



Economic Survey of the United States, 2008

What are the key challenges facing the economy?

How can monetary and fiscal policies help to attenuate the crisis?

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Summary

The US economy is going through an exceptionally difficult period after having been hit by converging adverse developments, some in reaction to previous excesses during the upswing, others more exogenous. A sharp downturn in the housing market, a financial crisis and temporarily high commodity prices have caused activity to slow sharply during 2008. This happened at a time when the external position was persistently weak and the fiscal stance had become unsustainable in the long term – making for a difficult challenge to steer policy between competing objectives. Policymakers have taken actions to support growth and stabilise the financial system, while keeping a careful eye on inflation expectations. It is nonetheless likely that activity will get worse before it gets better. In addition to these short-term severe difficulties, adverse social trends need to be addressed, including incomplete access to health care, the topic of a special chapter in this Survey.

Faced with a confluence of extremely adverse events, macroeconomic policy has moved quickly to provide stimulus. Aggressive cuts in interest rates, large tax rebates and liquidity injection into dislocated financial markets have provided crucial support. Even so, sharp downside risks to growth continue to prevail, reflecting uncertainties on bank solvency and credit supply. Monetary policy stimulus remains necessary in the near term, but interest rates should be raised promptly once the economy revives, so as to avoid igniting price pressures. Resolving the financial crisis will entail accumulating additional fiscal debts, and further fiscal stimulus will be desirable if financial conditions and economic prospects do not quickly improve; nevertheless, strong budget consolidation should be given priority as soon as possible to address the unsustainable long-term fiscal trends.

The most severe housing downturn in decades has triggered large-scale financial disruptions. While the housing market correction needs to run its course, additional measures could be useful to limit further fall-out to the household and financial sectors. The government takeovers of Fannie Mae, Freddie Mac and AIG, as well as the measures taken to recapitalise the financial sector were necessary to support financial market stability but, after the crisis has passed, the system of housing finance should be fundamentally reformed.

Resolving the financial crisis could be a long drawn-out process. A major financial institution failed and several others have been on the brink of bankruptcy, prompting the central bank to extend lender-of-last-resort protection, while the government has introduced a rescue plan to inject capital in distressed financial institutions and to

This Policy Brief presents the assessment and recommendations of the 2008 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.

purchase or guarantee troubled assets. If these initiatives are not accompanied by regulatory reforms, they could inadvertently serve to encourage imprudent behaviour on the part of lenders in the future. A major overhaul of regulatory and supervisory policy is necessary to remedy the deficiencies in oversight that the crisis has revealed. The new policy approach should be based on a more unified structure and a strong market-stability regulatory body that can make prudential supervision more coherent. The market for housing financing will also need to be overhauled.

Health-care reform is needed. Despite health spending being much higher in the United States than in any other OECD country, the US population's health status does not compare favourably on key indicators, in part because many people do not have adequate financial access to medical care. Starting from the present situation, a plan likely to be successful would replace the health insurance tax exclusion with subsidies for individual purchase of insurance and reform the insurance market as needed. There appears to be wide interest for such reform and numerous packages along these lines have been proposed. ■

What are the key challenges facing the economy?

After a long period of robust growth, the US economy has been struck by a confluence of adverse developments in reaction to past excesses during the upswing, as well as to exogenous shocks. The sharp housing downturn and the associated turmoil in financial markets have led to higher risk premiums, lower equity wealth and tighter credit standards, thereby hurting real activity. This has happened at a time when policymakers already had to grapple with persistent external imbalances and unsustainable fiscal trends. While financial intermediaries have suffered from heavy write-downs, the household sector has also paid a heavy tribute of eroding real incomes, job losses, home foreclosures and declining wealth. The authorities have chosen to provide macroeconomic policy support to avert a prolonged decline of output, while keeping inflation expectations in check, but activity is nonetheless likely to get weaker before it gets better. Over time, these shocks will be absorbed and the economy will return toward its robust path of potential growth. Nevertheless, a variety of fiscal, social and environmental problems needs to be overcome. In this light, the present Survey discusses three important policy issues:

