Conversations with Bill Kristol

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I: Middle-Class Prosperity 0:15 – 27:27

KRISTOL: Hi, I'm Bill Kristol, welcome to CONVERSATIONS. I'm very pleased to be joined today once again by Ed Conard, the scholar at American Enterprise Institute, author of the best-selling book, *The Upside of Inequality*. A controversial book, when it came out, I remember – when was that?– about five, six years ago?

CONARD: About that, yeah, a couple of years ago.

KRISTOL: Yeah. And a very successful businessman at Bain Capital, knows a lot about business. I always learn from you because you actually started businesses, and raised capital, and didn't just study and take economics courses about it. So, I always think you bring an excellent perspective, for that and other reasons. I think the subtitle of your book, *The Upside of Inequality*, was what?

CONARD: *How Good Intentions Undermine the Middle Class*.

KRISTOL: So let's begin with the middle class. Because one thing one is struck by – we're speaking in the beginning of May, 2019 – everyone thinks the middle class has suffered terribly. Donald Trump says so, it's "carnage in America." Bernie Sanders says so. Even the kind of mainstream types in the parties are very concerned about it, and I'm sure – what's the story about that?

CONARD: What's the truth?

KRISTOL: What's the truth about the American middle class?

CONARD: I think there's some political advantage to making that argument. But if you look at the Congressional Budget Office, who does a pretty careful tracking of this, and they've grown more sophisticated over time, they now can adjust for how much taxes are paid, how much government benefits are received.

So they can – well, look at income inequality after taxes, after transfers. They say that between 1979 and 2015, middle class incomes grew about 45 to 50 percent and since 2015 they've grown about 10 percent. A surprising updraft since 2015.

KRISTOL: So from 1980 to 2015, middle class income – so that's sort of the middle of the –

CONARD: 45 to 50 percent. Median income, yes.

KRISTOL: Have grown by almost 50 percent.

CONARD: Fifty percent.

KRISTOL: Which is way – I thought you always hear, I always hear about income stagnation.

CONARD: And I think another 10 percent in the last couple of years. So it's now around 60 percent really.

KRISTOL: And I always hear about middle class stagnation, and so what's – ?

CONARD: You know, and I think generally people would say that that's about one percent a year under – they're underestimating. Because in the case of say cellphones, you don't really know what the price reduction in cellphones have been because there were no cellphones. And you now have a supercomputer in your pocket, and the costs of dragging one around in the 1970s would have been astronomically high. So they really can't estimate how much value something like a cellphone has added.

And so I think generally people believe about a half a percent to a percent a year they're underestimating the true increase in prosperity. Over time there was something called the Boskin Commission a while back where they tried to make that estimate and that's the number they came up with. So it's probably significantly higher than the 60 percent that the CBO has suggested it is today.

KRISTOL: Wow. And so why does everyone think it's been flat for 30 years, and all these things one hears?

CONARD: Well, I think it's slowed down. So, don't forget we went through an enormously productive period in the 1950s, 1960s. That slowed down more than people realized in the '70s and '80s, mainly in the 1980s and early 1990s.

And then there was a rejuvenation in the mid-1990s with the beginning of personal computers and the Internet. That's, I think 1993 is when the internet was commercialized. And we've seen enormous growth in the United States relative to other high-wage economies, since 1995.

So an example, I think if you go back to the 1980s, the U.S. was – the median household income was about 18 percent higher than Germany. Today it's almost 30 percent higher than Germany, I think 28 percent higher than Germany. So we have seen accelerated growth relative to the European middle class.

And when I use a Germany or a Scandinavia, if you look at test scores for example, they have much higher test scores than the United States. So it's really not an apples-to-apples comparison. If you really wanted to make a comparison, it would be more to Italy, Spain, and France, where our wages are even higher than they are relative to German and Scandinavian wages.

But if you look at the average Scandinavian American, today is earning about 50 percent more than the median Scandinavian in Scandinavia. And if you look, if you really try to dig down deeper into the numbers, because Americans work more hours than the Europeans work, so if you want to get down to an hourly basis, on the surface it looks about the same. But if you dig a little bit deeper and adjust for differences in test scores, for any given test score or level of capability, an American earns about 20

percent more than a European does at the bottom end of the wage and skill level. At the high end, at about the 90th percentile, it's 50 percent more. Beyond the 90th percentile it's substantially more.

KRISTOL: We should talk about the inequality question which is related to that in a minute.

CONARD: Sure. But I think by any measure you'd say the United States is doing much better than Europe.

KRISTOL: So why does it not feel that way? And what is the basis for the common statement, which I take it has some basis in statistics, or if not quite in reality maybe, that incomes of middle class – incomes have stagnated for so long and so forth. What is that not capturing compared to – ?

CONARD: So the one other thing I'd say is this is all adjusted for inflation and adjusted for purchases, or real increases, not nominal and inflated increases. I think part of what happened is we came through the financial crisis. People lost a lot of confidence in the private sector.

They're worried about growth because we had very – we had the slowest recovery since the Great Depression in the – after the financial crisis. Productivity in the 20 years prior to the Obama administration was about 2.5 percent a year, a little less than 2.5 percent a year. It fell to less than 1.5 percent a year, so in half, in the eight years during the Obama administration. We've seen a little bit of increase now of late, but it's too early to tell whether or not we'll see an increase.

So I think people grew concerned. We also hit a peak in 2000. Remember when the internet boom was really taking place.

KRISTOL: Right.

CONARD: So we saw a peak in 2000. And so when you made comparisons relative to 2000, 2007 got back to about where 2000 was, a little bit below. And then we really saw it fall off in incomes and it's taken a long time to recover back to where we are today.

So, year after year after year, you kept saying incomes are lower than they were ten years ago in 2000 or 15 years ago in 2000, it was because I think everybody, both politicians and the media, have a vested interest in the sky is falling, you should watch my program, you should listen to me. They're always going to make a comparison to the highest point, the worst comparison they can possibly make. So they always make it to 2000. And 2000 is above the trend line.

And what you see if you look at trend lines over time is, as we get to the end of an economic cycle we peak up above the trend line. Then we go into recession, we fall below the trend line. And then we grow again; today where we seem to be significantly higher than trend line. We'd gotten back to trend line by the end of the Obama administration. But in the two years that President Trump's been elected, we were eight years into the recovery, we've seen large increases in employment; we've seen large increases in wages and median household incomes; we've seen a 45 percent rise in the Dow. And we've seen almost no rise, about 15 to 20 percent, in Europe's stock market over that same period of time.

So, America has grown a lot more optimistic and a lot more prosperous than it had been. So I think the recession, it shakes people's confidence. And I think a lot of what you see today is fallout from the financial crisis.

And I think growth – you know, there's a great book about the morality of growth written by the former Head of Harvard's Economic Department that says, you love your neighbor more, you're more cooperative. You just – growth has positive effects on the culture, which we haven't had for quite some time.

KRISTOL: Yeah, that's interesting. So you think – so the people who say globalization, automation, China coming into the world trading system, which is all sort of 2000-ish I would say, when those things

take off. And social problems, the Bob Putnam and Charles Murray stuff about social challenges, especially for working class Americans – that all of that may have some effect, I'm sure. But that, fundamentally that's not – we're not living in a new world where suddenly we have to live with much lower productivity gains, and a much less well-functioning economy and so forth. You don't buy that, really.

CONARD: Well, I think people – when it comes to forecasting productivity, I think the whole economics profession would agree that it's been almost impossible to do, and will continue to be impossible to do. So we saw a slowdown in productivity, and I think we do have to be fearful about whether or not that slowdown will continue.

The history of productivity has been what's called a J curve. So there's a slowdown, and then it takes time to cure cancer, or it takes time to come up with artificial intelligence. And then when those technologies are developed – and there can be a lull – then we see a lot of add-on innovation which accelerates productivity. And then we have to invent the next big thing, whatever that is. We don't know what it is and there's a lull.

So we might be in a period of lull. People, I do think, worry that maybe this lull could last a long time. We did see enormous productivity coming out of the Second World War. So, I mean, you went through the Great Depression, you went through the Second World War, you had two decades of pent-up commercialization of innovation. And so when that all came through in the 1950s and 1960s: electricity, automobiles, television, mass market products, like hair shampoo, things like that. You saw an enormous increase in productivity in those decades, that I think most people think is unusually high and can never be duplicated. So I think there's concern about that, but I think there's reasons to be optimistic as well.

I would say this though, I think that two things that have changed. I think one, the slower growth from the financial crisis makes everybody less confident about the future, no matter what the future prospects are.

But I also think there's been big shifts in our economy from where we were in the 1950s and '60s to where we were today. So, back then we were transitioning out of agriculture. It was a very painful transition. Remember, people went through the Great Depression during that time. Then you really had all the talented people in America focused on creating mass-market products produced by mass-market workers in big U.S. factories. There was no, very little trade, very little low-skilled immigration. And so the talent of America was focused on increasing the productivity of working and middle class Americans.

I think since that time, there's been a lot of low-cost offshore labor, so a lot of manufacturing moved offshore. That put enormous pressure on U.S. manufacturing to increase productivity. The productivity grew faster than the demand for manufactured goods. So we've seen the manufacturing employment drop. The shift into services, it's much harder to grow productivity in services – they're spread out, they're harder to manage. In a factory you can get engineers to figure out how to make the product and invest the capital. And so we've seen historically much faster productivity growth in manufacturing. But the productivity and growth in manufacturing is not so valuable to employees anymore because there's not very many employees in manufacturing.

