

Chapter 3

ECONOMIC STABILITY AND TRUST IN INSTITUTIONS IN THE UNITED STATES

This chapter outlines the importance of economic stability and public institutions in fostering public and private investment. It provides an overview of the performance of the overall economy, outlines macroeconomic developments and challenges, explains the federal-state-local governance system, and presents an evaluation of public institutions.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Macroeconomic policy environment

At the broadest level, stable and sound macroeconomic policies, leading to high growth and low and stable inflation rates, play an important role in setting a favourable environment for investment in farms or agri-food firms seeking to introduce new products, to adopt new production methods, or to undertake organisational changes that can lead to higher productivity growth and more sustainable use of natural resources. Assessment of the country's overall growth and growth potential in the short- to medium-term has implications for sector specific prospects as well. In some circumstances, macroeconomic policies and their impacts can contribute to implicit and perhaps unintended biases for or against the food and agriculture system.

The United States is a large economy with well-established institutions to manage economic policies. Monetary policy is carried out by an independent central bank, the Federal Reserve (the Fed), through a policy-making body called the Federal Open Market Committee (FOMC). The Fed's monetary policy directives are carried out primarily by the Federal Reserve Bank of New York, one of 12 regional Federal Reserve Banks, and the deep US financial markets allow for the use of a wide range of tools. Fiscal policy is carried out jointly by Congress and the President, with analytic and data support from the President's Council of Economic Advisors, the Department of the Treasury, and the Congressional Budget Office. Some fiscal policy actions — increases in expenditures or reductions in taxes — occur automatically through the design of existing statutes, without explicit immediate actions taken by policymakers (these are called automatic stabilisers). Other fiscal policy initiatives require explicit actions by policymakers.

The US economy was hard hit by the recession and financial crisis of 2007-09 (Figure 3.1). House prices, which had risen to unprecedented levels over the previous decade while accompanied by a residential construction boom and a proliferation of complex mortgage-related financial assets, started to fall in early 2007. The fall in house prices, and the associated declines in household wealth and the value of mortgage backed and related assets, led to a slowdown in consumer spending, increases in mortgage defaults and home foreclosures, reduced credit availability, and significant strains on financial institutions (Council of Economic Advisors, 2010).

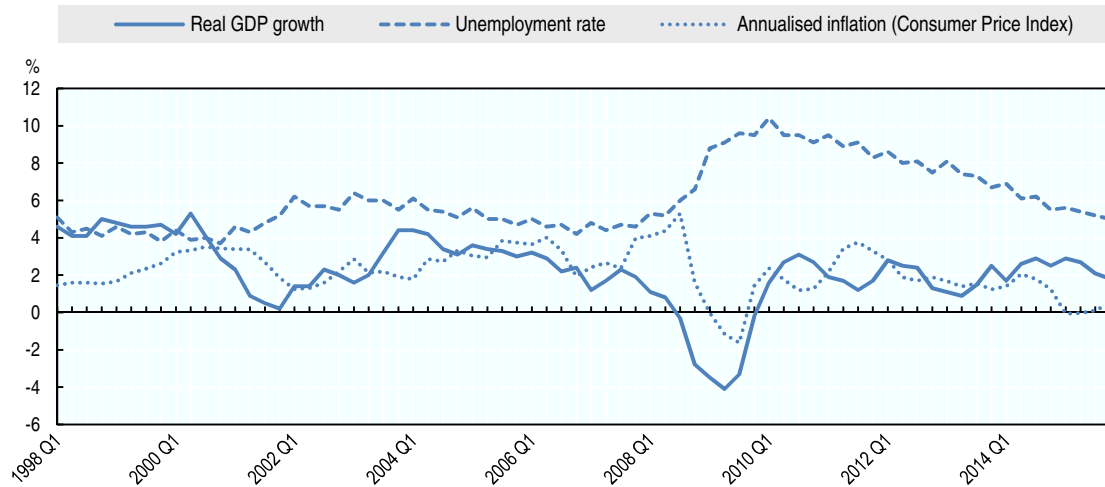
In the fall of 2008, the financial crisis intensified with the collapse of the investment bank Lehman Brothers and the near collapse of American International Group, a major insurer. Parts of the financial system froze, and seemingly safe asset classes became subject to “bank runs” as asset holders raced to dispose of them. Credit became considerably tighter, the stock market declined, and unemployment rose sharply as business activity slowed.

Real growth in Gross Domestic Product (GDP), which had begun to slow in late 2006, turned negative in 2008. Real GDP then contracted rapidly — at a 3-4% annual rate — through the first half of 2009. The civilian unemployment rate, which was at 4.2% in the 2nd quarter of 2006, reached 10.4% in the first quarter of 2010. This was the deepest recession since the Great Depression of the 1930s.

Recovery from the recession occurred slowly, like other recoveries after major financial crises (Reinhart and Rogoff, 2009). The financial crisis created sharp reductions in household wealth, which led households to reduce consumption expenditures as they sought to rebuild wealth stocks. Real GDP grew at an average annual rate of 1.9% between first quarter of 2010 and the first quarter of 2014.

