Briefing 14:05

LOW PAY AND THE COST OF LIVING:

A supply-side approach

By Ryan Bourne
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Summary

- The ‘cost of living crisis’ is now a substantial part of the UK’s political discourse. The prices of essential goods in some product markets have become politicised in a way not seen for a generation, and there is widespread concern about low pay levels.

- Most of the new policies offered up in response to these concerns entail more government intervention through price controls, regulation, higher minimum wages and higher transfer payments. This amounts to treating the symptoms of high prices rather than addressing the underlying causes and could be very economically damaging.

- The prices of many essentials such as housing, energy, childcare and food were rising substantially even prior to the financial crisis. Price rises in these markets have a disproportionate impact on those with low incomes. Policies which drive up costs in these product markets might have been tolerable in an age of abundance, but are much more difficult to justify given the recent living standards squeeze.

- The UK’s planning laws and development restrictions have been a key structural cause of high and rising house prices. Relaxing them and decentralising the UK’s tax system to encourage development, seeking to return to historic house price to income ratios, could see prices fall by as much as 40 per cent.

- An extensively regulated and formalised childcare sector, coupled with our restrictive planning laws, makes childcare very expensive in the UK. In international terms we have some of the highest out-of-pocket childcare costs as well as a very high taxpayer subsidy. Deregulation of the sector could bring significant savings to households with children.

- EU policies such as biofuels mandates and the Common Agricultural Policy drive up food prices. In addition, restrictions on building reduce the productivity of the retail sector and raise prices for UK consumers. A very conservative estimate suggests food costs could be reduced by around 10 per cent if these policies were abandoned.

- UK energy prices are raised by incoherent environmental policies. Rather than adopting simple, efficient means of pursuing carbon reduction, the EU and UK are encouraging green industrial policies, subsidies and price fixing, which increase energy bills unnecessarily. Abolishing the worst of these measures could reduce gas prices by 4 per cent and electricity prices by 22 per cent within the current carbon mitigation framework.

- Sin taxes on fuel, alcohol and tobacco are a significant burden on many of the poorest households. Current duty levels are considerably higher than those justified by estimates of the 'social cost' of the activities. Reducing all three duty levels by 20 per cent could offer substantial relief to low-income households.

- A market-oriented supply-side agenda in all of these areas could lower the cost of living for an illustrative working family with moderate needs by as much as £650 per month or £7,800 per year. Some of this would lead directly to higher disposable incomes, whilst savings on benefit payments could be used to reduce the tax burden.

- Lowering the cost of essentials, rather than seeking to artificially raise wage rates for those on low incomes, could help achieve the same aim as the 'living wage' campaign – an aspiration for working households to have the means of being able to live comfortably without significant state assistance.

Introduction

The debate surrounding the scale and timing of the UK government's fiscal tightening has ceased to be a regular feature of political discourse in the way it dominated for the first three years of the Parliament. Instead, the opposition Labour Party has sought to shift the focus away from the broad macroeconomic debate onto what it describes as a 'cost of living crisis' facing poorer and middle-income families across Britain (Balls 2014).

In a speech entitled 'The Cost of Living Crisis Facing Britain', delivered to the Resolution Foundation back in 2011, Labour leader Ed Miliband outlined his thinking behind the term. Miliband believes that there has been a structural breakdown between economic growth and improvements in living standards for the poor and those on modest incomes, arising even prior to the financial crisis. He suggested that the policies of the coalition government exacerbated living costs at a time when living standards were already being squeezed (Miliband 2011).

In the period since that speech, the scope of this narrative has broadened dramatically. The Labour leader has described this 'cost of living crisis' for low and middle earners as 'the greatest challenge for our generation'. The prices of goods in some product markets have become politicised in a way not seen for decades. High house prices, energy bills, food prices, childcare costs, rail fares and 'sin taxes' have been debated across the political spectrum, with all now seemingly falling within the purview of potential political interference. Politicians from across the spectrum have offered potential policy 'solutions' to many of these concerns.

This discussion as to the impact of the cost of essentials is inextricably linked with widespread concern about 'low pay'. There is huge focus on the fact that nominal pay levels have increased slowly in recent years,

and many have suggested that pay levels must increase across the economy to compensate for the squeezed living standards seen in the post-crisis period (O'Grady 2014).

In reality, low *real* pay levels can be just as much a function of high prices within an economy as they are of low nominal wages. Indeed, this Briefing will argue that the rising cost of essentials should be the area of focus for our politicians, though the approach outlined for dealing with this issue contrasts strongly with the recommendations of others. Most of the new policies offered up in response to the concern surrounding low pay and the cost of living, including from charities such as Oxfam, Save the Children and the Resolution Foundation, as well as politicians, see the solution as more government intervention through price controls, regulation, higher minimum wages and higher transfer payments.

It is argued in this Briefing paper that this approach is looking at things through the wrong end of the telescope. Rather than seeking to treat the symptoms of high prices with new market interventions, which potentially could be very economically damaging, we should undertake a thorough investigation into what has caused high product prices in the first place. In doing so, we find that the problems associated with low pay can be addressed by policy change in those areas where governments artificially raise the cost of living through existing policies.

In particular, Niemietz (2012), in a seminal work, argued that in a range of industries, state interference and an abandonment of market principles had led to structurally high prices for consumers, creating demands for redistributive welfare to make up for existing damaging distortions. Undoing this damage through supply-side reform could therefore be a means of improving the lot of the least well-off without ever-expanding government welfare, or damaging attempts to fix prices or overregulate markets.

This Briefing Paper seeks to update Niemietz's work. It will argue that the cost of living should be taken seriously as an issue for public policy and that the Labour Party's adoption of the 'cost of living crisis' as its central message has rightly recognised the extraordinary strain on household budgets resulting from a range of high product prices. It will show how the cost of many of these essential goods and services was rising significantly even prior to the financial crisis and the broader downturn resulting from it. The key message is that a substantial improvement in living standards can be achieved as a result of the deregulation of land-use planning,

energy markets, childcare and other product markets. This, it is argued, would be a welfare-enhancing way to deal with the problems of high living costs and low pay without the damaging side effects of higher minimum wages, price controls and new interventions in product markets.

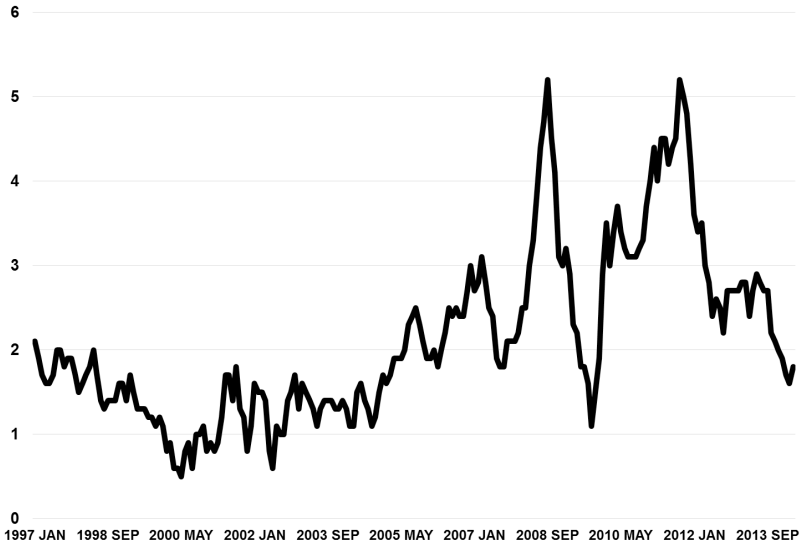
Is there a 'cost of living crisis'?

One of the big political debates surrounding the cost of living narrative is whether there is a 'cost of living crisis' at all. Politicians of different parties use various measures of living costs, and often conflate living costs with 'living standards', to argue that there is or isn't something substantial to worry about. This first section of this Briefing will attempt to unpick this debate, offering a clear definition of what the 'cost of living crisis' means and arguing that the cost of living is something that can be regarded as a genuine policy concern.

Not just about inflation rate or the price level…

'Cost of living crisis? What cost of living crisis?' thundered Alex Brummer in the *Daily Mail* in January 2014. The Consumer Price Index inflation rate for December 2013 was just reported to have returned to its target level of 2 per cent (Brummer 2014). One interpretation of the 'cost of living crisis' is simply to judge the movement of the aggregate CPI inflation rate of the economy relative to the Bank of England's 2 per cent target. The UK saw a period of above-target inflation from early 2010 to late 2013, with inflation peaking at 5.2 per cent in September 2011. But now the inflation rate has returned to around its longer-term trend as targeted by the Bank (see Figure 1). This cost-of-living narrative would therefore claim: we went through a cost of living squeeze but this has now dissipated and there is little to worry about.

Figure 1: CPI inflation rate (per cent change on year earlier)

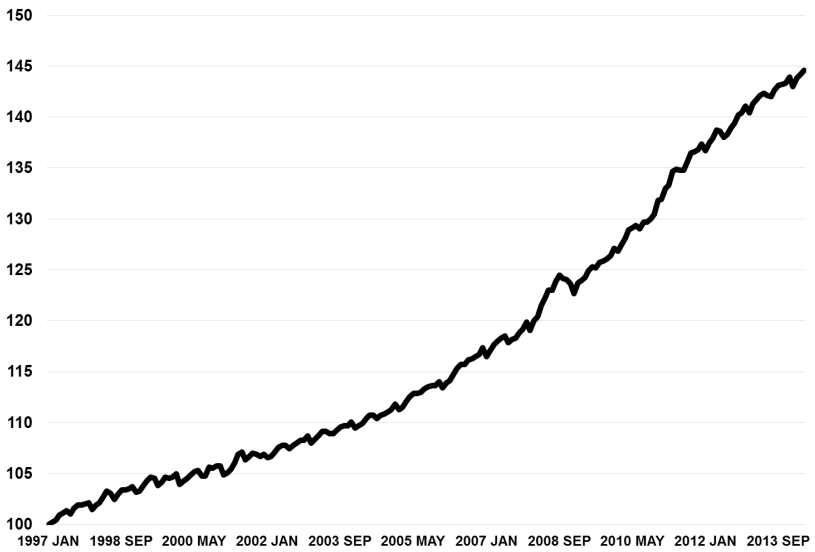


Source: ONS (2014a).

This interpretation is obviously unsatisfactory. The cost of living as most people understand it would be related to a 'level' of the cost of goods and services, not a rate of change. In other words, it would be interpreted as the actual cost of buying a pre-determined set of things, not the differential between the cost of things from one year to the next. As Figure 2 shows, price level increases have occurred throughout the period since 1997, but have accelerated somewhat since 2010.

Whether the cost of living is a problem depends also on what is happening to people's wages. If wages are increasing faster than prices then an increased cost of living will have less bite. CPI inflation is also an *average* inflation rate which comprises a wide basket of goods. It therefore ignores the differential price changes actually felt by certain households compared to others, and does not provide any sort of understanding of which prices of goods and services are increasing within the overall basket. On its own then, observing just the inflation rate or the price level tells us little about the cost of living and its effect on spending power for different groups.

Figure 2: Consumer Price Index (all items) – January 1997 = 100



Source: ONS (2014a).

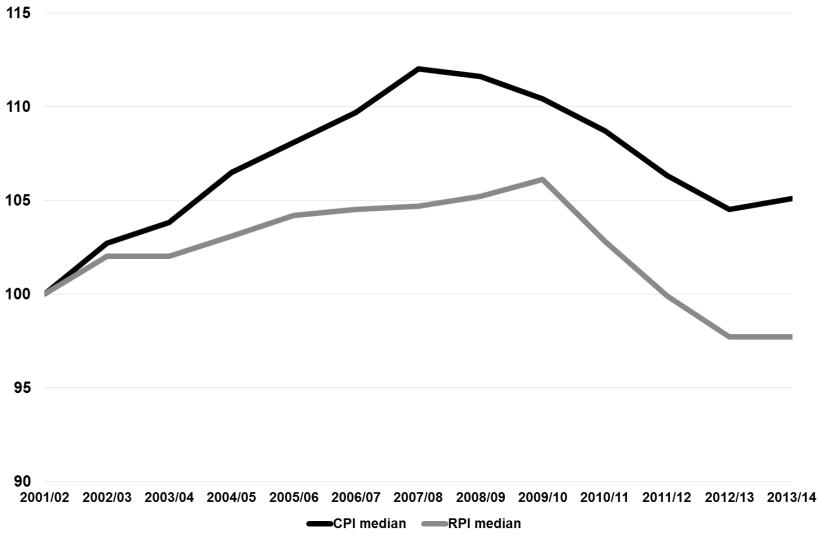
Not just about real incomes

It would therefore be tempting to simply assess whether there is a cost of living squeeze by assessing the state of real incomes. According to the projections of Adams et al. (2014), the real median household income is still below its pre-crisis peak. In other words, since the onset of the recession, the failure of household income to keep pace with prices has meant a living standards squeeze for the median household. This is unsurprising given the depths of the recession here, and the lamentable productivity performance in the post-crisis period. Figure 3 uses calculations by the Institute for Fiscal Studies to show the path of real household incomes since 2001/02.[1] Evidently, since the financial crisis we have seen a fall in living standards whether households' incomes are deflated by the CPI or RPI measures of inflation. Real incomes fell significantly from 2007/08 according to the CPI-deflation method, and from 2009/10 via the RPI deflation method and only began to recover (or in the RPI-deflated

1 IFS authors' calculations using TAXBEN and the Family Resources Surveys for the relevant years.

case, stabilise) after 2012/13.[2] Median real income (on the CPI measure) was still estimated to be 6.2 per cent below its pre-crisis peak by the end of 2013/14.[3]

Figure 3: UK real household incomes (deflated by CPI and RPI)



Source: Adams et al (2014).

