

Fiscal Stimulus

During a recession, a well-designed fiscal stimulus — a government spending increase, tax cut, or both — can shore up demand for goods and services and thereby help to reduce the recession’s depth and length and make the recovery more robust.

What Is Fiscal Stimulus?

Fiscal stimulus is an important tool that policymakers can use to reduce the severity of recessions. The federal government provides **fiscal stimulus** when it increases spending, cuts taxes, or both, to shore up households’ and businesses’ demand for goods and services during a recession. Strong, well-targeted fiscal stimulus allows people and businesses to keep purchasing goods and services. This bolsters aggregate demand, lessening the recession’s depth and length and promoting a stronger recovery.

The United States is almost certainly in a recession caused by COVID-19 and the public health measures needed to combat it. A **recession** is a significant decline in economic activity lasting more than a few months, whose precise start and end dates are determined after the fact by the National Bureau of Economic Research. Recessions can have profound [human and economic costs](#). Prolonged unemployment harms not only workers’ job prospects and lifetime earnings but also their and their families’ health and well-being. Long unemployment spells and business failures can also [depress the economy’s productive capacity](#) far beyond a recession’s end. This is why it’s important that lawmakers use the policy tools available to them to reduce the severity of recessions.

In recessions, the economy produces less than it is capable of when businesses are operating at full capacity and workers are fully employed, usually due to insufficient demand for goods and services. In the case of COVID-19, however, the pandemic and public health response have temporarily reduced both the quantity of goods and services the economy can produce and households’ disposable income, which supports the demand for these goods and services. Retail sales were down 16.4 percent in April, for example. And falling demand due to lost income in such sectors can make the recession even deeper when it spreads to goods and services that could still be produced if the demand were there. For example, slowdowns and business failures in restaurants and retail mean that their employees will face reduced hours or layoffs, and they will in turn reduce their own spending, lowering demand for an even wider range of goods and services.

When it is safe to reopen businesses and for people to go back to work, the temporary supply constraints will be reduced, but economic “**slack**” — the gap between aggregate demand and what the economy is capable of producing with full use of its productive resources — will likely persist due to weak demand. Fiscal stimulus can reduce this hit to demand by providing people with the resources they need to continue purchasing goods and services.

Other terms useful for understanding fiscal stimulus include the following:

- Fiscal stimulus that comes from new legislation is often referred to as “**discretionary**” fiscal stimulus; examples include the CARES Act’s relief rebates (officially “economic impact payments”) of up to \$1,200 per qualifying adult. This contrasts with “**automatic stabilizers**” — programs such as unemployment insurance (UI), Medicaid, and SNAP (formerly food stamps), which under preexisting law cushion the effects of a slowing economy. Automatic stabilizers help because they expand as the economy weakens and more people lose income and become eligible for the programs — and they [shrink again](#) in good economic times. However, the United States’ automatic stabilizers have significant coverage holes and modest benefits. As a result, U.S. policymakers have had to supplement them with discretionary measures, but they often haven’t done so until well into a recession or have ended them before the economy fully recovered. This highlights the importance of both strengthening existing automatic stabilizers and supplementing them as needed with discretionary measures.
- Fiscal stimulus complements **Federal Reserve** actions to fight recessions, including traditional **monetary policy**, that is, cutting interest rates to make borrowing easier. When interest rates are already very low, the Fed can use unconventional measures such as [forward guidance and quantitative easing](#), and in a financial crisis, it can act to stabilize financial markets and ensure credit flows. The Federal Reserve has been aggressively using these policy tools in the current recession, but further discretionary fiscal stimulus is also needed, Federal Reserve Chairman Jerome Powell has [warned](#).

What Fiscal Stimulus Is Most Effective?

Effective fiscal stimulus has a high “**bang for the buck**” (formally the “**fiscal multiplier**”). That is, for every dollar of cost to government, it generates the largest economic boost. For example, a policy with a multiplier of 1.5 means that \$1.00 of that stimulus will lead to a \$1.50 increase in economic output. A multiplier of 0.75 means that \$1.00 of stimulus will lead to a \$0.75 increase in output.

