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COVID-19 has revived the social contract in advanced economies—for now. What will stick once the crisis abates?

Massive government spending has sought to shield individuals from the economic consequences of the pandemic, reversing a long-term trend of institutional pullback in the social contract.

by Anu Madgavkar, Tilman Tacke, Sven Smit, and James Manyika

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Since the onset of the COVID-19 pandemic, G-20 economies have announced fiscal packages already exceeding $10 trillion, which in real terms is about three times the support provided during the 2008 financial crisis and 30 times the size of the Marshall Plan, which helped rebuild Europe after the Second World War. These large-scale policy interventions have significantly buffered risks faced by individuals, reversing a two-decade long trend in the social contract, the arrangements and expectations, often implicit, that govern how economic risks and gains are shared between individuals and institutions.

In the 22 advanced countries we studied, governments have increased fiscal spending as a percentage of GDP by an average of 20 percent in 2020 from 2019 and by as much as 39 percent in Canada (Exhibit 1). Countries such as the United States and the United Kingdom that were typically lower spenders on the social contract before the pandemic have raised their expenditure by significantly more than economies such as Denmark, which previously had ranked among the higher spenders. In 2020 alone, governments in the European Union are expected to spend an additional $2,343 per person compared to 2019, while in the United States, spending will be $6,572 higher.

In addition to this increased public-sector expenditure, the private sector in some cases also provided protection to its employees, at times in partnership with government. In the short term, companies did not—or could not—cut their costs as quickly as revenues declined. This is reflected in a decline of about $1 trillion in corporate profits in the United States and European Union, on an annualized basis, in the first half of 2020. This may have been driven by the stickiness of their underlying cost structures due to factors including labor laws or long-term contracts, as well as corporate decisions to retain employees for the rebound of economic activity. In addition, some companies have actively invested in the well-being of their workforce, such as by providing one-time bonuses to vulnerable workers or improving benefits.

As a result of this combination of public and private sector protection, disposable income (in the United States) and employment (in Europe) have been largely protected, even as GDP fell sharply in the second quarter of 2020. Indeed, in the United States, disposable income has actually risen as a result of stimulus programs, based on our estimates. Taking a long view, the support packages put in place over the course of just a few months in this pandemic year have generated increases in disposable income for the US median worker that are comparable to those delivered over the past 20 years, after accounting for the costs of basic goods and services including housing.

Comparable data in the European Union is not available, but there, employment declined much less than the drop in GDP would suggest, as governments and companies together guaranteed continued employment at more or less full pay to large swaths of the workforce.

The social contract is a broad concept, covering multiple facets of everyday life, including notions of economic, social, and political arrangements as well as values, justice, and other aspects of society and social arrangements. In our research, we use the more narrowly defined economic aspects of the social contract, and specifically the three key economic roles for individuals as workers, consumers, and savers. By any definition, while the social contract has evolved in fits and starts for centuries, such sudden and massive movement as has taken place in 2020 is highly unusual. As a result, the social contract may momentarily be stronger and more effective in buffering risks and guaranteeing basic needs for individuals than it has previously been in this century.

