

Economic Survey of the United States, 2001

Summary

After an economic expansion unparalleled for its length there has been an extremely rapid change in the economic climate in the United States over the past year, accentuated by the consequences of the 11 September terrorist attacks. The economy now seems likely to have entered a recession, albeit one that should prove short-lived. The downturn has quickly eliminated both excess demand and incipient inflationary pressures, in part because the underlying increase in productivity growth appears to have been well maintained. Activity may begin to pick up in the middle of 2002, leaving growth at only around $\frac{3}{4}\%$ in 2002 following a projected outcome of some 1% in 2001. A number of global and domestic economic uncertainties cloud the outlook, notably the risk that consumer confidence might be more severely damaged or that the drop in business investment might persist. Already, monetary policy has been eased rapidly without jeopardising inflation objectives. Significant further cuts in interest rates may be necessary, if these risks were to materialise. In any case a prolonged period of low interest rates will be needed to establish the recovery, but once it is firmly in place, the process of bringing interest rates back to more neutral levels should get underway. The substantial adjustment in fiscal policy will also be helpful. The speedy implementation of tax rebates in 2001 and a package of continuing tax cuts whose revenue cost will finally amount to $1\frac{1}{4}\%$ of GDP by 2010 came at an opportune moment from a cyclical perspective. But further measures should be carefully designed, both with regard to their magnitude and their permanence to avoid having counter-productive effects. In any case, early action

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- How will future pensions be paid?
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- Is the income tax system too complex?
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This Policy Brief presents the assessment and recommendations of the 2001 OECD Economic Survey of United States. The Economic and Development Review Committee, which is made up of the 30 Member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

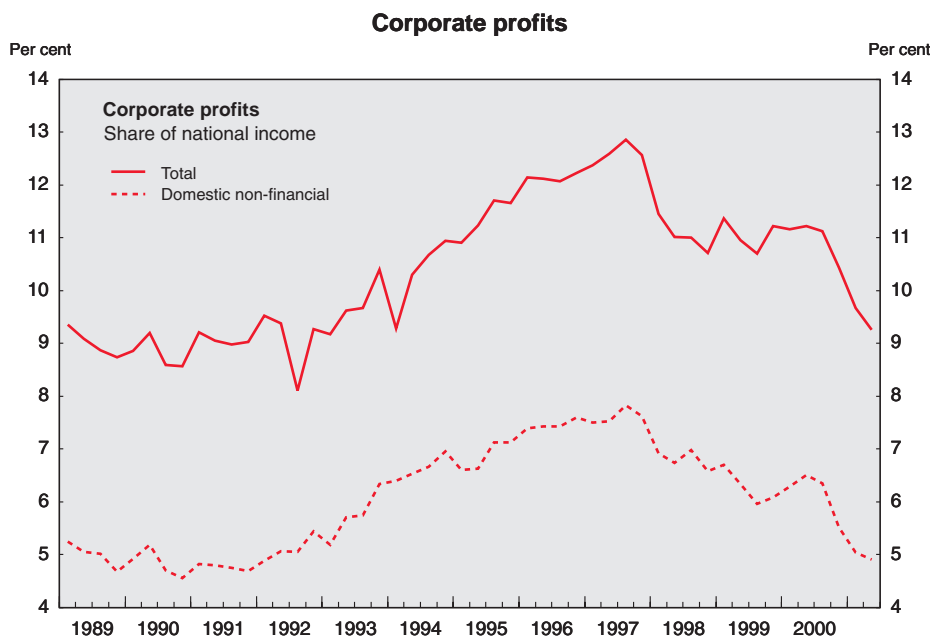
to ensure the long-run sustainability of Medicare and Social Security pensions is required. Cutting taxes on both physical and human capital would improve economic welfare and, most likely, growth prospects. The higher marginal income tax rates should be lowered further and the complexity of the income tax system should be reduced in a revenue-neutral fashion by considering the introduction of a value-added tax and environmental taxation. Additional regulatory reform and privatisation should be pursued in the areas of telecommunications, air travel and electricity, albeit with appropriate safeguards against oligopolistic behaviour. The ongoing structural transformation of the economy must not be hindered by policies designed to help specific sectors such as steel and agriculture. Pro-

viding the Administration with “trade promotion authority” relatively free of negotiating constraints would be one way of convincing agents of the US commitment to further trade liberalisation, despite the inevitable efforts required to deal with the aftermath of 11 September. In sum, the economic fundamentals remain sound and are expected to re-exert themselves in the not-too-distant future, but there remains an unfinished agenda of structural reforms that could improve economic performance over the longer run. ■

Why has the economy turned down?