For some commentators, the 'cost of living crisis' is therefore simply a means of expressing the squeeze in real earnings which has occurred in the aftermath of the recession. This has both been an absolute squeeze, and a squeeze relative to trend. Were the trend for real income growth observed between 2001/02 and 2007/08 to have continued, for example, households might now expect real incomes to be about 20 per cent higher than we currently observe.

This shows the scale of the living standards squeeze that has been experienced, and puts broader context to the obsessive focus given to the *direction* of real wages seen in our public discourse. Endless column inches have been filled discussing when real incomes might start rising

2 The reason for this discrepancy is the fall in mortgage costs which brought down the RPI level but is not included in the CPI.

3 The IFS figures show that this is overwhelmingly due to a fall in earnings income.

again. But this is largely a meaningless debate: marginal improvements to living standards one way or the other miss the bigger picture - of a significant living standards squeeze in the post-crisis period.

Differential inflation rates are part of the story…

The fall in real earnings and the subsequent squeeze in median living standards since the financial crisis is a significant reason why the 'cost of living crisis' has become a key political battleground, of course. Yet simply examining what is happening to median or average real wages does not really tell the story of why many families, particularly at the bottom of the income scale, feel so squeezed. This is partly because a fall in living standards of anywhere near this magnitude affects those with low real incomes much harder in terms of being able to live comfortably. But it's also because those on low incomes spend a disproportionate amount of their disposable incomes on certain goods and services, the prices of which have been rising more than average inflation indices.

The work of Adams et al. (2014), for example, has found that there are substantial differences between the spending patterns of high-income and low-income households and indeed the inflation rates for different goods and services. They estimate that this means the overall period 2008/09 to 2013/14 saw low-income households (the bottom quintile) face average annual inflation rates of 3.4 per cent per year compared with 2.4 per year for high-income households (the top quintile). Since 2007/08, they therefore estimate that the average price level for the bottom quintile has risen by 7.1 percentage points more than that faced by households in the top quintile– a gap that was especially large in the wake of the recession. This suggests that calculating the real incomes of both rich and poor using just an aggregate CPI number would tend to understate the decline of real incomes for the poor and overstate the declines of real incomes for the rich. In fact, when changes in real incomes are considered, overall proportionate declines in real incomes after 2008 were broadly similar for rich and poor (the rich saw a bigger squeeze on nominal incomes, the poor faced a bigger increase in their price level). Since the poor were starting from a much lower base, this would of course have more observable negative consequences for those on low incomes.

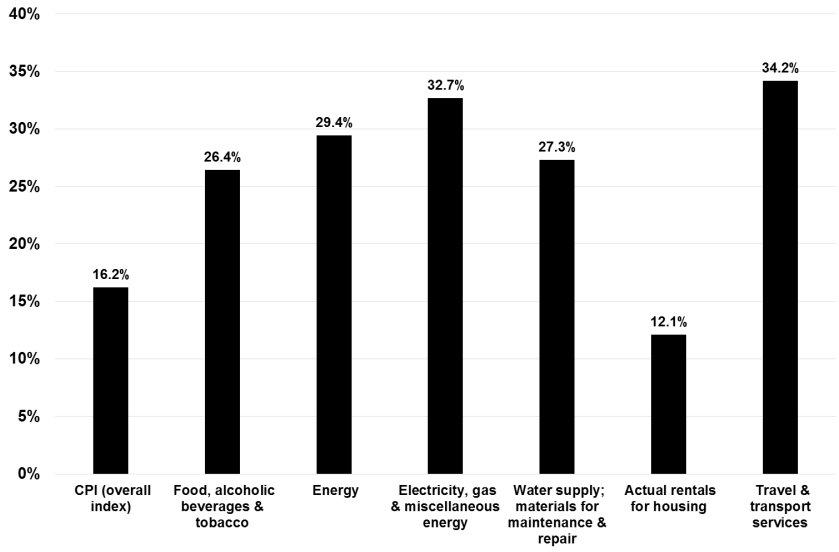
This occurs because the poor spend a much larger proportion of their overall spending on what can be described as 'essentials' than the rich.

Households in the bottom quintile dedicate, on average, 17 per cent of their overall spending to food, compared with just 9 per cent for the richest quintile. Similar differentials can be seen for rent (9 per cent vs. 3 per cent) and energy (see below). To observe whether there is a cost of living squeeze that in particular has negatively affected the poor over the longer term then, we can examine the differential changes in prices for these different types of goods.

The cost of essentials vs. other products over the past decade

Figure 4 shows that the price levels of many goods and services which might be regarded as essentials, and which the poorest groups spend disproportionately on, have risen by significantly more than average CPI inflation since 2008. For example, the price level of electricity, gas and miscellaneous energy has gone up by 32.7 per cent compared with an increase in the CPI of just 16.2 per cent. Table 1 provides a longer view of the changes in price levels observed since 1999. As can be seen, the prices of manufactured products such as clothing and footwear etc. have fallen substantially, whilst the prices of many essentials such as energy, food, and fuels have risen substantially more.

Figure 4: Overall change in price level of CPI components between 2008 and 2013



Source: ONS (2014a).

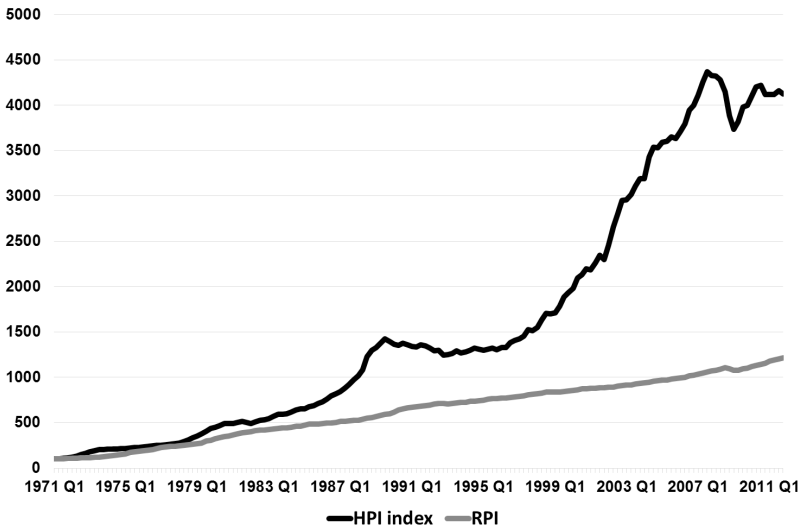
Table 1: Overall change in price index 1999 to 2013

Category	Change
Overall CPI	36.6%
Food, alcoholic beverages and tobacco	60.7%
Energy	129.0%
Electricity, gas & miscellaneous energy	161.4%
Liquid fuels, vehicle fuels etc	98.4%
Clothing and footwear	-44.4%
Water supply, material for maintenance	51.5%
Audio-visual goods	-76.2%
Housing services	50.9%
Rent (RPI series)	45.8%
Transport and travel services	111.6%
Communication	-1.8%
Recreational and personal services	60.2%
Education	189.9%

Source: ONS (2014a)

The cost of housing has also risen more than overall inflation. Figure 5 below shows that an index of mix-adjusted house prices has increased over 40 times in the last forty years, compared to a 12-fold increase in the price level as measured by the RPI. Housing is of course another essential product. Higher house prices, *ceteris paribus*, feed through into both higher mortgage costs and higher rents. House price inflation has in particular taken off again over the last couple of years in the UK, with Nationwide suggesting in June 2014 that prices had risen by as much as 11.8 per cent since June 2013. ONS figures echo this - UK house prices increased by 10.2 per cent in the year to June 2014, with house prices in London increasing by 19.3 per cent.

Figure 5: Mix-adjusted house price index vs. RPI index (1971 Q1 = 100)



Source: DCLG (2012) and ONS (2014a)

The key reason that the cost of living has found so much resonance, then, is that the prices of many 'essential' goods and services have increased substantially over the past 14 years. Many of these product prices increased more quickly than the overall Consumer Price Index even prior to the crisis, and hit the living standards of poorer households particularly hard. The onset of the crisis and squeeze in real incomes seen since have meant the effects of higher prices in areas such as housing, energy, childcare and food are much more noticeable now. The key question is this: can anything be done about them without damaging economic consequences?

Free markets for the poor

The rising cost of essentials does present a serious public policy challenge given the impact on many of the poorest in society. Whilst some of these price (and indeed wage) changes in recent years are due to global forces that it would be unwise for the government to try to overcome, it is clear that in a host of these markets government policies push prices higher than they need to be. An effective anti-poverty policy could thus seek to eliminate these distortions, reducing the structural level of prices by improving the functioning of the supply-side of the economy.

Many of these structural reasons for high prices have not occurred in recent years, of course. As such, it is commonly asserted that these cannot be blamed for the current cost of living squeeze. But the fact that other global economic conditions have changed and this has impacted on living standards is surely a reason to reassess the wisdom of existing government interventions which drive up the cost of essential goods and services. Policies which were tolerable in an age of ever-improving living standards are much more difficult to justify given the economic conditions we face today.

Unfortunately, the anti-poverty lobby and the political classes have focused so much on the role of benefits and wage campaigns in attempting to alleviate poverty and encourage improving living standards that they have a huge blind-spot when it comes to other government policies which have helped drive up the cost of living.

A recent Oxfam poster campaign entitled ‘The Perfect Storm’, for example, highlighted instances of high prices and rising childcare costs. But the accompanying report was predictable in its recommendations for a statutory ‘Living Wage’, fewer benefit sanctions and a clampdown on zero hour

contracts (Cooper et al 2014). Furthermore, politicians are now adopting the interventionist agenda. The Labour Party's policies on living costs (an energy price freeze, tenancy rent controls, state funding of housebuilding etc.) seem to be predicated on the idea that markets are the problem rather than the solution. The coalition government, while at least highlighting the virtues of a growing economy, has likewise initiated new interventions in the housing market (Help to Buy), in energy (changes to regulations on energy tariffs) and childcare (in the form of new subsidies).

This is a shame – because a supply-side approach to the cost of living has several key advantages over these types of policies. It could raise living standards significantly, without necessitating new government spending. It also happens to deal with some of the reasons why there currently exists a substantial need and demand for state transfers in the first place rather than seeking to compensate for them. Finally, it is likely to be a much more durable strategy, since anti-poverty measures reliant on state transfers are always beholden to the whims of the governing party of the day (Niemietz 2012), and interventions to control prices and wages inevitably collapse under the weight of their own contradictions.

The remainder of this Briefing outlines why a pro-poor supply-side agenda is needed in markets such as housing, energy, childcare and food, and sets out broad policy recommendations as to how this might be achieved. It also highlights the detrimental impact of 'sin taxes' on the poor.

Housing and the need for supply

The increasing unaffordability of housing, especially for the poor

It is now generally recognised by all political parties that the increasing unaffordability of housing for a growing share of the population is a major public policy challenge. Table 2 shows that in the past 40 years mix-adjusted house prices have increased by over 40 times.

Table 2: Mix-adjusted house price index versus Retail Price Index, 1971 level = 100

	HPI	RPI
1971	100	100
1981	491	364
1991	1339	669
2001	2184	879
2011	4120	1181

Source: DCLG (2012) and ONS (2014a)

This would not be so much of a problem if incomes had grown by a similar factor over the same period. But Demographia (2014) provides data on 'median multiples' – house prices relative to median incomes – and finds that while the long-term average median multiple is around 3 in English-speaking countries (meaning a household in the middle of the regional income distribution could afford a house in the middle of the regional price range by paying around three times gross annual salary), now no UK region has median multiples of that value or lower. In fact there are only

two UK regions (Belfast and Falkirk) where the median multiple is between 3.1 and 4, which Demographia defines as a range in which housing is merely 'moderately unaffordable'. As Table 3 shows, just under half of the UK's regions have a median multiple above 5.

Table 3: Median multiples in UK regions, 2013

Median multiple	
3.0-3.9	Belfast, Falkirk
4.0-4.9	Birmingham & West Midlands, Blackpool & Lancashire, Derby & Derbyshire, Dundee, Edinburgh, Glasgow, Hull & Humberside, Leeds & West Yorkshire, Manchester & Greater Manchester, Middlesbrough & Durham, Newcastle & Tyneside, Northampton & Northamptonshire, Nottingham & Nottinghamshire, Perth, Sheffield & South Yorkshire
5.0-5.9	Aberdeen, Bristol & Bath, Cardiff, Leicester & Leicestershire, Liverpool & Merseyside, Newport, Stoke-on-Trent & Staffordshire, Swansea, Telford & Shropshire, Warrington & Cheshire, Warwickshire
6.0-6.9	Swindon & Wiltshire
>7.0	Bournemouth & Dorset, London, London Exurbs, Plymouth & Devon

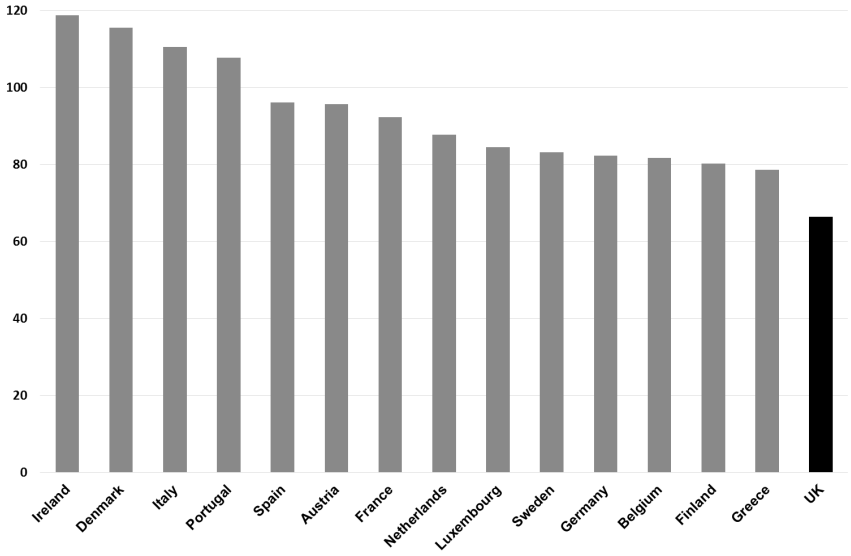
Source: Demographia (2014)

This is in stark contrast to most areas of the US (bar New York, and some areas of California and Hawaii). Shockingly, the median multiples of, for example, Washington DC (4.4) and Chicago (3.5), are lower than those seen in Swansea or Stoke-on-Trent and Staffordshire.

