U.S. CHAMBER OF COMMERCE

ANALYSIS OF THE IMPACT OF INCREASING CARRIED INTEREST TAX RATES ON THE U.S. ECONOMY

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Table of Contents

Table of Figures

Abstract

This study looks at recent congressional proposals to increase the tax rate on the general partner's share of a limited partnership's profits, known as carried interest, from the long-term capital gains rate of 15% to ordinary income tax rates of 35%. We show that carried interest is an element of partnership finance in every sector of the US economy engaged in capital formation. Increasing the tax rate on carried interest would lead to changes in the structure of partnership agreements; incremental tax collections would be small. To the extent the tax increase could not be avoided by restructuring, the costs would be borne by all the members of the investment process including general partners, limited partners and their beneficiaries, as well as owners and employees of portfolio companies. Increasing carried interest taxes would reduce the amount of long-term capital available to the US economy and undermine investment, innovation, entrepreneurial activity, productivity, growth and the ability of U.S. companies to compete in the global market.

Introduction

In today's political climate leading up to the 2008 elections, a number of presidential candidates and members of Congress have singled out private equity sponsors, venture capital funds, hedge funds and other businesses organized using limited partnership agreements for punitive attention. They are proposing more than a doubling of income tax rates on so-called 'carried interest' from capital gains rates to ordinary income levels.

The Chamber would like to better understand how carried interest affects the US economy as a whole and how different sectors and industries may be impacted by the proposed tax increase. The Chamber approached Rutledge Capital to conduct a study of these issues. Rutledge Capital has conducted policy impact studies for the Chamber in the past, and has twenty years of experience in the private equity area, including structuring partnership agreements and raising and investing two private equity funds.

This paper reports on Phase 1 of the study, in which we take a macro-level survey of the impacts of proposed changes in the treatment of carried interest. In doing so we will define carried interest, look at its history, examine which industries rely on carried interest to structure investments, look at the size of the asset base investing through partnerships and how fast it is growing. We will outline the major proposed changes in tax treatment, analyze the likely impact of a tax increase on the economy, and look at who bears the burden of a tax increase, the General Partner, the Limited Partner, or the operating company being financed. We will examine the channels through which the proposed tax increase would impact the capital markets including prices, rates of return, and level of investment. Finally, we will look at the broad impact of proposed tax changes on the overall economy, jobs, incomes, investment activity, and tax revenues.

Later, in Phase II of the study, we will use more detailed data from private industry sources to do econometric work designed to estimate the impact of carried interest tax increases in greater detail, including impacts on selected sectors and industries.

Background

Members of Congress have recently proposed legislation that would significantly increase tax rates on capital deployed in long-term investments in the United States. By calling for punitive tax treatment of certain sectors, and industries, those who would raise tax rates risk undermining America's preeminent position in the world as a leader in invention, innovation, entrepreneurial activities, and growth.

The proposed tax increases on carried interest are not targeted rifle shots at a few wealthy individuals—they are a shotgun blast that will hit every investor in America who uses a Partnership to structure their business and investment activities. Selectively raising tax rates on the long-term capital gains of limited partnerships will drive capital offshore, reduce the productivity of American workers and the ability of US companies to compete in global markets. It will cost American jobs and reduce American incomes. In today's global economy countries have to compete for the capital they need to grow. Raising tax rates on long-term capital gains of US partnerships would hang a "not welcome here" sign on our door.

The timing of these proposals to increase tax rates on capital income could not be worse. In recent weeks the US mortgage market has completely seized up under the weight of the sub-prime mortgage crisis. Likewise, the leveraged loan market, which provides the capital for mergers and acquisitions and for growth capital for US companies, is frozen like a fly in amber while financial institutions attempt to find a way to deal with $300 billion in "toxic" loan commitments made when credit market conditions were more favorable.

Meanwhile, foreign governments are watching this issue with interest. They have learned that an ample supply of capital and technology, and efficient capital markets are the keys to the increasing jobs, rising incomes and economic growth their people are demanding. They are becoming more capital-friendly every day, changing tax and regulatory policies to reduce risk and increase returns for foreign investors who bring capital to their countries. Developing countries are working to improve domestic infrastructure, such as transportation and telecommunications, to improve the business environment.[1] China has lowered tax rates and instituted personal property laws and continues to open industries to foreign cooperation, including banking, telecommunications, securities, insurance and tourism. India has special fiscal incentives and promotes local skills development to meet the need of foreign companies and has streamlined approval procedures for foreign investment.[2] In Asia and the Pacific, economic partnership and trade agreements are improving competitiveness, attract more FDI and better meet the challenges emanating from heightened competition.[3]

They are waiting for us to make a mistake that would drive America's capital offshore and into their welcoming arms. Raising tax rates on long-term capital gains for America's partnerships is just the mistake they have been waiting for.

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[1] Charlton, Andrew, 2003, Incentive Bidding for Mobile Investment: Economic Consequences and Potential Responses, Governing Finance and Enterprises (OECD Development Centre).
[2] Joksch, Jennifer, 2006, How India Attracts Foreign Investors, (Stuttgard).
[3] UNCTAD, 2003, World Investment Report 2003, Conference on Trade and Development (United Nations).

The Facts About Carried Interest

First, what is carried interest?

Carried interest arises when two or more investors who bring different skills and assets to the venture come together to form a new business venture or investment project.

A real estate developer, for example, may have an idea for a project, project plans, the ability to get zoning approvals, know-how, an organization, a network of trusted people, and a reputation for quality; but may not have the funds to develop the project. A pension fund, or other investor, may have the money to finance the project but lack the other entrepreneurial assets brought by the developer.

A half-century ago, in order to encourage entrepreneurship and capital formation, Congress created a flexible investment vehicle that these parties could use to work together. That vehicle is the Partnership, in which each partner contributes their unique assets, the partners have great flexibility to divide up the gains from their investment in any way they deem appropriate, and all income to the partnership flows through the partnership to be taxed to the individual partners, based solely on the character of the income—ordinary income, short-term capital gains or long-term capital gains—that the partnership receives.

Since its inception, the partnership structure has been a resounding success, giving American investors and entrepreneurs the tools to create and grow businesses, build shopping centers, build hospitals, explore for oil and gas, found new technology companies, and finance mergers and acquisitions. In 2004, more than 15.6 million Americans were partners in 2.5 million partnerships investing $11.6 trillion using the partnership structure.[4]

When creating and structuring partnerships that have a life of 5-10 years, investors work hard to make sure that the interests of the various partners are aligned to avoid potential conflicts later. Limited Partners, like the financial investor in the above property development example, who may put up 90-99% of the financial capital but lack the intangible entrepreneurial assets to carry out a successful project, typically agree to carve out a portion—usually 20%—of the ultimate gains of a project for the General Partner, who may contribute only 1-10% of the financial capital, in recognition of the fact that the reputation, network, know-how and other intangible assets of the General Partner are extremely valuable. To further align their interests, the partners often agree that the General Partner must wait until the end of the partnership, after all of the limited partner's capital, partnership expenses and fees, and usually a preferred return have been paid, before the General Partner receives their portion of the gain. These delayed payments—carried on the partnerships capital accounts until the end of the partnership—are referred to as the General Partner's "carried interest."

In addition to carried interest, the General Partner collects an annual management fee from the partnership—usually 2% of total committed capital per year—as compensation for the work of managing the partnership's activities. Such management fees are treated as ordinary income and taxed at ordinary income tax rates. According to a recent study by Andrew Metrick and Ayako

[4] Internal Revenue Service, 2007, Data Book 2006, (United States Department of the Treasury, Washington, D.C.).

Yasuda of the Wharton School, management fees for a typical private equity fund make up 60-67% of the total value received by General Partners, with the remaining 33-40% comprised of carried interest.[5]

Under well-established tax principles, all partnership income is passed through to the individuals making up the partnerships *based on the character of the income received*. To the degree the partnership receives fees or interest payments all partners—General Partners and Limited Partners—will be taxed at ordinary income rates. To the degree the partnership receives long-term capital gains or short-term capital gains, the partners will pay taxes on that income in the appropriate way.

