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CUTTING THROUGH

How to address the cost of living crisis

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Summary

- The cost-of-living crisis has been worsened by longer-term structural factors, beyond the immediate issues posed by loose monetary policy and supply-side constraints. Indeed, there were discussions about a cost-of-living crisis over a decade ago, long before Covid, the Ukraine war or Brexit.
- The British state intervenes heavily in various product markets through tax and regulatory measures, in ways which drive up costs. Some of those interventions may be justified (e.g. to correct externalities), but in many cases the costs imposed on consumers are substantial, while the benefits are either trivial or highly speculative.
- Childcare costs in the UK have risen to one of the highest levels in the developed world. This is in large part due to stringent minimum staff-to-children ratios, the imposition of a ‘curriculum’, accreditation costs and, more generally, over-formalisation of the sector.
- Relaxing childcare sector regulatory requirements does not have to mean complete deregulation. It could merely mean bringing them more into line with what is standard practice in many European neighbour countries. This could cut costs by around 40 per cent, or over £300 per child and per month.
- The ratio of median house prices to median gross full-time annual earnings has gone up from under 4 in the late 1990s to over 9 today. Rents in UK towns and cities are among the highest in the developed world. Renting a flat in Oxford, for example, is more expensive than renting a comparable flat in Berlin, Vienna, Rome or Brussels.

- There is a wealth of empirical evidence which shows that the severity of land use planning restrictions is a key determinant of housing costs. Easing restrictions in such a way that housing costs could fall back into line with the historic norm would imply a drop by at least 40 per cent. Median private sector rents in England could fall by over £250 per month.
- Paternalistic ‘nanny-state’ taxes cost a moderate smoker and drinker about £140 a month. These taxes could be cut back to a realistic estimate of the external costs imposed on others by those activities.
- Excessive occupational licensing rules and immigration restrictions raise consumer prices without a detectable increase in the safety or quality of the affected services.
- The UK should unilaterally abolish tariffs, and automatically recognise regulatory standards from countries where those standards can be reasonably expected to be equivalent to domestic ones.
- The UK has chosen an inefficient, unnecessarily costly decarbonisation strategy, which drives up energy costs for households and businesses by more than what is required in order to reduce CO2 emissions. The government should phase out renewable energy subsidies, bring carbon pricing into line with the EU average, allow the hydraulic fracturing (‘fracking’) of shale gas, and remove obstacles to investment in North Sea oil.

Introduction

by Matthew Lesh

Britain is in the throes of a cost of living crisis. Inflation has already reached a 30-year high and is expected to remain at elevated levels over the coming months if not years (Bank of England, 2022). Wage rises are not keeping pace with inflation, meaning a real-terms decline in incomes that had already flatlined since the financial crisis. The Office for Budget Responsibility has concluded that living standards are falling at the fastest pace since the 1950s (OBR, 2022). This is being felt by households. Four-fifths (81 per cent) of British adults say that their cost of living has increased in the last month (Office for National Statistics (ONS), 2022). These pressures will worsen as electricity and gas prices rise, conflict between Ukraine and Russia drives prices up and supply down, and China's 'Zero Covid' lockdown strategy disrupts global supply chains.

The typical responses to financial pressure on households are demands for taxpayer-funded cash transfers, more state spending on services, higher minimum wages, and even price controls (Kingsley, 2022; Weber, 2021). In February 2022, 30 charities, including Citizens Advice, the Joseph Rowntree Foundation and Age UK, called for a substantial increase to Universal Credit (Wait, 2022). The public sector union, UNISON (2022), called for the government to 'deliver the cash' to the NHS, the care sector and other public services to support higher wages. Chancellor Rishi Sunak was heavily criticised following the Spring Statement in March 2022 for 'not doing enough to help the poorest' (BBC, 2022). This recent debate echoes earlier discussions about the cost of living. The IEA's Kristian Niemietz (2012) has outlined how the 'poverty lobby' is 'focused entirely on government benefits as the solution to poverty'.

The government initially responded to higher prices by reducing council tax and providing a loan to households through energy bills. These measures are poorly targeted – the council tax reduction will apply to many wealthier households and the energy bill subsidy will apply to all households rather than just the ones struggling. The government has also increased the threshold at which workers begin to pay National Insurance. However, these measures will not go far to alleviate higher bills, including from higher taxes introduced by the very same government (OBR, 2022).

In the first instance, the government cannot and should not attempt to alleviate rising costs through transfers. Handouts are costly, only moderately effective in reducing poverty and they do not address the underlying issues that are driving up the cost of various goods. Stimulus and loose monetary policy made some sense during a demand-induced crisis caused by the pandemic. The same approach, however, is unlikely to be useful in the face of a supply-shock recession. Transfers are like putting a plaster on a gun wound. It will never be enough to stem the damage.

To start, not everything is within political control. Ministers cannot undo global supply chain pressures driven by Covid-19 or the Russia–Ukraine war, decide the global price of gas and petrol or retrospectively force the Bank of England to have tightened monetary policy in 2021. It would also be foolish and counterproductive to prevent specific prices from rising, as the ‘energy price cap’ has demonstrated. Prices send important signals about costs of production or greater demand from consumers that lead to dynamic responses to suppliers and consumers. A higher price in the short run is necessary to encourage greater supplies of particular goods.

The government can, however, take steps to address the regulatory issues that are at the root cause of so many high underlying costs. This is a ‘cost-based’ or ‘supply-side’ approach to reducing the cost of living. It aspires to boost the ability of the broader economy to produce products in order to lower costs. It does not have substantial fiscal costs, it is directly controllable by policymakers and comes with additional economic benefits such as boosting productivity. It could also prove immensely effective, unlike transfer payments that risk leading to more inflationary pressures. There is evidence that earlier supply-side reforms helped to reduce inflationary pressures, contributing to global disinflation since the 1990s (Schwerhoff and Sy, 2014). The only way to address a shock to supply is to increase the economy’s productive capacity.

This paper outlines the broad costs of regulation to consumers and highlights how over recent decades prices have tended to rise the fastest in highly regulated sectors. It also explains how a series of regulatory reforms could substantially reduce the cost of living for an average household. This builds on and updates the work of Kristian Niemietz (2012) and Ryan Bourne (2014).

This paper considers how reducing regulatory barriers in several areas could help the economy produce a greater volume of key goods and services at lower prices. This would, in turn, help alleviate cost-of-living pressures. It focuses on major areas of costs for households that are negatively impacted by state intervention including housing, childcare, energy, food and other goods, and labour regulation. Some of these policy reforms will directly respond to areas affected by recent supply shocks (e.g. by allowing fracking), others are long-running issues that could be addressed to counterbalance other causes of higher prices. These are not necessarily immediate solutions that will lower prices but they are reforms that could have a medium-to-long-term positive structural effect on them.

This paper is not an all-encompassing analysis of every field of household expenditure or every step the government could take to reduce costs. Indeed, there are many more supply-side reforms, from allowing more immigration to simplifying medical devices and novel food regulations. Nevertheless, these cases demonstrate how regulation must be central to any discussion about the cost of living.

The cost of overregulation

Regulation is justified for economic, social and environmental purposes. However, policymakers rarely give sufficient consideration to the downside cost of individual pieces of regulation or the combined economic impact of regulations. Every additional 'direction' to private enterprise and individuals reduces freedom to operate that imposes direct and indirect costs. Regulation discourages investment, hinders innovation, damages growth and increases costs to businesses that are pushed onto consumers (Coffey et al., 2020; Dawson and Seater, 2013; Fullenbaum and Richards, 2020). A 10 per cent increase in regulation has been associated with around a 0.5–1 per cent increase in prices (Chambers et al., 2019a; Loayza et al., 2005).

Regulation has particularly negative impacts on lower-income households. A study from the Mercatus Center found that regulation costs as much as six to eight times more as a share of income for lower-income households compared to higher-income ones (Bailey et al., 2019; Thomas, 2012). More regulation has also been associated with a ‘robust, positive and statistically significant relationship’ with poverty: a 10 per cent increase in regulation associated with a 2.5 per cent increase in the poverty rate (Chambers et al., 2019b). Regulation has also been found to increase inequality (Stanley and McLaughlin, 2016). Regulation tends to express the preferences of higher-income households while the costs are felt by lower- to middle-income earners. Lower-income households spend a greater proportion of their income on highly regulated goods such as housing, transportation, utilities, and food and alcohol (see Table 1). (Note that housing costs are reported net of Housing Benefit payments, and the implicit subsidies contained in social housing and council housing. It therefore greatly understates the true cost of housing.)

