

ASSESSMENT AND RECOMMENDATIONS

After a short and shallow recession...

The US economy entered recession in the first half of 2001, with employment falling and industrial production continuing the slide it had begun in mid-2000. The downturn was relatively short and mild. Real GDP increased by ¼ per cent in 2001 as a whole. It declined in the first three quarters of the year, as firms cut stocks and capital spending while household spending slowed. Demand recovered surprisingly quickly after the 11 September terrorist attacks, but the contraction in payrolls persisted until early this year, and the labour market has yet to turn around. Nevertheless, the low unemployment rate prior to the slowdown has meant that, so far, it has not exceeded 6 per cent — well below earlier cyclical peaks and close to what would have been considered full employment just a few years ago. Inflation has receded markedly. Meanwhile the current account deficit has resumed its trend increase. The weak economy has been accompanied by a significant profits drop and a series of revelations regarding misleading accounts and deficiencies in corporate governance, weighing heavily on equity markets and, to a lesser extent, on the value of the dollar.

... a recovery is proceeding...

The economy began expanding again late in 2001 as the previous massive inventory reduction abated and manufacturing production rose in response. As a result, job losses diminished and even showed a modest reversal this spring. Household spending, which had remained relatively healthy throughout the recession, has continued to be the key contributor to final demand. Real disposable income has grown steadily, as the slowdown in compensation growth has been offset by lower inflation, last year's tax rebates and this year's tax-rate reductions, and yet another surge in refinancing resulting from lower mortgage rates. These factors have fuelled gains in residential investment and private consumption.

... in part due to substantial monetary and fiscal easing

The early turnaround in activity owes importantly to fiscal and monetary policy actions. In addition to the tax cuts, government spending accelerated after 11 September, mostly as a result of the war on terrorism and homeland defence. In addition, this March's stimulus package gave a small lift to household incomes through extended unemployment benefits and should provide some impetus to business spending through its investment incentives. Monetary policy has also been very accommodative. The federal funds rate has been reduced sharply and held at a 40-year low since last winter. Other financial conditions have been less supportive: the dollar was very strong until the spring, and stock-market weakness has led to persistent declines in household net worth.

High productivity growth and low inflation bode

A welcome and important surprise during this recession and since has been consistently robust productivity growth, which points to a durable

well for a sustained expansion...

improvement in the rate at which the economy can expand without rising inflation, to around 3 per cent per year. Along with some easing in compensation increases, this has generated a deceleration and most recently an absolute decline in unit labour costs. With excess supply putting downward pressure on prices, inflation has fallen significantly. This has given monetary policymakers the flexibility to retain an accommodative stance.

... but the recovery is still fragile

The turnaround in production last winter stemmed primarily from reduced de-stocking, and a sustained recovery will require a broadening in final demand strength beyond household and government purchases, which have begun to moderate. The timing of a recovery in business investment, which contracted rapidly during the recession, is uncertain, although equipment spending has already shown signs of recovery. The OECD's central projection is for real GDP to increase by nearly 2½ per cent this year and 2¾ per cent in 2003. However, downside risks remain. Concerns over corporate profits may make managers more tentative when deciding on capital spending and employment. A slow improvement in the labour market and continued equity-market turbulence could further crimp confidence. On top of these uncertainties, the widening in the current account deficit has helped bring the dollar under pressure. Additional declines in stock markets and a rise in long-term interest rates could accompany a more severe depreciation, although a weaker dollar would eventually have some positive effect on exports. Oil prices, which have risen recently and could jump further, may also place a drag on activity. Finally, the question of how and when the large external deficit and associated weakness of domestic saving will be unwound remains a risk factor, even if some "corrective" scenarios — especially those associated with stronger domestic demand growth abroad — are not particularly disruptive. At the same time, positive factors should not be overlooked. Equipment orders have strengthened, and, as corporate profits recover with ongoing growth and tax breaks, a quicker-than-expected resurgence in business investment could emerge. And monetary and fiscal policies together continue to provide an unusually strong impetus to demand.

The Federal Reserve must decide whether to cut interest rates in the short term but also when to begin the shift to a more neutral stance...

