ANOTHER SILLY SEASON FIX?

THE Abbey National Building Society's call for cash compensation and tax credits for those who sell their houses at a loss is audacious.

Apart from calls for the Public Sector Borrowing Requirement (PSBR) to be "under-funded", or for a public sector wage freeze, the housing market is the focus of attention of all the silly season nostrums. Even those who call for devaluation or exit from the Exchange Rate Mechanism nurture the prospect of homeowners floating out of their debt-traps on rising prices. But at least the locus of these measures is the land market.

The fatal flaw in the Abbey plan is its massive cost. An alternative version of the Abbey's plan which fits in with overall economic strategy is outlined below.

TO ENCOURAGE a house vendor to sell at the lowest possible price the government could bridge the gap between the selling price and the vendor's original purchase price (physical depreciation apart) by creating non-redeemable bonds in the name of the vendor. The bonds would have a stock market value equal to the shortfall. That value would be assured through the appropriate fixed interest rate - about 9% now.

The trick would be to fund the interest by a charge on the property that has been sold, determined as a proportion of the property's site rent.

Though the government would collect and distribute the charge, the borrowing through the medium of the bonds would be by the private vendor, and the servicing of the bonds would be by the private buyer. The PSBR and the level of taxation would be affected only by administration costs and the income tax receipts from the bond interest payments.

The idea of a house buyer paying interest on behalf of someone else may seem incredible. But because a charge on land is reflected in a lower purchase price, it makes perfect sense. The lower price means that the buyer pays the charge (and thus, in this case, the interest on the seller's bond) instead of paying interest on the loan for purchase. The buyer is no worse off, and in fact his position might be improved.

A calculation has to be made to accommodate the further effect (shown in brackets) of the property charge on the sale price. If there were no effect, the cost would be borne by the purchaser. But he would discount the charge in the offered price. This is where we need to be clear about the exact nature of the property and the charge upon it.

A house is both bricks and mortar and land, which have specific values. Say a valuer apportions the £50,000 realistic price (i.e., low enough to sell fairly quickly) as £20,000 for the site and £30,000 for the building. The site price reflects an implicit annual rental income, which has been capitalised according to the following equation (assuming that a continuing 5% per annum decline in land price is also anticipated and capitalised):

$$V = \frac{a}{i - g}$$

$$\text{i.e., land price} = \frac{\text{annual land rent}}{\text{interest rate - capital gain rate}}$$

$$20{,}000 = \frac{a}{0.09 - (-0.05)}$$

$$a = 20{,}000 \times 0.14 = 2{,}800$$

The £900 annual charge on the land rent imputed to the property therefore represents a rate of 32%. This reduces the rent enjoyed after the charge by the landowner, and hence reduces the site price to £13,571 ([2,800 - 900]/0.14). Knowing that the charge has to be paid, the landowner would only offer £43,571 (£13,571/site, £30,000/building). However, that increases the capital loss and raises the amount of bonds that are needed, and the charge - hence the second line of brackets. The final outcome of this iterative process is shown in the third line of brackets.

Example (see text for explanation of brackets): £s

Original purchase price of house	= 60,000		
Current saleable price	= 50,000	(43,571)	(32,000)
Capital loss (= land price decline)	= 10,000	(16,429)	(28,000)
Stock market value of vendor's bonds	= 10,000	(16,429)	(28,000)
Annual cost of bonds (at 9%)	= 900	(1,479)	(2,520)
Annual charge on property	= 900	(1,479)	(2,520)

This means that a 90% charge will be made on the rental value of the site, so the purchaser will offer only £2,000 for the site, and £32,000 for the whole property, instead of £50,000. Despite the charge, the purchaser will be no worse off. His or her offer fully discounts the charge. The £2,520 pound annual outgoing is less than the interest (nearly £2,000 at current mortgage rates) on the additional £18,000 loan that would have been necessary to buy the house, plus the anticipated annual loss in the resale price of the land (£1,000 in the first year).

The opportunity to avoid debt - or pay the equivalent of guaranteed fixed long term interest rates rather than variable short rates, at a time when the former are considerably lower - might even stimulate demand from first-time buyers. Credit-poor house seekers would benefit, and the new demand would be targetted at homes where the occupiers are "debt-trapped".

The question mark hanging over this scheme is its effect on capital markets. Would £28,000 cash be available to buy the bonds in the example? £18,000 should be, because that is the amount of loans (or own savings) the buyer no longer has to find. Of the other £10,000, not all would be a new call on the market. The seller at the end of the housing chain would keep the savings pool topped up to an unpredictable extent.

To avoid upward pressure on long term interest rates,

Continued on previous page ☞

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A COUNTDOWN TO LIFT OFF

STABLE PROPERTY PRICES are crucial to growth. That means a zero rise in land prices. The prices of buildings should not be targetted, for they are part of the economy's output and their prices are encompassed by the low inflation target for product prices. Individual products should be free to vary in price relative to other products according to supply and demand. That goes for the rent of the factor land, too. But land price, a derivative investment asset, should be strictly pinned down.

