AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

PRIVATE EQUITY'S EFFECTS ON WORKERS AND FIRMS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MAY 16, 2007

Printed for the use of the Committee on Financial Services

Serial No. 110–31

U.S. GOVERNMENT PRINTING OFFICE

37–208 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin,
LINCOLN DAVIS, Tennessee
ALBIO SIRES, New Jersey
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
TIM MAHONEY, Florida
CHARLES WILSON, Ohio
ED PERLMUTTER, Colorado
CHRISTOPHER S. MURPHY, Connecticut
JOE DONNELLY, Indiana
ROBERT WEXLER, Florida
JIM MARSHALL, Georgia
DAN BOREN, Oklahoma

SPENCER BACHUS, Alabama
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
STEVEN C. LaTOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, Jr., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
GEOFF DAVIS, Kentucky
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
PETER J. ROSKAM, Illinois
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

CONTENTS

	Page
Hearing held on:	
May 16, 2007	1
Appendix:	
May 16, 2007	29

WITNESSES

WEDNESDAY, MAY 16, 2007

Frank, Dr. Robert H., Johnson Graduate School of Management, Cornell University	15
Lowenstein, Douglas, President, Private Equity Council	12
Luther, Jon L., Chairman and Chief Executive Officer, Dunkin' Brands Inc.	10
Stern, Andrew L., President, Service Employees International Union	9

APPENDIX

Prepared statements:	
Marchant, Hon. Kenny	30
Frank, Dr. Robert H.	31
Lowenstein, Douglas	41
Luther, Jon L.	51
Stern, Andrew L.	55

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Frank, Hon. Barney:	
New York Times article, entitled "Unkind Cut For Janitors At Hilfiger."	63

PRIVATE EQUITY'S EFFECTS ON WORKERS AND FIRMS

Wednesday, May 16, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Maloney, Watt, Meeks, Moore of Kansas, Hinojosa, Clay, McCarthy, Baca, Lynch, Scott, Cleaver, Moore of Wisconsin, Davis of Tennessee, Klein, Wilson, Perlmutter, Boren; Bachus, Baker, Pryce, Castle, Royce, Gillmor, Manzullo, Shays, Feeney, Hensarling, Barrett, Pearce, Neugebauer, Roskam, and Marchant.

The CHAIRMAN. This hearing of the Committee on Financial Services will come to order.

The subject of today's hearing is the question of private equity and specifically the effect that purchases of existing companies by private equity has on the workers and on the firms. There have been a number of concerns expressed about various new forms of activity in the economy, and this committee has had some hearings, and will have more, on the question of hedge funds.

Today, we are talking very specifically about private equity and one special area of concern. I will say, in general that I have not seen any argument that it is a matter for which public policy ought to be concerned as to whether people choose to own a company through a public shareholder method or privately. That seems to me to be a decision that ought to be left entirely up to the people who are making the investments, but we do have concerns about the impact on workers.

The committee, myself and many others, have been concerned for some time about increasing inequality in America. A year ago, we were debating the question about whether wages, real wages, were seriously lagging growth. We were debating inequality. That debate is largely over. There is general agreement that we have increasing inequality and that real wages have, in fact, lagged. There was a period earlier this year when they began to go up. That is now once again in jeopardy. I find the situation in which this country prospers overall, but the increased wealth is enjoyed by a relatively small number of people, to be troubling. It is morally wrong because it takes the efforts of most people to produce that wealth, and it should be shared fairly. No one is talking about equality. We are talking about degrees of inequality. I believe that the case for

being concerned about this excessive inequality goes beyond moral considerations.

There is a big debate in this country now about immigration. There is a debate about trade. We are engaged in the question about how welcoming we should be to foreign investment, direct foreign investment. As more and more Americans have become convinced that economic growth, globalization, and technological change do them very little good, and in some cases, harm, you have seen increasing resistance to the kind of public policies that many in the business community believe are in the interest of economic growth, and until we are able to diminish this trend of increasing inequality, I believe that resistance will grow.

Now, with regard to private equity, I assume that the market is rational and that the private equity method increases value. I do not think people make deals in large numbers for no good reason. The question we have is does any of that increased value accrue to the people who work for the companies. Conversely, there is the fear that, to the extent that private equity is accompanied by significant increases in debt in some cases, this may have a negative effect on workers.

Now, what goes into some of the other concerns we have had in terms of compensation—and we are talking here not about compensation paid by shareholders, which is a matter we dealt with elsewhere, but the compensation that some individuals get when a small number of individuals benefit from a particular deal in the tens and sometimes hundreds of millions of dollars, and, concurrently, workers are laid off. We have a situation which seems, to me, wrong. Now the question then is, well, what are we going to do about it?

It is not clear. There may or may not be public policy implications, but to the extent that there are public policies that have an effect on the private equity situation, some of which would come before this committee, some which would deal with taxation which would come before other committees, and to the extent that we see gross imbalances, then we are going to have to act.

As an example of that, I would ask to put into the record the article from today's New York Times with the headline, "Unkind Cut For Janitors At Hilfiger," which says that one consequence of a $1.6 billion buyout of Tommy Hilfiger is that janitors making $19 an hour were fired to be replaced by janitors making $8 an hour. The Hilfiger Company was bought for $1.6 billion. Janitors show up to work, and they make $19 an hour, union wages. They are fired, and they are going to be replaced by people getting $8 an hour. Mr. Hilfiger got $66 million as the result of the sale and will get $14.5 million a year through 2010. Workers in their 40's and 50's have been laid off with 1 day's notice.

I do not know, as I said, whether public policy can do anything about that, but I do know that this is the sort of pattern that will make many of us determined to do something. So the point is a very simple one. If we have a situation, private equity, where enormous values are created, as apparently they are, and if only a few people get these large sums of money, and the workers are either no better off or worse off, then from a public policy standpoint that seems to me to be undesirable. Whether or not there are public pol-

icy remedies is the second question, but the first question I want to focus on today is whether there is such a pattern.

I must say, and let me say in closing, that in many of the areas of private equity, we are talking about hotel workers; we are talking about service employees in buildings; we are talking about janitors. These are not people who are competing with low-wage workers elsewhere. These are people serving in very low-wage capacities in a market that cannot move.

I think America can do better. Whether or not there should be a public policy response, we will find out, but we might find out with respect to policies involving unionization, taxation, and elsewhere. But the question remains, does the way in which private equity deals go forward exacerbate what is already an unfortunate trend in America for growth to go forward, for wealth to increase, but for inequality to increase even faster.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Chairman Frank, for holding this hearing.

This is the second hearing the committee has held on alternative investment vehicles, and, of course, this hearing is on private equity industry. Private equity is not a new phenomenon. It has been used, at least with some frequency, since the 1960's. More recently, the industry has drawn attention, you could say scrutiny, because of several blockbuster transactions: earlier this week, DaimlerChrysler; and earlier than that, Clear Channel, Sallie Mae, and Equity Office Products, just to name a few.

In 2006 alone, U.S. private equity transactions totaled $406 billion and accounted for 27 percent of all U.S. mergers and acquisition activity. One telling barometer of the growth of the industry is that, in 2001, private equity firms purchased 324 companies. By 2006, that number had more than tripled to over 1,000 acquisitions.

Several factors appear to be driving the explosive growth in private equity. Institutional investors, including public and union pension funds and university endowments and foundations, are turning more and more to private equity investments to generate higher returns for their stakeholders. In addition, publicly traded companies face an environment in which burdensome or overly burdensome regulations result in frivolous shareholder lawsuits and demands of activist shareholder groups, and all of those things have made going private an increasingly attractive alternative. And I think the executive compensation legislation that we considered just a few weeks ago may even accelerate this trend towards private financing if it empowers activist shareholders even more.

Private equity can be a valuable tool for providing capital and expertise to underperforming companies or to companies struggling to generate quarterly growth and meet Wall Street expectations. The overwhelming majority of publicly traded companies are single-mindedly focused on one thing right now, and that is June the 30th, or the end of the next quarter, which is most usually June the 30th, with the second quarter. Are they going to meet or beat estimates? Has the market already accounted for the company's possible growth?

Additionally, taking a struggling public company private gives its managers the opportunity to address strategic concerns free of day-to-day competitive pressures. To improve corporate performance, private equity firms typically recruit top managers often drawn from the ranks of senior management at publicly traded companies and directly tie their compensation to long-term performance and growth, not to short-term stock price gyrations. Indeed, our former Treasury Secretary, John Snow, verified this trend when he described his firm's acquisition of Chrysler as providing "management with the opportunity to focus on their long-term plans rather than pressures of short-term earnings expectations."

We must, I think, support the continued growth of private equity and other alternative investments in our marketplace. An overly proscriptive, rules-based approach to regulation of private pools of capital could stifle the industry and drive private equity firms and their capital offshore or to investments in other countries, potentially compromising the competitive standing of our capital markets.

Concerns have been expressed about the treatment of workers at companies that are taken private, as the chairman did earlier. While I intend to carefully listen to the testimony of today's hearing on this point, it is at least not clear to me at this point that privately managed companies act any differently with respect to worker retention or compensation than publicly traded companies.

To conclude, we have heard anecdotal accounts of differences in workers' wages in private versus public companies—the chairman read one this morning—but we have yet to see any definitive empirical evidence in this area.

Further, we should not automatically concede the premise that taking action to increase efficiencies in a privately held company is always unfair, unwarranted, or not in the best interest of the company. The actions of new management may, in fact, restore a company to competitive health, preserving most workers' jobs that would otherwise be lost, maintaining pensions and providing other benefits.

We must also not lose sight of the fact that, according to a recent study, private equity created 600,000 jobs in the United States from 2000 to 2003. Given the increasingly competitive nature of the global economy, our policy should be to ensure that American public and private companies can survive.

So, in closing, Mr. Chairman, I will look forward to hearing the testimony of the witnesses and to learning more about the ways in which this committee can play a constructive role or if there are ways of enhancing the competitiveness and vitality of our U.S. capital market.

The CHAIRMAN. The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman, and thank you for holding this hearing.

First, I would like to say I am pleased to notice that a constituent of mine is here today to testify, Mr. Jon Luther of Dunkin' Brands, a Canton, Massachusetts-based company, who probably, I think, will offer a positive example of private equity involvement.

I am also very pleased that we are exploring the impact of the growth of private equity firms on the U.S. economy and financial

system. I think it is important that this committee has a solid and accurate understanding of the modern workings of private equity funds given the recent concerns about fund executive compensation, the treatment of capital gains tax benefits on their profits, and also their ability to exploit the debt market to make those profits, sometimes to the detriment of companies and their employees.

I am going to be interested in a number of questions, but one of those is related to the modern-day private equity investment framework and how does it differ from the corporate raiders and leveraged buyouts of the 1980's given that the same big names are still involved.

Also, I think this committee, which recently held a hearing regarding hedge funds, would like to know what the difference in investment strategies is between the two. That is the private equity firms—a more long-term strategy or a more short-term, such as the hedge funds have exhibited. I think the common connector seems to be making a profit, and there seems to be a lot of industry overlap these days.

The second issue that I will raise regards the pensions and benefits of the workers at the companies that are acquired by private equity firms. Yesterday's Wall Street Journal said that Cerberus, which has announced its takeover of DaimlerChrysler, has pledged to work with the UAW, and I am a former employee of the General Motors Corporation at their plant in Framingham, Massachusetts, so I have a particular interest there; but they have assured the UAW that the $18 billion owed to autoworkers, my brothers and sisters, in benefits will still be honored, and they refer to this deal as a watershed moment for the private equity industry in global finance dealings. I would like to have confidence in that, and perhaps the panelists can sort of expand on that concept if they are able to.

My third issue that I would raise is regarding the pension funds that invest in private equity firms. Mr. Lowenstein mentioned in his testimony that millions of retirees are benefiting from private equity investments through their pension funds, and that pension funds have at least $111 billion invested in private equity. I would like to hear a description of the allure in private equity investments and what are the benefits specifically to pension funds and being involved.