Table 1: Detailed household expenditure as a percentage of total expenditure by disposable income decile group, financial year ending 2018

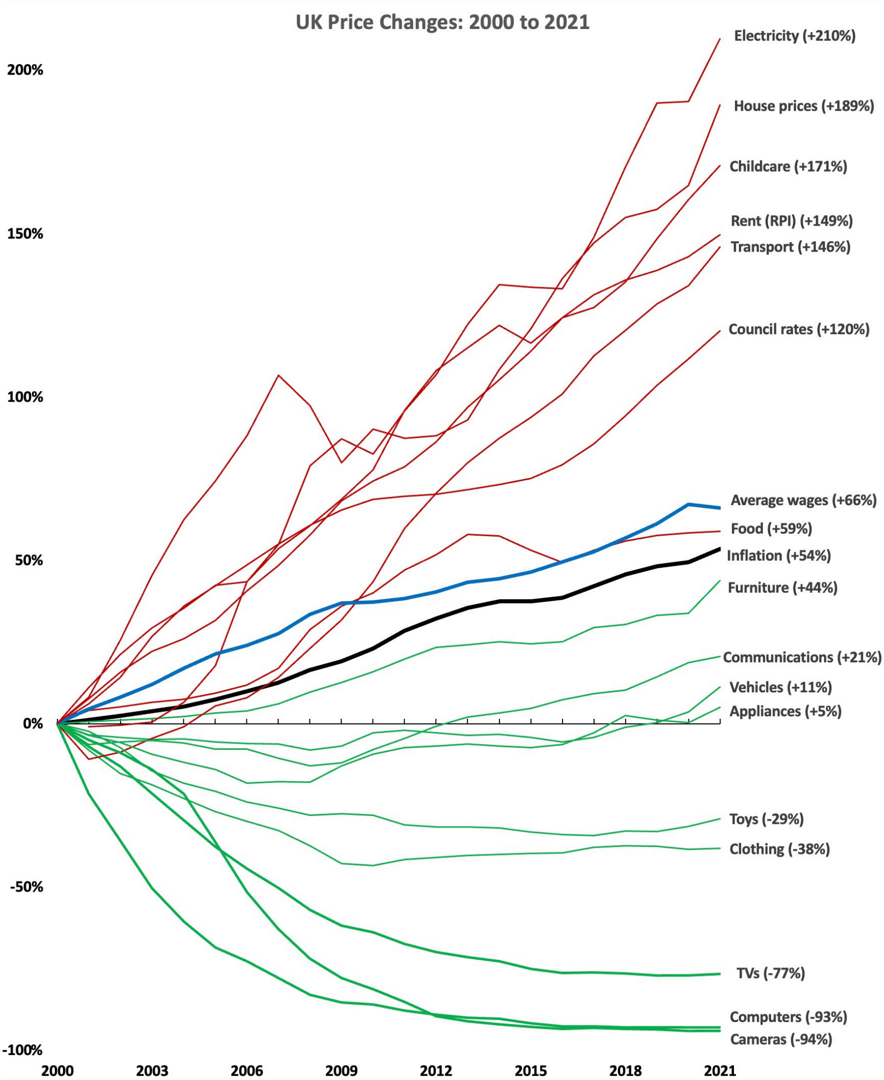
		Lowest 10%	Highest 10%	All households
1	**Food & non-alcoholic drinks**	13.9	7.6	10.6
2	**Alcoholic drink, tobacco & narcotics**	3.3	1.7	2.2
3	**Clothing & footwear**	3.6	4.4	4.3
4	**Housing, fuel & power**	22.9	8.3	13.2
4.1.3	Net rent	10.3	3.2	6.3
4.4	Electricity, gas & other fuels	7.8	2.6	3.9
5	**Household goods & services**	6.3	7.7	7.1
6	**Health**	0.9	1.1	1.2
7	**Transport**	8.8	16.7	14.1
8	**Communications**	3.8	2.4	3.1
9	**Recreation & culture**	10.7	14	13
10	**Education**	..	3.2	1.5
11	**Restaurants & hotels**	6.4	10.1	8.7
12	**Miscellaneous goods & services**	6.4	7.5	7.6
13	**Other expenditure items**	10	15.4	13.3
Total expenditure		100	100	100

Source: ONS (2019).

The phrase ‘cost of living’ can be amorphous. It usually refers to the typical household’s day-to-day expenditure. The notion of a ‘typical’ household should be interrogated. Individuals face deeply divergent preferences and needs. Nevertheless, there is value in analysing an average household. The most common method is the consumer price index (CPI), which is the weighted average of a basket of typical goods and services ranging from transportation and food to entertainment and holidays.

Since 2000, the UK has experienced an average price rise of 39 per cent, according to the CPI. Average wages have gone up by 66 per cent, indicating an overall increase in the standard of living. Nevertheless, this has by no means been consistent across sectors. The cost of some products has, in real terms, fallen over the last twenty years while the cost of other products has increased. Notably, in highly regulated fields such as housing, education and transport there has been a real-terms price increase impacting households. By contrast, in sectors relatively open to international trade, competition and innovation, such as toys, clothing, cameras, computers, televisions and furniture, prices have declined.

Figure 1: UK price changes (2000–21)



Source: ONS (n.d.).

The rising prices of many essential products, such as housing, electricity, childcare and food, predate the latest spate of inflation. They have been driven up, at least in part, by regulatory costs. Addressing these interventions could help reduce the cost of living for the worst off, with little cost to the Treasury and substantial broader economic benefits. While much is out of the control of policymakers, these policy changes present meaningful levers that can lower the structural basis of living costs for households.

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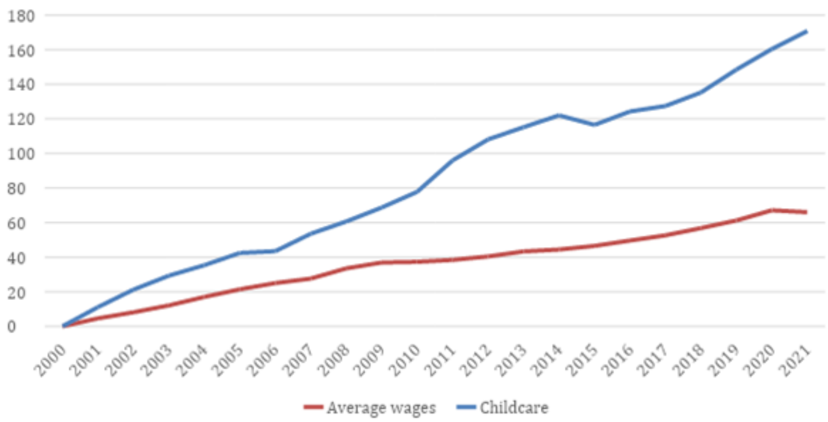
Childcare

by Matthew Lesh

The cost of childcare has grown significantly in recent decades. The annual cost of full-time childcare (50 hours per week) for an under-two-year-old has risen by 171 per cent since 2000, from £5,148 to £13,939 in 2021.[1] This is significantly faster than the rate of increase in household earnings (66 per cent) over the same period. The cost of putting two children into full-time childcare is almost the same as the median household income in the UK. This is putting childcare out of reach for many low- to middle-income households. It has been called a 'devastating tax on motherhood' (Oakeshott, 2021). Three in five non-working mothers have said they would enter the workforce if they could access convenient, reliable and affordable childcare (Department for Education, 2019).

1 Author's calculations based on reports from the Family and Childcare Trust from 2000 to 2021.

Figure 2: Childcare costs (full time, 50 hours, under 2, England (Index 2000 = 0))



Source: Family and Childcare Trust (various years).

The typical response to higher childcare costs is demands for more public spending (Jarvie et al., 2021). However, the significant growth of taxpayer funding over recent decades has not increased affordability. UK government spending on childcare has risen from 'almost nothing' in the 1990s to £5.4 billion in 2019 (Farquharson, 2019). Another study found that public spending on childcare grew by 577 per cent in real terms between 2000–01 and 2019–20 (Kelly et al., 2018). All three- and four-year-olds are entitled to 570 hours (15 hours for 38 weeks) of taxpayer-funded childcare per year. There are also additional programmes for working parents and 'disadvantaged' two-year-olds, subsidies through the benefits system, tax reliefs, VAT exemptions, Sure Start centres and after-school care support. The subsidies have actively increased demand for childcare, which, in turn, has contributed to higher prices.

Despite the significant and growing taxpayer funding, the OECD finds that England has the third-highest out-of-pocket childcare costs among developed countries (OECD, 2022). UK childcare costs, after government transfers, is almost one-third (30 per cent) of income for a two-earner household with one partner earning the average wage and the other partner two-thirds of the average wage. This is just below Switzerland (32 per cent) and Slovak Republic (31 per cent) but well above the United States (23 per cent), Australia (24 per cent) and Canada (16 per cent). This derives from the extremely high gross cost (before subsidies) of childcare, that the OECD found to be the second-highest among 38 developed economies, at 64 per cent of average earnings for a two-child family with two working parents (in 2015).

Overregulation and subsidies are driving higher childcare costs

Prior to the 1990s, childcare was largely a private matter for parents – who could either care for children themselves or pay for external childcare provided by private nurseries or childminders in a domestic setting. State intervention subsidised childcare services, to encourage mothers into formal employment, and impose regulatory requirements, to improve the educational attainment of young children (Bourne and Shackleton, 2017).

In practice, however, taxpayer-subsidised childcare has displaced other paid childcare and informal care from friends and family, decreasing expenses for higher-income families while resulting in little additional childcare per child (around 1.6 hours per week per child) (Farquharson, 2019). Furthermore, 'free' childcare in England has failed to increase mothers' participation in the workforce (Brewer et al., 2016). There has been a similar experience of subsidised childcare not significantly increasing parental workforce participation in both France (Givord and Marbot, 2015) and the Netherlands (Bettendorf et al., 2015). There is also a lack of evidence of longer-term benefit to children's development from early childhood education (Ireland and Hillman, 2018). Nevertheless, the subsidies have pushed up costs for those who cannot access the fully subsidised places while making it difficult for operators to break even. This is because the capped amounts provided by subsidies require providers to cross-subsidise their operations with higher charges for families that require additional care (Shackleton, 2018).

Childcare is provided informally by family, friends and au pairs, who are not required to register and are not regulated. It is also provided formally by regulated and registered nannies, childminders who look after a small number of children in their home for payment, and nurseries, a formalised setting for a larger number of children. Bourne (2014) explains how there has been an active move in the direction of formalised care that has pushed up costs:

> The UK childcare system is not neutral. It has been shaping the choices of parents to encourage greater employment and to expand the use of formal childcare, but in an increasingly regulated formal childcare sector. The state has therefore been stoking demand for

> childcare but imposing new costs on suppliers, and encouraging parents to use more expensive, formalised care settings.

