

The UK Budget 2010:

Darling's budget is not only a mistake from an economic point of view, it is a strategic mistake politically.

1. Cut taxes. Sounds crazy but consider that labour and capital mobility has increased since the mid 80's. A country is producing a product called Domicile, the price of which is Taxation. Today, demand for Domicile is elastic. Raising marginal tax rates is likely to reduce total tax revenue.

2. Cut the top rate. Drastically. The top rate is the most elastic bracket. Raising the top marginal tax rate will result in reduced tax revenue.

3. The inelastic bracket is the middle bracket. Unfortunately these represent the swing vote and would be political suicide. Strategically, this bracket should be left alone or cut. I favor cutting.

4. Cut corporate taxes as well. Cut inheritance taxes. Attract foreign tax arbitrage capital.

5. Strategically, cutting taxes is rational but risky. It is almost certain that the immediate is to drive the budget deficit higher. It is likely that the longer term impact is very positive as elasticity of domicile is likely to increase with time and the duration of the recovery in global growth. With an impending election loss, it makes sense to take a risky radical approach. It is short term populist and likely to win votes. If not, the fiscal problem will be inherited by the Conservatives. By the time the benefits accrue, the Conservatives would be blamed for an impairment in the UK sovereign rating. If Labour wins, there is time to claim success in time for the next election as things improve in 4 to 5 years time. Thus, doing the rational thing is also the right political strategy.