The situation in terms of affordability is even worse in the UK in reality. Demographia (2014) reports that the UK average new house size in metropolitan markets is around four times smaller than in the US, and far smaller than in either Australia or Canada. In fact, the UK now has the smallest average new house size in metropolitan markets except for Hong Kong. Even compared with Holland, which has 20 per cent more people

per square kilometre than England, Cheshire (2013) reports our new houses are 40 per cent more expensive per square metre. Figure 6 below shows that space per household in the UK is the lowest among European countries for which data are available. Even on a per capita basis, the UK is only second-bottom, behind Greece. Not only is our housing more expensive than most other countries then, but we get much less of it.

Figure 6: Residential floor space (in m^2) per household, 2008



Source: Niemietz (2014) based on data from Entranze/Enerdata and OECD.

This expensive housing of course feeds through into higher rents too. As Table 4 shows, average rent levels for those in the private rented sector are equivalent to 41.1 per cent of weekly gross household income (ONS & DCLG 2013). Even in the social rented sector (local authority and housing association), the figure is 29.6 per cent. This too is taking into consideration state assistance in the form of housing benefit as part of gross weekly income, the annual bill for which now stands at £23.9 billion, rising to £27.4 billion by 2018/19 (DWP 2014). Excluding this benefit, the average proportion of the remaining weekly household income going on rents from private and social renters would be as much as 50.7 per cent and 40.4 per cent respectively (ONS & DCLG 2013).

Table 4: Rent payments as a percentage of weekly household income

	% of gross income	% of gross income net of housing benefit
Social renters (1)	29.6%	40.4%
Private rental	41.1%	50.7%

(1) Includes Local Authorities and Housing Associations.
Source: ONS & DCLG (2013)

London in particular has extraordinarily high absolute rent levels. The Valuation Office Agency calculates that the median rental price for 2-bedroom accommodation in London is £1,387, over double the £575 figure for England generally. Median gross annual income in the capital, in comparison, is only 39 per cent higher than the national average (ONS 2013a).

But the problem is broader than just the capital and is not confined to renters. A recent Resolution Foundation report showed that as many as 14.4 per cent of UK households spend over a third of their disposable incomes on housing costs and 6 per cent spend over half. This is at a time when those with variable mortgages are likely to have been insulated by relatively low interest rates (Gardiner 2014).

What's more, in the past year or so house price inflation has taken off in the UK again. In the year to June 2014, house price inflation was running at 10.3 per cent per year. In London, this figure was as high as 19.3 per cent (ONS, 2014b). Whilst rent increases can become temporarily decoupled from house price changes, due to inertia on the part of landlords, vacancy risk, and income constraints on the part of tenants, one would expect rents eventually to adjust to reflect the increases seen in the price of properties. Indeed, when the HomeLet Index, which measures rent levels by new tenancies, is reporting rent increases of 6.4 per cent nationwide and 11.2 per cent in London between June 2013 and June 2014, one can already see the scale of the impact of rising property prices (Chu 2014).

Increasing housing costs have a disproportionate impact on the poorest too. Whilst middle-income households can adjust to the increased cost of housing by cutting back on the amount of housing space demanded, for low earners it is much more difficult to downsize when space is necessary. As many as 10 per cent of lone parent households with children already live in conditions deemed to be 'overcrowded' (ONS & DCLG 2013).

Because of this difficulty in continually adjusting downwards in terms of size, the poorest therefore have to dedicate an ever-increasing proportion of their income towards housing costs. Whilst this effect has been ameliorated in the past by a rising housing benefit bill, it's now clear that a desire to cut the spiralling housing benefit bill coupled with recognition that these demand-side measures push up housing costs further means this strategy is not sustainable.

Ever-increasing living costs, particularly in London, also of course make labour mobility more difficult – both in terms of people being able to move to places where there is more economic opportunity and for people to afford to remain in areas of commutable distance to their workplace.

The cause, and some potential solutions

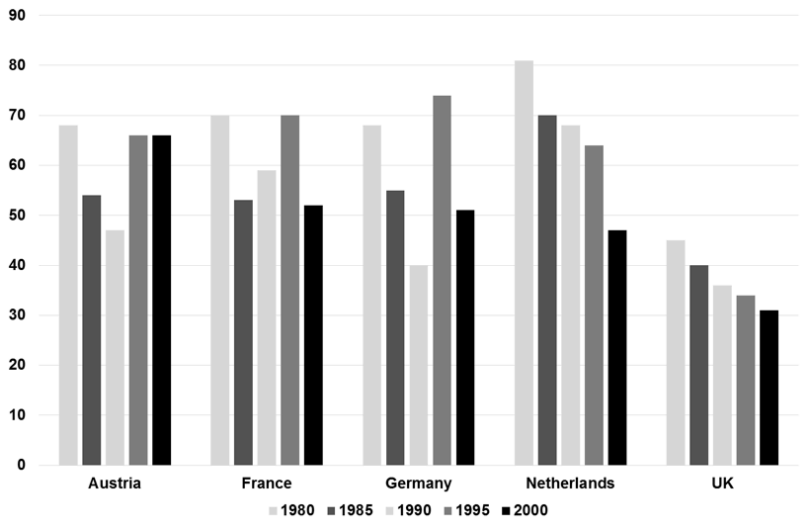
Any serious examination of the cost of living must therefore include a rigorous examination of the operation of the housing market. Almost all those who have examined this issue seriously realise that the problem is fundamentally one of supply (though for the exceptions, see the 'red herrings' outlined in Bourne and Niemietz (2014)).

It is argued here that governments have simply not allowed the supply of housing – privately built – to keep pace with demand. The overall shortfall of supply relative to the change in demand is estimated at anywhere between 1.6 and 2.3 million units (Cheshire 2014a). This is not because of a lack of land: just 10 per cent of land in the UK is 'developed'. As the Office for Budget Responsibility's recent Fiscal Sustainability Report recently outlined, 'evidence suggests that restrictions on housing supply relate more to policy restrictions via the planning system than a genuine shortage of land for building' (OBR 2014). The effects of this can be seen clearly - the agricultural price of land in the south of England can be worth anything up to £10,000 per hectare, whereas residential land per hectare, i.e. with planning permission, costs well into the millions (depending on the location) (Leunig 2007).

Figure 7 provides some international context as to the scale of this failure to build new homes. As can be seen, the UK has performed exceptionally poorly in relation to other large European countries over a long period. To make matters worse, the UK has a tendency for new supply to be built in areas where people would prefer not to live. To quote Cheshire (2014b):

> 'We persistently build houses where they are relatively most affordable and job prospects are relatively worst. This is true from Lancashire (compare Preston with Ribble Valley) to Northants (Corby to Daventry), but is perfectly encapsulated in London. In Tower Hamlets, Islington, Hackney, and Southwark, where unemployment in 2012-13 averaged 11.35 per cent and median house prices to median earnings (the affordability ratio) was 9.98, we added an average of 14.57 per cent to the housing stock in 2004-2012. Yet in Merton, Bexley, Sutton and Kensington & Chelsea, with an average unemployment rate of 6.75 per cent and an affordability ratio of 15.07, we added an average of just 2.11 per cent to the stock over the same period.'

Figure 7: Housing starts per 10,000 inhabitants



Source: Eurostat (2010) and ONS & DCLG (2012)

A comprehensive review of the literature in Niemietz (2012) found that the planning system was the chief culprit for this failure to allow new supply in response to market signals. On an international basis, Demographia (2014) are clear when they conclude that 'in every market where there has been a sustained and significant increase in the Median Multiple, more restrictive land use policies have been implemented'. This can be seen most acutely in the UK in areas where green belt restrictions have become a binding constraint, such as around London, Cambridge and Oxford. As our incomes rise, people want more space to live – including gardens and larger houses. Yet our green belt restrictions act as a constraint around the growth of these cities, preventing them from growing and causing prices for the rationed space within them to rise dramatically.

Clearly there needs to be substantial policy change to generate the new supply needed, especially if we want to tackle the cost of living squeeze – of which housing is quite clearly the key component. Unfortunately, however, there are significant vested interests and fallacious arguments pitted against the sort of reform required (Bourne and Niemietz 2014).

To return to the average long-term median multiple of around 3 from the current 4.9, for example, will require lots of new development. For the suburbs of London – defined here as the commutable areas of the east and south-east, the median multiple is currently 6.8. Even to return this to 4 (defined as on the high-end of moderately unaffordable) would require a fall in the median house price of just over 40 per cent (author's calculation based on Demographia 2014). This is only likely to be achieved if the arbitrary restrictions imposed on land labelled as green belt are re-examined.

A revision of these fairly arbitrary distinctions need not mean destruction of land with significant environmental value. Indeed, far from our image of green belt land as quaint rolling green fields, the commonest land use within the London and Cambridge green belts is intensive agriculture – which, as Cheshire again argues, has little environmental benefit.

Cheshire (2014c) has therefore examined how the green belt around London could be scaled back intelligently such that homes could be built where there is existing scarcity and high demand, and where there are already fairly well developed transport links. He has calculated that around London, for example, there are 514,000 hectares of green belt land within 800 metres of a station (a ten minute walk), which is not currently built on and has no special designation as an area of environmental quality. If just

4 per cent of this land were to be developed, it could potentially facilitate space for close to a million new housing units. Allowing development to take place in areas like this would not only help dampen increases in house prices directly, but would, by showing political willingness to review the planning system, have significant knock-on effects in terms of preventing speculative buying of property. Given the crushing price increases in London of recent years, pushing forward with this policy as soon as possible is vital – particularly when one considers the damaging consequences of not doing so: more and more people having to commute ever longer distances into London and constraining the potential for productivity enhancing agglomeration effects in the capital.

Similar proposals can be developed for the relaxation of green belt restrictions on the use of land around Oxford and Cambridge and other areas where current price-to-income multiples are extremely high (Cheshire 2014c). In time, however, we should go further and move away from arbitrary distinctions between green belt, greenfield and brownfield sites entirely – which are often unhelpful ways of thinking about both the aesthetic qualities of land and the potential environmental impact of development.

Relaxing the planning system alone is only one component of what must be a two-pronged strategy, however. In order to allow the paradigm shift in development that is so desperately needed, we must understand the incentives that our current system creates and why there is so much opposition to new building amongst existing homeowners in vast swathes of the country, especially given the inevitable externality effects of building new homes.

Existing homeowners know that new development is likely to lead to lower house prices than there otherwise would be in the alternative scenario of no development, *ceteris paribus*. There is therefore a direct cost to people in the locality of a development, as well as the secondary costs of more congestion, public service provision and loss of environmental amenities such as green space. There should also be benefits, of course. Economies of scale should be realised in providing public services. And by widening the tax base, existing residents should benefit from the new development through lower local taxes or better services. Rational residents should be able to weigh up these considerations when deciding whether or not to support new building then.

One problem is the UK's tax system is overly centralised (see Sinclair 2014). Ninety-five per cent of tax revenues are raised at a national level – the highest level by far seen in the western world. This means that some of the benefits of development, which we might expect to filter through into either lower taxes or better public services, do not accrue to local residents. Therefore it is hardly surprising that existing property owners, exposed to costs but not enjoying the benefits, tend to object to new development. In other words, the UK's planning system combined with its centralised tax system lends itself to NIMBYism.

If we are really serious about radically reforming our development process then, we need localism with teeth – local authorities raising their own funds through local income or land-value taxes, and being able to experiment with different planning regimes according to the wants and needs of the area.

This would of course be a radical shift in the whole structure of government. But with parties openly floating the idea of more decentralisation of power, the benefits of devolved tax raising and development powers, as well as spending, should be seriously considered following necessary attempts to liberalise planning laws at a national level. In the meantime, local authorities should be allowed to experiment with development compensation mechanisms.

Given the scale of the housing problem, which is increasingly recognised across the political spectrum, and the hugely significant impact that this is having on living costs, it is inevitable that any solutions will have to be radical.

The potential impact

The potential long-term impact of moving towards a sensible planning system could be dramatic for living standards. As discussed above, the UK's long-term median multiple for house prices has been just under 3. Reforming planning laws and attempting to return median multiple levels to, say, 2.9, from the current 4.9 would require house prices to fall by 41 per cent given current median incomes. Over time, rent levels would broadly follow this.

This is not an unachievable ambition. In fact, it is fairly modest aim. It reflects the status quo in the UK up to the early 1980s, and the long-term norms across English-speaking countries. In Germany, real house prices have remained steady over the past forty years whilst incomes have increased, meaning that median multiples have been falling. Academic analysis has also suggested that were the most regulated areas of England, such as the South East, subject to the same regulatory restrictiveness of the least regulated areas, house prices would have been roughly 25 per cent lower in the South East in 2008 – ignoring the fact that even the North East has more rigid planning laws than many other areas in an international context (Hilber and Vermeulen 2012). The same authors, based on conservative assumptions, suggest that house prices in the average English Local Planning Authority would be around 35 per cent lower if substantial regulatory constraints were revised.[4]

The implications of a fall in house prices of around 41 per cent would be highly significant. For the remainder of this paper, the potential effects of the policies advocated will be based upon the impact on a four-person family (two adults, two children) renting a two-bedroom flat in a medium-sized English city such as Bristol, Canterbury, or Milton Keynes (where rents are fairly high, but much lower than in London and much of the South East). The family have one child aged three and one aged eight.

