Investigation on one scheme can go ahead but we do not need to take a decision until we see what it looks like. MT

CONFIDENTIAL

Prime Minister
The Chancellor's proposal concerns machinery to save manpower, not policy. It seems alright to me. Do you want to discuss with the Chancellor; or shall we say 'yes' subject to any comments from Mr Heseltine?

CHANCELLOR OF THE EXCHEQUER

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

TAX AND HOUSING: ADMINISTRATION OF MORTGAGE INTEREST RELIEF

7.12

Flag A

You will remember that I sent you a fairly wide-ranging minute on the subject of Tax and Housing on 7 August, and your Private Secretary replied on 8 August saying that you were not prepared to countenance any reduction in mortgage interest relief and that you did not favour the possibility - mentioned in my minute - of the so-called "Universal Option Mortgage Scheme".

2. I recognise the difficulties of making any change in the relief for mortgage interest. Nevertheless I think that it is important to distinguish between the level of the relief and the administrative arrangements for giving it. I am not now seeking to change your view on the first point. But that, of course, is no reason for regarding the machinery for giving effect to the existing relief as sacrosanct, particularly if large staff savings could be achieved by streamlining the procedure. I accept that the description of such changes under the title of "Universal Option Mortgage Scheme" was unfortunate. What is contemplated and the point to which this memorandum is directed, is simply to give the present relief by way of a different mechanism. To make this clear it would be desirable to use a more accurate name for the proposals in mind and I refer to them in future as the "Mortgage Interest Relief at Source".

3. At present the relief is given case by case, through the adjustment of individual tax liabilities. This is a complicated and cumbersome business, involving a staff cost

/in the

in the Inland Revenue of some 1,400 even in a year when the rate of mortgage interest remains unchanged; a rate change can cause an additional staff cost of up to 1,000, depending on the size of the change, when it takes place, and so on. It would be possible to save a very substantial part of this staff cost if the relief could be given in a different way, and indeed the possibility of doing this was included in the list of options for staff savings which I sent to the Lord President in July.

4. As you know, for many years the normal income tax rule (which had been with us virtually since the inception of the tax) was that an individual paying interest should do so under deduction of tax. The present Building Society Arrangement was a departure from that rule, in that it allowed interest to be paid gross, the tax being collected from the Building Society and relief being given to the payer by way of adjustment of his PAYE coding or otherwise. The rules were changed in 1969, to make interest payable gross; and what I now have in mind is in substance that we should, within the area covered by the proposal, revert to the old rule. The borrower would thus get his tax relief by paying his interest net of tax. There would be no need, save in specific and limited circumstances, for an adjustment to the borrower's tax liability. The tax suffered by the societies by this form of deduction would be greater than their liability under the present Arrangement: and we should need to repay them - as we repay other people such as pension funds who are not liable to tax. There are of course considerable practical problems which will inevitably be reflected in the administrative arrangements but the principle underlying these arrangements would be as I have set out below.

/5. A similar

5. A similar exercise relating to relief for life assurance premiums has recently been successfully completed. Policy holders now obtain relief by paying reduced premiums rather than through their tax codings or assessments, and the tax relief is paid direct to the assurance companies by the Revenue. The relief in respect of those who are not liable to income tax scores as public expenditure. The change has been generally welcomed by policy holders and, despite the extra work for them, the assurance companies. Eventual staff reductions should be at least 1,000; over 900 have already been saved.

6. Any change on the mortgage front will of course require the most careful preparation and presentation. We will need the co-operation of the building societies, who will face extra costs and we shall have to carry them with us. One of the points to discuss with them is how to try to ensure that new arrangements do not significantly disturb the present pattern of borrowers' costs. Yet another sensitive area is the relief against the higher rates of tax. We shall have to make it clear that the fact that this will require to be given as a separate operation is not to be taken as implying that we have any intention whatever of withdrawing this relief. But I do not think that these considerations should deter us from carefully examining whether we can go ahead with the change. The prize in terms of staff savings is a very substantial one, and without it I see no prospect of being able to reach my target for staff reductions. It would also be a significant further step in simplifying the personal tax system.

7. Such a fundamental change in the administrative arrangements for mortgage interest relief cannot be introduced quickly; the best estimate is that because of the changes in the building societies' working arrangements which are likely to be needed,

/the date

the date of implementation will have to follow some two years or so after legislation. But before we can contemplate legislation, a lot of work on the details of the scheme will need to be done, and this will require discussions between the building societies and the Inland Revenue, and also DOE. Because of the long time-scale, there is a need to get discussions moving quickly if the staff savings in their turn are not to be delayed. But the first step must clearly be some kind of preliminary announcement about our intentions to enable discussions with the building societies to be opened. This announcement would of course make it clear that no-one should be worse off as a result of the change.

X

8. Before taking this step, however, I should wish to be assured that you are in agreement to my going forward on the lines proposed.

9. I am copying this minute to Michael Heseltine, in view of his interest in housing generally and in the present Option Mortgage Scheme in particular.

