SUBJECT

SECRET AND PERSONAL

cc Master 2ps

Not sent

2

10 DOWNING STREET

MCS.

THE PRIME MINISTER

Personal Minute

No.

CHANCELLOR OF THE EXCHEQUER

Mortgage Interest Relief

I couldn't disagree more with your paper on this subject.

It is fundamental to our policies that we raise the mortgage interest relief ceiling by a significant amount. It is fundamental to our policies for home-ownership, the property-owning democracy and the family.

It was Labour who imposed this ceiling for precisely the reasons which should lead us to raise it. Ideally, we should this year double the ceiling, and thereafter at least index-link it, as Arthur Cockfield believes. But, given the Budget arithmetic, I would be prepared to settle for a ceiling of £33,000 - i.e. index-linked since May, 1979.

On the arguments in your paper:-

(i) Of course, the £25,000 ceiling affects a minority of cases. It is bound to, because there is such a penalty in borrowing more than £25,000. But, as the figures in your para. 1 show, increasing the ceiling would increase the number of mortgages over £25,000 - and, I suspect, would relieve a log-jam in the market at the same time.

/(ii) There

(ii) There is an undue emphasis in your paper on the position of first-time buyers. We do, indeed, want to help them; but we should also help those already with large mortgages who are our natural supporters, and who are always the target of downwards-levelling policies of successive governments, aided and abetted by inflation.

(iii) It is quite beside the point that these people are better off now than when mortgage rates were around 15%. It was under us that they suffered the hike to 15%-: we are only just below where we were in May, 1979 on this.

(iv) I accept that the tax treatment of housing is already favourable as compared with that for industrial and other investment. So it should be: the first house is a home for for life and home ownership is at the centre of our philosophy.

(v) There is an inconsistency between your view (para. 6) that the favourable tax treatment of housing has switched funds from the equity market and your view (para. 8) that much mortgage lending ends up financing non-housing expenditure. I am astonished by your argument that tax relief encourages higher borrowing and so leaves more funds for people to spend as they choose: what conceivable objection is there to that?

(vi) Nor do I rate highly your monetary arguments. There simply is no evidence that our present monetary stance is lax as a result of excessive mortgage lending (para. 9).

/(vii) I note

(vii) I note the comparisons between owner-occupiers and council tenants (which, by the way, take no account of rent and rate rebates). The switch away from subsidising council houses and to assisting home ownership is precisely what we wish to achieve.

There is a further point on which I would be grateful for your view. Under the scheme whereby mortgage relief is deducted at source, will there not be a manpower argument for increasing the ceiling above £25,000? Does not every mortgage above that figure need to be processed by the Inland Revenue, at high and growing manpower cost?

I very much hope that you will now agree to double the ceiling; or, at least, to increase it to £33,000.

28 February, 1983

10 DOWNING STREET

(1)

Prime Minister

Mortgage Interest relief Ceiling

Here is the Chancellor's paper ; and a note from Alan Walters.

I have taken the liberty of annotating the paper (with Robin's help) with the counter-arguments.

As I warned you, they are all united in this view - and it is a concerted view.

MCS 25/12

For Budget file

10 DOWNING STREET

Prime Minister

Mortgage interest relief ceiling

I attach

(1) Flag A : The Building Societies Budget Representations. See Sir G Howe's 1979 remark.

(2) Flag B Budget Memorandum of Joint Taxation Committee of Building and Engineering Contractors

(3) Flag C House Builders' Federation Budget Representation

(4) Flag D DoE assessment of the number of mortgages above

£25,000.

(5) Flag E (less interesting)

Bank of England paper on mortgage lending, which argues that the connection between raising the limit and increased house prices is not as simple as the Treasury paper suggests.

MCS 1/3

The House-Builders Federation
82, New Cavendish Street, London W1M 8AD
Telephone 01-580 5588 . Telex 265763.

JRH/JCS/AC/107 24th January 1983

The Rt. Hon. Sir Geoffrey Howe M.P., P.C.,
Chancellor of the Exchequer,
H.M. Treasury,
Whitehall,
London. SW1

Dear Chancellor,

I am pleased to submit our 1983 Budget Memorandum. You have already received a Memorandum covering a wide range of issues affecting the whole of the construction industry from the Joint Taxation Committee of four of the major construction industry federations. However, in this further submission on behalf of house builders we highlight the particular advantages of an increase in private new house building for Government revenue and for the economy.

Yours sincerely,

J.R. Humber
Director

HD.83.30

HOUSE BUILDERS FEDERATION

MEMORANDUM TO THE

CHANCELLOR OF THE EXCHEQUER

BUDGET 1983

1. INTRODUCTION

The House Builders Federation's 1983 Budget Memorandum begins by placing the house building industry within the broad economic environment. The industry has a crucial role to play in leading the process of economic recovery. This is particularly important at present because, more than any other item of consumer expenditure, new houses create new jobs and have a minimum impact on imports. The industry also has a crucial role to play in enabling the Government to achieve one of its main policy priorities - the expansion of owner-occupation.

The Memorandum then considers specific tax changes which could be made to help increase housing output and improve the industry's profitability.

2. HOUSE BUILDING & THE ECONOMY

The important decisions taken by house builders are inevitably based on an assessment of housing demand any time between three months and three years into the future. This means that survival depends on how accurately house builders assess future prospects in the housing market. However, it also means that there is an element of self-fulfilling prophesy for the economy in these decisions. House building quickly generates substantial numbers of new jobs, while the domestic content of materials used in house building is relatively high. By starting work on houses for sales which are expected three or six or even twelve months ahead, house builders automatically provide a rapid boost to any upturn in the economic cycle as soon as they perceive a change in consumer confidence or in the general financial and economic climate. It is precisely because of these reasons that housing starts are a key variable in the Government's Longer Leading Indicator of the U.K. economic cycle.

However, house building is of particular economic importance at present. There is strong evidence that a consumer led economic recovery will result in a substantial increase in imports, with little impact on jobs and domestic output. Your own Autumn Economic Statement set out these risks very clearly. Yet with prospects in other sectors of the economy so uncertain, the recent increase in consumers' expenditure is a welcome sign of emergent recovery which must be encouraged.

The unique feature of new housing is that, although it is classified as an investment good in National Income accounts, it is paid for directly out of consumer sector income. Expenditure on a new house has much greater first round effects on jobs and domestic output than equivalent expenditure on any other consumer good.

House builders have made many changes over the last three years to their product mix and their marketing activities. Despite very difficult economic conditions, the industry has increased starts by almost 50 per cent since the trough of 1980. However, there are a number of factors impeding the operation of the housing market over which house builders have no control. If the industry is to be able to play its full role in the economy in both the short and long term, these factors must be addressed in the 1983 Budget.

3. INTERREST RATES

The key economic concern at present must be the trend in interest rates. Any rise in the mortgage rate would be extremely damaging to consumer confidence. House builders believe that a blow to confidence at this time would undermine the housing market even more than the direct effect of the rise in borrowers' monthly mortgage costs.

4. TAXATION

There are four specific tax changes which the Federation proposes for consideration in the 1983 Budget. When taken together, these changes would considerably improve the immediate trading environment in which house builders operate. However, they are also essential steps towards removing some of those factors which, in the long term, impede the ability of house builders to meet demand at the right price and in the right place. This in turn will mean that more new jobs can be created, while less consumer income will go into expenditure on goods with a high import content.

4.1 MORTGAGE TAX RELIEF

The House Builders Federation believes that a rise in the mortgage tax relief limit should be a Government priority in the 1983 Budget. For many years, Governments have been able to argue with justification that the £25,000 limit only affects a very small number of home owners and therefore should not be raised. This is no longer the case in London and many parts of the South East. House builders are able to quote new housing developments aimed at first purchasers and families on relatively modest incomes where 30 per cent, or even 50 per cent of borrowers take out mortgages of £25,000 or above.

The Government's commitment to maintaining the present system of mortgage tax relief is beyond question. What is less certain is the degree of commitment to maintaining the role of mortgage tax relief in real terms. There are many outside Government who argue that by leaving the £25,000 limit unchanged, mortgage tax relief can be allowed "to wither on the vine" without arousing public concern. Because the Government's attitude to this argument is not at all clear, a modest rise to £35,000, at a cost of less than £100 million, would provide a clear signal that the Government does not believe that relief should be allowed to erode gradually under the effects of inflation.

The mortgage tax relief limit should be raised to at least £35,000 in the 1983 Budget. Because this is well below the £50,000 required to fully restore the real value of relief to its 1974 level, the Government must also give a firm commitment to index the limit in subsequent years in line with any increase in house prices.

4.2 STAMP DUTY

The Government has raised the stamp duty thresholds twice since 1979, changes which the industry has welcomed on both occasions. However, this should not disguise the fact that approaching 50 per cent of new houses and 35 per cent of

second-hand houses sold in the third quarter of 1982 under a building society mortgage were priced at over £25,000. A tax which began as a luxury tax is still effectively a tax on almost half of all house purchases.

It may be argued that stamp duty is a convenient and economical revenue source for the Exchequer, and that a further rise in the thresholds cannot be afforded under present economic circumstances. The House Builders Federation would ideally advocate a return to the 1974 position where stamp duty applied to only a small minority of house purchase transactions. It is a tax which places a substantial extra financial burden on ordinary house buyers at a time when they are already faced with a multitude of other costs. It also reduces demand for new houses as demonstrated by the fact that many house builders are paying stamp duty for their new house buyers. This costly measure would clearly be unnecessary if stamp duty had no effect on demand.

Because full restoration of the 1974 position would be costly under present economic circumstances, HBF suggests that the thresholds be raised by a minimum of £5,000, but preferably by £10,000 in 1983. For example, the first of these options would cost the Exchequer only £60 million, but it would remove an extra 10 to 15 per cent of new and second-hand house sales from payment of stamp duty. The present "slab" system should also be put on a more equitable "slice" basis.

4.3 DEVELOPMENT LAND TAX

The Government has done much to mitigate the effect of DLT on the replacement of house builders' land banks over the last three years, although the one major problem still remaining is the burdensome exercise of assessing DLT on deemed disposals. This latter problem is an extremely time consuming and laborious process both for builders and the DLT office, and furthermore it produces a fairly low proportion of the total DLT yield.

