This time it has to be different: The policy response to the New Normal economy revisited

Ronald MacDonald
Adam Smith Business School, University of Glasgow

"{a} revolutionary moment in the world's history is a time for revolutions, not for patching".

The Beveridge Report, 1942

1. Introduction

This paper is a follow up to my recent Policy Scotland paper, *The Post Pandemic New Normal*[1]. In that paper I argued that, for a number of reasons, the COVID-19 pandemic represented a watershed moment for the world economy and offers a real opportunity in a number of directions for policymakers to deal with some of the most pressing issues facing the global economy. The nature of the current shock, with its origins in humankind's rapacious and unsustainable demand for natural resources, should be a wake-up call for governments at a global level to address environmental and climate change issues in a coordinated way. Furthermore, I argued that the current crisis should also be a wake-up call for many governments to finally address the economic model of shareholder and financial capitalism that has been the prevailing model in the UK and US for at least the last forty years. This model, with rent seeking rather than value/wealth creation at its heart and its focus on short-termism, has undoubtedly created huge inequalities in societies and certainly in the UK it is clear that this model is now at a dead end. What is needed is nothing short of a new social contract and in this regard it is worth requoting the FT from my last paper:

[1] MacDonald, Ronald, *The Post Pandemic New Normal: The Likely Socio-economic Implications and Policy Choices facing Scotland and the UK*, Policy Scotland, https://policyscotland.gla.ac.uk/post-pandemic-new-normal, 21 June 2020

In its editorial, 3 April 2020, The Financial Times claims that COVID-19 “lays bare the fraility of the social contract” and argues for:

“Radical reforms - reversing the prevailing policy directions of the last four decades - will need to be put on the table. Government will have to accept a more active role in the economy. They must see public services as investments rather than liabilities, and look for ways to make labour markets less insecure. Redistribution will be again on the agenda: the privileges of the elderly and the wealthy in question. Policies until recently considered eccentric, such as basic income and wealth taxes, will have to be in the mix.”

Many hoped that the financial crisis of 2008 would lead to a break with the old model and lead to the radical reforms referred to in the quote. This model has, in the private sector, had the maximisation of shareholder value at its heart with deleterious consequences which are well known, including short termism in terms of the investment horizon and strategies pursued by large leading corporations to ensure quick returns for shareholders. This unpleasant consequence of shareholder capitalism has been compounded by the invidious buy-back policy of many large corporations whereby managers have used the low interest environment of recent times and large profits to buy back their company’s shares, thereby increasing the earnings per share, the key measure of corporate success. As a result, senior managers are able to reward themselves with exorbitant salaries and bonuses and the bonus culture has become deeply engrained in today’s corporate world with the associated inequalities it has created. As I argued in my last paper the new model or social contract should have at its heart a move from maximising shareholder value to maximising stakeholder value.

The stakeholder model recognises that wealth creation is a collective process and involves many groups including employees, distributers, suppliers, government and importantly the community within which the company’s activities are located. Since the stakeholder model involves social as well as financial objectives and takes a takes a longer-term view of the investment process with value creation as the key overriding objective rather than value extraction. It is interesting to note that often countries, such as Germany, that have adopted a stakeholder model – so-called Rhineland Capitalism - have public banks which are central in supporting the adoption and functioning of the stakeholder model. For example, Germany has had the Kreditanstalt fur Wiederaufbau (KfW) since the end of World War Two and the bank has been closely involved in the startling economic growth performance of Germany in the post war period. Ironically, the KfW and public banks in other countries were inspired by a public bank – the ICFC created in the UK and discussed in Section 3 below.

Unfortunately, the misguided austerity policies pursued in the UK in the post financial crisis period have reinforced and exacerbated many of the inequalities that have been created by shareholder capitalism and shattered resilience in crucial areas of the public sector, such as health and social care, as the recent pandemic has amply demonstrated. These inequalities are likely to be further intensified during the current crisis especially if they are ignored by policymakers.

As I said in my last paper the initial response to the pandemic was one in which government and wider society prioritised health and wellbeing over economic growth. As we have moved away from the initial lockdown, the trade off in the UK has shifted quite sharply towards reopening the economy and it now appears that that process has been too rapid as we face an alarming rise in the R rate and the spread of the infection again. Not only is this bad news for the collective health and wellbeing of our society, it is also a worrying development for the recovery of the economy particularly given the dramatic changes in support that have recently taken place which seem to fail to grasp the magnitude of the issues that the UK economy is about to face. Indeed, the recent announcement by the Chancellor of the Exchequer regarding the change to the furlough scheme suggests that the UK government sees the crisis as a temporary aberration from a long-term trend.

