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## ECONOMIC NEWS UPDATE

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### **Private Equity Entrepreneurs Face Review of Their Tax Status**

No, class warfare has not broken out in America. And no, there is no “War on the Wealthy”. What we are seeing is another of the many adjustments market capitalism makes when excesses become offensive to a broad swathe of quite sensible people in a democracy.

The private equity crowd, fighting to defend its tax advantages, has only itself to blame for the backlash against the huge profits it has been making. It has failed to explain that the function it performs is extraordinarily valuable. The Blackstones, KKR and others use the low-cost credit now available in huge quantities to buy companies that are not as well managed as they might be. They reorganize these companies, and in something like five years return them to the public markets, leaner and meaner, capable of growing. And turn a handsome profit in the process.

So far, so good. But the dealmakers forgot to consult their undoubtedly dog-eared copies of Adam Smith, the man they cite for the proposition that they are being led as if by an invisible hand to do the public good. First, as James Buchan points out in his *Adam Smith and the Pursuit of Perfect Liberty*, that phrase occurs only three times in the million-word output of Smith, “and on not one of those occasions does it have anything to do with free-market capitalism...”. Second, and more important, Smith argued that “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.”

It is not unreasonable to guess that Smith would not have approved of a taxation system that allowed a British billionaire to pay taxes at a lower rate than the woman who cleans his office, or an American multi-billionaire to enjoy

a tax rate far below that inflicted on his butler. Never mind that such a lower rate provides private equity entrepreneurs with an incentive to risk the “sweat equity” – non-cash contribution – they invest in these ventures. At times a sense of equity trumps such economic considerations, and this is one of those times.

Here’s why. Americans have traditionally been unperturbed by inequality levels that would provoke Europeans to turn out their governments. And there is no indication that the most extreme populist politician, Democratic presidential wannabe John Edwards, is gaining much traction for his argument that there are “two Americas”, one very rich, the other very poor, unable to afford \$400 haircuts. But there is some indication that Americans worry that it is no longer the case that everyone can get rich, or at least look forward to a rising living standard. Add to that the decoupling of some high incomes from economic performance. Too many failed executives leave with golden goodbyes after mismanaging the companies they were supposed to take to the next level of profitability.

Then there is the not-so-trivial matter of the flamboyant life styles of the private equity class. Blackstone boss Steve Schwarzman threw a very public birthday party for himself at a cost variously estimated at between \$3 million and \$15 million. Tales of \$5,000 bottles of champagne and even more expensive female companionship, lavish parties in far-flung places, with private performances by the world’s most highly paid entertainers, create more than harmless gossip. They create an atmosphere in which it is difficult for politicians to defend a tax structure that claims between 10% and 15% of the

gains on private equity deals, but 40% of the overtime wages of moderately well-paid workers. The merits become irrelevant as politicians factor their own survival into the development of tax policy.

Private equity executives might take comfort from the fact that Adam Smith argued that the “altogether endless” desires of men for luxuries create benefits such as jobs for those who produce the goods to satisfy these limitless demands. But Smith also favored laws that would have brought the force of government down on the modern scale of these “endless desires”. Besides, Smith’s support for what we now call “trickle down” economic theories is politically unsustainable when real wages are not rising as rapidly as profits, and our television screens are bringing us scenes of shocking poverty in parts of the world.

Not that our congressmen are rushing to rein in the profits of private equity firms. Republicans are generally wary of raising taxes on business, and key Democrats such as New York Senator Chuck Schumer, and Connecticut Senator Chris Dodd, a dark horse in the race for his party’s nomination, would like the problem to go away. Schumer doesn’t want to reduce the competitiveness of New York’s financial markets, and Dodd represents the state in which most of the private equity entrepreneurs have their offices and mansions. Nor are Democratic presidential candidates Hillary Clinton and Barack Obama eager for this battle: both rely on private equity and hedge fund managers to fund their campaigns.

But the problem won’t go away. Warren Buffett, no slouch at money-making himself, says private equity

enterprises should be taxed at the same 35% rate that applies to most corporations. In addition to the authority that comes with his success as an investor, and the moral position that he has obtained by continuing to live in a modest house in Omaha, Nebraska (no Greenwich, Connecticut McMansion for him), Buffett earns points for having committed the bulk of his fortune to Bill Gates' charity. If congress follows the Sage of Omaha's advice, taxes Schwarzman et. al now pay on the profits from the sale of companies they have acquired would about double.

Fortunately, America's free-market democracy is responding to this summer of discontent in the time-honored fashion that has preserved it until now: noise from extremist politicians, followed by reflection and a tweaking of the tax structure to restore a bit of equity with minimal impact on the incentives of high-flying entrepreneurs to improve the economy's performance. No fear that America's dealmakers will find themselves as beleaguered as their UK counterparts, who, in the words of Rachel Johnson, a colleague at The Sunday Times (London) "are hearing the distant rumble of tumbrels...; the bourgeoisie are developing murderous feelings for the fat cats ... who are using loopholes and the 10% rates of capital gains tax to turn everything they touch to gold." She exaggerates, but you get the idea.



## **THE SUNDAY TIMES**

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