Inclusive growth in post-pandemic USA and its lessons

Memo for the Yale workshop on democracy and inclusive growth, April 2024

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Introduction and summary

What policies and political dynamics can make Western mature economies more inclusive?

The post-pandemic US economy might offer important insights. Due to a confluence of shocks and policy responses, the post-pandemic US economy has delivered inclusive growth, in a way not seen in the country (and in most other developed economies) for decades.

The main proximate cause of inclusive growth in post-pandemic USA seems to be increased competition for workers in the low-wage labor market. In a "great reshuffle", low- and middle-income workers have been able to leave worse jobs for better ones at a historically high rate, boosting their wages and regaining some ground over richer groups.

This suggests that politics and policies that directly and indirectly empower low- and middle-income workers in the labor market might be the key to a more inclusive economy. This mechanism could also help revive productivity growth, reallocating labor from less productive to more productive firms. These policies include a renewed focus on full employment as a policy objective; higher and more pervasive minimum wages; collective bargaining; unionization; making job-to-job transitions easier for workers.

What political dynamics could deliver these policies? I find it hard to escape the conclusion that a new (renewed and updated) social-democratic political equilibrium would be required. How this might come about in the current landscape is not easy to assess. Two important challenges are the lack of political representation for low- and middle-wage workers, and the likely adverse reaction of financial markets to pro-worker politics.

In Section 1 I justify restricting my focus here on mature economies. In Section 2 I briefly review patterns of inclusivity in mature economies in the last eight decades, and some debates on their causes. In Section 3 I lay out the evidence that the US economy has become more inclusive since the pandemics, and about the mechanisms at play. In Section 4 I tentatively draw some lessons about the policy and political determinants of inclusive growth in today's Western economies.

1. Inclusive growth is a different problem in mature and developing economies

The problem of inclusive growth is different in mature and developing economies.

One reason is simply the difference in expected average growth and its variance. In developing economies, government policy might have large effects on the growth rate, and sustained economic development is a necessary (although not sufficient) pre-requisite for broad-based economic progress. For example, in China and Vietnam in the last four decades high growth allowed economic development to be broad-based notwithstanding increasing inequality. In mature economies, relatively low average growth is probably a given, increasing the importance of distributional dynamics.

Moreover, possible equality-growth complementarities and trade-offs are likely different in developing and mature economies. Some increase in inequality might be a necessary byproduct of economic development in the initial stages in some countries,[1] while inequality is unlikely to be conducive to (or resulting from) growth in mature economies.

While developing economies are arguably the most important (they contain a vast majority of the world population, and an even larger majority of the world's poor), in this memo I will focus on Western mature economies. To be sure, besides the differences I have just described, there are also commonalities between the drivers of inclusive growth in mature and developing economies. But analyzing these commonalities, as well as the differences, is a vast task that I set aside here.

2. Western economies since the 1940s: from inclusive to non-inclusive growth

In the four decades between 1940 and 1980, Western industrialized economies experienced an era of inclusive growth. Growth was sustained and broad-based. Households across the entire income distribution experienced substantial gains, with lower incomes growing most rapidly. Figure 1 (from Piketty 2019) shows a measure of inequality during this period in the US and Europe.

Racial and territorial gaps, while large, were generally decreasing too between 1940 and 1980. For example, the US black-white wage differential fell by around 60 percent. The Italian North-South income differential fell by around 20 percent. There was, however, less clear progress in gender gaps; in the US, for example, while the gender gap in labor participation fell substantially, the gender pay gap stagnated at around 60%.

The subsequent four decades, from 1980 to 2020, displayed a regress towards a less inclusive economy. Although the picture is not as uniform, a clear trend towards

[1] For example, inequality resulting from the emergence of a new more productive market-based industrial sector in an otherwise predominantly rural economy might be a necessary initial step in the path towards inclusive growth for a developing economy.

increased inequality and slower growth (or even stagnation) of median and lower incomes emerges from the data. Inequality increased markedly in both the US and (to a smaller but still substantial extent) most of Europe (Figure 1).

