DEPARTMENT OF THE PRIME MINISTER AND CABINET
TE TARI O TE PIRIMIA ME TE KOMITI MATUA

Proactive Release

The following briefing has been proactively released by the Department of the Prime Minister and Cabinet, on behalf of Rt Hon Jacinda Ardern, Minister for Child Poverty Reduction:

Advice on the cost of living

Date of release: 12 November 2019

The following document has been included in this release:

Briefing: Advice on the cost of living

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant section of the Act that would apply has been identified. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to redaction code:

- 9(2)(a): to protect the privacy of natural persons, including that of deceased natural persons.
- 9(2)(f)(iv): to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

DEPARTMENT OF THE PRIME MINISTER AND CABINET
TE TARI O TE PIRIMIA ME TE KOMITI MATUA

Briefing

ADVICE ON THE COST OF LIVING

To:	Rt Hon Jacinda Ardern, Prime Minister, Minister for Child Poverty Reduction		
cc:	Hon Tracey Martin, Minister for Children		
Date	12/08/2019	**Priority**	Medium
Deadline	22/08/2019	**Briefing Number**	DPMC-2019/20-177

Purpose

1. You have requested advice on the costs of living, particularly for those on lower incomes. This note responds to that request, and provides you with:
   - the results of analysis of trends for the cost of living using different price indexes published by Stats NZ
   - more detailed advice on trends for specific costs, including rents and electricity
2. It also provides brief comment on future advice that could be provided on potential policy responses.

Executive Summary

3. We have undertaken analysis of trends for the cost of living using price indexes published by Stats NZ, including the Consumer Price Index (CPI) and the Household Living-Costs Price Indexes (HLPIs). This analysis shows that:
   - Beneficiaries and low-income households have experienced higher inflation than the average household over the past decade. Between 2008 and 2018, the cumulative inflation experienced by low-income households and beneficiaries was 25-26%, whereas for households generally it was 20% - a difference of around five to six percentage points.
   - The main reasons for this difference is because certain costs such as rent and electricity, which had significant price increases, make up a greater proportion of household budgets for those on the lowest incomes, meaning the increases have a greater impact. Low-income households were also less likely to benefit from recent decreases in the costs of servicing a mortgage.

4. Since 2010, the mechanism used for annually adjusting income support payments from CPI has been a special "CPI less tobacco" index. This has increased by just 16% since 2010, which is about 10 percentage points lower than the increase in the cost of living for beneficiaries recorded in the HLPIs.

5. By looking at specific categories within the CPI and HLPIs, we can track trends for specific costs within the context of inflation overall. The biggest drivers of increases in the cost of living over the past decade are rents, energy, housing insurance, and rates for local authorities, in that order. We have provided you with more detailed advice on these costs, with a particular focus on rents and electricity:

- Rental data from MBIE shows that rents at lower price points have increased significantly faster than inflation over the past decade, with particularly strong growth in the last five years. Because household incomes have also grown faster than inflation for most households, the impact of increasing rents has not shown up in some of the headline measures of housing affordability, though there is evidence of rising housing stress for some groups, particularly those on the very lowest incomes.

- The Electricity Price Review has found the primary reason for the increase in electricity prices has been a steady shift in the costs of distribution from businesses to householders, particularly during the 1990s and 2000s. There was also an increase in the cost of electricity generation in the 2000s, generally associated with high electricity demand growth. While these trends appear to have tailed off, with retail electricity prices stabilising in recent years, there is a risk that in the future prices might increase disproportionately for low-income households as part of the transition to a low-emissions economy.

6. s9(2)(f)(iv) [redacted]

7. Our view is that the key cost areas are largely already covered by existing work across Government, either underway or planned. As you know, there are already active work programmes focused on costs of housing, electricity and transport for low-income households, with the Commerce Commission investigating the functioning of the market for fuel. s9(2)(f)(iv) [redacted]

8. The policy settings most relevant to the cost of living *overall* are indexation arrangements for financial support. We note that the recent change to indexation arrangements should mean future adjustments to main benefits are more likely to keep pace with living costs, as wage growth has been higher than increases in the cost of living for those on the lowest incomes. s9(2)(f)(iv) [redacted]

Recommendations

1. **Note** the analysis of trends in the cost of living for low-income households included in this report

2. **Note** that this analysis indicates beneficiaries and low-income households have experienced higher inflation than the average household over the past decade

3. **Note** that the Government has existing work programmes focused on the following costs for low-income households

   - housing
   - electricity
   - public transport
   - petrol

s9(2)(f)(iv)

4. [redacted]