The amount of monetary stimulus is manifest in real short-term interest rates near zero. This is as low as early in the last recovery and compares with a long-term average of just below 3 per cent. However, current OECD projections of GDP growth imply that economic slack will only gradually dissipate. Given the marked deceleration in inflation and the tepid recent pace of final demand growth, the authorities would seem to have room to wait until the recovery is more clearly established before shifting to a more neutral stance. Moreover, in light of the moderate pace of the projected upturn, the considerable output gap and the continued equity-market weakness, policy tightening should probably proceed quite gradually. Indeed, the authorities could conceivably even need to ease policy further in the short run, should the recovery falter or financial markets not find their footing. On the other hand, given the extent of the current monetary stimulus to the economy, policymakers should also stand ready to

place more substantial restraint on activity if demand accelerates unexpectedly, especially if the dollar continues to give up earlier gains.

... and should consider whether to move more formally to an inflation-targeting framework

The Federal Reserve has already taken a number of measures to increase the transparency and accountability of monetary policy. But further steps in this direction could be considered — in particular, the introduction of an inflation-targeting framework as it exists in many other Member countries. In essence, informal inflation-targeting has been pursued in the United States in recent years. Thus, such a move would serve to a large degree to formalise some of the positive features of current practice. In effect, it could help institutionalise recent good monetary policy and provide some greater assurance of its continuity. Reduced uncertainty for investors, consumers and companies would better anchor inflation expectations and, ultimately, might lead to even better outcomes.

The fiscal position has deteriorated much more than earlier expected...

The federal budget deficit was close to 1½ per cent of GDP in the fiscal year just ended, a sharp reversal from the surplus of 2½ per cent recorded two years earlier. The deterioration reflects faster growth in discretionary spending, last year's large tax cut, cyclical revenue weakness and new expenditure requirements after 11 September. Increases in defence and homeland security outlays have been highest on the list of new priorities. But the stimulus measures enacted in March are also expected to increase the deficit by roughly \$50 billion in both FY 2002 and FY 2003. A return to federal budget surpluses is very unlikely over the next few years. Spending pressures remain strong, and the framework that has disciplined budget decisions since the early 1990s has just expired and needs renewal or replacement. In addition, federal tax receipts have been surprisingly weak this year, reflecting a shortfall in capital gains and stock-option-related revenue that will not reverse until after equity markets recover. The situation among the states is similar, although their revenue shortfalls have led to more rapid tax and spending adjustments since they are typically required to run balanced budgets on current outlays. Nonetheless, the general government deficit is expected to reach 3 per cent of GDP in 2002 before edging down to 2½ per cent in 2004.

...and federal finances face difficult medium- and long-run adjustments

Beyond the next couple of years, the federal budget will begin to encounter some structural challenges that are likely to worsen the fiscal position considerably, including currently slated changes in the tax law. The Alternative Minimum Tax (AMT) is expected to apply to a rapidly growing number of taxpayers over time, both because it is not indexed and because current law extends the tax to more households after 2004. The AMT contributes significantly to tax complexity and blunts a number of policy initiatives embedded in the tax code. Hence, the tax code will probably be amended to eliminate the AMT's rising importance, which could lower revenues by \$60 billion a year in a decade. In addition, the entire package of last year's tax cuts expires in 2010 (a provision that lowered the legislation's revenue cost and boosted projected surpluses), and efforts have already begun to make these permanent. These potential tax-law changes, together with a likely faster rate of discretionary spending growth than assumed in official forecasts, would imply that the return to substantial surpluses in current government projections is unlikely. Nonetheless, even moderate

deficits would lead to a continued decline in the debt-to-GDP ratio. But this does not preclude the existence of long-run imbalances in Social Security and Medicare. The evaporation of projected substantial surpluses over the next decade implies that any move towards effectively pre-funding these liabilities will require new revenues or cuts in other spending. Absent such pre-funding, reforms to Social Security and Medicare to reduce future benefit promises would seem essential to manage the transition to a sustainable long-run budget situation.

*After temporarily
receding, health cost
pressures have mounted
again...*

The US health-care system is unique in the OECD area. It is responsive, adapting quickly to changes in consumer preferences. Moreover, most Americans are highly satisfied with the care they receive. However, despite spending vastly more than other Member countries, both per capita and in relation to GDP, its relative performance on various measures of health status is only about average among OECD countries, and there is evidence to suggest that the same clinical outcomes could be achieved using fewer resources. Furthermore, the US system is the only one among the wealthier OECD countries that does not provide universal insurance coverage. After broad stability relative to national income over most of the 1990s, health spending has re-accelerated and is projected to rise from 14 per cent of GDP today to 17 per cent in 2011, just as the ageing of the baby-boom generation gets underway. The expansion of managed care succeeded temporarily in limiting cost increases, both by curbing prices paid to providers and reducing use of inpatient hospital care. With providers now exploiting more effectively their bargaining power with health plans and patients pressing for greater choice of providers and treatments, the managed-care approach seems to have largely exhausted its cost savings potential. As a result, premiums for private health insurance are again rising at double-digit rates. Public programmes are also facing unsustainable cost increases.