Those are the issues that I would like to raise in a general sense, Mr. Chairman, and with that, I yield back.

The CHAIRMAN. The gentlewoman from Ohio is recognized for 3 minutes.

Ms. PRYCE. Thank you, Mr. Chairman.

Thank you to our panel for being here today.

Already this year, 33 U.S. companies worth $160 billion have made equity buyout deals. The Chrysler deal serves as an example that private equity can go anywhere, even buying the most symbolic of American brands. Hitting close to my home, Limited Brands, based in Columbus, Ohio, announced yesterday that they would sell off their Express line to a private equity firm, Golden Gate Capital.

The timing of this hearing could not be more appropriate. Thank you, Mr. Chairman, for holding it. The maintenance of our capital markets is paramount to our continued economic growth.

I want to thank our witnesses for helping us demystify a market that has become an increasingly important source of funds for public firms seeking privatization, for companies in financial distress, for start-up enterprises, and for companies looking to spin off parts of their operations. There are often short-term losers with job losses tied to the public companies that had, for perhaps too long, delayed badly needed restructuring, but long term, a healthy, growing private company is better than a stagnant, underperforming public one, for the investors, the employees, and the economy.

Mr. Chairman, I think we should be focusing some of our energy on what is making it advantageous for these companies to go private or, to put it another way, what is making it disadvantageous for companies to be public. Going private frees companies from the short-term pressures of the stock market, and as the U.S. Chamber and others have pointed out, quarterly earnings per-share statements are a centerpiece to this problem. Companies often sacrifice, creating long-term value if it means missing quarterly earnings' projections. Even if they believe that the cuts are destroying business value over the long term, they are not investing in things in which they should be investing. We should be focusing on decreasing the regulatory burden on public companies, not increasing the burden on private equity.

I want to thank the witnesses once again and the chairman for having this hearing, and I yield back.

The CHAIRMAN. The gentleman from Louisiana is recognized for 5 minutes.

Mr. BAKER. Thank you, Mr. Chairman. I appreciate the interest in the matter in calling the hearing.

Although there is really no clear definition of "private equity," there are some characteristics of funds which I think are important to point out. Although sophisticated investors, those with a net worth in excess of $1 million, are certainly participants, it is financial institutions, insurance companies, mutual funds, and pension funds that provide the overwhelming bulk of the financial resources deployed by private equity. So, when we are contemplating regulatory constraint, we need to realize it is not just millionaires we are going after in this case, it is the CalPERS pensioners—by the way, CalPERS holds direct investment in private equity funds—and millions of others who, either through mutual fund investment or pension funds, have a share in the profits of private equity.

I was surprised to learn that in households with average annual incomes of $35,000 or less, 18 percent are invested in mutual funds—who would imagine?—and that if those families want to improve their quality of life, it will come through the democratization of investment opportunity.

As an example, Power Shares lists this morning in SmartMoney.com that they, by fall, may be a new ETF that will allow individuals to buy shares in an index that follows a benchmark of 30 traded private equity companies, companies that invest in private equities. This is similar in operation, I understand, to

hedge funds, which offer the same opportunity to individual investors.

So, in the search to help working people, we need to be very careful about how fat we make this regulatory book. It may fall right on top of them and deny them the opportunity to share in economic growth. Well, how big is this thing? Private equity investment in 2006 was just over $400 billion. That compares with $1.1 trillion to hedge funds in a single period. Although big, the two together are the source of enormous liquidity in a highly competitive international marketplace.

Hedge funds are going to act very quickly. They are going to see imbalances in the market, whether overpriced or underpriced. They are going to move, bring about market discipline, and get out. The churn rate for hedge funds is typically about 9 months. Where private equities are different is that they buy into the company and bring in management sometimes, and it can be there for 2 or 3 years. For them to turn their profit, it means the underlying economic value must be improved, and the company itself must grow and prosper. This is not just about squeezing just a little inefficiency out; this is about providing jobs that otherwise might disappear. So, in engaging about concerns over workers' fate, often it is better to have a healthy company grow over time than it is to let a staggering company fall under the weight of its failed economic model.

So what happens if the U.S. rulebook is unreasonably fattened? There is a high probability that money will go elsewhere. The view that we are an economic island from which there is no escape is a very limited view of the world. London, Bombay, and Hong Kong are experiencing extraordinary growth. I have heard many members of this committee concerned about London's passing New York as the primacy trading location for securities. The private equity firms in India enjoyed a 21 percent rate of return on equity last year. India passed China with $1 trillion, $239 million of private equity investments last year, and they, India and China, are modifying their rulebook to make their investment world all the more attractive to potential investors from the United States.

So we need to be very careful about how we act here. The Dow Jones Index of India, called CNX, is up 42 percent year over year. This is not an illiquid, overregulated market from which people are saying to outside investors, "Do not come." Instead, they are saying, "Come on down. Bring your money and your suitcases. We will make you a nice hotel room offer, and you can stay here for as long as you like."

How does that contrast with a market discussion where we are contemplating restricting the rules that enable smart people to deploy important resources to help grow our economy?

You know, we need to go slow. Maybe we need to go really slow, or maybe we do not need to go at all. Maybe we need to just watch for a while and make sure we understand market function before we unintentionally take it backwards in an enormous step.

Said another way, sometimes in Washington, people see a profit. So, first, they regulate it. If that does not stop it, then they tax it, and if that thing is still going, then they sue it. It is the three-step recovery plan to profit in America.

I think we need to get past that. I think we need to realize that working families, employed by companies, will change jobs, and new opportunities will come, but investing in the corporate growth for the long haul, not the next 10 minutes, is what grows value. That is what builds wealth in American families, and that is what American workers need.

The CHAIRMAN. The gentleman from California, for 4 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Chairman, I also want to thank you for holding this hearing to examine the effect that private equity has on the U.S. economy.

Recently a great deal of attention has been focused on private equity due to the increased role that it is playing in the capital markets, and I understand the committee's interest in exploring this topic. I am very concerned, though, that statutory exclusions from Congress are unwarranted. It could be very dangerous for the economy, and I think we have had some very cogent arguments from Congressman Baker. I am going to add a few additional points to this that I think we should be concerned about.

If the goal of our hearing today is for Congress to have a better understanding of this recent boom that we are seeing in private equity, then we should be asking ourselves and we should review some of the failings of our public equity markets.

For example, what is driving money out of the public into the private equity markets? One is the Sarbanes-Oxley legislation, frankly, coupled with abusive shareholders' lawsuits, and that has created a terrible operating environment for many firms in this country. Companies have become more risk-averse, resulting in less investments and new business ventures. Of course, this means fewer opportunities for employees and an inefficient capital structure for investors.

In my view, private equity is playing an important role in our financial system. As we have seen in recent years, private equity firms provide stagnant corporations with a viable alternative to public markets in a public market right now that is beset with enormous costs when associated with Sarbanes-Oxley. Private equity provides growth capital to these corporations, which frequently results in a properly capitalized corporation, which frequently means more investments in employees, and usually means the development of new business lines for that company.

In conclusion, I believe the presence of private equity is an important component of our financial system, and any attempt to regulate the industry will be harmful to our capital markets and to our economy as a whole.

Again, Mr. Chairman, I would like to thank you for exploring this issue today, and I look forward to hearing from our witnesses.

The CHAIRMAN. I thank the gentleman.

We will get to the witnesses, but I do want to ask one more question.

People may hear something that sounds like the gavel. It will be my cast inadvertently knocking against the wall. If you do not see the gavel, ignore the noise.

With that, we will begin with our witnesses. We will begin with Mr. Andrew Stern, president of the Service Employees International Union.

STATEMENT OF ANDREW L. STERN, PRESIDENT, SERVICE EMPLOYEES INTERNATIONAL UNION

Mr. STERN. Thank you, Mr. Chairman, and members of the committee. My name is Andy Stern, and I am president of the largest union, the Service Employees International Union, CTW, CLC.

The story of America's success is a story of work and working people. The greatness and promise of America has always been that if you work hard, you will have your work valued and rewarded. America's gift has been that every generation has done better than the previous one, but we are now at a moment when the promise of the American dream is in jeopardy.

A majority of Americans, sadly, say that they believe their children will actually be worse off than they are, and the facts are beginning to prove them right. People are working harder and harder for less wage increases. Opportunities are disappearing for access to jobs leading to the middle class. This is happening during an unprecedented period of prosperity in America. Some even have named it America's new, "Gilded Age." We have the highest rate of income inequality in this country since the Great Depression. Productivity is up, but wages are down. Profits are up, but Americans have less healthcare, less savings, and less stock ownership than they had the year before.

Private equity, as Steven Pearlstein wrote today in the Washington Post about the Chrysler deal, has become, "the most powerful force in business and finance." Today, private equity is buying and selling larger and larger companies and reshaping whole industries. It is engineering financial deals on a scale that, until a few years ago, seemed unimaginable. But the real story of private equity is the incredible wealth being created amongst its partners and the incomes being accumulated as a major contributor to the concentration of wealth amongst the top 1 percent of all Americans.

Private equity activity is raising significant concerns about the impact on workers, on companies, and on the financial markets. First, there is the increasing practice of quick flips and sell-offs that undermine the industry's claims that it seeks to promote long-term business growth. When private equity firms work with the managers and directors of companies that are targeted to buy and then offer those managers and directors ownership stakes in the new private company, it raises all kinds of questions of conflict of interest. And in discussing the conflicts between the banks and the private equity firms, the vice chairman of Morgan Stanley said, "We are totally conflicted. Get used to it."

We have seen the problems of the economic exuberance of Enron and high-tech industries in the past. As some of the experts have said, even if one major deal fails, there is very serious concern raised about its impact on the credit markets, on investors such as pension funds, and not least of all on the workers of the affected companies.

In terms of the workers, these risky deals at times put workers and companies at risk when high debt levels involved in buyout deals and high fees can create pressures to cut costs that are counterproductive to the stated goals of private equity firms to create long-term value and productivity. There are concerns about trans-

parency and disclosure and concerns that, obviously, not everyone is sharing in the success of these deals.

For all of the hundreds of millions of dollars of fees and billions of dollars of profits taken out of these deals by private equity firms, the workers at most of these companies have seen no increases in benefits and no increases in wages. If we had just taken the $4.4 billion in fees paid to the private equity firms in the 10 largest buyout deals, just the 10 largest buyout deals in the last 2 years, we could have paid for family healthcare for over 1 million American workers. You do not have to take my word for it. As the chairman said, look at what financial leaders and experts are saying about the private equity economy.

But here is the opportunity. The opportunity is we are creating value. The question is, are we sharing in the value? For working people today in the private equity world, there have been far more misses than hits in the private equity buyouts. There have been far more fees raised than paychecks raised. It would be best if the industry made its changes itself and took steps to self-regulate to make sure that private equity did work for working people in the rest of the country.

For workers in communities, the industry should also be expected to play by the same set of rules as everyone else. We should eliminate the conflicts of interest. If unions exist at a company being bought, like Chrysler, they should be at the table as soon as possible, and if no union exists, the private equity firms should make sure that workers have the right to form unions. But the private equity firms will not self-regulate, Mr. Chairman, or take their own steps to change, and we think it is necessary that Congress legislate.

America has been at its best when a broad group of people have shared in the prosperity being created in the economy. We have gotten away from that in recent years. The greatest country on Earth can do much better to make sure that everyone shares in the success and in the prosperity that workers help create. There is more than enough wealth in the buyout business for private equity firms to continue to prosper, while also adapting their existing business model to expand opportunities for communities, workers and our country. The incredible wealth that exists in the private equity buyout industry presents an historic opportunity. It is an opportunity to repair the American dream.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Stern can be found on page 55 of the appendix.]

The CHAIRMAN. Next is Jon Luther, the chairman and CEO of Dunkin' Brands, Inc.