[5] Metrick, Andrew, and Ayako Yasuda, 2007, The Economics of Private Equity Funds.

Table 1: Limited Partnership Composition, 2004

Item	All Industries	Construction and Manufacturing	Retail and Wholesale Trade	Securities, commodity contracts and other financial investments	Funds, Trusts, and Other Financial Vehicles	Real Estate and Rental and Leasing
Number of Partnerships	2,546,877	197,284	179,355	209,968	37,772	1,179,731
Number of Partners	15,556,553	668,444	640,177	2,844,890	318,665	6,642,700
Total Assets	11,607,698,140	627,381,778	203,602,605	5,300,159,994	811,843,194	2,638,104,997
Total Income	3,021,683,261	860,226,136	650,348,057	171,007,002	8,392,995	140,834,855
Net Short-Term Capital Gain	27,837,829	185,100	65,383	22,827,967	2,805,505	1,346,400
Net Long-Term Capital Gain	178,452,737	2,902,661	912,598	115,152,846	15,826,870	27,541,540
Portfolio Income Distributed directly to Partners	355,581,512	7,895,565	1,632,293	222,298,913	36,454,964	45,972,793
Long-Term Capital Gain as % of Total Capital Gain	86.5%	94.0%	93.3%	83.5%	84.9%	95.3%
% Income Coming from Long-Term Capital Gains	50.2%	36.8%	55.9%	51.8%	43.4%	59.9%
% Income Coming from Short-Term Capital Gains	49.8%	63.2%	44.1%	48.2%	56.6%	40.1%

Item	Professional, Scientific and Technical Services	Health Care, Education and Social Assistance	Arts, Entertainment, and Recreation	Accomodation and Food Services	Agriculture, Forestry, Fishing, Hunting and Mining	Other
Number of Partnerships	164,045	65,025	45,126	90,705	145,641	742,767
Number of Partners	662,629	343,584	256,552	390,768	904,097	4,441,677
Total Assets	106,794,416	72,869,967	58,653,325	155,238,737	268,807,666	2,026,605,572
Total Income	243,458,087	129,295,724	39,421,006	119,451,642	108,123,859	1,190,874,216
Net Short-Term Capital Gain	28,745	-399	13,872	2,863	44,097	607,474
Net Long-Term Capital Gain	1,807,015	604,603	320,105	1,439,648	1,880,855	16,116,222
Portfolio Income Distributed directly to Partners	3,768,751	887,949	516,917	1,907,851	6,286,764	41,326,984
Long-Term Capital Gain as % of Total Capital Gain	98.4%	100.1%	95.8%	99.8%	97.7%	96.4%
% Income Coming from Long-Term Capital Gains	47.9%	68.1%	61.9%	75.5%	29.9%	39.0%
% Income Coming from Short-Term Capital Gains	52.1%	31.9%	38.1%	24.5%	70.1%	61.0%

Note: Money amounts are in thousands of dollars.
Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

As you can see from Table 1, above, American investors organize partnerships for all kinds of business and investment ventures. For example, in 2004, the most recent year available, the Internal Revenue Service reports that there were 2.5 million partnerships doing business across all industries, made up of 15.6 people acting as partners; the total assets held by these partnerships added up to $11.6 trillion. The same partnerships reported $27.8 billion in short-term capital gains and $178.4 billion in long-term capital gains—85% of their total capital gains were long-term capital gains. The total income brought in by these partnerships in 2004 amounted to over $3.0 trillion, which we can break down into two main components—ordinary income (fees and short-term capital gains), which is taxed at 35%, and long-term capital gains, which is taxed at 15%.

Taking a weighted average of the two components, we can calculate the effective tax rate paid by all partnerships across all industries in 2004. Fees and short-term capital gains income, which are taxed at ordinary income rates (up to 35%), accounted for 49.8% of total partnership income. The remaining 50.2% of partnership income consisted of long-term capital gains and was taxed at long-term capital gains rates (15%). A weighted average of the two tells us that the blended average tax rate paid by partners in 2004 was 25%.[6]

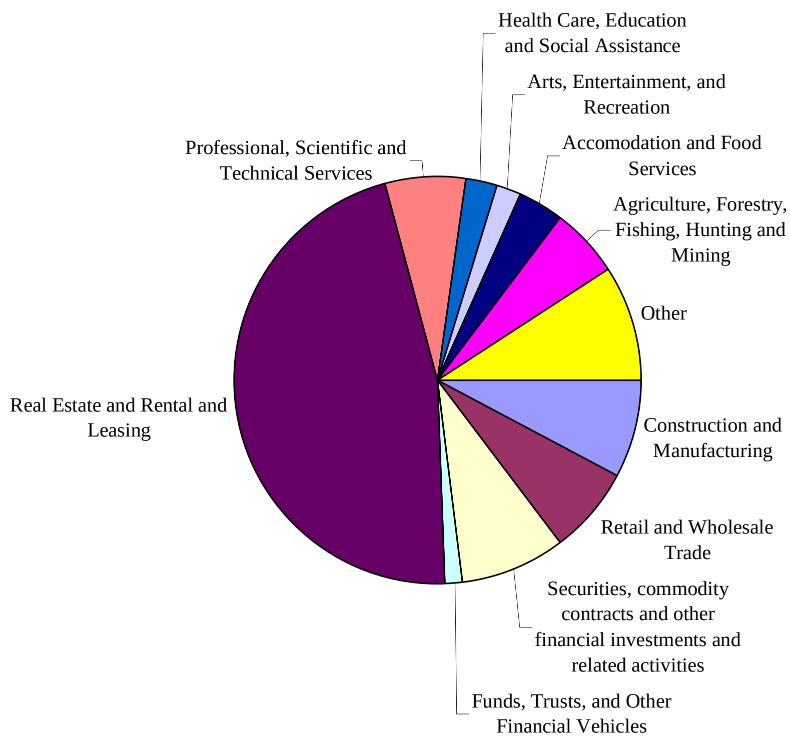
If we look closer at the partnerships separated into various sectors, we can see that the largest category of partnerships, by assets, is security and financial partnerships. There, 2.8 million people were partners in 210,000 partnerships which held $5.3 trillion of financial assets like stock, bonds, private equity, venture capital, hedge funds, and trusts. In this category, 51.8% of total income was contributed by long-term capital gain; 48.2% was ordinary income.

Real estate partnerships make up the second largest share, measured in total assets, but represent the largest share of both partnerships (1.2 million) and partners (6.6 million people). Real estate partnerships are responsible for investing $2.6 trillion in assets. 59.9% of their income comes from long-term capital gains; 40.1% is taxed at ordinary income tax rates.

Partnerships are used in many other sectors as well, from healthcare to hotels, restaurants, and manufacturing, as you can see in the charts below.

[6]Internal Revenue Service, 2007. The weighted average calculated as [(49.8)(.35)+(50.2)(.15)]/100=24.96%.

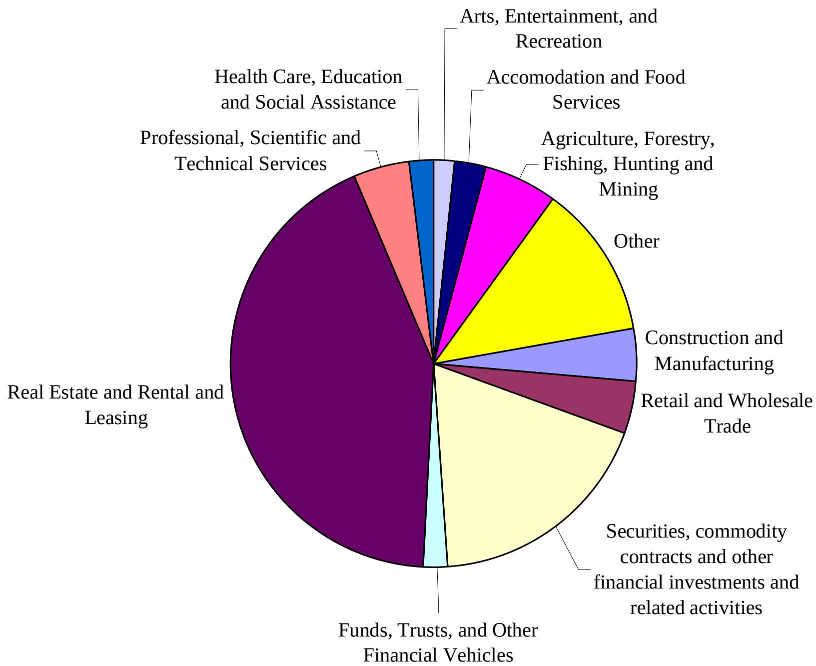
Figure 1: Number of Partnership Agreements, 2004



Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

Real estate activities dominate the number of partnerships, accounting for 46% of the total number but many other sectors are represented, including Retail and wholesale trade; Construction and manufacturing; Agriculture, forestry, fishing, hunting, and mining; Hotels and food service; Arts, entertainment and recreation; Health care, education and social assistance; and Professional, scientific, and technical services.

