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BRIEFING

The Poverty Premium

How poor households pay more for essential goods and services

Introduction

It is a shocking injustice that the poorest families in the UK pay higher prices than better-off families for basic necessities like gas, electricity and banking. The costs that poor families bear in acquiring cash and credit, and in purchasing goods and services, can amount to a 'poverty premium' of around £1,000 – 9 per cent of the disposable income of an average-size family.

Policy-makers expend considerable amounts of time and energy exploring the most effective ways to get more money into the pockets of low-income families. Yet they spend little time considering the unequal way in which that money comes out of those families' pockets. We know that when poor families' incomes rise, parents spend those gains on essentials for themselves and their children.[1] Imagine the gains in terms of basic necessities, clothes, food, social activities, savings and many other areas that an extra £1,000 a year would bring to poor families.

Eradicating the poverty premium requires action from a range of sectors. Save the Children and the Family Welfare Association call on service-providers in industries such as energy and banking to do much more to level the playing field for households on low incomes. We also call on the government to move faster in meeting its ambitions around tackling poverty, and to be more proactive in catalysing change in partnership with the private sector.

Save the Children and the Family Welfare Association are calling for:

1) the private sector to:
   - equalise charges for all gas and electricity customers with the cheapest tariffs
   - stop penalising customers on the basis of how they choose to pay their bills
2) the government to catalyse change by:
   - working with the financial services industry to secure genuine financial inclusion for all consumers
   - improving access to free, independent and high quality financial advice
3) the government to redouble its efforts to tackle poverty by:
   - reforming the Social Fund
   - reviewing the tax burden faced by those on low incomes
   - investing £4.5 billion in tackling poverty to meet the 2010 goal of halving child poverty.

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This briefing provides an overview of the key areas in which people on lower incomes face higher prices for essentials. In each case we compare the options available to people on low incomes compared to people on higher incomes. For these categories of goods and services, we estimate a notional 'poverty premium' – the total extra amount paid by poor families. We conclude with some clear recommendations for government and the private sector to bring about dramatic change in this area.

Affordable credit

The cost of basic consumer goods has reduced significantly in recent years. Yet many low-income families can neither afford to pay for items up front nor do they have access to the range of affordable credit schemes available in the marketplace. While many people use a range of means, including hire purchase and credit cards, to spread the cost of consumer goods, people on low incomes must often rely on 'sub-prime' credit shops – which market their products to low-income consumers – such as Brighthouse (formerly known as Crazy George's) and high-cost mail order catalogues. These options disregard credit history. Goods have both high annual percentage rates (APR) and mark-ups on retail prices.

Despite the expense of sub-prime credit shops, and the high charges and repossession that result from missed payments, these options are popular with people on low incomes, because of lack of access to better value mainstream alternatives.

Borrowing

There is a range of cheap borrowing options available to many people: low-interest overdrafts, low-cost personal loans, and credit cards with free interest on purchases and balance transfers for limited time periods. The options for people on low incomes who do not have bank accounts and who have poor credit ratings – and are therefore refused bank loans and credit cards – are much more limited. Home credit or doorstep lenders remain popular with many people on low incomes. A recent investigation by the Competition Commission found home credit or doorstep lenders lent £1.3 billion to 2.3 million customers in 2005 and APRs were generally in excess of 100 per cent and often above 300 per cent.[2] The total cost of loans varies from £30 per £100 to £100 per £100 borrowed, depending on the length of the loan.

There is an emerging market in sub-prime credit cards, aimed at those on low incomes or with poor credit history. These cards are increasingly important, with more commercial activity taking place over the phone or internet. The rate of uptake of credit cards has been increasing in recent years – one particular card with an APR of 39.9 per cent, for example, has 250,000 holders. Provident Personal Credit now offers a Visa credit card with 177 per cent APR – a similar rate to doorstep loans.[3]

A doorstep loan of £500 from Provident Personal Credit, which has 60 per cent of the market, would cost £825 based on a 55-week payment plan. This compares to £539 – the cost of borrowing £500 for a typical credit card with a 15 per cent APR.