- *Macroeconomic policy to steer through conflicting forces.* The adverse shocks that have pulled down growth are still exerting negative effects, and the negative feedback loop between the financial sector and the real economy may intensify. Steering a path through the various negative forces affecting the economy poses a severe test for monetary and fiscal policy.
- *Safeguarding and regulating the financial system.* The collapse of the privately-securitised mortgage market has triggered a broad dislocation of the financial system, including outside the United States. The authorities responded by introducing a range of initiatives intended to support liquidity in a number of markets. In addition, they acted forcefully to address the risks posed by the imminent failure of systemically-important financial intermediaries. But these actions run the risk of encouraging further imprudent behaviour in the future. The challenge will be to remain ready for further interventions if necessary, while improving prudential oversight.
- *Moving toward universal access to health care.* US health spending per capita is the highest in the OECD, but health status does not compare especially favourably with other OECD countries and nearly 50 million Americans do not have adequate access to non-urgent medical care. Because rapidly rising health costs contribute to increasing government spending, the challenge is to extend insurance coverage to all without causing a sharp rise in budgetary imbalances. ■

How is the financial crisis affecting the economic outlook?

The series of negative developments has been exerting a substantial drag on activity since mid-2007. The housing market is going through its most severe correction of the past 50 years, the financial crisis has intensified and commodity prices soared, before easing. The financial sector has been hard hit, with severe write-downs and depressed equity prices. Households have also been hit with job losses, real income cuts, home foreclosures, tighter credit conditions and declining wealth. Acting against recessionary forces, the fiscal authorities have taken aggressive stimulus measures to support consumption, successfully attenuating the slowdown, though only temporarily. In addition, the monetary authority has eased its policy stance considerably. Welcome support has also come from buoyant exports, reflecting a weak dollar. While the economy stood up better than expected given the circumstances in the first half of 2008, labour markets and household incomes have deteriorated. House prices appear to have further to fall, and foreclosures are widely expected to continue to rise. The financial sector faces further difficulties in absorbing losses and recapitalising. Crafting appropriate monetary and fiscal policies will be vital in the context of what is likely to be a severely weakening real economy.

The US economy was facing substantial difficulties even before the recent deepening of the financial crisis. Enabled by loosening credit standards, households have

borrowed at an unprecedented rate during the past 15 years. Households' saving flows fell close to zero as they increasingly relied on rising stock and housing wealth to achieve their consumption objectives. Consumption expenditure rose above 70% of GDP, an historic record, as households borrowed against wealth to finance consumption, and US household indebtedness at present exceeds that in most other OECD countries. Now that household wealth is declining and credit conditions have become much stricter, consumers will probably have to boost their rate of saving appreciably over time and reduce their reliance on borrowing.

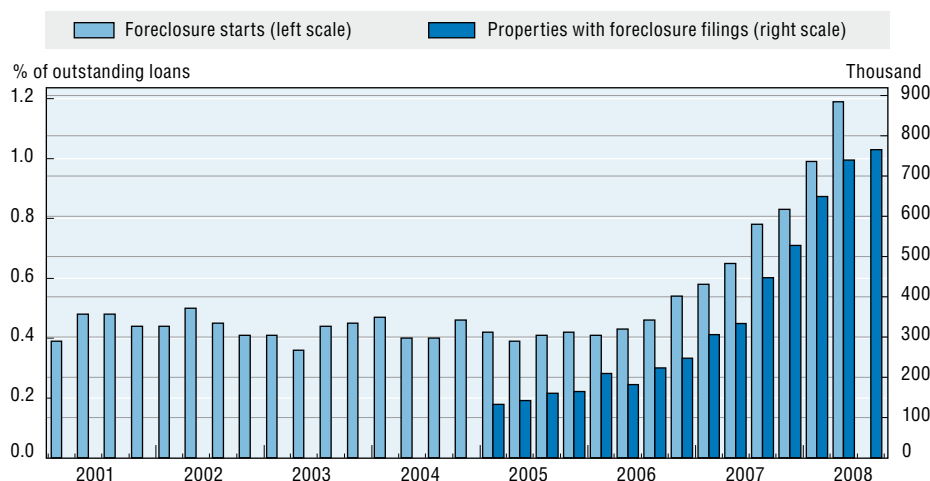
As the economy confronts these difficulties, real activity is likely to contract sharply over the near term. Once financial conditions normalise, recessionary forces should attenuate and the economy should gradually revive. The collapse of residential investment, following past excesses in the mortgage market, has exerted a strong drag on growth, but this negative contribution will eventually wane. As well, the negative effect of elevated commodity prices, which entailed real income cuts, has reversed, which should attenuate the downturn. Nonetheless, sharp downside risks to growth may aggravate the situation further. Solvency issues at some financial institutions are still a concern, raising the threat of further financial market disruption. The credit squeeze has been spreading from the mortgage market to other forms of lending and could impair the credit market further. The dynamism of exports, which have supported growth as domestic demand slumped, could disappear if sharply weaker growth becomes a global problem. Overall, macroeconomic policy should stand ready to provide renewed stimulus.