Seven years after the crisis, the US economy has recovered, but growth has been moderate at 2.4% of GDP per year in 2014 and 2015, and is expected to remain around 2% in 2016 and 2017 (OECD, 2016). Macroeconomic imbalances and fiscal sustainability have been largely restored, as explained below, although general government net debt accounted for close to 88% of GDP by 2013 and is expected to reach 90% in 2016.¹

Figure 3.1. US GDP growth, unemployment and inflation, 1998-2015



Data are quarterly averages; real GDP growth and inflation are reported as annualised percentage changes, compared to four quarters earlier.

Source: St Louis Federal Reserve Bank (2015), Federal Reserve Economic Data (FRED).

<https://research.stlouisfed.org/fred2/>.

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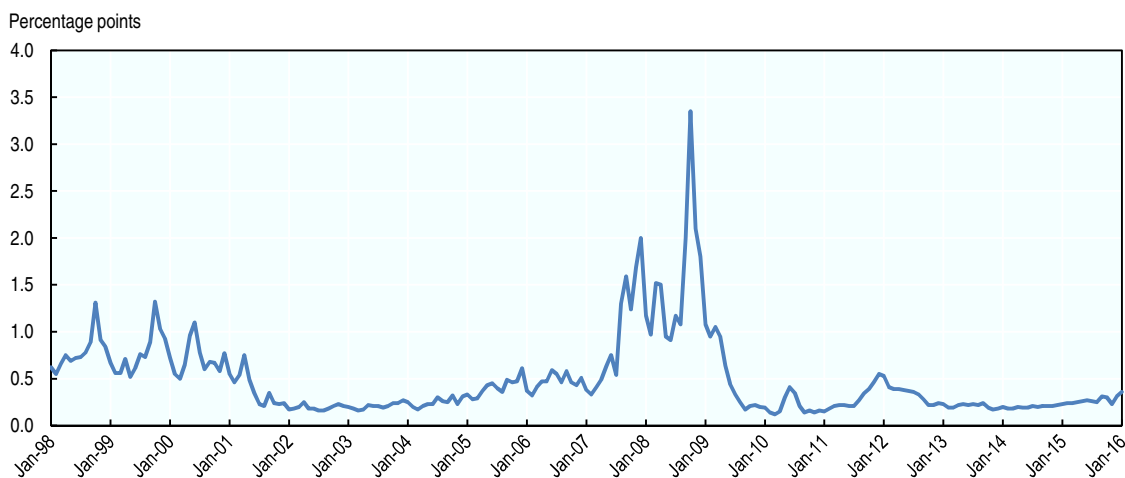
During the recovery, the unemployment rate continued to fall gradually to 4.9% in January 2016, and is expected to remain at 5% in 2016 and decrease to 4.7% in 2017 according to OECD projections. Private job growth, driving unemployment down to its structural level, has been a major element of the recovery from the crisis (OECD, 2016).

The crisis presented enormous challenges for central banks, as financial institutions strove to buy the safest financial assets and dispose of riskier assets, while also reducing lending for many business activities. As financial institutions sought the safest securities, prices for those securities were driven up, reducing their effective interest yields; as institutions tried to sell assets perceived to be riskier, those asset prices fell and their interest yields rose. Short and long-term credit for many activities dried up in the fall of 2008, leading to the spectre of a depression.

One measure of perceived credit risks is the TED spread, the difference in annualised interest rates between three-month US Treasury bills (viewed as the safest of assets), and interest rates that banks charge one another for overnight loans. The spread falls in a range of 0.1 to 0.3 percentage points in normal periods, reflecting the slightly higher risk associated with overnight loans among banks. However, the spread ranged from 1.0-2.0 percentage points in 2007-08 during a period of heightened credit risks, before rising to 3.35 percentage points in October 2008, as the crisis peaked and market participants surged into treasuries in a flight to safety (Figure 3.2).

Global trade, which is financed by institutions throughout the financial sector, fell sharply during the crisis (Figure 3.3). Merchandise trade is quite sensitive to changes in income, and declines in GDP would therefore have led to disproportionate declines in import demand, but trade financing also became difficult to access during the crisis. After growing by 24% between the beginning of 2005 and the end of 2007, global trade volumes stopped growing in 2008, and then plunged by 16% in the last quarter of 2009 alone. The global volume of merchandise trade did not return to its 2007 volume until the second half of 2010, and has grown slowly since.

