1. Economics of the ‘Third Way’: introduction

Philip Arestis and Malcolm Sawyer

‘Third Way’ is a term loosely used to describe the emergence of new social democracy governments throughout the world. Whilst it is easy to explain the term in this way, it is by no means a simple matter to analyse coherently. In view of this difficulty, and yet topicality, we decided to hold an international conference (26 May, 2000, University of East London) to which economists were invited from a number of countries where policies of the Third Way type had been implemented. In doing so we had thought we might be able to define Third Way and, more concretely, ‘Economics of the “Third Way”’.

In the UK, for example, the emergence and then election of ‘New Labour’ has been closely associated with the development of the notion of the Third Way. ‘New Labour is neither old left nor new right ... Instead we offer a new way ahead, that leads from the centre but is profoundly radical in the change it promises’ (Blair, 1997, p. 1). In a similar vein, Giddens appears to locate the Third Way by reference to two other ways of ‘classical social democracy’ and neo-liberalism.

Classical social democracy thought of wealth creation as almost incidental to its basic concerns with economic security and redistribution. The neoliberals placed competitiveness and the generating of wealth much more to the forefront. Third way politics also gives very strong emphasis to these qualities, which have an urgent importance given the nature of the global marketplace. They will not be developed, however, if individuals are abandoned to sink or swim in an economic whirlpool. Government has an essential role to play in investing in the human resources and infrastructure needed to develop an entrepreneurial culture. (Giddens, 1998, p. 99)

Hombach (2000, p. 1) talks of ‘a policy that will steer a third course, a path between competing ideologies, a system that represents a realistic response to the changes that have taken place in the world’, which supersedes ‘the extremes of free market economics on the one hand and a centralized welfare state economy on the other’.

The idea of a third way (or ‘middle way’) between two major routes has surfaced a number of times. In relatively recent times it was often used to

signify a way of a social democratic variety between free market capitalism and centrally planned socialism, though Franco and Tito, amongst others, used the term third way as a label for their own approaches. The current notion of a third way is between neo-liberalism and social democracy, and it is in this sense that we use the term (without implying that it is a viable way).

This chapter seeks to outline the type of economic analysis which we perceive to be involved in the ideas on the Third Way. We attempt to sketch out what we see as the analysis of a market economy that underpins the ideas of the Third Way. This is followed by some remarks on the role of the State which is also involved.

THEORETICAL FOUNDATIONS OF THIRD WAY

The exploration of the theoretical foundations of the Third Way, as with such an exploration for any other way, draws on analyses of the market economy and on analyses of the State and the role of State activity. Although there have been some notable contributions on the Third Way (for example Giddens, 1998, 2000), there has been rather little specifically on the economic analysis underpinning it, though speeches and other pieces by Blair and Brown provide some material. In this chapter we have to some extent to work back from the policies and policy pronouncements of governments (particularly in our case of the New Labour government) to seek to infer an economic analysis behind the Third Way. It is unlikely that there is a clear theoretical analysis of the economy in the minds of government ministers or their advisers. It is equally unlikely that economic policy pursued by any government is fully consistent either internally or with some theoretical paradigm. We would suggest, however, that in view of the approach adopted by those governments that purport to follow the Third Way, it can be variously described as 'new monetarism' (Arestis and Sawyer, 1998) or as interventionist neo-classical economics of a new Keynesian variety.¹ By this we mean firstly that the 'market failure' approach within neo-classical economics can be interpreted to support significant government intervention when market failures are viewed as widespread, though clearly there are neo-classical economists who would play down the significance of such market failures or who would counterpoise 'government failure' with market failure. Market failure is viewed as arising from the existence of externalities, the 'public good' nature of some goods and monopoly, and the emphasis on training and education by the new Labour government (and others) can be seen in this light of the government provision or encouragement of activities which would be underprovided by the market. We argue that the approach can be viewed as new Keynesian through its emphasis on the NAIRU (non-accelerating inflation rate of unemployment),

its neglect of aggregate demand and of fiscal policy, the elevation of monetary policy and the concern over the 'credibility' of economic policies.