*... while the number of
uninsured remains
excessive*

The share of the population covered by insurance has generally fallen over the past decade, despite some temporary improvement during the economic boom of the late 1990s. Given the absence of universal coverage and the high cost of care, many Americans are at risk of being uninsured at some point in their lives, and some of the insured are also at financial risk due to under-insurance. Some assurance of access to care for emergency services for the uninsured is required by law, and some other care is provided for free. This is, however, an inefficient and expensive way to provide care. It results in unnecessary spending on complications from conditions that could have been prevented and in population health that is inferior to what could be expected, given relative levels of per-capita income and health expenditure. This is also due to the prevalence of some risk factors, such as obesity — of which the United States suffers the highest rate among OECD countries — drug consumption and crime. Furthermore, service use and health outcomes vary widely across the population on a number of dimensions such as income, ethnicity and geographic location, raising equity concerns. The rise in the number of uninsured has occurred despite eligibility expansions for public programmes (in particular the introduction of the State Children's Health Insurance Program). In addition, competitive pressures are reducing the ability of providers to serve as a

safety net and provide free care for the uninsured and under-insured. In the absence of new policy directions, a further increase in the number of Americans without health insurance would seem likely, given both cyclical and renewed sectoral cost pressures.

Given the complex structure of the US health care system...

Incomplete insurance coverage, escalating costs and seemingly inefficient spending remain fundamental challenges to policymakers. Relatively few policy levers exist at the national level to address these problems, however, given the system's diversity and decentralisation. In fact, the US health sector consists of a number of systems of financing and delivery. Private employers, public programmes and individuals buy insurance from more than a thousand companies offering thousands of products. Although the public sector plays a significant role in financing and is the main purchaser in some markets, the private sector is dominant in providing insurance coverage for most Americans. It is, therefore, a critical force driving change and serving as a testing ground for potential reforms, more so than in any other OECD country. Of course, reliance on multiple sources of health care financing in a system of voluntary coverage has some drawbacks, notably high administrative costs, more difficult cost control and incomplete access to care.

... reforms will have to involve both expanded private spending...

With managed care's reduced leverage over health spending, there is a need to strengthen economic incentives for patients, providers and insurers to make more cost-effective decisions. Public policy can support this by providing tax incentives for the use of health insurance products that combine preventive care and coverage for catastrophic care with defined contribution components that reward value-based purchasing for other care (such as Medical Savings Accounts and Health Reimbursement Arrangements) and, thus, reduce over-consumption. At the same time, insurance product regulation might have to be strengthened in order to try to limit cream-skimming behaviour and its undesirable effects on risk pooling. To foster cost-conscious decision making, further efforts are also required to develop the information base on the relative performance of health plans and providers, and the relative value of different treatments and technology use. The most important source of health spending growth has been technological advancements, such as new surgical techniques, drug therapies and diagnostic and treatment devices. Strong cost pressures reflect minimal controls on either supply or demand, resulting in earlier and more widespread adoption of such approaches than elsewhere. Public programmes and agencies can encourage efficient application of health technologies through systematic, evidence-based assessment of the costs and benefits of new technologies, which should be made publicly available. Third-party payers, both public and private, should use such information in their coverage decisions and should promote its consideration by providers and patients alike in making their treatment choices through economic incentives (such as co-payments, selective contracting with agreed providers, and reformed providers' reimbursement schemes). More vigorous enforcement of anti-trust policies could also contribute to cost-effective use of new technologies and pharmaceuticals and possibly mitigate drug price inflation. Another desirable initiative would be reforming the framework for litigation

with respect to medical malpractice, a contributor to both higher prices (through costly insurance premiums) and to increased volume of services (due to “defensive” medical practices).

