

## Economic Survey of the United States, 2007

**How is the economy performing?**

**What are the key challenges facing the economy?**

**How can longer-run living standards be enhanced?**

**What needs to be done to achieve fiscal sustainability?**

**What tax reforms would enhance economic performance?**

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### Summary

Despite a sharp housing market correction, overall growth has been holding up fairly well. Strong foreign demand and a decline in import growth have slowed the rise in the external deficit. With activity near capacity limits, some inflationary pressures have emerged. Reining them in without stifling growth is the main challenge for monetary policy. Looking further ahead, the key challenges are to sustain healthy growth and ensure fiscal sustainability in the face of population ageing. Against this backdrop, the *Survey* focuses on the following issues:

**Enhancing the economy's growth potential.** Trend growth is slowing because labour productivity gains, though remaining high, no longer suffice to compensate for the deceleration in potential employment due mainly to demographic factors. Prospects for productivity growth appear favourable, but further efficiency gains could be achieved by tackling unfinished business in the area of structural reform. Labour supply could be boosted by increasing work incentives for the disabled, raising the earned income tax credit and delaying retirement eligibility.

**Ensuring fiscal sustainability and reforming taxation.** The federal budget deficit has narrowed, but eliminating it requires increased spending discipline. In this context, reinstating expired statutory budget enforcement rules would be helpful. The reform of entitlement programmes, which will come under increasing pressure from population ageing and medical cost increases, is essential to ensure fiscal sustainability in the longer run. On the revenue side, priority should be given to reforms that would broaden the tax base by reducing tax preferences, but consideration should also be given to consumption-based indirect taxes.

**Reconsidering housing support.** Direct and indirect support to home ownership may have led to higher house prices, and thus to increased borrowing by households. Tax preferences are costly and may create

*This Policy Brief presents the assessment and recommendations of the 2007 OECD Economic Survey of the 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.*

distortions, mostly benefiting high-income households that have easy access to home ownership anyway, and should be reformed over time. The regulation of government-sponsored enterprises needs to be tightened, as their activities have developed beyond their original mandate and pose a risk to financial stability, and their role should be refocused on their initial objective of promoting home ownership.

**Improving primary and secondary education.** US school students are outperformed in international tests by their peers in many other countries. Although the causes of this are unclear, a partial explanation is that decentralised standards, curriculum and examinations are undemanding. Federal legislation that aims at addressing such system weaknesses is in general well conceived. However, it could be strengthened, for instance by extending the legislated framework of standards, assessment and accountability through high school. Responsibility for education lies primarily with the states and local authorities, which have to adopt and implement more challenging standards.

**Facilitating access to higher education.** Despite shortcomings through the secondary level, the higher education system is generally performing well. However, one problem is that many potential students cannot afford to enrol. Policy makers have proposed addressing this by increasing student grants. Arguably, a more cost-effective, efficient and equitable means of reducing barriers to access would be to promote income-contingent student loans. Raising student loan limits would help students and promote access at little cost to the taxpayer. ■

**How is the economy performing?**

The economic expansion that followed the 2001 recession continues at a healthy pace. This is all the more remarkable since economic growth in 2006 – 3¼ per cent as in the year before – was achieved in the face of strong headwinds, such as surging energy prices until the summer and a sharp decline in home construction through the year. The resilience and continued good performance of the economy can in part be traced to past regulatory reforms that created a very competitive environment by international comparison and contributed to impressive efficiency gains over the past decade. With robust growth, labour markets have tightened and some capacity pressures have emerged. Still, given the energy price shock, core inflation has remained relatively well contained, as price and wage setters have expected the monetary authorities to keep inflation low. Although the fiscal stance has been broadly neutral, government finances have continued to improve thanks to an ongoing buoyancy of revenues that has outweighed additional spending. At the same time, the current account deficit has broadly stabilised relative to GDP – albeit at a high level, reflecting the strength of export growth and lower energy prices.