We postulate that the economics of the Third Way can be understood as based on the seven elements listed below which we would argue justify the description of interventionist neo-classical economics of a new Keynesian variety.² Giddens (2000) recognises this when he writes that

the ideas of the new Keynesians allow us to make more sense of how the modern economy works, particularly at its cutting edge, the global financial economy. Suboptimal consequences can happen in any market sector as a result of the interaction of imperfectly competitive markets with the less than rational actions of individuals. In some situations, such as those found in the finance markets, the consequence can be extreme. The tendency of financial markets towards crisis is structural and needs to be coped with by collaborative intervention. (p. 37)

(i) The market economy is viewed as essentially stable, and that macroeconomic policy (particularly discretionary fiscal policy) may well destabilise the market economy.³ Markets, and particularly the financial markets, operate with something like 'rational expectations'.⁴ Specifically, financial markets make well informed judgements on the sustainability ('credibility') of economic policies.

(ii) Monetary policy can be used to meet the objective of a low rate of inflation. However, monetary policy should not be operated by politicians but by experts (whether banks, economists or others) in the form of an 'independent' Central Bank.⁵ Politicians would be tempted to use monetary policy for short-term gain (lower unemployment) at the expense of long-term loss (higher inflation). An 'independent' Central Bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.⁶ It is argued that a policy which lacks credibility because of time inconsistency is neither optimal nor feasible (Kydland and Prescott, 1977). In situations of repeated games the authorities' are forced to take a longer-term view, since the future consequences of current policy decisions will influence the *reputation* of the authorities. In these situations, the authorities' incentive to renege is reduced because they face an intertemporal trade-off between the current gains from reneging and the future costs which inevitably arise from riding the Phillips curve. The overall conclusion is that the only credible policy is the one that leaves the authority no freedom to react to developments in the future, and that even if aggregate demand policies matter in the short run in this model, a policy of non-intervention is preferable. In view of the time-inconsistency and credibility problem monetary policy should be assigned to a 'credible' and independent Central Bank which should be given as its sole objective that of price stability.

(iii) The level of economic activity fluctuates around the NAIRU, and unemployment below (above) the NAIRU would lead to higher (lower) rates

of inflation. The NAIRU is a supply-side phenomenon closely related to the workings of the labour market. The source of domestic inflation (relative to the expected rate of inflation) is seen to arise from unemployment falling below the NAIRU, and inflation is postulated to accelerate if unemployment is held below the NAIRU. However, in the long run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. In this long run, inflation is viewed as a monetary phenomenon in that the pace of inflation is aligned with the rate of increase of the money supply.

(iv) The essence of Say's Law holds, namely that the level of effective demand does not play an independent role in the determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU). Fiscal policy has a passive role to play in that the budget deficit position varies over the business cycle in the well-known manner but fiscal policy is not required to either 'fine tune' or 'coarse tune' the economy. The budget (at least on current account) can be balanced over the course of the business cycle.

(v) The market system involves 'market failure' in the neo-classical sense of that term; that is markets do not reach an optimum outcome because of the presence of externalities, public and quasi-public goods (that is goods which are non-rivalrous in use and non-excludable), and monopoly situations. The policy conclusion is straightforward, namely that government seeks to correct externalities through appropriate taxation, subsidy and regulation, makes provision for 'public goods' either itself or through paying the private sector to provide the goods and competition policy can be used to reduce or restrain monopoly positions. The extent of government intervention may be extensive depending on views on the extensiveness of externalities and public goods and evaluation of the costs of 'government failure' (for example costs of government collecting relevant information and implementing appropriate policies, inefficiencies in government). This idea is, of course, not unique to the Third Way, and has been a central element in the neoclassical economics welfare economics. It is also the case that it is not the only idea motivating government intervention in a market economy.

(vi) Inequality has many dimensions and can be conceptualised and measured in many ways. It is, though, particularly significant to distinguish here what may be termed pre-market inequality and post-market inequality. The latter, which may also be seen in terms of inequality of outcomes (for example income), results from the former through inequality of 'initial endowments', through (partial or complete) exclusion from participation in the market (for example unemployment, discrimination) and through the ways in which the

market rewards particular endowments. 'Recent discussion among social democrats has quite rightly shifted the emphasis towards the "redistribution of possibilities". The cultivation of human potential should as far as possible replace "after the event" redistribution' (Giddens, 1998, p. 101).

