

# Measuring the Poverty Premium

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## Executive Summary:

This Social Market Foundation (SMF) report examines how, methodologically, one could quantify and track the size of the “poverty premium” in the United Kingdom. We define the poverty premium as “the extra cost that households on low incomes incur when purchasing the same essential goods and services as households on higher incomes”. Research suggests such premiums exist in a wide range of areas, including energy, insurance and groceries.

The methodology we propose builds on a range of studies produced in recent years, including work published by the University of Bristol, Save the Children, JRF, Citizens Advice and past SMF analysis.

This report:

- Sets out how a ‘**Headline annual poverty premium**’ metric could be established and measured.
- Recommends that this poverty premium measure could be adopted and adapted by regulators such as the Competition and Markets Authority, Ofgem, Ofcom, Ofwat and the Financial Conduct Authority to give insight into whether market outcomes are fair, and how to address existing premiums.
- Be reported annually by the Department for Business, Energy and Industrial Strategy, to ensure there is proper political and public scrutiny of whether markets are delivering fair outcomes. This should mirror the annual reporting on income poverty and fuel poverty.

The report also argues that other complementary measures could be developed including:

- A “poverty inflation” metric, which examines growth in the cost of living for low-income households, and contrasts this with economy-wide inflation.
- A long-term “cost of poverty” measure, which models the long-term financial implications of persistent poverty.

## Headline Annual Poverty Premium measure

This would be a measure of the average annual value of the poverty premium in the UK. The measure would consider the following types of poverty premium:

- Using higher-cost credit rather than lower cost bank credit.
- Insuring specific items.
- Not paying by cheapest billing method – for example paying bills on receipt rather than by direct debit.
- Premiums related to where people live – such as higher insurance and grocery costs.
- Not being on the best energy tariff.
- Using pre-payment meters.
- Paying to access money such as using ATM machines which charge a fee.
- Paying to receive paper bills.
- Not being on the best telecommunications tariffs.
- Not being able to benefit from bulk discounts (e.g. season tickets) for public transport.

This list would evolve over time as new premiums emerge and as existing premiums disappear.

We envision this measure of the poverty premium being presented in the following ways:

- The headline monetary value of the average annual poverty premium and each of its components, i.e. the £ value multiplied by the proportion of low-income consumers facing the poverty premium in each case.
- The proportional value of this premium as a percentage of disposable incomes for low-income households.
- Estimates of the number of low-income households affected by each type of poverty premium.
- Segmentations of the size of the poverty premium by age, disability status, region, household composition, income group and ethnicity.
- Information on whether each premium is “imposed” or “discretionary”. “Discretionary” poverty premiums refer to premiums where at least some degree of individual choice is present. For example, not being on a good energy tariff is arguably discretionary rather than imposed on lower-income consumers, though the impact of poverty on risk aversion and decision-making means one can also argue that this is an “imposed” premium.

We propose that the baseline comparison for estimating the size of the poverty premium should be a situation where lower-income households face the same poverty premium prevalence rates as higher-income households. For example, with respect to high-cost credit usage, the point of comparison under our definition would be a hypothetical scenario where the proportion of low-income households using higher cost credit is the same as it is for higher-income households.

While this method for calculating the premium differs from past attempts, we conclude that this is the most meaningful and useful measure. Given that some higher-income households face many of the same premiums as low-income households – for example, not switching energy provider and using paper bills – there is a risk of overestimating the size of the poverty premium by comparing to a baseline where the premium is absent across all low-income households. To do so would be to confuse society-wide issues with poverty-specific issues. We believe this would be unhelpful as it might lead policymakers and other stakeholders to target responses only at those in poverty, rather than taking market-wide interventions to address systemic failures.

Due to incomplete data, we are unable to provide a comprehensive assessment of how our methodology would affect the total size of the poverty premium, compared with the £490 per annum premium estimated by the University of Bristol in 2016. We do have data in some areas, and our preferred method suggests a poverty premium of:

- £25 rather than the £233 estimated by the University of Bristol for not switching onto the best energy tariff.
- £52 rather than £55 for using high-cost credit (though this figure is likely to be an overestimate as it relates to data from the last decade and only covers three forms of high-cost credit).

As such, our aggregate measure of the poverty premium would be much lower than that estimated by the University of Bristol. The three points above alone would reduce the aggregate poverty

premium from £490 to £256 per annum. This reduction would be partially offset by the fact that our method includes a larger number of premiums than the University of Bristol method.

As we discuss in this report, putting our methodology into practice would require a new detailed survey of UK households to be undertaken. The University of Bristol study assessed the prevalence of consumer behaviours through a survey of low-income households. Pursuing our method would also require asking questions to households above the poverty line. The survey would provide insights into the extent to which households in the UK face different types of price premiums – for example those that arise from expensive forms of credit and being on poor value energy tariffs. We do not believe it is possible to produce our proposed measure solely using existing datasets, though we suggest some interim indicators that derive from existing sources, which can give a crude indication of whether some premiums are becoming more or less prevalent over time.

#### **Additional measure: The basket of goods effect – “poverty inflation”**

This additional measure would estimate the rate of cost of living inflation faced by low-income households in the UK, which could be contrasted with UK-wide inflation measures such as the Consumer Price Index (CPI). Low-income households may face higher-than-average rates of inflation during times when the cost of essentials such as food and energy are rising at a faster rate than headline inflation. This is a result of these goods and services accounting for a higher proportion of total expenditure among lower-income households. Such a measure could be calculated relatively easily, drawing on data from the Living Costs and Food Survey produced by the Office for National Statistics. The ONS is also carrying out work that aims ‘to reflect UK households’ experience of changing prices and costs’ in its Household Costs Indices (HCIs) measures.<sup>1</sup>

To be clear, we propose that this measure could have specific benefits of its own and would not be incorporated into the ‘poverty premium’ measure.

#### **Additional measure: The longer-term costs of persistent poverty through housing**

This measure would capture the financial impacts of being in poverty which build up over periods longer than a year. Specifically, we believe that there may be substantial long-term costs associated with being unable to own property and benefit from the accumulation of wealth derived from this. Similarly, homeowners may face more stable housing costs than those in the private rental sector. Such “lifecycle” poverty premiums could be estimated using a model-based approach, which makes specific assumptions about factors such as house price growth, interest rates and income growth. As this would be a forward-looking exercise, it would be, by nature, heavily assumption-driven and more speculative than an estimate of the average annual poverty premium in the UK. Nevertheless, it could serve as a useful tool for policymakers to consider some of the longer-term issues associated with poverty, and whether they can lead to additional poverty premiums where lower-income households end up paying more for essentials such as housing. It could be used as an analytical tool to consider, for example, the longer-term implications of having a higher proportion of low-income households living in the private rental sector rather than the social rental or owner-occupied sectors.

## Chapter 1: Introduction

In recent years there has been a growing discussion around the “fairness” of consumer markets in the UK. The Conservative Government in Westminster has committed to publishing a Green Paper on ‘Fair Markets’ and to introducing a cap on energy prices. Although advocating some different responses, the Labour Party is concerned at consumer outcomes in a range of markets.

Vulnerable households, such as households on relatively low incomes, can be particularly susceptible to receiving a bad deal in consumer markets.<sup>2</sup> Indeed, as we discuss in this report, it can be the case that those in poverty pay more for a range of essential goods including food, credit, insurance and energy. Given their low-income status this may have a disproportionately detrimental impact on their lives.

### Purpose of this report

This report seeks to develop a methodology for measuring and tracking the poverty premium in the UK over time. There have been significant efforts made to identify and measure dimensions of income poverty, including the official definitions by the Department for Work and Pensions. However, as the JRF has noted, ‘the important impact of high costs on poverty has too often been ignored’.<sup>3</sup>

Our aim is to develop a measure that can help focus public and political attention on the problem and help social institutions, private businesses, regulators, the media and local and national governments understand and respond to the problem. To achieve this, the measure needs to be robust, useful and credible to a range of stakeholders. By tracking the poverty premium over time, and gaining a firmer understanding of its biggest drivers, government and regulators can gain a deeper knowledge of the policy measures that are most likely to lead to improved outcomes for lower-income households. Similarly, social entrepreneurs and charities focused on alleviating poverty can gain a better understanding of where their efforts are likely to be best focused and the impact of the interventions they are undertaking.

The report unearths and discusses challenges and judgement calls associated with measuring and tracking the poverty premium. While we present what, in our view, is a strong methodology for measuring the poverty premium, we acknowledge that some aspects of it are subject to debate. We have sought to engage in some of this debate with other academics, regulators, policymakers and NGOs through the research process. However, the final judgement remains ours and we accept that others may reach other conclusions.

This report was commissioned by the JRF as part of its commitment, and that of its partners in the Fair by Design project, to help eliminate the poverty premium by 2027.<sup>4</sup>

### Research methods

The research draws on a range of existing studies that have been produced which examine the nature of and size of the poverty premium in the UK. Furthermore, our findings have been informed by discussions held with a range of stakeholders in government, social investors, charities and private enterprise, including individuals from a range of organisations, including: consumer charities, regulators, government officials, social investors, research institutes, energy companies and experts.

Our analysis draws on data collected before the introduction of the price caps for pre-payment energy customers and for consumers in receipt of the Warm Home Discount. These will have reduced the poverty premiums for around 5 million consumers.