***... and public programmes
for the elderly and the
poor...***

There is widespread agreement that Medicare needs to be reformed to ensure efficient spending and to contain projected rapid cost growth and financing shortfalls associated with the retirement of the baby boom generation that threaten the programme’s long-term sustainability. At the same time, it is recognised that there are serious gaps in benefit coverage, with potentially adverse health consequences. Most notably, Medicare does not provide coverage for outpatient drugs. The Administration’s reform proposal addresses these issues, calling for regulatory and administrative changes, better health insurance options and an expansion of benefits to cover prescription drugs and preventive care. While it can be argued that Medicare should provide the most effective treatments and services, it has to be ensured that it has adequate levers to control the significant costs associated with enhanced benefits (up to 2 per cent of GDP by 2030). Harnessing the positive effects of competition among health plans and providers could produce efficiency gains through reducing unnecessary care while providing better preventive care, although adequate protection for the elderly and disabled populations served by the programme must be maintained. Medicaid is also being challenged to retain its expanded coverage in the face of strongly rising costs, particularly for prescription drugs. The programme is the main payer for services not covered by Medicare and private insurance, such as long-term care. Thus, other payers’ efforts to curb spending may just shift costs to Medicaid. This highlights the need for a comprehensive approach to cost containment.

***... as well as tax changes
to encourage enhanced
coverage***

In the absence of a universal coverage system, the basic options for addressing the problem of the uninsured are to build on existing public programmes or to facilitate additional private coverage. Recent experience suggests that broadening eligibility for public programmes to include more of the poor or near-poor can have some impact on the number of uninsured. However, budgetary constraints limit the scope for further expansion. Indeed, many states have recently had to reduce Medicaid funding and eligibility. The Administration has proposed the introduction of a modest refundable tax credit in order to assist uninsured individuals in purchasing private health coverage. The effectiveness of such a device will depend on critical design issues, notably the amount of the tax credit relative to premium levels. In this context, current tax concessions should be reconsidered. The unlimited tax exclusion of employer-furnished health benefits (amounting to about 1 per cent of GDP) encourages the purchase of costly insurance packages. Capping this subsidy could reduce this and, at the same time, partly offset the budgetary cost of any new tax credit. However, care would need to be taken to ensure that tax policy changes result in net increases in insurance coverage and minimal shifting of covered populations to less efficient forms of coverage. Finally, the problem of cost-induced shrinkage in insurance coverage by firms using the small-group market should be addressed by promoting larger risk pools at the state and local

level.

***Good structural policies
and the long expansion
have enhanced economic
and social conditions***

The better growth outcomes since the mid-1990s have complemented an improved set of structural policies, leading to gains in wellbeing that are likely to endure. In particular, the resurgence of healthy productivity growth and the tight labour market over the late 1990s combined to boost real incomes and to yield the lowest unemployment rates in a generation across all social/demographic groups. The rapid increase in income inequality witnessed throughout the 1980s and early 1990s moderated, and poverty declined markedly. Welfare dependency fell dramatically. And crime receded significantly as a result of tougher policing and sanctions, demographic changes, reduced drug use and reinforced work prospects for the less skilled. The recession will have dented these gains somewhat, but better economic conditions — especially for low-income working parents — should continue. To an important extent this stems from the expansion of social programmes targeted at increasing the returns to work and requiring work for social assistance. Perhaps the most important factor was the expansion in the Earned Income Tax Credit (EITC), especially in 1993, but the 1996 welfare reform also focussed squarely on work. The Temporary Assistance to Needy Families (TANF) programme eliminated the entitlement to government assistance, required work for welfare recipients and introduced a lifetime five-year time limit for welfare receipt. With the new emphasis on jobs, caseloads plummeted and work by single mothers rose. However, a significant and still unclear portion of these gains — particularly in employment — was due to the strong economy.

***The successes from
welfare reform need to be
broadened...***

The TANF programme is subject to re-authorisation over the coming year, and the debate has focused on what policy changes could solidify or even build on recent achievements. One contentious issue has been whether funding levels (which have not changed since 1996) should be increased in order to improve the provision of childcare or other supplementary assistance. Another has been whether work requirements should be tightened. The current programme places the onus on states to ensure that single- and two-parent families receiving assistance work 30 and 35 hours a week, respectively; but states receive credit against this requirement when caseloads decline, and hence the existing work requirements have not been binding. Raising the stringency of work requirements by lowering the credit for reduced caseloads would be an appropriate first step. Increases in the workweek, which would tighten work requirements further, could follow once the impact of binding work requirements is clear. Longer workweeks may complicate issues regarding childcare and transportation needs. In this regard, state-level experimentation on how best to encourage work by combining the programmes for cash assistance, childcare, food stamps and perhaps even medical care should be allowed. This would provide valuable information on the best combination of programmes to facilitate work and wellbeing. Such experimentation would also improve the functioning of the safety net by clarifying the reasons for the marked drop in the number of eligible children receiving assistance (e.g. through food stamps). Greater co-ordination between welfare and these other forms of assistance may reverse this trend. Another concern is that the increased work incentives provided by welfare reform and the

