

WHEN IS A SUBSIDY NOT A SUBSIDY? - The Cuts in Housing

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There has been a great deal of concern recently about the apparently astronomic rise in the cost of Council housing, and the corresponding increase in subsidies. And not without reason: for instance, loan charges in London housing authorities' housing revenue accounts have risen from £166.4m in 1972/73 to an estimated £388.4m in 1975/6 - an increase of 137% over three years, and an increase per year of over 30%. This has not been due to profligate spending: Conservative Sutton, for instance, had the average increase of 137% while Labour Newham showed the more modest increase of 112%.

My Article in "Roof" pointed to the reason for this amazing phenomenon. When inflation is occurring, money which is lent loses its purchasing power before it is paid back. Under the financial conventions we have inherited from the past, lenders are compensated for this not by writing up each year the nominal value of the outstanding loan by the amount of inflation which has taken place, but by a rise in the rate of interest. This, however, has the effect of increasing the payments of principal and interest early in the life of the loan, and reducing them later, when the payments are measured in terms of their purchasing power and not in "nominal" terms. This is fully demonstrated in table 3 of the "Roof" article, where it is shown that the cost of servicing a £10 000 loan repaid over 20 years is almost doubled in year 1, and halved in year 20, when inflation is running at 10% and interest is 15%, compared with a situation of zero inflation and a 5% rate of interest.

One consequence of this is that the concept of "economic rent" ceases to have any simple meaning under high inflation. Because of the altered time-pattern of real payments on a dwelling, it is inevitable that a Council's financial outgoings will be much higher early in the dwelling's life, and much lower later, when inflation is high than when it is low. Clearly it would be ridiculous to vary a tenant's rent in direct proportion to loan charges on his particular dwelling: and in practice, Councils act as a financial intermediary by "pooling" rents so that below-cost rents on new dwellings are counter-balanced by above-cost rents on old dwellings.

(Incidentally, this is why it could at present be financially catastrophic to give away old Council dwellings.)

A further - and more important - consequence also follows. This relates to the aggregate behaviour of loan charges in a Council's housing Revenue Account. Since the gains from charging above-cost rents on old dwellings are fed into the same account as the losses on new dwellings, and the Council's gains from the falling real value of outstanding debt are also fed into the same account as its losses from its earlier real payments on its loans, one might think that gains and losses would cancel each other out. Indeed, if there had always been a high rate of inflation, and if it remained steady, a Council would be no worse off than if there were zero inflation with the same real rate of interest. However, when there is a rise in the rate of inflation and therefore a rise in the rate of interest, an interesting phenomenon occurs: there is a "bunching" of loan charges measured in real terms. In other words, for a time (the "hump") loan charges rise at a faster rate than inflation; and then (the "trough") they rise at a slower rate than inflation, i.e. they fall in real terms. What has been lost during the "hump" is regained during the "trough": there has been what must be called an inter-temporal financial transfer.

An arithmetical example of "bunching" is illustrated in the Table. Values of the different variables have been chosen to correspond to the situation of a typical Housing Revenue Account over the past few years. Alternative plausible assumptions have also been used in a number of computer simulations using the same model." 60 simulations have been carried out. They reveal that substantial "bunching" occurs whatever the rate of rise of the rate of inflation and whatever the rate of rise of the rate of interest;* however, "bunching" is not significant if the ratio of new capital expenditure to outstanding debt at the beginning of the period is below around 7%, and the rate of rise of the rate of interest is slow. In fact, in the Housing Revenue Accounts of Local Authorities in England and Wales in 1972/1973 the ratio of new capital

* i.e. over all plausible values

expenditure to outstanding debt was 9.4%, or well above what appears to be the critical value. There can be little doubt that "bunching" has actually occurred.

We now have the answer to the conundrum posed at the head of this article: When is a subsidy not a subsidy? When it's an inter-temporal financial transfer. Council tenants cannot be expected to pay enough extra rent during the "hump" to meet the cost of the extra loan charges; and why should they? The Council will be getting the money back anyway during the "trough" (unless, of course, inflation and interest rates go on rising indefinitely, which is hardly conceivable). To keep the same proportion to loan charges in 1975/6 as in 1972/3, London Council rents would have had roughly to treble (to get a given increase in revenue, rents must go up by more because of extra payments of rent rebates and losses of well-off tenants to owner-occupation).

