

Funding the Future

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I posted this Twitter [thread on the multiplier this morning](#):

The government wants to cut its spending. It says we cannot afford it. The claim is that if we have to borrow or increase taxes to spend then that must mean we can't afford things like more education or healthcare. But they are wrong. We should spend, now. A thread to explain...

First, trust me, everything I say in this thread is actually pretty straightforward. It's just stuff no politician ever talks about. That's because the truth I relate doesn't suit a political narrative that wants to cut the size of the state, come what may.

Second, also trust me that what I am going to discuss is not some weird, unknown, form of economics. This is actually fairly bog-standard stuff that's been known for a long time. It's just that politicians pretend they do not know it.

Third, there's technical name for what I am about to describe, which is the 'multiplier'. The good news is that multiplication is, after adding up and subtraction, the easiest bit of maths, and vastly simpler than division, so nothing I am going to say is that hard.

So, as the saying goes, let's start at the very beginning. Let's assume a government spends an extra £1 into the economy. As assumptions go this is an easy one to make. The UK government spends more than £800 billion a year, so assuming it spends £1 more is not hard.

What the multiplier measures is how much new economic activity results from that additional £1 that the government spends. That's it. It's really not that hard to understand. That one sentence summarises what this whole thread is about.

It also hits the political economy of this on the head. If most right-of-centre politicians were to be believed every £1 that the government spends is paired into a black hole and we get not a penny's worth from it. They try to describe it as waste.

But that's not true, of course. The government does not pour money away. What it actually does is spend it for social purpose. What is more, its spending becomes someone else's income. And it adds to the sum of well being as a result. Understanding by how much is key.

The rule is simple. If the multiplier is 1, the £1 the government spends creates £1 of new economic activity. If that pound creates less than £1 of new income then the multiplier is less than 1. And if it creates more than £1 of new income the multiplier is bigger than 1.

So, a multiplier of less than 1 does not look good, and a multiplier of 1 only looks OK, whilst a multiplier of more than 1 is beginning to suggest something good is going on.

How does this work? An example will help. Suppose the government spends £1 extra on a teacher. That £1 is taxed, of course. The teacher probably gets about 67p of the income paid to them. Now, if they did nothing with that 67p the money spent would have achieved little.

This is possible, of course. The teacher could just put the money in their bank account and do nothing with it. That's what we call saving. But that means nothing happens with the cash: it becomes dead money.

And don't presume that saving is good because banks lend on the money deposited with them. We know that's not true now. The Bank of England admitted it in 2014. Cash savings are just money that's met a dead end. Banks lend newly created money, not savings.

So, if ending up in a savings account was to be the fate of the new government spending the multiplier would be very low. Income in the economy would hardly rise, at all.

Thankfully, that's not what usually happens when the government spends, for two reasons. The first is that few people save all their money. In fact, most people have almost no savings at all. That implies they spend most, if not all, of their income.

Suppose, then, that the teacher spends their extra 67p. What happens? The reality is that their spend does then become somebody else's income. The mechanism can be complicated, but if money is spent by one person it must always become the income of someone else.

On the way some more tax might be paid. If the money went to a shop then VAT might be paid. And even though the shop will have had to buy goods in some of what they get will also go to the shop staff. They're also taxed, of course, but then they'll also spend their net income.

That will also be true of the staff in the companies that made the goods that the shop

bought in. So they too have a bit more to spend as well out of the extra £1 the government spent.

And so the process goes on, and on, with the amounts getting smaller at each stage, but still being significant so long as the process does not stop because someone saves instead.

So, two effects have been created. The first is that the 67p the teacher gets after tax goes on to be additional income for a lot more people than the teacher who first got the money.

Second, tax is paid at each stage of this process. The £1 of extra spend already creates 33p of additional tax to pay for itself when it is first paid to the teacher. But, at each stage as the 67p the teacher got changes hands the amount of tax paid, overall, increases.

In that case the multiplier effect as the money spent goes around and around in the economy does not just increase earnings; it also increases government revenues too.

That last point is really important and yet no one says it. The fact is that every time the government spends it increases its tax take. Politicians never say that, but it is a fact. It is in fact possible that government spending can entirely pay for itself out of new taxes paid.

Suppose the average UK overall tax rate is 33%, as it is, near enough, in the UK. Then suppose the multiplier is 3. In other words, the extra £1 spend creates £3 of new income. If that £3 of extra income is taxed at 33% the net cost to the government of spending is nothing.

The additional spend is £1 in this example. And as a result of that spend the additional tax due in this example is £1. The result is that the books balance, despite an increased spend. The spend pays for itself. That's not a miracle: that can happen.

