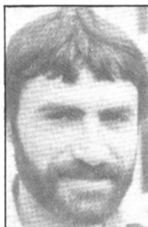
Ghost that haunts U.K. economy

By **DAVID RICHARDS**



BRITAIN's economic problems are now being blamed on "dirty" official statistics. Sir Claus Moser, a former chief of the Government Statistical Service, told last year's July conference of the Royal Statistical Society that cost-cutting in the Service 10 years ago – when a quarter of the staff was axed – had proved incalculably costly for the country.

He waved a copy of *Treasury Bulletin*, published the same week, as evidence. The first article of the first issue was a damning critique of the quality of official statistics, and it carried a recommended reading notice from John Major, the then Chancellor of the Exchequer himself.

According to the article, the estimates of the Gross Domestic Product gave the Government "misleading indicators" between 1986 and 1989, because they "clearly understated the buoyancy of the economy".

At the time of the 1988 Budget, initial estimates of the growth of domestic demand in 1987 understated the latest estimates by 2.25% (see 1987 Q4 in Fig. 1). At one stage, the expenditure measure of the GDP, which includes consumer spending, lagged the output and income measures by 5.5%.

Unprecedented shifts in the behaviour of the personal sector were going unrecorded, especially the consequences of steady deregulation of the financial sector since 1979. The stock market crash of October 1987 was, therefore, misinterpreted as foreboding declining consumer spending, due to people feeling poorer, so Chancellor Nigel Lawson continued to cut taxes – by a further £4bn – and help interest rates along their downward slope from the mid-1980s.

This enabled the building societies, awash with savings no longer attracted to the risky stock market, to channel them into that other area of "popular capitalism", house purchase. House prices, already buoyant, were unleashed, and a speculative frenzy ensued.

Not all of the loans were used for house purchase, however. Especially below £30,000 (thus qualifying for mortgage interest tax relief) such secured loans were a cheap source of consumer credit. With collateral soaring, and real capital gains making houses look like personal gold mines, the confidence to borrow against them was also soaring. Consumer spending was unleashed.

"It was the £40bn increase in borrowing that foxed me," Lawson later admitted in a TV interview. Meanwhile, steeply rising domestic demand outstripped supply, opened up a huge overseas trade gap, created inflationary pressures at home, and forced a belated defensive escalation of interest rates by the Bank of England – throwing sand in the supply side works, and producing stagflation.

A provision in the March 1988 Budget turned the screw further: the Chancellor announced that more than one mortgage interest tax relief per property would no longer be allowed after August 1. The borrowing binge was prolonged until that date – nearly two

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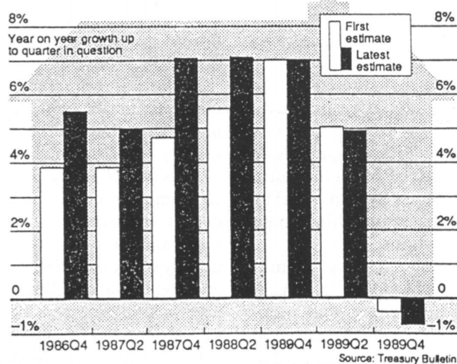
FIGURE 1. Real Domestic Demand



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months after the danger signals were officially recognised.

The scheduled abolition of the local domestic property tax (the rates) must have added an extra puff to the bubble.

JOHN Flemming, director of the economics division at the Bank of England, singles out one particular official mistake:

"Certainly we failed to forecast the consequences of [financial] liberalisation. But I don't think that that means that it's gone too far...it was a difficult process which wasn't perhaps managed as well as it might have been."

But was the matter simply one of measurement and forecasting? If the fruits of free trade in money had been foreseen, would an appropriate policy response have been forthcoming? *The evidence of the eventual response shows that it would not have been.*

One of the key movers behind the Budget of 1988, Professor Mervyn King of the London School of Economics, does not admit even to culpable forecasting errors. The future was in the lap of the gods, he believes. He looks to "exogenous shocks" to explain the borrowing boom after 1986: when the Conservatives were re-elected on their economic success of the mid-1980s, the private sector changed its expectations and based its spending and borrowing decisions on a sharp rise in economic growth - which never materialised.

He exonerates the two main suspected culprits: liberalisation of the financial sector, and the housing boom of 1986-88. The first had occurred steadily since 1979, the second, he says, was a symptom of excessive demand rather than a cause.

