BRITAIN'S NEW AUSTERITY: PENNY-WISE AND POUND-FOOLISH

Seaford Macro Research Brief

Britain's post-pandemic economic recovery has proved difficult. The only G7 country yet to make up the ground lost over the last three years, it also features the group's second-highest rate of inflation along with a level of labour-productivity that has barely moved since the 2008 financial crash. Now, the country faces a wave of strikes that has been likened to the 1979 'Winter of Discontent.' Most industrial action is taking place in the public sector while what isn't, is effectively quasi-public, like the railway strikes against private companies with government franchises. The principal issue is compensation, which in real terms has declined for most public-sector workers due to the combined effects of inflation and post-2008 government austerity. In effect, Britain's current labour militancy can be seen not as a generalised phenomenon but as a conflict between public-sector unions and the government. For its part, the government is refusing to meet union demands on two principal grounds, namely that the government cannot afford to offer its employees pay increases that match inflation and moreover, that doing so would constitute excessive fiscal stimulus and so worsen inflation.

This analysis is likely misguided and based on overly-simplistic economic reasoning. We expect that the government's pay policy will have a number of damaging consequences on the British economy:

- Because the labour market in Britain has become bifurcated, with public and private sectors operating largely separately, the government's restrictive pay policy is unlikely to have much if any disinflationary impact on the labour market in general
- Rather than constrain inflation, it will likely lead to 'shrinkflation' in the public sector as the quality of services declines until they align with their effective market-value at the government-set price
- The declining quality of public services will in turn have deadweight costs on the economy, in particular, in further aggravating the slow growth of labour productivity
- To the extent poor labour productivity constrains Britain's economic recovery, the resultant slow increase in tax revenues amid rising demands on the public sector could end up worsening the government's long-term fiscal position; although the government is ideologically-committed to not raising taxes, it may have no choice but to do so in the medium term.

Box 1. Wage Growth and Core Inflation: The 'Carl Lewis effect'

Named after the sprinter who, though famously slow-starting, would maintain his peak speed for longer than his rivals, the Carl Lewis effect is the term we use to describe the convergence of nominal wages with core inflation. Developed in an earlier analysis of the global inflation regime, we have found that wages have been able to track inflation and, in recent years, start overtaking it, due to structural changes in labour markets that have augmented the bargaining-power of workers. What this graph reveals is that in Britain the effect has persisted for private-sector workers, but recently broke down for public-sector workers, with the two curves parting sharply amid the recent inflation surge. This appears to be the result of the government's policy to suppress public sector wages.

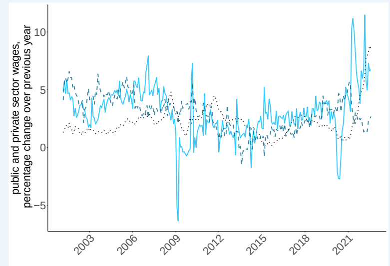

Figure 1: As core inflation has picked up since 2020, so has private-sector wage growth. Public sector wage growth, meanwhile, has fallen back.

Britain's Bifurcated Labour Market

Eroded by high inflation, real wages fell by nearly 3% in the United Kingdom in 2022. However, once public-sector wages are stripped out of the equation, what emerges is a convergence between wages and inflation—a phenomenon we have identified in other developed economies and which we call the Carl Lewis effect (see Box 1). Private sector wage growth is running at about eight percent. With a labour market that remains tight, and with employers in many cases struggling to fill vacancies quickly, the current trajectory of wages remains upwards. Meanwhile as inflation falls, as its genuinely transitory effects dissipate, we expect real wages in the private sector to turn positive, possibly as early as 2023.

