Revised by Policy Unit.

DMB 15/2

PRIME MINISTER

HOUSING : HOME IMPROVEMENT AND PRIVATE RENTING

Home improvement

Patrick Jenkin and Nicholas Edwards have produced a policy paper on home improvement with particular reference to loans, about which you had expressed concern. We shall brief you on home improvement shortly before your forthcoming meeting on the subject.

Private rented sector

DoE and the Welsh Office have also circulated to members of H Committee their revised proposals for the private rented sector. The only major difference between the proposals rejected by H last July and the present proposals is that DoE now accept that the extra PSBR cost of deregulating the private rented sector will be small and will be confined to the first couple of years after deregulation. Thereafter, substantial savings will be achieved. We calculate that, even now, DoE have underestimated the savings from deregulation, which could reach **£100-200m a year** after five years.

Existing lets

Existing lettings will be left untouched under DoE's proposals, since it would be politically unattractive, if not impossible, to take away from existing rent-controlled tenants the guarantee of a low rent on the basis of which they entered into the tenancy.

E.R.

New lets

New lettings, under DoE's proposals, will be freed from controls on <u>rent levels</u>. But <u>security of tenure</u> will not be deregulated. Tenants will still have lifetime security of tenure, the only minor change being the restriction of the right of succession to the tenant's spouse, as opposed to the present lifetime security plus two successions.

Conclusions

These proposals do not go far enough to be worthwhile. There is no point in exposing ourselves to the political flak that deregulation will attract unless security of tenure is deregulated as well as rents. Economic rents alone will do no more than slow the decline of private renting: if we want the job-creating, labour-mobilising advantages of a vigorous private rented sector (as in the United States), we must be radical and courageous enough to legislate to allow landlords and tenants the right to decide freely not only what rent will be paid but also how long the tenancy will last. Potential landlords who know that, if they let their property, they will lose it for a lifetime are not likely to become <u>actual</u> landlords in any significant numbers.

<u>We recommend</u> that you should call an urgent meeting with Patrick Jenkin, Nicholas Edwards and Ian Gow, before the H discussion of their proposals. Deregulation of the private rented sector is too important a part of our strategy for jobs and enterprise to be let drop for a second time.

<u>CHRISTOPHER MONCKTON</u> CM. 15 February, 1985

E.R.

ANNEX A : DEREGULATING PRIVATE RENTS - COSTS OR SAVINGS?

Deregulation of new lettings in the private rented sector will bring large PSBR savings. True, deregulating rents puts up the cost of housing benefit rent allowances as existing regulated tenancies come to the end of their life and are replaced by deregulated tenancies at higher rents (DoE now put this extra net PSBR cost, allowing for some extra tax paid by landlords on the higher rent, at **£14.5m** in year 1, rising to **£36m** in year 5).

But this cost is offset by reductions in mortgage interest relief because deregulation will allow many wholly new lettings to be made and will give young people the chance and the choice to begin life by renting rather than buying (DoE put this saving at **£8m** in year 1, rising to **£75m** in year 5). So even on DoE's estimates, the net cost of deregulation will be small and confined to the short term, while there could be substantial savings in the medium term.

Although these figures are much more realistic than DoE's previous submission to H, we continue to think them pessimistic: savings could reach as much as **£200m a year** in the medium term, particularly if security of tenure as well as rents were deregulated. The more the private rented sector expands, the bigger the savings will be. Alan Walters, who has helped us in calculating the possible savings, agrees that savings would be considerably greater than DoE think. His note is attached.

NOTE BY ALAN WALTERS

Notes on Rent Deregulation

General

1. Decisions should be made on a Cost-benefit (CB) calculation and not on a net PSBR criterion. The net PSBR calculation ignores, for example, the net benefits accruing to landlords--except insofar as they are taken in tax. If deregulation were to result in a fourfold increase in rents, then the net PSBR cost would be very large--because of the concomitant increase in subsidies. But such a conclusion would ignore the enormous benefits of deregulation manifest in the higher rents (productivity) of free property.

   [Note: General genuine benefits to the private and public sectors are shown with a small b, whereas Benefits such as Housing Benefits (HB) or Social Security Benefits, which are transfers from taxpayers to recipients, are shown with a capital B.]

2. The absurdity of the D of E criterion can be illustrated by reversing the argument. If we legislated more stringent rent controls by forcing down rents (and extending the regulations) then the (D of E) PSBR would be reduced; just as controlling the price of food would reduce Social Security benifits and so the PSBR. This provides a justification for general price control, just as the D of E criterion supports the continuation of rent control. Of course we have had enough experience with freer markets in food, electronics, furniture, etc., to know that the D of E type of case is laughable and petty. But in housing, regulated for 75 years, they are no laughing matter.

3. The D of E calculation is a flow figure for two particular years. The appropriate calculation, as any text will reveal, is the net present value. This takes account of all future revenues and costs discounted to an equivalent capital sum (now or at some other specified date). By D of E admission, most of the "negatives" occur in the first year or so and many of the big benefits appear in the medium term, so the misuse of flow figures biases the decision in favor of increased or more stringent regulation of rents.

