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SMOKING OUT RED HERRINGS:
The cost of living debate

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About 2020 Vision

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2020 Vision focuses on the future of the UK economy and identifies the key economic issues likely to face the next UK government.

Summary

- The approaches of the political parties to aspects of the ‘cost of living crisis’ seek to treat the symptoms of problems, rather than addressing the underlying causes. In particular, parties have advocated or implemented policies which completely ignore how existing government policies lead to structurally higher prices in essentials such as housing, food, childcare and energy.

- There is likely a political gain from being seen to be doing something which is populist, irrespective of what the long-term consequences might be. It is often difficult for voters to make the link between a negative outcome and a particular government policy, whilst policies often create some clear ‘winners’.

- The cost of living debate is distorted by a host of myths, straw men, red herrings and outright fallacies about housing, energy, food, childcare, taxes and welfare which are repeated ad nauseam in the media and in parliament.

- Arguments suggesting that the current housing supply is large enough for our needs and wants are misguided. Realistically measured, the UK housing supply is the lowest in Western Europe. Redistributing this meagre supply is not the answer to our housing crisis.

- Brownfield development is over-emphasised by campaigners as the solution to the housing shortage. There is little that is suitable for housing development, particularly where demand is high and once competing potential uses are considered. There are also prohibitively high clean-up costs for many sites.

- A decline in public sector house building is not the cause of our current housing shortage. Adjusting for population size, UK house building has been in decline since the 1960s. The real reason is the existence of planning constraints, which have become binding.

- ‘Greedy landlords’ have not been responsible for high rents. Overall, rents have recently risen by less than inflation whilst rents on new tenancies have risen at a similar rate to house prices.

- There is no evidence that privatisation is associated with higher energy bills. Bills fell significantly after energy was privatised, and the price increases of recent years have been associated with rising wholesale costs and government-induced environmental and regulatory policies.

- Privatisation per se is not responsible for high rail fares. Operators make fairly modest profit margins. Importantly, the potential productivity gains associated with private enterprise in rail have been suffocated by heavy-handed regulation, a complex and fragmented industry structure imposed by politicians, and huge sums being wasted on uneconomic projects.

- There is a variety of factors other than rising food prices that may explain the trend for the increased use of food banks. To the extent that food price rises have contributed to increased living costs, these have been caused by global factors.

- There is no general economic rationale for childcare subsidies. They can increase maternal employment and hence measured GDP, but this is no different from advocating subsidies to encourage longer working weeks or for people working until they are older. A policy for improving maternal employment rates should focus on making childcare cheaper overall.

- Childcare subsidies do not reduce the cost of childcare. Whilst the families receiving the subsidies may benefit, other families face higher tax burdens. In the UK we have high public and high family childcare costs. This suggests that childcare is expensive for supply-side reasons.

- It is very difficult to justify current levels of fuel, alcohol and tobacco duties using 'social cost' arguments. Fuel duty far exceeds the cost of roads and maintenance as well as the social cost of carbon emissions. Tobacco and alcohol duties, meanwhile, are way above the level which would account for the genuine financial costs borne by others associated with the activities.

- High levels of sin taxes are not legitimised because they are 'voluntary'. Fuel duty on petrol in rural areas can be considered to some degree essential. Furthermore, the government imposes some significant sin taxes with regressive effects despite knowing that demand is likely to be unresponsive.

- Historically and internationally, government welfare spending in the UK is very high. The living standards of the poorest could be improved, and poverty tackled, via a supply-side agenda in product markets to lower the cost of living. More government spending is therefore neither necessary nor sufficient to reduce poverty.

- The commonly used 'most poor people are in work' argument is, at face value, true. But this statistic is driven by the fact that there are more people in work than people not in work. There is strong evidence that the degree of labour market attachment matters in terms of lessening the probability of a household being in poverty.

- The extent to which tax credits subsidise employers is exaggerated – many households in receipt of them do not work or do not work a full working week. Furthermore, instituting a higher minimum wage as a policy response to this tax credit subsidy is ill-targeted to those really in need and could have negative consequences for young and unskilled workers.

Introduction

Barely a week goes by when some aspect of the 'cost of living' is not discussed in the public sphere. In the past two years, the Labour leader Ed Miliband has outlined how he thinks the squeezed living standards faced by many families, especially the poorest, is the 'the greatest challenge for our generation' (Miliband 2014). In particular, the extraordinarily high cost of essentials such as housing, energy and childcare are held up as significant problems which necessitate active government policy responses. In all of these areas, the coalition government has responded in turn with activist policy measures of its own.

Unfortunately, the policies put forward by all parties to try to tackle the problems associated with high product prices have either been completely misguided or trivial in comparison with the scale of the problem. Almost every proposed solution to the cost of living squeeze, from freezing energy prices and higher minimum wages, to tenancy rent controls, right through to more delivery of so-called 'free childcare', will have adverse unintended consequences without addressing the underlying problem.

What unites the approaches of the political parties in this debate is the tendency to treat the symptoms of problems or sub-problems, in turn almost completely ignoring how existing government policies lead to structurally higher prices in many product markets (Niemietz 2012).

Why might this be? In part, there lies the important distinction between the seen and unseen for voters. Politicians are in the business of winning votes. Many of their actions or proposed actions for more regulation or control in markets are popular, despite the fact that they could lead to a range of perverse consequences without offering comprehensive solutions.

Doing something simple and populist, but which is not so radical that it creates significant numbers of enemies, is a signal to voters that the politicians are acting on an issue which the voters care about. There are usually ‘winners’ from these policies who are willing to reward the political parties who implement or suggest them. In contrast, it is often difficult for the uninformed voter – who might be a loser from the policy - to make the link between a negative outcome and a particular policy.

To make rational political debate more complex, many of the discussions of issues which constitute the broader cost of living debate have been polluted by a host of myths, straw men, red herrings and outright fallacies which are repeated in the media and in parliament. This means that the underlying reasons for high prices in markets such as housing, energy, food, and childcare, and the justifications for high sin taxes, are misunderstood, as are the economic role of work and pay levels in alleviating poverty. A misdiagnosis of the cause of the problem leads to misguided solutions.

This paper therefore seeks to counteract some of the key misguided arguments which currently distort the policy debates on housing, energy, food, childcare, sin taxes and welfare – all of which together form the cost of living debate.

Housing: 'We do not need more homes'

Though all political parties broadly agree that a lack of supply of homes is a key contributor to structurally high house prices in the UK, several campaign groups and journalists seem intent on claiming that there is not a problem at all. This 'we do not need more homes' fallacy comes, broadly speaking, in three variants, which have different policy implications. They can be paraphrased as follows:

1. **Everything is fine**: 'The current size of the housing stock is about right, and there is no need to build anything. There are no major problems in the housing market, and affordability is not an issue. The status quo is fine.'
2. **Enough housing, just wrongly distributed**: 'The current size of the housing stock is about right, and there is no need to build anything. Affordability is a very serious problem, but it is solely a problem of distribution, not supply. Some people have too little because others have too much. The solution is not to build more houses, but to redistribute the housing stock that we already have.'
3. **Enough housing, but people live in the wrong places**: 'The current size of the housing stock is about right, and there is no need to build anything. There are problems, but they are due to geographical imbalances. There has been too much internal migration from the north to the south of England, leading to excess housing supply (and a vast supply of brownfield land) in the north, mirrored by excess housing demand in the south. The solution is to match the spatial distribution

of the population with the spatial distribution of the housing stock, i.e. to relocate large parts of the population northwards.'

'Everything is fine'

One of the starkest indications of the severity of the current affordability crisis for housing is that even organisations who have previously been most hostile to the idea of policies leading to significant increases in housing supply now feel obliged to pay lip service to building more homes. Few are now prepared to openly claim that the housing market is fine the way it is. However, up until very recently, this has been precisely the position taken by several organisations. In their official response to the Barker Review of Housing Supply, for example, the Campaign to Protect Rural England stated:

> '[W]e disagree with her [Barker's] review's central conclusion – that there has been a serious and chronic under-supply of market housing across the country […] [T]he supply of new housing for sale is adequate and there is no overall housing shortage' (CPRE 2005, p. 19-22).

CPRE did not dispute the increase in house prices as such, but described it as a perfectly normal and harmless development in a growing economy: as people grew more prosperous, they were prepared to spend a greater proportion of their incomes on housing, not least because housing was increasingly being used as a 'positional good'.[1] In addition, relatively weak returns on most types of investment meant that housing had increasingly become an alternative investment rather than just a durable consumer good, further increasing people's willingness to spend more on it. Hence, the housing market was doing fine the way it was, and increasing housing supply was not just unnecessary but harmful:

> '[T]here is no chronic, nationwide undersupply of market homes. It follows that implementing the findings of the Barker Review would lead to excess housing' (ibid. p. 31).

CPRE has since changed their rhetoric from 'build nothing' to 'we acknowledge the need for more housing, but…'. However, this looks merely a presentational change. It has not had any impact on the

1 A goods for which in part the value is (if not exclusively) a function of its ranking in desirability by others.

organisation's work on the ground, which remains much the same: seeking to block development. It remains a frequent claim that local authorities' estimates of housing need are 'inflated' or 'unrealistically high', leading to 'an oversupply of land allocated for housing' (CPRE, 2013 p. 2). Their main policy recommendation, then, is to give local anti-development activists greater powers to prevent development.

'Enough housing, just wrongly distributed'

The most elaborate exposition of this idea is Danny Dorling's book *All That Is Solid* (Dorling 2014). Dorling claims:

> 'What is reducing the chances of […] the badly housed, most is not government's failure to ensure that houses are built, but rather other people's overconsumption of housing' (Dorling 2014, p. 209).

And elsewhere:

> 'We have already built enough homes. We have more bedrooms than we have ever had before. But a few have been taking far more than their fair share' (ibid. p. 313).

Less sophisticated versions of the same argument have been presented by George Monbiot (2011, 2014) and Laurie Penny (2014). Justifications differ slightly. Dorling uses the number of rooms per capita as a proxy for housing supply. This number has increased from just under 1.0 a century ago to about 2.5 today, which Dorling interprets as a massive increase in the supply of housing. If this large past increase in supply has failed to solve the affordability crisis, what hope is there that future increases in supply would solve it?

Monbiot meanwhile refers to the English Housing Survey, which uses a formula for assessing the number of bedrooms needed by different household types. Households that do not meet this standard are classified as 'overcrowded', households that exceed it by more than one room are classified as 'under occupied'. Since there are a lot more under occupied than overcrowded households, solving the problem through redistribution is, on this measure, numerically possible.

Proponents of this idea seek to redistribute the given housing stock through the tax system, by taxing property heavily and in a steeply progressive way. People with 'excess' housing would be taxed out of their homes, freeing up space for others.

'Enough housing, but people live in the wrong places'

The most vocal proponent of this idea, particularly on a regional basis, is the National Trust chairman Sir Simon Jenkins:

> 'Travel down the Don Valley in South Yorkshire. You just travel for mile upon mile of unused, brownfield, infrastructures land. Everything is there'.

And:

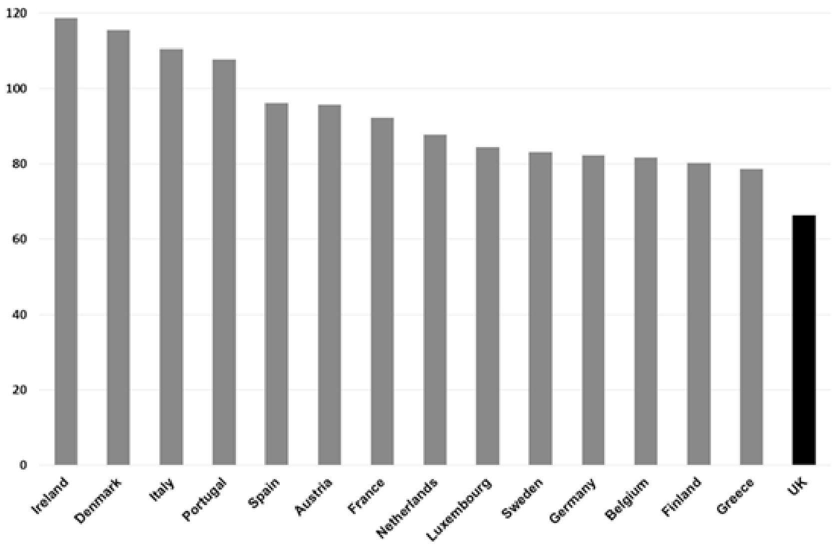
> 'These mill towns of the north, which I still think many of them are very attractive places […] are the sane places for people to live' (cited in Hope 2014).

