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REPORT

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ABOUT IPPR

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BOLD IDEAS
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EXECUTIVE SUMMARY

Living standards of households in the UK have fallen over the last six years due to a combination of exceptionally low increases in wages and larger increases in prices. Substantial rises in the price of essentials, including energy, public transport and childcare, have been a particular problem for some families, with those on the lowest incomes feeling the biggest squeeze because they spend more, proportionately, on these items.

Politicians are responding to these developments. The chancellor has suggested an above-inflation increase in the minimum wage and in recent months the Coalition has intervened in the energy, water and train markets to limit, or to try to limit, price increases. Meanwhile, Labour leader Ed Miliband has proposed a 20-month freeze in energy prices to create time for a reform of the structure of the market (while not favouring price controls as a permanent measure). One company has acted too, with the energy company SSE promising to fix domestic gas and electricity prices until 2016.

These are exceptional developments, however. For the most part, when politicians intervene in markets they prefer not to seek to control them, but to make them closer to the free market ideal. They seek to increase competition in the belief that a market-based solution will always produce the best outcome for consumers. In doing so, they are adhering strictly to traditional economic theory.

In many markets, this is a reasonable approach to adopt. Despite firms' attempts to exploit their behaviour, consumers get a reasonable deal most of the time. There are a large number of suppliers and a wide range of goods and services of varying prices and quality to choose from.

However, some consumer markets are characterised by market failures – in particular oligopoly provision and information asymmetries – which stack them in favour of producers. Consumers have little effective power in these markets and some consumers – particularly those with low incomes – have so little power that they end up paying a poverty premium.

Even when there is no oligopoly provision or inherent information asymmetry, new economic thinking shows that consumers rarely act in the way traditional theory assumes they do. Behavioural economics highlights the rules of thumb which consumers frequently use when making purchases, and complexity economics shows how firms are adept at exploiting these behaviours, to the detriment of consumers.

In some markets, consumers are fighting back, for example by using networks to expand their knowledge of markets. The internet has facilitated the development of websites that compare prices and the quality of goods and services, making it easier for consumers to make the right decisions.

But there is still plenty to do in three areas to make markets work better for consumers.

1. **Oligopolies:** The government should ensure that the Competition and Markets Authority (CMA), which becomes fully operational in April 2014, has sufficient resources to investigate the possibility of tacit collusion and a lack of competition in markets where there are a small number of dominant suppliers. Since attempts to reduce barriers to entry as a means of tackling an oligopoly are rarely successful, the CMA also needs powers to prevent firms in an oligopoly from colluding, including breaking it up, and to impose punitive fines when they seek to evade restrictions. Price controls, except as a temporary measure, should be a last resort.

2. **Information asymmetries:** In many instances, the solution to information asymmetries is not to make more information available to consumers as this risks overloading them. Forcing firms to adopt simpler and more transparent pricing structures will be more effective. Advice that steers consumers in a certain direction, such as government kitemarks, can also help consumers in some markets.
3. **Firms taking advantage of consumers:** When firms adopt practices that seek to exploit consumers' behaviour, such as complex pricing, drip pricing, bundling and exit fees, the CMA should have the power to stop them. The onus of proof should be on firms to demonstrate that their practices are beneficial and not detrimental to consumers. Direct action against firms is far more likely to be effective than seeking to change the behaviour of consumers.

Some markets are so complex that they require special analysis and regulation. In this paper, we consider four such markets: energy, public transport,[1] childcare and housing. In all four markets, prices have been rising faster than the general level of inflation, adding pressure to the squeeze on living standards. Low-income families, which spend a higher proportion of their income on these items, have been particularly badly hit.

1. **Energy:** Attempts to create a competitive market in retail energy seem to have failed. Consumers are unwilling to engage with the market and switch suppliers and supply is concentrated in six firms that appear broadly content with their current market share and in some cases regional monopoly. A simpler tariff structure will help, but will not remove all the barriers to switching and could have a perverse effect if it reduces firms' willingness to innovate. Greater regulation, for example to take permanent control of prices, is not the solution because bureaucrats cannot determine the correct price. In the long run, the answer might be to decentralise supply by enabling consumers to also become suppliers.
2. **Public transport:** The markets in bus and train travel are even less competitive than the retail energy market. Most consumers have very little power because they face a monopoly supplier on any particular route. And at a national level an oligopoly exists with a small number of firms dominating in both markets. In the rail market, the government should put pressure on train operating companies to improve the consumer's experience, for example through simpler ticket pricing. Allowing bids for future tenders from publicly owned companies will encourage private firms to innovate and control costs. In the bus market, the Transport for London model could be replicated across other city-regions, with bus companies having to compete periodically through a tendering process for the right to provide services.
3. **Childcare:** Attempts to promote a competitive market in childcare that delivers value to parents have failed. Although theory suggests giving parents the ability – and through subsidies and tax relief helping them with the means – to buy childcare would force suppliers to innovate and offer a better product, in practice this has not been the case. The result has been rampant inflation in prices without any discernible improvement in quality. In the long term, childcare should be seen as an extension of schooling and treated as a public service. However, given that there will be further substantial cuts in public spending in coming years, the government can only spend more in this area in the short term through switching spending from tax credits and vouchers.

1 Specifically the local bus and heavy rail markets. We do not cover other public transport markets such as light rail, trams and coaches.

4. **Housing:** The chief problem in the housing market is a longstanding shortfall in supply, not least because the construction of houses is very insensitive to their price. Even if private sector activity were to increase significantly, this shortfall is unlikely to be fully resolved until local authorities build more homes, but the public finances act as a constraint here too. In the meantime, steps to encourage greater private sector building could include getting housebuilders to use their land banks; significant changes to the planning regime to make building easier; and initiatives to facilitate the development of new towns.

The common theme in these four markets is that attempts to deliver goods and services through competition have been tried and failed. Yet government and regulators continue to pursue market-based solutions, seemingly oblivious to the factors that make it most unlikely they will succeed. This does not mean that more regulation is the answer. Bureaucrats cannot determine the correct price in these markets.

Each market has to be analysed individually and diverse ways found to advance the best interests of consumers and society. This will probably mean trying to make it more competitive, in the textbook economic sense. So, it might mean focusing on energy efficiency and decentralised energy generation; simplifying rail tickets and spreading the use of smart cards; treating childcare more like a public service; and breaking the stranglehold over the land market of housebuilders.

Making markets more competitive – reducing the power of oligopolies, increasing consumer information and banning practices designed to exploit consumers – is the best approach for many consumer markets. But complex markets require more complex and innovative solutions. In these cases, the choice is not between trying to make markets freer or reintroducing regulation (or even nationalisation). Instead, it should be about finding alternative ways of achieving the best deal for consumers.

INTRODUCTION

The biggest economic problems facing most families in the UK today is the fact that the prices of essential goods and services have been rising faster than earnings. In part, this is because some supposedly free markets are stacked in favour of producers and attempts by government and regulators to tilt the balance of power back towards consumers have failed. In some markets, the plight of poorer families is made worse because they are paying more than the average consumer, meaning those least able to cope often face the biggest squeeze.

The squeeze on living standards has risen to the top of the political agenda because consumer prices have increased faster than average earnings for most of the last six years, reducing real earnings, and so the spending power, of households in the UK. This has caused real suffering for some families, particularly those on low incomes; and it has also held back the economic recovery. Although real GDP is now growing at a reasonably strong pace, sustainable growth will only be possible when earnings are once again increasing more rapidly than prices.

A number of factors have combined to create the squeeze in living standards, but most attention has focused on large increases in the price of certain essential goods and services, including energy, transport and childcare. In particular, since the Labour leader, Ed Miliband, pledged in his party conference speech to freeze gas and electricity prices for 20 months and to overhaul the regulation of the energy sector, if his party won the next election, there has been a voluble debate about government intervention in consumer markets that have 'failed'. Perhaps not coincidentally, the Coalition government has also intervened, or announced plans to intervene, in a number of markets. It is to introduce a new law to cap the cost of payday loans; it is planning a 0.75 per cent cap on management fees for pensions;[2] it has placed additional limits on rail fare increases; it has written to water companies asking them to look closely at the level of price increases; and it is forcing energy companies to cut the number of tariffs they offer. The government has also taken direct action to cut households' annual energy bills by an average of £50 by making cuts to so-called 'green levies'. This includes scaling back the Energy Company Obligation (Eco) scheme, which is designed to cut the fuel usage of low-income households.

These moves are largely ad hoc and responsive, rather than being grounded in recent thinking in market theory. There is a basic presumption that – in accordance with the findings of traditional consumer theory – the best outcome in any market will result when there is a high level of competition. Government interventions are therefore designed, wherever possible, to facilitate increased competition – even when it is, in fact, a mirage. Measures such as price caps are seen as a last resort when the market has clearly 'failed', that is when there is an inadequate level of competition.

However, real-world consumer markets can be very different from the markets envisaged in standard economics textbooks. Market failures such as oligopolies and information asymmetries are rife and consumers do not behave as theory says they should. New economic thinking in fields such as behavioural economics and complexity theory throws a different light on consumer behaviour and businesses' response to it. Furthermore, consumer markets are far more complex than the simple model envisaged in the textbooks. All consumers are not equal in all markets. In some markets, some consumers have more power than others and so are able to get a better deal. In particular, consumers on low incomes, who have the least power, pay a 'poverty premium' in some

2 Though this has been delayed by a year until April 2015.

markets. Essential goods and services can cost them more than other consumers pay, exacerbating the problems caused by large price increases.

A more systematic approach to intervention in consumer markets by governments or regulators should be based on the answers to three questions:

1. What do we mean by market failure?
2. Is it possible to make the market work better, and if so how?
3. If not, what other steps are available to advance consumers' interests?

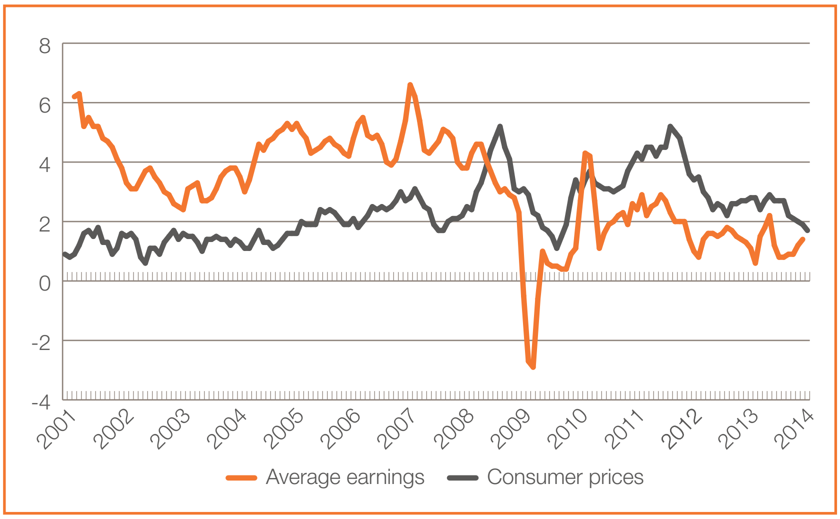
The answers to these questions vary from market to market and there is no universal solution. Instead, government and regulators need to respond on a case by case basis.

This report focuses on several important consumer markets. Chapter 1 sets out the background to the debate by looking at recent developments in living standards in the UK. Chapter 2 focuses on the poverty premium issue. This is followed in chapter 3 by a brief discussion of economic thinking on the theory of consumer markets – including the traditional economic model, market failures and lessons from behavioural economics and network theory – and what it has to say about market failure and when governments and regulators should intervene. Chapter 4 comprises four case studies of problem markets, looking at how they are stacked against consumers, how governments have tried to improve the way they work and why they failed. The final chapter sets out some thoughts on how to design and structure consumer markets.

1. THE LIVING STANDARDS DEBATE

The living standards of the average household in the UK have been severely squeezed over the last six years, in part by the prices of essentials rising faster than other prices and much faster than earnings. During this period, consumer prices increased by 20 per cent, while average earnings grew at only half this pace – by just 10 per cent.[3]

Figure 1.1
Annual growth in average earnings and consumer prices (%)



Sources: ONS 2014a, 2014b

The severe recession and stop–start economic recovery that followed the financial collapse of 2007 and 2008 made it inevitable that there would be some squeeze on living standards. Real GDP – the aggregate output of the economy – is still below its peak, reached in the first quarter of 2008. Rather than respond by cutting employment – as might have been expected based on past behaviour – firms have increased employment[4] and controlled their costs instead through a combination of reducing hours, moderate wage increases, wage freezes and in some cases wage cuts.[5] Average nominal wage growth is, therefore, at a historically exceptionally low level.

However, the squeeze on living standards is also the result of high price inflation – not by the standards of the 1970s and 1980s for sure, but relative to the government's two per cent inflation target.

Table 1.1
Increase in selected groups of prices, December 2007 to December 2013 (%)

All items	**20.1**
Food	31.0
Clothing	-8.3
Rents for housing	15.4
Water supply and sewerage	28.7
Electricity, gas and other fuels	70.7
Transport services	55.6

Source: ONS 2014a

3 Figures are for the six years to December 2013.
4 The employment rate for October to December 2013 was 72.1 per cent, only a little below its pre-recession peak of around 73 per cent, despite output being lower than six years ago (ONS 2014b).
5 There have also been structural shifts in the workforce, in particular increases in the prevalence of part-time working and self-employment, which have lowered average earnings.

Over the last six years, inflation in the UK has averaged over three per cent and this, in part, explains growing concerns that consumers are not getting a fair deal in some markets, particularly those where prices have been increasing faster than the average. What makes this more of a concern is that some of the biggest increases have been in the prices of essentials, such as food, energy and transport. As a result, poorer households, which spend a greater proportion of their incomes on such items, have been most squeezed.

Economists expect this squeeze to intensify over the next five years. Calculations by the Centre for Business and Economic Research (CEBR) for Asda's *Income Tracker* suggest that the average household in the UK will be spending £3,900 more in 2018 (compared to 2013) on essential items[6] as a result of further big increases in utility bills and transport costs, and of higher mortgage interest payments. Lower-income households will be hit the hardest, seeing their discretionary income fall by a whopping 29 per cent, while upper-income households will experience a two per cent increase (Asda 2013).

