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# The Economics of the "Third Way"*

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This paper seeks to outline the type of economic analysis which we perceive to be involved in the ideas on the 'third way'. In the UK, the emergence and then election of 'new Labour' has been closely associated with the development of the notion of the 'third way'. We sketch out what we see as the analysis of a market economy which underpins the ideas of the 'third way', which is followed by some remarks on the role of the State which is also involved. We seek to illustrate our analysis by reference to the policy statements of the new Labour government in the UK.

## INTRODUCTION

This paper seeks to outline the type of economic analysis which we perceive to be involved in the ideas on the 'third way'. In the UK, 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 neoliberalism. "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 eco-

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* This paper is still in the early stages of development: please do not quote.

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nomic 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).

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. The current notion of a 'third way' is though between neo-liberalism and social democracy, and it is in that sense that we use the term 'third way' (without implying that it is a viable way).

In this paper we being by sketching out what we see as the analysis of a market economy which underpins the ideas of the 'third way', which is followed by some remarks on the role of the State which is also involved. Then we seek to illustrate our proposed analysis by reference to the policy statements of the new Labour government in the UK. It is our view that the economics of new Labour and of the 'third way' do differ substantially and significantly from 'old' Labour and from the 'first way' of 'classical social democracy, and these differences are briefly highlighted in the next section. There is a brief concluding section.

## THEORETICAL FOUNDATIONS

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 has been some notable contributions on the 'third way' (e.g. Giddens, 1998, 1999), 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 paper 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

[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).

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 under-provided 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]

(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, economist or others) in the form of an 'independent' Central Bank.[5] Politicians would be tempted to use monetary policy for short term gain (lower

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[2] The key elements of the new Keynesian research programme 'include the following five propositions:
1) The frictions that prevent rapid and instantaneous price adjustment to nominal shocks are the key cause of business cycle fluctuations in employment and output.
2) Under normal conditions, monetary policy is a more potent and useful tool for stabilization than is fiscal policy.
3) 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).
4) 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.
5) 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' (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 seem 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).

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 know 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

[6] See Forder (forthcoming) for an extensive discussion and critique of the notion of credibility.

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' (e.g. 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 neo-classical 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 (e.g. income) and result from the former through inequality of "initial endowments', through (partial or complete) exclusion from participation in the market (e.g. 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.

(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 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).

Globalization 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 (e.g. to regions within a country) and sometimes in an upward direction (e.g. 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.

## 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).

"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 undertake the investments. Hence these investments suffer from a form of market failure and would be undertaken to a sub-optimal 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.

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 meet 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 remained 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 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 (e.g. 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 is 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.

## THE 'THIRD WAY' IN ACTION: THE 'NEW LABOUR' GOVERNMENT

In this section we seek to illustrate the theoretical ideas outlined in the two previous sections by relating the policies of the new Labour government in the UK to those ideas.

### (i) stability and financial markets

It has often been remarked that words like 'stability' and 'prudence' have peppered speeches of Gordon Brown (Chancellor of the Exchequer), and he has often placed great emphasis on the achievement of stability. By stability, he appears to mean both the stability of policies as well as stability of outcomes (in terms of output and inflation). In a speech soon after coming to power, he argued that "there are five barriers to success that this country has to tackle. We must overcome instability and imprudence in public finances. We must address under-investment and unemployment, and avoid the risk of isolationism" (Brown, 1997b). He then argued that there had to be five long term commitments to overcome those barriers, namely:

> "first, a commitment to monetary stability that allows businesses, as well as families to plan for the future with confidence;
> second, a commitment to long-term fiscal stability, to meeting our priorities within sustainable public finances;
> third, a long-term commitment to higher levels of investment both in people and in business to provide the capacity for strong and stable growth for the long-term;
> fourth, a long-term and far-reaching modernisation of the welfare state so that it complements the needs and realities of modern employment by extending the opportunity to work, and allowing the workforce to adapt within a dynamic economy;
> [...] [and fifth] a long term commitment to free trade and to Europe [...]" (Brown, 1997b)

Monetary stability is to be achieved through the quasi-independence of the Bank of England and the setting of an inflation target as outlined in the next section. Fiscal stability from the adoption of a Code of Fiscal Stability as outlined in the section after next.

One illustration of the idea that governments have been a cause of instability is contained in the following. "One key factor [for the UK's poor inflation record] — a factor under the Government's control — was that poor institutional arrangements were in place over this period. Monetary policy, if set correctly, should be a stabilising force for the economy. However, on too many occasions serious mistakes were made, which often meant that inflation was higher and more volatile that it would otherwise have been. This, in turn, created substantial economic instability that harmed the long-term performance of the UK economy" (Treasury, 1999).