### Report structure

The structure of this report is as follows:

- **Chapter 2** sets out to define the poverty premium, and considers the different types of poverty premium that exist in the UK.
- **Chapter 3** discusses some of the challenges involved in measuring, tracking and presenting the poverty premium in the UK.
- **Chapter 4** considers, methodologically, how policymakers could go about measuring the poverty premium.

## Chapter 2: What is the poverty premium?

This chapter sets out to define the “poverty premium”, and provides an overview of the different channels through which the poverty premium may manifest itself.

We draw on a range of existing studies, as well as the Social Market Foundation’s own thinking on the matter, which has been informed by discussions with a range of stakeholders from government, academia, charities and private enterprises.

### What do we mean by the “poverty premium”?

We define the “poverty premium” as:

**“the extra cost that households on low incomes incur when purchasing the same essential goods and services as households on higher incomes”.**<sup>5</sup>

By “low-income” household, we mean households that are in relative poverty. The government’s official definition of poverty refers to households that have below 60% of median equivalised household disposable income (before or after housing costs). There are other robust definitions of income poverty which may take a different threshold (70% instead of 60%). Other measures, such as the Minimum Income Standard, are based on what the public think people need for an acceptable minimum standard of living.

We emphasise the point about “the same” goods and services; the poverty premium is focused on the notion that individuals on lower incomes pay more for identical end products than someone on a higher income. That is, we are adjusting for differences in quantity and quality and comparing on a like-for-like basis – we are interested in the *per unit* cost that individuals face when purchasing goods and services. Likewise, the premium we are interested in does not infer a minimum level of reasonable consumption (as for instance does the definition of Fuel Poverty).

By “essential” we take as our starting point the Minimum Income Standard’s definition of budget categories in which households must spend money in order to reach a ‘minimum socially acceptable standard of living’.<sup>6</sup>

### In what ways does the poverty premium manifest itself? Evidence from existing literature

The notion of a poverty premium is not new. In 1967, *The Poor Pay More*, a book by US sociologist David Caplovitz, was published. It considered, for example, how instalment plans lead to lower-income households paying more for big ticket items such as televisions and kitchen appliances.

More recently, in the UK, studies have been produced which shed light on the scale of the poverty premium. The issue was raised up the UK policy agenda in 2007 with the first estimate of the costs of the poverty premium developed by Save the Children and the Family Welfare Association.<sup>7</sup> Save the Children developed its arguments and analysis further in a publication in 2010.<sup>8</sup> This decade a wider range of charities have looked at the phenomenon at a UK-wide level, within specific parts of the UK such as Scotland, at a local level and in specific markets, such as groceries.<sup>9</sup> Other research has addressed the topic through analysis of the costs of living for those on a low income.<sup>10</sup>

Academics at the University of Bristol produced the most comprehensive study to date.<sup>11</sup>

These studies identify a range of channels through which low-income households face a poverty premium, incurring greater per unit costs than higher-income households:

- **The cost of credit** – this type of poverty premium arises from the fact that those on lower incomes tend to find it more difficult to access credit at favourable rates of interest. Increased use of alternative lending including high cost credit (such as payday loans and “rent to own” products) creates a credit poverty premium.
- **The cost of accessing money** – this type of poverty premium relates to costs associated with accessing money, which may be higher among those on lower incomes. For example, those on lower incomes may be more likely to use ATM machines which charge for cash withdrawal. This may partly be a consequence of where people live and the access they have to free ATM services. In addition, those without access to a bank account may incur charges for cashing in cheques. They may also be more likely to use pawnbrokers as a means of accessing money.
- **Insurance-related premiums** – there are potentially a number of poverty premiums arising in the insurance market:
  - **Related to area of residence**- this type of poverty premium arises from the higher home and motor insurance costs that individuals on lower incomes may incur. As lower-income consumers are more likely to live in deprived areas, and deprived areas on average have higher rates of crime,<sup>12</sup> consumers in these areas have to pay higher insurance premiums.
  - **Cost of insuring specific items** – this poverty premium relates to an increased tendency among individuals on lower incomes to insure specific items such as computers and refrigerators. This can lead to higher per unit insurance costs compared with taking out more comprehensive home contents insurance.
  - **Related to payment method** – a lower-income household may incur an insurance poverty premium as a result of their choice of payment method. For example, paying for insurance in monthly instalments is often more expensive than a single annual payment. Those on lower incomes are more likely to lack the upfront cash to make an annual payment.
- **Energy-related premiums** – this relates to higher per unit costs for electricity and gas faced by some households in poverty. This arises through a number of channels:
  - **Being on a pre-payment meter** – those on lower incomes are more likely to be on pre-payment meters, which typically cost more than other means of paying for gas and electricity. They also typically offer worse deals.
  - **Using paper rather than electronic billing** – energy companies can charge more for paper billing. Given that digital exclusion is more prevalent among those on lower incomes, this can generate an additional poverty premium in energy. Low-income households may also prefer paper billing as a mechanism to enable them to control their budget.

- **Paying by a means other than direct debit** – for example, paying by cheque or BACS payment, which is often more expensive than direct debit. Those on lower incomes may be less likely to pay by direct debit given the risk of a direct debit payment exceeding the level of savings an individual has. Some individuals on low incomes may also be unbanked and unable to pay by direct debit.
- **Not being on the best energy tariff** – with those on lower incomes less likely to switch energy provider,<sup>13</sup> they are more likely to not be on the best energy tariff available. This results in a situation where those on lower incomes can end up paying a higher cost per unit of electricity or gas. Low-income consumers are also likely to pay a premium for their energy if they are on typical products that have standing charges because, on average, they consume less energy than the average UK household.<sup>14</sup>
- **Not having access to cheaper forms of energy.** In some areas, lower-income households are more likely to live in areas which do not have access to the gas network, leaving such households reliant on more expensive forms of heating such as oil and electricity.<sup>15</sup>
- **Telecoms**
  - **Paper billing for telecoms** – as with energy, those on lower incomes may be paying a premium for using paper telecommunications bills.
  - **Not being on the best deal** – Research has shown that low-income consumers were less likely to have switched providers in the last three years than their more affluent counterparts.<sup>16</sup>
  - **Paying upfront rather than on contract:** Research by Citizens Advice in Scotland in 2016 found that 47% of those on a low-income reported using more expensive Pay As You Go (PAYG) payment methods for their mobile compared with 21% of middle and 9% of high-income earners. Some have concluded that this premium no-longer exists as per unit costs for PAYG are now no higher than contract deals due to changes in product design, regulation and technology.<sup>17</sup>
- **Groceries-related premiums** - Literature has discussed the notion of “food deserts” – areas that are not well served by supermarkets and in which many low-income households are resident. Lack of access to supermarkets and a reliance on convenience stores may in turn lead to higher grocery expenses; for example, research by the consumer group *Which?* suggests that the supermarket convenience store price premium can be as high as 7%.<sup>18</sup> Having said that, the literature provides varying views on the existence of a groceries-related poverty premium. While the University of Bristol study includes such a premium in its analysis, research by the Institute for Fiscal Studies (IFS) conducted in 2012 suggested only small variations in food prices across households.<sup>19</sup>

## Existing estimates of the poverty premium

Both the Save the Children study and the University of Bristol have sought to quantify the annual size of the poverty premium in the UK. The Save the Children study, published in 2010, estimated an annual poverty premium of £1,289. The University of Bristol study, published in 2016, estimates an average annual poverty premium per low-income household of £490.

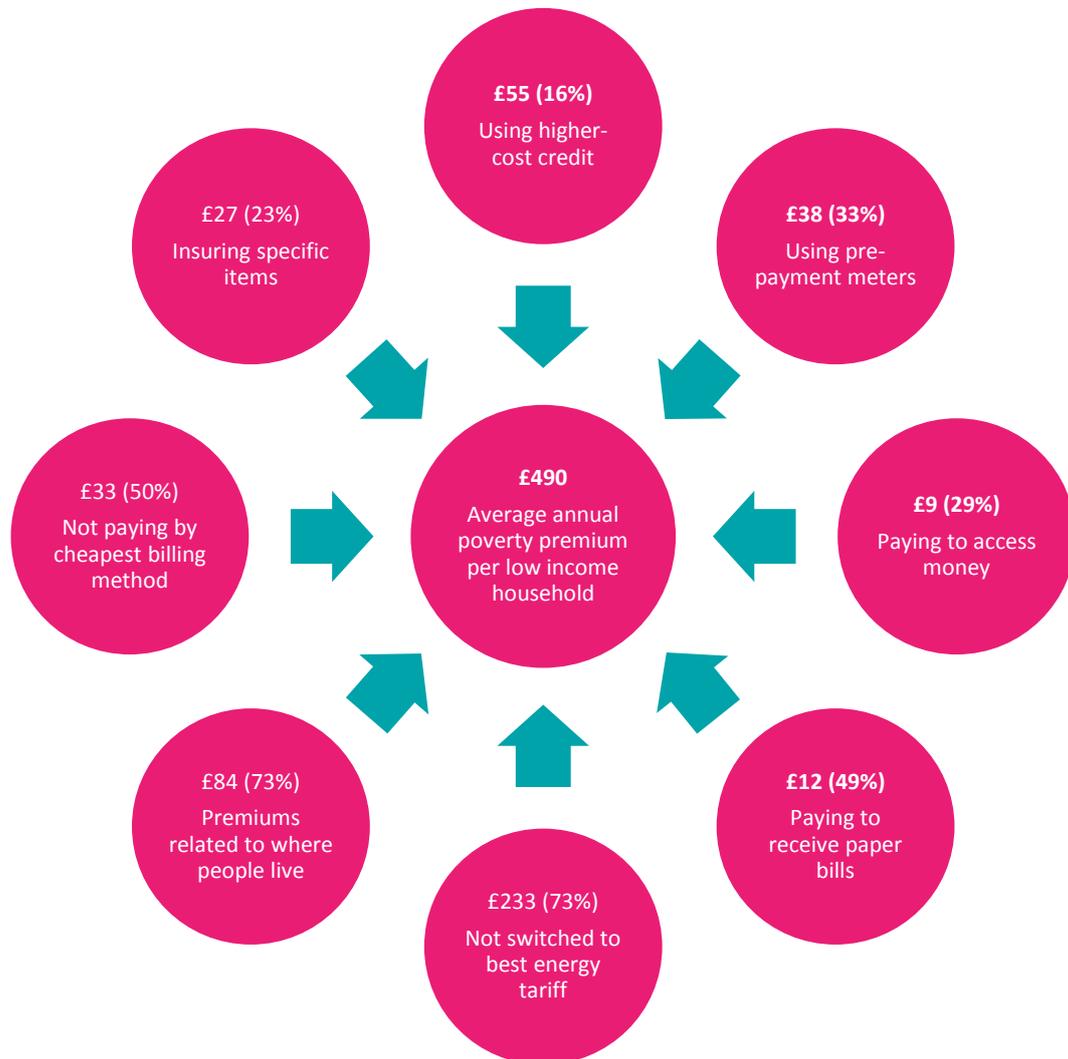
Of these two reports, the University of Bristol study is the more statistically robust. Unlike the Save the Children study, the University of Bristol study estimated the *prevalence* of different forms of poverty premium among low-income households. This allowed the University of Bristol to present an “average” poverty premium. In contrast, the Save the Children study presents an illustrative example of the total poverty premium a household could face, assuming it encounters each of the poverty premiums identified in their report. As such, the Save the Children’s estimate is a ‘worst case scenario’.