Figure 3.2. The TED spread, monthly averages, 1998-2015



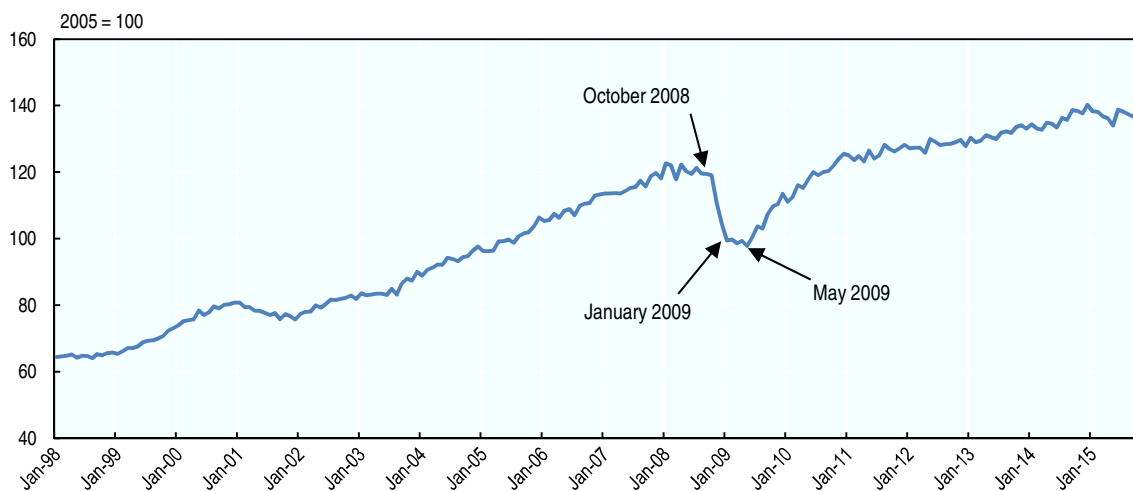
The TED Spread is the difference between interest rates charged on interbank overnight loans and 3-month US Treasury bills. It is a measure of credit risk in the US economy.

Source: St Louis Federal Reserve Bank (2015), Federal Reserve Economic Data (FRED).

<https://research.stlouisfed.org/fred2/>.

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Figure 3.3. World trade during the financial crisis, 1998-2015



Source: CPB (Netherlands Bureau for Economic Policy Analysis) (2016), *World Trade Monitor*. Seasonally adjusted merchandise trade. www.cpb.nl/en/world-trade-monitor.

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As implied by the figures on global merchandise trade, the financial crisis and recession were global economic phenomena. At the trough, global industrial production fell by 14% from its previous peak. The initial declines in production and trade mirrored those of the Great Depression of the 1930s (Eichengreen and O'Rourke, 2012).

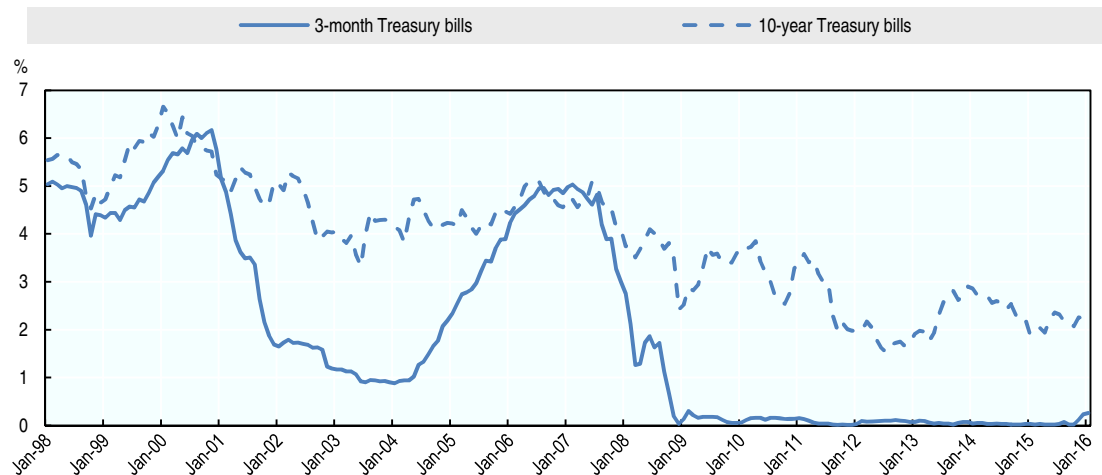
The Federal Reserve (Fed) and other central banks took extraordinary steps to resolve the global crisis by extending credit to, and purchasing financial assets from, bank and non-bank financial institutions. The impact of their actions on perceived risks in the financial system can be observed through the decline in the TED Spread, to 1% through the first quarter of 2009 and to 0.2% by the summer of that year.

The Fed also acted through traditional and non-traditional monetary policy channels to reduce interest rates (Figure 3.4). Rates on 3-month Treasury bills fell from 4.7% in August 2007 to 1.7% a year later as the Fed expanded short-term credit; they then fell to 0.19% by November 2008, and remained below 0.20% until December 2015.

In addition, the Fed took steps to reduce long-term interest rates through purchases of long-term securities in programs known as quantitative easing. Rates on 10-year Treasury bonds fell from 4-5% before the financial crisis, and remained near historic lows, at an average of 1.78% in February of 2016. However, low long-term rates likely also reflect slow global growth and large volumes of global savings.