Cost of the same cooker

Bought outright from Argos	£159.99
Bought from Brighthouse, paid for over 125 weeks	£405.00
Percentage difference:	153%

Cost of a £500 loan

From typical credit card (15% APR, paid over 52 weeks)	£539
From Provident Personal Credit (177% APR, paid over 55 weeks)	£825
Percentage difference:	53%

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Quick money: cheque cashing, pawnbrokers and cash machine charges

Everyone needs ready access to cash; for most people that means a trip to a cash machine. However, people on low incomes are often forced to rely on cash machines that involve a charge. A Treasury report in 2005 identified 309 low-income areas lacking a free cash machine within a 1km radius – 'cash machine deserts' – where people are forced to spend up to £3 to access their money, a 30 per cent charge on a withdrawal of £10.[4] These flat rates disproportionately hit those on low incomes who withdraw small sums of money.[5]

When the end of the month approaches, many people find themselves short of money and need to tide themselves over until payday. For people on average incomes, an overdraft facility or standard credit card suffices. People on low incomes needing cash urgently often have to resort to cheque cashing services[6] and pawnbrokers or buy-back stores, such as Cash Converters and Cash Generators. Typically, cheque cashing and payday advance services charge a flat fee and a percentage of the total amount. Traditional pawnbrokers and the newer form of buy-back shops have become more common since the late 1990s. They are very expensive options, with monthly interest rates of 5–12 per cent, equivalent to an APR of 70–200 per cent.

£200 cheque

Paid into bank account	Free
Cashed at Cash Converters (Fee+6%)	£16.50

Energy prices

Energy costs are a significant burden for those on low incomes, who are at both greater risk of fuel poverty[7] and more likely to live in an energy inefficient home.[8] Added to these factors, low-income consumers tend to pay more for their energy because they are more likely to opt for pre-payment meters, which allow customers to pay for energy as they use it. Meters make budgeting easier but are more expensive than direct debit schemes.[9] Suppliers commonly use meters as a means of recovering overdue payments from consumers, as an alternative to disconnection.

In 2004, 25 per cent of the fuel poor in England were pre-payment customers compared with just under 6 per cent of all households.[10] Pre-payment customers face a double disadvantage: not only do they pay more for each unit of gas and electricity they use but, because VAT at 5 per cent is payable on energy, they also pay more VAT per unit. So, VAT, which is in any case regressive, is particularly regressive here. In addition, customers who have old-fashioned token pre-payment meters can find themselves plunged into debt if their supplier is delayed in manually recalibrating their meter every time there is a price rise.

Annual gas bill[11]

Monthly direct debit customer (using 20,500kWh gas per annum)	£609.70
Pre-payment meter customer (using 20,500kWh gas per annum)	£673.70
Percentage difference:	10%

Annual electricity bill[12]

Monthly direct debit customer (using 3,300kWh electricity per annum)	£339.30
Pre-payment meter customer (using 3,300kWh electricity per annum)	£368.20
Percentage difference:	8%

The Essentials tariff, announced by British Gas in February 2007,[13] represents a significant step forward. However, until energy companies charge their customers the same prices for gas and electricity, irrespective of the payment method, many of the poorest will continue to pay more for this essential good.

Mobile and fixed-line telephones

The growth of the pre-pay mobile phone market has led to increasing use of mobile phones among people on low incomes. The cost of line rental charges for fixed telephone lines, as well as the falling number of public telephone boxes,[14] have made the mobile phone an essential item for many people on low incomes. Pre-payment mobile phones are particularly attractive to people on low incomes as they do not require a credit check, involve no monthly line rental, and enable users to control costs. Today, one in five consumers in social groups D and E only owns a mobile phone and has no fixed line at home.[15]

Given that pre-pay mobile phones have higher call costs than contract mobiles, and that low-income households are less likely to have a fixed telephone line – and are more likely to pay more if they make payments by cash rather than direct debit – poorer people pay more for telephone use than those on higher incomes. Not having a fixed landline makes connection to the Internet problematic, exacerbating the 'digital divide'. Similarly, people on low incomes are least likely to check that they are on the best deals and to switch network provider.[16]

The average consumer makes 22 minutes of mobile telephone calls per week and sends 11 SMS text messages.[17] Working on this assumption, the box below shows the average annual cost for a pre-pay customer – based on the four leading network providers – compared to a pay monthly customer.[18]

Mobile phone charges

Average total annual cost

Pay monthly customer (including monthly charge)	£315.96
Pay-as-you-go customer	£395.43
Percentage difference	22%

In February 2007, BT announced that customers who opt to pay by cash or cheque, as opposed to direct debit, will face an extra charge of £4.50 each quarter,[19] further increasing the poverty premium.