Figure 1 below provides a breakdown of the types of poverty premium estimated in the University of Bristol study. The figures therefore provide an estimate of the average premium per low-income household. The premiums that relate to ‘where people live’ refer to the costs of insurance, lack of access to cheaper groceries and free ATMs.

Of the £490 annual poverty premium estimated by the University of Bristol, over half comes from premiums associated with the energy market - £233 from households not being on the best energy tariff and £38 from using pre-payment meters; the energy market also contributes to additional costs in the form of paper billing and not paying by the cheapest billing method.<sup>20</sup> The smallest poverty premiums relate to paying to access money (£9) and paying to receive paper bills (£12).

As well as significant divergence in the costs of different poverty premium, there are very significant variations in the prevalence of poverty premiums; while about three quarters of low-income households were found to have not switched to the best energy tariff, under a quarter reported using high-cost credit. High-cost credit is an example of a poverty premium that impacts a minority of low-income households, but has a substantial financial impact on the households affected.

**Figure 1: Estimated average annual poverty premium according to the University of Bristol methodology. Percentages in brackets relate to the proportion of low-income households impacted by the particular type of poverty premium**



Source: Davies, Finney and Hartfree, University of Bristol (2016)

### Other premiums that should be considered

The University of Bristol study provides a robust and well-evidenced view on many of the poverty premiums that we have encountered through our research. However, we believe that there are other aspects of consumer spending where poverty premiums may emerge. We believe they merit further exploration to assess the extent to which they ought to be considered in a measure of the poverty premium.

### Bulk discounts and a public transport poverty premium

One potential type of poverty premium relates to individuals' ability to benefit from bulk discounts. It is likely that many individuals on low incomes are unable to benefit from the lower costs per unit of, for example, bulk grocery purchases because they lack the upfront capital to make such a purchase.

Evidence shows that low-income consumers incur a penalty for paying their insurance costs in monthly instalments because they cannot afford the one-off annual payments.<sup>21</sup>

A specific type of bulk purchase poverty premium could emerge with respect to public transport, where annual and monthly season tickets are often significantly cheaper than weekly or daily tickets. The relatively high up-front costs associated with annual and monthly season tickets may leave these beyond the means of those on low incomes that lack the upfront cash to purchase them.

To give an example, at the time of writing, a worker living in Zone 4 in London and commuting to a job in the city centre (Zone 1) would currently pay £1,960 for an annual travel card. In contrast, buying 12 monthly season tickets costs £2,258 - £298 more. Purchasing 48 weekly season tickets (assuming four weeks of holidays without travelling in London) would cost £2,352, a poverty premium of £392 compared with an annual season ticket.<sup>22</sup>

Such transport-related premiums may be becoming increasingly relevant, particularly in urban areas such as London where housing pressures are leading to longer commutes. Changes to social security policy, including the introduction of the Benefit Cap and changes to housing benefit policy, may also lead to more people living further away from the centre of cities like London.

There is some evidence that, rather than facing more expensive commutes, some individuals on lower incomes are opting for cheaper but lengthier (in terms of time or distance) journeys.<sup>23</sup> For example, individuals may be choosing to travel by bus rather than train due to lower costs. This may mitigate the extent to which a transport poverty premium exists, though arguably one should consider “time costs” that individuals face when opting for cheaper but lengthier commutes. When the value of time lost is factored in, a poverty premium may still be evident.

The prevalence and scale of a transport poverty premium is highly uncertain at this point, given the available data. It is likely to be a largely urban issue, and possibly a very London-centric issue. Nevertheless, we believe it is an area worthy of further examination.

## **Telecommunications**

While the University of Bristol study identifies a significant poverty premium relating to energy market switching, it does not consider there to be a premium relating to switching in telecoms.<sup>24</sup>

A telecommunications poverty premium exists if those on lower incomes are more likely to be on a “bad” package than individuals on higher incomes. Evidence suggests that consumers who do not switch can incur a penalty in telecoms: it costs an average of £92 more if a consumer stays with the same provider when his or her mobile contract ends; and, £113 more if someone sticks with a broadband provider after the initial contract has ended.<sup>25</sup> Ofcom research suggests that there is low awareness of affordable telecommunication deals among low-income users. Figures released in 2014 showed that just 26% of consumers on a low income knew about the existence of social landline tariffs offered by BT and KCOM.<sup>26</sup> Research by Citizens Advice in Scotland found that low-income consumers were less likely than more affluent consumers to have switched their telecoms providers over a three-year period. Past SMF research has shown that switching rates in telecoms and energy tend to be lower among lower-income groups than among higher-income groups.<sup>27</sup> Research by Citizens Advice found that those on lower incomes were much more likely to have stayed with their broadband

supplier and be paying a 'loyalty premium' in broadband than higher-income consumers.<sup>28</sup> A recent report from Citizen's advice on the 'Loyalty Penalty' found that low-income consumers were 97% more likely to have the same broadband contract for four years compared with higher-income consumers.<sup>29</sup> We note other research, however, that suggests that in many aspects of telecoms, consumers from lower socio-economic backgrounds are as engaged as those from higher socio-economic groups.<sup>30</sup>

Furthermore, an argument can be made that lower-income households face a higher cost per unit of consumption for telecommunications products because of the structure of these products. An example of this might be with respect to home internet connections, where the pay-as-you-go market has largely disappeared. Low-usage internet users thus potentially face higher per-unit costs (as they do when they face standing charges on their energy bills).

As with energy, telecommunications expenditure is greater as a share of disposable income for lower-income households than for higher earners. This is discussed in greater detail below. Given the relative importance of telecommunications in the "basket of goods" purchased by lower-income households, there is a case for further investigating the existence of poverty premiums in the telecommunications sector.

### **Longer-term, housing-related, poverty premiums**

There may also be longer-term poverty premiums that only become apparent over a period of time longer than a year, suggesting that there may be a case for examining the costs of poverty over the course of an individuals' life. We have identified housing as one particular area where this may materialise.

For example, over the longer-term, individuals on lower incomes may face a substantial housing poverty premium, particularly if they are in the private rented sector and unable to build up the savings required for a mortgage deposit. While mortgage payments can often hold steady or even decrease over time (as individuals build up equity in a property), rent contracts are often tied to inflation and increase each year. Therefore, the person pays more for the same quantum of housing.

This can potentially lead to a substantial divergence in housing costs over an extended period of time. To give an illustrative example, assuming steady interest rates, an individual with a £600 per month mortgage would spend £180,000 on mortgage payments over a 25-year period. Over the same time, if an individual is renting a property at an initial rate of £600 per month, with rents increasing by an inflation rate of 2% each year, rent costs would amount to £230,618 over a 25-year period—over £50,000 higher.

While a homeowner's housing costs fall dramatically once a mortgage is paid off, rents continue to impose a financial pressure into older age for those that are unable to buy a home.

This type of housing poverty premium is likely to have become more pertinent in recent years, with a higher proportion of individuals in poverty living in the private rented sector.

While the time period over which this type of poverty premium becomes apparent is greater than a year, it is not conceptually significantly different from the other types of poverty premium discussed

earlier. Ultimately, it is measuring the extent to which individuals on lower incomes may pay more for an essential good (housing) compared with a higher-income individual.

One distinction, however, is that longer-term poverty premiums may only be relevant to individuals in *persistent* poverty. This is important given that a significant proportion of individuals are in poverty temporarily. ONS research shows that while 16.8% of the UK population was in poverty in 2014, just 6.5% was in persistent poverty.<sup>31</sup> Persistent poverty is defined as experiencing relatively low income in the year of measurement, as well as at least two out of the three preceding years.