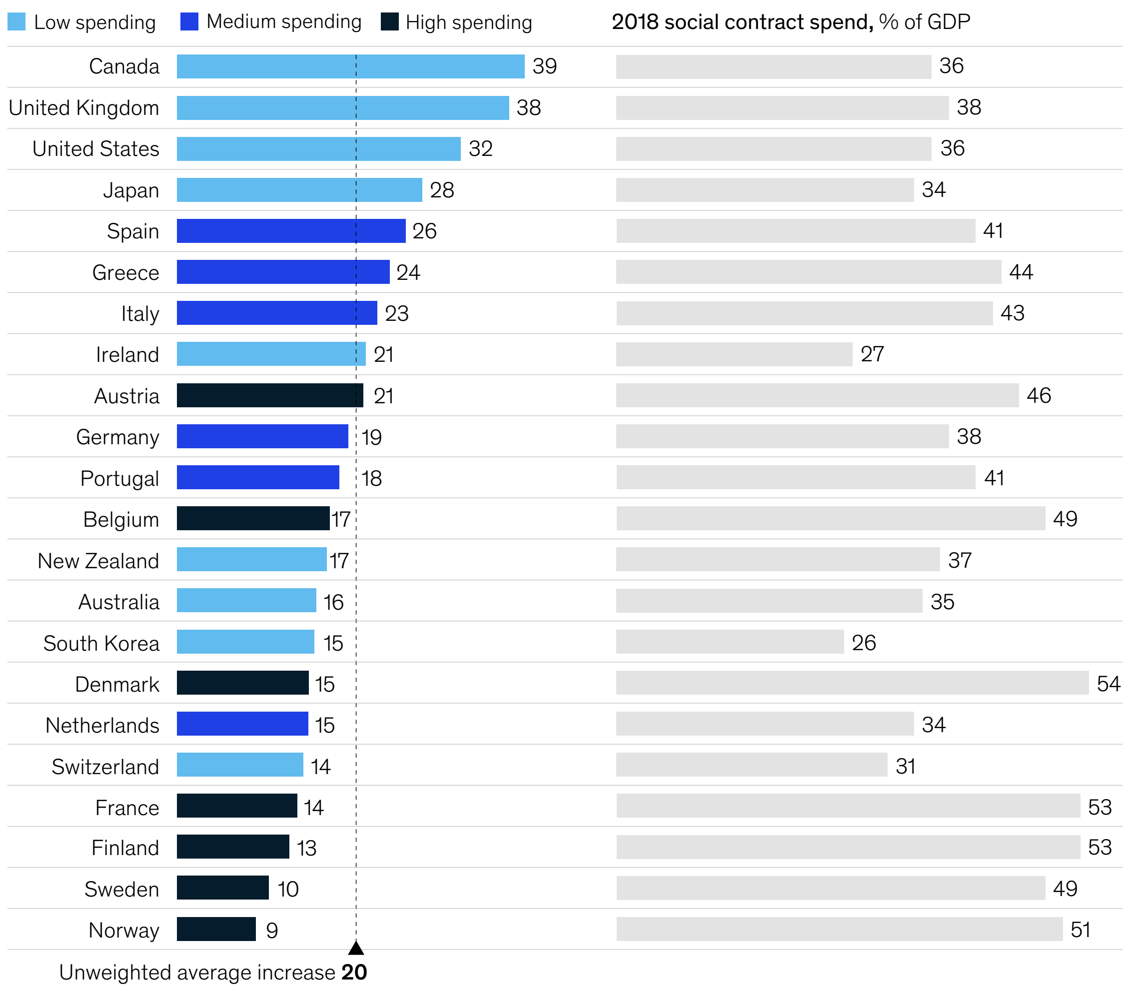
That is not to say inequality has been tamed; to the contrary, the pandemic has both revealed and exacerbated deep economic and social divisions in societies globally. Moreover, the huge fiscal packages being used to address the short-term effects of the COVID-19 economic fallout are like a bazooka firing in all directions without the fine targeting needed to address key underlying issues that are driving inequality, particularly among vulnerable groups.

The critical question in the months and years ahead is whether the pendulum will swing back just as sharply once the COVID-19 crisis abates, or whether at least some of the intervention and innovation will remain as permanent features of a renewed social contract.

Exhibit 1

As government expenditure rose, countries that usually spend less on the social contract have outspent higher-spending ones.

Increase in government expenditure in 2020 by archetype,[1]
% increase in 2020 vs 2019 as percentage of GDP



[1] Archetypes determined based on 2018 spending on the social contract including public-sector wages, total social spending (directed at individuals and households), for unemployment, active labor-market programs, family and other social policies, healthcare, housing, pensions, public spending on education, and government gross fixed-capital formation.
Source: IMF Fiscal Monitor; McKinsey Global Institute analysis

Large-scale institutional intervention has strengthened the social contract for workers, consumers, and savers

In the first two decades of the 21st century, our prior research has documented how economic outcomes changed for individuals in advanced economies in their roles as workers, consumers, and savers. Some had new opportunities, as employment reached record levels and the prices of many discretionary goods and services fell. Some 45 million more people were employed in 2018 than in 2000 in the 22 OECD economies we examined—and 31 million of them were women. However, economic outcomes for the bottom 60 percent of the population worsened in some respects.

For workers, while employment opportunities expanded, work polarization and income stagnation increased; average wages grew just 0.7 percent per year in our 22 sample countries between 2000 and 2018 (Exhibit 2). For consumers, the cost of basic necessities such as housing, healthcare, and education rose considerably faster than inflation, absorbing an ever-larger proportion of incomes (Exhibit 3). For savers, mandatory pensions have been scaled back for the same bottom three-fifths of the population. Real median net wealth declined on average in our 22 sample countries between 2007 and 2018 and had only just started to rebound when the pandemic struck.