In the name of improving child development, the government has imposed regulatory requirements on the childcare sector including staff-to-child ratios, mandatory targets, cumbersome record-keeping, staff qualifications and safety measures. These came following the Childcare Act 2006 and the Early Years Foundation Stage (EYFS) introduced in 2008 (in England). The EYFS mandates learning and development targets that range from verbal communication and language to physical, personal, social and emotional development to literacy, mathematics, arts and design. Ofsted monitors adherence and requires detailed written records and evidence along with elaborate parental feedback. The mandatory educational standards for children below school age are unusual, if not unique, by international standards (Bourne and Shackleton, 2017).

Childminders must pay to register with Ofsted or a handful of childminder agencies in a process that takes up to 12 weeks. They must have a criminal record check, first aid training, childcare training, a health declaration booklet and two references. They must follow the Early Years Framework and are also inspected by Ofsted to ensure safeguarding, welfare, learning and development requirements are met. Childminders can only care for a maximum of six children under the age of eight at any time, just three of whom can be below age five and just one child below age one. It is unlawful for a parent to take care of someone else's child for pay without going through this process of formal registration. The increased regulation and subsidies for nurseries have been associated with a substantial decline in the number of childminders registered with Ofsted, from 103,000 in 1996 to 36,600 by 2021 (Ofsted, 2021).

Britain's exit from the European Union has also significantly undermined the availability of European au pairs, who are typically paid around £5,000 per year and given lodging while learning English. An au pair must now enter through a skilled migration route requiring a salary of at least £20,480. The declining availability of childminders and au pairs has forced parents to use formalised childcare in nurseries, which have significantly higher overheads, thus pushing up costs.

Nurseries have also faced growing regulatory interference, which has contributed to higher costs for delivering childcare while not significantly improving the quality of care (Thomas and Gorry, 2015). There are expansive regulatory requirements, checked by Ofsted inspections, with respect to safeguarding, welfare, learning and development standards, training, the facility, complaints, and records and information. The inspections can be as specific as considering the amount of floor space per child in the nursery. Nurseries must also follow strict child-to-carer ratios. The UK has some of the highest requirements in Europe, with some countries, including Denmark and Sweden, having no ratio requirements (see Table 2). A 2018 study for the Department for Education found that 78 per cent of costs in childcare are for staff, with just 13 percent related to the venue and 10 per cent for other items (Paull and Xiaowei Xu, 2019). The need to hire more staff, who can only care for a small number of children, pushes up the cost of nurseries while lowering wages for staff. If an experienced, capable carer could take care of more children the higher revenue for the nursery could result in more productive, higher-paid staff. The Family and Childcare Trust has concluded that higher staffing ratios for younger children increase the costs compared to older children (Jarvie et al., 2021). The UK government has previously proposed reforming the childcare ratios to levels equivalent to the Netherlands, though this reform was ultimately abandoned after pressure from the Liberal Democrats during the Coalition years.

Table 2: Child-to-carer ratio regulations (how many carers are required per child)

Age	**<1**	**1–2**	**2–3**	**3–4**
England	3	3	4	8 or 13
Wales	3	3	4	8 or 13
Scotland	3	3	5	8 or 13
Netherlands	3	5	8	8
France	5	5	8	None
Ireland	3	5	6	8
Germany	4–8	4–8	4–8	9–20
Belgium (FR)	7	7	7	20
Spain	8	13	18	24
Italy	Unregulated	Unregulated	Unregulated	26
Denmark	Unregulated	Unregulated	Unregulated	Unregulated
Sweden	Unregulated	Unregulated	Unregulated	Unregulated

Source: European Commission (2019).

Potential impact

It is possible to deliver cheaper and accessible childcare that reduces costs for poorer families. In practice this would mean regulating the childcare sector less like formal education – a policy that would be justified by delivering greater parental choice and the aforementioned findings that highly regulated and subsidised childcare has not improved educational outcomes but has substantially driven up costs. Parents should be freer to decide what sort of childcare is appropriate for their children, whether in a domestic or formal setting, the number of carers for each child and the appropriate educational qualifications. Policy could be indifferent as to whether childcare is provided in a formal or informal setting.

The childcare reforms could include:

- Remove or reduce limitations on how many children nurseries and childminders are able to oversee;
- Allow other parents and family members to provide childcare for pay, even if not formally accredited by Ofsted;
- Abolish requirements for formal accreditation to become a childminder, allowing private agencies to set standards and provide accreditation checks such as in the Netherlands;
- Reduce or remove regulatory requirements, such as the EYFS, and oversight of nurseries – allowing standard-setting through private accreditation initiatives, quality comparison websites and parental oversight.

There are auxiliary reforms, such as post-Brexit restrictions on low-paid migration, cumbersome planning laws and the National Living Wage, that could also reduce costs for childcare.

In the longer run, this would alleviate the need for childcare subsidies that are likely pushing up costs. While there may be some role in supporting single-parent families with childcare, the overall policy case for broad-based childcare subsidies is weak. It means subsidising the childcare of many wealthier families and the primary beneficiaries are the mother and the family, not society at large, with little evidence of actually improving childcare or workplace outcomes.

Bourne (2014) suggested that a deformalisation of the sector could result in the cost of childcare being reduced to levels similar to that observed in other European countries with similar levels of enrolment (a reduction of around 40 per cent). Thomas and Gorry (2015) calculated, by comparing US states, the cost of various regulatory interferences. They estimate that a one-infant increase in the child-to-staff ratio is associated with a fall in the cost of care by between 9 and 20 per cent, while only requiring that lead teachers have a high school diploma (rather than more advanced qualifications) could reduce costs by between 25 per cent and 46 per cent. By this measure, increasing the UK's childcare ratio to Belgian levels could more than halve the cost of childcare – let alone the additional savings from addressing other regulatory costs. These are highly speculative when applied to the UK context; however, they give a sense of the realm of possibility that reform could achieve.

The Joseph Rowntree Foundation's minimum income standard, a theoretical budget developed through focus group discussions, calculates the cost of childcare to be £225 per week, or £900 per month, for a single child aged 2–4 (Davis et al., 2021). Following on from Bourne (2014), a 40 per cent reduction in the cost of childcare would reduce the monthly bill to £540.

Table 3: Potential cost savings

Childcare costs for one child per month	**£900**
Childcare cost reduction to observed rates in similar European countries	40% reduction
Childcare costs after reform	£540
Savings per month	£360
Savings per year	£4,300

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Housing

by Kristian Niemietz

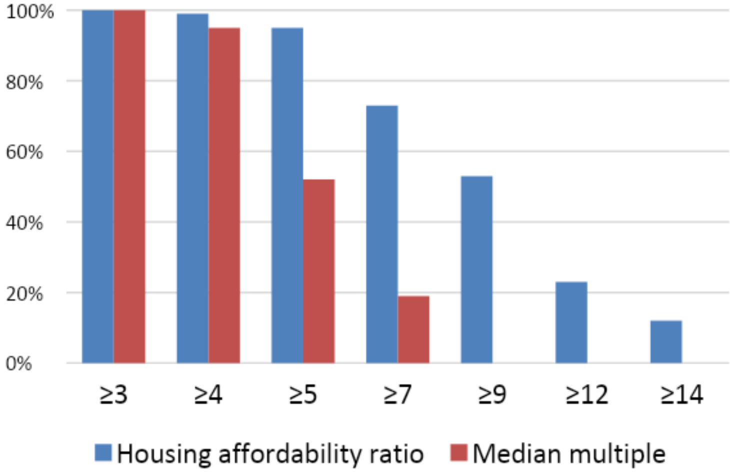
The housing affordability ratio (HAR) is the ratio of median house prices to median gross full-time earnings in a particular local area. It shows how many years of gross earnings someone in the middle of the local earnings distribution would need in order to purchase a house in the middle of the local price range.

In 1997, most local authorities in England and Wales recorded HARs between 3 and 5. Only a handful of local authorities recorded HARs above 6 (ONS, 2022).

By 2021, HARs below 5 had become a rare exception. Three out of four local authorities now recorded HARs above 7, and most recorded them above 9. In a quarter of them, the HAR was more than 12.

A related measure is the 'median multiple' (MM), the ratio of median house prices to median gross household incomes. On this measure, the affordability situation looks slightly less bad, because Britain's relatively high proportion of dual-earner households compensates somewhat for its high house prices. But the trend is the same. Until the early 2000s, the MM for the UK as a whole used to fluctuate between 2 and 3. Today, it stands above 4 in almost the entire country, and above 5 in most of the country (Demographia 2017; Demographia, 2022).

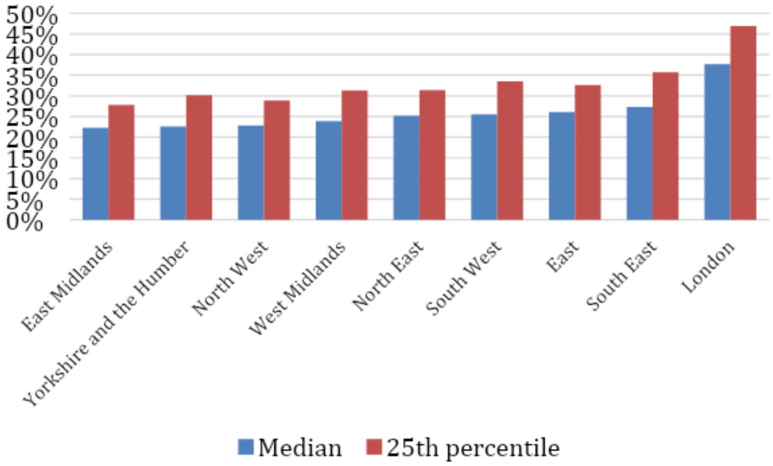
Figure 3: Housing affordability ratio and median multiple: per cent of housing markets in the specified band, 2021



Source: Demographia (2022) and ONS (2022).