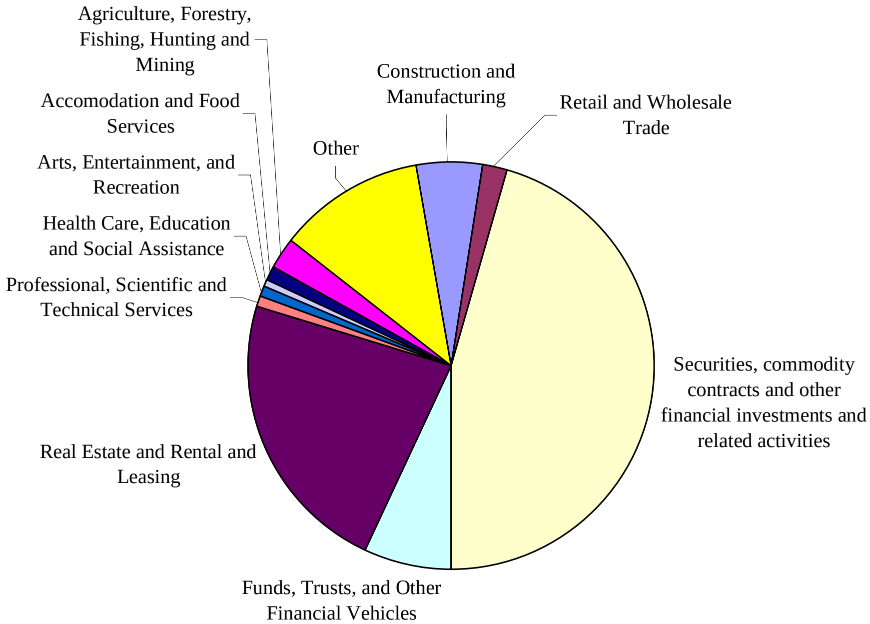
Figure 2: Number of Partners in Partnership Agreements, 2004



Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

More than 15.5 million people were partners in a limited partnership agreement in 2004. Almost half of them (43%) were in real estate partnerships.

Figure 3: Total Assets of All Partnerships, 2004

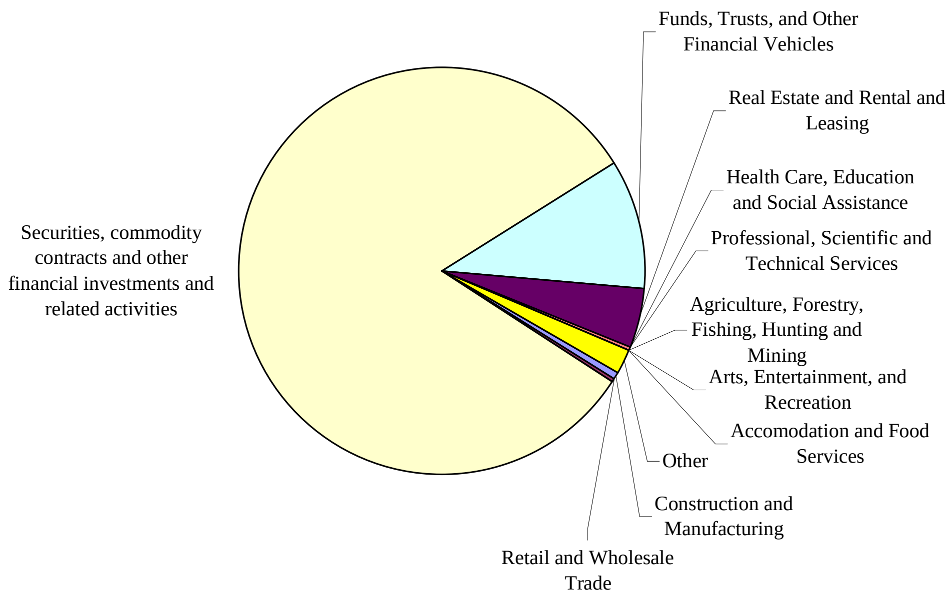


Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

Investment partnerships for the purpose of owning securities and financial assets are the largest component of total partnership assets, accounting for 45% of total assets. 23% in real estate makes up the second largest category.

The large share of financial assets relative to real estate and other hard assets reflects the trends in US financial markets since 1981. Tax cuts on capital income and systematically falling interest rates in an environment of subdued inflation rates caused investors to move a large portion of their portfolios out of commodities, real estate and other inflation hedging assets and into the stock, bond, and other security markets. This was the source of the quarter-century bull market the US has enjoyed over this time. More recently, the reduction in dividend and capital gains rates in 2003 significantly increased the value of US assets. America's deep capital markets, massive $50+ trillion net worth, and flexible financing methods are important drivers in innovation and entrepreneurial activities, which support growth and job creation.

Figure 4: Net Short-Term Capital Gain of All Partnerships, 2004

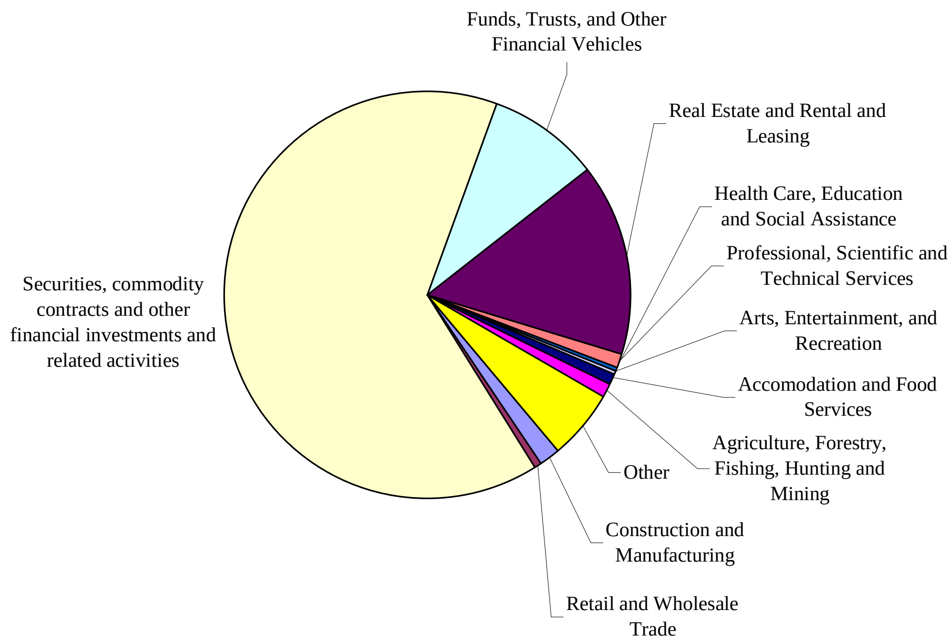


Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

In 2004 partnerships collected $27.8 billion in short-term capital gains, which make up only 13.5% of total capital gains and 49.8% of total income. More than three-quarters of short-term capital gains (82%) were collected by partnerships investing in securities with another 10% in funds, trusts, and other financial vehicles. The bulk of hedge fund gains would appear as short-term capital gains which are taxed at ordinary income rates. Industry sources report that hedge funds turn over 35% of their securities each quarter, or 82.2% in less than one year.[7] The implied mix of 82 % short-term capital gains and 18% long-term capital gains would produce an average tax rate of 31.4% on total capital gains for hedge funds.

