

# BOWYANG

WORK ON CHANGING AUSTRALIA

Number 6

1981

\$2.00



**Interest rates  
and home  
ownership**

Tom Fitzgerald



# The Haves and Have-nots in Home Ownership.

Tom Fitzgerald

In periods of rising interest rates, personal borrowers, essentially in their capacity as borrowers for home purchase, experience three disadvantages by comparison with business borrowers:

- (i) Unlike the business borrower, the home-buyer cannot hope to be able to pass on some of the higher interest costs in selling prices.\*
- (ii) The business borrower, if it cannot pass on the higher interest cost, is able to claim the whole interest charge as a deduction for income tax purposes, reducing the effective cost of the interest payments by about half. The personal borrower receives no such income-tax concession.
- (iii) Unlike company borrowers, the person who has borrowed from a bank or building society to buy a home has no cushion in the form of previous *fixed-interest* borrowings against the abrupt and sweeping impact of dearer interest rates. The personal borrower suddenly finds the higher rates applying to the entire amount of his borrowings. By contrast, the typical corporate borrower suffers little immediate impact, and only has to worry about the higher cost of future incremental borrowings and future roll-overs of present debt. For personal borrowers, the option of extending the period of a home loan from a bank, as an alternative to making higher monthly payments of capital and interest, has become less and less available with each successive increase in home borrowing rates.

This is a formidable combination of disadvantages: the one class of borrower who is most immediately and comprehensively hit by dearer money is the only class that cannot pass on any of the cost or obtain any tax relief from the impact. And the higher that interest rates rise, the more severe is the relative, as well as the absolute, margin of additional hardship to the disadvantaged group who have to bear a retrospective element in each increase.

\* Interest rates for home borrowing are not an item in the Consumer Price Index. Rents are included in the index. The averaging basis on which the index is compiled would in any case not provide an adequate offset for the cost of higher interest rates to actual borrowers affected.

These socio-legal disabilities of the personal borrower, though obvious enough when pointed out, play no part in economic or financial discussions. One has not seen them brought together anywhere in print. On the contrary, there is a continuing stream of declamation in the name of economic purism against an alleged featherbedding and subsidisation of home borrowers.

The existence of the disabilities just described is not refuted by statements to the effect that homebuyers eventually enjoy capital appreciation free of tax, or to the effect that there are technical objections against attempts to maintain differential borrowing interest rates in the money markets.

These are separate issues. In the first case, however, capital appreciation in housing is not assured or ubiquitous even in money terms, let alone when corrected in terms of, say, the consumer purchasing power of money. There is no windfall for an owner-occupier if his selling price for a dwelling has kept pace, in consumer purchasing power or in capacity for dwelling-substitution, with the price he paid has a buyer. Some recent work, as yet unpublished, by a student of real estate markets, Mr. N. Speirs, challenges a number of other assumptions about the reputedly favourable effects of inflation on the scope for levering-up by homebuyers.

Again to point out that the financial framework offers privileges to corporate borrowers which it withholds from individuals is not tantamount to insisting that differential market rates of interest are the only or the most suitable means of adjustment. Some comments on that subject will be offered later.

The social problem cannot be brushed aside by such means. For a combination of reasons, the growing seriousness of the personal borrower's handicaps requires special recognition at present in any consideration of broad monetary policy. On the international scene, an unprecedented interest rate war between countries for the attraction of mobile cash balances coincides with a trend in Australia towards an increasingly indiscriminate and carefree resort to higher interest rates as a matter of domestic official policy. There have recently been



official statements, for example, to the effect that dearer money rates are desirable for the purpose of pre-empting anticipated wage demands. There have been suggestions that a strong inflow of private capital to Australia (producing a condition of increased money supply) offers grounds for promoting higher interest rates!

Proponents of these policies show no awareness of the peculiarly amplified effects their proposals would have on personal borrowers. The market for money is not a pure market, but rather in present conditions applies serious distortions against the personal participants in it. Money markets are able to set levels of higher interest rates in conditions that are not available to the personal borrower. Some of the most active of the pace-setting intermediaries operate in the knowledge that they can immediately pass the higher cost on to borrowing customers.

Ironically, the one class of home purchaser who enjoys income tax deductibility is the speculative buyer: the multi-home owner and renter who has played an appreciable part in pushing up Sydney prices, working on a highly geared borrowing ratio to maximise early capital profits. He can the more afford to push up prices because of his taxation privileges.

A series of rises in interest rates pushes more and more home seekers beyond the margin of eligibility for borrowing (whether or not the traditional lending institutions continue to offer differential interest rates), and also pushes existing borrowers beyond the fringe of viability that the lending institutions had prescribed.