5. [redacted]

s9(2)(a) [redacted] Kristie Carter **Director, Child Poverty Unit** **Department of the Prime Minister and Cabinet**	Rt Hon Jacinda Ardern **Prime Minister** **Minister for Child Poverty Reduction**
12/8/2019	...../...../2019

Contact for telephone discussion if required:

Name	Position	Telephone	1st contact
Kristie Carter	Director, Child Wellbeing Unit	s9(2)(a) [redacted]	✓
Tim Garlick	Principal Analyst Child Poverty Unit		

Minister's office comments:

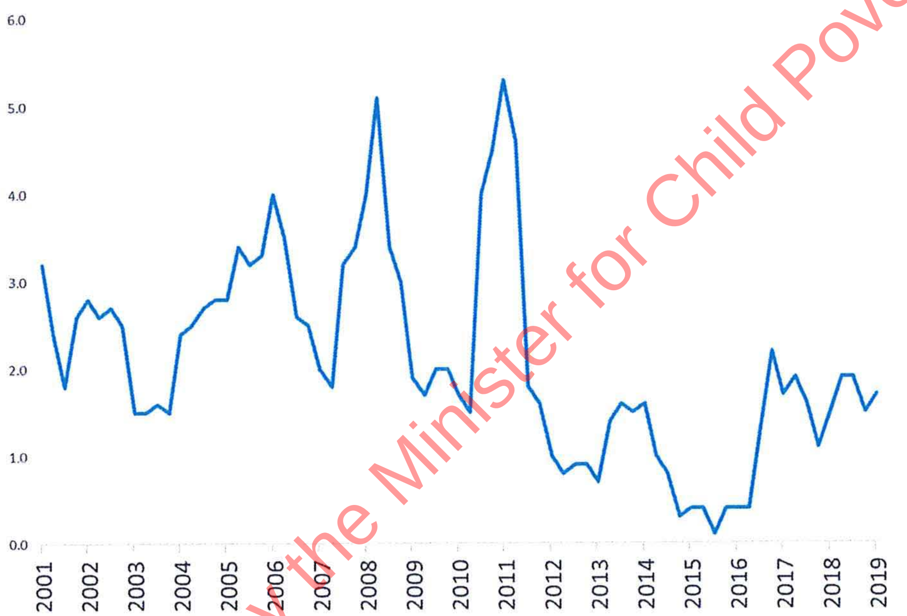
- ☐ Noted
- ☐ Seen
- ☐ Approved
- ☐ Needs change
- ☐ Withdrawn
- ☐ Not seen by Minister
- ☐ Overtaken by events
- ☐ Referred to

ADVICE ON THE COST OF LIVING

Headline trends in the cost of living

1. The most common way for tracking trends in the cost of living is by using price data published by Stats NZ. The Consumer Price Index (CPI) measures the change in the price for a 'basket' of goods and services intended to be representative for an average New Zealand household. According to the headline measure of CPI, since the cost of living significantly increased in December 2010 and March 2011, inflation has been low in historical terms, and has tracked consistently at or below 2% per year.

Figure one: annual change in the Consumer Price Index 2001-2019



2. Over the last decade, both wages and household incomes have generally risen faster than costs. Since the first quarter of 2009, inflation has increased by around 17%, whereas average wages have increased by 43%. Last year's Household Incomes Report from the Ministry of Social Development reported gains across the income distribution, even once inflation is taken into account, with net gains of around 11-12% across the spectrum from 2008/09 to 2016/17, from the top of the bottom decile (P10) and higher.

