A Study of Inflation in the UK's Economy in 2021 and 2022

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Abstract. After COVID-19, global economies have been hit to various extents, and inflation has become one of the global problems. Moderate inflation can promote economic growth, but excessive inflation can lead to higher cost of living and production costs. Therefore, controlling inflation has become one of the main goals of most countries. This article aims to find a new way to improve the abysmal economic situation in UK. The article analyzes how COVID-19, Brexit and rising energy affect the inflation in UK from 2021 to 2022. This study also evaluates the effectiveness of the policies that imposed by Boris Johnson government and Elizabeth Truss government, including tax policies and labor market reform to correct cost-push inflation. From the results of the analysis, it is clear that the UK needs a strong and stable government to maintain long-term geo-political situation. It could go a long way toward easing inflationary pressures, but this depends on the attitude of the government. Otherwise, the fact proves that demand-side economic policies are ineffective under existing situation, and that only supply-side reforms can inject new vitality into the UK economy.

Keywords: Inflation energy price, labour market, supply-side policy.

1. Introduction

The global economy has entered a phase of sustained turbulence since the beginning of 2020. The ravages of the New Coronavirus have impacted economies across the globe. In order to contain the virus, many countries have had to introduce policies to restrict the activities of their citizens, large shopping malls have been forced to close, and highly populated manufacturing industries have been called off. The global economy has been slowed down, and some countries have even experienced a trend of economic regression. In addition to this, complex geopolitical factors have led to continued economic volatility. The war between Russia and Ukraine has led to a new round of trade war, and the United States and the European Union have imposed economic sanctions on Russia, which, as one of Europe's major energy exporting countries, has drastically cut back on its energy exports to Europe after being subjected to the sanctions, causing inflationary pressures to surge in European countries. So far, economists believe that there are two main triggers for inflation, one is the strong total market demand, including the economic growth rate is too fast or currency over issuance. The other trigger is a decline in aggregate market supply due to rising production costs. A high inflation rate will bring a series of negative impacts to the economy, such as rising cost of living and currency depreciation.

This paper focuses on the impact of rising energy prices and COVID-19 on the UK economy. Both high living cost and production cost lead to cost-push inflation. This paper also evaluates the policies adopted by the two governments in 2021 and 2022, including tax reduction and labor market stimulating. Based on which, this paper argues that the UK needs a tougher government to implement long-term economic policies and that a real increase in gross national output is the only solution to hyperinflation.

2. Inflation in the UK

This paper will focus on the reasons for the continued downturn in the UK economy since 2021 and the willingness of the UK economy to perform poorly between 2021 and 2022 and the economic policies adopted by the UK [1].

2.1. Inflation in 2021

Figure 1 shows that the inflation rate in UK from 2019 to 2023, UK has been facing very high inflation since 2021, and there is reason to believe that this has been caused by the Covid-19, which, as mentioned above, During the epidemic, the British government had to issue a ban to restrict the activities of its nationals.



Figure 1. UK Inflation between 2019 and 2023 (Source: Tradingeconomics.com; Office for National Statistics)

In March 2020, UK government began to require large shopping malls, cinemas, theaters, pubs, nightclubs and other public places to stop operating. At the same time, a number of large companies had to stop production due to the excessive number of employees infected with the new coronavirus. The result of these circumstances is that the UK economy continues to grow at a slower rate and the country's total production decreases leading to cost-push inflation. Otherwise, the legacy of former Prime Minister Theresa May has not been resolved, with both UK imports and exports affected after Brexit and more imports subject to tariffs also leading to higher production costs [2].

In 2021, the British government began to put the economic recovery plan into effect. It is worth evaluating the policy posted by UK government in 2020 in the recovery of economy and curbing inflation. On the tax front, the biggest change has been in personal taxation, the UK government was cutting taxes directly or indirectly on individuals and collectives. The Income Tax Allowance Personal rose with CPI as a result of £12,570 [3], and the income tax threshold rose to £50,270. For individuals, rising disposable income means more consumption, while for businesses, the tax credit leaves more money to invest in research and development. Tax deductions increase aggregate demand. In the long run, however, tax relief is not a good solution to the problem, the government tax revenue decrease means that fewer capital will be attribute in health care education or infrastructure. The opportunity must be concerned, otherwise the long run aggregate supply did not change [4], so that the policies do not exactly improve the economic growth in UK.

