ReWAGE

Eight actions to tackle the impact of the cost-of-living crisis

ReWAGE Policy Brief

1.1 Introduction:

The 'cost-of living-crisis' refers to the fall in 'real' disposable incomes (that is, adjusted for inflation and after taxes and benefits) that the UK has experienced since late 2021. This ReWAGE policy brief considers the causes and extent of the cost-of-living crisis and recommends measures that could be taken to alleviate its impact.

1.2 The impact of the cost-of-living crisis:

Financial pressure

According to Bristol University's Coronavirus Financial Impact Tracker, the number of households in serious financial difficulties has risen from 2.8 million in October 2021 to 4.4 million in June 2022. More than a third of households with income under £10,000 per year, social renters, and lone parents are in this category. More than a quarter of working age households with no-one in work, with someone with a disability, with three or more children, renting privately, and with income between £10,000 and £19,9999 are also in serious financial difficulties.[1]

Debt and longer-term financial consequences

Those in serious financial difficulties have been accumulating debts to cope. Half (51 per cent) have borrowed money from formal sources to pay for daily living expenses and 46 per cent have depended on financial help from family and friends. 36 per cent have sold or pawned goods they would have preferred to keep, a quarter have cancelled at least one insurance product and a sixth have stopped or reduced pension contributions.[1]

Food insecurity and hunger

The Food Foundation's Food Insecurity tracker, which asks households about consuming less food, skipping meals, and being hungry for affordability reasons, found that in September 2022, 25.8 per cent of households with children had experienced food insecurity in the previous month compared to 11.0 per cent a year before.[2]

The Trussell Trust reports that it provided over 2.1 million food parcels in the year to March 2022. This is an increase of 81 per cent on five years earlier and an increase of 14 per cent on two years earlier. The only period in which more food parcels were provided was in 2020/21 – the first year of the pandemic.[3]

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[1] Evans and Collard (2022) *Under Pressure: The Financial Wellbeing of UK Households in June 2022,* abrdn Financial Fairness Trust

[2] The Food Foundation (2022) *Food Insecurity Tracking Round 11*

[3] The Trussell Trust (2022) *End of Year Stats 2021-22*

Unprecedented nature of the crisis

Annual inflation, as measured by the Consumer Prices Index (CPI), at 10.1 per cent in the year to September 2022, was higher than at any point since the early 1980s. Since World War 2, the mid-1970s, and 1979-81 are the only times when inflation has been higher.[4]

What is striking about this period is how wages have failed to keep up with prices. Wage growth in the year to August 2022 was 3.6 per cent lower than CPI price growth. Since the 1960s, the current real-terms decline in wages has only been exceeded in 1977.[5]

We have also seen a drop in the real value of benefits never seen before. The April 2022 uprating of benefits saw a 5.4 per cent fall in their value relative to prices – the largest fall since records began.[6]

1.3 Policy recommendations:

I. **More timely uprating of benefits** - reduce the time lag between the measurement of inflation and the uprating of benefits.

By default, benefits are uprated each April in line with inflation in the previous September. The substantial fall in the real value of benefits in April 2022 arose from the September 2021 CPI inflation rate being 3.1 per cent whilst inflation in the year to April 2022 was 9.0 per cent.[7] Larger disparities between the September and following April inflation rate are more likely at times of economic disruption.[8] Yet it is at these times that families on low incomes are more likely to be experiencing financial stress.

When the Covid-19 pandemic started, the government announced and implemented an increase in Universal Credit and Tax Credit rates with less than four weeks' notice. The government should aim in future to implement changes to benefits in April based on the inflation rate in January that year to reduce the effects of the time lag causing considerable hardship at times of economic disruption. This policy should be implemented in such a way that inflation that occurred before the change in policy is included in any new uprating – i.e., that claimants are not disadvantaged by the change.