3. That said, these broad trends are unlikely to reflect the experience of all households over the last decade:

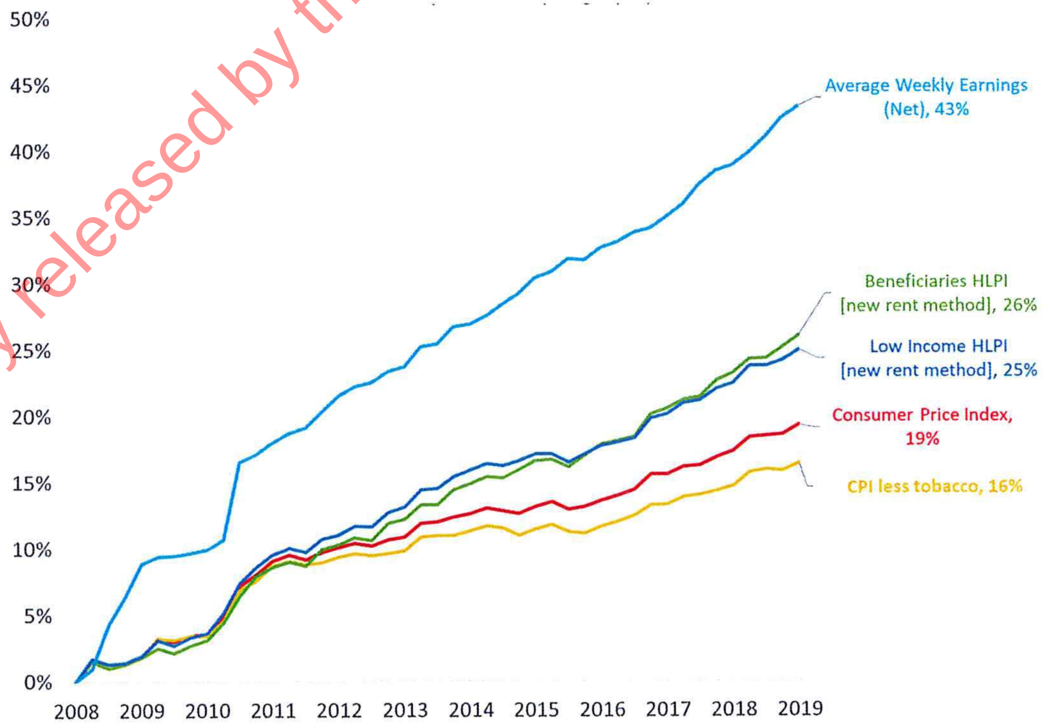
- Even though incomes at the top of the bottom decile grew strongly, this will have mainly reflected the incomes of superannuitants, whose incomes have been rising in real terms. This masks the experience of those supported by benefits, who are also in the bottom deciles, and have not seen the same increases in household income. Prior to the Families Package, the incomes of beneficiary households had been generally flat or falling in real terms, even when taking into account the one-off increase for families with children in the 2015 Material Hardship Package.

- The Consumer Price Index measures the change in the price in goods and services for a basket of goods intended to be representative for an 'average' New Zealand household. In reality, expenditure patterns differ for households in different circumstances, and general CPI does not perfectly reflect changes in the cost of living for low-income households, who generally spend a greater proportion of their income on basic essentials (rent, food, electricity).

4. In recognition of the limitations of using the CPI to track the cost of living, Stats NZ produces a series called the 'Household Living-Costs Price Indexes' (HLPIs), which track the different experience of inflation for different groups. According to these published indexes, beneficiaries and low-income households have had a greater than average experience of inflation over the past decade. The cumulative inflation for low-income households and beneficiaries since 2008 was 23%, whereas for households generally it was 18% - a difference of around four percentage points over a decade.

5. Stats NZ have also recently announced a change to the way they track housing costs in both indexes, with future reporting based on tenancy bond data from MBIE. Stats NZ believe the new methodology is likely to more accurately reflect changes in housing costs, and have provided the CPU with a back-series with this included. Once recalculated, the difference in cumulative inflation since 2008 is even higher – 25% for low-income households and 26% for beneficiaries, compared with 20% for all households – a difference of around 5 - 6 percentage points.

Figure two: Comparison of change in Consumer Price Index, Household Living-Costs Price Index, and the Average Wage



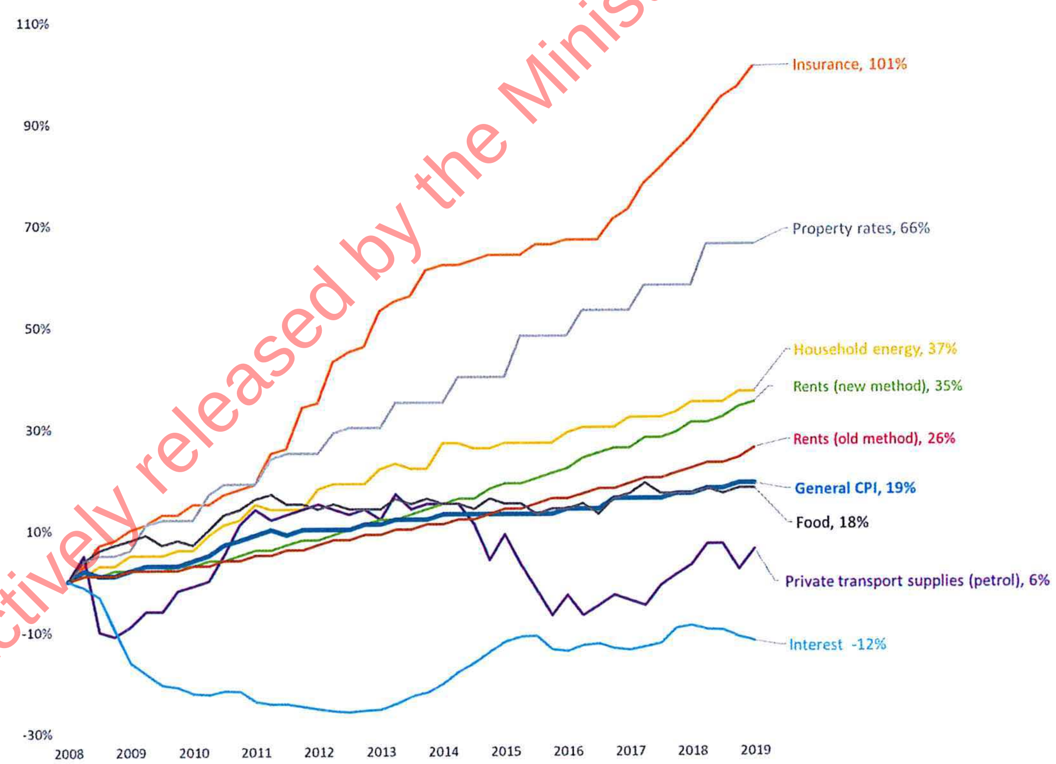
6. As Figure Two shows, these trends have important implications for our understanding of the measures used for indexation from year to year. In 2010, the Government changed the mechanism used for annually adjusting income support payments from CPI to a special "CPI less tobacco" index. While the impact of this change from year-to-year has been small, over a longer period the difference in cumulative inflation measured by CPI less tobacco (16% since 2008) and CPI (19% since 2008) has been more significant – around 3 percentage points.