STATEMENT OF JON L. LUTHER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, DUNKIN' BRANDS INC.

Mr. LUTHER. Thank you, Chairman Frank, and members of the committee.

As you mentioned, my name is Jon Luther, and I am the chairman and chief executive officer of Dunkin' Brands. Dunkin' Brands is the parent company of Dunkin' Donuts, Baskin-Robbins, and the

sandwich brand out West called Togo's. I appreciate this opportunity to share with you the Dunkin' Brands' experience with private equity ownership.

Our talented team of executives and employees, together with our thousands of franchisees and licensees, predominantly small businesspeople, has built a $6.4 billion enterprise operating in 47 States and in 50 countries. Thanks to their effort and commitment, our brands are known and loved by consumers around the world.

When I joined Dunkin' Brands in January of 2003, we were owned by Allied Domecq, a publicly traded spirits and wine company headquartered in the United Kingdom. In November of 2005, Allied Domecq was acquired by Pernod Ricard, another spirits and wine company, based in France. Shortly thereafter, because Dunkin' Brands was perceived as a noncore asset of Pernod Ricard, Pernod put our company on the auction block for sale. In March of 2006, we were acquired by a consortium of three United States-based private equity firms: The Carlyle Group; Bain Capital Partners; and the Thomas H. Lee Partners.

During the period when we were an Allied Domecq subsidiary, we were considered, for lack of a better term, a "cash cow." We were assigned yearly growth targets. We were usually last in line for attention, and certainly for capital to fuel our growth. Significant decisions required that I go to London. Our cash was swept every night, and our focus was usually on the next quarterly numbers. Our acquisition by Carlyle, Bain, and Thomas H. Lee has liberated our company. Our new owners expressed confidence in our management team, our leadership, our strategies, our vision, and our values.

Our three goals are to take Dunkin' Donuts national over time, transform Baskin-Robbins into a neighborhood ice cream shop once again, and to expand internationally, but rather than tell us to change our goals and our plans to achieve them, our new owners ask how they can support and how they can fuel our growth.

Finally, we had the attention and the resources that we needed to realize our goals. The benefits of our new ownership to our company have been enormous. Their financial expertise has led to a groundbreaking securitization deal that has resulted in very favorable financing at favorable interest rates. This has enabled us to make significant investments in our infrastructure and in our growth initiatives. In addition, they have helped us create new franchisee financing programs that provide flexible, convenient, and competitive financing options to our franchisees, those small businessmen and women of every size in all of our markets. They have opened the door to opportunities that were previously beyond our reach.

For example, they have introduced us to a real estate development firm that is assisting our Baskin-Robbins growth and are finding great real estate opportunities. They have done so well that we are now considering using them for our Dunkin' Donuts growth and development as well.

Our acquisition and the expansion plan for which we now have the resources have put us also in the national spotlight. Countless news stories about it have caused us to be sought out by many new

potential franchisees, small businessowners, and also new employees who want to join our company.

As a result of our franchising efforts, the engine for our growth has taken off. We are a 100 percent franchised enterprise. Every Dunkin' Donuts, and every Baskin-Robbins, store represents the achievement of a dream for an entrepreneur somewhere in America. A new Dunkin' Donuts means approximately 25 to 30 jobs per store, and a new Baskin-Robbins means approximately 12 to 15 jobs. Over the next 15 years, because of this growth vehicle we now have, you can expect 250,000 jobs, jobs for young people, and jobs with good career paths in restaurant management, making it possible for others to achieve the American dream.

Our new owners have never asked us to cut costs or to reduce our head count. Any reductions in staffing that we have had over the past 4 years have been as a result of our efforts to be more productive and more efficient. This year we expect to divest of Togo's, our west coast brand, because it generated only $200 million in annual system sales, and this decision we had considered prior to our new ownership because we wanted—because of its size, we wanted it to have the same attention that we were getting from our new owners, and we could not do that while focusing on our two larger brands.

You know, recently I was asked by a Boston Globe columnist whether Dunkin' Brands would follow the path of many companies and move to a location where the cost of doing business would be lower. I was pleased to say, Mr. Chairman, that Massachusetts is our home. We are not going anywhere. I have 700 or 800 families who work for Dunkin' Brands who rely on us for their employment. We believe in those strong community roots, and last year, together with our franchisees, we established the Dunkin' Brands Community Foundation, and we have given $1 million to that foundation out of our pockets, with no resistance from our new owners.

The mission of our foundation is to support those who serve our communities, especially in times of crisis, and this mission is true to our brand heritage and the values of the entire system, employees, franchisees, and our customers.

In conclusion, as a result of our relationship with Carlyle, Bain, and Thomas H. Lee, our business has benefited. Our franchisees and employees have benefited, and wealth-creating opportunities have been spread among hundreds of entrepreneurs and careerists associated with Dunkin' Brands.

Thank you.

[The prepared statement of Mr. Luther can be found on page 51 of the appendix.]

The CHAIRMAN. Next is Mr. Lowenstein, who is the president of the Private Equity Council.

STATEMENT OF DOUGLAS LOWENSTEIN, PRESIDENT, PRIVATE EQUITY COUNCIL

Mr. LOWENSTEIN. Thank you, Mr. Chairman, and members of the committee.

The Private Equity Council represents 10 of the leading private equity firms in the world, and we are pleased to be invited to par-

ticipate in the beginning of this dialogue with this committee on private equity.

Before addressing the issues that the committee has raised, I think it would be helpful to just take a brief second to demystify private equity, because private equity is about hundreds of thriving companies contributing to the economy in numerous positive ways. You just heard that if you get a cup of coffee at Dunkin' Donuts, you are interacting with private equity. When you see a movie produced by MGM Studios, and then buy pizza for your kids afterwards at Domino's, you are interacting with private equity. When you buy a new outfit at J. Crew, or you buy toys for your kids at Toys-R-Us, you are interacting with private equity. When you watch a movie or a sporting event at home, or when you use your cell phone, the chances are you are interacting with a semiconductor chip produced by a private equity-owned firm.

Furthermore, private equity investments directly and indirectly benefit tens of millions of Americans. As we have heard this morning, public and private pension fund foundations and university endowments have chalked up returns from private equity investments that far exceed those available from the stock market.

Between 1991 and 2006, private equity firms worldwide have distributed $430 billion in profits to these and other investors. That is $430 "billion" with a "b." These returns translate into stronger public employee pension programs, more funds for college financial aid and scholarships, and more funds for research and other causes supported by charitable foundations. Private equity, indeed, is about a lot more than enriching a handful of people.

Let me turn briefly to address a few of the questions that the committee has asked about. First, do private equity firms invest in the businesses they own and operate? Well, we have some examples in our testimony which are, I think, quite typical of private equity practices.

Sungard, for example, the software maker, has invested in its business. R&D projects since the private equity firm took ownership are up from 10 to over 50 today, and employment has grown by 3,000 people since the acquisition by private equity. Axel-Tech, with a 37 percent job growth and a 16 percent sales growth since the private equity firm acquired the company and the company moved into a new line of business, builds suspension systems and axles for vehicles, and it moved into servicing the United States military, which needs heavier suspension systems for the heavily armored vehicles serving our troops in Iraq, and Axel-Tech was a maker/supplier of those suspension systems. ITC Holdings, a Michigan utility, has seen private equity help grow the business, with job growth from 28 at the time of acquisition to 230, and capital spending up from $10 million to $200 million annually.

These are not the exceptions in any of these examples. You must understand one central fact about private equity which often gets lost in all of the rhetoric and debate. They only succeed if they improve the performance and increase the value of the companies in which they invest. The entire business model rests on selling investments at a gain. Firing workers and stripping assets is hardly the best way to show future buyers that you built something of greater value.

The second question raised by the committee concerns the impact of private equity on working men and women. Aside from case studies, which I think are helpful evidence of the impact, and there are hundreds more like it, it is true—data on private equity investments' impact on employment in the United States is, in fact, anecdotal at this point, but research in Europe does suggest that private equity investments do, indeed, result in long-term job growth. A study by the international management consulting firm A.T. Kearney found earlier this year that private equity firms worldwide generate employment on average at a much faster pace than comparable traditionally financed firms.

That said, the simple truth is that, as with any other acquisition involving a public or private company, private equity transactions can and do sometimes result in layoffs. In some cases, the most affected employees are the management level, and in other cases they are not. In some cases, the layoffs may eventually be offset by new hires over the long term when business grows stronger. Nor should we lose sight of the fact that even when there are layoffs, the willingness of the private equity owner to even acquire and invest in a troubled firm probably results in the savings of jobs that might otherwise have been lost.

There is no one-size-fits-all pattern to private equity. There is no pattern of busting unions and laying off workers in private equity. It is simply not there. By the way, these limited partners are pension funds, public employee pension funds, and I ask you: Does common sense tell you that if they saw private equity firms gutting employees and gutting workers that they would really continue to support this asset class the way they have?

The final area of interest to the committee is the impact of private equity on income inequality. Undeniably there are those in private equity who do very well. Equally undeniable is the fact that we have an income inequality problem in this country. Private equity is not the reason American companies and workers are under pressure or why wages and benefits are stagnant; these are based on pervasive global forces at work. Private equity alone cannot and will not and should not redress the income disparity problem in this country. That requires national will and national policies, and we are prepared to be part of any effort to attack that problem cooperatively and creatively either with government or with the SIRU and others in organized labor.

At the same time, I believe that ensuring the firemen and teachers of the income they expect when they retire or that kids get scholarships to college they might not otherwise have gotten suggests that private equity does more than just distort income disparity at the high end. I noted earlier the $430 billion in profits to limited partners and how these flow to average Americans, but let me give you one very concrete example.

The excess returns generated by private equity investments by the Washington State Investment Board for over 25 years has been $26,000 per retiree. Put another way, these returns have fully funded retirement plans for 10,000 WSIB retirees.

In sum, private equity makes significant contributions to the American economy. It is innovative and flexible. It is not a silver

bullet, but it is a part of the system, and it is a good part of the system.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Lowenstein can be found on page 41 of the appendix.]

The CHAIRMAN. Dr. Robert Frank.

STATEMENT OF DR. ROBERT H. FRANK, JOHNSON GRADUATE SCHOOL OF MANAGEMENT, CORNELL UNIVERSITY

Dr. FRANK. Thank you, Mr. Chairman. I am grateful for the opportunity to speak to you today about the consequences of the broader inequality problem.

I am an economist at Cornell University. I have been writing about the causes and the consequences of rising income inequality for the past several decades in books, including "The Winner Take All Society," "Luxury Fever" and, next month, "Falling Behind: How Rising Inequality Harms the Middle Class."

Much of the testimony you have already heard. I think private equity is part of a whole complex of forces that have made the U.S. economy much more competitive in the last several decades. One consequence of greater competition is that money tends to flow to the players that have the greatest impact on the bottom line. If you look at Jon Luther, he is a perfect case study of how high rewards at the top of the corporate ladder are not primarily, as many people seem to think, a result of corporate malfeasance, vivid cases to the contrary notwithstanding. Typically, somebody who is in charge of a big organization and who is making good things happen needs only to make 2- or 3 percent better decisions in a year's time in order to have an impact on the bottom line of tens of millions of dollars. So, if the economy is getting more competitive, the expectation is that the rewards will flow to individuals who can make that happen. That is just the way the market is.

The market produces a bigger pie. No economist ever claimed that the market guaranteed that a bigger piece of pie would automatically go to every person as a result of greater competition. Even though people in the middle have slightly higher incomes than they had before, one of the practical consequences—and here, I agree with Chairman Frank that we have to focus on the practical consequences of inequality rather than the moral ones if we want to see anything done about it—of higher incomes at the top is that people in the middle will have a much harder time meeting basic middle-class goals.

