Cheaper borrowing will complete the house of cards, write **Larry Elliott** and **Richard Thomas**

Introducing the three-cut trick

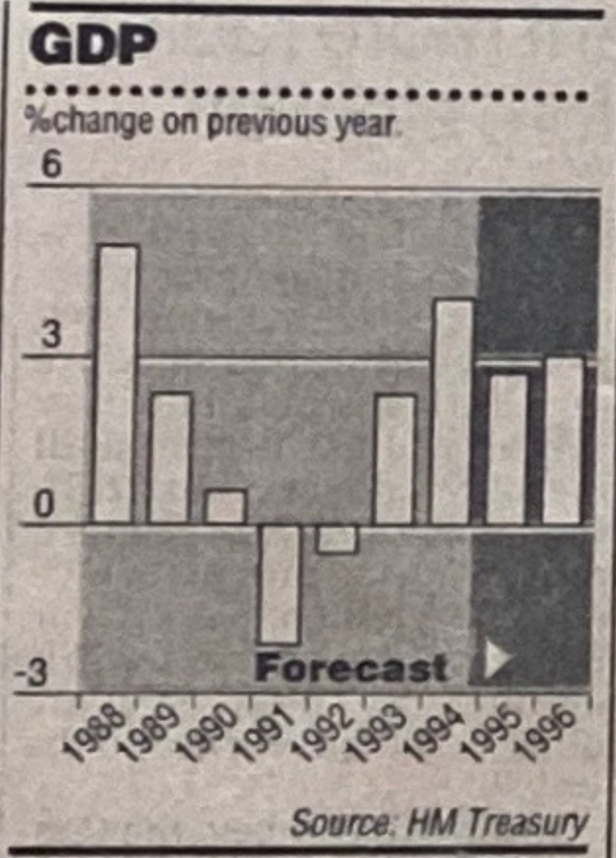
THE Chancellor's strategy for wooing back disgruntled Middle England to the Tory fold was only half-revealed yesterday, with the key ingredient — a cut in interest rates — remaining up his sleeve.

With the options for hefty tax cuts to recreate the "feel-good factor" limited by weak government revenues, Mr Clarke is banking on a relaxation in monetary policy over the coming months to give the economy, and voters, a lift.

The Treasury's own optimistic economic forecasts for next year almost certainly depend on a cut in borrowing costs of up to one percentage point from the current level of 6.75 per cent. City analysts were convinced last night that a reduction would be on the agenda at next month's monetary meeting with the Governor of the Bank of England, Eddie George.

Gerard Lyons, an economist at DKB, said: "This is a three-cut trick. Some cuts in spending, cuts in taxation — the third cut, in interest rates, will surely come soon."

Even with a cut in borrowing pencilled in, yesterday's package had the feel of the penultimate Budget before an election, rather than one delivered by a Chancellor facing an imminent test at the polls.



The tough line on spending reinforced the view on financial markets that this was not the Government's last throw of the dice.

As Nigel Richardson, economist with Yamaichi Securities, put it: "This smells like a mid-term Budget not one to win an election."

Had Mr Clarke really been going for broke, there might have been the windfall tax on utilities he scornfully dismissed yesterday, cuts in excise duties to flatter the inflation figures in the first half of next year, and a more headline grabbing reduction in the basic rate.

But Mr Clarke held out hopes of bigger giveaways next year. He outlined a three-pronged approach to the ultimate goal of a 20p basic rate — reducing the standard rate by 1p pence in the pound to 24p, widening the 20 per cent band and trimming the basic rate on income from savings to 20p.

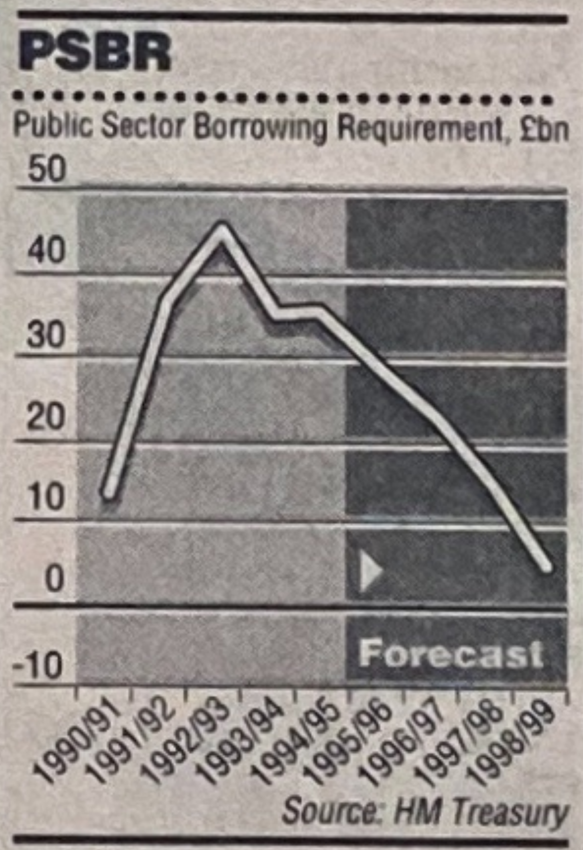
If the public finances permit, we can expect further inroads next November or at the very least a promise that the target will be reached if the Conservatives are elected for a fifth successive term.

The Chancellor justified his fiscally prudent approach by emphasising his determination to ensure the improvement in the public finances over the past two years is continued. In fact, with state revenues lower than expected, he made a virtue out of necessity; there is little doubt that the hopes the Chancellor harboured a year ago of having the wherewithal to finance substantial tax cuts have not been realised.

Most economists would probably agree that keeping fiscal policy tight while loosening monetary policy is the best option, but it may not be enough to win over voters in marginal constituencies.

Even the tax reductions which were achieved depended on a reduction in the Treasury's reserve, while the spending increases for health, education and the police relied on trimming elsewhere. As expected, capital spending was slashed, with Private Finance Initiative cash pencilled-in to take up the slack. Last night, most experts were dubious whether this strategy would work, given the sluggish start to the PFI.

Left with precious little scope, Mr Clarke had two thoughts in mind. First, he tried to batten down the Conservative Party's core constituencies — the elderly and small businessmen — while making a pitch for the lost voters in Middle England



with extra spending on education and health.

Savers and pensioners will be pleased by the Budget. As well as the lower tax on savings income, the Chancellor raised the ceiling on inheritance tax, and offered some help in the politically sensitive area of long-term care.

The ultimate goal of abolishing both death duty and capital gains tax was reiterated, but only "as resources allow". But Mr Clarke's reluctance to go too far in this direction was indicated by the relatively small steps taken — the threshold on inheritance tax was increased from £154,000 to £200,000, less than expected, and the capital gains fillip was restricted to small businesses.

Plans to help elderly people in need of residential care included a significant increase in the amount of wealth households are allowed to hold and still receive state help, from £8,000 to £16,000.

But the real innovation on this front came with the proposals for "Partnership Schemes", under which individuals who take out their own insurance against future care needs would be subject to a less stringent means-test.

On social policy, the Chancellor appealed to right-wing instincts, with a clamp-down on housing benefit for the under-25s and a tough line on single parents. But this was tempered by a sharp rise in the amount households can spend on child care without losing any family credit, from £40 to £60 a week — designed to help mothers with young children back into the labour market.