### **“Basket of goods” effects**

Another consideration with respect to differences in the cost of living between higher and lower-income households is what can be called “basket of goods” effects. Rather than looking at the price a lower income household is paying for a specific good or service, it considers the “per unit” price of their representative shopping basket and how this compares with higher-income households. Further, the interest is in the *growth* in the cost of living rather than the monetary value.

Particularly noteworthy here is the potential for lower-income households to be subject to a higher rate of cost of living inflation than average – for example compared with headline inflation measures such as the Consumer Price Index (CPI) and Retail Price Index (RPI).

Given that a higher proportion of the expenditure of lower-income households is accounted for by essentials such as utilities and food, they may experience a higher-than-average rate of inflation when the price of these items is growing strongly.

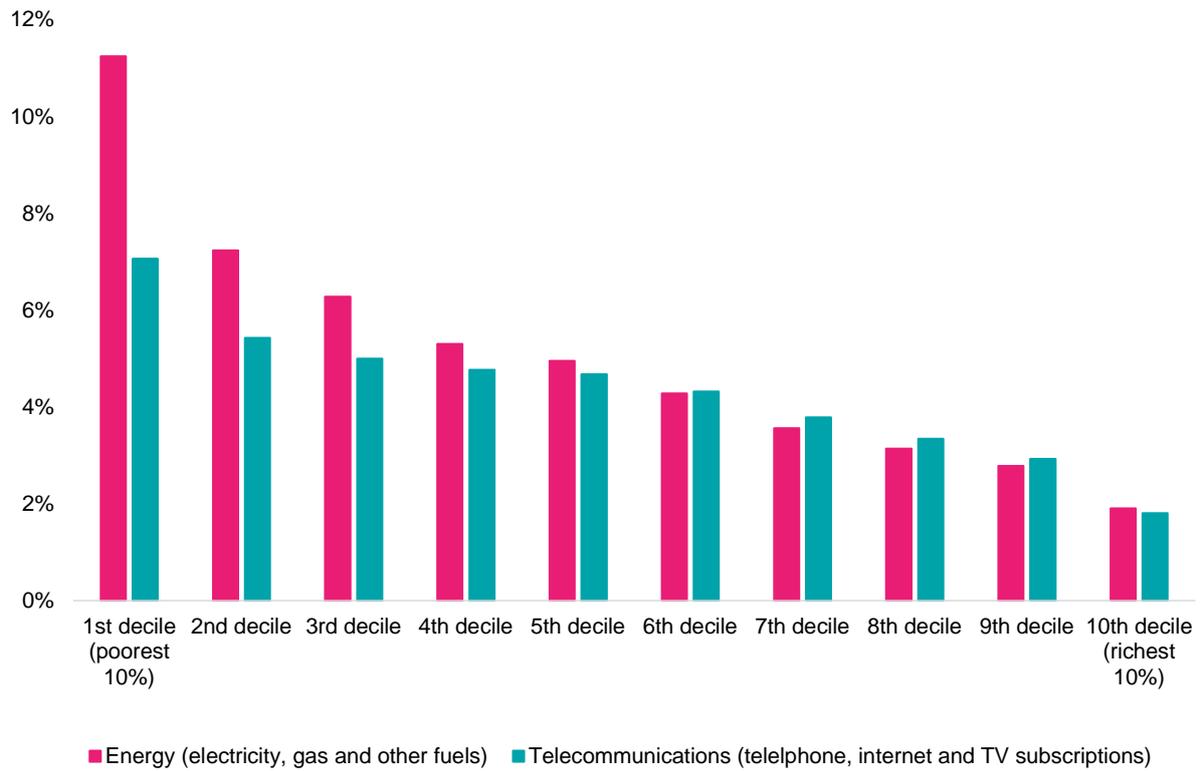
Such basket of goods effects may be of use to policymakers and social investors looking at ways of improving the living standards of lower-income households. For example, a poverty-specific inflation measure is highly relevant to the debate around welfare policy in the UK – if inflation for those on lower incomes is higher than the national average, then uprating benefits by an inflation measure such as the CPI is unlikely to conserve or increase living standards for lower-income households. As such, there may be a case for uprating benefits by a measure of inflation which is more representative of the changes in the cost of living faced by lower-income households.

While this is conceptually different to the poverty premium and we do not propose seeking to include it in a central measure of the poverty premium, it may help focus attention on the costs of living for low-income households. We are aware that the JRF is seeking to develop a measure such as this to include in its monitoring of poverty. The ONS is also carrying out work that aims ‘to reflect UK households’ experience of changing prices and costs’ in its Household Costs Indices (HCIs) measures.<sup>32</sup>

### **The relative impact of the premiums**

It is also important to recognise that low-income households spend a higher proportion of their incomes on essential goods and services than more affluent households. The consequence is that the poverty premium can have a disproportionate impact on the budgets of low-income households.

**Figure 2 Telecommunications and energy expenditure as a proportion of disposable income, by equivalised income decile**



Source: ONS, SMF analysis

Figure 2 shows how this applies to energy and to telecommunications. For instance, telephony, internet subscription fees and TV subscriptions are estimated to account for about 7% of total disposable income of UK households in the lowest income decile, over triple the 2% seen for households in the richest 10% of households. Spending on energy services as a proportion of income is also much higher among low-income households, with the poorest decile spending five times the amount as the richest decile as a proportion of their income.

## Chapter 3: Challenges and judgment calls

The previous chapter of this report examined some of the existing literature on the poverty premium, and discussed the different channels through which the poverty premium does and may impact households in the UK. This chapter considers some of the practical challenges and judgment calls that need to be made in defining and measuring the poverty premium and creating a measure that could be updated on a regular basis. Ultimately, data limitations impose constraints on methodology and the ability to examine every type of poverty premium in detail. Therefore, trade-offs must be made.

### Imposed vs discretionary premiums

A first consideration is the extent to which poverty premiums are “discretionary” or “imposed”.<sup>33</sup> Arguably, some of the types of poverty premium discussed in the previous chapter of this report are discretionary and escapable for individuals experiencing them. For example, many (though not all) consumers who receive paper bills could opt for cheaper electronic billing, and those that are not on good value energy tariffs could switch to alternative tariffs. In contrast, poverty premiums related to higher insurance costs may be more “imposed” – being on a low income limits the ability of some households to relocate to areas where they would face lower insurance costs for their homes and cars. The table below provides an assessment of the extent to which different types of poverty premium can be considered discretionary rather than imposed.

**Table 1 "Imposed" and "discretionary" poverty premiums**

Type of poverty premium	Largely discretionary or imposed?
Higher-cost credit	Imposed
Insuring specific items	Discretionary
Not paying by cheapest billing method	Discretionary
Premiums related to where people live	Imposed
Not being on the best energy tariff	Discretionary
Using pre-payment meters	Imposed (though not always)
Paying to access money	Discretionary
Paying to receive paper bills	Discretionary
Not being on the best telecommunications tariffs	Discretionary
Not being able to benefit from bulk discounts (season tickets) for public transport	Imposed (though not always)

Source: SMF analysis

A narrow view would entail excluding more “discretionary” factors in an aggregate measure of the poverty premium, as ultimately a reflection of individuals’ choices. Indeed, some discretionary decisions may reflect non-price factors. For example, some low-income households may be on a particular energy tariff for reasons such as better customer service.<sup>34</sup>

The inclusion or exclusion of discretionary factors is likely to have substantial implications for the size of the poverty aggregate premium in the UK. For example, we note that about half of the average annual poverty premium estimated by the University of Bristol arises from lower-income households not being on the best energy tariff.

The counterargument to excluding discretionary premiums is that factors that look “discretionary” at first blush may in fact be “imposed”. Existing evidence suggests that consumers may not switch for a wide range of factors. Specifically, some of the literature<sup>35</sup> suggests that decision-making is often constrained among individuals in poverty, reflecting the financial and social stresses faced by individuals on lower incomes. Furthermore, there is evidence that shows that individuals in poverty are more risk averse than individuals on a higher income, given the potentially greater financial consequences associated with making a decision that turns out to be wrong.<sup>36</sup> Risk aversion may explain why, for example, those in poverty are less likely to switch energy provider.

Given these counterarguments, there is a compelling case for looking beyond “conventional” definitions of what constitutes an imposed versus a discretionary circumstance, accounting for the impacts of poverty on the decision-making process.

### Breadth and depth of policy premiums

A second issue is the “breadth” of different types of poverty premium. While some poverty premiums impact a majority of those in poverty, others impact only a small minority. For example, the University of Bristol study suggested that just 16% of low-income households use high-cost credit such as payday loans. In contrast, close to three quarters are estimated to be on a poor value energy tariff.

A very narrow interpretation could hold that a measure of the poverty premium should only be interested in factors that affect a majority of individuals in poverty.

A related issue is the extent to which some factors are genuinely poverty-focused premiums. For instance, issues related to low switching rates for energy are pervasive across much of society.<sup>37</sup> In this sense, not being on the best energy tariff is arguably more of a society-wide phenomenon than a poverty-specific one. The CMA inquiry into the energy market estimated that 70% of all consumers of the Big Six energy suppliers were on the Standard Variable Tariff.<sup>38</sup>

As the table below shows, there are significant variations in the proportion of low-income individuals affected by specific premiums, as well as in the extent to which a premium is poverty-focused or impacting society more widely. The judgements in Table 2 are drawn from SMF analysis of the existing literature.

