THE BROOKINGS INSTITUTION

FALK AUDITORIUM

HOW CAN FISCAL POLICY BE GROWTH-PROMOTING AND AN ANCHOR FOR MACROECONOMIC STABILITY?

Washington, D.C.

Monday, April 18, 2016

PARTICIPANTS:

Moderator:

HOMI KHARAS
Senior Fellow and Deputy Director, Global Economy and Development
The Brookings Institution

Panelists:

MASSIMO D'ALEMA
President
Foundation for European Progressive Studies

JASON FURMAN
Chair
White House Council of Economic Advisers

STEPHANIE KELTON
Chair, Department of Economics
University of Missouri - Kansas City

RALF STEGNER
Chairman, Social Democratic Party
State Parliament of Schleswig - Holstein,Germany

* * * * *

P R O C E E D I N G S

MR. KHARAS: Good afternoon, everybody. Thank you all very much for coming to attend this conference. My name is Homi Kharas. I'm the deputy director at the Global Economy and Development Program here at Brookings, and I am stepping in for Kemal Derviş who was supposed to moderate this panel but who has been summoned for some emergency dental treatment. So Kemal is currently indisposed and I hope his treatment is a little bit more successful and shorter duration than the treatment of the global recession (laughter), which is really what we are here to discuss.

One other small change in the program that you may have seen earlier on -- I've got several different programs here -- is that Professor Stiglitz is also not going to join us on the panel. But we do have a tremendous panel.

So we've been discussing all day issues about fiscal policy, fiscal rules, and the state of the world economy. And let me just give you a few very brief framing remarks on that.

First, where do we stand in terms of the global economy? Our sessions were titled things like "Risks of a Slowdown of the World Economy." We all agreed that we are no longer in a world of risks, we are facing the reality of a slowdown in the world economy. More or less, if you look at industrial production levels in Europe and Japan we are still at about 90 percent of the level that we were prior to the crisis. So still there hasn't been significant recovery. And if you look at the United States, it's just a little bit above that. And in the comparisons between the United States, how the U.S. has done and the other major economies have done compared to the Great Depression we're very much at the same level although the depth of the recession this time around was much lower.

So that's just a way of saying that we have had a very long relatively slow period of slow growth. And this is leading us into some very unusual territory. There is a sense that many of the traditional policies for dealing with these kinds of issues, monetary policy may have run its course, certainly is looking to be a bit less effective than before. Many calls for structural reforms, but some concerns that structural reforms are not quickly initiated. And then, of course, a lot of discussion about fiscal policy and fiscal rules and can we do more with fiscal policy to sustain growth.

Fiscal policy naturally is limited by the fact that today we also have some of the highest levels of indebtedness of the advanced economies at any time since right after World War II. So there too there is some worry that the scope for fiscal reforms has gone down.

So we're going to talk a little bit about fiscal policy rules, why do we need these rules. In essence I think the discussion today hinged around the idea that fiscal policy is of primary importance for supporting economic development and social development in a range of spheres and also in a range of time scales from short-term countercyclical to longer-term structural. But at the same time the other objective of fiscal policy is should the arithmetic of a public budget constraint, an intertemporal budget constraint. And there is a sense that the rules are designed in part to provide an institutional anchor to ensure that these two objectives are pursued at the same time.

So with those few remarks I'm going to turn to our panelists. They'll give some opening remarks somewhere around 10 minutes each. We'll have a short discussion, we'll open it up to Q & A, and we will end this session at around half past give.

The order is I think actually going from right to left only in a physical sense, not an ideological sense (laughter), and so we will start with Massimo D'Alema. Massimo D'Alema, as many of you are aware, is the former prime minister of Italy. He's had a number of posts in government. He's also served as a member of the European Parliament and was also a foreign secretary in the government of Romano Prodi and is currently chairman of the Parliamentary Committee for the Security of the Republic. I'll introduce the panelists one by one as they speak.

MR. D'ALEMA: Thank you. Thank you very much. Dear friends, let me say something before starting. We are in our full annual conference and I have to say as a president, in my capacity of president of FEPS, that we are very happy. It's a great pleasure. It's very interesting, the cooperation with IPD and the Brookings Institution and I think that the dialogue, the effort to discuss together deeply common issues you have to face between progressives of the two shores of the Atlantic is for us very, very, very important.

During the seminar we discussed about government and public policy in the world of course. And I will focus my remarks on Europe. It's my duty. The situation of Europe is difficult. Europe is leading one of the deepest crises since the creation of the Union. Sluggish recovery, high unemployment, especially in the south and especially among the young people, growing precarious working conditions and inequalities within and across member states.

Let me stress inequality because the growing in equality is the very alarming signal of the crisis of European inclusive social model. In equality is undermining our social model. And more numerous external uncertainties are looming, conflict in the Middle East and the related refugee crisis, terrorist threats. She is so close to Europe and it's a threat coming now only from abroad, but is something which is coming from our own society. More than 40 million Muslims are living in Europe and the integration of those people, our fellow citizens, seems to be very difficult in some countries. And the economic and social crises, marginalization, of course is fueling terrorism. Someone said that the problem is not the radicalization of Islam but the Islamization of radical marginality.

On the other side we are waiting for the outcome of the U.S. elections, which will have a great importance, great influence on Europe. And closer than U.S. elections the UK referendum which may both in different ways encourage populist and anti European movements. It depends on the outcome of course.

Never like now Europe needs more cohesion, more solidarity, more growth, financial commitment means for security. And facing refugee emergency with European standards. What should be done in this context? It's so difficult. And what can be done according to the rules, particularly for the USO.

I will focus on the economy without forgetting the political context. A new approach, a deep change is needed. That's my opinion. Either we are able to sweep away austerity policy or European project itself risk to fail. That's the real situation of Europe. I'm thanking to my country, Italy. If I consider Five Star Movements, Northern League, the extreme left, more than 60 percent of the Italians are against European polices and many of them are against the European Union itself. It is the main challenge, the most difficult for progressives. And I assume we all agree that the challenge requires strong public intervention. Such intervention, as largely advocated, should be done in a countercyclical way so as to boost growth in sluggish times. What fiscal policy tool kit should be used? Two sets of policies choices I believe should be at the forefront of the agenda of policy makers in the EU.