The question is, how can the multiplier be 3? The answer is that this not only depends on the money continuing to move around the economy, although that is important. It also depends on what the extra money is spent on.

Some things, like defence spending, have low multipliers. Defence creates nothing that anyone wants to buy. So, whilst the spend on the people involved has some stimulus effect, because no one buys defence there is nothing for that extra government created money to be spent on.

The result is that money spent on defence might have a stimulus effect to the extent that the spend is re-spent by those who get it, the second critical aspect of the multiplier hardly exists with regard to defence spending.

That second critical aspect is the impact the spend has on the rest of the economy. Contrast defence spending with health spending. Both have broadly similar direct impacts in that what is spent on people gets re-spent. But their impact on the economy is different.

Defence is the black hole that right wing politicians think all government spending is. It literally generates no value. Spend on the NHS though and you have healthier, happier, more optimistic people. They go to work too. And they spend more.

What is more, because healthy people are more productive they add more value when they are at work. So that increases the multiplier as well, of course.

The result is that the multiplier effect of health spending is way above 1. The King's Fund - a UK health think tank - thinks that the multiplier effect of health spending is 3.6. So for every £1 spent £3.60 of income is generated. And more than £1 of tax is paid.

The US Federal Reserve has estimated that the multiplier on education spending is 2.4. It's a little hard to tell. It depends for how long you think the impact lasts. A lifetime is a long time. So maybe it's higher in this case. Multiplier measurement can be difficult.

But one thing pretty universally agreed is that spending on investment brings high returns. That's unsurprising. That's precisely what good investments should do. It also makes it hard to explain why the government does not invest more.

Another agreement is that multipliers are higher when unemployment is higher. Again, that's unsurprising. And, as @d_blancklower argues, we have so much spare capacity due to underemployment in our economy multipliers should usually be high.

Add it up then and a great deal of government spending largely or entirely pays for itself if there is even modest underemployment in the economy. That would be especially true if that spend was investment in something like a Green New Deal.

There's one more thing to add. That is that the multiplier also applies to taxes, and most especially tax cuts. Of course, a tax cut is just like a government spend. It appears to inject more money into the economy. But, who gets it has an enormous impact on its multiplier effect.

Suppose the tax cut goes to the least well off. They will spend it all. The multiplier effect is high. They keep the money circulating. But, give it to wealthiest and they can already spend all they want, and save what's left over each month. So they just save some more.

Remember, most of the wealthier people in any country are wealthy precisely because they can save out of what they earn. That means they have already got all they want and are unlikely to spend a great deal more.

So what happens if you give the wealthiest, or the companies that they tend to own, tax cuts? They simply save them. In which case the government's generosity does not move around the economy. It just ends up stuck in a savings account, and that is economically dead money.

That, incidentally, is why offering tax reliefs to those who can already afford to save is also a really daft idea, but we do it in the UK at a cost exceeding £55 billion a year. The multiplier effect of doing so is likely to be well below 1, which is crazy.

Crazy that is unless your aim is to increase inequality, which is what this tax relief to savers really does.

So, in conclusion, multipliers matter. Saying that I stress that money is not the only reason that governments should do things: it would be wrong to say it was. But when government money is being discussed then multipliers should be included in the debate.

That's because all government spending and all taxes have a multiplier. Their measurement is not perfect. But we know they vary enormously. Some things, like spending on the NHS and healthcare have really high multipliers.

Such things can actually, or nearly, pay for themselves as far as the government is concerned, and leave a lot of additional income remaining in the economy as well.

Other things, like defence spending and tax cuts for large companies and the wealthy have low multiplier effects: they don't provide much stimulus at all.

Not all government spending is equal then. Some is a waste of money. Boosting savings is pretty near top of that list. Some is amazing in terms of its impact in the economy. And it pays for itself. Health and investment usually does that.

And this matters. When the government says it can't afford education, healthcare and green investment for example, it's simply not telling the truth. As these things pretty much pay for themselves it's ignorance or dogmatic denial that motivates such claims.

That's also true on taxes: tax cuts for the wealthy really don't boost the economy, they just boost social division. So you have to ask, is that the aim of the who promote them?

The point is, knowing this matters. The next time a politician says we can't afford something ask them about the multiplier effect of the proposed spend. They'll squirm. Then patiently explain that much government expenditure pays for itself by boosting incomes.

After that ask them why they'd rather not boost incomes when they can, often costlessly. Hold them to account in other words. Make them explain. Because that's what democracy is all about. And that's what economics lets you do.