Our view is that the poverty premium should include factors which are *more prominent* among those on lower incomes (but not necessarily exclusive to those on lower incomes). For example, while low energy switching rates are pervasive across the country, evidence suggests that those on lower

incomes are more likely to not be on the best energy tariff than those on higher incomes.<sup>39</sup> As such, there is a case for considering this a “poverty premium”.

**Table 2 Breadth and depth of different poverty premiums**

Type of poverty premium	Poverty-focused premium or broader?	Proportion of people in poverty impacted – % figures taken from University of Bristol study
Higher-cost credit	Broader	16%
Insuring specific items	Broader	23%
Not paying by cheapest billing method	Potentially largely poverty-focused	50%
Premiums related to where people live	Poverty-focused	73%
Not being on the best energy tariff	Broader	73%
Using pre-payment meters	Poverty-focused	30% <sup>40</sup>
Paying to access money	Potentially largely poverty-focused	29%
Paying to receive paper bills	Broader	49%
Not being on the best telecommunications tariffs	Broader	Not known (not in the Bristol study)
Not being able to benefit from bulk discounts (season tickets) for public transport	Broader but likely to especially affect those on lower incomes	Not known (not in the Bristol study)

Source: SMF analysis

### Old and new poverty premiums – the resilience of a measure

Some types of poverty premium are likely to come and go with time, reflecting developments in markets and changing regulation, technology, consumer behaviour and market participation.

For example, there is some evidence to suggest that the mobile telephony poverty premium has diminished over time as pay-as-you go contracts have become more price competitive.<sup>41</sup> Likewise, some companies are starting to phase-out Standard Variable Tariffs – but we do not yet know what products will replace them.

The introduction of energy price caps for pre-payment meter consumers and for consumers who are in receipt of the Warm Home Discount reduce the poverty premium experienced by these consumers (though it is not yet possible to determine the overall impact).

Technological developments and changes in consumer behaviour may, conversely, introduce new forms of poverty premium that had not been evident previously. This could emerge for instance in financial services, where Open Banking is intended to enable the personalisation of products, but this may only benefit the most engaged and affluent consumers. This prospect presents some

methodological challenges. Ultimately, it will require ongoing monitoring and awareness of technological and market developments that could give rise to new premiums over time. A starting point would be to ensure that there is a tight definition of a poverty premium which can allow future researchers to identify new forms to be included if and when they arise over time.

### Issues of cost and risk

A major issue that can be contested, and which we discussed with stakeholders, is what constitutes “the same” goods and services when trying to establish variations in per-unit costs between households. In particular, the extent to which one accounts for variations in “risk” and “cost” are likely to have significant implications for the size of the poverty premium.

For example, an individual living in an affluent area may pay less to insure the same car as an individual living in a less affluent area, all other things being equal. One could argue that the individual in the less affluent area faces a poverty premium in insurance - paying more for the same product (car insurance) than the individual living in the more affluent area.

However, one could also argue that the insurance products are not in fact “the same” – less affluent areas may be inherently riskier from the perspective of an insurer if, for example, crime rates are higher. Therefore, the risk-adjusted price could be the same.

Similar arguments can be made about some other poverty premiums. Those on pre-payment energy meters (PPMs) pay more per unit of electricity and gas than those not on a PPM. Individuals on PPMs are more likely to be on a lower income than individuals that are not on PPMs. Historically, the higher price faced by the PPM consumer at least partly reflects the fact that the cost of servicing PPMs is higher than the cost of servicing individuals who, for example, pay their energy by direct debit. Such costs include installing the PPM, servicing the PPM and collecting money. In this sense, one could argue that electricity and gas from a PPM is not the same as electricity and gas derived from other means of payment.

High-cost credit is a further example. Borrowers who buy loans from alternative lenders such as payday lenders and home credit providers pay a premium – in part at least – because they are on average more expensive to serve as the risk of non-repayment is higher.

Given this, there is a fundamental question of whether the poverty premium should reflect a “residual” higher price that individuals on lower incomes incur for goods and services, even after accounting for differences in the risk and cost-based pricing. For example, this type of residual poverty premium might arise as a result of discriminatory pricing, where an organisation believes that it can “get away” with charging a higher price to lower-income households. Such discriminatory pricing could arise in markets where lower-income consumers are less likely than higher-income consumers to switch provider. If suppliers can identify groups of consumers that are less likely to switch they can raise prices for these consumers without seeing a loss of custom.

While there is logic in the notion of a “residual” poverty premium, we believe there is a compelling case for not accounting for variations in risk and cost. Under our preferred definition, insuring an identical car in an affluent and non-affluent area is thus seen as a like-for-like comparison. Similarly, we view energy purchased via a pre-payment meter to be the same as energy paid for by other means.

Two rationales explain our conclusion. The first rationale is a methodological one. Considerations of risk and costs would make a measure of the poverty premium very difficult – or impossible – to achieve in practice. In particular, it would require a vast amount of data from businesses about their cost structure and their approach to calculating risk. It would also require very sophisticated judgements on the functioning of the market that would be akin to frequent full market inquiries.

The second rationale for our approach to “the same” goods and services is the fact that considerations of risk and cost are potentially of great use to policymakers and social investors interested in alleviating price differences between lower and higher-income households. For example, they raise questions around how risk-rating practices could be improved to reduce insurance and lending costs for lower income individuals. Similarly, they raise questions around how technological innovation can reduce the costs of servicing pre-payment meters, narrowing the price differential with other forms of energy tariff. They also raise questions about which risks should be born privately or by the state. For example, is it right that private individuals should bear higher insurance costs because the state is unable to fulfil its security responsibilities and when the risks are beyond the control of the individual?

### Issues of counterfactuals

To calculate the size of the poverty premium, one needs to consider a relevant counterfactual in which low-income households face a lower per-unit cost than they currently face. In the purest sense, given the definition we presented in the previous chapter, this counterfactual should be the per-unit cost faced by individuals that are not on low incomes. That is, under this counterfactual, the poverty premium would be zero if estimated average per-unit costs for goods and services were the same for low and higher-income individuals.

We note that the Save the Children and University of Bristol estimates of the poverty premium adopt a different approach. The counterfactual is essentially a best-case scenario where all low-income households have switched to better energy tariffs, adopted electronic billing and eliminated higher insurance costs. Such an approach gives a much higher monetary value for the poverty premium faced by households, compared with the counterfactual described above.

This is particularly likely to be the case with poverty premiums related to not being on the best energy tariff – an issue we know to be pervasive among higher-income consumers as well as low-income ones. Under the first counterfactual, the relevant baseline comparison for this particular poverty premium would be a hypothetical world in which the same proportion of low-income and higher-income consumers are not on the best energy tariffs – i.e. a world in which a modest proportion of low-income consumers switch energy provider. Under the second counterfactual, the baseline comparison is a hypothetical world in which all low-income consumers switch to a better energy tariff. This counterfactual actually implies a transition from a world of poverty premiums to a world of “affluence premiums”, where higher-income households would face greater per-unit costs than lower-income households, assuming that a proportion of them continue to stick with expensive SVTs.

In our view, from a definitional perspective, there is a persuasive case for considering a different counterfactual scenario to the University of Bristol and Save the Children studies. This would define the counterfactual as the difference between the average cost to a low-income consumer and the average cost to a higher-income consumer.

## The usefulness of an average poverty premium

Given significant variations in the prevalence of different types of poverty premium, there are questions over the insightfulness of an average measure of the poverty premium, as for example presented in Figure 1 of this report. Given the fact that some types of poverty premium only apply to a small proportion of households, an average poverty premium figure may ultimately have little relation to a “typical” household in poverty. This is particularly likely to be the case if different types of poverty premium are clustered around particular segments of those in poverty – such as lone parents or the elderly.

Given this, it will be important for a measure of the poverty premium to allow individuals to segment the findings into subgroups. In particular, we propose it would be useful to examine how the poverty premium varies by:

- Age
- Disability status
- Region
- Urban / rural
- Household composition (e.g. number of children and adults in the house)
- Gender
- Ethnicity
- Income group – this would use the official definition of 60% of median equivalised household income as the starting point, but potentially enable assessment of households in severe poverty.

The desirability of being able to segment results has implications for the size of the survey needed to measure and track the poverty premium. For statistically-robust analysis of the size of the poverty premium for specific sub-groups, one would need to ensure sufficiently large survey sample sizes for the sub-groups.

## Chapter 4: Towards a working measure of the poverty premium

The previous chapters of this report explored the definition of the poverty premium, the factors which comprise the premium and some of the methodological challenges related to creating a trackable measure of the poverty premium.

This chapter of the report sets out a framework that could be used for measuring and tracking the poverty premium in the UK on an ongoing basis, given the challenges and judgment calls detailed in the previous chapter.

Overall, we believe there is a case for the development of three poverty premium-related measures:

1. A headline annual poverty premium metric, in a similar vein to that estimated by the University of Bristol.
2. A “poverty inflation” metric, which examines growth in the cost of living for low-income households, and contrasts this with economy-wide inflation.
3. A long-term “cost of poverty” measure, which models the long-term financial implications of persistent poverty, as discussed in chapter 2.

Ultimately, we believe that each of these measures would be useful to policymakers, social investors and the media, given that they explore different aspects of how poverty impacts household finances, each of which may require a different set of policy solutions.