The first should address the question on how to rebalance opportunities and social justice through a more redistributive fiscal policy. We are experiencing growing inequalities across income within social groups and within and across countries. To these we need to add the slow dismantling of the social key for many U.S. citizens who have seen their social protection gradually reducing. The gap between poor and vulnerable groups on one side and a new super wealthy class on the other side is widening dramatically. And super wealthy class is represented by people without nation, without citizens of the world actually.

I believe the CEO of Fiat is some days ago presenting Ferrari in the stock market and claiming for Italianity of Ferrari was wonderful. I know he's a man (inaudible) of the United States, Marcchione, but is citizen of Luxembourg only because the tax rate in Luxembourg is 20 percent while in Italy he should pay 42 percent like me. But he is a citizen for Luxembourg claiming for Italianity, but from Luxembourg. (Laughter)

The priority is to reestablish a progressive taxation system which would encompass several socioeconomic dimensions and goes beyond the specific need for a progressive personal taxation. We need indeed to aim at a more fair distribution of labor and capital income within a country and across countries. We need to tax financial rents and to reduce taxes for business aimed at creating new jobs. Finally, and related to this, we need to fight tax avoidance, tax competition, across countries, and issue already raised at the onset of the crisis, but somehow forgotten and badly overlooked, which bears huge implication on welfare and overall on the political legitimacy of our family, progressive.

To this end, a global effort as often predicated is indeed necessary. Unfortunately a step done at the EU level regarding the financial transition tax has been utterly disappointing. I understand the underlying and opposing forces and interest are very strong, but we need to be stronger. And for this we need to be united across the world because it's a global challenge.

So here is my plea in uniting our forces to fight tax inequalities and avoidance across the world. It's very important, I welcome the decision of the IMF to create a task force against tax evasion but, in my view, without a strong political will of the major power it will be difficult to fight seriously against tax havens which are unsustainable, in my opinion.

The second policy and political choice should address the question on how to sustain domestic demand in the context of high uncertainty and limited fiscal capacity. The problem, in my opinion, the first and the most important problem is how to promote an investment policy which could be sustainable and innovative at the same time. Our great expectations on the effect of the Juncker Plan have faded as we understand that no match can come from private investors. That's the problem. Without public investments it's very difficult to support to have an effective investment plan in Europe. The public investments are the key to mobilize also private resources. And in this sense my opinion is that the roles of stability pact are during the crisis at least unsustainable.

Well, now we have flexibility. Flexibility is something, means some possibility of interpretation of the rules. But I think that we need a real reform of stability pact, which is the real structural reform we need in Europe. As put forward on several occasions and also today, I'm in favor of excluding investment from those pending items that are bound by fiscal rules. Some may argue that an increase in investment spending would increase the deficit and debt. Yes, these will probably happen in the short-term, but if the investment has high returns on growth we will likely expect to have a lower deficit and a lower debt in the medium and in the long-term. This is the only way for Europe to find a way out from crisis.

And I don't want to now -- because I have no time -- I'm going to conclude -- to say in which sector innovation, green energy, et cetera, et cetera, we need strong public and private investment in Europe. But I want to say one word to conclude. It's very interesting what's happening. There is a new intellectual consensus and a new force for more progressive policies. In universities the near liberal mainstream thinking is not dominant like in the past. Stagley, Spigati, Mazukato, Krugman, many friends we are also here, there is a new way of thinking, but unfortunately the influence of the new progressive thought on politics is too weak, including the policies of progressive governments in Europe. We must be frank on that. I believe it's time for a change of EU policies including the treaties and I believe that is a time for the socialist to put on the table a mid-term vision and courageous proposals. Otherwise -- I'm speaking as a representative of think tank -- our goal, our mission is to give some advice to the political leaders. And my advice is the socialists in Europe are likely to remain prisoners of disappointing collaboration with the conservatives and around the fortress of traditional political forces, popular and socialist are growing; anti establishment, anti European, and populistic movement everywhere. It's a very dangerous situation and it's up to the socialist to change that situation.

Thank you.

MR. KHARAS: Thank you very much. Our next panelist is Jason Furman. He is the chairman of the Council of Economic Advisors. Hopefully he's no stranger to many of you in this room. I think importantly Jason before he went into government was here at Brookings at the Hamilton Project where I hope he honed his skills at this transition between think tanks and actual policy impact.

One thing is the chairman of the Council in the report on the state of the U.S. economy there is an extremely compelling case for public investment in the United States, a theme that President D'Alema just highlighted.

So, Jason, the floor is yours.

MR. FURMAN: Great. Thank you so much. Thanks for organizing this discussion. And I think Massimo made a number of really important points, including on issues like inequality and tax avoidance that we'll be happy to come back to in the discussion we have. I wanted to focus on more purely macro issues and advance five propositions.

The first proposition is that the sky isn't falling, at least not everywhere, although we do have a real problem. Number two is supply and demand both play an important role in that problem. Proposition three is we have many more levers on the demand side that can have quantitatively large impacts in dealing with the demand aspect of our problem than we do in terms of structural reforms on the supply side. And in fact those demand instruments may themselves do more about supply than many of the supply instruments that we have. Proposition four will be that in particular fiscal policy has a really important role to play in dealing with our current economic situation. And then the last point is even when we emerge from the current economic situation fiscal policy will continue to have a really important role to play.

So let me try to elaborate on all five of those, starting with the first. I think it is important not to twice a year come to a set of meetings in Washington and decide the sky is completely falling. We're not in 2008, we're not in 2009. The unemployment rate in the United States is half of what it was at the peak of the crisis; wages are growing at the fastest they have since the crisis. The growth rate in Europe in 2015 was higher than 2014. The unemployment rate there is falling. China has taken a number of policy steps that appear to have stabilized the situation with better communication and commitment to a set of changes that we'll have to see them follow through on. So I don't think we want to overstate it and get ourselves into a panic, but we also don't want to understate that industrial production around the world is growing slowly, is contracting right now, that the unemployment rate in the Eurozone is above 10 percent, and to put that in context what we think of as the worst crisis that we had in over half a century in the United States when was the unemployment rate rose to 10 percent and the Eurozone still hasn't fallen there yet. Wage growth in the United States is insufficient, growth is essentially absent in Japan, and China is slowing. So there's a range of issues wherever you look in the world.