Insurance

There is a range of ways in which people on low incomes are penalised in the insurance market. As insurers' ability to assess risk becomes more sophisticated, people on low incomes, who are more likely to live in areas with higher property and car crime, often face higher insurance premiums than people who live in more affluent areas. Household insurers continue to insist that policyholders insure for high minimum values, often well beyond the value of goods owned by people on low incomes. In terms of car insurance, older cars and those parked on the road – both of which are more likely to be stolen – attract high premiums. As a result, insurance is a high-cost option for people on low incomes. In part, this accounts for the fact that fewer than half of low-income households have home contents insurance, and are therefore unable to mitigate the greater risk of crime they experience.

A simple online comparison, averaging quotations from three leading insurers for the same house and car type in a deprived part of London compared to an affluent part of the city, reveals an annual difference of £150 on home contents insurance and nearly £100 difference on car insurance.

Insurance

Home contents insurance (for 12 months)

4-bedroom house in a deprived area	£618.80
4-bedroom house in an affluent area	£465.85

Car insurance (for 12 months)

a car worth £4,000 in a deprived area	£571.55
a car worth £4,000 car in an affluent area	£475.48

An illustration of the poverty premium

The table below gives an illustration of how poor people pay more for essential goods and services. The 'poverty premium' is the notional amount of additional money that a poor household pays for the same good and services over a year. Of course, the actual amount paid by a particular household depends on their specific circumstances, eg, household size, whether or not they have a car, whether they are in debt.

Here, we have considered the premiums for the goods and services discussed in this briefing. For some items – such as insurance and household bills – we take the simple annual cost. For others we take a reasonable approach: one expensive consumer good, one small loan, three cashed cheques and one mobile phone in the household. In this illustration, the total poverty premium is over £1,000 – a huge amount of money for a low-income family.

Consider a low-income family with two adults and two young children, where one of the adults is in work earning £250 per week (equivalent to a 35-hour a week job at over £7 per hour – well above the minimum wage). Their income after housing costs[22] would be £237 per week or £12,324 per year.[23] Their poverty premium therefore represents 9 per cent of their income after housing costs.

Table 1 Illustrating the poverty premium

	Typical costs	Costs to low-income households
One expensive consumer good	£159.99	£405.00
One £500 loan	£539.00	£825.00
Three cashed £200 cheques	£0.00	£49.50
Annual gas bill	£609.70	£673.70
Annual electricity bill	£339.30	£368.20
One mobile phone	£315.96	£395.44
Home contents insurance	£465.85	£618.80
Car insurance	£475.48	£571.55
Total	**£2,905.28**	**£3,907.19**
Poverty premium		**£1,001.91**

Seven steps to eradicate the poverty premium

What can be done to drive down the poverty premium, to ensure that those with the least do not pay more for essential goods and services? Can markets be made to work to ensure that low-income consumers get the benefits of competition and deregulation? What is the role of government and regulators in intervening to ensure equity of access, either through bulk purchase, subsidy or regulation? Where the market and the government are failing to meet basic needs, can social enterprise step in and spread existing provision, or develop new models of provision? Finally, where barriers are about information and understanding, can those on low incomes be provided with better tools to become active agents of their own financial inclusion? Beyond these broad questions there are seven specific steps that could be taken to reduce the poverty premium.

1. Gas and electricity providers should align pre-payment meter and standard credit rates with direct debit rates

2. Gas and electricity providers should stop backdating price rises for token pre-payment meter customers when they recalibrate a meter. A number of suppliers have abandoned this practice but it continues among some of the leading suppliers.

3. Telephones: Significant price variations exist among mobile phone providers. Ofcom should provide consumers with standardised price comparison information to ensure that consumers are alert to the potential benefits and savings of switching network providers. This should be similar to the service provided by energywatch for gas and electricity customers.

4. Tackle financial exclusion: While significant progress has been made on financial inclusion, there are several challenges, which are still to be met. Awareness of basic bank accounts remains too low; their use in many cases is limited; and they do not yet meet the needs of low-income customers, particularly around bill payment and flexible direct debit options. The banking industry and government must move faster on pursuing this agenda. While it is preferable that banks take a lead, driven by social responsibility or commercial strategy, the government must be willing to use incentives or regulation where appropriate, to ensure this basic need for suitable banking is met. One specific improvement to basic banking would be the introduction of a £10 overdraft buffer zone.

5. Access to financial advice: Financial advice that is independent and free is critical in this area, where options are complicated and there is a risk of exploitation. Ensuring that people on low incomes can access high quality and appropriate financial advice would enable people to understand their options and entitlements better. Improving access to advice would benefit not only individuals, but by improving financial literacy, would also benefit government and the financial services industry.

