Episode 357 – The Myth of the Keynesian Multiplier
Guest: William Boyes
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WOODS: I was delighted to learn after I decided I wanted to talk to you that you are actually one of the named lecturers at this year's Austrian Economics Research Conference at the Mises Institute. As a matter of fact, are you the Murray Rothbard Lecturer?

BOYES: I am the Murray Rothbard Lecturer.

WOODS: How about that!

BOYES: Yeah, no kidding. I don't know how that happened, but I am really honored that it did.

WOODS: I like to go to this conference every year, but as I was telling you before we went on, I have a birthday—we have a daughter who is turning one tomorrow, and I have always pledged I would never miss a birthday, so it fell at an unfortunate time for us. I am curious to know, before we get started, what do you plan to tell people in your—I will keep it under my hat. My listeners won't say anything, but what do you plan to tell people about in your talk?

BOYES: Well, actually, I am glad you asked me because I am the last lecturer before it adjourns, so I don't know if everybody is going to be gone by that time anyway. But what I want to do is sort of parallel in a way Murray's lecture on why or how he became a libertarian.

WOODS: Oh, okay.

BOYES: So I go through my—it took me a roundabout way to get here, and I go through that step-by-step and looking at some of the research along the way and then question where economists are today and why they are so left-leaning and a few issues like that.

WOODS: Well, it sounds like it will be very good. I first got to know about you from an article you had in an issue of the *Quarterly Journal of Austrian Economics* in late 2014. I will link to that on the show notes page. Today the show notes page will be

TomWoods.com/357, and this article, which came with a high endorsement from Joe Salerno, who is the editor of the journal, had to do with the Keynesian multiplier. Now people may not know that term specifically, but they certainly know the concept if they follow the news and they listen to standard economic analysis on the cable news networks. So why don't we start off by having you explain what the Keynesian multiplier says, not whether we agree with it or not, but what is it supposed to do?

BOYES: Well, if anybody ever reads Paul Krugman, it's just about every column he talks about the need for increased government spending, and that spending then will have an impact in the economy. It will go from one person's income to another person's income as they spend, and that's the multiplier idea: that if the government just primes the pump then the economy is going to pick up. It's an aggregate demand perspective. It's based on aggregates, which the whole Keynesian system is. It's real interesting. This idea has been percolating in my mind for a long time and why I finally got the gumption to write it up was I just got tired of reading Krugman and Blinder and the other Keynesians all arguing that the "austerity" program in Europe is wrong. We need more spending here in the States. Even if we hire people to dig holes and fill them up, that's going to lead to increased income, and it's just absurd on so many grounds.

WOODS: Well, the idea of it is that if the government spends a dollar, that's not the end of the story. The government's spending a dollar can yield you $3 of economic activity or $1.80 or $1.10, depending upon what you think the magnitude of the multiplier is. And so as you say in your article, since everybody takes the existence of the multiplier for granted, the debate always centers around what is the magnitude of the multiplier. How much extra boost do we get from our government-spent dollar?

BOYES: Exactly right. The estimates range from 0.27 to 5. The Council of Economic Advisors uses over 3 for their so-called multiplier, meaning that a dollar of government spending will increase real outputs $3. It's an incredible claim, and if life was that easy, there wouldn't be any economists.

WOODS: But how does that happen? In their view, what is the mechanism by which $1 turns into $3 of output? Can you walk us through that?

BOYES: Well, one way is nobody asks where the money comes from, so the government simply spends—let's say they hire somebody to sit in a rubber room. Well, that hiring is income to that person. That person then takes their income, and they will buy food and groceries and whatever. That then is spending in the economy that's created on top of that first dollar of government spending, and then where they spend, like the grocery store, that's income to them, and they will spend a portion of that when they receive that income, and it just goes on through infinity. And if you add up all those increases in spending and output, then that's the size of the multiplier.

