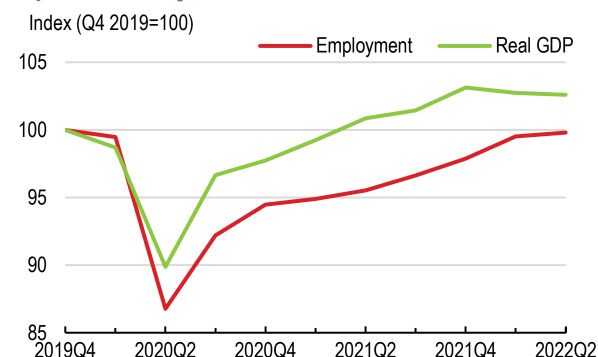
Executive summary

Inflation has risen as a strong demand recovery combined with supply constraints.

The United States economic recovery was more rapid than in most OECD countries. Unprecedented policy support combined with an early vaccination rollout allowed real GDP to recover its pre-pandemic level by mid-2021 (Figure 1). The employment recovery was stronger than those following other recent recessionary periods, but the mismatch between labour supply and demand has become pronounced. Inflation has escalated rapidly and economic activity is now slowing.

Figure 1. Economic growth is slowing after a rapid recovery



Source: OECD Economic Outlook Database

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The rise in inflation is posing significant challenges. Initially, strong domestic demand that was reoriented away from services and towards physical goods combined with limits on supply to push prices higher. More recently, inflationary pressures have broadened, with services inflation now increasing. This has been exacerbated by rising commodity prices that are partly due to Russia's war against Ukraine. While short-run inflation expectations have risen, longer-run expectations remain largely stable. Nonetheless, nominal wages are increasing rapidly, especially for lower wage workers.

OECD projections envisage annual real GDP growth in the United States of 1.5% in 2022 and 0.5% in 2023 (Table 1). Rising inflation and tightening financial conditions will further weigh on household and business spending. The resulting slowdown in domestic production is projected to be accompanied by an increase in the unemployment rate, relieving some of the upward pressure on wages. While core inflation will recede, it is expected to remain above the Federal Reserve 2% target through the end of 2023.

Risks and uncertainties are larger than usual and tilted to the downside. Inflation may prove surprisingly persistent, prompting more aggressive tightening of monetary policy by the Federal Reserve. Further disturbances to global markets in response to the war in Ukraine or other factors could also have a substantial negative impact on real GDP growth and cause even higher inflation. Another variant of COVID-19 that significantly disrupts economic activity would weaken growth, especially in those parts of the country with more limited vaccine coverage. On the upside, recent easing in supply constraints and commodity prices could contribute to a faster moderation of inflation than projected.

Table 1. Macroeconomic projections

Annual average growth, unless specified	2020	2021	2022	2023
Gross domestic product (GDP)	-3.4	5.7	1.5	0.5
Unemployment rate (% labour force)	8.1	5.4	3.7	4.3
Core inflation index	1.4	3.3	4.7	3.1
General government gross debt (% of GDP)	134.4	127.9	125.2	125.5

Source: OECD Economic Outlook Database.

Macroeconomic policies must remain responsive to changing conditions

Substantial macroeconomic policy support is unwinding. Pandemic related fiscal measures have now expired and monetary policy is being rapidly tightened. Rising cost of living pressures are posing challenges for certain vulnerable groups.

A decline in fiscal support is appropriate given elevated inflation and very low unemployment. There may be a need for new fiscal support for vulnerable households facing a dramatic increase in costs. However, any such measures should be well-targeted and temporary.

Monetary policy likely needs to be further tightened. The persistence and broadening of inflationary pressures mean that further increases in the Federal Funds Rate are necessary. Nonetheless, considerable flexibility is warranted,

and policy deliberations will benefit from careful monitoring of the impact of Russia's war against Ukraine, sanctions, other global events, production shutdowns and the tightening of financial conditions on the economy.