Stimulus policies with high bang for the buck deliver resources quickly, and to the households most likely to need help making ends meet and so will quickly spend rather than save any additional dollar they receive. For example, increasing nutrition assistance (SNAP) and boosting unemployment insurance have high bang for the buck because each dollar the government spends on SNAP or UI will likely be spent quickly by households on groceries and other necessities. The money that SNAP and UI recipients spend also helps

shore up the income of the businesses and workers that produced and sold the goods and services. *These* workers, in turn, will be less likely to cut back on their own spending, shoring up the incomes of still more business and workers. An initial, well-targeted dollar that the government spends can generate well more than a dollar of additional spending through the economy as its impacts ripple outwards. The Congressional Budget Office (CBO) and a range of economists generally rate measures such as SNAP and UI as highly effective stimulus, with multipliers greater than \$1 – for SNAP [roughly \\$1.50](#) – when demand is weak.

Federal fiscal relief for states and localities also rates as high bang-for-the-buck stimulus. In a recession, state budget receipts fall, and rising unemployment and poverty increase the demands on state-provided services. But nearly all states are prohibited from running deficits in their operating budgets. So without federal help, many of the actions that states must take to achieve budget balance in the face of falling revenues – cutting services, laying off workers, and raising taxes – would further weaken the economy. Federal financial assistance to states that mitigates these effects is therefore quite effective as stimulus. Currently, due to the COVID-19 crisis, states are on the brink of budget shortfalls that could be the largest on record, totaling more than [\\$765 billion](#).

In contrast, tax cuts for wealthier households, which they will likely save rather than spend quickly, do little to bolster demand and so typically generate far *less* than \$1 of output for each dollar of fiscal cost.

Broad-based tax cuts for businesses also typically rate much more poorly than measures that go to households that are financially struggling. In a recession, the biggest problem that businesses usually face is lack of customers, and, irrespective of a tax cut, businesses will not likely hire more workers or purchase more raw materials or intermediate goods from their suppliers if they cannot sell their products. Further, broad-based tax cuts are poorly targeted to get cash to those firms that need help surviving until their customers can return.

The impact of a stimulus policy on economic output is determined both by its cost-effectiveness – its bang for the buck – and by its size – how many bucks are spent.

The Great Recession and the COVID-19 Recession

The United States last experienced a recession in the Great Recession of 2007 to 2009. Although a substantial fiscal response prevented an even more severe recession, the stimulus ended prematurely and was insufficient to promote a sufficiently strong recovery. The protracted period of high unemployment and underemployment after the economy began growing again in June 2009 continued to cause hardship and impede long-term growth.

Today, it is already clear that the COVID-19 recession is [far deeper](#) than the Great Recession and could get even worse, unless policymakers enact further sound fiscal stimulus to mitigate the damage. Policymakers

have enacted substantial fiscal relief measures, particularly in the Families First Coronavirus Response Act on March 18 and the [CARES Act](#) on March 27. But CBO estimates that even with those measures in place, the gap between the actual size of the economy and its potential size is still far larger than the gap over the first two years of the Great Recession.

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For more information on fiscal responses to recessions, see:

Fiscal Stimulus Needed to Fight Recessions: Lessons From the Great Recession

<https://www.cbpp.org/research/economy/fiscal-stimulus-needed-to-fight-recessions>

Putting the Size of the Needed COVID-19 Fiscal Response in Perspective

<https://www.cbpp.org/research/federal-budget/putting-the-size-of-the-needed-covid-19-fiscal-response-in-perspective>

States Need Significantly More Fiscal Relief to Slow the Emerging Deep Recession

<https://www.cbpp.org/research/state-budget-and-tax/states-need-significantly-more-fiscal-relief-to-slow-the-emerging-deep>

Payroll Tax Cut Is Poor Stimulus

<https://www.cbpp.org/research/federal-tax/payroll-tax-cut-is-poor-stimulus>

CARES Act Includes Essential Measures to Respond to Public Health, Economic Crises, But More Will Be Needed

<https://www.cbpp.org/research/economy/cares-act-includes-essential-measures-to-respond-to-public-health-economic-crises>

Coronavirus Response Should Include Urgent Fiscal Policy Measures to Address Financial Hardship, Stave Off a Severe Recession

<https://www.cbpp.org/research/economy/coronavirus-response-should-include-urgent-fiscal-policy-measures-to-address>