NEWS

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Kenneth Clarke may yet produce a white rabbit in his budget

Last year the Chancellor was expected to produce a white rabbit out of the hat during his Budget speech. Instead, he released a gerbil, to howls of disappointment from his backbenchers.Can he conjure up anything this time?

Ahead of the Budget there is a general perception that the Chancellor's hands are tied. The recovery in the economy removes the need to give spending a further boost in the Budget. The high budget deficit limits his room for tax cuts.

The best policy for the UK is a tight fiscal stance and an accommodating monetary stance. This means cutting spending to reduce the Public Sector Borrowing Requirement, raising taxes to curb domestic demand, keeping interest rates low enough to give investment a boost and allowing the pound to fall to a competitive level to help exporters. Alas! This is not to be. Monetary policy is already tight but will get tighter. Interest rates could rise again and the pound will appreciate, compounding the problem. But will the Budget be cautious?

The most likely option is the Chancellor takes no risks. Fearful of prompting an adverse market reaction and antagonising the Bank of England he portrays himself as a prudent Chancellor in charge of a steady recovery. A safe pair of hands!

But even if he did this he could still find room for limited tax cuts of about £3 billion.

First, as last year, he could use the Contingency Reserve, which is set aside for unforeseen developments. But this gives little room for manoeuvre as last year he announced a relatively small reserve and the beef crisis may absorb much of this.

Second, low inflation may allow him to reduce spending plans. The trouble is that public expenditure has already been squeezed sharply in recent years, and ahead of the election there is pressure for extra spending on politically sensitive areas such as the Health Service.

What about tax cuts? The call for tax cuts really means income tax cuts. To deliver these the Chancellor may have to make various tax adjustments, which is like robbing Peter to pay Paul. The obvious one is higher excise duties. The Chancellor is committed to a 3% increase in duty on tobacco and 5% on fuel. Vehicle excise duty could also rise.

Savings could be made by curbing costly and unnecessary tax advantages. The most obvious is mortgage tax relief. This has been scaled back significantly in recent years, but it still costs the Exchequer £2.8 billion a year. With house prices rising this could be a good time to reduce it further, but politics may prevent it. Another possibility is to reduce the tax advantages for profit-related pay. Originally intended as a temporary measure it now costs £1.5 billion, and is probably being abused.

The Chancellor could use these measures to cut income tax, widen the lower tax band and raise personal allowances. Lowering the basic rate of income tax from 24 pence to 23 pence would cost £1.3 billion in the first year and £1.9 billion the year after.

Last year the Chancellor announced net tax cuts of £3.1 billion, including a one pence reduction in the basic rate to 24 pence. If he spent a similar amount this year he could cut the basic rate of income tax from 24 pence to 23 pence, widen the 20% tax band from £3,900 to £5,500, helping those on low incomes, and raise personal allowances by £225. If he found some more money he could increase the allowance for inheritance tax and raise the limit for capital gains tax, neither of which would cost too much money.

So, it is possible for the Chancellor to be cautious and deliver tax cuts. But it is not clear this would ease financial-market fears of higher interest rates or be viewed as a political success.

Another way is for the Chancellor to break with his behaviour in his three previous Budgets and be adventurous. Clarke could do a "Lamont in reverse". When Norman Lamont was Chancellor he announced a series of future tax increases to be phased in over a number of years. Although not popular it sent a clear signal that the budget deficit was to be brought under control. Doing this in reverse, Clarke could announce a series of tax cuts in advance.

The idea is that even if the Chancellor finds the money he does not have much economic case for cutting income taxes. But to do nothing would not help re-election prospects. Consequently he could reinforce the Government's medium-term plans to cut income tax to 20 pence, to be paid for by expected economic growth and tight future control on spending. He could even cut one penny this year and pre-announce one penny off in each of the next three years.

The Treasury may be cool on the idea. Announcing tax increases in advance, as Lamont did, is one thing. If you don't follow the plans through the electorate is happy! But if you announce tax cuts in advance people are clearly upset if you let them down by not delivering the reduction. But it might be well received politically. The Budget would not be seen as adding to interest-rate fears and he could challenge Labour to oppose the tax cuts.

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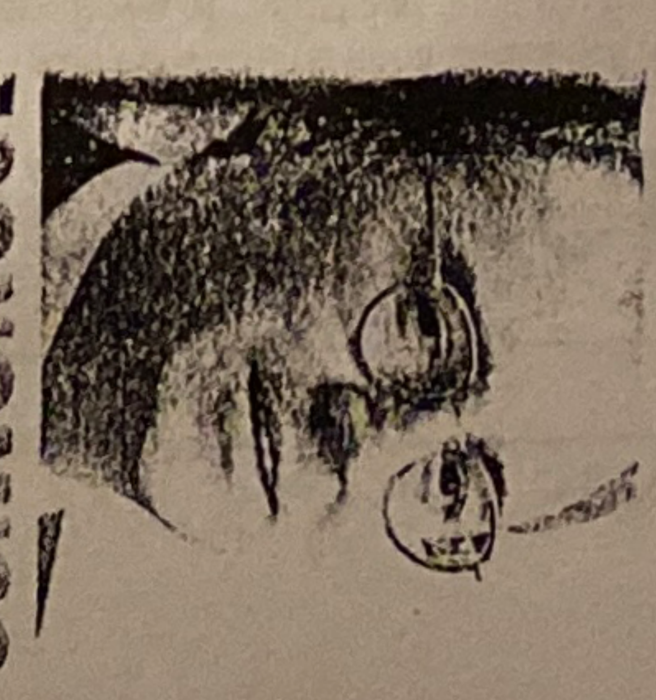

ECONOMICS WEEK

The Chancellor could surprise us and do a 'reverse Lamont' – pre-announcing future tax cuts, says **Gerard Lyons**