Below we set out an approach for developing each of these measures.

### Headline Annual Poverty Premium measure

#### The measure

This would be a measure of the average annual value of the poverty premium in the UK, in a similar vein to the University of Bristol study.

We propose that such a measure builds on the types of poverty premiums identified by the University of Bristol study. In addition, the measure should seek to include transport and telecommunications-related poverty premiums. We propose that these latter two premiums should be included as experimental measures subject to further testing in initial surveys.

In total, the measure would thus consider the following types poverty premium:

- Using higher-cost credit
- Insuring specific items
- Not paying by cheapest billing method
- Premiums related to where people live (higher insurance and grocery costs)
- Not being on the best energy tariff
- Using pre-payment meters
- Paying to access money
- Paying to receive paper bills
- Not being on the best telecommunications tariffs

- Not being able to benefit from bulk discounts (e.g. season tickets) for public transport

We envision this measure of the poverty premium being presented in the following ways:

- The headline monetary value of the average annual poverty premium and each of its components, i.e. the £ value multiplied by the proportion of low-income consumers facing the poverty premium in each case.
- Estimates of the number of low-income households affected by each type of poverty premium.
- Segmentations of the size of the poverty premium by:
  - Age
  - Disability status
  - Region
  - Household composition (e.g. number of children and adults in the house)
  - Income group
  - Gender
  - Ethnicity
- “Imposed” versus “discretionary” poverty premiums.
- Distribution of the premiums across low-income households.

#### *Imposed versus discretionary premiums*

This issue of discretionary versus imposed poverty premiums has arisen multiple times in roundtable discussions with policymakers, charities and businesses as part of this research, highlighting a lack of consensus on this matter. We predict that the inclusion of an imposed and discretionary segmentation of the poverty premium, based on the distinctions made in the previous chapter, could help build support for the measure, given debate around the extent to which more discretionary measures should be included. Those that are less convinced about the validity of “discretionary” poverty premiums could refer to a more limited measure which just looks at “imposed” poverty premiums.

#### *Calculating the poverty premium – the relevant counterfactual*

In contrast to existing studies, we believe that the baseline comparison for estimating the size of the poverty premium should be a situation where lower-income households face the same poverty premium prevalence rates as higher-income households. For example, with respect to high-cost credit usage, the point of comparison under our definition would be a hypothetical scenario where the proportion of low-income households using higher cost credit is the same as it is for higher-income households.

In contrast, studies such as the University of Bristol research compare to a situation where all low-income households stop using high-cost credit. Our proposed poverty premium implies an alignment in per-unit costs between low and high-income households, while other studies implicitly assume a counterfactual where lower-income households actually face lower per-unit costs than more affluent households.

The table below gives an illustrative example of the implications of these different approaches to calculating the poverty premium, considering the premium that arises from individuals being on poor

value variable energy tariffs rather than better value fixed tariffs. In this example, the University of Bristol-type counterfactual gives a poverty premium of £225. Under our counterfactual, which sees the proportion of low-income consumers on variable tariffs fall into line with the proportion for high-income consumers (rather than falling to zero), the poverty premium stands at £75.

In essence, our measure accounts for how “out of kilter” the behaviours and experiences of low-income households are compared with higher-income households. In our illustrative example in Table 3, the poverty premium increases the wider the gap in experience between low-income consumers and higher-income consumers – essentially the difference between rows “d” and “c” in the table. For an issue that is largely the preserve of low-income households, such as pre-payment meters, we would expect little difference in the scale of the poverty premium compared with a University of Bristol-type approach. For issues that affect society more widely, such as those related to energy switching, we would expect significant differences in the size of the estimated poverty premium.

In summary, we feel that our definition captures the concept of the ‘poverty premium’ and whether the poor pay more for the same product or service.

**Table 3 Illustrative example of estimated poverty premium under different counterfactual scenarios (figures given are for illustrative purposes only)**

a	Average annual variable dual fuel tariff	£1,200
b	Average annual fixed dual fuel tariff	£900
c	Proportion of low-income consumers on a variable tariff	75%
d	Proportion of high-income consumers on a variable tariff	50%
$c * (a-b)$	Poverty premium – approach used in other studies	£225
$(c-d) * (a-b)$	Poverty premium – SMF proposed counterfactual	£75

Source: SMF analysis

As discussed in the previous chapter of the report, we believe that our proposed counterfactual would provide a more “definitionally correct” and socially useful measure of the poverty premium.

We note the argument that the behaviour of low-income households could be interpreted differently from that of more affluent households. This thesis rests on the fact that low-income households may, for instance, face barriers to switching energy supplier whilst higher-income households do not. This is likely to be true in some cases. However, the evidence suggests that many barriers and behavioural factors affect a wide range of consumers. Furthermore, we should note that only a minority of both high- and low-income groups switch, suggesting that the groups have more in common than they do that differentiates them.

Given that some higher-income households face many of the same premiums as low-income households – not switching energy provider and using paper bills – there is a risk of overestimating the size of the poverty premium by comparing to a baseline where the premium is removed across all

low-income households. There is thus a risk of confusing society-wide issues with poverty-specific issues. This would be unhelpful as it might lead policymakers and other stakeholders to target responses only at those in poverty, rather than taking market-wide interventions to address systemic failures.

**Table 4 Breadth and depth of different poverty premiums**

Type of poverty premium	Average cost <sup>42</sup>	Proportion of people in poverty impacted (below 70% of median incomes) <sup>43</sup>	Proportion of high-income consumers affected	Bristol method weighted cost	SMF method weighted cost
Higher-cost credit	£344 <sup>44</sup>	16%	1% <sup>45</sup>	£55	£52
Insuring specific items	£117	23%	Unknown	£27	n/a
Not paying by cheapest billing method	£66	50%	Unknown	£33	n/a
Premiums related to where people live	£115	73%	Unknown	£84	n/a
Not being on the best energy tariff	£317	73%	65% <sup>46</sup>	£233	£25
Using pre-payment meters	£70 <sup>47</sup>	30% <sup>48</sup>	13% <sup>49</sup>	£20/£21	£12
Not being able to get the best deals because on a pre-payment meter in energy	£227	8%	Unknown	£18	Unknown
Paying to access money	£31	29%	Unknown	£9	n/a
Paying to receive paper bills	£25	49%	Unknown	£12	n/a
Not being on the best telecommunications tariffs	Unknown	Not known (not in the Bristol study)	Unknown	n/a	n/a
Not being able to benefit from bulk discounts (season tickets) for public transport	Unknown	Not known (not in the Bristol study)	Unknown	n/a	n/a

We are unable to provide a comprehensive assessment of how our methodology would affect the total size of the poverty premium. This is because in many areas we cannot find data on the prevalence of the specific behaviour in the general population which is comparable to the data we have on the behaviour of low-income consumers.

We do have data in some areas, and our preferred method would reveal a poverty premium of:

- £25 rather than £233 for not switching onto the best energy tariff.

- £52 rather than £55 for using high-cost credit (this figure is likely to be an overestimate as it dates from the last decade and only covers three forms of high-cost credit).

We propose that this figure should be presented in absolute £ terms. However, it is also important to draw attention to the disproportionate impact that the premium can have on those on low incomes and to illustrate the real-world implications of the penalty. We therefore suggest that the premium should also be presented as:

- A proportion of income. A simple method would divide the poverty premium sum by the average incomes of households below the poverty line.
- A proportion of the spending on the essential goods and services included in the poverty premium.

We also note that low-income households may consume a lower proportion of goods and services on average than more affluent households and therefore may be disadvantaged by the charging structure of some products. A good example is standing charges in energy. However, given it is very hard to gain information on the volume of goods and services consumed, we suggest that this remain a long-term aim. It could, for instance, be facilitated by new data initiatives.

## **Methodology**

### *Data requirements*

A key challenge with measuring the annual poverty premium is the lack of readily available official data on the prevalence and size of poverty premiums.

While there are a range of Office for National Statistics (ONS) datasets tracking trends in household income and expenditure, such as the Living Costs and Food Survey, data on the *quantity* and *quality* of goods and services consumed by households are lacking. Without data on quantity and quality, it is not possible to calculate the *per unit* cost that a household faces when purchasing a good or service – something which is crucial for establishing the existence of a poverty premium. Ultimately, we are interested in whether per unit costs are greater for lower-income households than higher-income ones.

While UK regulators produce many reports examining consumer outcomes, these are not collated in a consistent way. Income categorisations vary, for example, as do survey methodologies and definitions of what constitutes a “vulnerable” or “low-income” consumer. There is often good logic behind this divergence – differences in markets will mean that regulators end up monitoring different aspects of consumer behaviour and outcomes and being worried about different consumer segments. Furthermore, regulators often gather data for one-off market assessments, limiting the ability to use such data as an input into a regular measure of the poverty premium.

**Table 5 Overview of regular official data sources**

Data source	Contains data on...	Data can be segmented by household income?	Data on expenditure?	Data on usage /consumption volumes?	Data on prices?	Frequency of publication
ONS Living Costs and Food Survey	All categories of consumer spending	Y	Y	N	N	Annual
ONS Consumer Trends dataset	All categories of consumer spending	N (only aggregate economy-wide data)	Y	Y	N	Quarterly
FCA Financial Lives Survey	Consumer credit	Y	Y	Y	Y (interest rate data)	Unknown (currently one survey has been undertaken, which may or may not be repeated)
Bank of England NMG Household Survey	Consumer credit	Y	Y	Y	N	Annual
Ofgem Consumer Engagement Survey	Energy	Limited (data splits out those with incomes below and above £16,000)	Y	N	Y (data on type of tariff)	Annual

Source: SMF analysis

One option is to inquire as to whether specific surveys can be expanded to provide a better view on the poverty premium. Candidates for this could include the Living Costs and Food Survey.