"Today the judgement of markets — whether to punish or to reward government policies — is as swift as it is powerful" and "to succeed, countries must convince the markets that they have the policies in place for long-term stability" (Brown, 1997b). The context of these remarks suggests that markets should read global financial markets, rather than, say, labour markets.

It is nothing new for Labour (and other) politicians to feel heavily constrained by the operations of the financial markets. The 'gnomes of Zurich' (representing anonymous but powerful foreign financial markets) became a frequently attacked figure in the 1960s Wilson Labour government when markets were perceived to be attacking the fixed value of sterling. It is also indisputable that in global capital markets now "investors have more choice and more freedom than ever before, and [...] day to day flows of capital are greater and faster than ever before" (Brown, 1997b). But what is different is the view that the financial markets are benign. Blair, for example, has argued that "errors in macroeconomic policy will be punished rapidly and without mercy" (Blair, 1996) and Brown (1999) suggests that "in the new open economy, subject to instantaneous and massive flows of capital the penalties for failure are ever more heavy and the rewards for success are even greater" (p.7).

These brief quotes (and there are many other such policy statements) suggest a view that instability emanates from government policy (admittedly to be often labelled as mistakes) rather than from private markets, and that (financial) markets provide sound judgement on the credibility of economic policies.

**(ii) monetary policy**

The first significant act of the incoming Labour government in May 1997 was to announce that the Bank of England was to be given operational independence with interest rate set by a newly established Monetary Policy Committee (MPC) of the Bank of England to meet an inflation target (initially set at 2.5 per cent +/- 1 per cent). Brown (1997b) argued that the 'independent' Bank of England will "deliver the inflation target consistently over the long-term. If inflation is 1 per cent higher or, for that matter, lower than the target 2.5 per cent, then the Governor, on behalf of the Monetary Policy Committee, should write an open letter to the Chancellor. That letter should explain: the reasons why inflation has moved away from the target by more than 1 percentage point; the policy action which are taking to deal with it; the period within which they expect inflation to return to the target; how this approach meets the Bank's objectives as set by the government". He also argued that "interest rate decisions will be free from any political influence. They will be recognised as being based on good long-term economics: beyond any accusation of bad short-term politics. My appointments to the Monetary Policy Committee, made with the Governor's agreement, were based on economic expertise, not party political persuasion".

In a recent major speech, Brown argued that "the new post-monetarist economics is built upon four propositions:

• because there is no long term trade off between inflation and unemployment, demand management alone cannot deliver high and stable levels of employment;

• in an open economy rigid monetary rules that assume a fixed relationship between money and inflation do not produce reliable targets for policy;

• the discretion necessary for effective economic policy is possible only within a framework that commands market credibility and public trust;

• that credibility depends upon clearly defined long-term policy objectives, maximum openness and transparency, and clear and accountable divisions of responsibility" (Brown, 1999, p.5).

The first of those propositions is essentially an acceptance of a NAIRU framework, further discussed in the next section. The second is in effect a rejection of what may be termed crude monetarism, namely that the growth of the money stock determines the rate of inflation. The third and fourth propositions bring in the view that macroeconomic policy is discretionary rather than rules based though within the framework of the inflationary objective and the discretion exercised by an independent body (that is the Monetary Policy Committee). These propositions also incorporate the significant of credibility of policy in the eyes of the financial markets.

**(iii) NAIRU**

Within new Keynesian economics, there are many different approaches to the modelling of the supply-side of the economy, and specifically to the labour market. Some approaches, such as those of implicit contracts and menu costs, are more concerned to explain a degree of inflexibility of wages and prices in the face of demand changes. Some others, notably efficiency wages and insider-outsider models, seek provide to explanations of equilibrium levels of unemployment. Yet others, perhaps exemplified in Layard, Nickell and Jackman (1991) model price and wage determination based on some form of mark-up pricing and wage determination based on bargaining or on efficiency wage consideration from which a NAIRU is derived.

The 'equilibrium' level of output and employment depends on supply side factors, that is corresponds to the NAIRU, and those supply-side factors are generally seen in terms of labour market characteristics (rather than, say, the capacity potential of the economy). Various factors are said to determine the level of the NAIRU. These can include factors such as the power of trade unions and of business but also the skills and 'employability' of the work force (the latter is lowered by a history of unemployment). The policy instruments overlap (e.g. reduce trade union power but in the era of 'new monetarism', trade union power is no longer considered an issue), and initially seemed to involve a focus on education, skills, improving employability. This leads to declarations such as "New Labour believes in a flexible labour market that serves employers and employees alike" (Labour Party, 1997, p.15); also that "The more our welfare to work reforms allow the long-term unemployed to re-enter the active labour market, the more it will be possible to reduce unemployment without increasing inflationary pressures. And the more our tax and benefit reforms remove unnecessary barriers to work, and the more our structural reforms promote the skills for work, the more it is possible to envisage long-term increases in employment, without the fuelling of inflationary pressures" (Brown, 1999, p.10).