Aggressive central bank actions have not led to increased inflation. In the United States, annual inflation as measured by the Consumer Price Index (CPI) ranged between 2 and 4% between 2000 and 2007 (Figure 3.1). It surged briefly to 5.3% in the 3rd quarter of 2008 as food and fuel prices rose, but inflation then fell off in the financial crisis and recession, and the CPI actually fell during the 2nd and 3rd quarters of 2009. CPI inflation has remained below 2% since the 1st quarter of 2012, in spite of falling unemployment and growing real GDP. It was even close to zero in 2016, but is projected to increase in 2016 and 2017 (OECD, 2016).

Figure 3.4. US interest rates, 1998-2015

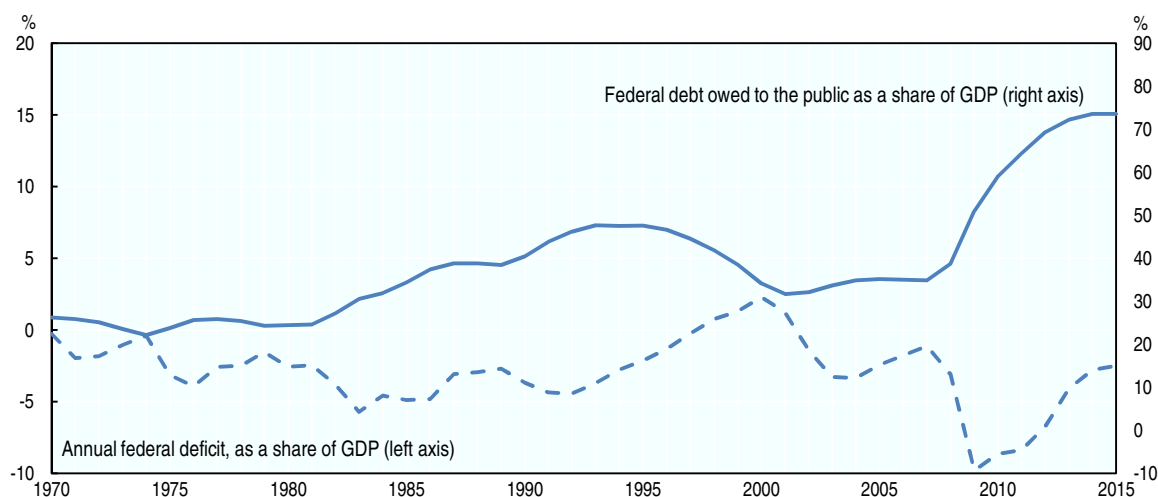


The data are monthly averages of daily data.

Source: St Louis Federal Reserve Bank (2015), Federal Reserve Economic Data (FRED).
<https://research.stlouisfed.org/fred2/>.

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Figure 3.5. US Federal deficits and debt as a percentage of GDP, 1970-2015



Source: St Louis Federal Reserve Bank (2015), Federal Reserve Economic Data (FRED).
<https://research.stlouisfed.org/fred2/>.

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The recession reduced tax revenues and induced increased federal spending through the actions of automatic stabilisers, and the US government took further fiscal policy actions to stabilise the economy. In consequence, annual federal deficits, which had been just over 1% of GDP in 2007, expanded to 3% in 2008 and nearly 10% in 2009 (Figure 3.5). Deficits remained above 8% of GDP in 2010 and 2011, and have since been steadily reduced, to 2.7% of GDP in 2015, and are expected to stabilise at 2.5% in 2016 and 2017 (OECD, 2016).

Increased deficits led to sharp increases in federal debt owed to the public, which amounted to 39% of GDP in 2008, 7 percentage points above its value in 2001, but which rose to 74% of GDP by 2015 (Figure 3.5). The Congressional Budget Office (CBO) projects that, under current laws governing taxes and spending, the share will rise to 80% in 2022, and will reach over 100% by 2040 (CBO, 2015). The projected 2022-40 growth of federal debt primarily reflects the impacts of an ageing population and growing health care costs on expenditures and annual deficits, which are projected to grow to 6% per year by 2040 under the current structure of taxes and programs. The projected growth also reflects specific macroeconomic assumptions regarding interest rates and real GDP growth. General government net debt reported by the OECD was around 88% of GDP over the period 2013-15, and is expected to reach 90% in 2016 and 2017 (OECD, 2016).

Current macroeconomic policy indicates a tightening of monetary policy and a modest loosening of fiscal policy. CBO baseline projections, based on current laws as of January 2016, indicate that the federal budget deficit will increase to USD 544 billion in 2016 (2.9% of GDP) from USD 439 billion in 2015 (2.5% of GDP). In turn, the CBO projects that outlays will increase by 6.2% and revenues by 3.9%. The agency further estimates that debt held by the public will rise to 76% of GDP in 2016 (CBO, 2015).

The Fed increased its target range for the federal funds interest rate by 0.25% in December 2015, the first increase since 2006. The rate refers to loans of reserves among banks and, as it is the interest rate most immediately affected by Fed actions, is used as a target and communications device by Fed policymakers and market-watchers. At the time of the increase, Federal Reserve policy makers indicated that the increase would be the first in a gradual but steady series of increases intended to return to a more normal range of short run interest rates. However, in the face of continued weakness in key economic indicators, the Fed left the target rate unchanged in early 2016.