Following seven years of strong growth (averaging 4% per year), the downturn in the US economy has

been sharp and notable for the speed with which it occurred. After still expanding rapidly in the first half of 2000, activity slowed in several stages. The first was in the autumn of 2000 when the first signs of the end of the ICT bubble came into view, bringing with it more moderate investment increases and worsening inventory problems. The second step of the downturn came in the spring of 2001 as growth ground to a halt, with further shrinkage in the manufacturing sector caused by absolute declines in durables purchases, especially of ICT-related goods, by consumers, businesses and foreigners. There were signs that the deceleration was bottoming out over the summer, but as more evidence became available, it became clear that the weakness was by no means over, as labour-market out-



Source: Bureau of Economic Analysis and Bureau of Labor Statistics.

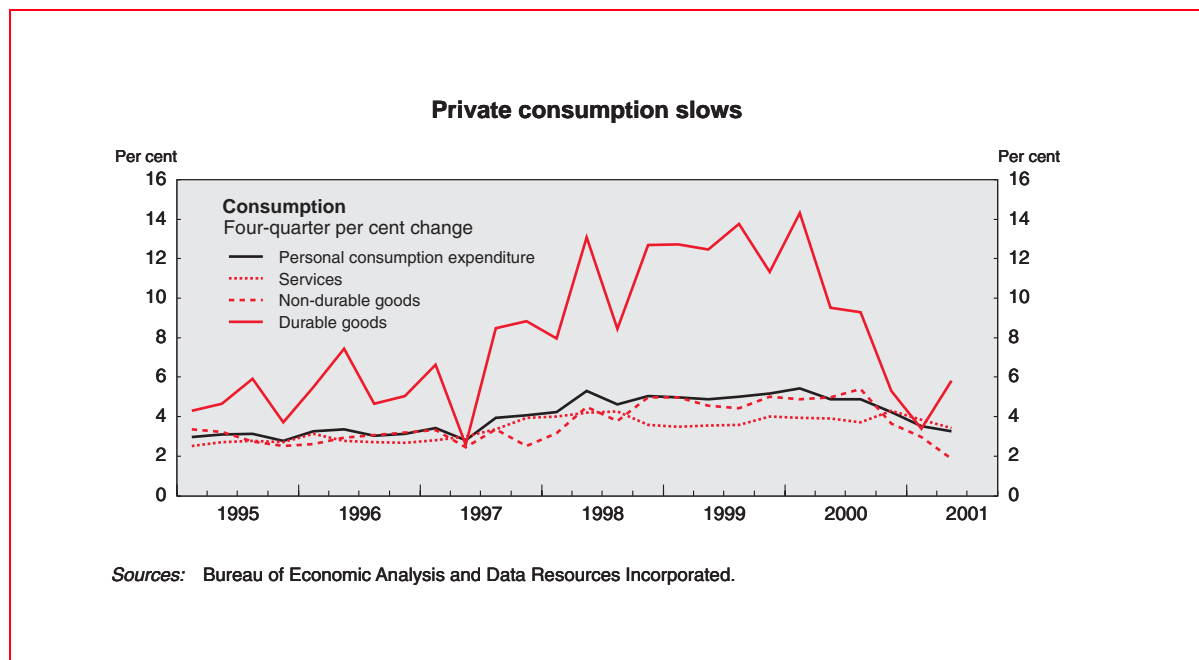
comes deteriorated and consumer confidence dropped sharply. The final stage began on 11 September with the terrorist attacks in New York and Washington, which most likely will have proved sufficient to push the economy into recession, with output falling in the second half of 2001, followed by only sluggish growth in the first half of 2002. As a result, real GDP growth is projected to be only around 1% this year. Some slowdown had been necessary and was indeed expected, as growth at the 4½% rate seen from 1998 to mid-2000 was beyond what is sustainable, and demand pressures were building, as exemplified by a sub-4% unemployment rate, the lowest since 1970.