4. Clearly D of E have selectively, and in my view rather crudely, presented data arguing against change. There may be a good political case against deregulation but one should not cloud the issue with a manifestly phoney pseudo-economic or financial case. Whatever the political costs, the net economic benefits--including those on public finances--would be overwhelmingly positive, and similar to those which appeared in all the great liberations, such as Germany in 1948, or the United Kingdom in 1951-54.

Particulars

Monckton's Note to Ian Gow

* Labour's Promised Repeal

  One should also recall that the early years of the next government (1988) will see the opportunity to restructure taxes and benefits. Even a Labour government (or an SDP-Liberal government a fortiori) will want to rationalise the HB system and the rapidly dying private rental sector (down to 1.5 million by then at present rates of attrition). In 1987-88 we expect the computeristion of the tax/benefits system.

* Security of Tenure

  Note that the present system precludes the freedom of negotiation; the imposition or threat of "fair rent" (what a wonderfully deceptive term!) which are required not to reflect "shortages" pre-empts any possibility of mutually beneficial free bargains. Would not an extension of the leasehold system with agreed tenure and rent arrangements do the job of assuring landlords and tenants of their rights?

* HB Cost

  In addition to the amendments and addenda of the Monckton memorandum, which seem to me to be correct, I would argue that the tax receipts from the increased rents are still much underestimated (or alternatively the landlords are in the poorer sections of the community, perhaps among the benefit recipients--do we know?).

  It is astonishing that the marginal benefit rate, with respect to rent increases, is 42.5 (or 43) percent, whereas the marginal tax rate is only 18 percent (i.e. L45 million in year 5 on income of L257.5+ million). If this is income and corporation tax, then landlords must be a poverty-stricken lot--and quite different from their image.

  But apart from that point, the calculations presumably assume that the landlords spend their income on food and newspapers which are zero rated for VAT--an unlikely proposition perhaps except, again, insofar as they are on the poverty line--and then we must count the reduction in Benefits brought about by their increased income. And if the landlords save all their additional income then they will accumulate future tax obligations--income, outlay and capital gains taxes--in the future. Thus the future PSBRs would fall continuously. Similarly the reduction of 20 percent for repairs implies either no new activity (and this is unlikely in a sector like house repairs) or no income tax or VAT paid by the repairmen.

W2

THE PRIVATE RENTED SECTOR: SAVINGS FROM DEREGULATION

The more thoroughly new lettings in the private rented sector are deregulated, the larger the PSBR savings will be. This short note explains why.

DoE put a paper to H Committee last July saying that deregulation puts up the cost of housing benefit rent relief because free-market rents are higher than controlled rents. It was suggested that the extra public cost would be £35-60m in year 1 after deregulation and £75m-£110m in year 5.

At our request, DoE have done further work on these figures. Their latest estimates, which will appear as an annex to the forthcoming paper for H on deregulation, put the net PSBR cost at £14.5m in year 1 and £36m in year 5. This significant downward revision is because:

1. DoE now accept that the most likely outturn is at the bottom end of the range rather than the top (their calculation for the top end of the range had made no allowance whatever for loophole lets, lets already at market rent and lets where HB was due but not claimed).

2. Results of a new lettings survey by the Office of Population Censuses and Surveys show that the rate of existing "loophole" lets is twice as high as originally estimated, reducing the number of lettings for which a higher amount of HB than at present would be claimed.

3. Landlords would pay income tax on the higher rent from tenants of deregulated lettings.

4. Fewer improvement grants would be payable to landlords: in future the only rented properties which will qualify for grants will be those with controlled rents.

At our request, DoE have now also calculated the fiscal effects of an increase in the supply of privately-rented accommodation as a result of deregulation. Their previous calculation had been confined to the turnover of existing lettings. The new calculations show a saving of £8m in year 1, rising to £95m in year 5. The saving comes from reduced liability to mortgage interest relief which would otherwise have had to be credited to households who cannot now rent but would rent privately rather than buy if they were given the chance to choose. This saving is partly offset by increased HB on the new lets. DoE now conclude:

> "... In the medium term there is a good prospect that such savings would materialise and that as a result deregulation would lead overall to a net reduction in public borrowing."

For what it is worth, my conjecture is that tax increases (income, VAT, fuel, excise taxes on tobacco and alcohol), would soak up more than 40 percent; if the tax rate is much lower (at 20 percent or less) then this must be because the marginal tax rate is low and the landlords are poor etc. The assumption that no new lettings will be made is characteristic of the perennial error of officials that the price system does not work. The lessons of the energy market etc. are ignored. Elasticity pessimism is as absurd as it is endemic (although it is true that distinguished dons, at Cambridge for example, regularly preach that the price system does not work). The fact that, because of uncertainties both economic and political, we cannot confidently predict the numerical consequences of new lettings is no excuse for making the blatantly false prediction that it will be zero. Indeed this zero prediction implies that there is a fifty percent chance of lettings being reduced by deregulation--again patently absurd.

W3