The political economy of the cost of living crisis in the UK: What is to be done?

Özlem Onaran writes on the UK cost of living crisis.

Soaring prices of energy, food, other essentials and rent in 2022, caused by multiple supply chain disruptions after Brexit and the pandemic, followed by Russia's invasion of Ukraine, brought an intensive cost of living crisis, exacerbated by inequalities in class, race, gender, as well as the care and ecological crises.

While the squeeze in wages is not new, the current scale of cost of living crisis is the deepest in a generation. The Bank of England expects inflation to come down to 3.9% by the fourth quarter of 2023, but the cost of living crisis will continue for many working class households.

Inflation (CPI) in January 2023 fell to 10.1% from its peak of 11.1% in October 2022. Core inflation (excluding food, energy, alcohol, and tobacco prices) declined to 5.8% as of January 2023. However, inflation coming gradually down does not mean prices are falling; they are merely increasing at a slower pace and they will remain high, deepening the cost of living crisis for the many, whose nominal wages have not been increasing at the same pace as inflation. Meanwhile, the inflation in the prices of food and housing and household services – including water and energy bills and rent – are still substantially higher at 16.8% and 26.7%, respectively. Consequently, the inflation experienced by the poorest 10% of households is 11.7% as opposed to 8.8% for the richest 10% (Resolution Foundation, 2023).

In the UK inflation as of January 2023 is higher than that in the US (6.4%) and the euro-zone (8.5%) and coming down at a slower pace. The UK is forecast to have a poorer performance than the rest of the G7 with a recession in 2023 and at the end of 2022 it is the only G7 economy which has still not returned back to pre-pandemic levels of economic activity.

Particular vulnerabilities due to years of austerity implemented by the 2010-15 Conservative-Liberal Democrat collation government, historically low investment in both physical and social infrastructure, a highly financialized economy, high debt levels of households and small businesses and Brexit hurting both investment and international trade with the EU – the most important trade partner – caught the country unprepared to deal with the pandemic and the cost of living crisis. Yet, fiscal and monetary policy responses are still centred around austerity and increasing interest rates to fight inflation, with repeated warnings against wage-price spirals by government ministers and the Bank of England governor alike.

A historical context of rising inequality

The squeeze in wages is not new. The cost of living crisis of 2022 comes on top of decades of fall in the share of wages in national income due to the deterioration in the bargaining power of workers as a result in changes in trade union legislation, labour market deregulation, structural change, neoliberal globalisation, and financialization, along with historically undervalued wages of key workers in the care sector and public services.

The wage share reached its peak in 1975 at 69.5%. The years of austerity after the Great Recession, followed by the pandemic and now the cost of living crisis brought it down to 63.7% by 2022 -about 6% lower than its peak (AMECO). Meanwhile, the rising top 1% share in income since 1980 grew from 6.8% to 12.7% as of 2021 (World Inequality Database): the fall in the wage share of the bottom 99% is even more dramatic.

Wealth inequality has also been increasing. During the pandemic, the wealth of UK billionaires grew by 22%, and the share of top 1% in net household wealth increased further to 21.3% in 2021 from 21.1 in 2019 (World Inequality Database).

The fall in union density and collective bargaining coverage are the most remarkable factors explaining the decline in the wage share and the rise in wealth inequality, and the effects of other factors such as globalisation has to be interpreted in that context. Union density fell from 52.2% at its peak in 1980 to 23.1% as of 2021. The fall in collective bargaining coverage is even more dramatical from 85.0% at its peak in 1975 to 26.0% as of 2021.

Since the Great Recession, real wage rates have been falling. The years of austerity in its aftermath deepened the squeeze in wages and the recovery since 2014 has been slow and incomplete, with real wages still lower than their 2007 level in 2019, and the cost of living crisis reversing any improvements since 2014. As of 2022 compared to 2007, real wages in construction and manufacturing are 9.9% and 3.7% lower, respectively; in the public sector wages are 5.4% lower in real terms compared to 2010. The only sector where real wages are still substantially higher in December 2022 compared to 2007 is finance and business services, with a real increase of 5.9%.

