget after the elections is likely to substantially modify these forecasts.

€# Note also that 2007 will be the first year in which the budget process will be carried out entirely under the budget reform law, the LOLF, paving the way for an acceleration of public sector reforms.

Reduced down to 2.7% of GDP in 2006 takes to dynamic tax receipts, the government deficit looks set to keep on retreating according to the 2007 budget bill, down to 2.5% in 2007. Cuts in both State expenditure (from EUR 43.5bn in 2005 down to EUR 41.6bn in 2007) and social security spending will contribute to this improvement. Meanwhile, local government expenditure will experience sharp increases due to end-of-term investments and hence is forecast to remain in the red.

(% of GDP)	2005	2006	2007
Public balance	-2.9	-2.7	-2.5
O/w: State	-3.0	-2.5	-2.4
Social security	-0.2	-0.4	-0.1
ODAC (*)	0.4	0.3	0.1
Local government	-0.1	-0.1	-0.1
Government debt	66.6	64.6	63.6
Government spendings	53.9	53.3	52.9
Rate of tax and social security contributions	44.0	44.0	43.7

Source: 2007 Budget Bill (*) Central administration bodies

State expenditure under control and lower taxes

The 2007 budget bill depends on control of public spending, which, as in 2006, is budgeted to increase by 1.4% by volume on the back of rises in local government expenditure (+3.1%) and social security spending (+1.2%), whilst State expenditure is set to fall by 1% (+0.8% by value), after a 4-year stabilisation period. Debudgeting and tax expenditure are two of the factors that have facilitated this situation.

Compulsory State spending (interest payment, wages, pensions) accounts for 64% of the increase. Prioritised ministries (police, higher education and research, gendarmerie and justice) enjoy a EUR 5.9bn jump in spending, financed in part by redeployment and the non-replacement one in five of all retirees (a forecast cut in the workforce of 15,002, compared to 5,430 in 2006).

Expenditure control will enable the government to finance tax benefits representing 0.4 points of GDP (see table). Tax and social security contributions will fall down to 43.7% of GDP.

HOUSEHOLDS: THE MAIN BENEFICIARIES OF THE TAX REFORMS IN 2007

Previous budget bills		-810
2006 budget bill	Income tax reform	-3 900
	Abolition of tax relief on rental income	-600
	Households	
	Revaluation of the Working Tax Credit (PPE)	-500
Tax "shield" (direct taxation capped at 60% of income)	-400	
Companies	Trade tax capped at 3.5% of value added	-1 100
	Revaluation of the Working Tax Credit (PPE)	-500
2007 budget bill	Households	
	Dependency tax reduction	-70
	"Transport" cheques	-25
	Fast growing SME provision	-60
	Reduction in tax on investment in SMEs	-190
	Companies	
	Share purchase cost amortization over 10 years	500
Taxation of capital gains on sale of investment securities	300	
Extension of the corporate income tax instalment regime	500	

Source: Ministry of Economy, Finance and Industry 2006 (MINEFI) (EURm)

Limited risk of taxation shortfalls

Tax receipts are set to rise by 1.7%, and local government and EU taxes by 0.1 percentage points of GDP. Sizeable non-tax receipts are called upon (+EUR 1.8bn on a like-for-like basis), thanks to higher dividends received and to the payment to the State of a third of the capital gain made by state-owned financial institution CDC on the sale of its stake in the Caisses d'Épargne (EUR 0.65bn).

The government has exercised a degree of caution in its tax receipt forecasts. The budget bill assumes an elasticity of tax receipts (assuming no change in legislation) to GDP of 1.2 by value, compared to 1.8 in 2006, which seems realistic. On the basis of our growth scenario and the government's elasticity hypothesis, taxation shortfalls would amount to EUR 1.1bn.

We can also use changes in the base for different taxes to estimate potential taxation shortfalls. 2006 forecasts for growth in households' disposable income were similar. In contrast, the budget bill assumes an increase in corporate margins in France in 2006, whereas our scenario does not anticipate such an improvement until 2007. This over-estimate could lead to corporate tax losses of around EUR 1bn. Lastly, the tax base for VAT is budgeted to rise by 0.5 percentage points less in our scenario, entailing a tax loss of EUR 0.9bn. The overall taxation shortfall should be close to EUR 2bn.

Over-optimistic assumptions on an improvement in the social security budget

A number of factors are likely to contribute to a reduction in the social security deficit: a substantial rise in standard and supplementary social security contributions and a decline in unemployment thanks to a pick-up in hiring; continued reforms in health benefits; a decline in retirement on the grounds of long service; and full implementation of the young children's early days benefit (PAJE). The overall social security deficit is budgeted to decline from EUR 9.7bn this year down to EUR 8bn next year, with all branches but work-related accidents remaining in the red (the deficit for sickness benefit is forecast to decrease from EUR 6bn down to EUR 3.9bn in 2007).

Yet, despite the pick up in hiring, our scenario shows 2007 job creation remaining lower than the figure assumed in the budget bill, with the wage bill growing by one percentage point less than in the budget implying consequent tax losses of over EUR 3bn. Unemployment benefit may record a lower-than-expected reduction. Moreover, the target for the increase in sickness benefit (+2.5% by value) seems ambitious following the sharp decline already seen this year (+2.7%, versus +4% in 2005). It is also plausible that the 2003 pension reforms will not be sufficient to keep the rise in old-age benefits down to 5%, due to the retirement of baby boomers.

The cut in debt is more apparent than real

The debt/GDP ratio for the period 2005-07 is expected to decline spontaneously only down to 66.5%. However, the government is to use all its 2006 privatisation receipts to pay off debt (-0.9 points of GDP), whilst active cash management should cut gross debt by 1.5 points of GDP. Similar measures to be adopted in 2007 should reduce debt by 1 percentage point of GDP.

Only a cut in the government deficit well below 2.5% of GDP (the so-called "debt stabilising" balance) would ease an in-depth stabilization of the public finances. However, the overall reduction in the structural balance in 2007 is likely to be minimal, thereby limiting the potential for decreases in the deficit, despite growth being close to its potential. **Laure de BATZ +33 1 42 14 93 49**

All opinions and estimations included in the report represent the judgment of the sole Economics Department of Société Générale and do not necessarily reflect the opinion of the Société Générale itself or any of its subsidiaries and affiliates. These opinions are subject to change without notice. It does not constitute a commercial solicitation, a personal recommendation or take into account the particular investment objectives, financial situations.

Although the information in this report has been obtained from sources which are known to be reliable, we do not guarantee its accuracy or completeness. Neither Société Générale nor its subsidiaries/affiliates accept any responsibility for liability arising from the use of all or any part of this document.

Société Générale may both act as a market maker or a broker, and may trade securities issued by issuers mentioned in this report, as well as derivatives based thereon, for its own account. Société Générale, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any issuer mentioned in this report.

Additional note to readers outside France : The securities that may be discussed in this report, as well as the material itself, may not be available in every country or to every category of investors.