If this is right, there is little prospect of sustainable economic growth in the UK at close to its historical trend.[7] Consumer spending, which accounts for almost two-thirds of GDP, will not grow strongly over the medium term while real earnings are falling, and without the prospect of increasing demand for their products, firms will not invest in additional capacity. The government says that growth is the only route to sustainably higher living standards. But higher living standards are also the only route to sustainable growth. Limiting increases in the prices of essential goods and services will help to bring about a reversal in the squeeze on living standards, allow consumer spending to increase, and as a result strengthen the economic recovery.

Of course, large price increases are to some extent the result of factors largely outside the control of UK firms, such as global oil and gas prices. But the suspicion is that some markets are stacked against consumers because their power is very limited and prices are kept high by well-organised, rent-seeking, oligopolistic firms. Furthermore, to add to the pressures on poorer households, in some of these markets they have to pay more than the average household – a 'poverty premium'. This issue is considered in more detail in the next chapter.

6 These include housing and utilities, food and clothing, transport, and mortgage interest.
7 Around 2.5 per cent.

2. THE POVERTY PREMIUM

In some markets, particularly those for certain essential goods and services, some groups of consumers pay more because of their position in the market. If these consumers are from families with low incomes, then they are said to be paying a 'poverty premium'.

A poverty premium can exist for one or more of several reasons.

- Consumers on low incomes might find that some purchasing options are not open to them because, for example, they do not have easy access to the internet or a credit card or a bank account with direct debit facilities.
- Consumers on low incomes might prefer, because of their circumstances, payment options that are more expensive to provide, such as pre-payment meters for gas and electricity.
- Consumers on low incomes might have to use credit more often to make major purchases because they do not have savings to draw on.
- Consumers on low incomes might be less active switchers, for example in utility markets, because they are less able to understand complex pricing structures.
- Firms might face additional costs when supplying goods and services to low-income families, so that, for example, if crime rates are higher in deprived areas, insurance premiums will be higher too.
- Firms might segment their markets and offer better terms to attract higher users, leaving consumers on low incomes, who are more likely to be low users, to face higher unit charges.

The existence of a poverty premium does not necessarily mean that a market has 'failed'.[8] For example, a low-income family might pay more for its food if it has to buy it from small local shops rather than a supermarket because it does not have the means to travel to the supermarket, or if the cost of travel would exceed the saving made on the food. Similarly, it could end up paying more for a new refrigerator if it has to buy it on credit, rather than paying at the time of purchase. These are both examples of a poverty premium, but not of a market failure in the food and refrigerator markets. In the first case, economies of scale explain why the supermarket can charge less than the local shop (it might also be better positioned to extract lower prices from its suppliers) and the transport market might also be working perfectly well in terms of matching supply and demand at a market clearing price. Similarly, in the second case, poorer families are paying more not because there is a problem in the operation of the market for refrigerators or in the market for credit, but because they have to use the credit market when wealthier families do not.

The problem in these markets is not a market failure but that the market outcomes create additional costs for those families least able to cope with them. Society might decide that it wants a different outcome from the market solution, such as better transport links, in which case government or regulatory intervention will be necessary.

Studies of the poverty premium tend to focus on utilities and financial services. These are markets that provide services 'fundamental to people's ability to have an acceptable standard of living' (Hirsch 2013: 6). Gas and electricity are needed to prepare food and to keep warm; telecommunications are needed to maintain social contacts; and financial products are needed to purchase other goods and services.

8 A market failure is said to exist when there are factors preventing the market price reaching its competitive equilibrium, for example because a monopoly supplier controls the market or consumers are unable or unwilling to express their preferences.

Hirsch identifies four types of poverty premium in these markets.

1. Paying higher than average tariffs for gas and electricity, either because of using a relatively expensive payment method or because of not switching to a better deal.
2. Paying more for each telephone call or text because of being a low user in a market where tariffs include fixed charges or provide an inclusive number of calls and texts.
3. Paying higher interest on consumer credit.
4. Paying more because of limited financial and communications capabilities.

He argues that the effect of these premiums on people's livelihoods is large, increasing the price that low-income families pay for utilities and credit by around 10 per cent. He calculates that a single person on a wage a third above the minimum wage falls £34 a week short of the minimum income standard, rather than £9 short if these premiums did not exist (Hirsch 2013: 8).

If poverty premiums are not the result of the different costs of providing a service to different groups of consumers, there is a strong case on social justice grounds for intervention by government or the appropriate regulator.[9] This intervention typically comes in a number of forms.

First, attempts can be made to improve the way the market works in general. This is the approach most often favoured by governments, who task regulators, such as Ofgem and the Financial Conduct Authority (FCA) with ensuring that markets are transparent and competitive and that unfair practices are eliminated. This benefits all consumers in the market, but it benefits low-income consumers particularly if a lack of competition or transparency affects them most. So, reducing the complexity of pricing tariffs in the gas and electricity markets will benefit low-income families if they are more likely to be deterred from switching by the current structure.[10]

Second, attempts can be made to improve the way that 'submarkets' used by low-income families work. Within the market for credit, for example, payday lending is a submarket predominantly used by those on low incomes. Actions that lead to greater competition and so lower interest charges would, therefore, benefit low-income families in particular.

Third, government and regulators operating on the government's behalf can directly intervene in markets to affect pricing structures or to require the provision of certain products. Requiring Royal Mail, after privatisation, to continue daily deliveries even to remote rural addresses at no extra charge, is an example of the latter.[11] Placing an interest rate cap on payday lenders is an example of the former.

Fourth, the government or its regulators can offset the poverty premium through various means of 'compensation'. This could be at the expense of other consumers, for example by requiring energy firms to offer lower tariffs to certain groups.[12] Alternatively, it could be at the expense of taxpayers.

9 Intervention may also be considered when the problem is different costs. The cost of flood insurance in high-risk areas, for example, is to be held down by a cross-subsidy from insurance premiums paid by those living in the rest of the country.

10 Frequent switchers under the current regime will, of course, lose out.

11 This also creates a cross-subsidy, in this case from those in urban areas to those in rural areas.

12 The government has also recently asked water companies to introduce special tariffs for struggling households.

Which approach is the most appropriate depends on the nature of the market. There are no general rules that apply and each case needs to be judged on its own merits. Chapter 4 contains four case studies of markets that are some distance from the perfect competition model and prone to the existence of poverty premiums. Each is an essential service provided largely by regulated private firms through the market mechanism. But in each case, the market can be said to have failed on a number of counts, including the service not being affordable and accessible to families on low incomes. Before these case studies, however, the next chapter discusses the main elements of consumer market theory, and in particular the latest thinking in this area by economists in the fields of behavioural analysis and network theory.

3. CONSUMER MARKETS AND MARKET FAILURE

The starting point in standard economics textbooks for the analysis of consumer markets is the perfect competition model (see, for example, Jehle and Reny 2011). This assumes any market in a particular homogeneous good or service is characterised by a large number of firms supplying it, very low barriers to entry for new firms, low transactions costs and all consumers and firms having a complete set of information about the market. It also assumes that firms are profit-maximising and that consumers are 'rational'. If all these conditions are met, the perfectly competitive market tends towards an equilibrium in which prices equal the average cost of production and firms only make 'normal profits'.[13]

Crucially, this is the best possible outcome for consumers; all others are worse. If prices are below this level, firms will not earn sufficient profits to remain in business and the market will close. If they are above this level and firms are making abnormal profits, it will be at the expense of consumers, whose welfare will be reduced as a result. In economic theory, any outcome other than the perfect competition one is bad for consumers.

The assumption that firms seek to maximise profits is not seen as contentious. Even when firms choose not to profit-maximise in the short term, preferring instead perhaps to target sales or market share, or to undercut a new competitor to prevent it getting a foothold in a market, their behaviour can be seen as consistent with long-run profit maximisation. If firms do not seek to maximise profits, their owners have an incentive to find a new set of managers; and if one set of owners chooses not to profit-maximise, then other entrepreneurs have an incentive to replace them. This logic is probably truer for large, public companies than for smaller, privately owned firms. The owner of a small business might face a trade-off between putting in more time to increase its profits and having more leisure time and opt for the latter. Generally, though, the assumption that firms choose to profit-maximise is seen as a reasonable approximation.

The same is not true of the assumption that all markets are supplied by a large number of firms. Economists have long been aware of the existence of monopolies and oligopolies and have analysed their possible effects on markets.

In the modern world, monopolies are quite rare but the same is not true of oligopolies: markets that are dominated by a small number of suppliers. These exist where producers benefit from economies of scale and there are high barriers to entry for new firms, for example due to the existence of high capital requirements, the threat of predatory pricing or the accumulation of patents by existing firms. Even if there is not an oligopoly at a national level in a particular market, there may be at a local level, which is what will matter to consumers.[14]

When there are only a few suppliers in a market, they will be interdependent and will base their actions, in part, on the expected response of the others. This creates the scope for collusion, for example to fix prices or restrict production (as OPEC does in its attempts to control the crude oil market). But overt collusion by firms in consumer markets is illegal, and therefore rare. Tacit collusion – firms deciding not to be as competitive as they might be – is probably much more common, though hard to identify and prove.

Economic analysis shows how the effect on market outcomes of the existence of oligopolies varies depending on firms' responses to each other's behaviour. If firms all

13 This is the level of profits required to keep them supplying the market (for example to ensure an adequate return on equity invested in the firm). Profits above this level are referred to as 'abnormal'.

14 This is becoming less true in some markets where products can easily be bought through the internet, but it still holds in many consumer markets.

choose to set a price at which they will sell, consumers will naturally purchase from the firm with the lowest price.[15] Other firms have to match this price and, in the absence of collusion, competitive pressures push the price down until it equals average cost – replicating the outcome of perfect competition. In this case, the presence of an oligopoly does not harm consumers.

However, if firms in an oligopoly all choose to produce a given quantity of a good or service, and to accept the market price, then analysis shows that in equilibrium prices will be higher than average costs and firms will make abnormal profits. And the fewer firms there are, the higher prices and profits will be. This is to the detriment of consumers.

The analysis becomes more complicated if the firms in an oligopoly are unequal and do not act simultaneously. If there is a market leader, which acts first with all other firms following, it will choose a quantity to produce, based on its expectations of how the followers will react and in order to maximise profits. The followers will then make their own decisions, knowing what the leader has done. In this case, analysis demonstrates that firms will make abnormal profits – and the leader will make the most per unit of output. Although total output will be higher and prices lower than in the case where all firms are simultaneously setting their production plans, there will still be a loss of welfare for consumers compared to the perfect competition outcome.

Recently, economists interested in the behaviour of firms[16] have begun to analyse the implications of dropping the assumption that firms have perfect knowledge of each other's prices, output plans and production costs. In this case, each firm's actions will be based on their best guesses about other firms' costs – for example to what extent they are correlated with their own costs, and whether they are likely to be high-cost or low-cost producers. Using complex mathematics, these economists have shown that when there are two firms in this position and they are setting prices, the market will be in equilibrium at a point when both firms are earning abnormal profits. Since this is not the case when firms are assumed to know what their competitors are doing, the firms' imperfect knowledge leads to a loss of consumer welfare.

In the real world, therefore, oligopolies are likely to be bad for consumers. Only in the specific case when firms set prices in the full knowledge of the plans of their competitors and a high degree of competition between firms drives prices down, is there no consumer detriment. When a market is dominated by a few firms, regulators usually judge whether there is likely to be consumer detriment by reference to firms' profit margins. High profit margins are likely to be a sign of abnormal profits, prices above the level that would be delivered by perfect competition and consequently a poor deal for consumers.

The instinct of regulators in such circumstances is to find ways of enhancing competition between firms. This might involve making it easier for new firms to enter the market or encouraging consumers to switch between providers. But, as the domestic energy and retail banking markets show, this will not work if there are significant barriers to entry and if consumers are disinclined to move between suppliers. In these instances, if the balance of power in consumer markets is to be shifted in favour of consumers, regulators need to take more direct action to diminish the power of oligopolies, perhaps through redesigning or restructuring the market.

15 All firms are assumed to be able to supply the whole market if necessary.

16 This is a related field to the study of consumer behaviour, but far less developed.

A major problem with measures to improve consumer markets by increasing competition is that they rely on consumers behaving in the way set out in standard economic theory. But the assumption in the perfect competition model that consumers are 'rational' has also been questioned, in particular by behavioural economists.

According to standard consumer theory, people are rational agents who, prior to making any consumption decision, weigh all the costs against the benefits and only make the purchase if the benefits are equal to or greater than the costs. And this all happens subject to their budget constraint – how much money they have to spend. Individuals are also assumed to have a fixed and clearly defined set of preferences when it comes to the types of goods and services available and, based on these fixed preferences and the choices on offer, always to make the best possible decision. Consumers always prefer more of a good or service rather than less and prefer averages (a bit of everything) to extremes (a lot of one thing). They are also required to have perfect information about prices and the availability of goods and services and to make consumption decisions in isolation from each other.

Simply observing people going about their day-to-day lives tells us this is not how they behave. Some economists are therefore increasingly interested in the implications of dropping the assumption that consumers behave as rational agents, and are focusing instead on how people actually make their decisions. This strand in economic thinking – behavioural economics – is now very well established. However, it is heavily reliant on laboratory experiments. While these often explain why consumer behaviour – and market outcomes – differs from what is supposed in standard theory, beyond paternalistic nudges, they have little to say about how, given human nature is what it is, markets can be made to operate better for consumers.

Consumption decisions take time and people are not always prepared to trade off what they regard as valuable leisure time to collect a full set of information before making them. Their ability to make the optimal consumption choice is therefore reduced. Consumers in the real world have to make so many decisions that it is impossible to accumulate a full set of information about any of them. Often, they display 'bounded rationality', that is they make what are otherwise rational decisions, as assumed in the textbooks, on the basis of a limited set of information. In particular, they use heuristics (rules of thumb) based on prior beliefs about markets. In many cases, these are reasonable: if you buy food at Waitrose, you will probably pay more, but get better quality, than at a discount supermarket. But in others, it can lead to false assumptions, for example that a firm that produces reliable products in one area will necessarily do so in others.