A fundamental reason for the initial slowing appears to have been the gradual realisation that parts of the “new economy” were not going to deliver profits on the scale that had been expected. Share prices in the high-tech sector fell over 80% and

were responsible for almost half of the stock-market fall that occurred in 2000. Following this change in sentiment, high-tech companies faced a higher cost of equity capital and increased risk premiums for borrowing. As a result, there was a sharp reduction in outlays on information and communication equipment, first in the high-tech sector and by start-ups and later elsewhere as companies became concerned about the profitability of such investment. In addition, purchases of cars fell, especially for the types produced domestically. As well, the dollar kept rising until the middle of 2001, hampering corporate competitiveness. The end-result was a sharp slowdown, accentuated by a normal stockbuilding cycle that was largely concentrated on the manufacturing sector. The immediate negative impact of the terrorist attacks in terms of disruptions in the airlines, tourism and financial-services sectors may be short-lived. But spill-

over effects are most likely to be substantial and longer lasting – even if these effects are as yet difficult to quantify. Consumers and businesses are expected to adopt a wait-and-see attitude and delay spending decisions in the current period of heightened risk premia and impaired confidence. A notable weakening in activity is suggested both by the steady stream of layoff announcements and the surge in new claims for unemployment insurance.

Despite the downturn, there is evidence that the improved growth of trend productivity seen in the second half of the 1990s has been maintained. Actual productivity growth in the non-farm sector has worsened for cyclical reasons, rising by only 1¾% in the year to the third quarter of 2001. This, however, represents one of the best performances in a period of major economic slowdown since the 1960s, supporting the view that productivity trends are better now than in a generation.



Nonetheless, the longer-term implications for productivity and supply more generally of the need for increased security and the resulting boost to transactions costs may ultimately prove non-negligible.

The weakness in demand over the past year has led to a run-up in the unemployment rate, which nonetheless remains below the level that was considered as full employment a few years ago. As the labour market became less tight, the growth in most measures of employees' compensation stabilised, but unit labour costs accelerated with the cyclical productivity slowdown, leading to a marked deterioration in overall company profits, which fell 13% in the year to the second quarter of 2001 and even more sharply in the third quarter. The core consumer price deflator has been quite stable below 2%, though energy prices led to an increase in the overall inflation rate for a time. The stability of underlying inflation has resulted from the combination of the continued albeit disappearing excess demand, offset by the effect of the unusually persistent appreciation of the dollar on the prices of tradable goods and services. ■

Has monetary policy laid the ground for a recovery?

Monetary policy reacted swiftly to the initial slowdown in the economy, with a cumulative cut in the target federal funds rate of 3 percentage points by August. The objective of monetary policy had been to prevent the downturn in stockbuilding and investment from spreading throughout the economy, affecting consumers and damag-

ing the health of financial institutions, without harming the still fairly benign inflation prospects. That objective may have been achieved before the terrorist attacks. Following the terrorist attacks and the resulting increased demand for liquidity and aversion to risk, the Federal Reserve cut another 1½ percentage points off the target funds rate, bringing it to 2%, near zero in real terms and the lowest level since 1961. It also injected massive amounts of liquidity for several weeks in order to ensure the financial system continued to function smoothly and efficiently. That liquidity is appropriately now being withdrawn. The stance of fiscal policy also changed markedly, with a major tax package legislated in the spring and a further loosening of the purse strings after the 11 September attacks (see below). All told, the cumulative changes to the federal budget balance beyond those caused by the business cycle look set to reach at least \$190 billion (1.9% of GDP) in 2001 and 2002, greater than the 1989-92 relaxation.

Following the projected late-2001 recession, there may be a further period of sluggish growth, as consumers strive to increase savings during this period of heightened uncertainty and rising unemployment that is coming on the heels of a year and a half of declining wealth. Also, companies will most likely continue to trim their fixed investment in response to downward revisions of sales expectations, preferring to wait for the prevailing uncertainty to dissipate. Foreign markets too look unlikely to provide any buoyancy for several more quarters. However, stockbuilding should give some lift to activity by early 2002, reflecting the sharp inventory cutbacks already achieved. Thereafter, the aforemen-

tioned fiscal stimulus and the easy stance of monetary policy should allow a pickup in private-sector demand and activity around mid-year. Assuming that no further disruptions will come from political and military developments, real GDP is projected to grow around ¾% year on year in 2002, but close to 2¾% through the year. A further acceleration to the 3½ to 4% range is expected in 2003, as pent-up consumer demand is unleashed and the overhang in the capital stock is overcome. But in the interim the cyclical downturn is projected to generate a rapid rise in labour-market slack, with the unemployment rate reaching 6¼% on average in 2002 before it reverses course. Excess capacity, combined with lower energy prices, should lead to some modest declines in inflation at least until end-2002. For similar reasons there should be further improvement in the external balance, with the current-account deficit stabilising at around 4% of GDP.