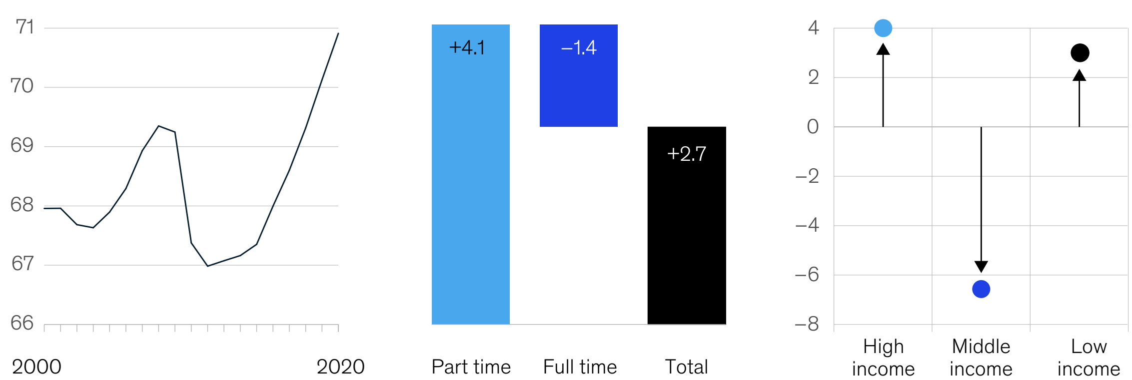
Global trends including technological disruption, globalization, and the economic crisis of 2008 and its recovery all played a role in these changes—but so, too, did a shift in institutional arrangements. In the 22 countries we studied, institutional intervention on behalf of individuals in the marketplace declined by 13 percentage points according to an index we compiled. In practice, this meant less employment protection for workers and a decline in the net replacement rate for mandatory pensions, among other effects.

Exhibit 2

In the 22 OECD countries we studied, outcomes for workers have changed in several ways.

Unprecedented job growth … | **… driven by part-time work …** | **… in a polarized labor market**

Employment rate, % of 15–64 population | Change in employment rate, 2000–18, percentage points | Europe and US employment share change 2000–18, percentage points

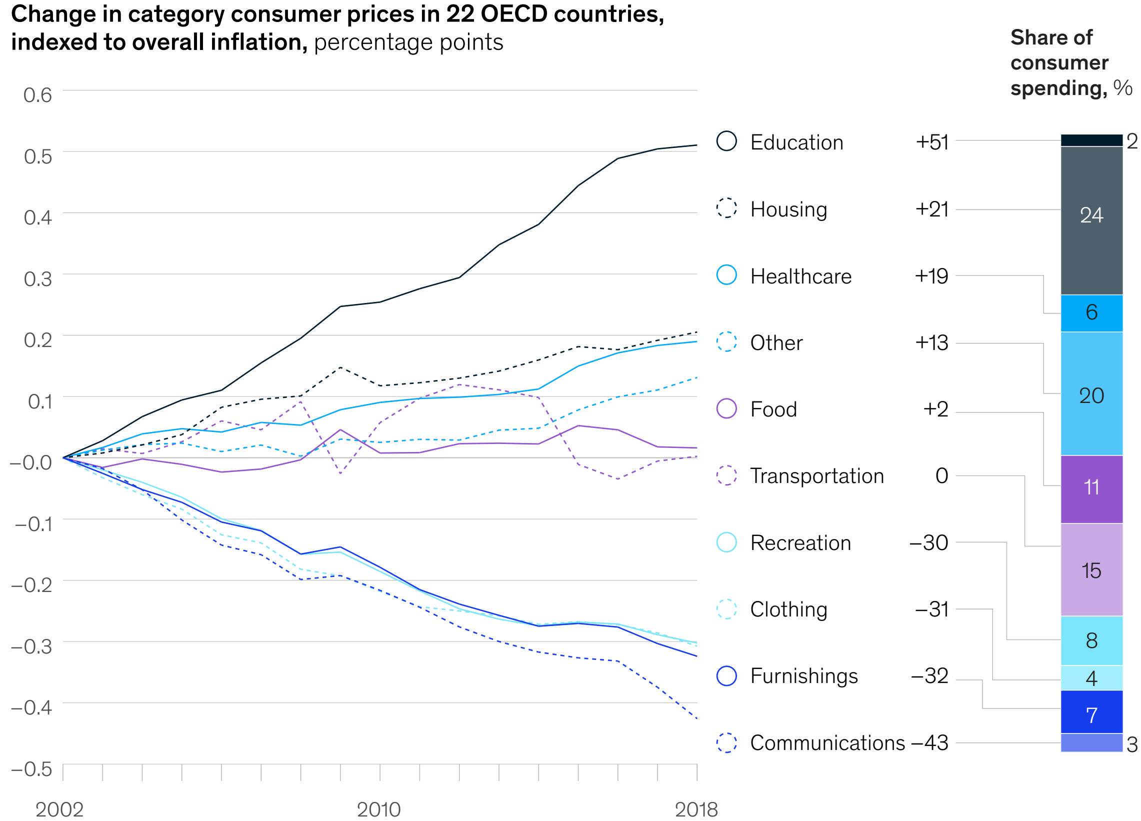


Source: McKinsey Global Institute analysis

Exhibit 3

For consumers, prices of discretionary goods have fallen, but the cost of basics including housing has risen sharply this century.

