The Trouble With Private Equity Is Privilege Not Profits: View
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By the Editors
Jan. 18 (Bloomberg) -- Mitt Romney, the favorite to win the Republican presidential nomination, has brought the rights and wrongs of private equity to the front of U.S. politics. He once ran a private-equity firm, and he has been attacked for it even by fellow conservatives.

This is a new version of an old complaint, and the quality of the discussion is not improving with age. The question to ask about private equity -- which involves taking over companies, restructuring them and selling them at a profit -- is not whether it creates jobs. It is whether taxpayers should be subsidizing its practitioners' paychecks.

Many politicians say private equity is rapacious. Not long ago, the same charge was laid against leveraged buyouts, and before that against hostile takeovers. The issue is essentially the same. When control of a company changes hands, are the new owners so intent on short-term profits that they act against the interests of other stakeholders -- not just shareholders, but also employees, customers and the wider community?

The current debate has revolved around jobs. Defenders of private equity say the new owners tend to boost employment, and critics say the opposite.

Small Effect

The most comprehensive study to date -- by Steven Davis of the University of Chicago and four other economists, one of whom has been a paid adviser to the private-equity industry -- found that private equity has only a small overall effect on employment. The researchers looked at 3,200 target companies and roughly 150,000 operating units (factories, offices, retail outlets and so on). They found that the acquired companies lost jobs at existing units but added jobs at new ones. Altogether, employment at companies bought by private-equity investors fell in the first two years by less than 1 percent relative to employment at similar companies.

More revealing than the net effect on jobs was gross employment turnover -- jobs created plus jobs eliminated. This total was 13 percent higher for private-equity targets than the control group. In other words, companies bought by private equity both fired more people and hired more people. The study concluded that “private equity buy-outs catalyze the creative destruction process.”

Exactly. In a market economy, some companies or industries are shrinking, while others are growing. You can’t have one without the other, and the spur for both kinds of adjustment is profit. Market forces raise living standards not by increasing wages and employment enterprise by enterprise, but by applying capital and labor to the best uses. Private equity, leveraged buyouts and hostile takeovers all serve this purpose. To keep managers on their toes, capitalism requires a functioning market for corporate control.

Now let’s suppose, contrary to the findings just quoted, that private-equity owners always reduce jobs. Suppose they always drive wages down, too, as some critics say. Would this prove that private equity is bad? Before you answer, remember that -- again at the level of the company, not for the whole economy -- labor-saving innovation also tends to have those effects. So does competition from new entrants. Such is capitalism.

If private-equity owners cut costs and improve efficiency, they are doing what incumbent managers should have done already. If the new owners manage incompetently, they will lose money. As for investors’ selfish motives, Adam Smith gave the wisest advice 250 years ago: “It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest.”

Valid Concerns

While politicians focus on misguided complaints about private equity, valid concerns are all but ignored. Two are pressing and closely related: debt and political influence.

The private-equity business relies on borrowing. If government policy were neutral on the matter, leverage and the risk that goes with it would be for managers old or new to decide. But policy is far from neutral. The U.S. tax code discriminates strongly in favor of leverage, for example, by giving companies a tax break on interest payments. Without this bias -- which should be reduced as part of a larger tax reform -- the private-equity business would be conducted differently, if it existed at all.

Private-equity and other high-paying financial firms also receive a tailored preference in the form of special tax rates on “carried interest.” This allows income to be taxed as if it were capital gains, hence at 15 percent instead of 35 percent, even if the person concerned has put no capital at risk. Romney said Tuesday that his effective federal tax rate is “probably closer to the 15 percent rate.” Efforts to close this loophole -- a move Bloomberg View supports -- have come to nothing, demonstrating how private equity has made an art of political connections and influence.

If private equity can succeed without preferences, that’s fine: The more competitive the market for corporate control, the better. Its current mode of operation, though, is largely a symptom of a flawed tax code. The industry’s borrowing is subsidized and so are the generous incomes it pays its staff. These privileges are a problem. The issues its critics choose to emphasize aren’t.