The possibility that some elements of demand could prove even weaker appears to be substantial. There is a risk that cutbacks in business investment outlays may accelerate or that the world economy might weaken further, given the current fragile global situation. Untoward developments pose some risk that the projected recovery next year could be jeopardised. If that risk materialised and downward momentum of the economy were to persist, then it is possible that further cuts in interest rates might be needed. In any case, to ensure a recovery, a strong monetary stimulus will need to be maintained until the end of 2002. But the strategy of keeping interest rates low to generate a recovery is not without danger. It encourages the accumulation of debt in

the private sector, perhaps only postponing the date at which households and firms react to their worrisome debt positions. Moreover, if low rates were to eventually result in a sharp fall in the external value of the dollar, inflationary pressures could be sparked, or financial instability could ensue. Once the recovery is firmly established and slack is being taken up, it would be proper to begin the process of reining in the amount of monetary stimulus by moving short-term interest rates back towards more neutral levels. ■

By how much has the thrust of fiscal policy changed?

As noted above, the direction of fiscal policy changed significantly in 2001. In a period of seven years, from 1993 to 2000, the federal budget balance had moved from a serious deficit to a healthy surplus, an improvement of 6 percentage points of GDP, generating a fall in federal debt held by the public to 35% of GDP at end-2000, down from over 49% in 1993. Restrictions on public spending contributed to this movement, but a large part of the swing in the budget balance reflected an increase in the tax-to-GDP ratio, which, driven by a buoyant economy, fiscal drag and high stock-price valuations, rose 3 percentage points of GDP in the same period. The new Administration and Congress considered that such a rise, should it persist, would impose a considerable deadweight cost on the economy. They, therefore, chose to reduce the level of taxation. By 2006, the annual revenue cost of the series of tax cuts is projected to rise to 1% of GDP, excluding resulting extra interest costs,

and peak at 1¼% of GDP in 2010. It was also decided to bring forward the impact of these tax cuts on household incomes through personal tax rebates implemented over the summer amounting to 0.4% of GDP. The new law includes reductions in marginal tax rates; tax breaks to encourage investment in post-secondary education and saving for retirement; and reductions in the estate tax, leading to its elimination in 2010.

This change in direction was accentuated by the events of 11 September 2001. Thereafter, the President was quickly granted authority to spend \$40 billion (0.4% of GDP) in order to react to the attacks. The money is likely to be spent over several years. An additional \$15 billion in support for the nation's airlines was also approved, even though several were already struggling to remain in operation prior to 11 September. Most recently, legislators have begun to plan a further stimulus package, whose size the Administration suggests should be between \$60 and \$75 billion, a limit that Congress may well exceed. Even with a package of only \$60 billion, if most of it pertains to the 2002 financial year, the budget that year is likely to move into deficit. There is some risk that too large a package could raise long-term interest rates, negating some of the expansionary effect of the fiscal measures and hampering the effectiveness of monetary easing. No decisions have as yet been taken as to the precise choice of measures, but policy makers should be guided by two principles: the measures should have temporary rather than lasting budget consequences so as to maintain the integrity of the medium-term fiscal position; and they should maximise the impulse to spending and activity from any

given (net) revenue cost. In particular, tax incentives should be focused on temporary measures that are most likely to induce incremental spending by households (by concentrating cuts on those with a high marginal propensity to consume) and businesses (by offering encouragement to additional investment rather than previous capital outlays). Indeed, a poorly designed, excessively large package might even prove counter-productive if the perception becomes prevalent in the markets that public finances are impaired. In any case, that is still not the most likely scenario, as the federal government should still be able to pay down a substantial amount of its debt over the next decade. However, this past year's experience is another reminder that ten-year budget projections are subject to considerable uncertainty.

A continuing decline in debt, if it materialises in the medium run, might give rise to pressure for further tax cuts in the future. Indeed, under present law the absence of indexation of the thresholds for the Alternative Minimum Tax – a parallel method for calculating tax liabilities with very few exemptions – may be one area where pressure for change may arise, as 35 million taxpayers are projected to pay this tax by 2010. In addition, a number of time-limited tax breaks are assumed to expire before this date. Together, these factors amount to an assumption of substantial fiscal drag. However, room to act in these areas will depend on the federal government's ultimate ability to keep to its plan to restrain annual discretionary spending growth to more than 2 percentage points below the growth of nominal GDP. This will be a difficult objective in view of probable increases in military outlays.

The government must also control spending on mandatory programmes. While savings may result from proposed reforms, there is also pressure to increase the scope of existing mandatory programmes such as by introducing a seniors' prescription drug benefit. ■

How will future pensions be paid?