Second point, both supply and demand play a role in those. Demand plays a role as is evident by countries that have -- or economic areas that have excessively high unemployment rates is where it's clearest. So when your unemployment rate is 10 percent that is prima facie evidence that you have a demand problem. That unemployment rate itself cannot be entirely or even primarily a function of structural policies because just five years ago the United States and the Eurozone had the same unemployment rates and now we have very different unemployment rates. What's changed isn't the structural policies in the two economic areas, it's the relative weight placed on aggregate demand (audio interruption) -- in terms of structural policies would also note that the United States by the OECD's reckoning has the most flexible labor markets, the lowest minimum labor costs of any of the OECD economies, the easiest to hire and fire, and we have a prime age employment population ratio that's lower than what it is in France, which doesn't come close on any of those metrics. So I don't think we want to take the current situation and explain it entirely or even primarily in terms of supply and structural reforms. Nevertheless the fact that, for example, most starkly in the United States you've consistently had the labor market out performing expectations in terms of the decline in the unemployment rate, the pace of job creation, you have not had a commensurate over performance in terms of GDP, and the reconciliation of the two of those is that productivity growth has come in below what anyone would have expected, below what the historical trend had been, and that slower productivity growth is something you see across a range of advanced economies and emerging economies and it really is an important supply side challenge that we all face.

Third point is in addressing these issues demand can have a quantitatively large role and can help solve supply issues as well. The fact that the world saw one of the largest deficiencies in aggregate demand it had in 75 years and at the same time a very significant global slowdown in productivity growth could be a coincidence or it could be one causing the other. I think the most plausible set of stories run from the demand side to the supply side with a lot of that being intermediated by the fact that investment today in most of the advanced economies is about 20 percent below where we would have thought it would be at this point in time. This investment shortfall is both evidence of and a consequence of the insufficient aggregate demand, and this investment shortfall in turn is reducing the growth in output per hour worked. In fact, if you looked at the United States capital services per hour worked has actually declined in the last five years, subtracting from productivity. The first time that's happened in the post war period. Addressing demand would help strengthen investment, both private and public, through an accelerator mechanism, would not just fill some of those Okun Law gaps which can be quite large in the range of economies, but could also through additional investment lead to additional productivity growth.

Structural reforms are important. The United States, for example, expanding trade, reforming the business tax system are two things that I think would be important to do and raise our productivity in the long run. But there's very few countries in the world, including the United States, for which a policy like that on a time scale of the one or two years that for many countries in the world is the time scale that we're most worried about, would have an impact of one or two percent of GDP or one or two percentage points in terms of inflation. So demand is very important.

Fourth, I think there's a number of very good arguments for fiscal policy and I think there's a number of very bad arguments against fiscal policy. In terms of the form, we have been seeing expansionary demand policies in a range of economies, but because of the constraints on fiscal policy they have been done disproportionately on the monetary side. In many if not most cases -- I'm not commenting on the United States, but if you look globally that could potentially be better than nothing. But it also creates a set of strains and imbalances, especially in a world where you see, for example, certain countries that have very large, and in some cases, rising current account surpluses where part of the way in which monetary policy operates is by shifting demand between countries as opposed to expanding world demand.

In contrast fiscal policy can have positive spillovers, both strengthening in a country, but also demand that spills over into other countries. It doesn't create some of the strains and side effects that can be associated with monetary policy and it can also, if done through infrastructure, help expand supply and productivity as well. I think arguments that we don't have fiscal space, there may be places or countries where that's economically true, but I think in general it's greatly overstated, and if anything the experience of the last decade, what we're observing in terms of capital markets and borrowing rates in not just the United States but Japan, Germany, Italy, Spain, et cetera, is indicative of the fact that there is considerably more space. What matters is debt as a share of GDP. The denominator raising GDP can matter a lot in that equation. And countries can, and in many cases have, bought themselves more fiscal space by engaging in policies that help address their deficit over the medium and long-run. You think the pension reforms in Italy, the affordable care act in the United States, and steps taken in many other countries, it's not neither or, you can potentially both deal with the fiscal demand in the short run and your fiscal situation over the medium and long run.

The final point I wanted to make is that I think we will ultimately get ourselves as a world to full employment. We'll ultimately get ourselves to fully utilizing our demand. When that happens I would not be surprised if we're still concerned that we have insufficient productivity growth, especially given a lot of the demographic challenges that we face in many countries around the world and in the world as a whole. Fiscal policy has an important structural supply side role to play there. It has a role in increased investment in infrastructure. The IMF's fiscal monitor has an excellent chapter showing that just .6 percent of GDP in additional innovative investment will raise the level of GDP by 5 percentage points according to their analysis. And fiscal policy also has a role in improving the functioning of jobs markets. In the United States, for example, more spending on active labor market policies, reforming unemployment insurance to help people search for jobs, expand creating wage insurance. You can actually have a more a flexible and dynamic economy often with actually fiscal inputs to help the functioning of labor markets.

And, finally, the issue of inequality, which is a really important one that's been with us for a while, that is going to be with us for a while. Fiscal policy in a progressive fiscal system can play a role in that as well.

MR. KHARAS: Thank you. Thank you very much, Jason.

Our next panelist is Stephanie Kelton. Professor Kelton was chair of the economics department at the University of Missouri in Kansas City. She has also served as chief economist on the

U.S. Senate Budget Committee for the Minority Staff, and she is a member of the TopWonks Network of the Nation's Best Thinkers.

Professor Kelton.

MS. KELTON: Thank you very much. It's very nice to be here with you all this afternoon. In many ways I'm going to echo what the previous two speakers have both said, both in terms of emphasizing the significance of the ongoing aggregate demand shortfall and in terms of providing rhetorical defense for the use of fiscal policy, not just as a temporary pump priming sort of stimulus, but as Jason said, as an ongoing tool that must be deployed in order to maintain growth and high levels of employment in the economy.

So actually I want to begin by taking a sense back in a sense. In the opening sentence to the final chapter of “The General Theory,” John Maynard Keynes described what he considered to be the two most striking flaws in our economic system. He said, and I am quoting, "The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes." After more than two decades of steady improvements on these fronts both problems resurfaced in the 1970s. And with brief exceptions both have intensified with the rise of the neoliberal economic agenda, supply side tax cuts, sweeping deregulation, and a renewed focus on balancing government budgets. Along with aggressively deregulating financial and other markets nearly every OECD country has substantially cut taxes over the past 30 years. Instead of unleashing the job creators and extending prosperity to all these supply side maneuvers were closely associated with widening inequality and greater financial instability. In other words, these experiments have failed. Market economies have become more unstable, the distribution of wealth and income has become more unequal, and it takes the system longer and longer to claw back the jobs that are lost each time we suffer a recession.

