PUBLIC-SECTOR DEFICIT ON A HIGH PLATEAU

- *France's 2008 draft budget forecasts that the public-sector deficit will level off very gradually, at 2.3% of GDP in 2008. This projection is based on GDP growth assumptions (2% in 2007 and 2¼% in 2008, vs. 1.8% in our scenario) that are on the optimistic side, given that the economic and financial environment is shakier than in the past. The cost of the summer 2007 tax breaks and of the previously decided cut in the business tax is expected to be offset by tighter control of public spending, as the "LOLF" framework law for the budget is being phased in, and by further health system reforms.*
- *Initially, France had pledged to EU institutions to balance its budget by 2010. This goal has been postponed to 2012, while planning only a token reduction in debt, from 64.2% of GDP both in 2006 and 2007 down to 64% in 2008.*

2008 BUDGET BILL

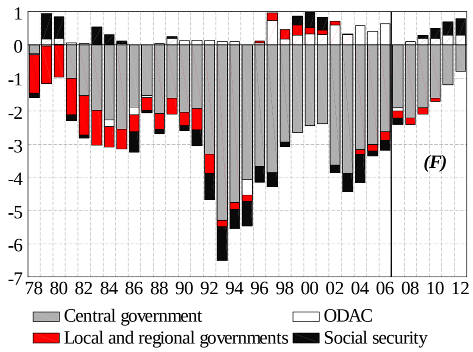
(% of GDP)		2005	2006	2007	2008
Public balance		-2.9	-2.5	-2.4	-2.3
O/w:	Central government	-3.0	-2.6	-1.9	-2.2
	Social security	-0.2	-0.3	-0.2	0.0
	ODAC *(*)*	0.4	0.6	-0.1	0.1
	Local and regional bodies	-0.2	-0.3	-0.2	-0.2
Public-sector debt		66.7	64.2	64.2	64.0
Government spendings		53.9	53.4	53.2	52.6
Tax-to-GDP ratio		43.8	44.2	44.0	43.7

Source: 2008 Budget Bill (*) Central administration bodies

Two objectives have been set out in the 2008 draft bill: 1) controlling expenditure (+1.4% in constant euros, after +2% in 2007) and making public services more efficient; and 2) enhancing growth potential by reasserting the value of labour and by making the French territory more competitive. The public-sector budget deficit, which has shrunk since 2004, is expected to continue doing so, but this trend will slow down (*see table*). The central government's deficit is expected to increase significantly compared to the actual 2007 budget (EUR 41.79 billion, vs. EUR 38.3 billion), but the accounts of the Social Security and of various central administrative bodies (ODAC) are expected to improve. Lastly, local and regional bodies' deficits should stabilise as their investments might slow down for the second consecutive year (4.4% in 2006, 3.4% in 2007, then 1.7% in 2008) against a backdrop of local elections in March 2008.

A GRADUAL RETURN TO A BALANCED BUDGET

As % of GDP



Source: Insee - Budget deficit as defined by Maastricht

Central government's deficit worsens

Thanks to EUR 2.2 billion in additional tax receipts and lower payments to the European Union (-EUR 1.9 billion), the deficit on actual 2007 budgetary spending should be significantly lower than expected, at 1.9% of GDP. In contrast, in the first budget of the new legislative session and the new presidential term, the central government's accounts worsen, hence putting an end to four years of improvement. The budget deficit is projected to increase significantly, up to EUR 41.79 billion (2.2% of GDP), or back to its 2006 level.

On the one hand, this budget is focused on further reigning in expenditure, given that spending on most items is almost flat in constant euros. However, some factors will boost expenditures and make them stable in volume terms (+1.6% in value vs. the initial 2007 budget bill, yet on a scope widened to transfers to regional and local governments and the European Union, i.e., EUR 68.5 billion):

- 65% of the increase in spending is due to the rise in "inevitable" costs: +EUR 1.6 billion for debt-servicing costs, given the higher interest rates and the costs of assuming the debt from *Charbonnages de France*, after three years of moderation; and +EUR 2 billion for civil servant pensions, owing both to massive retirements and to the increase in life expectancy;
- The revaluation and the upgrading of budgetary endowments to social programmes implies EUR 1.2 billion in additional spending compared to the initial 2007 budget law;
- And, lastly, public development assistance is up by EUR 0.8 billion.