II. **Uprating of the Benefit Cap** - increase the Benefit Cap to take into account inflation

The Benefit Cap affects only a small proportion of claimants[9] yet, because the rate of the Benefit Cap has been unchanged since 2017/18, its impact increases faster at

[4] Measured by CPI back to 1989 (ONS time series D7G7) and RPI before then (ONS time series CZBH)

[5] ONS time series KA5Q back to 2000 and time series MD9M before then, deflated by CPI (D7BT) back to 1988 and deflated by RPI (CHAW) for longer-run comparisons

[6] DWP (2022) *Abstract of DWP benefit rate statistics*, updated by the author with April 2022 data. Data in this publication goes back to 1948.

[7] ONS time series D7G7

[8] ONS time series D7G7 (CPI) back to 1989 and CZBH (RPI) before that.

[9] 2.1% of households claiming Universal Credit or Housing Benefit in May 2022 were subject to the Benefit Cap: DWP (2022) *Benefit Cap: number of households capped to May 2022*

times of high inflation. Its value has fallen by nearly 15 per cent in real terms since April 2017. Because it affects so few families, it would be comparatively cheap to increase the Benefit Cap and have a significant impact on the living standards of those families. The stated purpose of the Benefit Cap is to ensure that families on benefits are incentivised to work. However, since April 2017, wages have gone up by more than prices, so uprating the Benefit Cap in line with inflation would still have kept the Benefit Cap going up less slowly than wages.

III. **Provide support through the benefit system** - instead of paying flat-rate amounts, provide additional support through standard allowances in means-tested benefits

Adjusting standard adult and child allowances in means-tested benefits when providing one-off support to tackle cost of living pressures would address two shortcomings with the current approach (where flat-rate payments are provided to people receiving benefits). Firstly, families just above thresholds for means-tested benefits would gain something from the support, reducing cliff-edges. Secondly, it would allow support to be scaled by size of family so that larger families are not disadvantaged by the support system on offer.

In order to facilitate use of benefit standard allowances, work should be done now on benefit computer systems to provide for the possibility of using benefits for payment of one-off lump sum payments in addition to standard weekly benefits.

IV. **Additional public sector wage increases for the lowest paid** - increase the wages of the lowest-earning public sector workers by more than nationally-set pay norms

Today's rapid growth in prices is affecting people at all levels of income. However, it is people on the lowest incomes who are least able to cope with these price increases. They spend very little on non-essentials and have few other resources to draw upon. It is important, therefore, that any resources available are focused on maximising help for those who need it most.

Given that public sector wage growth is so far behind prevailing levels of price rises, it is highly unlikely that higher average public sector wage growth will add to inflation. However, for any given level of average public sector growth, it is possible for the state to spend relatively small sums of money, with almost no inflationary effect, on increasing pay for the lowest-paid in the public sector. This has been done successfully in the past in the context of Agenda for Change pay awards in the National Health Service.

This will have a number of effects. Firstly, it will provide a direct increase in income for many low-paid workers. It will increase competitive pressure on private sector employers to improve pay rates in low-paid jobs. It would also reduce the flow of workers from some public sector jobs to private sector employers who are already increasing pay rates. It may also have some effect in increasing labour supply by encouraging people who have given up work after the Covid-19 pandemic to return to the labour market. This will increase their incomes but also help in the medium term to reduce inflationary pressures in the economy.

V. Consider higher increases in the minimum wage - increase the Minimum Wage beyond the level implied by median earnings growth

The government's policy is to increase the Minimum Wage in line with median earnings. However, with earnings falling relative to prices, using median wages as the peg for the Minimum Wage will mean a reduction in living standards. However, since the Covid-19 lockdown, we have seen a reduction in economic activity rates. The result is that many low-wage employers are finding it difficult to recruit staff. Therefore, given the excess of demand for labour over supply, this is a time when the labour market has capacity for faster increases in the Minimum Wage. The government should therefore consider increasing the Minimum Wage beyond the level implied by the growth in median earnings.

VI. Review support through the benefit system for low-income owner-occupiers with mortgages - ensure that the system of support for low-income owner-occupiers is able to increase support to households if mortgage rates increase sharply

The system of housing support for low-income owner-occupiers has been changed radically in recent years with payments now made as loans. The government should review urgently whether this system is flexible enough to provide more support to recipients if mortgage rates rise sharply.