Home borrowers are unorganised and unable to articulate their problems in the language of the professional financial groups who have made submissions to the Australian Financial System Inquiry and have tended to dominate the hearings of the Inquiry. It is doubly noteworthy that many of these professional executives are themselves immunised against the full impact of the ordinary borrower's disabilities: they enjoy highly privileged concessional borrowing rates for home purchase from their employing institutions, including the Reserve Bank. On the one hand, this widespread practice among the financial institutions is eloquent testimony to the significance of such protection from the rigours of the ordinary personal borrower's lot. On the other hand, it also helps to explain the professionals' insensitiveness to the common experience. The remarkable consequence is that we have pronouncements by very senior representatives of these internally privileged glass houses, strongly attacking the comparatively minor interest rate differentials available to the general public from building societies or savings banks.

## II

Another factor contributing to the neglect of the home borrower's condition is the absence from the Australian National Accounts of recorded figures for the annual interest cost of these borrowings. The information can, however, be inferred from other figures in the national accounts. The interest cost represents the difference between two recorded items, the net operating surplus from ownership of dwellings by persons, and the income from dwellings in the household income table.

The derived figures for interest paid on home loans show an exceptionally strong acceleration since 1972-3. In the following year, when very sharp increases in Commonwealth bond rates precipitated a general trend to much dearer money, the interest cost for home borrowers rose by 37.7%: this was more than twice the previous rate of annual increase, and an illustration of the consequences of the lack of a cushion of fixed-interest loans for these borrowers. In the next year again, 1974-5, there was a further lift of 31.9%. That is to say, the interest bill of Australian home buyers rose by 81.5% in two years.

The following table gives the derived figures for interest paid on dwellings (both owner-occupied and other) for the 11 years ending 1978-9:

**Table 1:  
INTEREST PAID ON DWELLINGS**

1968-69	384	1973-74	1,042
1969-70	453	1974-75	1,374
1970-71	533	1975-76	1,620
1971-72	625	1976-77	1,956
1972-73	757	1977-78	2,273
		1978-79	2,631

SOURCE: Australian National Accounts, 1978-9. Figures are the differential between 'Net operating surplus — Dwellings owned by persons' (Table 9) and 'Income from Dwellings' (Table 35).

These amounts of interest paid are, of course, a function of the volume of home purchases and the prices of dwellings, as well as of interest rates. In abnormally inflationary conditions, price increases and high interest rates combine to exacerbate the interest cost. The upward trend of these costs over the last six years of the table has been much faster than the increase in wages and salaries (pre-tax, and a *fortiori* after income tax).

The upsweep in these interest costs to householders has thus cut into disposable personal income and discretionary consumer spending: especially when it has been accompanied by strong increases in the contractual capital-repayments required of new home buyers in inflationary



conditions (for which no statistics of trend are available). 'Consumer debt interest' on household durables has likewise, from its smaller base, been a disproportionately fast growing expenditure item in the household sector accounts.

Nevertheless, it must be noted that the sector's overall 'saving ratio', as conveniently calculated, has risen over the same period. In strict logic, such a trend is not incompatible with a squeeze on the discretionary income of home purchasers; for example, personal interest *recipients* have experienced an acceleration of pre-tax income growth corresponding to the upward trend of interest costs to borrowers. Clearly, however, it would be most desirable to arrive at an understanding of such a contrary overall trend if the relevant information were available. The rising trend recorded by the conventionally estimated saving ratio has possibly contributed to the diversion of most professional economic attention from the pressures on home buyers.

Some economists have indeed expressed puzzlement or scepticism about that recorded trend, and the INDECS team has summarised some of the doubts in the book *State of Play* (1980, pages 89-92).

I would suggest there are several additional defects to be noted in the conventional ratio as an indicator of discretionary saving. Four of these in particular may deserve to be mentioned in this paper.

First, it is methodologically unsound to include the *imputed* net income from owner-occupied dwellings as an item in 'household disposable income', and unsound also to include the imputed gross rents of such dwellings as items of discretionary consumption expenditure (tables 35 and 37 of *Australian National Accounts, 1978-79*). Whatever the force of philosophical arguments for treating imputed rents as beneficial income, they are not a cash flow or a monetary credit, and they do not form part of existing owner-occupiers' disposable incomes. For similar reasons, the estimates of depreciation on dwellings in the National Accounts are not in real life a deduction against householders' disposable cash flow.

Secondly, the conventional process of arriving at a discretionary saving ratio takes no account of many householders' contractual obligations to make *capital* repayments out of current income by instalments on dwellings and consumer durables. This is not a methodological criticism of the national income tables but of an unthinking derivation of inferences from them. Capital repayments make heavy inroads on the disposable income of the household sector. They are a significant and dynamic economic factor for which we do not have statistics.\*

\* An interesting A.B.S. publication, 'Survey of Housing Occupancy and Costs' (catalogue no. 8724.0) has recent information on combined weekly payments

Thirdly (and more tentatively), it may be doubted whether the statistical calculations of actual rent payments (from tenant to landlord) in the household sector allow for a self-cancelling element in those cases (perhaps a majority) where the rents are only transfer payments within that sector. Any anomalies on this score would compromise both the income and expenditure bases for estimation of a discretionary saving ratio.