EITC have been much less effective for less-skilled men. Even so, their unemployment rate has also fallen, but that is primarily attributable to their departure from the labour force and increased use of disability insurance (a factor that has depressed measured unemployment by perhaps two-thirds of a percentage point). Raising their returns to work by increasing their EITC credit and lowering their disincentives to work created by the disability programme would enhance the utilisation of available labour resources. While these in-work benefits have helped bring many people back to the labour market, they have been less successful in building good careers. This would point to a need for other policies that upgrade skills, though such policies in the United States have had a mixed record.

... and recent education reforms well implemented

This year's package of education-policy changes (the No Child Left Behind Act) focused appropriately on raising the quality of education received by students in poorly-performing schools (which are often those serving low-income areas). Funding at the federal government level for low-income school districts was increased, and the recent movement towards greater accountability in public schooling was strengthened. While the states will have a great deal of freedom in creating new required annual tests for those in Grades 3 to 8 and defining satisfactory progress and standards, biannual national exams will be a mandatory component of assessment. Results will be presented to parents with a detailed demographic breakdown to facilitate identification of pockets of weakness. Students in schools that have been identified as failing will be eligible for supplementary assistance, such as tutoring, and may even transfer to another school within their public-school district, although this may not inject a sufficient degree of competition into schooling, particularly at the secondary level where many districts contain few schools. There is a case for going further, perhaps by providing vouchers that could be used in any school. In addition, efforts to measure and increase the quality of teachers will be stepped up. Recent state efforts have shown that testing and accountability can improve results when properly implemented. State and local policies are decisive as federal funding is a tiny proportion of overall education expenditures. Even so, direct federal support for education is targeted almost exclusively on low-income areas and hence could have important effects. However, it is also worth noting that indirect federal support for education through the tax system disproportionately serves middle- and high-income areas, as property taxes are a primary source of school funding and are deductible from federal income tax liability. The overriding problem of unequal real funding across localities remains.

Weaknesses in accounting and corporate governance practices have led to a strong policy response

The collapse of Enron last year has been followed by a series of revelations regarding poor and misleading financial information from US corporations, and a number of large corporate bankruptcies. While market-based mechanisms have exerted pressure for auditors, analysts, rating agencies and investors themselves to be more vigilant, a strong policy response was also required, and the reforms contained in the summer's Sarbanes-Oxley Act have moved in the right direction. Penalties for fraud and provision of misleading financial information — including prison sentences for criminal actions — have been stiffened, a new oversight body policing auditors has been created, accounting firms have been forbidden

from providing certain consulting services to firms they audit, and corporate officers have been required to certify the accuracy of financial statements. In addition, funding for the Securities and Exchange Commission has been increased significantly, which will aid enforcement and facilitate the groundwork necessary to effectively implement recent reforms and study areas for future improvement. The Financial Accounting Standards Board has been directed to consider moving from the rules-based format of current Generally Accepted Accounting Principles (GAAP) to a principles-based approach. Indeed, the rules-based approach to accounting standards fostered by GAAP has created an environment in which the search for loopholes has become a preoccupation of corporate financial officers. The resulting earnings game has damaged investor confidence. A shift to a principles-based approach, such as that favoured by the International Accounting Standards Board, might ameliorate this problem. Moreover, the widespread use of stock options has not systematically aligned the interests of managers and shareholders (perhaps because managers have been encouraged to focus on boosting earnings in the short term at the expense of long-term performance). It also has distorted reported earnings (because options are not treated as an expense). Firms should consider — and perhaps, after further study, be required to implement — greater and more transparent disclosure of the structure of options granted to executives and their impact on earnings under a variety of possible outcomes, with particular attention to the incentives given to management.