There are four sources of variation in land prices:

(1) change in rents;

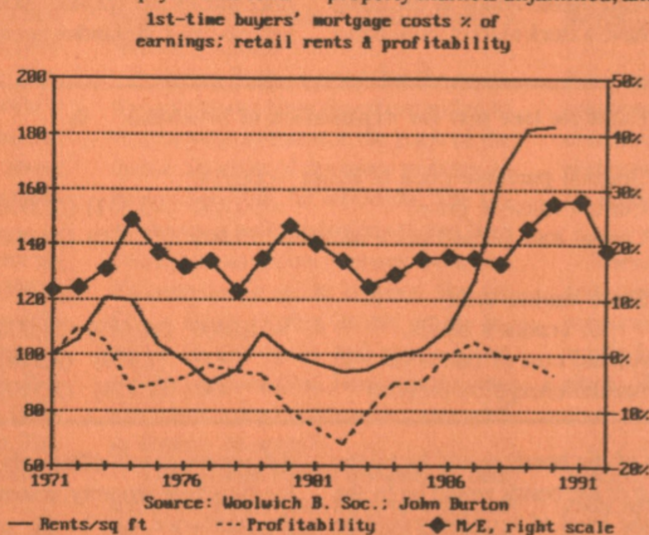
(2) change in real interest rates;

(3) change in the anticipated rate of change of land prices;

(4) change in taxation of land rents.

The first two are primary, the third can be targetted, and the fourth can be manipulated to achieve the target.

Real interest rates are variable in the short term, but rents tend to have a secular upward trend because the overall supply of land remains fixed while the uses for it multiply. Rents tend to rise at a rate even faster than economic growth, because well-located space is a "superior" good to which we devote an increasing share of our incomes as they rise. In the chart (inset), the upward trend of first-time buyers' mortgage costs as a percentage of earnings (M/E:right scale) is not primarily due to rising interest rates. Higher interest rates reduce the prices offered, rather than encourage buyers to take on higher annual repayments.



To prevent a rise in land prices, the rate of tax on land rents must increase over time. In the short term, however - as is now happening throughout the world - it may be that land rents are falling and interest rates are rising. In such circumstances, it may make sense in the short term - if we are trying to stabilise plummeting markets - to reduce land tax rates, in order to stabilise land prices. That is why 1992 is an inappropriate time to dismantle the distortions in the land market. Those distortions, historically, stemmed from the exemption of land from taxation (which was the surest way to stimulate land speculation and generate instability in the markets).

There is, of course, the political consideration. NO time is appropriate for introducing taxation unless politicians are as cunning as doves and as wise as serpents. Times of crisis offer the greatest opportunities for reform. On page 4 we examine one way to lower the price of particular sites today, and that method could have a wider application. Or it could complement other methods, by making zero land price inflation palatable to those with "negative equity".

Another route would be via real interest rates. Prime Minister John Major could give no more firm a declaration of intent to kill inflation than to commit himself to the criterion of zero land price rises and order the necessary tax machinery to be put into place. The imminent Council Tax presents him with a golden opportunity. The announcement in mid-1991 of the Council Tax as an emergency measure to replace the poll tax has no doubt prolonged the slide of land prices (just as the announcement in early 1986 that the tax on domestic property would be abolished heralded the rise of residential land prices). Mr Major could trumpet this return of the property tax as a step already taken in the correct direction, bringing housing land into line with business land.

One visible step Mr Major could immediately take would be the instruction to professional valuers to produce a comprehensive data-bank of values for all classes of land use, of the kind now available in Denmark.

By thus striking at one of the roots of the British inflation mentality, Mr Major could dispel the crisis of confidence in the currency markets which is adding a risk premium to interest rates. Sterling would bounce from the floor to the roof of its 6% band and scream for the Chancellor to slash the base rate to prevent it bumping its head. As the real interest rate fell, property markets unjammed, and land prices changed direction, the new tax machinery would begin to whir into action: the opportunities of this new fiscal regime will be examined in the next issue of EL.

Samuel Brittan was quite right. Without the exchange rate constraint the British government might never have become so desperate for a way to impress the foreign exchange markets. It could stop brazening it out and act now by grasping the surest means to hand.

☞ **Continued from next page**

however, it might be necessary to consider this scheme in conjunction with current calls for the government to relax its full-fund rule. This obliges it to fund the PSBR without resort to borrowing from banks and building societies through treasury bills, which would enable them on the strength of their additional assets to increase the money supply.

"Under-funding" the PSBR is appropriate for recessionary times, it is argued, to stimulate the money supply, reduce long rates of interest and raise equity prices. Under-funding means that the government issues fewer bonds, which would make room for more private bonds without reducing bond prices. To the extent that private bonds replaced gilts they would prevent the effects of under-funding from coming through. But that would only re-route the stimulus for the economy. The economic aim of the private bond scheme is to free the housing market of the jam caused by those who cannot move till they can sell their homes for enough to repay their mortgages.

The number of residential property sales (about 1 million a year) is now less than in the 1970s, when there were only two-thirds as many privately-owned homes. The economy is being immobilised - literally.