A similar measure for renters is median rents as a proportion of median gross household incomes. This figure stands between 22 per cent and 28 per cent in most English regions, and at 38 per cent in London. What this means in terms of *disposable* incomes depends on factors that vary from household to household. But if somebody's rent equals a quarter of their gross income, and if their disposable income equals three-quarters of their gross income, then their rent equals one-third of their disposable income. The equivalent figures for someone further down the income distribution are far greater, because the income gradient is much steeper than the rent gradient: a lot of people earn considerably less than the median income, but rental properties that are massively cheaper than the average are hard to find.

Figure 4: Private rents as per cent of gross household incomes: median and 25th percentile, 2020

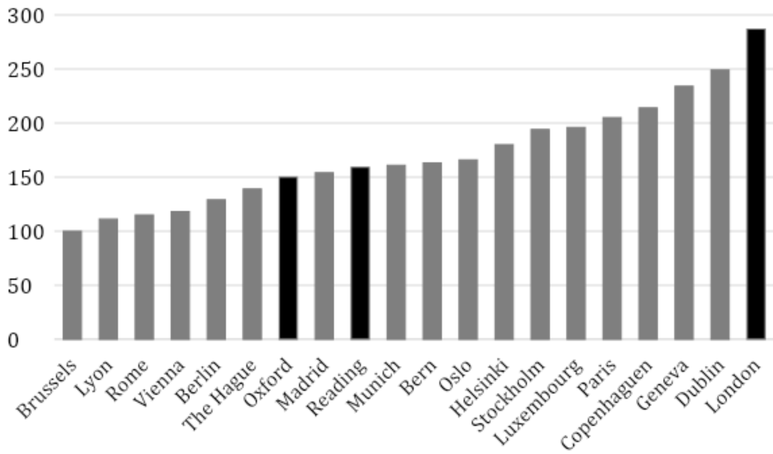


Source: ONS (2021a).

In absolute terms, the UK is an exceptionally expensive place to rent. It will come as no surprise that London is the most expensive rental market in Europe, with rent levels that are nearly three times those of Brussels, and more than twice those of Rome, Vienna, Berlin or The Hague. But this is not just a London issue. Rents in Oxford and Reading are comparable to those in Munich, Bern and Oslo, despite the fact that those latter cities are vastly more prosperous.[2]

2 See https://www.averagesalarysurvey.com/, http://www.salaryexplorer.com/.

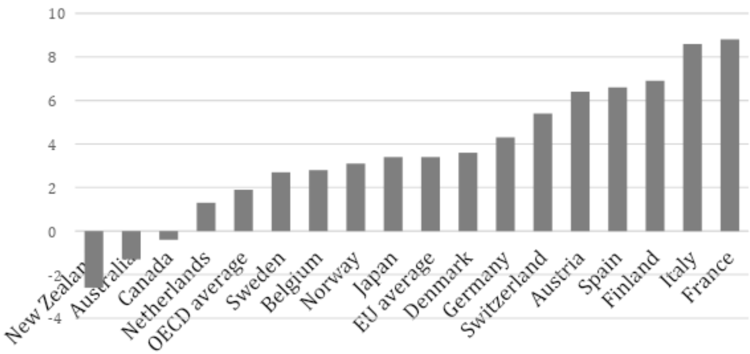
Figure 5: Rent index (Brussels = 100), 2020



Source: Eurostat (2020).

The core problem is easily summarised: Britain's housing stock is inadequate. Figure 6 below shows how many additional housing units England would have to build in order to match the housing stock of other countries, adjusted for population size. It would need close to 2 million additional homes just to catch up with the OECD average, and 3.4 million additional homes to match the EU average. Catching up with German-speaking Europe would require around 5 million additional homes. These figures understate the scale of the supply shortfall, because they do not adjust for size, but we also know that British homes are unusually small by European or OECD standards (Eurostat, 2020).

Figure 6: Housing supply shortfall: number of additional dwellings (in millions) England would have to build in order to match the housing stock (population-adjusted) of other countries, 2020 or latest available year



Source: based on OECD (2022).

To make matters worse, this already insufficient housing is also geographically badly distributed, because resistance to housing development tends to be strongest where housing demand is highest. As Cheshire and Buyuklieva (2019: 5) point out, housebuilding numbers in Oxford and Cambridge since 1980 have been only about half of those of Doncaster and Barnsley, despite much faster population growth in the former two cities.

Some economic problems are genuinely complex, and difficult to solve. This one is not. There is a huge amount of empirical evidence, from housing markets around the world, which conclusively shows that there is a strong, causal link between the severity of land use planning restrictions and housing costs (for a review, see Niemietz, 2015: 14–16; for more recent work, see Ganong and Shoag, 2017; Hsieh and Moretti, 2019).

Jean-Claude Juncker once quipped: ‘We all know what to do. We just don’t know how to get re-elected after we’ve done it.’ He was not referring to British housing policy, but he might as well have been.

British politicians know what to do. Going back to (at least) the Barker Review of 2004 (Barker, 2004), successive governments have commissioned expert assessments and issued White Papers, which all diagnose the problem in remarkably similar ways, and come up with remarkably similar reform proposals. There have even been several attempts to put some of those reforms into practice. The problem is that every time a government encounters some resistance from anti-housing obstructionists, it immediately caves in, and abandons its reforms, or waters them down to such an extent that they become meaningless (see e.g. Niemietz, 2012).

The latest example is the government White Paper *Planning for the Future* (MHCLG, 2020), which argued that the British planning system was too discretionary and thereby turned every planning application into a political football. It proposed a more rules-based system, under which planning authorities spell out in advance what can and cannot be built where, thus reducing the need for case-by-case decisions. It was a sensible proposal, which would have made Britain's planning system more similar to that of some of its European neighbours. But opposition to it quickly formed. In 2021, the government lost a byelection in what was previously deemed a safe seat, a result that was widely blamed on housing and planning.[3] In response, the government capitulated and, according to reports, has significantly weakened plans for planning reform.[4]

Curbing the worst excesses of Britain's housing crisis would not even require particularly innovative and imaginative policy solutions. It would be sufficient to merely muster up some political courage, and see reforms through, even if they are not instantly popular.

There are plenty of proposals for going beyond that, such as:

- Removing green belt protection from land that is not particularly green anyway, in proximity to commuter stations (Cheshire and Buyuklieva, 2019).
- Street votes, which would allow residents, on a street-by-street basis, to essentially opt out of the planning system altogether, and come up with their own rules if they so choose (Southwood and Hughes, 2021). This can be combined with similar plans to redevelop underused urban spaces (Southwood and Hughes, 2022).
- A localisation of the tax revenue associated with development, to make it lucrative for local authorities to attract residents and businesses.

3 'A victory for NIMBYs in Chesham and Amersham is no reason to give up on planning reform', *The Telegraph*, 18 June 2021 (https://www.telegraph.co.uk/news/2021/06/18/victory-nimbys-chesham-amersham-no-reason-give-planning-reform/).

4 'Ministers "to ditch overhaul of planning laws" after criticism', *The Guardian*, 11 September 2021 (https://www.theguardian.com/politics/2021/sep/11/ministers-to-ditch-overhaul-of-planning-laws-after-criticism).

There is no reason why it should not be possible to get housing costs back to the historic norm of a median multiple of three or below, which would imply a real-term drop in house prices of at least 40 per cent. This, as it happens, is roughly in line with one empirical study, which estimated that 35 per cent of the average house price in England is attributable to excessive planning constraints (Hilber and Vermeulen, 2016). The latter is a highly conservative estimate, which almost certainly understates the true impact that a sensible planning reform could have.

Nonetheless, we can use the 35 per cent figure to err on the side of caution, and/or as an absolute lower bound. Median private sector rents in England are currently about £750 per month (ONS, 2021b). If we use Hilber's and Vermeulen's conservative estimate, and if we assume that planning reform would have a similar effect across different tenures, then this figure could very plausibly be brought down to about £500, saving a typical household around £250 a month. If the effect were roughly symmetric across the country, savings in the East and the South East would be more like £300 a month, and close to £500 in London. But it would, in all likelihood, *not* be symmetrical: as noted above, planning constraints tend to be most binding where housing demand is highest. If so, the effect of planning reform would not just be an across-the-board reduction in rents, but a narrowing of the spread in housing costs between the country's most expensive and its least expensive regions.

Table 4: Median private sector rents, 2021

	Current	Post-reforms
England	£755	£500
East	£850	£550
South East	£925	£600
London	£1,425	£930

Source: ONS (2021b).

The exact numbers are, of course, up for debate. But the central point is not: Britain's housing crisis is the result of political choices, and if the political will was there, it could be ended any time.

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The nanny state

by Christopher Snowdon

Meet Matt. Matt works 35 hours a week earning the National Living Wage of £9.50 per hour. His annual salary is £17,290 which falls to £15,632 after income tax and National Insurance contributions have been paid.

Matt drives to work each day but it is not a long commute, so he only gets through a quarter of a tank of petrol every week (13 litres). He is a single man with no children, and he likes to treat himself from time to time. He is not a big drinker, but he likes to have a couple of pints of beer twice a week and he enjoys a bottle of wine at the weekend. He also likes a smoke, but he buys the cheapest cigarettes he can find, and he has managed to cut down to nine cigarettes a day which happens to be the average for a smoker in Britain these days (ONS, 2019).[5] He also loves a drop of Coca-Cola – the original recipe, not the artificially sweetened stuff – and he has four 500ml bottles of it every week.