Changes to the Treasury economic model during 1989, however, do not support this view. Housing wealth was introduced into the model's "consumption function" for the first time. Clearly, someone now thinks it has predictive value.

IN A debate in the letters column of the *Financial Times*, City economist Giles Keating goes only part of the way with Professor King. He writes: "It is time to accept that housing has been a relatively innocent transmission mechanism for the effects of macroeconomic policy mistakes and, possibly, of over-ambitious lending by financial institutions."

Peter Spencer, another City economist, and John Muellbauer, an Oxford economist, however, take him to task on this. The former responds: "Contrary to Keating's suggestion, the tax system has seriously complicated the task of macroeconomic management, particularly through its effect on the housing market. If we are now to shoehorn sterling successfully into the Exchange Rate Mechanism (ERM) of the European Monetary System, it will be essential to do something about these distortions."

• John Muellbauer

Muellbauer responds similarly: "I reject Keating's claim... A key UK problem is that monetary policy which is tight enough to keep the consumer in check devastates the supply side of the economy. Furthermore, he neglects the microeconomic critique of current distortions in the UK housing environment.... In the end, the lack of a well-functioning property tax is probably an even more serious distortion than mortgage interest tax relief. Both need to be addressed."

Keating is surely right that many of the supposed distortions in the housing market are exaggerated. Mortgage interest tax relief is no different from the tax relief that applies to all loans for the purchase of fixed assets. The Capital Gains Tax that would be necessary to level the playing field between housing and financial assets would be an "irrelevance for the vast majority of home-owners." There are financial instruments available now whose tax advantages compare favourably with housing.

But these points are insufficient to make housing "a relatively innocent transmission mechanism." Keating neglects to mention that benefits-in-kind (imputed rents) from owner-occupied housing were removed from the income tax net in 1963, that vacant land has always been a tax exempt asset, and that the last tax on imputed rents in the housing market was removed last year with the abolition of the domestic rates.

He fails abjectly, therefore, to make his major point. There is major distortion in the housing market. It is a tax haven for personal savings. It is a part of the economic structure which is tinder dry and awaiting any loosening of monetary policy to ignite it. Throw in credit liberalisation and you create a really combustible cocktail: free trade (in banking) without land value taxation.

Credit control during the 1970s prevented two land booms

from setting off consumer booms. By the end of the decade the average mortgage was worth 17% of the average property, compared with 25% in the 1960s. By the second half of the 1980s, however, the ratio was back to 25%. But this time property prices were soaring. The ratio of household debt to household income nearly doubled between 1980 and 1989.

Much of the borrowing leaked into consumption ("equity withdrawal"). The rate of household saving (income *minus* consumption) plummeted. The rate of national saving fell 3½% between 1980 and 1989.

Sparks were thrown into the combustible cocktail by Nigel Lawson. In 1985 serious targets for the money supply were finally abandoned. In 1986 sterling was allowed to depreciate with lower oil prices. In 1987 and 1988 sterling shadowed the Deutsche mark as a replacement for money supply targets. Both these exchange rate policies allowed interest rates to fall.

The structural fault in the housing market which makes it particularly dangerous is an absence of taxes - mainly of a land value tax - when all around there are taxes. This fault line stretches across all land markets, but is more overgrown in other sectors. The rates still apply to businesses (except farms). Corporation taxes and taxes on dividends capture property rents haphazardly. The public sector enjoys rents on behalf of the public.

Mrs Thatcher later pointed to her Chancellor's policy of shadowing the Deutsche mark and pronounced that that was where Britain had "picked up the inflation bug."She was right - but for the wrong reasons.

Robbed of the freedom to raise interest rates to counter an "overheating" economy, inflation and a trade deficit did indeed result. But it was the burgeoning land prices and the credit they stimulated that produced the demand that sent too much money chasing too few domestic goods (demand for investment goods as well as consumer goods, for firms are not immune to the "wealth effect", either).

Without land price escalation, low interest rates are in themselves desirable. Countering land price escalation has been the only success of high interest rates. Raising interest rates raises at first the measured inflation rate, stimulating high pay demands. The resulting high mortgage repayments raise pay demands. Strong export demand supports high pay demands. High interest rates directly increase firms' capital costs.

Not surprisingly, unemployment began to rise in the spring of this year for the first time for almost four years.