However, it is increasingly becoming clear that this is not a temporary aberration and the title of this paper is intended to reflect that. In contrast to the policy reaction to the financial crisis on this occasion it is important that the opportunity to reshape the UK and Scottish economies to provide a new social contract in the public and private sectors should not be missed for a whole range of reasons. The public sector part of the social contract that underpinned the work-life balance relationship of the post-world war two baby boomer generation was contained in the Beveridge Report, discussed below, and its implementation post war. The pandemic has made clear that this part of the inherited social contract needs to be rebooted in a number of directions.

In this paper I pick up on two key themes discussed in the last paper and that underscore the need to reboot the social contract, along the lines described in the FT quote. The first issue considered is that of unemployment and what the policy response should be to the expected steep rise in unemployment in the transition to the new normal and what should employment look like in the new normal to be consistent with a new social contract. The second theme is the role of the banking sector in the UK economy and how the pandemic has highlighted crucial flaws in the functioning of the banking system and how this has stymied the growth of the economy. If we are to have a flourishing economy in the new normal and one that provides value creating jobs in both the public and private sectors, then reform of the banking sector will be a necessary part of the reform mix.

2. Employment and unemployment: The New Normal and the transition to the New Normal

Given that the current macroeconomic shock to the economy, on both the demand and supply sides, has been created by government in its bid to control the virus, many commentators anticipated that if the shock is temporary in nature the economic rebound from lockdown would be rapid once the initial lockdown restrictions were lifted – a so-called V-shaped recovery. The Bank of England has been the most prominent advocate of a V-shaped recovery with its real time data suggesting a sharp rebound as the lockdown restrictions are eased and a return to normalcy in the autumn. Structural changes in employment aside, discussed below, a V-shaped recovery would perhaps have been expected to maximise the protection of jobs in the economy if the initial lockdown had achieved suppression of the virus.

It is now clear that the initial lockdown has not contained the virus, the recovery is now unlikely to be V-shaped and the associated measures that have been put in place to protect jobs now seem unlikely to be able to protect mass unemployment occurring. Indeed even if a V-shaped recovery took place, the need for social distancing, either by behavioural changes or by lockdown restrictions, in sectors (such as leisure and hospitality) that generate the largest percentage of jobs but make a lower contribution to output than sectors relatively unaffected by social distancing (which make a large contribution to output but generate a much smaller percentage of jobs) means that a contraction of this sector will have a big impact on unemployment – a V-shaped recovery in output is not matched by a V-shaped recovery in employment but something more akin to a reverse J-shaped recovery.

Before turning to unemployment issues per se it is worth first sketching the timeline of the UK Government's economic response to the pandemic which has had three phases to date. The first phase involved trying to protect as many jobs and businesses as possible through the furlough scheme for employees and the self-employed (the job retention and self-employment income support schemes) and implementing the Future Fund, the Bounce Back Loan Scheme (BBLS), and the Coronovirus Business Interruption Loan Scheme (CBILS) for businesses and the Future Fund administered by the British Business Bank. Given the expected temporary nature of the shock, the furlough scheme initially reimbursed employers for a generous 80% of their employee's wages and a similar scheme existed for the self-employed. This was to be tapered going forward with the government paying 70 % of wages in September 60% in October when the scheme is due end. The phase 1 model has been widely praised for its quick action and comprehensive nature and was underpinned by the expectation of a temporary shock.

The second phase came in July's summer update with support for the demand side of the economy with a cut in VAT for the hospitality sector, the hugely popular Eat Out to Help Out scheme and the cut in stamp duty on property purchases.

From the start of November we will enter phase 3 of the government's economic support involving a new job support scheme which has been widely welcomed, but which also raises questions about its implications for unemployment. The new scheme makes it relatively expensive to hold on to workers on a part-time basis since employers have to pay for some of the hours not worked – employers have to pay up to 55% of workers' normal wages for 33% of their normal hours, which amounts to a tax of 67% of the hourly wage. Given that the tax rate will fall the greater the number of hours worked the scheme is clear incentivising employers to employ fewer workers working more hours each which in all likelihood will favour skilled workers and those that are difficult to replace.

The expectation from the phase 3 measures therefore is that they will lead to an uptick in unemployment and certainly for those jobs that require less than 33% of hours worked which are regarded as non-viable. The VAT cut of phase 2 has been maintained and help has also been given to private sector firms by allowing them spread tax deferrals over a longer period and a new 'pay as you grow' approach to the emergency loans scheme will give a more lenient approach to repayments. However, it is extremely doubtful that these extra measures will be sufficient to prevent mass unemployment

Prior to the phase 3 scheme being announced the Bank of England predicted a rise in unemployment to 7.5% which amounts to an extra 1 million workers on the dole (i.e. 2.5million in total). So far, we have already seen a considerable increase in unemployment in high street retail and in all parts of the aviation industry. Furthermore, there are sectors of the economy such as the culture and events sector that are still not able to open and will undoubtedly pay a heavy price in terms of bankruptcy and unemployment. The Labour Party, for example, has estimated that 1.6 million jobs are at risk in the culture and events sector if action is not taken to protect these jobs and, as I shall argue below, such creative jobs are very much the kind of jobs we need to protect going forward.