G.H.

(G.H.)

28 November 1980

CONFIDENTIAL

FILE Sup

bc. Mr. Ingham

Econ Pol.

10 DOWNING STREET

From the Private Secretary

4 December 1980

TAX AND HOUSING: ADMINISTRATION OF MORTGAGE INTEREST RELIEF

The Prime Minister has now considered the Chancellor's minute of 28 November on the above subject. She is content for him to initiate an investigation of the proposed scheme of "mortgage interest relief at source", and that an announcement should be made to this effect. But this is on the understanding that no decision on whether to introduce the scheme will be taken until the investigation is completed.

I am sending a copy of this letter to David Edmonds (Department of the Environment).

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

KRB

CONFIDENTIAL

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10 DOWNING STREET

Prime Minister

Before writing to the Treasury on this, I thought I ought to point out - in case you missed it - that the Chancellor will need to announce that the investigation will take place - because of the need to discuss with the building societies (see last page - x). But as you say, there must not be any commitment at this stage to the scheme. Content?

Yes MT.

TL 3/12

Econ Pol

Confidential

Tx to note

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2nd December 1980

D. Edmonds, Esq.,
Private Secretary to
the Secretary of State,
Department of the Environment

3/12

Dear David,

Your office asked me for a copy of a minute the Chancellor sent to the Prime Minister on 7 August about taxation and housing.

With the Chancellor's agreement, I am now enclosing a copy of the document with this letter. As you will see, it surveys a range of tax issues - which probably have as much significance in the context of the politics of income distribution as in that of the economics of the housing market - from the standpoint of the Chancellor's own Departments. As you will know, the Prime Minister has not favoured changes in the tax treatment of building societies and people who borrow from them, and the Chancellor's minute of 28 November reflected further work on one specific aspect of present arrangements which does not give rise to the difficulties which the Prime Minister saw in any more far-reaching changes.

In view of the political sensitivities involved in this correspondence and its subject matter, I should be grateful if you would restrict the circulation you give to the Chancellor's minute in your Department, and also ensure that it is handled very carefully.

I am sending a copy of this letter to Tim Lankester.

yours ever

John Wiggins

A.J. WIGGINS

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

TAX RELIEFS FOR HOUSING

Since the Budget, I have pressed ahead with preparations to involve a few experienced people outside Whitehall in the work on taxation and savings which you endorsed earlier in the year (your Private Secretary's letter of 31 March to mine). The involvement of the outsiders was made public in a Written Answer on 4 July. I am also asking officials (but not the outsiders) to consider the tax treatment of gilts and chattels as you suggested.

Background

2. You also mentioned the present bias towards housing. I have been thinking carefully about the scope for doing more work on this. This is a difficult area, and I thought it might be useful to set out some of the considerations which we would need to take into account in deciding what work to put in hand. There are a number of conflicting issues.

3. I have not concerned myself with rented housing - either in the public or private sectors - but have concentrated on owner-occupation, where the tax reliefs are given. What we decide on owner-occupation, however, will need to be viewed alongside our policy in the public rented sector, where our aim is to increase rents and reduce subsidies, and in the private rented sector where one of our aims is to improve the working of the market by reducing the extent of rent controls.

The Reliefs Available

4. The main tax provisions from which owner-occupiers can be said to benefit (apart from general help for housing) are:-

(a) mortgage interest relief on loans up to £25,000 for the purchase or improvement of one's main or only residence;

(b) exemption from capital gains tax on disposal of one's main or only residence;

(c) exemption from stamp duty on the transfer of residential property not exceeding £20,000, and reduced rates up to £35,000; and

(d) (included for the sake of theoretical completeness) the absence since 1963 of tax on the "imputed" income from owner-occupation - the old Schedule A tax.

5. The cost of these provisions cannot be calculated with any degree of certainty. It would be misleading simply to aggregate the various costs in calculating the total tax subsidy to owner-occupation. But the cost in 1979-80 of mortgage interest relief was around £1.4 billion (and is estimated this year to be around £2 billion), and the cost of the stamp duty relief some £230million. The tax "forgone" in giving CGT relief and from the absence of Schedule A is likely to be more than £1 billion in each case.

6. The value of these reliefs has continued to increase rapidly in recent years with the growth in the size of mortgages (due to inflation) and the increase in mortgage rates. In 1973-74, for example, the cost of mortgage interest relief was only £500 million - equivalent to about £1.2 billion at 1979-80 prices.

7. On the other hand, domestic rates, which yielded last year nearly £3 billion, work in the opposite direction to these reliefs. They are a tax on the occupation of property, and assessed on its annual value. As such they are paid by those who rent their house as well as by owner-occupiers; but even so they represent something of an offset to the fiscal concessions outlined above (though domestic ratepayers are still better treated than industrial and commercial ratepayers because of domestic rate relief).