HBF, therefore, recommends the abolition of the DLT deemed disposal arrangements, at a cost of only £15 million, as these have the most detrimental effect on bona fide development as well as substantial public sector manpower implications. We understand that such a move might need to be accompanied by further provisions to prevent this from being used as a tax avoidance loophole but, having considered this point, we feel sure the necessary safeguards can be achieved by restricting deemed disposal exemptions to registered housebuilders starting a scheme which has received full approval from a local planning authority.

4.4 STOCK RELIEF - Treatment of Houses Taken in "Part Exchange" by Private Housebuilders

The house building industry is subject to a special constraint in that "land" (including buildings) which forms part of a firm's trading stock - e.g. a house-builders land bank - does not count for relief unless of a type ordinarily sold only after a process of development.

This condition was apparently intended to exclude relief claims by mere speculators who buy and re-sell properties in an unaltered state: this is a general purpose with which the construction industry need not quarrel. But the

actual wording used has the undesirable effect of denying the character of trading stock to a house which a housebuilder takes from a buyer in part-exchange. In the present very poor market for middle-range houses, house builders have offered part-exchange or buy-in facilities as part of a whole range of purchaser incentives. Some of these will be discontinued as the market improves. However, many in the industry now believe that the buy-in will become a permanent element within the overall marketing package offered by house builders.

We ask that the stock relief general rule referred to should be qualified by making a statutory exception for residential property bought from a customer on the occasion of, and in connection with, the sale to him of property that was trading stock before its sale.

JCS/AC
January 1983

Extract from internal DOE Housing Market Assessment: 4th Quarter 1982.

First-time purchasers and former owner-occupiers

11 Building societies made half as many advances again in the 4th quarter 1982 as a year earlier and 15% more, in seasonally adjusted terms, than in 3rd quarter 1982. First-time purchasers' advances rose to 134,000, another record (excluding LA sitting tenants the figure was 109,000, just below the 3rd quarter 1971 record). Former owner-occupiers' advances in the 4th quarter were 123,000, 7% above the previous record in 4th quarter 1977.

12 The average income recorded by building societies was 7% higher than a year earlier for first-time purchasers and 12% for former owner-occupiers, compared with an increase of 8% in national average earnings. The rise in the first-time purchasers' average has been curbed by the growing number of council tenants buying their houses with building society mortgages.

13 The average building society advance to first-time purchasers in the 4th quarter was 11% higher than a year earlier and to former owner-occupiers 17% higher. In the second half of 1982, 6% of first-time purchasers and 13% of former owner-occupiers received loans above the tax relief limit of £25,000; in Greater London 23% and 30%, respectively.

(Banks to be excluded)

Local authority sitting tenants (Table 3)

14 In the first half of the financial year 1982/83, 91,000 council houses were sold in England, of which about half were mortgaged to the councils for an average of £9,100. From the 5% sample survey, building societies provided loans averaging about £8,700, for about a third of the sales in that half-year. The higher average council advance is partly explained by relatively fewer building society advances being in the high priced London and South East areas.

15 In 1982 as a whole, in the whole United Kingdom, the societies granted 75,000 mortgages on council houses, about 24,500 of these in the 4th quarter. The average price rose to £11,010 (equal to 56% of the price paid by other first-time purchasers) from £10,140 in the 3rd quarter. Local authorities' P1 returns gave an average price of £9,700 (58% of the valuation) for council houses sold in England and Wales in the 3rd quarter.

16 LA sitting tenants borrowing from the societies were older than other first-time purchasers, had lower incomes and borrowed a lower multiple of their income (average 1.3 against 1.9), but their advances were for a slightly higher

Mortgage lending and the housing market

This article, which has been prepared mainly by E P Davis and I D Saville of the Bank's Economics Division, argues that:

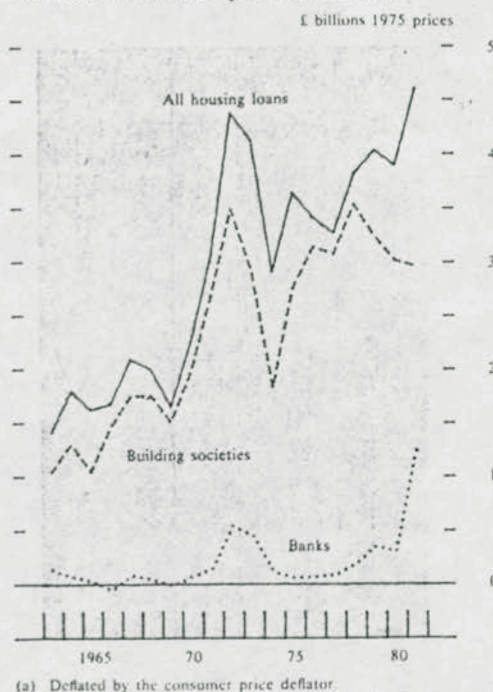
- *Now the banks have entered the housing market in a major way, the market for mortgages is more likely to be cleared mainly by interest rate movements rather than by rationing.*
- *The recent sharp rise in mortgage lending reflects the removal of restrictions, allowing persons to increase their capital gearing, and probably does not reflect a significant rise in the demand for housing.*
- *A substantial part of mortgage lending does not ultimately finance new or improved housing, but is available for the acquisition of other assets or other spending.*
- *House prices are somewhat low in real terms, and may recover in the course of the next few years.*

The last two years have seen a sustained, though not unprecedented, rapid growth in the stock of mortgages outstanding—substantially faster than the growth in either the general price level or the price of houses. Banks have once more become substantial lenders, accounting for a third of recent flows. So far, this has had little obvious repercussion either on house prices in real terms or on housebuilding, both of which are little above their lowest levels of recent years. This article examines developments in the mortgage market, and their likely consequences for the housing market.

Developments in the mortgage market

New mortgage lending has recently been growing rapidly in real terms (Chart 1), and since the summer of 1980 banks have been taking an important and growing share. The 'real' stock of mortgage lending outstanding, deflated by consumer prices, is now at a record level (Chart 2). (The recent rise is even more pronounced when an index of house prices is used to deflate the stock).

Chart 1
Real flows of house purchase loans[a]

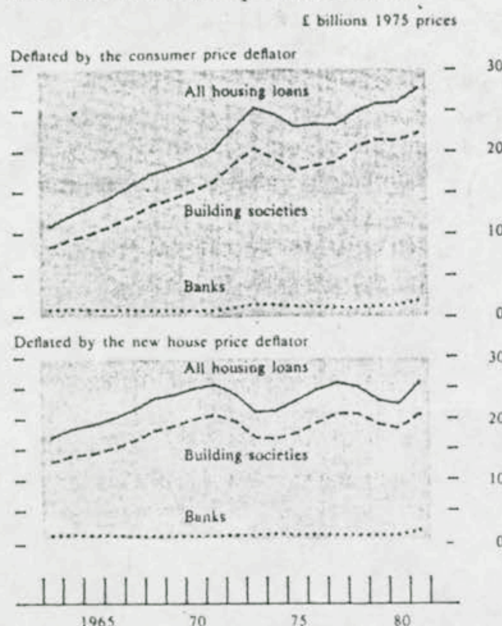


(a) Deflated by the consumer price deflator.

The real stock of mortgages fluctuated quite widely during the 1970s, after some years of steady growth. The reasons for this are complex and rooted in the behaviour of building societies. Building society interest rates tended to be more stable than market rates. This was partly because of the administrative costs of changing them, but also to protect borrowers from the full effect of high interest rates. When market rates were rising, building societies could, for a time, partially maintain lending by running down liquid assets; but would later introduce rationing devices such as queuing and giving priority to certain types of loan, leaving some demand for housing finance unsatisfied. When interest rates fell, societies were initially content to accumulate (or rebuild) liquidity from which to satisfy future mortgage demand. But they would eventually drop their rates to avoid an excess of lower yielding liquid assets, and in response to pressure to reduce the burden on borrowers.

The consequences of this behaviour are demonstrated in Chart 3. Building societies offered very competitive deposit rates in 1971–72 (see, for example, the difference between the gross share rate and the three-month local authority deposit rate), and maintained high liquidity despite a rapidly growing real stock of lending. As interest rates generally rose, their deposit rates became much less competitive in 1973 and 1974, and their liquidity fell away. This was followed by a fall in lending in 1974, which

Chart 2
Real stocks of house purchase loans



continued into 1975, as societies raised their rates to attract deposits and rebuild liquidity. In subsequent years up to 1979, growth in real lending resumed, financed partly by a falling liquidity ratio against a background of generally weak competitiveness. (Exceptionally high competitiveness in 1977 had surprisingly little effect on inflows.) More recently, the growth in the real stock of mortgage loans has slowed, and there has been some rebuilding of liquidity. Competition for deposits from national savings and from the banks has been an important factor in recent years.

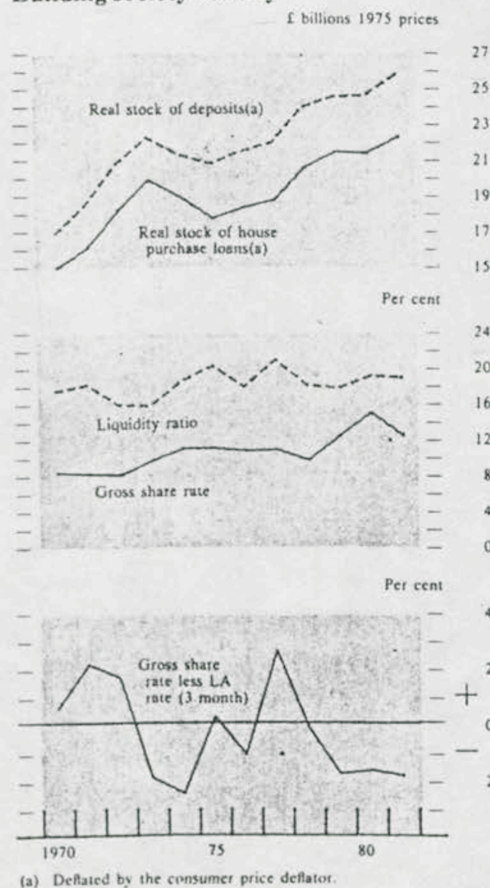
This analysis has placed little emphasis on the demand for loans, since rationing was in force for much of the period. Clearly, however there were periods when queues were short: but these were generally at times when interest rates and other factors combined to produce weak demand. Thus in 1973 and 1974 high rates were coupled with flat or falling real incomes, and this pattern was repeated in 1977. In periods of high and increasing demand, rationing by building societies became important.