[7] Easterling, Ed, 2007, Hedge Funds: Myths and Facts, *Crestmont Research* April 10, 2007.

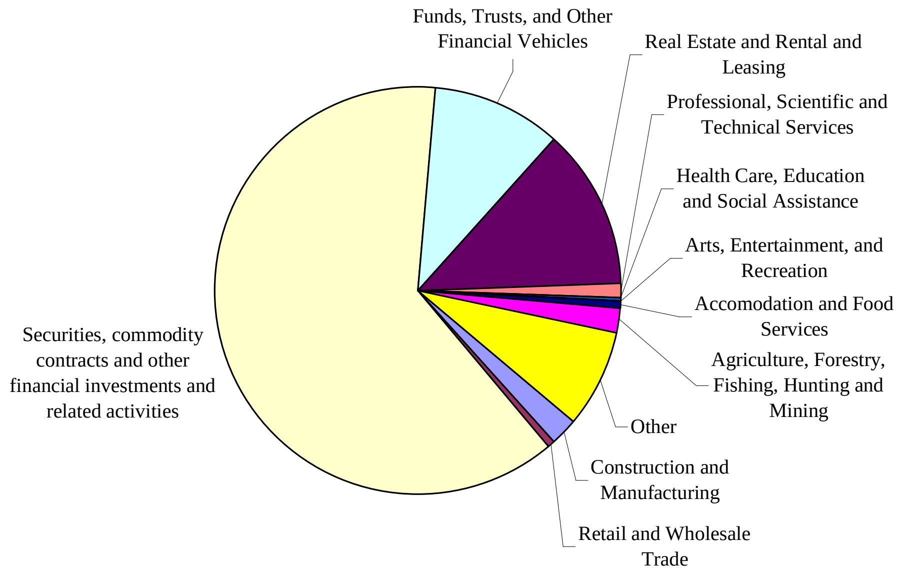
Figure 5: Net Long-Term Capital Gain of All Partnerships, 2004



Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

Securities partnerships make up the largest share of long-term capital gains. Together with funds, trusts, and other finance vehicles they make up 64% of total long-term capital gains collected by partnerships. This is where you would find private equity partnerships, including leveraged-buyouts, mezzanine financing, growth financing, and venture capital. All make investments they intend to hold over a number of years. Real estate partnerships are also responsible for a large share of long-term capital gains for the same reason—they own long-term assets.

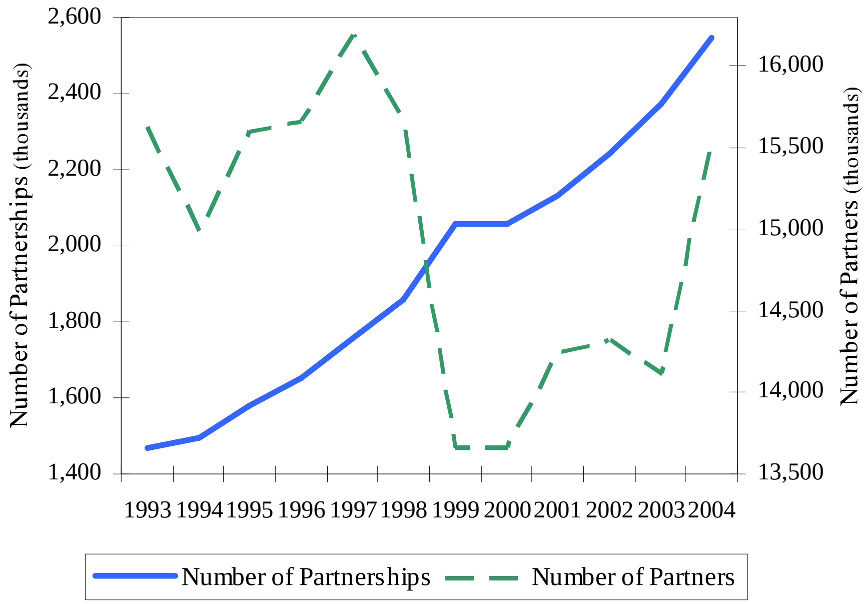
Figure 6: Portfolio Income Distributed Directly to Partners of All Partnerships, 2004



Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

In 2004 the partners of limited partnership agreements collected $3.0 trillion in portfolio income, 63% of which was contributed by securities partnerships. Funds, trusts and other financial vehicles and Real Estate made up 10% and 13% of total portfolio income, respectively, over the same period.

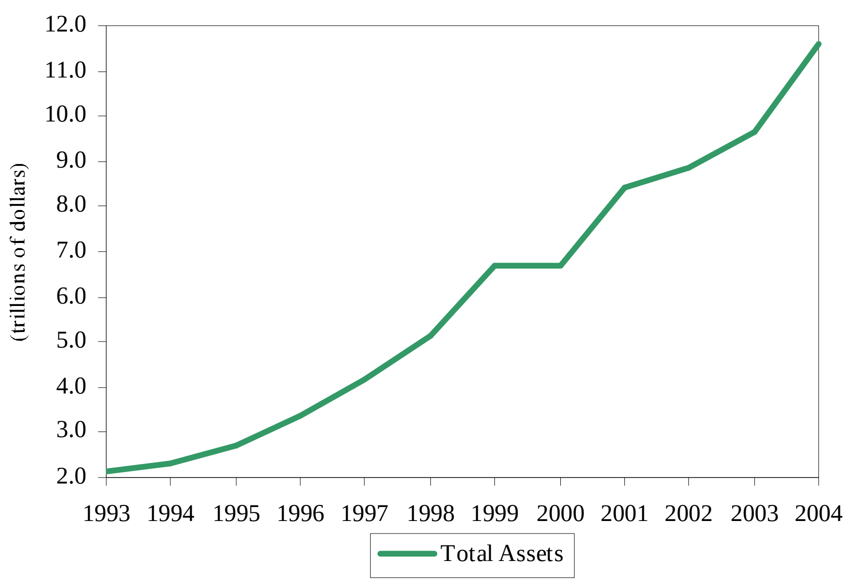
Figure 7: Growth of Limited Partnership Agreements, 1993-2004



Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

The number of partnerships has increased steadily from less than 1.5 million in 1993 to 2.5 million in 2004, as shown in Figure 7. After a sharp decline in the late 1990's, there were 15.6 million partners in partnerships in 2004.

Figure 8: Growth of Total Assets of Limited Partnerships, 1993-2004



Source: IRS Statistics of Income Division, Fall SOI Bulletin, February 2007.

Figure 8 shows the dramatic increase in partnership assets over the past decade from just over $2 trillion in 1993 to $11.6 trillion in 2004. This increase provided capital for the growth of the U.S. economy over this period.

Congressional Proposals

On June 22, Representative Sander Levin along with Representatives Charles Rangel and Barney Frank and a dozen other members of the House of Representatives introduced H.R. 2834 to address “Investment Management Services Taxation,” [8] which could have a large potential impact on the economy and the capital markets than. The legislation would add a new Section 710 to the IRS Code of 1986 that re-classifies the carried interest of an investment services partnership interest (ISPI) from capital gains to ordinary income tax treatment, more than doubling tax rates on carried interest earned by General Partners of investment partnerships, and on investment funds created as limited liability companies who choose to be taxed as partnerships, from the current long-term capital gains rate of 15% to the 35% ordinary income tax rate. H.R. 2834 would also limit the amount of losses available to managers of the partnerships; a net loss would be treated as an ordinary loss.

In the bill’s accompanying fact sheet, the bill’s sponsors state the tax increase will apply to “any investment management firm without regard to the type of assets, whether they are financial assets or real estate.”[9] In addition to private equity funds, venture capital funds, and hedge funds, they will affect all investment partnerships including both Real Estate Investment Trusts (REIT’s) and publicly traded partnerships.