And then in the case of talent, we had all of these technologies, personal computers, all the knowledge of internet and enterprise software and emails that allowed much more communication. Those really increased the productivity of our most talented people.

And we saw a migration out of collective enterprises, big businesses, to management consulting, Wall Street startups. Where they'd say my capability can be more individually measured. And so they, in some ways, left what they were doing before, engineering products and jobs for the middle class, and moved on to engineering products and services for other capable people.

And I think the middle class feels that. There has been a slowdown in middle class growth. If you look at the most productive companies, Apple, all of its blue collar employment is outsourced. You still have engineers at Ford, but they're designing jobs for Mexican workers more than they are America workers.

And so a lot of the talent migrated to the coast, and so now you're left in Detroit saying where's the talented guy who's creating a higher paying job for me? And I think that's going to lead to, on top of the financial crisis, in addition to it, it leads to concern, loss of confidence about what the future might look like for me and my children.

There's other trends too – I could go on and on with this, by the way. We saturated the population with education. We saw an enormous increase in productivity. Now we're testing everybody from kindergarten on. There's not a lot left for us to squeeze the lemon out of education. Maybe we can reengineer it, but for the last 30 years it didn't produce the kind of gains that we got when we educated an uneducated population and found a lot of people who grew a lot more productive when they got educated.

KRISTOL: And they had been denied chances before because they were poor or they were African Americans or they were recent immigrants or something.

CONARD: Yes. But I think the net gets better and better at picking those people up. We saw a huge migration to the city. I think that's a one-time increase in productivity off the farms into the cities that we're not going to see again.

I think we've seen other things. We've seen an erosion in, I'll call it, respect for authority. But there's – people are less religious. There's more divorce. There's less participation in the workforce, you see more opioid addiction – this is at the bottom end where people have a little more difficult time managing themselves. You don't see these issues at the most skilled levels. But that too is going to, it's going to grind at productivity gains.

And the other thing I think you see as well is in-services, a lot of low skilled services require subordination. You're a nurse subordinating yourself to the patient, if you will, or a sales clerk or somebody like that. Women have turned out to be better at those jobs than men. Men were better at factory work and taking risks and being strong enough to lift a box and things like that. So the whole economy has shifted in a direction that's more difficult, I think, for an unskilled man to differentiate himself financially. I think that they felt all of those effects as well. And you know, I think that has led to a certain loss, less confidence in the future than probably is warranted given the historical track record, which has been much better than people realize.

KRISTOL: So on the one end you're saying we actually are better off, including the people who seem to be, are somewhat relatively disadvantaged, perhaps, by all these trends. Which, you know, in the modern economy, they are still better off. And maybe they feel less better off either because they're less confident about the future or they see people above them doing even better or the kinds of jobs they have.

So what about the inequality issue? There has been, is it true that there's been an increase in just inequality, basically?

CONARD: So we've seen two bursts, increases in inequality. One is probably false, the other is certainly true. In the mid-1980s, we saw an increase in inequality largely centered around the Reagan tax cut, which really moved, I think, a lot of income from corporations on to people's personal tax returns because the rates were lower. And so there was an apparent increase in inequality at the time, which I think today most economists are pretty skeptical that there was actually an increase. And productivity was slowing down in the '80s before it revived in the 1990s.

We then saw a pretty sharp increase from 1995 to 2000. That's really the commercialization of the Internet. And two things happened. We saw a lot of growth and inequality, largely at the high end, the top one percent – and we can come back and talk about them. But we also saw some of the fastest growth in middle class incomes at the time. We saw between, according to the CBO, between 1994 and 2000, we saw like a 17 percent increase in median household incomes during that time, after taxes, after government transfers. So, we saw both a rise in inequality and an increase in middle class wages.

Then if you look at the top 1 percent it's pretty much stayed at that level, from 2000 until today. It fluctuates up and down a little bit, a little higher at the peak of the economic cycle, a little lower at the – in a recession. If you look at the 80th to the 99th percentile, which would be college graduates if you will, relative to say the 50th percentile, would be a person with some college, maybe some maybe not, but a median income. You've seen kind of a gradual rise from the 1990s to today. I think they earned about 30 percent more; today they earn about 40 percent more. And part of, I think, this is technology that enables data and communications and computation has increased the productivity of the most talented workers.

But I think what you find at the top 1 percent is a very different phenomena. Which is, if you wanted to – most workers are limited by the number of customers they can serve. If you're a school teacher, you can only teach so many students. If you're a doctor, you can only serve so many patients. If you're a waitress you can only wait on so many tables.

KRISTOL: So even if you're a better one, or at a superior establishment, or hospital, you can earn more –

CONARD: You can earn more.

KRISTOL: – but you're not going to earn orders of magnitude more. I saw that.

CONARD: Right. So how do you get to the top, the 1 percent or even higher than the top 1 percent? You have to get to economy-wide scale. In the 1950s getting to economy-wide scale, Ford Motor Company, you have to build a lot of factories, put in a lot of inventory, train a lot of dealers, have a lot of workers.

Google, Facebook, you can get to world-scale, and need no capital investment at all. You're cash flow positive. The companies that are successful are cash flow positive almost from the get-go, after they're started.

So, that led to a lot more risk-taking by our most talented people. And it's ironic, you talk about business startups, how they've slowed down. What's really slowed down is Mom and Pop restaurants and retail establishments, of which there's many, many in the numbers.

If you really look at our most talented people, and the startups that they are producing, these are small startups that grow large. That's what you need to really grow the economy. There's been – was a sharp increase to 2000. That was a peak way off the line. It took a while to recover. We're past the 2000 peak today.

So, because of this phenomena, this lottery-like phenomena, where you have a chance to scale to economy-wide success and need very little capital and investment to do it, you largely need talent and good ideas. We've seen a lot more –

KRISTOL: And luck, maybe.

CONARD: Yeah, luck, you need a lot of luck, too. But you've seen a lot more risk-taking by talented people at the top of the skill level. That's produced institutions like Google and Facebook and Silicon Valley. That gives American workers exposure to cutting-edge ideas.

And we know that when you get exposure to cutting-edge ideas, the payoff for risk-taking and the payoff, meaning the probability of success and the value of success, the two multiplied together – that's what we call the expected value, before you've taken the risk – is much, much higher in the United States than it is in Europe.

Where a cutting edge company is working for BMW in the auto industry. You have a difficult time in the United States recruiting people into the auto industry because they're all out in Silicon Valley working on technological innovation. And they're willing to do it, by the way, they're willing to take a pay cut to do it, because of the entrepreneurial possibilities after they've gotten the exposure to cutting-edge ideas.

So, what ends up happening here in the United States is, a small amount of taxation on a really valuable opportunity doesn't discourage anybody from taking really valuable opportunities. At the margin, you're definitely discouraging because you're saying that could have paid twice as much, now it'll pay one times as much, if you tax it at 50 percent.

In Europe, if you don't have a good idea, you can tax it at zero, and no one's going to take the risk because they say I haven't had the exposure to the cutting-edge ideas. And so what you see is a positive feedback loop that has formed in the United States, taken hold.

We haven't seen it in Europe; we don't see it in Japan; we're hoping we might see it in China, although we're scared of it in China, using it to come after us. But the rest of the world has contributed almost nothing to innovation.

And in the United States what we've seen is exposure to cutting-edge ideas ramps up the amount of risk people are willing to take. They take more risk, they gradually produce institutions like Silicon Valley and Google, which increased the exposure to cutting-edge ideas, which increases the risk-taking.

And you step back and look at it, the most talented Americans are getting better-trained, they're working longer hours, they're taking more entrepreneurial risk, they're producing by some measures startups valued at more than a billion dollars, five times as much innovation as their counterparts in Europe. And they're doing it with an eight percent of Americans scoring at the highest levels on academic tests, versus 14 percent of the Germans, and 18 percent of the Scandinavians. Oh, and our middle class incomes are 20 percent higher. Their incomes would be even lower if they weren't benefiting from the enormous outsize contribution of U.S. innovation –

KRISTOL: 'They' being –

CONARD: Europe and Japan.

KRISTOL: Europeans. But also middle class Americans I guess.

CONARD: What I'm saying is we make the comparison middle class Americans to Europeans, without America's contribution as a nation, Europeans would be even lower than they are.

KRISTOL: So you don't buy the argument at all that the decline in startups, which I guess is – or the decline in new business formation, which I guess is true in some quantitative way – and the decline of labor mobility and other such things, is, reflects like a decline of risk-taking in America or something like that?

CONARD: No.

KRISTOL: And that's a very partial – that's just a – as you say, fewer Mom and Pop coffee shops, but the important risk-taking from a macroeconomic point of view is happening as much as ever you think?

CONARD: I think if you look at venture capital investment, if you look at the number of high-tech startups, what are called high-quality startups, so not restaurants and such. All those measures, we're at higher levels today than we were at the peak in 2000.

And 2000 is well-off the trend line, extraordinarily. And if you look at the quality – people were starting camera shops, going to online camera shops in 2000, all that stuff went bankrupt. Amazon, real serious competitors that goes with the stuff that's being created today, is much more durable, much more interesting, much more sophisticated than what you saw in 2000.

And you start factoring in like the amount of R&D money that companies like Google and Facebook and Amazon and Microsoft and Intel – I mean these guys have close to trillion dollar valuations for a reason. What we're seeing today is way more valuable.

