No need to fear gradual tax cuts

GILT-EDGED

The economy is slowing, inflation is low and this week there is every likelihood that the Bank of England's Governor will relent in his demand for higher interest rates. This is good news for gilts.

Disinflationary pressures still dominate the global outlook, as intense competitive pressures force companies to keep costs down. This explains why official interest rates overseas are falling and international bonds are performing well.

Yet the policy outlook provides two big hurdles for gilts to clear. What will the Conservatives do as they desperately try to retain power? And what policies will Labour unveil if it wins the election and can let its guard down?

These questions explain why investors are cautious, particularly foreigners. Overseas participation has become more important in the gilt market as UK institutional cash flow has fallen, limiting the ability to buy gilts.

There is always a big risk when making money depends upon the actions of politicians. In spite of this, gilts can rally. The big fear is that the Chancellor will throw caution to the wind, heavily cut taxes, undermine fiscal policy, and in the process trigger inflation. But this is unlikely.

After recent tax rises, the Chancellor knows that voters will see through any blatant attempts to bribe them with large tax cuts. It would win few new votes and trigger an adverse market reaction, with sterling falling and base rates rising. More likely, the Chancellor will learn from his predecessor Norman Lamont, announce tax cuts now and phase them in over a few years. For instance, 1p could be knocked off income taxes this year, with 2p off in each of the next two years. Affordable and providing an incentive to re-elect the Tories, with the last tax cut planned for after the election. Such a "giveaway", or even slightly more, would not undermine the fiscal position, threaten inflation or justify higher base rates.

There are three ways to reduce high budget deficits: stronger growth; government action through tax rises or spending cuts; a dose of surprise inflation. Britain's PSBR improved in recent years as emphasis was put on the first two of these ways. After sterling's ERM exit, monetary policy was loosened, allowing the economy to recover, and the fiscal stance tightened. Now the economy is slowing and government spending is not being kept fully under control. It should be no surprise that the PSBR is overshooting the path needed to achieve the Government's £23.5 billion target.

Yet, this should not prevent a Budget giveaway. The key is to look at the economic cycle. This suggests there can be some fiscal relaxation without triggering inflation. The high rate of unemployment suggests ample spare resources in the economy. And judging from the recent sluggish pace of economic growth, this will remain the case.

Such tax cuts need not undermine fiscal credibility. One factor that should not be overlooked is that the UK's longer-term fiscal outlook is good, according to an OECD study this summer. By 2015, taking into account demographic trends, pension and health care costs, Britain's fiscal position will have net assets of 14 per cent of GDP, while France will have net liabilities of 37 per cent, the US 45 per cent, and Germany 49 per cent.

Furthermore, Britain's position would improve slightly, while these other countries would deteriorate.

The main message is that small, phased-in tax cuts will not undermine fiscal policy or inflation. The problem is that taxes may be cut along with a spending overshoot. And the Chancellor can't have it both ways. The gilt market should focus on government spending. Pressure for this to be boosted before the election will be intense. Such pressures will intensify afterwards if Labour wins. The best way to avoid these concerns and revive the economy is for the Chancellor to take advantage of low inflation and cut interest rates.