INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/221

UNITED STATES

July 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with United States, the following documents have been released and are included in this package:

- **Staff Report** prepared by a staff team of the IMF, following discussions that ended on June 12, 2014, with the officials of United States on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 7, 2014.
- **Informational Annex** of July 7, 2014 prepared by the IMF.
- **Staff Statement** of July 22, 2014.
- **Press Release** summarizing the views of the Executive Board as expressed during its July 22, 2014 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

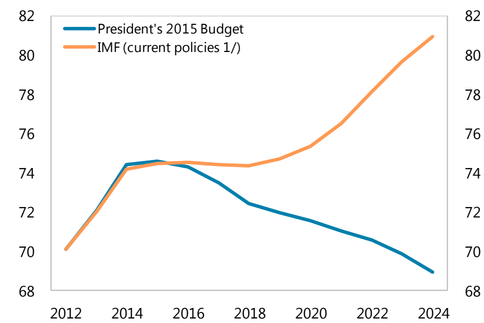
International Monetary Fund
Washington, D.C.

pro-work tax cuts. If put in place today, the authorities believed that such policies would push growth up to an average 3¼ percent over the next three years and achieve a potential growth rate of 2¼ percent over the medium-term. On energy policy, the authorities indicated they were taking an active look at the implications of growing domestic energy supplies including the economic, environmental, and security opportunities and challenges that it presents and would evaluate policy options as needed.

PUTTING PUBLIC DEBT ON A DOWNWARD PATH

23. *Medium-term adjustment*. Past policy advice has emphasized the importance of a medium-term fiscal plan and early action to slow entitlement spending (see Annex III for a summary of past policy advice). It also made the case that less fiscal withdrawal in the short run, accompanied by a medium-term fiscal plan and ambitious structural reforms, would allow for a more balanced policy mix by partly relieving monetary policy of its burden of supporting the recovery. This, in turn, would generate more favorable outward spillovers while reducing the risks to U.S. and global financial stability from a prolonged period of low interest rates. Consolidation in 2011–13 was stronger than had been earlier anticipated (the federal primary structural deficit declined by 1¼ percent of GDP more than was predicted in 2011). However, the outlook for potential growth has worsened, lowering future federal revenues and compounding the long-term fiscal sustainability challenge. As a result, under current policies, after stabilizing in 2015–18, the debt-to-GDP ratio is expected to begin rising again as aging-related pressures assert themselves and interest rates normalize. Staff estimates that, relative to current policies, an additional 2¾ percent of GDP in fiscal adjustment at the general government level would be needed between now and 2023 in order to put the debt-to-GDP ratio on a downward path over the medium term (even as age-related outlays for health and social security start to accelerate).

Federal Debt Held by the Public
(fiscal years, percent of GDP)

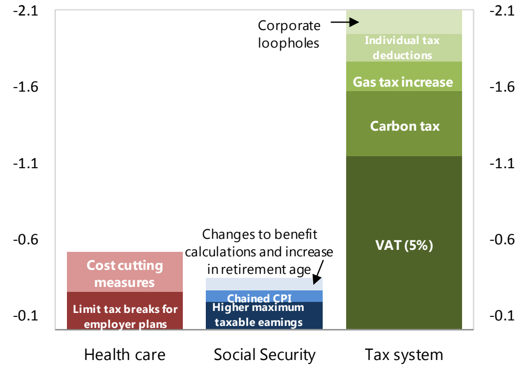


Sources: OMB; IMF staff estimates.
1/ See note in Table 3 for the differnce in policy assumptions compared to the Presiden'ts Budget.

24. *A better policy mix*. Given the substantial slack in the economy, there is a strong case to provide continued policy support to the recovery. A credible medium-term fiscal consolidation plan would provide the flexibility for some near-term fiscal support to the economy that is designed with a focus toward reducing poverty and encouraging longer-term growth. Helping to kick-start growth and job creation in this way would have near-term demand effects but, more importantly, lasting implications for potential growth. It may also, at the margin, allow for an earlier withdrawal of exceptional monetary stimulus with some positive spillovers to both domestic and international financial stability.