Alarmingly, House Ways and Means Committee Chairman Charles Rangel announced that the tax increase may be applied retroactively to partnership agreements signed many years in the past, stating that “due to the potential erosion of our tax revenues in this case, my historic opposition to retroactive tax legislation may not apply.”[10] This bill is such a stark departure from long-accepted tax principles that one law firm, in a communication to their clients and friends, stated: “This bill, if enacted, would have broad sweeping effects on the structure of investment funds, and would represent a sea change in the private investment funds industry.”[11]

The Senate Committee on Finance held two sets of hearings on the subject of carried interest; the first on July 11,[12] the second on July 31.[13] Senator Baucus, in his opening

[8] Committee on Ways and Means, Press Release, “Levin, Democrats Introduce Legislation to End Carried Interest Tax Advantage, June 22, 2007.
[9] 2007, Levin and Democrats Introduce Legislation to End Carried Interest Tax Advantage.
[10] Means, House Commitee on Ways and, 2007, Rangel Applauds Senate Legislation on Publicly Traded Partnerships.
[11] Proskauer Rose, 2007, Congress Takes Formal Steps To Tax Carried Interest as Ordinary Income.
[12] 2007, Carried Interest I, Senate Finance Committee (Washington, DC).
[13] 2007, Carried Interest II, Senate Finance Committee (Washington, DC).

statement at the first hearing, stated the concern that "Some hedge fund managers and private equity managers are taking home more than $100 million a year in what is called 'carried interest income'. And much of that income is taxed at the long-term capital gains rate of 15%."[14] The question arises, he states, "are some people of great wealth merely taking advantage of the tax code to pay less that their full and proper share?"[15]

Later, Senator Baucus again refers to hedge funds, which "now manage nearly $2 trillion in assets."[16] This is interesting because hedge funds generally hold securities for very short times and pay ordinary income tax rates on short-term capital gains income, which makes up the bulk of their profits and carried interest.[17] The rhetorical value of his statement is obvious—everybody loves to hate hedge fund managers, making them a great choice of whipping boy for the press. But the facts are clear; hedge funds are a minor factor in the issue of taxing long-term capital gains as carried interest.

Senator Baucus lays down a set of ground rules for the discussion that suggests he is fully aware of the critical importance of investment and capital formation for the American economy:

> No matter what we may ultimately decide to do, we will in no way wish to change the interests of the limited partners. […] Entrepreneurs create new jobs. We do not want to stifle the mother of invention. […] We want to ensure that our entrepreneurial system continues to function well. We want to ensure that people are free to continue to create wealth.[18]

Senator Grassley, in his statement, echoes many of the same ideas by stating what the inquiry and any proposal that it may produce is *not* about":

- This bill [is not] an attack on capital formation [or] a tax increase on a single industry. […]
- Not about raising taxes on capital income. […]
- Not an attack on the investor class. […]
- Not a revenue grab from private equity firms or hedge funds. […]
- Not about well-settled tax policy principles regarding capital assets, or the propriety of current law capital gains rates.[19]

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[14] Baucus, Max, 2007, Carried Interest I, Senate Finance Committee (Washington. DC).
[15] By "taking advantage of the tax code to code to pay less that their full and proper share" senator Baucus means simply following current law when calculating their taxes.
[16] Baucus (2007).
[17] See Easterling, Ed, 2007, Hedge Funds: Myths and Facts, *Crestmont Research* April 10, 2007. Hedge fund industry data suggest that hedge funds turn over roughly 35% of their portfolios every quarter, or 82% per year, which suggests that more than 80% of hedge fund profits and carried interest payments take the form of short-term capital gains, which are taxed at ordinary income rates.
[18] Baucus (2007).
[19] Grassley, 2007, Carried Interest I, Senate Finance Committee (Washington, DC).

Senator Grassley reminds us that "keeping taxes low on investment returns is sound tax policy." And later, that "lower taxes on capital gains and corporations can help American businesses compete in the global economy."[20]

These are important and worthy principles. It is the conclusion of this report, however, that the proposal to increase tax rates on America's partnerships would violate every one of them.

The durability, flexibility, and tax treatment of the Partnership as the dominant vehicle for undertaking new business and investment ventures is one of the cornerstones of the American business and investment model. The Partnership is on no small measure responsible for the innovation, entrepreneurial activity and growth that have made US capital markets and the US economy the envy of every country in the world. We must be cautious if we want to remain the preeminent country in the global economy.

The Impact of Investment Partnerships on Economic Performance

Over the past 30 years there has grown a vast academic literature on partnerships in general and private equity partnerships in particular. Although there are many different opinions on different aspects of private equity markets, the vast majority of researchers agree on several key points.

First, private equity is a large and extremely important part of the US economy that has played an irreplaceable role in the restructuring of American companies over the last 25 years into today's strong global competitors.

Second, private equity arises partly in response to a market failure in the public markets, known as the "Jensen hypothesis,"[21] in which some entrenched managers of public companies fail to look after the interests of their shareholders. The stronger governance and tighter control exercised by private equity investors combined with the closely aligned interests of the private equity investors and the managers of their portfolio companies through partnership agreements work to correct this problem.

Third, private equity is a major and growing source of expansion capital for family-owned "middle market" companies that are too small or otherwise unsuited for the public markets. These small companies are the backbone of the American economy, accounting for more than half of GDP and virtually all employment growth.

Fourth, private equity sponsors and the network of operating resources they bring to portfolio companies significantly improve the productivity, profitability, asset

[20] Ibid.
[21] Jensen, M.C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, *Journal of Finance* 48, 865–880.

management, and growth. According to Steven Kaplan, Professor at the University of Chicago School of Business and one of the leading experts in the area, "the academic evidence for the positive productivity effects of private equity is unequivocal."[22] Rutledge (2006) examined the stock market performance of a unique sample of newly-public companies in which private-equity firms retained an ownership and governance role in the company after the public offering. She found that these companies significantly outperformed the overall stock market during the period of private equity control, confirming the Jensen hypothesis.

Fifth, private equity in the form of venture capital invested in computers, industrial, energy, retail, distribution, software, healthcare and consumer products has had an extraordinary record in creating new businesses, new technologies, new business models, and new jobs. According to Venture Impact, a study prepared by Global Insight (2007), venture-backed companies like Intel, Microsoft, Medtronic, Apple, Google, Home Depot, Starbucks, and eBay accounted for $2.3 trillion of revenue, 17.6% of GDP, and 10.4 million private sector jobs in 2006. Venture-backed companies grow faster, are more profitable, and hire more people than the overall economy.

Sixth, and finally, private equity in the form of real estate partnerships has dramatically increased the availability and lowered the cost of capital to build homes, shopping centers, office buildings, and hospitals for American families and businesses. In Emerging Trends in Real Estate (Urban Land Institute (2007)), the study reports that in 2006 investors provided $4.3 trillion in capital to the U.S. real estate sector, including $3.2 trillion in debt capital and $1.1 trillion in equity capital. Of the equity capital, the bulk was provided through partnerships by private investors ($451 billion), pension funds ($162 billion), foreign investors ($55 billion), life insurance companies ($30 billion), private financial institutions ($5.1 billion), REITs ($315 billion), and public untraded funds ($37.4 billion).[23]

Literature Review

Although it is not possible to review all of the articles in this paper, in this section we will discuss several papers that are especially relevant for our topic. I have also included in the reference section a detailed set of literature on the topic for the reader's further reading.

1. *Cumming, Siegel, and Wright (2007)*[24]

In an extraordinarily thorough review article in the current, September 2007 issue of the *Journal of Corporate Finance,* Cumming et al. conclude that "there is a general consensus that across different methodologies, measures, and time periods, regarding a

[22] The Wall Street Journal, 2007, Trading Shots: Taxing Private Equity, (The Wall Street Journal).
[23] Miller, Jonathan D., 2006. *Emerging Trends in Real Estate* (ULI-the Urban Land Institute, Washington, D.C.). p. 21.
[24] Cumming, Douglas, Donald S. Siegel, and Mike Wright, 2007, Private equity, leveraged buyouts and governance, *Journal of Corporate Finance* 13, 439-460.

key stylized fact: [leveraged buyouts] (LBOs) and especially, [management buyouts] (MBOs), enhance performance and have a salient effect on work practices. More generally, the findings of the productivity studies are consistent with recent theoretical and empirical evidence, Jovanovic and Rousseau (2002) suggesting that corporate takeovers result in the reallocation of a firm's resources to more efficient uses and to better managers."