Given the lack of existing data, to measure and track the poverty premium on an ongoing basis a new, regular consumer survey would be required. Indeed, it was through a new survey that the University of Bristol was able to provide its estimate of the poverty premium, discussed in the previous chapters of this report. We also note that relying on existing data sources is likely to lead to a focus on what can be measured rather than what needs to be addressed. For instance, we note that pre-payment meter outcomes have continued to receive significant attention, even though the premium has been significantly reduced. This is probably at least in part a consequence of the fact that their prevalence and consumer outcomes are measured.

Even with the possibility of a new consumer survey, there are multiple challenges in measuring the poverty premium. One issue that was pointed out in our discussions with stakeholders is the fact that some survey respondents are unwilling to disclose their income. If this group is disproportionately lower-income consumers, then there is a risk of survey findings being biased, leading to over or underreporting of some types of poverty premium. Further work is needed to understand how large a problem this is and how it could be addressed. The University of Bristol informed us that around 20% of respondents refused to disclose their income, and these individuals were left out of the analysis. This problem may be reduced by asking respondents which income bands they fall in.

Furthermore, there are likely to be limits to the amount of data that can be gathered from a survey. Official surveys include multiple prompts to ensure that information of income and expenditure is as accurate as possible. Similarly, we would expect a significant proportion of consumers to lack awareness of things such as the type of energy and telecommunications tariffs they are on. Non-answers to such questions are likely to be high.

Digital exclusion is also an issue for some households. This means that some households will be unreachable via an online survey. This would necessitate over the phone or face-to-face surveys to gather information on consumer behaviours.

### *Designing the survey*

Given likely knowledge limitations among survey respondents about their consumption levels and the prices they face, our starting position is that a new survey gauging the poverty premium would have to be relatively simple in design. A brief scan of existing international surveys suggest that it would be possible to find information on consumption levels, though this is likely to be a very intensive exercise. An example in the USA is the Residential Energy Consumption Survey.<sup>50</sup> In the medium term, this exercise may become much cheaper and more practicable by using administrative data on consumer spending (e.g. via details on transactions collected by banks) and consumption of goods and services (e.g. energy smart meters).<sup>51</sup>

To establish the existence of poverty premiums, the survey would largely focus on the extent to which individuals adopt particular behaviours, such as:

- Paying by direct debt
- Using paper billing
- Using ATMs that charge
- Switching energy and telecommunications providers
- Using high-cost credit
- Buying monthly travel season tickets and insurance products

It is important to note that consumers are likely to experience the poverty premium in different ways over time. For instance, this may be because they are accessing different services (e.g. home lending rather than payday lending) or because they are consuming services in different ways.

High-income households would need to be surveyed as well as low-income households to allow us to examine the extent to which the prevalence of different behaviours differs across households. Given

outcomes in markets change due to policy, innovation and other forces it will be important the survey is carried out regularly to provide insight. A survey carried out every two years could strike the balance between costs and impact.

We envisage that the bespoke survey could also be designed to add insight into the factors underlying the poverty premium, with a special focus on the most costly aspects of the premium. This would also help us test our hypothesis that it is not only the income poor who are disadvantaged by some of these factors.

Understanding the prevalence of consumer behaviours from the survey would give us an estimate of the prevalence of different types of poverty premiums, but it would not be sufficient to give us a monetary value for the poverty premium. To do this, survey findings would need to be complemented with price and usage data gathered elsewhere. Table 6 summarises data sources that can be drawn upon to complement the survey data and allow the poverty premium to be monetised.

**Table 6 Overview of regular official data sources**

	Data that can realistically be gathered from a survey	Data that can be gathered elsewhere
Using higher-cost credit	Extent to which individuals use high-cost credit versus lower cost forms of credit.  Number, term and approximate value of high-cost loans taken out over the past year. (We would expect a significant share of households to be aware of this)	APRs advertised by the main high street banks and largest high-cost lenders, to establish the difference in borrowing costs.
Insuring specific items	Extent to which individuals insure specific items.	Online desk research to establish typical insurance costs for specific items
Not paying by cheapest billing method	How individuals pay their bills and which provider they use	Online and phone-based desk research to establish cost savings offered by energy, insurance and telecommunication companies by changing payment method
Premiums related to where people live	Area of residence, type of car owned, size/type of home.  Extent to which individuals purchase supermarkets from convenience stores or supermarkets.	Car and home insurance quote estimates from price comparison websites using a range of postcodes covering different scores on the Index of Multiple Deprivation.  Defra Food Survey data on food purchases, by income group.
Not being on the best energy tariff	The type of energy tariff that individuals are using and the last time they switched provider	Ofgem energy price data for different tariffs. One consideration is what tariffs should be used. Typically, this has been the difference between the average SVT and the cheapest tariff on the market (around £300). However, it should be noted that if everyone switched

	Average monthly/quarterly spending on energy (we would expect a reasonable proportion of households to know this)	products then the gap between these products would likely reduce (given some of these are loss-making). <sup>52</sup>  Ofgem’s “Beyond Average Consumption” report, which provides some insights in usage for different income groups.  Ofgem data on typical consumption patterns.
Using pre-payment meters	Whether an individual has a pre-payment meter	Ofgem energy price data for different tariffs.  Ofgem’s “Beyond Average Consumption” report, which provides some insights in usage for different income groups.  Ofgem data on typical consumption patterns.
Paying to access money	Extent to which individuals have used ATMs which charge	Data from Link on average ATM charges and average ATM withdrawals.
Paying to receive paper bills	Whether individuals receive paper bills	Desk research to establish costs associated with paper billing
Not being on the best telecommunications tariffs	The type of telecommunications tariffs individuals are using and the last time they switched providers	Ofcom price data, desk research from telecommunications websites.  Data on telecommunications expenditure from the ONS Living Costs and Food Survey.
Not being able to benefit from bulk discounts (season tickets) for public transport	How people pay for public transport and how often they use public transport. Typical commuting lengths.	Price data from Transport for London and other public transport providers

Source: SMF analysis

Were the measure to become an official measure, the Government may be able to require regulators and suppliers to provide information on tariffs to shortcut some of the work described in the table above.

### **Making use of the measure**

Our discussions with the social investment sector suggest that this high-level headline measure could be valuable to allow funders and actors to assess the nature of the problem and how it is changing. We note however that some interventions funded by social investors may be targeted at specific local areas or targeted groups of consumers. The impact of these programmes could not be evaluated through the national headline measure as the sample sizes would be too small in many cases to draw statistically-significant results. In these cases, we hope that the methodologies described above could be used to design a bespoke survey for the target impact group.

## Interim indicators

As discussed above, to establish a robust measure, a new survey would be required or additional questions inserted into existing official surveys. In the absence of such a survey we propose interim measures that could, if tracked, help give a rough indication of whether the poverty premium is getting better or worse. In each case, where possible information would be gathered on the prevalence among low-income consumers. In presenting this information, we re-emphasise that focusing simply on what can be measured can give a misleading impression of the poverty premium and how its changing. For instance, the University of Bristol study concluded that the poverty premium relating to where people lived (e.g. the costs of insurance) was a significant part of the premium. However, this is poorly tracked in existing official data.

- Proportion of energy consumers on pre-payment meters (Ofgem Engagement Survey), combined with information on how average PPM tariffs compare to average non-PPM tariffs.
- Proportion of energy consumers on SVTs (Ofgem Engagement Survey), combined with information on how average SVTs compare to the best tariffs (Ofgem Retail Market statistics).
- Proportion of consumers who have not switched their energy tariff (Ofgem Engagement Survey).
- Proportion of consumers paying by alternative payment methods (Ofgem Engagement Survey).
- Proportion of consumers who have not switched their mobile and broadband deal (Ofcom Switching Survey), combined with information on the average additional costs borne by consumers who do not switch products.
- Proportion of consumers using high cost credit (Bank of England NMG Survey / FCA Financial Lives Survey).

The table below provides a summary of the interim indicators available – including an assessment of whether the measures can be segmented by income. It also provides information on the frequency with which the interim indicators are published, and the extent to which historic data is available.