As the quote from Giddens illustrates, there has been a shift from concern over inequality of outcome to inequality of 'possibilities'. The former concern could be seen to be addressed through a progressive tax system and a redistributive social security system. The latter concern can be addressed through education and training (initial endowments), through 'employability' policies (for inclusion in the labour market and employment), and through seeking to change the rewards offered by the market. With the exception of the national minimum wage, it could be said that there has been little attempt to modify the rewards thrown up by the market. As Giddens (1998, p. 101) notes, a 'winner takes all' element in parts of the labour market means large inequalities. But also Giddens (2000, p. 86) perceives that 'that incentives are necessary to encourage those of talent to progress and that equality of opportunity typically creates higher rather than lower inequalities of outcome'.⁷

(vii) The final aspect refers to globalisation, and it has to be recognised that globalisation does not feature in new Keynesian economics but has been central to the analysis of the Third Way. The global nature of financial markets places constraints on the use of fiscal and monetary policy, at least in comparison with the constraints present in the 1950s and 1960s when exchange controls were in place. However, as discussed below, those constraints may be rather benign and take the form of providing well-informed market judgement on the validity or otherwise of the policies being pursued.

The rising ratio of international trade relative to GDP (at least again by way of comparison with the ratios of the 'golden age' of capitalism in the 1950s and 1960s) and the increased role of foreign direct investment by transnational corporations is an accepted (and indeed welcomed) 'fact of life'.

Globalization, in sum, is a complex range of processes, driven by a mixture of political and economic influences. It is changing everyday life, particularly in the developed countries, at the same time as it is creating new transnational systems and forces. It is more than just the backdrop to contemporary policies: taken as a whole, globalization is transforming the institutions of the societies in which we live. (Giddens, 1998, p. 33)

Globalisation is viewed as limiting or ruling out a range of policies, such as domestic based fiscal policies. The nation state still has a role to play, though there are trends for moving government away from the nation state, sometimes in a downward decentralised direction (for example to regions within a country) and sometimes in an upward direction (for example to European

Union). But the role of government is seen to shift towards creating a favourable environment for transnational investment whether in the form of low taxation on profits, subsidies to inward investment or to creating a highly skilled work force. Giddens (2000, p. 73) speaks of the effects of globalisation on policy perspectives in terms of a shift from industrial policy and Keynesian demand measures favoured by 'old' social democracy but also from deregulation and market liberalisation emphasised by neo-liberals.

Third way economic policy needs to concern itself with different priorities – with education, incentives, entrepreneurial culture flexibility, devolution and cultivation of social capital. Third way thinking emphasizes that a strong economy presumes a strong society, but does not see this connection as coming from old-style interventionism. The aim of macroeconomic policy is to keep inflation low, limit government borrowing, and use active supply-side measures to foster growth and high levels of employment.

'In a world of ever more rapid globalization and scientific changes we need to create the conditions in which existing businesses can prosper and adapt, and new businesses can be set up and grow' (Blair and Schröder, 1999, p. 163). 'It is not only the forces of globalization that demands the modernization of our institutions and political programmes, but, to no less an extent, changes in patterns of employment, in values and in demographic and social structures' (Hombach, 2000, p. 31).

It could be argued that the Third Way perceives globalisation as having virtually eliminated the possibilities of industrial policy (other than competition policy) and of macroeconomic policy. The mobility of industrial and financial capital is seen to preclude independent national economics policies in these regards. Labour, however, is much less mobile, and policies such as education and training are to be directed towards ensuring that the national economy is attractive for inward investment through the skills of the workforce.

THE ROLE OF THE STATE

There are many suggestions from the literature that the Third Way would not advocate the scale and range of the State being significantly larger than it is at present. In terms of the level of public expenditure, the general posture seems to be to hold the ratio of public expenditure to GDP at around its present level, but with some restructuring of the composition of public expenditure.