It is therefore in the public sector where the principal decline in real earnings is manifesting itself, with real wages contracting at more than double the rate of the national average. Since the 2008 financial crisis, real wages in the public sector have declined by around 4.5%, which has resulted in low morale in many departments alongside difficulties in recruitment and retention. It is in this context that the government is now introducing its pay-restraint policy. The principal cause of this sharp divergence between public-sector and private-sector wages has to do with market structure. The private-sector labour market is effectively a free one in which firms compete to hire the workers they need. In a previous Seaford Macro Research Brief, we argued that several developments in the global economy over the last decade have combined to increase the wage-bargaining power of workers in the private sector, something that we have ob-

Box 2. Monopsony Power and Employment Relations

A monopsony is a market with a single purchaser. Whatever the merits of monopsony as a model of labour markets, it's useful in interpreting public-sector labour relations. Public-sector employees have specific skills whose value is not readily applicable to the private sector. Although a shift out of the public sector might be feasible, workers typically face obstacles in marketing these skills and lack knowledge of private employment markets. Besides, many people are drawn to public service by the preference for a particular kind of work, one focused on vocation, something that is especially visible in the 'caring professions,' teaching, or public policy work that is seen to be in the national interest. Both of these features of public employment, together with the obvious fact of the unity of control over wage-setting in the public sector, give the government a degree of monopsony power. It can then exploit this advantage by reducing the number of posts and driving wages below the competitive market rate, resulting in a transfer of resources from employees to the public sector. However, because such measures then diminish the attractiveness of public-sector employment in the broader job market, public-sector workers become increasingly difficult to replace from the private sector. So even if they can't bargain for better wages, they can, by withdrawing labour input (for example, with work-to-rule initiatives) reduce the productivity of the public sector, creating deadweight costs for the economy.

served across many developed countries. It is significant that this is occurring even though the rate of unionisation has fallen to very low levels across the private sector.

However, the public sector effectively functions as a monopsony (see Box 2). Unlike private sector wages, public sector wages are largely within the control of policy-makers due to the asymmetry resulting from the lack of inter-employer competition. The government has used its market power as an employer to limit wage rises, something ministers typically justify in terms of both a desire for prudence and a determination to prevent a wage–price spiral. So even though the level of unionisation is higher in the public than in the private sector, employers currently enjoy lower bargaining-power than their private-sector peers. However, though they may appear to restrain expenditure, such policies are far from costless.

Wages and Inflation: Mind the Public–Private Gap

The government holds that public sector employment provides it with a lever to exert downward pressure on wage growth. In conventional price-theoretic models, lower wages offered by a large monopsonistic employer influence the market by setting a lower baseline. In addition, the effect of a decision by a monopsonistic employer to limit the number of jobs on offer increases the supply of workers available to more competitive labour markets, thus reinforcing the downward pressure on wage growth.

However, even if we concede the existence of this lever, its size is debatable. Given the deeper underlying causes of private sector wage growth—the return of labour bargaining power, which is being exercised to address the accumulated pressure of asset and consumer price inflation—the impact of public sector wage restraint on private sector wages is likely to be relatively weaker than in a situation where inflation is purely a monetary phenomenon and not a consequence of deeper structural causes (as we argued in our previous Seaford Macro Research Brief).

In addition, the use of this lever comes with a number of identifiable side-effects. It is, for example, generally conceded that the result of a policy of public sector wage restraint is to make workers worse off. This is taken to be counter-balanced by the fact that users of public services will in turn pay less in taxes and fees for the public services and benefits they use. However, a side-effect of such a policy is that such a transfer comes at the cost of dead-weight losses. The comparatively weak attraction of public-sector employment for new market entrants (graduates) makes recruitment more difficult, while existing employees with transferable skills will have a stronger incentive to leave the public sector to take private-sector employment. At some stage, unfilled posts and unmotivated workers start affecting the quality as well as the size of public services. The effects of this go beyond the simple one of the inconvenience to the public which results from eroding the quality of the public services they access. The macroeconomic costs can be considerable. As is being seen in Britain's National Health Service, declining staffing and low morale are worsening the health crisis, which in turn is constraining the growth of labour supply.

So even though public-sector employees appear to enjoy little bargaining power, there are tools at their disposal they can use, and whose effect can be to undermine the government's stated policy goals. These can take the form of what have been categorised as exit and voice (see Box 3).