Besides, tax relief the British government to achieve economic recovery in fact also spent a lot on subsidies, national investment and so on. At the end of 2021, the UK government had a total revenue of £ 786.3 billion and a total expenditure of £ 1,140.9 billion [5], with a deficit of 16.9%. What's more, with the easing of controls on the epidemic, consumer demand has soared, fueled by retaliatory spending and tax breaks. Yet, the social productivity of UK is recovering slowly. The imbalance between supply and demand will create a new and more violent round of inflation in the future. Indeed, in the second year after the tax cuts, in 2023, the UK's inflation rate reached a staggering 11.7% in the first quarter.

Affected by the war in Ukraine, energy prices have also soared, and inflation rate is still rising. The UK government was forced to adopt a more aggressive contractionary policy. For this reason, another across-the-board increase in tax rates to ease inflationary pressures by Prime Minister Rudy

Sunak sparked protests in British society, leading to strikes in the rail, health and postal sectors in the first three months of 2023. One more thing worth mentioning is the British government's policy on interest rates. On November 3rd 2022 the Bank of England raised its benchmark interest rate by 75 basis points to 3 per cent. Higher interest rates attract more deposits, and there will be less money in circulation, thus reducing money supply. People put more money into savings, so as interest rates rise [6].

However, the truth is that, since Brexit, the UK's economy has become increasingly unstable, consumers are inherently not confident, and suddenly high interest rates will no doubt spur people to save a lot of assets, making a sharp decline in consumption more likely to bring the UK economy into recession in the long run [7]. Lower aggregate demand due to high tax rates is bad for job creation in the UK labor market, which is not good for the slowing recovery in manufacturing and services. This is evidenced by unemployment having risen to 6.25% by 2022.

British government in 2021 adopted a series of economic policies did not achieve the desired results. Tax cuts and huge spending to stimulate the economy have left the UK government in the red, which was followed by more sharp inflation in 2022. The reckless increase in interest rates has also put renewed downward pressure on the British economy. Since the outbreak of Covid-19, the British government has switched heads of state three times in just two years, and each has taken aggressive fiscal measures to demonstrate their ability. This has directly led to turbulence and chaos in the UK economy, reducing consumer confidence while also making the society more unstable.

2.2. Inflation in 2022

The economic policy adopted by the UK government in 2021 was undoubtedly a failure if only assessed in terms of outcomes, with higher inflation maintained into 2022 and economic policy changed with the new government in place. British government announcing on September 23rd, 2022 that it will take a series of measures to boost the economy and curb inflation in the UK, including large-scale tax reductions, and labor market reform.

The UK economy is in a very hostile environment, with inflation and downward pressure sending the economy into a vicious cycle. UK government must take measurements to make it back to economic well-being. There are two main reasons for malignant economy in the UK. First of all, the UK's involvement in sanctions against Russia has led to a sudden drop in the amount of energy exported from Russia and a spike in energy prices in the UK itself, which affects the UK across the board, with a consequent rise in the cost of production and a reduction in aggregate supply and there is a cost push inflation in UK [8].

The impact of rising energy prices on the UK economy is likely to be all-encompassing. On the one hand, the cost of living for people in the UK has risen dramatically following higher energy prices, with electricity bills, domestic heating and kitchen gas bills becoming more unaffordable. In addition to this, higher fuel prices have also led to an increase in the cost of industrial production. On the other hand, higher energy prices lead to more pounds being used to pay import bills, and the sterling exchange rate will be at risk of depreciation, which will lead to a new round of cost-push inflation, and thus to a vicious circle [9].

