

Funding the Future

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I would be amused at reaction to the news that George Osborne is going to miss his borrowing targets, yet again, as became obvious this morning when much higher than expected October borrowing was announced. The reaction, [according to the Guardian](#), amongst many so-called expert commentators is to suggest that George Osborne now has to impose yet more austerity.

This, very politely is absurd. As I say in a new City University paper co-authored with Prof Ronen Palan to be published early next week:

The core argument for austerity economics as the harbinger of economic growth harks back to highly controversial proposals that originated in the 1990s known as 'expansionary fiscal contraction.' The idea behind these proposals is that the public and private sectors compete over the same pool of capital. It follows that if a policy of deliberate deflation in wages, prices and public spending through reduction in the state's budgets, deficits and debts was pursued, then business confidence would be created as the foundation for growth. The state would no longer be 'crowding out' the private sector in a race to command scarce capital, resources or labour. The assumption is that private sector's use of these resources (lower cost of capital, resources or labour) would result in higher growth than if they were used by the state (for discussion see: Barry & Devereux, 1995; Blyth, 2013).

Expansionary fiscal contraction theory is predicated, in other words, on three linked, but highly controversial assumptions: first, that there is a finite pool of available capital at a national level; second, that interest rates at national level are determined by a simple demand and supply curve; and third, that private sector investment (and correspondingly, debt) is always preferable to the public sector investment (and hence also debt).

This belief in the superior performance of the private sector has been implicit in the forecasting methodology adopted by the UK Office for Budget Responsibility (OBR), which George Osborne established in 2010 to audit the Treasury's economic forecasts (a task previously undertaken for Labour by the National Audit Office). The OBR has worked on the assumption since 2010 that the [multiplier](#) to be applied to government revenue spending has been around 0.6 on average. The OBR has been a little more

generous with the multiplier impact of government investment spending, where it has assumed the multiplier to be 1 (Office for Budget Responsibility, 2015, 39). The implications of the OBR's methodology are far reaching: Controversially, as we will discuss below, the OBR's forecasting methodology assumes that government revenue spending actually reduces GDP, whilst government investment could at best just recover cost. It follows from this methodology that any transfer of resources to the private sector — whether by tax cuts or reduction in spending — is bound to increase the growth rate in the economy.

Those who are now arguing for more austerity must share this view that government spending harms the economy, and that shrinking it delivers growth and so more tax revenue and so balanced budgets.

But the reality should, by now have dawned on the Office for Budget Responsibility, whose forecasts have been consistently wrong. If the multipliers are above 1, as the IMF argue is nigh on inevitable, cuts shrink the economy, and so shrink tax revenues by more in many cases than the value of the cuts, meaning that austerity is in fact self defeating: you have slower growth, more unemployment and deficits still.

When will the Treasury admit they've just got this wrong? And will it be too late when they do?