VII. Better measurement of inflation experienced by the poorest households - commission research into the reality of inflation experienced by low-income households

In any supermarket, there are potentially up to five price levels available for a given product: a premium brand, mainstream brand, own brand, own brand 'basic' variety and products on the discount shelf. Current measures of inflation are not able to distinguish between price rises for these different price levels and so cannot track the extent to which reductions in availability of the lower price variant might be causing hidden inflation.

Furthermore, not enough is understood about how low-income households make choices between these price levels or choose more local but potentially more expensive shops to avoid transport costs.

The Office for National Statistics should commission research into the reality of inflation experienced by low-income households.

VIII. Reduce trade barriers with major trading partners – work with the European Union to minimise non-tariff barriers to trade

The UK's Trade and Co-operation Agreement with the European Union is relatively new. As with all international agreements, arrangements can take time to bed in and operate effectively. The government should prioritise ensuring that operational arrangements and co-operation with the European Union are maximised so that non-tariff barriers to trade do not exacerbate goods price inflation with the UK.

1.5 Summary of evidence:

The extent of the cost-of-living crisis:

Annual inflation, as measured by the Consumer Prices Index (CPI), at 10.1 per cent in the year to September 2022, was higher than at any point since the early 1980s. Since World War 2, the mid-1970s, and 1979-81 are the only periods when inflation has been higher.[10]

What is striking about this period is how wages have failed to keep up with prices. Wage growth in the year to August 2022 was 3.6 per cent lower than CPI price growth. Since the 1960s, the current real-terms decline in wages has only been exceeded in 1977.[11]

We have also seen a drop in the real value of benefits never seen before. The April 2022 uprating of benefits saw a 5.4 per cent fall in their value relative to prices – the largest fall since records began.[12]

Causes

The underlying causes of high inflation are as follows[13]:

- **International causes**
    - There was high demand for consumer goods as economies opened up after the pandemic, particularly in the USA. Companies had not anticipated this surge in demand and supply chains had insufficient capacity to meet it. Ongoing lockdowns in China restricted further the ability of companies to meet this demand.
    - Global energy prices have risen, which feeds through into domestic energy bills and fuel costs, which in turn affects the prices of other goods.
    - Russia's invasion of Ukraine has pushed global energy prices even higher, and also contributed to an increase in global food prices.
- **Domestic causes**
    - The majority – around 80% - of the high inflation that we see now has international causes:[14] high inflation is also found in the Euro area and the United States. However, a component is down to domestic factors:
    - Businesses within the UK are facing higher costs as labour shortages and high expectations of inflation have led to higher wage settlements.

[10] Measured by CPI back to 1989 (ONS time series D7G7) and RPI before then (ONS time series CZBH)

[11] ONS time series KA5Q back to 2000 and time series MD9M before then, deflated by CPI (D7BT) back to 1988 and deflated by RPI (CHAW) for longer-run comparisons

[12] DWP (2022) *Abstract of DWP benefit rate statistics*, updated by the author with April 2022 data. Data in this publication goes back to 1948.

[13] Bank of England (2022a) *Monetary Policy Report – August 2022*

[14] Bank of England (2022b) *Exchange of letters between the Governor and the Chancellor regarding CPI Inflation - June 2022*

1.6 The effects of the cost-of-living crisis

Inflation

Expenditure patterns vary across the income distribution. National inflation rates are measured via an average basket of goods. For any given national inflation rate, it is possible that richer and poorer households could experience different rates of prices rises for the goods and services that they typically buy.

Up until the end of 2021, cost pressures were similar at the top and bottom of the income distribution[15], partly because better-off households spend more on transport and fuel prices were a significant driver of inflation last year.