Let me describe quickly a process that I call "expenditure cascades." People at the top have vastly more money than before. People of middle income do not seem offended by that. That is one of the nice things about the United States. People are not jealous of the success of the rich. People at the top are spending more because they have more money. People just below the top are influenced by their spending. Maybe it is now the custom to have your daughter's wedding reception in the home rather than in a rented club, so you need to build bigger. People just below those just below the top build bigger in response to that, and so on. Now the median house newly constructed in the United States is about a third bigger than it was in 1980.

The rub for the middle-class family, which has no more real income now than in 1980, is if you do not buy the median-priced house for your area, your children will go to below-average schools. That is the way it works. So the median family is forced to save less, work more, commute longer distances, and work longer hours, in short, to be squeezed on every margin in order to meet the minimal goal of sending their children to a school of average quality. There is no pretending that this is not a genuine burden on the middle class.

If we are to do something about this, it is a fool's error to castigate corporate pay boards for not showing individual restraint. There is no such thing as individual restraint in a perfectly competitive system. You pay the market rate, or you do not get the talent that you need to be able to compete successfully. The only lever we have is tax policy in this arena if we are not happy about the way income distribution changes have been going. Most countries that have rising inequality have attempted to lean against it by increasing tax rates on top earners and increasing benefits for those who have been failing to keep up.

For some reason in this country, we have moved in precisely the opposite direction by reducing tax rates at the margin for top earners and cutting the social safety net. This is a testament, I think, to the mysterious power of trickle-down theory, that if we cut the taxes on the top earners, we will somehow cause the economy to grow much more quickly. I do not have time to go into it in detail, but it has been widely discredited by economists of all political persuasions. Bruce Bartlett, in The New York Times last month, said that it is time for the supply-side economists to stop saying that tax cuts for the rich generate increases in tax revenues.

So, again, I think there is no indictment of the people who are reorganizing businesses to make them more competitive and generate expansions in profits, and there is nothing morally improper about their being paid the going rate. There is, however, something morally questionable about a society that allows people's fate to hinge solely on market outcomes. That has never been a prescription for a sound society. Societies that have tried that in the past have failed to prosper in the long run. Even the rich, the ostensible beneficiaries of tax policy in recent years if you reckon the consequences of those tax cuts, have actually been harmed by them.

The tax cuts have enabled the rich to build bigger houses. What we know now is that, when everybody builds a bigger house, that just redefines the standard for what constitutes an acceptable dwelling. So you have more money after taxes, and you build larger. No gain. It is not really a tax cut. It is a loan financed by borrowing from China, Japan, Korea, and other nations that will have to be repaid in full with interest. In the meantime, we have been cutting the Energy Department's project for rounding up loose nuclear materials in the former Soviet Union. We have been cutting back on a whole array of public services. This is not intelligent public policy. I think, in another 50 years, people will look back and say, "What on Earth could they have been thinking to do that?"

[The prepared statement of Dr. Frank can be found on page 31 of the appendix.]

The CHAIRMAN. Thank you.

Let me begin by asking Mr. Stern: There is a lot of top equity. We have talked about this, that there are acquisitions, office buildings, hotels, and places that employ a large number of workers. We are not competitive with manufacturing workers elsewhere. Dunkin' Donuts would be the same.

One of the things that concerns many of us has been the hostility to unions, and I am just wondering what your experience has been, and I would say people are ready to talk about it. I would say for many of us—and obviously, there is a difference between parties on this—but the unions do seem to be one way to deal with this without government intervention, collectively bargaining for chambermaids and janitors, and this is a new class of people. These are the people who sit in the lobbies of office buildings and make me show them my driver's license so that I will not blow up the building. I do not know if that works very well, but it does not pay a whole lot, and that is probably the best job we have had since the WPA.

What has been your experience in terms of trying to get collective bargaining agreements with these new owners?

Mr. STERN. Well, first of all, I should say in response to the broader question, there have only been three ways we have distributed wealth in America historically: one has been the market, which as Alan Greenspan is saying is no longer working; two has been the government; and three has been unions. You know, unions are just a way to distribute wealth and end inequality. So, when you see a purchase like Cerberus, as Congressman Lynch said, you are glad the union is at the table, because you wonder what would happen if they were not.

And so I do think there is an issue here of how, not through government regulation, but by private activity that goes on. I would say, you know, the private equity people have to make a decision of whether they are going to proceed in a way that too many employers have been proceeding as owners, which is to not let workers make a free and fair choice about whether they want to have an organization.You know, that is a conversation we would love to have with a new owner.

The CHAIRMAN. What has your experience been?

Mr. STERN. There have been no better than the private equity field, but there is now a growing—they are much more involved in the economy today, and so we are going to get to see again, you know, as they go from owner-distressed companies to very successful companies like Equity Office Properties or—you know, how they are going to behave as the new owners. Time will only tell, but so far there is no difference.

The CHAIRMAN. Let me ask you. I do want to make one comment, and that is that one of the things we hear is that, to the extent that, for instance, we did our executive compensation bill, and to the extent that there were concerns about the compensation of the CEOs of public companies, that becomes an incentive for them to go into private equity. I must say that is the most serious attack on the morals of those people that I have ever heard. What it says is that they are so concerned with their own pay that they will make a fundamental decision about the form of ownership. It is the notion that someone is running a public company with his or her

obligations to the shareholders who says, "I can make a lot more money if I sell out my shareholders and go to private equity," and that would be a motive for making a change. I am shocked that people would think so ill of these people.

Now let me ask Mr. Lowenstein. I agreed when you said that private equity did not cause this, but sometimes there are opportunities for the inequality, and I appreciate your acknowledging it. You say that private equity would be willing to participate in the dialogue. Let me ask, for instance, with regard to unionization, is there any general principle, is there any kind of general predisposition one way or the other? I must say, if we saw that there was some willingness to enter into those kinds of agreements, that would be relief for a lot of us.

Mr. LOWENSTEIN. Well, I think it is difficult, obviously, for me to speak in the context of, you know, hundreds of deals and transactions that are being done involving dozens and dozens of private equity firms.

My sense in the little time that I have been involved with this sector is that there is an openness to meeting and to talking with people from a variety of different stakeholder groups, including organized labor. There is no sort of antilabor, antiunion bias in private equity. There are plenty of private equity companies where union employees are a central part of the business, and those jobs have grown as part of the basic business plan. So, beyond that, I think it is difficult for me to generalize other than to, as we have in recent weeks, make clear that we are more than open to opening constructive and cooperative discussion with all stakeholders on these kinds of issues.

The CHAIRMAN. Well, I appreciate that. My time is up. I do think, from the standpoint of many of us workers, particularly, frankly, low-wage workers in some of these occupations, they are a particularly important group for stakeholders, and it does seem to be—you say you are prepared to enter a dialogue. Some concern for the workers sharing in this value created would be very helpful.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, I saw and the members of the committee saw a "Dear Colleague" that the chairman sent out yesterday.

It says, "Dear Colleague, I appreciate the concern expressed by many about why my arm is in a sling. In order to avoid having to repeat the same conversation, I am sending out this 'Dear Colleague.' I ruptured a tendon in my left arm using a curling machine in the gym, and had it surgically repaired yesterday at Bethesda."

My staff went to that gym, found the curling machine, and found that it was manufactured by a private equity company. Now, we all know why we are here. His arm will be out of a sling in a week or 2, and we can maybe put the focus on something else.

Mr. LOWENSTEIN. Perhaps it was a stronger curling machine than one made by a nonprivate equity firm.

Mr. BACHUS. All right. Mr. Luther, I noticed as I was reading the history of Dunkin' Donuts that it seems like, since it has been taken private, the number of franchises has expanded. Has being

owned by private equity investors been something that is financing that, or has there been a change in corporate policy?

Mr. LUTHER. Yes. Under the Allied Domecq regime, and shortly with the Pernod Ricard regime, they would sweep our cash every day to fuel their wines and spirits business. Our good cash generated—our good cash flow would go to them to build a Beefeater gin brand. For example, since private equity and since the ownership, they focus on our growth and enable us to go forward, meaning that they invest in infrastructure, which is something that we were not able to do before, meaning our IT systems and technology, so we can remain competitive with our competitive segment. Because of their brilliance in financing and the financial world, it has enabled us to put a program together, a franchisee financing program, which is more convenient for them to apply so they can build these stores to add the jobs and to get in these communities and do good work, and if it were not for their great expertise in that area enabling us to do that, our franchise system would be slower in growth, and that is important. Since we are 100 percent franchised, obviously that is the engine for our growth, and one of the most important attributes to our business growth.

Mr. BACHUS. So your private owner sponsors actually help finance these franchisees?

Mr. LUTHER. No. They have aided and abetted us to work with outside financial firms to get better favorable rates by their better understanding of financial aspects, and perhaps we get too close to it sometimes, but for this outside influence to come in and educate and coach us in those areas, it has benefited us greatly.

Mr. BACHUS. I will ask this to anyone on the panel. Back in the 1980's, we had corporate raiders, and we had the LBOs. As to private equity investments, how are they different from that, or is there a difference?

Mr. LOWENSTEIN. I will take the first crack at that.

I think there are a number of differences today than 20 or 30 years ago. For one, in the early days of private equity, the lending typically would come from a single lender, the debt levels in a transaction would typically be at the 90 percent level, maybe even higher, and the transactions were much more tied to asset sales as a way to quickly repay the debt to make the leverage play work. Today, you have a lot of differences.

First of all, the typical debt level in recent years in private equity transactions has been hovering around 40 percent—I am sorry—equity levels are around 40 percent, so up considerably. There is a lot less leverage in the transactions. Secondly, the level of due diligence of private equity firms today compared to 20 years ago is quantumly farther along than it was then, and even the simple technology available to do effective analyses of the investments and so forth is far better. Sometimes it takes private equity firms 2 years before they actually make an acquisition, so they raise funds, but they are not investing all of their funds immediately.

I think you also have—the other critical point is that we are at the point where the way today that you make money in private equity is not by an asset sale, because, in a sense, everybody knows what the assets are, and they are priced into the deal. These are all auctions. They are competitive processes. If you are going to

grow a firm, you have to grow it with operating improvements. That is a big change from the way it was 20 years ago, and so the value creation comes from investment, from growing, from improving operations in the management of the company. So I think those are some of the major changes.

Mr. STERN. I am not as familiar with all of the details, but I do want to read to you what the founder of The Carlyle Group says, which I know we talked a lot about value and decisionmaking, but he says, "The fabulous profits that we have been able to generate for our limited partners are not solely a function of our investment genius, but have resulted, in large part, from a great market and the availabilities of an enormous amount of cheap debt. Frankly, there is so much liquidity in the world financial systems that lenders, even our lenders, are making very risky credit decisions," and I think that is a very big difference from the 1980's.

Mr. BACHUS. If they are paying top dollar, of course the shareholders are all benefiting from these sales, I would think, and then the private equity investors—I mean, if they pay top dollar, and they still make it work, that seems like a win-win situation.

Mr. LUTHER. Just to weigh in, my experience is that there has been a lot of equity put into our deal, so it is not leveraged quite as it was in the 1980's. I think a significant difference for me in being in this industry for a while, meaning my industry, the restaurant industry, and watching what happened in the 1980's as compared to today is the fact of Carlyle, Bain, and Lee. During our auction process, we were engaged with maybe 25 of these firms that were in the auction process. They looked at the leadership. They looked at the management. They looked at organic growth as opposed to ways to cut their way or to save their way to success. They looked at all of those organic pieces—management values. What kind of leadership values do we have? What do you give back to the communities? What kind of relationships do we have with communities and franchisees? That was a greater part of their due diligence than maybe 20 years ago—I am not sure—but in talking with all of the potential bidders for our company, they all had those questions and that curiosity rather than the 5-year plan or the numbers.

By the way, just for the record, in our case we were able to put our numbers together—the management team's and the management projections—in the bidding process. No one told us to put the numbers higher or lower or whatever. They left it up to us, and then the auction was based on that. So there was not this, "Make it better than it is. Let us take this thing forward in a way so we win or lose." It was how do we do this the right way, and I think that is an important distinction, maybe, of the perceptions of the past.

