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Clinton and Blair: The Economics of the Third Way

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Abstract

Former United States President Bill Clinton and the current Prime Minister of the United Kingdom Tony Blair have both described their approach to public governance as a 'Third Way' that is neither of the Right nor Left but new and different. Clinton and Blair have claimed that their Third Way is a social democratic response to the demands posed by globalization, composed of increased public investment on the one hand and 'sound' public finance on the other. The concept of a Third Way has also gained currency in Australian political circles, especially amongst the Australian Labor Party, and is particularly associated with politicians such as Mark Latham (1998) and Lindsay Tanner (1999). The Third Way has also been invoked by Liberal politicians such as Tony Abbott as well as popular economic and social commentators such as Clive Hamilton (2003).

Current interpretations of Clinton and Blair's Third Way are brief and limited to the philosophical and political. The purpose of this paper is to analyse the Third Way as an economic policy programme and its analysis finds that conflict between public investment and 'sound' public finance emerged and was resolved in favour of the latter, locating Clinton and Blair's Third Way within standard neoclassical theory. Their Third Way is thus, contrary to Clinton and Blair's claims, neither 'new' nor social democratic.

Introduction

On 27 January 1998, five minutes into his sixth State of the Union Address, President Bill Clinton announced to the many dignitaries assembled in the United States' Senate Chamber: 'My fellow Americans, we have moved past the sterile debate between those who say government is the enemy and those

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who say government is the answer. My fellow Americans, we have found a third way' (Clinton 1998).

Later the same year the Prime Minister of the United Kingdom, Tony Blair, wrote: 'the "Third Way" is to my mind the best label for the new politics which the progressive centre-left is forging…' (Blair 1998, p. 1).

The Third Way is 'New'?

Use of the term 'third way' is not new but has been used to describe quite an eclectic range of different governments since at least the end of the 19th century when Pope Pius XII called for a third way between socialism and capitalism (Reich 1999, p. 46).

So what is meant exactly by the latest use of the term, that associated with Clinton and Blair. It is with this last form of the Third Way – that of Clinton and Blair's – that this paper is concerned and, in particular, with exploring their Third Way as an economic programme, with the aim of determining whether it is in fact 'new' or if it actually adheres to some existing economic theoretical tradition(s).

Existing analyses of the Third Way focus on its philosophical and political nature but economic assessments are lacking. Thus, it is the purpose of my research to analyse the Third Way as an *economic* programme. Before turning to an assessment of the Third Way as an economic programme, an overview of the Third Way as both a social philosophy and as a political strategy is warranted.

The Third Way as a Social Philosophy

One interpretation seeks to explain the Third Way as an emerging social philosophy. The Third Way's current chief philosopher and the person Scanlon (1999, p. 25) describes as 'Tony Blair's favourite intellectual' has written extensively about the Third Way as an alternative public philosophy to the two other ways of 'classical social democracy' and neoliberalism (Giddens 1994; 1998; 2000a; 2000b; 2000c; 2001). It is an alternative public philosophy, according to Giddens, because it transcends both social democracy's concerns with economic security and redistribution and neoliberals' concern with competitiveness by uniting these values in developing an 'entrepreneurial

culture' that addresses the nature of contemporary societal risks rather than abandoning individuals 'to sink or swim in an economic whirlpool' (Giddens 1998, p. 99).

The Third Way as a Political Strategy

Another interpretation – and one which enjoys widespread support – is that of the Third Way as a political strategy designed to reposition parties of the Left within the political mainstream as a viable alternative to those of the Right, capable of successfully governing capitalist economies in the age of globalisation (Reich 1997; Dionne 1999; Harris 1999; Hay 1999; King & Wickham Jones; 1999; Morris 1999; Scanlon 1999; Baer 2000; Campbell & Rockman 2000; Meeropol 2000).

The literature in this interpretation utilises Anthony Downs' framework from his *Economic Theory of Democracy* (1957). Down's argued that 'political parties tend to maintain the ideological positions that are consistent over time unless they suffer drastic defeats, in which case they change their ideology to resemble that of the party that defeated them' (Downs 1957, p. 300).

According to Dionne (1999, p. 303), voters like and want capitalism so that in order to win elections 'parties of the left…have to prove they're comfortable with the market [economy] and accept its disciplines'. Harris (1999, p. 52) adds that if parties of the Left were to persist in what he calls the 'redundant argument of socialism versus capitalism', they would face certain political irrelevance. In this way, the Third Way represents a reinvention of the Left so as to re-enter the mainstream political debate. We can now turn to considering the Third Way as an economic programme.