25. ***Policies***. In this vein, the President's 2015 budget outlines various valuable steps that would move toward such a policy mix. It proposes health care savings (including through higher Medicare premia), immigration reform, and measures that limit tax deductions and exclusions for higher earners. There are also sensible options laid out in various proposals under consideration in Congress. Given the long gestation period of reforms, producing measurable savings over the medium term will require up-front action and will need to encompass:

Options for Federal Fiscal Deficit Reduction
(change in primary deficit in 2014-24, percent of GDP)



Sources: CBO, JCT; IMF staff estimates.

- *Controlling health care costs.* Some progress has already been made in taming the fiscal pressures from rising health care costs and there has been a tangible slowdown in the growth of health spending, partly attributable to the implementation of the Affordable Care Act (ACA).[4] However, it is unclear to what extent this cost slowdown will persist and what are the fiscal and cost implications of the Medicaid expansion under the ACA. As a result, more could be needed. Measures that could be considered to bend the cost curve include the enhanced coordination of services to patients with chronic conditions, the education of patients to reduce the overuse of expensive medical procedures and technology, greater cost sharing with beneficiaries, and the elimination of tax breaks for some of the more generous employer-sponsored health care plans.

- *Strengthening social security finances*. The 2013 Annual Report by the Social Security Trustees projects that the combined trust fund reserves would decline beginning in 2021 and reach zero by 2033, at which point continuing income would be sufficient to pay only 77 percent of benefits. The clock runs faster for the Disability Insurance Trust Fund, which would be exhausted as early as 2016. Addressing the expected depletion of the Social Security Trust Funds will require early and fundamental reforms. These could include a further gradual increase in the retirement age (potentially with steps that link the future retirement age to average life expectancy or other actuarial indicators of the solvency of the system), a modified benefit structure to increase progressivity, an increase in the maximum taxable earnings for Social Security purposes, and an indexation of benefit programs and tax provisions to chained CPI (rather than standard CPI).

- *Improving the tax structure and raising revenues*. In addition to the tax measures described earlier (to enhance long-term growth by making the direct tax system simpler, more equitable, and with less negative incentive effects), there is also a need to raise additional revenues so as to contribute to the needed medium-term fiscal adjustment. To do this, the U.S. could consider a

[4] See D. Igan, K. Kashiwase, and B. Shang, "Risky Business: The Uncertainty in U.S. Health Care Spending," in IMF Country Report No. 13/237.

range of options, including a broad-based carbon tax, a higher federal gas tax, and a federal-level VAT.[5]

26. ***Authorities' views***. The authorities agreed that the benefits to the U.S. economy from a clear fiscal consolidation plan would be significant. They indicated this was exactly the approach that had been taken in the President's 2015 Budget, which proposed a roadmap for accelerating economic growth, expanding opportunity for all Americans, and ensuring fiscal responsibility. Under their budget plan, the federal deficit would be lowered to 1.6 percent of GDP by 2024, bringing debt down to 69 percent of GDP. This would be achieved through improved efficiency savings as well as longer-term health, tax, and immigration reforms. They also agreed that a credible medium-term consolidation plan would give some space to provide more support to the recovery in the near term (particularly through investments in infrastructure, education, and other productivity-enhancing areas). However, they believed that, although it would be politically difficult to agree on a comprehensive medium-term fiscal plan, it could be possible to achieve bipartisan support to pass, by the end of the current administration, a reform of the business tax regime, increased funding for infrastructure and work training programs, and immigration reform. In this regard, the Bipartisan Budget Act of December 2013 could be a blueprint to replace automatic spending cuts in FY2016 with mandatory savings in future years. On health care, officials believed that the full effects of the ACA had yet to be felt and they favored waiting on other health care reforms in order to allow the system time to adapt to the various provisions of the ACA.