WOODS: All right, so as you say in the article, there have been people who have, and as you've just mentioned, the people who have said that the multiplier could be 3. You have some who have said that, in the short run anyway, it could be close to zero. But in a way, this is all beside the point, because if the multiplier concept itself is faulty, then there is no point in trying to measure it.

BOYES: Exactly right. That's what I maintain. It's absolutely faulty for several reasons. Rothbard talked about it and Hayek talked about it and Hazlitt talked about it. I think the one that I talk about in that paper I haven't run across anywhere, but it's a pretty simple concept, but I think all of those argue for the multiplier as being a concept that we shouldn't even consider.

WOODS: All right, let's talk about—I do want to get to the various critiques, but I want to focus in on your critique. It is so Austrian. It is the opposite of fixation on aggregates. You are focused on the micro-level and micro-level adjustments and the problems that come from treating micro-level adjustments as if they can be repaired with huge doses of just spending in general. So, again, I think before we can understand this, we have to understand from the Austrian point of view what's wrong with the economy in the first place that people would even be considering the stimulus spending. That's the real question.

BOYES: Yes, it is, and that's the complaint always about the Keynesian model is where does the unemployment come from? Where does it start? If we assume we'd start from a period where there's some unemployed, then we'd talk about this government spending increase. Then we'd talk about the multiplier. Then we'd talk about how that drives unemployment down. Nobody questions where that initial unemployment comes from, and it's really just a distortion—misallocation of resources in the economy. Mises and Hayek and other Austrians all talked about that, that what happens when there's a distortion in the economy like, for instance, caused by monetary policy that resources get allocated to where they are less valuable. At least temporarily, it might look like they are more valuable, but they get shifted into less valuable activities, or they get shifted out of activities altogether for a short time, but then adjustment in the market takes place, and relative prices adjust, and we move back to the boundary of the production possibility curve if you want to use that, or to the full-employment level of resources, and they are allocated efficiently. What happens with the multiplier idea, and the whole Keynesian idea, is that adjustment can't take place. The government interferes with the reallocation of resources.

So one of the things I maintain is that when we have unemployed resources, they put downward pressure on their relative prices. If left alone, then, there will be an adjustment in the quantity of demand and supply so that the resources can be employed again where they are valuable. If we employ them in something like rubber rooms, they don't produce anything productive or valuable. The money used to pay them is taken away from the private sector, and that reduces the quantity of valuable goods produced. So the government spending may reduce unemployment, but it doesn't increase output of national income.

But the problem is even larger than this because the unemployed resources are no longer putting downward pressure on prices, and the opportunity cost of that is more lost output. So what we've really got, I think, if you are going to argue for a multiplier at all—it's got to be negative. By definition, if there is such a thing, it's got to be negative.

WOODS: All right, let me make sure that my listeners are following along, because I have people at all different levels. On the show notes page, I will link to a previous episode in which we talk about Austrian business cycle theory, so you can get a refresher on that if you need it—tomwoods.com/357. But what happens during the Austrian business cycle is that you get artificial interference with interest rates. This leads to intertemporal discoordination. It means that resources are being employed in stages of production and lines of production that are out of whack with consumer preferences in terms of the time dimension and everything else they are out of whack, and when the economy adjusts from this—when you get the recession and the economy tries to adjust its way out of this, you temporarily get, as you say, unemployed resources. You get factories that are idle, and human beings that are idle, and resources that are idle, and the Keynesian temptation is to try to jumpstart these resources back into activity artificially by just dumping a lot of spending into the economy.

But your point is that the idle resources serve a purpose. They are idle because right now people are trying to figure out what use is best for them under the changed conditions. Now that we know real economic conditions, now we've got to really reevaluate what can we use this resource for, and the price that's being demanded for this resource will be pushed downward by the fact that there's less demand for it. Eventually, it will reach a point at which it will be low enough that some entrepreneur will need it for something, and then it will be used for something valuable as supposed to the arbitrary thing the government might have used it for. Is that the gist of it?