7. When comparing the change in CPI less tobacco (16%) with the change recorded by the HLPIs for beneficiaries (26%), the difference between the index used for adjusting payments and the change in the cost of living for beneficiaries since 2010 is 10 percentage points.[1]

Trends for specific costs

8. We have also looked at individual costs within the basket of goods covered by HLPIs, to identify which categories have seen significant changes in price. Figure Three below shows the changes in these costs for low-income households since 2008, focusing on those costs with the greatest weight in the HLPI. Trends for a broader range of costs are included in a table attached as Appendix One, which also shows their weight in the 'basket' of goods and services, and price change in percentage terms since 2008, 2014, and 2017.

Figure three: Low-income Household Living-Costs Price Index: Cumulative Price Change in Selected Costs Since 2008



[1] The difference in the percentage change for both indexes is the same, regardless of whether taking 2008 as the starting point, as per the comparison in the graph, or 2010, when the index first began being used for adjusting payments.

9. By factoring in their weight in the indexes, we have also explored which costs make up a greater proportion of household expenditure, and thus have had the greatest impact on the cost of living overall. This indicates that:

- The biggest drivers of increases in the cost of living over the past decade are rents, energy, insurance, and rates for local authorities, in that order. These costs saw significant price increases, and make up a sizeable proportion of overall expenditure for households generally.

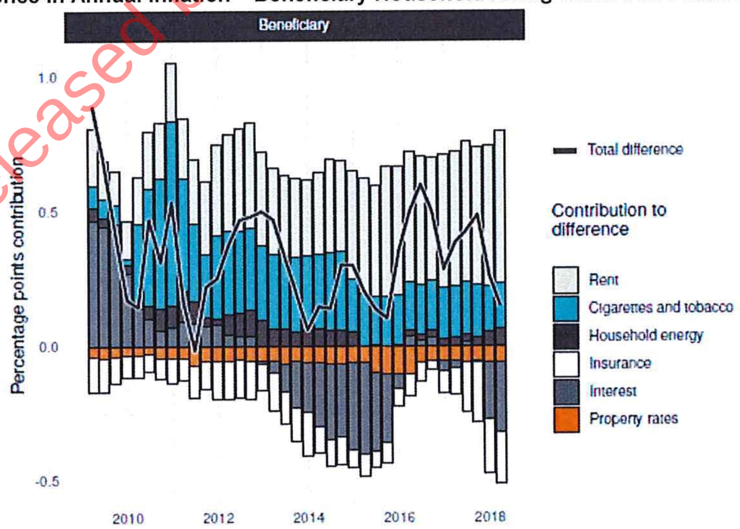
- The cost of petrol and food has been volatile, with significant price increases followed by significant price decreases. Overall, the cost for both categories has decreased in real terms over the past decade, despite recent increases in petrol prices.

- Due to increases in excise tax[2], the price of cigarettes and tobacco has increased more than any other cost (208% over the past decade), but these costs still make up a relatively small proportion of overall expenditure, which reduces their impact.

- Similarly, some education and health-related costs have increased faster than inflation, but these costs also make up a smaller proportion of the overall budget and so will have had less of an impact on the immediate material wellbeing of households.