Under a more sensible planning system, rent levels for the family, which are currently £633 per month[5], could easily instead be around £373 per month – a monthly saving of £260, or £3,120 per year. In terms of its effects on take home pay, this equates to a pay increase for someone in the 20 per cent tax band of around £382 per month or £4,585 per year. Of course, families in differing situations who might be in receipt of housing benefit may not fully benefit directly from this financial saving, as their benefits may simply be reduced accordingly in a world where house prices are much lower. But reductions in housing benefit would facilitate the fiscal space for significant income tax cuts for low earners or cuts to regressive taxes such as VAT.

4 Hilber and Vermeulen (2012) acknowledge that their results are likely to be very conservative for a couple of reasons: firstly, their analysis begins in 1974 and assumes that planning constraints were not binding prior to then. In reality, other evidence, from for example Hall et al. (1973), suggests this is unlikely. Secondly, contrary to their methodology, there is likely to be a degree of substitutability of property between different areas, meaning that local constraints affect aggregate prices.

5 Figures extracted from LHA Direct (2014).

This substantial potential impact is likely to be a conservative estimate of the benefits that liberalised planning laws could have on living standards. As we will see later, the planning system and high property prices have knock on effects for both retail productivity and the childcare sector. Since, as we have seen, housing, childcare and food all represent significant budget items for the poorest and working families on modest incomes, land-use planning reform looks to be as close as anything to being the single biggest policy which could structurally improve living standards for the least well off.

A supply-side policy response to the high cost of housing should therefore entail:

1. **Relaxation of green belt restrictions, particularly around London, Oxford and Cambridge, as a matter of urgency.**
2. **In the longer-term, abolition of green belt, greenfield, and brownfield distinctions entirely.**
3. **Allowing local authorities to experiment with development compensation mechanisms.**
4. **In the longer-term, making local authorities self-financing with tax-raising powers via local income, sales or land-value taxes.**

Childcare costs and the need for deregulation

The high cost of childcare

Barely a week goes by where the cost of childcare does not feature in public debate. This is perhaps unsurprising. The Family and Childcare Trust (2014) estimates that childcare prices have risen by 27 per cent since 2009 and the average annual cost of a part-time nursery place is now £5,710 per year. Based on 25 hours per week, this works out at £4.39 per hour, over two-thirds of the national minimum wage. For a family with two children in full-time childcare, the yearly bill can be closer to £12,000.

Childcare costs are thus an important component of any approach to the cost of living issue. Over 4 million families currently use formal care, and according to the OECD (2011) the out-of-pocket cost of childcare as a percentage of income (assuming a two-earner household where one partner earns the average wage and the other partner half the average wage) is 28 per cent in the UK; behind only Ireland at 31 per cent and the USA at 30 per cent. This is despite the fact that the British government now spends around £7 billion per year subsidising childcare in various forms.

Labour introduced early years' provision, extended such that from 2006 all three and four year olds were entitled to 15 hours a week 'free' childcare for 38 weeks of the year. This has since been expanded by the coalition to all 'disadvantaged' two year olds. The state also funds extended school services, subsidised childcare in Sure Start Centres and provides tax relief for various employer-based schemes. The childcare element within the working tax credit refunds up to 70 per cent of childcare costs. When

combined with childcare disregards in housing and council tax benefits, this means that up to 97 per cent of childcare costs may be paid by the government.

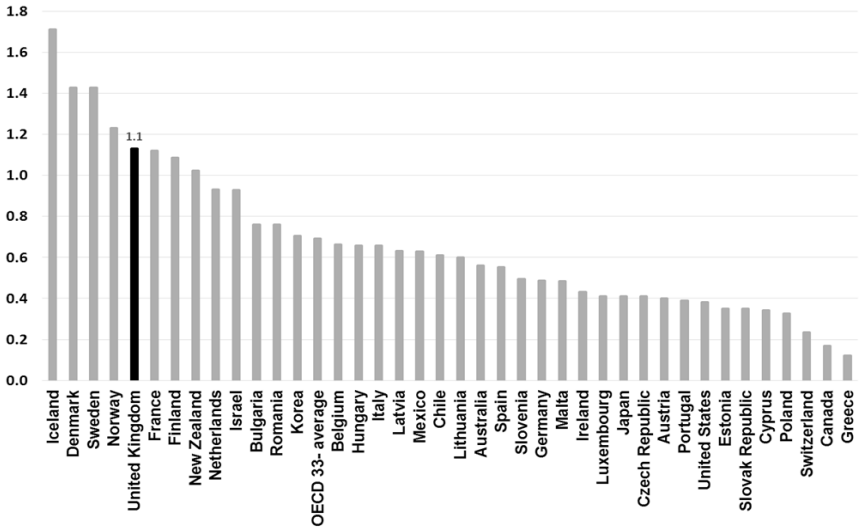
On top of these inherited schemes, the coalition has also introduced so-called 'Tax Free Childcare' whereby families with two parents working will get government top ups of 20p for every 80p spent on childcare up to a total overall cost of £10,000 (such that the scheme provides an upper limit of £2,000 of subsidy for children under the age of 12). They have also pledged that Universal Credit will extend childcare support to parents working less than 16 hours a week.

Going forwards, the parties look committed to further interventions still. The Liberal Democrats have suggested that in future they would like to see state subsidised childcare for all two year olds, and in the longer term provision for all children from nine to 24 months old too.[6] The Labour Party, in contrast, has suggested extending 'free' childcare to 25 hours for parents with children aged 3 and 4.

Although their figures have been criticised, the OECD (2011) clearly shows that the UK is an outlier in that both the public (see Figure 8) and private costs of childcare costs are exceptionally high. Whilst there are places in the world where childcare costs are largely a private matter with limited state support and others where financing of childcare is considered a universal right – the UK seems to combine the worst of both models. British childcare users pay some of the world's highest rates, and they do so twice over: first as taxpayers, and then in their role as consumers.

6 See, for example, BBC News: 'Lib Dems pledge free childcare for all two-year-olds', 3 September 2014.

Figure 8: Public spending on childcare and pre-primary services as a proportion of GDP



Source: OECD (2011)

The unclear aims and poor results of policy…

A key problem of childcare policy in the UK is that it has sought to meet several different aims at once, and this is likely to have exacerbated both the public and private costs of provision (Paull 2014). Prior to the 1990s the provision of childcare was largely seen as a private matter, with decisions made by parents: if parents wanted to care for their own children, then that was up to them; if they wanted to pay for childcare in order to facilitate more work, then that too was a decision for the family. There is much to be said for this neutral approach in which parents are left free to decide.

Since then, however, proponents of intervention in the childcare market have used two key justifications for greater state involvement: to assist mothers back into formal paid employment, and to use childcare as a means of seeking to improve the development or educational attainment levels of young children.

The declared objectives of childcare policy have therefore remained pretty much the same since the 1990s, irrespective of the party of government: to raise the 'quality' of care, to make childcare more affordable and to make childcare more accessible. Different governments have placed emphasis on some objectives more than others, though all pay lip service to each. Before 1997, Conservative government action was focused primarily on getting people into the labour market; for the early Labour government, more emphasis was placed on low-income families being able to work as a route out of child poverty. The later Labour government began to shift the focus onto the idea that the quality of childcare provision needed to be improved as a means of reducing social inequities (Paull 2014).

The obvious problem here is that there are clear and obvious trade-offs between some of these objectives. One could envisage that a policy of complete deregulation of the childcare market and abandoning the concept of the educational role of childcare would vastly improve both the accessibility and affordability of childcare, which might facilitate more maternal employment and lead to less child poverty caused by both worklessness and high out-of-pocket childcare costs. Yet, one might also expect this to lower the average quality of the childcare provided.

'Quality' itself, however, is a loaded term which only really makes sense in the context of the preferences of parents. For those parents who merely demand a safe and loving environment for their children, 'quality' might mean the ability of childcarers to provide parent-like oversight in a trustworthy and reliable way. For those who take the term to have semi-educational implications, quality might instead be shown through the qualification levels of childcare staff and other regulated outcomes like staff-to-child ratios.

The UK childcare system is not neutral. It has been shaping the choices of parents to encourage greater employment and to expand the use of formal childcare, but in an increasingly regulated formal childcare sector. The state has therefore been stoking demand for childcare but imposing new costs on suppliers, and encouraging parents to use more expensive, formalised care settings.

Government policy itself has therefore contributed to driving up the costs of childcare by increasingly regulating inputs, processes and the industry structure of the childcare market in order to seek to improve the quality of

the educational benefits to children. Over the past fifteen years, the government has increased regulation relating to staff qualifications, staff-to-children ratios and safety measures etc. (Shackleton 2011; Truss 2012). Prospective childminders now have to be registered and assessed by Ofsted, in a similar way to educational establishments – and have to incur the registration and training costs themselves. Those dealing with young children are required to undertake training for the Early Years Foundation Stage.

This period of increased regulation and public subsidy has been associated with a halving in the number of registered childminders from 103,000 in the mid-1990s to just 53,000 this year (Ofsted 2014). The combined effect of the increased regulatory burden coupled with vast public subsidies has been to encourage expanded use of more expensive formalised nursery care and reduce competition within the industry. Reduced competition also means that subsidies are more likely to push up prices rather than increase childcare provision and employment.

Childcare policy is therefore currently a mess of contradictions. What's more, through seeking to improve affordability, accessibility and the quality of childcare all at the same time, we seem to have failed in achieving any of these goals:

- The costs of childcare are high both in terms of the public subsidy provided and the out-of-pocket costs faced by individual families (Niemietz 2012).
- There has only been a limited impact on maternal employment: since 1999, when the childcare tax credit was introduced, for example, the proportion of mothers in work has risen from 56 per cent to 60 per cent – i.e. very little change which may just reflect unrelated long-term trends (Paull 2014).
- On many of the formal measures used as proxies for quality, the UK performs poorly – staff-child ratios and qualification levels tend to be lower than in other OECD countries (ibid. 2014).

Why have costs risen significantly?

It is unclear exactly what is driving up childcare costs. To a certain extent we should expect childcare to be relatively expensive as it is a fairly labour-intensive industry, meaning it is likely to suffer from what economists refer

to as Baumol's cost disease. It is much more difficult to find productivity gains in labour intensive industries, particularly where human care is the key service provision. Yet over time, salaries rise as the need for provision leads to competition for workers with other industries where more productivity gains are being made, which can feed through into higher prices.

However, there is not much evidence that childcarers and childminders are particularly well paid in relation to other areas within the labour market. And the Baumol cost disease explanation cannot explain the significant increases in childcare costs observed over the past decade, when – particularly since the crisis – productivity growth has been poor across the economy as a whole and wages have increased very slowly as a result.

It's difficult not to conclude therefore that a combination of increased regulation and higher subsidies has been primarily responsible for the significant increase in costs in recent years. High property prices and rents - due to restrictive planning laws and a lack of development - are also likely to be an important structural reason for high costs in the industry.

A new approach

How one approaches the issue of childcare from a policy perspective therefore depends on what one's goals are. If a major objective is to reduce the cost of living for poorer families, there is a strong case for adopting policies that would enable the provision of cheap and accessible childcare.

The starting point would be to emphasise the virtue of choice and the role of parents in deciding what they believe is best for their children. This would entail a conscious decision not to regulate the childcare sector as if it were an extension of formal education, nor (in the longer-term) to overtly subsidise childcare through the public purse in order to increase rates of parental employment, except in a very limited way.

The rationale for this approach is clear. In a free society, should parents opt to use formal childcare, they should be able to choose their childcare provider according to what they believe is in their best interests and those of the child. This might mean very formal nursery care which in many ways acts like an early school, or it might instead mean a more laid-back approach with a home-based childminder. Government action over recent decades has clearly warped the sector towards more formalised care – one of the reasons for higher costs.

At the same time, the economic case for subsidising childcare broadly is actually incredibly weak. Some (see Paull 2014) have argued that 'mothers'' employment has external societal benefits beyond the private benefits accruing to the individual in enhancing the productivity of other factors of production in the economy. This supposed positive externality, some might argue, could therefore justify government subsidies, as childcare might be under-consumed in a free-market.

However, this analysis is highly contentious and incomplete. It neglects the possibility for positive externalities arising from mothers being at home with their children (which one could envisage might include more time being spent in community groups, less neighbourhood crime resulting from a higher daytime presence of adults in homes etc). It also ignores the deadweight losses associated with a higher tax burden.

But perhaps more importantly, the externality justification could also be used to justify subsidies to a host of other groups who we might believe are 'under-represented' in the labour market, such as able-bodied

pensioners, or non-working partners in single earner households with no children, to encourage them to work too. This argument could therefore be used to advocate vast increases in expenditure, and one suspects that there would be far less sympathy for this wider generosity of public funds. Whilst there may be a social policy case for limited subsidies for those families with single-parents or no working adults, it is clear that the current myriad of subsidies goes well beyond this ambition.

How might actual policy look if more market-based principles were adopted? In the long-term, non-distortionary child allowances operating through the personal tax system would be an effective means of recognising the costs of caring for children, whether or not the family want to care for their own children or decide to use some type of formal childcare. This system would also likely necessitate limited means-tested demand subsidies for those with low levels of labour market attachment, particularly those who are in receipt of welfare with work requirements.

But in the shorter-term there is an immediate need to deregulate the formal childcare market, and to allow parents to decide what type of childcare they want and how much they are willing to pay for heterogeneous interpretations of quality. This would see a return to a policy more like that seen in the early 1990s. The government should not seek to control any inputs to the childcare process, and any role it has should be merely as a provider of some selected pieces of information. As far as possible, regulation and standards should be delivered in the market itself, through accreditation by childminding agencies. This would mean the government would no longer set staff-to-child ratios on a statutory basis, Ofsted would not be charged with carrying out regular inspections, and childminders would be treated in the same way as parents in terms of not having to undertake extensive training, nor the Early Years Foundation Stage. This would not of course preclude nurseries or agencies from delivering these outcomes or information to parents as signalling devices, should they so wish.