In some circumstances, an inability or unwillingness to process information can result in impulse buying. Paradoxically, in other circumstances it can lead to inertia. Some decisions are never made by consumers because they are complex and prices may not be a clear signal (for example complex tariffs for utilities).

Evolutionary economics, a relatively new branch of the subject, has tried to take behavioural economics a stage further and explain why households and individuals have certain preferences, how these change and the processes people use to come to their consumption decisions. Its focus is on the process of information gathering, and evolutionary consumer theory places learning at the centre of consumer behaviour. People copy and exchange information with a range of people in their networks and this shapes consumer choices (Earl and Potts 2004). Trial and error also play an important role. People learn through experimentation and mistakes until they reach a particular consumption decision (Nelson and Consoli 2010).

Consumer theory therefore needs to focus on how people with limited information make decisions in a constantly changing environment. A crucial element of consumer choice, for example, is the arrival of new goods and services in the market and how they result in changed tastes and preferences. Evolutionary economics explores the processes by which economic agents learn to adapt to novelty.

Evolutionary economics does not believe people try to achieve an optimal allocation of resources or to maximise utility; instead it sees them as having an evolving set of decision rules. When observing people's decisions and purchases over time, it is clear that their preferences are not fixed and tend to change and evolve. A number of factors contribute to the fluid nature of individual preferences in real life, but the main drivers are culture, other people's preferences and experience (ibid).

The implications of this viewpoint are huge for consumer theory and policy. If people are continually responding to their environment and adapting to it, the economy is in a constant state of flux. It is a dynamic system and markets can never reach the perfect competition equilibrium envisaged in the standard model, so policy prescriptions based on the assumption that they do could be ineffectual.

This new way of thinking about consumers does not deny that their behaviour is the result of individuals reacting to changes in incentives, in particular price. But it argues that there are other influences, including the behaviour of others within social networks that can be just as important (Ormerod 2012). Network theory, another new branch of economic thinking, acknowledges the power of other people to influence a person's preferences. It recognises the social element of decision-making. People do not carry out an extensive cost–benefit analysis before every decision but instead look to other people in their networks for guidance, help and advice. As a result, network effects can be a big driver in consumer behaviour. Cultural preferences, which are transmitted through networks, also play an important role; many people want to have similar tastes to others in their groups, or to people they respect (Henrich and Gil-White 2001, Cialdini and Goldstein 2004).

Consumers copy and learn from opinion leaders and other people. Although copying may not always lead to an optimal decision, it can be a good strategy, particularly if a decision requires processing a large amount of information. It is a quicker and easier way of solving a consumption 'problem'. If a consumer faces an overwhelming array of choices, copying can make a decision simpler by reducing their number. It can also be a good strategy when people do not have complete information or any previous experience; consumers often believe that other people have better information than themselves. Copying people who appear to have more knowledge or have previous experience can be a smart strategy for consumers to make the best use of the time they can devote to a particular consumption decision (Ormerod 2012).

People do not make decisions in isolation; they are directly influenced by others. This influence is spread through social networks, including family members, friends, work colleagues and the wider community. The internet has led to a broadening out of these networks. Before buying music or a book online, for example, it is possible to read reviews written by complete strangers that may sway a person's decision about whether or not to go through with a purchase. And many sites will make recommendations based on past purchases. Consumers can also use comparison sites like Trip Advisor to gather more information before, say, booking a hotel room. This might not be rational behaviour as assumed in the standard economic model, but it makes sense when purchasing in an unfamiliar market to spend time discovering the views of others who know the market, rather than doing your own time-consuming research into that market.

The growth of networks through the internet and social media has increasingly turned us into social decision-makers (Helbing 2013). This makes reputation crucial for firms operating in consumer markets: ‘people rate products, sellers, news, everything, be it on Amazon, eBay or Trip Advisor’, and these ratings help to determine sales (ibid). One study suggests that having a good reputation is associated with consumers getting a better service and sellers being able to charge a higher price (Przepiorka 2013).

Some analysts believe consumers’ power will be enhanced in future by the growth of new types of intermediaries between the consumer and the firm selling the good or service. Ctrl-Shift (2013) argues that a second generation of consumer empowering intermediaries (CEIs) is developing which will give consumers more assistance with decisions, for example by telling them how to switch energy companies, and which will offer future monitoring of rates and tariffs. They will, therefore, do a lot more than first-generation CEIs, which are just price comparison sites. Furthermore, Ctrl-Shift envisages the eventual development of a third generation of CEIs that will offer a fully bespoke service, acting as an agent for the consumer in complex markets. These intermediaries, they argue, would behave more like ‘rational’ consumers, in terms of being fully engaged with markets, and so would force firms to be more competitive on price, quality and innovation. There is an obvious risk, however, that if these intermediaries do evolve, they will draw their customers only from higher- and middle-income families. Whether they will be dominant enough in markets to wrestle power from firms is therefore moot. Alternatively, firms might seek to segment markets, treating CEIs and direct consumers differently.

Perhaps the most important contribution new economic thinking has made to the analysis of consumer markets recently is to add to our understanding of the complexity of the interaction between consumers, firms and regulators. Each action by one player in a market is likely to produce a reaction from the others. In particular, firms have used the greater understanding of consumer actions by behavioural economists to develop strategies to exploit deviations from ‘rational’ behaviour.

Consumers’ tendency to postpone decisions, or not to take them at all, for example, makes it easier for firms to segment their markets and offer better deals to new customers than to existing ones. This is common in the financial sector. Banks offer savings products, particularly ISAs, that pay above-market rates for a fixed period – usually a year – before reverting to a market, or even a below-market, rate. And insurance companies offer lower premiums to new customers than to existing ones with identical circumstances. Energy firms also offer different terms to different groups of customers, safe in the knowledge that levels of switching are low.

Firms also take advantage of people’s tendency to underestimate their use of some services and to overestimate their ability to forecast usage. Telephone companies, for example, offer tariffs with limited quantities at zero marginal cost to the consumer (free call minutes and texts) accompanied by a steep increase in prices when these limits are exceeded. Consumers expect to remain within the limits, but end up paying the higher charges when they do not.

Other techniques used by firms to take advantage of consumer behaviour include complex pricing (for example by energy and train operating companies); drip pricing (when booking flights or events on the internet); bundling (for example of telephone, internet and satellite/cable TV services); and exit fees. In each case, the firm makes it harder for consumers to assess the price they are paying and whether it is a fair one.

When firms use these techniques, they make more money from consumers. They also introduce an element of cross-subsidisation between different groups of consumers: those who always move their money into accounts that pay higher rates of interest, switch their insurance companies and energy suppliers frequently, and never exceed their pre-paid limits on their mobile phones (but do get close to fully using those limits) are being subsidised by consumers who do not move their money around; and those who stick with their existing insurance and energy companies, and regularly pay higher tariffs for telephone calls and texts. Cross-subsidisation can also exist in markets where firms are not segmenting their customers. For example, those who pay off their credit card bills every month are being subsidised by those who do not. They enjoy the convenience of making purchases with their credit card rather than having to carry around lots more cash, and not having to pay for them for up to several weeks, all at no cost. In most cases, the cross-subsidisation will be from low-income to higher-income consumers. Firms' exploitation of consumers, therefore, creates a type of poverty premium.

Firms are not able to exploit consumers in all markets for goods and services. Despite firms' attempts to exploit the deviations of consumer behaviour from the 'rational' model, many of the goods and services that consumers purchase are bought in markets that are reasonable approximations to the standard textbook model of a perfectly competitive market. In these markets, consumers get a reasonable deal most of the time. This includes markets in such goods and services as food and drink, clothing and footwear and furniture and household goods. Many of these markets have a large number of firms, low barriers to entry and a wide range of goods and services of varying price and quality. Some – particularly at a local level – are dominated by a small number of firms: in any local area, there are likely to be a few supermarkets that account for the bulk of the spending on food, drink and household goods. This might create opportunities for firms to exploit consumers, so regulators need to ensure that this does not happen. But, generally speaking, consumer detriment in these markets is low.

This suggests the traditional approach to improving the functioning of consumer markets – by trying to increase choice, identify and prevent collusive behaviour, reduce barriers to entry for new suppliers, ensure transparency of pricing and giving consumers more information – will, for the most part, be effective. New economic thinking does, however, suggest caution is needed in some areas. Complex systems and networks are inherently unpredictable. It is impossible to forecast how they will evolve and attempts to influence consumer behaviour risk having unforeseen consequences. It is possible to give consumers too much information. Deluging them with knowledge might lead to inertia rather than better decision-making. Imperfect knowledge can also lead to overconfidence. In some markets, for example for complex financial products, a limited degree of information might lead to a bad decision. Making it easier for consumers to switch providers might also not be what they want. Switching always takes time and effort and there can never be a guarantee that it will prove beneficial in anything but the short term unless firms' ability to change their prices is restricted.

There are also some markets that are a long way from the perfect competition model, and for which traditional solutions have been tried and failed. This might be due to consumers' behaviour and firms' ability to exploit it or because there is an oligopoly that is not demonstrating competitive behaviour. It may also be that the market is inherently very complex. Four such markets are discussed in the next chapter.

4. CASE STUDIES

This section comprises four case studies of markets that are far from the perfect competition model, either because of consumers' behaviour and firms' ability to exploit it; or because there is an oligopoly that appears to be keeping prices high; or because the market is inherently complex – or some combination of the three. In some of these markets, there is also a poverty premium issue. In each study, there is a description of how the market is stacked against consumers and a critique of how government and regulators have dealt with the market's particular issues. The final chapter of this report suggests the direction future reform of these markets might take.

4.1 The energy market

Consumer energy markets in the UK – the delivery of gas and electricity to households – have undergone significant change over the last three decades. Prior to the 1980s, retail energy markets were state-controlled but by the late 1990s, following a series of reforms and restructurings, they had been privatised and liberalised. As a result of these changes, consumers are now free to choose their energy suppliers, in theory introducing a high degree of competition into the retail energy market. It was hoped and expected that a properly functioning competitive energy market would develop and that this would deliver cheaper energy and a better-quality service for consumers across the UK; but the results have been disappointing. There is no evidence that the liberalised energy market has delivered lower prices or better services for consumers.

Before privatisation and liberalisation, the consumer energy market in the UK comprised a state monopoly, British Gas, and 14 regional public electricity suppliers. The gas and electricity markets were first privatised in the 1980s, and a decade later they were opened up to competition: first, in 1998 the domestic gas market and then in 1999 the domestic electricity market. As part of further moves towards a liberalised energy market, domestic price controls were lifted in the early 2000s. This meant there was no longer a cap on the maximum price that energy suppliers could charge their customers. A high degree of competition in the gas and electricity supply markets was expected to prevent prices climbing unnecessarily, with the back-stop of Ofgem, the market regulator, ready to act if there were signs of abuse.

However, privatisation and liberalisation did not lead to the well-functioning, competitive market that their supporters anticipated. There are three particular problems in the market: the concentration of supply in a small number of firms; the low switching rates of consumers between firms; and the complexity of pricing structures.

Following consolidation in the industry, there are now six major suppliers of gas and electricity to consumers in the UK (known as the 'Big 6'). In 2007, British Gas had the largest share of the gas and electricity markets (at 44 per cent and 22 per cent, respectively). The other major suppliers are E.ON, EDF, npower, Scottish Power and SSE. The electricity market also has a number of smaller suppliers, but they account for only 0.3 per cent of the market in aggregate, while the gas market has just two small suppliers delivering gas to 0.05 per cent of consumers (Ofgem 2008).

The gas and electricity markets are oligopolies and, as in most oligopolies, there are significant barriers to entry for new firms. However, the existence of an oligopoly does not necessarily mean a lack of competition. Six firms all driving down costs to fight for market share could, in theory, produce a very competitive market. Despite the small number of firms, supporters of privatisation in the energy market argued that competition would deliver better results for consumers than state-controlled provision. And in 2004, Ofgem conducted a substantial review of the competitiveness of the retail energy market, which concluded that it was competitive, but not yet 'mature' (Ofgem 2008). But in the subsequent decade there has been little evidence of a truly competitive market emerging.

A major concern with any oligopoly is that there will be collusion by the suppliers to set prices higher than they would otherwise be. Evidence in the Retail Market Review has shown that the six large suppliers of domestic gas and electricity price their tariffs very similarly, and that they tend to increase and reduce their tariffs at around the same time and by similar amounts (Ofgem 2012). Prices moving in close synch do not on their own prove that collusion is occurring; the same result is predicted by the perfect competition model. Furthermore, it could be that firms are responding to similar cost increases, for example caused by shifts in global energy prices. But there may be tacit collusion. It could be that suppliers are opting to take a 'risk minimisation' strategy – where each firm chooses to be no worse off than its competitors – rather than engaging in a fierce price war that could lead to a worse outcome for all providers (Which? 2012). In effect, it could be that all energy providers have simply decided to be content with roughly their current market share rather than aggressively seeking to increase it and risking retaliation by other firms.

If this is the case, it will require new entrants to the market to bring prices down. However, most new companies that have entered the retail energy market and succeeded in gaining customers from the Big 6 have subsequently been bought out or acquired by one of them. Examples include Atlantic Electric & Gas, which entered the market in 1998 and was bought by SSE in 2004, and Amerada, which also entered the market in 1998 and was bought by E.ON in 2002.

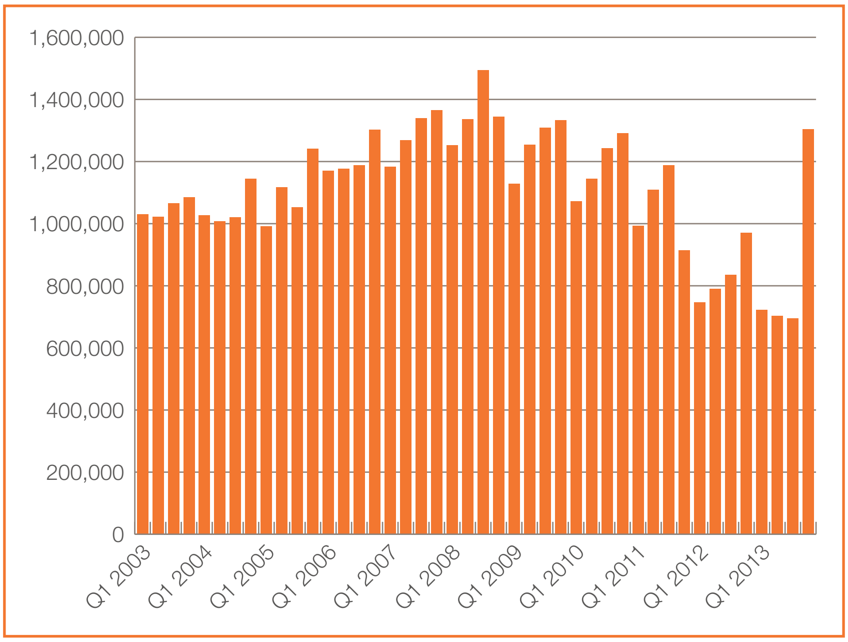
More recently, Ovo Energy and First:Utility have entered the retail energy market in direct competition with the Big 6. This had some impact on prices, but not for the majority of consumers because the six major suppliers responded by giving offers and tailoring deals intended to attract 'active' customers (those that are willing to frequently switch suppliers) rather than changing tariffs for all consumers (ibid).