The solution, then, does not lie in housing policy itself, but in broader regeneration policy, to make people move north.

The reality

Throughout more than three decades, the UK has been building fewer new homes than any other country in Europe (Eurostat 2010). As a result, residential floor space per household is now the lowest in Western Europe– see Figure 1. This is a much better measure of housing supply than the number of rooms per capita favoured by Dorling - especially in the UK, where dwellings tend to be subdivided into large numbers of exceptionally small rooms. Average room size in the UK is therefore, of course, the smallest in Europe (Evans and Hartwich 2005).

Figure 1 **Residential floorspace (in m2) per household, 2008**



Source: authors' calculation based on data from Entranze/Enerdata and OECD

This shows that the housing problem cannot be solved through redistribution, neither between income groups nor across regions, for the simple reason that there is not a lot to redistribute. The housing stock is inadequate in total. There is no 'excess housing' in any UK region; there are only different degrees of shortfall. Even in northern regions, median multiples (the ratio of median house prices to median incomes) are well above the historic norm (see Demographia 2014).

Still, there is a distributional problem which exacerbates the problem of the overall shortfall, but it is not of the kind described above. In any half-way functioning housing market, one would expect a breakdown by region to show at least some correlation between changes in house prices and subsequent changes in construction levels. In the UK, no such relationship exists. House-building levels are not just inadequate in total, they are also heavily skewed towards the regions where the problem is least bad (Cheshire 2014). This is because the areas which experience the highest housing demand (Greater London, Oxford, Cambridge, Bristol, Bath etc.) also account for a disproportionate share of greenbelt land, and have particularly virulent anti-development campaigners. So, paradoxically, the regions where demand is lowest account for a disproportionate share of construction activity (though still inadequate in absolute terms). Inadvertently then, the housing market already provides strong incentives of the kind that Simon Jenkins wants to see: namely, incentives to move to (or stay in) less prosperous areas.

Verdict: Arguments suggesting that the current housing supply is large enough for our needs and wants are wrong. Realistically measured, the UK housing supply is the lowest in Western Europe. Redistributing this meagre supply is not the answer. Allowing it to expand is.

Housing: 'Brownfield development can solve our housing crisis'

The existence of a housing crisis has now become so obvious that even those groups most opposed in principle to new development have had to change their line and pay lip service to the need for more housing. They now claim that they have always supported development – provided it takes place within existing urban areas, especially on brownfield sites, rather than on the edge of cities, towns and villages. The debate, they claim, is not really about the volume of development, but merely about its type. It is not about 'more development versus less development', but rather about 'inward development vs outward development'. The most recent example is the Campaign to Protect Rural England's '#WasteOfSpace' campaign, a virtual map of derelict sites based on photos submitted by CPRE members.

This argument sounds superficially attractive because, at its best, brownfield development really can deliver a win-win situation. The environmental and amenity value of brownfield land is usually low, and it can easily be negative. A derelict ex-industrial site can be a blight that negatively affects its surroundings. Redeveloping such a site for housing would not just benefit the people using those new housing opportunities, but the communities around them as well. When such sites are located within existing settlements, brownfield redevelopment also minimises the need for additional infrastructure.

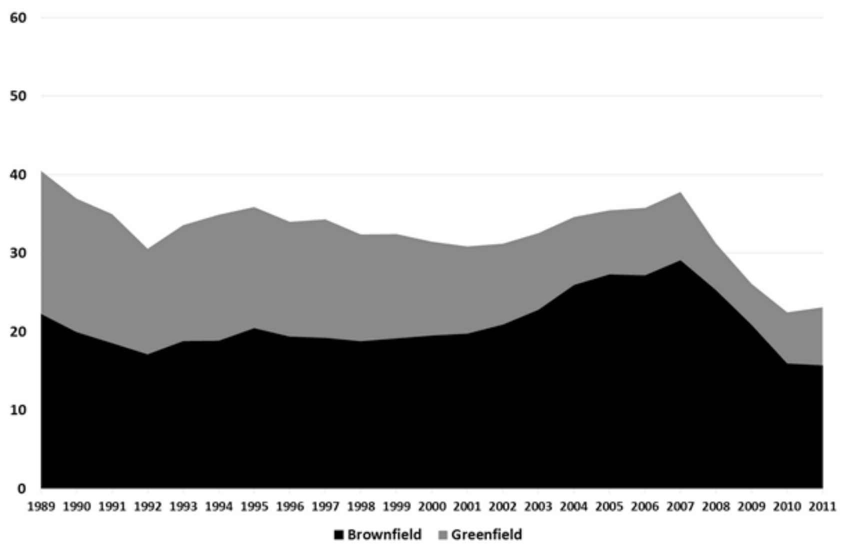
For these reasons, nobody disputes that brownfield redevelopment can make an unambiguously positive contribution, and should be part of the solution in helping deliver more housing. But the idea that brownfield redevelopment is the panacea to the housing crisis relies on a number of unstated assumptions:

1. There is enough brownfield land suitable for housing to begin with.
2. Most brownfield land is a close-enough substitute for greenfield land.
3. Most brownfield land can be redeveloped at a tolerable cost.
4. The location of brownfield land happens to coincide with housing demand.
5. Housing is the best use for brownfield land, i.e. that there are no competing uses.

Of course, other things being equal, developers will always prefer greenfield over brownfield development, in order to avoid the clean-up cost associated with the latter. But if the cost of clean-up and related other costs is lower than the value of the housing which will be built given the general scarcity of housing and low level of greenfield development, brownfields could still be developed profitably. Brownfield redevelopment may not be a developer's ideal solution, but the idea that developers would rather build little or nothing and turn down profit opportunities is absurd.

Development is already very heavily skewed towards brownfield sites. Brownfield development currently accounts for more than two out of three new housing units. The exact proportion fluctuates over time, but it has accounted for more than half of new developments for as long as comparable data is available, and in the late 2000s, it accounted for as many as three out of four homes.

Figure 2 **Housing units completed per 10,000 inhabitants, 1989-2011, 'greenfield' vs 'brownfield' development**



Source: authors' calculation based on figures from DCLG (2013) and DCLG (2014)

But there are good reasons to suggest that brownfield development alone cannot solve the UK's housing crisis. Firstly, brownfield land is not quite as abundant as anti-development campaigners claim. There are about 90km^2 of brownfield land in England that are deemed to be, in principle, suitable for redevelopment for housing purposes. Extrapolating from current dwelling sizes and densities of new development, this means that if every square inch of brownfield land was used for housing, it would be enough for 1.5 million new homes.

Unfortunately, data on brownfield sites does not give much information about the specific properties of individual sites. It is safe to say, however, that not every development that is physically possible is economically viable. Some of these sites will be in places with low housing demand. Others will be heavily contaminated, involving clean-up costs that are, for the time being, prohibitively high (The Economist 2013). For others, there will be several competing potential uses: land is urgently needed for housing, but land is needed for other purposes as well. In a lot of cases, the most appropriate use for an ex-industrial site will be to use it as an industrial site once again; the most appropriate use for a derelict office block will be to refurbish it and use it once again as office space; and so on. If brownfield land were not used for non-housing purposes, there would be higher demand and higher prices in these other sectors.

This does not mean that the brownfield argument should be brushed aside. Some brownfield land is locked, simply because it is held by local authorities that have no particular use for it. The legal situation regarding contamination problems that only show up after a long time could probably be simplified, and so could the tax code around brownfield land.

Still, brownfield land is nothing like the panacea it is currently made out to be. The only thing the greenfield-brownfield debate really shows is the inadequacy of crude, bureaucratic categories of land use. To put it simply: an ex-industrial site that is now used as a parking lot or a skateboard park is not really 'derelict', and intensely farmed agricultural land is not pristine countryside (see Cheshire 2013). The value of land should be judged by its own merits, i.e. by its environmental and amenity value to the local population, not through a bureaucratic box-ticking exercise.

Verdict: Brownfield development has a role to play in providing new housing supply to solve the UK's housing crisis. However, campaigners who emphasise it as the solution overstate their case. There is not much of it suitable for development of housing, particularly where demand is high and once competing potential uses are considered. There are also prohibitively high clean-up costs for many sites.

Housing: ‘The market has failed to build, we need a public house building programme’

Tsarist Russia had almost no car production. Neither did the Soviet Union in its early decades, but in the 1970s it began in earnest. At least in terms of quantity, the Soviet Union became one of the largest car producers in the world.

A Soviet citizen in 1991 could quite plausibly have dismissed the case for wholesale privatisation of the car industry as ‘simplistic’ and ‘historically ignorant’, as ‘blind faith in free market dogma’. Past experience, he could have claimed, shows that large-scale car production requires a significant presence of the state. There was no historical precedent, even in the capitalist era, for private sector car production on anything like the required scale.

A variant of the same logic is alive and well in the UK today. It is expressed in the idea that solving the housing crisis requires a huge public sector house building programme (see e.g. Copley 2014; Jones 2013a; Jones 2013b; Montgomerie 2014), which should start by lifting councils’ borrowing caps.

At first sight, a breakdown of construction data by sector seems to support these views. Private house building volumes have been relatively constant throughout the post-war period (pre-war data may not be exactly comparable). They have declined since their mid-1960s peak, but until their collapse in 2008, not substantially so. The really big change occurred in public sector house building (Lloyd 2014). Until the early 1980s, the private and the public sector were equally important players in the construction sector. Then, however, council building collapsed. A small part of the slack was taken up by social housing associations, but they never came anywhere near filling the gap, which was therefore simply left unfilled. One could conclude that there is simply an upper limit to how much housing the private sector is able, or willing, to deliver, and that any development beyond that level will be delivered by the public sector, or not at all.

This reasoning is entirely consistent with the historical data. And yet, it is as flawed as that of our hypothetical Soviet citizen, because it represents a purely inward-looking perspective. There may be few examples from British history in which the private sector acted as a large-scale house builder, just as there were no examples in Russian history of large-scale private car production. But the point is that throughout most of the developed world, private production is the norm, and state production is the exception. In both car production and housing construction, the great bulk is performed by the private sector.

There is no detailed empirical analysis of the exact pattern we see in the British construction data, but there is a plausible explanation that is consistent with what little evidence there is. While the Town and Country Planning Act dates back to 1947, the constraints it imposed on development were initially largely theoretical. They only started to bite over time. It was a case of non-binding constraints that eventually became binding: a process that has been observed many times around urban growth boundaries (UGBs) in the United States (Cox 2011). Boundaries that prevent a town from growing outwards have little effect as long as ample opportunities remain for ‘inward development’: i.e. a densification of the urban area and a more intensive use of inner-city space. As long as those remain a close substitute for development at the urban fringe, UGBs will only affect the location of new development, not its volume. In the post-war years, British cities probably met those conditions. There were areas devastated by Luftwaffe raids that had to be rebuilt; there were slum clearance programmes, and there were new settlements in recently but not yet intensely developed urban areas.

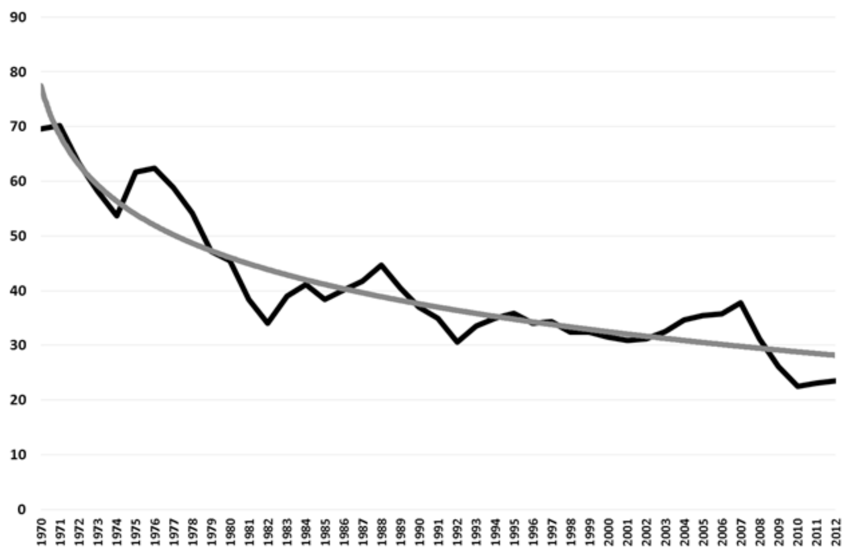
In addition, the effects of the Town and Country Planning Act were initially, to some extent, offset by the designation of ‘new towns’ such as Milton Keynes, Harlow, Redditch and Basildon. For all the well-known flaws of these policies, they created spaces where development was still allowed, and where spillover housing demand could be accommodated.