While household demand used to be the mainstay of activity in the first few years of the recovery, last year saw a shift of demand toward business investment and exports. This bodes well for a continuation of the economic expansion. Some spill-over effects from the housing market correction are likely to damp activity in the near term, but growth should pick up again when the housing market adjustment has run its course. Easing capacity pressures and the fading impact of last year's energy price increases would bring core inflation down to more comfortable levels, while strong exports, supported by increasing activity abroad and a favourable competitive position, would prevent the external deficit from widening. There are significant risks to such a benign scenario, however. On the one hand, the housing market correction and spill-over effects onto consumption could be more pronounced than generally expected. On the other hand, consumer spending may hold up better than projected, despite the negative household saving ratio, and cause price pressures to increase rather than ease. ■

**What are the key challenges facing the economy?**

The Federal Reserve faces the difficult task of carrying out its dual mandate in an environment where inflation remains uncomfortably high and real economic growth, while still apparently solid, faces downside risks. In the first few years of the recovery, it has successfully balanced the need for supporting activity and preserving price stability. With increasing signs that the upswing had become self-sustained, monetary stimulus was appropriately withdrawn over the two years to mid-2006, when the monetary stance turned slightly restrictive. Since then, the monetary authorities have refrained from further monetary tightening, although core inflation has remained above their comfort zone. This reflects their view that some of the factors that had pushed up core inflation are transitory, that inflation expectations apparently remain well anchored and that

the cooling housing market should, over time, ease resource and price pressures. There may be scope for reductions in interest rates once core inflation is on a clear downward trajectory. For the moment, however, it seems appropriate to keep policy on hold until a clearer picture of output and inflation trends emerges. Should core inflation fail to ease, a further policy firming might be needed to keep inflation expectations in check.

The Administration has emphasised economic growth as a top priority. Ensuring such an outcome will be a challenging task, however, despite recent accomplishments. The growth in the labour force is slowing as the population ages and participation among certain groups is levelling off. Thus, the economy will increasingly depend on productivity gains to achieve GDP growth that can maintain the rise in standards of living for both the working age and the dependent population. Policies and global trends that have made the economy more open, flexible and dynamic – thereby boosting productivity and overall prosperity – may have increased inequality. If unaddressed, concerns about inequality have the potential for eroding support for such policies. There is a crucial need to improve education outcomes, which are central both to reducing inequality and boosting efficiency. Population ageing, along with medical cost pressures, will also put enormous pressures on government finances that need to be addressed early on to avoid an excessive burden on future generations and eventually a fiscal crisis. While economic growth is unlikely to solve the country's long-term fiscal problems, it can help mitigate budgetary pressures in both the short and long run. In view of these various long-term challenges, this *Survey* focuses on the following important policy areas:

- How to respond to slowing labour-force growth?
- What reforms to entitlement programmes could restore fiscal sustainability?
- Should public support to housing be reduced?
- What are the appropriate policies to raise educational achievements and facilitate access to higher education? ■