Headline inflation was high for most of 2008. Although commodity prices fell in the second half of the year, their past ascent pushed up headline inflation and core inflation to higher levels than the Federal Reserve would have preferred. Second-round effects, however, have been limited, thanks to reduced margins, wage moderation and dynamic productivity. While some indicators suggested that near-term inflation expectations had moved up temporarily, long-term inflation expectations always appeared relatively well anchored. ■

How can monetary and fiscal policies help to attenuate the crisis?

Facing strong headwinds and severe financial turbulence, monetary policy has been aggressively eased. In addition, the Federal Reserve has implemented innovative steps to address strains in financial markets and to circumvent liquidity trap risks, by sharply changing the size and composition of its balance sheet as well as by extending credit to nonfinancial corporations. These aggressive steps have helped to

Figure 1.
FORECLOSURES HAVE SOARED



Source: Thomson Datastream, Mortgage Bankers Association; RealtyTrac, Inc.

boost liquidity, but the full effects of the forceful easing of monetary policy should be felt only after financial market conditions normalise. Monetary policy is now more accommodative than what would be suggested by standard policy rules. However, it appears to be roughly appropriate in light of the adverse effects on real activity of factors such as the financial crisis, including high credit spreads and sharply tightened lending standards. *Monetary policy should remain highly accommodative for quite some time to support the economy and the financial system. However, interest rates will have to be normalised promptly as the economy starts to recover and concerns about a worsening of financial market instability recede.*

The 2008 fiscal stimulus package, with rebate cheques worth nearly 1% of GDP sent to eligible households in record time, has provided strong and timely support to aggregate demand. The tax rebate payments boosted household disposable income sharply during the second quarter and a share of this additional income was used to increase consumer spending. The budgetary stimulus should have continued to exercise positive effects on private consumption during the third quarter, but it is expected to wane towards the end of the year. This prospect of a fall-back in consumption has prompted discussions about a second fiscal stimulus package to steer the economy towards recovery. *If financial conditions and the economic outlook do not quickly improve, additional fiscal stimulus would be desirable to firm up prospects for a more rapid recovery. However, given the underlying fiscal situation, the package should aim to be strictly temporary, timely and targeted – like the first stimulus package.*

Resolving the financial sector's difficulties is requiring substantial government spending, as did past banking crises. The public sector is assuming very large fiscal and quasi-fiscal contingent liabilities. The Federal Reserve, the US Treasury and the Federal Deposit Insurance Corporation (FDIC) have taken indispensable decisions when financial institutions faced sudden liquidity squeezes, but the long-term effects of these actions pose challenges. In the course of facilitating the Bear Stearns transaction and opening a secured lending facility for AIG, the Federal Reserve exposed its balance sheet to the risk of losses from mortgage related assets; if realised, such losses would flow through to the federal government. The recently enacted Emergency Economic Stabilization Act of 2008 has authorised outlays of up to USD 700 billion to inject capital into financial institutions as well as to purchase or guarantee a broad array of assets. Large contingent fiscal liabilities stem from the government takeover of Fannie Mae and Freddie Mac. Past banking crises have been expensive in terms of deposit insurance, as shown by the experience of the Resolution Trust Corporation created in the early 1990s to deal with the savings-and-loans crisis, which came with large fiscal costs. Future bailouts, if needed, should similarly be tailored to be highly effective in combating financial-market stress, while protecting taxpayers as much as possible.