Distortion-increasing actions in agriculture and trade are regrettable and should be reconsidered

The Administration helped launch the new round of global trade talks at Doha, and the Congress has followed through by providing it with Trade Promotion Authority (TPA). TPA will allow any new trade agreement to proceed through the Congress without modification and is hence one important prerequisite for a successful round. But the prospects for such a success have been weakened by a number of contentious measures. One is in agriculture, whose liberalisation is a central focus of the Doha round. While the Administration has tabled an ambitious proposal for agricultural liberalisation with the WTO, this welcome step forward comes on the heels of a step back from liberalisation in farm trade earlier this year. The farm bill approved this spring reverses the intended US move towards liberalisation in 1996 by both increasing total support to farmers and doing so in a manner that is likely to further distort the role of market forces in farmers' production decisions. In fact, the increase in support is a continuation of the trend in recent years, when emergency appropriations were repeatedly used to underpin farm incomes. However, the level of support (relative to revenue in the agricultural sector) in coming years might not greatly exceed that observed recently and will probably remain below that in some other OECD regions (notably the EU and Japan). Nonetheless, the implied signal has been ill timed, coming on the heels of the safeguard action earlier this year to impose temporary tariffs of up to 30 per cent on most steel imports and the anti-dumping and countervailing duties on imports of softwood lumber from Canada. In recent years, the domestic steel industry has been contracting sharply and shedding jobs, and these losses contributed to the pressure to impose tariffs. The import restrictions may help the steel industry, but the fundamental sources of the industry's problems have been the weakness in domestic demand, the strong dollar, a need for restructuring to address a lack

of competitiveness and heavy costs associated with previously accrued pension and health-care liabilities. The losses to domestic steel-using industries and to consumers resulting from the subsequent price increases and the global outcry that has ensued suggest that the imposition of tariffs has come at a high cost. Notwithstanding the US proposals in agriculture (at the WTO) and in steel (at the OECD), the moves away from market-based outcomes in trade and agriculture should be reconsidered.

The targeted modest cuts in greenhouse gas emissions could be achieved more efficiently

Another area where international frictions have been aggravated is climate change. The United States decided, along with Australia, not to ratify the Kyoto Protocol because it exempts developing countries and, moreover, was not felt to be in its best economic interests, as there were expectations that the costs involved would be disproportionate to the benefits. This decision will have significant repercussions. The absence of the United States from the global market for carbon emission permits will imply much lower demand on world markets for emission permits, reflecting the outsized US contribution to the share of total emissions. The Administration has offered an alternative three-pronged plan based on the development of new abatement technologies, building on experience with the use of market mechanisms to lay the groundwork for current and future action and improving understanding of the mechanisms of global warming. The Administration's plan would introduce or prolong a number of tax credits, provide a framework more favourable to nuclear energy, boost spending on a number of research projects and turn the existing voluntary register of greenhouse gas emission reductions into a system that will generate property rights, thus allowing a hedge against possible future emissions limits. However, the price of these rights is likely to be low and volatile, reflecting changing expectations of the likelihood of limits being introduced. The strategy would have the nation proceed gradually, in order to avoid abrupt shocks to the economy. Its objective would be to reduce the greenhouse gas intensity of output by 18 per cent over the next decade, 4 percentage points more than what would otherwise occur. As a result, the level of US emissions may be nearly 30 per cent higher than in 1990, compared to a reduction of 7 per cent that would have been required to reach its target under the Kyoto Protocol. It should be noted, however, that the targeted abatement within the United States is not significantly different from that implied by the plans developed by the previous Administration, which foresaw its achievement largely via substantial purchases of emission rights through the carbon-trading mechanisms planned for in the Kyoto Protocol. Nonetheless, without US purchases, the price of such permits on the world market will be much reduced (near zero, according to some estimates), and the global amount of such emissions cutbacks will be lower. The piecemeal nature of the Administration's initiatives, together with the variety of recent, more ambitious state-level projects to reduce carbon emissions, suggests that the costs of achieving the Administration's target could have been reduced. A cap and trade system, with a low ceiling price, would have achieved a unified market in carbon within the United States and therefore reached the target more efficiently.

Improved pricing of water would help reduce its

Another area with serious sustainability concerns is groundwater supply, with water tables continuing to be depleted at overly rapid rates.