And I think the second thing you see is because that talent was sucked out and moved to more valuable ventures, what's been left in the world of Mom and Pop startups is less talented than what it used to be, because these other opportunities weren't available.

Then we swooped in with – because you've got all these guys who are working on technologies, and they say yeah, but I got to have somebody to program my computer, I got to have somebody to do this, to do that – that you've seen community colleges swoop in to the middle and find the most talented guys that weren't going off to college and say, "well, you used to run your parent's Italian restaurant, why don't you learn computer programming or some sophisticated, how to program a machine or something like that." We pulled that group off. That was the group of sort of blue collar front-line supervisors. I think we've pulled them off and made them much more technical.

And then what's swooped in behind them are companies like Uber, Walmart, McDonalds, who say we can have a better management model for lesser skilled workers that requires less talent to manage it more effectively because we don't have the talent because the talent has been pulled off.

KRISTOL: And automation allows you to do things today that it didn't 20, 30 years ago.

CONARD: Absolutely. But I think there's a real opportunity there for people to come in with management models that don't depend on as much talent and manage it more effectively. So now you're going to start a Mom and Pop restaurant in the face of all the franchise and all the sophistication those franchise have? Yes, they still do it, but at a much, much lower level than what had been done previously, because the economy just, over time, is growing more and more sophisticated. And those opportunities just aren't there.

It can change. Something can chance. We might be facing global warming and IT technology is not what's powering the economy in the next wave. This is all very circumstantial. But we just happen to be in an IT wave that has transformed how we think about work.

I'm reminded of a story, I read an article in *The New York Times* where a guy who ran a boiler plant – makes boilers, manufactures boilers in the United States – was complaining that he couldn't get the quality of worker that his competitor in the German boiler plant could get. And he was saying, "look at how great their employees are at blah, blah, blah – I can't compete with that." It's like yeah, because anybody who was that capable wouldn't be working in your boiler plant in the United States. That's the job those guys are getting in Germany: working in a boiler plant. There's nobody willing to work in a boiler plant of that level of capability in the United States. They're all off programming computers, working in IT or doing other more interesting jobs. And we know this from their wages.

And people talk about the internships of Germany, how great the internships are. Yeah, well the people earn 20 percent less for the same level of capability on a per hour basis. Maybe that's not the way, maybe that's not the future.

II: Innovation and Productivity 27:27– 53:49

KRISTOL: So stipulating this is correct, I mean, why is it? I mean, Germany is full of, or Scandinavia or anywhere else, is full of intelligent, well-trained workers, apparently probably have better education systems than we have, all-in on K-12, and not bad colleges and universities, and certainly good technical schools. They have engineers. Why is it so lopsided by your account at least, in the U.S. in terms of innovation and risk taking and especially the high tech companies? And why isn't it more evenly – I mean, automobile companies, there are good French automobile companies; at least there were, now they're all globalized, but Renault is a good company and –

CONARD: France hasn't created a new large company since the 1970s.

KRISTOL: If you looked around the world in the '70s or '80s, you would say there were great Japanese cars, there were great German cars, there were great French cars, there were great American cars – actually, probably less good American cars. But it was like a global, they were competitive, right? That is not the case with Apple, Google and Amazon, right?

CONARD: Yes.

KRISTOL: Nothing really, not much that's equivalent. So why isn't there, what is it in Europe that discourages what happens in the U.S.? The tax rates aren't that different for wealthy people, I don't think.

CONARD: Yeah, I think it's the tax rate multiplied by the value of the opportunity. So as I said, I don't think you can get exposure to companies, the cutting edge technology, like you can in the United States. So at any tax level, they simply don't get the payoff to motivate them to leave their high paying job as a lawyer, as a doctor where they're going to make hundreds of thousands of dollars a year, retire with a couple million dollars. There aren't opportunities, even at zero tax rates, to make the kind of multiple of that that would motivate you to leave near certain success for near certain failure.

Now why did it happen in the United States? It might be happenstance. It might be –

KRISTOL: Culture of –

CONARD: Could be culture. It might be cheaper to lay off workers, so we were faster to transition. It could be more open borders that put pressure on our manufacturing and caused productivity to grow faster.

KRISTOL: High-end immigration, which produced a non-trivial percentage of the people who started some of these Silicon Valley companies.

CONARD: No doubt about that. But whatever the reason is, we know this: higher payoffs have caused Americans to take a lot more entrepreneurial risk. And we also know that the tax rate multiplies directly against that payoff.

So we can say, "You know what? We're going to cut those payoffs in half." We can say, "you know, we're going to cut those payoffs to 30 percent because we're going to tax 70 percent of them." So we as a matter of policy can decide how much payoff we want to allow for risk taking.

Now if you don't have good ideas, the tax rate doesn't matter. But if you're lucky enough to have ideas where the tax rate matters like we have in the United States, then the tax rate matters.

KRISTOL: But doesn't so much, I mean, I do sort of, I'm half convinced by the liberals, moderate liberals I should say, who say, "Oh come on, someone is not going to start Apple because it's a 50 percent tax rate on incomes above $10 million as opposed to 40 percent?" Or, "I mean, are we really – capital gains goes from, I don't know, [a tax rate of] 20 to 26 or something like that. Is that really going to change –" I mean, isn't there a pretty big band that probably doesn't affect risk taking?

The risk-taking pays off so well if it really succeeds that there's less direct kind of one-on-one reduction of risk-taking if you hike taxes a bit. Clinton hiked taxes a bit; we had a huge internet boom, I guess, right?

CONARD: Yes. So I think two things. I think it's pretty, from my perspective, it's pretty clear that payoffs matter. That payoffs in the United States are higher. We get way more innovation than Europe, probably five times as much innovation because the payoffs matter.

We know that the payoffs are higher in California. Even though the tax rates might be a little bit higher, the payoffs are a lot higher and people flock to California and they take a lot of risk in Silicon Valley.

KRISTOL: It doesn't work out the other way, because the tax rates in California are higher than the tax rates in Tennessee or something.

CONARD: Yeah, I just think the payoffs for risk taking are enormous. And then we slap a small tax on, and I'll come back to the tax. So okay, risk taking is reduced a little bit, but from an enormous number. And when you really look at the calculation, what you see is the payoffs are high enough to encourage people to take the risk there.

You don't see it in Kansas. You don't see it in Germany. You see it in places where the payoffs are high. So I would contend to you that whatever the reason is for the higher payoffs, the higher payoffs are causing more risk taking.

Now economic policy just decides what payoff you're going to allow. So you can say I'm going to cut all the payoffs in half. I'm going to cut them by 10 percent, I'm going to cut them by 20 percent. It's hard to believe that cutting them – you know, it's a little scary I think to do this: cut them a little doesn't have much effect, let's round to zero and say no effect. We'd say well, what if we hit it with a 50 percent tax, which is kind of close to 35 percent is probably what we're hitting it with. At the margin, if you stack up all the ideas, you hope that you have the luxury of so many great ideas that even if you cut the payoffs by a third, it doesn't really cause that much reduction.

It's hard to believe, though, I think anybody in economics would say that they are stacking up both exponentially at the margin and then there's a couple ideas that are so great, okay. But also they're power law distributed and I think every venture capitalist knows, every investor knows that a small number of home runs at the highest end is what generates virtually all the returns.

So even if you say look at Bill Gates, didn't expect to be a multi-billionaire. So what we're going to do is cut off the tail at the high end of the power law distributed curve, you're basically cutting off all the return that drives – if you look at venture capital returns, they're kind of mediocre. The Kaufman Institute does this. The returns have been mediocre in the United States relative to just investing in public markets.

KRISTOL: So you need the high return not so much for Bill Gates, but for all the investors at the beginning to make up for all the other startups they've invested in that don't pan out.

CONARD: I'd say this. Don't kid yourself that the lone genius is the real driver of productivity. We tend to look at the Bill Gates' of the world and the Sergei Brin's, they created billions and billions of dollars. They created lots of hundred millionaires along the way.That's part of the reason their idea was so valuable: that they created an army of risk takers who were willing to go out, quit near certain success for near certain failure to try to make their ideas work.

And what we've seen in the – and we know this. We know that Europe and Japan have way more engineers and scientists per capita than the United States does. They are very short on MBAs. So it seems to be a blend of the two that matters, and that it's not some lone genius scientist. It is an army of money-grubbing business people who are trying to make that idea successful. And in the aftermath of Bill Gates and Steve Jobs, what we have seen is a gigantic army or risk takers form in their wake.

So we could say, "You know what? We'll just cut Bill Gates and all these guys down to 10 million dollars." Would we have seen the army that we saw? Well, we know this. Europe didn't see the army, Japan's never seen the army. Something happened in the United States. I'll contend to you, it's the big payoffs that caused people to get very excited and to even take reckless risk.

And I'd add one more thing. You mentioned investors. Investors can diversify away what's called unsystematic risk, company-specific risk. They just own a lot of different investments. An employee can't do that. They're working, their life is invested in the company. What you want is talented people to take an enormous amount of risk: to quit, to not become a lawyer, to not become a doctor, to not become an engineer. To go off to business school and then go, or wherever, probably a combination of –

KRISTOL: You can skip business school, right?

CONARD: That's right. But I'm talking about leave, walk away from near certain success and do something very entrepreneurial, presumably to make ten times more than they could have made, because it's probably less than a ten percent chance they're actually going to succeed. It's probably like a one or two percent chance that they're going to succeed.