The recent second wave of the pandemic will inevitably push many companies that were on the brink of bankruptcy out of business with the consequences this will have for unemployment. Furthermore, there is no guarantee that the half a million people on the Kickstart Scheme will end up unemployed and the 900,000 on Universal credit are likely soon to become unemployed too. The recent imposition of the 10pm closing time rule on the hospitality sector could result in significant extra unemployment of up to 300,000 people. All of this will likely push unemployment into the teens, percentage wise, making the upper limit of 16% referred to in my previous paper a not unrealistic outcome, particularly if the virus remains for a sustained period.

From this discussion it now seems inevitable that the UK will be facing mass unemployment in the post pandemic period, the magnitude of this, as we have said, will very much depend on the uncertainty of further lockdowns and how the pandemic progresses going forward. We shall discuss how the challenges of mass unemployment can be addressed below after considering key structural trends driving employment and unemployment some of which have been accelerated during the pandemic.

The phase 3 scheme is clearly a turning point in the UK Government's economic response to the pandemic as it signals that it is no longer prepared to support the old normal economy. The direction of travel is towards the new normal where so-called zombie companies[2] no longer have a future and their employees must move to where the New Normal jobs are going to be. However, such a strategy is all well and good if the jobs being lost from the old normal can quickly be absorbed into the New Normal. But with a skills mismatch comparable to the 1980s recession this seems unlikely since many of the jobs that will be lost are in the gig economy, hospitality and high street retail sectors where the skill sets of those in these sectors are unlikely to match skills in the sectors that are likely to grow. And, of course, there is no guidance from government as to what the new normal is likely to be. It seems this is to be left to market forces and although they are admittedly already signalling where at least part of the new normal is likely to be there appears to be no attempt to link this direction of travel with the needed skills set.

[2] The term zombie company arose in Japan to describe companies that could not exist except for the bailouts they received from the banking sector. In short, they are not viable long-term concerns and in a company sense are amongst the walking dead.

One of the important consequences of the pandemic is that it has accelerated the application of digital technology in a number of areas and this has greatly mitigated the effects of the pandemic on the economy by stabilising employment in certain sectors and creating many knew digi-tech jobs along with the associated professional service jobs to support them. For example: the availability of good digital connectivity along with appropriate software such as Zoom and Teams have facilitated teleworking, allowing many to work from home; e-health has enabled the health sector to continue to provide services that would otherwise be curtailed by social distancing; the dramatic move to online shopping (in groceries and retail) and home delivery services has created new job opportunities; the move to online and blended learning in education enable this sector to continue to provide university courses and skills training despite the need for social distancing; the use of computer generated technology in the TV industry has enabled a buoyant programming mix to continue.

These technology changes have produced dramatic rises in the stock valuation of the leading tech companies, such as Amazon and Google, and the main employment vacancies in the UK are currently in this sector, with a 36% increase in the number of job adverts posted by tech companies in the UK during August. Although these jobs are primarily for those with the appropriate tech-based skills, support and ancillary jobs such as those for project managers, marketers, HR professionals are also available. Of course, although this technology shift is facilitating a stabilisation of employment in certain sectors, to a greater degree than if it were absent , along with the noted boost to employment there is also the significant skills mismatch since those who are being made unemployed in the sectors noted above do not have the skill sets or access to the requisite technology to transfer into the areas where the job vacancies are.

It is noteworthy that although these technological changes are currently producing opportunities during the pandemic this is contrary to the wider, underlying digitisation trend which could in the longer term lead to further job losses, and this must surely be taken into account in thinking about the skill sets that the economy needs especially as we anticipate the new normal. Globotics is a term coined by Richard Baldwin in his recent book[3] and represents the transformational effect that the combination of globalisation and robotics, in the form of machine learning, will have and is having on advanced economies such as the UK.

The globalisation part refers to the growth of remote intelligence (RI)– the advent of machine translation along with excellent internet connectivity that allows people working anywhere in the global economy to compete for service and professional jobs in the UK and beyond. The robotics part of Globotics captures the striking advances in artificial intelligence in the form of machine learning by computers and the robots they can run. Baldwin refers to the Globotics transformation as the third great economic transformation (following the Great transformation – the switch from agriculture to industrialisation post 1700 - and the post 1970 transformation from industry to services).