So what can be done? We spent the better part of a day here discussing a wide range of policy proposals to address the sorts of problems that economies both here in the U.S. and around the world face. Policies to improve the human condition should be evaluated on the basis of their anticipated social and economic outcomes rather than on narrow budget considerations. This means eschewing the current obsession with balancing the budget and embracing a more ambitious use of fiscal policy to transform the system into one that replaces shared sacrifice with broadly based prosperity. To get there we must liberate ourselves from the flawed theories and destructive policies that govern current thinking. This requires first and foremost dispensing with the convenient but mistaken idea that governments, like households, must balance their budgets.

As the experience of the U.S. and the U.K. have shown budget outcomes are mostly indigenous, oscillating along with changing conditions in the real economy. In the U.S., for example, the automatic stabilizers move the budget in near perfect tandem with changing conditions in the job market. Rising unemployment drags the government budget down just as improvements in the labor market drag it up. On rare occasions conditions get so tight that the budget may even move into surplus. This happened in the late '90s and early 2000s when the unemployment rate to around four percent and there was a job vacancy for every job seeker in the economy.

Unfortunately, policy makers have been conditioned to think of things the wrong way round, viewing widening budget deficits as the cause rather than the result of weakness in the real economy. Instead of allowing the budget to come to rest at a place where conditions in the economy are stabilized governments have tried to force the economy to balance the budget. It is a violation of the intuition shared by Keynes in a 1933 radio interview in which he said, "You will never balance the budget through measures which reduce the national income. It is the burden of unemployment and the decline in the national income which are upsetting the budget. Look after the unemployment and the budget will look after itself." While it may sound like little more than a clever quip there is now ample evidence to support Keynes' insight. Witness Europe, for example, where governments have tried to cut deficits with spending cuts and tax increases that is by using austerity to fight widening deficits, only to suffer the self defeating effects of fiscal tightening as slower growth pushed the debt to GDP ratios higher. Elsewhere in the U.S., the post World War II era gives us 64 years of data against which to judge Keynes' intuition. If the budget really does look after itself when the economy does well, then one should expect deficits to check themselves in good times. And this is exactly what history confirms. Indeed, budget deficits have touched three percent of GDP or higher in the U.S. only 20 times in the last 64 years and only when the burden of unemployment was 5.5 percent or higher. In other words, we have never run, in the last 64 years, a budget deficit that exceeded 3 percent of GDP unless the unemployment rate was also 5.5

percent or higher. This is important evidence for policy makers obsessed with balancing the budget. But there are even more critical lessons that must be learned. It is not enough simply to relieve anxiety about occasional budget deficits. What we need instead is a fundamental change in the way that we define fiscal responsibility. Policy goals, such as full employment can occur with the budget in deficit, surplus, or in balance. Thus policy makers should never target a particular budget outcomes for the budget is not an end in and of itself. Instead, the budget should be used as an ongoing means of achieving societal goals aimed at raising living standards, promoting a more equitable distribution of income. Without a more ambitious of the government budget the system will never deliver the public investments in education, technology, and infrastructure that are critical for long-term prosperity.

For some countries this easier said than done. But for nations that spend, tax, and borrow in their own non convertible fiat currencies there is the potential for a radical break from the prevailing economic wisdom that promotes shared sacrifice over prosperity enhancing investments in our people and planet. The case for such a break was laid out most cogently by an economist who wrote extensively in the 1940s, 50s, 60s, by the name of Abba Lerner who urged policy makers to abandon the paralyzing philosophy of so called sound finance in favor or a mission oriented approach he dubbed "functional finance." For all of their power and importance the automatic stabilizers will never move the budget into the mission critical investments that will reshape our future, only we can do that. Rediscovering the lessons of functional finance is a necessary first step in the journey toward reasserting fiscal policy as a critical tool for promoting sustainable distribution of a growing economic pie.

MR. KHARAS: Thanks. Thank you so much. Our last panelist hails from Germany. Dr. Ralf Stegner is the chairman at the SPD Parliamentary Group in the State Parliament of Schleswig-Holstein in Germany. He's been the deputy chairman at the SPD since 2014, a member of their National Executive Board, and has also been a minister in the State of Schleswig-Holstein for Interior, Finance, and Research and Culture.

Ralf.

MR. STEGNER: Well, thanks very much to IPD and FEPS for the invitation, and I think it's a good idea after decades of neoliberal thinking and doing that progressive tried to discuss things and change things. That's more needed than ever I would say. Therefore thanks for the invitation.

As you might notice this discussion is about the policy maker's perspective, and I'm not even an economist, so sorry for all things that may go wrong because of that. Looking at the largest economy in Europe, Germany, if you looked at Germany you could see at least three dimensions of our current state. If you looked at the naked economic figures it seems that Germany would be in a fairly good state. Record employment levels, modest but solid growth rates, 1.7 the last years, and the year to come, still strong expert industries, very strong tax revenues as a consequence of high employment, and increasing salaries as well as the introduction of a minimum wage. And in 2015 there were more than a half million job vacancies notified. Moreover the extra spending of about 10 billion euro last year and the years to come for integration measures for refugees had the effect of a small stimulus plan for Germany. Despite extra spending we have a solid federal budget and run way below our self imposed (inaudible). So far, so good.

Looking secondly at the downside of this picture nearly every institution, be it German, European, or global, some criticism from the United States as well, point out that we have a substantial investment gap. It is economic common sense that a general level of under investment leads to an increasing decay of destruction of capital formation. Since 2000 the value of public infrastructure has decreased by almost 500 billion euro, which is 20 percent of our annual GDP. Immediate and accumulated investment shortfall on the local and the economy level amounts to 130 billion euro. This problem of under investment also has a relevant immaterial side. As the OECD points out Germany's investment in education, the formation of intellectual property, software (inaudible), et cetera. It's underdeveloped relative to demands and the potential of the German economy.