In short, there were viable alternatives to development at the urban fringes. There is no theoretical upper limit to how far this process of densification/intensification can go, but there comes a point when the low-hanging fruits have been picked and, from then on, some combination of inward and outward development becomes preferable to pure inward development.

In theory, one could imagine a land-use policy which initially sets non-binding growth boundaries in order to encourage a more intensive use of inner-city land, but which then relaxes those constraints as soon as they become binding. But what has really happened is the precise opposite: planning constraints have become more stringent over time. Greenbelt status, for example, was continually extended, especially in high-demand areas: 'Most local planning authorities initially designated Green Belts in the 1950s and '60s, but there have been many extensions to their boundaries since then. For instance, in 1971 the Metropolitan Green Belt around London was extended to include most of Hertfordshire' (Redbridge Council n.d., p. 6). Even between 1997 and 2004, a period which experienced explosive house price inflation and almost no increase in house building, the total greenbelt area grew by yet another 26,000 hectares (Barker 2006, p. 62).

House building rates in the UK did not fall because the public sector stopped building. They fell because existing constraints became more and more binding. The impression of a sudden collapse in the 1980s arises because building rates are always presented in absolute numbers. Adjusting them for changes in population size, an entirely different picture emerges. Building has been in a more or less continuous state of decline since the end of the 1960s. The 1980s are not a very special period in this respect; they were simply a period in which a pre-existing trend was neither halted nor intensified.

Figure 3 **Number of dwellings per 10,000 inhabitants, 1970-2012**



Source: author's calculation based on figures from DCLG (2014)

Even if councils' had no financial constraints, they would not have continued to build houses. They would have come against the same planning constraints that private developers were, and are, facing. British housing policy is largely dictated by the sensitivities of anti-housing campaigners, and if councils do not dare to upset those groups by permitting development, much less will they dare to upset them by actually doing the development. The real lesson to be learned from the British housing data is this: planning constraints may initially be harmless, but they cannot easily be loosened again when they become harmful. By then, they will already have created an entitlement mentality among their beneficiaries, and a political constituency defending what they perceive to be their 'right'.

The idea that we need the government to build houses because house prices are high is as daft as proposing that the increased price of food requires government to buy up land for, and to run, farms.

Verdict: Looking solely at aggregate levels of private and public sector house building might suggest that a decline in public sector house building from the 1980s has caused our current housing shortage. However, adjusting for population size, UK house building has been in decline since the 1960s. The real reason is the existence of planning constraints, which have become binding.

Housing: 'Greedy landlords are to blame for high rents, we need rent controls'

Most people who discuss the state of the UK housing market recognise that the overwhelming problem is a lack of supply of new homes. On a regular basis, however, there are some who propose attacking the symptoms of the problem – high rents – whilst pinning the blame on so-called 'greedy landlords'. These landlords can only be brought to heel, so the argument goes, by the imposition of rent controls – a means of not allowing them to profit from the scarcity of rentable accommodation.

Finding scapegoats is a natural human reaction to difficult problems. This was true as far back as the early 20th century when Britain first introduced rent controls in 1915. In the 1920s landlords were depicted as 'bloodsuckers, profiteers and despots' (Kemp 2004). The idea of the unscrupulous landlord is now a deeply imbedded part of the mythology of the political left, particularly following the behaviour of landlords such as Peter Rachman in the 1950s – a man who would use intimidation, noise and neglect of the upkeep of his accommodation in order to attempt to drive tenants out of properties he wished to sell (Bartholomew 2004).

Given these experiences, some still harbour for the idea that the state must act as a strong-armed protector of tenants, to prevent them being exploited. In particular, they believe the state should act to prevent so-called 'economic eviction' – preventing landlords from being able to unexpectedly raise rents to such an extent that the tenant has to move because he can no longer afford to live in the property.

A good example of this line of argument comes from the Guardian journalist Owen Jones:

> ‘Private landlords can do as they please, of course. Having a roof over your head is a basic human requirement and, when there is a lack of houses to go around, it is a need that can be exploited. A landlord knows that, if their tenants don’t like an outrageous rent hike, their only option is to put themselves back at the mercy of the ever more pricey private renting market.’ (Jones 2012).

The only way for the state to wrestle back control, according to Jones, is to implement rent controls. In his view, landlords are raising rent deliberately in the knowledge that either renters will stump up the cash or else the government will increase housing benefit payments.

It is first worth noting that the rent control policy implemented by governments in the past was largely responsible for creating the warped incentives which led to the behaviour of Rachman and others. Following years of rents being held below market rates under Britain’s rent control policy, it became extremely profitable for landlords to sell properties. In such an environment, landlords also had an incentive to allow properties to fall into dilapidation to compensate for the lower rent. By creating such terrible conditions that tenants decided to leave, however, Rachman was actually able to sell the property ‘with vacant possession’. The unscrupulous landlord was thus created by the rent controls that some still believe are the solution to our problems.

The crude rent controls adopted in the UK in various forms until 1989 were disastrous in other respects too – not least that they led to a collapse in the private rental market. In the very early part of the 20th century, the private rental sector made up close to nine-tenths of the housing stock but this collapsed to close to one-tenth by the late 1980s and early 1990s (Bourne 2014a). Of course, other factors such as council house building and rising incomes leading to more owner occupation were other significant factors, but it noticeable that, since liberalisation in 1989, the size of the private rental market has increased to 16 per cent of the total housing stock. A vast range of academic literature therefore comes to the conclusion that crude rent controls reduce the availability of rental accommodation, reduce quality, worsen landlord-tenant relations and lead to severe misallocation effects with knock-on consequences for the broader economy.

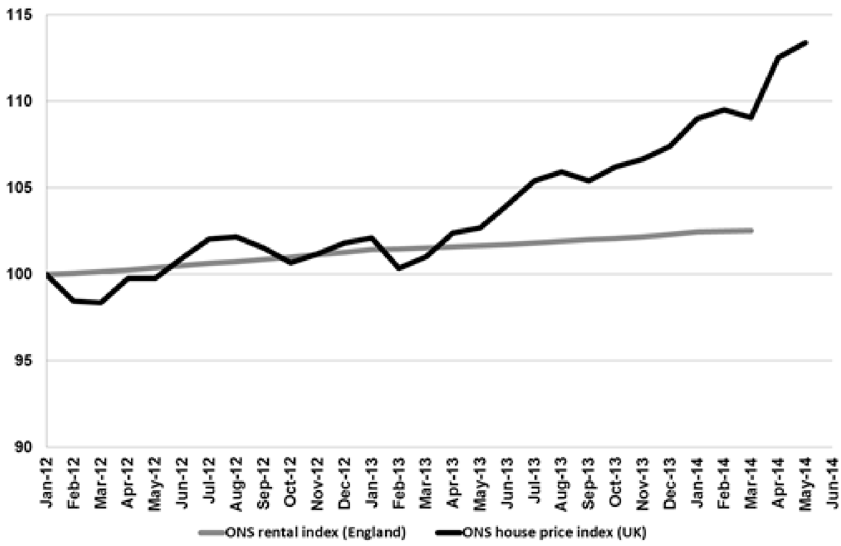
Thankfully, this is now widely acknowledged. Our political debate though is dominated with proposals to introduce 'tenancy rent controls' – a form of 'second-generation' rent control - whereby rents can be freely set between tenancies, but landlords can only increase rent up to some benchmark of average increases within a locality, some measure of inflation, or both, within a fixed-term contract.

The claim that landlords are greedy and that this form of tenancy rent control is necessary to stymie their behaviour therefore requires one to show both that landlords are able to set rents with impunity beyond economic fundamentals determined by supply and demand, and that 'tenancy rent controls' would somehow mitigate this effect. Both parts of this analysis can be shown to be untrue.

It's certainly true that rents are very high, particularly in London. The Valuation Office Agency calculates that the median rent for two-bedroom accommodation in London is £1,387: more than double the average for England despite annual incomes in London being only 39 per cent higher. But this seems a structural problem – there is little or no evidence that it is somehow due to 'landlord greed'.

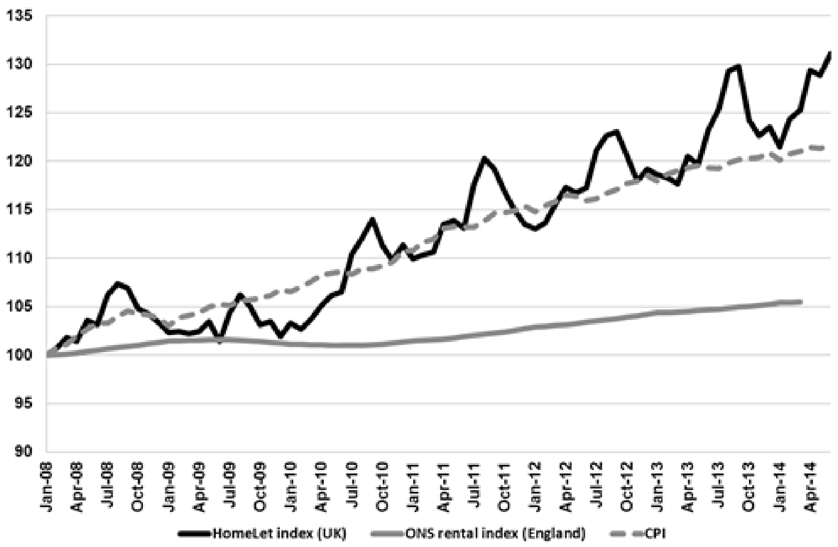
In fact, over the past six years, the Office for National Statistics' (ONS) rental index has increased by just under 10 per cent: less than both its house price index and CPI inflation. See Figure 4 from Ben Chu's Eagle Eye blog below (Chu 2014). The ONS index covers all tenancies, rather than just new ones, which means it is not as helpful in analysing dynamics in the market. But what it does show is that landlords, on average, have not been quick to increase rents even though house prices have increased significantly. There may be many reasons for this. One is that rents are also determined by interest rates, which have been very low in the aftermath of the crisis. A second explanation is that many landlords recognise that tenants are income constrained given the large fall in real wages and are thus willing to accept lower rents to avoid potential vacancy risk.

Figure 4 **House prices and ONS rental index – January 2012 = 100.**



Source: Chu (2014).

Figure 5 **HomeLet Index, CPI and ONS rental index – January 2008 = 100.**



Source: (Chu 2014)

Whatever the causes, there is little evidence that landlords overall have collectively been ‘greedy’ or exploitative and that significant new regulations in the form of rent controls are necessary.

It is certainly true that evidence on new tenancies shows high rent inflation. The HomeLet index, as Figure 5 shows, has risen above inflation since 2008 and rents nationwide were 6.4 per cent higher in June 2014 compared with 2013. In London they went up by 11.2 per cent. But even these are not out of kilter with house price increase movements being experienced in both London and the country more broadly.

To the extent that high rents do cause an affordability problem, it is a problem that tenancy rent controls are unable to solve. Since landlords are free to adjust rents between each three-year tenancy contract, rents will adjust to market rates on a regular basis – even if the control of rents may lead them to deviate within tenancies. At best then, tenancy rent controls are likely to change the timing of the total cost of rent over a tenancy and might offer some more security for the duration of the tenancy to the tenant (Bourne 2014a). However, the existence of tenancy rent controls is likely to increase overall market rents because landlords have less ability to manage risks and because of the risks that arise from acceptance of the general principle of interference in the rental market. Landlords are likely to ‘front-load’ rents at higher levels so that the overall rent charged within the tenancy will be the same as that which would occur in a free market, and there are likely to be a host of other economic trade-offs owing to misallocation of property and less mobility of labour (ibid).

Ultimately, the affordability issue relating to rents and house prices can only be solved by building more homes. This necessitates planning liberalisation. Other policies are attempts to treat a symptom of a structural problem.

Verdict: There is no evidence that landlords have been ‘greedy’. Overall rent levels have risen by less than inflation whilst rents on new tenancies have risen at a similar rate to house prices as would be expected. The introduction of old-style rent controls would be disastrous in terms of the effects on the quantity, quality and misallocation of private rented accommodation. The milder form of rent controls (tenancy rent controls) now suggested in public debate would not help with the key problem faced by households – affordability – and are likely to be damaging.

Energy: 'Privatisation of the energy market is to blame for high energy bills'

Energy bills have risen quickly over the past decade. Average bills for a typical UK consumer paying via standard credit for gas and electricity have increased by 170 per cent and 67 per cent respectively since 2004 in real terms (see Bolton, 2014). For some commentators, particularly on the left of the UK's political spectrum, these higher prices and the fact that energy companies make profits are evidence enough that the blame for rising costs to consumers can be laid squarely at the door of the privatised energy market. The logic seems to go something like this: 'energy companies have been privatised, and prices are going up, ergo, privatisation must have caused the price increases' (Niemietz 2014a).