The effects of the crisis and real pay cuts are also gendered. Women are at the frontline of the cost of living crisis, doing still more than 60% of domestic unpaid care work , including budgeting, shopping, cooking, caring, providing for the children, elderly and the household, sewing and mending. These activities increase during cost of living crises to compensate for the loss in real income of households, and this is not due to their own choosing; it is not a hobby but a stressful daily survival struggle when women need to make difficult choices between eating and heating.

Women also constitute a larger proportion of the most vulnerable on the lower end of the wage scale and those with precarious contracts. They make up the majority of workers in the public sector, such as health, social care, education and childcare, who have suffered from pay freezes and dismal increases since 2010. This situation has changed little after the pandemic, despite their being clapped as key workers by policymakers.

Households headed by women and single mothers are more likely to struggle with debt and soaring utility bills. Women also carried the brunt of the rise in the increased care needs after the pandemic with the rise in long-term illness against the backdrop of overstretched healthcare and social care services, due to years of cuts in the National Health Service and social care. The result was that many women had to leave paid work against their will.

Against the background of these facts, it is difficult to see evidence for the Bank of England governor’s warnings of the risk of a wage-price spiral . The big difference to the 1970s is the fall in the bargaining power of labour, as indicated by the fall in trade union density and collective bargaining coverage as well as labour market deregulation that brought a rise in zero-hours contracts and dodgy self-employment.

It is yet to be seen whether the biggest strike wave of the past three decades will be able to stop the real cuts in wages. Nearly 2.5 million working days were lost to industrial action in 2022 Two million of these days of strikes were in the private sector – the highest in three decades. Taking the public and private sector strikes together, the record in 2022 is still much lower than the historical highs of late 1970s, but the severity of the cost of living crisis and the discontent among public sector workers led to 2023 starting with a historical escalation of public sector strikes in rail, education, and civil service.

Causes of the current waves of inflation

The first wave of inflation in 2021-22 was due to the increase in critical imported input costs due to the supply chain disruptions after the pandemic and later due to Russia's invasion of Ukraine. Brexit added further dimensions to the supply chain disruptions in the UK. Apart from these transitional aspects, longer term problems related to climate change disasters inflated food prices too. All these factors led to soaring prices of energy, fertilizer, animal feed, food, some industrial metals (nickel, copper), neon gas (input for semiconductors). The immediate effects were worsened by commodity price speculation.

Against these exceptional and transitional factors, mainstream economists still try to point at expansionary fiscal and monetary policies during the pandemic. To date there has been little evidence of a wage-price spiral in the UK and policymakers so far have paid very little attention to firms' price setting behaviour, which has driven a second wave of inflation due to increasing profit margins in the UK, as well as the US and the EU. Firms have not only passed on the rising costs of inputs to their output prices but have increased their mark-up rates.

In the UK, some companies increased their profit margins by up to about 60% points in the fourth quarter of 2021 or first quarter of 2022 compared to the 2017-19 average (Jung and Hayes 2022). Overall, about half of the companies could either preserve or increase their profit margins during 2021-2022's first quarter. This suggests they increase wages without causing higher inflation if profit margins decrease in some industries or firms.

There is a striking variation across firms in the UK with about half experiencing a decline in their profit margins. Small and medium-sized enterprises (SMEs) are not able to pass high input or wage or borrowing costs to their customers who are themselves cutting back non-essential spending as their real incomes fall. Company insolvencies and the number of listed companies issuing profit warnings have been increasing since the third quarter of 2022.

The fiscal and monetary policy response in the UK

The monetary policy response by the Bank of England, following the conventional wisdom of mainstream central banking, failed to address the root causes of inflation, which was driven by increasing imported input costs and mark-ups rather than demand or a wage-price spiral. On the contrary, focusing narrowly on the wage-inflation expectation spiral, in an interview in February 2022, its governor Andrew Bailey said that while it would be “painful” for workers to accept that prices would rise faster than their wages, some “moderation of wage rises” was needed to prevent inflation becoming entrenched. He continued to warn of apocalyptic prices and implied that workers must pay for the crisis by moderating their wage demands.

According to its own projections, the current actions of the Bank – relying on increasing interest rates to control inflation – is expected to lead to a recession of–0.5% in 2023 and –0.25% in 2024 and growth is expected to remain well below pre-pandemic rates.