And, third, the distribution dimension. Ten percent of all households own more than half the German's wealth. The trend is ongoing and distribution questions dominate the public debate. Not surprisingly. Key question in this context is of course the question of inequalities and equal chances for all. In fact, the inequality in Germany is bigger than in any other comparative country.

The other more macroeconomic question is the effect for very uneven income and wealth situations. I'm supporting the school that inequality from a certain level on has negative supply and demand side effects. It is an economic platitude that increases of lower incomes have a higher accumulated demand effect than increases for the high income groups. It is slightly more tricky to quantify effects on the supply side, however the argument is intuitive. Inequality leads to weakening of human capital. Financing of education measures, health measures must not become dependent on the income situation, at least not so much as it does lead to an inherent cycle of wealth and education levels. For an economy like Germany, highly dependent on human capital, this should ring the alarm bells.

And if I may add another point, if you look at Europe the biggest economy should be the locomotive for the economies of the others, but we are rather the last wagon. So there is a lot of criticism and we're rather part of the problem than part of the solution in this Europe. And we have countries in Europe where youth unemployment is more than 50 percent. And you can imagine what that makes with affiliation to democracy in the long run if you tell the young people, you're not needed. If that's the first thing you tell them they won't fight for democracy I would think. So there's a lot to do.

What to do? Let me again name at least three dimensions. First, it doesn't make sense to play the blame game in direction to the ECB policy. Our German finance minister is playing the populist card here. He's even arguing that the gains of right wing parties, populist parties in German states have to do with these ECB policies, which is complete nonsense from my point of view. In a situation of weak growth or recession a number of European countries, as well as deflationary tendencies, this is I would say the ECB's task, especially if others fail in supporting a course that leads to more growth. It goes without saying that the distributional effects of zero rates are more than problematic. A small lucky part of the German population wins, a large part suffers.

Second, how to change this. Germany has to become much more part of the solution than part of the problem. That tackles the investment dimension. We need another Keynesian moment for investment and strengthening demand. The social democrats in the grand coalition try to advance this part, but we ran against black walls of economic dogmas of ordoliberalism. I'm well aware that the fact that especially in the U.S. this fiscal policy orthodoxy is hard to understand. We have to come up with an investment package for social needs, schools, and childcare, as well as economic broadband, infrastructure innovation, and the whole infrastructure of the country.

Sixty billion euro per year for a substantial modernization is our goal -- about roughly 10 years, that makes 600 billion euro. Only part of that is public investment. The (inaudible) has to tackle the mobilization of private capital, which hasn't worked well on the other side. We want more of an entrepreneurial state as we have at the moment.

Third, the distributional tendencies and effects are no longer acceptable. You have talked about tax havens. They are rather deserts of social justice I would say, and we really have to fight tax evasion all over the world. If we don't do that we lose I think our capacities to solve the problems. And I mean we have fought other enemies together, so we should be able to get in the taxes of big corporations of people who most business is to evade paying taxes. So that's one of the things I would say that is very important for strengthening our democracy. And not only for getting more growth, which is only side of it, but also for managing all the crises you referred to, from terrorism, from situations in the whole world where, if you look at Europe, you described Europe in a difficult state, we have had decades of peace and prosperity. In the end we will lose both if we're not able also to share with that part of the world that is much poorer than we are. And we'd better start with that and starting telling that to our people as well; otherwise we won't solve the problem.

So there is a big need for investing in social capital, there's s big need for tackling the inequality question, and then there's much more need for combining the progressive forces. We discussed today a lot of questions, one of them was how could be convince the liberals and the Europeans and the conservatives to follow a policy that we find the right one? Because they won't do that because they are in content with the misery of others. That's not usually the point for conservatives to change their policies, but they might do that if they know that peace and prosperity won't be here any longer if we're not changing our policies. So we have to do that.

I found this whole day inspiring in looking for solutions and I look forward to discussion with you.

MR. KHARAS: Thank you. Thank you very much. We've got just under a half an hour left so I'm going to actually proceed immediately to some questions from the floor.

But, you know, while you're thinking about (inaudible) these things I think it's quite striking how the perspectives differ depending on which side of the Atlantic we're on. So I think that we heard from our Prime Minister D'Alema that this is a very dangerous situation where the interaction of economics and politics is leading to a very toxic cocktail with very unpredictable consequences, including existential consequences potentially for Europe, whereas over here Jason Furman was suggesting that the sky isn't really falling, things aren't quite as bad as perhaps we make them out to be in an effort to get policy makers to respond, to do something. So there's also this tension about how do actually force political action.

I think in all of the contributions the issue of the distribution of income, income inequality and wealth came out very starkly, both at the bottom end of the spectrum as well as the top end with tax evasion and indeed corruption. And then I think in a somewhat new twist, at least in the discussions that we've been having around here, the emphasis of fiscal policy as an investment in the long-term functioning of the economy seems to have gotten much more attention from all of the panel members, whether that's investments in the functioning of the labor market, as Jason was suggesting, or for innovation in science and technology and other areas, there are public investments that need to happen in order for modern economies to actually work effectively.

So, questions from the floor. Let's just wait for a microphone. We'll take a couple at a time. If you can pose a question please, if there's anybody specific, indicate, and introduce yourself.

QUESTIONER: Hi, I'm (inaudible). My question is directed at Mr. Jason Furman. So you briefly mentioned the tax system in the U.S. and I was curious to know your thoughts about tax policy reform in the U.S. and its effects on job growth and economic growth.

MR. KHARAS: Thank you.

QUESTIONER: I'm Basil Scarlets. I've spent most of my career living in Europe and talking to European policy makers. And what strikes me is the acceptance of automatic stabilizers and their impact on tax revenues, but a refusal to then take the consequence of that and adopt stimulative fiscal policies. In fact the view of one finance minister I spoke with recently was it would only lead to greater budget deficits. We first need structural reforms and to reduce the budget deficit and then we'll be able to consider investments.

My first question is how do you convince someone with that hardened view that your approach is the correct one?

And, secondly, how do you identify quality infrastructure policies that enhance growth and how would you identify structural reforms that would allow the private sector to benefit from additional infrastructure spending?

MR. KHARAS: Thank you. The lady over there.

QUESTIONER: Hi, my name is Izzy Buggel-Jones. I guess my question is directed at the European half of the panel. What economic consequences do you foresee if Britain does vote to leave the EU in June?