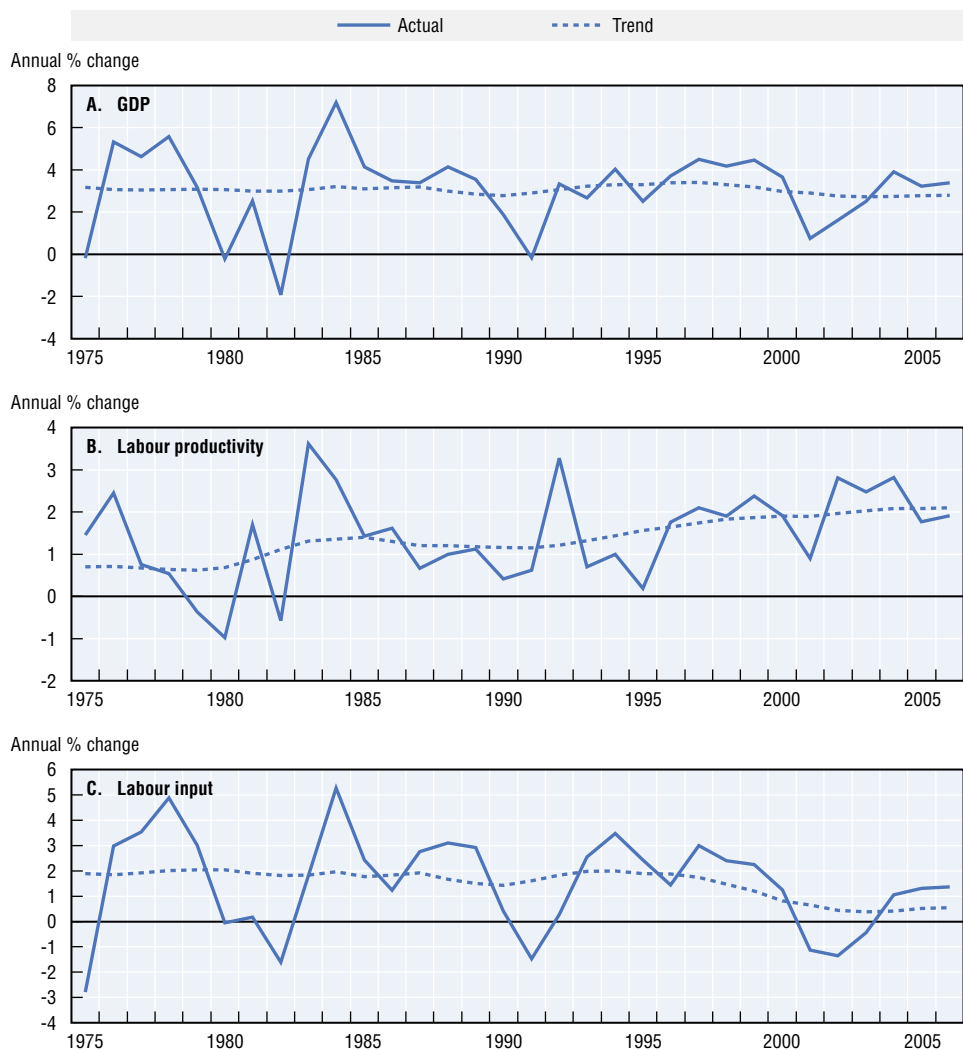
### How can longer-run living standards be enhanced?

Trend GDP growth is slowing because labour productivity gains, albeit remaining high, no longer suffice to compensate for the deceleration in potential employment. The latter reflects a levelling off of labour force participation of women and the fact that the baby boom generation is entering low-participation years. Productivity growth has weakened recently, but this is attributable, to a large extent, to cyclical factors. Over the past decade or so, productivity performance has been above the OECD average by a wide margin. The initiating force behind the productivity resurgence in the mid-1990s was the information technology revolution, together with the fact that, given the favourable economic environment, the United States has been better placed to benefit from the opportunities

provided by technological advances than most other countries. In recent years, strong productivity growth has spread from the high-tech sector to other sectors, in particular service-producing industries, where it has outpaced that in (non high-tech) goods-producing industries. The diffusion of new technologies and their application to more firms and sectors should continue to underpin productivity gains, although their pace is likely to fall short of the brisk growth recorded in the first half of this decade.

Even if productivity growth can be sustained at a reasonably good rate, this is unlikely to prevent potential output growth from slowing, given the trend decline in labour-force participation. This suggests that it would be prudent to deal with unfinished business in structural reform. For instance, *further efficiency gains could be achieved by reducing trade-distorting support to agriculture and continuing trade liberalisation.* As to labour market trends, many of them reflect changes in preferences and demography that governments

**Figure 1.**  
**DECOMPOSITION**  
**OF ECONOMIC GROWTH**



Source: OECD, Analytical database.

cannot influence. Nevertheless, there are some policy measures to boost employment that should be helpful. For instance, the disability insurance system appears to be discouraging a rising share of the population from staying in the workforce, probably to an unnecessary degree. This partly reflects replacement rates that have risen to unusually high levels, partly as a result of trends in health costs. To combat adverse incentive effects, these *high replacement rates should be reduced and screening requirements tightened*. Moreover, *raising the age at which workers become eligible for full Social Security benefits would discourage premature retirement* and also make the Social Security system financially more secure. Finally, with some evidence that increases in tax rates tend to reduce labour supply, *efforts to restrain taxes and government spending may also be beneficial* in this regard.