The restructuring of government should follow from the ecological principle of 'getting more from less', understood not as downsizing but as improving delivered value. Most governments still have a great deal to learn from business best

practice – for instance, target controls, effective auditing, flexible decision structures and increased employee participation. (Giddens, 1998, pp. 74–5)

The state should not row, but steer: not so much control, as challenge. Solutions to problems must be joined up. Within the public sector bureaucracy at all levels must be reduced, performance targets and objectives formulated, the quality of public services rigorously monitored, and bad performance rooted out. (Blair and Schröder, 2000, p. 164)

Third way politics, it could be suggested, advocates a *new mixed economy*. Two different versions of the old mixed economy existed. One involved a separation between state and private sectors, but with a good deal of industry in public hands. The other was and is the social market. In each of these, markets are kept largely subordinate to government. The new mixed economy looks instead for a synergy between public and private sectors, utilizing the dynamism of markets but with the public interest in mind. It involves a balance between regulation and deregulation, on a transnational as well as national and local levels; and a balance between the economic and the non-economic in the life of the society. (Giddens, 1998, p. 100)

There is also considerable emphasis on the *investment* role of the State. 'Government has an essential role to play in investing in the human resources and infrastructure needed to develop an entrepreneurial culture' (Giddens, 1998, p. 99). Further, the guideline is investment in *human capital* wherever possible, rather than the direct provision of economic maintenance. In place of the welfare state we should put the *social investment state*, operating in the context of a positive welfare state' (Giddens, 1998, p. 117). Viewing public expenditure as investment provides a positive gloss. It suggests public expenditure has a positive effect and avoids the connotation of waste, and also links with the notion that borrowing can be used to finance public investment rather than current expenditure. It is also significant that investments in education and training (human resources) and in infrastructure are generally viewed as cases where the benefits of the investments cannot be fully appropriated by those who undertake the investments. Hence these investments suffer from a form of market failure and would be undertaken to a suboptimal extent by the private sector.

Further, the State can borrow for investment purposes but not for consumption ones as illustrated below in the discussion of fiscal policy. The rhetoric of the British Third Way has placed considerable emphasis on the so-called 'golden rule' – that over the course of the business cycle governments should only borrow to meet investment needs.⁸

There appears to be little positive role for public ownership, or indeed for social ownership alternatives to individual private ownership, on the Third Way. It is notable that in his first year as leader of the Labour Party, Blair successfully proposed the change of clause 4 of the Labour Party constitution which had stated the objectives of the Party to include 'to secure for the

workers by hand or by brain the full fruits of their industry and the most equitable distribution thereof that may be possible upon the basis of common ownership of the means of production, distribution and exchange, and the best obtainable system of popular administration and control of each industry or service'. This was replaced by a clause which included the idea that 'where those undertakings essential to the common good are either owned by the public or accountable to them', and the last phrase has been interpreted in terms of regulation. Thus in keeping with the 'market failure' approach indicated above the presence of monopolies (as in the case of many utilities) is met by regulation. The Third Way of New Labour has meant not only accepting the privatisations of the previous Conservative government but also engaging in some of their own, albeit on a relatively small scale (which is more an indicator of few assets remaining in public ownership).

The Private Finance Initiative (PFI), which had been introduced by the previous Conservative government, has not only been continued but enlarged. The Labour Party (1997) manifesto spoke of the 'need to simplify the rules of PFI and engage with much greater creativity and energy in driving this project forward' (p. 13). The PFI can be viewed as privatisation not in the sense that previous publicly owned assets are sold to the private sector, but rather in the sense that the type of assets which had historically been owned and managed by the public sector (for example school buildings) may now be constructed, owned and managed by the private sector. The public sector then leases the assets from the private sector for a specified number of years.

Governments have always drawn on private finance: the cumulative effects of which is the national debt. But the PFI differs from bond-financed public expenditure in that the company constructing the asset borrows itself on the finance markets (usually at a higher interest rate than the government), creates the asset, and then leases the asset.

From these brief remarks, it could be said that the Third Way generally sees a somewhat reduced role for the State, and specifically a reduced role in the ownership and management of assets.

CONCLUDING REMARKS

We believe that the theoretical ingredients of the Third Way as just put forward constitute the theoretical foundations of the contributions that follow in this book. We had not sought to ask contributors to adhere to this way of thinking about the economy. On the contrary, the thrust of this introductory chapter was written after the conference. It was based on the contributions therein rather than used as the benchmark of the chapters in the book.

We would very much like to take this opportunity to thank all the

contributors and participants to the conference. Their contributions and comments helped to shape up the contents of this book. The University of East London was generous in its hosting of the conference, as was June Daniels of the Department of Economics who generously provided that invaluable secretarial and related support. Our publishers, Edward Elgar and his staff, were as always absolutely excellent throughout the genesis of this book. We are both grateful to them all.