Over time one would expect this to have a significant dampening effect on the cost of childcare - enabling parents to return to work for greater reward net of childcare costs, if they so choose. The use of child allowances would mean those parents who would prefer to look after their own children would likewise be free to do so.

A good first step would be to merge and simplify existing subsidies into the childcare element of the working tax credit, which is supply-blind,

work-contingent, a co-payment (such that it retains parental incentives for value for money) and is targeted at low earners.

Potential impact

It is extraordinarily difficult to quantify the impact of a fundamental deregulation of the UK's formalised childcare sector. However, there is no reason that childcare should be inherently expensive if accessibility to it is the key objective of policy.

Most of the large continental European countries have similar enrolment rates to the UK but with both government and out-of-pocket childcare costs of somewhere between a third and a half of our current levels.

The Joseph Rowntree Foundation's (JRF) minimum income standard, a budget developed through focus group discussions, suggests that a family with two children (one aged 2-4 and one at primary school – similar to the illustrative family set out in the housing chapter) would need to spend £162 per week on childcare, or £703 per month (JRF 2014).[7]

Assuming that a combination of deregulatory policies, planning reform and a move away from the formalisation of the sector could reduce the cost to the levels observed in some other European countries with similar rates of enrolment then (a reduction of around 40 per cent), the cost to the family outlined would fall to around £424 per month – a monthly saving of £281. This would be a saving of £3,376 per year – equivalent to someone enjoying a pay rise of £4,965 in earnings before tax.

As with the reduction in housing costs, this fall in the cost of childcare might not necessarily be passed on to all families directly - particularly those eligible for the childcare element of the working tax credit, where it might be offset by reductions in tax credit payments. But the reduction in government spending which this would facilitate could just as well be passed through to the family indirectly through tax cuts.

7 There are debating points surrounding the use of the JRF's minimum income standard, which isn't really a 'minimum' standard at all – see Snowdon (2014). However, it is useful for the purposes of this Briefing, which is discussing the cost of living in a broader context and is not restricted to just looking at the living standards of those on the very lowest incomes.

In fact, the whole of the childcare market is complicated by the fact that there is a vast array of state interventions in the form of benefits-in-kind too. This means the above estimate of the savings is likely to be conservative. The calculation takes no account of childcare provision funded by government which represents a benefit-in-kind, as these are not included in the minimum income standard. The 3 year old in our family would currently, for example, be eligible for 15 hours free childcare a week from the government. Reducing the underlying cost of childcare would also make it cheaper for the government to purchase this care. Thus, there would likely be a further indirect benefit to families too, as the lower costs to government of benefits-in-kind could be passed through to them as further reductions in taxation. And there would potentially be further savings still if all other subsidies were streamlined through the childcare element of the working tax credit.

A supply-side policy response to high childcare costs should therefore entail:

1. **Fundamental deregulation of the childcare sector (including on staff-child ratios, Ofsted inspections and child carer qualifications), and a shift away from the idea that the purpose of childcare is as a form of pre-primary education.**
2. **Simplification of existing childcare subsidies, only maintaining the childcare element of the working tax credit.**
3. **In the longer-term, the introduction of child allowances through the personal income-tax system with limited means-tested demand subsidies for single parent households in receipt of welfare with work requirements.**

Food for thought - removing protectionism in agriculture

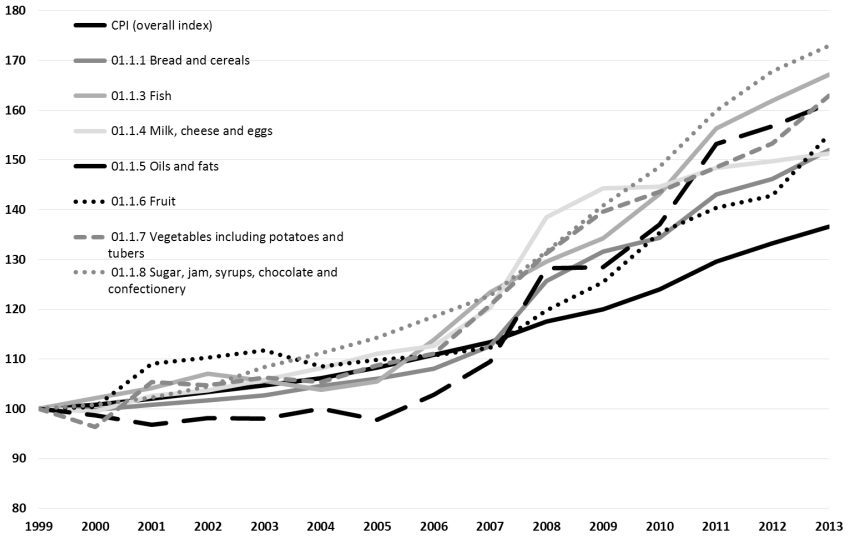
Food prices rising

In 1977 an average British household put 25 per cent of its overall spending budget towards food and non-alcoholic drinks. In 2012, the average was just 11.6 per cent. The second lowest decile spent 16.4 per cent and the lowest 15 per cent (ONS 2013b). In other words, in relative terms today's least well off spend less on food than the middle classes a generation earlier. This reflects both rising real incomes and a fall in the relative price of food.

However, as Figure 9 below shows, since 2005 food prices have increased significantly relative to price increases of other goods (ONS 2014a). In the 8-year period between 2005 and 2013, the price index for food and non-alcoholic beverages rose by 55 per cent, whilst the overall consumer price index increased by 37 per cent. This has meant that, especially in the years after the financial crisis when real incomes faced a sharp squeeze, the upward pressure on food prices has become a significant media story within the debate on the 'cost of living crisis'.[8]

8 See, for example, the headline from the *Daily Mail* on 13 February 2013: 'Food prices rise three times faster than wages as the cost of living "crisis" continues'.

Figure 9: Consumer Price Index (1999 = 100)



Source: ONS (2014a)

The problem for those on low incomes is that their relative expenditure on food, as shown above, is already much higher than for groups further up the income spectrum. Changes in food prices therefore have a bigger impact on low-income households than the CPI would suggest, as the CPI is based on the consumption behaviour of average households. Significant increases in food prices can also make it much more expensive for low-income families to buy certain types of food. It may be the case, for example, that in the face of rising prices, some families are switching to lower quality food products.

Since food is so obviously a necessity, the images of families on low incomes using 'food banks' has had a vivid impact on the debate about the cost of living. Although many directly conflate the rise of food banks with rising food prices, we know that ultimately the ability to buy food is influenced by the much broader determinants of disposable incomes and the costs of all essentials. Whilst food prices are a component of the latter, it is almost impossible to determine their importance relative to other living costs, such as housing, energy, childcare and taxes, or indeed changes to benefit levels or eligibility criteria, in being the cause of rising food bank use. The existence of 'food banks' has, however, meant that 'food poverty'

has taken on a high profile in public debates, with some even calling on supermarkets or 'the food industry' to take responsibility for soaring prices (see, for example, Sandys 2012).

In reality global food prices are determined by a multitude of factors, and there is no evidence that supermarkets or retailers are engaging in anything untoward. Many of the drivers of prices are short-term phenomena, like bad harvests, the effects of natural disasters on supply, oil price fluctuations, currency fluctuations and the use of export restrictions (Downing et al. 2014). There is also the longer-term structural impact of rising food demand owing to the increasing affluence of both India and China. Unlike many of the other policy areas in this Briefing then, there are not very many specific UK policy factors which have driven up prices substantially of late. To find policy factors which matter, we have to think more structurally and often look to policies developed at an EU level.

Given that several recent studies, such as those from Prestige Purchasing and Radobank (see footnote), have forecast that structural trends will lead to food prices continuing to increase in the coming years, it makes sense for policymakers at an international level to reassess policies which are directly increasing costs to consumers.[9] This is especially true given that, as we have seen, rising food prices affect those on low incomes disproportionately. The 'first do no harm' principle should be a guiding one for policymakers in this area.

Biofuels and price increases

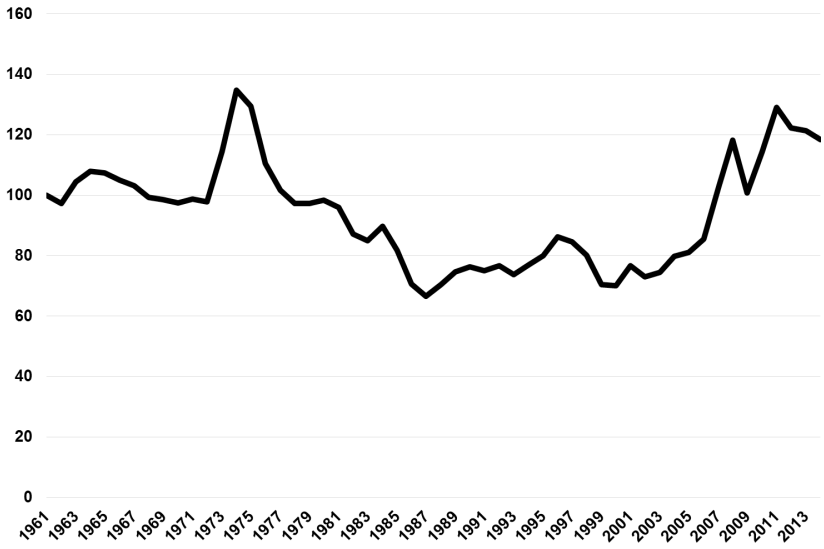
The existing academic literature on the reasons for food price rises in recent years splits explanations into short-term and more structural trends. The 2007/08 food price spikes have been attributed to currency fluctuations and oil price increases, which raised transportation costs and increased biofuel production as a substitute, driving food prices higher still (Abbott et al. 2009). Many of these trends went into reverse when the global financial crisis hit in 2008/09, suggesting that they were short-term factors.

9 See, for example, recent articles in the British press within the last year. From *The Daily Mail* on 9 December 2013: 'Food prices to rise faster than salaries until 2018: Fresh produce could become a rare treat for poorer families' and from *The Daily Telegraph* 23 September 2012: 'World on track for record food prices "within a year" due to US drought'.

Significant droughts and water shortages in the US, South Africa and Russia have in recent years also affected supply (Downing and Harker 2012), as has the use of export restrictions by Russia.

However, recent price spikes also seem to be part of a steady upward structural trend in global prices since 2006 (see Figure 10 for a time series from the UN). Analysis within the World Bank has suggested that the initial increase in food commodities prices was led by grains in 2004/05 despite a record global crop (Mitchell 2008). In this regard biofuels production has been recognised by many sources as a significant driver of price increases. Other factors such as rising energy prices more broadly were significant in this initial period, but the World Bank analysis suggests that much of the longer term trend has been driven by the large increase in biofuel production from grains and oilseeds in the US and EU, resulting in part from state-led directives for renewable fuels to be used for transportation.

Figure 10: FAO Food Price Index in real terms (1960 = 100)



Source: FAO (2014) Food Price Index, Food and Agriculture Organisation of the United Nations.

In the EU, a 2003 Directive made it a goal to reach 5.75 per cent of renewable energy used in the transport sector by 2010. In 2009 a new Directive was issued which raised the target to 10 per cent for every member state by 2020 in order to contribute to cuts to greenhouse gas emissions. The effect is expected to be a tripling of biofuel use in the EU by 2020 (Bowyer et al. 2012).

The problem from a policy perspective is that these policies both put upward pressure on food prices directly, and make food prices more volatile by effectively linking them to fluctuations in oil prices (since oil is a substitute for biofuels). Land-use changes encouraged by policies like mandates, subsidies and import restrictions in favour of oilseed for biofuel production lead to lower global wheat stocks than otherwise would be the case and higher wheat prices. There are also second-round effects in terms of the impact on other food commodities, such as rice prices. But perhaps more importantly, high prices in food commodities markets tend to result in more speculative activity and to encourage anti-free-trade actions like export bans.

A range of academic studies which have examined the precise impact on global food prices of this EU directive through to 2020 have estimated that the effects of the policy will increase prices of oilseeds by 8 to 20 per cent, vegetable oils by 1 to 36 per cent, cereal/maize by 1 to 22 per cent, wheat by 1 to 13 per cent, and sugarcane by 1 to 21 per cent (ibid. 2012).

The aim of these biofuels policies, at least the stated aim, seems to be to reduce greenhouse gas emissions. But, as will be outlined in the next section, there are economic methods of internalising the externality effects of carbon emissions without directly interfering in individual markets through these types of subsidies and mandates.

Both through raising energy costs - which raises food prices - and by raising food prices directly through the redeployment of land to grow crops for biofuels, such policies currently raise the cost of living. Higher agricultural prices in turn result in higher retail food prices, diminishing living standards for consumers and hitting the poorest disproportionately. It is for this reason that a range of organisations and individuals have urged major governments to abandon biofuel mandates and subsidies, both for production and consumption (Bowyer et al. 2012).

Abolition of all subsidies and mandates would not completely de-link food prices from oil price fluctuations. Very high oil prices, for example, would still incentivise biofuel production. But as well as reducing agricultural commodity prices, and in turn retail food prices, one would also expect the removal of subsidies to dampen the volatility of commodity prices owing to the oil-biofuel link.

The government should therefore press at the EU level for the abolition of all biofuels mandates and subsidies, and on the world stage for similar policy action to be taken by the US and others.

Agricultural protection and the CAP

One of the key hurdles to removing subsidies and trade barriers in terms of biofuels is that there are now significant vested interests who would lobby against their removal. In fact, agriculture as a whole is probably the industry most associated with protectionism. The OECD outlines hundreds of policy instruments used to support agriculture around the world, from subsidies and protection of outputs, to tariffs, subsidies for inputs, subsidies for different types of capital goods and subsidies for production related services (OECD 2010a; OECD 2010b).