10. As shown in Figure Four below, the main reason that low-income and beneficiary households have experienced higher inflation than the average household is because certain costs – particularly rents, electricity and tobacco – had significant price increases and also generally made up a greater proportion of household budgets for those on the lowest incomes, meaning the increases have a greater impact. Low-income households were also less likely to benefit from recent decreases in the costs of servicing a mortgage, as discussed further below.

Figure four: Difference in Annual Inflation – Beneficiary Household Living-Costs Price Index vs All Households[3]



[2] The Government has legislated to increase tobacco excise by at least CPI + 10% each year since January 2010, with the latest series of increases scheduled to end in 2020.

[3] Source: Bentley, Alan (2018), Diversity in New Zealand's cost of living: insights from our Household Living-Costs Price Indexes

Housing costs

Costs of home ownership

11. The costs of home ownership has been influenced by two trends. On the one hand, New Zealand has seen a dramatic rise in house prices over the past decade, which significantly affected the cost of purchasing a home; one the other, New Zealand has also experienced a long period of very low interest rates, which decrease the cost of servicing a mortgage.[4] In the HLPIs, at an aggregate level, these two factors balance each other out, meaning that the cost of mortgage interest is slightly lower than a decade ago.[5]

12. For existing homeowners with a mortgage, low interest rates mean the costs of home ownership are likely to decrease, whereas new homeowners are more likely to be impacted by rising house prices. Both are likely to be impacted by other indirect costs associated with home ownership, which have recently increased much faster than inflation:

- Insurance premiums have risen, primarily driven by insurance for housing, which has increased by 300% - this is likely to be connected to recent natural disasters, including the Canterbury and Kaikoura Earthquakes, and a shift towards risk-based pricing in disaster-prone areas.

- There has also been a significant increase in rates for local authorities. A recent (draft) report by the Productivity Commission identified a range of cost pressures: development capacity for housing in fast growing areas; environmental and public health standards for water and flood protection systems; pressure on local infrastructure from the tourism industry; and costs associated with climate change mitigation and adaptation.

13. Both the direct and indirect costs of home ownership are less likely to impact on beneficiaries and low-income households, as rates of home ownership are lower for these groups. Below we have also provided further detail on two specific costs – electricity and rent –which are generally accepted as 'essential' costs that low-income households spend proportionately more on, and which are one of the reasons they have experienced higher than average inflation in recent years.

---

[4] Within the context of the recession that followed the Global Financial Crisis, the Reserve Bank cut the official cash rate significantly, which had a substantial impact on interest rates for mortgages. These low interest rates have continued, other than a modest increase in 2014.

[5] The treatment of the costs associated with home ownership is one of the key differences between the Consumer Price Index and the Household Living-Costs Price Indexes. The HLPIs use 'mortgage interest payments', which are calculating using a combination of property prices and interest rates.

Measures of rental growth

14. Analysis of rental prices indicates using MBIE tenancy data shows that nominal lower quartile rents have increased by around 46% over the past decade, with particularly strong growth in the last five years (26%). Average rents have risen at a similar rate (50%, and 26% respectively). Until late 2014, rents more or less grew at the same rate as wages, but since then rents have risen faster than wages and much faster than prices generally.

15. We have looked at trends for specific geographical locations, and found that increases in rental costs at lower price points have occurred across the country, but over the last five years growth has been particularly strong in Wellington and in regional cities in the North Island, including Whanganui (75%), Rotorua (71%), Tauranga (54%), Whangarei (52%), Napier (51%), and Hastings (56%). More recently, this significant growth appears to have spread to tenancies in the South Island - with the notable exception of Christchurch, where rental price growth has been muted.

Figure five: Tenancy Bond Data: Lower Quartile Rental Prices in Key Centres ($2017)