[3] Richard Baldwin (2019), *The Globotics Upheaval: Globalization, Robotics and the Future of Work*, Weidenfeld and Nicolson.

The consequences of the Globotics transformation, along with the technology changes that have occurred as a result of the pandemic, are likely to be profound. If home working, for example, becomes part of the new normal will firms see opportunities from RI to outsource the office working to other countries? This may be easiest for firms who can allow staff to work 100% from home compared to those that may require a blended mix of home and office working. E-health, in the form of consultations and diagnostics, is already being provided from countries that have the commensurate skill sets to provide a service at a lower cost and this trend may increase given the important role that e-health has played during the pandemic with potential implications for jobs. Enterprises, particularly in manufacturing that find it difficult to ensure social distancing, could decide to replace people with robots in order to survive, and those that already use robots may use them more intensively.

For example, pre-pandemic online retailing was already using robots extensively and again that trend is likely to increase post pandemic, which will mean that people being made unemployed from high street retailing may well not find jobs on a one-to-one basis in the online retail sector even if there exists a direct match there.

In a Scottish context, and with the right infrastructure in place, it is not difficult to see how the Globotics transformation could harness the great potential of the Highlands and Islands of Scotland, especially given, and as noted in my previous paper, the desire for people in the post pandemic world to live in an area that offers them more space and a better quality of life than city living. The latest NRS population projections for Scotland show that overall, the population of Scotland is projected to increase by 3% between 2016 and 2026 with the majority of Scotland's local authorities – 24 of the 32 – projected to increase in population over the next decade. However, a quarter of – 8 local authority areas – are projected to decline in population over the same period. These areas are predominantly in the West of Scotland, the Western Isles and Highlands and in sum the projected population changes[4] show a West-East migration into the areas of Scotland that are already intensively populated. Carefully crafted policies, especially those with a focus on digital infrastructure could perhaps reverse this pattern given the huge attraction of the great outdoors in the West of Scotland during the COVID period.

The underlying technological changes that are occurring in the world economy, both pre and post pandemic, make it vitally important that the skills training that is provided post pandemic are fit for purpose and will meet the needs of the new normal. We already have some indications of where these are likely to be: the new growth sectors will be as a result of the underlying Globotics transformation and we can infer that they will be 'sheltered' from the transformation process by being sectors that AI and RI cannot compete with or replace the unique advantage of human beings. In sum, as Richard Baldwin notes they will be in sectors that require creative and social/ emotional intelligence, those that require the great advantages that human beings have over machines in terms of social intelligence, and

[4] National Records of Scotland, *Population projections and depopulation across Scotland* https://blog.nrscotland.gov.uk/2018/03/28/population-projections-and-depopulation-across-scotland/, 28 March 2018

skills involving sharing, caring, understanding, creating, empathising, innovating and managing people.

To address where these jobs might be in the new normal and to deal with mass unemployment that now seems the inevitable consequence of COVID-19 and the government's response, it is useful to return to some initiatives that have been taken in the past during past world crises such as the Great Depression and the Second World War. The latter seems particularly apposite since the analogy with war is often made with respect to the pandemic. In the UK the Beveridge Report was published in 1942, in the middle of the Second World War, and promised significant rewards for everyone's war sacrifices. It specifically sought to address the five giant scourges of the time and that were expected to haunt the post-war era, namely Want, Disease, Ignorance, Squalor and Idleness. As a result of Labour's victory in the 1945 election the Beveridge Report and the report's recommendations were implemented through a series of Acts of Parliament: specifically, the National Health Service Act 1946, the National Insurance Act 1946 and the National Assistance Act 1946. The implementation of Beveridge was the establishment of the social contract that underpinned the lives of the baby boomer generation and although the tenor of the report is as valid today as it was then its implementation has to be recast for more recent and future generations.

The implementation of the report was overwhelmingly popular with the general public. By recasting Beveridge's five giants into areas that will be more familiar to today's reader (in parenthesis below) we can perhaps gain some insight into how idleness (unemployment) may be tackled. Although many of the diseases that were prevalent in Beveridge's time have been addressed in a wider sense Disease (health, including public health, and social care) is still a very real issue and the pandemic has indicated that we surely need to build more resilience in both health and social care. In terms of the health sector one of the key issues has been that, in fire-fighting the pandemic other medical conditions, both physical and mental, have been neglected thereby worsening the health profile of a significant sector of the community. So not only do we need to build resilience for the ongoing current pandemic and the next potential pandemic, we also need sufficient resilience to deal with the range of other diseases that still need to be treated whilst the medical aspects of the pandemic are addressed.