As noted earlier, the very factors that have contributed to economic success and rising overall standards of living – market liberalisation and globalisation – have had some side-effects that risk undermining the support for such policies. Workers and households experience variability in their earnings and income from year to year and, over the past 25 years or so, income inequality has increased considerably. To a large extent, the rise in inequality reflects an increase in returns to investing in skills. This, in turn, is associated with technological advances, such as improvements in information technologies, which tend to raise the productivity and hence the wages of high-skilled workers relative to those of low-skilled workers. In addition to technological change, globalisation has been a factor behind rising inequality, though probably a less important one. There is some evidence to suggest that immigration has depressed somewhat the wages of domestic low-skilled workers, and outsourcing appears to have had a similar effect. As to international trade more generally, any effect on the rise in income inequality appears to be small. Nonetheless, with a view to attenuating the adverse side-effects of skill-biased technological change and globalisation, consideration should be given to *expanding trade adjustment assistance programmes (including wage insurance and health-care support) to include additional, if not all, dislocated workers, regardless of the cause of dislocation*. With skill differentials a major source of inequality, focusing on improvements in education is of key importance (see below). Raising the minimum wage is a poor means to address inequality and poverty. Even though the effects of recent legislation are likely to be limited, such a measure helps many workers who are not poor, fails to help many who are poor and risks job losses. *The Earned Income Tax Credit should be raised, because it reduces poverty more effectively than the minimum wage and delivers more favourable employment outcomes.* ■

### What needs to be done to achieve fiscal sustainability?

The federal unified budget deficit declined further in fiscal year 2006, to just below 2% of GDP. This met the Administration's objective of halving the deficit (relative to a 2004 baseline) three years ahead of schedule. As in the previous year, it was not the result of discretionary measures but

reflected an unexpected boom in tax receipts, which expanded at almost twice the rate of GDP. *The narrowing of the deficit is welcome, not least in light of the low level of national savings.* But it has to be put into perspective. With the economy operating close to capacity, the deficit is largely structural, and the structural budget balance is still worse than at the beginning of the decade (to the extent of 3 percentage points of GDP, although there are significant uncertainties attached to such estimates). The Administration has set a new fiscal target, which calls for the elimination of the federal budget deficit by 2012. *This would seem to be the minimum, given the demographic and other pressures that threaten both fiscal sustainability and the country's future prosperity.*

While accelerating budget consolidation might be desirable, even attaining it over the medium term involves considerable efforts. Indeed, with a substantial structural deficit remaining, more radical fiscal tightening than in recent years will be necessary to achieve budget balance. The temptation to spend any revenue windfalls should be resisted (the buoyancy of revenues has persisted in the first few months of fiscal year 2007). And discretionary spending, which has grown faster than GDP in the first half of this decade, will have to be tightly controlled. Changes to the budget process could be helpful in this regard. The budget enforcement rules that expired in 2002 – including expenditure caps and pay-as-you-go rules requiring new measures to be budget neutral – contributed to fiscal consolidation in the 1990s, although they were undermined by loopholes (such as “emergency spending”). *Statutory caps on discretionary spending and pay-as-you-go requirements for increases in mandatory spending and tax cuts should be reinstated, and loopholes in the previous system eliminated.*

The major entitlement programmes – Social Security, Medicare and Medicaid – are the main reason that government finances are on an unsustainable course. Under current law, public spending on retirement and health programmes is expected to rise toward 20% of GDP by the middle of the century; resulting soaring budget deficits would entail a government debt twice the size of GDP at that time. Raising tax rates to finance such spending would be an expensive and inefficient solution. Entitlement reform is therefore essential to address this longer-term fiscal challenge. The problem facing Social Security is population ageing. As the post-World War II baby boomers retire while increases in life expectancy continue, the ratio of people receiving retirement benefits to the working-age population will rise steadily. Relatively limited changes to programme parameters would suffice to put the scheme on a solid financial footing, but it has been difficult to reach an agreement on the appropriate measures. A compromise package for Social Security reform could include: *an acceleration of the already legislated increase in the normal retirement age and indexing benefits for rising longevity; a reduction in replacement rates for higher earners; and an increase in the taxable maximum amount of earnings subject to Social Security tax.* The situation is more challenging for health-care programmes, where medical cost pressures compound the effect of population ageing. The growth

in costs per beneficiary has exceeded that of per capita GDP by a large margin. To address this problem, *ways should be sought to improve efficiency in Medicare-related health delivery, so as to be able to limit payments to providers without affecting access to and quality of care.* At the same time, *premiums for higher-income beneficiaries could be raised further.* Cost-conscious decisions would be encouraged by *expanding individual health savings accounts and eliminating the tax bias towards high-cost insurance.* The Administration has proposed to achieve the latter by replacing the unlimited tax exclusion of employer-furnished health insurance plan premiums by a tax deduction available to everyone. Arguably, a tax credit would have a greater effect on health insurance coverage. ■