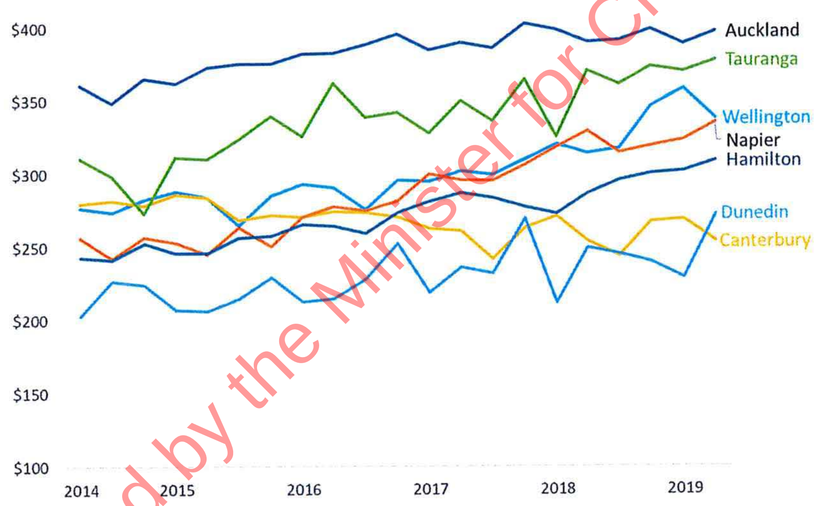
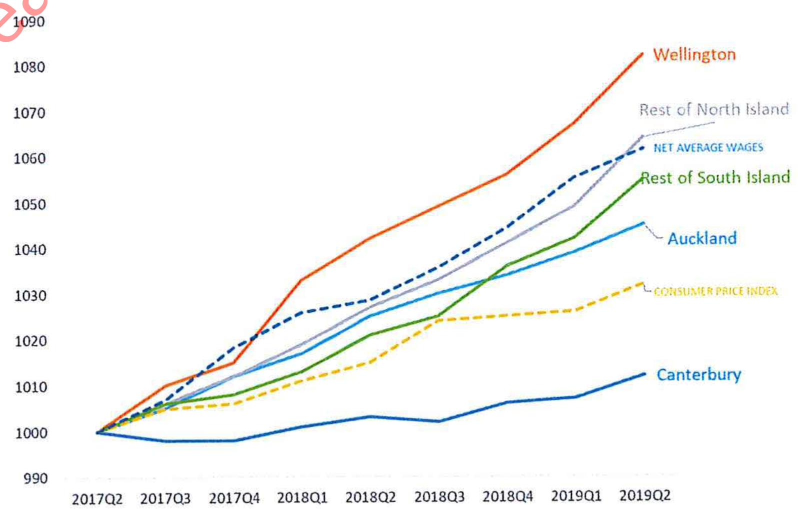


Figure six: Regional Rental Price Growth (rental index in CPI) vs Net Average Wages and Consumer Price Index



The experimental Housing Affordability Measure

16. The Ministry of Housing and Urban Development's (HUD) Housing Affordability measure (HAM) is a suite of experimental measures of affordability, each of which can be applied to renting and home buying. The rent versions of the measures are as follows:

- HAM Percent measure identifies whether each household in New Zealand is spending more or less than 30 percent of their income on housing

- HAM Rent Median measure compares the after-housing-cost incomes of renters in different parts of New Zealand to the national median after-housing-cost income for all households in 2013.

17. The latest results of the HAM were recently released, and found that at a national level, on average, housing affordability was either stable or improving for both renters and potential homeowners. According to the measure, affordability improved in Auckland, Wellington and Christchurch, and worsened in a number of provincial areas.

18. HUD are undertaking further work to understand these findings, and are suggesting that these results are used with caution – they advise that the headline findings related to improved affordability may be masking the real experience of many households, and that improvements to the measure are required.

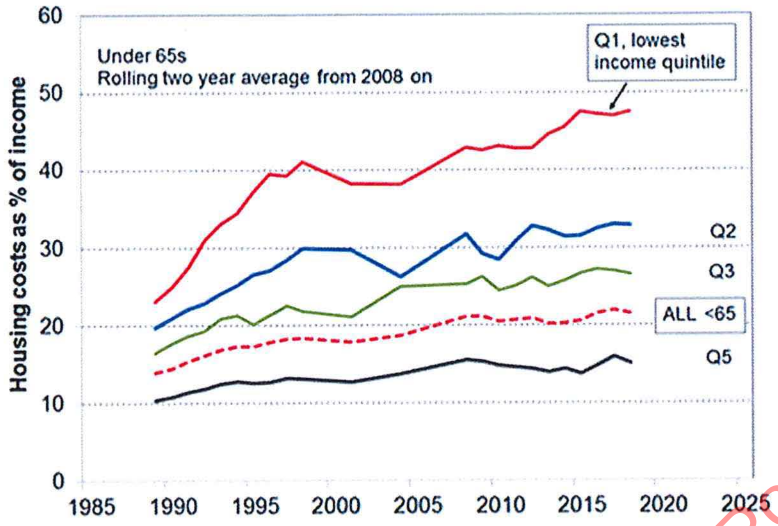
19. One possible explanation for the improvements in rental affordability offered by HUD, which they are yet to confirm, is that it is the result of potential first home buyers waiting longer to buy a home, meaning that a greater proportion of renters are higher income families. The CPU also notes that their findings are not inconsistent with housing affordability trends reported in MSD's Household Incomes Report – though these provide a more detailed picture of trends for those on the lowest incomes.