A 'New' Agenda for Globalisation: The Third Way as an Economic Programme

A third interpretation of the Third Way is that of a national economic programme for addressing the demands of globalisation. This interpretation is not mutually exclusive to the preceding two and is the one with which this paper is specifically concerned. The Third Way economic programme begins with the analysis that the world is undergoing unprecedented change in the form of rapid economic and technological globalisation. Clinton (1996) argues: 'the future prospects of average Americans today are being driven by

one central force: rapid economic change'. Blair similarly observes that the Third Way 'is about addressing the concerns of people who [are] undergoing rapid change…in a world of ever more rapid globalisation' (Blair & Schroeder 1998, p. 157).

The fundamental drivers of this 'rapid economic change' in the Third Way are the instantaneous mobility of capital across national frontiers and the emergence of global networks of production and competition, both facilitated by developments in information technology.

The importance of international modes of production is that goods and services are no longer produced and consumed within the one country but, facilitated by technology, can be designed in one or more countries, manufactured in others and exported to yet others for consumption. Thus, competition between countries for employers, and hence for employment, has become as global as the competition between producers for sales.

The implications of the instantaneous mobility of capital across national frontiers are particularly significant for national economic policy. Most importantly, it is understood to mean that national governments that do not observe the economic policy preferences of the international capital markets risk capital flight.

Thus, the Third Way economic programme can be understood as a national response to the development of globalisation consisting of two strategies: one for economic growth and the other for the management of public finance. Each will be considered in turn.

The Third Way as a Programme for Economic Growth

As a programme for economic growth, the Third Way is predicated on the idea that capitalism has entered a new stage of development – the 'New Economy' – in which technological innovation and human capital have become especially important as the factors of economic growth. As Blair argues:

> The new economy – like the new politics [the Third Way] is radically different...Its most valuable assets are knowledge and creativity. The successful economies of the future will excel at generating and disseminating knowledge, and commercially exploiting it. The main source of value and competitive advantage in the modern economy is human and intellectual capital. (Blair 1998, p. 8)

Indeed, for the Third Way, economic growth depends only on technological innovation. In turn, technological innovation, it argues, demands higher levels of skills and education, hence the premium the Third Way places on high educational standards. According to Blair (1998, p. 6), 'technological advance and the rise of skills and information as key drivers of employment and new industries…[are] placing an unprecedented premium on the need for high educational standards'. Income in the knowledge economy is dependent on education. Or as Clinton and Gore (1992, p. 16) put it: 'what you earn depends on what you learn'.

The proliferation of information technology, according to the Third Way, has led to a declining demand for unskilled workers, whose job opportunities and wages therefore also decline, whilst those with high skills or education can command a premium income (Giddens 2001, p. 183). In addition, the 'Fordist' model of mass industrial production and the long-term employment it offered has been replaced by the rise of the dynamic 'information economy' with an associated increase in workforce fragmentation and employment instability (Reich 1991).

Given these economic developments, the appropriate national response, according to the Third Way, is to equip people with the education, training and skills which will enable them to prosper in the knowledge economy. Specifically, governments should invest in education, research, technology and associated infrastructure. In fact, Clinton (1996, p. 38) has argued that the most important part of his strategy 'has been investing in our people and our future – in research and technology, in education and skills'. Similarly, Blair (1996, p. xii) has called for 'an economic strategy based on investment in people, infrastructure and industrial research and development'.

Thus, as an employment strategy the Third Way is predicated on the idea that the unemployed can be helped into the labour market through various supply-side policies (principally education) without the need for a demand-side agenda.

In terms of economic theory, the Third Way programme for economic growth is primarily based on evolutionary economic theory and its rich literature on so-called 'national systems of innovation'. Metcalfe (1997, p. 285) defines national systems of innovation (NSI) as 'a system of interconnected institutions to create, store and transfer the knowledge, skills and artifacts which define new technologies'.

Normatively, the NSI approach advocates a central and active role for government institutions in promoting innovation and economic growth through the provision and investment in legal and regulatory infrastructure, education and training, as well as physical infrastructure.

Within the NSI approach, Michael Porter and Robert Reich have had a particularly strong influence on the Third Way programme. In his 1990 work *The Competitive Advantage of Nations*, Porter (1990, p. 617) argues that 'the central goal of government policy towards the economy is to deploy a nation's resources with high and rising levels of productivity' through investment in both physical and human capital, education, research and infrastructure.