Change in category consumer prices in 22 OECD countries, indexed to overall inflation, percentage points



Source: McKinsey Global Institute analysis

To support tenants, one in five OECD countries either suspended rent increases or actively subsidized rent and almost half have provided forbearance for mortgage payments.

Lower-income workers, women, ethnic minorities, and young people were among the groups most vulnerable to these changes, our research suggested, despite gains including rising female participation in the workforce.

With the onset of COVID-19, governments intervened in an unprecedented fashion. Much of their increased spending has been channeled into policies designed to strengthen the social contract and protect individuals from the immediate effects of the pandemic. This is most apparent in large-scale interventions to support individuals as workers, with additional support provided to individuals as consumers and savers. With a second wave of the pandemic now rolling across Europe, some governments including in France, Germany, and the United Kingdom are extending these policies.

Workers have been protected from steep falls in employment and income

As COVID-19 and the measures to combat it brought economies to a standstill, governments used two main approaches to protect workers: job retention schemes, pursued primarily in Europe, and direct income support, pursued mainly in the United States. Job retention schemes give employees a degree of financial security to survive the crisis by protecting individuals' employment status. In OECD countries overall, these schemes have been widely used, enabling one in four workers (corresponding to 50 million workers) to keep their jobs. They have generally taken two main forms: either short-time work schemes which subsidize hours not worked (for example *Kurzarbeit* in Germany and *chômage partiel* in France), or wage subsidy schemes, which subsidized overall wages including both hours worked and hours not worked. In Canada, for example, these cover 75 percent of usual wages, and up to 85 percent in Ireland.

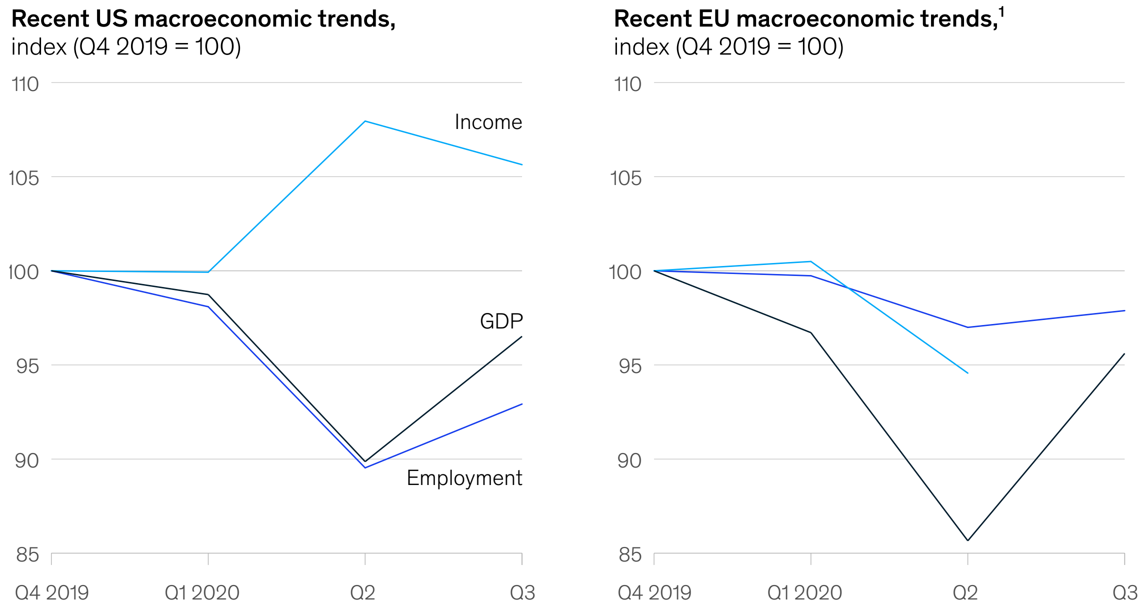
Although some of these schemes may have been used before, their scale during the pandemic has been unprecedented, with about ten times more workers covered now than during the global financial crisis. Additionally, many of the 23 OECD countries that had short-time work programs in place made significant changes to adapt them to the crisis. Japan, Korea, and Germany, for example, reduced the eligibility thresholds to claim the benefits. They and others, including Austria, Belgium, Spain, and Sweden, also made the programs more generous by increasing the replacement rates for wages.