2. *Kaplan (1989)*[25]

In a classic article, Kaplan examines a sample group of 76 large management buyouts of public companies from 1980 to 1986, presenting evidence for long-term changes in operating results for these companies. Kaplan found that in the three years following the buyout, the sample companies experienced increases in operating income, decreases in capital expenditures, and increases in net cash flow. Consistent with these documented operating changes, the mean and median increases in market value (adjusted for market returns) were 96% and 77% over the period from two months before the buyout announcement to the post-buyout sale. Kaplan provides evidence that the operating changes and value increases are due to improved incentives as opposed to layoffs, managerial exploitation of shareholders via inside information or wealth transfer from employees to investors.

3. *Wright, Wilson and Robbie (1996)*[26]

The authors examine the longevity and longer-term effects of smaller buyouts. The evidence presented shows that the majority of these companies remain as independent buy-outs for at least eight years after the transaction, and that entrepreneurial actions concerning both restructuring and product innovation are important parts of entrepreneurs' strategies over a ten year period or more. Wright, Wilson and Robbie also provide an analysis of the financial performance and productivity of these companies using a large sample of buyouts and non-buyouts. Their analysis shows that buy-outs significantly outperformed a matched sample of non-buyouts, especially from year 3 onwards. Regression analysis showed a productivity differential of 9% on average from the second year after the buyout onwards. Companies which remained buyouts for ten or more years experienced substantial changes in their senior management team, and were also found to undertake significant product development and market-based strategic actions.

[25] Kaplan, S.N., 1989a, The effects of management buyouts on operating performance and value, *Journal of Financial Economics* 24, 217–254.
[26] Wright, M., N. Wilson, and K. Robbie, 1996, The longer term effects of management-led buyouts, *Journal of Entrepreneurial and Small Business Finance* 5, 213–234.

4. *Nikoskelainen and Wright (2007)*[27]

The authors use a data set comprising 321 exited buyouts in the UK from 1995 to 2004 to investigate the realized value increase in exited leveraged buyouts. Nikoskelainen and Wright test Michael C. Jensen's (1993) free cash flow theory, showing that value increase and return characteristics of LBOs are related to the associated corporate governance mechanisms, most notably managerial equity holdings. They also show that return characteristics and the likelihood of a positive return are related to the size of the target company and to any acquisitions executed during the holding period.

5. *Renneboog, Simon and Wright (2007)*[28]

This paper examines the magnitude and sources of the expected shareholder gains in UK Public-to-Private (PTP) transactions from 1997 to 2003. They show that pre-transaction public shareholders receive a premium of 40%. They test the sources of value creation from the delisting and find that the main sources of value are undervaluation of the target firm in the public market, increased interest deduction and tax savings and better alignment of owner-manager incentives.

6. *Jensen (1989)*[29]

Jensen argues against the 1980's protest and backlash from business leaders and government officials calling for regulatory and legislative restrictions against privatization (takeovers, corporate breakups, divisional spin-offs, leveraged buyouts, and going-private transactions). He believes that this trend from public to private ownership represents organizational innovation and should be encouraged by policy. Jensen explains that there is a conflict in public corporations between owners and managers of assets known as the "agency problem", particularly in distribution of free cash flow. He argues that weak public company management in the mid 1960s and 1970s triggered the privatizations of the 1980s. He sees LBO firms as bringing a new model of general management that increases productivity because private companies are managed to maximize long-term value rather than quarterly earnings. He argues that private equity revitalizes the corporate sector by creating more nimble enterprises. Jensen further asserts that it is important that the general partners of LBO partnerships take their compensation on back-end profits rather than front-end fees because it provides strong incentives to do good deals, not just do deals.

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[27] Nikoskelainen, Erkki, and Mike Wright, 2007, The impact of corporate governance mechanisms on value increase in leveraged buyouts, *Journal of Corporate Finance* 13, 511-537.
[28] Renneboog, Luc, Tomas Simons, and Mike Wright, ibid. Why do public firms go private in the UK? The impact of private equity investors, incentive realignment and undervaluation, 591-628.
[29] Jensen, M., 1989, The eclipse of the public corporation, *Harvard Business Review* 67, 61–74.

7. *Jensen (1993)*[30]

Jensen describes the problems that accompany the "modern Industrial Revolution" of the past 20 years, citing that "finance has failed to provide firms with an effective mechanism to achieve efficient corporate investment." He explains that large corporations today do not follow the rules of modern capital-budgeting procedures, most specifically succumbing to agency problems that misalign managerial and firm interests – damaging managers' incentives to maximize firm value instead of personal gain. The classic structure of private equity buyouts helps to realign incentives through increased managerial equity holding, increased monitoring via commitment to service debt, and the active involvement of investors whose ultimate returns depend on the firm's value upon exit. Jensen provides a framework for analyzing expected longevity and improved performance in the long-run, arguing that financial sponsor involvement in companies that have previously been wasting free cash flow and under-performing can permanently improve the company's performance through improved organization and practices.

8. *Knoll (2007)*[31]

Knoll presents the first academic analysis to quantify the tax benefit to private equity managers of the current treatment of carried interests and the additional tax that the Treasury would collect if current tax treatment were changed in accord with recent proposed legislation. He points out that it is misleading to look at one party in isolation because private equity investments involve several parties including general partner, limited partner, and portfolio company owners and managers who are joined by negotiated business agreements. Knoll uses a method for estimating tax impacts that was developed 25 years ago by Merton Miller and Myron Scholes (1982). Using the Miller-Scholes methodology, he estimates the tax implications of raising tax rates on carried interest for all parties in the private equity transaction.

The fund's investment capital comes from its limited partners--wealthy individuals, charitable foundations with large endowments, pension funds, and corporations, insurance companies and. Each has a different tax status. Using estimates of the composition of limited partners Knoll calculates estimates of net tax revenue gain from the proposed tax increase.

Knoll estimates, based on assumed $200 billion of annual limited partner investments and with no change in the composition of the partnerships or structure of the fund agreements, that the change in tax treatment as a combination of ordinary income tax rates and accelerating taxation of corporate entities would generate an additional $2 to $3 billion/year. He notes, however, that it is highly likely that the structure of private equity

[30] Jensen, M.C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, *Journal of Finance* 48, 865–880.
[31] Knoll, Michael S., 2007, The taxation of private equity carried interests: Estimating the revenue effects of taxing profit Interests as ordinary income, Social Science Research Electronic Paper Collection (Philadelphia, PA).

funds will change in response to the tax treatment revisions, shifting some portion of the burden of increased taxes to limited partners and to the portfolio companies. Assuming that companies are generating taxable profits, and can use the additional expense deduction, shifting carried interest to portfolio companies would virtually cancel out any additional taxes paid by the general partners, with the result that increasing carried interest tax rates would generate little or no net increase in tax collections.

9. Fleischer (2006)[32]

Fleischer proposes a "cost-of-capital" approach under which the general partners of investment partnerships with more than $25 million in capital under management would be allocated an annual cost-of-capital charge (e.g. 6% of the 20% profits interest times the total capital under management) as ordinary income. The limited partners would then be able to deduct the corresponding amount (or would capitalize the expense, as appropriate). Fleischer argues that this tax treatment more closely reflects the economics of the arrangement, explaining "in the typical fund, the GP effectively receives a non-recourse, interest-free compensatory loan of 20% of the capital in the fund, but the foregone interest is not taxed currently as ordinary income."

Fleischer claims that his cost-of-capital approach also provides a reasonable compromise on the character of income issue: "as when an entrepreneur takes a below market salary and pours her efforts back into the business as "sweat equity," the appreciation in the value of a private equity fund reflects a mix of labor income and investment income. A cost-of-capital approach disaggregates these two elements, allowing service partners to receive the same capital gains preference that they would receive on other investments, but no more."

10. Weisbach (2007)[33]

Weisbach argues that the arguments behind the Levin bill are misplaced for two reasons: 1) the labor involved in private equity investment is no different than the labor that is intrinsically involved in any investment activity, and should be treated no differently; and 2) even if there were good reasons for taxing carried interest as ordinary income, the tax changes would be "complex and avoidable, imposing costs on all involved without raising any significant revenue".