The other particularly influential adherent to the NSI approach is Robert Reich (1991), who served as Clinton's first Secretary of Labour. In his *Work of Nations: Preparing Ourselves for 21st Century Capitalism* (1991), Reich argues that that the international mobility of capital, the emergence of global networks of production and the ascendancy of the information economy point to the need for government to invest in the human capital of its workforce as its most important (and perhaps only) enduring resource in the pursuit of national prosperity.

Thus, in the Third Way's programme for economic growth, the principal role for government is to invest in the provision of education, research and public infrastructure. This policy points to the need for increased public spending in the provision of these public goods.

We now turn to consider the other component of the Third Way economic programme: its programme for public finance.

The Third Way as a Programme of Public Finance

The other component of the Third Way programme – its programme of public finance – promulgates the principles of 'sound' public finance. In fact, Tony Blair and German Chancellor Gerhard Schröeder have implored that 'sound public finance should be a badge of pride for social democrats' (1998, p. 167). The Third Way programme favours tight fiscal policy, low rates of taxation and monetary stability, rejecting Keynesian demand-side policies as incompatible with the demands of global capital (Clinton 1996, p. 22; Blair 1998, p. 10). As Blair (1998, p. 10) warns: 'in macroeconomic policy…countries cannot "go-it-alone": they must be continually sensitive to

the international economy and its driving forces', otherwise they risk losing investment and employment through capital flight.

In terms of economic theory, 'sound' public finance is firmly based on the standard neoclassical theory of public finance. Neoclassical theory views the economy as always being or tending to be fully employed, so that all resources are fully utilised and therefore goods and services purchased by the government cannot also be purchased by the private sector. Hence, any government expenditure must displace a proportion of private expenditure – so-called 'real crowding out' (Arestis & Skouras 1985, p. 100).

Funds borrowed by the government to purchase goods and services in excess of tax-revenue (deficit-finance) cannot also be borrowed by the private sector and, by causing interest rates to rise, government borrowing can displace private borrowing – so-called 'financial crowding-out'. In an open economy, higher interest rates due to public budget deficits' attract foreign lenders which appreciates the currency and reduces the affordability (and therefore volume) of exports. This can result in a current account deficit. This argument – that public budget deficits can also cause trade deficits – is the neoclassical theory of the twin deficits. It will be shown that the neoclassical theories of crowding out and the twin deficits exerted a decisive influence on the Third Way's practice of macroeconomic policy. It is of historical interest to note that Adam Smith pioneered the theory of crowding out as early as 1776 in his *Wealth of Nations* (1776, p. 925).

Normatively, neoclassical theory's concern with government is two-fold (Buchanan, Rowley & Tollison 1986, pp. 49-78). First, increased government expenditure increases the size and scope of the state at the expense of individual liberty. Second, the public sector is not thought as capable of allocating resources as efficiently as the private sector. Therefore, government expenditure should be kept to a minimum so as to interfere as little as possible with the efficient (private) allocation of resources.

Increased Public Investment versus 'Sound' Public Finance

At this point a potential conflict within the Third Way economic programme clearly emerges. Its programme for economic growth – based as it is on evolutionary theory – calls for increased public investment in education and infrastructure. Its programme of public finance, however, advocates neoclassical theory's prescription for 'sound' public finance: balanced or

surplus budgets, low taxation and minimal government spending. It will be shown that, given these two competing demands, *in practice* the Third Way sacrificed its programme of public investments to adhere to its neoclassical programme of 'sound' public finance.

The Third Way in Practice

The defining feature of the Third Way's macroeconomic policy is its fiscal austerity (Council of Economic Advisers 2001, p. 81). In the United States, the cumulative effect of Clinton's fiscal policy was to reduce the budget deficit every year in office, from 3.9 cent of gross domestic product (GDP) in 1993 to a surplus of 2.4 percent in the year 2000 (Office of Management and Budget 2002, Table 1.3). In the process, he reduced federal net debt from 49.5 percent of GDP in 1994 to 34.7 percent in 2000 – the lowest level since 1984 (Office of Management and Budget 2002: Table 7.1). The difference between the pre-Clinton deficit path and after is striking: before 1993 the national debt was expected to *exceed* GDP by 2009, yet in 2001 the President's Council of Economic Advisers projected its *elimination* by 2011.