Fiscal policy has to deal with other difficult issues in the next few years. In particular, there is strong pressure for reforming the Alternative Minimum Tax (AMT), which will reach a sharply higher number of households starting in 2009 if left unchanged, due to expiring provisions. Similarly, the tax reliefs of 2001 and 2003, which temporarily reduced personal income taxation, are set to expire at the end of 2010. Extending these tax cuts without offsetting budgetary measures would, however, cause additional fiscal gaps. Over the longer term, the ageing of the population and other trends put the federal budget on an unsustainable course. According to the Congressional Budget Office, under current legislation Social security spending on retirement income will increase from 4.3% to 5.6% of GDP in 2055. Even more worryingly, health-related public expenditure (Medicare and Medicaid) will rise from 4.1% to 12% of GDP in 2050, reflecting the combination of population ageing and technology-related rises in health expenditure. In view of this, *the budget should be put back on a course of consolidation as soon as possible, with both expenditure and revenue measures.* ■

What needs to be done to improve the functioning of markets for housing finance?

The trigger for the financial crisis was the wave of subprime mortgage defaults, following sharp falls of house prices from unsustainably high levels. These events caused large losses on mortgage-backed securities, which were often highly rated and therefore thought to be safe, but turned out to be much riskier than expected. Mortgage defaults and foreclosures have soared in the non-prime market, adding to the inventory of unsold houses, crowding out regular house sales and putting market prices under further downward pressure. Measures have been taken to help distressed borrowers, such as two new programmes to prevent avoidable foreclosures. In addition, the Federal Housing Administration (FHA) has been authorised to guarantee up to USD 300 billion in refinanced mortgages, provided that lenders agree to write down significantly the amount of the loan. While the FHA programme is estimated to help up to 400 000 borrowers (out of some 2.2 million mortgage loans that may enter foreclosure by 2011), it is likely to be too small to solve the housing crisis. Further action could be needed to prevent avoidable foreclosures and ensure that the fall in house prices does not become excessive.

The wave of defaults on subprime and Alt-A mortgages shows that the process of originating these loans was often inadequate. Lending standards eroded across the entire funding chain, from mortgage origination to final distribution. While securitisation is likely to remain an important part of the financial landscape, *stronger supervision is needed at all levels, including underwriters and credit rating agencies*, which faced conflicts of interest between the process of rating instruments and the advice provided to the issuers of and investors in these instruments. Investors' due diligence also needs to be reinvigorated. A good place to start is where mortgage loans are originated and, in this respect, the new rules issued by the Federal Reserve to protect borrowers from predatory lending practices are welcome. As well, legislation has established a federal register for mortgage brokers and developed stronger licensing standards, so as to ensure that mortgage brokers are qualified and properly screened and that prospective borrowers can easily look up a broker's employment history, violations, complaints, and other information. *These rules should be rapidly implemented.*

The government took over Fannie Mae and Freddie Mac to safeguard financial stability and support the mortgage market. Over time, it will be necessary to overhaul the structure of the market for housing financing. If the government were to continue to play a role in it, public support should be explicit to avoid the ambiguities present in the charters of Fannie Mae and Freddie Mac. Fundamentally, however, it would be preferable to leave the securitisation of mortgages, especially prime ones, entirely to the private sector, as in most other countries. *In order to foster competition and reduce moral hazard, the two government-sponsored enterprises should no longer have access to preferential lending facilities with the federal government; be more tightly regulated and subject to the same regulation and supervision (including capital adequacy requirements) as other issuers of mortgage-backed securities; and divided into smaller companies that are not too big to fail. This would imply that, in due time, new debts issued by privatised GSEs would be explicitly not guaranteed.* ■

How should financial sector regulation and supervision be strengthened?

Fallout from the financial crisis that started in mid-2007 intensified in late 2008. The financial sector is still experiencing severe problems of confidence, credit availability is restricted in some major markets, liquidity is still lacking and credit spreads are abnormally high. The first phase of the crisis was confined to the subprime mortgage market and associated leveraged products, but events have been progressing to the broader economy. In the current second phase, some prime borrowers have felt the hit from slowing economic conditions and defaulted on their mortgages. Credit spreads are widening on other markets, such as student loans, and severe liquidity difficulties have hurt auction-rated securities. As the real economy weakens, in particular in energy-sensitive industries such as cars and airlines, a negative feedback loop between the real economy and the financial sector could intensify.