Mr. BACHUS. Thank you, Mr. Chairman.

The CHAIRMAN. I would note that you got extra time for reading my "Dear Colleague."

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman.

I want to thank our panelists for being here today to help us understand what has become a very, very important area as we look at our responsibilities here in this committee.

I would like to know from Mr. Lowenstein, I believe it is, if you can help me to understand what requirements are placed on the fund, the private equity funds, by the investors. For example, CalPERS in California has a $240 billion portfolio there, and if they invest in one of these funds, what do they ask of the fund? What do they say they want you to do if they are investing in funds so that the fund can be involved in these buyouts where we are concerned about the employers in the community? What kind of requirements do they place on the people they give the money to?

Mr. LOWENSTEIN. Congresswoman, I think that, in all candor, the question is probably better put to CalPERS and the investors, themselves. I am not part of those negotiations. I will say that there are very, very intensive negotiations that occur between the limited partners and the private equity firms in putting the partnerships together. These are very, very intensely negotiated funds over an extended period of time, and certainly, in that context, limited partners are able—

Ms. WATERS. But you do not know of any standard code of conduct that is being required?

Let me ask Mr. Stern.

Mr. Stern, does the union place any requirements on its money that it invests in these kinds of deals?

Mr. STERN. Well, I mean, most of the unions who are in the private sector are governed by fiduciary responsibilities that would not allow us to place particular kinds of requirements, you know, in terms of investment decisions other than the nature of the return that we would get on the investments. I think CalPERS' instructions, for better or worse, to the private equity firms are to make a lot of money.

Ms. WATERS. So public-employee pension funds and union funds could be investing in deals where people are going to get laid off?

Mr. STERN. Yes, because, as I understand most of these limited partnerships, you know, they are called "limited partnerships" because they have a limited role in the decision-making process, and so part of the problem with some of the laws in our country today is that they do not allow investors to make what one might think are appropriate decisions about issues like that because it would be a breach of our fiduciary responsibility.

Mr. LOWENSTEIN. If I may just add to that, though, nobody is forcing any limited partner to invest in a private equity fund, so the best way to vote against companies that are not using your money in socially responsible ways that you care about is to not give them your money. As we said, CalPERS and many other limited partnerships' stakeholder pension funds are providing billions and billions of dollars to fuel this, in a sense, and then vote with their pocketbooks if they see a problem of how these transactions are being conducted.

Ms. WATERS. Well, let me just say this: For years, I was involved in a struggle in California to divest our pension funds from companies doing business in South Africa. We heard all of the fiduciary arguments, but we changed it, and we got involved in a divestment movement that helped to change the attitudes and create some social responsibilities, so it is something that we need to examine.

I yield back the balance of my time.

The CHAIRMAN. Mr. Hensarling.

Mr. HENSARLING. Thanks, Mr. Chairman.

First, Mr. Stern, you spoke about income inequality, I believe, in your testimony. Does the janitor who cleans your office make the same income as you do?

Mr. STERN. No, sir.

Mr. HENSARLING. So can one say that you, yourself, are practicing income inequality?

Mr. STERN. No, sir.

Mr. HENSARLING. Why not?

Mr. STERN. Because I think what we are talking about here in terms of income inequality is the growing gap between the rich and the rest of the population—that 150,000 or 300,000 Americans now make as much as the other 150 million Americans. I think we are talking about a very drastic set of extreme circumstances that were raised in the colony of the Great Depression.

Mr. HENSARLING. So are you more offended by the income inequality of those who make less than you? It appears that maybe you have more concern for those who make more than you.

Mr. STERN. I am not concerned with people getting wealthy, but I am concerned that people who work every day cannot own a home, raise a family, and live the American dream. And I am very concerned about a country where my kids and grandkids will be the first generation in American history to do worse than their parents. I do not think that is America.

Mr. HENSARLING. Well, I happen to agree with you there, and that is, for one, why I am concerned that recently the House passed a budget that included the largest tax increase in American history that will impose an approximately $2,700 tax increase on all of the families back in the Fifth Congressional District of Texas.

Dr. Frank, in your testimony, you talked about, I believe—I do not want to put words in your mouth—that we have been cutting the social safety net. Does that capture what you said in your testimony?

Dr. FRANK. Yes, sir.

Mr. HENSARLING. I have been reviewing figures for the Congressional Budget Office and the Office of Management and Budget, and by the figures I have seen since 2001, healthcare assistance has increased 40 percent at the Federal level; housing assistance, 27 percent; food assistance, 58 percent; cash and other assistance, 40 percent; and general anti-poverty spending at the Federal level has been 41 percent. The only major poverty program that I can find that has decreased is TANF. That is because the caseload is down about two-thirds due to work requirements. What have you discovered that CBO and OMB and everybody else who calculates these numbers haven't discovered?

Dr. FRANK. Well, part of what you have to understand, Congressman, is that the cost of a lot of the entitlement programs goes up for everyone, so we can provide that year by year. There have been cuts in the earned income tax credit programs. There have been cuts in the rate at which public transport has been supported. The public schools—

Mr. HENSARLING. I'm sorry, if I could interrupt. Where did you get your figures on the earned income tax credit? Because my figures show that it has increased at least 38 percent since 2001.

Dr. FRANK. Relative to the cost of the middle- and low-income family meeting basic needs, those payments have not kept pace, Congressman.

Mr. HENSARLING. Let me ask you another question. I think you spoke of the need of tax policy changes to address income inequality. Is that a fair assessment of your testimony?

Dr. FRANK. Yes.

Mr. HENSARLING. From my figures, we have roughly 50 percent of the population that for all intents and purposes pay no income tax at the moment. Do your figures differ from that?

Dr. FRANK. No, they don't differ from that. Most of those people do, however, pay payroll tax.

Mr. HENSARLING. That they do, and if we don't reform our entitlement programs, they will pay more as well. My figures show that over the last 25 years, the top 20 percent of income earners have seen their percentage of Federal tax paid increase and 80 percent of the taxpayers have seen them go down.

Do you have some other set of figures besides the ones that I viewed from the U.S. Department of the Treasury.

Dr. FRANK. No, sir, that is an expected consequence of the change in where the pretax income has gone. The more pretax income that goes to the top, of course the more tax will be paid by people at top.

Mr. HENSARLING. I see where the top, I believe, 5 percent of income earners pay almost 60 percent of Federal income taxes. What percentage would you have the top 5 percent pay?

Dr. FRANK. A higher percentage than that because we are currently borrowing $800 billion a year because we are not collecting as much in revenue as we are incurring in expenses. The tax increase—

Mr. HENSARLING. Maybe we need to do something on the spending side as well. I see my time is up.

The CHAIRMAN. Ms. Maloney.

Mrs. MALONEY. I would like to thank you, Mr. Chairman, for having this hearing, and to thank the panelists for attending. Many of you have touched on the widening gap between the haves and the have-nots in our country, which is a tremendous concern, I would say, of all Members of Congress. It is very troubling and has major ramifications. Last year, Steven Schwartzman, the chief executive of the private equity group Blackstone warned in an interview with The Financial Times that the widening gap between the lavish pay of executives and CEOs and middle America's stagnating wages may result in a backlash and in a political and social crisis in our country, and the best way to deal with this widening income inequality, according to Mr. Schwartzman, is for the middle class to do better.

So I would like to ask Mr. Lowenstein and Mr. Stern if you would comment and anyone else on my question. Mr. Lowenstein, can you tell us how the private equity deals where Mr. Schwartzman and his colleagues are reaping, literally, billions of

dollars in fees and payouts, how are their private equity deals helping the middle class do better?

Are the workers sharing in the increased profits of these private equity firms through increased wages or benefit packages? How are these deals helping middle America?

Mr. LOWENSTEIN. Well, I think as a general proposition, as I said in my testimony, we believe that private equity is strengthening companies, and making them more competitive. And by definition, if that is true, people who work for those companies have more secure jobs. And in many cases, as I also said in my testimony, the few examples we use there has been job growth in those companies.

And so, I think in that way that obviously supports middle income wage earners and so forth. As I also said, there is a range of indirect benefits. When you talk about private equity profits, 80 percent of the profit when an asset is sold goes to the limited partners. And those limited partners, as we discussed, have money that then flows back to retirees and many others in our community who benefit from that indirectly.

I would also suggest to you that there is another indirect benefit to the extent that private equity firms are allowing and strengthening businesses that are part of people's everyday lives—Dunkin' Donuts and Domino's Pizza and J. Crew and other places that people shop on a regular basis. That is also helping people acquire the necessities of everyday life.

So I think there are various ways that these transactions promote value and growth and flow through to lots of individuals.

Mr. STERN. The Census Bureau reports that America has had its fifth straight year in a row that Americans did not get a raise, the longest period of economic stagnation in the history of our country. And it is all about that we are creating wealth, but it is not being distributed. I don't think private equity per se—maybe indirectly, but not directly, has done anything to help rebuild the middle class. There used to be a joke about when people were creating new jobs, they would say there are 10 million new jobs and I got 3. I think that is a lot of what we are seeing here.

We are not necessarily creating the middle-class jobs that we saw in the plants in Massachusetts, where there were union jobs, and jobs where people could own a home and raise a family. And I am not saying that private equity is the cause of it. I am just saying that I don't think they are the solution to it either, so far.

Mrs. MALONEY. Would you like to comment, Dr. Frank, or anyone else, on this?

Dr. FRANK. Again, I don't think that attacking the competitive forces is the lever that you want to pull. I think the lever that you want to pull—you do have to cut spending where possible, but the government we elected last time campaigned as an opponent of government waste. You cut what you can. Yet one of the programs they cut was the Energy Department's program to round up loosely guarded nuclear materials in the former Soviet Union.

We just don't have the revenue to do the things that we need to do, and I think that is where your focus should be.

Mrs. MALONEY. Mr. Luther?

Mr. LUTHER. Yes, my experience might be a microcosm of the overall economy, but in our case when private equity acquired, the

opportunity for many of our employees who worked for Dunkin' Brands, not our franchise organizations, we distributed some of that wealth to them in the form of stock and options to over 150 people in our organization; that is 15 percent of our company that now has some opportunity perhaps for their children to go to college without borrowing money or whatever.

Our goal is to continue to distribute those stock options and equity opportunities into our organization deeper and deeper, so we distribute the wealth in that regard.

Our franchise communities create the jobs and create management jobs within our restaurants and multi-unit jobs that hopefully can enable those employees to continue to grow their experiences and their careers so that they can compete in the middle-class environment, so we try hard to make sure we do that.

The CHAIRMAN. We will take Mr. Castle and then we will break for the votes and come back immediately. There is apparently only one 15-minute vote. Mr. Castle. And then we will break and come right back.

Mr. CASTLE. Thank you, Mr. Chairman. This is an interesting plight and tug of war going on here. Mr. Stern, let me ask you a question. I read your paper and listened to what you had to say and you are concerned, as you should be, with working people and the status and how they have gone. My question or concern here is, frankly, I am not sure how private equity has impacted that directly. You do have some comments in there and some anecdotal evidence of some things.

But my question to you is—or to anyone else who really knows the answer—is there any empirical or statistical evidence with respect to private equity in terms of their investments and what has happened to the employees either in losing jobs or losing benefits, be it healthcare or pensions or whatever? And has any of that been laid up against what might have happened otherwise? That is, what is happening with corporations today in America? I am trying to get the gist of whether private equity has had a negative impact on that or not.

Mr. STERN. I don't think there is it enough data or studies really yet to make those decisions. And we all can cite anecdotal situations and claim that they sort of represent the macro level, but I think we are all watching what happens. I think there is a huge opportunity here as private equity does receive, as the Congresswoman said, money from lots of public sources, you know, and that has helped make them incredibly successful, to think differently about what is their social responsibility as we would expect any business in America.