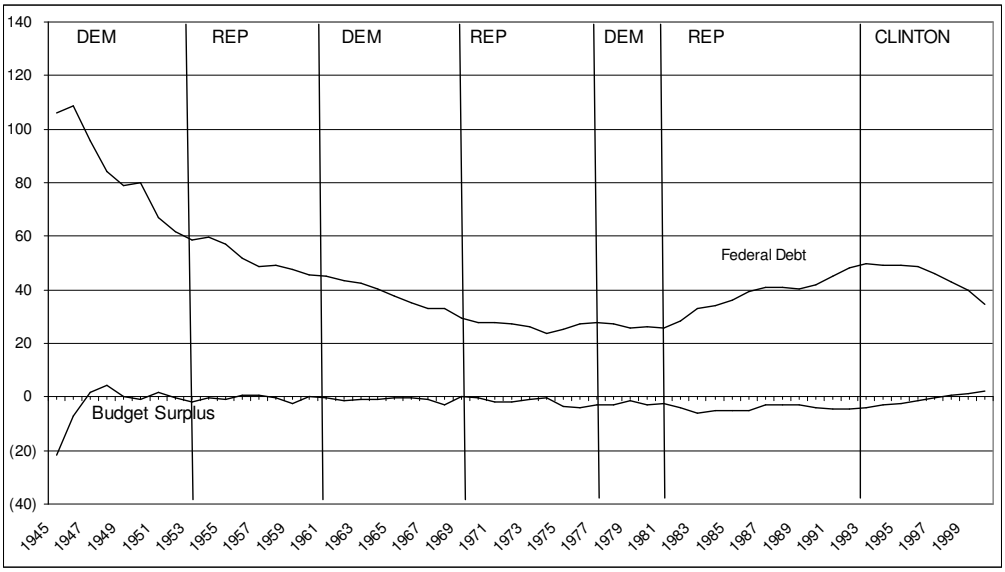
Clinton told the Congress in his 1998 *State of the Union Address*:

> Americans in this chamber and across our nation have pursued a new strategy for prosperity: fiscal discipline to cut interest rates and spur growth…Tonight, I come before you to announce that the federal deficit – once so incomprehensibly large that it had eleven zeroes – will be simply…zero…And if we maintain our resolve, we will produce balanced budgets as far as the eye can see. We must not go back to unwise spending, or untargeted tax cuts, that risk reopening the deficit…I ask all of you to meet this test: approve only those priorities that can actually be accomplished without adding a dime to the deficit. (Clinton 1998)

Eventually, Clinton came to credit his policy of fiscal discipline as the cornerstone of economic growth. The following passage, for instance, is to be found repeatedly throughout his economic policy documents and is also a precise summary of the neoclassical theories of crowding out:

> Our strategy has been based, first and foremost, on a commitment to fiscal discipline. By first cutting and then eliminating the deficit, we have helped to create a virtuous cycle of lower interest rates, greater investment, more jobs, higher productivity, and higher wages…As the deficit becomes a surplus, the virtuous cycle keeps turning…mounting surpluses mean that the government, rather than draining resources away from private investment, is now freeing them up. Budget deficits force the Government

> to borrow money in the private capital markets. That borrowing competes with (1) borrowing by businesses that want to build factories and machines that make workers more productive and raise incomes, and (2) borrowing by families who hope to buy new homes, cars, and other goods. The competition for funds tends to produce higher interest rates. (Council of Economic Advisers 2001, p. 43)