This highlights another flaw in the retail energy market: there are very low levels of switching between suppliers, and without more switching there cannot be an adequate level of competition. If consumers are not prepared to signal their preferences in the market, then there is no market. Consumers are at high risk of being exploited by firms. High levels of switching would force firms to offer the lowest possible price and encourage innovation and improved service levels to attract and retain customers, but the evidence suggests consumers are not prepared to make the effort.

Switching rates in the UK declined between 2009 and 2012 and remained low in the first three quarters of 2013, before almost doubling in the final quarter (DECC 2014). This followed the announcement by energy firms of large price increases and politicians pushing energy prices into the news headlines. It remains to be seen whether this is a blip or the start of a sustained increase.

Even in the final quarter of 2013 fewer than five per cent of consumers switched their energy supplier, supporting analysis that shows only 5 to 10 per cent of consumers are active, in the sense of regularly looking for a better deal (Ofgem 2011). These low switching rates – although they are high relative to rates in many other European countries – are likely to mean poor competition in the market.

Figure 4.1
Quarterly domestic electricity switching statistics



Source: DECC 2014

Low switching rates are the result of a combination of factors, some of which can be self-reinforcing. These include the perceived hassle of switching; the complex tariff structures with multiple pricing options that the energy suppliers have adopted; consumers' tendencies towards inertia if a decision is likely to be time-consuming and there is no guarantee that they will get it right; low levels of trust in the energy firms and a general sense that they are all the same; and the possibility that future shifts in pricing structures will mean that the current best deal will be supplanted in future, requiring another time-consuming switching exercise. As a result of these factors, the UK retail energy market has a largely 'sticky' consumer base, with just under two-thirds of customers never having changed their gas or electricity supplier. This may be a factor deterring new entrants to the market. It also opens up these consumers to the risk of exploitation by suppliers, who could, for example, leave them on old, expensive tariffs and there is some evidence that some suppliers have charged higher rates to sticky customers, in part to cross-subsidise lower tariffs (Platt 2012, Which? 2012). Certainly, in markets for essential goods and services like gas and electricity, where consumers' responsiveness to prices changes is likely to be low,[17] there is no incentive for firms to offer sticky customers a better deal.

However, just as firms' pricing behaviour could be the result of a high level of competition or of a collusive oligopoly, so switching is an imperfect measure of the degree of competition in retail energy markets (although it is one that Ofgem uses). As it is currently measured, switching only captures the number of switchers, not whether they secured a better deal (that is, lower prices) and if so for how long this remained the case. Analysis by Which? in 2012 suggests that only 60 per cent of switchers in the energy market save money. Nor does it include households who considered switching but could not find a better deal than their current one. And it also fails to measure whether the level of switching is adequate to have a ripple effect on pricing for consumers who do not switch.

17 In the economist's jargon, where the price elasticity of demand is low.

An important reason for both the low level of switching and the failure of 40 per cent of those who do switch to get a better deal is the complexity of the pricing structure in the gas and electricity markets. Consumers face a complex and confusing set of tariffs that appear designed to befuddle them and to discourage switching. An Ofgem consumer engagement survey, conducted in 2008, found that 70 per cent of energy consumers regarded the number of different tariffs as confusing (Ofgem 2012). In order to effectively switch to a better deal, a minimum prerequisite is that consumers understand the prices they are currently paying and can research the market to find the best deal for their personal circumstances. However, to do so in August 2012 would have required them to compare around 900 'live' tariffs presenting costs and benefits in a variety of ways (Which? 2012).[18] Although there has been pressure on the energy firms to reduce the complexity of their tariffs (see below), it remains the case that consumers are faced with a bewildering choice. It is, therefore, not surprising that many of them decide not to expend their time and effort trying to engage with the market.

The growth of switching sites on the internet is a direct response to the complexity of the market (as well as being a chance for the firms running the sites to make money). In theory, they allow consumers to compare more easily the offers of different energy companies and to choose the one offering them the best value. However, even using these sites requires a good deal of effort, for example in terms of accumulating information on likely energy usage and deciding on what payment method to use. So, while there is undoubtedly more switching taking place than there would be without the existence of switching sites, they are only a partial solution and consumers are still not doing enough to make the market competitive.

In the textbook economic model, greater choice is one of the major benefits of competition and free markets. But behavioural economists have shown how consumers, rather than fully researching markets, use heuristics in order to conserve valuable leisure time and how too much choice can lead to inertia and disengagement from markets. This appears to be the point that the retail energy markets have reached. As a result, firms are able to segment the market, only competing for those active consumers who are likely to switch providers and extracting higher returns from the larger, disengaged market.

In part, this is, perhaps, a consequence of the nature of the service gas and electricity suppliers are selling. In one sense, there could not be a simpler product than electricity (or gas). When consumers flick a switch, they want the lights to come on. Pretty much most of the time, that is what happens, irrespective of their supplier. This means energy firms have very little scope to compete for business on the basis of quality of service (and with the advent of smart meters and online billing what little scope exists is diminishing). When there is no scope to compete on quality and the service is completely homogeneous, everything comes down to price. If tariffs were greatly simplified to the point where pricing was completely transparent, everyone would choose the cheapest tariff. To stay in business, therefore, standard theory argues all firms would have to offer the same price and – unless there was illegal collusion or firms opted not to seek to increase their market shares – this would tend to be the perfect competition price. This would maximise consumer welfare, but mean that firms could only earn the minimum level of profits they need to stay in the market.[19]

18 There were also estimated to be around 650 'dead' tariffs which people were paying but which were not open to new customers. It is likely that many of these tariffs offered poor value relative to 'live' ones.

19 However, it would also reduce firms' incentive to innovate.

It is, therefore, unsurprising that the Big 6 energy firms have complex tariff structures and appear content to maintain market share. There is evidence that this causes more detriment to some consumers than to others: 'Vulnerable consumers participate less actively in the competitive energy markets, switch suppliers less frequently, and are less likely than other consumers to have access to the best price deals in the market' (Ofgem 2008).

Vulnerable consumers, including those on low incomes, are less likely to have internet access (there are still 5 million homes in the UK without internet access). As a result, they are less likely to use switching websites or to be able to access deals that involve online billing. Low-income households are also more likely to be in arrears with their energy bills, meaning that they have to clear their debts before they can switch provider (ibid). Evidence shows that people who tend to use comparison websites are those who belong to the more affluent socioeconomic groups, can choose to pay by direct debit (which is usually the cheapest option), are aged between 35 and 64 years old and, unsurprisingly, have internet access (Ofgem 2012). Awareness of the ability to change tariffs is lowest among low-income households, BME groups, those in rented accommodation and those who have pre-payment meters. Older people are also more likely to stay with their current provider and therefore to miss out on better deals, in part because they prefer to stick with what they know (Ofgem 2008).

There is, therefore, evidence of a poverty premium and a wider problem of different groups of consumers getting different deals, with the most vulnerable at risk of doing worse. Energy companies have policies in place to support some vulnerable or low-income households. A number of energy suppliers offer a Warm House Discount, which entitles eligible consumers to a one-off discount equivalent to £135 a year. Although each supplier has its own eligibility requirements, targeting vulnerable or low-income households, it is a legal requirement that every supplier have some variation of this scheme.[20] Previous statutory schemes that came to an end in 2012 included the Carbon Emissions Reduction Target and the Community Energy Saving Programme. These programmes were energy efficiency schemes targeted at particular groups and designed to reduce costs.

Unlike the above schemes which were statutory obligations, suppliers have also initiated their own schemes to reduce costs for particular groups. For example, EDF energy automatically enrols vulnerable elderly customers on to their cheapest tariffs. These customers are also eligible for direct debit discounts irrespective of how they actually choose to pay. Scottish Power and E.ON have programmes in place for those who are struggling to make their payments (Which? 2012).

An alternative way to assist some vulnerable consumers would be to help them to access the lower tariffs that are already available. Ctrl-Shift's vision of a new generation of commercial consumer empowering intermediaries, who, among other things, will seek out the best energy deal for a consumer, is set out in the previous section. However, they are likely to be less interested in vulnerable groups who might not be able to afford their services. For these groups, local authorities or housing associations could act as intermediaries, taking collective action to switch groups of their tenants onto better deals. The Department for Business, Innovation and Skills (BIS) and Department for Energy and Climate Change (DECC) both have guides to collective switching for community groups, though they do nothing proactive to encourage such action.

20 http://www.adviceguide.org.uk/england/consumer_e/consumer_energy_and_water_supply_e/consumer_energy_supply_e/consumer_help_if_youre_older_disabled_or_on_a_low_income_e/warm_home_discount_scheme.htm

Rising energy prices are one of the main causes of the squeeze in the average UK household's living standards over the last six years. Energy is a large component of living costs, particularly for those on low incomes, it is not an area of spending that can be easily cut, and there have been large increases in prices. The UK has the fifth most expensive consumer prices for electricity among the EU15 and is a middling performer on gas prices (Ofgem 2013a). In aggregate, the profit margin for the overall supply of gas and electricity is 3.6 per cent, ranging for each supplier between −1.4 per cent (Centrica) to 6.6 per cent (EDF) (Ofgem 2013b). There has also been a large increase in fuel poverty. The number of households in the UK that are defined as fuel poor doubled between 2004 and 2007 from 2 million to 4 million, and 1 in 6 households now fall into this category (Platt 2012).

As a result, energy prices have become a political football. In response to questions about what he would do to help people struggling to pay their energy bills, the prime minister promised in October 2012 that energy companies would be required to put all their customers on the lowest tariff. In effect, this was a promise to formalise and extend a commitment that the energy companies had already made to make their customers aware if cheaper deals were available. The government's Energy Act, which received royal assent on 18 December 2013, includes provisions on consumer protections, including 'to set a limit on the number of energy tariffs offered to domestic consumers; require the automatic move of customers from poor value closed tariffs to cheaper deals; require the provision of information by suppliers to consumers on the best alternative deals available to them from them'.[21]

Although these powers are not strictly necessary because Ofgem already has the power to determine licence conditions for energy companies, the government has made it clear that it wants to ensure that every consumer is on the cheapest tariff that meets their preferences, mainly in respect of payment method.

Ofgem has already set out its proposals for forcing energy companies to limit the number of tariffs they have for gas and electricity charges (see box 4.1). In each of a number of categories, mainly depending on whether there is one unit rate or more than one depending on the time of the day, companies would only be allowed to charge four core tariffs. They could, therefore, only have one tariff for paying by direct debit, one for paying quarterly in arrears, one for pre-payment meters and one other.

The outcome Ofgem appears to want to achieve is a market in which it is possible to publish an easy to understand table showing the tariffs of each company, so that consumers can choose a payment option, from a limited number, and then simply run their eye across a row to identify which of the energy companies has the lowest price for this plan. One way to get nearer to this ideal would be to set a standard standing charge, so that comparisons could be made on unit price alone. However, this could be detrimental to low users, who should currently favour tariffs that offer low standard charges and higher unit rates. An alternative, therefore, would be to set the standard standing charge at a low level, or even at zero. However, the companies have complained that this would mean they could not reflect their fixed costs in standing charges (though in most other industries fixed costs are reflected in unit prices and there are no standing charges).

21 https://www.gov.uk/government/collections/energy-act

Box 4.1: Ofgem's proposals for reforming the domestic energy market

- Introducing a maximum limit on the number of core tariffs that suppliers will be able to offer at any point in time.
- Simplifying tariff structures to ensure that all tariffs have a simple standing charge (which could be zero) and unit rate structure (no multi-tier tariffs).
- Simplifying how discounts, bundles and reward points are offered and presented.
- Improving existing and introducing new consumer protection safeguards for both evergreen and fixed-term offers.
- Migrating customers from tariffs that are closed to new customers ('dead tariffs') on to open tariffs, where this would be beneficial to the customer.
- Facilitating collective switching schemes that meet consumer interests and the aims of the Retail Market Review, and allowing 'white labels' time to absorb and adapt to proposals.
- A Tariff Comparison Rate (TCR) helps consumers to compare the costs of different energy tariffs by different suppliers. This is similar to the Annual Percentage Rate (APR) used in savings, credit and loan agreements.
- Personal Projections to establish a common means of calculating estimated annual energy costs that are personal to the consumer. This will help consumers to make accurate comparisons between suppliers on a like-for-like basis.
- Cheapest Tariff Messaging (CTM) to provide consumers with personalised information on how much they could save by switching tariffs with their current supplier. This is designed to improve consumers' awareness of the savings available from switching and prompt them to consider their options.
- Tariff Information Label (TIL) to create a standard way of presenting energy tariff features to help consumers understand all the characteristics of a tariff and compare them across suppliers.
- Bills to contain personalised information for the CTM, and Personal Projections on the first page. The second page will include consumers' tariff information such as tariff name, exit fees and their annual consumption. Finally it will also include information on the TCR for the consumer's current tariff, where applicable.
- Annual Statements to provide a range of information on a consumer's energy costs and consumption in a specified layout. This includes information such as the CTM, where to find independent advice on switching, a version of the TIL and a graph of a consumer's consumption over the last 12 or 24 months.
- Price Increase Notices to contain two clear and easy to understand tables showing the price increase. These compare the previous and new rates and a comparison of the Personal Projections at the new and old rates.
- End of Fixed Term Notices to include information on what tariff options are at the end of the current tariff and what will happen if the consumer takes no action.
- Dead Tariff Notices to ensure those consumers who are on evergreen tariffs which are no longer open to new consumers (that is, dead tariffs), are aware of any changes to their tariff and understand what their tariff options are.
- Terms and Conditions (T&Cs) to provide greater consumer protections for individual consumers by ensuring T&Cs for contracts reflect the effect of our new rules.