Niemietz (2012) outlined the well-known economic case against this protectionism and made the argument for a genuinely free market in agriculture. However, he also cautioned that there were particular features of agriculture which made it more likely to be prone to the sort of rent-seeking activity predicted by the public choice school of economics. For a start, farmers' political interests are largely homogenous whilst their associations have high affiliation rates and large endowment funds. The value of agricultural subsidies also tends to mobilise landowners, another powerful lobby group, due to the fact that subsidies tend to be capitalised in the value of the land. In terms of the product market too, agricultural products tend to be price and income inelastic and the scope for individual farm-level innovation and production differentiation is limited. Add to this that the policy responsibility is centralised to a bureaucracy at an EU level, primarily under the Common Agricultural Policy, and one can observe a perfect storm for rent-seeking activity and vested interests.

The EU's Common Agricultural Policy in particular has long been criticised by those in favour of free trade. Fortunately, this criticism has led to

substantial reform in recent years, such that the CAP is far less damaging than it once was. However, as Table 5 shows, EU food prices have still on average been 6 per cent above world market levels over the five years from 2007 to 2011. This figure was low in part because support measures are inversely related to market prices, which have been very high through that period (though the reforms have been significant too). For the ten-year period 2002 to 2011, the average mark-up was 15 per cent (and even higher the further one looks back).

This measure is of course relatively crude, because it assumes uniform consumption patterns across Europe. In reality, the price mark-up paid by low earners in the UK might be above or below these values – but it nevertheless represents a rough indicative cost of the CAP to consumers. Given that the lowest earners spend around 16 per cent of their budgets on food, it would suggest that the cost of the CAP to families in the bottom quintile of the disposable income distribution has been, on average, 1-2.5 per cent of their expenditure over the past ten years. On top of this, of course, they pay more in taxes than they otherwise would to provide the support in the first place.

Table 5: Different models of agriculture

		EU-27	*New Zealand*	*Australia*	*Chile*
Value of producer support measures in % of farm revenues	2007-2011	21%	1%	4%	4%
	2002-2011	27%	1%	4%	5%
Food price mark-up above world market prices	2007-2011	6%	2%	0%	1%
	2002-2011	15%	2%	0%	2%
Total value of agricultural support (% of GDP)	2007-2011	0.8%	0.2%	0.2%	0.3%
	2002-2011	1.0%	0.2%	0.2%	0.4%
Agriculture as a % of GDP	2011	1.5%	7.2%	2.5%	3.6%

Source: Based on data from OECDStat.Extracts (2014) and World Bank (2014)

As Table 5 again shows, relative to countries that have undertaken significant liberalisation of their agricultural markets (like Australia, New Zealand and Chile), the EU still has much higher levels of producer support as a proportion of farm revenues and as a proportion of GDP. This is driving up food prices for UK consumers. For politicians who claim to desire sustainable ways to structurally reduce the cost of living for British consumers in the longer-term, abolition of the CAP is an obvious policy to work towards at an EU level.

Retail productivity

Both abolition of the CAP and removal of biofuel mandates and subsidies will require substantial negotiation at an EU and international level. But are there any policy areas which we could work towards domestically to reduce food prices in the UK?

Some point to the impact of monetary policy and the exchange rate in both contributing to commodity price inflation and importing inflation with foodstuffs from overseas. But in truth, the monetary policy stance of an economy must be set according to broader economic conditions and cannot be altered such that it simply aims to provide cheaper food for UK consumers.

A far more fruitful area for reform would entail returning to our dysfunctional planning system, which, as we have seen, has contributed to extremely high house prices. Existing planning regulations have also had perverse effects on supermarkets and the efficient use of retail space (Cheshire et al. 2011).

Cheshire et al. (2011) have documented how planning regulations introduced in England in 1988 have sought to both determine the amount of land available for retail development, but more importantly also determine where that development should take place. Restrictions were tightened even further in 1996 when developers were required to show that a local area both needed more shopping space and that there was no ‘suitable’ space in the town centre before being allowed to develop. With further conditions on suitability, the planning system was in effect, according to the authors, ‘micro-managing the location…for development and effectively prohibiting out-of-town superstores.’

The results of this are striking. Cheshire et al. (2011) find that stores which opened before the regulations achieve better productivity performance relative to those which opened up afterwards. Furthermore, this relationship only held in England, in particular in areas where the regulations were rigorously enforced.

Restrictive planning laws have similar effects for supermarkets and retail space as we saw earlier for housing. They cause the price of retail space to be higher and thus stores tend to be smaller – and it is generally accepted in the literature on retail development that larger stores tend to be more productive. It has been estimated, for example, that the UK has significantly less than half as much retail space per head as the US (see footnote).[10] Using quantitative methods, Cheshire et al. (2011) estimate that England's planning policies overall reduce retail productivity by more than 20 per cent.

Restrictive building policies thus ultimately end up hitting the pockets of consumers in the form of higher prices. If we want to reduce the cost of food, then the policy implications are obvious: relax planning restrictions, particularly around the development of large supermarkets in out-of-town locations.

Potential impact

What might be the impact of liberalised policies on the living costs of our example family? It is very difficult to know with any degree of uncertainty. What we do know, however, is that the Common Agricultural Policy alone currently raises food prices by around 6 per cent above world market prices. Even within the EU, comparison websites such as Numbeo estimate that the cost of groceries in the Netherlands and Germany is around 20 per cent lower than in the UK. It is likely that at least part of this difference is explained by restrictive land-use planning laws here, as outlined above.

The Netherlands has a similar climate, income levels and population density to the UK. There is no inherent reason why grocery costs should be so much lower. Yet it is impossible to say with any certainty that differences in land-use planning approaches can completely explain the

10 These figures have been cited in numerous places, yet a primary source is difficult to obtain. See, for example, Mish's Global Economic Trend Analysis 'Country by Country per capita retail space comparison' which shows the UK has 23 sq feet of retail space per capita, compared to 46.6 sq feet in the US.

differential. Other factors such as local preferences, transport policies, advertising rules and regulation on shop opening hours might all have an impact, and are beyond the scope of this paper.

According to their minimum income standard, the JRF currently estimates that our two-parent, two-child family would need to spend around £455 per month on food. Abolition of the Common Agricultural Policy combined with reducing food prices to the level seen in the Netherlands (using the much more conservative EU estimate that food prices are four per cent lower there - see Eurostat 2014) would suggest a 10 per cent direct fall in food bills. This would lead to savings of £45.50 per month or £546 per year – which would have equivalent on take-home pay of an increase in salary of around £805 per year for someone paying the basic rate of income tax.

This is clearly likely to be a very conservative estimate. It ignores completely the unknown impact of the abolition of biofuels policies and is likely to understate substantially the impact of improved retail productivity on food bills. It furthermore ignores the dynamic gains to be had from less agricultural protection, allowing competitive forces to reshape agriculture to realise gains from extending the division of labour. Finally, there would also be a small gain due to a reduced tax burden from not having to subsidise the CAP any longer. It would therefore not be beyond the realms of possibility to enjoy a reduction of bills of over double the estimate outlined above, were all of these policy goals realised.

A supply-side policy response to high food prices should therefore entail:

1. **Work to abolish biofuel mandates and subsidies at an EU and global level.**
2. **Advocacy at an EU level for abolition of the Common Agricultural Policy and other agricultural protection.**
3. **Relaxation of planning restrictions to allow more development of large, out-of-town supermarkets.**

Energy and misguided interventionist policies

Rising prices are partly policy induced

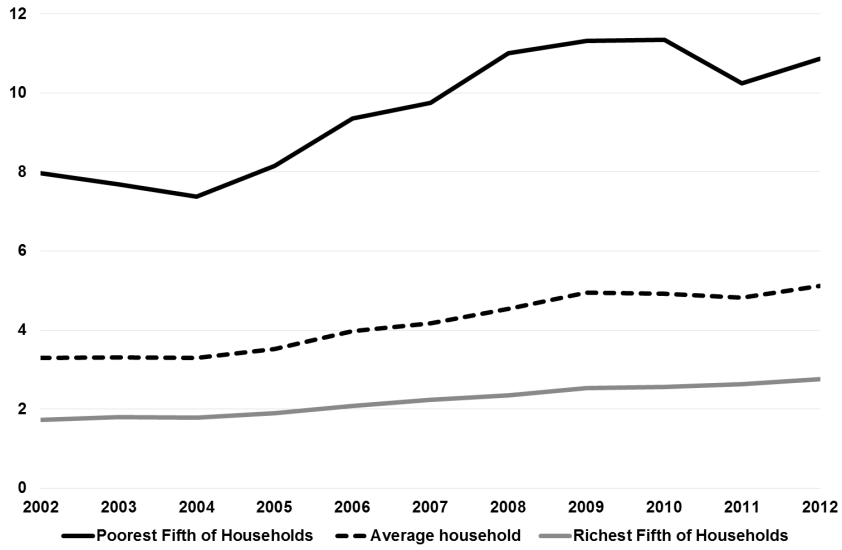
Energy prices – both electricity and gas – have increased substantially since the early 2000s. Following the liberalising reforms of the 1980s and 1990s, consumers had enjoyed a sustained period of falling gas and electricity bills. In 2013 prices, the average annual domestic gas bill for a typical consumer in Great Britain had fallen from £493 in 1990 to just £402 in 2001. For electricity there was a similar story, with the average annual bill falling from £424 to £332 across the same period. Since then, bills have increased dramatically. In 2013, the average bills for gas and electricity were £896 and £532 respectively (Bolton 2014). This means that average bills for gas and electricity have increased by 123 per cent and 60 per cent respectively since 2001.

It is also clear that the increases in bills have occurred purely because of increased prices. Between 2002 and 2012, figures show that the average amount of energy used per household has fallen by 17 per cent. Yet household spending on energy increased during that period by 55 per cent, with most of this increase in spending coming during the period between 2004 and 2009 (ONS 2014c).

It is understandable then that energy bills and their impact on consumers have become a key component of the cost of living debate. This is especially true when one considers that poorer households tend to spend a higher proportion of their disposable income on energy than other households. As Figure 11 shows, the proportion of household disposable income spent

by those in the poorest quintile of households has risen from a low of 7.4 per cent in 2004, to 10.9 per cent in 2012. There has also been a significant increase in this ratio for both average households and the richest, but given that the poorest already have lower disposable incomes, and energy is regarded as by-and-large a necessity, energy price rises have a much harsher impact on the poorest (ONS 2014c).

Figure 11: Average percentage of household disposable income spent on household energy



Source: ONS (2014c)

This impact of the increased cost of fuel can also be seen by examining the government's official measure of 'fuel poverty' – the number of households for whom heating a home to a predefined standard would take more than 10 per cent of their budget (as opposed to what they actually do spend). Though this measure has been criticised on the basis that it doesn't take good account of the choices people make in terms of the sorts of properties in which they decide to live, the change over time can be instructive about the impact of changing prices. It shows that the number of households in fuel poverty fell from 6.5 million in 1996 to 2 million by 2003 before rising to 5.5 million by 2009. Since then the figure has fallen somewhat to 4.5 million, but this is much higher than that

experienced in the early 2000s and means that around 17 per cent of the population are now officially defined as being in fuel poverty (DECC 2013a).

What has caused the recent increases in prices then? Most evidence suggests that there have been significant increases in wholesale energy costs during the past decade which are not unique to the UK. Ofgem believes that wholesale gas prices have increased by over 240 per cent over the past ten years, for example, due to international oil and gas shortages. Meanwhile, wholesale electricity costs have increased by 140 per cent over the same period, mainly driven by developments in global energy markets. Carbon prices, which for most of this period were determined by the EU Emissions Trading Scheme (EU-ETS), have also added to the costs of generating electricity, as has the investment needed for low carbon generation (Ofgem, OFT and CMA 2013).

But even putting aside international factors that are beyond policymakers' control, and assuming that it would be unlikely for the UK to abandon carbon obligations under the EU Emissions Trading Scheme, it is clear that at least some of the upward pressure in energy prices is due to domestic policy decisions taken by both the government and the regulator. This is particularly true for environmental policies, which 'drive up energy prices directly through the environmental charges in the bill but also indirectly, and significantly, through the impact on generation and network investment costs' (Jenkins 2014).

The rest of this chapter will seek to outline how confused interventionist policies in the energy market are putting unnecessary upward pressure on prices, beyond that necessary to achieve the carbon emissions mitigation strategy outlined under existing EU obligations. It will also explain why actions by the regulator in the retail energy market have acted to stifle competition, to the detriment of consumers. What it will not do is set out a fundamentally radical departure from either the existing institutional structure of the energy market or the UK's broad objectives of climate mitigation.

There are good reasons for not doing so. The Competition and Markets Authority is set to begin a fundamental investigation into the wholesale power market as well as energy company profits within the retail sector, and this should provide a useful starting point for examining whether there any real issues in terms of lack of competition within the industry. Provided that this investigation takes full account of the role of policy-induced

regulation (Robinson 2013) and the regulator's own actions in the retail market (Littlechild 2013), this could prove a useful starting point in defusing what has become a toxic political debate.

On the broader approach to climate policy, Niemietz (2012) outlined how a policy of adaptation to climate change might be more politically and economically realistic than the current mitigation approach in an environment with large uncertainties. This analysis still remains relevant today, and so there is little to update here. Instead I will focus on three clear areas where government policy is clearly detrimental to consumers through increasing energy prices: subsidies to renewable energy, the UK's unilateral carbon price floor and Ofgem's heavy-handed approach to tariff regulation.

The cost of green measures

There are many aspects to green and environmental policies, which makes their overall impact difficult to assess. The environmental and social levies which contribute to our energy bills include measures that rebate bills for those on low incomes, increase the price of electricity at the point of generation, subsidise renewables, and raise bills to support the installation of efficiency measures for some households.