The banking system has reacted to asset write-downs by raising fresh capital, but doing so is expensive and difficult in the current environment. Thus, a significant amount of deleveraging is underway, with a severe impact on the supply of credit. The government has responded to these developments by establishing a plan to inject capital into distressed financial institutions and to purchase troubled assets in order to provide the funds needed to normalise conditions.

There is wide agreement that gaps in regulatory oversight are at least partly to blame for the crisis. Many of these gaps were caused by the fragmented structure of regulation, which maintains specialized regulatory agencies across segregated lines of services, such as banking, insurance, securities and futures. While this arrangement may have worked in the past, it is not well suited to the modern financial system. The traditional components of financial services have converged over the past decade and most financial providers now operate across regulatory boundaries. Also, at present in the United States, no single regulator possesses all the information and authority necessary to monitor overall market stability, although there is an increased potential for events triggering a series of defaults affecting the whole financial system and the real economy. Finally, the conduct of business regulation proved weak in the run up to the crisis, enabling the decline in lending standards and, in some instances, deceptive practices. The risks associated with this inadequate regulatory structure have been heightened by the recent shoring up of individual financial institutions, which has increased moral hazard risks. Without tighter prudential standards, the authorities' financial support to failing institutions will encourage imprudent behaviour of market participants in the hope that their losses would be absorbed by the taxpayer in case of failure. *Combating moral hazard costs more effectively should be a major objective of reform to financial supervision and regulation.*

The Treasury blueprint provides a sensible starting point for addressing these weaknesses, with a proposal to consolidate the current system around three regulators: a *market stability regulator* responsible for overall financial risks potentially impacting the real economy; a *prudential financial regulator* responsible for the supervision of individual institutions, notably those benefiting from a form of government guarantee and therefore prone to moral hazard; and a *business conduct regulator* responsible for enforcing business-related rules, notably protecting consumer interests. However, the framework does not address explicitly whether it would be desirable to regulate financial institutions that are currently subject to no, or less demanding requirements, but may be or may become systematically important, notably hedge funds and private equity firms. The prudential supervisor needs to have authority over all systematically important institutions and all institutions that have access to the central bank's credit facilities. The market stability supervisor, if it is separate from the prudential supervisor as the Treasury blueprint proposes, needs extensive access to financial sector data to be able to arrive at an independent judgment regarding systemic risks. A number of different institutional arrangements would be consistent with these principles, including the tri-partite approach proposed by Treasury and a "Twin Peaks" model. In the latter case, the market stability and the prudential regulators could be unified within the central bank (as in the Netherlands) which already has considerable responsibility in this area through monetary policy and as lender of last resort to the financial system. An argument can also be made for an independent market stability supervisor (as in Australia or the United Kingdom) to ensure focus on supervisory issues and avoid possible conflicts between monetary policy and prudential concerns. *The credit crisis has thrown into sharp focus the need for a substantial overhaul of US financial supervision. While some progress has been made through informal and incremental cooperation agreements (memoranda of understanding) among regulators, in the longer term a more formal and dramatic process, such as that outlined in the Treasury blueprint, is likely to be necessary. The new regulatory structure should feature unified supervision in line with the current business model adopted by financial conglomerates. The*

market stability supervisor, whether a separate institution or not, should have access to sufficient information to assess macroeconomic risks and have the tools to promote corrective action if needed.

Many financial institutions, including several large banks, took more risk than was compatible with their capital holdings. Lehman Brothers was one of those, and finally had to file for bankruptcy. Risk-based capital standards should be re-assessed, and tightened where needed to discourage these practices. *Financial institutions should hold capital against off-balance sheet risks and assets held in so-called trading accounts.* The financial crisis has also revealed major risk with the investment banks' highly leveraged business model and the regulatory framework to which they were subjected. The remaining two large investment banks, Goldman Sachs and Morgan Stanley, have become bank holding companies, which puts them under the Federal Reserve's regulatory umbrella and gives them greater access to the Federal Reserve's credit facilities. However, regulatory overreaction should be avoided, as this could encourage the shift of certain financial activities into segments of the financial markets where they would be even further away from the reach of regulators (e.g. hedge funds or offshore). These and other suggestions to overhaul financial supervision and regulation will be important to increase the robustness of the financial system against future stresses. Introducing a greater degree of regulatory enforcement would go a long way towards preventing the recurrence of financial crises and averting their detrimental effect on economic stability. Once repaired, the US financial system will once again play its key role of efficiently intermediating between savers and investors and contributing to economic growth. ■

How well does the health system perform?