THE OECD's annual report on the UK is in line with the general consensus. Its diagnosis is of the spark-meets-explosive-cocktail kind. It recommended ERM entry, but proffered no advice as to how to mitigate the consequences.

The *Financial Times* chastised it for this: "How can a target for the exchange rate be pursued without repeating the monetary policy errors to which the OECD rightly draws attention? This will be difficult and may prove impossible."

In another leader the *Financial Times*, commenting before Mrs Thatcher's departure, declared: "Mr Muellbauer is surely right that in the long run

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LVT the only solution

MRS THATCHER's gut resistance to sterling's entry to the ERM weakened in the face of the consensus view that that was the only way to restore credibility to the Government's anti-inflationary stance.

With a relatively fixed exchange rate against low inflation currencies, the economy must either squeeze out its inflation or be squeezed out of world markets.

And this means that land prices, too, must fall, or labour and capital will emigrate. Houses cost only half as much in France. That was the rub for the Prime Minister just befdore her party turned on her and forced her to quit No. 10 Downing Street.

It is not really surprising that her political instincts should have been against both the ERM and the removal of distortions from the housing market - "bucking the market" on the one hand, and "not bucking the market" on the other.

Her electoral support came from home-owners, and they could give her a nasty pain in the ballot box if house prices fell and the excesses of borrowers couldn't be blamed.

Interest rates will tend to fall towards West German levels, but they will have to remain relatively high in the long run to mitigate Britain's inflationary tendencies, which would otherwise build up pressure to devalue sterling. With relatively high interest rates, the British economy will be at a disadvantage.

The only solution in both the short term and the long term is the one the Government avoided the first time round when it was shadowing the Deutsche mark: structural reform in the housing market - land value taxation.

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the way to encourage a more efficient use of land and property is to return to a property tax on imputed rents from land.

"But such long-term proposals do not address the immediate problem with ERM entry....if the Prime Minister's political instinct on mortgage relief prevail, some form of capital gains tax on equity withdrawal, however distorting in the long run, may offer the only alternative."

When does one begin planning for the long term? The Oxford Economic Forecasting research group in their July report, *UK Economic Prospects*, are also looking for short term fixes in the housing market so that ERM entry will not "leave the UK as an uncompetitive, high unemployment region in Europe."

Unfortunately, they come up with higher income taxes and credit controls (unpopular policies from the 1970s), the worn out proposals which Giles Keating had disposed of, relaxation of planning controls (unpopular policies from the 1980s), and, preposterously, subsidies to encourage house building.

It seems that the UK is confronted with a choice: accelerating economic decline, or reinstatement of a policy which no political party has the courage to nail to its mast - taxation of land rents.

EVEN IF the housing market were merely an "innocent transmission mechanism" for the wider failures of the Government's economic policy, as some claim, it took the Government the best part of a decade to incorporate the mechanism into its understanding of the economy, as crystallized in the Treasury's economic model.

Housing wealth was not treated as influencing consumption in the Treasury's model until November 1989, seven years after the Bank of England first published research on the diversion of housing loans into consumer spending.

Fittingly, 1989 was the first year in which a trial series of estimates of the housing wealth of the previous year were not published in the Blue Book. But the appearance of such estimates later suggests that the uncertainty surrounding the compilation of complete national balance sheets may have been dispelled.

The Treasury's new model of the economy, which has been in operation since June 1988, is called SLIM - to distinguish it from the "HM Treasury" model, which had become obese and inefficient. It has 530 variables, compared with HM Treasury's 1,275 variables.

Four hundred of those variables consist of equations stating behavioural relations and identities, 130 are exogenously determined. There are also two satellite models, which disaggregate parts of SLIM for separate use. These cover public sector receipts and the domestic monetary sector.