Other institutions did not generally fill the vacuum created by rationing. Local authorities and insurance companies have made a comparatively minor contribution, as have banks until rather recently. This is in contrast to experience elsewhere; for example, in the United States, banks account for 17% of outstanding housing loans, and 45% in France, compared with about 7% in the United Kingdom in 1981. The banks in Britain have tended to concentrate more on lending to the corporate sector. This has been partly for historical reasons, and partly because controls imposed on bank lending for monetary policy purposes may at various times have inhibited them from entering this market. Moreover, the building society movement became important at an earlier stage in the United Kingdom than in other countries.

In the period between the introduction of 'competition and credit control' in 1971 and the imposition of the corset[1] (and the onset of much higher interest rates) at the end of 1973, the banks took over 10% of mortgage flows (Chart 1). The abolition of the corset in 1980 may have been a factor in stimulating the banks' re-entry to the housing market in the last two years. There are, however, differences between recent activity and 1972–73. In the earlier period, lending for house purchase was not generally distinguished by the banks from other personal lending; interest rates were tied to base rates, and applications processed in the same way as other personal loans. By contrast, the recent resurgence of bank lending has seen separate mortgage schemes vigorously marketed, and, more important, a divorce of rates charged on mortgages from base rates. Bank mortgage rates are now more closely associated with the building societies' recommended rate, making mortgages offered by banks more competitive in general with those from building societies. Building societies have responded to this competition by reducing or eliminating additional charges for large loans.

With the banks willing to expand their lending freely, the effect has been, broadly speaking, to satisfy all demand for mortgage finance, and to make the building societies more responsive to market interest rates and keener to compete for funds. (A separate influence affecting building societies in the same way was a drive to attract more funds to

Chart 3
Building society activity



(a) Deflated by the consumer price deflator.

(1) See 'Competition and credit control', June 1971 *Bulletin*, page 189, and 'The supplementary special deposits scheme', March 1982 *Bulletin*, page 74. The corset was not in operation between February 1975 and November 1976 and between August 1977 and June 1978.

national savings.) Although the banks' introduction of special rates for mortgage lending may have increased the stability of interest rates for these borrowers (compared with a situation in which they were charged a rate more closely related to base rate), the effect on borrowers from building societies may prove to be the reverse, with building societies probably under greater pressure than before to follow market interest rates.

The entry of the banks into the mortgage market in a major way in mid-1981 probably eliminated the rationing which had persisted since the house price surge of 1972–73. However, in recent months some banks have begun to limit the growth in their mortgage lending (which, in the second quarter of this year, represented 26% of all their outstanding personal lending, compared with 15% two years ago). Further rises in corporate loan demand might reinforce a tendency for banks to stabilise mortgage lending at some target share of their portfolio. It remains to be seen, therefore, whether the elimination of rationing will prove to be permanent.

The supply of housing

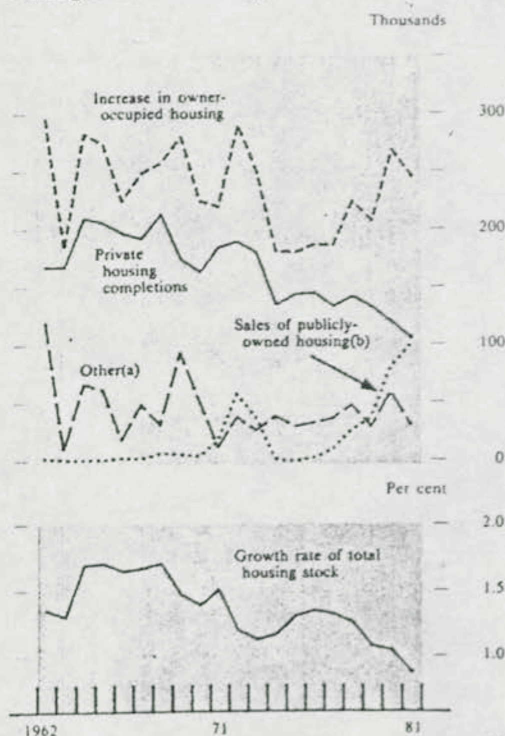
It would be natural to interpret sharp rises in the real stock of mortgage lending as an increased desire to own dwellings which would be transmitted either into increases in the stock of the owner-occupied housing through new building, or into a rise in the real price of housing. The lending surge of the early seventies was indeed followed by a sharp rise in real house prices; private housing completions recovered somewhat from the depressed level of 1969–70, but only to levels well below those of the middle sixties, and they fell sharply in 1974 (Chart 4). Sales of dwellings from public ownership were also high in 1972–73, but there were few additions by conversion of existing property or transfers from the private rented sector, net of demolitions.[1]

House building is generally the principal source of dwellings for owner occupation. There are several characteristics of the supply of dwellings in this form[2] which differentiate it from the supply of most other goods. In the long term, the supply of dwellings is virtually unlimited; in the medium term, the number of plots with planning permission limits building; and in the short term (under a year), the number of dwellings which can be completed is constrained by the number already under construction. Dwellings are very long lived, and even what is by normal standards a high level of completions has little effect on the size of the overall stock. Furthermore, sales of new dwellings can differ from the number of completions, because of selling before completion in a boom, or leaving them unsold in a stagnant market.

The stock of dwellings is thus little affected in the short run by changes in demand. The degree to which the supply can respond to demand is important in determining how far increased demand is passed on in increased house prices. In recent years, the rate of growth of the national housing stock (including the rented sectors) has been declining (Chart 4). In the mid-1960s, the annual rate of increase was often over 1.5%, whereas, since 1970, it has never exceeded 1.3%. The 1970s have seen two peaks in growth, in 1971 and 1976, but these were followed by declines. Completions, the main influence on the housing stock, have been at a much lower rate in the 1970s than the 1960s, with peaks in 1970–71 and 1975–76. They fell to their lowest level since the war in 1981, though a small recovery in starts has occurred this year.

The determinants of new building are imperfectly understood. Most econometric models of housing emphasise costs (labour, materials and interest rates) and the level of house prices (as an indicator of demand and profits). All of these have moved sharply against builders in recent years, 'explaining' the slump in building. Mortgage lending is not used to determine housebuilding in these models, except in so far as it affects price increases.

Chart 4
Changes in the housing stock



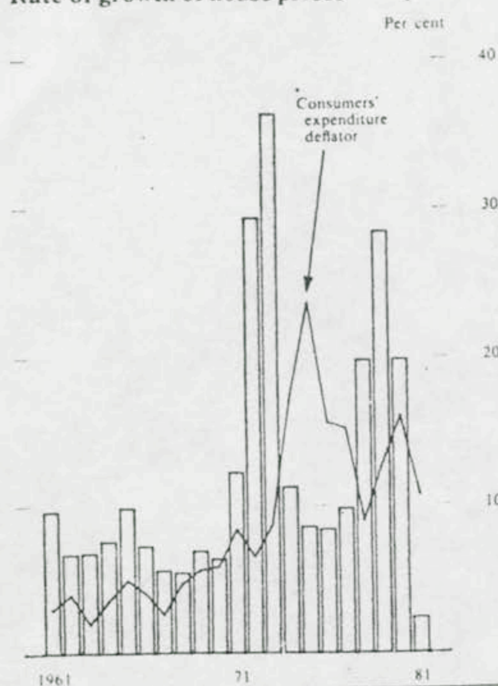
(a) Conversions, transfers from the rented sector *less* demolitions.
(b) Including new towns.

The demand for housing, and house prices

The long-lived nature of the housing stock, and the slowness with which it can change, suggest that any increase in the demand for owner-occupied housing will be reflected, initially at least, principally in higher house prices, and to a lesser extent in net conversions of existing property and transfers from the public and private rented sectors. The underlying demand for all housing (including rented) is likely to depend on the number of actual (and potential) households and on social trends affecting the size and quality of housing wanted. Furthermore, movements in

(1) These additions, and council house sales, add to demand as well as supply, but by a lesser amount.
(2) The other sources of supply referred to in the text have not until recently been very important—see Chart 4.

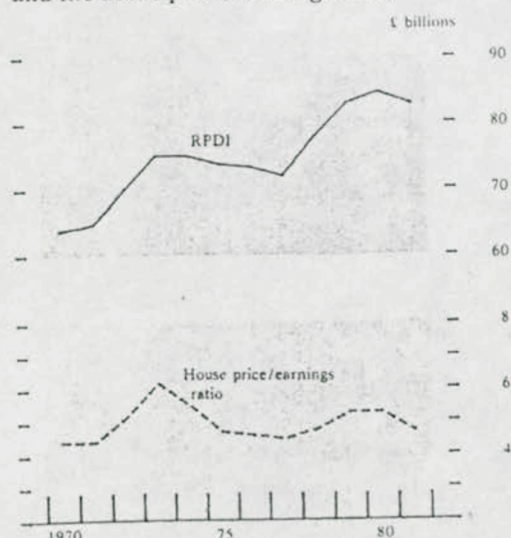
Chart 5
Rate of growth of house prices



real incomes, real house prices and mortgage rates may be influential in producing fluctuations particularly in demand for owner-occupied housing, since prospective buyers can generally advance or postpone their purchase—by continuing to live with parents, for example: incomes are also important because maximum loans are an infrequently-changed multiple of the borrower's income.

The gap between post-tax mortgage rates and the rate of increase of house prices indicates the financial gain to be made from borrowing to buy housing; but when interest rates are high, the proportion of income devoted to debt service may be so high as to choke off demand for mortgages to buy housing, even if rates are still negative

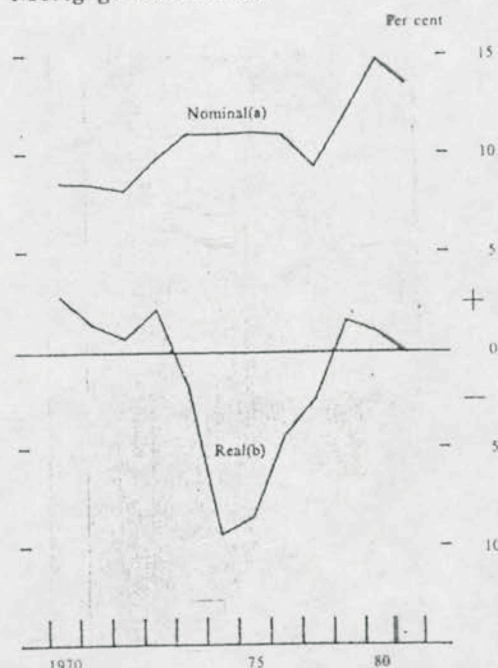
Chart 6
Real personal disposable income (RPDI) and the house price/earnings ratio[a]



(a) The average price of new dwellings on which building society mortgages were approved divided by average earnings.

in real terms. When mortgages are freely available at a market-clearing price, house prices will be determined by the interplay of a demand, determined by all these factors, and a supply of housing that is largely—in the short term—fixed. The amount of mortgage lending was an important additional explanatory factor during the period of rationing, since demand was only effective to the extent that funds were available to those wishing to buy for the first time, or to trade-up.

