THROTTLING THE LAND PRICE VICE

"The jolt from EMS membership is just what British Governments require if they are to be forced to change their policies of excessive housing subsidy and NIMBY [planning] controls. If EMS membership has to wait for housing reform, neither will occur."

SO WROTE Samuel Brittan in the *Financial Times* on January 18, 1990. The discipline of the Exchange Rate Mechanism would make high interest rates inevitable by removing the devaluation option as a cushion for the inflationary pressures in the economy, which are centered on the land market. To avoid punishingly high interest rates it would be necessary to demote capital gains in land, which are promoted by "tax expenditures", as a source of personal and company wealth.

Brittan observed on July 30 this year that "the more and the less recession-prone countries" are distinguished not by exchange rate arrangements, but by "a massive credit boom in the late 1980s and...now suffering from a debt overhang."

As *The Economist* noted on August 8: "It will be no bad thing if Britons are made less obsessive about investing every penny in houses. Prices rose to unsustainable levels in the 1980s - propelled by an ingrained British belief that this was one area where the laws of gravity did not apply - and carry much of the blame for the subsequent surge in inflation and Britain's current economic woes. A country less conditioned to expect house-price inflation would enjoy an economy less prone to booms and busts".

Professor Walter Eltis, an adviser to the government, has also sought to fend off critics of the ERM by pin-pointing the root cause of our economic woes: "Our trade is likely to remain in substantial deficit for reasons entirely unconnected with the competitiveness of British manufacturers. If any economy has an excess of investment over savings, its trade will be in automatic deficit...[S]uch a country will inevitably borrow from overseas and have a corresponding current account deficit...A propensity to borrow has been at the root of Britain's deficits" (FT, July 29).

Given this analysis, it seems clear that the squeeze that is now being applied to the country is not being caused by the anti-inflationary policy of keeping sterling strong, but by a reluctance to be flexible in our expectations of future land price increases. These expectations are due to the refusal of politicians to tackle the tax-distorted land market. Devaluationists are looking at the wrong side of the vice.

UNFORTUNATELY, the apologists for the ERM are not channelling the attention of critics in a constructive direction.

◆ Professor Eltis, for example, did not add that prospective capital gains in land have been the cause of our high propensity to borrow.

Banks, of course, use land as collateral, which - in a regime of rapidly rising land prices - encourages an expansion of money, credit, and consumer demand, at rates that exceed supply. Ergo: inflation.

◆ *The Economist*, like the Government, is relying on the historical evidence that "eventually the market will pick itself up." (The past may not be a good guide to the 1990s, however.) Sensibly, it is concerned that the current woes of the land market are bringing out demands for new tax favours for housing: "The greater the indulgence shown to the housing market now, the greater the risk of another future burst of illusory well-being and its attendant inflation."

Even so, *The Economist* does not go all the way with the therapy of letting fingers burn and then abolishing mortgage interest tax relief (MITR). It is prepared to countenance some humanitarian relief at the expense of a lesson well-learned in the downside of land investment:

(1) MITR could be concentrated on first-time buyers to spur them into action to relieve sorry sellers; and

(2) the Government could stop competing for savings with building societies and buoying up mortgage interest rates (but start competing more strongly for savings elsewhere, presumably - which is exactly the reason *The Economist* does not normally advocate such favouritism.)

◆ And Samuel Brittan? What has he been saying to ram home his message that the EMS requires swift treatment of housing distortions in order to make life comfortable again? Nothing at all (until August 20, when he merely endorsed the minimalist reform strategy already adopted in 1991).

The nearest he has come to showing us how the land market might be tailored to fit the new anti-inflationary regime has been his support for reform of the commercial leasing system. Twenty-five-year leases with five-yearly upwards-only rent reviews may have provided security of investment for institutions and security of tenure for tenants but they are now a cost-inflating relic of Britain's "'upwards only' price mentality" (FT, August 6). The wide 1980s U-bend in retail rents per sq ft, shown in his chart, was the result.

Security of tenure legislation should go, as part of the process of negotiating upwards-only provisions out of existence. "Do you think these belated efforts...would survive if the government gave in to the siren voices demanding that it should throw in the [ERM] towel?" (FT, July 30)

Economic Intelligence warned in October 1988 that the inflexibility of the rent review process was exaggerating the economic cycle. However, this is not the tax-induced distortion of the land market that Samuel Brittan was thinking of in the quote at the beginning of this article. He remains silent on that.

The pundits believe that reducing the tax favours for housing now would only make property prices fall further and perhaps tip the recession into protracted slump. But, of course, when house prices do eventually turn up, that will be an equally inopportune moment to kick them back down again ("After all we've been through, we property owners deserve a break!").

In fact, the world seems desperate for another fix of rising land prices to cure the industrial economy of the problems created by the last fix. In Tokyo, where for all their inscrutability the Japanese do not mince words, that is exactly what the financiers are demanding: they want their government to buy their land off them - presumably at artificially high prices.

If Britain is to realign itself onto the path of economic sobriety, another macro-economic policy criterion is needed to accompany the Maastricht criteria and the steady pound. This is it: *the national land price index should neither rise nor fall*. How this might be achieved is examined on the next two pages.