The logical implication of this is that the only thing that can save us from large energy price rises is re-nationalisation of the energy sector. Indeed, in an article for The Independent newspaper, Owen Jones advocated just that policy (Jones 2013c):

> 'It is irrational, immoral and unjust to leave Britain's energy in the hands of companies responsive to shareholders...A temporary freeze in prices will be a welcome respite to consumers battling sleepless nights over mounting bills. But it does not address the fundamental absurdity of leaving our energy supplies in the hands of profiteers. That does not mean a return to old-style statism, with Whitehall bureaucrats replacing shareholders. Consumers should have elected representatives in a new publicly run British energy industry. All profits should be reinvested in lowering prices, in modernisation, and in building the renewable energies of the future'.

Jones provides evidence that a good proportion of the electorate seem to agree with him. For example, polling carried out for the CLASS think-tank shows that the public seems to overwhelmingly support re-nationalisation of the energy sector, by 68 per cent to 21 per cent (Heath 2013).

In contrast to the idealistic vision of a state-owned energy sector that Jones advocates, the reality of the pre-liberalisation period in the UK was far from good. Not only was the sector dogged by the inefficiencies and mismanagement that one might imagine in a sector without the profit motive or the constraints of market competition, but the sector was highly politicised. Vested producer interests in the coal industry ensured that consumers – those who Jones purports to represent – were unable to benefit from the substitution of expensive coal for cheap natural gas. In the 1970s, Britain found itself suffering from power outages, and was even forced at one point to adopt a three-day working week. Later, government planning also dictated the development of a nuclear programme that is probably one of the most expensive government project disasters in history.

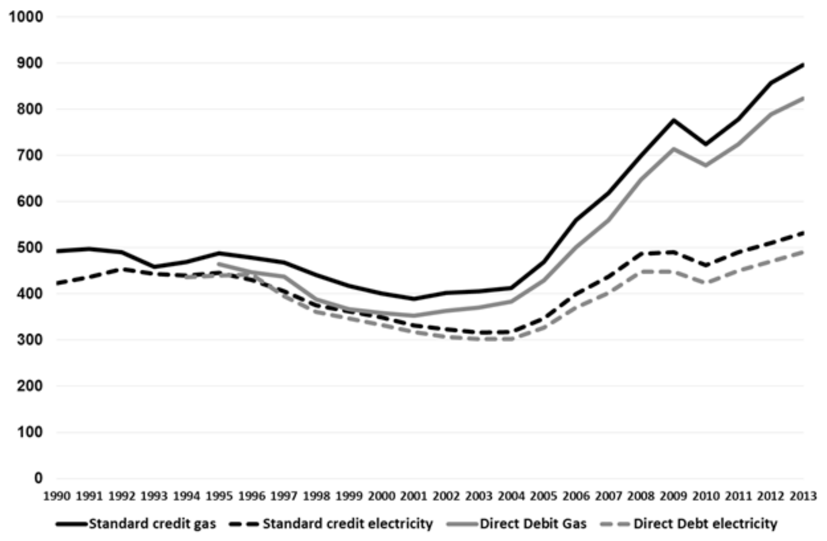
Hence, as a first argument, Jones' characterisation of a nationalised energy sector ushering in a harmonious relationship between consumers and a guardian state owner in contrast to a privatised energy sector (where consumers are at the mercy of greedy parasitic energy company owners) looks a highly questionable distinction. The nationalised energy sector that Britain experienced in the 1970s and early 1980s was dominated by producer interests to the detriment of consumers.

His belief that it is privatisation that has led to higher energy prices looks even more shaky, however, when we consider what actually happened to consumer bills after the privatisation process actually occurred.

The privatisation process happened through the 1980s and early 1990s. Natural monopoly aspects of the industry faced regulated prices, and the regulators were tasked with promoting competition.

In the fourteen years after privatisation, we can observe that energy bills for the average UK consumer became markedly cheaper. Between 1990 and 2004, the average annual bill for gas for a UK customer on standard credit fell by 16 per cent, from £493 to £413 (2013 prices). Similarly the average annual electricity bill fell by 25 per cent, from £424 to £318. This can be seen below in Figure 6.

Figure 6 **Average annual domestic electricity bills for a typical consumer in the UK**



Source: Bolton (2014).

If it were privatisation that had led to higher energy bills, then why did bills fall in the period directly after privatisation? Some would argue that it was due to falling world energy prices – but until privatisation, electricity companies had to use expensive domestic fuels due to the political special interests. Benefiting from falling world energy prices was therefore a feature of the privatisation process and the de-politicisation of energy, rather than something that happened in spite of it.

There is therefore little evidence that privatisation per se leads to high energy bills and negative outcomes for consumers. The key question in the debate on the cost of living today is what has caused the recent upward trend in price rises.

Here, there is clear evidence that rising wholesale costs are a significant factor. 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. At the same time wholesale electricity costs have increased by 140 per cent over the same period, mainly driven by developments in global energy markets. However, the actions of government policies themselves have served to directly increase the price of energy to consumers, in particular environmental policies and the new regulations on retail tariffs imposed by Ofgem over the past five years. In fact, over the past decade, we have abandoned the liberalised market associated with the successful period directly following privatisation and have instead instituted very high degrees of state control and intervention in the sector.

Over the last ten years, the energy market has been successively interfered with through a long list of overlapping initiatives, including but not limited to: the Climate Change Levy, the Renewables Obligation, the Emissions Trading Scheme, the Climate Change Act 2008, Feed-in Tariffs, the 20-20-20 EU commitment, Electricity Market Reform, Contracts for Difference, the Capacity Market, the Carbon Price Floor, the Large Combustion Plant Directive, new Ofgem tariff regulation and Emissions Performance Standards.

Many of these interventions have been introduced only to tackle problems caused by the previous set of actions. And they are not just a feature of governmental attempts to tackle climate change either. Carbon reduction, though likely to be significantly costly economically, could be achieved in the least distortionary way possible by either a simple uniform carbon tax or operation of an emissions trading scheme such as the EU's ETS. Businesses and consumers could then seek to reduce carbon emissions in the most efficient way for them – whether turning the heating down, installing insulation or, perhaps, buying energy from a company that uses non-carbon generation.

Instead, the government has engaged in significant amount of green industrial policy by subsidising renewables through obligations, instituting a unilateral carbon price floor, and hiding insulation schemes within energy bills. In part it has been forced into this by EU targets for 15 per cent of energy to be generated by renewables by 2020, and regulations which are closing many coal plants at a time when coal is very cheap. Nevertheless, all of these types of schemes are forecast to raise average electricity prices by about 22 per cent and gas prices by 4 per cent by 2020.

On top of this, the government has directly negotiated contracts for expensive nuclear energy, locking in high cost energy for consumers in the future in the name of 'clean energy' and ensuring 'energy security'. Recently too, Stephen Littlechild has documented how the regulator Ofgem has hindered innovation and competition in the delivery of retail market tariffs by first banning, then reversing with threats, 'unfair pricing differentials' between regions and different payment types, and now regulating the number and type of tariffs companies can offer – such that many cheap and popular tariffs are unviable.

In truth then, though notionally privatised, the energy sector is now back under an extraordinary degree of state control, with government policies directly increasing energy prices. Yet public debate still labours under the misapprehension that we are somehow in a liberal ‘free-market’ environment, where the high bills faced by consumers are a result of greedy profiteering by energy companies.

This viewpoint is in part justified by campaign groups who use evidence that retail energy companies change prices simultaneously, sticky consumers face higher prices and prices rise faster than they fall when wholesale costs change. But none of these observations means that there is necessarily anything underhand occurring on the part of the energy companies. It is likely that the cost movements faced by the companies are likely to be very similar, for example, and the non-symmetrical reaction to changing costs in prices is a feature of many markets and so need not indicate significant market power. At the same time, it is surely obvious that more active consumers will be able to search out better deals.

The Competition and Markets Authority investigation into the industry will hopefully depoliticise this issue by taking a comprehensive overview of what has gone wrong. But, at the moment, politicians, such as the Leader of the Opposition Ed Miliband with his suggested energy price freeze policy, and Sir John Major with his ‘windfall tax’ idea, are legitimising even greater state intervention by articulating policies which deal with symptoms of a government-induced dysfunctional market, rather than addressing the problems directly.

Verdict: There is no evidence privatisation was or is associated with higher energy bills. The nationalised energy sector was highly dysfunctional and served the interests of producers, not consumers. Bills fell significantly after energy was privatised, and the price increases of recent years have been associated with rising wholesale costs and government environmental and regulatory policies.

Rail: 'Privatisation of the railways is to blame for high fares'

Rail fares per passenger-kilometre are on average around 30 per cent higher in Britain than in comparable Western European countries (McNulty 2011: 10). In addition, annual regulated fare increases exceeded the Retail Prices Index by one percentage point per year from 2004 to 2013 (Butcher 2014). This is widely held to be a consequence of privatisation: the necessity for private rail firms to make a profit and pay dividends to shareholders meaning that fares must be substantially higher than otherwise would be the case. It is therefore argued that the rail industry should be reformed to help tackle the cost-of-living crisis and secure a 'better deal' for passengers.

In May 2014 more than 30 Labour parliamentary candidates called for train operations to be taken over by the government as current franchise agreements ended – a form of gradual renationalisation.[2] Official Labour Party policy does not go quite so far, but would allow publicly owned train operators to compete with private firms.[3] This approach could lead to creeping renationalisation given political influence over the franchising process. There are also calls to introduce a freeze on rail fares or at least a 'tougher cap' on increases.[4]

2 'The solution to rail misery', The Observer, 4 May 2014.
3 'A new settlement for a new era', speech by Ed Miliband, 19 July 2014.
4 For example, 'Freeze rail fares and win votes, unions tell Ed Miliband', The Independent, 17 August 2014.

Proposals to address the cost-of-living crisis by increasing state involvement in rail are based on a series of misconceptions. Indeed, the heavy focus on fares suggests fundamental ignorance of the economic importance of rail to the UK economy. While the average household spends approximately £64 per week on transport, only about £3.30 is spent on train and tube fares (ONS 2013). The impact of any fare reductions on the cost of living would thus be trivial. By contrast, policies that reduced motoring costs (c. £56 per week per household), such as cuts to fuel duty and car tax, would offer substantial relief to household budgets (see Wellings 2012).

Another problem for those who wish to renationalise is the relatively modest profit margins of the train operating companies, estimated at around 3 per cent of turnover (ATOC 2013). This implies that the 'savings' from no longer paying out dividends to shareholders would simply not be large enough to fund a significant reduction in fares. This conclusion also holds when other privately owned elements of the rail industry are considered.

Additional state intervention in the rail market would also be poorly targeted if poverty alleviation were the aim. On average rail travellers are far better off than the general population. Almost 60 per cent of spending on rail fares is undertaken by the richest 20 per cent of households, who also spend a far higher proportion of their incomes on rail fares than poorer groups (ONS 2013: Table A6).

The skewed distribution of rail use towards high-income groups severely limits the potential for enhanced price controls to reduce the living costs of those on modest incomes. Indeed, for the population as a whole, more stringent fare regulation is fundamentally flawed as a cost-reducing measure, since what is saved in fares must be paid in additional taxes.[5] Worse still, price controls reduce the efficiency of the rail network by artificially stimulating demand and increasing industry costs. Lack of price flexibility also makes it much harder to make better use of existing capacity (Starkie 2013). The resulting overcrowding creates political pressure for state spending on uneconomic new rail infrastructure at additional expense to taxpayers.

Even if they were successful then, the proposals for additional state intervention to moderate rail fares would be ineffective at addressing cost-of-living issues, and further price controls would be entirely counterproductive.

5 Assuming service frequencies and quality etc. are retained at previous levels.

However, the proposed interventions would almost certainly fail to achieve even their stated objectives, in particular because they reflect a flawed analysis of the problems facing the sector.

There are several reasons for the high costs of the rail industry, but ‘privatisation’ per se is not one of them. Firstly, the effects of the history and geography of Britain’s railways should not be neglected. For example, the high share of rail travel involving trips to and from London – a vast and expensive global city – raises costs compared with other countries, even if other factors are held constant.

Secondly, it is misleading to refer to the reforms of the 1990s as ‘privatisation’ without understanding the extent to which the state continued to regulate, fund and direct the industry. Nominal ownership was indeed transferred to the private sector, but key decisions remained with the government. Opportunities for entrepreneurship, innovation and cost-cutting were heavily restricted by regulation. Unsurprisingly, major productivity gains were not forthcoming.