Chart 7
Mortgage interest rates



(a) The building societies recommended rate.
(b) The nominal rate *minus* the average rate of consumer price inflation over the previous two years.

Experience of the seventies

The experience of the seventies illustrates some of these influences. In 1970, house prices were at their lowest level in relation to average earnings since 1963. However, in the same year, real personal disposable income (RPDI) began to grow steeply following several years of stagnation (Chart 6). It continued to rise until 1973, increasing the demand for house ownership, and hence for mortgages, especially since it was accompanied by a large increase in potential first-time buyers resulting from the post-war 'baby boom' (Chart 8). The value of the stock of mortgages rose by 32% more than consumer prices over this period, and was largely financed by an increase in building society inflows. Initially, the stock of new houses for sale was large and house prices rose only slightly (Chart 5). But, by the end of 1971, the annual rate of increase of house prices had risen to 16%, as the stock of unsold new houses ran down; and an announcement of increased local authority rents raised demand further. Moreover, the cut in the mortgage rate to 8% early in 1972 stimulated demand further, and real rates fell fast from 1973 (Chart 7). Large rises in RPDI during 1972 and 1973 (15% in all) also helped to encourage demand (Chart 6). The increase in housing loans peaked in the second quarter of 1972, and fell until 1974, as interest

rates [illegible]; but the slowdown in lending had little early effect in restraining house prices. These accelerated to an annual rate of growth of 48% early in 1973 in a market largely determined by speculative purchases.

In the second phase, 1974–77, mortgage rates were high in nominal terms and RPDI was stagnant. This produced only slow rises in house prices, of around 7% per annum, far below the general rate of inflation.

In 1977, a further turning point was reached. RPDI again started to increase, and the number of building society commitments rose to almost 800,000; this was possible because of the sharp increase in real inflows into the building societies of the previous two years. Over the year, the market was able to absorb the demand, but, by the end, house prices began to look low in relation to earnings. At the same time, the interest rate, fell in stages from 12¼% to 8½% by January 1978. The continuing rise of RPDI in 1978 and 1979, and the rundown of the stock of unsold new and secondhand houses built up in the previous three years, combined to produce a rise in house prices of 28% in 1979.

New building society lending was reduced in 1978, following a government request, but effective demand for housing continued at a high level. The rate of price increase slowed with the recession of 1980–81, with both nominal and real[1] mortgage rates high, and RPDI flat. This stagnation has continued to date, despite the growth in lending and slump in completions discussed above. However, in both previous episodes, rapid increases in house prices followed the growth of lending with a lag.

The experience of the early 1970s when a sharp rise in house prices was followed by a sharp rise in inflation might suggest a link, with house prices being a leading indicator of more general inflation. Thus, higher house prices might increase perceived wealth and lead to excess demand for goods; at high levels of activity this might lead to 'demand-pull' inflation. Alternatively, rising house prices and a buoyant labour market might raise wage claims and produce 'cost-push' inflation. If so, it is relevant to consider whether the recent rise in mortgage lending may have implications for house prices and inflation.

Prospects for house prices

Econometric models attempting to explain house prices with parameters based on the experience of the seventies, assign an important role to the real stock of mortgages. This is used as an indicator of whether underlying demand is allowed to become effective, as well as giving some weight to the more fundamental factors discussed above. If these models, were used to forecast house prices now, they would suggest large rises, stemming principally from the recent substantial rise in the real mortgage stock. The failure of house prices to show much movement in recent months, despite high lending, may be consistent with the experience of the seventies; a substantial backlog of houses remaining unsold during the period of falling real house prices may yet have to be cleared.

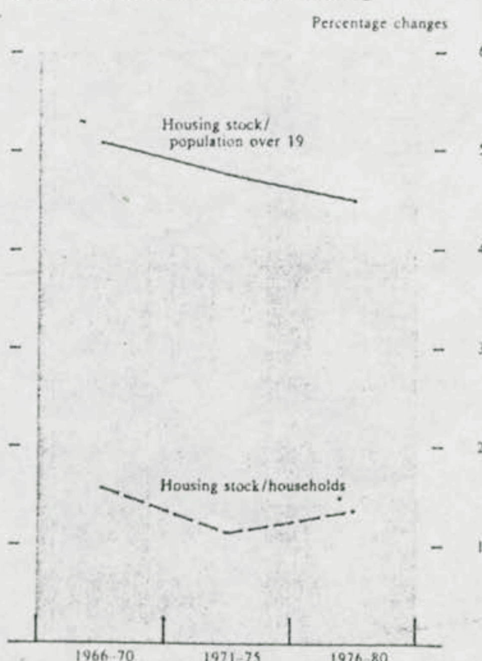
Although recent experience does not yet give cause clearly to reject the relationships which predict substantial rises in house prices, a number of modifying factors need to be considered. One is that most forecasts for the United Kingdom suggest that no sustained rise in RPDI is in prospect. Both of the house price booms of the last decade were accompanied by very substantial rises in RPDI (Chart 6). The econometric relationships estimated over the seventies may thus have difficulty in separating adequately the effects of RPDI and real lending. Continuing high levels of unemployment may dampen demand for trading-up, and by increasing uncertainty about future incomes, make people more reluctant to borrow. In addition, about 100,000 council houses were transferred into owner-occupation in 1981, adding about 1% to the stock of owner-occupied housing, while increasing demand for houses to own by rather less. On the other hand, the total housing stock has not grown so fast in the seventies as the sixties (Chart 4), and its rate of growth has fallen relative to the growth of the adult population, and to a lesser extent, the number of households (Chart 8).

Attractions of mortgage finance

Tax relief on mortgage interest offers a significant incentive to individuals to use mortgage finance when buying a dwelling. In particular, interest on housing loans up to £25,000 is subject to income tax relief, and the treatment of houses for capital gains tax has been particularly generous. However, the limit for tax relief on interest has not been indexed, and has fallen in real value significantly over the years. The introduction this year of indexation of capital gains tax on all assets means that housing is no longer a uniquely advantaged asset.

These changes may reduce the relative attractiveness of housing as an asset. (But in practice, most house-owners,

Chart 8
Indicators of demand for housing



(1) Allowing for current consumer price inflation. See Chart 7.

[in]cluding first time buyers, have home loans of less than £25,000. The average loan by building societies in the first quarter of 1982 was £15,385, or 1.68 times borrowers' average income, so most interest on housing loans is still fully tax-deductible.)

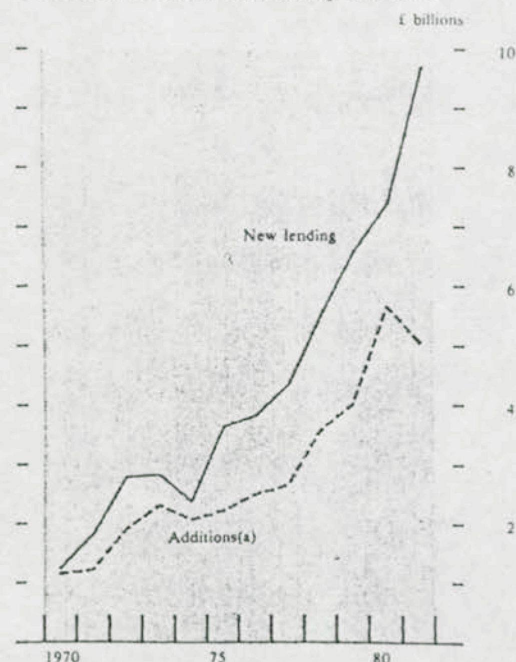
Another attraction of housing as an investment good has been its value as a hedge against inflation. The increase in house prices between 1970 and 1981 was 440%, compared with a 280% rise in consumer prices. However, recently, house prices have risen more slowly than consumer prices (Chart 5); this trend, if continued, should reduce such demand for housing. And falling inflation and high interest rates now being experienced have provided positive real returns on other assets, including most recently some liquid assets. Furthermore, the indexation of some gilt-edged stocks and national savings instruments provides some investments with a guaranteed real return.

The use of mortgage funds

The most important recent development has probably been the removal of rationing, which may have allowed borrowers to restore their gearing (ratio of debt to assets) towards desired levels, without necessarily raising demand for housing. The rise in mortgage lending may therefore reflect principally a demand for assets other than houses, or to maintain consumption.

Not all of mortgage lending is used to finance additions or improvements to the housing stock. If all 10,000 or so houses completed monthly for sale to the private sector were purchased at the average house price on a 100% mortgage, only about £300 million of new lending would be required. Since most completions are thought to be at the cheaper end of the market, little more than a third of total net lending can be for new houses. Council house sales also need to be financed, and more have been financed through banks and building societies than might have been expected. (The lower-than-expected lending by councils is one reason for the public sector borrowing requirement undershoot in 1981/82.) But this, and some small transfer of formerly rented property, could account for only another 10%–15% of new lending. Home improvements could account for a further substantial element. Nevertheless it seems certain that a sizable amount of new lending has gone indirectly to finance spending on goods or other real or financial assets, rather than additions or improvements to the owner-occupied housing stock (Chart 9 shows an estimate of this flow, including borrowing to finance improvements).

Chart 9
New lending and the estimated value of additions to the owner-occupied stock



(a) Calculated by multiplying the number of houses entering the owner-occupied stock (as in Chart 4) by average house prices.

