Alcohol (Minimum Pricing) (Scotland) Bill

Pricing mechanism

Andrew Leicester

Thank you for this email and the opportunity to respond on uprating mechanisms.

Once a minimum price is implemented, the issue of how it is uprated is clearly important. Even assuming inflation at 2.5% per year, a minimum price introduced at 45p in 2012 would, in real terms, be worth 35p per unit just a decade later, by 2022.

In the early phase of introduction, it may be that the minimum price is adjusted within the first year or two based on evidence from further modelling and ex post evidence on the impact of the policy. Once a settled 'appropriate' minimum price is established, it would seem less important to rely on regular re-modelling exercises in determining the new price each year. It may be that periodic assessment is made on the appropriateness of the current minimum price based on new data and new modelling of the impact but this need not be an annual occurrence.

Unless there is clear evidence that the rate is substantially 'wrong' it would not seem necessary to adjust the minimum price more than once per year. This is typically the approach taken towards tax thresholds, benefit levels, excise taxes and so on. It is not obvious what the advantage of quarterly adjustments would be.

The question is then against what benchmark the uprating should take place. There appear to be four main options:

1. Inflation as measured by the Retail Prices Index (RPI)
2. Inflation as measured by the Consumer Prices Index (CPI)
3. Some measure of inflation specific to alcohol prices
4. Some measure of income, earnings or other factors which might determine 'affordability'

Since region-specific inflation measures are not routinely published by the Office for National Statistics, any choice from options 1-3 would have to depend on UK-wide inflation estimates rather than Scottish-specific inflation rates. It may be possible to obtain estimates of the Scottish inflation rate or alcohol price inflation rate from ONS but it is not obvious that there is any reason to expect inflation trends in Scotland over the medium run to differ substantially from the rest of the UK.

At present, UK excise duties are uprated annually, typically at the Budget, based on a forward-looking measure of the RPI. In particular, the 'default' position is that the excise duty is uprated in line with the year-on-year RPI rate as expected in the third quarter of the year following the Budget. The Chancellor has discretion to set duty rates at any level, however, and it is my understanding that this default is not statutory in that if the Chancellor made no announcement on duty rates then they would not change in cash terms. In other words, the 'default' has to be confirmed as an active policy decision.
For excise duties on motor fuel in particular there has been a recent trend towards pre-announcing future changes several years in advance, with these announcements later changed. This is not a helpful way of making policy leading to considerable uncertainty. A more sensible approach would be to pre-commit to a mechanism by which the price is uprated each year according to some measure of inflation, and perhaps spelling out that the rate is subject to periodic review every few years (perhaps every 5 years) at which point there may be a more substantial revision. This would generate relative medium-run certainty about future pricing whilst leaving open a way in which the price could be updated to take account of wider social trends. Of course, flexibility is desirable, so leaving open the option of changing the price outside of this mechanism is important but the option should be exercised only in extreme circumstances (where, for example, there is strong evidence that the price is no longer appropriate).

There does not appear to be a strong case for uprating the minimum price according to alcohol-specific inflation measures. In the short-term, alcohol inflation rates will be strongly influenced by the introduction of a minimum price or wider alcohol policy such as duty rates. If alcohol prices are rising more rapidly than general inflation, then a minimum price uprated according to general inflation will have steadily less ‘bite’ but presumably the higher alcohol price would be the desired outcome in any case. Again, having a periodic review of the price leaves open the possibility of using evidence about differential price rises for cheaper and more expensive alcohol in determining an appropriate minimum price level.

The question of whether to use the RPI or CPI is not clear cut. There is a growing trend towards basing uprating decisions on the CPI but for the moment the RPI remains the inflation measure used for alcohol and other excise taxes. The RPI includes housing costs and is arguably a ‘better’ measure of inflation as experienced by households, though the method by which the CPI is calculated may make it a better reflection of how higher prices affect the cost of living since it allows (in a particular way) for the possibility that households substitute when relative prices change. A simple discussion is at http://www.ifs.org.uk/publications/5301 (and links therein).

It is also not really clear why excise duties are uprated according to forecasts of the RPI in the future whereas benefit uprating depends on outturn inflation from the previous September. Over the long run it probably makes little difference, but it may be more credible to base the uprating on observed outturn inflation measures rather than forecasts.

I hope this is helpful. I should stress these are personal thoughts and not those of the IFS.

Thanks

Andrew Leicester