Long term real interest rates — that is, rates on securities with maturities in excess of one year, and adjusted for expected inflation — have remained low, relative to their historic values, for well over a decade (Bean et al., 2015). Nominal interest rates on ten-year Treasury bonds have remained below 2.4% over the 3rd and 4th quarters of 2015 (Figure 3.4); inflation expectations, as measured by the difference in yields between ten-year Treasury bonds and ten-year Treasury inflation-indexed securities, were at 1.8%, suggesting that the real inflation-adjusted rates on ten-year Treasury bonds were less than 0.6%. Nominal and real rates have been declining in the United States and around the world for two decades (Council of Economic Advisors, 2015).

Interest rates affect agriculture, especially through land values and equipment purchases. Lower rates imply a greater present value for any future stream of land rents, and should therefore lead to higher land values. Agricultural land values in the United States have risen steadily since 1987, with a pronounced rise in 2004-14 (Nickerson et al., 2012). Rising land values have increased the wealth of farmland owners, including farm operators and non-operator landowners, but also raise the cost of land for new entrants to farming who wish to purchase land.

Lower interest rates also reduce the cost of capital equipment and structures for farmers and their lessors, and therefore induce greater investment in new structures and equipment in agriculture. New capital embodies many innovations, and typically substitutes for labour, so investment in new capital contributes to greater productivity growth and also contributes to shifts of production to larger farms.

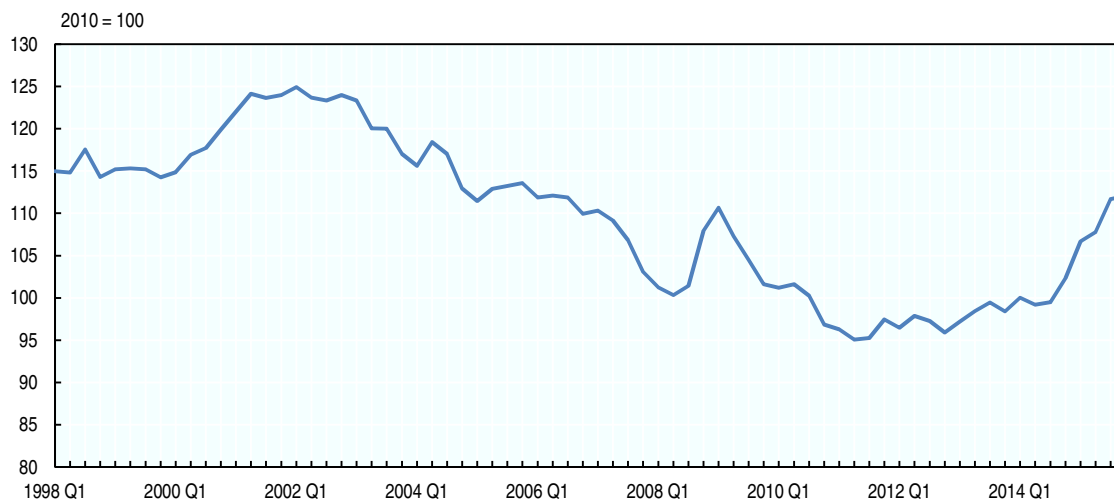
Monetary policy has affected short and long-term rates, but policy is not the sole driver of current low long-term rates. Market forces, in the form of expanded global savings combined with slow growth in industrialised countries, have likely placed separate pressures on rates over time, as have policy decisions that affect national savings. As a result, changes in monetary policy alone are not likely to raise long-term rates back to historic levels.

Currency exchange rates affect the performance of agriculture, because agricultural commodities are prominent in US trade. A high value of the dollar makes US exports more expensive and imports less expensive. In some periods, the effects can be pronounced. For example, in the early 1980s, high real interest rates — a policy choice resulting from a combination of tightening monetary policy and expansive fiscal policy — led to a large and sustained increase in the value of the dollar, and corresponding rise in US export prices. Agricultural exports fell by over a third between 1981 and 1986; with reduced export sales, domestic feed and food grain prices fell by about 40%, triggering substantial increases in commodity programme payments.

Exchange rates respond to international differences in economic growth, inflation, interest rates, and political and financial risks. The value of the US dollar underwent a long depreciation between 2002 and 2008; with a broad agricultural export-weighted index falling by about 20% (Figure 3.6). The US dollar then appreciated sharply during the financial crisis as foreign and domestic capital — seeking safety — flowed into US Treasury securities (increased purchases of US securities imply corresponding transactions for dollars, driving up the value of the dollar). As financial markets recovered, the dollar again depreciated over the next two years. However, the dollar appreciated sharply in the 2nd half of 2014 and through 2015 as financial capital again flowed into US securities in response to slowing growth and perceived financial risks elsewhere in the world (Figure 3.6). Since these conditions are expected to persist and US monetary policy is expected to tighten, the dollar is expected to remain strong in the near term. Sharp exchange rate appreciation has depressed manufacturing activity and export competitiveness (OECD, 2016).