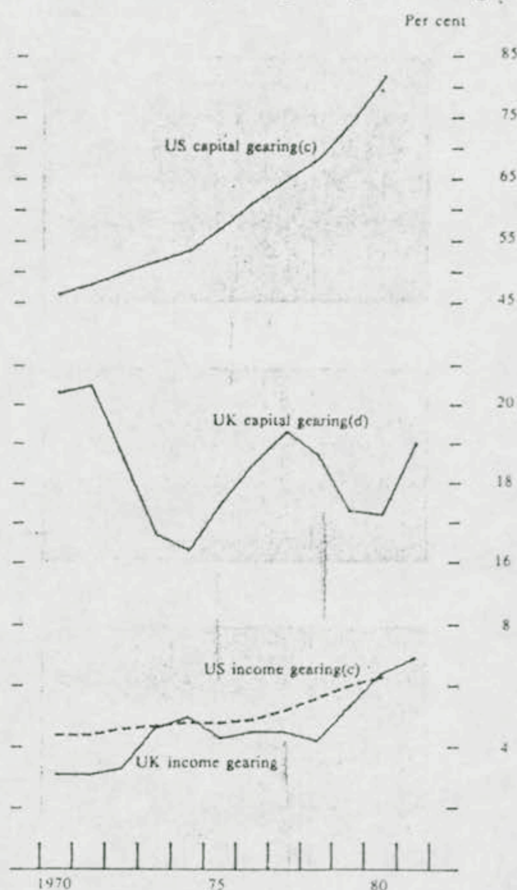
In fact this is inevitable; every chain in the secondhand housing market has an end: the final house comes onto the market because its owner-occupier has died, or ceased to own his house for other reasons, or because it is put on the market by its landlord after the tenant has left. The final seller will end up with cash equivalent to all the increases in mortgage lending granted to members of the chain, *plus* any equity they have injected, *minus* professional fees and taxes caused by purchases in the chain, and *less* any equity that members of the chain have converted into cash. The rapid growth in owner-occupation of a generation ago may suggest that more people are now ceasing to be house-owners—from death or other causes— than in the past. But the number of households continues to grow, perhaps partly because elderly people are now less likely to move to live with their children than in the past, although the net effect is small.

Apart from these withdrawals of equity it is possible that unemployment has persuaded some to trade down and use the cash realised to support their living standards in other ways. Cash will also add to consumption, if mortgages are used to finance estate agents' and solicitors' fees, repairs and maintenance to houses purchased, and new fixtures and fittings purchased at the time of moving. There may have been some increase in the number of formerly rented houses sold over the period and the proceeds invested in other assets or used for consumption. And schemes aimed to help the elderly to purchase annuities with the equity in their house may also have absorbed a small part of higher mortgage lending. It must be presumed that a substantial part of net mortgage lending has gone to sustain spending, repay other debt, or increase holdings of financial assets through these routes.

The destination of these mortgage flows cannot be measured at all precisely because most of the information collected about house purchase transactions, for example, through the Building Society Mortgage Survey, is about purchasers and not sellers. But the Department of the Environment's estimates of the sources from which second-hand houses come onto the market[1] suggest

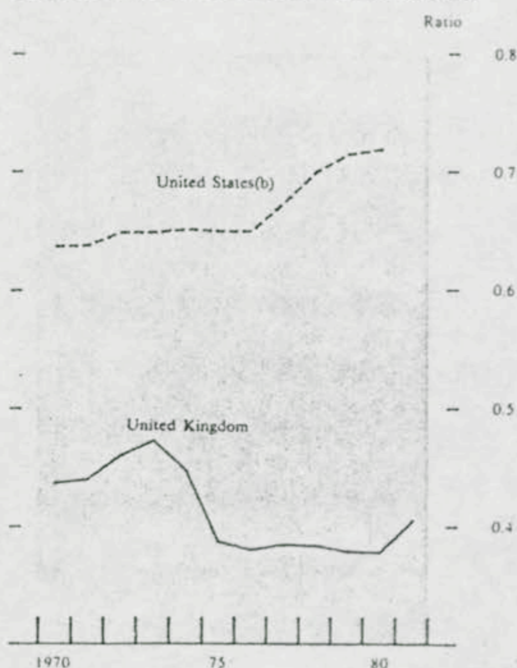
(1) Published in the *Housing Policy* Technical Volume, Chapter 3, Table III 10.

Chart 10
Income[(a)] and capital[(b)] gearing in housing



(a) Interest payments divided by personal income.
(b) Outstanding mortgage loans divided by the value of the housing stock.
(c) Household sector. Data unavailable for 1981.
(d) Bank estimate for 1981.

Chart 11
Debt income ratios for the personal sector[(a)]



(a) Total liabilities divided by gross personal income.
(b) Household sector. Data for 1981 not available.

strongly that sales by the estates of deceased owner-occupiers, and by owner-occupiers moving to other tenures or ceasing to be householders, accounted for the largest part of the money leaving the housing market. Lending on houses for purposes other than house purchase (mainly home improvement) has risen considerably.

Gearing in the housing market

The readier availability of funds in the mortgage market has relaxed a frequently binding constraint on personal financial behaviour. There is no obvious reason why individuals should not respond by increasing their capital gearing in housing (raising mortgage lending as a proportion of house values); particularly as tax concessions still provide an incentive for most home owners to do more borrowing in this way. Trading-up, financed entirely by an increased mortgage, will achieve this: but as noted above, some indirect drain of mortgage funds from the housing market inevitably occurs in this process particularly if trading up is matched by others trading down. Concern about the possibility of direct withdrawal of equity from housing by borrowers obtaining more finance than required for house purchase, and its possible implications for credit and monetary aggregates, prompted a request to mortgage lenders by the Bank of England and the Treasury in January 1982 to limit this possibility.

The capital gearing associated with housing—mortgage loans outstanding divided by the value of the owner-occupied housing stock—fell from almost 22% in 1969 to 20% in 1970, and to around 17% in 1980 (Chart 10). Most of the fall occurred during the early seventies, with the sharp rise in the real price of houses. In 1981 gearing recovered to 19%, but there would seem to be scope for further rises on this account. Estimates for the United States are also shown on Chart 10: during the seventies capital gearing there rose very sharply as borrowers took advantage of their houses to secure their borrowing, in a much freer mortgage market. This may owe something to the fixed interest rates at which many US mortgages have been advanced, when interest rates may have been expected to rise with inflation. (Also anti-usury laws have set a ceiling on interest rates.)

It is possible that the US experience represents a switch, not yet paralleled in the United Kingdom, from unsecured borrowing to borrowing on mortgage. Chart 11 goes some way to confirming this, in that the ratio of all personal sector liabilities to personal income has risen less strongly for the United States, and has fallen less for the United Kingdom up to 1980 than capital gearing on houses alone.

One factor which may constrain borrowing is the level of income gearing (the ratio of debt interest to personal income). Although inflation may act to reduce the burden of repayment in later years, high interest rates with a conventional mortgage impose a heavy front-end burden on borrowers. A summary measure of income gearing for the personal sector is shown in Chart 10, and has risen during the last decade. But this measure includes other interest

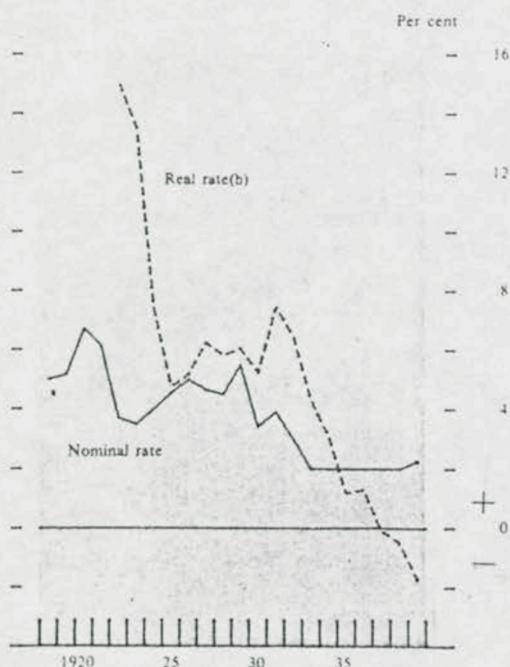
payments besides those on mortgages, and adds together borrowers with new and old mortgages; it thus understates the deterrent effects of the large share (20%) of average income pre-empted to service an average new mortgage in the first year of the contract. A relaxation of the income gearing constraint could come from the wider availability and greater take-up of low-start mortgages.

The consequences of innovation

It has been argued that the banks' substantial and probably permanent move into the housing market represents a considerable financial innovation. A rather similar change took place in Britain in the early 1930s, when building societies became much less restrictive in the proportion of the purchase price and the period over which they would lend: and, more important, in their attitude to lending to those with low incomes. Previously, low income borrowers had been unable to accumulate a sufficiently large deposit, or finance borrowing over the short terms available.

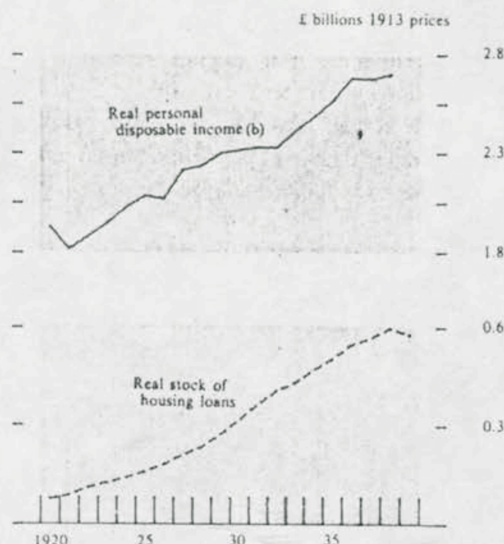
These changes in building societies' practices owed much to the availability of deposits from investors discouraged by profitability prospects for real capital; and to a reduction in the uncertainty which the sharp contraction of activity and price falls of 1930–32, had brought about. They relaxed an effective constraint for many potential home-owners. As Matthews[1] puts it, this amounted to 'an additional factor—a financial innovation—separate from the purely monetary fall in interest rates'.

Chart 12
Bank rate[a]



(a) See footnote (4).
(b) Bank of England Bank rate minus the average rate of consumer price inflation over the previous two years.

Chart 13
Real incomes and housing loans[a]



(a) See footnote (4).
(b) Data for 1939 not available.

The fall in nominal interest rates from 1931, followed by falls in real rates as prices started to rise again in later years, was substantial, and also influential (Chart 12). It enhanced borrowers' ability to fund mortgages, and directly reduced speculative builders' costs. In addition, several other factors favoured a rise in house building. Demand for houses had built up since, and as a consequence of low levels of building during the war; the number of families increased;[2] migration occurred from the more depressed areas to the South and Midlands; and local authorities took a larger share of house completions during the twenties. From 1932, RPDI grew sharply, after stagnating since 1928 (Chart 13).