Exit takes the form of the large and apparently growing number of public-sector workers, from doctors and librarians to care-home workers and civil servants, who are leaving the public workforce, either by retiring early or by leaving to take jobs in the private sector. As a rule, this shows up most sharply among recent entrants, since older workers of long duration in public-sector employment have

Box 3. Exit, Voice, and Loyalty

Development economist Albert O. Hirschman identified two alternative ways in which people react to deteriorating conditions in an organisation. They can 'voice' their concerns and try to change things. Or they can walk away from the situation and 'exit'—for example, by ending their relationship with the organisation. For employees, voice takes the form of protests, petitions, and lobbying management; but strikes, too, can be a form of voice if they're accompanied by campaigns to raise wider awareness of a problem and call for change. Exit, in contrast, leads to employees giving up on the organisation and going elsewhere—a different employer or a different sector.
A key factor that shapes the choice between exit and voice is *loyalty*. Loyalty to an organisation can come from a range of sources. An employee may be loyal to the idea for which an organisation stands, to its specific mission, to the people an organisation serves, or even to members of their team. Loyalty of this type is particularly strong in relation to core public services that have a culture of mutual support, team working, and belief in the public importance of the service being provided. But loyalty is not infinite, and even strong ties of loyalty can be strained if the factors that underpin that loyalty are eroded beyond a certain tipping point.

often specialised in such a way that their skills are not easily transferable. The result is that the public sector workforce tends to get older, demoralised and more skewed towards a staff complement that is not optimally-productive (since those who are, are the ones better able to compete and find jobs in the private sector). The overall result of these developments is that the standard of service in the public sector will tend to decline, at the risk of offsetting any cost-savings made by the government.

The voice option has been most evident in those who have expressed their disapproval by joining industrial action. By such means do they seek to convey their disapproval of policy both to the government and to the wider public. But the attendant cost in lost working-days has negative implications for aggregate economic output. Crucially, hard tactics of imposing pay restraint, typified by the government's refusal to meet with union leaders and its interventions in negotiations to block wage agreements it deems too high, alter the dynamic of choice between exit and voice.

Organisational loyalty plays an important role in shaping a worker's choice between exit and voice, by holding exit at bay. In effect, a high degree of loyalty makes it likely that workers will submit to a monopsonistic employer's demands—up to a point, at least. While from an employer's view this might appear the ideal outcome—workers who persist in their task despite eroding salaries and increasing workloads, whether from a sense of duty to those they serve,

Box 4. Do Public Sector Unions Undermine Labour Market Efficiency?

There is a long-standing assumption, which shapes the UK government's position, that a high degree of unionisation reduces the efficiency of labour markets, by pushing wages above the competitive market-level. But in fact, we see the irony of the British case, where it is in the competitive private market that wages are rising fastest. This does not come as a surprise to scholars of labour markets, who have long understood that in countries with powerful trade-union movements, labour markets can balance pay claims with the long-term interests of the sector. Part of the argument is that powerful unions can help to ensure that workers have a stake in the long-term performance of the industry. In the UK, what appears to be happening in the public sector is that the government, not the unions, is distorting the operations of the labour market, with unions playing the role of trying to counterbalance the effects of a monopsonistic employer.

or simply due to a perceived lack of options—there are risks attendant to it. At some point a 'death spiral' can set in. If the erosion of public employment benefits results in unfilled posts, even greater demands must be placed on those who stay behind, which leads to further erosion. If exit and voice are not viable strategies, then workers might turn from loyalty to quiet quitting, if not active resistance.

Accordingly, one can look for canaries in a coalmine that might serve as a warning that the stifling of voice is about to lead to an increase in exit. The key variable explaining whether workers exit, or voice their concerns without going elsewhere, is 'loyalty'. Loyalty varies with industry/sector but we can surmise that 'caring' professions with a high degree of engagement with an (often grateful) citizenry will be more loyal than, say, workers in the transport sector. So we treat transport as the canary in the coal-mine and find precisely that warning anticipating the problems in the health sector—a visible expression of dissatisfaction, that may be simmering below the surface in more loyal industries. Figure 2 illustrates the case: a surge in train strikes which have heralded the spread of industrial action across the public sector. The fact that nurses are now staging their first strike ever in Britain should thus be seen a severe breakdown in a loyalty that had been taken for granted for decades.