Matt's lifestyle is not lavish or decadent, but he pays a heavy price for it. Every year he pays £2,092.90 on four sin taxes: fuel duty, alcohol duty, tobacco duty and the sugar tax (see Table 5). The term sin taxes refers to excise duties applied to products to deter their consumption, typically because the products are deemed unhealthy to the user or harmful to society. They are not to be confused with Pigouvian taxes which are designed to make people pay the full cost of an activity, including the cost to the rest of society, although some sin taxes have a Pigouvian element.

5 Based on self-reported survey data. Smokers tend to under-report how much they smoke. Sales figures suggest the real figure is around a third higher.

In the case of Matt, 13.4 per cent of his income is spent on sin taxes. This includes the VAT that is charged on the sin taxes, but it does not include the VAT on the products themselves. Nor does it include other stealth taxes such as air passenger duty, betting duty or green levies.

Table 5: Poor Matt

Product	**Monthly expenditure on sin taxes**
Cigarettes (63 per week)	£114
Petrol (13 litres per week)	£36
Beer (4 pints per week)	£11
Wine (1 bottle per week)	£11
Sugary drinks (2 litres per week)	£3
TOTAL	**£175**
TOTAL (Not including petrol)	**£139**

If this is how sin taxes affect a relatively moderate consumer like Matt, imagine what it is like for people who are less restrained. In the USA, 90 per cent of all sin taxes on tobacco, alcohol and soft drinks are paid by just 20 per cent of households. Incredibly, 68 per cent of these sin taxes are paid by a tiny group of 'super-consumers' who make up just 2.5 per cent of the population (Conlon et al., 2021).

With such a heavy burden placed on the shoulders of so few people, paternalistic taxes raise questions about fairness and discrimination. Is it ethical to punish people so severely for their lifestyle choices, especially when the revenue from these taxes vastly exceeds any plausible estimate of the negative externalities associated with the activity (Snowdon, 2015)?

When politicians bemoan the cost-of-living crisis, we should never forget that they have been deliberately putting up prices for decades. Sometimes this is explicit and deliberate, as with tobacco duty. At other times it is inadvertent, as with regulation that pushes up the cost of doing business.

Taxes at least have the virtue of raising revenue that can be spent on public services. Less defensible are policies which raise prices in a way that incurs costs without any compensatory benefit. Minimum pricing, which sets a floor price for a unit of alcohol, has been in place in Scotland since 2018 and has since been introduced in Wales and Ireland. As recent IEA research demonstrates, minimum pricing cost Scottish consumers £270 million in the four years after it was implemented (Duffy et al., 2022). The cost of living has increased as a result and the Scottish government has received no extra tax revenue (except perhaps a marginal increase in VAT).

Similarly, the UK government plans to ban multi-buy deals on food that is considered to be high in fat, sugar or salt in October 2023. These deals include Buy One Get One Free (BOGOF) and 3-for-2 offers. Price promotions of this kind help manufacturers launch new products and help retailers manage their stock. Supermarkets get bigger discounts from wholesalers when they place large orders and multi-buy deals help them sell the products quickly. But the main beneficiary is the consumer who uses them as a way to make their money go further. This was acknowledged by Public Health England in 2015 when it first proposed the idea of banning BOGOFs:

> There is also evidence that during the high inflationary period of 2008–2010, promotions were a useful coping strategy for shoppers to manage the worst effects of food and drink inflation.
>
> During this period as food and drink became relatively more expensive, behavioural data shows that many shoppers increasingly selected items offered on promotion to help them save money.
>
> (Public Health England, 2015: 15)

Public Health England estimated that a ban on multi-buy deals would cost the average household £634 a year if people continued to buy the same basket of goods. In practice, the cost is likely to be less than this, firstly because shoppers are likely to change their shopping behaviour to some extent (as the policy intends) and secondly because retailers will be able to discount prices in other ways. But whilst the policy might not cost consumers £634 a year, it will almost certainly raise the cost of living to some extent. In October, when the policy is due to come into force, the Office for Budget Responsibility predicts that inflation will have reached

8.7 per cent[6] and the ‘problem’ of cheap food will be low on the list of voters’ concerns.

Both minimum pricing and the ban on multi-buy deals have a ‘public health’ justification. Nanny-state campaigners want higher prices to deter people from buying alcohol and so-called ‘junk food’. But there is very little evidence that banning BOGOFs on food will reduce obesity[7] and the evidence from Scotland suggests that minimum pricing is ineffective in reducing alcohol-related harm (Duffy et al., 2022). Even if these policies had some beneficial effect on the margins, it is not clear why all consumers of food and alcohol should have to pay more just because some people consume to excess.

This also true of many sin taxes. The difference is that the government makes a lot of money from sin taxes whereas it makes no money from minimum pricing and will make no money from banning multi-buy food deals. Politicians could therefore abandon these policies tomorrow and not lose a penny in revenue. If they genuinely cared about the cost of living, it would be a no-brainer.

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6 https://obr.uk/overview-of-the-march-2022-economic-and-fiscal-outlook/

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Employment rules

by JR Shackleton

Recent governments have greatly increased state involvement in the labour market. This employment regulation has an impact on living standards. Some interventions, such as increased minimum wages, can relieve cost-of-living problems for some workers (although they may generate other problems such as reducing overall working hours or jobs). However, many interventions have a more malign effect. They can reduce the rate of increase of wages – a real problem in the UK in recent years – or, by raising costs, increase prices to the consumer.

Negative effects on pay

Take the possible negative effect on pay. In a reasonably competitive market, employers pay workers the value of their marginal contribution to the business. The government's increase in employer national insurance contribution (NIC) – a payroll tax – means employers must pay workers less to maintain profitability. Economic theory predicts that much of the cost will therefore be passed on to the worker in terms of lower pay increases over time – which means that April's increase in both employee and employer NICs was a double whammy to workers. The Office for Budget Responsibility estimates that 80 per cent of the cost of increased employer NICs will be passed on in lower wages (with 20 per cent passed on in higher prices) (OBR, 2021). The same analysis applies to much employment regulation which inevitably increases employer costs.

Government employment regulation – auto-enrolment in pensions, holiday entitlements, extended parental leave – acts as 'stealth' payroll taxes. From the public's point of view, employers appear to pay for the regulation, just as they appear to pay employer NICs, and the government avoids the outcry it would get by raising taxes overtly. But this is misleading: the cost of employment regulation will gradually be passed on to employees, who will receive smaller wage increases over time than might otherwise have been the case.[8] In the UK there has been a steady expansion of mandated benefits in recent years. The greater regulation of employment may well be one of the reasons for the slow rate of growth of real wages, particularly since the financial crisis.

Increasing restrictions on the way in which workers can be used and contracts formed (for example, recent restrictions on the self-employment status of gig workers such as Uber drivers, or the use of zero-hours contracts, or agency workers) also slows productivity increases. This restricts working opportunities for people, while also raising costs to the consumer. Regulation that is perceived and designed to benefit workers can in fact reduce their employment opportunities and wages.

Occupational regulation

One particular type of employment regulation operates by deliberately restricting competition. This is occupational regulation, which limits the ability of people to enter particular jobs in the labour market without certification and approval from the government or its agencies. Around a fifth of all UK workers now require a government licence, a proportion which has doubled in the last twenty years (Shackleton, 2017).

Here the costs fall differently. By restricting entry, such regulation creates an artificial scarcity of practitioners and this tends to raise their pay. An 'economic rent' is created. This means users of these services – for example, the services of solicitors or gas engineers – face higher prices.

However, workers in regulated occupations do not necessarily benefit from this situation either. If one has to incur considerable expense in order to meet the criteria for admission to a regulated occupation, the apparent gains from higher pay may be illusory, as they will largely represent a return on the investment in passing entrance examinations or meeting

8 It can be argued that they get a benefit in return; but mandates typically favour particular groups of workers (parents, those with dependent children) while reducing real wages for all workers.

other entrance costs.[9] And those who are not able to obtain entrance suffer, particularly where they may have incurred the costs of training but are unable to obtain entry. For example, many people who have studied law with the intention of becoming a barrister are rejected because of the limited number of pupillages available in chambers.

Occupational regulation often involves very specific rules and requirements, such as mandatory annual checks and updating commitments, which add to employer costs and thus to prices to the consumer – or, in the case of regulated public sector employees such as teachers and social workers, the taxpayer. It discourages competition and innovation. Occupational licensing has typically been justified by information asymmetries, the idea that consumers lack signals for quality. However, occupational licensing has increased just as online ratings systems and reviews are mitigating this problem by highlighting poor or incompetent service and, importantly, when new technology is undermining the unique skills of professionals.

Even in medicine, our oldest regulated group of professionals, new expert systems and artificial intelligence can diagnose many health problems faster and more reliably than humans. This reduces the need for much of the routine work of general practitioners, radiographers and even consultants – and offers opportunities for less-qualified staff such as nurses and pharmacists to take greater responsibility for patient care. These innovations are of course resisted by traditional practitioners as they undermine protected statuses. For example, there has been GP resistance to pharmacists taking on responsibility for treating minor ailments.

Measurement of the effects of regulation on wages and on the costs of providing services has been conducted extensively in the United States, where occupational regulation is markedly higher than the UK. Studies suggest that occupational licensing generates a wage premium of as much as 18 per cent with no discernible improvement in quality, although there is considerable variation from state to state. An early study suggested that the comparable figure for the UK might be around 13 per cent (Shackleton, 2017: 37–43). More recent across-the-board estimates are lower, but in some sectors the effect is substantial (Koumenta and Pagliero, 2017). One

9 Occupational regulation often comes about through lobbying by existing workers in the field. They can gain disproportionately from regulation, as typically they have ‘grandparent rights’: they are exempted from the cost of acquiring new entrance qualifications.

area may be medicine, where government restrictions on medical school places reduce the supply of doctors and dentists and boosts their pay. As I have suggested previously (Shackleton, 2017), a comprehensive review of occupational licensing could usefully be undertaken with a view to increasing competition and boosting productivity: an OECD study has recently suggested that there are potential gains of up to 1.5 percentage points of GDP (Bambalaite et al., 2020).