So if you want that to work, those guys are even more than investors depending on the power law distributed end of the payoff. Because even investors who are diversifying company-specific risk away, don't get good returns without the home runs.

The employees who are facing – talented employees who are facing company specific risk – are facing way more risk than the investors are. You'd have to think that they need even higher returns in order to motivate them.

And for whatever reason, we do not see any motivation across all of Europe, we don't see it across all of Japan. We're beginning to see it in China, but the United States is alone, is unique in this. I would contend to you that it is the payoffs that drive it; and the tax rate simply multiplies against the payoffs.

So if you go out to California I think you actually see the reverse, or New York. That what happens is the amalgamate, the community of experts is what you'd call it in economics, has enormous synergistic value that magnifies the payoffs. That allows you to put a tax on it without slowing the growth too much. But it's the very success that allows the taxation.

Now if you're somebody else in the United States or in the rest of the world, what do you think about California being the guy who can exclusively tax Silicon Valley? It slows down the growth in Silicon Valley and it affects the whole world. Are the educational outcomes better in California because of the taxation they put on the internet? Have they created better housing for middle class workers in San Francisco as a result of the taxation of the technology that's driving the growth of the entire world, driving middle class incomes in the entire United States? Are we seeing better educational outcomes here in New York as a result of it? No, it's all going into the pocket of municipal union workers. Do we have better infrastructure in New York because of the higher tax rates? Are poor people better off in New York because of better tax rates? I don't think we see – if we were getting the results it would make sense. But I think it's reverse causation. It's the value of the synergistic community that allows you to put the taxation on.

And the same way the good weather of California allows you to put the taxation on.The fact that New York was a port allowed you to put taxation on. There were assets that were extremely valuable to the United States and you could put taxes on them because they were so valuable. It doesn't mean it didn't slow the growth; it just means that you can get away with it. Now if people were benefitting from it, I think it would be marvelous. But it's shocking how little benefit we see from it.

KRISTOL: And I suppose in Europe they would argue they do have some benefits. They have much better trains, and I don't know, some infrastructure and public services, allegedly.

CONARD: Yeah, I think what you really see, though, in Europe is two things. For any level of capability 20 percent less pay and their companies are providing 20 percent less employment per worker. So 20 percent less hours. Almost the difference between fulltime and part-time. So if you live in that environment, France hasn't created a large company – one large company in 1990, otherwise they created a cell phone company in the 1970s. Complete stagnation.

What you want as a middle class and working class worker – Okay, mankind's talent is unevenly distributed. You want the same thing that a capitalist wants which is, we want the maximum amount of value from our talent from the least amount of cost. That's what every capitalist wants, that's what every middle and working class worker should want. And they should look at that and say, all we're really

debating with Bernie Sanders is what price do we have to pay that talent to get them to produce the value that raises our wages?

Now, I think every economist would agree. I wrote in my first book that you have to create five dollars of value to put a dollar in your pocket. I said it's probably more like twenty. But I'm going to say five because I don't think any liberal economist will disagree with five. And then in my calculations I used $3.50.

The book ended up on the cover of *The New York Times* Sunday Magazine because Mitt Romney, my partner, was running for President. And they said this book depends on twenty times, that an investor has to create twenty times of value, $20 dollars of value, to put a dollar in their pocket. They went and got Dean Baker, leading liberal economist, to dispute the $20. And he said, no, I certainly would agree with $5. Okay? They made the *very* point in the book, even though in the article they were misrepresenting what the book said.

So if you have to create $5 dollars of value for other people to put a dollar in your pocket. What we're trying to do is get the most talented people to go get the training, work the hours, take the entrepreneurial risk, that puts money into our pockets. We're just debating what price is required to do it.

And we would say, well, the free market's a pretty good measure of what that price should be. It thinks the price needs to be very, very high. Okay. Bernie Sanders, Elizabeth Warren, says no, we can slap it with a 70 percent tax, and it won't affect middle class wages, it won't affect the growth rate.

And we say, well, there's not a lot of data in the world, but let's go see where we have data. Let's check Germany for example, where the payoffs are lower. What we find is, is a very different outcome. I don't know how you look at that outcome and don't get very scared, because once you go down this path, you have to be very worried. You can never really recover from this path. It's not like you go, oh, well let's just slap it with a 70 percent –

KRISTOL: From which path? From the path of slowing the growth.

CONARD: And so you slap it with a 70 percent tax.

KRISTOL: Right.

CONARD: You end up 20 years later, we look a lot like Europe. And you say, "oh, geez, that was a big mistake. Let's go back to where we were before." There's no – Germany cannot, Europe cannot recover from what they did. There's no going back. They're not going to catch up with us in information technology. I mean, in decades they might, but over the next twenty years they're not going to catch up with us.

It's not like they can just cut their tax rate and go, oh, yeah, there goes the growth rate. We have all the institutions which are required to be successful in this information-driven world. They have none of the institutions, they have none of the culture. Their people aren't trained right. They're in manufacturing for god's sakes. You can make that stuff for $3 dollars an hour in China. We'd long since said let's move on and get to stuff that will add more value.

And they assert this with a level of confidence, but they have no business. It's a reckless level of confidence, given the data that we have in the world. You look at the rest of the world and say, why would I even take a step in that direction?

And as long as I'm on this rant, I'll add one more thing. We took a step in this direction after the financial crisis. We got the slowest recovery since the Great Depression. We got the lowest productivity levels, 1.5 percent a year, down from 2.5 percent before, less than 1.5 percent a year, down from 2.5 before. We saw anemic capital investment relative to what we saw in 2007, 2006, 2005.

We never – we're not going to recover from the eight years of slow growth. We've had a tremendous social unrest as a result of it. And what we've seen in two years since, but I'm not trying to give all the credit to President Trump, nobody can get credit that fast, but we did see an enormous rise in the stock market, eight years into the financial – eight years into the recovery.

Normally the stock market tops out eight years into recovery. Forty-five percent increase in the stock market over the last two years. I mean that's extraordinary. Eight years into the recovery. We have seen 250,000 people get employed every month. You wouldn't think there's any people left to employ. They're coming out of the woodworks.

We're finally, after all this time, once again seeing wages and middle class incomes rising at the rate we wanted to get them to. It's reckless to have the level of confidence that these people have when you look at the real world evidence that's out there.

KRISTOL: So I guess when someone says, when sort of an intelligent liberal says, look, a lot of this is network effects. It's Stanford and Cal Tech, it's having an attractive place to live. That a lot of this shows that you could afford higher tax rates. That a lot of it is public investment in perhaps education.

And I guess the counterargument is that the culture you're talking about, the culture of risk taking, which does seem very important. I mean it is kind of amazing when you step back and look at it from 30,000 feet, that all these Stanford graduates want to do startups. And they don't have to do that. As you say, in most countries, if you're a graduate of a prestigious university – and in the U.S. in the old days I would say – you wanted to be a member of a reasonably – of an elite: a lawyer or physician or whatever. But it wasn't particularly risk-taking necessarily. You just had a good upper-middle class job in an elite.

And I do think the question is what in America contributes to that extraordinary, apparent willingness to take risks? And you're saying you don't want to – one thing that contributes is the outsized returns.

CONARD: Well, it's the success of other people, right? I think you'd say, I'm not getting status as a doctor in the United States. I don't want to go to medical school. I'm not getting status as a lawyer in the United States.

KRISTOL: Right.

CONARD: I have to go out, start a company, be quite successful in order to gain the status.

But I'll only say this about the network effects, which I think are very, very powerful and important. And the synergistic community, the experts in the institutional capabilities, the argument is that those things grow gradually and slowly over long periods of time. And that what matters is, at the margin, are we growing slightly faster? Because that compounding over 20 years creates the difference between the United States and Europe.

And what we saw up to 1995 is Europe catching up, Japan catching up to the United States. After World War II it got to about 80 percent of the United States, and then it was completely unable to shift into the new information economy. And the reason is because its talented people aren't motivated to get the training, work the hours, and take the entrepreneurial risk.

And that didn't happen overnight in the United States. It happened gradually over 20 years. And now, with the institutions and the networking effect in place, now we have much better ideas and now the payoffs are much higher.

And now we simply decide how much we want to reduce the payoffs through taxation. And I would contend to you that every step in the direction towards Europe is a step towards lower middle class prosperity.

And where we have seen heavy taxation, in San Francisco, in California, in New York, has not resulted in a more prosperous middle class, working class, or poor. If we saw genuine results, if we could find a place where heavy taxation was leading to higher middle class incomes, I'd be all for it.

I mean, I think the estimate – my rough estimate would be this, which is, if you look at how much an African American earns versus a white American, it's about a little less than 40-ish percent, I think 60, 65 percent. That after taxes and redistribution it gets into the range of about 20 percent, rough estimate.

KRISTOL: A 20 percent gap.

CONARD: A 20 percent gap. Maybe it's a little bit bigger than that, but in that range. That's about the range where we are relative to Germany, adjusted for skill levels on a per hour basis. So, our African American population is doing about as well as a middle class German population is. Why anybody would want to step – show me some place where somebody has been made better off by stepping in that direction?