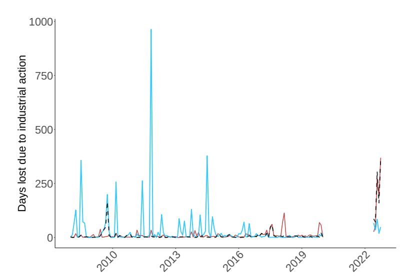

Figure 2: Official statistics appear to show a greater number of days lost to industrial action in the private sector (red) than in the public sector (blue). A closer look, however, shows that most lost days occur in the 'quasi-public' sector, *e.g.* Transport (dashed line) where wage settlement are under the effective control of public policymakers.

Against this backdrop, the government's approach appears ill-advised. Two factors appear to be driving it towards a hard-line approach. The first is its ostensible goal of using its control over public and quasi-public wages to limit inflation (which, as we have argued above, is based on a misunderstanding of the causes of inflation). The second is the political divisions within the governing Conservative Party. Leaders often try to shore up their base by invoking the Thatcher-era narrative of fighting the unions, a nostalgic device which enjoys broad support within the party. Having come into office with a weak base in both the party and the wider society, the current prime minister has been at pains to solidify his hold over the party. But if picking a fight with the unions may seem politically astute, it is a case of generals fighting the last war, since the union landscape has altered profoundly since the industrial unrest of the 1980s.

The loyalty of the public service is not bottomless. Suppressing the voice option predictably encourages greater use of exit. If more loyal sectors are denied a means of voicing their discontent, then exit becomes their only remaining option despite its challenges. And at a time when private sector wages are rising at an attractive rate, pursuing this last remaining option may only require a small nudge. Testing this hypothesis in Figure 3, we find that the attractiveness of work in the National Health Service has diminished considerably, causing vacancies to rise at a rate faster than in the private sector.

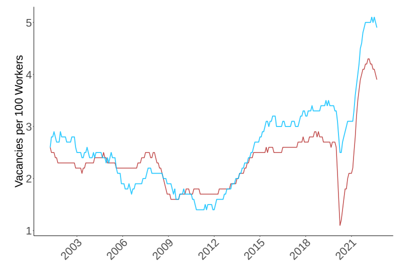

Figure 3: Starting around the beginning of 2015, the number of vacancies in the predominantly public (and 'quasi-public' health and social work sector has outpaced those in the economy as a whole. Limiting pay-settlements will likely result in an increase in the number of unfilled positions.

Worth noting in this respect is that vacancies began rising across the economy in the middle years of the previous decade (something we explored in our earlier research brief on inflation). This has shaped the context in which labour markets operate, raising the bargaining power of labour and thus leading to an increase in earnings. The fact that the government is trying to resist this trend is not, in fact, leading to a more competitive labour market. It is instead reinforcing the erosion of public services.

The deadweight costs on an already-fragile economy of this policy thus look considerable. Continued erosion of public services will inhibit Britain's already-poor labour productivity, which has hardly moved since the 2008 financial crisis. But the alternative, of a government U-turn, is politically fraught. The prime minister's political vulnerability would rise to the surface, quite possibly initiating another period of leadership contestation in Britain's governing party. This would aggravate an investment landscape which has been been suffering from the uncertainty caused by the country's evolving trade and policy environments, further restraining private-sector investment and slowing Britain's economic recovery.

The government appears to have picked a battle it can't afford to lose, and which the economy can't afford it to win. There appear to be no good macroeconomic outcomes from what has been called Britain's new winter of discontent.

At Seaford Macro, we explore currents deep within the global political economy to better interpret the movements at the surface. To hear more about our ongoing research projects and future investigations, contact us at info@seafordmacro.com or go to http://www.seafordmacro.com.

TT Arvind
John Rapley
Lindsay Stirton