Testimony

Testimony on Financial Markets and Private Equity

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**The views expressed here are my own and not those of the American Action Forum. I thank Thomas Wade for his assistance.*

Introduction

Chairman Sanders, Ranking Member Graham, and members of the Committee, thank you for the opportunity to discuss financial markets in general, and in particular, the role of private equity firms. In this testimony, I hope to make several main points:

- Financial markets serve key economic functions such as intermediation between savers and investors, allocation of capital, diversification of risk, separation of ownership and management, pricing return and risk, and others.
- Participants in financial markets have myriad business models – banks, insurance companies, pension funds, hedge funds, private equity, etc. – to undertake these functions; legal, regulatory, and tax policies should be as neutral as possible with respect to the choice of business models.
- Evaluating the effectiveness of any intervention, in particular a restructuring undertaken by private equity, must be done relative to an unobserved counterfactual, as opposed to a basis of absolute performance.
- Policies that target private equity such as the Stop Wall Street Looting Act violate the neutrality principle, discriminating against public equity firms and damaging the outlook for the private equity industry and the economy as a whole.

Let me discuss each of these in greater detail.

Financial markets are a crucial component of developed economies. Well-functioning financial markets permit savers to provide their pooled savings to firms for investment in skills, technologies, and physical capital. They permit savers to diversify across risks and provide important price signals regarding the expected returns and risks of alternative investments. In the absence of financial markets, owners would be forced to also manage each firm and hold undiversifiable risk regarding its performance; financial markets permit specialization of management functions as well as diversification of risks.

These economic functions may be supplied by a variety of entities – banks, pension funds, insurance companies, mutual funds, and others offer various combinations of these desirable economic activities. In developing the legal, regulatory, and tax frameworks within which they operate, it is desirable to tilt the playing field as little as possible, allowing financial market participants to compete on the basis of performance. As noted by most economists and this administration, healthy market competition leads to lower prices, higher quality goods and services, greater variety, and more innovation.

Background on Private Equity

Private-equity (PE) firms are a crucial part of capital allocation and the pricing of return and risk. PE firms invest in businesses they see as undervalued, provide additional capital and management services, and raise value. The vast majority (over 85 percent) of these investments are in small businesses (under 500 employees).

PE has been very successful. For example, the American Investment Council's **2021 Public Pension Study** shows PE has the highest return of any asset class public pension portfolio. In 2020, PE had a median annualized return of 12.3 percent over a 10-year period.

Its success in raising value has resulted in a substantial economic footprint. According to E&Y, the PE sector directly employed 11.7 million workers earning $900 billion in employee compensation. The average employee earned roughly $73,000 in wages and fringe benefits in 2020, while the median worker received approximately $50,000 in wages and benefits in 2020. These workers helped the private equity sector produce $1.4 trillion of gross domestic product (GDP), or roughly 6.5 percent of total GDP.

The PE sector has substantial backward linkages. Suppliers generated $900 billion in GDP, employing another 7.5 million workers, and paying roughly $500 billion in wages and benefits.

In short, PE is a very successful sector of the economy and the fruits of its success are widely shared by the investors in PE and the economy as a whole. As a corollary, unwise policies that damage PE would impose widespread harm in the economy.

Importance of Counterfactual in Evaluation

The apparent success of the PE sector (outlined above) is not a conclusive demonstration of the efficacy of any particular restructuring episode. The crucial question in this regard is what would have happened in the absence of the restructuring efforts. If a struggling company would ultimately have failed and been liquidated, any viable future is a success. Similarly, a company may be headed for bankruptcy protection and reorganization. A restructuring that generates greater employment, profits, and growth than would have happened post-bankruptcy, and does so on an accelerated timetable, would be very successful (relative to the counterfactual). In any case, it is the performance relative to the counterfactual, and not the absolute performance, that is the key.

Economic Implications of the Targeted PE Policies

Some have proposed legislation that targets the PE industry. For example, the Stop Wall Street Looting Act (SWSLA) is one such potential policy misstep. The SWSLA would impose a separate set of tax, regulatory, and legal frameworks on the PE industry. Among other provisions, it would impose:

- A 100 percent surtax on fees received from portfolio companies;
- A tax increase on carried interest capital gains;
- Limitations on interest deductibility;
- Restrictions on dividends;
- Joint and several liability on holders of economic interests in a private fund for all liabilities of a portfolio companies; and
- Alternative rules for the treatment of worker claims in bankruptcy.

It follows that the net result would be to make investments in PE less attractive, pushing capital to less productive uses, and imposing a loss on the economy. The only question is how large the losses would be.

A 2019 study by the U.S. Chamber of Commerce found that the "imposition of increased risk, taxes, and restrictions…would likely cause some (and potentially all) of the private equity industry to cease to exist." As a result, the SWSLA would result in a loss in the range of 6.9 million to 26.3 million jobs, from $671 million to $3.36 billion per year in investor earnings (about half of which would be lost to pension fund retirees), and substantial tax revenue for local governments, state governments, and the federal government.

Thank you. I look forward to answering your questions.