The political economy of this could not be clearer, particularly after the long squeeze in wages since the Great Recession. Currently, the profit share of the employers and the wealth of the top 1% are increasing, while workers’ share in national income is being squeezed by the spike in the cost of food, utility bills and rent. The current policies of the Bank of England of increasing the interest rate does not tackle the rise in imported input costs or rise in mark-ups at the root of today’s inflation and pretends that it is demand-driven. A recession is seen as an unavoidable outcome to make sure that the bargaining power of labour remains muted and the wage-price spiral does not escalate. This ultimately means that workers will pay for this crisis in the form of real wage cuts.

In this spirit, the Bank puts a lot of emphasis in its monetary policy reports on the tightness of the labour market, low unemployment, high economic inactivity and worker shortages in justifying its rate-setting decisions after ten successive increases in the interest rate within 18 months until February 2023, bringing it to 4%. While the unemployment rate in the last quarter of 2022 at 3.7% is still lower than pre-pandemic levels, it has started to increase. Crucially, total hours worked have decreased compared with the previous three-month period and remain below pre-pandemic levels.

The economic inactivity rate of 21.4% is still higher than before the pandemic, mainly due to health conditions, unpaid care responsibilities particularly among women, or unacceptable working conditions: the Great Resignation. But recently economic inactivity has started to decrease, putting pressure on unemployment.

This rather narrow mainstream analysis misses the broader range of policy tools beyond interest rates that could address the root cause of economic inactivity and labour shortages. The latter would require investing in the care economy – in both health and social care as well as childcare- and a radical reversal of the new migration policies in the post-Brexit UK. Some migrant workers from the EU returned home during the lockdowns and have never returned, which adds to labour shortages -an outcome partly related to the migration policies after Brexit.

In September 2022, the new Conservative government announced a new revised budget. The main changes included an increase in planned borrowing due to regressive tax cuts for high-income groups, informed by supply side and trickle-down economics.

Markets’ reaction to the mini-budget was clear that this will not stimulate the economy, and a blind trust in simplistic low tax supply-side economics will not solve stagflation or long-standing problems in the UK.

This shift in fiscal policy stance coincided with the opposite stance in monetary policy, teaching a perfect lesson on the consequences of a lack of coordination between monetary and fiscal policy. The September 2022 “mini-budget” led to an increase in government borrowing, coinciding with an announcement of quantitative tightening (QT) by the Bank of England. The day before the mini-budget, the Bank committed to actively selling off government debt by shrinking its quantitative easing gilt portfolio by £80bn over the next year, including, in contrast to other central banks, outright sales of bonds before they matured. This meant both the Bank and the government were selling huge quantities of government debt in the markets. The detrimental lack of coordination between fiscal and monetary policy institutions triggered a financial crisis in parts of the pensions sector, which no policymaker had foreseen.

Eventually, the Bank had to pause QT and buy large quantities of gilts to prevent a financial crisis in the pension funds. The new government’s “mini-budget” was abandoned in three weeks, and a third party leader and Prime Minister was appointed by the Conservative Party.

The “mini-budget” is now replaced by a return to austerity policies by the Conservative government. Austerity, including real cuts to public sector wages of nurses, teachers, and civil servants, and a reduction in public debt/GDP are said to be essential to prevent inflation and to plug a “fiscal hole.”

This second age of austerity, following the big wave of cuts by the 2010-15 Conservative-Liberal Democrat coalition government following the Great Recession, will not only be detrimental in a country with already weak social and physical infrastructure. It will be self-defeating on its own terms, as it will lead to further negative effects on national income, thereby leading to a fall in tax revenues, despite some increase in the tax rates. Even the ultimate impact on public debt sustainability is ambiguous.

The new Conservative government has drawn the wrong lessons from the collapse of the previous Conservative Prime Minister Truss's "mini budget". The Financial Times reports that even asset managers say that austerity isn't going to solve many of the UK's problems.

The resistance to increases in public sector pay in health, education, and the civil service after decades of below-inflation pay rises, along with the discourse that the best way to fight the cost of living crisis is to halve inflation, demonstrates the class bias in these policies. Nurses', teachers,' or civil servants' pay rises would not directly feed into a wage-price spiral, as they do not lead to a rise in the input costs of private companies.