Indeed, the expenditure consequences of the present systems of public health care and pension provision for the elderly are unsustainable. In the longer term, providing the funding for two federal government programmes – Social Security pensions and Medicare insurance – will cause difficulties. Both benefit senior citizens. Part of their problem arises from the retirement of the baby-boom generation. In addition, a constantly increasing life expectancy and the overstating of inflation by the consumer price index, to which pensions are indexed, are also troublesome. A number of solutions are possible, though one – steadily increasing Social Security contribution rates – seems unlikely to materialise. Two possible avenues to restore balance are the introduction of some link of the retirement age to life expectancy, once the current adjustment is fully implemented in 2025 (while maintaining the option of retiring at an earlier age with an appropriate benefit reduction), and slightly limiting the extent of indexation of benefits to wages and prices. The introduction of private accounts to augment Social Security pensions could have, as well, a role to play in complementing the provision of public pensions over the longer term, as was advocated in a previous *Survey*. It is likely to require an increase in

mandatory saving in order to fund the transition from a largely pay-as-you-go public system to one with a larger capitalised component, involving some degree of redistribution between generations. Various options for reform are now being studied by a Presidential Commission. For health care, all currently proposed reforms imply increased spending for the elderly, without providing coverage for the one in six non-elderly Americans without medical insurance, at a time when some reduction in the long-term growth of public healthcare spending seems unavoidable. ■

Is a tax reform needed?

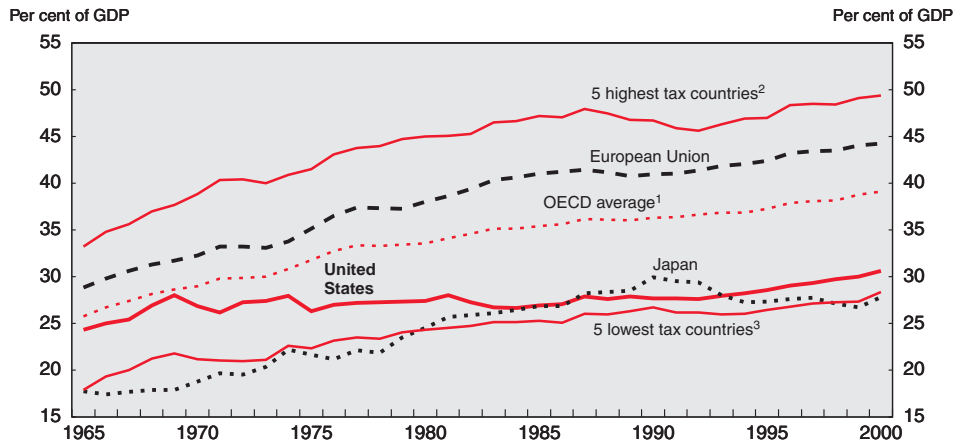
Even before the recently legislated tax cuts, the United States was a relatively low-tax country: only five OECD Member nations had a lower ratio of all tax revenues (including those levied by states and local governments) to GDP in 2000. However, there are a number of areas where statutory rates were quite high. The top rates for income tax and estate tax stand out, while the corporate tax rate is no longer amongst the lowest in the area. Consequently, concerns that reductions in taxation are distributed equally to all should not be the only driving force for future tax reform, as high tax rates may introduce economic distortions by changing individuals' behaviour. Moreover, higher-income taxpayers appear to be more responsive to movements in taxation than others – raising the possibility that yields from this group might rise if their tax rates fell. Some have suggested returning to the upper limit of 28% in force between 1986 and 1992. In the interest of equity, such a reduc-

tion could best be coupled with some extension of the phase-out range of the Earned Income Tax Credit in order to reduce the high effective marginal rates faced by those in this low-income part of the income distribution. ■

Would it be better to tax consumption?

As important as reducing the progressivity of marginal tax rates is reforming the very uneven system used for the taxation of capital. Public policy in the United States has long considered that taxing capital imposes a welfare cost on society. Overall, almost half of all personal-sector assets are held in a form whose yield is exempt from personal income tax. Even most businesses are not subject to corporate tax. However, personal capital held through large corporations is highly taxed, with the overall tax rate approaching 62% in some states. Income that is retained within a company is taxed slightly less, as a result of the low capital gains tax rate. Even after such tax has been paid, capital is taxed again on the death of the owner. The effective yield of the estate tax is low relative to the total value of personal wealth; nonetheless, the top marginal rate is higher than in many other countries, and there is some evidence that this tax deters capital formation. It certainly stimulates estate planning far beyond its socially optimal level. The eventual elimination of the estate tax, together with the abolition of the possibility of revaluing at death the cost basis used for subsequent capital gains tax purposes, may improve efficiency, though the gains in the first instance will be concentrated on a very few people.