27. ***The institutional framework***. The three-week shutdown in October 2013 is estimated to have subtracted 0.3 percentage points (annualized) from fourth quarter growth with the uncertainties generating negative spillovers to various other countries. Fiscal policy uncertainty has been temporarily reduced, but many of the same features—linked to discussions on appropriations, negotiations on removing the sequester provisions for fiscal year 2016, and raising the debt ceiling—could come back to the fore in spring 2015. A more durable, institutional solution to risks from political brinkmanship is needed both for the sake of the U.S. and the global economy. Useful measures could include reaching bipartisan agreement on a clear, simple medium-term fiscal objective (with an integrated view of all budget functions and numerical targets for the debt and deficit); adopting carefully-designed mechanisms to trigger revenue or spending adjustments if targets are breached; an automatic process that would raise the debt ceiling once there is agreement on the broad budget parameters; and shifting to a budget cycle where annual spending levels are agreed for a two-year period (but with the possibility for supplemental budget resolutions during that two-year window under clearly specified conditions).

28. ***State and local finances***. At the state level, higher levels of unfunded pension liabilities and political polarization appear to be associated with lower credit ratings.[6] To support their credit

---

[5] See IMF, 2010, "From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies," for a broader discussion of tax policy options.

[6] See M. Estrada, D. Igan, D. Knight, "Fiscal Risks and Borrowing Costs in State and Local Governments," Selected Issues Paper, 2014.

ratings and lessen financing costs, state and local governments should adopt budget institutions that reduce the impact of these factors, including less stringent voting requirements to implement revenue increases and more flexible rainy-day fund rules. Steps could also be taken to require states to measure their unfunded liabilities under more realistic actuarial assumptions and to restore actuarial soundness for public sector employee pension and other post-employment benefit programs.

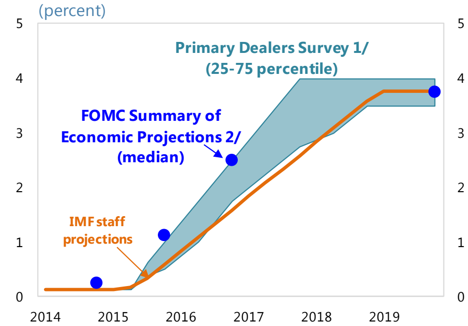
29. ***IMF quota reform***. The implementation of the 2010 reforms remains a high priority and the U.S. was urged to ratify these reforms at the earliest opportunity.

30. ***Authorities' views.*** Counterparts were supportive of the importance of budget process reform, including through a more sensible approach to the debt ceiling, although they expressed skepticism on whether any of these changes would be achievable in the near term. On IMF quota reform, the authorities reiterated their belief that IMF quotas must truly reflect countries' weight in the global economy and indicated that they were actively working with Congress to secure legislation to implement the 2010 IMF quota reforms.

THE PATH TO LIFT-OFF

31. ***Monetary policy***. The Fed currently has to contend with multiple areas of uncertainty including the degree of slack in the economy, the degree to which this slack will translate into future wage and price inflation, and the transmission to the real economy of an increase in policy rates. Currently, the median forecast of participants in Federal Open Market Committee (FOMC) deliberations indicates that the fed funds rate is expected to lift-off from zero by mid-2015, with a gradual path upward toward a 3.75 percent long-term level. Staff's baseline path is somewhat more gradual than this median. However, even with this path for policy rates, the economy is expected to reach full employment slowly and inflation pressures are forecast to remain muted. This could mean that—presuming systemic financial stability risks are contained—there is some scope for policy rates to stay at zero for longer while still keeping inflation under 2 percent. On the other hand, inflation could start rising faster than expected. This would place increasing tension between the Fed's mandates of maximum employment and price stability. In that case, if expectations remained anchored and financial stability risks were low, there could be room for the Fed to tolerate a temporary and modest rise of inflation above the 2 percent target. Much will depend on the source of the higher inflation. If the increase were transitory or not accompanied by rising wages, there could well be more space to defer rate increases. However, if this inflation were driven by an unexpected upswing in wages, then there would be a need to carefully reconsider whether preferred measures of slack were still appropriate, reassess if the economy was actually much nearer to full employment than it currently appears, and potentially begin raising rates at an earlier stage.

Expectations for Future Policy Rates
(percent)



Sources: Federal Reserve Board, Federal Reserve Bank of New York; IMF staff estimates.
1/ April 2014.
2/ June 2014.