NOTES

1. It may appear strange that we use both the terms 'new monetarism' and 'new Keynesian' to describe the same approach. However, recall that new Keynesian economics does not involve any significant role for aggregate or effective demand, and shares the common feature of a labour market, supply-side determined equilibrium level of unemployment (the 'natural rate' or the non-accelerating inflation rate of unemployment).
2. The key elements of the new Keynesian research programme 'include the following five propositions:
 - (i) The frictions that prevent rapid and instantaneous price adjustment to nominal shocks are the key cause of business cycle fluctuations in employment and output.
 - (ii) Under normal conditions, monetary policy is a more potent and useful tool for stabilization than is fiscal policy.
 - (iii) Business cycle fluctuations in production are best analyzed from a starting point that sees them as fluctuations around the sustainable long-run trend (rather than as declines below some level of potential output).
 - (iv) The right way to analyze macroeconomic policy is to consider the implications for the economy of a policy *rule*, not to analyze each one- or two-year episode in isolation as requiring a unique and idiosyncratic policy response.
 - (v) Any sound approach to stabilization policy must recognize the limits of stabilization policy, including the long lags and low multipliers associated with fiscal policy and the long and variable lags and uncertain magnitude of the effects of monetary policy' (De Long, 2000, pp. 83–4).
3. One of us (Sawyer, 1992) has argued elsewhere that the definition of 'the market' and hence of the market economy is problematic. We use the term 'market economy' here as shorthand for the interaction of privately owned enterprises.
4. It should be noted that most of the literature on 'rational expectations' and on credibility does not distinguish between different markets and hence all are assumed to hold rational expectations. However, it is the financial markets which are seen as crucial in determining whether a policy is deemed to be credible.
5. Further, from Rogoff (1985), there is the idea that those operating monetary policy should be more 'conservative' (that is place greater weight on low inflation and less weight on level of unemployment) than the politicians.
6. See Forder (2000) for an extensive discussion and critique of the notion of credibility.
7. It could though be argued that inequality of opportunity acts as a barrier for many to fulfil their potential. Those disadvantaged do not forego education because of a lack of incentives in terms of higher pay for the more educated but because of a range of barriers to their doing so. Greater opportunity would be expected to increase the supply of the well trained and so on, and reduce the pay of the well trained relative to the pay of the untrained.
8. It should though be noted that 'investment' in the context of the 'golden rule' is expenditure on fixed capital formation, whereas there is often reference to 'investment in education' or 'investment in health' which may be regarded as investment in human capital but expenditure on education and health which takes the form of salaries, purchase of materials and so on does not count as investment in the capital formation sense.

REFERENCES

- Arestis, P. and Sawyer, M. (1998), 'New Labour, new monetarism', *Soundings*, 9 (Summer), 24–41.
- Blair, T. (1997), Introduction to Labour Party (1997).
- Blair, T. and Schröder, G. (1999), 'Europe: The Third Way/Die Neue Mitte' (reproduced in Hombach (2000), pp. 159–177; to which page numbers in text refer).
- De Long, J. Bradford (2000), 'The triumph of monetarism?', *Journal of Economic Perspectives*, **14**(1), 83–94.
- Forder, J. (2000), 'The theory of credibility: confusions, limitations, and dangers', *International Papers in Political Economy*, **7**(2).
- Giddens, A. (1998), *The Third Way: The Renewal of Social Democracy*, Oxford: Polity Press.
- Giddens, A. (2000), *The Third Way and its Critics*, Oxford: Polity Press.
- Hombach, B. (2000), *The Politics of the New Centre*, Oxford: Polity Press.
- Kydland, F. and Prescott, E.C. (1977), 'Rules rather than discretion: the inconsistency of optimal plans', *Journal of Political Economy*, **85**(3), 473–92.
- Labour Party (1997), *New Labour Because Britain Deserves Better*, London: Labour Party.
- Rogoff, K. (1985), 'The optimal degree of commitment to an intermediate monetary target', *Journal of International Economics*, **35**, 151–67.
- Sawyer, M. (1992), 'The nature and role of markets', *Social Concept*, **6**(2) (reprinted with revisions in C. Pitelis (ed.), *Transactions Costs, Markets and Hierarchies*, Oxford: Blackwell, 1993).