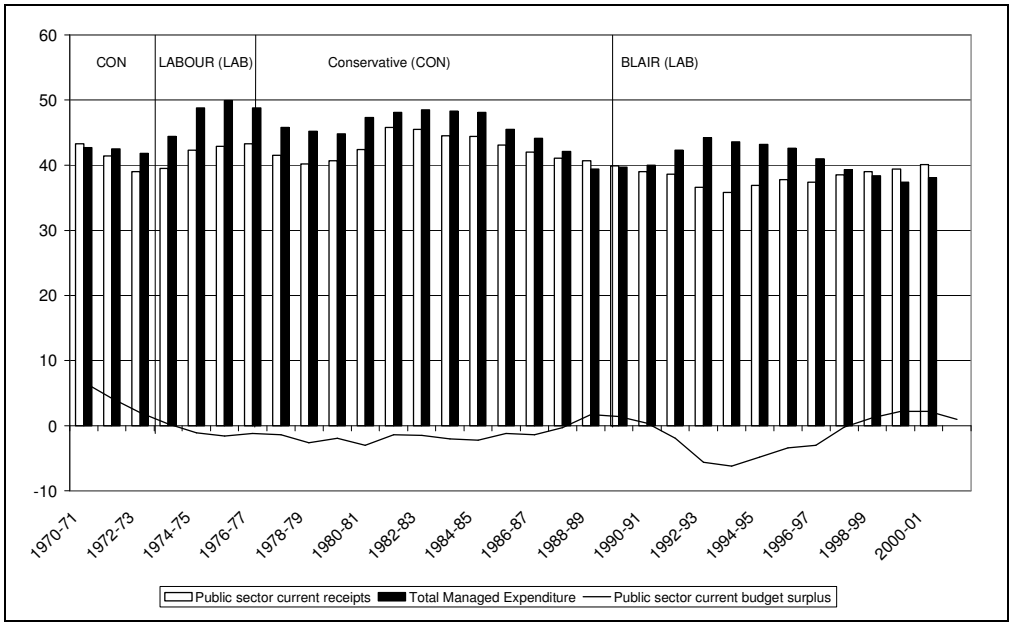


Source: Office of Management and Budget 2002, Tables 1.2 and 7.1)

Figure 1: US Federal Budget Surpluses and Federal Debt (Percentage of GDP), 1945-2000

Based on his 1991 analysis, Reich wrote in 1992 that the Third Way's 'centerpiece…is a major increase in public investment in education, training, and infrastructure' (Reich 1992, p. 1). However, due to the Clinton's commitment to reduced government spending – what Reich calls the 'conceptual prison' of deficit reduction (1997: 1999) – Clinton was unable to match that rhetoric with actual public investments. As Reich (1999, p. 3) notes about the Clinton Administration, due to its fiscal discipline it '…didn't give [public investment] a chance'. Without the all important public investment agenda, Reich describes the Third Way as not a third way at all but '…the Second Way, blazed by Reagan and Thatcher' (Reich 1999, p. 12). Reich's disappointment with the Third Way *in practice* eventually compelled him to resign from the Clinton Cabinet (Reich, 1997).

The story with Blair's fiscal policy in the United Kingdom is remarkably similar to Clinton's. As Blair had promised in his 1997 election manifesto, New Labour adhered to the previous Major Conservative Government's spending limits for its first term in office (Foley 2000, p. 98). In its 2001 budget, the Blair Government restated its ongoing commitment and adherence to its two fiscal rules: first 'the golden rule' that over the economic cycle it will borrow only to invest and not to fund current spending and, second, its 'sustainable investment rule' which requires that public sector net debt as a proportion of GDP be maintained below 40 percent over the economic cycle (HM Treasury 2001).

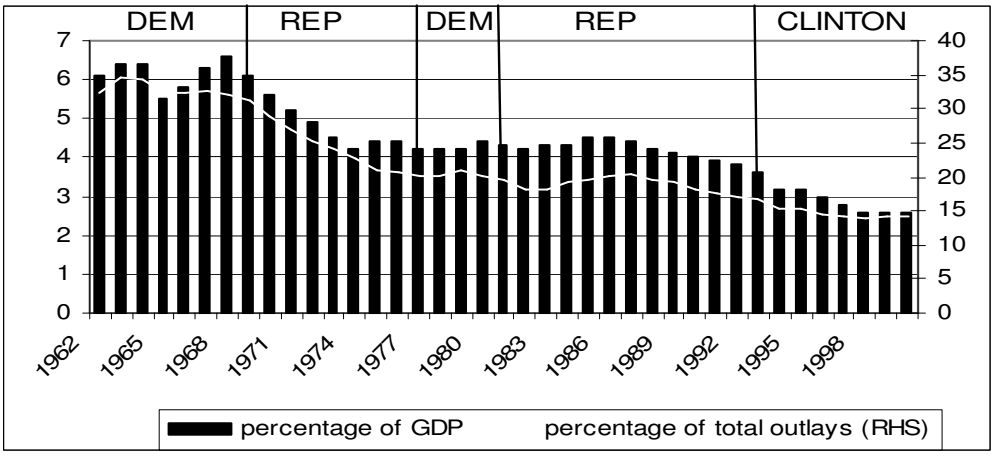


Source: HM Treasury 2002, Tables C23 and C24

Figure 2: United Kingdom Public Expenditures, Receipts and Budget Surplus (Percentage of GDP)