To make matters worse, policymakers imposed a complex, artificial structure on the industry. Contrary to evolved practices, the sector was fragmented, with separate firms managing the infrastructure, owning the rolling stock and operating the trains. These arrangements required armies of highly paid lawyers, consultants and bureaucrats, and also created numerous other inefficiencies.[6]

Under a genuine privatisation model, there would have been strong incentives to reduce these additional costs, for example by moving back to a structure of vertical integration. However, traditional railway industry structures and full private ownership are effectively banned under European Union law.[7] The proposals for part-renationalisation will not address the fundamental flaws in the structure of the rail industry that push up costs. EU ‘open access’ rules limit the options for more radical reform.

Renationalisation also risks further undermining the limited opportunities for entrepreneurship and innovation on the railways. The shortcomings of state-owned enterprises are well documented, and include poor cost control, lack of entrepreneurship, susceptibility to political interference

6 A detailed analysis is given in Wellings (2013).
7 See, for example, Council Directive 91/440/EEC.

and endemic misallocation of resources (Parker 2009:15-26). In the longer term, these inefficiencies would tend to lower productivity on the railways, resulting in some combination of higher fares, higher subsidies or reduced quality of service. A range of new problems would be added to an already sub-optimal industry structure.

Finally, the high cost of Britain's railways to a large extent reflects wasteful investment in uneconomic new infrastructure. Since the mid-1990s it has been government policy to encourage modal shift from private road transport to public transport. This contrasts with the previous post-war emphasis on the managed decline of rail.

In this context, subsidies and other interventions have artificially inflated passenger numbers, creating a rationale for new capacity. Moreover, government funding helped create a powerful rail lobby with a strong financial interest in extracting additional resources from taxpayers.

Several large rail projects have been undertaken during the 'privatisation' era, including High Speed 1 (HS1), the West Coast Main Line upgrade, Thameslink and Crossrail. The cost of these five schemes alone is approximately £50 billion in 2014 prices. While taxpayers have paid the lion's share of the bill, there has also been a significant impact on fares in some areas. For example, passengers in Kent have seen steep increases following the commencement of HS1 commuter services.[8]

More generally, wasteful spending has contributed to concerns about the taxpayer funding such a high proportion of industry spending, strengthening the case for regulated fares to be raised above the official rate of inflation.[9] Importantly, rail infrastructure projects have typically been heavily loss-making in commercial terms and poor value compared with road schemes (Dodgson 2009). They would not have been undertaken by a genuinely private rail industry that was not reliant on state subsidy. Wasteful investment, and its impact on fares, is the direct result of government policy and should not be blamed on privatisation.

Clearly there are strong grounds for criticising the privatisation model imposed on the rail industry. The productivity gains associated with private

8 Southeastern commuters face double fare rise', Daily Telegraph, 26 October 2009.
9 In 2013, taxpayers funded approximately 40 per cent of heavy-rail spending, including non-Network-Rail expenditure such as on Crossrail (author's calculation).

enterprise were largely suffocated by heavy-handed regulation; a complex and fragmented structure pushed up costs; and huge sums have been wasted on uneconomic projects. In this context, it is unsurprising that fares have not fallen. However, it is also the case that these problems are symptoms of government intervention rather than the result of privatisation per se. Indeed they would not have occurred had the railways been privatised on a fully commercial basis under a 'light-touch' regulatory framework which allowed the organisation of the industry to evolve according to market conditions.

Verdict: Proposals for additional intervention through part-renationalisation and price freezes in rail will make an already inefficient sector still more dysfunctional, putting further upward pressure on fares. The solution to problems caused by political interference is not a greater role for the state.

Food: 'Food banks are a sign of food being too expensive: the food industry needs to take more responsibility'

That increasing numbers of families have felt the need to use food banks has perhaps been the factoid most associated with the rising cost of living. The Trussell Trust, the organisation which organises the UK's largest body of food banks, has estimated that in the period April–September 2013 around 350,000 people received food aid from them – a more than three-fold increase on just 12 months earlier. This has risen from an estimated 3,000 users back in 2005/06 (Downing et al 2014).

This period also coincided with a significant rise in food prices. Since 2005, for example, the food component of the CPI has increased by 55 per cent whereas the overall CPI increased by 37 per cent. During that period wages have not risen as quickly, meaning that overall real median wages are still about 6.2 per cent below their pre-crisis peak (IFS 2014). We know that those in the poorest income quintiles spend a high proportion of their income on food (16 per cent), so rising food prices will be expected to hit the living standards of the poorest hard.

Given the correlation between rising food bank use and rising food prices, it would be tempting to assume a direct causal link: food prices are going up, and food aid is increasing, ergo, rising food prices are leading to more people being forced to turn to food banks. Indeed, many people have directly made this connection. The Conservative MP Laura Sandys, for example, in an article about food banks, directly attributed their use to the fact that food prices had risen over the past five years and urged more government action to ensure that the food industry ‘recognise its wider responsibility to society’ (Sandys 2012).

Whilst there is no doubt that increases in food prices in recent years have been a significant factor in the rising cost of living, in reality there are many other factors that have also contributed. The price of two other essentials - housing and energy - have become increasingly high. Meanwhile, nominal wage growth has been very subdued, due to both the recession and poor productivity growth.

Since households are extremely unlikely to operate their food shopping decisions from a fixed budget, unresponsive to changes in the prices of other goods or wages, the ability to buy food is therefore ultimately determined by both the level of disposable income of the household and the cost of other essentials. To pin much of the blame on food prices directly, just because food banks represent food aid, would be to ignore the multifaceted causes of the current living standards squeeze and the structural causes behind rising living costs in a range of areas. As such, it could lead to extremely bad policy.

In fact, there is significant international evidence to suggest that households are more likely to cut back on other expenditures, for example heating, or else adjust their food patterns by buying other types of products, such that they can continue to purchase adequate amounts of food, rather than become reliant on food aid. Evidence from Canada, for example, has suggested that households are likely to use food aid as a last resort (University of Warwick 2014).

This suggests that many of the users of food banks in the UK find themselves in very difficult situations whereby they face sustained levels of low incomes and/or very high costs of living, or else face significant unexpected situations whereby their net disposable incomes drop dramatically. When one considers the list of possible structural or short-term factors that might lead to the increase in food bank use, there are therefore many other potential explanations above and beyond the recent spikes in food prices which might be important. These include:

- Unemployment - even though it is now falling quickly, the unemployment level is still significantly higher than the level seen in 2005. 638,000 more people were unemployed in 2014 Q2 than in 2005 Q2.

- The significant fall in disposable incomes – as noted above, median real household incomes are still 6.2 per cent below their pre-crisis peak (IFS 2014). Given that those on low incomes already start from a very low base, a fall of this magnitude is likely to lead to some households finding themselves in very difficult situations – particularly as those in the bottom income quintiles have faced higher-than-average inflation rates due to the increasing cost of essentials (Bourne 2014b).
- Referrals from Job Centre Plus - since September 2011 Job Centre Plus centres have been signposting people believed to be in need to food banks. In particular, those people who have a Crisis Loan or short term benefit advance refused, have payments of benefits delayed, or have had significant changed circumstances which alter the benefits they are able to receive have been referred.
- Increased supply and awareness of food banks - over the past few years, food banks have received considerable media attention, and many more have opened around the country. It is likely that, at least in part, this has led to a feedback mechanism in which this increased awareness has created some new demand – which might not be unwelcome, if it is serving genuine need that was unmet before.
- High housing and energy costs
- Benefit reforms and the sanctioning regime - between April-September 2013 the Trussell Trust estimates that 19 per cent of its users were referred due to benefit changes and 35 per cent due to benefit delays.

Even acknowledging that food prices have played a part in increased living costs, the vast literature on this subject suggests that food prices have risen due to global factors, such as rising demand from countries such as India and China, increased oil prices, currency fluctuations, bio-fuels policies and export restrictions (Downing et al 2014). There is no evidence that these have in any way been due to anti-competitive practices in the food industry.

In fact, some of those who have been most vocal in their fury about food banks seem to acknowledge this and have even lambasted the supermarket and food industry in the past for food being ‘too cheap’. A remarkable Observer editorial piece, for example, far from praising the benefits of cheap food to the poorest in society, actually slammed the role of competition in delivering price reductions in the supermarket sector:

> 'Price is the key factor in our behaviour with food and food may, simply, be too cheap…But it is the supermarkets' eternal price wars – their one-track marketing philosophy where "value" trumps all other qualities in food – that have driven prices so low. Without restoring a sense of the real value of food, how will we stop all but the hungry wasting it?' (Observer 2013).

Verdict: There is a variety of factors other than rising food prices that explains the trend for the increased use of food banks. Simply focusing on high food prices as the main cause would lead to bad policymaking. To the extent that food price rises have contributed to increased living costs, these have been caused by global factors, not anything untoward in the food industry.

Childcare: ‘Subsidies are good for the economy because they get women back to work’

The wisdom of increasing subsidies for childcare is often couched in terms of a potential positive impact on the economy arising from increased maternal employment, alongside a resultant improvement in the public finances. For example, when Prime Minister David Cameron recently announced his ‘Tax-Free Childcare’ policy, a childcare subsidy in all but name, he told the Daily Mail: ‘I think it’ll make a big difference to families across the country, it’ll be good for them and good for the economy too.’[10] This policy comes on top of a range of other subsidies, including the direct publicly funded entitlement to nursery places, the childcare element of the Working Tax Credit and subsidies directed towards employer voucher schemes. The left-wing think-tank IPPR has suggested that the government should play an even greater role in terms of intervening in the childcare market, however, to ‘improve’ the maternal employment rate. They believe that this would have a positive impact on the public finances too:

> ‘…increasing overall maternal employment by five percentage points (up to 62 per cent) would be worth around £750 million annually in increased tax revenue and reduced benefit spending. Increasing the proportion of mothers who are working full-time rather than part-time by five percentage points (up to 52 per cent) would be worth around £700 million a year.’ (Ben-Galim and Thompson 2014).

10 See ‘Childcare subsidy will boost economy, says PM, but critics blast £2,000 perk as unfair on stay-at-home mothers’. Daily Mail. 18 March.

The question of whether subsidies are good for the economy and hence the public finances therefore hinges on three broad assertions: that maternal employment is good for the economy, that the government should subsidise this, and that subsidies actually work in raising the maternal employment rate.

It is undoubtedly true that higher levels of maternal employment, all else equal, are likely to be good for headline economics numbers to the extent that they increase the recorded level of GDP by formalising economic activity. But this would also be true if each current working individual decided to work much longer hours (and have less leisure or, for example, hire a gardener). As Lea (2014) has outlined, in a relatively prosperous country such as the UK, there are diminishing returns from working more and individual preferences should determine whether or not, or for how long, individuals choose to work. Artificially encouraging more activity in the formal recorded sector of the economy would no doubt be good for the government in terms of metrics such as its debt-to-GDP ratios and tax receipts, but this might not necessarily translate into higher living standards given individuals' preferences for work and for leisure.

If we are to claim an overall welfare benefit from more people working we have to move beyond looking at whether this raises headline GDP and instead ask whether higher maternal employment would enhance the productivity growth rate within the UK economy, over and above the negative impact of any necessary increase in the tax burden to fund the policy.

Some believe that there is evidence that an increase in maternal employment can 'enhance the productivity of other factors in the economy' (Paull 2014). This would suggest that the social benefits of high levels of maternal employment exceed the private benefits to the individual – with gains accruing to people other than the individual mother. It is therefore argued that there might be under-employment of mothers in a free market, relative to some pre-defined economic 'optimum'.

It is unclear, however, even if this were to be the case, that this legitimises government subsidy for childcare with the aim of raising maternal employment. That is because, based on this 'productivity enhancement' effect, one could justify virtually any subsidy aimed at increasing employment rates of groups currently believed to be 'under-represented' in the labour market. For example, we could say that the government should subsidise able-bodied pensioners back into the workforce, even if left free to make their own decisions they would decide not to do so (Niemietz 2014b). It is also worth noting that there might be externality benefits from mothers not returning to work, such as more time for civic activities or less crime due to a greater presence of people in local neighbourhoods. In general, it is impossible to ascertain and compensate for the externalities of all possible courses of action.

It is also worth noting that there is also little evidence that, on aggregate, the subsidies that have been introduced over the past decade or so have actually had a significant impact in terms of increasing the maternal employment rate. For example, since 1999, when the childcare tax credit was introduced, the proportion of mothers in work has risen from 56 per cent to 60 per cent – very little change which may well just be indicative of an overall trend which would have occurred anyway (Paull 2014).