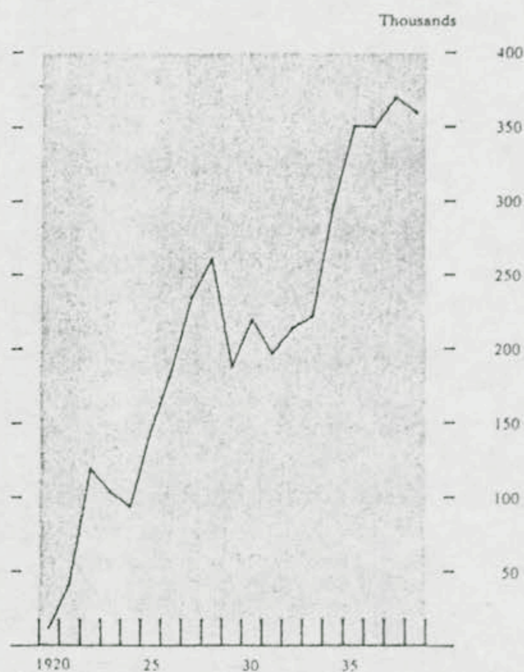
The result was a sharp rise in private completions from 1932 (Chart 14)[3] financed largely by mortgage borrowing. Although little evidence is available, house prices did not appear to rise during the building boom. Improved transport and absence of planning controls in the thirties meant that land for building was in very elastic supply: and building costs actually fell, under the influence of higher productivity, until early in 1935. The outcome was a house building boom which was an important—though far from the only—element in the recovery of the middle thirties, accounting directly for an extra 300,000 jobs between 1932 and 1937.

Although there are some similarities between financial innovation in the thirties and today it seems unlikely that a revival in housebuilding on the scale that took place then will recur. Several of the features of the thirties are lacking today. Interest rates have fallen in nominal terms, but remain high in real terms by the standards of the seventies. Real incomes are not rising strongly, and building land is in rather inelastic supply. The housing stock is high in

(1) R C O Matthews, 'The Trade Cycle' (1959) Page 111. *The Cambridge Economic Handbooks.*
(2) This had grown by 30% in the ten years from 1921 in London and the South East, for example.
(3) Chart 14 shows all completions, since private completions can only be estimated rather imprecisely.
(4) Data sources for Charts 12 and 13: see D K Sheppard, *The growth and role of UK financial institutions 1880–1962* Methuen & Co Ltd 1971, and C H Feinstein, *Statistical tables of national income expenditure and output of the UK 1855–1965,* Cambridge University Press, 1976.

comparison to the population over nineteen[1] by recent standards, after some years of rapid growth in the sixties; and migration of population within the United Kingdom is not occurring on the scale of the thirties. Recent demographic trends which imply more rapid growth of the adult population in the next decade, and the slowdown in building, may presage a degree of pent-up demand in future years, but do not seem to be influential as yet.

Chart 14
Total housing completions



(1) Other indicators of pressure on housing are either themselves influenced by economic conditions, or unreliable for other reasons.

JOINT TAXATION COMMITTEE

of

National Federation of Building Trades Employers
Federation of Civil Engineering Contractors
Committee of Associations of Specialist Engineering Contractors
Export Group for the Constructional Industries

Please reply to : 82 New Cavendish Street, London W1M 8AD Telephone 01-580 5588

(23)

DWT/JRS/FK

20th December 1982

The Rt.Hon.Sir Geoffrey Howe M.P., P.C.,
Chancellor of the Exchequer,
H.M.Treasury,
Treasury Chambers,
Whitehall, London S.W.1.

Dear Chancellor,

I am pleased to submit our 1983 Budget Memorandum on behalf of the four major construction organisations who are represented on the Joint Taxation Committee. Our Committee brings together all the major interests on the employers' side of the construction industry, covering building and civil engineering and the various ranges of specialist contract work both at home and overseas.

These recommendations have a direct relevance to your Government's economic policy objectives and do not call for a reversal of the Government's overall strategy. Our proposals will encourage both increased public investment in essential national infrastructure and a major contribution next year from the private sector. Our aim has been to concentrate upon measures to promote greater domestic output and to avoid stimulating any further import penetration.

We deal in this Memorandum with both public expenditure and tax recommendations. Some restoration of public capital investment to proper levels is now widely accepted as an over-riding pre-requisite for the regeneration of the productive economy. This objective holds a high priority in our overall representations.

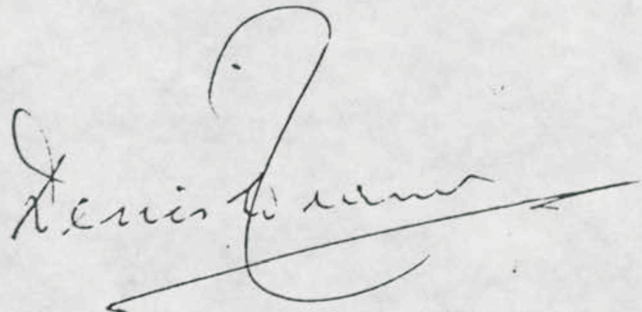
The civil engineering sector in particular wished me to stress that they would not wish tax reductions to be pursued at the expense of proper capital investment. They further feel that recent examples of under-spending on budgets in this respect demonstrates the inefficiency of trying to operate these long-term investments on an annual basis. Accordingly, we hope that you will find means to fund the infrastructure programme on a longer term rolling basis with provision for adequate carry-over from one year to the next.

The Rt.Hon. Sir Geoffrey Howe M.P., P.C. 20th December 1982

Our tax recommendations are also closely geared to your own specific economic priorities, and I do think that it would be most opportune for either yourself or one of your Ministers to meet with myself and senior members of the Committee to discuss these proposals and the benefits which they would create, not simply for our industry, but for the economy.

We would greatly appreciate the opportunity of explaining to you personally the importance of the recommendations we are making in the attached Memorandum, and why we regard them as particularly crucial in the forthcoming financial year.

Yours sincerely,



D.W.Turner
Chairman

DWT/FK

JOINT TAXATION COMMITTEE

of

National Federation of Building Trades Employers
Federation of Civil Engineering Contractors
Committee of Associations of Specialist Engineering Contractors
Export Group for the Constructional Industries

MEMORANDUM TO THE

CHANCELLOR OF THE EXCHEQUER

BUDGET 1983

PART I .... ECONOMIC INTRODUCTION (pages 1 - 3)

PART II .... TAXATION RECOMMENDATIONS (pages 4 - 8)

PART I - ECONOMIC INTRODUCTION

1. The economic introduction to our Budget Memorandum this year starts from the new climate which has been created by the **Prime Minister's initiative** this autumn to give greater priority and political momentum to the construction investment programme. Notwithstanding our specific comments below on the Government's recent **"capital underspend"** announcements, we welcome the clear, explicit recognition now being given by the Government to the **exceptionally depressed** state of our industry and to its overwhelming **economic importance.**

2. This memorandum will therefore move on from an analysis of the likely impact of these latest Government construction measures to highlight the dangers next year of **import penetration** and to set out why and how further encouragement to construction is critical to forestall this threat to the Government's economic strategy.

3. Before specifying in Part II the individual taxation recommendations which the Federations believe would help the industry and the economy, this economic introduction will close with a review of how **cost-effective** the implementation of a construction tax and expenditure package in the Budget would be to achieving sustained, non-inflationary growth.

PRIME MINISTER'S INITIATIVE

4. The Prime Minister's response to the representations made at her meeting in mid-October with the combined construction industry "Group of Eight" was prompt and welcome. She has now written to the local authority associations to encourage them to ensure that much more of their available resources are used for construction investment. Her strong public commitment to reducing the scale of capital underspend has been followed by several announcements during October and November, from the Chancellor of the Exchequer, the Secretary of State for the Environment and the Minister for Housing and Construction, of measures aimed both at easing the path towards extra construction expenditure in this financial year 1982/83 and at boosting the capital allocations for the next financial year 1983/84.

5. The substantial political weight and publicity given to these announcements demonstrate beyond doubt not only how serious has the construction industry's depressed workload become but also how important is the role now allocated to construction investment in promoting any kind of sustainable economic recovery. In our Budget Memorandum last year we drew attention to the precipitate decline in construction output and to the lack of any convincing evidence, despite Government optimism, that a significant recovery was in prospect. That analysis has been fully justified by developments in the past year and the Government's latest initiatives only emphasise how stagnant is the present outlook for construction. Down 20% on the position three years ago and with a virtually flat trend in overall new orders for the past eighteen months, the industry must now be accepted by all sides to be lodged in its deepest and longest post-war recession.

TIMING

6. These construction initiatives are particularly welcome for their emphasis upon the benefits of public investment in construction and for their clear recognition of the distinction between curbing current public expenditure and improving the amount of resources devoted to the capital account. Capital investment as a proportion of total public expenditure has been halved in the past seven years to less than 10%. This damaging trend has been followed by successive Governments and must be reversed. The Federations themselves have been highlighting the urgent need for such action in our last three Budget Memoranda and it is regretted that these sensible moves were not made by the Government at a considerably earlier stage. Nevertheless, the Federations have responded positively to the Government's latest measures in the hopes that they will help to get some extra construction work moving. We have also identified a number of financial and procedural obstacles which may make it more difficult than originally envisaged to obtain a substantial take-up of the capital underspend in this financial year.

7. These latest measures may therefore be less favourable for firms' prospects this side of the Budget itself than the Government had hoped. The reductions in National Insurance Surcharge will, by contrast, have an early, beneficial impact upon construction companies and this has been widely welcomed throughout all industries. Yet this alone will not be sufficient to alleviate the industry's very high unemployment problem and to reverse the exceptional decline in building recruitment and apprentice intakes which has occurred during the past year and which holds such damaging consequences for the nation's future building performance. More substantive measures both before and in the Budget to encourage greater construction investment will be required.

IMPORT PENETRATION

8. The Chancellor's Autumn Economic Statement also contained the alarming forecast that whilst Gross Domestic Product would only rise by 1½% in 1983, consumers expenditure would rise by 2½% and imports by 5%. These figures illustrate the dangerous tendency for marginal changes in personal post-tax incomes to leak disproportionately into imports, especially of finished manufactured goods. This remains probably the single most serious threat to the success of the Government's economic strategy in 1983 and it must pay the Government to encourage any sector whose growth can encourage domestic supply rather than imports.