The United States also put in place a job-retention scheme as part of its Coronavirus Aid, Relief, and Economic Security (CARES) Act: a paycheck protection program that provided small businesses with funds to pay up to eight weeks of payroll costs including benefits. However, the bulk of its spending was focused on supporting households directly either through one-off payments or expanded unemployment insurance. For example, 159 million one-off "economic impact payments" of $1,200 to individuals earning less than $75,000 annually have been processed. CARES also extended unemployment insurance benefits for 13 weeks, and provided an additional $600 per week to unemployed individuals on top of existing benefits. For many, this support increased incomes beyond what they were previously earning. For example, some 76 percent of unemployed US workers were eligible for benefits that paid more than their previous wages.

In both the Unites States and Europe, these policies have helped to largely protect employment and individual incomes from GDP shocks, with a significant variance among countries (Exhibit 4). In Europe, while real GDP declined by 14 percent between the fourth quarter of 2019 and the second quarter of 2020, the public sector covered a large proportion of the shortfall. Employment was shielded and declined by 3 percent, and real disposable income fell by only 5 percent. In the United States, even though real GDP dropped by 10 percent between the fourth quarter of 2019 and second quarter of 2020, real disposable income actually increased, by 8 percent (while employment, which the US social contract protects to a lesser degree, fell in line with the GDP drop by 10 percent).

Exhibit 4

Institutional intervention has shielded income and employment during the pandemic, despite a sharp fall in GDP.



[1] Q3 income data for the EU not available.
Source: Eurostat; US Bureau of Economic Analysis; US Bureau of Labor Statistics; McKinsey Global Institute analysis

Institutional support for consumers aimed mostly at ensuring access and affordability of housing and healthcare

While governments have focused their efforts on supporting employment and income, they have also helped safeguard other aspects of the social contract, especially consumption of basic goods and services. Housing, which is typically the largest expenditure item for households, has been a particular focus. To support tenants, one in five of the OECD countries either suspended rent increases or actively subsidized rent and almost half have provided forbearance for mortgage payments. A few countries including the Netherlands have suspended foreclosures altogether. So far, these policies have helped keep rents low: in the United States, rents of primary residences increased by 2 percent between December 2019 and September 2020 while in Europe, rents have essentially stagnated—increasing by only 1 percent in the same period.

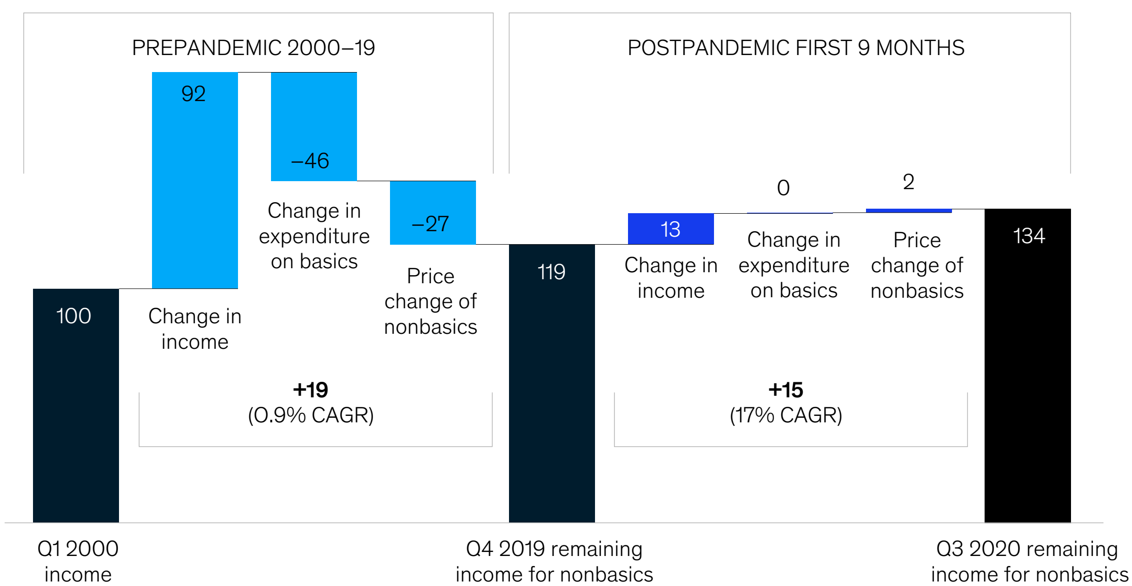
Healthcare is another essential element of the social contract that has become particularly relevant during the pandemic. Across the G-20 economies, about 5 percent of the stimulus has gone directly into measures to support the healthcare system. Large leaps have been made by the United States, where, unlike in most European countries, the government does not guarantee universal health coverage, but instead allows risks to be borne by individuals and employers. However, in the aftermath of the pandemic, the United States significantly increased protections, including guaranteeing free COVID-19 testing for those without health insurance, mandating that employers provide two weeks of paid sick leave for those who get COVID-19, and requiring insurance companies to cover COVID-related preventative treatments such as vaccines when they emerge.