Source: Ofgem 2013c

It is not clear that this will help those who are currently seen as vulnerable, in part because they do not switch provider. It could lead to an increase in the average price paid, if it is the cheaper tariffs that are axed in the process of rationalising down to four. It is also likely to lead to an ossification of tariff structures. Firms will be reluctant to drop one of their existing tariffs to try out a new pricing structure in the market.

Meanwhile, the Labour leader, Ed Miliband, has said that, should his party win a majority at the next general election it would enforce a 20-month freeze in retail gas and electricity prices to give it time to abolish Ofgem and introduce a new regulatory framework for the industry. This would be designed to deliver better outcomes for consumers, as well as securing long-term supply and enabling the government to meet its targets for decarbonisation. The party's policies have been set out in a consultation document (Labour Party 2013). The principal measures proposed specifically to improve the retail market in energy are: simplifying tariffs so that consumers can compare prices and engage with the market; ringfencing supply and generation businesses within vertically integrated companies; increasing transparency in the wholesale gas and electricity markets by formalising uncleared over the counter trading; and improving competition and transparency in the wholesale electricity market through an open pool.

Apart from the first measure, which matches the government's pledge and is likely to have been put into effect by Ofgem before the 2015 election, these measures are all targeted at energy firms. The presumption is that energy firms are able to report low profit margins in their retail businesses because they are making much larger margins in their wholesale businesses. This happens because their wholesale arms charge their retail arms higher prices than would be the case in a competitive wholesale market. Making the wholesale market more transparent is, therefore, a good way to lower prices in the retail market. However, it will not make the retail energy market more competitive.

The problem is that neither the government nor the opposition have developed an understanding of what a realistic, healthily competitive retail market in energy might look like, or indeed if it is actually possible for one to exist. The root of the problem is the assumption that increasing choice always empowers consumers and encourages firms to compete more for their business. This only works if consumers are prepared to cooperate. Behavioural economists have shown that consumers do not necessarily want more information and more options. In many markets, including the energy market, they want to be able to make a reasonable choice with as little effort as possible. Making markets simpler might, therefore, be the best way to increase consumer power. This means fewer tariffs, fewer changes in deals on offer and easy comparison between different suppliers. But it does not necessarily mean there will be more competition. Firms might respond by being less prepared to cut tariffs to attract new customers.

Simplifying tariffs will not create a competitive energy market. Reliance on indicators such as the degree of switching and the number of tariffs on offer misses the point. From a consumer's perspective, all that matters is that the supply of energy is reliable, that the means of payment is convenient and that the price is as low as possible. For most consumers, everything else is largely irrelevant. This makes it difficult for firms to differentiate themselves except on price. In this context, the government/Ofgem plan to limit firms to four tariffs might appear sensible. However, it will only result in lower prices if firms are prepared to compete for market share; if alternatively they are prepared to accept broadly their current market share, then prices will be higher.

Economic theory suggests that in the former case firms will only make ‘normal profits’; in the latter case ‘abnormal profits’. The profit margins of the Big 6 would, therefore, appear to be a key indicator of how well the energy market is functioning. They are not, however, a perfect indicator. First, because energy firms are vertically integrated (that is, they operate throughout the energy supply chain), it is necessary to assess their profit margins in the retail and wholesale markets to ensure they are not applying cross-subsidies within their businesses. This is what the Labour party’s proposals seek to do. Second, assessing profit margins is a very static approach. Low present-day prices are not the only reason for wanting a competitive market. Another is to encourage firms to drive down costs and ensure that prices remain low in the future. From the consumer’s perspective, there is little difference between normal profits and high costs and abnormal profits and low costs.

A thorough review of the energy market is long overdue and Ofgem announced in March 2014 that an inquiry will be carried out by the CMA. If, as seems likely, the evidence suggests that retail energy markets are not competitive and are not encouraging efficiencies in suppliers as hoped when price controls were lifted in 2002, then action will be required to deliver lower energy prices and ease the squeeze on living standards. This could include the break-up of the Big 6 companies, forcing them to separate their generation and power supply arms.

4.2 Public transport

A well-functioning transport system is vital to support a growing economy. Transport can play many important roles: it gets people to work; it can transfer goods around the country; it increases leisure opportunities; it can encourage the integration of different communities; and it helps tackle problems of isolation.

The UK has good levels of connectivity compared to other European countries (Eddington 2006). However, the current transport system has a number of weaknesses:

- Poor access to transport: the system can exclude those on low incomes, vulnerable groups and those living in rural areas, creating social injustice and feeding social exclusion.
- Concentration of public transport providers: the bus and train markets in the UK are dominated by a small number of providers and in local areas there are oligopolies or even monopoly provision, which have the potential to lead to abnormal profits, low levels of innovation and weak incentives to control costs.
- Failure to meet the demands of consumers: the structure of the transport system makes it hard for consumers to have an effective voice in shaping provision.
- Fares: the cost of public transport in the UK is high relative to other European countries.

Accessibility is particularly important for those on low incomes. Access to key markets and services can influence life chances. Poor access – ‘transport disadvantage’ – can restrict where people work and the type of work they can do; it can limit access to healthcare, education and training and affordable shopping; and it can lead to increased isolation, particularly for the elderly population. It is generally the poorest and most socially disadvantaged who experience transport disadvantage (Lucas et al 2008). One of the reasons the government intervenes in transport markets is to attempt to mitigate transport disadvantage, which it sees as a market failure.

The government intervenes in transport markets to correct perceived market failures in a number of different ways. It can attempt to influence the level of supply or demand through changing price. For example, the London congestion charge increases the cost of driving in central London, and so reduces the demand to do so. This reduces congestion and lowers pollution levels. Alternatively, it can intervene directly in markets to change supply or demand – low emission zones, for instance, restrict some vehicles from using certain roads at certain times. But the government's most significant interventions are in the markets for public transport, in particular bus and train travel.

Bus services in the UK were deregulated in 1986 (with the exception of London and Northern Ireland). Bus operators have control over fares and what services they run. Local transport authorities (LTAs) have no role in the provision of services but they do supplement them by tendering contracts with bus operators for supported services. In 2010/11, roughly one-quarter of all bus mileage in England (excluding London) was supported by local transport authorities (House of Commons 2012).

Bus services were deregulated because it was believed that a competitive market would provide a better quality of service and better value for money, compared to services provided by local authorities. Private companies, driven by the profit motive, were assumed to have a greater incentive to be aware of consumers' demands and needs and so to produce services to meet them.

In London, bus services were not deregulated. The mayor of London, through Transport for London (TfL), is responsible for: planning the system; appointing private bus companies (through a competitive tender process) to provide services on a route by route basis; and setting transport fares. Operators contract to receive a certain income from TfL, rather than on fare levels, so they bear no revenue risk. They bid on cost and service quality. There is no head-to-head competition on individual routes. TfL's current policy is to raise fares by an average of 2.7 per cent, while the cost of travelcards increases by retail price inflation in line with train fares.

The Office for Fair Trading (OFT) recommended an investigation into local bus service providers in 2009. It wanted to know whether competition in the provision of local bus services outside Northern Ireland and London had succeeded in achieving the government's aims of greater quality and lower prices, after taking into account government support in the form of subsidies. It was also concerned about market concentration within the bus market. As a result, the Competition Commission undertook a study and published a review which identified a number of problems in the bus market (OFT 2010).

The OFT found evidence of significant market concentration among bus service operators. Despite there being over 1,200 bus companies in Great Britain, the industry remains concentrated, with five major companies – the so-called 'Big Five' – dominating the bus transport market (FirstGroup, Stagecoach, Arriva, Go-Ahead and National Express). Taken together these five operators provide over two-thirds of all local bus services outside London.[22]

The Commission's review also found that most operators were not competing in the same areas as a result of geographical market segregation. This meant there was little head to head or on the road competition. As a result, one operator has controlled bus services in many areas for a significant period of time (Competition Commission 2011).

22 House of Commons Library, *Buses: Franchising*, Standard Note SN00624, April 2012, see http://www.parliament.uk/briefing-papers/SN00624

For example, south Manchester is primarily served by Stagecoach, while FirstGroup dominates the market in north Manchester.

A further finding of the review was that market segregation and a lack of real competition had allowed operators to generate persistent profits above the cost of capital on a national basis. This indicated that competition was not effective in the market.

The result of weak competition in the bus market therefore is that consumers have faced poorer quality services and higher fares. The Competition Commission calculated passengers and taxpayers are paying between £115 million and £305 million more a year than they should be, with taxpayers shouldering between £5 million and £10 million and passengers the rest (ibid). A better outcome for consumers would result if firms were in direct competition on routes, or for routes.

Deregulation does not appear to have boosted bus usage. Bus journeys in England, outside London, and Scotland have fallen by around one-third, while in Wales there has been little change. On the other hand, in London, the number of passenger journeys has almost doubled, with most of the growth occurring since 2000, in part due to the introduction of the congestion charge in 2003 and a large increase in government subsidy to Transport for London compared to the rest of the country, where government support increased mainly through concessionary fares. This suggests subsidising passenger travel directly may not be the best way to ensure overall passenger increase.

Bus fares have been rising faster than inflation. Between 2005 and 2011, fares increased by 6.8 per cent more than the general rate of inflation (although since 2009 fares have fallen by 4 per cent). The picture was not even across the country, however. In London, there was a real increase of 18.4 per cent; and fares increased by 20 per cent in real terms in the English metropolitan areas. In contrast, fares fell in real terms by two per cent in non-metropolitan areas (DfT 2012). In metropolitan areas, therefore, bus fares are one part of the squeeze on living standards.

These increases will have had significant implications for young people and those belonging to lower-income households. Younger people and older people with limited access to a car are more likely to be bus users – a third of bus users are people under the age of 21. And one-third of local bus trips are carried out by people who belong to the lowest income group (ibid). Among people who are in the two bottom income deciles, 63 per cent do not own a car, and therefore rely on friends, walking and public transport to make their journeys.

The high cost of bus transport can have a number of impacts. It can limit job opportunities, shopping and leisure activities. This contributes to social inequity and exclusion. For some, the cost of taking the bus or owning a car is a barrier to securing work, while others are forced to use expensive local shops as cheaper supermarkets require access to public transport or personal cars. In response to these problems, the government has intervened in the bus market in a number of ways, mainly to improve the mobility of the elderly.

Local authorities outside London spend significant sums on 'supported services': services that are categorised as necessary but not 'commercially viable' (House of Commons 2012). In England (excluding London), expenditure by central and local government on such services amounted to £2.5 billion a year on bus-related revenue expenditure. In 2010/11, over £1 billion of this expenditure was spent on concessionary bus travel – a subsidy provided to eligible groups of bus passengers, including older and disabled people. Bus companies are reimbursed for concessionary travel on a 'no better, no worse off' basis. In 2010/11 just over a third of journeys were made by concessionary passengers.

The government also offers financial support through the bus service operators grant (BSOG). This grant is paid to bus operators and community transport organisations to assist them with costs associated with their annual fuel consumption. Concessionary fares are effective in boosting bus usage, but their blanket nature means that support is not well targeted, with wealthy pensioners receiving the same benefits as those that are less well-off. In addition, unemployed people for whom transport costs are a major barrier in the labour market do not receive help with their fares.

The rail industry is regulated by the Office for Rail Regulation (ORR), which was established in 2004, and also by the Department for Transport (DfT). The DfT is responsible for the contractual regulation of service provision and most fares, including commuter fares. The ORR oversees the operation of Network Rail and licenses operators on the network. Network infrastructure is owned by Network Rail (a non-dividend paying corporation). The vast majority of rolling stock (carriages and engines) are owned and leased out by three rolling stock operating companies (ROSCOs). Passenger services are provided primarily by 16 train operating companies (TOCs) which compete for passenger rail franchises from the DfT (there are also seven train operators providing services outside the franchising system). The government does not set individual fares, but it does control some fare rises and tries to influence others. In 2014, it limited the average increase in regulated fares to RPI inflation (3.1 per cent), after a number of years in which prices had been allowed to increase at a faster rate than inflation.

In 2011/12, the government provided £3.9 billion in support to the rail industry, just under one-third of its total income.[23]

Demand for rail – in terms of the number of passenger journeys – has soared since the industry was restructured and privatised, though it should not be assumed that privatisation was the main, or even a significant, factor leading to the growth of demand. Growth has not been uniform across the country, but rather is centred on London and is associated with a growth in commuter traffic that, in many instances, has little real alternative to train travel. The result is that, while commuter trains are often full to overcapacity, there are often empty seats on other journeys. If this was a free market, the logical response would be to increase fares for commuters and reduce them for other travellers. However, regulation prevents this from happening because there are social benefits in ensuring that people can afford to travel to work.

The nature of the rail market means that the government has a role as an agent for consumers, acting on their behalf to agree levels of service and prices with the train operating companies (TOCs). Although the TOCs have delivered higher passenger numbers without the scale of price hikes seen in, for example, energy supply and childcare, this arrangement is problematic. First, there is no adequate mechanism for consumers to make their preferences known to the government. Second, even if there was such a mechanism, it is not clear that the government would listen. It has two potentially conflicting aims: to secure the best deal for consumers, in terms of lower fares or improved services, and to maximise its revenues from (or to minimise its subsidy to) the

23 http://www.rail-reg.gov.uk/upload/pdf/gb-financials-2012.pdf

rail industry. Although it limited fare increases in 2014 by more than it initially planned, the government's priority tends to be the taxpayer rather than the passenger.

The bus and rail transport markets are not competitive. Both are dominated by monopoly providers and consumers have no effective choice and so cannot take commercial action. Once a decision is taken to make a journey by public transport, there is likely to be no choice of provider. Furthermore, the Competition Commission found that, in the bus market, even if there was a choice, passengers would simply take the first bus that came along, regardless of the operator or the price.