These would be medium- to long-term gains, but in the short run we might at least resist extending regulation. For example we could abandon the recent moves towards licensing of estate agents (and requiring them to pass a range of exams), a move which will add to the already costly business of buying a house.[10]

Immigration restrictions

Another form of government involvement in the labour market is immigration restrictions, an important issue post-Brexit. The government has claimed that the new immigration system, after abolishing free mobility of labour from the EU, would not restrict immigration for workers who can make a useful contribution to the economy. But setting out detailed rules about government-perceived shortage occupations and minimum earnings allowed to justify entry into the UK restricts competition, potentially worsening shortages of some important groups of workers.

For example, the House of Commons Environment, Food and Rural Affairs Committee has recently reported that the difficulties of the farming and food processing industries in recruiting staff have been exacerbated by the complicated and expensive bureaucratic procedures involved in bringing in workers from outside the UK (House of Commons Environment, Food and Rural Affairs Committee, 2022). This has led to unharvested crops, the pointless killing of healthy pigs because of insufficient workers in meat processing, unavailability of some foodstuffs and rising prices.

The new post-Brexit immigration system (UK Government, 2022) has allowed temporary short-term (three-year) visas for poultry workers, pork

10 J. R. Shackleton, 'Occupational licensing of estate agents will restrict competition, and protect incumbents', IEA Blog, 17 April 2018 (https://iea.org.uk/the-extension-of-occupational-licensing-to-estate-agents-is-a-political-ploy/)

butchers and HGV drivers,[11] but the costs and difficulties of using these routes have meant that they have not had the desired effect. Although the government believes that the charges for and the difficulties of using the Skilled Worker Visa route are modest, experience suggests otherwise. The Association of Labour Providers estimates that the total cost of recruiting 50 workers through the SWV route comes out at well over £400,000 (House of Commons Environment, Food and Rural Affairs Committee, 2022).

The government has at times suggested that the UK should move to a high-wage economy which would attract more British workers into difficult-to-fill jobs previously taken by EU migrants. In late 2021, Boris Johnson among other ministers pointed to rising wages as a sign this strategy was proving successful – however, ultimately inflation has risen even faster, in part because of worker shortages, meaning workers have lower real wages.

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11 The shortage of HGV drivers has a number of causes, of which immigration restrictions are only one. For instance changes to IR35 rules have led many self-employed drivers to leave the industry.

Shackleton, J. R. (2017) Conspiracy against the public? Occupational regulation in the UK economy. Current Controversies No. 56. London: Institute of Economic Affairs.

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Trade restrictions and the cost of goods

by Victoria Hewson

The cost of everyday goods and services is rising at the fastest rate for decades. The main drivers for this in 2021 were housing and motor fuels, but food, clothing and household goods are also significant contributors. A large proportion of these latter goods are imported, and so their cost is influenced by trade policy and subject to tariff and non-tariff barriers.

Leaving the single market and customs union has led to new trade barriers with the EU that have not yet been offset by either unilateral reforms or gains from trade elsewhere. It has been reported that imports to Great Britain from the EU have fallen since January 2021, leading to a 6 per cent increase in food prices (Bakker et al., 2022). In Northern Ireland, thanks to the operation of a protocol in the Withdrawal Agreement designed to protect peace and the EU's single market, economists have identified costs running into hundreds of millions of pounds, and an increase of around 6 per cent in the cost of bringing goods from Great Britain.[12] The protocol has not yet been fully implemented, much to the chagrin of the European Commission, which requires yet more barriers to be introduced before it will even contemplate mitigations.[13] But for both Great Britain and Northern Ireland, there are still ways for the UK government to address the impact of trade barriers on the cost of living.

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12 'Esmond Birnie: The Irish Sea border is costing Northern Ireland £850m a year', *News Letter*, 12 August 2021 (https://www.newsletter.co.uk/news/opinion/columnists/esmond-birnie-the-irish-sea-border-is-costing-northern-ireland-ps850m-a-year-3344732).

13 See the 'non-papers' published by the European Commission in October 2021 (https://ec.europa.eu/info/strategy/relations-non-eu-countries/relations-united-kingdom/eu-uk-withdrawal-agreement/protocol-ireland-and-northern-ireland_en#october-2021-package).

The UK's independent external tariff schedule that came into force in January 2021 cut tariff rates and removed them entirely from many goods.[14] But there is scope for removing many more. Tariffs were retained on some goods that are not produced in this country to protect the preferential treatment of developing countries. Preference schemes that give reduced or zero tariff rates to poorer countries are rendered meaningless if the importing country does not apply tariffs to goods at all. But it is debatable whether such schemes deliver real, sustainable benefits to beneficiary countries, and the government should look again at this (Hewson, 2021). Tariffs for the protection of domestic industry should also be removed, to benefit consumers and manufacturers in this country who rely on importing intermediate goods. As well as direct benefits from this tax cut, removing tariffs entirely takes away the need for rules of origin compliance with existing FTA partners like the EU. This reduces the fiscal risks and burdens of customs compliance, which could also benefit taxpayers by cutting back the resources needed within HMRC. Perhaps most importantly, it would reduce distortions and increase competition across supply chains.

Regulatory, or non-tariff barriers, are more intractable, but here the UK has a pathway to very liberalising measures that could be world leading (an overused phrase that could actually be apt here for once). Non-tariff barriers can arise in many ways, in substantive rules for goods, in testing and certification requirements and as checks and inspections at borders. So far, since leaving the bloc the UK has remained relatively open to EU goods. The UK has continued to recognise the EU's 'CE' mark as certifying compliance with our regulations, which remain largely the same as the EU's. Full-scale veterinary checks have not been required on food and agricultural goods brought to this country from the EU[15] and HMRC has put in place a number of facilitations to reduce the burden of declarations and associated fiscal compliance.

Much of this unilateral openness was due to come to an end in the course of 2022 and 2023. Domestic producers, especially farmers and food exporters, hit hard by the EU applying full 'third country' checks on imports from the UK, have been calling for a level playing field, that is, for the UK to reciprocate these checks on imports from the EU. It is government policy to cease recognition of the CE mark and require manufactured

14 https://www.gov.uk/government/publications/the-uks-integrated-tariff-schedule/the-uks-integrated-tariff-schedule

15 However, some checks have been applied to higher-risk imports such as live animals.

goods for the GB market to be tested to and certified with the new UKCA certification of conformity.

Minister for Brexit Opportunities and Government Efficiency, Jacob Rees-Mogg, announced in April 2022 that the planned introduction of veterinary certification and inspections of food from the EU will be delayed again. The government is carrying out a review of policies and systems as part of its overall ‘2025 Border Strategy’ and intends to establish a risk-based approach, drawing on data and technology. Non-tariff measures like sanitary and phytosanitary SPS regulations and veterinary checks can add up to an equivalent of a 20 per cent tariff to the cost of goods, so a wider review that could see the UK moving away from the EU approach to SPS regulations on all food imports, not just those from the EU, could make a material impact on the cost of food.

Rees-Mogg has also indicated that he would favour a review of the move to mandatory UKCA certification.[16] As outlined in the recent IEA paper *Changing the Rules* (Hewson, 2022), the UK should continue to accept goods marked with the CE mark for so long as the relevant EU rules and standards represent an acceptable level of safety. This should also be extended to other jurisdictions, without waiting for agreement through mutual recognition. The UK’s regulators and standards bodies should be tasked with establishing which countries’ standards offer equivalent levels of safety and quality to our own, and opening our market to them. The resulting dynamic effects on competition could see both lower prices and better-quality goods.

It has been suggested that this policy would put British consumers at risk, however (in respect of the EU) it is effectively the practice in Northern Ireland at present. The ‘dual regulatory regime’ proposed by the British government in its 2021 Command Paper on the Protocol (HM Government, 2021) and provided for in the Northern Ireland Protocol Bill currently before Parliament would formalise this. If acceptable for British citizens in Northern Ireland, any risks from EU goods must be tolerable for the rest of the country. Indeed, if UK and EU standards are to be accepted equally in Northern Ireland, and no checks to operate between NI and GB, then logically the dual regulatory zone would have to extend to the whole of the UK. Instead of treating this as a loss of leverage or undesirable

16 At present, the policy remains to cease CE mark recognition and require UKCA certification, with a series of measures to phase in the mandate announced in June 2022 (https://www.gov.uk/guidance/using-the-ukca-marking).

concession, this should be welcomed as a truly liberalising move showing real leadership in the pursuit of free trade.

In Northern Ireland, even though substantive regulations remain identical, and UK-wide supply chains were deeply integrated, the introduction of EU measures (even only incompletely applied) has caused significant diversion of trade, price increases and unavailability of some products. This is a clear illustration of the distortionary and costly effects that the EU's regulatory barriers have. A complete overhaul of regulation in this area, to be genuinely risk and science based, not treating UK barriers as an asset to be traded away in negotiations, could make a real contribution to reducing the cost of living for British people.