9. Thus it is not only for the strength of the construction industry itself but also for the health of the domestic economy that the Federations put forward more strongly than ever the priority claims of construction investment to the benefits from any room for manoeuvre which the Chancellor may have in the next Budget judgement. For whilst imports account for around one-fifth of the materials used in construction, this is a far lower proportion than is the case for most of the goods on which people tend to spend their post-tax income increases. If one calculates the import content out of the whole construction process (ie. including labour, plant and materials), its proportion falls to below 10%. Furthermore, some of the more urgently and obviously required areas for increased investment, such as sewer renewal and replacement, not only are highly labour-intensive but also have a substantially lower import usage than even the average figure of just under 10% for the construction industry as a whole.

10. In addition, the Chancellor's Economic Forecast referred to the key role that would be played in next year's recovery by the response of private investment, especially in housing, to the fall in interest rates. The Government's rightful concern with stemming the rise in unemployment must also reinforce this importance of construction investment, since repeated studies have demonstrated - and the Chancellor himself recognised in last Budget statement - that this industry is the most effective generator of real new jobs in the economy. With so much expected from this sector and with so little clear evidence so far that interest rates alone are sufficient to generate a significant investment response, it is all the more important that the Chancellor should use the opportunity of the Budget to smooth the path wherever possible for increased construction investment. This means not only extra direct capital expenditure but also an approach towards the encouragement of privately funded construction initiatives which will be additional to existing public programmes rather than simply replacing previously planned public projects.

CONSTRUCTION TAX PACKAGE

11. In the second section of this Memorandum, the details of the Federations' proposals for encouraging housing investment through mortgage tax relief and stamp duty amendments, as well as for encouraging business investment through better first-year depreciation allowances, will be set out. The total tax expenditure cost of those specific "construction tax package" measures would be no greater than £500m in a full year. Within a Budget judgement that could envisage room for between £2,000m and £3,000m fiscal adjustments, these are modest measures to encourage domestic output and investment compared with the much higher costs of across-the-board personal tax reductions for which the domestic output, as opposed to import benefits are highly dubious.

PART II - TAXATION RECOMMENDATIONS

1. BETTER CAPITAL ALLOWANCES FOR BUILDINGS:

1.1 We strongly recommend that a new special 100% capital allowance should be introduced as part of the Government's urban renewal programme, specifically to encourage the refurbishment, reconstruction or conversion of existing commercial or industrial buildings for re-use. Throughout the UK, there are many empty and disused factories, mills, warehouses and offices etc in towns and inner cities which could be adapted and put to use, so creating more badly needed permanent jobs as well as extra work for the construction industry. We believe that an imaginative approach along these lines would serve as a particularly valuable stimulus to economic regeneration in localities adjacent to Enterprise Zones.

1.2 Industrial Buildings Allowance:

We would again ask that consideration should be given to raising the IBA rate from its present level of 75% closer to the level of the full 100% allowance given for plant and machinery. We also recommend that the IBA arrangements should be improved in the following three respects:-

- the permissible office content of an industrial building for IBA purposes is unrealistically low and outdated, particularly in relation to new high technology industries; it should be increased from 1/10th to 3/10ths of the total construction cost;

- the definition of "industrial building" should be widened to include all buildings falling within Classes III to X of the Town and Country Planning Act 1971. In addition to increasing the categories of buildings that would qualify, this would have a twofold administrative advantage: it would simplify the procedures for verifying whether or not a building qualifies for IBA, and also enable this to be determined in advance with certainty;

- in the rule governing the transferability of IBA by the landlord of an industrial building to his tenant, the definition of "long lease" needs amendment: the requirement that the lease must be for a term exceeding 50 years is seen as unnecessarily restrictive and out of touch with normal commercial practice; we urge that the qualifying period should be reduced to one of 25 years or over.

1.3 Commercial Buildings:

1.3.1 In our view, there is an overwhelming case for the introduction of an allowance for commercial buildings. For many years past, successive Governments have acknowledged that the existing tax discrimination against commercial buildings is unjustified and anomalous, and we greatly hope the Chancellor will finally "unlock the door" in the forthcoming Budget.

1.3.2 Ideally, we should like to see an annual allowance of 2% for all commercial buildings. But we appreciate that this could be very costly to the Exchequer, and accordingly suggest that as a first step, entitlement to the allowance should be restricted to capital expenditure on new commercial buildings incurred after Budget day.

MORTGAGE TAX RELIEF

2.1 We most strongly urge that the existing £25,000 limit for tax relief on mortgage interest should be raised to at least £35,000 in the 1983 Budget, and that it should be indexed for future years.

2.2 This Government has always given high priority to the expansion of home ownership, and we were naturally heartened by the Prime Minister's recent assurance that the Government has no intention of abolishing mortgage interest relief. Certainly MIR has been an essential factor in enabling over 50% of households in the UK to become owner-occupiers, and it is vital that the real value of this assistance be protected against the constant erosion of inflation.

2.3 We must emphasise that the construction of new houses, which creates new jobs and adds to the nation's housing stock, is being hampered by the present £25,000 limit. During the 8 year period since it was first introduced by a Labour Government, there has been a 130% rise in average house prices, while the average mortgage loan (as recorded in Building Society Association figures) has risen from around £7,000 to approximately £17,000.

2.4 We wish to point out that in those parts of the UK where economic recovery is likely to begin most strongly - namely London and the South East, which together constitute almost a third of the housing market - house prices are higher than elsewhere, and increasing numbers of first-purchasers and existing owner-occupiers are finding that their mortgage exceeds the £25,000 limit. In London the average loan on new houses is now over £23,000 for first-purchasers and £26,000 for owner-occupiers; in the rest of the South East, the comparable figures are £20,000 and £21,000.

2.5 In short, the problem is already acute, and action must be taken by the Chancellor to raise the MIR limit, so as to enable the private housebuilding industry to respond to the more favourable demand conditions expected in 1983 and increase its output, with minimum adverse consequences for inflation and imports. We would add that in our view, failure to raise the limit would also seriously jeopardise the Government's welcome plan to achieve a reduction of 1,000 tax officials' jobs through the proposed change next April in the administrative arrangements for giving mortgage tax relief.

3. STAMP DUTY ON HOUSE-PURCHASE

3.1 While we applaud the action which the Chancellor took in the 1982 Budget to ease the Stamp Duty burden, we should nevertheless like to see still further progress towards taking most house-purchase transactions out of the Stamp Duty net.

3.2 The present Government has raised the stamp duty thresholds twice since 1979. This has undoubtedly removed a very damaging impediment across a substantial part of the housing market, especially for first-purchasers. However, just as the £25,000 mortgage tax relief limit imposes an increasingly harmful distortion on the housing market in London and the South East, so also the present £25,000 stamp duty lower limit places a substantial burden on first-purchasers and owner-occupiers in those areas where average house prices are above £25,000. In London and the South East, average prices are over £30,000. In the South West, the average is over £25,000. For the United Kingdom as a whole, the average is now over £26,000. This means that more than half of all house purchasers must still pay stamp duty, as against a very small percentage as recently as the mid-1970's.

3.3 We therefore recommend that the present exemption from ad valorem stamp duty should be raised by £10,000 to £35,000 - at least for purchases by individuals of private dwelling accomodation.

3.4 We also recommend that the "slab system" of assessment should be abolished and replaced by a "slice system" - once again at least for purchases by individuals of private dwelling accomodation. A simplified version of the slice system, which we would support, would be a charge at a single flat rate of 2% on the excess over the proposed £35,000 exemption limit.

4. VALUE ADDED TAX

4.1 We were most concerned that the overall effect of the proposed VAT changes regarding building alteration work which the Chancellor outlined in his March 1982 Budget speech (but which have since been deferred as a result of certain litigation now before the Courts) would have been to impose an even heavier VAT burden on this industry than hitherto. We cannot emphasise too strongly that we are looking to the Government for measures which will alleviate the impact of VAT on the industry and help its economic recovery.

4.2 We would particularly urge that consideration should be given to the removal of VAT from building repairs and maintenance - a move that would benefit many millions of private householders and also curb the very serious problem of the Black Economy in this sector of the construction market by helping to reduce the present unfair distortion of competition against bona fide VAT-registered builders. According to official estimates, the cost of extending zero-rating relief to repair and maintenance work carried out by VAT-registered building firms would be about £150 million a year (Hansard - 15 June 1982). Such a VAT change would achieve a clearly defined social purpose and be of direct benefit to the ultimate consumer.

4.3 We also recommend that the existing zero-rating concession for supplies of reconstructed buildings (as described in paragraph 20 of Customs' Public Notice No 708) should be put onto a statutory basis, in order to remove the legal uncertainty stemming from a recent VAT Appeal Tribunal decision (in the case of David Wickens Properties Ltd -v- Customs & Excise).

4.4 The scope of the present scheme for giving relief from VAT on bad debts is too narrow and urgently requires revision; the requirement that the debtor must be formally insolvent should be abolished.

5. NATIONAL INSURANCE SURCHARGE:-

5.1 The Federations warmly welcome the proposed measures which the Chancellor announced in his November 1982 Statement to reduce the existing NIS burden on employers. The promised 1% cut in the NIS rate from next April down to 1½% is certainly a helpful and encouraging step in the right direction; and we are very glad to note that employers will be getting some interim relief next February.

5.2 Whilst in principle we wish to see NIS abolished completely, we recognise that this would be costly to the Exchequer. A significant proportion of our members, particularly in the Civil Engineering Industry attach much greater priority to the need for capital investment, particularly in the National infrastructure, which is a basic essential to the efficiency and competitiveness of all manufacturing industry.

6. DEVELOPMENT LAND TAX

The Government has introduced a series of changes which have mitig d the worst effects of DLT; in spite of this we feel that fundamental objections remain which can only be eliminated by the complete abolition of this tax. It is an inordinately bureaucratic statute to operate, particularly the deemed disposal mechanism, with high administrative costs and a relatively low yield to the Exchequer. Repeal of the Act will give rise to considerable manpower savings.

7. STOCK RELIEF AND CONSTRUCTION - Treatment of Houses Taken in "Part Exchange" by Private Housebuilders

7.1 The construction industry is subject to a special constraint in that "land" (including buildings) which forms part of a firm's trading stock - eg. a housebuilder's land bank - does not count for relief unless of a type ordinarily sold only after a process of development.

