4

Prime Minister

Content in principle for the Chancellor to introduce deduction at source?

MCS 26/11

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

Provided he can present it all right!

MT

ADMINISTRATION OF MORTGAGE INTEREST RELIEF

You agreed last December that the Inland Revenue should study with the main lending institutions a scheme for giving mortgage interest relief at source. I can now let you know the outcome of this review.

2. The study has confirmed that a switch to deducting basic rate tax from most mortgage interest payments is feasible and offers a substantial manpower saving in the Revenue - around 2,000. This is a much bigger saving than was contemplated a year ago. The main reason is that a reappraisal has revealed the cost of operating the present system with the more frequently changing interest rates we must now expect. Moreover provided deduction at source could start in April 1983 the change could contribute over 1,000 to the manpower targets for 1 April 1984. It would also mean a major simplification of the tax system for a great many ordinary PAYE taxpayers. Lenders too accept that there is a very strong case for it, although it will give them some extra work.

3. Of course there is nothing new about deducting tax; it used to be the normal rule. Allowing interest to be paid gross to building societies was a departure for reasons which were good in the 1920s when it was done. Circumstances have changed greatly since then and the balance of advantage is now clearly the other way. You will recall too that since 1979 we have been successfully giving tax relief for life assurance premiums by a deduction mechanism.

4. Changing over to a basic rate deduction scheme would not affect the final amount of relief or the borrower's ultimate tax

liability, although his tax payments would go up to balance the reduction in mortgage payments. Those liable at higher rates would continue to get the higher rate part of the relief through codings and assessments.

5. There is an awkwardness in changing over to deduction at source for the ordinary 'repayment' (or annuity) kind of mortgage, under which the borrower repays a constant monthly sum with an interest component reducing each year. The tax relief naturally goes down as the interest reduces. A straight conversion to deduction at source would therefore mean increasing the level of repayment every year. The building societies and local authorities could not handle this. To get round the problem they propose rescheduling the borrower's capital repayments to keep the new, lower, monthly payments constant. This would make it easier for borrowers to plan their family budgets but initially it would mean that net outgoings after tax would increase a little in the early years because they would be paying off their capital debt more quickly. The increases would not be large (typically, around 5 per cent) and would not affect the RPI. In the later years - and overall - they would pay rather less than they would have done. The lenders have said they will be sympathetic to those borrowers who do not wish to increase their mortgage outgoings (an extension of the term is one possibility).

6. There is also a money cost to consider. There is a first year PSBR cost of £m225-250 mainly due to a once for all bringing forward of the cost to the Exchequer of the relief. In later years the PSBR effect is neutral, or possibly a small saving. I judge this to be a price worth paying.

7. Giving relief at source opens up the possibility of winding up (with a further small staff saving in DOE) the option mortgage scheme which nowadays overlaps with the tax relief arrangements to a considerable extent. A lot of people who take an option mortgage

could equally well take a tax relief mortgage. We can protect the others by allowing them to keep the benefit of a basic rate deduction even though they may not be liable to tax. The lenders would want the option mortgage scheme absorbed within any new arrangements - they do not want to have to operate two similar but slightly different schemes.

8. In the run up to the General Election we must obviously approach any change on the mortgage front with caution. The view I have come to, however, is that we ought to make this change and also wind up the option mortgage scheme. The staff saving the scheme offers is a very attractive prize indeed, particularly given the scale of the reductions still required before I can meet the 1 April 1984 manpwoer target for my Departments. Also the opportunity to simplify the tax system for so many ordinary PAYE taxpayers at relatively little cost is not something we should lightly reject. In announcing our intentions we should of course make it absolutely clear that it is merely a change of method and not a cutting down of relief.

9. I have shown the detailed report to Michael Heseltine and also invited George Younger, James Prior and Nicholas Edwards to give their views. Michael has said that he fully agrees with my proposal to introduce the scheme in April 1983 and to absorb option mortgages into it. (The others are of the same mind.) Michael has raised some points of detail which I will pursue with him. I need only mention that he would like to see further assurances from lenders that they will not impose the rescheduling referred to above o unwilling borrowers. This is clearly a sensitive point - and there will be further discussions with the lenders' associations about it. At the same time we have to recognise that it is probably not in their power to give an assurance binding on every member.

10. The timetable for a 1983 start is already tight. But putting the starting date back to 1984 would mean that we lost the contribution the scheme can make to the 1984 manpower target.

Also it will be better to get the change over well before the next election. A 1983 start requires legislation in next year's Finance Bill. To give time for further discussion with lenders (who are waiting to hear the result of the review) we need to make an announcement very shortly. If therefore you are content that we should go ahead I propose asking the Financial Secretary to make our intentions known in the House as soon as I have settled the terms of the statement with Michael.

11. I am copying this minute to Michael Heseltine and to George Younger, James Prior and Nicholas Edwards in view of their housing responsibilities and I am also sending copies to other members of E Committee.

G.H.

(G.H.)
25 November 1981

25 NOV 1981

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

30 November, 1981.

Dear John,

Administration of Mortgage Interest Relief

The Prime Minister was grateful for the Chancellor's minute of 25 November.

The Prime Minister is content with the course of action proposed by the Chancellor. She has commented that much care will be needed in the presentation of these changes.

I am sending copies of this letter to David Edmonds (Department of the Environment), Muir Russell (Scottish Office), Stephen Boys-Smith (Northern Ireland Office), John Craig (Welsh Office), and to the Private Secretaries to the other Members of E. A copy also goes to David Wright (Cabinet Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

CONFIDENTIAL