Asset prices are being impacted by rising interest rates and heightened uncertainty. The banking system appears to be well capitalised and profitable, but there are signs that non-bank financial institutions have become more highly leveraged. To evaluate the associated risks, better data collection is needed on non-bank entities, such as hedge funds and insurance funds.

Significant long-term fiscal challenges loom

Ageing related fiscal costs are estimated to increase by over 8% of GDP between 2021 and 2060 absent policy reforms. Spending pressures will also stem from further initiatives to strengthen the social safety net and achieve the climate transition. To eventually stabilise the public debt to GDP ratio, additional revenue and improvements to public spending efficiency will be needed.

In broadening the tax base, the first priority should be reducing tax distortions that erode revenues and have unwanted economic consequences. Reforms should include eliminating the mortgage interest tax deduction and gradually phasing out the deduction of state and local taxes from federal income tax liabilities. At the same time, tax evasion could be reduced by continuing to invest in the Internal Revenue Service, for which the additional funding in the *Inflation Reduction Act* is a good start.

There is scope to improve spending efficiency in areas such as health and infrastructure. The cost of health services and large infrastructure projects are high compared with other OECD countries. Declining competition between healthcare providers has led to rising markups which could be combatted through giving consumers more control of their data, including by introducing clear national data portability policies. Very high pharmaceutical costs could also be addressed through further expanding the number of pharmaceuticals subject to negotiation by Medicare. In undertaking infrastructure projects, there are governance challenges related to cross-sectoral planning at the national level. A dedicated federal institution tasked with ongoing cross-sectoral and cross-state infrastructure advisory would be beneficial in response.

Now is also an appropriate time to evaluate shortcomings in the policy framework highlighted by the pandemic. For instance, administrative bottlenecks and outdated systems curtailed the distribution and design of expanded unemployment insurance payments. In response, the administration is undertaking initiatives to help modernise state unemployment insurance systems. This should be seized as an opportunity to better integrate these systems with job search assistance and training schemes.

The US middle class is under pressure

Low economic mobility and rising inequality have contributed to a shrinking middle class. The income and wealth distributions have become more polarised since the 1970s and the fading of pandemic-related government support may see disparities rise further. At the same time, current costs for child care are significant for middle class households and the climate transition will entail further costs.

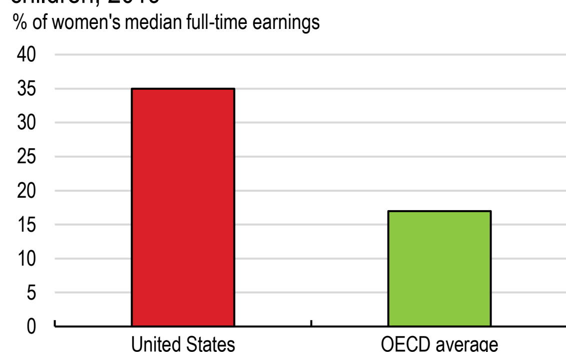
Child care affordability and enrolment is low for the US middle class, partly reflecting the scarcity of licensed child care centres in certain areas (Figure 2). Public investment in child care is below that in most other OECD countries, and most state and federal funding consists of programmes targeting low-income families. Significantly increasing public funding for child care providers, while widening the income eligibility for public programmes, would help lower the cost of child care for middle-class families and encourage enrolment.

The quality of child care is difficult to assess for families searching for care. Child care licensing, regulations and quality rating systems and their coverage differ from state to state, with some states requiring child care providers to participate in rating systems while others do not. Establishing minimum federal standards for the provision of child care (similar to Head Start Performance Standards) would ensure that all child care providers meet minimum standards set at the federal level. In addition, the Quality Rating and Improvement

System, a rating system for child care providers, could be revised and harmonised across states.

