Politicians, the Housing Scandal and Inflation

By Roger Sandilands

ONE OF THE most disturbing consequences of inflation is that the initial response of governments is to seek to repress rather than cure it: to attack symptoms rather than the disease itself. Nowhere is this more apparent than in the field of housing policy.

It is only quite recently that statisticians have succeeded in constructing satisfactory general price indices. One unfortunate consequence has been the tendency to define inflation as a rise in one of these general price indices (usually the retail price index). Previously, inflation had always been defined as "an excessive increase in the money supply". This latter definition has the great virtue of concentrating energies on control of the money supply in order to control inflation. The price index definition of inflation instead encourages governments to tackle the symptoms of excess monetary expansion—rising prices—directly, through a variety of price controls.

In the field of housing policy price controls have taken different forms in the three main sectors: the private rented sector, the public housing sector and the owner-occupier sector. In the first category, rent controls have helped produce the predictable and familiar result of a sharp contraction in private rented accommodation. From over 90% of dwellings in 1914, today only 15% fall in this category. Partly, of course, this trend reflects the increasing preference for owner occupancy. However, by severely reducing the profitability of this sector, rent controls have sharply and artificially accelerated this trend in the last twenty years.

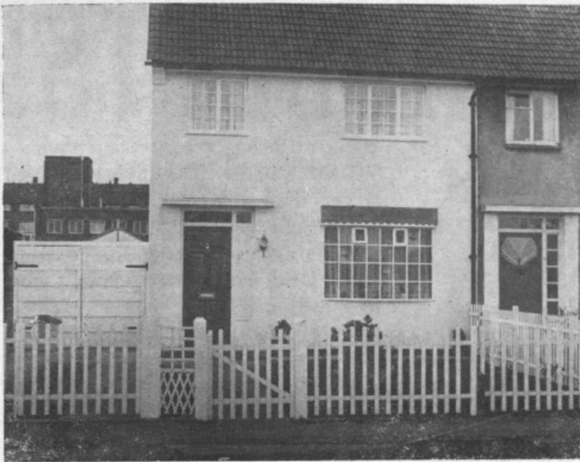
In 1977 about 400,000 of the two million private tenancies had rents at a level fixed in relation to 1956 gross rateable values. The faster the rate of inflation, the more out of line these fixed rents become in relation to the market clearing price and to alternative investment opportunities. New private landlords are deterred; established landlords change the use of their properties whenever they can regain vacant possession. Established tenants gain from low rents (but probably complain increasingly about inadequate repairs and maintenance), while for those households who seek a new private tenancy rents are exorbintantly high and properties increasingly difficult to find. Over-crowding of properties, particularly in the inner cities, is the increasingly common result.

If rent controls were abolished, historically fixed rents would rise sharply but current rents would fall as the supply of private rented accommodation increased. In specific locations, of course, demographic forces would drive up the prices of fixed land and hence the total rentable value of some dwellings. But the answer to this problem is not rent controls, which simply distort rational land and housing allocation mechanisms, but land value taxation. The 1977 Green Paper on Housing Policy (HMSO Cmnd. 6851) evinces total ignorance on the part of our policy makers of the relationship between land and housing policy. Virtually the only reference made to land, as distinct from housing, is a paragraph that trusts that local authorities will use the powers of the Community land Act to ensure adequate supply of building land!

SIMILAR problems arise from inflation with respect to the supply of local authority housing (about 30% of the total). Council rents, once set, tend to be sticky. In a period of severe inflation housing costs rise in money terms and existing rents diverge increasingly from current costs. Existing council tenants gain, the general taxpayer foots the bill. Inflation is associated with high interest rates, and those local authorities which have large outstanding debts to finance recent house-building programmes can face unexpectedly large interest charges which they cannot meet from existing rents. Under these circumstances, the exchequer meets most of the deficit on local authorities' housing revenue accounts.