7.2 This condition was apparently intended to exclude relief claims by mere speculators who buy and re-sell properties in an unaltered state: that is a general purpose with which the construction industry need not quarrel. But the actual wording used has the undesirable effect of denying the character of trading stock to a house which a housebuilder takes from a buyer in part-exchange.

7.3 In the present state of the market for middle-range houses, the need for part-exchange schemes to facilitate sales is expected to be a continuing feature, and we ask that for the sake of much-needed stimulation, the general rule referred to should be qualified by making a statutory exception for residential property bought from a customer on the occasion of, and in connection with, the sale to him of property that was trading stock before its sale.

8. CONSORTIUM RELIEF

8.1 A consortium company structure for international collaboration helps overcome overseas taxation difficulties that arise when a joint venture is used as the operating "vehicle".

8.2 It is regrettable, therefore, that the restrictions in the consortium relief rules should prevent potential benefits and reliefs being obtained by the members of a consortium. In practice, this is often the sole reason why UK contractors are constrained to use a joint venture rather than a consortium company. The Minister for Housing and Construction is aware of the difficulties caused when, for UK tax reasons, a joint venture rather than a consortium company is the vehicle negotiating to obtain large interational contracts in new markets particularly where English is not the official language of the country.

We recommend that the law should be amended in three particular aspects, namely:-

8.2.1 The loss which is available for surrender by a consortium company to any of its corporate members should also be capable of surrender to any other company that stands in a group relationship with a member company.

Similarly any loss available for surrender under the normal group relief procedure to a member company should also be capable of surrender to consortium companies.

8.2.2 It should be possible for a consortium claim, within the meaning of Section 263(5) Income and Corporation Taxes Act 1970, and a claim other than a consortium claim to be made in respect of a loss for an accounting period.

We see no reason why it should not be permissible to fully utilise a loss incurred by a company for an accounting period by surrender wholly or partially to any company that stands in a group relationship and wholly or partially to any consortiom company.

8.2.3 . The participation of a non-resident company as a member of a consortium company should not prevent its UK resident corporate members benefiting from their aliquot share of reliefs which would be available if all the members were companies resident in the UK.

9. BENEFITS IN KIND

The statutory definition of "higher-paid employment" for benefits in kind purposes should be amended and simplified. In practice, it not only gives rise to serious anomalies as between individual employees but also imposes a heavy and unnecessary administrative burden on employers. The definition should be amended by excluding all tax deductible expenses from the reckoning of "emoluments" for the purposes of the "higher-paid" threshold.

JCT/JBR/JH
December 1982

THE BUILDING SOCIETIES ASSOCIATION

December 1982

REPRESENTATIONS TO THE CHANCELLOR OF THE EXCHEQUER ON THE 1983 BUDGET BY THE BUILDING SOCIETIES ASSOCIATION

1. Since 1978 the Association has requested Chancellors of the Exchequer to act in respect of two fiscal measures which are not in harmony with the policy of encouraging owner-occupation and which also can have adverse effects on the mobility of labour -

(a) Stamp duty on the purchase of owner-occupied dwellings.
(b) The £25,000 ceiling on loans qualifying for tax relief.

2. The Association was encouraged by the measures contained in the Finance Act 1982 to reduce the impact of stamp duty. In these Budget Representations, the Association renews these requests. The state of the housing market and the general economic recession mean that action in respect of these two points is particularly appropriate. House prices have begun to move upwards, albeit slowly, thus increasing the burden of stamp duty and meaning that the £25,000 ceiling for loans qualifying for tax relief is being further reduced in real terms. Stamp duty and the tax relief ceiling hit hardest at those buying in London and the South East where house prices are considerably higher than the national average. They can also have a particularly adverse effect on first-time buyers and those forced to move house for job reasons.

Stamp Duty

3. The costs of buying a house are considerable. They may include valuation, survey and legal fees and Land Registry charges and, first-time buyers apart, there are the expenses of selling the present house. They will include stamp duty where the price of the house exceeds £25,000. The duty is levied on the whole of the price (not just the excess over £25,000) and is at the rate of ½% where the price is over £25,000 and up to £30,000, 1% where the price is over £30,000 and up to £35,000, 1½% where the price is over £35,000 and up to £40,000 and 2% where the price exceeds £40,000. In many cases, the largest single item of expense will be the stamp duty.

4. The latest figure (October 1982) for the average price of houses mortgaged to building societies is £26,502. The purchaser of this average house would therefore pay £130 in stamp duty. In the third quarter of 1982

about 38% of houses mortgaged to building societies cost in excess of £25,000 and therefore attracted stamp duty. Successive governments have allowed the real value of the stamp duty threshold to fall considerably. In 1974 only 16% of building society borrowers bought houses which were above the stamp duty threshold; now the proportion has reached 38% (If comparative figures for bank lending were available the proportion of all buyers could well be much higher.)

5. National figures tend to mask considerable regional variations. In the third quarter of 1982 the average price of houses mortgaged to building societies in the Greater London area was £30,800 and in the rest of the South East it was £31,000. Thus in these areas the buyer of this average house has to pay over £300 for what is effectively a tax payment when he purchases his home. In the third quarter of 1982 nearly 65% of the houses mortgaged in London to building societies cost in excess of £25,000 and therefore attracted stamp duty.

6. The regional bias in the incidence of stamp duty accentuates the inherent unfairness of this tax on house-buyers. The tax runs counter to the Government's policy of encouraging owner-occupation and, indeed, conflicts with other policy instruments. For example, through the Homeloan scheme the Government offers a bonus to first-time buyers of up to £110 which, in many cases, is immediately returned to the Government in a very modest part payment of stamp duty.

7. The Association again make a strong plea that stamp duty on house purchase be abolished. It is estimated that in 1982/83 this would have cost £290 million. If this is too much to consider, then as an earnest of the Government's commitment to owner-occupation, the Association suggests that the various thresholds be increased substantially.

Tax Relief on Mortgage Interest

8. The Finance Act 1974 set a limit of £25,000 for a house purchase loan for which interest payments were fully eligible for tax relief. No relief is due for interest on the excess of any mortgage loan over £25,000. The legislation specifically provides for the limit to be reviewed annually.

9. The major political parties are agreed that the promotion of owner-occupation is a desirable policy and that tax relief is an essential means to this end. Paragraph 5.30 of the Labour Government's Housing Policy Green Paper, published in 1977, commented -

> "The Government consider that tax relief on mortgage interest - which has a long history as part of the tax structure - and the option mortgage subsidy must form an integral part of their housing policy. The continuance of mortgage tax relief and option mortgage subsidy is vital to the growth of home-ownership."

10. The Labour Government accepted the need to review regularly the £25,000 limit. When the limit was introduced, the Financial Secretary to the Treasury said: "The Government accept that there may be a need from time to time to revise it", and he went on to say: "I accept on behalf of the Government that there is a need to protect people against the problems of inflation." The Minister concluded that "any responsible Government will review a limit of this sort regularly". In a debate on the Finance Bill in the House of Commons on 24 May 1978 the Financial Secretary, Mr Robert Sheldon MP, said: "Of course there will come a time when the increase in house prices will be large enough if inflation continues even at a modest rate, to justify raising the limit."

11. The Conservative party has been equally committed to owner-occupation and to tax relief. In 1978 a Conservative Front Bench spokesman, Mr Nicholas Ridley MP, put down an amendment to the Finance Bill to increase the loan ceiling to £40,000 and he suggested that this was the figure suggested by the change in house prices since 1974. More directly, on 1 March 1979 the then Conservative housing spokesman, Mr Hugh Rossi MP, said: "We must, for example, raise the £25,000 tax relief ceiling on mortgage borrowing, because inflation has overtaken that figure." When asked at a pre-election conference in April 1979, whether a Conservative Government would raise the mortgage relief tax limit, Sir Geoffrey Howe said: "Yes, we are committed to that. The present £25,000 figure should be more like £40,000 at today's prices, but I do not want to commit myself to a figure."

12. Since the £25,000 limit was originally set the retail prices index has increased by 200% and the house price indices by 144%. The limit has, therefore, been more than halved in real terms. The Association considers that it is appropriate for the limit to be restored to nearer its real value in 1974 and suggests a figure of £50,000. However, it is recognised that in taking any such decision the Government must have regard to its other fiscal and social priorities.

13. When it was introduced, the tax relief ceiling affected only a small number of purchasers of very expensive houses. The majority of people who were affected were probably higher rate tax payers and were certainly people at the upper end of the income scale. This is no longer the case. The average house price in London and in the South East is now in excess of £30,000 and indeed the latest figure for the average price throughout the country is in excess of £26,000. In London the average price paid by first-time buyers is above £25,000. Following their normal cyclical pattern, house prices have begun to move upwards again and, although no explosion is expected, a steady increase over the next year or two is probable and this will mean that the £25,000 limit will bite harder and harder on those least able to bear it, that is, young first-time buyers in London and the South East of England, people who need high percentage mortgages and are already adversely affected by the discriminatory effects of stamp duty. In a speech to the HBF on 30 April 1982, the Chief Secretary to the Treasury seemingly justified the £25,000 limit by referring to average loan figures but it is those borrowers who need loans higher than the average who are most adversely affected.

The evidence is that the £25,000 limit deters potential house-buyers in that there is a bunching of mortgage loans just below that figure. Presumably this means that some purchasers are able to find the additional resources themselves, but others are probably excluded from the market. The number excluded will rise as house prices increase.

14. There is the further point that next April, as a result of the Finance Act 1982, the method by which house purchasers obtain tax relief on their mortgage interest will change. Instead of making a gross payment to the building society and recovering tax relief through the PAYE system, borrowers will pay a net rate to their society. Societies have made a substantial investment in this change of system and are enabling the Government to save some 1,000 civil servants. If the £25,000 limit is not increased this work will be wasted as an increasing proportion of new loans will be outside the new arrangements and will have to be treated as special cases by building societies and will be subject to tax relief through PAYE as at present, thereby necessitating an increase in the number of civil servants. The Association and building societies have worked to bring in the new mortgage tax relief system, believing it to be in the interests of the great majority of their borrowers. The value of this work, and the new system as a whole, will be nullified if it is not the Government's intention to increase the £25,000 limit.

15. If the Government feels unable to restore the limit to nearer its real value in 1974 then the Association urges that the limit should be increased modestly to £35,000 so as to continue to embrace the vast majority of first-time buyers and not to undermine the changes in the tax relief system. The limit should then be further increased to take account of inflation year by year.