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Energy

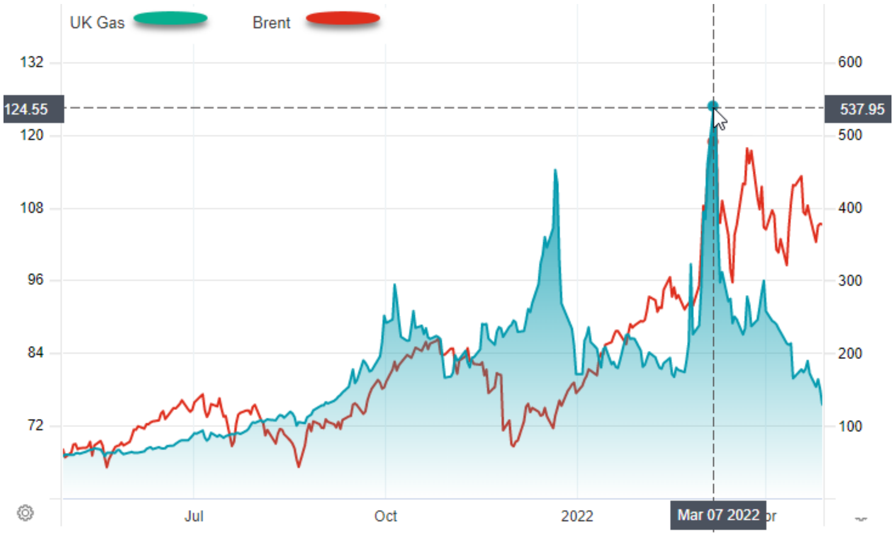
by Andy Mayer

If the cost-of-living crisis were an action movie, the supervillain would be energy prices. Energy is responsible for some 2–3 percentage points of the 8 per cent annual rise in the May 2022 inflation data (ONS), and indirectly for much more (even though these effects are hard to quantify precisely). Energy is the ultimate commodity; it is at the root of all industrial and most service activities, essential to domestic power, heating and transportation. Paying more for less energy undermines productivity and makes us all poorer.

The problem

Global oil and gas prices, driven by the war in Ukraine and the pandemic, are pushing up the energy prices that are contributing to the higher cost of living (see Figure 7). European gas prices have peaked at 5–10 times their pre-crisis level, and while there was a falling back in spring, the expectation is for prices to go back up again as we head for next winter. Global oil prices have also spiked. The OPEC cartel of major producers are currently refusing to increase supply, resulting in the price of liquid fuels (diesel and petrol) more than doubling. In the UK this feeds through to an increase of over 40-50 per cent in pump prices for motorists and hauliers. (The UK’s high fuel duties mean that wholesale oil prices are a smaller proportion of pump prices.)

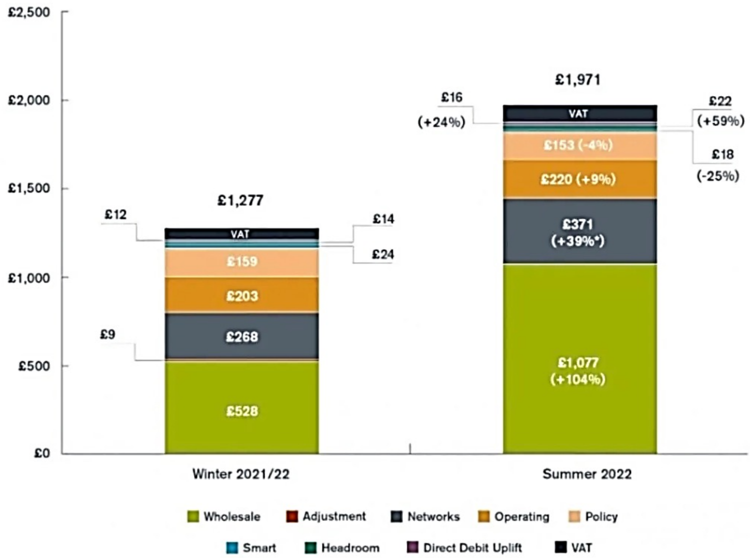
Figure 7: Energy commodity markets April 2021-22



Notes: Left: Brent crude ($ per barrel of oil). Right: Natural gas UK prices (pence per therm). Source: Tradingeconomics.com

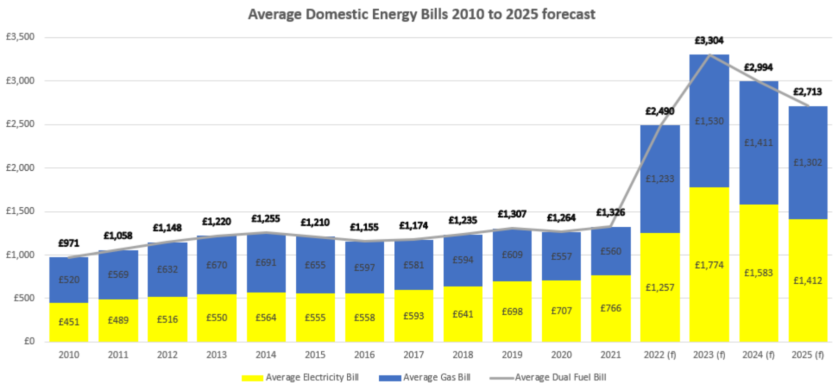
The wholesale component of domestic bills has risen by 104 per cent between winter 2021 and summer 2022 (Figure 8). Nevertheless, in October a further 50–100 per cent rise is expected as the UK domestic price cap lags the market. The cap has also forced 29 energy retail companies into bankruptcy, or temporary nationalisation. The cost of these bailouts is added to bills and taxes.

Figure 8: OFGEM average domestic energy bills by cost area, February 2022



After a decade of relative stability (domestic energy prices rose 9 per cent in real terms between 2010 and 2020), this is a big surge (Figure 9), which, unless there is a large reduction in wholesale prices, is not expected to go away any time soon.

Figure 9: Average energy bills 2010–25 forecast



Source: BEIS Annual Domestic Bills 2.2.1/2.3.1, OFGEM Default Tariff Cap, Cornwall Insight forecasts, IEA model.[17]

This is not even the full picture. Since 2001, UK energy consumption has fallen by 14 per cent across all sectors. In the domestic sector alone, energy use has dropped by 20 per cent. However, customer numbers have been rising, up 5 per cent for electricity (28.7 million households) and 6 per cent for gas (23.7 million). More people are paying much more for less energy.

Yet throughout this period wholesale gas-fired electricity prices were low and stable at £40–50/MWh. Nearly all of the electricity price increase can be attributed to climate change policies (now rebranded as 'Net Zero' policies). These will remain and are growing whatever happens to commodity prices.

As a result, energy supply chiefs expect some 30–40 per cent of households to fall into 'fuel poverty'[18] during winter 2022 (Clinton and Jolly, 2022). In response, Chancellor Rishi Sunak announced a cut in fuel duty of 5p per litre to 52.95p (HM Treasury, 2022). Energy-intensive businesses are set to have their assistance doubled (Pickard and Pfeifer, 2022), while the pass-through to households has been delayed by a domestic price cap (since 2019) along with a new loan and repay scheme.

17 BEIS assumes the average household uses 3,600 kWh electricity and 13,600 kWh gas, versus 2,900/12,000 in the OFGEM model.

18 An old measure, meaning 10 per cent or more of household expenditure on energy.

Other dynamics

Any energy strategy faces trade-offs between security of supply, affordability and decarbonisation. The challenge is to make the low-carbon transition as affordable as possible, without blackouts, causing the elderly to freeze to death, preventing people from getting to work or rendering domestic industry uncompetitive.

The UK Net Zero strategy, however, seeks to reach a decarbonisation target by a fixed date, regardless of the cost, with uncertain consequences for energy security, in the hope of leading the world to resolve climate change. The UK is in substance responsible for under 1 per cent of global greenhouse gas emissions and only has comparative advantage in some green finance and services, not manufacturing. It has spent 20 years proving this point by becoming a net importer, not exporter, of green technologies such as wind, solar and novel building materials. This approach has been recently upgraded by the UK Energy Security Strategy, recognising that security of supply matters, but attention to affordability still eludes the government.

The successful privatisations and liberalisation of energy markets in the 1980s and 1990s (Currie, 2000) led to a ‘dash for gas’, which has now almost entirely displaced coal generation, while accounting for 85 per cent of domestic heating solutions. Oil holds a similarly dominant position in transport markets with petrol and diesel accounting for over 95 per cent of all miles travelled (BEIS, 2021a).

Renewables are in turn displacing gas, and electric cars are replacing petrol-powered ones, but not in the same way, and not as quickly. Renewable generation is unreliable because power is not generated when the sun is not shining, and the wind does not blow. This necessitates costly storage technology at a scale that is currently not viable. Gas thus remains the technology choice for most grid balancing. Gas also sets the price paid to some 80–90 per cent of renewable generators (before they get an additional payment from the Renewables Obligation (RO) scheme).

Likewise, gas remains the main power source for the electricity needs of the growing fleet of electric vehicles, and the same for any expansion of heat pumps to replace gas boilers. Future technology will change this mix, for example battery storage, green hydrogen, some nuclear and one day fusion generation, but none of these solutions is arriving fast enough to impact the cost of living today.

When ministers and activists refer to ‘cheap renewables’ (Kwarteng, 2022), they mean only the bid prices for the latest schemes using the latest incentive scheme, Contract for Difference (CFD) feed-in tariffs. Most of this has not yet been built, while the parts which have are only making rounding-error differences to bills and some are deferring subsidies in order to secure currently elevated spot prices.

Renewables are not cheap. They increase the cost of the electricity grid (the chunky network costs in Figure 8), which must cope with balancing intermittency. They raise the costs of standby or storage power. These costs are hidden in the way the government and OFGEM present data as part of their Net Zero campaign, but are there nevertheless, and do explain the strange rise in energy costs while consumption is falling over recent decades.