***depletion and rationalise
its use***

Municipalities are selling water at prices that do not take into account the costs that are imposed on future users by the decision to pump today, while other public-sector bodies place barriers in the way of creating free markets for the irrigation water they supply. The principal beneficiaries of these policies are farmers who use irrigation water to produce crops that are often, in any case, heavily subsidised in other ways. Government control over the water supply has led to significant distortions. Policy needs to be re-orientated to ensure that water is correctly priced and that market mechanisms are not obstructed.

***Water quality has been
raised, though
inefficiently, and
non-point nutrient
emissions control remains
inadequate***

Yet there are some areas where notable improvements have been made in environmental outcomes. Water quality has been raised and soil erosion reduced. However, the pursuit of better water quality has suffered from excessive reliance on command and control methods when economic instruments could have achieved the same results at a lower cost. Moreover, the relevant legislation largely ignores emissions of nitrogen and phosphorus that degrade the quality of water in estuaries and has not controlled agricultural non-point emissions of these pollutants. Given the difficulty of applying command and control techniques to such diffuse emissions, it is likely that the trading of individual rights to a proportion of an overall cap on the discharges allowed in a given watershed would be the best way to achieve further improvements in surface water quality.

***More consistent use of
thoroughly audited
cost-benefit analysis is
required***

Further progress is needed to ensure that economic concerns are properly taken into account where environmental decisions are made. While the executive has been required to assess environmental impacts for more than 30 years when proposing major projects, the legislature has not always allowed the executive to weigh economic benefits against costs, especially in the area of clean air and water. This has led to unjustified differences in procedures according to the environmental legislation in question. For example, policies governing discharges to river water are determined without regard to benefits, whereas a benefit test is required under the legislation applying to drinking water. This lack of harmonisation is inefficient and unjustified on environmental grounds. However, it is clear that more generalised use of cost-benefit analysis would be no panacea, as environmental benefits are often difficult to measure. Careful independent audits of such analyses would be required if large amounts of public money are not to be wasted. Given the importance of regulations, such audits need to be undertaken by a unit responsible to Congress and provided with an adequate level of funding.

Summary

The recession that followed the longest expansion on record was surprisingly mild, despite the disruptive effects of the terrorist attacks in September 2001. This owed a great deal to monetary and fiscal stimulus. But it also reflected firms' ability to maintain productivity gains. While this bodes well for a renewed period of economic expansion, the recovery that began early this year is still fragile, given the substantial role played by inventories, the weak labour market and the further decline in the stock market. Against this backdrop, the Federal Reserve will face a delicate balancing act in the period ahead. It will have to stand ready to ease monetary policy, should the economy falter in the coming months. But

eventually it will have to raise short-term interest rates. That should come early enough to ensure that price stability is maintained, but not so fast as to jeopardise the recovery. Looking ahead, there also remains the question of how the external deficit will be unwound. On the fiscal side, recent tax cuts and spending increases have moved the federal budget into deficit, perhaps durably. The onus is on Congress to ensure that adequate mechanisms are in place that discipline perennial spending incentives. In addition, given the ageing of the population and the long-run imbalances in the present public pension and health-care programmes, early action to reduce future benefit promises, increase dedicated revenues or trim other government programmes is needed to smooth the transition to a sustainable longer-term budget situation. Current health-care reform initiatives are geared more toward expanding benefits — in particular for prescription drugs — than ensuring the system's long-term viability. There is certainly a need to improve coverage, both in terms of services provided by public programmes and reducing the large number of uninsured. But whether this is done by extending such programmes or providing tax incentives for the purchase of private insurance, the effect on the budget will have to be compensated by measures to contain surging health-care costs, which are likely to persist without major reform. Restructuring and capping the generous tax exemption for employer-sponsored health benefits could provide part of the answer. Good policies and a strong economy have contributed to a marked improvement in social conditions, as manifest in declining poverty, welfare dependency and crime. It will be important to sustain these gains in a less favourable economic environment. Another challenge is to ensure that recent legislation regarding corporate governance and financial reporting is implemented in a way that enhances market discipline without unduly adding to the regulatory burden. Moreover, additional changes in this area, including a move towards principles-based accounting standards, should be considered after careful study. Recent distortionary moves in the agricultural and trade areas should be reconsidered. Finally, environmental policies could be designed and implemented in a manner that more thoroughly and consistently takes into account their economic costs and benefits. Such structural reforms would safeguard the impressive economic performance recorded over the past decade.