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The Class Warriors Get One Right

Yes, hike tax on private-equity dealers

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LIKE a stopped clock, even the class-warfare crowd can sometimes be right. Case in point: the push by Sen. Hillary Rodham Clinton and others to raise taxes on private-equity deal-makers.

Yes, if Clinton, Sen. Barack Obama or ex-Sen. John Edwards wins the White House, they'll raise *your* taxes, too. Never mind that as countries around the world slash taxes, American corporations' ability to compete for markets and create jobs diminishes.

But the fact that the class warriors are leading this particular charge doesn't mean that the current level of taxes on these private-equity entrepreneurs is right.

This is not to deny that the restructurings caused by these deals are of real value. When they do their jobs right, private-equity operators buy firms that have grown fat and lazy (or at less less efficient than they could be) and prune out layers of management, executive perks and other inefficiencies before bringing them back to the public markets, leaner, meaner and more profitable.

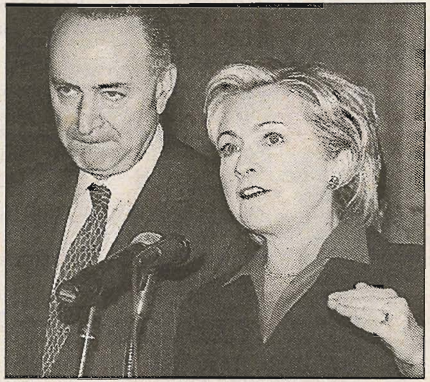
That's what dynamic market capitalism is all about — a process of continuous creative destruction that has produced improvements in the material standard of living so great that even Karl Marx couldn't help noticing it, and turning green (well, red) with envy.

In return for their efforts at putting these deals together, private-equity entrepreneurs charge the investors who provide them with capital 2 percent of the value of the fund and pay income tax at the rate of 35 percent on that fee, just as the rest of us do. But they also get a 20 percent interest in every deal — the so-called "carry" — and when they sell the firms they have acquired, pay only capital-gains taxes on their profits. That comes to something like 15 percent.

Now, no sensible person denies these deal-makers the money they make — even if it runs into the sort of huge sums that they flaunt from Park Avenue to Greenwich, Conn. But it's not only populist politicians who wonder why those sums get the benefit of low capital-gains tax rates.

The deal-makers, who have invested none of their own money in these transactions, argue that they are at risk of losing the "sweat equity" — time and skill — that they have "invested" in return for their 20 percent "carry." Their critics argue that the sums that they earn are no more than fees for managing their investors' money — that is, no different from the fees that money managers make, and at no greater risk than a movie star whose pay includes a cut of the profits from his latest picture.

Enter two players — Sen. Chuck Schumer and the greatest of all dispute-settlers, the market.



She's right, Chuck: Sen. Schumer opposes Sen. Clinton's push for tax fairness. UPI

While the tax-the-rich crowd dominates his party, Schumer also fears alienating the Wall Street crowd that he regularly taps for contributions to the Democrats' Senate campaign funds — and his own. So he has come up with a typically clever ploy: Insisting that taxes *also* be hiked on Texas oilmen and everyone else who operates through partnerships that resemble these private-equity funds.

This puts senators from states other than New York in a spot: Hit the New York financial community, and hit your own constituents. So Congress is doing what it does best: stalling until after the summer recess.

By then, markets will have had their say. Indeed, they are already doing just that — and not in whispers. The recent financial turmoil that brought down Bear Stearns' hedge funds and wiped billions in value off the books of some mortgage lenders has led to a flight from risk. That has made it more costly for private-equity deal-makers to borrow the money they need to acquire the companies they have in their sights.

Lots of deals will still get done, because lower stock prices make acquisition targets cheaper. But the marginal ones won't, and the profits of the private-equity crowd will be squeezed — not so much as to force foreclosures on mansions in Greenwich, but enough to matter.

Thanks in part to Schumer's efforts, thanks in part to intensive lobbying by the private-equity and hedge-fund industries, Congress is having second thoughts about changing the tax rules. But sooner or later, Congress will have to do something about dissatisfaction with a system that allows what seems to be ordinary income to escape income tax.

Unless, of course, the beneficiaries of the lower capital-gains rate can produce evidence that their activities make for a more efficient economy, create more jobs and contribute to economic growth. And that, if they lose the advantage of the capital-gains tax rate, their incentive to do all that good would be so reduced that they'd pick up their marbles and go into another line of work — or move offshore to more benign tax environments.

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