However, in 2022, inflation has fed through into domestic energy prices and into food.[16] Lower-income households spend a much higher proportion of their weekly expenditure on food and energy[17] so inflation is hitting poorer households harder in 2022. In August 2022, the Institute for Fiscal Studies predicted that by October, the poorest tenth of households would face an inflation rate of 17.6 per cent compared to 13.1 per cent for the richest tenth of households.[18]

Mainstream inflation measures are not designed to pick up differences in price movements within item categories. In each store visited by ONS price collectors, only one representative item is measured within each category. However, people on lower incomes are more likely to purchase lower-price own-brand, 'basic' or discounted products. This issue was highlighted by Jack Monroe, the food writer, who highlighted the withdrawal by some supermarkets of some of the most discounted items.[19]

The Office for National Statistics responded to this challenge by producing experimental statistics to look at the cost of the cheapest available varieties of 30 staple food products. This found that, in the year to April 2022, some products had gone up by substantially more than the average inflation rate, but that, across the basket of 30 items, the average increase of the least cost items was similar to the overall inflation rate.[20]

Wages

There is substantial variation in wage growth across the labour market. In the year to June to August 2022, public sector wages fell by 6.7 per cent in real terms whilst pay in the private sector fell by 2.7 per cent. Within the private sector, average wage increases vary from a real-terms fall of 4.9 per cent in manufacturing to a fall of 2.6

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[15] ONS (2022) *Inflation and the cost of living for UK households, overview: June 2022*

[16] In the year to September 2022, the prices of Electricity, Gas & Other Fuels had risen by 70% and Food prices by 15% (ONS time series D7CH, D7C8).

[17] In 2019/20, the poorest tenth of households spent 38% of their weekly expenditure on housing, fuel, power, food and non-alcoholic drinks compared to 18% for the richest tenth. (ONS (2021) *Family Spending*)

[18] Johnson et al (2022) *The long squeeze: rising inflation and the current government support package*, Institute for Fiscal Studies

[19] Holmes (2022) "Is Jack Monroe right about food inflation hitting the poorest hardest?", *The Grocer*, 28 January 2022

[20] ONS (2022) *Tracking the price of the lowest-cost grocery items, UK, experimental analysis: April 2021 to April 2022*, 30 May 2022

per cent in finance and business services and a fall of 1.6 per in distribution, hotels and restaurants.[21]

Benefits

Whilst benefits are normally uprated in April each year on the basis of inflation in the previous September, the period between September 2021 and April 2022 saw inflation jump from 3.1 per cent to 9.0 per cent. Failure to uprate benefits in real time resulted in a drop of 5.4 per cent in the real value of benefits in April 2022 – the largest ever seen.[22]

The combined effect of the withdrawal of the £20 uplift (paid from April 2020 to October 2021) and benefits failing to keep pace with inflation during the four years of the benefit freeze from 2016 to 2020 and in April 2022, means that the real terms value of the basic rate of unemployment benefit is now lower than 35 years ago. The result is that the UK now has one of the lowest net replacement rates in the OECD[23], reducing the resilience of claimants to cope with sudden increases in costs.

Furthermore, the amount of money actually received can be lower than the headline level of benefits. Deductions can be made from benefits for: advance loans to cover the initial 5-week waiting period for a new claim, overpayments, and third-party debts relating to housing rents, water and energy bills. In February 2022, 45 per cent of Universal Credit claimants received a deduction.[24] This is higher (53 per cent) for disabled claimants than for non-disabled claimants (42 per cent). Claimants in areas with higher levels of deprivation are also more likely to have a deduction in place.

1.7 The prospects for the future

In its August 2022 Monetary Policy Report, the Bank of England forecasts inflation to peak at slightly over 13 per cent during October to December due to further increases in energy and food prices caused by Russia's invasion of Ukraine.[25]

The majority of the effect on consumers is due to the operation of the energy price cap set by Ofgem which limits domestic energy prices for 22 million households and is set according to market expectations of wholesale energy prices. This cap has been revised each April and October[26] and the April 2022 revision saw a rise of 54 per cent, whilst the October 2022 revision was expected to see a further rise of 80 per cent.