Housing affordability in the Household Incomes Report

20. In its annual Household Incomes Report, MSD publishes trends for housing costs using a relatively common measure of housing affordability known as the "outgoings to income ratio" (OTI), which compares housing costs to disposable income. It reports on the percentage of households paying more than 30% on housing - a common benchmark for 'high' OTIs - but also on higher thresholds of 40% and 50%.

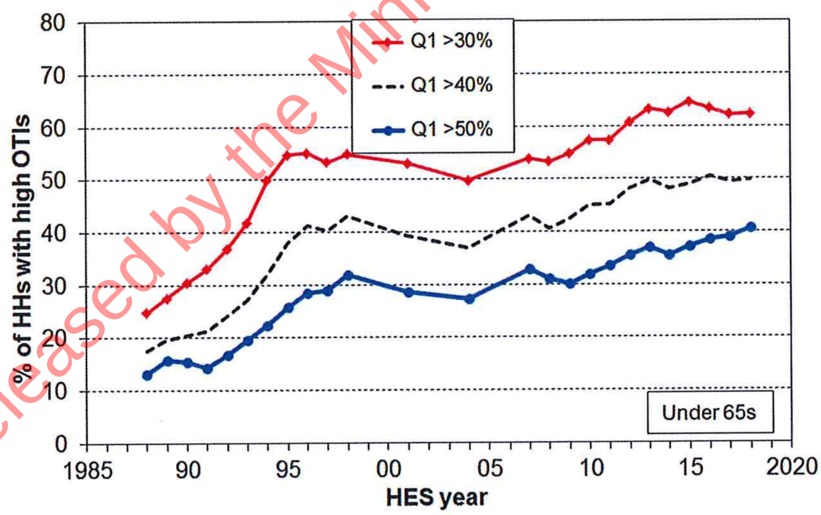
21. This reporting shows that high OTIs are of greater concern for low-income households. The graph below shows average housing costs as a proportion of average income for under 65s in different income quintiles; on average for the bottom quintile, these increased from 23% in the late 1980s to 47% in the 2017 and 2018 HES years. The increase for the second quintile was from 20% to 33%.

Figure seven: Average Housing Costs for Households Aged Under 65 in Different Income Quintiles[6]



22. The graph below shows the percentage of under 65s in the bottom income quintile spending more than 30, 40 and 50 percent of their incomes on housing costs. While the trend for those spending more than 30% and 40% seems to have levelled out in recent years after a steady rise, the proportion of households spending more than half their income on housing continued to rise through to the 2017/18 survey, with two in five households in the bottom quintile in this category in 2017/18.

Figure eight: Under 65 Households in Lowest Income Quintile with OTI Ratios of More than 30%, 40% and 50%



23. These trends go only so far as the HES 17/18 survey, and so they do not show the impact of the July implementation of the Families Package, and capture only a very small part of the April adjustments to the Accommodation Supplement.

[6] The OTI information that follows is MSD's analysis of the Household Economic Survey data up to and including 2017/18, prepared for this note. A fuller account is expected in the 2019 Household Incomes Report (forthcoming).

Costs of electricity

24. As you know, in April 2018 the Minister of Energy and Resources commissioned an independent review into New Zealand's electricity market, on the basis that electricity prices have increased faster than inflation for many years.

25. The review found that, after adjusting for inflation, residential prices are 79 per cent higher than in 1990, whereas industrial prices have risen only 18 per cent and commercial prices have fallen 24 per cent. This divergence in prices was caused by three key factors:

- distribution charges shifted from businesses to households – as the historic cross-subsidy that favoured residential consumers was gradually unravelled;
- generation and retailing related charges increased significantly for households, particularly in the 2000s due to strong electricity demand growth;
- GST, which only residential consumers ultimately pay, rose to 15 per cent in 2010.

26. Of these, the shift in the costs of distribution from businesses to householders was the biggest factor in residential price increases.

27. These trends appear to have tailed off, and nominal retail electricity prices have stabilised in recent years. However, the review found that there is some risk that prices may rise in the future, albeit for different reasons. The shift to a low-emissions economy will mean increased demand for electricity through widespread use of electric vehicles and the electrification of industrial processes. This may result in increased costs from the need to invest in additional generation, and associated upgrades to transmission and distribution networks which can be expected to flow through to end consumers. This is not a foregone conclusion, however, given the costs of renewable generation have fallen in recent years and are expected to continue to do so.