To support his first point, he compares private equity investment to purchasing stock through a margin account. In both situations, investors combine their capital with that of third parties, and labor effort is requires to make the investment. The only difference between the two scenarios is that private equity funds issue limited partnership interests as a means of financing their investment instead of margin debt. Weisbach argues that

[32] Fleischer, Victor, 2006, Two and Twenty: Partnership Profits in Hedge Funds, Venture Capital Funds and Private Equity Funds, Colloquium on Tax Policy and Public Finance (NYU School of Law).
[33] Weisbach, David A., 2007, The Taxation of Carried Interests in Private Equity Partnerships.

there are no valid reasons to change the way that these sponsors are taxed simply because they have chosen a different method of financing their activities or because they use a partnership.

The problem of complexity and avoidance that Weisbach describes is independent of the issue of what is appropriate according to tax law, and is concerned mostly with practicality. In order to change the tax treatment of carried interest as proposed, we would first have to define carried interests. In addition, if that were accomplished satisfactorily, fund managers would have little problem avoiding the bulk of these new taxes by acquiring non-recourse loans from limited partners.

Weisbach concludes that the decision of private equity fund managers to use limited partnerships instead of debt to finance their investments does not warrant such a significant change in tax law; and that even if it did, the small increases in tax revenues (after investors have avoided the bulk of the impact of the tax rate increase with simple changes in financing structure) would not outweigh the difficulties and costs that the new laws would present.

11. Abrams (2007)[34]

Abrams discusses current issues surrounding carried interest tax changes, concluding that while current tax law was drafted largely out of administrative convenience, it is in fact a fairly good compromise between the many conceptual and practical difficulties of fashioning a proper tax treatment for investment activities. He argues that while surely some portion of the returns could be considered compensation for services, it is not valid to classify all of the carried interest received by the general partner as compensation since a large part of carried interest is in fact the risky return on a capital investment and should qualify for capital gain treatment.

Abrams considers Fleischer's (2006) proposed cost-of-capital approach as a compromise, arguing that though much of the logic is sound, the proposal has very little effect on tax revenues since with every cost-of-capital charge the general partner pays, the limited partners are allowed a corresponding deduction, except for non-profit tax-exempt entities for whom the deduction holds no value. Because of the small impact this system would have on tax revenues, Abrams suggests that even if Fleischer's approach were the correct one, the transaction cost of changing current tax law is greater than the ultimate benefits of such a change, due largely to undesirable complexity and avoidance issues.

12. Fenn and Liang (1995)[35]

This thorough review of the history and structure of private equity and venture capital was published as a staff study of the Federal Reserve Board. The report traces the historical positive role regulatory and tax changes have played in fueling investment

[34] Abrams, Howard E., 2007, Taxation of Carried Interests, Tax Notes.
[35] Fenn, George W., Nellie Liang, and Stephen Prowse, 1995, The Economics of the Private Equity Market, Staff Series (Board of Governors of the Federal Reserve System, Washington D.C.).

activity through the widespread adoption of limited partnerships as the dominant form of organizing private equity ventures.

Fenn and Liang describe the rise of the partnership as the most effective structure for dealing with issues of information and incentive structure between the general partner, institutional investors, and portfolio companies. Fenn and Liang emphasize that the expansion of the private equity market has increased access to outside equity capital for both classic start-up companies and established private companies.

Relevant to the current proposed regulatory and tax changes, Fenn and Liang describe the abrupt slowing of venture capital investment in the late 1960s and early 1970s due to a shortage of qualified entrepreneurs, a sharp increase in the capital gains tax rate, and a change in tax treatment of employee stock options. These changes not only discouraged investments in start-ups but drove fund managers to shift to other strategies for private equity investing. The result, they note, was an increase in leveraged buy-outs of larger, more established companies and very little investment in new ventures.

Public concern about the scarcity of capital for new ventures prompted another round of regulatory changes in the late 1970s, changing the guidelines for public pension fund investing to include private equity and venture capital investments. The initial impact of these changes was to reinvigorate the new-issues market; its long-run impact has been to encourage pension fund investments in private equity partnerships. The evolution of the limited partnership in combination with favorable regulatory and tax changes led to early notable start-up successes such as Apple Computer, Intel, and Federal Express.

Analysis of the Impacts of Proposed Changes

The ultimate impact of increasing tax rates on carried interest from the long-term capital gains rate of 15% to the ordinary income rate of 35% will be determined, of course, by the degree to which it can be legally avoided by simple changes in the behavior and contractual arrangements among the various parties involved in private equity investing activities. I state this obvious point because many analysts[36] have reached the conclusion that such a tax increase will be largely avoided.

Before we start lynching private equity managers for their likely future (entirely legal) efforts to avoid a tax increase, let's take a moment to ask why it is highly likely that it can be avoided. The reason is simple—*the carried interest profits that Congress is trying to tax actually are long-term capital gains*.

To illustrate this point, if a group of financial investors came together to form a partnership to engage in exactly the same investment activities as today's private equity partnerships, but with no general partner, 100% of the profits from the partnership would be taxed at long-term capital gains rates because that is the purpose of the partnership in the first place. All that today's partnership structure has done is to take a slice of the same

[36] See, for example, Knoll (2007), Weisbach (2007), Kaplan (WSJ, July 25, 2007), and Fleischer (2006).

long-term capital gains and assigned them to the general partner to induce them to contribute their intangible assets—brand, reputation, deal flow network, and experience—to the venture. The fact that limited partners do so willingly, through arms-length negotiations with general partners, serves as a measure of the value that a good general partner brings to the table.

As Knoll (2007) convincingly shows, whether the tax increase raises any revenues at all depends entirely on the nature of the limited partners that make up a partnership. To the extent that limited partners are comprised of tax-paying high net worth individuals, for example, which make up approximately 20% of current private equity assets, taxing carried interest at ordinary income rates would collect no money at all since the increased income to the general partner is exactly offset by the increased deductions for the limited partner. For corporations, which comprise another 20% of private equity assets, the analysis is more complicated but the result is very nearly the same.

For tax-exempt investors, however—the pensions, charitable foundations, university endowments, and foreign investors that make up 50% of today's private equity pool, the story is different. To the degree that general partners are able to pass along the higher tax rate by negotiating higher fees or carried interest, tax exempt investors will not be able to benefit from deducting the additional expense. This points out a glaring truth. The only reason why raising tax rates on the carried interest income generated by a partnership's long-term capital gains is an interesting, i.e., potentially revenue generating, proposition is that tax-exempt organizations have grown to be such large and important long-term investors for the American economy. Increasing carried interest tax rates are, in part, an assault on the tax-exempt nature of these organizations.

If carried interest tax rates can be largely avoided, of course, they are unlikely to be a major problem for the economy or the capital markets. The more important question to ask is what will happen if the tax increase *cannot* be avoided.

The first issue to address is the incidence of the tax—who will bear the burden of any net new revenues collected by the government. The comments in Senator Baucus and Senator Grassley's statements suggested that the higher tax rates they propose can be crafted to fall solely on the (wealthy) shoulders of private equity sponsors without reducing the returns of the pension funds and their retirees or the university endowments and their students, and without any negative effects on capital formation or entrepreneurial activity.

I have even seen a recent study by the Economic Policy Institute, EPI (2007), that claims the proposed tax increase would not harm pension fund returns because "the tax change would apply to hedge fund managers and not investors, " and because "pension funds don't pay taxes."[37] This is beyond bad analysis; it is disingenuous rhetoric. Every undergraduate student learns in their first semester of Economics 101 that the incidence of a tax depends on the elasticity, or price sensitivity, of the buyers and sellers—in this

[37] Dodd, Randall, 2007, Tax Breaks for Billionaires: loophole for hedge fund managers costs billions in tax revenue, EPI Policy Memorandum (Economic Policy Institute).

case the limited partners and general partners—not on who is taxed. If the authors of the study in question were *my* students, I would make them take the course over again.