Part of the complete databank

FIGURE 2. Variable 101 in the Treasury's economic model

$$\text{Ln CND} = \underset{(3.1)}{0.0748} + \underset{(2.7)}{0.91004}\ g\ \text{Ln CND} + \underset{(5.2)}{0.1447}\ (1 - g^2)\ \text{Ln AY}$$

$$+ \underset{(2.7)}{0.008996}\ g^2\ \text{Ln}(100\ \text{NFWPE}/(^*\text{PC AY})) + \underset{(2.7)}{0.08096}\ g\ \text{Ln AY}$$

$$+ \underset{(2.7)}{0.0389}\ g(1 - g)\ \text{Ln}(\text{NFWPE}/\text{PC}) + \underset{(1.3)}{0.1013}\ g^2\ (1 - g)\ \text{Ln PC}$$

$$- \underset{(1.7)}{0.000478}\ \text{RS} + \underset{(3.8)}{0.01251}\ \text{DUM}$$

CND = consumption of non durables £m 1985 prices
AY = inflation adjusted real disposable income £m 1985 prices
NFWPE = net financial wealth of the personal sector
PC = consumers expenditure deflator
RS = short term interest rates
g = lag operator

FIGURE 3: Variable 101 in November 1989

$$\text{Ln CND} = \text{Ln}\ g\ \text{CND} - \underset{(2.5)}{0.0595}\ [\text{Ln CND} - 0.95\ \text{Ln AY} - 0.32\ \text{Ln}\ \{100\ (\text{NFWPE} + 1000\ \text{GPW})/\text{PC AY}\}$$

$$+ 0.0043\ (\text{RS} - 400\ (1 - g)\ \text{PC}/g)\text{PC}] + \underset{(4.3)}{0.01327}\ \text{DUMCND} - \underset{(2.7)}{0.052579}\ (1 - g\ (1 - g)\ \text{Ln U}$$

$$+ (\underset{(3.3)}{0.114072} + \underset{(5.6)}{0.211211}\ g)(1 - g)\ \text{Ln AY} + \underset{(2.6)}{0.082784}\ (g - g^2)$$

$$\text{Ln}\ \{100\ (\text{NFWPE} + 1000\ \text{GPW})/\text{PC AY}\} - \underset{(2.2)}{0.024881}$$

Source: H.M. Treasury

used for estimating the equations is published annually as the UK National Accounts (the CSO Blue Book).

SLIM attempts to model the determinants of both aggregate demand and aggregate supply in the economy, in order to simulate and predict, given exogenous changes, changes in its component parts.

One of the components of aggregate demand is consumption, and this sector of the model is called the "consumption function". It contains two behavioural equations, two identities, two exogenous variables and a technical equation. The incorporation of housing wealth into this function has involved the replacement of the behavioural equation in Fig. 2 with that in Fig. 3.

With 340 such behavioural equations, each needing to be fed numerical measurements of the real world, the time and expertise required to develop and operate such computer models can be readily appreciated.

In Fig. 3 it will be noticed that the net financial wealth of the personal sector (NFWPE) is always accompanied by gross physical wealth, mainly housing (GPW). This means that GPW has been incorporated with NFWPE into the definition of wealth. As gross physical wealth represents just over half of all personal sector wealth, this doubles the size of the wealth effect.

The variation of consumers' expenditure on non-durables (CND) relative to personal sector wealth, which also has to be empirically determined, is tripled in magnitude. This is an "elasticity" which is imposed when calculating the long-run solution of the equation.

The second behavioural

• Samuel Brittan

equation, governing consumers' expenditure on durables, has the wealth term similarly revised.

The influence of land prices enters the model again in the "investment function", governing the aggregate demand for private sector capital goods. Here, a rise in the price of new houses relative to building costs leads to a rise in the price of new houses relative to building costs leads to a rise in private investment in new dwellings, as does a fall in interest rates. (However, other construction sector equations do not include implicit land prices).

New house prices, and in the process second-hand house prices, are modelled in SLIM as part of the determination of producer prices and retail prices. Implicit land prices emerge through the relationship of housing supply and housing demand, and thus are incorporated, with the quarter's building costs and improvement costs, into the revaluation each quarter of the GPW component of personal sector wealth.

Rents do feature in the model but only as an output distributed by assumptions contained in technical equations. They are not part of the causal behaviour of the model. For example, it is assumed that total personal sector rent rises in line with the GDP deflator (i.e., inflation).

HOUSING wealth (for which read land prices) is more than just a transmission mechanism. It matters, therefore, that the national balance sheet, which covers land prices, is the poor relation of national book-keeping, and that rent statistics are the laughing stock of the national income accounts.

A start has been made at incorporating the development of land prices into the causal behaviour of SLIM, the Treasury's new economic model. But there is no role for land speculation, in terms of upward pressure on house prices due to reduced supply of building land or properties for redevelopment. Or in terms of artificially high land rents reducing the marginal productivity of labour and capital.