MR. KHARAS: Why don't we start with these? And, Jason, there was one question specifically addressed to you.

MR. FURMAN: Sure. I'll just take the first question and then I suspect others will cover the other issues.

MR. KHARAS: Why don't you also answer the question about identifying quality infrastructure because you've written a lot on that?

MR. FURMAN: So on taxes I recently wrote something that was in “Democracy, a Journal of Ideas,” which is on line that expands quite a lot on this topic that you might be interested in. I think there is some role for a conventional, make the tax system more efficient, and increase the level of output type of reform. And in particular the United States has a combination of the highest statutory rate of any of the advanced economies, but also more loopholes and things that narrow our tax base than many other advanced economies. And that distorts investment decisions, leads to overleveraging in the economy, and other economic issues. So I think broadening the business tax base, reforming it, bringing the rate down, and reforming the international system so that we don't have the worst of all world we have now or we don't collect revenue and we distort the decisions of companies. So I think there's some economic benefit from that.

I think though if you look at individual tax reform one of the most ambitious plans put forward in the last decade was put forward by a tax reform commission that President Bush appointed. It was thoughtful, it had a lot of good idea, you know, things you would argue it to. But when the Bush Treasury Department analyzed it they said it would raise the level of output by between 2 and .9 of a percent of GDP. Now that's the level that would be spread out over decades to get that addition to GDP.

You then look at all the changes we've made with cutting taxes for low and moderate income households, expanding the earned income tax credit, establishing and expanding the child tax credit. That has raised after tax incomes for the bottom 40 percent by I think its 6 or 7 percent. So it's about 10 times more from those types of just very direct cutting taxes for families who would benefit from and need those tax cuts and paying for that in part by higher taxes on high income households. So I think a lot of the biggest gains from taxes would frankly come from just making the system more progressive, cutting back on tax benefits for high income household, cutting taxes for families need it.

In terms of infrastructure I think that's a really important question. First of all I think we need to spend more money, that just marginal infrastructure spending that we're already doing, even if you don't improve how you're spending (inaudible) reforms would be enough to justify the cost of that investment and we propose a substantial increase in infrastructure investment. We got a small increase last year spread out over five years which was a good thing, but we need to do a lot more and to build on that. To some degree there's different areas you could put the money into and our proposal going forward is centered around green infrastructure, what you can do in terms of rail, making it possible to have more fuel efficient cars, the network you need for them to operate, et cetera. Next gen aviation saves fuel, so a whole bunch of things that would have that in effect double dividend. And you could also have institutional structures that can help get more quality infrastructure. So the administration's proposal for an infrastructure bank is something that chamber of commerce and the AFL/CIO have supported proposals along those lines. And that doesn't just increase funding, it doesn't just leverage funding, it also help with project selection, multimodal projects across state lines, and other things that I think would include the selection. So I think we can do a lot to improve the targeting of infrastructure, but I don't think we should be under any illusion that that's a substitute for larger investments or that larger investments are contingent on all of those changes.

MR. KHARAS: Prime Minister D'Alema, would you like to take -- why don't you take Brexit?

MR. D'ALEMA: Brexit. I don't think Brexit could have a heavy economic impact on the European Union. What I'm afraid about is the spillover effect, a sense of fueling anti European feelings in several European countries. Economically I think that U.K. would pay some price and the trend of the pound in the last week shows clearly that the markets are not in favor of Brexit for the interest of the U.K. But my concern is political. And the idea that the European Union is a reversible process and the message would be very, very dangerous in suffering Europe and in Europe in which the anti European feelings are quite spread already. Some were about structural reforms, but when we talk about structural reforms, which is some very magic formula, and so far, particularly we focused on pension reform and labor market reform. And we did, we have a sustainable pension system and I'm doubtful that the pension system would be sustainable also for retired people but for public finance is sustainable. And we have a very flexible labor market now.

And in my opinion we should address other issues which are very important in order to attract private investments. Looking at Italy, first of all public administration and we are doing something but I think the functioning of (inaudible) administration is very, very important, judiciary system, which is very slow, uncertain, and I believe we must in education and maybe it's possible to have not a neoliberal approach to the structural reform, but some progressive approach to the structural reform and some different priorities and some of that priorities are the priorities have indicated.

MR. KHARAS: Good. Well, I look forward to seeing the structural reforms in public administration resulting in a decline in the salaries of Italian Parliamentarians (laughter) which I think are some 50 percent higher than anywhere else in Europe.

Stephanie, I mean there was a question really about jobs growth and things like that. It's something you've though a lot about.

MS. KELTON: Yes. I think he was asking about the automatic stabilizers and you were noting that people recognize clearly that when there is a downturn in the economy that tax revenues tend to fall off. But you were saying, if I got your question correct, that we don't tend to also understand that spending increases quite automatically as the government automatic stabilizers kick in to support the unemployed, newly made poor people, children, and so forth. So I think your question was how do you get people to see that. Well, I do it with a chart and I just have a really simple chart that I think makes this very striking reality for people because, you know, I just plot the unemployment rate against the final budget outcome. And the two move, as I said in my remarks, in near perfect unison, in reverse. So people I think understand that if you're hemorrhaging 800,000 jobs a month that incomes disappear, people don't pay federal incomes tax, and as the automatic stabilizers kick in on the spending side to support the newly unemployed that the budget deficit just explodes. And so you see the budget deficit exploding in the wake of the great recession. And largely that had nothing to do with the stimulus or anything like that. Overwhelmingly that was due to the automatic stabilizers doing their thing and it was a good thing that the budget deficit got up there as it did because it allowed private sector balance sheets to get repaired so that households could begin to deleverage.

But the other point is that as the economy began to recover the deficit began to come down all by itself. You didn't need activist, interventionist, fiscal policy to restrain budget deficits; it was the improvement in the real economy that did the bulk of that work. And so what we had before the fiscal cliff, before sequestration, we had a situation where the budget deficit was falling at the fastest pace since demobilization after the end of World War II. And so the budget deficit was, if you like, quietly fixing itself as the underlying economy improved.