KRISTOL: And I suppose – I want to challenge you on two fronts, but I suppose one other thing I could say, and it would I think fit into your argument is, the things that have really taken off in the U.S., were among the less-regulated parts of the economy, probably because they were so new. And they also were sort of up in the air as opposed to digging into the ground. So there wasn't pollution and there wasn't thought to be pollution and there wasn't thought to be all the obvious things that were slapped on to old industries in the '60s and '70s especially. Which also can make a case for –

CONARD: And no taxation, because you're basically expensing all the – your investment, which is talent, as opposed to, say, capital where you've got to depreciate it over 20 years.

KRISTOL: Right.

CONARD: So really much lower tax rates.

KRISTOL: I mean it's funny that everyone in Silicon Valley is cheerfully liberal and wants all these things. But of course they don't want it about their own companies. There are not a heck of a lot of them that are unionized; there are not a heck of a lot of them that have huge compliance costs with the EPA and with OSHA and with –

CONARD: No. And more importantly they did the very thing that I think the whole economy is doing. They said, we don't want to be in the business of supervising blue collar workers. And they outsourced all of it. Not only outsourced all the manufacturing of iPhones to China, but you look at who's cleaning the floors, and who's serving them in the cafeteria. Back in the day at Ford Motor Company those would have all been Ford Motor Company employees in a collective enterprise. They've shed all those workers. I mean it is pure, smart guys working with smart guys, leaving everybody else behind.

And what you find on iPhones, I'll contend to you is, a whole bunch of people playing games and doing social chatting and looking at Instagram. And a small number of people who are making 150 emails aimed at making money every day, day after day after day after day. It's incredibly valuable for the most talented people.

So the truth is, they're creating technology for the most talented workers. Everybody else is benefiting from it, somewhat. But over and over these companies – Microsoft, Google, Apple – it's technology for the most productive workers, making the most productive workers more productive. And in an economy where talent is your binding constraint – because if you're in the information economy and you need talent, talent's going to be your binding constraint – we know capital is not binding. We are eight years into the recovery, and the interest rates are at like 2 percent. Okay? Almost zero. Because capital is not the binding constraint in today's economy. It's talent and getting the talent to take the risks that are required to grow the economy.

And that taking the risk part – we don't even have a shortage of talent. We have a whole bunch of people that want to study our history because they're rich enough to get away with it. And you say, "How about studying accounting, and how about you rolling your sleeves up and studying marketing and serving customers one customer at a time." They go, "Oh, you got to be kidding me." That is not what we get a lot of our talented people to learn in college. We get some of them to – engineers and accountants – and to do the tedious, arduous work that's required, and really serve customers, grow the economy.

And then we get a small subset of those guys to take the risks that actually produce the innovation that makes us all more prosperous. It's actually not a shortage of talent; it's a shortage of talent willing to take the necessary – willing to get the training, do the work and take the risks. That is a small, small subset of America's talent. So you know if you read my books, I'm sure nobody has, but –

KRISTOL: Bestselling book, what do you mean?

CONARD: It doesn't take much to be a bestselling book.

I want talented students to feel a moral responsibility. You got lucky enough to get the God-given talents, you have to put those talents to work serving your fellow man.

Now everybody goes, I'm going to do something great, "I'm going to help my fellow man, I'm going to help them in charity." And every day you wake up, go to work and serve your fellow man as a customer. And so you have great intentions that you never follow through on. You roll up your sleeve, you serve them as customers. We need our most talented people to feel a moral responsibility to roll up their sleeves, serve customers, create $5 dollars of value for every dollar they put in their pocket. It's not enough to just be smart. You have to get the training, you have to do the tedious, arduous work. You have to take the entrepreneurial risks that help your fellow man prosper and grow.

And the cascading effects of this are enormous, by the way. I don't know the statistic, but if you look at poverty in the entire world, there has been a massive reduction in poverty since the 1990s when all of this started. And it is largely driven by the United States driving the innovation, leading the way on putting the rest of the world to work through international trade.

KRISTOL: No, I very much – I always try to make that case, too. That, plus I think a U.S.-maintained and supported global international order, which has minimized big wars in East Asia, which has provided basic structure of security, basic structure of pretty free trade and movement of capital, and the ability to outsource labor, all of which together – I mean they deserve the credit, the Indians and the Chinese, they made big changes in their policies, incidentally, in the late '70s and the early '90s.

CONARD: Which had enormous effects.

KRISTOL: But that combined with our ability to help, you know, make that possible, I would say, so they're not having massive wars and so forth, and also protectionist kind of efforts, mercantilist policies.

People just wildly underestimate that, I agree with that. The moral achievement of a billion people coming out of poverty in about twenty years is not like a trivial one in history.

CONARD: Yes, yes. Oh, by the way, one other thing. We paid for all of the defense. Europe freeloaded on it. We produced all of the innovation. Europe freeloaded on it. Oh, by the way, we paid all the profits in healthcare, all the drugs, all the medical technology, and they freeloaded on all that. And they still didn't contribute anything.

When I tell you this, I'm not here to critique Europe; I'm here to critique the 'let's go step in that direction arguments' which go on. "And there's no risk to doing it; and there's no cost to the middle class of us stepping in this direction. And all we got to do is tax success and the middle class is going to be better off." Even though we can't find a single example in the whole world where it's true.

III: The Financial Crisis 53:49 – 1:14:18

KRISTOL: Okay, so tapping into my inner social democrat or whatever, such as I have it, I'd say two things. First of all, you mentioned the financial crisis several times as this totally exogenous event. But it was caused by things, presumably.

And some people would say, this is the rather conventional, I would say, liberal view or lefty view of it: we divert a huge amount of talent into pointless kind of paper shuffling on Wall Street. A huge amount of effort to, allegedly, make capital markets more efficient. But they were made more efficient in a very, very marginal way. And eventually we channeled all this talent into such a desperate effort to maximize returns or to keep arbitraging – arbitrages from arbitrages – that you ended up with this massive financial crisis.

So isn't that sort of the downside of – I mean Silicon Valley and IT, happy talk story – but isn't the finance capital side of it sort of the dark side of that?

CONARD: So no.

KRISTOL: Did I make the point?

CONARD: Yes, you made the point very, very well and I think it's a very powerful point, by the way. And I think it's important to hear the rejoinder of the point as well.

Prior to the financial crisis, we were running trade deficits of 6 percent a year, so we were flooding U.S. capital markets with risk-averse savings. Now part of the reason for that was because Germany and Japan and China, which were all manufacturing oriented countries, economies.

And you remember what's happening in the United States, productivity is growing faster than demand for manufactured goods, so manufacturing employment is declining. You need entrepreneurial effort to move to other sectors of the economy, create them, create the jobs, et cetera. They continued down the path of manufacturing and the solution to their problem was to export manufacturing to the rest of the world, which accelerated the demise of manufacturing in the United States. Not only by pushing the jobs overseas, but also by accelerating the productivity gains that were required to keep the jobs here.

But the flip side of that is that once you get all of this America money from buying cars from Germany, okay, you have to take that money. It's I owe you a dollar of U.S. labor. You either have to buy a dollar of U.S. labor, which balances trade, or you have to buy assets.

And they were very risk-averse and they said I don't want to buy an entrepreneurial startup, I don't want to invest in venture capital. I don't want to take any risk that grows the economy. It's very risk-averse savings. I'm going to buy government guaranteed debt.

So we had this huge flow, six percent, of debt back in to the U.S. economy. Now if I run a trade deficit, and affect the following. I fire a worker because he's not saving, and I go I'm going to hire a Chinese worker or a Japanese worker or a German worker who saves a very high percent of his income and that money is going to flow back into the United States. I then have to borrow –

KRISTOL: A dollar denominated debt or whatever.

CONARD: And I'm going to have to borrow that money, take the risk of putting it to work to reemploy the person who was laid off as a result of the trade deficit. So what's missing in the understanding here is somebody to keep the economy in equilibrium has to take a lot of risk.

Bear with me for a second, okay? Wall Street was – and there's something called, I would describe it as a Keynesian paradox of thrift. What happens in a recession and what can happen in the circumstance I just described is that I get very fearful in a recession. I say, "Oh, the world is coming to an end; therefore,

I'm going to stop consuming and I'm going to start saving, but I'm not going to increase investment because I'm scared." And so savings are going to start to grow.

Now what savings are in a corn economy is the silos start filling up with corn, except we don't have silos. They are small. And so we say start shutting down the fields, start laying off the workers. And so there's this concept of the paradox of thrift, which is if people start increasing their savings, reducing their consumption, and not investing the money, then it has a cascading effect and you end up with a much smaller economy.

So we have six percent of GDP flowing back in offshore that has to be, somebody has to take the risk and put it to work. Oh, by the way, we already know, here we are at ten years after the financial crisis, interest rates are zero, our economy is not capital constrained. Yes, it's called capitalism because it used to be constrained by capital and the capital in savings. It's not constrained by savings anymore. And yet we have a massive flow of savings coming into the country as a result of the trade deficit.

What Wall Street did at that time was say – they didn't do this like as a matter of strategy. Business is all micro. Your head is down at your sides, you're just trying to solve the problems in front of you. You don't see the macro effects which is, in some reasons, why business people are dangerous guides to macroeconomic policy. They see a very micro view of the world.

There was a business opportunity and Wall Street went to go to work on it. Which was how do you recycle six percent of the GDP back into the economy when nobody, no business needs any capital? Okay, they created syndicates to draw the money in, they created securitization to layer the risk, they created subprime mortgages.

Now, they get blamed for subprime mortgages. But keep in mind, as a – homeowners are hiring Wall Street to raise money for them to buy a home. Okay, and Wall Street goes out and they talk to a German insurance company, and they say, "My guy doesn't have any reported income, will you lend him money?" Yes.