6. Social Fund reform: Reform of the Social Fund is long overdue. At the same time, it is vital for the government to consider why people on low incomes make use of much more expensive options (as described in this briefing). A social fund with wider eligibility criteria, far more cash available, more flexible terms of repayment and less stigma in the way it functions could deliver affordable credit to those who need it most.

7. A fairer tax system: The government is a guilty party in making the poor pay more. VAT accounts for about 12.7 per cent of the poorest families' incomes compared to just 4.4 per cent of the richest. This is highly regressive and counter to the principles we espouse through the direct tax system. Similarly, council tax and national insurance are both regressive; the

former having a dramatic impact on those not claiming council tax benefit. Reviewing the tax burden and realigning it in line with progressive principles would be a positive step.

It is an injustice that those with the least should pay the most for essential goods and services. This briefing sets out the problem of the poverty premium and suggests a range of solutions. But above all, it is a call to action on poverty. Tackling income poverty would be the most significant step to tackling the poverty premium. Households' low and unpredictable incomes are at the heart of their financial exclusion. The government's target of halving child poverty by 2010 is getting closer. Without significant investment in benefits and tax credits – £4.5 billion according to the Joseph Rowntree Foundation[24] – the target will not be hit. Meeting this 2010 target of halving child poverty will be a significant step to the shared goal of eradicating child poverty by 2020, particularly if those in the most severe poverty benefit.

The challenge for the government, the private sector, and the community and voluntary sectors is clear. They must now rise to it.

To support the campaign please visit
www.savethechildren.org.uk/endchildpoverty and www.fwa.org.uk

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Notes

[1] P Gregg, J Waldfogel and E Washbrook, *Expenditure Patterns Post-Welfare Reform in the UK: Are low-income families starting to catch up?* CASE paper 99, Centre for Analysis of Social Exclusion, London, 2005

[2] *ibid*

[3] *Moneyweek*, 5 July 2006

[4] House of Commons Treasury Committee, *Cash Machine Charges*, The Stationary Office Limited, 2005

[5] In December 2006 the Treasury announced a deal with banks to introduce free cash machines into many low-income areas. This represents an important step forward.

[6] Cheque cashing services are also an important lifeline for those who do not have a bank account.

[7] Department for the Environment Food and Rural Affairs, *Fuel Poverty in England: The Government's plan for action*, DEFRA, 2004. A household is in fuel poverty if, in order to maintain a satisfactory heating regime, it would be required to spend more than 10 per cent of its income on all household fuel use.

[8] *ibid*.

[9] National Consumer Council, *Life Lines: Affordable utilities*, National Consumer Council, 2004

[10] Fuel Poverty Advisory Group, *Response to Ofgem metering price control review consultation, 2006*

[11] Based on a comparison undertaken on the energywatch website in January 2007 for a household in London with average gas usage.

[12] Based on a comparison undertaken on the energywatch website in January 2007 for a household in London with average electricity usage.

[13] Centrica, 'British Gas announces energy price cuts' (press release), 8 February 2007

[14] Ofcom, 2006, http://www.ofcom.org.uk/media/mofaq/telecoms/usofaq/

[15] Ofcom, *The Consumer Experience: Research report*, Ofcom, 2006

[16] Ofcom, *Consumers and the Communications Market: 2006*, Ofcom, 2006

[17] Ofcom, *The Communications Market 2006: Overview*, Ofcom, 2006

[18] Comparisons were undertaken among the four leading network providers on http://www.uswitch.com/. The average total annual cost for a pay-as-you-go mobile phone includes £9.99 to cover the cost of purchasing the phone. This is based on the assumption that consumers replace a mobile phone every three years and that a pay-as-you-go mobile phone can be purchased for £29.97.

[19] www.bt.com/payments

[20] Seeley A and Lobstein T, *Going Hungry: The struggle to eat healthily on a low income*, NCH, 2004

[21] Competition Commission, *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom*, Competition Commission, 2000

[22] Taking into account housing benefit

[23] DWP, Tax and Benefit Model Tables 2006. National Statistics

[24] Hirsch, D, *What will it take to end child poverty? Firing on all cylinders*, Joseph Rowntree Foundation, 2006

This briefing was written by Jason Strelitz of Save the Children and Claire Kober of the Family Welfare Association.

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Save the Children and the Family Welfare Association are part of the campaign to End Child Poverty.

end child poverty

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