And then you had a question about infrastructure and identifying projects. I just wanted to mention in addition to what Jason said, focusing on more need for new investments in infrastructure, there's also obviously a huge need for maintenance of the existing infrastructure that is dilapidated that we have. And the American Society of Civil Engineers in this country every couple of years puts out a report and the do an assessment, and it's a state by state, and it's by type of infrastructure. And so if you were interested you could go, for example, to this report and take a look at exactly where they think the needs are greatest and one could imagine government putting together some sort of a rank ordering based on priorities of need across the country. And the projects are already there and laid out for us.

MR. KHARAS: Ralf, you know, at the state level infrastructure is one of the things that can be done locally, you don't have to wait and rely on the federal government to do it. So what are the differences in approach when you actually have some capacity at the state level to just move forward on that? Why do we have to wait? You said that in Germany public investment has fallen to such a low level. Why don't states just come up and do it?

MR. FURMAN: And can I add to your question? As I understand it you don't have a fiscal rule that puts a cap on your borrowing at the state level in Germany?

MR. STEGNER: Oh, we have. It's even more severe than it is on the federal level, which make it worse, and which is one the answers to your question. That break is much more impediment on the state side than it is on the federal side.

But I mean the question was also how the private sector benefits from that. Well, if we modernize our streets and if we modernize our education system, and if we do something for literature development and if we do something for another green policy in terms of energy development, that all creates jobs and helps the private sector. And they demand doing just this. I don't like the word of structural reforms because if you look at the (inaudible) structural reforms people have to suffer from that. Where is the improvement? We don't need structural reforms in the labor market anymore; we need structural reforms in terms of improving education, in terms of stopping tax evasion, in terms of a better foreign policy that sees the needs of others, in terms of integration of the refugees. Those are the structural reforms we need, tax reforms we need, but not the so called structural reforms.

And if you look at how people vote, if they go to vote, they don't vote for the structural reforms, they'd rather vote for something else. So part of the rise of the populist movement has to do with this understanding of structural reforms and so we have to change that.

I wanted to add another point to the question as far as Great Britain is concerned. I still hope that they don't vote to get out because I agree with you; it's much more to their damage than it would be to Europe as far as the economic side is concerned. On the other hand, if the second largest economy leaves the European Union, I mean how much would that fuel the populist right wing nationalist movements we have everywhere. So Great Britain would only be the first. Therefore it's a very dangerous development. And therefore I hope that Great Britain, the citizens won't decide that way. Still it seems to be very close. If you go to London they seem more optimistic than if you read the papers about what's happening there, but I still hope -- that would be a real set back to European development. And everything that damages European development also damages the economy in the end. So things they belong together I would say.

MR. KHARAS: Okay. Let's come back. We've got time for maybe a couple of more questions from the audience.

QUESTIONER: Stephany Griffith-Jones, (inaudible). I really like many of the points that Jason made, but I found a new one that fiscal policy, good fiscal policy has positive externalities whereas monetary policy has negative externalities across countries. And I find that very compelling.

So a difficult question is because the fiscal policies of certain countries in Europe are so damaging, not just to the rest of Europe but also to the rest of the world economy, what can other countries do to try and persuade or put pressure, or however one wants to phrase it, on the countries that are pursuing dysfunctional fiscal policies for world growth? And I think we need some help in Europe. So any ideas of how coordination of macroeconomic policy is so much in this town, in the annual meetings of the IMF and the World Bank, but how could it be implemented in practice given the great need for better fiscal policy in Europe?

MR. KHARAS: Thank you.

QUESTIONER: Yes. Interest rates seem to be pretty low in countries that have their own currency, even with relatively high debt to GDP ratios. Is it time to rethink the crowding out theory? And why do deficits matter if crowding out isn't something we should be worrying about?

QUESTIONER: I noted that there was not a mention to the demographics in this discussion. I would like to ask the panelists if they feel that changing demographics and aging societies have an impact on economic rules and multiplier. For example, do other people buy less or what is the impact of demographics in growth, in economic growth, and what are the solutions for this aging population and (inaudible)?

MR. KHARAS: Thank you. And one more here in the front.

QUESTIONER: Thank you. Ernst Stetter from FEPS Foundation. It's a question to the two American panelists. Perhaps not an easy question, but a short question. What is the success story of the 4.9 unemployment rate in the U.S.? If you compare this to the more than 10 or 12 percent unemployment rate we have at the moment in Europe, all over Europe. So we are amazed to see these figures in Germany, but on the other side -- or in Europe -- but on the other side there are a lot of people saying well be careful, 4.9 is perhaps not the real figure of the unemployment so you have to be careful also on the figures in that way if you compare.

MR. KHARAS: Thank you. I think I'll just go straight down the line and if there are any closing thoughts that you would like the audience to take away feel free to add that to your answers to the comments.

So, Ralf, would you like to start?

MR. STEGNER: I would like to start with the question as far as the demographic challenge is concerned. I think that is really one thing that changes our economies pretty much. On the other hand you have to prepare an aging society that things have to change in terms of innovation, in terms of also that the elderly today have a different way of getting older than their grandfathers and grandmothers used to have. So there are not only problems with that but also chances I would say.

One of the chances we see is that half of the refugees that come to Germany are younger than 25 years old. So if we educate them well, if we integrate them well, if we don't see them as a problem but rather as a chance for us, I would say we'd be able to solve some of the challenges we have with the demographic problems. On the other hand, there are only very few countries in the world, like Norway, they have enough oil that they can finance public infrastructure even in regions where no people live anymore. (Laughter) That won't be possible I guess for most other countries. So there has to be also some technological change I would say. If you look at that worldwide the demographic challenge is quite a different one. So, again, I think it's useful to look at the whole picture.

And my closing remark would be I think it's very valuable to exchange views and especially would be very valuable to have a more transatlantic perspective, the European and the American together, because of the challenges are the same. And the worrying about the future of the democracy you could have not only looking at European countries, but also if you look at some parts of your presidential campaigns here, I'm not really sure that things stay as they are in a good sense. In certain areas we have the same challenges to meet and therefore talking together is a good way to tackle this.

MR. KHARAS: Thank you. Stephanie?

MS. KELTON: Sure. Let me just say something because Joe Stiglitz was supposed to be with us today and he is not here and so, to your question, do we need to rethink models and theories and so forth. You know, Joe has been arguing that pretty forcefully in recent pieces. He did so just this past week I think in a piece on negative interest rate policy where he not only questioned whether that made a whole lot of sense, but he also talked about much more broadly the economic theories and models that we have relied upon for the last couple of decades or more anyway. And he's making the case very clearly; he thinks it's time for a rethinking of many of those fundamental models.