Passengers have few levers to demand better service. Although there are well-established complaints procedures, individuals are likely to feel that their complaint will make little difference, and so are loath to take the trouble to make it. Unlike in a well-functioning market, therefore, there is very little feedback from consumers to firms about how happy they are or how services could be improved.

The scope for introducing real competition into the rail market is very limited. On some routes – such as London to Brighton – there is sufficient capacity on the line to have two operators providing a service, but in many instances this is not the case. The issue, therefore, is how to ensure that a monopoly provider is doing everything to provide good value to its customers, in terms of improving quality and keeping prices down.

The bottom line is that there will never be a competitive consumer-facing market in either bus or rail transport. The government will continue to shape both markets and only it has the power to get a better deal for consumers.

4.3 Childcare

Potential demand for childcare is determined in large part by demographic and labour market trends. In particular, the changing size of the female workforce of childbearing age and the employment rate of women shape demand for childcare (Lloyd and Penn 2012, Thompson and Ben-Galim 2014). Over the last 20 years, women's increased participation in the workforce has contributed to, and been facilitated by, a rapid expansion in the UK childcare market. Despite a fall in the early years population from 3.9 million to 3.4 million, the childcare market expanded during the 1990s and the first half of the 2000s. In 2010, the childcare market in the UK was valued at £4.1 billion.[24]

But a number of other interconnected factors also come into play, including the flexibility of work arrangements made available by employers, availability of childcare places, access to informal childcare (which in turn depends in part on employment rates among grandparents) and parental preferences. The affordability of childcare – after allowing for any government subsidies and employer contribution – is also important. The ability of a family to pay for formal childcare largely determines whether or not they will make use of it, and so also determines whether both parents can go out to work. Since it is usually the mother who stays at home to look after children, the cost of childcare can have a large impact on maternal employment particularly among women without formal qualifications and lone parents (Thompson and Ben-Galim 2014).

Ability to pay also influences the mix of formal and informal childcare that parents adopt. When the cost of formal childcare increases, parents use informal care more. Lloyd and Penn (2012) find a positive correlation between the price of childcare and how often

24 http://www.laingbuisson.co.uk/Portals/1/PressReleases/ChildrensNurseries_11_PR.pdf

families use informal care. However, some families do not have the option of using informal care, for example if the child's grandparents (the main source of informal care) do not live close by or are themselves in full-time employment.

There has been a shift towards greater use of informal care. Between 2005 and 2008, the proportion of working mothers with three- and four-year-old children using grandparents for informal childcare increased from 42 per cent to 49 per cent. For non-working mothers with children under three years old, grandparent use rose from 19 per cent to 25 per cent over the same period. In contrast, use of formal childcare fell from 14 per cent to 10 per cent. This suggests the formal childcare market is not working. Moreover, a 'care gap' could emerge in the future if more grandmothers and grandfathers stay in work longer. If the option to use informal care diminishes, there will be greater pressures on the formal childcare market (Ben-Galim and Silim 2013).

Formal childcare services are what economists call a mixed good, delivering both private and public benefits, including greater parental employment and incomes and reduced early childhood disadvantage. The adequate delivery of childcare can, therefore, have significant impacts on economic, social and educational outcomes. However, the childcare market in the UK is not delivering the outcome desired by society, particularly for those on low incomes (Lloyd and Penn 2012). Childcare costs in the UK are among the highest across the OECD;[25] there is a lot of diversity in terms of the quality of provision; and a lack of flexibility for working parents (Cooke and Henehan 2012).

The private sector is used to deliver the bulk of childcare in most English-speaking countries, while in most European countries public provision is the dominant model (Lloyd and Penn 2012). The UK childcare market is primarily a pay-as-you-go private market dominated by profit-making providers, who also provide much of the free care that children aged three and four are entitled to, though there are also not-for-profit operators and some government provision. The private sector has increased its share of the childcare market significantly over the last 15 years and profit-making providers now account for around 80 per cent of all provision. This shift towards profit-making providers is, in part, a result of the Childcare Act of 2006, which made local authority or state provision the last possible course of action (ibid).

The presumption underlying the move to greater private provision was that in a demand-led private market funding would only go to those providers who represented parental preferences. If parents were responsible for paying for childcare services, even using government money, the theory was that they would seek out the best quality at a reasonable price, just as they are presumed to do in other markets, and that this would produce the best outcome for them as consumers. There was an assumption that the childcare market is like other markets, in terms of demand, supply and the interaction of the two.

This does not mean there is no state involvement in the market. In fact, there has been a substantial shift towards more policy support for childcare since 1997, under both Labour and the Coalition governments. The state adds to the supply of childcare directly by providing some places and it subsidises demand. In keeping with standard economic thinking on competition and markets, this route is preferred because, in theory, it allows the market to set prices and families to signal through their preferences in the market who they think are good and bad providers, leading eventually to the expansion of good providers, while bad ones are forced to exit the market.

25 In 2011, only in Switzerland and Ireland did parents pay more for childcare (OECD 2011a).

As a result, childcare is largely delivered through the market because standard economic theory concludes that the market leads to the most efficient allocation of resources. Market provision gives parents greater choice and therefore, it is assumed, increases competition between providers, so raising quality and reducing prices (Plantenga and Remery 2009). As a result of this theoretical bias, government support for eligible parents is mostly channelled through demand-led subsidies, allowing parents to make choices and the market to allocate resources.

Box 4.2: Government support for childcare in England[26]

- Three- and four-year-olds and two-year-olds from disadvantaged backgrounds are eligible for 15 hours of free childcare a week for 38 weeks a year.
- There is tax relief on employer-supported childcare (which tends to benefit those on middle to higher incomes). From 2015 this will be replaced by a system under which all families with an income of less than £150,000 will receive up to £2,000 towards the cost of childcare for each child under the age of 12.
- Parents on low incomes who both work for 16 hours or more are eligible for subsidies though childcare tax credits that cover up to 70 per cent of childcare costs up to £175 for one child or up to £300 for two or more children (this was cut from 80 per cent in 2011). Childcare tax credits will eventually be rolled into the universal credit when they will cover 85 per cent of costs.

In theory, market provision means that parents can switch providers rather than having to use state-provided care. This should encourage greater competition between providers, which means parents are more likely to face lower childcare costs (Cooke and Henehan 2012). It also means new providers can enter the market if they think they have identified a gap in provision that parents want to be filled. More generally, if providers are allowed to make profits, it is assumed that they have an incentive to innovate and adopt new methods to differentiate themselves from their competitors, leading to greater quality and lower costs.

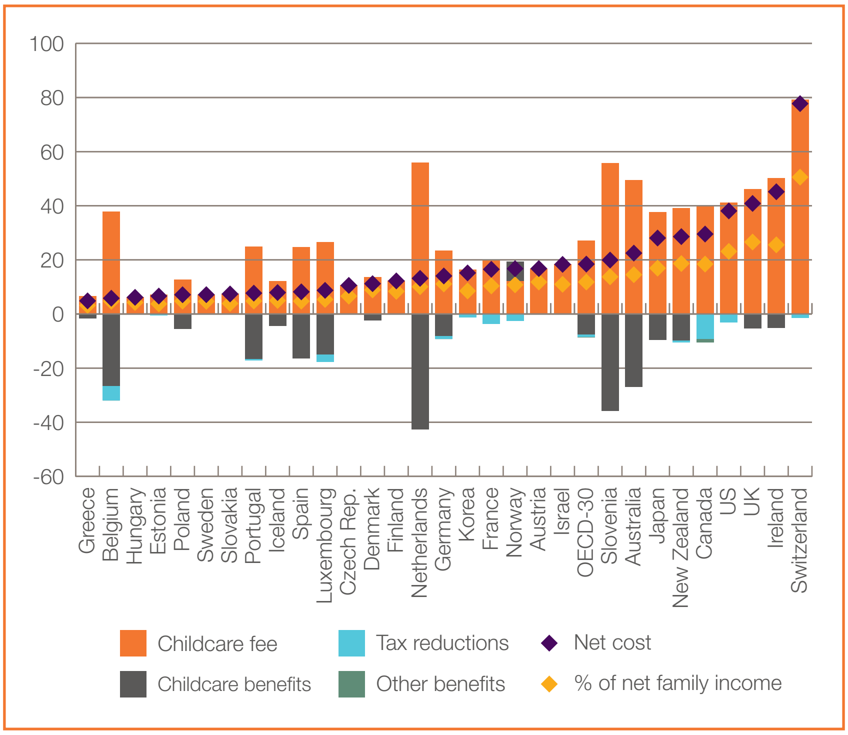
So much for the theory. In practice, the childcare market in the UK is not delivering the desired results.

UK childcare is among the most expensive in the world. Competition is not driving prices down. The government's various support measures bring down the cost of childcare for some families but fall a long way short of meeting the needs of all families. The high cost of childcare remains a barrier to work for many families, particularly mothers, including those who are ineligible for the childcare element of the working tax credit and those whose needs are not met by the free provision offered to three- and four-year-olds. Although a lot of support is available to eligible low-income families, 8 in 10 people who live in severe poverty state cost as a barrier to accessing childcare (Save the Children 2011). A majority of parents in severe poverty say they are no better off working and paying for childcare, compared with just one in five families with incomes over £30,000. For these families, the high cost of childcare prevents them from using formal childcare and is a disincentive to working. This is particularly relevant to single parents and low earners. Twenty-four per cent of parents find it difficult or very difficult to cover childcare

26 Childcare provision is a devolved matter and support differs in Scotland, Wales and Northern Ireland.

costs (Alakeson 2011). Most state support for childcare is offered to low-income families or benefit-reliant families. This means that net childcare costs, after including state support, vary considerably for families across the income spectrum: 'Families on low-to-middle incomes face significantly higher costs for the same number of hours than families that are reliant on benefits' (Cooke and Henehan 2012).

Figure 4.2
Childcare costs as share of average wage for a dual-earner couple both on the average wage with two children, 2008



Source: OECD 2011a

The quality of provision has not improved much, and where it has it is due to investment in qualifications rather than the market. Consumer theory suggests competition and the possibility of making profits will lead producers to increase quality to attract more business. But UK providers of childcare appear to have opted for the alternative route to higher profits of cutting costs and this could have compromised quality, potentially lowering it to the minimum acceptable standard (Lloyd and Penn 2012). When this happens, those on the lowest incomes – who have the least power in the market – suffer most. Ofsted reports that for-profit poorer quality nurseries tend to be found in poorer areas and the best ones in wealthier areas (Lloyd and Penn 2013). The market structure encourages providers to open in affluent areas with high rates of parental employment, which further widens the quality gap in provision.

The childcare market has not evolved through innovation to deliver the flexible supply that parents want. The labour market has developed in such a way that many parents no longer work Monday to Friday, 9am to 5pm and this has created a need for formal childcare providers who will care for children out of 'normal' hours. But most childcare centres only operate between regular working hours (8am to 6pm) (Singler 2011). Again, it is those on lower incomes that lose out most. In the UK, at least one partner in 75 per cent of families on low to middle incomes is working atypical hours (Alakeson 2011). While it is easier for high-income parents to find childcare for atypical hours – using nannies or au pairs for example – low-income parents are unable to access these costly options. As a result, low-income families may be forced to use other types of childcare which are not their preferred option (Singler 2011).

The buyer–seller relationship in the childcare market is far more complex than assumed in economic models. Although competition is enhanced in theory because parents can switch providers if they are unhappy, in practice this does not happen often. Parents can be reluctant to express unhappiness if they want to ensure a good relationship with the people who care for their children. They might not want to upset their children by taking them from a place where they have many friends and moving them into a new environment. On the whole, parents are likely to be risk averse and to prefer to stick with what they know, rather than try 'untested' ground. This means that competition, and the potential for new entrants, does not guarantee improved quality.

Providers face difficulties trying to obtain a highly qualified workforce. This is partly explained by the low pay associated with childcare, and the fact that childcare work is often undervalued despite its important contribution to society. Early-years staff in many other European countries tend to be paid higher wages for equivalent work. These factors can lead to high turnover of staff (Nutbrown Review 2013).

The UK model of childcare provision is based on the presumption that leaving parents with the decision over choice of provider while giving them cash subsidies will lead to a vibrant market and improved quality. But market provision of childcare clearly has not worked in the UK. As Cooke and Henehan note:

> **'It is striking though, that all but the lowest-income families in the UK face significantly higher net childcare costs than those right across the income distributions in a number of other countries. Even the most affluent of families in Sweden, Portugal, Netherlands, Iceland, France, Finland, Denmark and Belgium face lower net childcare costs as a share of their income than all but the poorest UK families.'**
> Cooke and Henehan 2012: 18

This might be acceptable if quality was also higher, but it is not. Subsidies have been associated with strong price inflation and rapidly rising public expenditure (Thompson and Ben-Galim 2014) but not better childcare. A vibrant market has failed to materialise. The government's approach of making an element of childcare tax free is not making it more affordable for families. Radical reforms are needed to improve affordability and quality.

4.4 Housing

Although people talk about the housing market as if homes were the same as other goods and services, this is not the case. For several reasons, housing needs to be assessed differently.

First, housing is a necessary good. In most consumer markets – for example in the market for cars – we accept that there is a market price at which supply equals demand and that some people will be left wishing they had a car but unable to afford one. In the housing market, however, the desired outcome is that everyone who wants their own home should be able to have it. Total potential demand is important.

Second, housing is heterogeneous. There is not one single market in housing, but several different markets with different players in each. The actions of players in one market can spill over into other markets. So, a major programme of social housebuilding, for example, would affect demand in the private rented sector, which would lead to lower rents, and eventually to lower demand for buy-to-let properties. This would, in turn, lead to lower purchase prices for homes to buy.

Third, with the exception of the private rented sector, people move home infrequently. There is, therefore, a shortage of signals from consumers to the market.

Fourth, housing is both consumed and it is bought as an asset. When economists seek to understand the housing market through standard economic theory, they think of a home as providing a stream of housing services that are consumed by the occupier. This enables them to think about the different types of tenure in a comparable way. However, many UK owner-occupiers also see themselves as making an investment – buying an asset that they might sell to help finance their retirement or leave to their children. Owner-occupied housing is not, therefore, directly comparable with other housing options.