Another challenge facing US policymakers is to improve the performance of the health system. Notwithstanding very high health spending (about 15% of GDP) and the use of cutting-edge technology, the health status of the US population does not appear to fare well by international comparison. The United States ranks poorly in terms of life expectancy at birth, infant mortality and "amenable mortality" (i.e. mortality that can be averted by good health care). While there are factors beyond the health-care system itself that contribute to this below-average health outcome and/or higher health expenditures – such as the relatively high risk of death or injury from violence or accidents, the higher prevalence of obesity and of low-birth-weight babies, and the cost of the medical liability litigation system and the associated practice of defensive medicine – these factors do not appear to explain all of the gap in performance between the United States and other countries.

A particular source of concern is the large number of people who lack adequate health insurance. It is estimated that 46 million persons were not insured at all in 2007 (16% of the population), with a further large share of the population underinsured. With Mexico and Turkey, the United States is the only OECD country that does not get close to universal health-care insurance. The large majority of the uninsured are people who are not offered health insurance by an employer, because they work in a small firm, work part time or are not employed. Most people without adequate insurance belong to lower-income groups, which have shorter life expectancy than average and have benefitted much less than others from improvements in life expectancy in past decades. It is therefore plausible that the significant and growing proportion of the population that is uninsured or underinsured is one of several factors that help to explain the growing gap in life expectancy between the United States and other countries. Although there are several public insurance schemes (such as Medicare for the elderly and disabled, Medicaid for the poor, and SCHIP for poor children), the number of uninsured is widely considered to be a problem that needs to be rectified. *Making progress towards health insurance coverage for all Americans should be given a high priority on the policy agenda.* ■

What could be done to encourage more efficient health-care purchasing decisions?

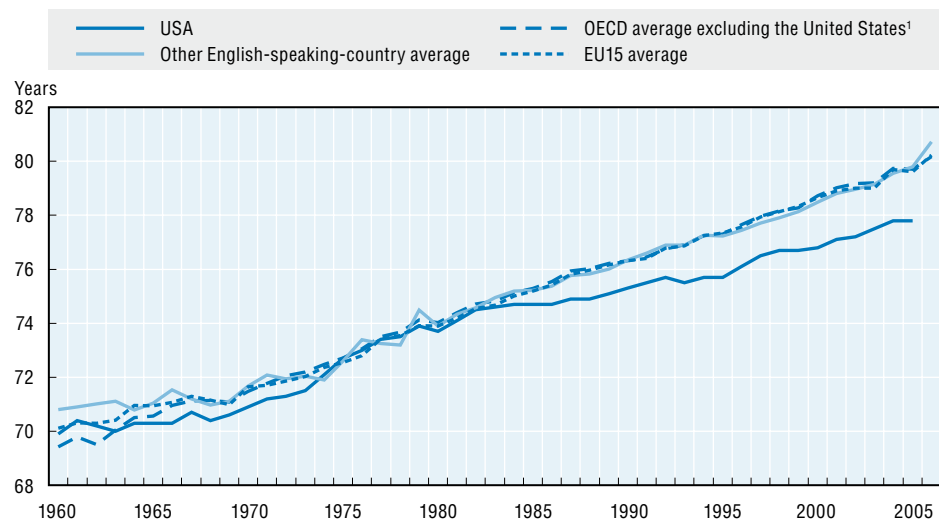
The tax exclusion has played an important role in promoting employment-sponsored health insurance in the United States because it reduces its cost to the employee both by treating compensation in the form of employer contributions to health insurance as tax-free income to the employee and by encouraging the formation of employer-sponsored insurance pools. However, it does not reach workers not offered insurance by their employers and is more beneficial to workers in upper tax brackets, i.e. it is regressive. Moreover, it locks workers into jobs, for fear of losing coverage. Because it is uncapped, the tax exclusion encourages the purchase of more generous insurance plans, notably plans with little cost-sharing, thus exacerbating moral hazard. *The existing health tax exclusion should be terminated to mitigate these problems, even though ending the tax exclusion would lead to a reduction in the number of people offered employer-sponsored health insurance, especially among those working for small companies. The tax revenues resulting from the elimination of the tax exclusion would be available to subsidise the purchase of insurance by individuals in a way that is independent of the choice of health plan, provided that some minimum standards of required coverage are satisfied. Such subsidies, which could take many forms, such as direct subsidies or refundable tax credits, would improve the current situation in at least two ways: they would reach those who do not now receive the benefit of the tax exclusion; and they would encourage more cost-conscious purchase of health insurance plans and health care services as, in contrast to the uncapped tax exclusion, such subsidies would reduce the incentive to purchase health plans with little cost sharing. Policy makers should consider means testing these subsidies.* The extent to which such subsidies reduce the number of uninsured will depend on many factors, including their level and structure. ■