Okay? As a homeowner, Wall Street is doing the job they're supposed to do. They go, "how about they put no money down?" And the guy says, yeah, I'll do that, too. And how about they do this, they do that? And you keep saying, yes, yes, yes. Their job representing the homeowner is not to represent the German bank, who's loaning the homeowner money. Their job is to go raise capital for the homeowner.

So what they discover in the world was six percent – sorry I've gone off on this tangent – but what they've discovered, in a world with six percent flow, is that there's – the credit standards have eroded, and they're working on behalf of their customer to get the cheapest, most flexible financing.

You can buy a house, no money down, don't have to basically guarantee your income, and you can rent – in effect rent this house because you haven't put any money into the house. If it appreciates, you're going to put money into your pocket, and if it falls in value you could walk away. You don't have much down payment invested in it anyway. Most of that down payment was made by a subordinated lender in a securitization – I know I'm getting very, very complicated.

KRISTOL: No, no, it's all right.

CONARD: What I'm saying here is, Wall Street solved a major macroeconomic problem: How do you recycle all this money into an economy that doesn't need capital? And what it found was that if you go to a homeowner who hasn't got much of a pay raise in 20 years, and say, "I don't know if you noticed, but you have a huge amount of embedded equity in your house. And you can borrow that, pull that money out, and spend it. And oh by the way, if the house drops in value that would have come out of your hide because you're the last owner, but now your equity is out of the house, so that's going to come out of the bank's pocket."

They created a very valuable deal for homeowners, and they solved a major macroeconomic problem for the United States. And they got paid a ton of money to solve it because it might have been our biggest macroeconomic problem in 2005, 2006, and 2007.

Now, what you want banks to do is to think about credit risk. Can that homeowner pay back that loan? What you don't want banks thinking about is, is there going to be a liquidity crisis? Because if they go – Look, here's the problem you have in banks. You see it in – what's that movie, *A Wonderful Life*. There's no money in the banks.

KRISTOL: Right.

CONARD: What you want the banks to do is empty the corn out of the silos, and loan it back to the farmers to get them to either eat it or plant it. So when everybody runs with their IOU, you owe me a bushel of corn, and they want it withdrawn from the silo, there is no money in corn to pay anybody the withdrawl.

So, the banks can go bankrupt for liquidity problems, not for bad loans. So what we did in the financial crisis, huge mistake, I'm sorry, we can edit this all out, and no one's going to know.

KRISTOL: No, no, it's good, it's good. Well, it was a liquidity crisis, not a solvency crisis, right?

CONARD: Right. And we don't want banks in a macro business of worrying about liquidity. Because if they are, they won't make loans. The way you solve a liquidity crisis is fill the silo up with corn. The very thing that you –

KRISTOL: Which we did, eventually.

CONARD: We do now. And we faced eight years of slow growth as we, you know, had enormous reserves put in our banking system.

KRISTOL: Right.

CONARD: But my point being, Wall Street solved a major macroeconomic problem. They got paid a lot of money for it. We faced a liquidity crisis. We know banks are highly unstable equilibriums because if you run to the bank you will not be able to get your money out.

And they will – Goldman Sachs was shorting the mortgage market and they're still going to go bankrupt from a liquidity crisis. So they're making money from the short, but they're still going to run out of cash to pay the withdraws.

So you want them – there's a very cheap solution to this, and we've known it for a hundred years. The Federal Reserve steps in and says, "Oh, you want your money? Turn on the printing press, here's your dollar." You take your dollar, and what are you going to do with it? Stick it back in the bank. The bank takes it, they go, thank you very much; throw it in the incinerator and burn it.

KRISTOL: So a better policy in '07, early '08 could have averted it.

CONARD: Really. It did avert it.

KRISTOL: It did eventually, I mean, after a pretty nasty fall.

CONARD: There's going to be nasty falls in this – when you get to this unstable equilibrium. The Fed pretty much did what they did. What we ended up doing, stupidly, is we said, you know what? We're going to villainize the Fed, we're going to villainize bank bailouts, we're going to villainize Wall Street, and we're going to make it highly, highly, highly ineffective for the government to be able to crack, to solve, in a low-cost way, the next liquidity crisis.

And part of the reason for that is because we tried to solve it in the middle of the crisis. What we should have said is, you know what? We're in the middle of a crisis. So, let's just print, give the guys the money; we're not going to let everything go bankrupt; we're not going to let GM go bankrupt. It's crazy stuff that in one week of liquidity crisis we're going to let everything go bankrupt for 50 years? It makes no sense.

Okay, we just turn on the printing press, boom. Now, what we're going to do is we're going to look and see, did you have loan losses? Because if you did, we're going to charge you every dollar for those loan losses. Because what we want to hold you accountable for is that when you make a loan, that loan had better be paid back. You are responsible for credit default risk; you are not responsible for liquidity risk.

KRISTOL: Right.

CONARD: So, we're going to watch you, Lehman Brothers. And sure enough, Lehman Brothers probably would have gone bankrupt. J.P. Morgan, the loan losses – I've tried to look, and it's very hard to find this data. The loan losses on Triple A, the real loan losses, are like three, four percent. I mean, and we had a 20 percent reduction in real estate prices. You'd say the rating agencies in Wall Street actually did their jobs in that situation. I know I'm taking a very unpopular position.

But, we don't have this problem anymore. I mean, trade deficits are now growing again, but they got quite low. Okay, Wall Street got paid a lot less money during that time, too. You know, you see the vibrancy of Wall Street today relative to where it was in 2005, 2006, 2007. Do I think that we diverted –

KRISTOL: Much less today, you think?

CONARD: Much less. And do I think we diverted a whole bunch of talent away from more productive efforts, solving the problem we created by allowing the trade deficit to get to six percent. And I'm saying 'allowing' in my first book.

And in my second book I say the following, which is, the world suffers from a huge surplus of savings. The world solves that by dumping their risk-averse savings on the United States. And our workers pay the price of it. And our risk-takers have to take the risk of guaranteeing their risk-averse debt instead of taking the risk of starting a startup. Why should we, America, allow the rest of the world to solve their – to allow us to solve their problems?

KRISTOL: And so, but the counter argument is they're paying for our excessive consumption – for us consuming more than we actually save, or produce even. We run these massive deficits and the rest of the world finances them. So we're perfectly happy to take their savings. Because they're paying for all of us to have government services, one trillion dollars – provided one trillion dollars more of government services than we're willing to pay taxes for.

CONARD: I think there's two ways to think about that. Okay? So, I think the one way is the way you described, and I think the truth probably lies somewhere in between. So on one side you'd say, all we did was borrow a bunch of production from China and consume it.

KRISTOL: Right.

CONARD: Okay? And voila, party time for us.

The other way to think about it is, because I ran a big government deficit, I needed savings. So I fired an American, and I hired a Chinese, because that guy will save a lot more money, a lot more of his income, than an American will. Now I've got the Chinese savings. And when I spend the money here in the United States, by giving somebody a tax reduction or transferring money, then that worker gets reemployed. So I didn't get any increase on my side. All of the increase came on the Chinese side.

KRISTOL: So either way, it's not friendly – I mean, you're not in this case friendly particularly to the deficit. I mean, the deficits are not economically a wise thing to have.

CONARD: Well, I think two things.

KRISTOL: I mean, except in –

CONARD: So, here's a really, really important point. If we borrow money and throw a big party, consume it, spend it, then future generations are going to have to pay for the party that we had today.

KRISTOL: Right.

CONARD: We get the prosperity today, they get the bill tomorrow. I'm 100 percent against it. Okay?

There's a second way to think about it. I won't say think about it, but a different type of borrowing. I borrow money, I buy a factory, the factory produces more income than the interest paid on the debt.

KRISTOL: And when we pay it back, the debt, we're wealthier. And we – and it's a good –

CONARD: Well, let's say I never pay back the debt. Let's just say that I –

KRISTOL: It keeps rolling over.

CONARD: Yeah, keep rolling over, and I keep reinvesting in the factory. And when you look at all the calculations, I'm producing more income than the interest on the debt that I borrowed.

KRISTOL: Yes, so that's a plus.

CONARD: My children, and future generations are made better off by the additional interest, not poor by the debt.

If you look at the Republican tax cut that was passed, which includes a couple of components, not only one, a business tax cut which the Congressional Budget Office and all economists think will accelerate growth and accelerate GDP beyond what it would have, because it will increase investment gradually over a long period of time.

The second component is a middle class tax cut, which you could say theoretically we didn't need because it doesn't produce growth, it produces enormous deficits, is the kind of party-first problem, but may very well have been necessary to get the very unpopular business tax cut passed. Which most people are against, even though that's what the CBO would say creates all the value.

And then ten years – well, we reduced the healthcare mandate which saves more money than it costs. Okay, so that adds a little bit of money to this calculation. And then you roll the camera forward ten years in the CBO forecast, and this was a forecast that assumed that nominal GDP would grow about $250 billion dollars a year more as a result of the tax cut, than it was going to.

Oh, by the way, they also forecasted, "No, but it'll grow $750 billion more, but we're not attributing the $500 billion to anything. Not the tax cut – we just happen to have a big increase in optimism. Oh, by the way, we increased the optimism even more at a time when the rest of the world was slowing down because the results were even better than we expected."

