The Nature of Stimulus

What is the essence and nature of what the politicians and the media have called the “Stimulus”?

We at the Philosophical Angle have been a bit confused by the use of this term, taken in the context of its use, it appears to mean that should the government increase its spending, it will multiply its effect in the economy generating additional economic effect consequentially and necessarily increasing the economy has a whole.

Thus, the political administration of just a couple of years ago in the form of Obama, Pelosi, and Reid passed a huge spending bill in 2009 and called it a Stimulus Bill. The stated reasoning was that should the government intervene and increase its spending that these expenditures would necessarily cause an economy to grow and prosper. This theory or thought line has its origins in an economist of the first half of this century, known as John Maynard Keynes. The principle that he espoused is called the multiplier effect. Keynes hypothesized that autonomous expenditure, such as government spending, would increase aggregate income by a greater amount through the multiplier mechanism and this provided the analytical stimulus for Demand management by the state. Thus, he saw an increasing role for the government in directing a nation’s economy.

In times of stagnation, he hypothesized that the government could increase its spending, and this new money would cause
the new spending to travel through the economy exchanging each time there is a transaction.

Politicians have come on board with this thought line by taking any downturn in the American economy by passing what they call either a Jobs Bill or Stimulus Bill that has the government spending money that it does not have in the present; that is, it borrows the money, and spends the money hoping the this additional expenditure would stimulate the economy bring the economy out of its doldrums.

Hence, here at the Philosophical Angle we are hesitant to agree with this hypothesis and so we would like to take a step back and examine this, now, famous economic theory.

Keynes says that should an economy falter due to whatever reason, such as ...say ... a business cycle ... or say ... an oil embargo, as we experienced in of the 70’s, the government could take up the slack in the GDP and increase its spending. This spending would not only take up the slack of the decreased economic activity but over time due to a multiplier effect increase the overall economic activity.

Let’s see if this is true. In order for us to get a grasp of the makeup of an economy and the effect of a stimulus, let’s take the example of a very simple economy.

Suppose there is a rudimentary society composed of a pig farmer (we’ll call it Hog Company, a beef rancher (aka Beef Company),
and an agricultural producer of corn (Corn Company), all living in an area called Happy Valley.

In the daily course of events, here, the pig farmer sells his pork to the corn and beef guys in exchange for the corn and beef by which Hog Company provides meat for his family and employees, and he uses the corn for the dual purpose to feed his pigs and for the additional sustenance for is family.

Beef company meanwhile trades with his two parties for the corn for consumption for his family and his steers and trades his beef for the pork for a second type of meat for his family’s consumption.

Corn & Company trades obviously with his two economic partners to obtain their two types of meat for nourishment for his family and employees.

Additionally, in Happy Valley there is a local government to which the three members pay a percentage of the value of what they produce in order to obtain those things that a government can provide and for which it was created such as a judiciary system and a police or self-defense force.

One year in Happy Valley, there is a drought and the corn producer suffers a decrease in the amount that he can harvest causing a recession. Because he has produced less corn, his trade for beef and pork diminishes and his family suffers as the beef and pork is not as plentiful.
The government, understanding the present hardship of Corn & Company decides to help out. The Happy Valley Commonwealth goes across the river to another region - known as the Peoples Republic - and borrows from a bank there $100, takes the money to a farmer in the Peoples Republic which had a good harvest and purchases some corn and brings it back and gives it to Corn & Company.

Naturally, Corn & Company is very happy and uses this produce to feed itself and resume trade with Beef & Company and with Pork & Company

Again, all is well in Happy Valley. Well, almost. There is the small matter that the Happy Valley government owes for the corn that came from the Peoples Republic of $100 plus interest.

This is because the government of Happy Valley decided to get the Peoples Republic corn anyway, and so, it (Happy Valley) owes the $100 plus the interest. The Happy Valley Government will now collect the repayment in taxes from its constituents which is comprised of the three companies.

However, Corn & Company would not have wanted to pay for the Peoples Republic Corn because Corn & Company decided it would be best to ride the recession out; otherwise, it would have to pay the cost of the PR corn plus the interest charge were it to obtain the corn directly. But of course, the Happy Valley Government did that instead.
So what, you say! The recession was arrested and Corn & Company along with the other constituents through its intermediary, the Happy Valley Government, can pay it back in the future.

That’s right it could!

But what has happened here is that the freedom for Corn & Company to make its own decision to whether to borrow the money or not was usurped by the Happy Valley Government.

Here are the possible results.

1) Corn & Company goes without its customary buying power until the next normal harvest.

2) The Happy Valley Government borrows from the People’s Republic and the Happy Valley government owes the Peoples Republic Government the cost plus interest. And if the Happy Valley government owes the Peoples Republic Government, then the constituents of Happy Valley, (Corn, Beef, Pork) will have to pay it back ultimately.

3) Corn & Company borrows directly from the Happy Valley Government and now owes the $100 plus interest by itself. If Corn & Company borrows, the economy remains almost as usual for the next year until the next harvest. We say “almost” because in this interim Corn & Company must begin paying it back. This money goes out of the economy and is repatriated to the Peoples Republic.
If the Happy Valley Government borrows, the constituents must pay it back; and thus, when this payment begins, the money will be taken out of the economy eventually over time.

In summary in each case, the deficiency caused by the poor harvest must be repaid eventually, and this money will leave the economy. Either it is paid by the immediate sacrifice of Corn & Company which eschews the temptation to borrow; or it is paid back by the sacrificing of the constituents of Happy Valley when they pay their Happy Valley Government for its borrowing from the Peoples Republic Government or its bank.

Ultimately, nowhere is there an increase in the economy; it remains static. There is no such thing as the multiplier effect by itself causing an increase in economic activity.

All economic activity is controlled by the equation of

Production = Risk, Time, Effort, & Knowledge/Information

The multiplier stimulus has no effect on these components; therefore, no government stimulus that just borrows and spends will ever increase economic activity.

In the simple economic exemplar before us, all that happened was that one borrowing entity or potential borrowing entity (Corn & Company) was supplanted by the government. The economic activity, should the government make the spending and borrowing choices, although it increase close to constant in
the short term, over time it will decrease back down to the original level when there was that original deficiency in the first harvest.

As shown here, the government cannot over time cause a stimulus. In order to cause a stimulus, companies must become more efficient in its action upon the ingredients of the economic transaction namely, time, risk, effort, and knowledge and now to our panel.