It is ironic that the first recognition of the influence of land prices should concern the demand side of the model rather than the supply side. Inefficient land use is a recognised failing of the economic system, and artificially induced land shortage was the basis of Henry George's supply-side theory of industrial depressions.

The widely read economist/journalist, Samuel Brittan, for example, welcomes proposals to tax land values because "they would improve the allocation of resources, increase mobility and therefore reduce unemployment."

Fiscal subsidies and privileges for land ownership "do not in the end benefit the young suburban couples of Tory fantasy but spill over into higher land values and house prices... There is much less disagreement among economists on this issue than almost any other subject."

Land rents and prices, therefore, *are* artifically high, particularly in the UK with its obsession with housing investment. Artifically high land costs *must* lower the marginal produc-

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The 'elusive' effect that's so important

tivity of the factors of production combined with it, in other words they *must* lower wages and the returns to capital investment.

But in SLIM there is no place for land rent as a discreet cost of production, or any possibility of time trends in rent levels affecting time trends in profits and employment. Only wages are modelled separately. If relatively high land rents reduce the competitiveness of British firms, the effect lurks within the databanks of the model, influencing the estimation of equations, but finds no separate expression, and provides no explanatory power. It is a ghost within the machine.

Rent is treated only as final income. This happens to be the aspect of land rent which is not beneficial, but the model does not take up the story. Income from land ownership is not distributed in the economy according to the productive efficiency of owners. It masks, therefore, the poor performance of many an owner, and encourages inefficient investments made possible by loans secured against land values.

If the introduction of land value taxation restored rent as a cost centre instead of a profit centre, the increase in trend productivity would be observed by the data gatherers, and would become an altered assumption within the model. But the causal structure of the model itself could not predict the results independently.

Land is the factor of production peculiarly subject to speculation, hence to fluctuations in availability and price. But those fluctuations are absent from the supply side mechanisms of economic models. It is not surprising that they cannot predict major turning points in economic cycles.

The mere existence of private income from land must produce an artificial shortage of labour and capital, hence lowering average incomes. There is less need to work and to save for

NATURAL AS BREATHING **REVIEW**

Les Hemingway, *Rent as Revenue: The Enemy of Interest,* published by the author

ECONOMISTS rarely mention land, mainly because they ignore the simple facts which connect it with social problems and most of the intelligent ones have given up trying to convince governments who are hide-bound to the vested interests of most of their land-holding supporters. So the status quo must not bedisturbed; anything suggesting reform as advocated by Henry George gives the British government nationalisation creeps. Even the opposition parties cringe at any mention of the subject. Anyway, that is my own opinion.

So it takes a brave man - and a determined optimist - to write one more book on land reform in the belief that all hope is not lost - must not be lost - in a just cause. Les Hemingway, a doctor practising in Warrnambool, Victoria, presents us with his detailed diagnosis and prescription, pointing out clearly how site rent provides a logical source of revenue for every human community. *Rent as Revenue* ia as natural as breathing, and it is time all nations recognised this fact.

Unfortunately, anyone who talks about rent and revenue in the presence of professional economists tends to be treated with disdain, or regarded as a member of the "lunatic fringe".

To quote some more of his hard-hitting passages: "That source of income is the earth itself, with its innumerable sites and abundant natural resources. Rent appears when sites are occupied and natural resources are utilised. Rent also appears - whenever a site or resource has a potential use ... we are terrestrial beings. We cannot live without occupying land ... people who lack land must beg, buy, rent or borrow it and ... they must do so on a landowner's terms.

"Here in a nutshell, is the reason why the rich get richer and the poor get poorer. I cannot help wondering why the fact is barely mentioned by politicians, economists and others who comment upon the economy, or who complain about the widening gap between rich and poor ..... This is common sense, so common in fact, that one is appalled when so few people grasp its significance".

A chapter on taxes in Australia indicates that they are much more numerous and complex than our own, which probably accounts for most of the incentive prompting Hemingway to write his book. A chapter on inflation is concise and should clear up any misunderstandings on this social evil.

In some of his final words, he says: "Poverty will not be eliminated, anywhere, until owners can no longer exploit those who must rent or buy land. Such exploitation will not cease until rent is recognised as public property. Once that enlightenment comes, and is acted upon, then poverty will disappear. But not before".

This is a textbook which deserves a place on your bookshelf; better still it could land on the desks of those who presume to govern us.

ROBERT MILLER