Nuclear energy is not cheap either. Each station takes between 13 and 17 years to build. The government’s impact assessment for Hinkley Point C (the only new plant possible before 2030) suggests it will cost £68–120 billion, while replicas come in at £24–63 billion each (BEIS, 2021b) (and more likely closer to the upper end, given the record of the industry at predicting costs). We are, for example, still paying £3 billion a year for the prior failure of British nuclear experiments from the 1950s onwards.

Nor are heat pumps cheap. They cost £10–25k to install, and even with subsidy support they are beyond the means of most people. Heat pumps will increase the costs of the gas grid; when usage falls, the marginal cost for each user rises, and maintenance becomes more difficult. At some point the grid may be shut down, leading large numbers of likely older and more vulnerable customers to be shifted to home deliveries of gas until they can upgrade their boilers. (If that is even possible for those with limited space and thermally inefficient properties.)

However, energy efficiency is not cheap. High energy prices entail an increase in private initiatives to improve homes, businesses and other processes with higher energy bills. Government efforts then tend to focus on the poor, vulnerable and other groups that cannot afford the works. But they do so ineffectively; schemes like CESP, CERT, the Green Deal, Green Homes Grant and ECO have been noted as complex, slow and poor value (NAO, 2016; PAC, 2021). State-enforced home improvement does not work for consumers, while mandating the projects to box-ticking suppliers encourages poor-quality work with substandard materials.

Finally, electric vehicles (EVs) are not cheap either. Their running costs are lower, but manufacturing costs are substantially higher, and the components such as rare earth metals are exposed to global commodity markets as much as oil and gas. One of the highest rates of inflation outside energy has been observed in the second-hand cars sector (30 per cent +), within which the rate for second-hand EVs is 120 per cent (The Car Expert, 2021). This is due to the current unavailability of new vehicles and the semiconductors they require.

What can be done?

Increasing fossil fuel supply

The largest impact on prices in the short to medium term can only come from a reduction in global oil prices and regional gas prices, in turn by increasing global supply. Here the government has few levers to pull and is pulling most of them already. Both the UK and EU are setting up new bilateral deals with major producers, for example Saudi Arabia, the US and Qatar. These are the only countries that can rapidly increase supply, and their efforts, so far, are limited. There are also limits to this approach, namely the size of the global shipping fleets for LNG and oil tankers, and capacity at ports with facilities for loading and unloading cargoes. New investment will expand capacity, but slowly. The UK historically has used the North Sea as its reserve and there is no reason to believe it could not do so again.

The UK can straightforwardly expand domestic capacity in oil and gas by abolishing the 2019 moratorium on fracking and removing barriers to investment in the North Sea. The former can yield returns in 1–3 years and the latter 3–5. But it depends on how seriously companies take the government’s commitment to their industry after three years of dogmatic Net Zero policy. This has involved hyper-regulation, abuse of the precautionary principle, discriminatory treatment, the moratorium, future product bans and windfall taxes.

There is a deep lack of seriousness in the government’s simultaneous recognition that we need oil and gas for decades to come, while crippling domestic development through policy confusion. There is for example talk of climate tests on future developments (OGV, 2021). This is precisely the sort of tinkering and central-planning delusion that will constrain investment, and unnecessarily so given extensive existing climate policies to signal the longer-term desire to exit this market.

Carbon prices

A serious approach would stop putting Net Zero targets at the heart of policy, preferring instead efforts to align market carbon prices internally and with our industrial peers. This would ensure that the UK low carbon transition is aligned with the pace of global commitments rather than dashing ahead at the expense of domestic consumers, and a deeper, longer cost-of-living crisis rooted in energy.

Free-marketeers generally prefer carbon prices to picking winners and technologies. The UK has many carbon prices, but the most explicit is the UK ETS, a post-Brexit successor to the EU ETS, a cap-and-trade scheme that makes generators, major industry and airlines pay for the cost of burning fossil fuels for energy. Both schemes attempt to align permitted emissions with pathways towards Net Zero and this has encouraged regulators to treat the global reduction in activity from the pandemic as an opportunity to test higher prices.

As a result, the UK ETS price has shot up from when the country exited the EU ETS on 31 December 2020, paying around €25–35 (£21–30), to £75–85 per tonne of CO_2. This adds to the cost of living by artificially inflating the price principally of gas for generation and industrial purposes. The UK price now exceeds the EU price by nearly 10 per cent. This is actively inflaming the affordability crisis in order to accelerate emissions reductions.

This has a simple solution. The UK could increase the availability of allowances to reduce the price and has a legal mechanism to do so immediately – the Cost Containment Mechanism (BEIS, 2022). This allows the ETS regulator to act to correct prices caused by market shocks, when sustained above a trigger level (currently £56.58/tCO_2), a test that has clearly been met.

This would have a downwards impact on domestic and industry prices for energy and improve UK competitiveness. Between March 2021 and March 2022, for example, the OBR revised its expected receipts from emissions trading up from around £1.2 billion a year to £5.5–6 billion a year. These costs are hidden in wholesale prices on bills.

The regulator has so far refused to act, despite price rises caused by a global pandemic and the first major war in Europe for 75 years. This decision appears to have been endorsed by ministers, raising serious questions about what kind of crisis would trigger the mechanism. It seems perverse that the UK has left the EU ETS as a result of Brexit and the freedom to act it entails, only to engage in a deliberate act of self-harm that is sustaining higher prices.

Renewable windfall taxes

The main component of the environmental and social charges on domestic bills today is the Renewables Obligation (RO – Table 6). This consists of the top-up payments added to bills (both business and domestic) and granted to the renewable suppliers for 20-year terms, for assets built between 2002 and 2017. The OBR predicts today's annual costs of £6.5–7 billion will continue to rise for some time, vanishing only in 2037.

Table 6: Environmental levies

	£ billion						
	Outturn	Forecast					
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
Renewables obligation	6.3	6.3	6.8	7.2	7.5	7.7	7.9
Contracts for difference	2.2	0.2	-0.7	1.4	3.2	3.3	4.5
Capacity market[1]	0.0	0.9	0.7	0.9	1.1	1.5	1.5
Green gas levy	0.0	0.0	0.1	0.1	0.2	0.2	0.1
Environmental levies	8.5	7.4	6.9	9.6	11.9	12.6	14.1
Memo: Expenditure on renewable heat incentive (RHI)	0.9	1.0	1.1	1.2	1.2	1.2	1.2

Source: OBR March 2022 Economic & Fiscal Outlook – supplementary tables.

The scheme, designed to incentivise early investment, was so generous that it has contributed to 30–50 per cent annual profit margins for the big energy companies' renewable generation at bill-payers expense for the last decade (Prior, 2022), with reasonable expectations of 100–200 per cent during the current supply shock. This is due to rent-granting inefficiencies in the RO's design. It makes no sense to apply a windfall tax to (already highly taxed) oil and gas companies without applying the same to (heavily subsidised) RO-funded renewable generators benefiting from exactly the same windfall.

The schemes have changed, the Contract for Difference Feed-In-Tariff (CFD) replaced the RO, which closed in March 2017. CFD bids are only subsidised when the wholesale power price is below that of the contracted 'strike price'. However, prices are currently so high that some newly deployed CFD schemes are using a three-year delay clause in contracts to seek market prices to avoid this repayment period (GBNews, 2022).

There are then grounds to either windfall-tax all renewable energy generators for some part of their excess profits (as a result of poor policy design), or bring in primary legislation to permanently amend RO contracts to limit future windfall gains (bringing them into line with CFDs), or simply cancel the subsidy element of the RO altogether, saving £6-8bn a year.

Agreeing a way to recoup the full cost of the RO from generators could save domestic consumers around £100 a year, with the rest of the savings being picked up by business energy users outside any RO exemption schemes. Self-evidently CFD contract design also needs to be revisited if it is possible for developers to avoid downside risk.

Conclusion

The most effective short- to medium-term action the government can take to reduce the cost-of-living crisis from energy is finding new sources of oil and gas, from trade and domestic supply. That is the only sustained way to reduce wholesale prices now and for the next decade or more.

This involves applying diplomatic pressure to OPEC members or finding common ground in other ways. It involves lifting the moratorium on fracking and making serious efforts towards lighter, more proportionate regulation in permitting and planning both onshore and offshore.

A strong signal needs to be sent that carbon prices and markets are the route the government intends to transition away from oil and gas in the longer term, not production targets to arbitrary dates. There is little prospect of serious investment if the UK continues to tinker with new taxes, central planning and layered climate regulations that suppress market signals while duplicating environmental ones.

To provide immediate relief to what may be a period of higher prices for 2–4 years the government can do the following:

- Constrain the artificially high cost of carbon in the UK ETS for the period of the crisis.
- Implement zero-rate VAT across all energy markets, not just domestic, and remove VAT from fuel duty.

– Direct any windfall from the net stable funding ratio (NSFR) to fund welfare relief and a 10p cut in fuel duty.

– Reform the RO, to directly reduce bills.

The impact of these measures would be substantial, but hard to quantify, particularly for businesses with complex bills. But for average domestic consumers they might reduce transport costs by £200–250 a year, and energy bills by around £240, while providing adequate funds for targeted benefits to those most in need. Ending the RO could knock around £100 off an average domestic energy bill of just under £2,000.

Meanwhile the government should resist the urge to treat accelerated mitigation measures, demand reduction and other nanny-state interventions as a quick fix. Largely these and new tax proposals like Carbon Border Adjustment Mechanism (CBAM) will inflate the cost-of-living crisis today, for uncertain benefit tomorrow. And likely a negative one given decarbonisation solutions tomorrow will be cheaper, and more effective. There is no case for a climate sprint but there is every case for the government to focus ruthlessly on affordability.

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