The value of the US dollar rose by 13% between the 3rd quarter of 2014 and the end of 2015 (as measured by the index based on agricultural export weights shown in Figure 3.6). The value of US agricultural exports fell by about 11% in 2015, while the value of agricultural imports rose by about 2%. The agricultural trade balance — net agricultural exports — fell by nearly half from its record high in 2014. The US Department of Agriculture (USDA) expects a relatively strong US dollar to contribute to a smaller agricultural trade surplus than in the next ten years than in the previous decade.

Figure 3.6. The US exchange rate for agriculture, 1998-2015



Bilateral exchange rates are weighted by US agricultural exports, based on 2008-11 export shares, and converted to an index with a base of 2010.

Source: USDA (2016), Economic Research Service. www.ers.usda.gov/data-products/.

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Productivity growth is sluggish despite the rapid pace of technological innovation. The US Bureau of Labor Statistics estimates that US productivity — measured as net multifactor productivity in the non-farm private business sector — grew at an annual rate of 0.5% per year in 2007-14, after growing by 1.5% per year between 1995 and 2007. That slowdown may largely reflect the effects of the financial crisis and recession, but there is also concern that economy-wide productivity growth may continue to lag in the future. Increases in the educational attainment of the US population have supported past productivity growth, and those increases have slowed (Jorgenson, Ho, and Samuels, 2015). Moreover, some argue that major innovations no longer provide the productivity impact that they once did (Gordon, 2016), and that it will be difficult to again attain the rates of multifactor productivity growth realised in 1995-2007. OECD (2016) points to possible mis-measurement of productivity growth, low business capital expenditure and slower rates of entry and exit, which both drive productivity growth, and a changing composition of the economy shifting towards lower productivity activities in response to ageing population needs or changes in relative prices.

Slower economy-wide productivity growth would likely lower federal revenues and raise federal debt, compared to current projections. The future outlook for debt, and the continuing imbalance between federal revenues and expenditures, will likely constrain future public expenditures on farm commodity, insurance, and conservation programs. The budget outlook may also constrain future public expenditures in support of research and development (R&D), for science in general and for agriculture specifically. Past public support has played a significant role in spurring continued productivity growth in agriculture and in the broader economy.

Governance and the quality of public institutions

Good governance systems and high-quality institutions provide economic actors with the assurance that the government is accountable, transparent, and predictable. They are a fundamental pre-condition both to encourage public and private investment in the economy and to enable those investments to achieve the intended benefits, both for investors and for the country. Moreover, governance systems play an important role in addressing market failure, influencing the behaviour of firms as well as the efficient functioning of input and output markets.

Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction (North, 1990). Economic research has focused on the development of legal and regulatory rules that guarantee private property rights and facilitate the transfer of such rights; that secure such rights for a broad cross-section of society; and that place constraints on the political executive, particularly through the existence of an independent judiciary and a separation of powers among executive, legislative, and judicial branches (Acemoglu, Johnson and Robinson, 2005). Such economic institutions are an important factor in accounting for the very large differences in per capita incomes among countries.

The United States maintains secure property rights for private investment, has an independent judiciary, and constrains the executive. The governance system has been able to address externalities in research and the environment, and to provide for public investment in education and infrastructure over a long period. These and other institutions have contributed to private investment, innovation, and rapid economic growth over 150 years (Gordon, 2016).

Box 3.1. How the US government is organised

There are three levels of government in the United States: federal, state and local.

The **Federal Government** assumes responsibility for national security, foreign affairs, and interstate commerce, and has broad powers of taxation and expenditure in support of the general welfare. Under the Tenth Amendment of the US Constitution, all powers not granted to the federal government are reserved for the states and the people.

All State governments are modelled after the federal government, with executive, legislative, and judicial branches. While State governments share power with the Federal Government in many ways, **local governments** must be granted power by the States.

The Federal Government comprises three independent branches: executive, legislative, and judicial. The executive branch is headed by the President, elected for a four-year term. The legislative branch consists of two houses: members of the Senate are elected for six-year terms, while members of the House of Representatives are elected for two-year terms. Federal judges are nominated by the President to lifetime appointments, and confirmed by the Senate.

The Federal Government has been a primary actor in US agriculture for many years. It administers large federal farm commodity, conservation, and crop insurance programmes; funds and performs agricultural research; administers and regulates agricultural credit programs; manages food safety and agricultural pest and disease programs; and funds food programs.

State governments also play important roles in agriculture. Most agricultural colleges are located at State Universities, and the states independently fund some research and extension activities at universities. States may impose environmental regulations, in addition to federal regulations, on farms. States operate resource conservation programmes, and may form regional compacts with nearby states to attack regional water basin issues. They often engage in joint programmes of agricultural pest and disease control with federal agencies. State Departments of Agriculture administer state-specific promotion, training, and statistical programmes.