Some local authorities, however, have only minimal outstanding debt on housing account. Their housing stock may be relatively old, so current interest payments may be very small. In addition, inflation means that the historic cost of most of their housing is very low (most pre-war housing cost much less than £1,000 per unit). These authorities feel there is no need to increase rents on such properties. If they did, they could run into trouble anyway since authorities are not supposed to make a profit on their housing accounts.

The government, in their 1977 Green Paper, accept the principle of historic cost rents for council housing on the grounds that owner occupiers also gain from a divergence between historic and current housing costs. This view suffers from a failure to note the tremendous differences in rents for comparable properties *within* the public sector simply because of



◆*DIFFERENT motives make these two houses—and their occupants—uneasy neighbours. The council-built house on the left was bought by the tenant and transformed into a neo-Georgian style, while the next-door neighbour's home remained in the public sector. . . . . .*

differences in historic costs as between one local authority and another. Thus, even if it is true that broad equity is achieved between the public and the private sectors, this criterion certainly does not achieve equity within each sector.

TURNING lastly to the private owner occupied sector we discover a sad history of boom and depression that goes a long way to explain the general instability and high unemployment rates in the British economy in recent years. High inflation rates inevitably produce high interest rates, at least in nominal terms. This makes it difficult for building societies to attract a stable, growing volume of funds.

When funds are scarce new loans and new building contract. Unemployment and depression ensue. The building societies are in a dilemma because if they raise their rates to competitive levels, borrowers may find their debt servicing payments rising sharply to current incomes. A 2% increase in interest rate, from 8% to 10%, is a 25% increase in gross interest payments which represent the largest fraction of debt charges on more recent mortgage contracts. These outgoings are included in the calculation of the retail price index whose rise the government is clearly anxious to curb. Hence a rise in building society interest rates is strongly discouraged.

The first result is that building societies' net receipts contract. The second result is often that the government will step in with a "stabilization loan" (£500m in 1974). These loans increase the public sector borrowing requirement. This tends to add further upward pressure on interest rates (reducing further the competitiveness of building society deposits) or is financed with the printing press. An expanded money supply increases prices and this eventually forces a rise in interest rates anyway. So at this point building societies are forced to raise their rates. From the point of view of building society investors this is only fair since inflation depreciates the real value of their savings, and higher interest rates are required to compensate for this. Borrowers gain from inflation because the real value of their money debt is reduced by the devaluation of money.

THE GOVERNMENT'S attitude to this in the 1977 Green Paper is very confused. On the one hand they point out that the 'front-loading' problem that borrowers face in the early years of a mortgage contract when interest payments are high is offset by tax relief. On the other hand declining real payments in later years are not thought to be too deplorable because of the sacrifices made earlier and because council tenants make similar gains from historic cost rents. Nowhere do the government acknowledge that the cost of this is being borne by a particular group—building society investors, who not only suffer from negative *real* interest rates but also pay tax on the nominal interest they do receive. These tax payments finance the tax relief enjoyed by borrowers, who are often richer people than the savers.

A more equitable system would be one of index-linked housing finance. This involves making adjustments ("monetary correction") to building society deposits in line with the inflation rate. Borrowers would also have the book value of outstanding debts indexed in the same way but repayment would be spread more evenly throughout the mortgage repayment period. The best solution of all, of course, would be to tackle the problem of inflation at its roots—by responsible monetary control. This, however, may in the short run involve higher interest rates to ensure that all government spending is financed either by taxation or by voluntary purchases of bonds.

But political expediency dictates a very short-sighted view of interest rate movements. Every attempt is made to avoid increasing interest rates even where this is essential to compensate prospective buyers of government bonds against the ravages of inflation. This is followed by direct interest rate controls on those sectors most easily controlled (including building societies) and by further expansion of the money supply. Both these measures are self-defeating of course. Increased money supply increases inflation and this in turn eventually forces even larger increases in nominal interest rates. One of the main casualties is a stable housing finance system, without which there can be no stable construction industry and no end to the dreary cycle of boom and bust that has characterised the industry for years.

◆*The author is lecturer in economics at the University of Strathclyde, Glasgow.*