The black-white earnings gap stopped shrinking in the US over this period, and territorial disparities like the gap between the North and the South of Italy restarted to widen. An important partial exception is the female-male earnings ratio, which rose from 60% to around 75% between 1980 and 1994, although it stagnated again thereafter.

Figure 1: Top decile share of total income in Europe and the US

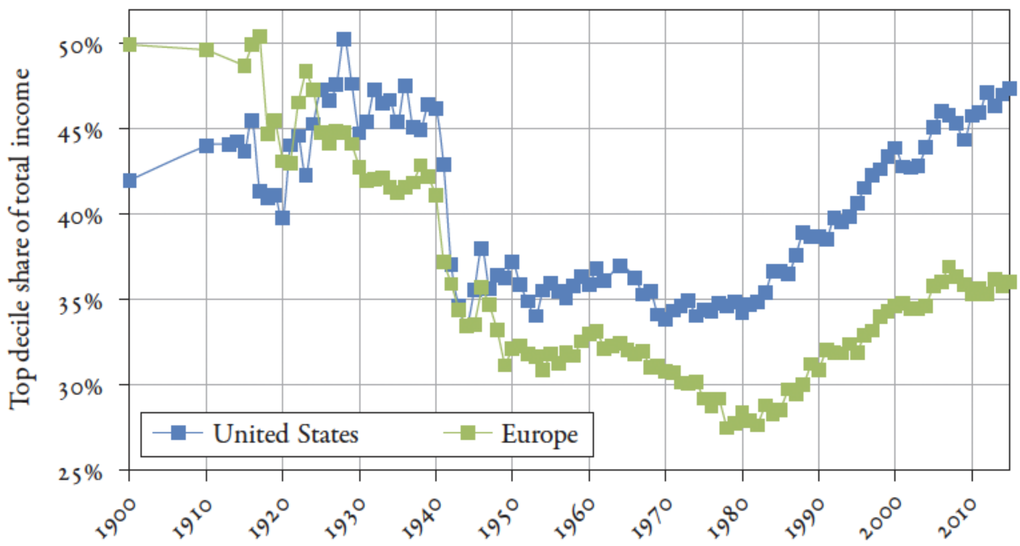


FIG. 10.1. Income inequality in Europe and the United States, 1900–2015
Interpretation: The top decile's share of total national income was on average around 50 percent in Western Europe in 1900–1910 before falling to around 30 percent in 1950–1980, then rising above 35 percent in 2010–2015. The increase of inequality was much stronger in the United States, where the top decile's share was 45–50 percent in 2010–2015, above the level for 1900–1910. *Sources and series:* piketty.pse.ens.fr/ideology.

Source: Piketty, "Capital and Ideology", 2019

There are two camps, broadly speaking, in the debate about the causes of these trends.

The first emphasizes the role of exogenous market forces and explains the recent rise in inequality in the West as the result of "skill-biased technical change" (Card and DiNardo, 2002, Acemoglu and Autor, 2011). The widespread adoption of computer technology since the 1980s would have caused a surge in the relative productivity of (and demand for) highly skilled workers, in turn boosting earnings inequality. Ultimately, this framework stems from the neoclassical tradition in economics, focusing on the supply and demand for factors of production under competitive conditions and seeing incomes as reflecting contributions to society (marginal productivity).

In the second camp there are explanations based on political and economic institutions, ideology, and policy choices. The decline and then fall of the Soviet alternative, the decline of social democracy, and the embrace of free-market capitalism and globalization by mainstream parties on both the left and the right would have led to policies that increased inequality and eroded the middle class (see for example Piketty, 2019). The decline of labor unions would have caused low- and middle-income workers to lose bargaining power, leading to wage stagnation in the bottom half (Farber et al 2021, Western and Rosenfeld 2011, Ahlquist 2017, Stansbury and Summers, 2020).

3. The return of inclusive growth in post-pandemics USA

Since the COVID pandemics and its aftermath, the US economy has unexpectedly and remarkably broken these trends. We are now in the fifth year of what increasingly looks like a new spell of inclusive growth in the USA.