The concept of the NAIRU (non-accelerating inflation rate of unemployment) plays a significant role in the thinking of the Treasury. For example, "The sustainable rate of unemployment, or NAIRU, is believed to have risen in the UK during the 1970s and 1980s, but there is broad agreement that this increase has been partly reversed since the late 1980s. Although the magnitude of any fall is very difficult to estimate, most estimates of the current level of the NAIRU lie in the range of 6 to 8 per cent on the LFS measure of unemployment. However, considerably lower levels should be achievable in the long run through re-integrating the long-term unemployed back into the labour market, upgrading skills, and reforming the tax and benefit systems to promote work incentives (Treasury, 1997, p.82).

However, "the idea of a fixed natural rate of unemployment consistent with stable inflation was discredited by the evidence of the 1980s" (Brown, 1999, p.9), presumably on the grounds that unemployment and the estimates of the natural rate moved higher during the 1980s. "So the new government has taken a decisively different approach to employment policy over the past two years aimed at reducing the NAIRU" (Brown, 1999, p.10)

In the quotes given above, there is some acknowledgement that the level of the NAIRU shifts over time, and specifically "the 'scarring effect on skills and employability inflicted by the deep and long recession of the 80s", "the mismatch between skills and expectations of redundant manufacturing workers", and "the failure to reform the Welfare State especially its unemployment and poverty traps which, for many, meant work did not pay" (Brown, 1999, p.10). This notion has been given the label of hysteresis and path dependency within the new Keynesian literature.

The NAIRU is generally viewed as a labour market phenomenon, and hence actions to change the NAIRU should focus on the labour market. This is reflected in the statement from Brown quoted above: the shifts in the NAIRU are all ascribe to factors which influence the effective supply of labour. However, the NAIRU is based on the interactions of price and wage determination, and the abilities of firms to employ labour and to supply output and their pricing and output decisions are also relevant. Specifically, the productive capacity of firms is relevant for their ability to offer employment and influences the real wages which they offer. In a number of papers (e.g. Arestis and Sawyer 1999, Sawyer, 1999) we have argued this more formally.

**(iv) fiscal policy**

Fiscal policy is supposed to fulfil two criteria in delivering sound public finances:

- "*the golden rule* — an average over the economic cycle, the Government will borrow only to invest and not to fund current spending; and,
- [...] *the sustainable investment rule* — the public sector net debt as

a proportion of GDP will be held over the economic cycle at a stable and prudent level" (Treasury, 1999, p.19).

Both these rules seem to involve balancing the current budget. However, these rules are not sufficient to fix precisely the size of the budget deficit since it merely refers to borrowing to finance investment, but without saying what the scale of investment is[7]. Furthermore, fiscal policy is viewed largely in passive terms, that is the budget position may vary over the course of the business cycle but is not managed in any active manner to achieve high levels of employment. Indeed, government pronouncements have repeatedly praised the virtues of 'sound' government finances and the achievement of surpluses. Brown (1999) argues that "governments which pursue, and are judged by the markets to be pursuing sound [...] fiscal policies, can attract inflows of investment capital more quickly, in greater volume and at lower cost than even ten years ago" (p.7).

### (v) 'market failure'

The 'market failure' approach is neither unique to the new Labour government nor does it describe all of its microeconomic policies. It is rather that the 'market failure' approach is consistent with some major thrusts of policy and that microeconomic policies which fall outside the ambit of 'market failure' approach have been largely abandoned.

There has been changes to competition and monopoly policy which fit with this argument. "We will reform Britain's competition and consumer protection laws and in the utility industries we will promote competition where possible and pursue tough, efficient regulation where necessary" (Labour Party, 1997, p.14). The 1998 Competition Act is a prohibition-based competition policy which outlaws a range of anti-