Overall, such measures combined with relatively stable or higher incomes in the United States have made up at least in part for the erosion of income gains over the past two decades. In the United States, thanks to transfers and consumption-oriented measures, average real median disposable income increased in the first three quarters of 2020 by about 75 percent of the cumulative increase over the first 20 years of this century, after adjusting for expenditure on basics (housing, healthcare, education) and inflation in other categories of consumption (Exhibit 5). This is an estimate, based on consumer expenditure surveys and data from the US Bureau of Labor Statistics (BLS). We estimated trends in median income adjusted for consumption by taking the average of the third quintile of the income distribution. Although data on aggregate quarterly disposable income and expenditure are available for 2020, the share by income quintile is not. We assumed the annual third quintile share for 2019 as a proxy, which may have changed in 2020.The trend of strengthening economic prospects for those who typically face challenges is nonetheless corroborated by other studies. For example, BLS data on the median usual weekly earnings of full-time wage and salary workers tell a similar story, with gains in the last nine months almost equaling those made in the preceding 20 years. (The trend does not however describe the income trend of those who are unemployed or have dropped out of the labor force.) In addition, researchers found that unemployed individuals in the United States doubled their liquid savings between March and July 2020.

Exhibit 5

Median income per capita in the United States has grown during the pandemic after accounting for spending on basics.

Change in median disposable income per capita in the US, index (Q1 2000 = 100) nominal dollars



Note: Median income approximated taking the average of the third quintile of the income distribution. Income data is seasonally adjusted. Basics defined as expenditure on health, education, and housing.
Source: US Bureau of Economic Analysis; US Bureau of Labor Statistics; McKinsey Global Institute analysis

Savers in many countries received subsidies for pension contributions and income support, leading to an increase in household savings
Governments in some countries also intervened to support savers, both directly and indirectly. Countries including Switzerland, Iceland, and the Netherlands provided subsidies to cover pension contributions. Income support and job retention programs also indirectly help enable savings: across Europe and the United States, savings rates are at historic highs. In the United States, savings rates more than doubled to 16.1 percent of disposable personal income in the third quarter of 2020 from the level a year previously. In Europe, savings rates rose to 24.6 percent in the second quarter of 2020 from 13.1 percent in the same quarter of 2019. Based on a study of US household level bank account data, the poor disproportionately increased their savings rate compared to the rich in the United States, due to the level of the income support offered to low-income individuals. This reduced liquid wealth inequality between February and May. It remains unclear how many of these interventions will stick.

Despite additional institutional support, some groups in the labor market that were already vulnerable have been hardest hit by the crisis.
Market intervention and protection have not shielded all groups and geographies to the same degree. We see clear evidence that vulnerable groups have been disproportionately hit by the shock to labor demand, although our more holistic understanding of how they have been affected or aided by the social contract is limited due to scarce disaggregated data on income, consumption, and savings.

Low-income and low-skill individuals have had a harder time keeping their jobs on both sides of the Atlantic. In the United States, the employment rate among workers in the bottom quartile as of end-September 2020 was 19.2 percent below January 2020 levels, even as it increased slightly by 0.2 percent for high-wage workers. In Europe, preliminary Eurostat estimates show that low-income workers were three times more likely to lose their jobs and 34 percent more likely to be temporarily laid off or have their hours cut than high-income earners.

Women—and, in the United States, especially women of color—are more likely to have been laid off or furloughed during the COVID-19 crisis, stalling their careers and jeopardizing their financial security. In the United States, more than one in four women contemplated downshifting their careers or leaving the workforce completely.

Ethnic minorities have also taken disproportionate blows; in the United States, the employment rate for African Americans declined by 9 percent between December 2019 and October 2020, almost double the 5 percent for whites. In the United Kingdom, 22 percent of people from Black, Asian, and minority ethnic backgrounds (BAME) lost their jobs after being furloughed, far above the average of 9 percent.

In times of large-scale economic crises, the extent to which the social contract has worked for these vulnerable groups depends not only on government policies regarding transfers, but also on the infrastructure available to support such programs. Without fully robust financial infrastructure such as digital payment channels, high-assurance digital identification and linked data that permit targeting benefits to those who need them, government disbursements tend to be slower and subject to greater fraud, disproportionately hitting the more vulnerable.