Fourthly, an important question mark hangs over the item Saving itself in the National Accounts. Saving is a balancing item, representing the difference between the aggregates of income elements and expenditure elements. But within the item itself there has developed since 1972-73 an extraordinary expansion and change of direction of its apparent 'discrepancy' element ('Other net lending (including discrepancy)', table 36 of the accounts). After that year, the mathematical sign of this balancing item within a balancing item changed from a regular *minus* to a consistent *plus*. This means that the identifiable avenues for household saving (net lending to banks, building societies, etc.) have come to fall heavily short of the figure necessary to equate identified factor incomes with expenditure.

The period of this changed direction and enlargement of the discrepancy coincides with the period of a marked increase in the conventional saving ratio. Indeed, the swelling of the internal balancing item (which has recently been accounting for about one-quarter of the statistical item, Saving) would be sufficient in amount to supply the whole lift in the recorded saving ratio.

It is possible, but not so far established, that the growth of the discrepancy in Saving could be mostly due to anomalies of the kind suggested above. In that case, the lift in the saving ratio would be mythical. More work remains to be done with the limited data available, and this is hardly the occasion to chase the mystery further. The object has been to suggest the extreme shakiness of the conventional saving ratio as a potential challenge to the thesis of serious difficulties for home purchasers. The building of *post hoc* explanations and theories on that ratio's recorded trend is a hazardous enterprise.

### III

This paper's main purpose is diagnostic: to reverse a common assumption about the relationship of home borrowers to the rest of the economy and to indicate the magnitude of a serious human problem in conditions of abnormally high and still rising interest rates.

The time available to the writer has not permitted a lengthy discussion of the policy options available to correct the anomalies (he is available for oral discussions, if desired); but a number of remarks may be offered on this score.



Monetary authorities should re-think any notions they have of employing higher interest rates as an instrument of policy in a more carefree manner than previously and for a wider range of (sometimes remote) domestic economic objectives. They should appreciate exactly what such notions would mean to the household sector.

The traditional margin of concession in the *nominal* borrowing rates for home buyers has been no more than a partial offset for the disadvantages described at the beginning of this paper. *A priori* value judgements hostile to the differentials are misplaced: to the extent that they have been technically feasible, the differentials have been fully justifiable on grounds of equity. Though the development of the system of differentials may have been due to instinct rather than reasoned justification, they have in their rough and ready way performed a valuable function.

The ability of the savings banks and building societies for so many years to carry the social responsibility of somewhat lowering the cost of home borrowing stemmed largely from resources made available to them from motives of self-interest or convenience by the ordinary people themselves. The desire to be eventual borrowers prompted many small savers to become depositors at relatively low interest rates, and in conditions of economic growth this process of mutual aid by time intervals provided a substantial part of these institutions' resources. Other small savers, with limited scope for using alternative investment channels, deposited with these institutions for reasons of simplicity and ease of withdrawal.

If the savings banks and building societies were no longer to be regarded as prospective providers of relatively favourable terms for home borrowers, they would cease to command a proportion of their traditional depositor support. How great the defection would be over a period is a matter of conjecture.

Observation suggests that the recent weakening of the capabilities of these traditional housing financiers is partly a result of the great upswing in general interest rates in conditions of already subdued economic growth; and that it is not only a matter of the relative differentials widening, but the absolute scale of interest charges has become a destroyer of home purchasing aspirations.

If that is so, the preservation of the roles of these traditional lending institutions becomes another reason for a restrained official attitude towards interest-rate hikes. The best tonic for these institutions and for home buyers would be a substantial reduction in interest rates. (For home buyers, the amplifying effect over the remaining corpus of their capital debt would begin to work in a downwards direction.)

A weakening capability of the traditional institutions must reinforce arguments for other, fiscal means of redress for home purchasers. The fiscal options would be either forms of direct Government subsidising of housing interest rates or the allowance of interest rates as a deductible item for income tax.

Income-tax deductibility for home buyers is a well established principle in the United States. It is the logical answer for believers in the full play of competitive market forces\*, for the household sector has to be accorded as valid a place in the market economy as that of the business sector. Even in the narrower perspective of the Taxation Office, which would confine deductibility to expenses necessary for the earning of taxable income, no sustainable distinction can be drawn between wage or salary earning and business taxpayers. The unsatisfactory record of nomadic people as taxable objects on this continent and elsewhere supports the intuitive proposition that permanent shelters are a necessary condition for the derivation of taxation revenue from the employee class. Indeed, the narrower line of argument could prove a risky one for the authorities to maintain, as it could promote claims for tax deductibility from domestic rent payers as well.

Those who are less than absolutely dedicated to the play of the competitive market may argue for the alternative of subsidised housing interest rates for home purchasers, on the ground that a given fiscal cost could be more efficiently directed to relieving the most seriously disadvantaged cases. This proposal could have the further merit of blurring the distinction between home purchasers and rent payers, by holding out to rent payers a more hopeful prospect of being able to graduate to the status of home borrowers.

June, 1981