

## **Presentation of the 2005 OECD Survey of the US economy**

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### Speaking notes

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It is a great pleasure to present this survey of the US Economy. Having Doug Holtz-Eakin to discuss it and Representative Kolbe to moderate the discussions is a privilege.

As you know, we survey every member country every 18 months or so. Giving advice on US policies is however a great challenge. After all US performance has been one of the very best within the OECD over the past 10 years.

But still even the best and brightest can improve at times.....

The OECD has produced a very rich survey. And for the sake of brevity, I would like to concentrate on 4 areas: macroeconomic developments, current account imbalances, tax policy and energy policies.

This survey includes an updated forecast for 2005 and 2006. It shows a continuation of growth around trend despite the disruptions brought about by various hurricanes and the spike in gasoline and gas prices. In this forecast inflation remains also under control. There is currently a spike of inflation, which is normal given the spike in gasoline prices. But core inflation remains stable and so do most measures of inflation expectations. We expect such a stable inflation outlook to extend into 2006.

This is of course a tribute to the credibility of monetary policy, which will continue on its tightening course for some time.

Altogether the US economy has shown considerable resilience over the past few years despite all the shocks (NITC bubble, geopolitical uncertainty, oil price hikes....) it had to cope with. This resilience stems in large part from US highly flexible labour product and financial markets.

That this success is not accidental is confirmed by the excellent performance of other economies such as Australia, Canada, Ireland, the Nordic countries and the UK, that have emulated the US in improving the functioning of their markets. They too benefit from strong long-term growth and high resilience in the short-run in the face of shocks.

Like any forecast, this one is not without risks. The major one being a back up in long-term interest rates in a context of high oil prices, large fiscal deficits and a possible abrupt unwinding of current account imbalances.

We are not saying that this risk is an immediate risk. But it is there in the background. It may complicate the management of the US economy. It would most likely be detrimental to growth outside the US. (Japan and Continental Europe would have difficulties to cope with the adjustment).

In this context it is a bit worrying to see current account deficit in the US moving around 7% of GDP and also surpluses in China and Japan looming a lot larger.

There is no way policies can fine tune the current account, which is largely a market outcome. But there are policies, which have good consequences domestically while having also positive side effects on current account imbalances.

It is not just an issue for the United-States but also for its Asian and European partners.

What is needed for a gradual unwinding of imbalances is:

1. Greater exchange rate flexibility in Asia.
2. Faster economic growth in Europe.
3. Higher saving in the US.

Let me elaborate on each one in turn.

1. More *flexible exchange rates in Asia* can be helpful indeed, even if they would make only a small dent in the US deficit. As underlined last month in our first-ever OECD Survey of China, there would also be important benefits for monetary policy in China.
2. A *pick-up in European growth* would of course be welcome on my side of the Pond. But a distinction between trend and cycle is in order here.

Working off the slack in the euro area would indeed contribute somewhat to reducing international imbalances.

But faster potential growth in Europe, driven by structural reform, may help less to shrink the US current account gap than is sometimes alleged:<sup>2</sup> stronger long-term growth does not just mean higher imports on the part of US partners, but also ultimately larger exports. In fact, different types of structural reforms can influence the current account differently. On the one hand, successful labour market reforms would boost Euroland's competitiveness, strengthening its external balance. On the other hand, financial and product market reforms would tend to work in the opposite direction.

In fact, the main channel through which structural reforms may impact current account imbalances is probably more indirect: with higher trend growth, surplus countries may be better placed to absorb the costs of adjustment. And better economic structures would also increase their short-run resilience and boost domestic demand, thereby helping to ease international imbalances.

3. Last but not least, a turnaround in *household and government saving in the US* would help. Again, both for domestic and external reasons.

Looking at the current account as the balance between saving and investment, corporate saving is high these days. But government and household saving are low.

Public sector dissaving is one factor underlying the external deficit, even if it is not a one to one correspondence. I need not dwell on fiscal consolidation but we share the CBO's concerns both on the budgetary side and on the social side, given the mounting Social Security and public health spending pressures.

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<sup>2</sup> As shown by recent OECD research, see "Structural policy reforms and external imbalances", OECD Economics Department Working Paper No. 415, January 2005.

The Survey sets out measures to address this challenge. For example, accelerating the transition from 65 to 67 for the age at which full pension benefits are paid, and then indexing that age to longevity gains. Also, we support raising the early retirement age from 62 to 64 and strengthening the financial incentives to delay exit. This would stimulate participation in the labour market.

The personal saving rate has essentially trended down to zero. One way to boost household saving might be stronger private incentives to save for retirement. But tax reform more generally might help as well.

## **Overdue tax reform**

I will start by noting that useful tax cuts have been implemented over the recent years to improve the supply side of the economy. But a more general overhaul is now needed to simplify and reform the tax code in the spirit of the splendid 1986 bipartisan reform. Since the mid-1980s, the *tax code* has undergone some 14 000 changes. That amounts to an average of three to four amendments per working day. Again, an example of high US productivity! The complexity and numerous distortions thus created are obvious and widely recognised, including those that harm incentives to save.

In our view, the tax system can be streamlined and become more conducive to growth, even without altering the basic structure of the income tax. The Survey highlights two sets of measures in particular:

1. The deductibility of interest on home equity loans (which are for consumption purposes) should be eliminated. And the deductibility of interest on loans for the purchase, construction or improvement of houses should be restricted and gradually phased out. The United Kingdom has demonstrated that such a reform can be pushed through. All in all, it seems a bit contradictory to promote savings through special tax treatment, while undoing this good policy, by subsidising consumption through special tax treatments of equity loans.
2. The exclusion of employer-provided health insurance premiums should be capped to increase cost consciousness and limit health care cost inflation.

More ambitious tax reforms would deliver additional efficiency gains. The marginal corporate tax rate in the US ranks among the highest across OECD countries, but the corporate tax intake as a share of GDP among the lowest. A

simpler corporate income tax structure, with a broader base and lower marginal rates would improve economic incentives and reduce deadweight losses.

In principle, it would even make sense to go further still and to replace the corporate income tax by a federal value-added tax. With a broad base, such a VAT would raise enough revenue to reduce reliance on income tax revenues. At the same time, retaining a personal income tax would allow the desired degree of progressivity of the overall tax system to be achieved. In addition, if states changed their own sales taxes to a VAT, jointly administered federal and state VATs could lead to substantial efficiency gains for economic decisions and tax compliance and administration. This is indeed what Canada is now doing with great success.

## **Energy**

Soaring oil and gas prices have focused attention on energy markets. In this area, the US is perhaps less of a model for other OECD countries. Granted, energy use relative to GDP has been on a downward trend, but is much higher than elsewhere. Energy supply remains dominated by fossil fuels, while the small share of renewables is now lower than in the mid-1990s.

The OECD fully supports the notion that it is important to boost the supply of energy and to increasing refining capacities. There is indeed a lot to do to overcome the “not in my backyard” syndrome. But US policy should also be geared to economic incentives for raising *energy efficiency* – especially in the transport sector – and the production of renewables.

Finally, policies to curb *greenhouse gas emissions* could be reinforced. Acknowledging that voluntary approaches to environmental control typically lack effectiveness. One could mix elements of a domestic cap-and-trade system, as exists for air pollutants, and a carbon tax on all carbon-based energy products. This would not only reduce air pollution and combat global warming, but also promote energy independence and raise public revenues.