The issues

8. The reliefs for owner-occupation are now very generous - arguably too generous, at least in the extent to which they are particularly concentrated on those who already own, in contrast with those wishing to buy for the first time. Indeed, from an economic, social and fiscal point of view, a case can certainly be made for re-examining them. They are not a very cost-effective way of increasing owner-occupation; the fiscal incentives push up house prices so that much of the benefit goes to existing owners, rather than first-time buyers. By diverting savings flows away from the capital market, they raise the cost of money to industry and commerce and may crowd out productive investment. Some reduction in the tax concessions would go some way to widen the income tax base. And it should reduce the overall level of interest rates at which the monetary target can be met. (Tax relief damps the price sensitivity of demand for housing credit and so raises total credit for any given level of interest rates generally, except insofar as housing finance is directly rationed.)

9. On the other hand, as a Government, we are committed to a property-owning democracy and it is right that we should retain a range of generous incentives in this area. I would not, therefore, want to make a substantial reduction in the total scale or scope of reliefs - at least while mortgage rates remain relatively high. If at any stage the pattern of reliefs was changed, that would need to happen gradually to avoid hardship.

10. Certainly this does not mean that we should rule out making changes at all. But in considering what might be done, the points I would wish to stress are these:-

(i) the need for tax simplification. We must try to reduce the administrative complications of the present arrangements. Mortgage interest relief is costly in manpower - requiring some 1400 Inland Revenue staff, and even more when PAYE codes have to be changed mid-year to take account of alterations in the mortgage rate;

(ii) the effect of labour mobility. As part of our policy of improving the supply side of the economy, we should aim to make changes that will encourage labour mobility. I have little doubt, for example, that the present burden of stamp duty on house transfers is harmful in this respect;

(iii) the possible need for greater competition among the building societies. We have up to now acquiesced in exempting the building society cartel from restrictive trade practices legislation because it helps to ration mortgage finance and so keeps down mortgage rates. But there can be little doubt that the building society cartel creates inefficiency. It restricts price competition between the societies, ensuring that the least efficient can survive. One conspicuous consequence of the cartel has been the recent increase in the number of high street building society branch offices.

Possible developments

11. If we were thinking of making changes, I would suggest the following broad approach:

12. Schedule A. I cannot believe that we could or would wish to turn back the clock and re-introduce Schedule A. It would be costly to administer, and cause enormous trouble with our supporters.

13. Capital gains tax. Nor could we contemplate taking away the exemption from capital gains tax for owner-occupied houses. It would be absurd to impose a heavy CGT charge on owner-occupiers, with the most damaging effects on labour mobility, at a time when we are still giving thought to reducing the burden of this tax generally.

14. Stamp duty. Clearly there is a good case for reducing or even abolishing stamp duty on house sales. A change here would encourage labour mobility, and abolition would represent a useful simplification of the tax system. But stamp duty is now a big revenue-raiser and changes would be expensive.

15. Mortgage interest relief. There are a number of possibilities here. We could reconsider the £25,000 ceiling, and the rate of tax at which relief is given. The ceiling has remained unchanged since 1974 and there are strong pressures within the party to increase it. One possibility which has been suggested would be to increase (or even abolish) the ceiling whilst restricting the value of the tax relief to the basic rate. (We should need to examine the distributional consequences of this and other possibilities.)

16. A second possibility would be introduction of a universal option mortgage scheme - replacing the present tax relief with a direct

subsidy paid by the Government to the building societies, who would then pass it on to the mortgagee in the form of a lower mortgage rate. The Government could then choose to set the subsidy at whatever rate it wished. Such a scheme would produce staff savings in the Inland Revenue, though these would be partly offset by the extra staff needed by the DOE for a wider option mortgage scheme.

17. A more radical approach, of which Peter Bottomley is a persistent advocate, might be to do away with mortgage interest relief as such, replacing it with a general relief covering life assurance premiums, mortgage interest and possibly other forms of contractual or medium-term savings. Supporters of this scheme see it as a way of limiting relief for owner-occupiers, whilst removing some of the existing distortions in the tax field. Though it would raise difficult problems, it is certainly an interesting longer-term idea.

18. Lastly, there is a rather separate point on the building societies. The Wilson Committee recommended a number of changes in the tax treatment of the societies which are not far removed from this general area and I am arranging for these to be looked at in the Tax and Savings Group.

Conclusions

19. There can be little doubt that the tax treatment of those already established in owner-occupation is generous. This reflects the priority we give to encouraging home ownership. Whether we want to make any changes is as much a matter of politics as of economics, and is something which you will no doubt want to consider very carefully. I would rule out any thought of re-introducing Schedule A or removing the CGT exemption. But it might be worth commissioning some work on the various suggestions for mortgage

interest relief, along with reducing or even abolishing stamp duty on house sales. There could be a useful package here which would make better use of the revenue involved and save staff, whilst simultaneously reinforcing the forces of competition and encouraging and assisting labour mobility.

20. If you wanted to proceed, I would ask officials in the Tax and Savings Group (without outsiders for this purpose) to embark on a study. But perhaps we should first discuss.

(G.H.)

7 August 1980