Since 2019, low-wage workers and historically disadvantaged groups experienced strong real wage growth and regained some ground over richer groups. The recent unexpected compression of the US wage structure is illustrated in Figures 2, 3 and 4, compiled by Economic Policy Institute (2024) and Autor, Dube and McGrew (2023) using Current Population Survey data. Real wages for the bottom 10% of workers grew by 12% between 2019 and 2023, and the median wage grew by 3%, versus 0.9% growth for the highest-paid workers (Figure 1). This is a clean break from the 1979-2019 period, when wage growth was concentrated at the top (Figure 2). Remarkably, nominal wage growth during this period has been a decreasing function of the wage percentile (Figure 3).

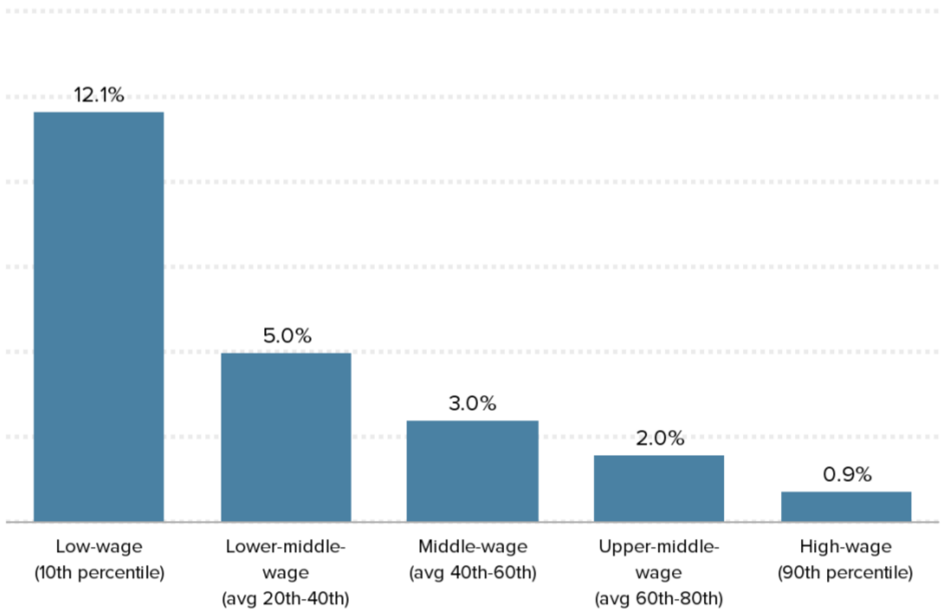
Autor, Dube and McGrew calculate that the 90/10 wage ratio, which had increased by 28.5% between 1979 and 2029, decreased by almost 11% between 2020 and 2023 (Figure 5). In other words, substantial nominal wage growth at the bottom of the distribution following the pandemics reversed around 38% of the rise in wage inequality occurred in 1979-2019.

As a result, since the pandemics, the college wage premium decreased (Bengali et al, 2023), and the black-white unemployment and wage differentials narrowed significantly (Dube, 2024). Moreover, real wage growth in 2019-2023 has been stronger for younger workers (EPI, 2024).

This reduction in (pre-distribution) inequality did not happen in a struggling economy. To the contrary, and notwithstanding the short but steep pandemic recession and a global surge in inflation, real wages for the middle quintile of the distribution are above their pre-pandemic trend (Figure 6). The rate of unemployment has been below 4% since December 2021, and labor force participation is near its pre-pandemic level.

Some resurgence of labor unions and workplace activism has also been observed. Data on work stoppages from the Bureau of labor statistics suggests a revival of labor unrest. Gallup surveys point to a surge in public support for labor unions. On the other hand, however, the unionization rate has not shown any sign of recovery yet, remaining at an all-time low of 10%.

Figure 2: Real wage growth in the US, 2019-2023



Notes: Low-wage is represented by the 10th percentile and high-wage is represented by the 90th percentile. The lower-middle, middle, and upper-middle-wages are the averages of the 20th–40th percentiles, the 40th–60th percentiles, and the 60th–80th percentiles, respectively.