Figure 2. Child care costs are high

Child care costs for median-earning couple with two children, 2019



Source: OECD Tax and Benefit Models, 2019. http://oe.cd/TaxBEN

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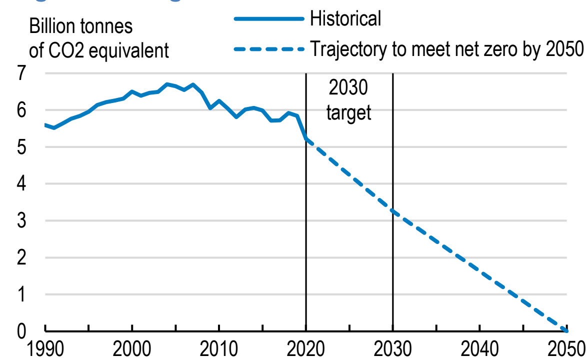
A well-balanced policy mix is needed to achieve the climate transition. The *Inflation Reduction Act* recently introduced a wide-ranging set of policies that will achieve further emission reductions. Nonetheless, further regulatory changes, green investment, structural reforms and pricing will be required over the years ahead. Largely as the result of high social, geographic and economic inequality, emissions inequality is high in the United States, meaning climate policies will have heterogeneous effects across regions, industries and households. The national climate strategy should explicitly take these inequalities and distributional effects into account.

Figure 3. Large emission reductions are needed



Source: OECD Greenhouse Gas Emissions dataset.

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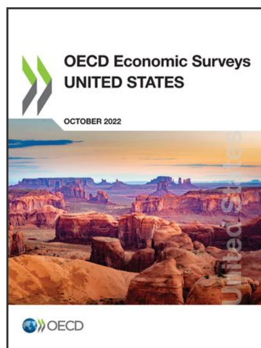
While the labour market overall may not be greatly impacted by the climate transition, job losses will be concentrated in certain sectors and regions that are more reliant on fossil fuel production and may be accompanied by significant costs for households. Those regions most heavily reliant on fossil fuel production for employment and output will require a combination of place-based policies and reduced barriers to geographical and labour mobility of those affected by employment losses. Active labour market policies, local investment and R&D can help the most affected regions transition towards other activities, and will likely require state or federal funding given the hit to local public revenues.

Residential emissions will need to decline substantially in order to meet climate targets (Figure 3). The residential sector accounted for 17% of total GHG emissions in 2019. Indirect residential emissions related to the consumption of electricity generated from fossil fuels accounted for more than 60% of residential emissions in 2020. Looking forward, a suite of policy instruments should be deployed to ensure that low- and middle-income households can benefit from investment in energy efficiency and be shielded from hikes in energy prices. Programmes providing financial support and preferential lending for weatherisation and deep housing retro-fitting should be expanded to cover middle-income households at the same time as states are incentivised to update building energy standards.

Transportation was the largest contributor to total greenhouse gas emissions in the United States in 2020, accounting for 27% of the total. The light-duty vehicles used by US households were by far the largest contributor, accounting for 57% of greenhouse gas emissions from transportation. Alignment with emissions targets will essentially require all new light-duty vehicles to be zero-emissions in the 2030s. Accelerating the tightening of fuel efficiency and tailpipe CO_2 standards will be important to incentivise the proliferation of electric vehicles.