Secondly, contributing to recession pressure in the UK is the continued downturn in economic activity since the COVID-19 epidemic, during which the UK government issued a series of bans to restrict people's activities in order to prevent large-scale contagion, which led to a significant reduction in consumption. In addition, the widespread contraction of business due to mismanagement has dampened investor confidence as well. When the consumption and investment decline, aggregate demand also decrease. All these eventually led to the stagnation of the British economy. Generally, UK's economy is now facing the problem of cost push inflation and the recession pressure caused by inefficient aggregate demand. Although the inefficient aggregate demand seems to lower the price level but refer to the real-world situation in UK, it is significant that the price increase caused by inflation is much greater than the price decrease caused by economic downward pressure. Otherwise, UK is facing a stagflation pressure [10].

In order to control the cost push inflation UK government uses a series of supply side policy to stimulate production [11]. From the aspect of taxation, UK government decrease both personal income tax rate and the corporation tax. Higher personal income taxes will reduce the incentive for labor to earn higher wages and thus discourage production. Decreasing in personal tax rate means that the opportunity cost of not working at leisure time increase, so more labor will trend to work more for higher profit. As for lower rate of corporate tax, when there is a lower tax rate, firms are able to keep more profit and more money will be available for investment. In an economy, investment could be concerned as the capital which is one of the factors of production. UK government also imposed labor policy in labor market. As the article mentioned, tougher criteria were set for the receipt of unemployment benefits, while the amount of unemployment assistance was reduced either.

These will also encourage the labor to find a new job quickly, because the opportunity cost of not working increases and unemployment benefit drops. Both personal tax cut and unemployment benefit decrease will give a positive effect on labor which is also one of the production factors. Cut in corporation tax allows company to keep more profit for investment which present as capital factor in production [12]. As the aggregate factor of production increase, aggregate supply will increase.

These supply side policies also present the demand-side effect. Lower income tax also lead to more disposal income and disposal income increase will finally present as more consumption. In addition, decline in value added tax for tourists also lead to more consumption in UK, which could be considered as the inflow in current account of UK which could release the depreciation pressure mentioned before.

Although supply-side policies taken by UK government seems efficient to solve the problem, it will lead to some negative effect which make them unable to achieve the desire effect. Personal tax cut is desirable for encouraging labor work more, but in fact when disposal income more people trend to work less since they already have a higher wage level. Otherwise, refer to the model of most large firms, the extra profit brought by corporation tax will be shared by shareholders and a more inequality may occur. Besides inequality, the restring in unemployment benefit also affects those who really needs. Cumbersome procedure also sows the seeds of potential corruption and social instability.

Supply-side policy adopted by the UK government does provide some relief from the cost-push inflation that the UK is facing at this stage, while national output increases. However, one thing must also recognize is that these policies also have negative impacts, as tax cuts may make people less motivated to work, and at the same time lead to a more serious inequality in income distribution. Finally, the demand-side effect could also lead to more inflation. The UK economy faced a similar situation in both 2021 and 2022, but it is clear from today that the problems remain unresolved, with inflation reaching another record high in 2023, national strikes once again, and even a vicious cycle of stagflation. The UK is in dire need of a strong and stable government to regulate the economy.

3. Conclusion

This paper analyzes the state of the UK economy in 2021 and 2022, and the economic policies adopted by the UK government during this period. If evaluated in terms of results, the performance of both UK governments has been substandard, and currently the UK is facing higher inflation with an increasing tendency towards stagflation. In the face of rising costs of living and a society-wide general strike, including in the social security sector, people are left wondering where the future of the UK lies. Based on the available information, as speculating that the UK will need more increases in long run aggregate supply to drive real economic growth to get out of the quagmire, but implementation is predicated on solving short-term livelihood issues first. The UK may need a stable, strong government to ensure this is implemented. However, at this stage, the above objectives are still difficult to achieve, the complex political system of the United Kingdom decided that the government will be subject to a variety of checks and balances, and the conflict of interests between parties and classes will often reduce administrative efficiency. In addition, geopolitics has also made it difficult for the United Kingdom to reduce inflation. The current situation, unilaterally withdrawing from the

sanctions against Russia, is not a viable option. This also means that the energy price problem will be difficult to solve in the short term. Finally, the poor performance of the government over the past three years has led to a significant decline in public trust in the government, with more people tending to use radical methods to express their demands, which will also make it more difficult to implement policies.

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