Source: EPI analysis of the Current Population Survey Outgoing Rotation Group microdata, EPI Current Population Survey Extracts, Version 1.0.48 (2024a), https://microdata.epi.org.

Source: Economic Policy Institute, "State of Working America Wages 2023", 2024

Figure 3: US real wage growth, 1979-2019 vs 2019-2023

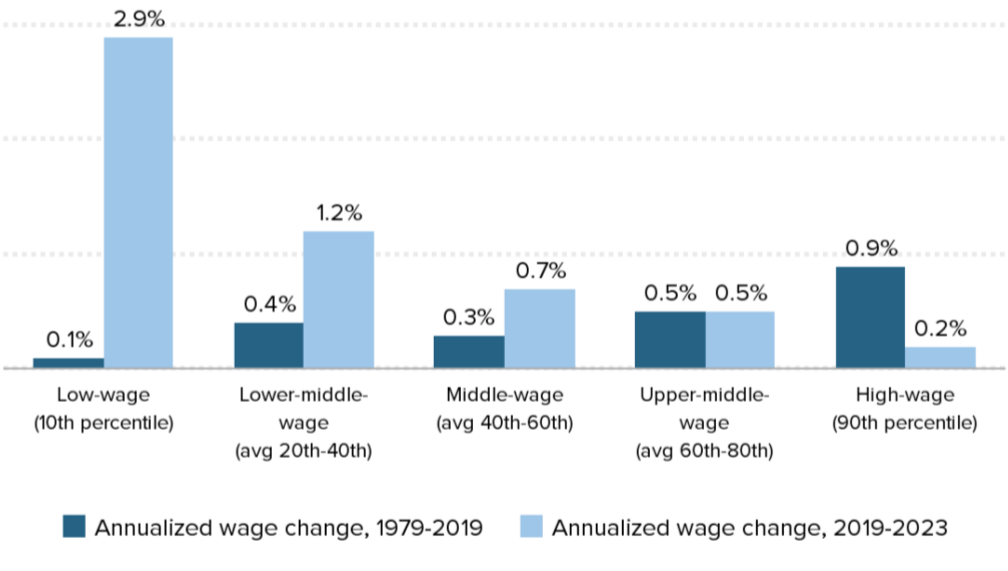