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[7] Keynes can be viewed as advocating something akin to the 'golden rule', that is current budget balanced and capital expenditure deficit financed. However, there is a rather crucial difference, namely that the level of public investment should be set so as to match the excess of private savings over private investment to ensure aggregate demand consistent with a high level of employment. Keynes argued that "in peace-time budgets through the Chancellor making a forecast of capital expenditure under all heads, and comparing this with prospective savings, so as to show that the general prospective set-up is reasonably in accordance with the requirement of equilibrium. The capital budget will be a necessary ingredient in this exposition of the prospects of investment under all heads. If, as may be the case, something like two-thirds or three-quarters of total investment will be under public or semi-public auspices, the amount of capital expenditure contemplated by the authorities will be the essential balancing factor. This is a very major change in the presentation of our affairs and one which I greatly hope we shall adopt. It has nothing whatever to do with deficit financing" (Keynes, 1980, p.352). The sheer scale of public investment could be noted: but of more significance to our argument here is the notion that public investment is used as a balancing item, bringing overall savings and investment into line (presumably at full employment or at least a high level of employment). But the capital budget proposals would mean that public investment was financed from the difference between private savings and private investment (at high level of employment). In this context, we can note a letter written in 1944 from Meade to Keynes in which he wrote that "it is my fear that if the budget is divided into a capital and a current budget, this will reinforce the orthodoxy of an annual balance for the current budget" (reported in Keynes, 1980, p.318).

competitive practices, and harmonises UK law with European Union legislation on restrictive practices (see Parker, 2000 for a review). This Act represents some significant changes in the competition law, though antecedents for it can be found in pronouncements of the previous government. The significance here is the stress on the benefits of competition and the role of government in creating conditions of competition.

The 'market failure' arising from forms of 'natural monopoly' in the utilities has been approached by new Labour through regulation rather than through changes in ownership. A range of changes in the regulatory framework for the utilities have been proposed and/or made (for initial set of proposals see A Fair Deal for Consumers, Cmnd. *****). "Regulatory institutions and processes are important. They are the key to securing better decisions, better understood and more widely accepted decisions, and greater legitimacy. With legitimacy and acceptance comes regulatory stability" (from web site).

The policies to emphasise education and training can be seen in the correction of 'market failure' terms. It is a well-known argument that the private market would under-invest in training and skill acquisition.

Previous Labour governments have also recognised 'market failures' but these have been of a much broader form than envisaged in neo-classical economics: failure of the capital market, failure of managers, a failure of industries to achieve appropriate structures etc.. There had particularly been policies to restructure industries. In many cases nationalisation can be seen as forming a vertically integrated single firm industry which could exploit economies of scale: each of the post-war Labour governments had extended public ownership. The Industrial Reorganisation Corporation of the 1960s and the Industrial Strategy and National Enterprise Board of the 1970s fit into this mould. Labour Party (1989) calls itself 'supply side socialism': "In our report, *A Productive and Competitive Economy*, we set out our strategy for 'supply side socialism'. In our view, the economic role of modern government is to help make the market system work properly where it can, will and should — and to replace or strengthen it where it can't, won't or shouldn't. … The Conservatives are the party for the City. We are the party for industry and, like the governments of our competitors, we will form a government that helps industry succeed" (p.6 of the introduction signed by Neil Kinnock)).

In so far as there are perceived failings of the British economy, this now seems to be assigned to failures of education and training. Since education is largely provided by the public sector, this translates into a failure of the public sector rather than the private sector. If there is a mismatch between the demands of business in terms of skills etc. and the supply of such skills, blame is attached to the supply side rather than to the demand. There is a sense in which the thrust of policy has changed from seeking to make British industry competitive (or similar phrase) to one of making the British work force, tax system and regulatory regime welcoming to foreign direct investment.

**(vi) inequality**

The major ways by which the State redistributes income 'after the event' is clearly through the structure of the tax system and the social security system (though it generally appears that the tax system is a proportional one and hence with virtually no redistributive element). The general thrust of the new Labour government has been to change the taxation system in the direction of maintaining the higher rates of income tax and the rate of value added tax, but with some reductions in the lower and standard rates of tax (and with increases in some 'stealth taxes' such as tax on insurance premia). In a similar vein, the changes in social security benefits have been focused mainly on low income old age pensioners, with the indexation of benefits to prices (rather than wages) being largely maintained.

It is perhaps surprising to find that one of the major policy initiatives of the Labour government has been the introduction of the national minimum wage (especially as it is a policy long advocated by many trade unions, particularly by the more left wing ones). It is re-distributive and it involves intervention in the 'free market'. However, a minimum wage involves some clear winners, but the losers are less clearly identified and income reduction is spread over many whilst the income gains are relatively concentrated. Further, efficiency wage type arguments are invoked (whereby an increase in wages invokes increases in productivity). Arguments based on discriminating monopsony models have also been invoked. This may be an example of where the implications of new Keynesian arguments (based on efficiency wages and insider-outsider models) coincide with those from arguments based on pursuit of equality and fairness to underpin a policy of national minimum wages. 'It could be argued that the minimum wage should be seen as part of the 'new welfare' policies that moved away from increased public expenditure and taxation. As such, it could be argued, that the minimum wage was a policy acceptable to the right of the party because it was cost-free' (Hill, 1999, p.158). It is then significant that the hourly rate set for the minimum wage of £3.60 is pitched somewhat below the lowest hourly wages prevailing in the public sector, whereas a rate more like £4.50 an hour would have a significant impact on public sector pay and hence on the volume of public expenditure.