But leaving that out of the equation, and just focusing on the piece in April of 2018 that the Congressional Budget Office said they would attribute to the business tax cut primarily. Then you get some short-term growth from the stimulatory effect of the middle class tax cut, which goes away at the end, when they take that tax cut away.

If you look out in the 8th, 9th, 10th years, they're producing more tax revenues than interest expense. Which means they bought a factory and they're now in a position where they're generating more tax revenues than they're generating in interest expense. That tax cut makes people better off.

Now, we could have gone – you know, we didn't need the middle class tax cut; we should have just cut business taxes. We would have had no deficit, and we just would have gotten the increase in tax revenues and the increase in growth rate, and the increase in middle class. Because if you look at where the tax cut, there has been distribution analysis, it was spread pretty well across the tax brackets. Obviously richer people get more because they earn more, but spread fairly evenly across the tax brackets.

You get out to those 8th, 9th, 10th years, and the Congressional Budget Office says we're going to generate more tax revenues than we would have without this tax bill.

And oh, by the way, the 40 percent increase in the stock market and the reduction in regulations on business and the general sort of emphasis on business over-redistribution, for whatever unidentified reason, is going to give us another $500 billion in nominal GDP on top of the $250 billion we're attributing to the tax increase.

Okay, I think that's a very different increase in debt than borrowing money and redistributing it and consuming it, and getting prosperity today at the expense of future generations. If I were in charge, if I was the one rewriting the Constitution, I would say that in very few cases can you simply push it off on – push the costs off onto future generations. And there's some cases where you might want to do that, but you get complicated.

KRISTOL: Right.

CONARD: In general I am opposed to that. I think it's a bad idea. I think the Congressional Budget Office should sharpen their pencil and say, are we making an investment here that produces more income than the cost of the debt?

And when I say more than the cost of the debt, by the way, they predicted what the debt would be ten years from now, and they said that increase in interest – I mean, they predicted the interest rate, and they predicted an increase in the inflation rate. So you got an increase in the interest rate, not only from inflation but because there was more money being borrowed. And, they said that delta multiplied by all the debt that's out there, not just the additional debt, they did the calculation the way you should do the calculation, and *still* said it produces more tax revenue than the additional interest expense.

You know, nobody hears that story. I get killed by conservatives who insist that the first kind of debt is exactly identical to the second kind of debt. And that I don't know how to read the Congressional Budget Office Report. I have to get them out, and go into the exhibits. It's – I've done it so many times, it's Exhibit B, Table 3, of the April 2018 CBO Budget, ten year budget. Go look it up and see. And go look at years 8, 9, and 10, and tell me if the cash flow statement doesn't show you that the tax revenues are greater, and tax revenues and cost reductions are greater than the interest expense.

KRISTOL: Okay. So you're less alarmed – so, I mean, net-net it sounds like you're a little less alarmed about the rise of the deficit and the rise of debt.

CONARD: I hate the idea.

KRISTOL: Than some of the conservatives.

CONARD: Well, wait, we went from – prior to the financial crisis we were at about 33 percent debt to GDP.

KRISTOL: Right.

CONARD: At the end of the Obama administration we were at 75 percent debt to GDP. We did not get a rise in earning – additional earning capacity – to cover the additional interest expense.

KRISTOL: So that was –

CONARD: That money basically got, you know, consumed. It did not lead to increased investment. We saw anemic investment. We saw anemic productivity growth. We saw the slowest recovery since the Great Depression. We did not see an increase in middle class prosperity. We did not see an increase in working class prosperity.

We did get more generous at the lowest end of the income scale, and we took off a lot of the work requirements for food stamps and some of those programs. So there was an increase at the lowest end of the wage scale.

I will contend you that a lot of that comes *out* of the middle class because all of that comes – it reduces risk-taking at the margin, which slows growth, which slows middle class wage increases, which – that money does land in the pocket of the people in the bottom 20 percent. And the bottom 20 percent, is largely people that don't work, many who can't work.

You know, I think there's – conservatives would tell you they all don't work because they don't want to. A lot of them have young children, so it's hard for them to work. A lot of them have disabilities and can't work. There are drug addicts, mental illness, all kinds of stuff down there.

IV: Equity and Social Mobility 1:14:18 – 1:32:14

KRISTOL: Yes. Okay, what about equity and also social mobility? So, are we just going to accept the pretty drastic increase of inequality? Not so much between, as you say, the 90th percentile and the 50th or 30th, but between the top one percent and everyone else, A.

And B, how worried are you about the social mobility issue? That it's one thing, it seems to me, for these people – it's everyone has a chance to become Bill Gates, and it's great, and this is America, and fine. So some people become wildly wealthy but everyone's got – well almost everyone – well, at least there's enough distribution of the people who have a chance, that one feels that you're not hurt by being born into a certain class. And are you worried? But there has been some decrease in social mobility, right?

CONARD: Well, I think if you look – So, my book looks at this very carefully, *The Upside of Inequality*. I use all the studies that are out there, liberal and conservative. There's a lot of political issues.

KRISTOL: Right.

CONARD: There's a lot of politicking in what you think is the academic analysis. My conclusion from looking at it, and I'll tell you this: I want to be in the business of not spewing propaganda, even though I have a point of view, and anybody listening can hear it loud and clear. But I want the facts to be right, I want people to understand.

So I try – in the books I'm always trying to get my facts right and not take them out of context. Show you, explain to you what the other side of the argument is, so you can judge it for yourself. So, I try to go through – I use a lot of the Brookings mobility study to do my analysis.

I think what you find is that the mobility in the United States is virtually identical to Scandinavia, except for the poorest 20 percent, and what you find in that poor 20 percent is a very high incidence of single motherhood. It kills you in mobility. A very high incidence of high school dropout. It kills you in mobility.

Now, I'm reluctant to say, it's simply a matter of single motherhood and dropouts, which causes a lack of mobility, because part of the reason why you're at the bottom is because high school is not that useful to

you. And there's a lot of pressures on you to keep marriage together. Arguably your mother said, "You know, I'm better off without this guy than I am with him." So she might have made decisions which made you better not worse. So I'm very sympathetic to liberal points of view about what's going on.

But aside from that group, the mobility in the United States is basically the same.

If you look at the distributions of income – because there's another argument related to this hollowing out of the middle class – what you find is that the distributions of income are virtually identical, except for a little blip way out here at the top one percent, or the more you want to slice it, 0.1 percent, .01 percent. There's more and more of a blip way out there because, as I said, you can scale to economy-wide success without needing very little [sic] capital. And we're seeing more success out there at the tail. But it's very, very small in terms of the number of people.

The distributions are virtually identical except they're shifting upward. In the book, I look at – so I look at fulltime employees, because I think you're not going to be middle class if you don't have a fulltime job. It's a different issue. But I look at white not Hispanic, Hispanic, African American, and all three combined.

Every single one of them has increased, Hispanics the least because we keep getting flooded with supply. I think – I forget the difference between white Americans and African Americans, but fairly close. African Americans are affected, I think, by low-skilled Hispanic immigration that increases the supply and pulls the wages down. Virtually identical distributions.

And when you read studies, like there's a Pew study that says the middle class is hollowing out, it's gone from 61 percent to 50 percent. The way they do that is they go, I'm going to bracket it with dollar bookends. Okay, now, remember, people are getting richer, so they keep getting pushed off the top end of the bookends. And then they say, it used to be 61, now it's 50. So, 11 points, lost middle class. So I dug into those 11 points. It's seven points up, four points down.

KRISTOL: Seven points of the 11 of the disappearing middle class are moving into the upper middle class.

CONARD: Yes.

KRISTOL: So that's not a bad thing.

CONARD: Four points are moving down. Three of the four points are from an increase in Hispanic immigration. So really if you go native-borns, it's one down, seven up. I think we'll take a hollowing out of the middle class at seven up, one down.

And then we've added an additional three points because we've increased the population below the median wage with – we have 40 million foreign-born adults, 20 million native-born adult children. That's 60 million. It's actually more than that now, 35 million of that 60 million, there's another 20 million children that don't work. But 35 of that 60 million are Hispanic immigrants, largely low-skilled Hispanic immigrants. So, there's been an increase down at that end of the wage scale. But that's how you lie with statistics.

There's another report that just came out that said, a big decline in the middle class. Yeah, it declined in their measures from – I think they go from 75 percent above the median to 25 percent below the median. In that measure it declined from 63 percent to 60 percent. And pretty – I'm not sure you can measure it that accurately to tell you the truth.

KRISTOL: Right, right.

CONARD: And I think some of that is Hispanic immigration. I didn't look deeper into those numbers, but I'll bet you two of those three points are from that as well. And some of it is going to be from moving up to the high end of the range. So I just don't think you see a hollowing out.

But I would say this: It used to be that we didn't educate anybody, in the 1950s. We said, you know, we put public education in in the '40s and '50s; we started sending everybody to college on the G.I. Bill. As the baby boomers came in we sent more and more people to college. We really expanded, we were ahead of the rest of the world.

KRISTOL: Huge expansion in the state universities and so forth.

CONARD: We were way ahead of the rest of the world. And we were ahead of them because we started educating everybody in high school, but before the rest of the high wage world did, before the whole world did. The high wage world followed shortly behind us.

Okay, today – so what we found was a whole bunch of people who were uneducated. And man, we educated them and they got a lot more productive. They turned into doctors, lawyers, engineers, boom, off the charts. Okay, we saturated the population with education. We test everybody in kindergarten now. So, how much more mobility should we be seeing as a result of the hidden mobility that we discovered by educating the workforce?

