

# TURNING ROUND THE COUNCIL TAX

THE POLL TAX helped to wreck Margaret Thatcher's administration. Unless her successor, John Major, places the new council tax at the heart of his economic strategy - and acts to neutralise its damaging blows to the economy - he may suffer a similar fate.

Handled correctly, the politically embarrassing council tax could be converted into the pillar for the new economic strategy the Government has been seeking since the "strong pound" fell by the wayside. This would be achieved by transforming the tax into the means for lowering interest rates.

As things stand, the council tax will prolong the depression, if the bills fall on homeowners' doormats before real interest rates have been reduced to levels that help to revive the economy. This is because the extra burden on household budgets, which will be tied to homeownership, will bear down on house prices. The prospect may already be contributing to a negative effect on house prices, which have dipped since details were announced in mid-'91 (see chart).

Falling house prices (more accurately, land prices) exert downward pressure on consumer spending. This is the "reverse-wealth effect". Rising real incomes are being devoted to paying off debts rather than servicing new borrowing, so the personal sector savings ratio is still rising. As consumer spending forms over two-thirds of aggregate demand, this is holding back recovery.

The introduction of the council tax in April, however, could be used as a platform for launching the climb out of recession. This is how:

The tax, which is levied on the value of domestic property, must be assigned primacy in the government's fight against inflation. It may be proclaimed as the first weapon in place to meet the Government's new target of zero aggregate land price growth. To convince the markets, it should be set within a wider framework of measures to meet the target, which would include a supplementary "land price stabilisation tax" (which will be discussed in *Economic Intelligence*, Jan. 1993). Harnessing the council tax within a clear anti-inflationary framework would allow the base rate to be reduced without unleashing a falling pound and rising prices.

The council tax is due to raise about £14bn, before rebates (which is what matters to the land market - rebates will reduce net revenue by about one-third). That will all be at the expense of housing land rent (about £40bn), which represents a 35% rate of tax on land rent.

Land prices will fall by 35% as a consequence. However, if real interest rates are reduced by 35%, the effect on land prices may be cancelled. We can assume that land price growth expectations are negligible at present, and therefore will not change if the Government's target is believed.

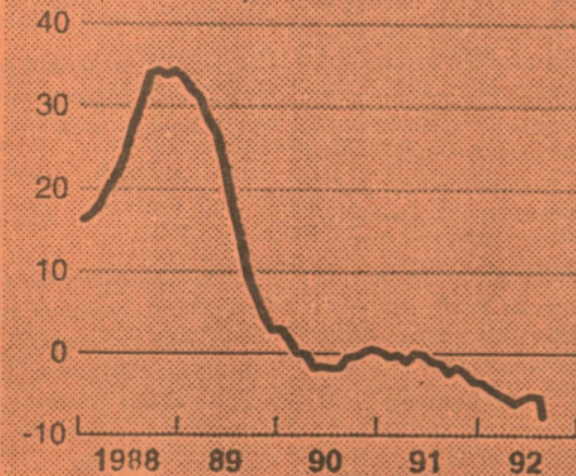
(NOTE that the tax rate in the capitalisation equation on

page 2 is related to land price, not rent. A 2.8% tax on land price would tax the effective base - land rent - at 35%, given an interest rate of 8%. Strictly, the equation applies to a land tax alone, whereas the council tax is partly a buildings tax. However, the tax on buildings will be passed on to land through a drop in the £40bn market rent, which will have the same effect on land prices.)

Taking the real interest rate or yield (rent as a percentage of price) on housing land as 8% at present, it will need to fall to 5% to counter the effect of the council tax on land prices. Mortgage rates will, therefore, need to fall by at least 3 percentage points. The Government may effectively accomplish that by lowering the Bank of England base rate.

This fiscal insurance policy against rising land prices makes possible lower interest rates, which would channel rising demand towards capital formation and the creation of jobs. Lower interest costs, and sterling at a natural level, would raise export competitiveness. The assault on the depression would have begun.

Annual % change in Halifax house price index (all houses)



## WHITHER MITR?

Mortgage interest tax relief (MITR) is caught in a tug of war between those who wish to extend it to revive the housing market, those who wish merely to redirect it to first-time buyers to produce a costless stimulus, and those who believe it should be reduced as a far-sighted way of tackling the structural budget deficit, as the government "goes for growth".

The first proposal stores up obvious longterm difficulties; the housing market will inevitably overshoot, but parliament will find it impossible to take back the concession.

The second takes away with one hand from existing mortgagors what it offers with the other, in terms of more buyers.

The third does the same for the housing market as a whole, exchanging the hope of lower interest rates for lower tax relief.

Only the first of these proposals addresses the immediate need of the market. Allied with the strategy set out in this bulletin, it might appear in a different light. House prices would stabilise, but not rise - the land stabilisation tax on land-rent would take care of that. It would also recoup the cost to the exchequer.

Remember: MITR only became a market distortion because taxes on imputed rents were removed.

FOOTNOTE: a first-time buyer who paid a 5% deposit for his house in the south-east at the beginning of this year has now had his capital wiped out.