Meanwhile, funds are being reallocated to finance measures to enhance France's growth potential. Credits to higher education and research have been increased by EUR 2 billion vs. the 2007 initial budget, as well as those dedicated to non-military equipment investment (+EUR 0.6 billion) and, to a lesser extent, to the judicial system (+EUR 0.3 billion).

Three sources of leverage will be used to prevent budget overruns: 1) central government reform to enhance efficiency, among other things through a reorganisation of employment policies (-EUR 1.4 billion); 2) the stabilisation of the public sector payroll; to do so, 22,921 positions would be suppressed, after 11,244 cuts in 2007, thus generating EUR 0.458 billion in savings in 2008 (50% of which will be passed on to civil servants); this means that one out of three retirees will not be replaced (including 11,200 in education); and 3) central government financial endowment to local and regional governments will, from now on, only be indexed to inflation (and no longer to GDP growth in value terms).

MAIN TAX MESURES IN 2008 (in millions of euros)

TEPA law on work, labour and purchasing power ***(*)***		-6,751
O/W:	Exemption on overtime work	-4,250
	Increased pay for overtime work for companies of less than 20 people	485
	"Tax shield" lowered down to 50 % of income (incl. CSG and CRDS taxes)	-625
	Income tax credit for mortage interest	-220
	Reduction in estate and transfer taxes	-1,571
	Wealth tax (incl. partial exemtion on main residence)	-530
2008 Budget Bill		315
O/W:	Taxation of dividends at the obligatory flat rate of 18%	490
	Doubling of income tax credit for mortgage interest payments the 1st year	-220
	Change in the research tax credit	
	Cap on tax deduction for Internet tax declaration	-25
	Taxation of SPI real-estate investment capital gains at the normal rate	50
	Non-deductibility of fines	20
2008 Social Security Budget Bill		1,975
O/W:	Automatic withholding of tax and social contributions from dividend paymer	1,300
	Tax on pharmaceutical laboratory revenues maintained at 1%	100
	Tax on indemnities for forced retirements	300
	Increase of contribution on company early retirements	80
	Elimination of exemptions for workers comp contributions (AT-MP)	180
Other measures		-3,634
O/W:	Deduction of the business tax ("PVA" caps and "DIN" investments)	-2,065
	Sustainable development tax credit for equipment purchases	-480
	Exit Tax	-687
	Tax credit for first-time homebuyers	-180
Total impact in 2008 on taxes and levies		-8,095

Source: 2008 Budget Bill - MINEFE (*) Eventual full impact: -EUR 13,197 bn; In 2007 -EUR 1,477 billion

On the other hand, and more importantly, the increase in the budget deficit is due to a shortfall in receipts because of tax cuts that have been decided (*see table above*), amounting to more than EUR 8 billion (0.4 points of GDP). In particular, the "TEPA" law dealing with labour, employment and purchasing power will imply a EUR 6.8 billion decrease in tax receipts in 2008 (0.3% of GDP), on top of the EUR 1.5 billion in 2007. As a result, the tax-to-GDP ratio will dip slightly in 2008, down to 43.7%.

Aside from the tax cuts, the assumption on the elasticity of taxes to GDP in value terms (i.e., 1.3, after 1.6 in 2007) may seem high, as corporate taxes are expected to rise significantly less than budgeted. On a like-for-like basis, spontaneous growth in tax receipts is expected to slow down for the second consecutive year (to 5.5% vs. 8.2% in 2006 and 6.2% in 2007). On the basis of this elasticity, our growth scenario would mean a EUR 1.3 billion taxation shortfall.

Potential taxation shortfalls estimated solely on taxable bases would be limited, as our forecasts of disposable revenue in 2007 (income tax) and consumer spending in 2008 (VAT) are close to those of the draft budget. However, margins of non-financial companies appear to have been overestimated in the draft budget law, hence implying a taxation shortfall of less than EUR 1 billion (corporate tax).

By contrast, a significant cut in welfare programme deficits

SOCIAL ACCOUNTS

(As EUR bn)	2005	2006	2007	2008
Healthcare	-8.0	-5.9	-6.2	-4.3
Labour	-0.4	-0.1	-0.4	0.3
Family	-1.3	-0.9	-0.5	0.3
Pensions	-1.9	-1.9	-4.6	-5.1
General regime	-11.6	-8.7	-11.7	-8.9

Source: PLFSS 2008

In 2007, the deficit of the general "Sécurité Sociale" system was well above forecasts, at EUR 11.7 billion, vs. EUR 8 billion, owing to the pensions (700,000 retirements, including 110,000 early retirements) and the healthcare components.