We see a lot of assortative mating, which is, people go to college, they meet people that they – you know, it used to be women didn't go to college. There was a lot more, a lot less assortative mating –

KRISTOL: Right.

CONARD: – than you see today. There are many other trends –

KRISTOL: Which increases inequality, obviously. If a doctor marries a doctor and a nurse marries a nurse, the income gap between those two couples will be greater than if a doctor marries a nurse and a doctor marries a nurse.

CONARD: Yes.

KRISTOL: Really. And that's how I think – and that is the case today, obviously, with women having equal opportunity and half the people in medical school being women, you know.

CONARD: And then we saw other things as well. We saw people move out of collective enterprise, which I talked about earlier, into more individual-oriented enterprises. What that has caused is that you can have a very good year, and click into the 0.1 percent, and then you'll click out, click in, click out.

So if you just look at the one percent, the 0.1 percent, however you want to – the more you slice it, the more extreme it gets, by the way. What you'll find is, "Oh, geez, if I slice it to the .01 percent, that's a guy who sold his business and made $20 million dollars." So he clicks in and he clicks out. If you really try to look at lifetime earnings, yes, the one percent's expanded. The 0.1, the .01, but much less than it appears to have expanded. Because it used to be, in the 1950s and '60s, the guys that were in the top were on the top every year their whole life, when distribution was narrower. Now what you see is people clicking in and clicking out.

And so, there's much more volatility in who's actually in these very little slices. So, by some measures there've been almost no increase in lifetime inequality overall. I find it a little hard to believe, because I do believe that the internet and IT revolution has allowed some entrepreneurs to get – and I don't mean just the Bill Gates' of the world; there's lots of people who are benefiting from this.

KRISTOL: And also the removal of arbitrary barriers. So that, I mean, you're going to have a huge amount of mobility when people who were unjustly kept out of opportunities – women, African Americans, or people who were just immigrants or kids of immigrants. And this is the first generation that went to college, and you have a massive expansion of that, those numbers – you're going to have a lot of upward mobility, obviously.

CONARD: Yeah.

KRISTOL: But that's both a good thing and not a good thing. I mean it's a reflection of a certain injustice and lack of opportunity before then, right? And in a way a lot of that easy, what's called 'low-hanging fruit' has been taken, in terms of social mobility.

CONARD: There was a recent Raj Chetty study, and when you dug into his data, as often is the case, you find something different than what his headline is. But he did look at – you could look at immigrant mobility. And I think what you – when I looked at it, Asian, white, African, Hispanic, basically the kids ended up being, even though they started off very, very poor, they ended up where the native-born averages of those demographics were, in one generation.

KRISTOL: Wow, so that's good.

CONARD: So, you'd say – yes. I mean, yes.

KRISTOL: If you were coming to the U.S. in the '70s and '80s and their kids are ending up in the same place as the people who have been here three generations, that would be a sign that the system is not resistant to mobility, I suppose.

CONARD: Right. Yeah. I mean I think capitalism is such you can't be – I think there's a huge shortage of talent. You're looking for talent anywhere you can find it. And I think what you'd find is, the GEs of the world who go, hey, we need programmers to program machine tools, and things have gotten a lot more sophisticated – they're in the community colleges trying to recruit every remaining person that they can train, and bring into the workforce.

I think what you find is there's a large shortage of talent in the United States and people are working hard to fill the gap. So I don't know that you have a lot of people walking around saying, "You know, I just don't like women. I think we'll just exclude them a hundred percent from our workforce." I think you've got an opportunity to get smart, talented women, you're going to take advantage of that. You're not going to sit around and go, sorry, I don't do that.

KRISTOL: And that's why you argued – I guess we discussed this in the previous Conversation, which people should also go watch and listen to – that the case for a sort of specially-skilled immigration is so strong in terms of possible contribution to the economy. We're short of talent.

CONARD: Well, yes. I mean we issue a million green cards a year. I do this calculation; I think I did it the last time, but I'll do it again. Because I do think – yeah, we can cut the tax rate, do this, do that, it's small changes at the margin, and gradual over long periods of time. We can try to jawbone talented people into taking more responsibility. It's going to go in one ear, out the other. We can try to improve our education system, which we've tried to do for 50 years and have not done – have not seen much results.

We face two extraordinary challenges. The first is baby boomers retiring. We've already seen the debt go from 33 to 75, 80 percent of GDP. It's on its way to 150 percent, if we don't have growth-crushing tax increases to pay for the retiring baby boomers and the rising medical costs that have gone along with this, unless we find ways to control medical expenditures, largely by denying care like Europe does.

But we face a big problem. And after we've been eaten alive by the baby boomers – which I'm one, sorry – retiring, then we have to worry about if China is as successful as it could be, we could face a major military threat at that time, and we'll be at our weakest point.

So, we need faster growth and we're not going to get it with the kind of programs I just described. It's just not going to have a big enough impact. So, we have about 120 million fulltime workers. The top five percent is six million workers. We issue a million green cards a year. In six years or twelve years we could double the number of top five percent workers, which potentially could double our growth rate.

Now, I don't know if one plus one is two, or one plus one is one and a half, but doubling the number of top five percent workers in an economy where we have a shortage of talent. And all we have to do is take a talented person and expose them to the cutting edge ideas in the United States, and they will get a lot more productive for no other reason than just that.

It's not like Google and Facebook and Intel and Microsoft and Apple said, "Oh, geez, we can't get the people, I guess we won't grow." No. They're skyping all those people in from Romania, and Eastern Europe, and India, and all over the world.

So what's happening is, those people are creating jobs for teachers, for doctors, for truck drivers, for waitresses and all those jobs are in Romania. Because Apple says, why in the world would I want to move that person to San Francisco and have to pay them enough money to cover their San Francisco rent, when I can pay Romanian rent, which is one-tenth of what San Francisco rent is?

But the middle class is losing all the jobs that end up in Romania. But Apple is not losing the employee because they're just skyping the employee in on the phone. And building – every company's got skyscrapers full of talented people in other countries because they're not going to sit on their hands and say, "Oh, sorry, you wouldn't let me in. You wouldn't let the immigrants come that I need, therefore I'll just suffer the losses because I can't get the people." They can get the people. It's crazy that we're letting that happen.

And that is the one way. And what we need, I think when it comes to immigration is, you want people who are paying a lot more in taxes than they're consuming in government services so that you have that money to pay the baby boomers.

And I think, you know, I grew up in Detroit. Guys were working in the auto industry. And I don't mean in the UAW, although I worked for Ford Motor Company and I knew plenty of guys who worked for the UAW. But most of my friends, I went to a school of 750 kids in my graduating class. Twenty percent of them went to college. You'd work in your Dad's machine shop, working for a supplier of a supplier of a supplier of the auto industry, making a very high wage.

Those companies, the auto companies moved their manufacturing, first to the Carolinas, and then to Mexico and those guys are left producing, you know, much lower-paying jobs. Meanwhile all the talent migrated to the coasts. So they're not there going, "I'm going to start the business that's going to put these people back to work."

If you want to really boost that middle class prosperity, I think you have to saturate with much more talent. But that person is going, "You know what? I need my Social Security. I need my Medicare because I didn't get to save any money as a result of having gone through this transition from manufacturing to the service economy. And now you're talking about spending money on other expenditures, fighting wars in the Middle East, lowering tax rates. All of that comes at the expense of jeopardizing my Social Security and Medicare, the very thing I need in my old age. So you talk a lot about the disruption of trade and such on my life, but you're not really willing to do anything to help me. And the one thing you can do to help me is get me my Social Security and Medicare."

And it's the very thing that we're putting in jeopardy. And I think they look at Republicans and they say, you guys aren't helping us. And they look at Democrats and they say, you guys aren't helping us. Elites on the Left and the Right, you are not – we are not your priority.

Which is why I think they turned to President Trump as the guy who says, "I am going to create a shortage of workers to drive up your wages. I'm going to make sure that you get paid your Social Security and Medicare. I can't guarantee it, but I'm going to go out of my way to not spend money on other stuff." Even though maybe he hasn't delivered on that promise.

You know, my friends – they're not Republicans and they're not – they were Democrats; I don't think they're Democrats – I'm saying the guys I went to high school with.

KRISTOL: Right.

CONARD: They're not Democrats any more.

KRISTOL: The true solution for those people is not kind of protectionism or, you know, a managed economy of the kind of semi-conservative sort. It really is just more growth, which then allows, to use an unfashionable term, the proceeds of growth, the consequences of growth to trickle down to the middle class. And also to pay for the benefits for retirees and some –

CONARD: The only thing I can say to this is – I call it 'trickle up' not trickle down.

KRISTOL: Right.

CONARD: You've got to create $5 dollars of value to put a dollar in your pocket. That's – if you want to help the middle class, get another guy to create $5 more dollars of value. Get another Steve Jobs. Get another Bill Gates. Get another Microsoft. You're going to create a lot of value for other people.

It's trickle up, it's not trickle down. We learned trickle down. They propagandized this in the third grade. Okay. I refuse to use their propaganda term. It is trickle up. Okay?

KRISTOL: On that note, we can – we should end this conversation. And I'm sorry for using that propaganda term, but I gave you a chance to correct it, so that was good.

Ed Conard, thanks so much for joining me today. And thank you for joining us on CONVERSATIONS.

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