The cost of living

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Once upon a time, before Covid (and before children!), I had a life. I used to go on holiday to interesting places. It seems strange to say, sat here in my living room-cum-office and having worked from home for the past 351 days (not that I'm counting), but fewer than five years ago I took a very interesting holiday…

I went to the USA to attend a friend's wedding and spent a few days on the East Coast, before going on to Ecuador. Ecuador, by the way, is a lovely (and massively underrated) country to visit, full of gorgeous scenery and interesting places.

However, one of the interesting things about Ecuador (if you're a nerd like me and get excited about visiting the central bank's museum), is that it uses the US dollar as its currency. As a result, it was instantly clear that prices in Ecuador were very, very different to the US. Moreover, because the two share a currency, this can't be written off as being due to the vagaries of currency market (anyone who has travelled to or from the UK in recent years has experienced the dramatic change in the cost of their holiday due to currency gyrations).

In the US, I winced at the cost of staying in a shady motel in a dodgy part of Baltimore (I told you my holidays were interesting!) In contrast, in Ecuador a hotel typically cost somewhere between half and one-third of the amount of said motel and frequently included breakfast. A nutritious and tasty (if simple) meal could be had for $2.50 in many places.

In fact, my experience was typical. Rich countries are systematically more expensive than poorer ones. Usually, the wealthier the country, the higher the cost of living. Of course there are exceptions, but as a general rule the phenomenon is remarkably consistent. In economics, this is known as the Penn effect and is widely accepted in the literature. Indeed, there is an entire branch of the literature devoted to hypotheses and models that might explain the effect and econometric testing of these.

One leading explanation – known as the Balassa-Samuelson hypothesis, after those who proposed it – posits that this is caused by relative differentials in sectoral productivity. Specifically, productivity differences in goods and services that are tradable are very large between rich and poor countries but significantly smaller in sectors where trade is not possible.

Intuitively, this makes sense: manufacturing a jet engine is highly skilled and capital intensive, whereas labour-intensive agricultural work or textiles manufacturing is not. Moreover, this has ramifications for relative prices of goods and services in each country. Again, the reasons are intuitive.

The price of a haircut differs dramatically around the world. The price of a pair of scissors differs by much less. Scissors are tradable – if it's more expensive to buy scissors in France than in Spain then I can simply ship them from one country to the others. In contrast, you're unlikely to switch barbers from Paris to Madrid just because a haircut is a few euros cheaper in Spain!

What's interesting is that this effect clearly also exists regionally within a country. Wealthy areas are systematically more costly than poorer ones. Pre-pandemic, a pint of decent real ale in my local used to cost about £3.20. My family in the South East (on the outskirts of London) pay about £4.50. In central London, prices of £6 or more are not uncommon.

The UK is not unusual here: the same is true in the USA (compare Mississippi and New York), Germany (Bavaria vs. Brandenburg), Italy (Bari is cheaper than Milan!), France etc. What's new is that a slew of recent academic work has begun to quantify these effects. It confirms our intuition: they are big (and often bigger in countries with larger inter-regional disparities).

Why might this be the case? The Balassa-Samuelson hypothesis relies crucially on immobility of labour: people can't move easily from Nigeria to Norway. Clearly that isn't true within a country.

There are barriers to moving – upping sticks from Hull to Hounslow isn't easy – but significant numbers traverse the country that, over time, the effect should be diluted. Recent work, however, suggests that in the UK at least these divergences are, if anything, getting bigger.

I suspect that the explanation is housing. The data certainly supports this in the UK context (the cost of housing differs far more than any other product) and it has diverged. For many reasons, the supply of housing is extremely inelastic in costly locations. Moreover, it isn't difficult to see the high value of many tradable products produced in wealthy regions.

So what does this mean for regional disparities? A simplistic take would argue that this simply means that inter-regional disparities are not as bad as claimed and move on. That would be a profound mistake.

It is true that accounting for price differences massively shrinks inter-regional differentials in average (median) full-time wages. In fact, the remaining differentials are very modest and can probably be explained by differences in workforce composition (especially in terms of skills and age). However, what this hides is a tail of extremely high earners in wealthy regions.

In addition, because so much of the inter-regional price differences can be accounted for by housing what we see is that the owners of that housing are the ultimate beneficiaries of higher (nominal) wages in wealthy regions. We should expect this to show up in (subnational) differences in wealth and unearned income. Insofar as we can tell (and statistics are somewhat patchy), this is indeed the case.

In other words, prices are the missing link between debates on inter-regional disparities and those on inter-personal ones (think of the work of anyone like Thomas Piketty). Ameliorating the former will also help with the latter. This matters everywhere: in the EU it has strong implications for cohesion policy, in the UK it profoundly affects plans to 'level up' or 'build back better' and there are clear policy ramifications in the US, China and elsewhere. Knowledge of regional prices will help us to target support appropriately, but it will also help us to design more appropriate policies because its ramifications for productivity are profound. This is a subject to which I will turn in a future blog.