What could be done to promote health insurance coverage?

Even so, further measures are likely to be necessary to expand coverage substantially:

- At present, the individual health insurance market is not attractive, in part because adverse selection risks have led to high premiums compared to their actuarial value, and because administrative costs are high. These problems could be addressed by increasing the size of risk pools and reforming individual and small-group insurance markets by requiring community-rated and guaranteed-issue policies, thus disconnecting the payments from individual health risks.

Figure 2.
TRENDS IN LIFE EXPECTANCY



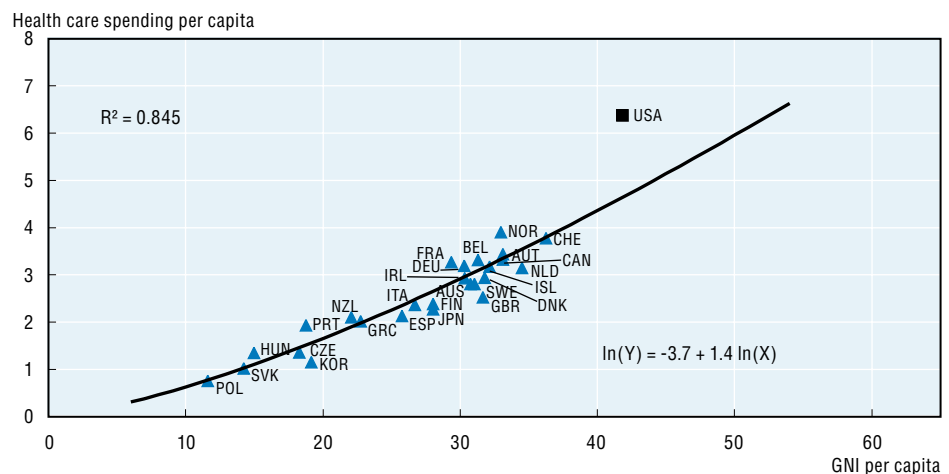
1. Averages are population weighted. Also excludes Korea, Mexico, and Turkey.

Source: OECD Health Data (2008).

- This approach would have a greater impact on coverage if accompanied by a requirement to be insured, as otherwise healthy people may choose to be uninsured rather than to pay community-rated premiums, which are higher than experience-rated premiums for healthy people. Bringing these people into the risk pool would also make insurance in the individual and small-group market even more affordable on average. However, such a requirement has its own drawbacks: the complexity of defining the required coverage; the risk that this requirement will become unduly inflated; the inherent reduction in consumer choice; and difficulties in designing and implementing appropriate enforcement mechanisms.

Public insurance, notably the Medicare programme (for those aged 65 or over and for qualified disabled persons aged less than 65) is also an important insurance solution for many Americans. Medicare expenditure now accounts for approximately 3% of GDP, or about 20% of total health expenditure and under current trends is projected to rise sharply in the years ahead. Given the scale of the programme, it is important that potential for reducing costs without harming the quality of treatments received by enrollees be exploited. Detailed analysis shows that per capita Medicare spending varies widely across the United States without associated variation in health outcomes. Some hospitals seem prone to high-cost procedures without additional benefit to patients, while others seem able to provide lower-cost care that proves to be effective. *The authorities should consider ways to enhance the dissemination of information on the effectiveness and cost of treatments and procedures.* Savings could also be made by reducing payments to Medicare Advantage (MA) plans, which provide Part A (hospital) and Part B (medical) coverage as well as medically-necessary services to individuals who choose to receive their Medicare benefits through private plans, to the level paid to providers under the traditional fee-for-service Medicare programme. It has been estimated that payments for Medicare Advantage Plans currently exceed the costs of Medicare Parts A and B by approximately 13% for similar beneficiaries. According to MedPac, a significant portion of these extra payments goes to fund plan administration and profits and not to services for beneficiaries. These extra payments also raise equity concerns as they are funded by all Medicare Part B beneficiaries (through their Part B premiums) and by all taxpayers (through general revenues) while only MA enrollees benefit. In addition, such payments enable MA plans to attract