Of course, there are many other factors that could have influenced the maternal employment rate in that period. Some might argue, for example, that the subsidies have been necessary to offset overall increases in the cost of childcare, which have made moving into work unaffordable even for those who would like a job. In other words, in the absence of the broadening scope of subsidies, we may have seen a decline in maternal employment.

Whilst there may indeed be something in this explanation, for someone convinced of the benefits of maternal employment, the conclusion to be drawn is surely not that ‘subsidies are good for the economy’, but rather that ‘cheap childcare is good for the economy’. The policy implications for this conclusion are likely to be very different, and would lend themselves towards a substantial deregulation of the whole market, rather than attempting to conceal the high cost behind a myriad of new demand-side subsidies. Indeed, as the next section of this Briefing shows, childcare subsidies might actually be contributing to increasing the overall cost of childcare.

Where subsidies may have more of a justification is where they are used as highly targeted spending to facilitate the increased ability to return to work for those single parents with weak levels of labour market attachment where children are at risk of living in poverty. Entrenched worklessness is a known economic problem for these individuals, and is also associated with adverse impacts on mental and physical health. If childcare subsidies can alleviate some of these problems through improving employment rates for these groups, then it may therefore be worthwhile as a social policy – though the benefits primarily accrue to the individuals rather than to the broader economy.

Almost by definition, however, even targeted subsidies for these groups will not necessarily improve the state of the public finances. Those who fall into this category tend to have very low earnings potential. With the existence of the subsidy combined with the current substantial in-work benefits going to those on low incomes, it is not entirely clear that the extra tax revenues generated and lower out-of-working benefits being paid will compensate for the subsidy and in-work provisions. This is not a significant reason, given the aims, not to undertake the policy, but one should not exaggerate the potential savings to the exchequer of any increase in maternal employment caused by the policy.

There are other downsides too. Targeted subsidies have to be withdrawn as income levels rise, leading to substantial marginal effective tax rates which can undermine work incentives further up the income scale. They also create deadweight losses associated with the taxes necessary to fund them.

Subsidies therefore cannot ever really be an effective substitute then for an effective market in childcare. There are many significant structural and regulatory reasons why childcare provision in the UK has become a high-cost venture, with internationally high levels of both public and private costs. If politicians genuinely think that the affordability of childcare is a substantial barrier to returning to work and that maternal employment rates are responsive to changes in affordability, then they should focus on supply-side policies to ensure that childcare is cheaper in the first place, rather than treating the effects of this with ever-increasing demand-side subsidies.

Verdict: There is no general economic rationale for childcare subsidies. They can increase maternal employment and hence measured GDP, but this does not mean they improve economic welfare. There may be a positive impact of higher maternal employment on economic productivity, but it is unclear how this justifies subsidies. A policy for improving maternal employment rates would be better if it focused on making childcare cheaper overall.

Childcare: ‘Childcare subsidies reduce the cost of childcare’

In 2011, the OECD (2011) estimated that the cost of childcare as a proportion of income in the UK was as high as 28 per cent – putting us third-highest among OECD countries (behind Ireland and the United States). The Family and Childcare Trust (2014) estimates that the average annual cost of a part-time nursery place is now £5,710 per year. For a family with two children in full-time childcare, the yearly bill can be close to £12,000.

The cost of childcare to families is thus an important political issue within the ongoing debate surrounding the ‘cost of living crisis’. The debate often seems to be predicated, however, on the idea that more childcare subsidies provided by government, whether directly in the form of more generous handouts, or through the direct purchasing by government of free care in the form of early education, will make childcare inherently cheaper for families. This is at best highly misleading and at worst outright wrong.

Of course, for any individual family lucky enough to benefit from a new or expanded childcare subsidy delivered as government policy, it is likely that the direct out-of-pocket costs of childcare to that particular family will fall. For example, the UK government’s recent policy labelled ‘Tax Free Childcare’, which is really a government subsidy, is likely to reduce out-of-pocket costs for those families with two working parents who will benefit from the taxpayer-funded 20p top-up for every 80p spent up to a total childcare bill of £10,000 (Gov.uk 2014).

However, this is clearly only part of the story. Given that the scheme is taxpayer-funded, taxes must rise on some groups of people, from levels that would otherwise have pertained, in order to finance the expenditure.

For these groups, remaining disposable income will fall, and childcare – and other goods and services - will become less affordable than they otherwise would be.

More importantly, however, childcare subsidies are a distraction from the real problem. They will do nothing to address the fact that the overall cost of childcare, whether the demand comes from government subsidies or individual families, is too high. In fact, demand-side state subsidies are likely to increase the underlying cost of childcare.

To see this, one can simply observe that the UK has much higher public expenditure on childcare services than most countries in the OECD. In fact, at 1.1 per cent of GDP, it finds itself behind only the Scandinavian countries in the level of state financing (OECD 2011). This comes despite the fact that, as noted above, out-of-pocket costs are extraordinarily high too. The fundamental problem for the UK is thus that the total cost of providing childcare is very high – suggesting that the UK's childcare is expensive because of problems with the supply-side of the market.

In other words, if public spending was the solution to making childcare inherently cheaper for families, then the UK would have achieved that ambition long ago. That is has not simply shows that shifting a greater proportion of the costs of childcare from customers to taxpayers will do nothing to address the underlying problem.

The cost of childcare is high in the UK in part because of the formalisation of the sector through extensive regulation of inputs and processes implemented over the past 15 years. This incorporates burdensome regulations and the need for Ofsted inspections – which has contributed to a significant fall in the number of home childminders: from 103,000 in the mid-1990s to just 53,000 this year (Ofsted 2014). But the cost is also influenced by stringent planning regulations driving up the price of property, licensing costs, the formalisation and training necessary, and the mandatory staff-to-children ratios.

Childcare is also, of course, very labour intensive. This can sometimes be associated with a service becoming increasingly expensive due to the phenomenon known to economists 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. This can feed through into higher prices.

But, given that childcarers and childminders are some of the lowest paid workers in the labour market, and productivity growth in general has been very poor, this is unlikely to be an explanation for the trends observed in the UK in recent times. It is difficult not to conclude that it is the increased regulation of the industry over the past decade that has had the most significant impact in increasing overall childcare costs.

On top of this, of course, the vast range of demand side subsidies is also likely to push up underlying prices to some degree. In markets which are not fully competitive, subsidies push up prices directly and lead to greater profits for the childcare provider. Even in competitive markets, we might expect that many people might just use the subsidies to upgrade to more expensive care.

The increased regulatory burden over the last ten years is likely to have led to the supply-side of the market being less responsive to changes in demand than it otherwise would have been. Therefore, increasing demand-side subsidies further would likely lead to further increases in the overall price of childcare and hence make childcare even less affordable for those who do not benefit from the subsidy directly. There is some evidence for this already. The fact that there has not been substantial growth in overall spending on childcare (net of government subsidies) but prices have risen substantially, suggests that subsidies have indeed pushed up prices (Paull 2014). Transferring even more cost from families to taxpayers will not change this.

Verdict: Childcare subsidies do not reduce the cost of childcare. Whilst the families receiving the subsidies may benefit, other families face higher tax burdens. In the UK we have high public and private childcare costs, which suggests a supply-side explanation for why childcare is so expensive. Increasing demand-side subsidies into this market will simply push the cost of childcare up further.

Sin Taxes: 'Sin Taxes merely reflect the externalities of certain activities'

In 2013, IEA author Chris Snowdon released his report *Aggressively Regressive – the sin taxes that make the poor poorer* (Snowdon 2013). It showed clearly that taxes on activities such as motoring, smoking and drinking were highly regressive. Households in the poorest income quintile on average spend 12.4 per cent of their disposable income to meet the cost of sin taxes (£1,416 per year) 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). This compares with just 4.4 per cent of disposable income for those in the richest quintile.

In reality, these averages mask a much higher burden for some poor households given that tobacco and alcohol consumption are under-reported in the surveys used to calculate these figures and since people in many poorer households either do not drive, drink or smoke. Those who do engage in these activities therefore tend to pay much more than averages might suggest. A person in the bottom quintile who drinks moderately, smokes and drives a car could spend up to around 27 per cent of their disposable income on these taxes (Snowdon 2013).

When confronted with these facts, and Snowdon's recommendation that the taxes be cut significantly in order to squeeze the cost of living for those on low incomes, it is common for those who believe in high duties on these goods to admit to the regressive impacts. However, they still justify these taxes on Pigouvian grounds – and furthermore they imply that the external costs of the activity borne by others in society translate into direct financial costs to taxpayers. The MP Diane Abbott has said, for example, about tobacco: 'Smoking is a killer that every individual pays for, whether you smoke or not. The cost of smoking to the UK is estimated to be over £13.7 billion a year.' (Abbott 2011). Dr Sarah Wollaston MP has claimed regarding alcohol: 'What about taxpayers? The cost of the ['binge-drinking'] epidemic is out of control. It is at least £20 billion' (Wollaston 2012).

Both of these statements seek to imply that smoking and drinking do not just have significant 'social costs' – but that these costs manifest themselves in direct financial costs to taxpayers.

In reality, the economic understanding of 'social costs' of an activity is any effect above and beyond the cost to the individual of buying the product and any negative consequences experienced personally. These can include intangible emotional costs to others and effects of lost productivity on others. They do not refer to costs borne by the individual undertaking the activity. The economist Arthur Pigou suggested that the existence of these external costs would mean that in a free market these goods would be over-consumed, justifying interventions by government in the form of taxes to account for these 'negative externalities' such that these costs were reflected in the price and we moved closer to some social optimum level of consumption. 'Sin taxes' have been justified as an example of this.

Note that taxes such as this are only justified economically if they are set to account for net social costs. They do not imply that higher and higher taxes are better or fairer for society. They would also take account of social benefits – financial or otherwise – of activities. Even theoretically, they should simply be set such that any social costs – where the broader society is paying for the activity of the 'sinner' either financially or non-financially – is reflected in the price.

There are obvious problems with these types of taxes. It is extraordinarily difficult to estimate and measure social costs of activities and to assign financial values to them. It is also extremely burdensome to account for all the positive and negative externality effects associated with a particular activity. If, for example, smoking was estimated to lower productivity, this may lead to lower wages for the individual concerned (a private cost). But lower wages in turn could mean lower tax revenues, necessitating either higher taxes elsewhere or lower spending on particular groups if governments sought to maintain revenue (a social cost). Should this be accounted for[11]? The matter is clearly ambiguous, especially when one considers that earlier death as a result of smoking may actually lead to less need for government spending for pensions and old-age healthcare provision. In other words, whilst nobody would advocate setting policy to encourage earlier death, one must seek to weigh up both the costs and benefits of an activity before one can calculate the net social cost of smoking.

Abbott and Wollaston, however, are implying that there are large direct financial costs to taxpayers of smoking, drinking and driving and that higher taxes are necessary to account for this. Unfortunately, most of the narrative surrounding these taxes seems to imply that higher rates are always necessary –based on inflated cost figures, which blur financial and social costs. Commentators do not examine the benefits of any of these activities and often treat private costs to the individual as a social cost too.

If the problem is examined rigorously, there is significant evidence that motoring taxes, alcohol duties and tobacco duties are all too high to be justified as Pigouvian measures and are a long way above the level necessary to compensate taxpayers for the direct financial cost of an activity.

The most commonly cited externality to be dealt with by fuel duty, for example, is the social cost of carbon emissions. When Kenneth Clarke introduced the fuel duty escalator as far back as 1993 he justified it according to 'meeting our Rio commitment' (Sinclair 2011). Vehicle Excise Duty increases have also been justified for similar reasons. But current levels of fuel duty alone are set way beyond what can be justified by any measure of the social cost of carbon.

UK fuel duty is currently charged at 58p per litre for petrol and diesel. Yet estimates of the social cost of carbon vary from $50 per tonne of carbon (Tol 2009) to $312 per tonne of carbon (Stern 2006), with many middling estimates around $100 per tonne (Hope and Newbery 2007). These would imply necessary fuel duty rates of around 2p, 12p and 4p respectively (Sinclair 2011; Wellings 2012). Clearly, there is no economic argument on the basis of carbon emissions for raising fuel duty further, as some environmentalists claim. In fact, taking account of the social cost of carbon alone would suggest we should have a much lower rate.

11 It is worth noting that, according to this argument, leisure has a social cost as it leads to lower income tax revenues.

Those in favour of high fuel duty rates instead therefore claim that other costs and externalities (the operating costs of the roads, accidents, air pollution, noise pollution and congestion), can be added together to justify the current very high rates of fuel duty.