In fact, insisting on further real pay cuts in the public sector is a political decision based on the government's class position on the distribution of income. One note about the hypocrisy of this position is also relevant here: public sector workers have suffered more than a decade-long real pay loss following the austerity wave during the 2010-15 Conservative-Liberal Democrat Coalition government. Most of them worked under very difficult and risky conditions during the pandemic and were praised as the "key workers" by policymakers and the public alike.

Increases in interest rates, cuts in public spending and the recession will deepen the crisis for indebted working class households as well as indebted firms at the bottom of the distribution of profit margins. The crisis for indebted households and firms is yet to unravel even when inflation starts to decline in the second half of 2023. The use of interest rates as the tool to fight a surge in inflation fuelled by imported input costs turns a transitionary problem into permanent distributional scars for indebted households and companies.

The increase in interest rates has led to higher mortgage and other debt payments by households, who have already been struggling to make ends meet due to real wage cuts and rising food prices and utility bills. More than 750,000 households are at risk of defaulting on their mortgage payments in the next two years according to the Financial Conduct Authority, because their mortgage costs will be more than 30% of their income. About 200,000 households had already fallen behind on their home loans by mid-2022.

The increase in the interest rates, fall in mortgages and slowdown in activity is feeding a fall in house prices. Mortgage approvals have fallen to their lowest level since January 2009. The Office of Budget Responsibility (2022) forecast that house prices will fall by 9% between January 2023 and the third quarter of 2024. While a correction in house prices might be welcome, this happening in a recessionary climate rather than due to a rise in housing investment, is expected to lead a further deterioration in business as well as consumer expectations and investment. There is also an increase in sales by buy-to-let landlords who cannot cover mortgage payments, which then intensifies the crisis in the rental market.

For companies, on top of supply chain pressures, rising input costs, high energy prices and rents, higher interest rates increase the pressure, particularly on already indebted companies. The total number of company insolvencies in 2022 reached 22,123, the highest since 2009 and a 57.4% increase compared to 2021. Companies in construction, retail and hospitality sectors have seen higher numbers of insolvencies.

There are concerns that more companies will fail when the government's energy support package is scaled back in April 2023. Personal insolvencies also reached the highest numbers for three years in 2022.

What are the economic policy alternatives?

In the short-run, two sets of urgent measures are required:

i) First, we need policies to urgently reverse the squeeze on wages and low incomes. The policy tools to achieve this include increasing the minimum wage to £15 per hour in the UK; increasing public sector pay above inflation; tying benefits to the increase in inflation; and rebuilding the trade unions' power for collective bargaining agreements to ensure adequate pay rise in the whole economy. Mindful of the risk that these measures may increase company insolvencies, in particular at the bottom of the distribution of SMEs, a reactivation of fiscal support for short-time work to avoid transitional shocks is essential.

ii) Second, the extreme nature of the cost of living crisis requires price controls, in particular on energy prices, rents and essential food items. The New Economics Foundation (2022) proposed a package for guaranteeing basic energy needs for households, while avoiding subsidising fossil fuel consumption above a certain threshold. In the international context, France acted early in November-December 2021, directly limiting electricity price increases to 4%, and froze domestic gas prices, with energy subsidies to businesses and households It enjoyed the lowest inflation in the eurozone with 7.0% as of January 2023. The measures, which included discounts at the pump and cuts to electricity taxes, cost the government just over €34bn in 2022.

Another major component of essential spending for low-income households which increased substantially is rent. The

Conservative Government in the UK limited the increase in the social (housing) rents to 7% in November 2022 for the next year, but a genuine policy of rent controls require controls in the private housing market too. Both in the context of energy prices and rents, these policies need to be accompanied by a ban on disconnections or compulsory instalment of pre-paid meters for utilities and a ban on evictions. The latter was implemented during the pandemic.

A third category where price controls could help is essential food items. France with a competitive supermarket sector had lower food inflation because of limits on the rise in profit margins in the retail sector. In the UK where competition has not sufficed to limit food price inflation, some coordination to curb the rise in mark-up rates or subsidies could go a long way to avoiding the worst poverty effects of the cost of living crisis.

Overall, anti-trust scrutiny and windfall taxes targeting the increase in mark-up rates as well as banning speculation in commodity markets are other short-run policy tools to tackle the rise in inflation.

In the medium run (1-5 years during the first term of a new government), the multiple crises require a paradigm shift towards a needs-based approach to macroeconomic policy, addressing the deficits in the care and green economy and avoiding competition between urgent social and ecological requirements.