However, in August, the government announced its Energy Price Guarantee, which limited the October increase to 27 per cent. The effect of the government's intervention is that domestic energy prices have increased by 96 per cent in one year, with typical bills rising from £1,277 to £2,500 a year. Without the government's intervention, they

[21] ONS time series KAC6, KAC9, K5CC, K5CI, K5C6, deflated by the 3-month average of D7BT.
[22] DWP (2022) *Abstract of DWP benefit rate statistics*, updated by the author with April 2022 data.
[23] OECD.Stat: *Net Replacement Rate in Unemployment* measures the proportion of income whilst working that is maintained in unemployment.
[24] PQ 17006
[25] Bank of England (2022a) *Monetary Policy Report – August 2022*
[26] Ofgem will be switching to quarterly revisions of the cap from October 2022.

would have stood at £3,549 a year by October 2022, which would have been a 178 per cent rise in 12 months.[27]

The Bank of England is also expecting some domestic upward pressure on inflation from shortages of workers and companies raising prices to meet higher costs. However, they are expecting energy prices to stabilise at these high levels and they expect global supply chain issues to resolve themselves.

Further, they expect that the high energy and goods prices that we are now seeing will themselves cause a sharp slowdown in UK economic activity. Consumers under financial pressure and firms trying to restore their profit margins will reduce demand for goods and services, leading to higher unemployment and less upward pressure on prices. This may have already started to happen as economic activity fell in August 2022. The Bank expects inflation to remain high in 2023 before falling to the 2 per cent target in two years and, due to the slowdown in economic activity, to fall further in the subsequent year.

Government measures

As mentioned above, the government's Energy Price Guarantee means that a consumer with a typical bill will see energy costs of £2,500 per year instead of the £3,549 implied by Ofgem's energy price cap.

The government is also providing £400 of support to all households through reductions in energy bills, £150 to households in Council Tax bands A to D, £650 to families on means-tested benefits, £300 to pensioners in receipt of Winter Fuel Payments, and £150 to families on disability benefits.

These are substantial amounts of money and will shield many of the poorest families from a proportion of the effects of inflation in 2022/23. However, these payments are designed to support households in 2022/23 only and the Bank of England forecasts inflation to remain very high in 2023. So, the question of how to support households in 2023/24 will remain.

Furthermore, flat-rate payments to all recipients of various benefits have a number of consequences. Firstly, there is a cliff-edge: families just above the threshold for means-tested benefits will not get any of the £650 flat-rate payment when their need may be only a small amount less than the family receiving the benefit. Secondly, the flat-rate payment takes no account of family size. Larger families are likely to have higher costs – for food and energy – but will get the same amount of support as smaller families.[28]

Interest rate rises

Throughout 2022, the Bank of England has been raising interest rates to put downward pressure on inflation.[29] Following the government's mini-budget on 23 September 2023, yields on UK government bonds rose sharply, although some but not all of this

[27] BEIS (2022) *Energy bills support factsheet*
[28] Resolution Foundation (2022) *Back on target: Analysis of the Government's additional cost of living support*
[29] Bank of England (2022) *Official Bank Rate history*

increase has reversed after changes in policy.[30] As fixed-rate mortgage deals come to an end and households look to re-mortgage, they will face higher mortgage costs.

Increased mortgage costs will exacerbate the effects of the Cost-of-Living crisis for mortgaged owner-occupiers. Whilst owner-occupiers are on average better off than people in other tenures, it is important to remember that there are large numbers of low-income owner-occupiers. In 2020/21, 2.3 million people in poverty lived in a home owned with a mortgage[31] and are likely to find increases in mortgage rates particularly difficult to manage.

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This policy brief represents the views of the authors based on the available research. It is not intended to represent the views of all ReWAGE members.

Funding:

ReWAGE is part of an integrated research infrastructure funded in response to COVID-19 by the Economic and Social Research Council. The ESRC is part of UK Research and Innovation, a non-departmental public body funded by a grant-in-aid from the UK government. For more information visit www.ukri.org.

About ReWAGE

ReWAGE is an independent expert advisory group modelled on SAGE, which supports government's strategic response to the recovery and renewal of work and employment in the UK as it tackles the impact of current challenges to the UK's productivity and prosperity.

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[30] Financial Times (2022), *Markets\Markets Data\Bonds\UK 10 Year Gilt*

[31] DWP (2022) *Households Below Average Income 2020/21*, using variables TENHBAI and LOW60AHC