28. In addition, the review suggests that lower-income households could end up bearing certain costs that higher-income households avoid because they have installed solar panels and batteries on their premises – which lower income households are less likely to be able to afford. Also, if electric vehicles become more common and are recharged during the hours of daily peak electricity demand, then distribution network upgrades could be needed. These costs may end up being recovered by all households; including lower-income households who receive no benefit from the network upgrade as they are less likely to own an electric vehicle. MBIE note that electricity distribution price reform may address some of these concerns.

29. The review noted other issues can increase the impact of electricity costs on low-income households. They are more likely to have issues with housing quality, and are less likely to have adequate insulation and efficient heating devices. They are also more likely to be disadvantaged by the emergence of a 'two-tier' retail market in electricity: where those who actively shop around enjoy the benefits of competition, and those who do not pay higher

prices. Retailers are less likely to target low-income households as potential consumers, and often reject low-income consumers because of poor credit histories and previous disconnections. Low-income consumers also miss out more often on prompt payment discounts, which budget and advocacy groups argue are really late-payment penalties in disguise.

30. We understand that the Minister of Energy and Resources intends to propose a range of changes to the sector in response to the recommendations, and has also proposed specific recommendations related to energy hardship. This includes s9(2)(f)(iv) [redacted] developing a definition of energy hardship, with associated indicators, and establishing a cross sector group focused on addressing the issue. s9(2)(f)(iv) [redacted] We will provide you with a separate Aide Memoire on the review to support your discussions with your colleagues at Cabinet Committee.

Policy responses

31. s9(2)(f)(iv) [redacted]

32. There are currently active work programmes across Government focused on the costs of housing and electricity, and also to investigate a scheme to reduce the costs of public transport for low-income households. The Commerce Commission has also commenced a study of the market for petrol, with a draft report due in August, and a final report in December. s9(2)(f)(iv) [redacted]

33. s9(2)(f)(iv) [redacted]

34. The policy settings most relevant to the cost of living *overall* are indexation arrangements for financial support. The analysis above indicates that CPI (less tobacco) has been an imperfect measure for routinely adjusting benefits to compensate for changes in the cost of living. This issue has been mostly addressed by the recent change to index main benefit rates to wages, as wage growth has consistently been higher than increases in the cost of living - even for those on the lowest incomes.

35. s9(2)(f)(iv) [redacted]

s9(2)(f)(iv)

[redacted]

Appendix One: Low-income Household Living-Cost Price Index: Price Change in Selected Costs Since 2008

		2019 Weight	Since June 2008	Since June 2014	Since June 2017
Housing and household utilities		**33.2**	**35%**	**13%**	**6%**
	Actual rentals for housing (old method)	17.5	26%	13%	5%
	Actual rentals for housing (new method)		35%	17%	7%
	Property maintenance	1.4	34%	14%	7%
	Property rates/services	5.8	66%	23%	8%
	Household energy (incl. electricity)	8.5	37%	8%	4%
Food		**21.3**	**18%**	**3%**	**1%**
	Fruit and vegetables	3.9	20%	5%	-11%
	Meat, poultry and fish	3.6	20%	3%	4%
	Grocery food	8.8	14%	0%	2%
	Non-alcoholic beverages	2	20%	3%	4%
	Restaurant meals / ready-to-eat food	2.9	33%	13%	7%
Transport		**10.2**	**3%**	**-9%**	**4%**
	Purchase of vehicles	2	4%	-4%	-4%
	Private transport supplies (incl. petrol)	6.3	6%	-8%	10%
	Passenger transport services	1.9	-5%	-11%	-5%
Recreation and culture		**6.1**	**8%**	**3%**	**1%**
Alcoholic beverages and tobacco		**4.7**	**95%**	**31%**	**11%**
	Alcoholic beverages	2.5	13%	4%	3%
	Cigarettes and tobacco	2.3	208%	63%	19%
Communication		**4.6**	**-10%**	**-3%**	**-3%**
Household contents and services		**3.8**	**0%**	**0%**	**1%**
Health		**2.9**	27%	3%	1%
	Medical products / equipment	1.2	22%	0%	0%
	Out-patient services	1.7	31%	5%	2%
Other expenditure		**2.8**	**-2%**	**14%**	3%
	Interest payments	2.8	-12%	10%	2%
Clothing and footwear		**1.6**	**2%**	**2%**	**0%**
Education		**1**	**30%**	**-1%**	**-9%**
	Early childhood education	0.1	60%	9%	2%
	Primary/secondary education	0.2	46%	15%	3%
	Tertiary education	0.7	21%	-8%	-16%
	Other educational fees	0.1	34%	17%	8%
Miscellaneous goods and services		**7.7**	**48%**	**15%**	**10%**
	Insurance	4.6	83%	22%	16%
Total low-income			**22%**	**6%**	**3%**