MAIN FINDINGS	KEY RECOMMENDATIONS
Ensuring a sustained recovery in output and jobs	
Monetary policy has begun to tighten. Elevated inflation and convergence to full employment will likely require further tightening of monetary policy.	Continue to raise the Federal Funds Rate and further reduce asset holdings, with the pace of normalisation remaining highly responsive to changes in economic conditions.
There are signs that institutions in the non-bank financial sector have become more highly leveraged and have significant exposure to leveraged loans that have experienced declining credit quality. However, assessment of non-bank risks is complicated by data limitations.	Improve data collection on the activities of non-bank financial institutions, including hedge funds and life insurance companies.
The pandemic-related fiscal measures announced in 2020 and early 2021 have now expired. Even so, earlier stimulus checks, supplementary unemployment benefit payments and expanded benefit coverage, have resulted in accumulated savings that could continue to support consumer spending in the short-term.	Further reduce the fiscal deficit while continuing to invest in combatting climate change and improving the social safety net.
Expansions in unemployment insurance eligibility and benefit amounts during the pandemic were accompanied by significant delays in processing claims in most states. In addition, outdated software systems placed limitations on the design of supplementary unemployment benefits.	Continue to modernise and streamline unemployment insurance systems, strengthening integration with job search assistance and training schemes.
To eventually stabilise the public debt to GDP ratio, additional revenue and improvements to public spending efficiency will be needed. Mortgage interest tax deductibility and the state and local tax deduction push up property prices, disproportionately benefit high-income families and have limited economic justification.	Phase out regressive distortions from the tax code, including the mortgage interest tax deduction and state and local tax deductions. Reduce tax evasion by investing further in the Internal Revenue Service.
Improving public spending efficiency	
Enabling greater data portability by consumers may promote competition and opportunities for young high potential firms. However, there is a patchwork of sectoral and state-level data protection laws with data portability requirements.	Identify opportunities for introducing data portability policies at the national level and give regulators an active role in supervising interoperability standards.
Substantial ageing related fiscal pressures are on the horizon. Pharmaceutical prices are much higher than in most OECD countries, pushing up public spending. The passage of the *Inflation Reduction Act* will mean Medicare will be able to directly negotiate pharmaceutical prices with manufacturers, but this will only be for a small subset of available drugs.	Consider further expanding the number of pharmaceutical drugs subject to negotiation by Medicare.
Infrastructure gaps are being addressed through the legislated *Infrastructure Investment and Jobs Act*. Particular governance challenges relate to cross-sectoral planning at the national level and public procurement processes.	As in other OECD countries, establish a dedicated federal institution tasked with ongoing cross-sectoral and cross-state advisory about infrastructure priorities and best practices.
Addressing key policy challenges for the middle class	
Enrolment in childcare in the United States is low compared with other advanced economies, especially for low and middle-income households. Net child care costs are among the highest in the OECD, largely reflecting low public investment. Underfunding results in low participation in existing programmes.	Significantly increase public funding for childcare and expand the levels of income eligibility for public programmes.
Childcare quality across different centres is difficult to assess for families searching for care. High turnover of childcare staff, partly due to low pay, reduces quality given the importance of developing relationships between children and care-givers.	Establish minimum federal standards for child care and implement a tiered quality rating system that is consistent across states and that accounts for differences across types of providers.
Total greenhouse gas emissions have steadily fallen since 2004, driven by a shift in the energy mix. Nevertheless, emissions intensity remains one of the highest in the OECD and needs to decline significantly to achieve emission reduction targets. Largely as the result of high social, geographic and economic inequality in the United States, emissions inequality is high and climate policies can have differentiated effects across regions, industries and households. Jobs in fossil fuel and energy intensive industries are geographically concentrated and are often held by middle class households.	Make use of a broad range of climate mitigation policies to meet emission reduction targets, including regulation, public investment and carbon pricing. Develop a national climate strategy that explicitly takes into account emissions inequalities and the redistributive and regional effects of climate policies. Raise public expenditure on active labour market policies, with a focus on job placement and cost-effective retraining policies.
The residential sector accounts for 15% of total GHG emissions. Reductions in household emissions will be key to achieving overall emission targets. Achieving these emissions reductions by significantly increasing the energy efficiency of housing will be costly for households. Residential building energy codes vary significantly across states, and some do not have state-wide codes.	Further expand existing weatherisation and retro-fitting programmes to cover middle-income households. Provide fiscal incentives for states to update their building energy codes.
Transportation was the largest contributor to total GHG emissions in the United States in 2020, accounting for 27% of total GHG emissions. Alignment with emissions targets will require all new light-duty vehicles to be zero-emissions in the 2030s.	Accelerate the tightening of fuel efficiency and tailpipe CO_2 standards.



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