Figure 3.
HEALTH EXPENDITURE
IN RELATION TO GNI PER
CAPITA, 2005¹
 Thousand of USD PPP



1. The figure displays GNI per capita with respect to real total health spending per capita. This figure excludes Luxembourg, Mexico, and Turkey. The data point for Norway displays mainland GNI per capita. A non-linear regression line has been included that suggests that health spending may increase more than proportionally with rising income.

Source: OECD, Health Data (2008).

new clients without improving efficiency, a problem underlined by the rapid growth in fee for service plans. A start to overcoming these problems was made in recent legislation, which reduced payments to MA plans and required most fee-for-service MA plans to form provider networks. *This process should be taken further by gradually lowering MA payments to the level for traditional fee-for-service Medicare plans.* Savings also should be made without reducing the quality of health care by introducing more competition into the process for purchasing durable medical equipment. Currently, Medicare administrators are prohibited from harnessing competition or negotiating prices of medical equipment and supplies; instead, they must use fee schedules based on historical charges. On the basis of pilot programmes, it has been estimated that using a competitive bidding process instead of the fee schedules could reduce costs by 26% on average, based on strict criteria for product quality and security of suppliers, without significantly reducing access of beneficiaries to supplies. *Generalisation of competitive bidding for medical equipment and supplies should not be delayed beyond the 18-month period stipulated in recent legislation.* ■

How could the economic costs of achieving climate change objectives be minimised?

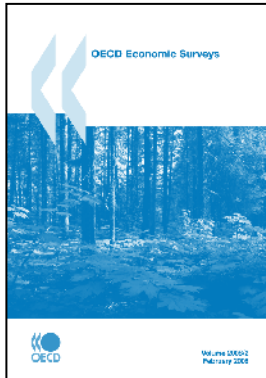
US policymakers also face the challenge of reducing growth in greenhouse gas (GHG) emissions in the context of global efforts to combat climate change. The US contribution to these efforts will have an important bearing on their success owing to the scale of US emissions, which are approximately one sixth of the global total. Such emissions have grown somewhat more quickly in the United States than in most other OECD countries since 1990, mainly reflecting higher economic growth, and are much higher in relation to either economic activity or population than in many other countries. Factors that contribute to high US emissions include reliance on traditional coal-fired power stations and high annual distances travelled per capita in vehicles that, on average, have relatively high fuel consumption. Low road fuel taxes may contribute to relatively high annual vehicle miles travelled and household preferences for lower fuel economy vehicles. The US authorities have adopted the targets of reducing the GHG emission intensity of the economy by 18% over 2002-2012 and of stabilising GHG emissions by 2025. The government also signed a G8 declaration to cut GHG emissions by 50% by 2050. To support the achievement of these goals, the government is focusing on improving vehicle fuel economy standards, increasing the domestic production of bio-fuels, and supporting energy R&D for cleaner energy supply technologies, renewable sources, methane capture and use, and nuclear energy. Currently, US bio-fuels are mainly produced from maize-based ethanol. Studies suggest that support for such first-generation bio-fuels programmes is an inefficient means of reducing GHG emissions and has put upward pressure on some commodity prices. The government is also supporting the development of second-generation bio-fuels, which promise to be more efficient but for which significant technical barriers remain to be overcome before commercialisation. *In addition to revising current R&D support to be more technology-neutral, the authorities could price carbon emissions to reflect their environmental costs, either through a cap-and-trade system or a carbon tax.* In this way, emission reductions could be achieved at the lowest economic costs. For substantial global emission cuts to be achieved at a manageable cost, it will also be necessary for other large emitters, countries and sectors to adopt similar policies. ■

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