The above surely indicates the need to increase physical capacity in our hospitals but also increase the workforce dramatically both in terms of clinical and ancilliary staff. To be pandemic robust we will need an expansion of those working in the care home sector and they will need better training, which should lead to care home workers being paid properly in their roles especially given the heightened value that society now places on this work. The Resolution Foundation estimates that it would take an extra 180,000 care workers to bring the ratio to the over-70s population back to where it was at its 2014. These kinds of jobs have the advantage of being in the categories that should be sheltered from the Globotics transformation, as do other public sector jobs such as those in teaching, nursing, social and mental health care.

In terms of Beveridge's giant Squalor (housing) clearly the need for affordable housing is as relevant today as in Beveridge's time with the skewed market that exists between old and young, the wealthy and the poor. An ambitious housing strategy combined with associated infrastructure spending could both address this and tackle a significant component of the mass unemployment and an important part of the UK's inequality gap. Beveridge's Want (Poverty) is still very much with us both in the UK and in Scotland. In terms of the Scottish data[5], which are similar to those in England, between 2014 and 2018, 13% of people in Scotland were in persistent poverty after housing costs and 17% of children in Scotland were in persistent poverty after housing costs, compared to 15% in 2013-2017; children have consistently had a higher risk of living in persistent poverty after housing costs than working-age adults and pensioners in Scotland. For working age adults 11% for the period 2013-17 were in persistent poverty after housing costs. This compares to 10% in 2013-2017. Twelve per cent of pensioners in Scotland were in the persistent poverty category in the 2013-17 period, compared to 11% in 2013-2017. Policies designed to eradicate poverty are likely to have an immediate impact on the wider economy given the relatively low savings rate of those in this category. I have discussed policies to deal with Ignorance (skills, education and training) above and will do so again below.

Beveridge's proposals have a strong resonance with President Franklin D Roosevelt's (FDR) New Deal. Much political capital has recently been made of FDR's New Deal, whose 'war' was the Great Depression, as a relevant model for addressing the consequences of the pandemic, but little has been said about the New Deal's key recommendations for dealing with mass unemployment. One of the boldest and most famous components of the New Deal was the Works Progress Administration (WPA) that employed more than 8.5 million people tasked with infrastructure improvements, including building bridges, roads, public buildings, public parks and airports.

The WPA employed more men than women, with women being tasked with more community-based jobs such as care for the elderly, nursery schools, school lunch programmes and recreational work. Interestingly also there was also support for the creative arts in federal art, music, theatre and writers' projects, a protected area from much, but not all, of the Globotics transformation but one which could greatly add to the UK's unemployment total if a viable model to cope with social distancing is not adopted soon in this sector. Although the WPA cost more than direct relief payments its director Harry Hopkins nonetheless noted: "Give a man dole and you save his body and destroy his spirit. Give him a job and you save both body and spirit". That sentiment surely is as important today as it was then.

Another key component of the New Deal was the creation of the Civilian Conservation Corps which was for unemployed men aged 17–28. This provided manual labour jobs related to the conservation and development of natural resources in rural lands owned by federal, state, and local governments. Initiatives included dust storm prevention in the Great Plains, planting three billion trees and creating 700 state parks. Maximum enrolment at any one time was 300,000, and through the course of its nine years in operation three million men participated in the programme. With the green and conservation agenda rising to the top of the political agenda both in the UK and in Scotland, alongside an increased awareness of the

[5] Scottish Government, *Persistent Poverty in Scotland 2010-2018*, https://www.gov.scot/publications/persistent-poverty-scotland-2010-2018, 26 March 2020

damage being inflicted on the environment, it is not difficult to imagine the creation of a 21st century equivalent of the CCC that could create many hundreds of thousands of jobs in, for example, flood control, peatland regeneration and sustainable agriculture. Also in community-based programmes, the sharing of resources, and caring for the elderly and children. It is not difficult to imagine a truly radical plan of action for unemployment in the UK that cherry picks and recasts the best components of the WPA and CCC initiatives from the New Deal to deal with mass unemployment in the UK: investment in infrastructure and the green economy and in jobs that society values and are largely sheltered from the Globotics transformation.

3. The need for reform of the banking sector: a decentralisation stakeholder model

As I have noted, one of the key measures that the UK government has taken during the campaign is that of CBILS, and related company support, which is designed to provide bridging loans for small to medium sized businesses (SMEs). In the wider UK economy, SMEs account for 99.9% of the business population with 60% of total employment or 16.6 million people. In Scotland SMEs account for 99.3% of all private sector companies, providing an estimated 1.2 million jobs and 55.4% of private sector employment. The support to SMEs during the pandemic period has been crucial. However, the need for the CBILS initiative raises an important question about the functioning of the banking and wider financial system in the UK and, particularly in the context of the shareholder capitalism model referred to in the introduction, how this model has been detrimental to the longer term growth of the UK economy.