So you asked about the relationship between deficit spending and interest rates and is it time to rethink the way that we as economists have traditionally thought about the effects of deficit spending where the belief was that budget deficits drive up interest rates and rising interest rates crowd out private investment, and then you have the whole Ricardian equivalence and all that kind of stuff. And I think yes. I mean my own position would be that we ought to pay attention to the lessons that the world has been teaching us. I mean Japan, for example, as on case. But the U.S., Canada, the UK, Australia, name your country if you've got a country, as Paul Krugman has written. You know, does currency regime matter, in a blog post that he did a number of years ago where he concludes that yes, it actually does turn out that it matters whether you're in control of your own currency because then the interest rate becomes a policy variable. And that's very different from countries that gave up sovereign currencies and have to compete on bond markets and so interest rates become endogenous and you get a very different sort of story.

There is also a large literature on the possibility that you get not crowding out but crowding in effects from public sector spending, going back just as far as Ben Friedman, who wrote on this as a professor at Harvard, to Steve Fazzari, who's been doing work along these lines at Washington University; I've written on this a little bit. So there is -- I would say yes to your question, should we rethink it. I think we should rethink it completely 180 degrees where we're beginning to ask the question well if it's not crowding out maybe we get crowding in effects. And then we begin to look at the empirical evidence on that front as well.

So that's all I wanted to say.

MR. KHARAS: Thank you. Jason?

MR. FURMAN: Picking up on that and actually disagreeing a little bit. I'm not sure that we need a new economics so much as we need to apply the old economics in the current circumstances. And you can take an ISLM model that we've had for 70+ years and if the interest rate is positive you're going to have some crowding out. If there interest rate is constrained at zero you're not going to have crowding out. And that very same old model will give you two different answers depending on what circumstance you're in. Right now we're in that second circumstance, there's not crowding out. In fact, as Stephanie said, there might even be crowding in.

Now crowding out isn't a reason not to do fiscal policy. You know, crowding out isn't a hundred percent. There's a lot of other benefits to fiscal policy, but there's even less of that downside right now. I think that we don't need a new economics, we just need to apply the old economics is part of the answer to your question.

I think the unemployment rate decline is a real one. Unfortunately it's 5.0 -- it ticked up a tenth last month. That's below where it was on average before the recession. If you add in discourage workers it's also below where it was. If you take a broader universe of people who aren't looking for a job right now, but if one came to them they'd take it. It's also below where it was before. The labor force participation rate has fallen. The main reason for that is aging. Some of the other reasons are things that have been going on for a while. So I think we have had a genuine recovery and I think you can measure that in the unemployment rate differences. I think what we did was we did a lot of fiscal policy up front, not just the Recovery Act, but also 12 other fiscal measures that added up to $1.5 trillion of discretionary fiscal stimulus in addition to what happened with the automatic stabilizers. Interest rates went to zero early and stayed there with consistently projecting out that they were going to stay there without any of this false rises and then cutting it back. We injected a substantial amount of capital into the financial system and did that quickly and early and people knew there was more if it was needed. And we did a stress test that came clean about the inadequacies of the capital in the financial system that was judged to be completely credible, something that in Europe they got right on I think the fourth try and we got it right on the first try. So I think a lot of different things came together. And I think, Stephanie that helps answer your question as part of the argument we're trying to make, is look at our experience, look at what's worked. Not everything has worked, not everything is perfect. We spent a lot of time trying to figure out what we can do to make it better, but in broad terms, you know, two unemployment rates were the same five years ago, divergent now. Follow some of the lessons we've learned, follow some of the things that we wish we could have followed. We wish we could have had more demand from fiscal policy at various points, including now than we've been able to do with Congress.

You look at the G20 Finance Ministers in Shanghai, they agreed on the importance of growth and they agreed on fiscal policy being one of the tools for growth. Not every country agrees with every aspect of everything. We need to make more progress in the discussions, but I think we are making some progress in those discussions. And forums like this at Brookings will just get us the rest of the way there I'm sure.

MR. KHARAS: Thank you. Prime Minister D'Alema?

MR. D'ALEMA: Yes. Something on demographic issues because for Germany and Italy this is a key problem. The average of the age of Italians is 44 and in Germany it's 45 I think. And aging society is also an opportunity for more investment in care economy, for creating more jobs, but one point I want to be clear, in order to keep the balance between retired people and working people we need immigration. That will be one of the most difficult challenges for Europe because Europe is not a multi ethnic society, multi cultural. It's difficult for us. It's much more difficult for us than for the United States to receive and to integrate people coming from the Middle East, Africa, and Asia, but we need that absolutely. And without a shared intelligent, common European policy on immigration I think it will be difficult to talk about this sustainable growth in the future of Europe. And that's really one of the main challenges we have to face, particularly for the progressives because on the other side we have racist and populist movement which refused the reality, but that's the reality.

And, finally, I think about pushing Europe, helping Europe, but President Obama was quite clear in the last years requesting to the European leaders a more expansionary fiscal policy and several times. Sometimes European leaders didn't understand, but I think that the Americans tried to push Europe in the right direction. It's strange that say for a European socialist that we receive more socialist message from the United States (laughter) in the last year.

SPEAKER: That is true. To be clear, I'm not sure I'd phrase it that way. (Laughter)

MR. D'ALEMA: Yes, I know that socialist -- it's impossible to say socialist, but you can understand we cannot say liberals. It's difficult. And Joe Podesta wrote in a very -- and say that being impossible for European to understand that liberals means to be on the left and being difficult for the Americans to say socialist, we can call each other progressive. And I agree, it's a good solution. (Laughter)

MR. KHARAS: Okay. Well, I'd like to really thank the Initiative for Policy Dialogue at Columbia University, FEPS for coming to Brookings for this dialogue. One thing I certainly learned over the course of the day is how difficult it is to come up with any kind of solution or something that will work in all of the varied institutional environments, all these places with very different histories in our cultures. Everything has to be finely tuned to those realities. But it certainly does seem that we've got enough natural policy experiments going on right now that I hope that we will actually learn a little bit about how to manage these kinds of crises in the future.

So thank you very much to our panel. (Applause)

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III

(Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2016