Furthermore, in some areas, particularly in parts of London, the market is distorted by purchases of property purely as an asset, rather than as a home. Much of this investment comes from overseas. In London, 60 per cent of new builds in the first half of 2011 were bought by foreign investors. This creates the risk of a London housing bubble and inflated housing prices that price local people out of the market. Overseas investment in housing is now £5 billion per year (Heywood 2012) – five times annual investment in affordable homes in London. Home ownership in London is already significantly lower than in England as a whole (54 per cent compared to 66 per cent). This risks being exacerbated by inflated house prices (ibid).

The housing market in the UK comprises a mix of privately owned property, rental property, local authority housing and housing association properties, but it is becoming increasingly market-oriented (GLA 2003). Sixty-five per cent of the dwelling stock is owner-occupied properties, 17 per cent privately rented properties and 10 per cent belong to housing associations. The remaining 8 per cent comprises local authority housing; a huge fall compared to 1971, when the comparable figure was 31 per cent.[27] This is largely the result of the Right to Buy scheme introduced by the Conservative government in the 1980s.

This substantial shift in the mix of the housing market has had significant social impacts. The social housing sector provides housing to eligible people on low incomes and accommodation is allocated according to need and income. Rents are commonly subsidised and are lower than market rates. This type of housing can, therefore, be targeted at particular groups of tenants, such as disabled people or young people. The reduction in social housing – as provided by local authorities or housing associations – as a share of the total has forced some people into the private rented sector while younger people have to live for longer with their parents.[28]

Housing demand is driven by a number of social and demographic factors, including birth rates, net migration and changes in social trends such as divorce rates (Schmuecker 2011: 5). It is also influenced by economic factors that affect the affordability of different types of accommodation, including market-specific factors like house prices and

27 See: https://www.gov.uk/government/statistical-data-sets/live-tables-on-dwelling-stock-including-vacants

28 In 2013, one in three men aged 20–34-years-old and one in three women lived with their parents: http://www.ons.gov.uk/ons/rel/family-demography/young-adults-living-with-parents/2013/index.html

mortgage rates and more general economic trends in consumer confidence, income and employment levels (Schmuecker 2011, GLA 2003: 8).

When housing policy has been aimed at shaping demand within the housing sector, it has often been transformative. The Right to Buy initiative, which offered tenants in council housing the opportunity to buy their homes at discounted prices, had a lasting widespread impact on the housing sector. Selling existing council homes and not building new ones led to owner-occupied properties increasing from half to just under two-thirds of the market and, as these properties later changed hands, to a big increase in the private rented sector.

The Coalition's Help to Buy scheme, with its deliberate echoes of Right to Buy, is the most recent example. It offers potential purchasers of houses costing up to £600,000 the option of only providing a five per cent deposit. For a fee, the government guarantees the mortgage loan taken by the purchaser, up to 15 per cent of the value of the property. Lenders are, therefore, able to make larger loans than they would otherwise have done and the demand to purchase homes is increased, although – unless supply responds – the main effect will be to push up prices. In effect, therefore, the policy will make it easier for people to buy a home now at the expense of making it harder in the future.

The stock of housing in the economy that is available for occupancy is a function of current and past rates of housing construction and demolition, the ability to bring unused houses back into use and the conversion of non-residential building into residential properties (GLA 2003: 14). Despite excess demand for housing, there are a significant number of empty houses across the UK. In 2008, three per cent of all private sector homes, two per cent of local authority homes, two per cent of social landlord stock, and six per cent of other public sector properties were unoccupied, equating to roughly 700,000 empty homes (DCLG 2010b). In 2010, 450,000 houses – many of them bought as investments – were left unoccupied for more than six months (Griffiths 2010). On top of residential properties, there are a great number of empty commercial properties (roughly 266,000) that could be converted into residential dwellings across the UK (Morton and Ehrman 2011). In addition, there are many properties in the UK that are under-occupied. In 2007, close to half of all homes in England with one to two occupants were under-occupied (Hull and Cooke 2012). Under-occupation tends to happen mostly in the owner-occupied sector and reflects people continuing to live in large houses once their children have left and after their partners have died. But there is also under-occupancy on a smaller scale in the social rented sector and in the private rented sector.

But the most important contributor to increased housing supply is construction by private housebuilders. Their motives are, therefore, crucial to the state of the housing market. They are primarily influenced by the economic climate, current house prices, land prices, construction costs and land availability, but other factors that can have an influence include interest rates (which affect the cost of financing construction), the availability of finance and the planning regime (FTI Consulting 2012, GLA 2003: 14).

New housing supply is falling a long way short of demand in the UK. This problem has been exacerbated in recent years by the recession and subsequent stop–start recovery, but it was evident prior to 2007. One consequence is that the housing market is not providing an adequate number of affordable homes in many parts of the country. These challenges are expected to intensify in the coming years because demographic pressures mean the demand for housing is set to rise. By 2025, there will be an additional 4 million households in the UK as a result of demographic change, increasing divorce rates and net migration (Hull et al 2011).

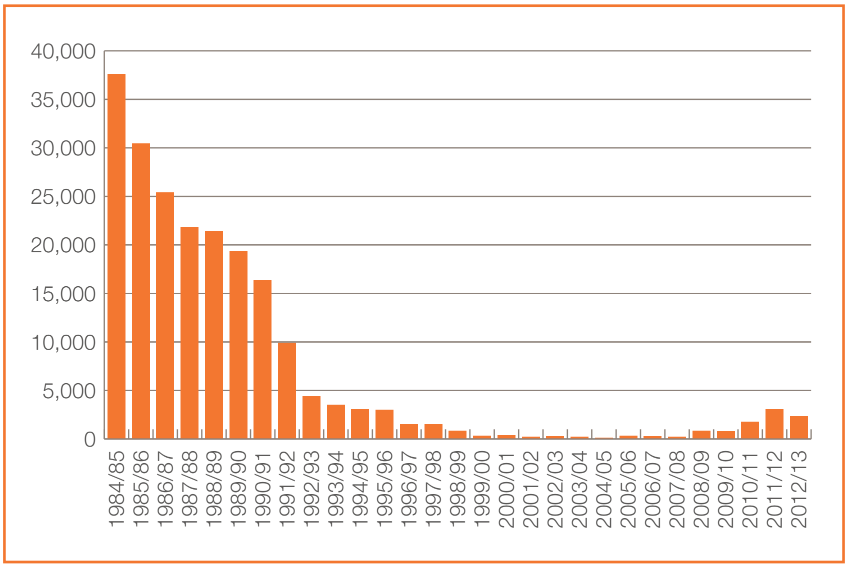
Based on these trends and construction rates over the past 20 years, the UK could experience a shortfall of over 750,000 homes by 2025 (Schmeuker 2011: 5). If this was allowed to happen, one consequence – in addition to the social problems that it would create – would be home ownership and private rented accommodation becoming increasingly expensive and unaffordable for a significant section of society.

Undersupply of housing in the UK is not a new phenomenon, though the position has deteriorated since 2008. Since the 1980s, there has been a chronic undersupply of housing, with supply failing to meet demand by between 50,000 and 180,000 units a year (ibid). Although the problem is nationwide, it particularly affects London, the south east, the east of England, the south west, and Yorkshire and Humber. England alone will need around 250,000 additional homes to be built in each year for the foreseeable future in order to close the supply gap (Schmuecker 2011).

Following the crisis, there has been a sharp drop in housebuilding; in England only around 107,000 were completed in 2012/13, the lowest level of housebuilding since 1923 (NHF 2013). Against the backdrop of an increasing number of household formations in the future, closing the housing gap is one of the major challenges facing the current and future governments.

A decline in the construction of social housing has also contributed to the UK's housing shortage. In 1985/86, local authorities constructed over 30,000 homes but by 2012/13 only 2,300 homes were completed by local authorities.

Figure 4.3
Housebuilding: permanent dwellings completed by local authorities



Source: DCLG 2014

This drastic decline has largely been a reflection of public policy changes around housing since the war. Large-scale housebuilding happened following the second world war: over a million homes were built under Atlee's government, of which 80 per cent were council houses.[29] From the mid-1970s, social housing construction began to decline. Taken together with the Right to Buy scheme, a programme which offered tenants the opportunity to buy council housing, these factors all contributed towards the erosion of social housing stock.

Throughout most of the recent period of insufficient construction, house prices in the UK have been rising rapidly and significantly faster than consumer prices in general. Housing supply in the UK appears to be largely unresponsive to rising prices. The Barker Review of the housing market found that although the prices of houses had risen significantly in real terms from the early 1990s to the mid-2000s, the supply of houses 'has not increased at all' (Barker 2004). In economists' terms, the price elasticity of supply (the responsiveness of supply to price) is very low. Indeed, research has shown that French housebuilding is twice as responsive, and German housebuilding four times as responsive, to prices as UK housebuilding (OECD 2011b, Dolphin and Griffith 2011). What is more, the responsiveness of housebuilding to price worsened as house prices rose (Barker 2004). The low elasticity of supply means that rises in demand translate into larger increases in house prices than would otherwise have been the case. In large part, this is due to an oligopoly in housebuilding and to the planning system.

Incentives for building are not as high as increasing prices would suggest. For builders, holding land and planning permission can sometimes be as profitable as building homes. As a result, building homes is done slowly so as to maximise return, and this may conflict with housing needs (Griffith 2011). There exists an oligopoly of major housebuilders in the UK. Their business model consists of producing a small number of homes, while generating profits at high margins and keeping housing prices high (ibid). The planning system operates as a barrier to entry for new construction firms (FTI Consulting 2012). Housebuilding requires a lot of planning and happens in stages, and so it requires local knowledge and expertise. This complexity has led to the market being dominated by a few large firms that can pursue housebuilding while making a profit.

The planning system in the UK is one of the most heavily 'constrained systems in the developed world' (Whitehead 2011). The limitations it places on development and change of use was a major contributory factor to the shortage of supply and rising prices of houses in the UK between 1997 and 2006 (Goodhart and Hoffman 2008). Building is also limited by land availability in particular locations (FTI Consulting 2012). The planning system also gives people the opportunity to veto proposed housing rather than to vote on it, which gives current homeowners a louder voice than prospective homebuyers. Because people buy homes in the hope that their value will increase as well as a place to live, current homeowners are incentivised to prevent further home construction in their area in order to raise prices; and they have become adept at using the planning system to do so (Hull et al 2011). Current homeowners and others with vested interests under this system are able to block building, while those in need of new housing have limited say or influence. The lack of democratic engagement in planning is a failure within the housing market.

A failure to build sufficient homes has resulted in unfulfilled demand; and it has also meant that housing has become less affordable. This has added to the squeeze on living standards. The owner-occupied sector has become increasingly unaffordable particularly for first-time buyers (GLA 2003). Despite official interest rates being at record lows, and so mortgage rates also being at rock-bottom levels, housing is still expensive. Increases

29 http://www.bbc.co.uk/news/uk-14380936

in house prices have outstripped earnings growth for many years. In the decade up to 2007, the ratio of median house prices to median income increased from 3.54 to 7.23.[30] This trend went into reverse temporarily during the financial crisis, but more recently house prices have started to rise faster than earnings again. Average house prices are currently around five times average earnings.[31] Poor affordability of homes has meant that some people are excluded from the property market and subsequently forced into the expensive private rented sector where accommodation can all too often be of poor quality.

As houses have become less affordable to purchase, greater strain has been placed on the social rented and private rented sectors. This is particularly acute in the social rented sector, where construction has not been sufficient to offset council house sales. Most local authorities do not have sufficient properties to meet demand and have long waiting lists. As a result most property is allocated to individuals based on need and not just their income. Allowing people to buy social housing without replacing sold-off stock has led to rationing of a public good (Hull and Cooke 2012). Therefore, a number of people who are ineligible for social housing have ended up in the private rented sector (Shelter 2014).

There are, however, a number of problems with the way the private rented sector operates. Tenancy is relatively insecure. The standard tenancy agreement is for just 6 or 12 months, with a two-month notice period once the initial letting agreement expires (Shelter 2012). Increases in average rents have outstripped earnings growth (Shelter 2014). Rents increased by over 70 per cent between 1998 and 2008, well above CPI inflation of 20 per cent over the same period (Fenton 2010). Seventy per cent of private renters polled in 2010 were paying rent classed as unaffordable (Shelter 2010). This has in turn increased the housing benefits bill. And the quality of accommodation is poorer than other types of accommodation. In 2012, 33 per cent of accommodation in the private rented sector is classified as non-decent (Shelter 2014). In 2007, 3.1 million vulnerable households were living in the private rented sector and just under two-thirds of them were living in non-decent accommodation (CLGC 2010).

Poor quality housing is not confined to the private rented sector. In the mid-2000s, 1.4 million children in the UK were living in 'bad' housing (Shelter 2006). In 2008/09, 654,000 households in England were overcrowded (DCLG 2010a). And in 2010 the proportion of households living in crowded conditions had doubled to five per cent compared to a decade earlier (ONS 2010). However, poor-quality housing in other sectors, and the general lack of housing, reduces the incentive for landlords to improve housing conditions. And because housing is unaffordable some tenants have to sacrifice quality for affordability.

Poor quality housing and the lack of supply have a number of indirect impacts. The lack of housing supply leads to exported costs in health (£2.5 billion annually) and crime (£1.8 billion annually) (Hull et al 2011). It also disproportionately affects children growing up in low-income families – £14.8 billion in earnings is lost due to the children of low-income families attaining poor GCSE results due to the impact of poor housing (Freidman 2010: 7).

The government currently spends in excess of £20 billion on housing benefit (Webb 2012). The UK has the highest proportion of the population in receipt of housing cash allowances in the OECD (Hull and Cooke 2012) and around 10,000 more households receive housing benefit every month (NHF 2012). Housing benefit solves the economic problem caused

30 See http://data.gov.uk/dataset/ratio-of-median-house-price-to-median-earnings/resource/3a73de15-73df-487c-9144-111f09f5912f

31 Halifax house price index, http://www.lloydsbankinggroup.com/media/economic-insight/halifax-house-price-index/

by the gap between low incomes and high rents, but it is tackling the symptom of the problem, not the underlying causes of high rents and a lack of affordable housing. Since the 1970s, government spending on housing has increasingly been directed away from investment in building and into housing benefits (Webb 2012). In terms of policy, the government approach to housing shortage has become gradually more demand led with increasing reliance on housing subsidy, and reduced investment in supply-side subsidy for construction (Hull and Cooke 2012).