Addressing the cost of living and energy crises, as well as reversing the ecological crisis requires a massive and urgent mobilization of substantial amounts of public investment in the green economy, that is, renewable energy, public transport, housing, energy efficiency, sustainable organic plant-based agriculture, forestry, recycling, and repair.

The long-standing deficits in the care economy are no less urgent, and are now behind the labour shortages, and public provision of high quality universal free basic services in social care, health, childcare, and education is key to tackling both the care deficit and inequalities by creating decent care jobs while providing much-needed services. The scale and the urgency of the spending needs to address both deficits in the green and care economy; and the public good character of these services requires a large public spending programme, which cannot be substituted by private investment based on the profit motive. There has never been a better moment to make the case for creating permanent public sector jobs with decent wages to build a caring and sustainable society based on a green, purple, red new deal.

How to fund a green, purple, red new deal?

The social and ecological needs, and the urgency of an effective response to the multiple crises of inequalities, care and climate change requires the use of all tools of policy.

Public spending even without any increases in tax rates, is partially self-financing, thanks to the strong multiplier effects. However, an increase in economic activity and thereby tax revenues without a change in tax rates will finance only half of the public spending needed in the UK.

Public borrowing to fund the deficit can be justified given the effects on productivity and sustainability, or the expected damage to the ecology, society, and economy, if investment needs are not delivered on time.

Monetary policy should accommodate fiscal policy for public investment in the care and the green economy. The Bank of England’s mandate should include a dual target of full/high employment and an inflation target high enough to be consistent with this. There is a major problem with the current mandate of the Bank targeting narrowly the inflation rate at a level as low as possible, which only helps the rentier who make profits by speculation and lending.

National and regional investment banks working in cooperation with the government and central bank are also crucial for funding largescale public infrastructure projects.

However, eventually the large scale of spending needs requires also an increase in the degree of progressivity of taxation of both income and wealth. A progressive scheme of wealth taxation, aiming especially at the top 1% of the wealthiest households, rather than a limited one-off windfall tax targeting only one sector or increasing tax rates merely on dividends and capital gains, is particularly important after the Great Recession, QE and the pandemic which has increased wealth inequality.

Wealth is more unequally distributed than income in aggregate and in terms of gender gaps. Progressive taxation of wealth is essential to prevent excessive wealth concentration. Wealth taxation also helps to control wealth-demand-driven inflation. Progressive wealth taxes and the consequent decline in wealth inequality are good for private investment, taming speculation, financialisaton, market concentration and barriers to entry.

A progressive scheme starting with a high threshold targeting the top 1% wealthiest households, has the advantage that only a small number of households would be valued and is easier to monitor.

The coordination of fiscal and monetary policies with labour market policies eases the funding pressures as higher wages lead to higher tax revenues. Strong, well-coordinated trade unions, equal pay legislation, increased job security, permanent contracts, higher minimum wages, and improved and equitable parental leave are good for an equality-led sustainable development. Labour market regulation for a shorter working week can also promote a rise in gender equality in paid and unpaid work and income, while facilitating a green transition and higher productivity.

At this crucial juncture of food, energy and ecological crises, international policy coordination is vital, especially for the emerging economies. Firstly, the effects of public spending are stronger and negative effects on the current account balance are moderated, if policies are implemented simultaneously in all the countries. Secondly, cancellation or restructuring of parts of the debt of low and middle income countries needs to be part of the international agenda. Thirdly, transfer of technology to support mass not-for-profit global production of key public goods, from vaccines and medication to solar panels, turbines, or batteries for storing renewable energy, is the only way to tackle global crises such as the pandemic or climate change.

Finally, these multiple crisis open a space to rethink not just the role of fiscal policy but also of public ownership in the care and green economy and finance, with national coordination in combination with collective, municipal, and cooperative ownership and democratic participatory planned decision making.

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Image: Liz Truss and Kwasi Kwarteng, authors of the "mini-budget" in September 2023, c/o

Article originally published by Labour Hub, 7 March 2023 https://labourhub.org.uk/2023/03/07/the-political-economy-of-the-cost-of-living-crisis-in-the-uk-what-is-to-be-done/ Also republished at [International Viewpoint]() and [Anti Capitalist Resistance]()