### What tax reforms would enhance economic performance?

On the revenue side, it may be difficult to sustain the recent reductions in marginal tax rates, while meeting the fiscal burden from entitlement programmes, although this would be clearly desirable. *To the extent that revenues have to be raised, the tax base should be broadened, rather than reversing reductions in marginal tax rates.* Since the comprehensive tax reform in 1986, which broadened tax bases and reduced marginal rates, most of the resulting gains in simplicity and efficiency have been lost through a renewed expansion in tax expenditures. To be sure, not all of them are undesirable. However, *tax expenditures, which are distorting, ill-targeted and ineffective, should be reduced or abolished.* The President's Advisory Panel for Federal Tax Reform has recommended, *inter alia*, that tax preferences for mortgage interest payments, employers' contributions to health insurance plan premiums, and state and local tax payments should be reduced. But, in addition to the Panel's proposals, *consideration should also be given to shifting the tax burden from direct taxes to consumption-based indirect taxes – such as a national sales tax or a value-added tax.* This would produce efficiency gains, including reducing disincentives to saving. *Furthermore, higher taxation of carbon-based energy consumption would help reduce greenhouse gas emissions.*

The housing market is an example of the adverse effects of certain tax concessions. In principle aimed at promoting home ownership to lower- and middle-income households, tax preferences have mostly benefited high-income households with easy access to home ownership. Furthermore, tax preferences have encouraged investment in residential property at the expense of other household assets, possibly affecting capital formation elsewhere in the economy and, thereby, productivity growth. *The mortgage interest tax deduction should be replaced with a tax credit available to all home owners, with a maximum amount reflecting the average cost of housing, so as to promote home ownership, without unduly subsidising housing consumption.* *The interest deductibility on home equity loans and second homes should be eliminated to avoid encouraging overinvestment in housing.* Other distortions arise from the activities of government-sponsored enterprises. Their large portfolio of mortgage-based securities poses a risk to financial stability and result in a large contingent liability for the federal government.

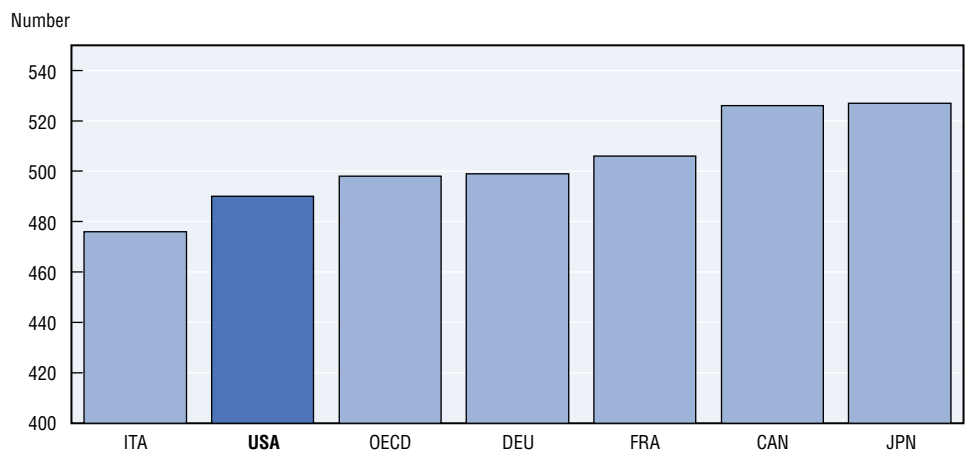
The regulation of government-sponsored enterprises (GSE) needs to be tightened and their role refocused, and eventually restricted, as their activities have developed far beyond their original mandate of promoting home ownership. As well, it would be useful to review the legislation considering GSE debt as government securities, as this suggests that such debt is guaranteed by the government. ■

**What can be done to improve primary and secondary education?**

A country’s ability to compete in an ever more integrated world economy crucially depends on a highly educated workforce. It is thus a matter of concern that US students are outperformed in international tests by their peers in many other countries. It is also a concern that many students seem underprepared for work and higher education. Although large achievement gaps persist between population groups, performance is broadly unsatisfactory, including affluent and academically successful students, and hence appears to reflect above all system-level weaknesses. Available evidence does not unambiguously establish the reasons for this. This Survey focuses on one partial explanation, the role played by academic standards, curriculum and examinations, which are undemanding by international comparison. These weaknesses appear to be linked to the combination of the highly decentralised character of education delivery and the lack of central steering related to learning objectives and assessment. Other factors thought to be related to student achievement, including teaching quality and school choice, are not discussed in this Survey.