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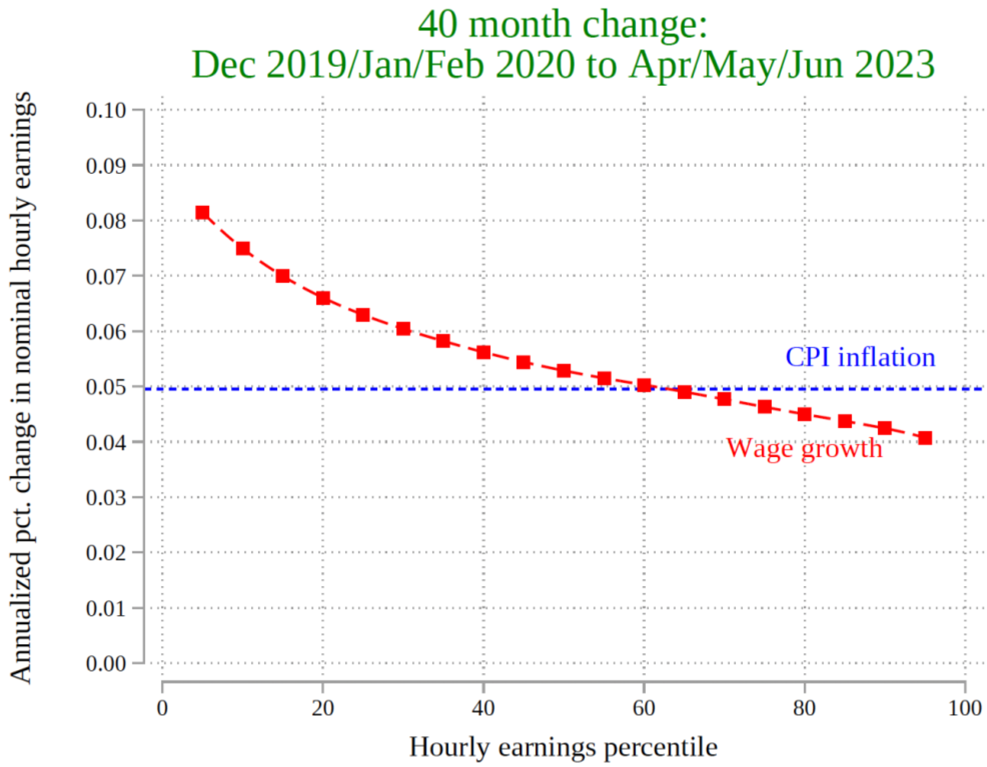
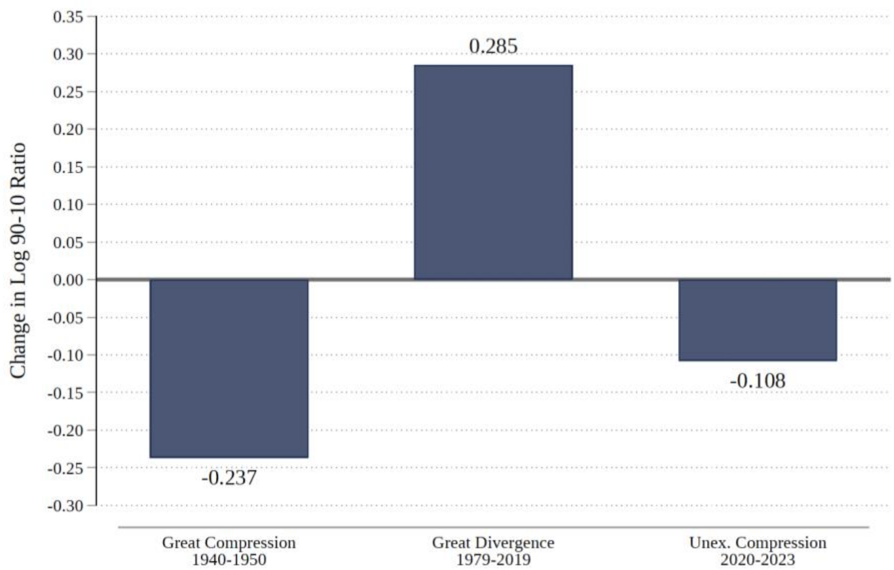
Figure 4: Nominal wage growth by percentile, Dec 2019- Jun 2023



Source: Autor, Dube and McGrew, "[The unexpected compression: competition at work in the low-wage labor market](#)", 2023

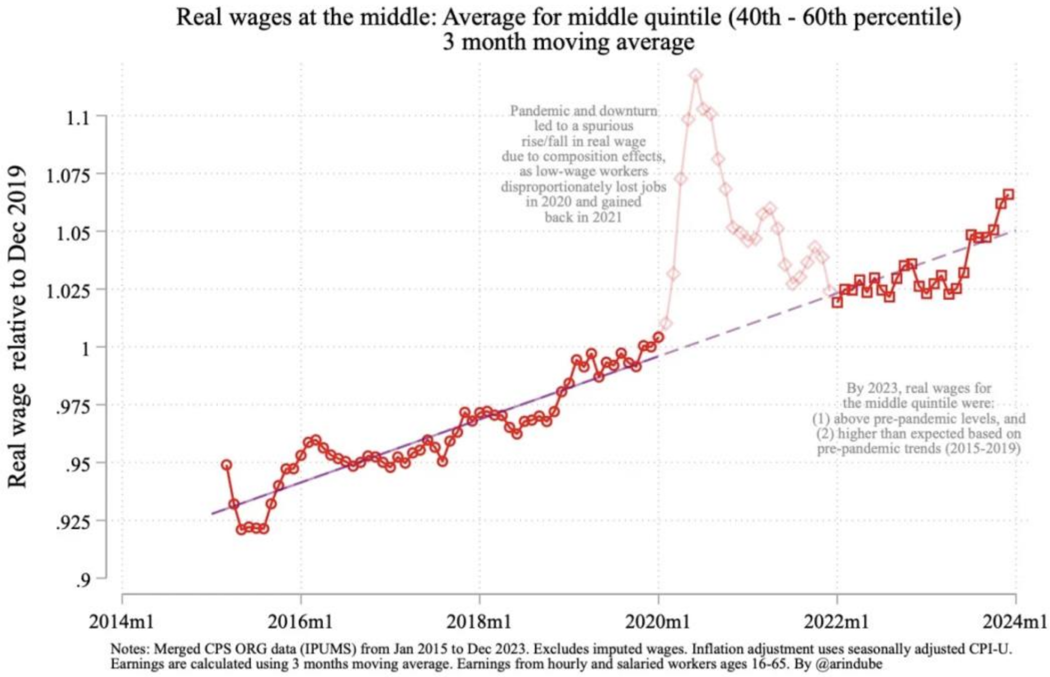
Figure 5: Percentage changes in wage inequality in the US (90-10 wage ratio)