There has been a much greater emphasis on reducing inequality (specifically the reduction of poverty) through the creation of employment opportunities and participation in the labour market. These policies have taken a variety of forms as indicated in the companion paper (Arestis and Sawyer, 2000). There have also been a range of policies under the general heading of the 'New Deal' which has also sought to lead people back into employment. "The New Deal ... offers opportunities to work but demands obligations to do so is the first comprehensive approach to long term unemployment. Designed to reengage the unemployed with the labour market, it addresses both the scaring effects of unemployment and the mismatch between jobs and skills. The Working Families Tax Credit and associated reforms that integrate tax and benefit are, for the first time, making work pay more than benefits, and our education reforms including lifelong learning, the university for industry, individual learning accounts and our computers for all initiative will tackle skill deficiencies" (Brown, 1999, p. 10). This quote does not specifically mention inequality but does illustrate the focus on moving people back into work, though with the implicit assumption that jobs are available.

### (vii) globalisation

In most respects, the new Labour government has continued the policies of its predecessors in so far as they interact with globalisation. The exchange rate is left to be determined in the exchange markets, and indeed the overvaluation of sterling (not unrelated to the interest rate pursued by the Bank of England) has been accepted and even welcomed by government ministers. As indicated above, monetary and fiscal policies have been designed with the intention of their acceptance as credible in the financial markets. There has been no change with respect to the policy of attracting inward direct investment, with no attempt to ensure that the benefits of the inward investment outweigh the costs.

(merge in) Previous Labour governments have recognised the problem of low levels of investment. In the Labour Party manifesto there was some passing references to the need to build up investment, though usually with reference to training and education. There is, however, little by way of clear proposals for increasing investment and creating the necessary capacity so that full employment can be restored. The little there is clearly suggests a policy of making the UK attractive to inward investment. 'With Labour, British and inward investors will find this country an attractive and profitable place to do business' (Labour Party, 1997, p. 15). If this has any meaning, it must be the first time that a Labour government has proclaimed that it seeks to shift income from wages to profits. Whatever the merits of inward investment, government policy should be directed towards ensuring that the gains of that investment accrue to the British people and not to the multinational enterprises. Further, there is little reason to think that inward investment will create jobs in areas of high unemployment, and does little to encourage local entrepreneurial activity: it is more like the promotion of a dependency culture.

## CONCLUSIONS

The economic policies of Social Democrat governments did not fit into an single mould, and of course varied over time and across countries. At the cost of gross over-simplification (and no doubt other costs as well), we would suggest that the following played significant roles (at least so far as the UK is concerned). There was an acceptance of some key aspects of Keynesianism, particularly that budget deficits can be used to support aggregate demand. Each postwar Labour government made some extension of public ownership. The perceptions of the 'failures' of the economy which were broader than 'market failure'. These failures have ranged over lack of exploitation of economies of scale, poor management, under investment etc.. Unemployment to be addressed through regional and industrial policies rather than labour market policies. There was generally a use and development of some forms of corporatism, for example, through tripartite approaches to industrial policy, the operation of incomes policy.

It is clear that the 'third way' and the new Labour government operate along quite different lines. Macroeconomic policy is better described as 'new monetarism' with a rejection of Keynesianism, with an emphasis on control of inflation rather than the reduction of unemployment and a perceived need to acquire credibility in the financial markets. We have described microeconomic policy as concerned with the correction of 'market failures': this can also be seen as a policy which accepts the beneficial operation of markets, albeit one that can be improved by appropriate government action. The 'third way' does appear to seek to better prepare individuals to compete in the market, e.g. through training and education[8]. These features suggest to us that the 'third way' is 'neoliberalism with a human face'.

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[8] For example, 'in this new economy our task is to ensure that, as individuals and companies and indeed as a country, we are fully equipped to contribute to and compete within this global marketplace' (Brown, 1999). 'Foreign investors do want a flexible labour market, but they are concerned about the poor level of our skills and education. The new Labour approach should be to correct the defects of the latter, without undermining the former' (Labour Party, 1997, p.15).