Clearly, the housing market is not functioning properly. There is a longstanding gross mismatch between demand and supply that has not corrected itself despite rapid price inflation. The rising unaffordability of homes, the chronic undersupply of housing and the lack of quality homes for people on low incomes are all examples of how the housing sector is failing to meet the needs and demands of people in the UK (Hull and Cooke 2012).

5. WHAT NEXT?

Behavioural economics has shown that consumers do not react rationally – in the economic sense – in most markets. Complexity economics has shown that the interaction between firms and consumers (and regulators) in markets can create outcomes that are far from the competitive equilibrium that free markets are supposed to deliver. In particular, firms have become adept at exploiting consumers' behaviour to make abnormal profits, which is to the detriment of consumers.

Unfortunately, new economic thinking is better at identifying snags with established ideas than it is at coming up with solutions to economic problems, including in the area of consumer markets. Perhaps this is unsurprising. If the economy is judged to be made up of a set of complex, dynamic systems, then it will, by definition, be difficult to articulate how to make those systems behave differently.

New economic thinking does, however, highlight how the structure of markets affects the balance of power between consumers and firms. Attempts to make markets work better for consumers, so that they can get better value and thereby ease the pressures on the cost of living, should therefore be focused on shifting the balance of power away from firms and towards consumers.

Because their thinking is still dominated by traditional ideas and a desire to move markets closer to some sort of perfect competition equilibrium, the inclination of successive governments and regulators has been to try to achieve this power shift by increasing the power of consumers within a free market framework, for example through increased information and making switching suppliers easier. If they take any lesson from new economic thinking it is the behavioural economists' idea that consumers can be paternalistically 'nudged' into what the economic models regard as more 'rational' or appropriate actions in consumer markets.

However, a broader reading of new economic thinking suggests this will not be easy, or even possible. If consumers prefer to use heuristics, giving them more information will have a limited effect in changing their behaviour. And even when consumers can be persuaded to change their behaviour, firms will respond with behavioural changes of their own. In some cases, the outcome could be worse than before the intervention took place. If a power shift is required, measures that reduce firms' power are likely to be more effective than attempts to change consumers' behaviour. This does not mean heavy regulation of markets to the point where they are controlled by regulators and bureaucrats rather than firms and consumers. But if there is evidence that firms are using their power unfairly to take advantage of consumers, there is a strong case for action to prevent them from doing so.

Restricting firms' actions is necessary because attempts to turn consumers into the rational economic creatures found in economics textbooks are almost certainly doomed to failure. Trying to change the way people choose to live and make decisions is futile; so intervention in markets needs to be framed with their likely behaviour in mind. A key question is: what do consumers want from markets? Do they want to make the effort necessary to ensure that every price is driven down to the perfect competition ideal? Or do they want a general sense of being able to purchase decent-quality goods and services at a reasonable price and knowing that firms are not taking advantage of them, without having to make too much effort in terms of time and mental activity?

If it is the latter, then – in most markets – three problems need to be tackled: oligopolies/monopolies, information asymmetries and firms taking unfair advantage of consumers.[32] These should be the primary focus of the Competition and Markets Authority (CMA), which became fully operational in April 2014.[33]

The signs that an oligopoly is hurting competition and resulting in consumer detriment are well known: high profit margins and a failure to drive down costs or improve quality. Identifying them in practice is not always straightforward but the latest economic thinking – in particular on oligopolies in which firms have imperfect knowledge about each other's behaviour – suggests that such uncompetitive oligopolies may be more prevalent than previously thought.

The government should ensure the CMA has the resources necessary to investigate the possibility of tacit collusion and a lack of competition in any market where there are a limited number of suppliers and there is a risk of serious consumer detriment. The CMA also needs the powers to rectify any situation where an oligopoly results in a market that is not competitive. Reducing barriers to entry for new firms will be a part of any response, but such policies have rarely been successful. Once an oligopoly is in place, it is very hard for new entrants to establish a sizeable market share. It might, therefore, be necessary to break up the oligopoly by insisting that an existing firm (or firms) is split into two or more firms (as happened with BAA and London's airports).

Such actions to make the market work better are preferable to the alternative, which would be to impose permanent price controls. In most markets, the government or the CMA would be very reluctant to take such a step, not least because firms might respond by cutting supply. But the Labour party has said that it would impose a temporary cap in the retail energy market. And there are examples of caps already being set, though only in what might be regarded as special cases. Annual price increases for rail fares are limited by the government; and the Civil Aviation Authority has recently announced that Heathrow will only be able to increase the amount it charges airlines by 1.5 percentage points less than the rate of inflation for the next five years.[34]

New economic thinking suggests some approaches to the problem of information asymmetries will work better than others. Forcing firms to simplify pricing structures is likely to be effective because it goes with the grain of consumer behaviour by reducing the effort that consumers have to put into a purchase. But increasing the amount of information available to consumers risks overload and inertia. And some products are just inherently so complex that consumers are unlikely ever to get to grips with all the information they need. Additional information only improves the workings of a market if consumers act on it and behavioural studies suggest that often they will not.

Generally, advice that steers consumers in the right direction and gives them a general sense of getting a reasonable deal on price and quality is likely to be better than more information, especially in markets for complex products. Government kitemarks have not always been judged a success, but in a complex market – like personal pensions for example – ensuring that certain products have some form of government approval is more likely to encourage consumers to make a purchase than giving them additional

32 This is, of course, in addition to measures that might be needed in areas such as health and safety.

33 The Competition and Markets Authority was formed by the merger of the Competition Commission and the Office for Fair Trading. Its draft vision, values and strategy document can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/245454/CMA_vision_strategy_values_FINAL_GOV_UK.pdf

34 http://www.caa.co.uk/application.aspx?catid=14&pagetype=65&appid=7&mode=detail&nid=2328

information about all the products on the market. In other markets where consumers have little knowledge and might have difficulty trading off price against quality, networks can be very powerful in transmitting advice. Private sector solutions are developing rapidly. But there are many markets where networks would be useful.

The area where the government and the CMA could achieve most in making markets work better for consumers, however, is by tackling firms' attempts to take advantage of consumers' behaviour. This should be done through direct rather than indirect means. Measures like cooling-off periods that allow consumers to cancel warranties purchased at the same time as consumer durable goods are unlikely to work. They go against the grain of observed behaviour by requiring consumers to think twice about a purchase when they have already proved reluctant to think about it a first time. Similarly, requiring banks to send letters to consumers when a period of paying a higher 'bonus' or introductory interest rate on an ISA comes to an end have proved ineffectual because many consumers still do not switch accounts, even when they are receiving a relatively poor rate of interest. Activities such as complex pricing, bargain-then-rip-off pricing, drip pricing, bundling and exit fees bring few or no benefits to consumers and are simply attempts to exploit them by firms. Competitive markets have not seen these practices squeezed out; indeed they have proliferated in recent years as firms have come to understand consumers' behaviour better. Where there is clear evidence of consumer detriment, their use should be limited or banned.

Some markets need particular attention either because they are complex, or because there is an enhanced risk in them of consumer detriment, or because there is a serious poverty premium issue. These include the markets in energy, transport, childcare and housing.

Both the Coalition and the Labour party appear to believe it is possible to create a genuinely competitive retail market in electricity and gas, with easy access for new firms – at both the wholesale and retail level – and sufficient switching by consumers to force firms to innovate and drive down costs. It is not clear, given the experience of the last 12 years, that this is a reasonable expectation without more radical reform. Unless the Big 6's oligopoly and regional monopolies can be broken, with new entrants gaining a significant market share, and consumers can be persuaded to switch suppliers in greater numbers, a free market in retail energy is unlikely to emerge. Simplifying tariff structures may help by encouraging consumers to switch, but could also have the perverse effect of making suppliers less able to compete. The nature of gas and electricity supply is such that it is hard for firms to innovate in terms of the quality of their product, so most of the innovation in the last 12 years has centred on pricing. Simpler tariffs might therefore lead to less competition.

The CMA is going to conduct a thorough inquiry into the energy market and in particular into the profits of energy suppliers (at the retail and wholesale levels). If this shows that energy firms have been making abnormal profits despite the best efforts of Ofgem to create a free market, there will be calls for heavier regulation of the sector, including possibly the reintroduction of permanent price controls. This would, however, carry a number of risks. Regulators might wrongly predict the future costs of an efficient supplier and set prices too high, to the detriment of consumers. Conversely, it might set prices too low, resulting in suppliers being unable to invest adequately in additional capacity. Permanent price controls might also limit the incentive for suppliers to be innovative and drive down costs (NAO 2008: 4–5). In particular, they would restrict locally led innovation.

What both the free market and regulatory approaches miss is the rapid development of technology within retail energy supply and the new possibilities that this is opening up. The basic concept of consumers as mere price-takers at the bottom of the supply chain is now outdated. They can own renewable generation and sell demand reduction services back into the grid. Energy can be operated and managed on different spatial scales, not just at a national level. Rather than debate the merits of free markets versus regulation in the supply of energy, reformers would do better to focus on encouraging these developments. Although it is a very long-term solution, ultimately the best way to increase consumers' power in the energy market might be to turn them into suppliers too.

Like the retail energy market, the markets in bus and train transport are not competitive. At a national level an oligopoly exists with five firms dominating both markets, while at a local level – that is for any particular journey – the consumer is likely to be faced with a monopoly or duopoly supplier. High barriers to entry make it difficult for new firms to enter the markets and in the case of trains the need to control access to tracks mean that monopoly provision on most routes is inevitable. There is very little prospect of a truly competitive market emerging in either bus or train transport. Commuters in particular have little choice but to use public transport and so they have little power in these markets. They are largely shaped by government and so the best hope for consumers is that the government will take more account of their needs in future transport policy.

However, in the rail market, the government faces a trade-off between cutting prices for consumers and extracting the maximum revenues for taxpayers. It may, therefore, have to concentrate on improving the consumer's experience in other ways. Rail tickets should be rationalised and simplified, for example by making single tickets half the price of returns. This would not be to reduce the information asymmetry between consumers and rail companies but more importantly it would give travellers a better sense that they are getting a fair deal when travelling. Journeys could also be improved through the introduction of smart ticketing systems nationwide and the better use of technology to provide real-time information to customers. One way of putting pressure on the TOCs to make such improvements would be to increase competition from publicly owned companies, like East Coast, which has a better track record than the private companies that have run services on the same route.

In the bus market, the government should examine the case for replicating the Transport for London model in other parts of the country, particularly in city-regions. Although it would not introduce daily competition to the market, and consumers would still find it hard to express preferences, if city-regions appointed private bus companies to provide services they can use the tender process to extract the best value for consumers in terms of quality of service and price.

Successive governments have also placed their faith in the private sector to deliver childcare in the UK and tried to create a free market in which competition between providers would deliver good value for parents. This approach has not been a success. Despite subsidies, the cost of childcare for parents has rocketed without any evidence of an improvement in the quality of provision. This has added to the squeeze on the living standards of families with young children and prevented some parents – overwhelmingly mothers – from going out to work.

Employers benefit from the provision of childcare because it enables parents to return to work sooner, increasing the pool of talent from which they can draw their workforces, but only the largest firms are ever likely to make any provision for childcare in the workplace. Parents also benefit by being able to go back to work and earn more money, but they only benefit when childcare costs are reasonable and provision is flexible enough to meet their needs. And the country as a whole benefits from the availability of high-quality, affordable childcare too. Higher maternal employment rates mean reduced welfare spending and higher taxes; and studies have shown that childcare is associated with strong cognitive and behavioural development among young children. Childcare should be seen as a public service – an extension of schooling – but with a diversity of providers and parental choice.

The problem with extending free childcare is the cost. Limited additional provision – extending some free childcare to two-year-olds or extending hours for three- and four-year-olds – could be afforded by redirecting some of the £7 billion currently spent on childcare through free entitlements, tax credits and vouchers towards entitlements. But funds for expanding the entitlement to free childcare by providing more hours for all children would have to be found from elsewhere in the government's budget. In the current climate, that is likely to mean painful cuts elsewhere. The alternative, however, is that the UK remains stuck with an expensive and poor-quality childcare system.

Like the markets in energy, public transport and childcare, the housing market has also been characterised by above-inflation price increases. The chief problem in this market is that not enough new houses are being built; therefore solutions should focus on increasing supply, in particular of affordable homes. One problem is that housebuilders, who we rely on to deliver new homes, have an interest in restricting supply to keep prices up. They are also happy to make a profit from their landholdings without ever having to build a home on them.

The UK's chronic housing shortage has its roots in the decline in public sector housebuilding and it is unlikely to be fully resolved until local authorities again build more homes. But, until there has been vast improvement in the public finances, this is not going to happen. In the meantime, steps need to be taken to encourage greater private sector building. These might combine measures to encourage housebuilders to use their land banks; innovative schemes like allowing housing associations, if they choose, to raise money through equity investment (Elphicke 2010); significant changes to the planning regime to make building easier; and government initiatives, for example to facilitate the development of new towns.

What each of these case studies highlights is how free markets – while they are the best solution for most consumer goods and services – cannot deliver competitive outcomes and a better deal for consumers in complex cases. Similarly, having free markets but rigging them in favour of the poor – for example through special tariffs – is at best a partial solution, requiring some consumers to pay more so that others can pay less. But heavy-handed regulation is generally to be avoided too. Bureaucrats cannot determine the correct price for, say, domestic gas or electricity. Instead, the design of each market has to be analysed individually and steps taken to advance the best interests of consumers and society. This does not necessarily mean trying to make it more competitive, in the textbook economic sense. Instead, it might mean focusing on energy efficiency and decentralised energy generation; simplifying rail tickets and spreading the use of smart cards; treating childcare more like a public service; and breaking the stranglehold over the land market of housebuilders.

Making markets more competitive – reducing the power of oligopolies, increasing consumer information and banning practices designed to exploit consumers – is the best approach for many consumer markets. But complex markets require more complex and innovative solutions. In these cases, the choice is not between trying to make markets freer or reintroducing regulation (or even nationalisation). Instead, it should be about finding alternative ways of achieving the best deal for consumers.

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