Tax-to-GDP ratios in selected OECD countries and regions



1. Non-weighted average. Excluding Czech Republic, Hungary, Poland and Slovak Republic. Including Mexico from 1980.
 2. 5 highest countries: Belgium, Denmark, France, Norway and Sweden.
 3. 5 lowest countries: Australia, Japan, Korea, Mexico (from 1980) and United States.
- Source: OECD.

Taxation of capital income, rather than the taxation of the consumption from that income, introduces a bias into the tax system. It ensures that the eventual consumption that flows from saving, over time, is less than that obtained by consuming immediately. Hence, a system that taxes consumption rather than income, in theory ought to overcome such a disadvantage and would therefore improve economic welfare. Previous attempts to move towards a consumption base have illustrated the difficulty of implementing such an approach. As a result, there has been an understandable preference for retaining an income tax but reducing the extent to which the income from some forms of saving is taxed.

A series of incremental changes to the existing system seems the best way to shift towards a consumption base. A combination of lowering the corporate income tax rate, exempting dividends from personal income tax and sharply reducing capital gains tax rates would move in this direction and could be reinforced by progressive increases in the limits that govern contributions to various tax-exempt saving schemes. The latest tax law is oriented in this direction to some extent, as it restored the limits on contributions to Individual Retirement Accounts to their original value. While such measures help reduce the taxation of financial capital, there remains the difficult problem of the taxation of human capital. Any future reform should attempt to ensure that the income from such capital should be

treated no differently from other forms of capital. Under the proposed modified income tax system this could be achieved by allowing deductibility of most educational expenditure from income tax. The income from human capital would be taxed only when realised – returns on human capital would then be subject to a similar taxation regime as pensions. Thus, the decision to increase the deductibility of educational expenditures in the recent tax reform is appropriate and, indeed, should be extended. However, an opportunity to widen the base for corporate taxation by ending a number of tax breaks while simultaneously lowering the tax rate was not taken. Indeed, there was a move to increasing special purpose deductions in this area. ■

Is the income tax system too complex?

If anything like the current personal income tax system remains in use, then the degree of complexity of the system should be reduced. Besides the resulting reduction in compliance costs, this would enhance transparency, which in turn would facilitate the alignment of political and general welfare incentives. Examples of unnecessary complication abound. One is the proliferation of specific deductions that depend on the status of the individual and the purpose for which income is used. As there is no overarching check on these deductions, there are multiple definitions of, for example, dependent children and educational expenditures. Moreover, the cost of these deductions has to be

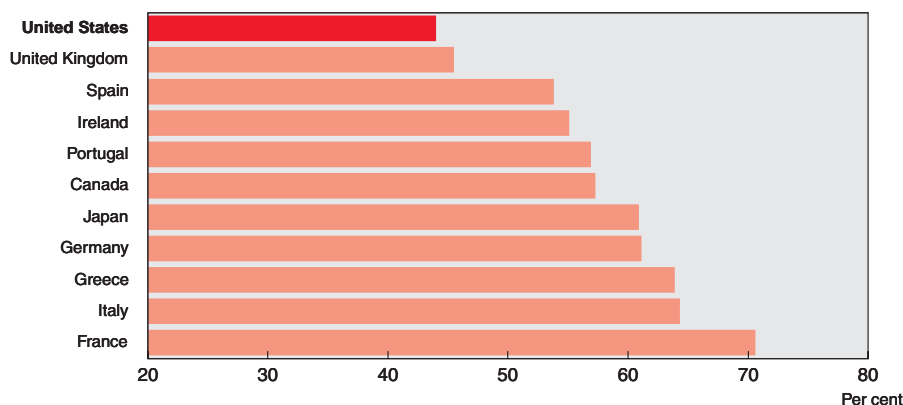
limited by ensuring that they are reduced as income increases. In 2000, there were 22 such phase-outs, with the result that individuals in the same income bracket could face as many as four different effective marginal tax rates. Indeed, the large number of special deductions and their associated phase-outs make for horizontal inequities. Another area where simplification is needed is the taxation of Social Security benefits, where the rules are complex at low-income levels and differ from other forms of taxation. Since half the cost of these pensions are met from post-tax income, only half of the income should be taxed. Making this share uniform would also have the advantage that current disincentives for low-income people to save through pension schemes would be eliminated. Finally, a major simplification would be to end the Alterna-

tive Minimum Tax. If the rest of the tax system is well designed, this backstop mechanism is unnecessary and entails a major duplication of compliance costs. ■

How to pay for a reform?