And we are hoping that, given the source of their capital particularly, you know, from public pension funds and other places, that there could be a dialogue about doing as we saw with the deal in Texas, where environmentalists and people tried to work something out that was reasonable and rational for everybody.

Mr. CASTLE. Does anybody else know if there is any real study or statistical evidence, and not just your conjecture on it.

Mr. LOWENSTEIN. There is data in Europe. It is not perfect data, but there have been studies done in Europe that show that private equity tends to result in net job growth and more investment in

R&D, and other sort of measures of economic growth. There has been very little research here, so I think that is a gap that we are looking to fill.

Mr. STERN. If you don't mind, there is one study that I think is important that shows that the private equity companies pay a lower premium to the public shareholders than other strategic reinvestors pay for the same companies. This is where Chairman Frank was asking questions about conflicts. It is not yet known whether that is true, but we are seeing the private equity pay a lower premium to shareholders in public companies than other strategic investors.

Mr. CASTLE. This is an unanswerable question, I guess. Mr. Lowenstein to you, with the news of the Cerberus capital management takeover of DaimlerChrysler, or of Chrysler at least, I have a concern. I am from Delaware and we have a Chrysler plant there that has already been notified that they are going to lose a number of those jobs—not this year, but in the next couple of years.

With respect to private equity type takeover, my question is what will happen to those employees—I am not suggesting we can wave a magic wand and get them reinstated—but with respect to their pension and healthcare plans, what has been the approach of private equity with respect to the rights of employees in circumstances such as the private equity takeover of a public corporation?

Mr. LOWENSTEIN. As I said, with respect to the Chrysler particulars, I am really not in a position to discuss that. As a general proposition, as I said in my opening statement, I am certainly not aware of any pattern or consistent effort on the part of private equity firms to raid pension funds or do a variety of things that are anti-worker, anti-pension, or anti-benefit. As I said, the long-term business strategy is growth and you need to have a motivated and viable workforce to do that.

Mr. CASTLE. I don't think Cerberus is under your direct jurisdiction, but again, on the automobile or perhaps any large investments—they have already made investments in the auto industry to a degree and my concern is that is a very capital-intensive business. And do they have the ability to be able to make the investments in equipment technology, research, and some of the other things that are going to be needed to restore the American automobile industry to where it was before or is this a temporary investment on the way to making a profit someplace shortly down the road?

Mr. LOWENSTEIN. Let me answer that two ways: One is—I can't say what they will or won't do in the long run—I do believe that as all private equity funds the intent here is to grow and add value to the company. Chrysler is a difficult case study because obviously it has been operated as a public company, and it is hard to argue that it has been operated successfully as a public company in recent years. They announced 16,000 layoffs recently, as you know. I think as to exactly how that transaction plays out, we will just have to wait and see.

But again, as an overall business proposition, there is nothing I have been exposed to in my conversations with private equity firms that suggests that they have sort of an anti-worker or anti-growth

bias in the business model, and in fact, quite the opposite in my experience.

Mr. CASTLE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. Now, Mr. Watt informed me that I was too optimistic. Apparently this is a motion to adjourn and then there is going to be 10 more minutes of debate and a couple of votes. We will be gone for 45 minutes. Can the witnesses stay? If they can, we will reconvene at 12:15 p.m.. We will have time to do whatever, and we will be back in 45 minutes. So we are in recess for 45 minutes.

[Recess]

The CHAIRMAN. Another vote has been called. I am going to end the hearing. I apologize. You sat around for nothing. I wish—you got caught in the crossfire of a parliamentary dispute. It is another adjournment vote.

I appreciate you having put up with this. I am apologetic. I was misinformed and I would not have held you here. I thank you for coming and we will not hold you here any further.

If any of the witnesses wish to submit anything for the record, please feel free to do so.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

A P P E N D I X

May 16, 2007

Congressman Kenny Marchant
5-16-07 FSC-- Private Equity hearing

I'd like to thank Chairman Frank for holding this hearing on private equity. Private equity is an industry that I feel is much misunderstood and undeservedly maligned. I am happy that the Chairman has given the industry this stage to educate us on this subject matter.

Private equity has been grabbing headlines lately with larger and larger profile deals. The latest—Cerberus's deal to buy Chrysler—even involves one of the Big Four automakers. It is because of deals like these and others like it that the private equity industry has stepped into the public eye. Unfortunately for them, they are a victim of their own success because now they have to come educate Congress on their industry.

I have the utmost confidence that once we take a closer look, everyone will see that there is absolutely nothing sinister about this industry. In my opinion, this is capitalism in one of its most innovative and efficient forms.

I look forward to the testimony of the witnesses and thank the Chairman again for scheduling this timely hearing.

Falling Behind: How Rising Income Inequality Harms the Middle Class

Testimony by Professor Robert H. Frank[1] before the House Financial Services Committee

May 16, 2007

Economic inequality has been growing rapidly in the United States. Congress must soon decide whether to make permanent recent changes in tax policy that will increase it further. In this testimony I will review the causes and consequences of rising income inequality and explore possible policy remedies for it.

The Historical Context

At the end of World War II, income inequality was lower in the United States than at any time since the 1920s. During the ensuing three decades, incomes grew briskly and at about the same rate—almost 3 percent per year—for households up and down the income ladder.

That pattern began to change in the 1970s. Since 1979, for example, the incomes of families in the bottom 80 percent of the income distribution have grown by less than 1 percent each year, and only households in the top 20 percent have enjoyed income growth comparable to that in the earlier period. For a small group at the very top of the economic ladder, however, incomes have been growing explosively. The top tenth of one percent of earners, for example, now earn four times as much as in 1980.

The gains have been larger still for those even higher up the income ladder. For more than 25 years, *Business Week* has conducted an annual survey of the earnings of chief executive officers of the largest U.S. corporations. In 1980, those executives earned 42 times as much as the average American worker, a ratio larger than the corresponding ratios for such countries as Japan and Germany even today. By 2000, however, American CEOs were earning 531 times the average worker's salary.

But the biggest winners of all have been top earners in the financial services industry. Thus, according to Institutional Investor's *Alpha* magazine, James Simons, a hedge fund manager, earned $1.7 billion last year, and two other hedge fund managers made more than $1 billion. The combined income of the top 25 hedge fund managers was over $14 billion in 2006.

Why Has Inequality Grown?

In the standard textbook account, the salary a person commands in the labor market is proportional to his or her stock of human capital—an amalgam of talent, experience, education, training, and other factors that affect productivity. Armed with this perspective, many economists have argued that the recent growth in inequality has been the result of an increase in the rate of return to education and other forms of human capital. Yet we observe essentially the same pattern of inequality growth among college graduates as in the population as a whole. The least prosperous college graduates have struggled to stay even, those in the middle have made only modest gains, while those at the top have done spectacularly well. Among college graduates, the return to education has been higher in some fields than in others. For example, the earnings of computer science graduates grew more rapidly during the last two decades than those of English majors. But even among English majors, those at the top have enjoyed spectacular earnings growth.

Others have argued that inequality has increased in the United States because globalization has put unskilled American workers in competition with low-wage workers from other lands. Yet the basic pattern of inequality growth has been the same even among dentists, who are largely immune from foreign competition. Most dentists today earn little more than their counterparts from 1979, but the best paid dentists earn almost three times as much.[2]

The human capital story directs our attention to the worker rather than the job. Yet a person who embodies a certain level of human capital will realize its full value only if placed in a position with adequate scope and opportunity. For example, whereas the value of having a slightly more talented salesperson may mean little if the task is to sell children's shoes, it will mean a great deal if the task is to sell securities to the world's largest pension funds.

Philip Cook and I have argued that an important contributor to increased inequality has been the spread and intensification of reward structures once confined largely to markets for sports and entertainment.[3] In conventional labor markets, reward is proportional to absolute performance. Thus, in the classic piece-rate scheme, a worker who assembles 101 widgets in a week gets paid one percent more than a coworker who assembles only 100. In contrast, we define a winner-take-all market as one in which small differences in performance often translate into enormous differences in economic reward.

---

[1] Henrietta Johnson Louis Professor of Management and Professor of Economics, Johnson Graduate School of Management, Cornell University, Ithaca, NY 14853. Contact: www.robert-h-frank.com.

[2] For a discussion of increased inequality among different groups, see Frank and Cook, 1995, chapter 5.

[3] See Frank and Cook, 1995.

The winner-take-all perspective urges us to look first to the nature of the positions people hold, rather than to their personal characteristics. An economist under the influence of the human capital metaphor might ask: Why not save money by hiring two mediocre people to fill an important position instead of paying the exorbitant salary required to attract someone unusually good? Although that sort of substitution might work with physical capital, in does not necessarily work with human capital. Two average hedge fund managers or CEOs or novelists or quarterbacks are often a poor substitute for a single gifted one.

The result is that for positions for which additional talent has great value to the employer or the marketplace, there is no reason to expect that the market will compensate individuals in proportion to their human capital. For these positions—ones that confer the greatest leverage or "amplification" of human talent—small increments of talent have great value, and may be greatly rewarded as a result of the normal competitive market process. This insight lies at the core of our alternative explanation of growing inequality.

Technology has greatly extended the power and reach of the planet's most gifted performers. The printing press let a relatively few gifted storytellers displace millions of village raconteurs. Now that we listen mostly to recorded music, the world's best musicians can literally be everywhere at once. The electronic newswire has allowed a small number of syndicated columnists to displace a host of local journalists. And the proliferation of personal computers enabled a handful of software developers to replace thousands of tax accountants.

For present purposes, a key feature of winner-take-all markets is that participants' rewards depend on relative, not just absolute, performance. Whereas a farmer's pay depends on the absolute amount of wheat he or she produces, and not on how that compares with the amounts produced by other farmers, a software developer's pay depends largely on her performance ranking. In the market for personal income tax software, for instance, once the market reached consensus on which among the scores or even hundreds of competing programs was the most comprehensive and user-friendly, the lesser-ranked programs quickly disappeared. And although Intuit's *TurboTax* may have been only slightly better than its nearest rivals, the rewards to its developer were enormously greater.

Of course, the dependence of economic reward on performance ranking is nothing new. What is new is the rapid erosion of the barriers that once prevented the top performers from serving broader markets. In the music industry, the driving force was the arrival of breathtakingly lifelike pre-recorded music. Changes in physical production technologies have been important in other industries as well, but these changes often explain only a small part of the picture.

Of central importance in other cases has been the emergence of the so-called information revolution. In the global village, there is unprecedented market consensus on who the top players are in each arena, and unprecedented opportunity to deal with these players. A company that made the best tire in Akron was once assured of being a player in at least the northern Ohio tire market. But today's sophisticated consumers increasingly purchase their tires from only a handful of the best tire producers worldwide.

Before there can be large and concentrated rewards in a winner-take-all market, the top performers must not only generate high value, but there must also be effective competition for their services. Yet in many markets, a variety of formal and informal rules traditionally prevented such competition.

Most major sports leagues, for example, once maintained restrictive agreements that prevented team owners from bidding for one another's most talented players. It was major league baseball's reserve clause, for example, that made players the exclusive property of the teams that drafted them. Even though the introduction of nationally televised games in the 1950s increased the economic leverage of baseball players enormously, the ensuing decades saw little real growth in their salaries. In the wake of Andy Messersmith's successful court challenge the reserve clause in 1975, however, player salaries began to grow explosively, now averaging almost $3 million per year. Similar salary trajectories have ensued as players have won at least limited free agency rights in all the major professional team sports.

Unlike the owners of professional sports teams, the owners of businesses were never subject to formal sanctions against bidding for one another's most talented employees. But there were often informal norms that seemed to have virtually the same effect. Under these norms, it was once the almost universal practice to promote business executives from within, which often enabled companies to retain top executives for less than one-tenth of today's salaries.