In its 2015-16 report, the World Economic Forum (WEF) ranked the United States third among 144 countries in its Global Competiveness Index, which is based on scores calculated from 126 specific items in 12 broad categories (WEF, 2015). Twenty-eight items are based on various statistical indicators like GDP and inflation, while 98 are based on survey responses by business leaders in each country to questions about the business, political, and social environment in their country. There were 369 respondents for the United States, primarily corporate chief executives.

The business leaders ranked the United States high in the categories of “efficiency enhancers” — higher education and training, goods and labour market efficiency, financial market development, and technological readiness. They also gave the country and themselves high marks for innovation and business sophistication. However, the business leaders were far less sanguine about the quality of public governance in the United States.

Sixteen questions on public governance were sorted into five categories: protection of property rights, ethics and corruption in government, undue influence (judicial independence and favouritism in administrative decisions), efficiency of government operations, and security. Business leaders were asked to provide ratings, from 1 (very poor) to 7 (very good) on each of the component questions. Figure 3.7 reports average scores across items in each category for the United States, all OECD countries, and the five OECD countries that received the highest overall quality of governance scores (Finland, New Zealand, Switzerland, Sweden and Netherlands).

The United States scored above the OECD mean in protection of property rights, although below the OECD top five (Figure 3.7). It was close to the OECD average in ethics and corruption, undue influence, and government efficiency, and below the OECD average in security, while scoring below the OECD top five in each.

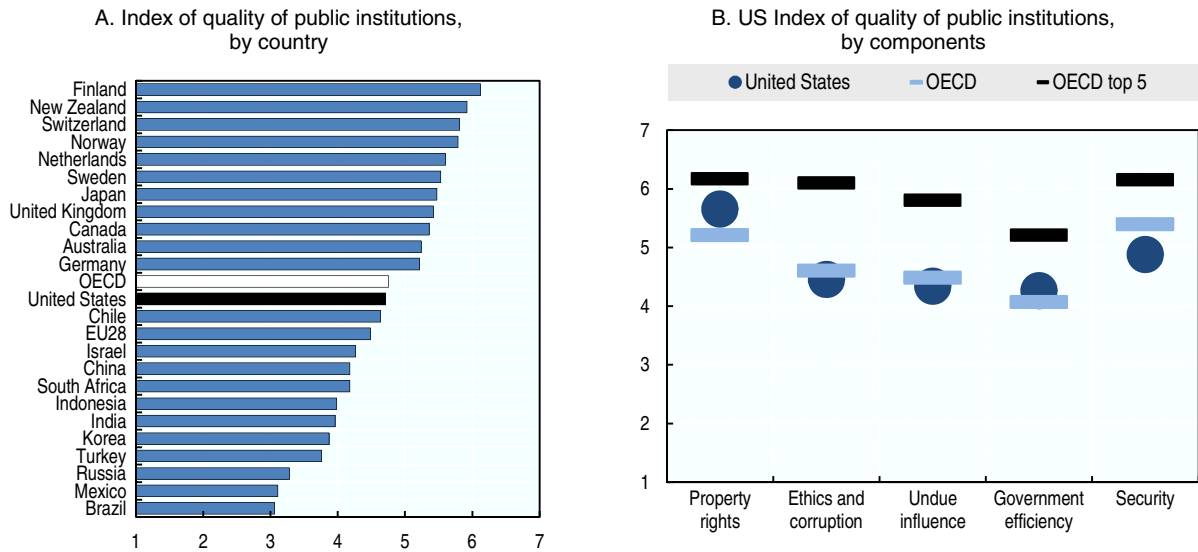
The WEF indexes are largely driven by surveys of business leader opinions of their countries. Surveys of the US population, taken over the last four decades, show substantial declines in Americans’ confidence in major institutions (Figure 3.8). In surveys conducted since the mid-1970s, respondents were asked how much confidence they felt in each of a set of institutions, with the choices being “a great deal”, “quite a lot”, “some”, or “very little”. The combined values for the top two choices — “a great deal” and “quite a lot” are reported in Figure 3.8 for 1975 and 2015. Substantial declines are reported for each of six institutions — churches, public schools, banks, the Supreme Court, Congress, and the Presidency.

Measures of political polarisation have been growing over the same period that surveys of confidence in institutions show declines (Pew Research Center, 2014). Between 1994 and 2014, the difference in political values between self-described Democrats and Republicans grew substantially wider. In 2014, people of opposing political views expressed much stronger antipathy for those with opposing views than in earlier survey years, and they expressed a stronger willingness to live in communities and associate with like-minded people. Strong political polarisation may be reflected in declining measures of trust in institutions, by the public and by business leaders.

The economic research linking institutions and economic performance focuses on the existence and design of institutions, and their links to long-run economic performance. There is no evidence linking public trust in societal institutions, or the opinions of business leaders concerning their country’s public services, to long-run economic performance. Nevertheless, growing political polarisation and eroding faith in institutions may hamper effective public governance systems in the future, and may foreclose the introduction of useful policy innovations affecting sustainable agricultural production.