Of course, if the rate of interest falls again, the "trough" will occur sooner, and be deeper, than is suggested in the Table, which is based on the assumption that inflation and the interest rate remain stable at their new high levels. But the market rate of interest would have to fall heavily from its current level to prevent the "pooled" interest rate rising still further. This means that we are still experiencing a "bunch".

There is no space here to draw out the obvious parallels in the market for owner-occupied housing. What must be done, however, is to draw out some of the implications of "bunching" for other areas of social and economic policy. Within the field of local government, it is easy to see that the cause of rocketing rate demands is the same "bunching" effect. The latest Annual Abstract of Statistics shows that the capital expenditure of Local Authorities in England and Wales in 1972/73 was no less than 15.6% of the gross loan debt outstanding at the beginning of the financial year. Ratepayers' action groups should take a look at "bunching" across the whole field of local authority capital spending, and not just housing, before planning the next round of their campaign. Even more topically,

the basis of the current negotiations on rate support grant is shown to be mistaken. "No real growth" actually means swingeing cuts in real terms. The Table shows that to keep real capital investment at the same level during a "bunch" involves allowing loan charges to rise faster than the rate of inflation - and given conventional reasoning, this will appear to be a growth in "real" terms even though it is not: it is only a growth in financial outgoings. As the Red Queen said, "Now here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast."

The most dramatic implications involve the management of the economy. What is true of local government capital spending appears to be true also of the public sector as a whole. In 1973, gross domestic fixed capital formation by the public sector was 15.1% of net total National Debt in the same year.

At present, economic policy is dominated by the notion that the "public sector borrowing requirement" (PSBR) must be kept down. We know that public spending is running at a level of 47% above that of last financial year. This is not due to the employment of extra armies of civil servants or indeed necessarily to any extra demands on the real resources of the community. It is due to "bunching" of the loan charges of the public sector. Therefore the correct response is not to cut capital investment or current spending measured in real terms: this will ensure another Great Depression. Nor should the extra loan charges be met by flooding the capital market with extra government stock (this would expand the credit base of the economy too much and cause demand inflation). The only possible response is the immediate partial "index-linking" of government debt. The point is that the government does not in total owe too much: but like housing authorities, it is having to pay out too much too soon to service its debt. Like them, it must slow down its rate of repayment.

It would seem that we are faced with the need for a radical change of course in economic policy.

ARITHMETICAL EXAMPLE OF "BUNCHING" OF LOAN CHARGES IN A HOUSING REVENUE ACCOUNT

	Year									
	1	2	3	4	5	6	7	8	9	10
"pooled" rate of interest	6	6	8	10	12	14	14	14	14	14
rate of inflation	5	15	20	20	20	20	20	20	20	20
Outstanding debt at commencement of year (£m)	100.0	109.5	120.5	133.8	150.1	169.4	193.6	222.7	257.6	299.7
Capital expenditure (£m)	10.0	12.1	14.5	17.4	20.9	25.8	31.0	37.2	44.6	53.5
Loan charges (£m)	7.63	8.6	12.0	16.5	22.0	29.0	33.4	39.2	44.9	52.4
Change in nominal terms in loan charges	-	+ 11%	+ 40%	+ 38%	+ 34%	+ 32%	+ 15%	+ 17%	+ 14%	+ 17%
Rise or fall in real terms: (ie. increase greater or smaller than rate of inflation)	-	FALL	RISE	RISE	RISE	RISE	FALL	FALL	FALL	FALL

Notes: 1 All figures are in nominal terms

2 Capital expenditure remains constant in real terms (at £10m. per year measured in terms of the price level at the beginning of year 1).

3 The "pooled" rate of interest rises slowly because only new borrowing and refinanced debt is affected by the current market rate and local authorities have a high proportion of long-dated stock.

4 Annual debt redemption has been assumed to be 1% of the outstanding debt at the commencement of each year. This is a simplifying assumption, permissible because debt redemption is negligibly small.