Table 6: The cost of environmental and social measures as a percentage of energy retail prices, 2020

	Measures included	*Cost in % of domestic retail price*
Gas	Eco Support Cost	4.2%
	Smart meters and better billing supplier costs	
Electricity	Eco Support Cost	21.7%
	Smart meters and better billing supplier costs	
	Carbon Price Floor carbon cost	
	Renewables Obligation	
	Electricity Market Reform support cost and FITs	

Source: DECC (2013b)

Table 6 above represents a best estimate of the impact of environmental and efficiency measures on average domestic energy prices by 2020, and

shows how much prices would fall were these measures abolished. By construction this excludes the Warm Home Discount support cost, which factors into gas and electricity bills in order to support lower income customers with their bills. This should rightfully be administered transparently through the tax and benefit system as a welfare policy.

It also excludes the impact of the EU-ETS. As outlined above, the rest of this analysis will work from the assumption that the UK continues to fulfil its obligations under this scheme. It is simply worth noting at this stage that the EU-ETS also makes up over 2 per cent of the domestic price of electricity in the retail market in addition to the cost of the measures outlined above.

The remaining environmental measures – which for electricity represent as much as 22 per cent of the overall price – only represent the direct cost to consumers, of course. There will also be the indirect impact of increased goods prices arising from increased energy costs in areas where production is energy-intensive.

DECC claims that although these measures increase the price of energy, the impact on bills is negligible overall and may even be good for consumers in terms of affordability in the longer term. This is because of the other efficiency measures contained within the policies, and predicted behavioural change. However, the Joseph Rowntree Foundation (2010) has suggested that the households which will be most adversely affected by the increase in prices are also those least likely to benefit from energy efficiency upgrade measures (Niemietz 2012). The overall effect of the combination of all environmental policies on poor families is therefore ambiguous in theory, but certainly it is likely that many of them will be hit hard by the resulting price rises.

Subsidising renewables

The Renewables Obligation (RO) scheme and other feed-in tariff policies, including those within the Electricity Market Reform, require energy retailers to purchase larger and larger shares of their portfolio from renewable resources, with the cost passed onto consumers via higher bills. Other aspects of the policies guarantee higher prices for producers, particularly in the delivery of nuclear power. These mimic the effects of subsidising certain energy producers through imposing taxes on consumers.

The declared aim of all of this is to reduce CO_2 emissions targets. The problem is that total CO_2 emissions are already capped at EU level by virtue of the UK's participation in the EU-ETS. Though it has been criticised as being ineffective at setting a high enough price (some say that there was an oversupply of initial credits, though a collapse in demand due to the recession is also important here – see *The Economist* (2013)) the theory behind a cap and trade scheme is that the government sets the overall volume of emissions by creating a certain level of tradable credits, but does not interfere with how these reductions in emissions are met in terms of how the energy is produced. It is supposed to allow market processes within this framework to find the least costly way of achieving the emissions reductions, and as such depoliticise the path of shifting away from carbon.

Instead, the renewables and nuclear-supporting interventions imposed by the UK government seek to plan how the CO_2 reductions are met. The Renewables Obligation and Feed-In Tariffs, for example, are akin to industrial policy – picking winners – in the energy generation market, with government seeking to second guess what will be the most efficient way to reduce emissions. This can mean that inexpensive ways of reducing CO_2 to meet emissions targets are crowded out and replaced with expensive ones. Hence, for example, we get extraordinarily expensive offshore wind being subsidised by consumers (The Economist 2011).

The problem from a UK policy perspective is that the UK has also signed itself up to a European directive on renewables that requires Britain to generate 15 per cent of its energy from renewables by 2020. The European Union is now agitating for a new directive which would have a legally binding target of 27 per cent renewables in the final energy balance of the whole of the EU by 2030. Both of these are unnecessary and result in higher prices for consumers. Whilst certain renewable energy sources may eventually be economically feasible without subsidies, feed-in tariffs or other support from taxpayers and consumers, imposing targets on how carbon emissions are met represents an industrial policy which will warp investment into economically unfeasible sources and will not allow the market to adapt to technological innovation. The other problem that the UK faces is that is has committed to close over 12GW (gigawatts) of coal and oil power plants by 2015 to meet EU environmental objectives on desulphurisation.
Even if one takes the EU-ETS as given then, there is simply no rationale from an environmental or economic perspective for the vast array of renewables subsidies and regulations which currently drive up bills. If the

UK is to go on committing to its carbon emissions targets under the EU-ETS, but feels that this trading scheme is not working effectively, then it should work towards reform at an EU level. This in itself is likely to impose costs on consumers, which policymakers should be willing to explain in a transparent way. But this does not necessitate a green industrial policy. As the statistics outlined above show, environmental interventions are a significant cost to UK households and the poorest households would benefit to the greatest degree from abolition of these measures. Even just abolishing the Renewables Obligation, Feed-in Tariffs and Electricity Market Reform support could lower average electricity prices by 10 per cent by 2020.

The carbon price floor

In addition to all of these existing interventions which drive up energy prices, in 2010 the coalition government took the decision to unilaterally increase prices further by adding a price top-up to the EU carbon price such that the UK's electricity generating sector saw a fixed and rising carbon price trajectory.

The carbon price floor (CPF) was originally set to rise to £30/tonne in 2020 and £70/tonne in 2030 (Lodge 2012). This was justified on two grounds: that the rising carbon price would encourage business to invest in low emissions energy generation, which it might not do with a volatile and low EU-ETS carbon price. And that EU carbon prices would start increasing steadily to shadow the new UK trajectory anyway. (It's also worth noting that the CPF was expected to raise significant revenue for the government).

Again, this policy does nothing to cut carbon emissions per se, the overall levels of which are determined by the EU-ETS. In fact, by unilaterally setting a higher price than that set by the EU market, demand for carbon here falls – meaning that the UK uses fewer of the carbon credits. Lower demand for credits in Britain reduces the carbon price faced by the rest of the EU, which is able to emit more. In other words, the overall level of carbon emissions is unchanged, but the UK's competitiveness is diminished relative to other European countries. Pushing up the cost of energy generation in this way of course will have an impact on the domestic viability of certain industries – and may lead to diminished economic opportunity in the UK in the form of lost jobs (Sinclair 2011).

In truth, the government's other arguments for the CPF just do not stack up anyway. Some of the policies criticised above, such as provisions in the Energy Market Reform in the form of subsidies and strike prices, already provide significant incentives to invest in low carbon energy – arguably making the CPF superfluous (Lodge 2012). But more than that, the carbon price in the EU-ETS has remained significantly lower than the UK carbon price floor plus EU-ETS carbon price – meaning that there have been significant extra costs to consumers and industry.

The harm caused by this domestically-inflicted policy was recognised by the Chancellor of the Exchequer George Osborne in his 2014 Budget speech (HMT 2014). He announced measures to exempt combined heat and power plants from the CPF given their use by manufacturers, but more significantly decided to freeze the carbon price at £18.08/tonne from 2016/17 for the rest of the decade – an admission that the previous trajectory could have been very economically damaging for the UK.

Even with this decision, however, the UK's carbon price is still significantly above that in the rest of the EU, where it is around €6 today and is not expected to rise above €10 before 2016/17. Given the gap to the UK's £18.08, UK consumers will still be paying significantly higher electricity bills than they otherwise would have to.

Again, if the UK believes that the EU-ETS is not working effectively, then it should work to reform that at EU level. Taking unilateral action through the CPF does not make environmental or economic sense, but does help to push up energy prices for hard-pressed consumers. The CPF should be abolished, reducing average electricity prices by 6 per cent by 2020.

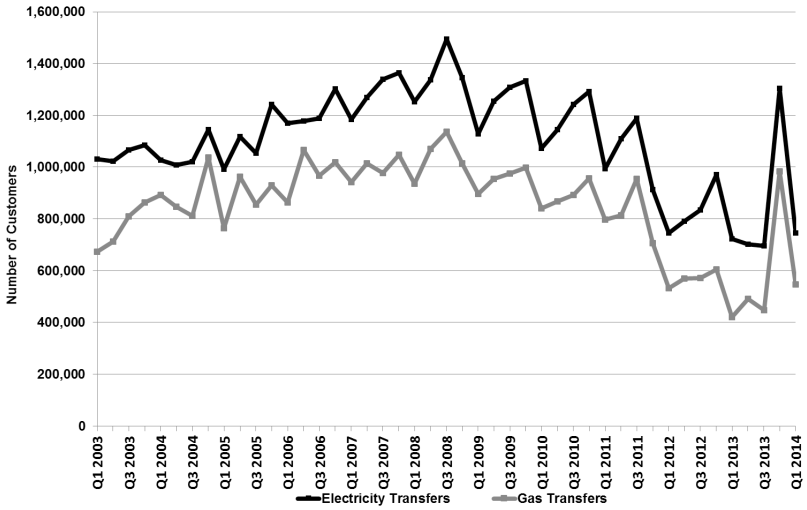
Potential problems with retail market competition

In recent years there have also been new policies imposed by the regulator in reaction to concerns that the retail energy market is not competitive. This has mainly come in the form of restrictions on the type of tariffs that companies in the retail energy market are able to offer their customers, but which evidence suggests may be having the perverse effect of stifling competition and driving up average prices.
In a series of articles for the IEA in recent years, energy market expert Stephen Littlechild has documented how the regulator's interference in the market has been detrimental to consumers (Littlechild

2013/2014a/2014b/2014c). This process began in 2008, when Ofgem ruled against the use of 'unfair price differentials' in the energy market, including companies charging higher prices in their own regional areas while charging lower prices (for the same tariffs) in areas where they challenged incumbents or for different payment types (Littlechild 2013). What happened as a result was that companies increased their out-of-area prices, eliminating competitive pressure and driving up prices for consumers and profit margins for companies.

The regulator discontinued its formal ban on unjustified differentials in 2012, but warned suppliers it would take action if the differentials returned. This has, according to Littlechild, contributed to the long-term trend of falling customer switching (see Figure 12), which since has been held up as a policy problem which requires the regulator to restrict, through 'simplification', the tariffs that energy companies are able to offer.

Figure 12: Energy market quarterly switching in domestic gas and electricity markets



Source: Ofgem (2014)

Ofgem's whole outlook on this has been that consumers often got a bad deal because of the complexity and confusing tariff structures offered by companies. It therefore seeks to set a limit of four core tariffs per customer

for both gas and electricity. Littlechild has outlined some of the potential negative implications of these changes, which could include: the effective abolition of tariffs with no standing charge (which were incredibly popular with some customers – particularly poorer pensioners), stopping discounts expressed in percentages rather than pounds, stopping companies offering discounts on grocery purchases to customers who buy energy from them, and stopping discounts for prompt payment of bills (Littlechild 2014a).

Far from improving competition, these sort of tariff regulations will prevent innovation and in many cases stop energy companies from offering consumers what they want. The overall impact will be to drive up the average bill from what it would otherwise be.

Given that there is now a Competition and Markets Authority investigation of the retail energy market, Ofgem should (as Stephen Littlechild has suggested) suspend its simple tariffs rules for the duration of the investigation in order to halt the potential damage being done to the market. This, combined with actions to abolish renewables subsidies and the unilateral carbon price floor, could have significant benefits for UK consumers – particularly the poorest.

The potential impact

According to the Joseph Rowntree Foundation, our illustrative family with two adults and two children would currently need to spend around £112 per month or £1,338 per year on domestic fuel costs. This is based on the household using gas central heating. The direct savings from energy price reductions of 4.2 per cent for gas and 21.7 per cent for electricity through eliminating unnecessary renewables subsidies and unilateral policies such as the carbon price floor would allow household savings of £12 per month or £143 per year. This would have an equivalent impact on disposable incomes as an individual in the basic rate income-tax band enjoying an annual wage £210 higher.

Again, this is an extraordinarily conservative estimate of the likely impact of the policies advocated here. Current renewables policies raise production costs for many companies, which raise prices of goods and services in a host of other industries. There would therefore be indirect benefits to households (as consumers) of lower goods prices. The estimate above also ignores the tariff reform policy outlined earlier and assumes that we

stick to our EU Emissions Trading Scheme obligations, i.e. we will continue to pursue our carbon reduction objectives but in a more efficient way.

In the longer-term, an energy market which allows dynamic market processes to operate, even under the constraint of seeking to reduce carbon emissions, is likely to deliver benefits to consumers relative to a market littered with subsidies and additional interventions. Whilst there may be an argument for some Pigouvian interventions in the energy market, current policy is a mass of contradictions which go way beyond this ambition and raise costs for households unnecessarily.

A supply-side policy response to high energy bills:

1. **Abolish renewables subsidies and green industrial strategy.**
2. **Abolish the UK's unilateral carbon price floor.**
3. **Allow innovation to operate in tariff formation by energy companies by suspending new Ofgem regulations until the conclusions of the CMA investigation are known.**
4. **Reassess policy of mitigation relative to adaptation to climate change.**

Aggressively regressive sin taxes

A heavy burden on the poor

The burden of indirect taxation on poor households is often overlooked in discussions of the cost of living. Yet the poorest fifth of households on average spent almost 30.5 per cent of their disposable income on indirect taxes in 2012/13 (ONS 2014d). It is well acknowledged that indirect taxes – that is, taxes on spending – tend to be much more regressive than taxation on, say, income or capital gains, yet they are rarely discussed by anti-poverty campaigners. Given their high burden, however, it is impossible to talk about a 'cost of living crisis' seriously without discussing them (Snowdon 2013).

