Osborne bets the farm on an untested theory

The fall in GDP should come as no shock after the Chancellor's decision to take a daring gamble on austerity

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The slump in Britain's economic activity revealed yesterday has astonished the Government and financial markets, but the direction of the movement, if not its magnitude, should have been predictable.

Since George Osborne's tough post-election Budget, many economists have argued that Britain faced a greater risk of double-dip recession than any other leading economy. If investors and ministers chose to ignore these warnings, it was largely because of wishful thinking about the robust economic conditions immediately after the election.

It was convenient to imagine that the economy's strong performance in the summer reflected an upsurge of confidence in the new Government. In fact, as Treasury and Bank of England officials should have explained to David Cameron and Mr Osborne, in the months after the election Britain was still enjoying the delayed effects of the economic stimulus introduced in early 2009 by Gordon Brown.

It was not just the weather that suddenly turned frigid in the autumn; the turn in government economic policies was just as severe. And it will not be until the second half of 2011 that the full effects of the coalition's tax rises and spending cuts will be revealed.

Mr Osborne's post-election Budget and his spending review in October represented a series of daring gambles, not just on the underlying strength of the economy and its ability to grow without a lead from the financial services industry, but even more on a controversial economic theory. This is the idea that private citizens and businesses will increase spending even as their incomes are cut by higher taxes and reductions in government spending. That money flows ultimately to public sector workers, benefit recipients and government contractors who, in turn, spend it in the shops.

Academic economists can come up

> There's no convincing evidence that spending will rise as incomes fall

with plenty of arguments to explain why consumers might, in theory, spend more and why businesses might, in principle, increase hiring and investment as their after-tax incomes are reduced by a government bent on budgetary rigour. The problem for Mr Osborne — and now perhaps for the coalition and indeed the whole of Britain — is that no economist has produced convincing evidence that this kind of counterintuitive behaviour actually happens in practice, at least under economic conditions that bear much resemblance to Britain today.

The argument that budget cuts and higher taxes can stimulate private spending rather than suppress it revolves around two ideas, one based on practical common sense and solid business experience, the other on the conjectures of theoretical economists.

The first argument, which is highly plausible from both a theoretical and an empirical perspective, is that cuts in public deficits create the conditions for lower interest rates, a cheaper currency or easier availability of credit. If interest rates fall sharply or the pound becomes significantly cheaper, it is easy to see that businesses might build more factories, exporters might win new business and homeowners might increase their mortgages and spend more on consumer goods.

There have been plenty of recent examples of a more relaxed monetary policy offsetting fiscal tightening, allowing severe budget cuts to coincide with strong private sector growth. This counterbalancing of belt tightening with lower interest rates and a falling currency saved Britain from recession in 1981 and 1993. It also produced the remarkably successful fiscal consolidations in Canada and Sweden in the mid-1990s.

Unfortunately, the possibility of using easier monetary policy to offset higher taxes and government cuts hardly exists in Britain today — and certainly does not seem to be what the Government is considering to make its sums add up. With interest rates already near zero, there is limited scope for monetary policy to be eased any further, and now that the VAT rise has produced a potentially worrying uptick in inflation, Mr Cameron has joined the chorus of economists and pundits — dangerously misguided in my view — demanding that the Bank of England consider tightening monetary policy to control inflation, instead of easing it to stimulate growth.

Which brings us to the second reason for the Government's optimism in the face of the fiscal stringency it is imposing — confidence. It hopes that

> He hopes that cutting the deficit will boost future confidence

people will be impressed by its determination to cut borrowing and therefore to reduce potential pressures on the public purse — so impressed that consumers will spend more, businesses will create more jobs and entrepreneurs will start new businesses, all based on the confidence that their future taxes will be lower than today.

Why has the Government decided to bet the economy on this untested theory? Apart from the pure party politics of branding Labour's policies as recklessly irresponsible, there is an interesting intellectual background to Mr Osborne's faith that the confidence engendered by cuts will offset the depressing effects on demand predicted by Keynesian economics.

This faith is based on a theory traced back to the works of David Ricardo, perhaps the most respected economic thinker of all time. In a paper written in 1820, Ricardo examined whether a government that went to war would be better off collecting £20 million in taxes or borrowing the same amount at an interest rate of 5 per cent or £1 million a year. "In point of economy, there is no real difference," he concluded. "For £20 million in one payment and £1 million per annum for ever . . . are precisely of the same value."

This was seized on by conservative anti-Keynesian economists as Ricardo's endorsement of their view that government borrowing was indistinguishable from taxation — and therefore that cuts in borrowing would automatically boost private spending.

This came to be known as Ricardian equivalence, but conservative economists failed to mention that Ricardo himself poured scorn on this simplistic idea, pointing out that it was based on unrealistic assumptions about human nature. Just after the passage about the theoretical equivalence of public borrowing and taxation, he added: "But the people who paid the taxes never so estimate them, and therefore do not manage their private affairs accordingly . . . It would be difficult to convince a man possessed of £20,000, or any other sum, that a perpetual payment of £50 per annum was equally burdensome with a single tax of £1,000." In other words, Ricardo himself doubted the Ricardian equivalence on which the coalition's entire economic policy depends. After yesterday's figures Mr Osborne had better take note.