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). Key then is to account for whether the costs of congestion, accidents and pollution justify such high fuel duty rates.

It is not at all clear that they do. There are other regulations and planning controls which already try to account for effects such as noise pollution and accidents (Sinclair 2011). To a certain extent, justifying fuel duty as solving these problems therefore amounts to attempting to deal twice with the same externality. The key external cost driver is congestion, which has been estimated to cost £20 billion per year (Blythe 2005). Congestion problems are often caused by the planning system itself, however (Wellings 2012). Furthermore, congestion is heavily concentrated in particular bottlenecks and densely populated urban areas at peak hours of the day – which taxes such as fuel duty do not accurately reflect. To a large extent, the costs of congestion are also internalised in the body of road users too.

Overall, it is extraordinarily difficult to justify the current rates of fuel and vehicle excise duty according to Pigouvian externality arguments. And a similar story is found for alcohol and tobacco – where social costs are often spoken about as if they are the same as direct financial implications for taxpayers.

Alcohol undoubtedly has some genuine externality effects which manifest themselves financially in terms of healthcare and policing costs. Claims that drinking costs us over £20 billion, however, are based on studies which include emotional costs, productivity effects and many other costs which are either not financial or else are born borne by the individual undertaking the drinking (Cabinet Office 2003). 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).

On smoking, it is clear that most of the costs are private and borne by the individual concerned. The ‘social costs’ highlighted which manifest themselves as financial costs most often are the supposed healthcare costs. Regarding this, it is worth noting that tax revenues from tobacco duty already exceed the healthcare costs of smoking by four times and many studies have actually found that smoking leads to net savings in public spending as a results of lower costs of healthcare, social care and pension payments etc. (Barendregt et al. 1997; van Baal et al. 2008).

Verdict: It is very difficult to justify current levels of fuel, alcohol and tobacco duties according to 'social cost' arguments. Fuel duty far exceeds the costs of roads as well as the social cost of carbon. Even including effects of congestion and pollution it is difficult to justify current high duty rates. Tobacco and alcohol duties, meanwhile, are substantially above the level which would account for the genuine social costs associated with the activities.

Sin Taxes: 'Sin Taxes are voluntary taxes'

As outlined in the previous section, the cost of sin taxes to the low paid is highly significant (Snowdon 2013). A household in the bottom income quintile in which a member drinks moderately, smokes and drives car would pay as much as 27 per cent of their income on sin taxes related to health and the environment alone. If we add in VAT, this increases to 37 per cent.

Sin taxes are taxes applied to goods deemed socially undesirable, and are often justified – as we have seen – in the name of certain goods exhibiting negative externalities. But some people seek to dismiss criticism of very high sin taxes (and dismiss the arguments about how regressive they are) by simply stating that 'sin taxes are voluntary taxes'. Given that people are technically able to avoid paying them by not buying the good on which the tax is levied, it is said that these taxes are merely imposed on certain behaviours and as such people can avoid these taxes adversely affecting their living standards by changing behaviour.

This justification is based on flawed reasoning. Firstly, it is arguable that, for certain groups, some goods on which sin taxes are imposed are not non-essentials. For individuals and families living in some rural and sub-urban areas, it might be considered essential to have a car. As such, fuel duty might be considered an essential component of living costs. Energy is also pretty essential, so this explanation cannot apply to the green levies which are often imposed on energy bills.

Of course, in the case of rural communities one might argue that families choose to live in these areas 'voluntarily', but taking the argument to these extremes, one could argue that virtually all taxes and activities are voluntary.

Nobody ‘forces’ someone to work, for example. Should income tax be considered voluntary?

In other words almost all activities in which human beings engage can be regarded to some extent to be voluntary. More than that, almost all goods purchased can be described as ‘non-essential’. Whilst one can argue that individuals do not need many goods on which sin taxes are imposed – tobacco and alcohol in particular – it is just as true that people do not need iPhones or to go to football matches, yet we do not impose heavy taxes on such non-essentials. The decision of governments to impose sin taxes is therefore clearly nothing to do with whether the goods are non-essential and as such whether they are ‘voluntary’ or not.

No, sin taxes are justified because certain activities are regarded as being undesirable. This is a respectable position as far as it goes, but one cannot end debate about the fairness or desirability of the tax simply by claiming that sin taxes are voluntary. For petrol, tobacco and alcohol, tax makes up a great deal - and sometimes the majority - of the retail price of the product. We know that the individuals hit hardest by the tax in terms of relative out of pocket expense are both the poor and those with highly inelastic demand (i.e. consumers whose demand is not very responsive to the price – such as alcoholics and those addicted to tobacco). When the tax imposed is so high for these groups and we have a good idea of what their likely demand response will be, it seems particularly disingenuous to then blame the consumers for the effects of these choices[12].

In the case of tobacco in particular, we might consider that the more addicted someone is to the product, the less ‘voluntary’ is their decision to continue buying it. As Snowdon (2013) shows, an individual consuming budget cigarettes and smoking the same amount as an average smoker would spend £2,007 on his habit per year. If there were no tax on the product whatsoever, the cost would be just £253. We know that despite years of very high and increasing taxation on cigarettes and other tobacco products, many on low incomes have very unresponsive demand patterns. Knowing this, policymakers have a responsibility to observe that their policies of high duty rate are making poor people poorer deliberately.

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12 It is also worth noting that there is a paradox in this debate. The more ‘voluntary’ an activity is (or, more correctly, the more elastic is demand) the more damaging is a tax in terms of the way in which it distorts economic activity. However, this section relates to a different aspect of the problem.

Verdict: Sin taxes are not imposed on goods because they are non-essential and voluntary to purchase, but because they are deemed undesirable. Some goods on which sin taxes are applied, such as fuel duty on petrol in rural areas, can be considered to some degree essential. Furthermore, the government imposes significant sin taxes with regressive effects even though there is clear evidence that demand is likely to be unresponsive, so it cannot shirk responsibility for harmful effects on low income groups.

Welfare: 'Higher benefits and more government spending are needed to reduce poverty'

The anti-poverty strategy of the last Labour government was highly state-centric. Their governments adopted explicit poverty targets and primarily used expanded spending on cash benefits and publicly provided services in order to meet those targets (Hills et al 2009). Following this period, the anti-poverty lobby, particularly anti-poverty charities, have accepted that higher fiscal transfers and state spending are the best means of eliminating poverty (see for example: CPAG 2008; Oxfam 2010; CPAG 2009; CPAG 2010). This has manifested itself in substantial opposition to attempted government spending restraint and, in particular, to any attempts to cut the vast welfare budget.

Given the impact of the huge increase in the cost of essentials such as housing, energy, childcare and food over the past five years, the focus of campaigners on the welfare system is rather narrow. In fact, most publications on poverty by these campaigners essentially point the finger at the government (for changes to benefits) and to employers (for paying low wages) for the existence of poverty in the UK (Cooper et al 2014). They almost all conclude that more 'government action' is necessary to improve living standards, arguing for more state spending on cash benefits, more house building by government, more childcare subsidies, more help for those struggling with energy bills and higher minimum wage rates.

This faith in the ability of government to improve outcomes arises from the record of government intervention between 1997 and 2004. Then, the anti-poverty strategy of the Labour government seemed to be effective. Annual median incomes for those in the bottom quintile of the income distribution had grown strongly, relative poverty had fallen, absolute poverty had fallen, child poverty had fallen and the amount that a household in the bottom quintile spent on essentials (housing, fuel and power, and food and clothing) had collapsed from 49 per cent of overall expenditure to just 36 per cent (Niemietz 2012).

This record, of course, occurred in a period during which there was robust economic growth. Following that period, however, the strategy's effectiveness in improving outcomes appeared to stall and few of these measures continued to improve. The UK now has large-scale income transfers - as many of the campaigners have long desired – but they no longer seem as effective in achieving their aims. For the campaigners, the only logical response to this failure is for the government to do more.

Certain statistics show clearly how significant the welfare state has become as a redistributor of income in the UK. For households in the bottom fifth of the income distribution, the state now, on average, provides 54 per cent of their gross income. For households in the second fifth, households on average receive 41 per cent of their income from the state. Indeed, even among households regarded as middle earners, the figure is still as high as 24 per cent (ONS and DWP 2014). It's only when you get to the richest 40 per cent of households that the contribution of the state really becomes supplementary, as opposed to providing a fairly significant chunk of income. In particular, fiscal transfers have increased significantly for families with children. As many as 60 per cent of all children now live in households receiving a major income transfer, even excluding child benefit (ONS and DWP 2013).

This is before even accounting for the vast benefits-in-kind which governments provide. In the UK, particularly given the nature of the state-funded education and health systems, a large part of government spending on the poor comes in the form of free schooling and healthcare, as well as implicit rent subsidies in social housing. Contrary to popular belief, for example, the UK still has an extremely large social housing stock compared to our EU neighbours. At 18 per cent of the total stock, social housing here is more significant than in France (17 per cent), Sweden (17 per cent), Finland (16 per cent), Ireland (8 per cent) and Germany and Italy (5 per cent each). In fact, there are only three European countries that have more social housing as a proportion of the total stock than we do: the Netherlands (32 per cent), Austria (23 per cent) and Denmark (19 per cent).

Whilst many are keen to promote the idea that there is some Scandinavian or Germanic scale of welfare that would be vastly preferable than the UK's in eliminating poverty, the reality is that levels of welfare spend here already rival other 'big welfare' countries. In fact, as Table 1 below shows, the UK spent more than any other Scandinavian or Germanic country on family benefits as a percentage of GDP, even at the height of the boom.

Table 1 **Social expenditure in the UK and the Scandinavian and Germanic countries, 2007**

	Net social spending as % of GDP (public and publicly mandated)	*Family benefits as a % of GDP*
Austria	24.8	2.6
Denmark	23.9	3.3
Germany	27.2	2.7
Iceland	16.8	2.9
Netherlands	20.4	2.8
Norway	20.0	2.9
Sweden	26.0	3.4
Switzerland	n.a.	1.4
UK	22.7	3.6

Source: Niemietz (2012)

The figures in Table 1 are instructive, because since the financial crisis and subsequent recession it has often been suggested that the large welfare bill is purely a consequence of the downturn. It is also more difficult to compare countries now, given that many are still struggling due to the aftermath of the crisis. But what Table 1 shows is that the UK was spending significant amounts on the provision of transfers, comparable with any other Germanic or Scandinavian country in the EU, in the build up to the crash.

That there still exist problems and difficulties for many families is therefore a challenge to be explained for those who believe that more spending is the solution. Some simply argue that the strategy has not been aggressive enough. At the very least, however, those who believe in the power of transfer spending to alleviate poverty should acknowledge that an anti-poverty strategy that is reliant on ever-growing spending, at a time when the UK is still borrowing vast amounts and has large fiscal headwinds over the next two decades, may not be robust given changing political priorities.

Unfortunately, the obsessive focus on welfare and government spending to alleviate poverty has meant that many of those concerned by the plight of the poor have ignored policies that damage the poor in a host of other areas. For example, government interventions in housing (restrictive planning), energy (renewables subsidies and green industrial strategy), childcare (excessive regulation) and food (the Common Agricultural Policy and planning laws again), as well as high sin taxes, all raise living costs for families but are widely ignored as causes of poverty. Many of these items are essentials, on which the poor spend a disproportionate amount of their incomes. An increase in the cost of these things ultimately worsens living standards for low income groups and feeds through into demands for higher welfare spending.

An obvious example of this is in housing. Most of the literature on the subject is clear that house price increases in the UK over the past thirty years or so have been driven by planning constraints. But, rather than calling for this problem to be tackled at source, anti-poverty campaigners have demanded higher housing benefit spending. They expend lots of energy advocating very minor reforms to eligibility to housing benefit (the so-called ‘bedroom tax’), rather than calling for significant liberalisation of planning laws which could help solve the underlying problem.

It is time to change tack. A strategy which sought to reduce the cost of living by tackling these high costs of essentials from the supply side (as outlined in Niemietz 2012) would be a highly effective means of reducing the cost of living and thus improving the absolute living standards of the poor. But such a strategy would also have the virtue of not being reliant on the continued political support of different parties, nor of necessitating higher government spending. Crucially, it would be an attempt to tackle some of the causes of poverty today rather than treating the symptoms through cash transfers (which themselves can have a host of unintended consequences).

Verdict: Faith in the ability of government spending and cash benefits to eliminate poverty dominates the anti-poverty lobby’s literature. This is despite the fact that historically and internationally government

welfare spending in the UK is very high. The living standards of the poorest could be improved, and poverty tackled, via a supply-side agenda in product markets to lower the cost of living. More government spending is neither necessary nor sufficient to reduce poverty.