Note: Figure displays the change in the log 90-10 ratio for different time periods. The first bar compares the years 1940 and 1950, while the second bar compares years 1979 and 2019. The last bar compares the first quarter of 2020 to the second quarter of 2023. Percentiles are smoothed using lowess for the latter two time periods. Data for 1940 and 1950 are from the Decennial Census. CPS monthly data is obtained for 1979 from NBER and for 2019-2023 from IPUMS. Estimates in this figure correspond to Table A1.

Source: Autor, Dube and McGrew, "[The unexpected compression: competition at work in the low-wage labor market](#)", 2023

Figure 6: US real wages, middle quintile, Jan 2014 – Jan 2024



Source: Arin Dube, "Wage growth, inflation, and inequality", 2024

What caused the unexpected return of inclusive growth in the US economy?

Recent research suggests that an exceptionally tight labor market and generous government support during the pandemics increased competition for workers in the low-wage labor market (Autor, Dube and McGrew, 2023). The monopsony power of employers decreased and the relative bargaining power of low-wage workers increased. In a "great reshuffle", workers were able to leave lower-paying jobs for better ones, as reflected in substantial increases in quit rates and job-to-job transitions. A wave of minimum wage increases in many States since 2015 might have contributed too.

4. Making mature economies more inclusive: what are the lessons from the US unexpected compression?

What can we learn from the current spell of inclusive growth in the US economy? Of course, whether the "unexpected compression" will prove to be a durable new trend or a short parenthesis is yet to be seen and will depend on future economic shocks and policy choices. Either way, this episode is in my view informative about the determinants of inclusive growth in today's mature economies.

First, I will try to lay out what *policies* are likely to produce dynamics like those observed in the US wage distribution since the pandemics. Second, I will try to tentatively discuss what political economic and institutional factors are likely to be conducive to those policies.

4.1 Policies

The recent US experience suggests that policies that empower low- and middle-wage workers in the labor market (and correspondingly decrease the market power of employers) might be a key ingredient to make Western advanced economies more inclusive. Opportunities in the low-and middle-wage labor market need to increase. The ability of "bad" employers – less productive firms that pay lower wages and offer worse labor conditions – to retain workers should be undermined.

First, the role played by tight labor markets in the "unexpected compression" suggests the importance of counter-cyclical fiscal policy that responds strongly to recessions and prioritizes full employment. Had the net loss of 15 million jobs in the US in March 2020 not been quickly reversed by unprecedented fiscal stimulus, we would probably not have observed a subsequent strong rise of wages at the bottom. This is particularly important for Europe, where self-inflicted austerity has had devastating effects on low- and middle-wage labor markets, especially in Southern Europe and for younger workers.

The post-pandemics experience might also suggest that, during a downturn, strongly supporting households and economic activity might carry advantages over prioritizing preserving existing job matches. In 2020-21, the US did less than European countries to preserve existing job matches but generously supported households and economic activity with stimulus checks, child payments, unemployment-insurance extensions, and infrastructure investment. This might have helped the "great reshuffle" to happen, by facilitating job-to-job transitions.