**Table 7: Overview of interim indicators for different types of poverty premium**

	Interim measure available?	Income split of measures available?	Frequency of data
Using higher-cost credit	Proportion of consumers using high cost credit (Bank of England NMG Survey / FCA Financial Lives Survey).	Yes	Bank of England survey data just for 2016  FCA data currently just for 2017. Potentially annual/bi-annual updates to me made available.
Insuring specific items	No	No	n/a
Not paying by cheapest billing method	Proportion of consumers paying by alternative payment methods (Ofgem Engagement Survey).	Yes	Annual Ofgem data from 2014
Premiums related to where people live	No	No	n/a

Not being on the best energy tariff	Proportion of consumers who have not switched their energy tariff (Ofgem Engagement Survey).  Proportion of energy consumers on SVTs (Ofgem Engagement Survey), combined with information on how average SVTs compare to the best tariffs (Ofgem Retail Market statistics).	Yes	Annual Ofgem data from 2014
Using pre-payment meters	Proportion of energy consumers on pre-payment meters (Ofgem Engagement Survey), combined with information on how average PPM tariffs compare to average non-PPM tariffs (based on desk research/price comparison websites).	Yes	Annual Ofgem data from 2014
Paying to access money	No	No	n/a
Paying to receive paper bills	No	No	n/a
Not being on the best telecommunications tariffs	Proportion of consumers who have not switched their mobile and broadband deal (Ofcom Switching Tracker) combined with information on the average additional costs borne by consumers who do not switch products (based on desk research/price comparison websites).	Yes	Annual Ofcom data from 2016
Not being able to benefit from bulk discounts (season tickets) for public transport	No	No	n/a

### The basket of goods effect – “poverty inflation”

This additional measure would estimate the rate of cost of living inflation faced by lower-income households in the UK, which could be contrasted with UK-wide inflation measures such as the Consumer Price Index (CPI). As discussed in Chapter 2, low-income households may face higher-than-average rates of inflation during times when the cost of essentials such as food and energy are rising at a faster rate than headline inflation. This is a result of these goods and services accounting for a higher proportion of total expenditure among UK households.

Such a measure could be calculated relatively easily, drawing on data from the Living Costs and Food Survey produced by the Office for National Statistics. This survey details the expenditure patterns of households, which can be segmented by income group. One can thus use this dataset to produce an inflation measure that is weighted by the typical spending patterns of low-income households. In such a “poverty inflation” measure, items such as food and energy price inflation would have a greater weighting than is the case in inflation measures such as the CPI and RPI.

In addition to being easy to calculate, such a measure is also relatively simple to convey to a wide audience, given that knowledge of the notion of inflation is pervasive. We are aware that the JRF is seeking to develop a measure such as this to include in its monitoring of poverty. The ONS is also carrying out work that aims ‘to reflect UK households’ experience of changing prices and costs’ in its Household Costs Indices (HCIs) measures.<sup>53</sup>

To be clear, we propose that this measure could have specific benefits of its own and would not be incorporated into the 'poverty premium' measure.

### Modelling the longer-term costs of persistent poverty

As discussed in Chapter 2, there may be a case for exploring and modelling the longer-term costs of persistent poverty over the course of an individual's life. This would capture financial impacts which build up over periods longer than a year.

Specifically, we believe that there may be substantial long-term costs associated with being unable to own property and benefit from the accumulation of wealth derived from this. Similarly, homeowners may face more stable housing costs than those in the private rental sector.

Furthermore, there may be costs associated with lower-income households having to take on additional debt, due to lower levels of inheritance and other financial support (such as gifts and interest-free loans) from family and broader social networks compared with higher-income households.<sup>54</sup>

Such "lifecycle" poverty premiums could be estimated using a model-based approach, which makes specific assumptions about factors such as house price growth, interest rates and income growth. As this would be a forward-looking exercise, it would be, by nature, heavily assumption-driven and more speculative than an estimate of the average annual poverty premium in the UK. Nevertheless, it could serve as a useful tool for policymakers to consider some of the longer-term issues associated with poverty, and whether they can lead to additional poverty premiums where lower-income households end up paying more for essentials such as housing. It could be used as an analytical tool to consider, for example, the longer-term implications of having a higher proportion of low-income households living in the private rental sector rather than the social rental or owner-occupied sectors.

As with the proposed annual poverty premium measure, consideration would need to be given to the relevant counterfactual used in quantifications. We suggest that the relevant point of comparison, similar to the annual measure, is a situation where prevalence rates of longer-term poverty premiums fall to the same rates seen among individuals not in persistent poverty. For example, the relevant baseline with respect to any housing-related premiums is a situation where the homeownership rate for individuals in persistent poverty is the same as the rest of the population (that is, acknowledging the fact that higher earners that are not homeowners also face similar price premiums).

## References

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- <sup>2</sup> Regulators have multiple definitions of ‘vulnerable consumers’. Our interpretation is someone who, due to their personal circumstances, is especially susceptible to detriment or may be affected particularly severely if they experience detriment.
- <sup>3</sup> JRF, *We can solve poverty in the UK* (2016)
- <sup>4</sup> <http://www.fairbydesignfund.com>
- <sup>5</sup> This definition is derived from original literature on the poverty premium, such as Caplovitz (1967), *The Poor Pay More*. This definition is also used in recent UK studies – see footnotes below.
- <sup>6</sup> Matt Padley and Donald Hirsch, *A Minimum Income Standard for the UK in 2017* (JRF, 2017)
- <sup>7</sup> Save the Children and the Family Welfare Association, *The Poverty Premium - How poor households pay more for essential goods and services* (2007)
- <sup>8</sup> Save the Children, *The UK Poverty Rip-Off* (2010)
- <sup>9</sup> Church Poverty Action Group, *Paying over the odds? Real-life experiences of the poverty premium* (2011); Citizens Advice Scotland, *Still Addressing the Poverty Premium A report for Citizens Advice Scotland by Cambium Advocacy* (2015); Citizens Advice Scotland, *Paying More to be Poor: The Poverty premium in energy, telecommunications and finance* (2016); Laura Blow and Andrew Leicester, *Do the Poor Pay More? An Investigation of British Grocery Purchase Prices* (IFS, 2012)
- <sup>10</sup> Adam Tinson, Peter Kenway, Sabrina Bushe and Tom MacInnes, *Poverty and the Cost of Living: an evidence review* (JRF, 2014)
- <sup>11</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016)
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- <sup>13</sup> See for example, CMA, *Energy Market Investigation: A report for the Competition and Markets Authority by GfK NOP* (2016), pp.25-16.
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- <sup>16</sup> Citizens Advice Scotland, *Paying More to be Poor: The Poverty premium in energy, telecommunications and finance* (2016)
- <sup>17</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016)
- <sup>18</sup> <https://www.which.co.uk/news/2017/03/supermarket-convenience-stores-charge-up-to-7-more/>
- <sup>19</sup> Laura Blow and Andrew Leicester, *Do the Poor Pay More? An Investigation of British Grocery Purchase Prices* (IFS, 2012)
- <sup>20</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016); Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Costing Methodology Appendix* (University of Bristol, 2016)
- <sup>21</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016)
- <sup>22</sup> Price data from Transport for London: <http://content.tfl.gov.uk/adult-fares.pdf>
- <sup>23</sup> See, for example, Trust for London, *Living on the edge: the impact of travel costs on low paid workers living in Outer London* (2015)
- <sup>24</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016), p.21.
- <sup>25</sup> Nigel Keohane, *Stick or Switch? Making markets fairer and more competitive* (SMF, 2017);
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- <sup>28</sup> Roberto Merola and Lizzie Greenhalgh, *Exploring the loyalty penalty in the broadband market* (Citizens Advice, 2016)

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- <sup>29</sup> Temi Ogunye, Caroline Rogers, Lizzie Greenhalgh and Barney McCay, *The cost of loyalty: Exploring how long-standing customers pay more for essential services* (2018)
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- <sup>31</sup> *Persistent Poverty in the UK and EU: 2014* (ONS, 2016)
- <sup>32</sup> ONS, *Developing the Household Costs Indices (HCIs)* (2017)
- <sup>33</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016), p.30
- <sup>34</sup> SMF qualitative interviews for Poverty Premium project.
- <sup>35</sup> See for example, Behavioural Insights Team, *Poverty and decision-making – how behavioural science can improve opportunity in the UK* (2015); Sheehy-Skeffington and Rea, *How poverty affects people’s decision-making processes* (2017); Anandi Mani et al, ‘Poverty Impedes Cognitive Function’, *Science*, 341 (2013)
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- <sup>37</sup> Nigel Keohane, *Stick or Switch? Making markets fairer and more competitive* (SMF, 2017)
- <sup>38</sup> CMA, *Energy market investigation Final report* (2016)
- <sup>39</sup> See for example, CMA, *Energy Market Investigation: A report for the Competition and Markets Authority by GfK NOP* (2016), pp.25-16.
- <sup>40</sup> Average across gas and electricity.
- <sup>41</sup> See for example, Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016)
- <sup>42</sup> Numbers taken from University of Bristol study.
- <sup>43</sup> Numbers taken from University of Bristol study.
- <sup>44</sup> Note this is the average across the different forms of high cost credit weighted by prevalence.
- <sup>45</sup> Sara Davies, Andrea Finney and Yvette Hartfree, *Paying to be poor: Uncovering the scale and nature of the poverty premium* (University of Bristol, 2016). This data is from WAS 2006-08 and covers the whole UK population.
- <sup>46</sup> CMA, Consumer survey. Data for all those on incomes above £18,000. <https://assets.publishing.service.gov.uk/media/576bcbbc40f0b652dd0000b0/appendix-9-1-cma-domestic-customer-survey-results-fr.pdf>
- <sup>47</sup> Note this only includes costs of using a PPM in electricity and costs of using a PPM in gas (rather than any deals that PPM consumer re able to get).
- <sup>48</sup> Average across electricity and gas.
- <sup>49</sup> Average across electricity and gas. GfK, Ofgem Consumer survey 2017, Q5 and Q6. Taken as households on incomes >£16,000.
- <sup>50</sup> <https://www.eia.gov/consumption/residential/>
- <sup>51</sup> [https://web.stanford.edu/~pista/cons\\_survey.pdf](https://web.stanford.edu/~pista/cons_survey.pdf)
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