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THE CONVERSATION

Academic rigour, journalistic flair

Ignore the armchair economists, Osborne's plan is sensible

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Yes, yes, yes. Julien Behal/PA

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George Osborne long ago realised that policy programmes designed to avert crises do not win elections. What he has offered instead in his **Autumn Statement** is once again a simple trade-off of public austerity today in exchange for unimaginable private prosperity tomorrow.

As a politician, the chancellor may be prone to overstating the expected benefits of his policies. But it is important to remember that there is a strong economic case for the government's broader strategy of deficit reduction through spending cuts.

It is particularly worth recalling this now, as the Autumn Statement has provided both journalists and politicians with an opportunity for a bit of armchair macroeconomic theorising. This can be confusing, for two reasons.

First, both groups make liberal use of terms and expressions that have their origins in macroeconomic theory, but in ways that have only a tangential relationship to what these words actually mean. Second, they infer all manner of relationships (positive or negative, depending on ideological persuasion) that have no basis in either theory or data. In the case of politicians, one can only hope that deceitfulness, rather than ignorance, is at the root of this behaviour.

Take the supposed impact of austerity on economic growth. When economists refer to growth, we mean the long-term trends in gross domestic product, not the quarter-to-quarter fluctuations upon

which both the media and the political class fixate.

This distinction is important, because while there is some evidence that cuts to government spending (austerity) can reduce growth in the short-run, neither theory nor empirical evidence suggest that shrinking the size of the state holds back growth in the long-run.

Indeed, macroeconomic theory suggests quite the opposite. As a large state must be supported by higher taxes, and these taxes deter work and investment, shrinking the leviathan can generate some medium-term economic expansion. Probably less than some would like to believe, however.

Of course there is some evidence that investments in human capital (knowledge and skills) do not suffer from the decreasing returns associated with physical capital such as machinery or computers. So it could be argued that government may be able to raise the growth rate sustainably by spending more on education or research and development.

Alas, empirical evidence for non-decreasing returns is inconclusive and neither democratically elected politicians nor government bureaucrats have the incentives or expertise to funnel taxpayer money only to those technologies most likely to be commercially successful.

Averting crisis

So ignore the arguments about whether the economy grew last quarter because of or despite government spending cuts. Austerity was not implemented to foster growth, but to avert a sovereign debt crisis.

Sovereign debt crises evolve much like bank runs, often triggered by a sudden loss of faith in the government's ability or willingness to honour its obligations. The larger the outstanding debt, the more reason creditors have to be wary and the more likely they are to demand higher interest rates as compensation for the greater risk of default and to rush for the exits at the first hint of trouble.

Yet it is these higher interest rates that often exacerbate the underlying insolvency and force countries into default. Controlling one's own currency does little to ameliorate this problem. True, in the short term, it allows central banks to buy up public debts and increase the money supply thus, through inflation, relieving the real burden of debt. But soon enough the rate of return adjusts upwards to compensate.

Back in 2010, this was the trap the UK risked finding itself in. Despite keeping the pound, we were much closer to a sovereign debt crisis than most people appreciate. It was for this reason that during the last election, the two largest parties both proposed public-sector spending cuts that were remarkably similar in their scope and timing.

Opponents of austerity will once again insist that the trade-off between pain in the present and future prosperity is never necessary. They'll say the overall size of the economy always expands in response to an increase in government spending, and does so by enough to keep the debt burden from rising. Yet not so long ago the current opposition did support austerity – but that was before the election, when they thought they might have to govern.

So in the great austerity debate, does either side in the UK really believe its own rhetoric? The world's credit markets apparently think not, otherwise they would not still be lending it money.

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