The anti-raiding norms of business have recently begun to unravel, in part perhaps because managerial talent is has in fact become more fungible in the new environment. It once would have been unthinkable for a computer giant to hire a former tobacco executive as its CEO. But IBM's decision to hire RJR Nabisco CEO Louis Gerstner is now widely viewed as a move that ensured IBM's survival.. In the interim, inter-firm and inter-industry boundaries have become increasingly permeable, and business executives are today little different from the free agents of professional sports. Firms that fail to pay standout executives and investment managers their due now stand to lose them to aggressive rivals.

With corporate malfeasance much in the news in recent years, there is little doubt that at least some of the spectacular corporate pay packages were not won on merit. But it is a mistake to view corporate malfeasance as the only, or even the most important, cause of rising pay disparity. Despite the well-publicized cases of late, corporate

corruption is almost certainly a less important problem today than it was several decades ago. Interlocking directorates, for example, are less common today, and shareholder activists backed by multibillion dollar pension funds simply did not exist several decades ago. Pay disparities have increased because new technologies have increased the leverage of key players in every arena, and increased competition has translated that additional leverage into higher pay.

Do Growing Pay Disparities Matter?

Technologies that extend the reach of top performers have greatly benefited consumers. But they have also led to increased inequality. Thus, as noted, the incomes of middle-income families are now slightly higher in real absolute terms than they were two decades ago, but substantially lower, in relative terms.

I will consider two possible ways in which this rise in inequality might have made things worse for these families. First, I will examine how the capacity of material goods to deliver satisfaction, in purely psychological terms, depends heavily on the context in which those goods are consumed. I will then discuss a variety of more tangible ways in which a family's economic welfare might be adversely affected by the spending of others.

The Psychological Costs of Inequality

Most of us were taught from an early age not to worry about how our incomes compare with the incomes of others. This sensible advice stems from the observation that since there will always be others with more, focusing closely on income comparisons can't help but generate reasons to feel unhappy.

But suppose you were faced with a choice between the following hypothetical worlds:

World A: You earn $110,000 per year, others earn $200,000

World B: You earn $100,000 per year, others earn $85,000.

The income figures represent real purchasing power. Thus your higher income in World A would enable you to purchase a house that is 10 percent larger than the one you would be able to afford in World B, 10 percent more restaurant meals, and so on. No matter which world you choose, your relative position will not change in the future. Confronting a once-for-all choice between these two worlds, which one would you choose?

Much of neoclassical economic theory rests on the premise that World A is the uniquely correct choice. This theory assumes that people derive satisfaction primarily from the absolute quantity of goods and services they consume. On that measure, World A is better because it offers higher absolute consumption for every citizen. That fact notwithstanding, however, a substantial proportion of people confronted with this choice say they would opt for World B.[4]

Many economists appear reluctant to take seriously the concerns that might lead people to make this choice. On its face, this is a curious position for a profession whose practitioners often warmly endorse Jeremy Bentham's dictum that a taste for poetry is no better than a taste for pushpins. If most people say they'd prefer World B, a genuine commitment to consumer sovereignty would appear to rule out any categorical claim that World A is necessarily best for all.

Modern disciples of Adam Smith have nonetheless been extremely reluctant to introduce the purely psychological costs of inequality into discussions of economic policy. Yet as Smith himself recognized, experiencing such costs is a basic component of human nature. Writing more than two centuries ago, he introduced the important idea that local consumption standards influence the goods and services that people consider essential (or "necessaries," as Smith called them). In the following passage, for example, he described the factors that influence the amount an individual must spend on clothing in order to be able appear in public "without shame."

> By necessaries I understand not only the commodities which are indispensably necessary for the support of life, but whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without. A linen shirt, for example, is, strictly speaking, not a necessary of life. The Greeks and Romans lived, I suppose, very comfortably though they had no linen. But in the present times, through the greater part of Europe, a creditable day-labourer would be ashamed to appear in public without a linen shirt, the want of which would be supposed to denote that disgraceful degree of poverty which, it is presumed, nobody can well fall into without extreme bad conduct. Custom, in the same manner, has rendered leather shoes a necessary of life in England. The poorest creditable person of either sex would be ashamed to appear in public without them.[5]

---

[4]See, for example, Solnick and Hemenway, 1998.

[5] Smith, 1937.

4

The absolute standard of living in the United States today is of course vastly higher than it was in Adam Smith's 18th-century Scotland. Yet Smith's observations apply with equal force to contemporary industrial societies. Consider, for instance, *The New York Times* correspondent Dirk Johnson's account of the experiences of Wendy Williams, a middle-school student from a low-income family in a highly prosperous community in Illinois.[6] Both of Wendy's parents are employed at low-wage jobs, and the family lives in Chateau Estates, a trailer park at which her school bus picks her up each morning.

> Watching classmates strut past in designer clothes, Wendy Williams sat silently on the yellow school bus, wearing a cheap belt and rummage-sale slacks. One boy stopped and yanked his thumb, demanding her seat.
>
> "Move it, trailer girl," he sneered.
>
> It has never been easy to live on the wrong side of the tracks. But in the economically robust 1990's, with sprawling new houses and three-car garages sprouting like cornstalks on the Midwestern prairie, the sting that comes with scarcity gets rubbed with an extra bit of salt.
>
> ....
>
> To be without money, in so many ways, is to be left out.
>
> "I told this girl: 'That's a really awesome shirt. Where did you get it?'" said Wendy, explaining that she knew it was out of her price range, but that she wanted to join the small talk. "And she looked at me and laughed and said, 'Why would you want to know?'"
>
> A lanky, soft-spoken girl with large brown eyes, Wendy pursed her lips to hide a slight overbite that got her the nickname Rabbit, a humiliation she once begged her mother and father to avoid by sending her to an orthodontist.
>
> For struggling parents, keenly aware that adolescents agonize over the social pecking order, the styles of the moment and the face in the mirror, there is no small sense of failure in telling a child that she cannot have what her classmates take for granted.
>
> "Do you know what it's like?" asked Wendy's mother, Veronica Williams, "to have your daughter come home and say, 'Mom, the kids say my clothes are tacky,' and then walk off with her head hanging low."

An adolescent in 18th-century Scotland would not have been much embarrassed by having a slight overbite, because not even the wealthiest members of society wore braces on their teeth then. In the intervening years, however, rising living standards have altered the frame of reference that defines an acceptable standard of cosmetic dentistry. On what ground might we argue that inequality's toll on individuals like Wendy Williams is unimportant because it occurs in psychological rather than explicit monetary terms?

More Tangible Costs of a Widening Income Gap

Increased spending at the top of the income distribution has not only imposed psychological costs on families in the middle, it has also raised the cost of achieving many basic goals. It has done so by means of a process I call expenditure cascades.[7] Expenditure cascades have been launched by the large growth in purchasing power at the top of the income ladder.

Consumption generally tracks income. When the incomes of the wealthy rise, they eventually spend more on houses, cars, clothing and other goods, just as others do. Upon learning that someone at the top has built a 60,000-square-foot house or purchased a new Ferrari Scaglietti, most people in the middle quintile feel no inclination to alter their own spending. But among those just below the top, such purchases have an impact. They subtly change the social frame of reference that defines what kinds of houses and cars seem necessary or appropriate. Additional spending by top earners thus leads others just below them to spend more. And when they do so, others just below them are affected in the same way, and so on, all the way down the income ladder.

In short, burgeoning incomes at the top have launched expenditure cascades that have put financial pressure on the middle class. An expenditure cascade in housing, for example, helps explain why the median size of a newly constructed house in the United States, which stood at less than 1,600 square feet in 1980, had grown to more than 2,100 square feet by 2001.[8] During the same period, the median family's real income increased by less than 15 percent—not nearly enough to comfortably finance so much larger a house.

---

[6] Johnson, 1998, p. A1.

[7] See Frank and Levine, 2007.

[8] http://www.census.gov/prod/2003pubs/02statab/construct.pdf; http://www.census.gov/hhes/income/histinc/f03.html.

The steep rise in median house prices is one of the most important sources of the middle-class economic squeeze. It is an indirect consequence of the higher incomes and spending of top earners. Although it might seem that a family could escape the squeeze by just buying a smaller house, that option would in fact entail a significant cost. The problem is that there is a strong link between the price of a house and the quality of the corresponding neighborhood school. Failure to buy a house near the median price for the area means having to send one's children to below-average schools, a cost that most parents seem unwilling to bear. The upshot is that despite a modest increase in their incomes, middle-class families must now work longer hours, borrow more, save less, and commute longer distances in order to continue sending their children to schools of just average quality.

Increased spending at the top has also imposed other costs on those below. Middle-class families who buy a typical 3,000-pound sedan will incur risks that didn't exist in the 1970s, since they must now share the roads with 6,000-pound Lincoln Navigators and 7,500-pound Ford Excursions. In self-defense, they may want to spend more for a heavier vehicle.

Consider, too, how increased spending at the top affects how much one must spend on a professional wardrobe. Placement counselors have always stressed the importance of dressing well for job interviews. But dressing well is a relative concept. To look good means to look better than other candidates. Because top earners have more money, they spend more on clothing, which has led those just below them to spend more, and so on. So to look good for a job interview, the median earner must spend more than before. Of course, if one job candidate is clearly much better qualified than others for a given position, the clothing he or she wears during job interviews is unlikely to make any difference. But competition is stiff for jobs that pay well and offer opportunities for advancement, and there are typically many well-qualified candidates for such jobs. Under the circumstances, candidates are prudent to take whatever steps they can to gain an edge.

Even the gifts that middle-income families feel compelled to give are have been affected by the greater affluence of top earners. Top earners have been spending a lot more on gifts because they have a lot more money. And as in the examples just considered, their extra spending has launched an expenditure cascade. When others spend more for gifts at weddings, anniversaries, birthdays, and other special occasions, the rest of us must follow suit, or else risk being seen as people who just don't care.

The Educational Arms Race: Another Costly Burden for the Middle Class

Because the pay gap between top earners and others has grown sharply in every field, there is much more intense competition than before for top positions. The employers that post openings for such positions typically receive résumés from hundreds or even thousands of applicants, more than they can possibly interview. Increasingly, a candidate's educational credentials have become the most important criterion in the screening process. Many employers now limit their interviews to applicants from a small handful of top-ranked schools. As expected, this change has fueled explosive growth in demand for elite educational credentials.

For the sons and daughters of the middle class, it was always more difficult than for the children of the wealthy to gain admission to the nation's leading universities. The growing demand for elite credentials has made access even more difficult. It has also made higher education more expensive and made it less likely that financial aid will be awarded on the basis of need.

In response to the increased demand for elite credentials, a growing number of institutions have moved aggressively to acquire the resources that confer elite academic status. But because elite status is an inherently relative concept, the primary effect has been to bid up the prices of these resources. The resulting "positional arms races" help explain why tuitions at both public and private university have risen sharply.[9] At public universities, for example, tuitions more than tripled between 1980 and 2004, and rose at nearly the same rate in private universities.[10] At some elite private schools, the annual cost of tuition, room, and board now exceeds $45,000.

Even as tuition and other college costs have been rising, the amount of financial aid available to middle-income and poor families has been dwindling. Because the average SAT score of entering freshmen is itself an important index of an institution's academic status, schools aspiring to elite status have little choice but to bid aggressively for top-scoring students. And hence the growing tendency for merit-based financial aid to displace need-based financial aid. The upshot is that for students from middle- and low-income families, the net cost of receiving a college education has risen dramatically.

At the same time, the economic payoff from a college degree has not kept pace. Indeed, the median salary of college degree holders has actually fallen during the last three decades. Among young male wage and salary workers, for example, the median earnings of those holding a bachelor's degree or higher was $52,087 in 1972 but only $48,955 in 2002 (both figures in 2002 dollars).[11]

---

[9] For a discussion, see Frank and Cook, 1995, chapter 8.

[10] College Board, 2004.

[11] U.S. Department of Education, 2004.