Although banks have a number of important functions, such as deposit providers and providing liquidity to the financial system, perhaps the most crucial from an economic growth perspective is the transformation function; that is banks' ability to transform short term loans into longer term lending for businesses that cannot access capital through equity or bond issuances. This is the key way in which banks can add value in the modern economy rather than the value extraction or rent seeking that has been so prevalent in the UK and US financial and corporate systems. However, the challenge from the banks' perspective is that depositors desire relatively high interest rates and for their funds to be liquid with the ability to withdraw funds at short notice. Industry borrowers on the other hand want to borrow funds for a relatively long period of time and at relatively low interest rates. Furthermore, investments of relatively small amounts of money are seen as riskier and more costly for lenders, which puts small businesses seeking loans at a disadvantage. Larger firms, of course, can borrow for investment by issuing equity or bonds, (although these channels bring with them their own issues – discussed below). As noted in my previous Policy Scotland paper one of the key historical failures of the UK banking sector has been the failure to fully engage in the transformation process in the UK economy because the banks have not built long term relationships with industry and the key component of trust that goes with that such relationships.

This contrasts strongly with the situation in Germany and Japan, for example, where business networks between the banking sector and industry are strong and long established and the strong post-war growth in these countries was financed primarily by banks, rather than through equity finance as in the UK and US. For example, the commercial banks in Germany grew to a large scale in close relationship with particular industries they knew intimately and to which they supplied capital and so, for example, the Diskontongesellschaft became known as the 'railway bank'. Such banking groups, and their Japanese counterparts, provide a degree of stability in terms of company finance in good and bad times and they give German companies the ability to take a longer-term perspective in their investment compared to equity financed companies in the UK and US. Such banks are more likely to be based on the stakeholder model referred to in the introduction and have at their heart value creation rather than valuer creation, and this is especially so for public banks in Germany such as the KfW. Francis Fukuyama[6] notes class and status barriers in Britain prevented such communal linkages between banks and industry and their banks abandoned long term investment in industry as early as the late 19th century.

The disconnect between the banking sector and the industrial sector in the UK was compounded in the latter half of the 20th century with the greater emphasis on rentier capitalism in the form of shareholder capitalism, which was underscored by the financial sector's increasing share of the UK economy, with the latter trend paralleled in the US. Since the 1970s the share of GDP in manufacturing in the UK fell from 30% of total value added to 10% in 2014 at the same time as finance and insurance rose from less than 5% in the 1970's to over 8% in 2014. Financial services' share of profits rose dramatically during this period mirroring the shift in the sectoral shares. For example, in the United States financial corporations' profits as a share of total corporate profits, which had been stable at 10-15% from 1945-1980's rose steadily to a peak of 40% at the start of the twenty first century.

In addition to the expanding size of the financial sector in the UK and US it also became greatly diversified with one sector being particularly important, namely asset management. For example, in the US the asset management industry grew dramatically from $3.1 billion in 1951 to some $17 trillion in 2015. In the UK asset management accounted for £5.7 trillion of financial funds by the end of 2015 which was more than three times the size of GDP in the same year. The size of the asset management sector evolved to meet the needs of the vast pool of savings built up as a result of the growth in the world economy in the post-World War Two period and the resulting pensions and life insurance commitments that resulted from this.

During the period of the Great Moderation, in which inflation targeting was the key function of central banks, politicians of nearly all hues in Scotland, the UK and US regarded the increased importance of the financial sector as providing a huge productivity boost to their economies and a key replacement of the declining manufacturing sector. However, the reality was, as Marianna Mazzucato[7] and other commentators have pointed out, that the asset managers driving the financial revolution were effectively rent seekers working largely for the benefit of managers and shareholders with, the ordinary customers often only getting mediocre returns. If the huge pool of savings referred to above had been channelled into truly productive investment by the financial sector, along the lines of the

[6] Francis Fukuyama (1995), *Trust: The Social Virtues and the Creation of Prosperity*, Hamish Hamilton.
[7] Mariana Mazzucato (2018), *The Value of Everything: Making and Taking in the Global Economy*. Penguin.

transformation model, then the UK economy would undoubtedly have had a very different growth and productivity record as it ended the 20th century and entered the 21st century.

