***Editor’s Note:*** *The near-term forecast of our Fiscal Impact Measure incorporates recent legislation and the automatic effects of the recession on taxes and spending. While additional legislation to combat the recession is likely, we don’t know what form it will take and have not included it in the forecast.*

**FISCAL POLICY AND THE ECONOMY IN 2020 AND 2021**  
**By** *Manuel Alcala Kovalski and Louise Sheiner*

The fiscal policy response to the pandemic had a massive impact on GDP growth in the second quarter, boosting it 14.6 percentage points at an annual rate, according to the latest reading of the Hutchins Center Fiscal Impact Measure (FIM). The FIM translates changes in taxes and spending at federal, state, and local levels into changes in aggregate demand.

The GDP contracted at an annual rate of 32.9 percent in the quarter, according to the latest government estimates. The FIM illustrates how much worse the decline would have been if not for federal fiscal policy. This is the highest level of the FIM since 1973, the earliest year for which we have data.<br><br>

Taxes and transfer programs accounted for the largest component of the increase in the second quarter FIM, reflecting the boosts to consumption from the CARES Act’s payments to households and expanded unemployment benefits, as well as the effect of the automatic stabilizers—the reduction in taxes and increases in unemployment and SNAP benefits that occur automatically when an economy falls into a recession. Federally financed purchases, mainly grants to state and local governments and spending on the processing of Paycheck Protection Program (PPP) loans, also boosted the economy in the second quarter.<br><br>

Purchases financed by state and local governments, on the other hand, were a restraint—holding down GDP growth by 6.8 percentage points, as state and local governments shed workers in response to school and office closures and tight budget conditions.<br><br>

Our forecast reflects only legislation Congress has enacted so far, not what it is likely to do in the near future. With that assumption, we project that fiscal policy will continue to support the economy in coming quarters, although by decreasing amounts barring further action from Congress. But as the effects of the CARES Act and other legislation wane, the effects reverse; fiscal policy will become a negative factor for GDP growth. In the second quarter of 2021, for example, fiscal policy will decrease GDP growth by 6.1 percentage points below its potential. We will update our forecast in the future to reflect further action by Congress.<br><br>

While the overall trajectory of the FIM is clear—a near-term boost to the economy that abates quickly, followed by several quarters of restraint—the exact magnitude and timing of the effects are not. For the current projection, we’ve made several assumptions: about the timing of the outlays from the recent legislation, for example, and, importantly, about the behavioral responses to it. The impact of taxes and government transfers on the pace of GDP growth depends on the marginal propensities to consume (MPC)—for instance, how much households spend versus how much they save from the $1,200/person payment that the CARES Act provided to most households. During the pandemic, the MPCs could be smaller or larger than in normal times. The effects of lockdowns and social distancing could reduce consumption; the progressivity of the increased federal spending—particularly the $600 per week increase in unemployment benefits—could produce larger effects on consumption. Data available thus far suggest the spending response has been robust, and we have boosted our standard MPCs, both for the payments to households and the expanded unemployment benefits, a bit.<br><br>

Estimating the impact of the PPP on GDP is particularly difficult, as it is too soon to know what share of those grants went to businesses that would have otherwise laid off employees—in which case the PPP funding operates much like unemployment insurance—and what share should be viewed like standard business tax cuts that have only small near-term effects on business spending. Recent evidence suggests that these loans did boost employment, although only for a minority of the firms that received them. As a result, we’ve assumed that additional spending as a result of the PPP grants is likely to be relatively small and slow. (Specifically, we’ve assumed a weighted average MPC that is 30% the MPC we assume for UI, and 70% the MPC we assume for corporate tax cuts.)<br><br>

Finally, the FIM may not capture all the effects of recently enacted legislation on the economy. The FIM is intended to capture the effects of fiscal policy on aggregate demand. Thus, we don’t include the benefits of the up to $450 billion to support emergency lending by the Federal Reserve to lend, nor do we include the potential benefits of PPP in keeping businesses from going bankrupt. We consider whether the dollar amounts of the PPP loans are spent, but not the longer-term benefits of keeping businesses from folding.<br><br>

Before the onset of the COVID-19 pandemic, federal, state, and local fiscal policies were providing a modest boost to GDP growth.

*For more on the FIM, see our* [*methodology »*](https://www.brookings.edu/research/the-hutchins-centers-fiscal-impact-measure/)*. You can also read our* [*Guide to the FIM »*](https://www.brookings.edu/2019/07/26/a-guide-to-the-hutchins-center-fiscal-impact-measure/%20/)*.*