The drift in the pension component highlight the need to make adjustments when the "Fillon reform" is updated in 2008 (even though the upward revisions of long-term estimates for the working population are a favourable factor). Incentives for keeping older people working have, up to now, fallen short of what is needed. Moreover, numerous employees who began to work while very young are now taking early retirement.

A surge in healthcare spending triggered the early-warning mechanism last July. This mechanism, along with the "generics plan", is part of a series of reforms aiming to cut down spending by the national healthcare system and, hence, its deficit, which otherwise would have reached EUR 12.7 billion in 2008. The adopted measures (implying EUR 1.7 billion in savings compared to the trend growth in expenditure, thanks to deductibles on drugs and health-related transport and almost EUR 2 billion in new receipts, *see table on page 19*) are expected to decrease the healthcare deficit significantly (EUR 8.9 billion). However, this deficit projection assumes, ambitiously, that the increase in national healthcare spending (targeted by the "ONDAM" measures) will be lowered down to 2.8% in 2008 from 4.2% in 2007 (the objective had been 2.5% for 2007).

Moreover, because of above-inflation revaluation in benefits in 2007, indexing rules will lead to a slowdown in pension and family-assistance spending in 2008.

All in all, and while the accounts of the UNEDIC unemployment insurance system should keep on improving, administrative social security spending is expected to rise just by 1.7% in volume terms in 2008, vs. 2.9% this year. Meanwhile, 2008 will see a clarification of relations between the central government and the Social Security system, including the state's full repayment of its debt to the general system (EUR 5.1 billion), as well as a full compensation for the payroll tax exemptions on overtime work (EUR 5.1 billion) and the compensation for payroll tax cuts on low salaries (EUR 0.5 billion). As a result, the family-assistance and accidents at work (labour) components will return to balanced budgets in 2008.

France at the back of the EU class in public finances

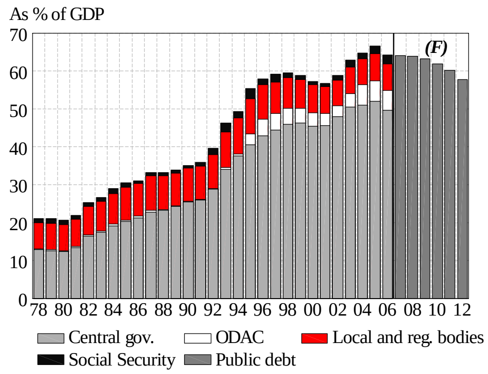
Even though its GDP growth assumptions exceed the potential growth rate, the French government has postponed its balance budget target date from 2010 to 2012. This is bad news, given the state of French public finances, especially as there are real risks of budget shortfalls given the prevailing macroeconomic uncertainty.

The tax-to-GDP rate will thus remain well above the European average. It is projected to decline from 44% in 2007 down to 43.4% of GDP in 2012, according to the government's medium-term projections, but this would still be significantly higher than the EU-27 average for 2005 (39.6%).

As a corollary, France is the eurozone country with the highest public-sector expenditure as a percentage of GDP: 53.2% in 2005 vs. the 12-country eurozone average of 47.6%. In the EU-27, only Sweden has higher level of public-sector expenditure (56.4% of GDP in 2005).

Highlighting the stubbornness of the large public-sector deficit, debt as a proportion of GDP is expected to remain almost flat, at 64.2% of GDP[1] in 2007 and 64% in 2008. As for the deficit, this figure may be slightly corrected upwardly if the GDP growth rate ends up being closer to our scenario than to the official projection.

PUBLIC SECTOR DEBT IS LEVELLING OFF



Source: Insee - Debt as defined by Maastricht

All in all, the structural reforms undertaken or planned aiming to increase growth potential (i.e. reform of higher education and research, tax cuts in favour of research, reform of special state pension funds and further reforms to the public pension system in 2008, merger of ANPE and UNEDIC to create a "one-stop-shop" for unemployed persons, deregulation of markets for goods, services and labour, further to the conclusions of the Attali's Commission, etc.) will have to come with a vast effort to reform the public sector with a goal of improving its cost/efficiency ratio.

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[1] Based on Eurostat's recommendation, French public debt has been recalculated since 1993 with the reclassification as public-sector debt of the SNCF's adjunct debt for debt servicing (EUR 8.2 billion, or 0.5% of GDP).