Figure 3.7. Global Competitiveness Index: Quality of public institutions, 2015-16

Scale 1 to 7 (best)



A. Indices for EU28 and OECD are the simple average of member-country indices.

B. OECD top 5 refers to the average of the scores for the top five performers among OECD countries (Finland, New Zealand, Switzerland, Sweden and Netherlands).

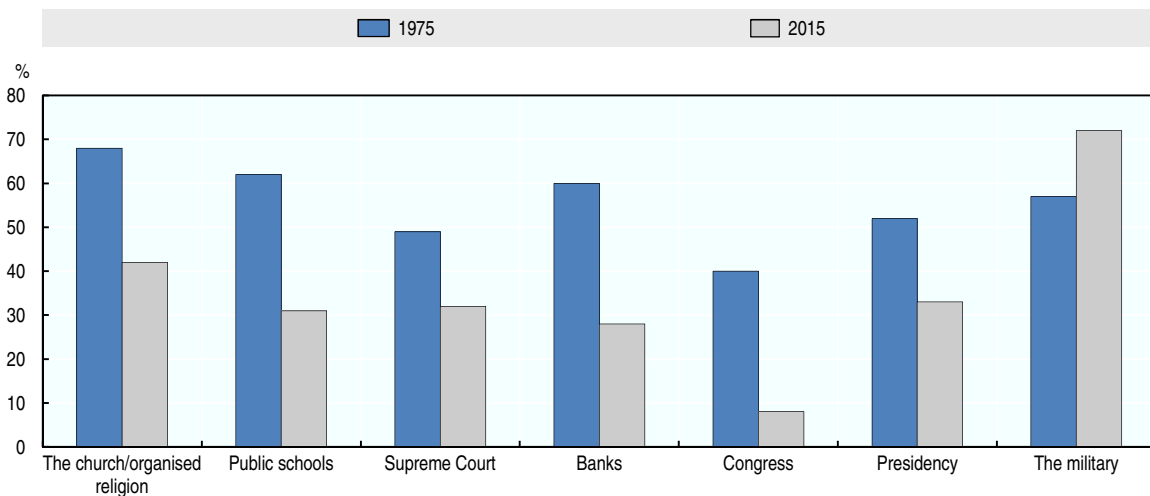
Property rights refer to the average of the indices Property rights and Intellectual property rights. Ethics and corruption refers to the average of the indices: Diversion of public funds, Public trust in politicians and Irregular payments. Undue influence refers to the average of the indices for: Judicial independence and Favouritism in decisions of governmental officials. Government efficiency refers to the average of the indices for Wastefulness of government spending, Burden of government regulation, Efficiency of legal framework in settling disputes, Efficiency of legal framework in challenging regulations and Transparency of government policymaking. Security refers to the average of the indices for: Business costs of terrorism, Business costs of crime and violence, Organised crime and Reliability of police services.

Source: World Economic Forum (2015), *The Global Competitiveness Report 2015-2016*, www.weforum.org/reports/global-competitiveness-report-2015.

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Figure 3.8. Americans report declining trust in most institutions, 1975 and 2015

Percentage of respondents with "quite a lot" or "a great deal" of confidence in each institution



Source: Gallup Organisation (2016), *Trust in Institutions*, www.gallup.com/poll/1597/confidence-institutions.aspx.

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Summary

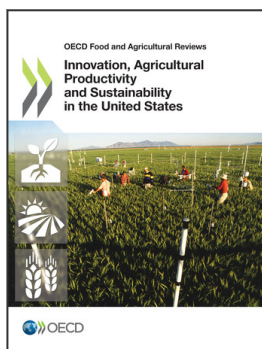
- The United States is a large, leading and wealthy economy, with well-developed institutions to manage economic policies.
- The US economy was hard hit by the recession and financial crisis of 2007-09, but the government took action to reduce financial risk and restore short and long-term credit for economic activities, and stabilise the economy. In addition, the Fed took step to reduce long-term interest rates. At the same time, inflation remained moderate.
- Recovery from the recession occurred slowly, as sharp reduction in household wealth led to reduced consumption expenditure. Since 2010 GDP enjoys moderate annual growth slightly above 2%. Federal deficits which had increased sharply have been steadily reduce to 2.5% of GDP in 2015, but debt as a percentage of GDP remains high (74% in 2015).
- Low interest rates affect agriculture, especially by raising land value and facilitating equipment purchase. Investment in capital embodies many innovations. Changes in exchange rates have also affected the performance of US agricultural exports.
- Governance responsibilities are shared between federal, state and local governments.
- The United States maintains secure property rights for private investment and has an independent judiciary system. Business leaders rank US institutions close to OECD average, although security is a concern for them. Surveys of US population indicate a declining trust in institutions and growing political polarisation, which could hamper the introduction of new policies.

Note

1. General government shows the consolidated (i.e. with intra-government amounts netted out) accounts for all levels of government (central plus state and local). This measure is not the same as federal debt held by the public, which is typically reported in US budget analysis (OECD, 2016) and used in this chapter.

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