Earlier a warning was sounded of the potential for conflict between the Third Way's programme for increased public investment and fiscal discipline. In practice, this conflict did emerge. Clinton and Blair resolved the conflict by choosing to sacrifice their public investment programme. As Figure 3 shows, total public investment outlays for major physical capital, research and

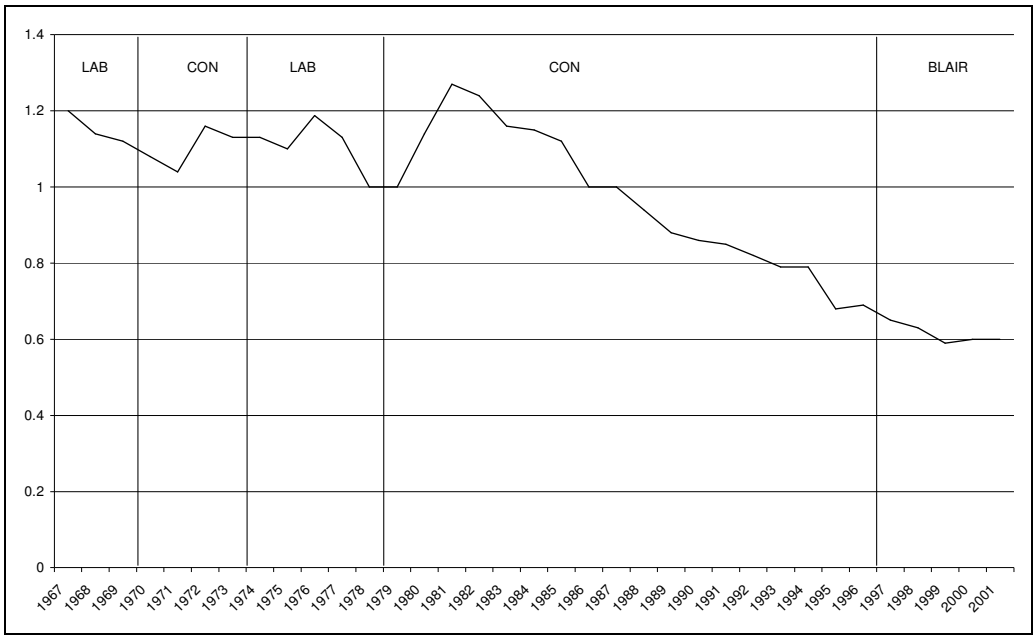
development, and education and training actually declined during Clinton's presidency by a cumulative shortfall of US$11.5 billion in constant (1996) dollars by the year 2000 (Office of Management and Budget, 2001)



Source: Office of Management and Budget 2001, Table 9.1

Figure 3: US Total Public Investment for Physical Capital, Research and Development & Education and Training, 1962-2000

As Figure 4 shows, the situation is again remarkably similar in Blair's Britain. Public investment on research and development has fallen almost continuously since the early 1980s and has continued to decline under Blair.



Source: Office for National Statistics 2002, Table 4

Figure 4: United Kingdom Total Net Government Expenditure on Research & Development (Percentage of GDP)

Conclusion

The key macroeconomic policy effect of the Third Way may be summarised as fiscal austerity through reduced public expenditure. Thus, the Third Way is not third at all but the first (neoclassical) way. This finding raises the question of why it is that two governments at least nominally of the political Left came to adopt neoclassical policy agendas associated with the Right wing of the political spectrum? The answer to this question is to be found in the discipline of political science not economics.

It was earlier mentioned that a convincing interpretation of the Third Way that enjoys widespread support is that of a political strategy designed to reposition the Left within the political mainstream as a viable alternative to the Right, capable of successfully governing capitalist economies in the age of globalisation. As noted, Downs posited the powerful argument that 'political parties tend to maintain the ideological positions that are consistent over time

unless they suffer drastic defeats, in which case they change their ideology to resemble that of the party that defeated them' (Downs 1957, p. 300).

Dionne (1999), Harris (1999), Hay (1999), Baer (2000) and Meeropol (2000) have all convincingly applied Downs' economic theory of democracy to explain that the Third Way represents the Left's response to the New Right and the 'victory' of laissez-faire capitalism over rival economic systems. According to this argument, the New Right, led by Conservative Prime Minister Thatcher and Republican President Reagan, had so successfully installed the neoclassical economic paradigm in the United Kingdom and United States respectively that they compelled their successors (Blair and Clinton) to follow suit for fear of electoral irrelevance.

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