An added dimension of the unbalancing of the UK economy in favour of finance is the extraordinary concentration of finance in the City of London which may be fine in a rentier model but does nothing to build the kind of trust relationship which facilitated the transformation of resources to industry in different parts of the UK; having the once-world leading Scottish banks such as RBS and Bank of Scotland London-based does little or nothing for the much-needed transformation of the declining economies in the Highlands of Scotland, for example, or for the needs of industry in the North West of England.

The CBILS initiative has highlighted the lack of a close long-term relationship between the banking sector and small to medium sized businesses, although even with such a relationship the sector would presumably still have needed state support during the COVID period. Interestingly, a previous major crisis in the UK in the form of the 1929 financial crisis highlighted the fault lines in the UK banking system referred to above and the actions that were taken at that time to correct these are worth revisiting since I believe they contain important lessons that resonate today. The Committee on Finance and Industry – more commonly referred to as the Macmillan Committee – was formed by the British Government in 1929 to examine whether the then banking and financial sector in the UK was to blame for the crash and whether it was sufficiently supportive of trade and industry.

Although a key aspect of the Macmillan Committee's work was the assessment of the so-called 'Treasury View', that government expenditure on public works was not the answer to mass unemployment[8], its final report also noted that the relationship between the British financial system and industry have never been as close as the respective relationships in Germany and the US. This lacuna was referred to as the "Macmillan Gap" and this was also one of the few recommendations of the Committee that were actually acted upon.

The Industrial and Commercial Finance Corporation (ICFC), was inspired by the Macmillan Committee and formed in 1945 by a combination of the Bank of England and the major UK clearing banks. The basic mandate of the ICFC was, as we noted above, the recognition that small to medium-sized businesses in the UK traditionally faced a gap in available finance due to banks being unwilling to provide long-term capital and the companies being too small to raise capital from the public. During the 1950s and 1960s, the ICFC expanded to become the largest provider of growth capital for unquoted companies in the United Kingdom. Also, in 1945, the Finance Corporation for Industry (FCI) was established to focus on large companies and the ICFC and FCI were eventually merged in 1973 to form Finance for Industry (FFI) which was rebranded Investors in Industry in 1983 and later privatised as 3i in 1994. It is noteworthy that the demise of the ICFC as a public body coincided with the transformation of the UK economy from manufacturing to financial capitalism and the rent seeking and value taking that coincided with that. It is also noteworthy, as highlighted in the introduction, that other countries such as Germany adopted public sector versions of the UK's ICFC model and the contrast between the value creation rather than value extraction that they have achieved is striking.

[8] The report came down in favour of this view (with dissenting voices from JM Keynes and other economists) and a focus on stable monetary policy to maintain the exchange rate parity and price level stability.

David Merlin-Jones' study[9] indicates that there are four main lessons from the experience of the ICFC for today's world. First, the ICFC was decentralised, established local branches, and recruited staff who acquired expertise in specific industrial sectors and local businesses and made themselves knowledgeable about individual companies. This allowed them to make sound long term investments, in contrast to today's clearing banks. Second, the knowledge of the companies with sound underlying business fundamentals allowed the ICFC to invest long term rather than the short termism that has been so prevalent in modern day banking and finance. The third lesson from the experience of the ICFC is that such an entity should not be a limited company relying on share issuance but that if private sector finance is needed it should be in the form of bonds or other financial instruments that insulate the bank from short-term pressures. Fourth the ICFC was originally established by the Bank of England and initially relied heavily on the existing banks. However, it was only when the ICFC was free of the Bank of England's input that it was able to compete with the main banks, and it was able to meet the demand from SMEs.

I propose that a modern-day equivalent of the ICFC should be established as a rival for the main banks, not as a dependent offshoot, and certainly such a bank should be under at public ownership with stakeholder governance. This bank should be highly decentralised and its branches should be where the businesses are that they seek to serve. The bank should build the long-term relationships of trust that are so evident in continental European modern day equivalents of the ICFC model and are so lacking in this country.

4. Concluding comments

In this paper I have revisited some of the key issues contained in my earlier Policy Scotland paper *The Post Pandemic New Normal* and particularly the need, in light of the pandemic, to construct a new social contract and what steps need to be taken in terms of the latter in the specific areas of employment and the financial sector. The immediate issue I have identified in this paper is that with the original furlough scheme coming to an end, combined with the resurgence of the virus, this clearly opens up the prosect of a return to the kind of mass unemployment that we saw in the 1980s and I have given various indications of why this is likely to be the case. It is of considerable concern that, in addition to the absence of an effective support mechanism being in place from November, is the absence of a rational education and training programme that would likely guide the unemployed and potential unemployed to the skill sets that they need for the new jobs that are likely to be created, in the sectors that have been greatly strengthened by the pandemic such as the digital technology sector. I have also argued that jobs that are sheltered from the ongoing digital revolution as encapsulated in the Globotics transformation are jobs the country needs to direct education and training towards.