BOYES: Well, you captured it better than I do. That's great—absolutely the gist of it. For economists out there or people who teach economics, they will often teach about the potential GDP and how there's a GDP gap.

WOODS: I wanted to ask you about that. Explain that concept, please.

BOYES: Potential GDP supposedly is the GDP that would be produced if resources are fully and efficiently employed, and of course, that's impossible to measure. What they do is project out from where there was previously a full-employment level—5.5% of labor force unemployed or something like that—project out, and then they compare that to the actual GDP, and they say the difference between the two is the GDP gap. So one fiscal policy target is to reduce that gap. So they will say, okay, if the multiplier is 3 and that gap is 30, then we have to increase government spending by 10, and that will move us back to the potential GDP. But that's no longer potential GDP because it's the potential created by distorted or misallocated resources. So when the government spends on that economic system, which means that spending will take place differently at some firms and other firms will take place differently in some industries and different industries. In the Keynesian system it doesn't matter, it's all shmoo. It's all the same. So the spending takes place evenly through the economy. But it doesn't, and that means the resource misallocation is exaggerated—is made even worse. So it's impossible to get what the economists call potential GDP.

WOODS: All right, I am so glad you explained that. Now I know there's an episode in the 357 in which I talked a little bit about potential GDP. I have no idea which one it is. So we might as well just do it from scratch. So I am glad we're talking about it, but I want to just review just in my mind because I read much, much more about economics than the average person, but I don't have any degrees in it, so I do want to make sure that I am getting it, and that I am explaining it right to the audience. What I always thought was funny about this idea is that, well, of course it neglects Austrian analysis. That's the fundamental problem because it's saying that this is where GDP would be if the current configuration of capital were being employed in the maximum possible way. But the problem would be, what if the current configuration of capital is all screwed up because of monetary policy? What if the resources aren't where they need to be? Then it's a phantom number to say, well, if all these things were working at their maximum capacity, this would be the output we'd have, but they can't because they don't interlock properly. The different stages are out of whack with one another. The whole structure has been distorted. So you can't reproach yourself that your economy isn't producing at full employment and we have this gap in output as a result of that when the fact is that your economy is screwed up in the first place. Get it unscrewed up, and then you might have some target to aim at.

BOYES: That's exactly right. Look at the European economies right now with all their rules and regulations. Now you tell me increased spending doesn't exaggerate the misallocated resources. It's got to. And the same thing with the U.S. economy. We interfere with the allocation of resources. For instance, we carry out a policy, and it shifts resources into what we call first-order goods, nearer consumption, taking away from the higher-order goods, which would be long-term capital investments, and then if you increase spending, all you're doing is increasing spending on those first-order goods. You're not doing anything with reallocating resources back to where it would make sense.

WOODS: The trouble is the average person doesn't think a whole lot about capital theory. The average person is likely to be swept away by the following argument that you know it's a shame that there's so many people on food stamps, and it's a shame we have to spend all this money in that way, and it’s too bad these people don’t have jobs, but the silver lining is that when they spend the money, they spend it on the local shop that you yourself patronize. They spend it on local restaurant food. They spend it in ways that give a boost to the economy. So really it actually winds up being not so bad and maybe even a net plus. I think some people would be drawn into that, and to then say to them, well, but you're missing the problem of capital maintenance and whatever would seem a little bit obscure and remote to them. Is there any easy way we can counter that kind of argument?

BOYES: Well, I think your argument is exactly right. We could ask people: Would this increase the economy? Get a divorce, have your kids be juvenile delinquents, throw rocks into windows, have a natural disaster and wipe out a city, and they’d probably say, well, no, of course not. That’s destruction. But then you can point out, well, that’s the same thing we’re talking about. If you increase spending here, what does that do? Does that rebuild the window? No, not unless the individual rebuilds it by reallocating his or her own resources, and what the government is doing is taking resources away from the private sector, and their choice is in putting them into what it wants. It’s a very big problem of misallocation.

