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PRIME MINISTER

BUILDING SOCIETIES : THE COMPOSITE RATE

You should, I think, know of the way in which I propose to overcome a problem which has arisen over the determination of the composite rate of tax paid by building societies for this fiscal year. It will involve tabling a new clause to the Finance Bill, preferably at the Committee Stage next week.

2. Some increase in the composite rate this year is an inevitable consequence of the abolition of the lower rate band in the Budget. The building societies are correctly anticipating that it will be about 1½p on last year's rate of 21p. This will put pressure on their margins. I do not think that we should seek powers to avert this increase. To do so would be to risk the criticisms, not least from industrialists and other financial institutions, that we were exempting building society investors from the tax changes in the Budget and increasing subsidies to housing. Further, recent statements by building society leaders about their future interest rates already take account of this.

3. A much more serious problem has just become apparent. The Revenue conduct periodic surveys of building society investors in order to ensure that the composite rate is revenue neutral, namely that it produces the same yield as

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would have been produced by charging individual investors at their marginal rate. The rate for 1980-81 is due to be based on such a survey. The preliminary results from the sample survey now becoming available show that the composite rate should be increased on this account also, probably by at least 2p, just possibly by as much as 4p. We will not know the precise figure for about another month. To apply a totally unexpected increase on this scale for this financial year - as the law at present requires - would involve an element of retrospection which the building societies would argue would be inequitable. They could not possibly have made provision for this in advance, especially since a revision of this size on the basis of a new survey is totally unprecedented. I think that it would be indefensible to back date it to 6 April.

4. The present position on the mortgage rate merely reinforces the need for action. Societies have been showing restraint since last July. In particular they have left their investment rates uncompetitive since January, waiting for other rates to fall, in the interests of not raising the mortgage rate above 15 per cent. To impose the additional charge from 6 April would very much increase the pressure to widen margins - possibly requiring a total increase of 1 per cent, or possibly even more. Its imposition would strengthen the hands of those in the movement who want to be more aggressive in setting their interest rates, and would give societies a justification for blaming the Government for an increase in the mortgage rate. It would make it most unlikely that we could avoid an increase in the mortgage rate this autumn.

5. I therefore intend to restrict the increase in the composite rate this year to the amount of the change which

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is the result of the Budget changes, i.e. probably to an increase of $1\frac{1}{2}$ per cent. This would be achieved by introducing a new clause to the Finance Bill to provide that the results of any periodic survey should not apply in computing the composite rate until the beginning of the tax year following that in which the results became available. While it would be obvious to all that one of the objects of the exercise was to keep the mortgage rate lower than it otherwise would have been, I think that it can be defended as being entirely consistent with our general approach to taxation. It is specifically directed to the problem of retrospection, which we think is wrong in principle. In theory at least, it should be revenue neutral over the years, sometimes deferring an increase in rate, as this year, and at other times deferring a reduction. Unlike any attempt to insulate building societies from the Budget, such as would be involved in delaying the $1\frac{1}{2}$p change, it would not be a further outright subsidy to the housing market.

6. This action will, of course, not completely remove the risk of an increase in the mortgage rate since that will depend on what happens to building society inflows and to other interest rates. But it will substantially reduce the risk. Also if there does have to be an increase, this action will reduce the amount both because the pressure on margins will be very much less, and because the societies will be more inclined to show continued restraint.

7. I think that there would be advantage in dealing with this in as low a key as possible in Committee rather than waiting for the Report Stage. We will therefore tell the Building Societies Association on Monday and then table the new clause.

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8. I am sending a copy of this minute to the Secretary of State for the Environment.

G.H.

(G.H.)

19 June, 1980