As every economist knows, the incidence of the tax will be spread across all the players in the story—general partners through lower after-tax gains, limited partners through higher partnership costs and lower returns, beneficiaries through lower pension benefits, and owners and managers of operating companies through lower values for the companies they are working to build. As Steve Forbes pointed out, "raising taxes on private equity doesn't just harm fund managers or investors—it also harms the companies that need private equity investments to bring their innovations to market, which, in turn, makes our entire economy less competitive."[38]

Higher tax rates also harm the limited partners who have massive amounts of their beneficiaries' money at stake. In 2006, the 20 largest pension funds invested in private equity represented 10.5 million retirees, scattered across the country including plans from California, New York, Texas, Florida, New Jersey, Ohio, Pennsylvania and Michigan. Put together, these 10.5 million beneficiaries hold private equity investments that add up to $111 billion. The 20 largest corporate pension plans in 2006, representing 3.8 million members and including AT&T, DaimlerChrysler, Boeing, GE, and TIAA-CREF, have a collective investment of $44 billion in private equity funds.[39] We will address estimates of these costs in Phase II of the study to be completed in October.

The best analysis I have found to date of the amount of additional tax revenues that would be generated by higher carried interest tax rates is the study conducted by Knoll (2007). Using Black-Scholes analysis of the value of the embedded call option on partnership gains implied by carried interest, and a careful analysis of the impact of the tax rate change on each class of investor, Knoll estimates that changing both the character and timing of carried interest income would generate additional tax revenues of between $2 billion and $3.2 billion dollars, or 1.0% to 1.6% of invested capital, *before taking into account likely changes in partnership structure*. This is hardly a bonanza. Accounting for likely changes in the business arrangements between general partners, limited partners, and operating companies, however, erases even these modest revenue gains. If general partners shift carried interest charges to their portfolio companies, for example, Knoll concludes that "the tax savings by portfolio companies will exceed the additional taxes collected from general partners on their carried interest."[40]

In summary, Knoll concludes "It is, thus, possible that there will be little or no net increase in tax collections from taxing carried interests as ordinary income and accelerating taxation to the grant date once the structure of private equity funds adjusts in response."

But what if Knoll is wrong and the proposed tax rate increase succeeds in generating additional tax revenues of $2 billion, $3 billion or more per year, what would be the

[38] Forbes, Steve, 2007, Private Equity, Public Benefits, (The Wall Street Journal).
[39] Private Equity Council, 2007, Public Value: A Primer on Private Equity.
[40] Knoll (2007), p. 18.

impact on the economy? In Phase II of the study, we will produce estimates of likely impact on the economy and the capital markets. At this stage, however, we can say unequivocally that the impacts will be negative for capital formation and growth.

As the 2003 reduction in the dividend tax rate and capital gains rate showed, the principal impacts of changing tax rates on capital income are on values of capital assets. There, reducing tax rates on capital income raised after-tax returns on equities relative to other assets, raising their intrinsic value by more than $1 trillion.

In this case, increasing tax rates on private equity gains will work the same way, but in reverse. Higher tax rates push after-tax returns on partnership assets lower relative to returns on other assets here and abroad. Investors will react to the return gap by redeploying capital away from the lower-return use. This will push the prices of private equity assets—portfolio companies—lower along with the prices of the real estate and other assets held by partnerships and reduce returns for the investors owning the assets at the time. The result will be lower asset prices and less new investment activity, especially in venture capital, private equity, and real estate where partnerships are the dominant form of organization. Over time, lower investment means slower capital formation, slower productivity growth, lower incomes, and fewer new jobs. What is being advertised as a "soak the rich" tax on Wall Street will have its biggest and most damaging effects on Main Street.

The glaring comparison, however, is not between after-tax returns on private equity and returns on other assets in the U.S.; it is between after-tax returns on capital in the U.S. and returns in fast-growing countries like China, where the tax rates on both long-term and short-term capital gains are zero. In the long run, the country with the most capital wins. We should think twice before we give capital owners a reason to move their capital offshore.

Conclusion

Using language of closing a "tax loophole" members of Congress have proposed legislation that would significantly increase tax rates on capital deployed in long-term investments in the United States. They are making a big mistake. Those who would raise tax rates risk undermining America's preeminent position in the world as a leader in invention, innovation, entrepreneurial activities, and growth. Selectively raising tax rates on the long-term capital gains of limited partnerships will drive capital offshore, reduce the productivity of American workers and the ability of US companies to compete in global markets. It will cost American jobs and reduce American incomes. In today's global economy countries have to compete for the capital they need to grow. Raising tax rates on long-term capital gains of US partnerships would hang a "not welcome here," sign on our door.

Meanwhile, foreign governments are waiting eagerly. They have learned that ample supplies of capital are the key to creating the rising incomes and economic growth their people are demanding. They are becoming more capital-friendly every day, changing their tax and regulatory policies to reduce risk and increase returns for foreign investors who bring capital to their countries. They are waiting for us to make a mistake that would drive our capital offshore and into their welcoming arms. Raising tax rates on long-term capital gains for America's partnerships is just the mistake they have been waiting for.

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Biography: Dr. John Rutledge

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Dr. John Rutledge was one of the principal architects of the Reagan economic plan in 1980-81 and has been an advisor to the Bush White House on tax policy. Dr. Rutledge is the Chairman of Rutledge Capital, a private equity investment firm that has invested more than $150 million in middle market manufacturing, distribution, and service companies. He is a member of the Advisory Boards of B.V. Group, a venture capital, hedge fund, and real estate investment firm and First Q Capital, a hedge fund. Active in China, Dr. Rutledge is Chief Advisor for Finance and Investment to the Governor of the Haidian District in Beijing and a visiting professor at the Chinese Academy of Sciences. He is a board member of the Progress and Freedom Foundation, the Heartland Institute, and a senior fellow at the Pacific Research Institute.

Dr. Rutledge has an active lecture practice, giving talks on global economics, capital flows, financial markets, investment strategies, the impact of technology on the economy, and strategies for owning and growing the value of a business. After tours of duty in both academics and government policy, he has started, run, chaired, owned, and harvested dozens of companies, and has managed real money in both mutual funds and private equity.

Dr. Rutledge first introduced his Asset Market Shift framework for analyzing capital markets in *The Wall Street Journal* in the 1980's. Initially controversial, the framework, in which interest rates and other asset prices are determined by private arbitrage behavior, applies a rigorous foundation from thermodynamics to portfolio management. Dr. Rutledge uses the framework to track asset market shifts and develop strategies that attract capital and build wealth, bridging the gap between macroeconomic analysis and portfolio management. Over the past twenty years he has used this framework on economic analysis, asset allocation, portfolio selection, business strategy, restructuring, acquisitions, and divestitures. Dr. Rutledge advises institutional and individual investors how to structure portfolios to take advantage of opportunities created by a temporary divergence of prices from Intrinsic Value. His many advisory and speaking clients include governments, corporations, and financial institutions around the world.

When not traveling the globe, Dr. Rutledge appears weekly on Fox News' Saturday morning business show *Forbes on Fox*. He also appears regularly on CNBC's *Kudlow & Company*, PBS' *Wall Street Week with Fortune*, and CNN's *In the Money*. Dr. Rutledge wrote the Business Strategy column for *Forbes* for more than a decade and writes for *Forbes.com* and *TheStreet.com.* He also authors the acclaimed *Rutledge Blog* on economic and technology issues at **www.rutledgeblog.com**. Dr. Rutledge is one of the principal authors of the U.S. Chamber of Commerce study on telecom reform and has written two books, *Rust to Riches*, and *A Monetarist Model of Inflationary Expectations*, and hundreds of articles for *The Wall Street Journal, the American Spectator, Barron's, Forbes, Fortune, the National Review, the Financial Times, US News and World Report, Business Week,* and other publications. He has testified before Congressional Committees and has advised government officials in the US, UK, Ireland, and Kuwait.

Dr. Rutledge began his career as a professor of monetary economics, international finance, and econometrics at Tulane University and Claremont McKenna College. In 1978, Dr. Rutledge founded the Claremont Economics Institute, an economic advisory business in Claremont, California. He holds a BA from Lake Forest College and a PhD from the University of Virginia. He divides his time between Greenwich, Newport Beach, Maui, and Beijing.

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