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ECONOMIC NEWS UPDATE

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The Political Economy of Private Equity

Operate internationally, and at times you have to fight a two-front war. That's what the private equity industry, with bases both in New York and London, finds itself called upon to do, as politicians in the United States and the United Kingdom launch simultaneous attacks on its tax status. Never mind that the deal makers, led as if by an invisible hand, have been contributing to the solution created for market capitalism by the separation of the ownership and control of both nations' corporations.

That separation is one factor leading to the current battle. For the battle between the politicians and the private equity industry didn't suddenly flare up because a British deal-maker commented that he pays taxes at a lower rate than his cleaning lady, or because an American equivalent threw himself a birthday ball costing \$2 million,

or \$5 million, or \$15 million, depending on your tabloid of choice.

The controversy began, in part, because corporate executives, unconstrained by the dispersed and therefore relatively powerless owners of the corporation (aka shareholders), persuaded many supine boards of directors to award compensation bearing little relationship to performance. That created a background in which publics on both sides of the Atlantic began to wonder why inept executives exit the executive suites as multi-millionaires. Since those who do not follow Wall Street or the City closely can be forgiven for failing to distinguish between corporate bureaucrats and the inventive, risk-taking entrepreneurs who run private equity firms, public grumbling became a generalized dissatisfaction with "unfair" compensation. That, of course, attracts

the attention of politicians and, when the private equity operators proved inept at explaining what they contribute to the economy, the stage was set for a battle.

Which is a pity since, by taking over troubled companies, private equity entrepreneurs cure the problems stemming from the separation of ownership and control. They and their partners now own and control formerly publicly traded companies, and have every incentive to reward only those managers who earn their pay by increasing profits and growth rates. Enter that invisible hand, and the further long-run result is job creation and enhanced value of the pension funds and other institutional investors who share the profits of these ventures.

Abuse of executive compensation procedures is not the only bit of background noise that has drowned out the defenses offered by the private equity industry. Critics have long argued in both our countries that the prosperities resulting from the Bush tax cuts, in America, and then-Chancellor, now Prime Minister Gordon Brown's economic management in Britain, have not been shared equitably. Globalization has increased the value of education and management skills in the international market, while the entry into that market of over one billion unskilled laborers has contained wages of lower earners. High earners and consumers are winners, but unskilled workers, even those who benefit from low-cost made-in-China t-shirts and trainers, see themselves as losers.

So when the press reports that the hundreds of millions earned by some private equity entrepreneurs are taxed as capital gains rather than as ordinary income, it should come as no surprise that politicians feel compelled

to act. Or at least to seem to act. To an elected official, lectures on efficient tax structures matter less than letters from their constituents complaining about the disparate tax treatment.

So far, more noise than action. Sir David Walker's report for Britain's private equity industry calls for greater transparency, something the industry can easily live with more comfortably than with a review of its tax status. After all, many of the companies acquired by private equity firms have publicly traded debt, and are already required to fully disclose their finances.

In America, congress seems to have decided to do nothing this side of its summer recess, for the quite sensible reason that the tax status of the private equity industry is not something of concern only to a few billionaires in Greenwich, Connecticut and on Park Avenue in New York City. For one thing, many private equity firms are quite small, specializing in deals of around \$5 million.

For another, as New York Senator Chuck Schumer points out, sauce for Wall Street deal makers – many of whom are his constituents and financial supporters – is surely sauce for the Texas oil men who rely on similarly structured partnerships. Raise taxes on my constituents, Schumer is telling his colleagues in the Senate, and I will raise taxes on yours. For Senators who represent neither New York and Connecticut-based deal-makers, nor Texas oil men, that might sound more attractive than Schumer intends.

In Britain, Brown would dearly love to get his hands on additional tax revenues to fund his insatiable desire to spend on social programs. But he has to consider whether a crackdown would lead to a flight of high earners from

London to sunnier climes, taking with them the revenues they now provide the Treasury, and the jobs their spending creates. The difficulty of doing that sort of arithmetic is as good an excuse as any for doing nothing, at least until the autumn.

On both the American and British fronts, then, we have a phony peace. Private equity entrepreneurs are gathering ammunition to support an autumn offensive in support of the status quo – continued taxation of the bulk of their profits at relatively low capital gains rates. Politicians are marshalling forces for an assault on that position, both to appease their constituents and to increase the immediate flow of revenues to their treasuries. Most civilians, meanwhile, are studying their maps, not in order to follow the battle, but to decide where to spend their holidays. Very sensible, since the rise in interest rates caused by the fallout from the meltdown in the subprime mortgage market might by then have made many of the private equity deals simply undoable. Markets are, in the end, more reliable than politicians in solving these sorts of problems.



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