While responsibility for education lies primarily with states and local authorities, the federal government can play a role by making financial support conditional on the achievement of certain objectives. Federal legislation – the No Child Left Behind Act of 2002 – calls for annual testing and greater accountability. In particular, it requires states to establish clear contents standards and thresholds for adequate yearly progress against which performance can be assessed. Preliminary indications, including

**Figure 2.**  
**EDUCATION PERFORMANCE AT THE COMPULSORY LEVEL**  
 Average of mean PISA scores in Mathematics, Science and Reading, 2003



Source: OECD, PISA 2003 database and OECD, *Education at a Glance*, 2006.

test results, assessments of educational observers and international experience, are consistent with it raising school performance and narrowing achievement gaps. The *No Child Left Behind Act* is in general well conceived and should be re-authorised. But it could be strengthened. For instance, it would be desirable to extend the legislative framework of standards, assessment and accountability through high school. Although the federal government cannot set standards, it could strengthen incentives for states to adopt more challenging standards. Indeed, standards by which performance and yearly progress is evaluated are very low in some states. States and school districts need to implement more challenging curricula and levels of performance. Advanced Placement and the International Baccalaureate provide models of standards that could be adopted more widely. As tests are often focusing on the wrong things, states need to align tests more closely with curriculum and expected levels of performance. Moreover, *No Child Left Behind* should require the states to implement curriculum-based external exit exams. ■

### How could access to higher education be increased?

The US higher education system is one of the best in the world. However, one problem it faces is that many potential students cannot complete college because of inadequate preparation or financial resources. Despite the expenditure of considerable government funds through direct provision, grants, tax concessions and loans, significant financial barriers to access still exist. Student loans provide the most efficient and equitable means of overcoming these barriers. The loan programme in the United States compares favourably with those in other countries, although there is room for improvement. Most important, *student loan limits should be raised substantially*, especially for unsubsidised direct loans, so as to cover the full cost of study, including living costs. Doing so would benefit students and promote access at little cost to the government. While it might encourage further increases in tuition fees, this is a likely effect of any measure to ease access barriers. To assist risk-averse students, repayments should vary with income. Such an option already exists but is little used, partly because of a lack of information. Accordingly, *the default repayment plan should be income contingent, and borrowers who are risk-averse should be advised that they will be better off with that option*.

Were a good student loan system in place, with high limits and income-contingent repayments, the rationale for means-tested “Pell” grants, which are favoured by the Administration and many policy makers, would be greatly weakened. In contrast to loans, grants involve large fiscal costs, redistribute money to those with high lifetime incomes, and appear to be of doubtful effectiveness. There remains *some scope for grants in dealing with informational problems and externalities, but this would probably involve fewer payments*. The Administration is to be commended for planning to simplify the application process for financial aid. This should include *removal of unimportant means-testing criteria and abolition of the asset test*. Tax concessions for higher education benefit middle- and upper-income families, rather than

those on lower incomes where the main barriers to access are. Accordingly, they are an inequitable and cost-ineffective means of promoting access. They interact badly with the financial aid system. Most important, they are complicated – so much so that many eligible tax filers do not claim them. These problems outweigh the theoretical advantages of the concessions. Accordingly, *these tax concessions should be simplified, or even abolished*. Finally, with a good system of student loans, state government subsidies would no longer be necessary to promote access. However, perceived social benefits from higher education would justify retaining some level of government support. ■

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**Economic Outlook No. 80**, December 2006.

More information about this publication can be found on the OECD's website at [www.oecd.org/eco/Economic\\_Outlook](http://www.oecd.org/eco/Economic_Outlook).

**Economic Policy Reforms: Going for Growth**, 2007 edition.

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