The need for a Keynesian spending programme to bolster the economy, is reinforced by the latest ONS data showing that the household savings ratio (that is, the percentage of aggregate disposable income that is saved) in the second quarter of the year hit 29.1% a

[9] David Merlin-Jones (2010) *The Industrial and Commercial Finance Corporation: Lessons from the past for the future,* Civitas, Discussion paper

whopping 20 percentage point increase on the previous quarter. This represents the reduced opportunities for discretionary spending and presumably also an increased risk aversion on the part of consumers (this ratio has been consistently below 10% in the noughties and below 5% in some years such as 2017). Given consumption spending remains the mainstay of the UK economy it should be replaced by an appropriate expansionary fiscal offset. In the longer term a movement away from a debt fuelled consumption-based economy would be an important component of a new social contract.

In order to address the levels of unemployment we are about to see, the first Policy Scotland paper argued for a cut in National Insurance and that remains an important tool at the UK Government's disposal to give business an incentive to retain workers and indeed hire new workers in expanding sectors. On its own such a cut is unlikely to be sufficient and I have argued in this paper for a return to the report that underpinned the social contract developed in the post Second World War period, namely the Beveridge Report. I have argued that the five Giants that Beveridge described (Want, Disease, Ignorance, Squalor and Idleness) in the 1940s are as relevant today as they were then and their recasting in today's equivalents should provide a programme that will spare the economy from mass unemployment and guide it on a path to a New Normal. Much has been made recently of the comparable social contract drawn up for the US in terms of FDR's New Deal. I have also argued that there are key components of this such as the Works Progress Administration (WPA) and the Civilian Conservation Corps (CCC) that could be recast as a response to the pandemic. A particularly attractive feature of these programmes are the emphasis on improving infrastructure of the WPA and the environmental friendly policies of the CCC.

I have also argued in this paper that an important element of the new social contract should be a move away from the shareholder capitalism model that has ruled the roost since the 1970s, and the associated short termism and value extraction associated with that model, to a stakeholder model based on value creation. In that regard we have argued for a rebooting of the banking sector in this country and one based on a stakeholder model which provides the long-term relationship that business needs to sustain value creating jobs going forward. That model was actually first brought to life in the UK through the creation of the Industrial and Commercial Finance Corporation and has been successfully copied in other countries but unfortunately was a casualty of the privatisation revolution in this country.

Given that the existing support mechanisms in place during the pandemic have pushed the UK's debt to GDP ratio north of 100% and the fiscal deficit is at £174 billion, is there fiscal space to go the extra mile, as advocated in this paper, to protect the economy from mass unemployment and direct it to a new normal that replaces value extraction with value creation? In this regard I would rule out Modern Monetary Theory (MMT) - the view that since the UK Government issues fiat money it can simply 'print' money to finance any given deficit as long as this does not generate inflation – as a feasible method of deficit finance. As I hope to show elsewhere, MMT fails to capture the important role of expectations and the influence of monetary expansion on expectations, asset prices, and the interaction of expectations, asset prices, including the exchange rate, and the balance of payment; such interactions would render MMT impotent in an open economy such as the UK. Indeed, it is now clear that the one economy that could have potentially run MMT, and where the theory was developed – the US, with its currency reserves status and 'exorbitant privilege' –

would not be able so to do because even it now seems to be bound by its large balance of payments deficit and the implications this has[10] for expected exchange rate adjusted yields on its debt.

As I argued in the earlier paper the large deficits and debt accumulation that have arisen as a result of the COVID pandemic, and will arise going forward, should not be a concern of central government for the forseeable future given that the government can borrow at rates of interest close to zero and there seems to be a huge appetite by financial markets for that debt. As I have noted, this is especially so if the rate of interest on government debt remains below the economy's rate of growth, which seems to be a safe bet for the foreseeable future. Although I argued that at some point down the road there will be a need for either spending cuts or tax changes to restore some of balance in debt deficits, I argued that was likely to be some time off given the backdrop of secular stagnation and the likely increased appetite for risk in the private sector as a result of the pandemic. The optimal path for addressing debt and deficits going forward will, as in the post-World War Two era, will be by growing the economy in terms of a mix of real and nominal growth. Inevitably, as a part of the new social contract, and as set out in the first paper, there will be a need to reboot the tax system and we should be planning what that structure should look like now to impart extra credibility into current borrowing.

[10] Stephen Roach, *The end of the dollar's exorbitant privilege*, Financial Times https://www.ft.com/content/46b1a230-8c6c-4feb-b617-21a520cc201b, 5 October 2020