The private sector is both conduit and initiator of measures that are strengthening the social contract

The private sector has played an important role in strengthening the social contract during this crisis, both directly and indirectly. Many companies have opted to retain their employees and continue to pay salaries in expectation of deploying them for a fast recovery once the pandemic-related restrictions ease. Especially in Europe, companies have also been the conduit through which governments have supported workers through job-retention schemes. In a few cases, companies have had to contribute to these schemes. In the United Kingdom, for example, employers continue to pay national insurance contributions and pension contributions even on hours not worked. In other cases, business has played an even more direct role, innovating not just to weather the crisis, but also strengthen the social contract for everyone.

Some companies reacted quickly to support both their employees and the workers in their ecosystems. For example, recognizing that many of their lower-income workers were likely struggling, the US retailer Kroger early in the crisis provided $300 bonuses to full-time employees and $150 for part-time employees. A survey conducted by the National Alliance of Healthcare Purchaser Coalitions reports that more than half of employers have invested in mental and emotional health programs in the United States. Many have also expanded caregiver or sick leave benefits: Deliveroo provided 14 days of paid sick leave to its riders, while Wolt, a Finnish food delivery startup, launched a COVID-19 partner support program, to provide financial assistance to its couriers affected by COVID-19.

Not all of this private-sector support for the social contract has been voluntary; indeed, companies' decisions are restricted by existing labor laws and they are facing pressure from both governments and investors. Many governments including Germany and the United Kingdom have imposed stringent conditions such as restrictions on dividend payments and bonuses in return for the unprecedented financial support they have offered to firms in the form of loans and equity injections, some of which may help combat wealth and income inequality in the future.

Which paths forward could the social contract take?

History teaches us that crises can sometimes unleash a new era of change. In the United States, the Social Security program emerged in the aftermath of the Great Depression, along with unemployment insurance as well as improved labor protections. In Denmark, the Kanslergade Agreement, which formed the basis of the Nordic welfare state model, was signed when the economic crisis of the interwar years was at its peak. In the United Kingdom, the Beveridge Report, which helped establish the country's modern welfare system, was written during the Second World War.

In this crisis too, beyond scaling up and building on existing channels to address the immediate problems, some countries have put in place innovations designed to improve the social contract in the long term. These innovations might similarly form the basis for a new role for both the private and public sector. One example is universal basic income, an idea that has been much discussed in recent years and was the subject of a recent test in Finland, where 2,000 randomly selected unemployed people received 560 euros per month. Spain has announced that it will set up a basic income scheme for 850,000 of its poorest citizens. In South Korea, about 13 million people in Gyeonggi province have received a basic income during the pandemic, which they can only spend locally. There are now calls to expand the program to other regions.

Other countries have begun testing measures to address long-term challenges. For example, Singapore and Australia have created initiatives to provide workers with new skills, recognizing that COVID-19 has accelerated automation and brought about structural changes in the economy that will likely slow the recovery of sectors such as travel and tourism. In Singapore, the government is partnering with employers in tourism, aviation, retail, and food services to retrain 330,000 local workers and increase chances of job redeployment. In Australia, the government is giving a 50 percent discount on enrollment fees for courses in high-demand professions like nursing and IT.

The question of what new innovations will arise, which existing ones will stick, and which ones may actually retreat is of huge significance. Many individuals could exit this crisis with more savings than they had at the end of 2019 and therefore a somewhat greater capacity to mitigate economic hardship. However, many of them are also exiting as workers without jobs or in companies that might no longer have a sound business model. The pandemic has triggered consumer and business shifts toward e-commerce, automation, and remote work. To the extent some of these trends stick, this will have significant long-term consequences for the occupational and skill transitions workers will need to make in the coming decade.

What paths forward for the social contract will this pandemic bring? We see three main outcomes.

The first is a return to the social contract as it was before COVID-19, that is a swinging back of the pendulum. Absent rapid gains in economic and productivity growth achieved through business dynamism, investment, technology, and continued focus on jobs growth, such a scenario would resurface the many questions and rekindle the many vulnerabilities that were already becoming apparent before the pandemic struck—and to which the public and the private sector alike have not yet found lasting responses.