Welfare: ‘Most people in poverty are in work’

The vast majority of people in poverty are white. White people account for 82 per cent of those with (equivalised) incomes below 60 per cent of the national median. People from Pakistan and Bangladesh are doing a lot better, on this metric. They account for just 4 per cent and 2 per cent, respectively, of the poor (DWP & ONS 2013). What are we to make of those figures?

Nothing, of course: they are meaningless. They are simply a reflection of the fact that there are far, far more white people than there are (ethnic) Pakistanis and Bangladeshis in the UK (89 per cent versus 2 per cent and 1 per cent respectively of the total). The relative risk of poverty is far higher among the two latter groups than among the white population, or, in other words, the latter groups are over-represented among the poor while whites are under-represented. One needs no statistical training to see why a statement such as ‘most of the poor are white’ contains no useful information about the risk of poverty. Yet, somehow, a variant of the same mistake has become conventional wisdom along the lines of ‘most of the poor are in work’. Work, it is claimed, does not offer a route out of poverty, because most poor people are already working.

This claim was initially circulated by the poverty industry (Niemietz 2012), and has since been repeated all over the media (e.g. Jones 2014a; BBC News 2013; Huffington Post 2013). Yet the two groups are far from equally sized. 71 per cent of the total population live in households with at least one member in work, so in almost any statistic, one would expect those in work (or in a household with somebody in work) to outnumber those not in work.

Presumably, what those who make the ‘work-does-not-pay’ argument really mean is that work should be a cast-iron guarantee against poverty: perhaps they are implying that, whatever the size of the groups, it should be next to impossible to be poor while in work. This is a fair point to make for full-time, year-round employment. But what we really find, especially among low-income households, is a much greater variety of work patterns. For example, 6 million people now live in a household where nobody works full-time, but where (at least) one person works part-time (DWP & ONS 2013). Also, among those on the lowest incomes, work retention is as much of an issue as finding work in the first place - many do find work, but do not keep it for long (Browne and Paull, 2010).

Work status is no longer a binary variable, and grouping people into ‘those in work’ and ‘those out of work’ is no longer a useful way to think about labour market outcomes. It makes much more sense to think of it as a spectrum of varying degrees of labour market attachment. The spectrum ranges from full-time/year-round employment at one end to long-term economic inactivity on the other end, but it also comprises part-time work, minor employment, temporary work, and various combinations. The relevant question is whether an increase in the strength of labour market attachment reduces the relative risk of being in poverty. The answer to this is a resounding ‘yes’.

Unfortunately, there is no good data on poverty which tracks work status over time, but this problem can be ameliorated by replacing the measure of relative poverty with a measure of ‘material deprivation’ (MD). MD is a poverty measure based on consumption rather than income, and since consumption tends to fluctuate a lot less than income, it is a closer approximation to long-term living standards. There are problems with all poverty measures, but compared with relative poverty measures, MD is superior in virtually every respect (Niemietz 2011). There is no good data on poverty which takes account of weekly working hours either, but the data does allow us to go a bit beyond the flawed working/workless dichotomy.

This is shown in Table 2 below, which breaks down MD poverty rates by work status. Since this measure is not available for the population as a whole, the table only refers to households with children. It shows an unambiguously negative relationship between poverty status and labour market attachment, with almost no poverty at all among those with the strongest labour market attachment.

Table 2 **Material deprivation poverty rate by work and family status, households with children, 2011**

Work and family status	*MD poverty rate*
Couple, neither in work	48%
Single parent, not in work	39%
Couple, neither in full-time work, at least one in part-time work	29%
Lone parent, in part-time work	14%
Couple, one in full-time work, one not working	10%
Single parent in full-time work	6%
Couple, self-employed	6%
Couple, one in full-time work, one in part-time work	1%
Couple, both in full-time work	1%

Source: DWP & ONS (2013, p. 114)

Of course, this does not mean that the problem of poverty can be solved solely by increasing labour market attachment among the poor. The figures must be strongly influenced by a self-selection bias, as those with the greatest earnings potential will also be most likely to be in permanent employment and to work longer hours. Even if all those currently economically inactive suddenly started to work as many hours and as regularly as the most highly skilled and experienced, they would still not be as likely to escape poverty.

Increasing work levels is not a cure-all. But many of those who use the in-work poverty argument appear to imply that work levels of the poor are already high enough, and that attempts to raise them further are pointless unless the whole labour market is rebuilt according to their agenda: raising the minimum wage to the living wage, legal privileges for trade unions, more public-sector employment etc. Whilst there is nothing wrong with being critical of the current state of the labour market, it is not true that work is currently an ineffective weapon against poverty. The conclusion to be drawn from the above figures is that employment policies and welfare policies have to be about more than 'getting people a job'. Labour market entry is the decisive first step, but enabling people to remain in the labour market and progress within it is no less important (Niemietz 2012 Chapter 8).

To claim that work does not reduce poverty, on the grounds that most poor people already work, would be like claiming that exercise does not reduce obesity, on the grounds most obese people already exercise. While this could be true, it would mean nothing unless one took account of how intensely and how regularly people exercise. If those who exercise three times a week throughout the year were thrown in with those who exercise for three weeks and then give up, or if cardio training counted for as much as playing darts, such results would be meaningless. If people could work full-time and year-round and still be poor, we would indeed have a major structural problem. But, as it stands, we mostly have a problem of the need for strengthening labour market attachment among low-income families. This is no less of a challenge, but it is a very different kind of challenge.

Verdict: The ‘most poor people are in work’ argument is, as such, true – but it is meaningless. The statistic is driven by the fact that there are more people in work than people not in work. There is strong evidence that the degree of labour market attachment matters in lessening the probability of a household being in poverty.

Welfare: 'The taxpayer subsidises employers through tax credits, so we need a higher minimum wage'

Some commentators recognise that we are at the limits of welfare spending and that there is little public appetite for a rising benefits bill. Instead, many now state that the causes of high welfare spending are such that they justify more government action or state intervention.

One example of this was seen earlier, when the rising housing benefit bill was blamed on greedy landlords rather than the UK's sclerotic planning system, helping to make the intellectual case for rent controls. Another viewpoint often shared by a wide variety of commentators is that the UK's high tax credit bill is the flipside to firms paying very low wages, and that government must act to prevent exploitation by business of taxpayer generosity by increasing the national minimum wage.

According to this argument, taxpayers are subsidising low-paying employers through the tax credit system, to the tune of £29 billion per year. The existence of tax credits lowers the wages that workers are prepared to accept, so employers are able to offer lower wages, effectively outsourcing part of their wage bill to the general taxpayer (Niemietz 2014c). A higher National Minimum Wage (NMW) – perhaps even raising the NMW to the level of the 'living wage', it is argued, is therefore a necessary policy counter-weight to prevent employer abuse of this system since it prevents employers from paying extremely low wages and the state having to step in.[13]

13 The 'living wage' rate is currently calculated as £7.65 per hour for the UK generally and £8.80 per hour in London.

Owen Jones perhaps makes this argument most clearly from the political left, when he says: ‘Why are we, the taxpayer, subsidising the poverty wages of the likes of Tesco and Sainsbury’s, to the tune of tens of billions of pounds each year? Instead, let’s have a deficit-reducing living wage’ (Jones, 2014b). Even some commentators who are usually sympathetic to free market arguments, such as *The Telegraph*’s Jeremy Warner, have justified increasing minimum wages at least in part because of the existence of tax credits: ‘The other issue concerns the use of means tested tax credits to top up people’s take home pay. That the taxpayer should be subsidising low paid work in this way is totally absurd and should be ended as soon as possible’ (Warner, 2013).

There therefore seems to be somewhat of a consensus developing that the state provision of tax credits is a cause of low pay, with some believing that a significant increase in the NMW is an effective (and one assumes, relatively pain-free) way of correcting for this distortion.

Yet the premise of this whole argument is highly challengeable. When tax credits and the NMW were introduced by the last government, they were thought to be complementary policies rather than substitutes. Both aimed to improve the living standards of low-paid employees directly, whilst also increasing the difference between the low-paid and the economically inactive. Tax credits were seen as a wage supplement to the low paid, and not a wage substitute.

It is certainly true that tax credits to some extent act like a negative income tax. As such we might expect them to lower worker’s reservation wages, and to reduce incentives to demand higher wages or accept better-paid positions, especially if the position involves more training or responsibility. But the set-up of the UK tax credit system and the demographics of those households trapped in low pay in the UK means that the extent to which tax credits act as a substitute for wages is exaggerated. Furthermore, increasing the minimum wage is not a good substitute for tax credits in terms of who it helps, whilst it risks a host of other unintended consequences.

To see why ‘tax credits subsidise employers’ is an exaggeration, consider first the Child Tax Credit, by far the most important component of the tax credit regime. This does not come with any work requirements attached. As a result, 1.5 million of the total 4.6 million households in receipt of tax credits do not have any adult in paid employment. This means that £8.9 billion of the total tax credit bill of £29.6 billion goes to households with nobody in work (HMRC 2014). Child tax credit is best thought of as simply a means-tested benefit, rather than as a negative income tax in this sense.

Therefore a very large chunk of the tax credit bill cannot be considered as a subsidy to employers, because the recipients themselves do not work. Furthermore, many other recipients of in-work tax credits work hours substantially shorter than a full working week. In this sense, another large chunk of the tax credits bill can be considered a substitute for working longer hours, rather than as a substitute for low wages paid by employers. Though a breakdown of the costs of tax credits based on hours worked by households does not seem to be available, figures show that a further 0.9 million households, of the 3.1 million households in work receiving tax credits, work less than 30 hours per week (HMRC 2014). If tax credits are subsidising anything for these groups, it is a short working week.

Of course, this still does leave 2.2 million households where someone works more than 30 hours per week who are eligible for tax credits. Assuming that most of these work what can be considered a full working week, then surely the critics have a point: to some extent, taxpayers are subsidising employers for this group.

The question then is this: what is the best way of ensuring that tax credits act as a wage supplement rather than a wage substitute? The tax credit system could be reformed so that the Child Tax Credit became a genuine credit with work conditions like the Working Tax Credit. At the same time, the entitlement to tax credits could be based not on the income that recipients actually earn, but on their full-time equivalent income, i.e. the income they would earn if they worked full-time at their given wage rate (meaning an increase in working hours would no longer lead to a loss in tax credit income; only an increase in the hourly rate would). This would mean that tax credits did not subsidise working less than a full week. Restoring the tax credit system to its original purpose of complementing, rather than substituting for, wages would be a hugely valuable task.

But those who advocate for higher minimum wages instead believe that raising the statutory minimum hourly wage rate could be a good substitute for tax credit spending, without significant negative consequences.

This seems unlikely, on two levels. First of all, tax credit spending is highly targeted towards those with low household incomes. Among the 3.3 million in-work recipient households, almost four out of five – 2.5 million – have annual incomes below £20,000 (HMRC and ONS 2013). Those earning less than the living wage hourly rate, on the other hand, do not necessarily live in poor households. The Institute for Fiscal Studies, for example, has shown that 44 per cent of all UK low-paid workers are in families in the top half of the income distribution, whilst 12 per cent are in the top fifth of the distribution (IFS, 2014). Raising the minimum wage significantly therefore is not in many cases likely to affect the same households as those in receipt of tax credits, because many of those earning less than the living wage rate are second-earners or young people in relatively affluent households.

More importantly, however, raising the NMW as a substitute for the tax credit system would only be a sensible policy if it did not have any negative impact on the employment prospects of those with the greatest difficulties in the labour market. Yet a comprehensive review of the theoretical and empirical literature carried out in by Bourne and Shackleton (2014) showed that negative impacts are likely. The mainstream academic literature still shows that the level of the minimum wage matters, and that a significant rise in the rate would dampen labour demand to the detriment in particular of young and unskilled workers. This is because, by and large, wages are determined by productivity and, if minimum wages are raised, more people would be in a position where their productivity did not justify the wage the employer was obliged to pay.

Allowing markets to set wages for workers with low productivity and supplementing wages via the tax credit system facilitates the opportunity for low-skilled workers to remain attached to the labour force. Increasing the minimum wage on the other hand may well price the unskilled out of work, by imposing the full cost of their labour market entry on the employers and customers of a business who are giving them an opportunity in the first place.

Verdict: The extent to which tax credits subsidise employers is exaggerated – many households in receipt of them do not work or do not work a full working week. Furthermore, instituting a higher minimum wage as a policy response to this perceived tax credit subsidy is ill-targeted to those really in need and could have negative consequences for young and unskilled workers whose productivity does not justify a higher wage level. Instead we could reform tax credits so that they fulfil their original purpose.

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