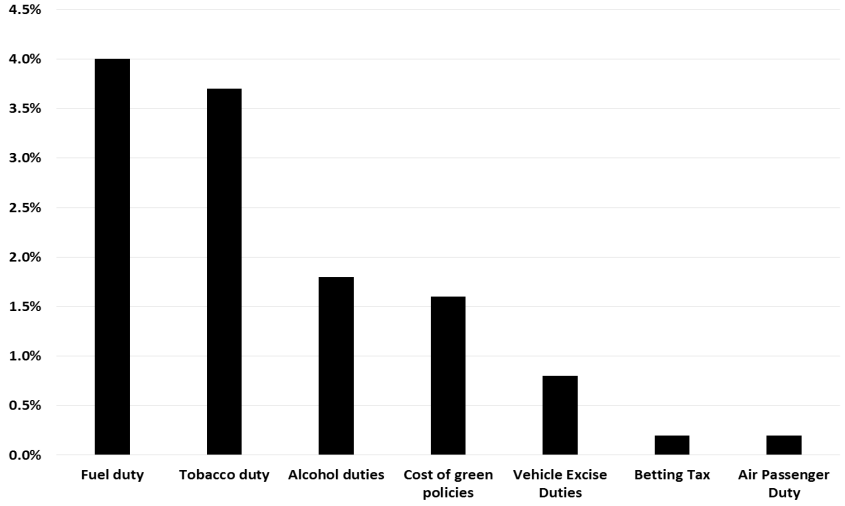
Indirect taxes comprise a wide range of different taxes, of course. The most obvious is VAT, which currently accounts for 40 per cent of the total £3,488 of indirect taxes paid by the average household in the bottom quintile (ONS 2014d). But on top of this, the state imposes a range of taxes and duties, collectively described as 'sin taxes'.

In 2012/13, the poorest twenty per cent of households in Britain spent an average of £1,416 on 'sin taxes', including betting taxes, vehicle excise duty, air passenger duty, 'green taxes' and duties on tobacco, alcohol and motor fuels (including, where relevant, the VAT imposed on the duties – but excluding VAT imposed on the products themselves).[11] This is equivalent to 12.4 per cent of their disposable income. In contrast,

11 Green taxes based on Which? figures which suggest 'green levies' - de facto taxes - on domestic fuel used to subsidise wind farms and other renewable energy industries cost on average £185 per household.

the burden of sin taxes on the richest quintile was equivalent to 4.4 per cent of their disposable income.

Figure 13: 'Sin taxes' as a proportion of disposable income for households in bottom quintile



Source: ONS (2014d)

As can be seen from Figure 13, according to official statistics the amounts spent on fuel duty, tobacco duty and alcohol duty (including the VAT on those duties) on average by the poorest quintile are as high as 4.0 per cent, 3.7 per cent and 1.8 per cent respectively. This compares to figures of 1.8 per cent, 0.5 per cent and 1.1 per cent for the richest quintile.

This is not to imply that the poorest engage in all of these activities more – the figures are only a reflection of higher consumption by the poorest in the case of tobacco. Both alcohol and purchase of fuel are more heavily consumed as income increases. But the relative burden for the poorest is higher given their much lower disposable incomes. In other words, as disposable income increases, the proportion of that income spent on the duty imposed on these 'sin' goods falls.

Official statistics do not tell the full story of the burden of 'sin taxes' on many families, however (Snowdon 2013). Firstly, we know that the sort of self-reporting used to develop these figures is subject to significant underreporting for the consumption of alcohol and tobacco. According to

Brewer and O'Dea (2012), just under 50 per cent of all recorded alcohol sales and just under 40 per cent of all recorded tobacco sales show up in expenditure surveys. Secondly, average figures mask the fact that many people do not smoke at all, do not drink or do not have their own car.

In order to try to work out the extent of the average burden on households which smoke, drink, or drive, we have to try to estimate what the consumption patterns are of those who do engage in these activities by controlling for these two effects. This work was undertaken by Snowdon (2013). He estimated that:

- A smoker in the bottom income quintile who smokes an ordinary popular brand of cigarettes would tend to smoke around 19 cigarettes per day and would spend 21.8 per cent of their household disposable income on cigarettes, with the taxes alone taking up 16.8 per cent of their disposable income.
- The average drinker in the lower quintile, if self-reporting was correct, would spend an average of 2.5 per cent of their income on alcohol taxes, rising to 3.7 per cent if drinkers underreport by 50 per cent (Boniface, 2013).
- Low-income drivers on average spend 8.2 per cent of their annual household income on motoring taxes (including 1.6 per cent on Vehicle Excise Duty) (after controlling for the fact that close to half of those in the poorest quintile do not own cars).

Overall then, whilst the official statistics show the proportion of income spent on sin taxes and VAT on average by a household in the poorest quintile is 23 per cent, a household in the bottom quintile where an individual drinks moderately, smokes and drives a car could spend around 37 per cent.[12] Though it is perhaps unlikely that someone on these low levels of income could afford to engage in all of these activities, these figures are instructive of the burden of these indirect taxes – and the extent to which they empty the pockets of many of the poorest households.

12 Based on assumptions from other sources that 46 per cent of people on low incomes own a car, 83 per cent drink, and 30 per cent are smokers.

Justified by externality arguments?

Many argue in favour of these taxes on the grounds that they help to tackle externalities. But the high level of duties on tobacco, motoring and alcohol in particular can be shown to exceed the social cost of the activities already (Bourne and Niemietz 2014). UK fuel duty is currently charged at 58p per litre for petrol and diesel, for example. Yet estimates of the social cost of carbon would suggest that fuel duty levels of between 2p to 12p would be needed to internalise the social cost of burning carbon within the price. Direct spending on roads and maintenance is just £7.1 billion, but revenues from fuel duty and vehicle excise duty are over £30 billion more than that (HMT 2013). Other potential externalities of congestion, noise pollution and accidents are often used to justify such high fuel duty rates, but there are already other regulations and planning controls which try to mitigate these effects. Plus there other motoring levies too.

The excessiveness of the duties in accounting for the externality effects of smoking and drinking is even clearer. If intangible, private and non-financial costs are excluded from the estimate, the true cost to the government of alcohol use comes to around £6 billion, and yet alcohol tax revenues currently amount to £12 billion (Snowdon 2013). For smoking, the 'social costs' highlighted which manifest themselves as financial costs most often are the healthcare costs. On this, it is worth noting that tax revenues from tobacco duty already exceed the healthcare costs by four times and many studies have actually found that smoking leads to net savings in public spending as a result of lower costs of healthcare, social care and pension payments (Barendregt et al. 1997; van Baal et al. 2008).

Sin taxes on fuel, alcohol and smoking are therefore above the levels which would be justified according to the social cost of the activities. However, they do represent a significant cost burden for those on low incomes. In the case of tobacco, for example, it is self-evident that the high levels of duty have been unsuccessful in changing the consumption behaviour of the very poorest smokers – the elasticity of demand appears to be very low for these groups. Continuously raising tobacco duty therefore has a direct impact in reducing the net disposable incomes of some of the poorest people.

Any attempt to lessen the burden of high living costs therefore cannot ignore sin taxes. This is particularly true given that on top of these existing taxes, new measures such as minimum unit alcohol pricing and sugar taxes are consistently advocated in public debate.

Instead, we should be advocating cutting the duties. This policy would be an extremely well-targeted means of returning money to the pockets of many of the poorest people in society.

Of course, given the budget deficit, the overall impact on the poor would depend on whether other taxes were subsequently increased or spending cuts made. But duties on alcohol, fuel and tobacco could all be reduced by 20 per cent at an approximate direct fiscal cost of just £7.1 billion.[13] This would begin to take us much closer to the levels justified by the social costs of the activities. In the longer term, we could aim to halve these duties, in line with the recommendations of Snowdon (2013).

The potential impact

The impact on household finances can be illustrated through the example of our two-adult, two-child family.

Suppose one of the adults in the family is a smoker, whose declared smoking habits are the same as those for an average smoker in a low-income household. This individual would likely declare that they smoke 14 cigarettes a day, but tend to underreport by anywhere up to 40 per cent. Assuming he or she underreports by a third, this would imply a smoking habit of 19 cigarettes per day. At current duty rates, this would mean smoking 6.7 packets of 20 cigarettes per week, carrying a duty tax cost (including VAT on the duty, though not VAT itself) of £164 per month or £1,971 per year. Reducing tobacco duty by 20 per cent could therefore reduce the cost of the duty for this smoking habit by as much as £33 per month or £394 per year (assuming that the consumption remains unchanged).[14]

13 HMRC (2014). Calculations for 20 per cent reduction in duties on each of beer and cider duties, wine duties, spirits duties, tobacco duties, petrol and diesel duties.

14 Duty rates taken from HMRC (2014).

In terms of alcohol duty, we make the assumption that one of the adults in the family drinks ten pints of beer per week and the parents also share one bottle of wine a week. This would imply that the family currently spends £34 per month or £406 per year on the duty (including VAT on the duty). The cost of maintaining these drinking habits would fall by £7 per month or £81 per year if alcohol duties were reduced by 20 per cent.

We also assume that the family drives an average amount for a low-income household which has and uses a car – suggesting the family would use 18 litres of petrol per week (Snowdon 2013). This implies they currently face duty costs (again, including the VAT on the duty) of £54 per month or £651 per year. Cutting fuel duty by 20 per cent could therefore save the family £11 per month or £130 per year.

In total then, reductions in all three of these taxes by a fifth could save our household £50 per month or £606 per year if they were to maintain the same driving, drinking and smoking habits. In terms of the effect on disposable income, this would be equivalent to someone in the basic income tax bracket being paid an extra £890 per year by his employer. Some may decide, of course, to react to these price changes by driving or drinking more (smoking habits are likely to less responsive to price changes). But, in the case of driving, this may actually facilitate new opportunities in terms of being able to afford a longer commute to work. The full impact of fuel duty cuts is actually likely to be much larger than suggested here (making the calculations above a conservative estimate). Fuel duty is a business cost to significant numbers of firms, not least in retail transportation. Cuts to this tax may therefore benefit households indirectly through lowering prices for goods and services, including food.

A supply-side policy response to sin tax costs:

1. **A reduction in duties on alcohol, fuel and tobacco by 20 per cent.**
2. **In the longer-term, aim to achieve a halving of all three duties.**

Conclusion

This Briefing has demonstrated that a range of current government interventions, both in product markets and in terms of 'sin taxes' imposed on certain activities, raise the basic cost of living substantially. Whilst political debate obsesses over tweaks to certain benefits or relatively minor increases in minimum wage rates, there are a host of policy areas where supply-side reform could have a much larger impact on living standards, especially for the poor and working families on modest incomes. Housing, childcare, food and energy are all areas where efforts to allow markets to work effectively could have a significant positive impact on disposable incomes.

Due to the nature of supply-side reform, and the fact that many of the recommendations outlined here are explained as broad principles rather than specific policies, it is impossible to accurately estimate the impact of this sort of agenda in financial terms for families. But it is possible to gauge the potential scale of the benefits using an illustrative example. Through this document, we have highlighted the impact that the recommended policies might have on an imaginary two-adult, two-child household renting a two-bedroom accommodation in a medium-sized English city like Bristol or Milton Keynes. Table 7 brings these calculations together, and suggests that a supply-side agenda often based on very conservative assumptions could reduce the cost of living for this household by as much as £650 per month. This would work out at £7,800 per year – the equivalent (in terms of take home pay) of a basic-rate income-tax payer receiving a pay rise of £11,470 from his or her employer.

Table 7: An illustrative example of the possible effects of market liberalisation (£ per month)

Cost area	*Current cost*	*Estimated reduction*		*Post-reform*
Rent (e.g. Bristol or Milton Keynes)	£633	41%	£260	£373
Childcare	£703	40%	£281	£422
Food	£455	10%	£45	£410
Energy	£112	4.2% (gas) 21.7% (electricity)	£3 £9	£100
Alcohol, tobacco and fuel duties	£252	20%	£50	£202
TOTAL	£2,155		£648	£1,507

Assumptions: Based on a 4 person household (2 adults, 2 children) renting a two-bedroom flat in a medium-sized English city like Bristol or Milton Keynes. One of the children is aged 3, the other is aged 8. The estimated cost of childcare, food and energy for this family is based upon the JRF (2014) Minimum Income Standard estimate of what is necessary for a household of this composition where both parents work full time. On sin taxes, we assume that the parents in the family drink ten pints of beer per week, the parents consume one bottle of wine per week, there is one parent who smokes an average amount for a smoker in a low income household, and we assume that the family uses 18 litres of petrol per week (in line with estimates of fuel use for households in low-income groups which have a car).

Policy measures:

- Liberalisation of planning laws, with estimated reduction based upon returning to historic norm for median house price to income multiple of 2.9 from 4.9.
- Deregulation of childcare with significant planning reform and de-formalisation of the sector. Estimated reduction based upon reducing cost of childcare in line with other EU countries with similar enrolment rates.
- Abolition of the Common Agricultural Policy and domestic measures such as planning reform and abolition of Town Centre First policies. Estimated reduction based on direct impact on abolishing CAP and modest reductions in food prices to the level seen in The Netherlands (according to the EU).
- Reductions in alcohol, tobacco and fuel duty by 20 per cent.

This does not mean that a family in different circumstances would be better off by £650 directly. Those in receipt of housing benefit or the childcare element of the working tax credit, for example, may see their benefit entitlement fall as housing and childcare becomes cheaper. However, the reductions in government spending on these benefits would allow taxes to be reduced, bringing dynamic benefits through economic growth and allowing cuts to some of the most regressive taxes.

The lower cost of living would furthermore mean that working households would not be as dependent on government to top up their incomes. The aspirations of a 'living wage' campaign – that those working full time should be able to earn enough to live comfortably – would be much more likely to be achieved, but without the need to cajole or legislate for higher wages, with all the potential negative consequences for those with weak labour market attachment that this would bring.

Some will no doubt argue that an agenda of this sort is 'politically impossible' and thus that the illustrative numbers outlined here are meaningless. But the fact that so much focus is now being placed on the cost of living provides an opportunity for these arguments to be heard. The cost of essential goods and services has risen dramatically in the past decade. This hits the poor hard - so it is right that this area has become the focus of political debate.

For too long an obsessive focus on the role of government transfers and state-imposed wage rates in alleviating poverty has blinded campaigners and politicians to other policy areas which fundamentally raise living costs and mean wages go less far. It is now vital that we seek to undo some of this damage, rather than doubling down with a more interventionist agenda which would seek to treat the symptoms of problems arising from existing policies.

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