Fiscal Policy in the COVID-19 Economic Recovery

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Congress is currently considering a new stimulus package to address the economic recovery. As of December 2020, the unemployment rate for private nonagricultural workers was 6.7%, down from 13.3% in May and 14.7% in April, but significantly above the 4.4% rate in March before the Coronavirus Disease 2019 (COVID-19) pandemic began to affect the economy. COVID-19 infections and deaths, while slowing in the late spring of 2020, began to rise steeply in the fall and winter.

Causes of the COVID-19 Recession

The recession was caused by a steep decline in demand in sectors requiring personal contact, including the service sector (and particularly travel and leisure), as well as petroleum products due to decreased travel (see CRS Report R46460, *Fiscal Policy and Recovery from the COVID-19 Recession*, by Jane G. Gravelle and Donald J. Marples for a more detailed discussion of issues discussed in this Insight). Job losses and wage reductions were concentrated in low-wage workers. Although many state and local officials issued stay-at-home and shut-down orders, economic studies indicate that the primary cause was consumer fear of catching the virus. Those findings suggest that bringing the virus under control through vaccination and testing is key to recovery.

Policies Enacted in 2020

Several policies were enacted in 2020 in response to the pandemic. The largest in size was the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), enacted at the end of March, which provided $1.7 trillion in fiscal policy initiatives and lending authorities. The major components of the CARES Act were the Paycheck Protection Program (PPP), providing loans for small businesses that could be forgiven; an extension and expansion of unemployment benefits, including an additional $600 weekly supplement; and direct payments (refundable tax rebates) of $1,200 ($2,400 for joint returns). The $600 unemployment supplements lapsed at the end of July. The second major act, enacted in December 2020 as part of the Consolidated Appropriations Act, 2021 (P.L. 116-260), provided about $900 billion in COVID-related spending and tax cuts, including an extension of the PPP, an extension of unemployment benefits with an additional $300 weekly supplement through March 13, 2021, and a $600 rebate. The policies were aimed at both economic stimulus and relief for those individuals and businesses left behind.

Proposed Policies Under Consideration

Prior to his inauguration, President Biden proposed an additional $1.9 trillion of stimulus. Reports indicate that the major aspects of this proposal (and their budgetary costs) include a $1,400 rebate per person ($465 billion); state and local government assistance ($350 billion); an extension of unemployment benefits through September and an increase of the supplement to $400 ($350 billion); vaccination and testing funding ($160 billion); education funding ($170 billion); temporary expansion of the child credit, including the refundable portion ($120 billion); rental support ($30 billion); and child care providers support ($25 billion).

Ten Republican Senators have proposed a $600 billion plan, retaining $160 billion in vaccine testing, but reducing the direct payment to $1,000 (with $500 for dependents) and phasing it out at lower-income levels ($220 billion), no increase in the unemployment benefit supplements but extending it through June ($132 billion), no aid for state and local governments, $50 billion for PPP and other aid for small businesses, $20 billion for child care support, and $20 billion for education.

Size and Form of a Fiscal Stimulus

The effect of a fiscal stimulus depends on both its size and nature. The difference between the economy's actual production and production potential (known as the "output gap") was estimated at 2.85% for the fourth quarter of 2020. In dollar terms, this corresponds to an annualized shortfall in GDP of $630 billion. This gap could grow if coronavirus infections increase (e.g., from the new more transmissible strains being identified).

The effect on the economy from additional stimulus depends on what economists refer to as the "multiplier" effect, or the amount by which an initial increase in spending or reduction in taxes translates into increased demand, and hence output. If the fiscal multipliers are large enough and the output gap does not grow, the $1.9 trillion stimulus could be too large relative to what is needed to return the economy to full employment.

Economic theory and empirical evidence suggest different multipliers associated with different policy levers. Evidence from the past and studies of recent policies indicate that (1) expanded unemployment benefits are likely to have a large multiplier effect and be most effective in the current economic recovery where spending decreased because consumers are avoiding personal contact; and (2) rebates would be more effective if targeted at low incomes. Past evidence also suggests that aid to state and local governments is effective partly due to a relatively strong multiplier effect.

Researchers at The Brookings Institution find the $1.9 trillion stimulus would generally move the economy back toward its longer-run potential growth path, although the stimulus would initially cause the economy to noticeably exceed its potential for a short period. The researchers also find that aid to financially vulnerable families would have the greatest short-term impact. Researchers at Wharton generally agreed on the need for a significant stimulus but suggested elements could be more targeted, including rebates and aids to businesses; they also noted the likely effectiveness of transfers to state and local governments. Michael Strain at the American Enterprise Institute suggests that the size of the package is too large given the output gap and that rebates should not go to higher-income individuals, but he supports state and local transfers and direct spending on containing the coronavirus. Larry Summers, former Secretary of the Treasury in the Obama Administration, indicated that the size of the package was large relative to the output shortfall, but noted that the package has the goal of both macroeconomic policy and structural fairness. He suggested the vaccination package and aid to state and local governments were the most important policies and expressed some concern about stimulus checks going to individuals who do not need them. Jason Furman, who served in the Obama Administration, suggested that the plan should be contingent on the course of recovery, given the uncertainties, but also stressed the need for vaccinations and relief for the low-income and unemployed.

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