The above reforms need to be introduced in a way that does not jeopardise the budget balance. A number of deductions, which mainly accrue to high income taxpayers, could be eliminated in order to help lower the taxation of capital income. The current deductibility of mortgage interest (regardless of the use of the loan) and state income taxes are two areas that stand out. The introduction of a value-added tax could possibly offer a way to finance some part of tax reforms advocated above

**Highest combined social insurance and personal income tax rate
2000**



Note: The combined tax rate is calculated as the complement of the ratio of take-home pay to the product of the gross wage and one plus the employers' social security rate.

Source: OECD Tax database.

and would be consistent with a move to taxing consumption. Moreover, by taxing residential construction the consumption of owner-occupied housing would be appropriately caught in the tax net. But introducing such a tax would have to be weighed carefully. There would need to be co-operation between different levels of government in order to ensure common tax bases, building on current work by the states. Moreover, supplemental value-added taxes for states, even though replacing existing sales taxes, could impose compliance burdens. These costs would have to be seen both in light of the gains from the overall package and the greater neutrality of expenditure taxation.

As regards environmental taxes, previous *Surveys* have suggested introducing either taxation or cap-and-trade programmes in order to ensure that consumers face the marginal social cost of consuming products with negative externalities. In particular, it is estimated that an increase in the taxation of gasoline would be in order to internalise all the costs of its use, but the size of the required hike would be fairly limited. Given the reluctance to raise taxation on gasoline even modestly, a regulatory move to raise the required fuel efficiency of so-called light trucks (sports utility and four-wheel drive vehicles) towards the limit for cars may be an appropriate second-best option. The efficiency of this programme could be boosted by allowing motor vehicle manufacturers to trade fuel consumption permits. The major externality of driving motor vehicles, though, especially in urban areas, is not pollution but the cost of the congestion imposed on others. Reducing the time lost in traffic jams is best achieved through road pricing, and

pilot studies in the United States show this to be an effective instrument. Substantially reducing greenhouse-gas emissions would probably require a new set of initiatives: ideally, a tax on the carbon content of natural gas and coal, or an effective cap-and-trade system for the right to emit. Technological initiatives, voluntary agreements, reporting and registry programmes and regulatory reform can clearly also contribute, but such measures are likely to be more costly overall for achieving any given level of emissions reduction than a market-based approach. ■

How can air travel and telecommunications be made more efficient?

The focus of budgetary policy on restraining spending has meant that, in certain areas, there has been a lack of public infrastructure investment. This has been most noticeable in the field of commercial air travel. Air-traffic control is under federal management, while investment in airports is largely in the hands of local governments, albeit with a large federal subsidy for centrally approved projects. This lack of investment has been one factor contributing to mounting flight delays (although henceforth security may be the more binding constraint, given the fall in demand following the terrorist attacks). A greater commitment of private-sector capital in these two areas and more emphasis on ensuring reasonable access for all carriers at congested airports would be advantageous, as would competitive pricing of take-off and landing slots. Also, the federal government

owns several air bases that could be sold to the private sector for conversion to commercial airports, thereby helping to increase capacity. As to the tightening of security, a greater federal role would seem to be desirable in order to restore the public's confidence in the system (which heretofore has had inadequate incentives), but that could be implemented through the imposition of a licensing system without a full government takeover.

Lack of infrastructure has not been, on the other hand, a problem in the telecommunications sector. Investment in this area has exceeded that in computers in the past five years. As a result of previous frequency auctions, competition has lowered the cost of using mobile phones. Government agencies should face the full cost of using their existing frequency allocations, in order to ensure that they relocate to less valuable airspace that can then be sold to quickly further increase capacity available to the private sector. For landlines, the problem has been ensuring that competition results in prices to consumers falling in line with costs. The telecommunications sector is highly regulated by federal, state and local governments. The 1996 legislation tried to increase competition in both local and interstate markets by making the participation of each incumbent local operator in the long-distance market conditional on the opening of that operator's local market. This policy has had limited but growing success. Larger penalties on incumbent operators that do not co-operate with new entrants should be considered in order to speed this process and so lower entry barriers throughout the industry. ■

How should electricity regulation be changed?