Second, higher minimum wages and more generous unemployment insurance might help increase the bargaining power of workers and (in the case of unemployment insurance) make job-to-job transitions easier. A standard efficiency-wage model suggests that reducing the 'cost of job loss' increases the bargaining power of workers. In addition to national minimum wages, sectoral and occupational minimum wage standards could be instituted by wage boards composed by representative of workers, employers, and government (as in the Australian system). Sectoral and occupational wage standards would affect a higher number of workers and sectors than a national minimum wage, therefore they would increase wages not only in the bottom 10% but more broadly in the bottom 60% of the distribution.

Third, consistent with research showing that unions decrease inequality (Collins and Niemesh, 2018; Callaway and Collins, 2018; Farber et al, 2021), empowering workers requires reforming labor laws to better protect the right to unionization and union activity. The aim should be to reverse the secular decline in unionization rates and in the share of jobs covered by collective bargaining agreements.

Fourth, noncompete clauses should be banned. Whatever advantage they might provide in protecting trade secrets and incentivising investment in training is likely to be swamped by their negative effect on the mobility, outside opportunities, and bargaining power of workers. It has been estimated that almost 20% of US workers are currently subject to noncompete agreements. There is no EU-wide data on this, but the proportion might not be very far: for example, around 16% of workers in Italy are subject to noncompete clauses (Boeri, 2022).

Of course, there are surely other policies (in health and education, in addressing climate change, in regulating new technologies) that are needed to deliver inclusive growth. But in this memo I want to stick to what I think can be logically inferred from the post-pandemics US experience, rather than providing a shopping list of all the policies I support.

4.2 Politics and institutions

What political dynamics could deliver policies that empower low- and middle-wage workers in today's Western economies? My considerations on this are tentative and I would very much welcome insights from other participants in this workshop who might have clearer ideas than me on this.

That said, I find it difficult to think of an answer that does not involve some type of new (and renewed) social democratic political equilibrium. By social democratic political equilibrium I do not mean left parties winning elections, but rather a convergence toward a social-democratic compromise between social groups, which I think is what happened during 1940-1980 in Europe and the US (strikingly, in the US a social-democratic equilibrium emerged even in absence of a social-democratic party).

A first obstacle to a new social democratic compromise is the lack of political representation for low- and middle-wage workers. Current political cleavages in Western democracies, summarized by Piketty as "Brahmin left versus Merchant Right", leave these categories with little political representation. Forms of identity politics have become more salient relative to social class in the political behavior of workers.

In this respect, a resurgence of labor unions might represent a catalyst for change, given their effects on political behavior. Unionized workers might be more likely not only to vote as a class (instead of according to ethnic, territorial, or religious identity) but also to run as candidates (Feigenbaum et al, 2018).

Another major obstacle comes from the expected (and feared) reaction of financial markets to pro-worker politics. The announcement of ambitious policies that empower low- and middle-wage workers, even without any harm to aggregate growth, is a negative shock for stock market valuations (consistent for example with Girardi, 2020). This might reduce the ability and willingness of any political coalition to take steps towards a more inclusive economy: there is evidence that lower stock market returns harm incumbents (Crane et al, 2024).

While we should be aware of this constraint, it should not be seen as unsurmountable. If the announced policies are not growth-reducing (and might even increase productivity), they should cause one-off level effects for equities, but not long-lasting growth effects. At the same time, negative effects on equity values might be counterbalanced electorally by tangible gains in wages and working conditions. Moreover, if pro-worker policies are implemented in a booming (as opposed to stagnating) economy, any effect on equity values will be much less visible, as it will manifest in a lower growth rate relative to an unchanged-policy counterfactual, rather than an actual crash.

After all, given evidence that fast growth in equity values from 1989 to 2017 mainly reflected redistribution from workers to shareholders (Greenwald et al, 2023), lower stock market returns might constitute a sign of economic success, not failure, for policy makers interested in making growth inclusive again.