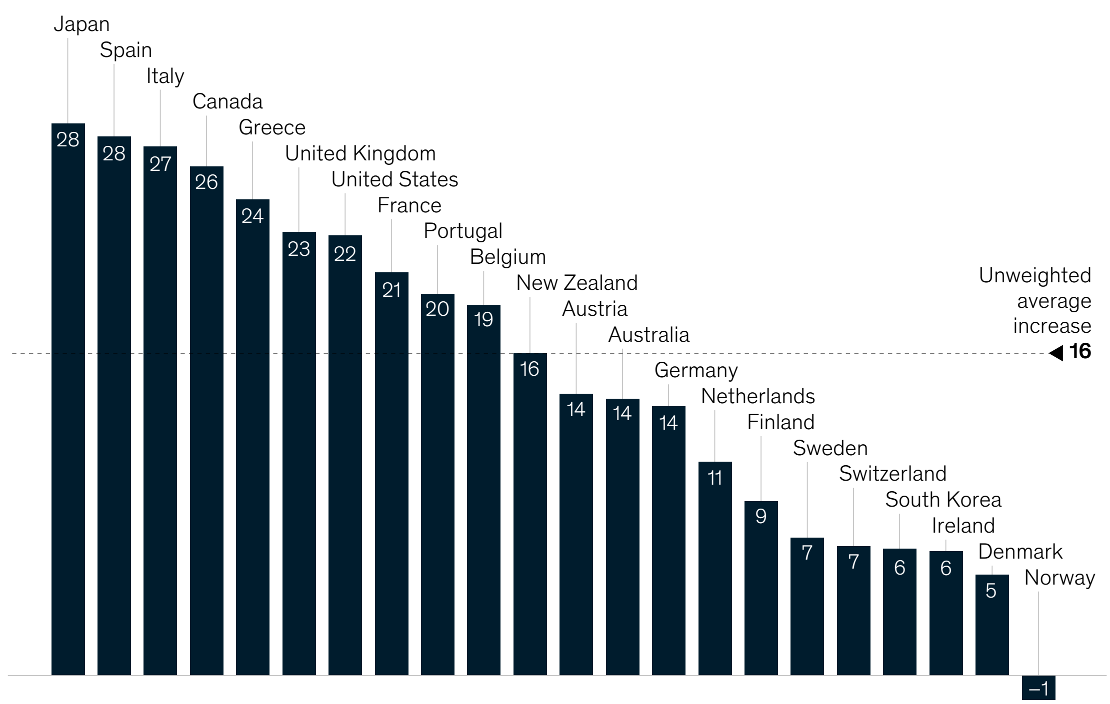
The second is for the current high level of spending and institutional intervention to continue to a large extent, at least for some time. Depending on the speed with which vaccines and treatments bring about the herd immunity that will end this crisis, this could be a short-term option for many governments. However there is an evident issue of long-term financial sustainability and stability. On average, the 22 countries in our sample are expected to increase their gross debt position by 16 percentage points between 2019 and 2020 (Exhibit 6).

A third path is for the overall level of social contract spending to be cut back significantly, to make it

Exhibit 6

In 2020, the ratio of public debt to GDP is projected to increase across advanced economies.

Increase in gross debt position as a percentage of GDP, difference 2020 vs 2019, percentage points



Source: IMF Fiscal Monitor; McKinsey Global Institute analysis more sustainable, but for the interventions to be better targeted at the most vulnerable, including low-skill workers, women, youth, or minorities. Ideally, there would be a more substantial and systemic role for the private sector. For example, enabling the provision of critical goods and services, such as housing and child care, at affordable prices may be more cost-effective for the social contract than aiming to stabilize incomes; this is as much about public sector regulation as it is about the supply of cost-efficient affordable housing provided by private sector construction and real-estate management firms. The right financial infrastructure including digital identification, payment channels and data would also help target the most vulnerable groups, reduce fraud and improve the efficiency of support programs.

The pandemic is not yet over and its social contract consequences and repercussions will likely continue playing out over months, if not years. Governments will have to select with care which initiatives to keep and which to phase out. They will need to continue innovating to address lingering and new challenges posed by the pandemic. Businesses will need to rethink their core role in the economy with an emphasis on supporting workers, consumers, and savers. In many ways, the last few months have opened up a new era of experimentation during which governments and businesses have had to react with extraordinary speed to new economic and social realities. This is the time to learn from these experiments, and translate them into long-term solutions aiming to strengthen the social contract of advanced economies in a lasting way.

The critical question in the months and years ahead is whether the pendulum will swing back just as sharply once the COVID-19 crisis abates, or whether at least some of the intervention and innovation will remain as permanent features of a renewed social contract.

Anu Madgavkar and **Tilman Tacke** are partners at the McKinsey Global Institute (MGI) based in Mumbai and Munich, respectively. **Sven Smit** and **James Manyika** are McKinsey senior partners, in Amsterdam and San Francisco, and co-chairs of MGI. The authors wish to thank **Rishabh Tagore**, a business analyst in Washington DC, for his contribution.

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