WOODS: Before we go, what are some of the other approaches to the Keynesian multiplier that Austrians in the past have taken?

BOYES: Hayek looked at the multiplier as an aggregation problem and the fact that all this information, you know, his dispersed information argument—all the information that’s out there and individual behaviors and prices is thrown away when you aggregate up to C + I + G + X – M, which is what the Keynesian model does, and so he’s arguing that the aggregation loses all that information and that a multiplier doesn’t make sense. Rothbard took a little argument—he took a little equation—and took the Y income equals C + I + G equation. He broke out 99.99% of people and one person, and he’d use that little equation to show that the one person’s multiplier would be 200 billion. So if that one person in the economy would spend $1, it would lead to a $200 billion increase in the economy. It’s of course absurd. It’s sometimes called *reductio ad absurdum*. So Rothbard’s argument was simply that it just makes no sense. The multiplier makes zero sense. Most of the Austrians, I think, would argue that the effect on the Austrian business cycle—the effect on moving resources to lower level or upper level arbitrarily is going to be a problem, and those three arguments are the ones that I have been able to run across.

WOODS: I know where he says that in *Man, Economy, and State*, but if he also wrote an article on it that I can link to, one way or another I am going to link to his funny equation about how the reader’s own personal multiplier is so tremendously high. It’s so funny.

BOYES: Yeah, it is in *Man, Economy, and State*, and of course, people have taken it up on various websites and Google searches you can find references to it.

WOODS: All right, I am going to dig that out somewhere. Now, you are professor emeritus at Arizona State University, and you founded a free market center there?

BOYES: Yes, we started December 2014 with funding from two large donors and several smaller donors. It's called the Center for the Study of Economic Liberty. We just call it Center for Economic Liberty. We are trying to model it as a very small base. We are trying to model it on the lines of Mises or Mercatus. We are going to hire some free-market economists there at Arizona State in political economy, and we're dealing with students and financing students, and we're doing local and national research on issues such as regulation or occupational licensing or other Austrian issues—entrepreneurship. So we're just getting started. It's exciting, but it's also really trying because we want to get exposure, and your show is terrific for that. We want to get exposure and try to raise money to finance us on down the line. We have a five-year grant, but we need to get a lot more to keep going from there.

WOODS: Well, I'll definitely link—I see you have a link here. I am looking at it right now. You've got a page at ASU, so we'll link to that at tomwoods.com/357, today's page.

BOYES: Thank you.

WOODS: It's funny: the Barry Goldwater family actually controls a chair there, a chair in conservatism that they had let go dormant for a while, but they revived it recently. And several years ago Barry Goldwater Jr. strongly urged me to apply for this chair. He says it's a good salary.

BOYES: I wish you had.

WOODS: You get good money to hold confidences, and it was so tempting, but it would have meant that I would have moved for the third time in like three years, and I just couldn't do that to the family.

BOYES: I understand.

WOODS: It was a very attractive offer, and as a matter of fact, as we look around the country at places that might be attractive to live, we're actually looking at Arizona, as it turns out.

BOYES: It's a great place to live, and the Goldwater chair—I was on that committee when they first organized it, and I had lined up Tom Sowell to come in, and it was supposed to rotate between econ and history and political science, I think. It's much broader now, and Barry Jr. let it ride, and non-conservative people were appointed and people that don't even understand were appointed, so it hasn't done a lot recently, so if ever you get a chance, arrange it so that you could commute.

WOODS: Yeah, maybe so.

BOYES: Come out for a couple of days a week or every other week or something like that. That would be terrific.

WOODS: Yeah, I think Tom DiLorenzo does that. I think he likes to live in Florida. He flies up to Baltimore so he can be in Maryland as little as possible.

BOYES: Smart, very smart.

WOODS: And then flies back to Florida. Well, Bill, thanks a lot for your time today and best of luck with your talk at the Mises Institute this week.

BOYES: Thank you, Tom, I really appreciate it.