The experience with electricity deregulation thus far has been mixed. Electricity markets had been liberalised in 24 states by July 2000, while another 18 states were considering deregulation. The exact nature of the deregulation differed according to the state concerned, with the result that outcomes have varied considerably. In particular, in California the liberalisation of wholesale (spot) prices, while regulating retail prices and restricting, over many years, the provision of new infrastructure, resulted in a temporarily chaotic outcome. A drought-induced reduction in hydro-electric supply, along with the chronic failure to add new capacity, ensured that demand exceeded supply at the regulated retail prices especially, as there is no real-time pricing of electricity. At the same time, with only five companies sharing most of the state's electricity plant, oligopolistic behaviour was possible in the wholesale market. Generators were able to increase their revenues by withholding supply at peak periods, thereby pushing spot prices well above the level justified by higher fuel costs. The overall result was a ten-fold rise in wholesale electricity prices in one year. This rise was curbed only when federal price caps were introduced in spring 2001.

The long-term solution to excess demand for electricity in California cannot entail a persistent risk of a combination of rolling blackouts, price-caps and state intervention in the electricity market. At present, federal regulations have placed price limits on electricity and obliged plant owners to sell at no higher

than this level. Even with a price cap there is an incentive to invest in the state, despite its higher environmental standards, as the cap is three times the price observed in other parts of the country. The state government should allow retail prices to fluctuate with demand more generally. When retail prices were allowed to rise this year, the resulting conservation was so substantial that by early October spot prices in California had moved back into line with those in other major domestic markets. Equally important, cost-based retail pricing would stop the deterioration in state public finances, which has amounted to 1.4% of state product (0.2% of US GDP) for 2001, threatening its credit rating. All consumers should eventually be switched to real-time pricing, which would limit the oligopolistic power of producers. Long-term contracts will be an important element in mitigating risks for new investors in capacity, but these contracts should be competitively negotiated. If the state government enters extensively into such contracts, taxpayers, rather than shareholders, are left bearing the financial risks – or alternatively the state government may have to ban access to lower-priced electricity in the future. Planning delays on the construction of new plant and transmission lines should be further reduced and efforts to construct a national grid that is based on the principle of open access should be intensified. Overall, as the new Administration has recognised, there is a clear need to boost the nation's energy supply, even though demand-reducing policies also have an appropriate role. ■

Is agricultural policy moving in the wrong direction?

Government policies on agriculture need a significant overhaul. Spending on all forms of support has risen sharply between 1996 and 2000, despite the 1996 reform, which was designed to cut such expenditures by 75% in the same period. Fortunately, increased outlays have not been directly linked to current production nor maintaining prices above market levels and so has not obviously distorted acreage or crop decisions, but instead has been designed to support farmers' incomes. Nonetheless, with four consecutive years of "emergency payments" moral hazard considerations may come to play an increasingly prominent role. Furthermore, the United States has accounted for a growing share of total support for farmers in the OECD area in recent years. Benefits elsewhere in the economy are time-limited and generally available only to poor people, but the large majority of government payments to farmers go to already prosperous households or to companies. Means-testing of government support is one way of diminishing the spreading culture of dependency in the sector. At the same time, further efforts to decouple payments from current or past production by reducing market price support, especially for milk and sugar, would be appropriate. ■

Should trade policies be changed?

The US policy in the area of international trade has not been without controversy. On the one hand it continues to press forward with liberalisation proposals in the context

of a new world trade round, regional agreements or bilateral treaties. This year the Administration has asked the Congress for “trade promotion authority” so that any submitted agreement has to be either accepted or rejected without amendments. Such authority would aid in the outcome of new negotiations, such as those that all parties hope will get underway later this year under the auspices of the World Trade Organisation (WTO). The House of Representatives is currently examining enabling legislation, but the draft law includes numerous restrictive clauses that could tie negotiators’ hands excessively. At the same time, the Administration has pursued a hemispheric free trade agreement

and has signed a bilateral deal with Jordan. Against these potential liberalisation moves, it is investigating whether to impose restrictive measures in steel and has gone down a parallel road in softwood lumber. Such restrictions are detrimental to economic efficiency and, if restrictions on steel imports were to divert output to other markets, this could generate pressures for reciprocal responses and escalate trade tensions. A WTO dispute settlement panel recently ruled that the Foreign Sales Corporations Repeal and Extraterritorial Income Exclusion Act is incompatible with the United States’ obligations to the WTO. That law allows exclusion from corporate taxation of foreign-source income.

An appeal has now been launched. Finally, concerns have been expressed about the new law that obliges the government to pay the proceeds from anti-dumping fines or countervailing duties to the industry concerned. ■

For further information

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- **Economic Outlook No. 69,** June 2001. A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

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