For the millions of students who have been unable to attend college because of the economic squeeze on the middle class, things are even worse. For although the payoff to a college degree has declined in absolute terms, it has increased relative to the payoff of having only a high school diploma. For those with only a high school diploma, median earnings was $42,630 in 1972 but only $29,647 in 2002 (again, both figures in 2002 dollars).

So even the slight income gains received by median earners in recent decades are illusory in a broader economic sense. The real hourly pay rates for most individuals in this group are lower now than they were 25 years ago. Their small gains in total family income are the result almost entirely of greater labor force participation of married women.

Consequences of the Financial Squeeze

If the real incomes of middle-class families are little larger than before, how have these families financed their higher levels of consumption and larger tuition payments? In part by working longer hours, but mainly by saving less, borrowing more, and doing without things that were once considered essential. American families with at least one credit card, for example, now carry an average of more than $9,000 in credit card debt, and before recent changes in the laws governing bankruptcy, personal bankruptcy filings were occurring at seven times the rate they did in 1980. The national personal savings rate, always low by international standards, has fallen sharply since the 1980s and have been negative for the past two calendar years (the first time that has happened since The Great Depression). One in five American families has zero or negative net worth. Some 45 million Americans now have no health insurance, 5 million more than in the early 1990s.[12]

In brief, the data support popular press accounts portraying widespread and genuine economic distress among middle class families. The difficulties confronting these families are not the result of exploitation by employers with market power. Rather, they stem in large part from the growing inequality in income and wealth that has resulted from ordinary market forces. Modern technology has greatly amplified the economic leverage of the best performers in every domain. By all indications, it will continue to do so. If future income gains continue to be captured disproportionately by top earners, as the winner-take-all perspective suggests, things will get worse. Luxury spending will continue to grow briskly, launching additional expenditure cascades that will raise the price of admission to the middle class still further.

Income Inequality Also Distorts Occupational Choice

Consumers clearly gain when modern technology and increased mobility allow the most talented people to serve broader markets. Once the world's hospitals are linked by high-speed data transmission networks, for example, the world's most gifted neurosurgeons can assist in the diagnosis and treatment of patients thousands of miles away—patients whose care would otherwise be left to less talented and experienced physicians. And we should count as a benefit that the most talented executives are now more likely to manage the most important companies.

Yet the lure of the top prizes in winner-take-all markets has also steered many of our most able graduates toward career choices that make little sense for them as individuals, and still less sense for the nation as a whole. In increasing numbers, our best and brightest graduates pursue top positions in law, finance, consulting, and other overcrowded arenas, in the process forsaking careers in engineering, manufacturing, civil service, teaching, and other occupations in which an infusion of additional talent would yield greater benefit to society.

One study estimated, for example, that whereas a doubling of enrollments in engineering would cause the growth rate of GDP to rise by half a percentage point, a doubling of enrollments in law would actually cause a decline of three-tenths of a point.[13] Yet the number of new lawyers admitted to the bar each year more than doubled between 1970 and 1990, a period during which the average standardized test scores of new public school teachers fell dramatically.

One might hope that such imbalances would fade as wages are bid up in underserved markets and driven down in overcrowded ones, and indeed there have been recent indications of a decline in the number of law school applicants. For two reasons, however, such adjustments are destined to fall short.

The first is an informational problem. An intelligent decision about whether to pit one's own skills against a largely unknown field of rivals obviously requires a well-informed estimate of the odds of winning. Yet people's assessments about these odds are notoriously inaccurate. Survey evidence shows, for example, that some eighty percent of us think we are better than average drivers; and that more than 90 percent of workers consider themselves more productive than their average colleague.

Psychologists call this the "Lake Wobegon Effect," and its importance for present purposes is that it leads people to overestimate their odds of landing a superstar position. Indeed, overconfidence is likely to be especially strong in the realm of career choice because, in addition to the usual motivational biases that support it, there is also

---

[12] http://www.nchc.org/facts/coverage.shtml

[13] See Murphy et al., 1991.

the fact the biggest winners are so conspicuous. The seven-figure NBA stars appear on television several times each week, whereas the many thousands who fail to make the league attract little notice. Similarly, the handful of hedge fund managers with 10-figure salaries are far more visible than the legions of aspiring hedge fund managers who never made the final cut. When people overestimate their chances of winning, the number who forsake productive occupations in traditional markets to compete in winner-take-all markets will be larger than what could be justified on traditional cost-benefit grounds.

The second reason for persistent overcrowding in winner-take-all markets is a structural problem that economists call "the tragedy of the commons." This same problem helps explain why we see too many prospectors for gold. In the initial stages of exploiting a newly discovered field of gold, the presence of additional prospectors may significantly increase the total amount of gold that is found. Beyond some point, however, additional prospectors contribute very little. Thus, the gold found by a newcomer to a crowded gold field is largely gold that would otherwise have been found by others.

Consider a man who must choose whether to work in a factory for $10,000 a year or to become a prospector for gold. If the two activities are equally attractive apart from the matter of pay, he should become a prospector only if he expects to find at least $10,000 worth of gold a year. Suppose he expects to find $11,000 in gold, and that $9,000 of that gold would have been found by others if he had worked in the factory. It will still be worth his while to go prospecting, even though his presence in the gold field increases the total amount of gold found by only $2,000. Yet society's total income would have been $8,000 higher had he instead gone to work in the factory.

Similarly misleading incentives confront potential contestants in winner-take-all markets. Beyond some point, for example, an increase in the number of aspiring hedge fund managers produces much less than a proportional increase in the amount of commissions on managed investments. One MBA student's good fortune in landing a position in a leading hedge fund is thus largely offset by his rival's failure to land that same position.

To be sure, even those who fail to win the biggest prizes often go on to earn comfortable incomes. But career choices must be measured not in terms of absolute pay, but relative to what might have been. Contestants for the top prizes in finance are highly talented people who could have held interesting jobs at high pay in other fields. Those who end up as account managers in small banks may not starve, but neither do they realize their full potential.

The externality that leads too many people to shoot for the top positions in law and finance is similar to the one that caused trouble in the case of prospectors for gold: Just as individual prospectors take no account of the fact that most of the gold they might find would otherwise be found by others, so also do aspiring superstars tend to ignore the fact that their presence makes other contestants less likely to win.

So for both informational and structural reasons, overcrowding in winner-take-all markets is not likely to be a self-correcting problem.

Inequality Is a Public Problem

Some have castigated organizations for their lack of restraint in curbing runaway salaries at the top. But to the extent that competitive forces have driving these salaries, it is quixotic to expect that they might be attenuated by individual restraint. A slightly more talented CEO or hedge fund manager can boost a large organization's annual bottom line by hundreds of millions of dollars or more. An organization that fails to bid aggressively for its top candidates all but ensures they will end up working for rivals.

The point is not that talented individuals are too lazy to work hard unless they are paid multimillion-dollar annual salaries. Rather, it is that most highly talented people, like others, tend to choose the employer that makes the best offer. Evidence suggests that if all salary offers were cut by half, the most talented individuals would work just as hard as before. But individual organization control only the amounts they pay, not the amounts paid by other organizations. If society wants to slow the rate of growth of income inequality, tax policy is the only available lever.

When market forces cause income inequality to grow, public policy in most countries tends to push in the opposite direction. In the United States, however, we have enacted tax cuts for the wealthy and cut public services for the needy. Cynics explain this curious inversion by saying that the wealthy have captured the political process in Washington and are exploiting it to their own advantage.

This explanation makes sense, however, only if those in power have an extremely naïve understanding of their own interests. A careful reading of the evidence suggests that even the wealthy have been made worse off, on balance, by recent tax cuts. The private benefits of these cuts have been much smaller, and their indirect costs much larger, than many recipients appear to have anticipated.

On the benefit side, tax cuts have led the wealthy to buy larger houses, in the seemingly plausible expectation that doing so would make them happier. As economists increasingly recognize, however, well-being depends less on how much people consume in absolute terms than on the social context in which consumption occurs. Compelling evidence suggests that for the wealthy in particular, when everyone's house grows larger, the primary effect is merely to redefine what qualifies as an acceptable dwelling.

So, although the recent tax cuts have enabled the wealthy to buy more and bigger things, these purchases appear to

have had little impact. As the economist Richard Layard has written, "In a poor country, a man proves to his wife that he loves her by giving her a rose, but in a rich country, he must give a dozen roses."

On the cost side of the ledger, the federal budget deficits created by the recent tax cuts have had serious consequences, even for the wealthy. These deficits will exceed $1 trillion over the next six years, according to projections by the Congressional Budget Office. The most widely reported consequences of the deficits have been cuts in government programs that serve the nation's poorest families. And since the wealthy are well represented in our political system, their favored programs may seem safe from the budget ax. Wealthy families have further insulated themselves by living in gated communities and sending their children to private schools. Yet such steps go only so far.

For example, deficits have led to cuts in federal financing for basic scientific research, even as the United States' share of global patents granted continues to decline. Such cuts threaten the very basis of our long-term economic prosperity. As Senator Pete Domenici, Republican of New Mexico, said: "We thought we'd keep the high-end jobs, and others would take the low-end jobs. We're now on track to a second-rate economy and a second-rate country."

Large deficits also threaten our public health. Thus, despite the increasing threat from micro-organisms like E. coli 0157, the government inspects beef processing plants at only a quarter the rate it did in the early 1980's. Poor people have died from eating contaminated beef but so have rich people.

Citing revenue shortfalls, the nation postpones maintenance of its streets and highways, even though doing so means having to spend two to five times as much on repairs in the long run. In the short run, bad roads cause thousands of accidents each year, many of them fatal. Poor people die in these accidents but so do rich people. When a pothole destroys a tire and wheel, replacements cost only $63 for a Ford Escort but $1,569 for a Porsche 911.

Deficits have also compromised the nation's security. In 2004, for example, the Bush administration reduced financing for the Energy Department's program to secure loosely guarded nuclear stockpiles in the former Soviet Union by 8 percent. Former Senator Sam Nunn now heads a private foundation whose mission is to raise private donations to expedite this effort. And despite the rational fear that terrorists may try to detonate a nuclear bomb in an American city, most cargo containers continue to enter the nation's ports without inspection.

Large federal budget deficits and low household savings rates have also forced our government to borrow more than $800 billion each year, primarily from China, Japan and South Korea. These loans must be repaid in full, with interest. The resulting financial burden, plus the risks associated with increased international monetary instability, fall disproportionately on the rich.

At the president's behest, Congress has already enacted tax cuts that will result in some $2 trillion in revenue losses by 2010. According to one recent estimate, 52.5 percent of these cuts will have gone to the top 5 percent of earners by the time the enabling legislation is fully phased in.

With the economy already at full employment, no one pretends these cuts are needed to stimulate spending. Nor is there any evidence that further cuts would summon outpourings of additional effort and risk taking. Nor, finally, does anyone deny that further cuts would increase the already high costs associated with larger federal budget deficits.

Moralists often urge the wealthy to imagine how easily their lives could have turned out differently, to adopt a more forgiving posture toward those less prosperous. But top earners might also wish to consider evidence that their own families would have been better off, in purely practical terms, had it not been for the tax cuts of recent years.

The nation's recent fiscal policy choices provide striking testimony to the incredible staying power of trickle-down theory. This largely discredited theory's claim that lower taxes on the rich will spur economic growth has animated the push for less progressive taxes for almost two decades. Trickle-down theorists are quick to object that higher taxes would cause top earners to work less and take fewer risks, thereby stifling economic growth. In their familiar rhetorical flourish, they insist that a more progressive tax system would kill the geese that lay the golden eggs. On close examination, however, this claim is supported neither by economic theory nor by empirical evidence.

The surface plausibility of trickle-down theory owes much to the fact that it appears to follow from the time-honored belief that people respond to incentives. Because higher taxes on top earners reduce the reward for effort, it seems reasonable that they would induce people to work less, as trickle-down theorists claim. As every economics textbook makes clear, however, a decline in after-tax wages also exerts a second, opposing effect. By making people feel poorer, it provides them with an incentive to recoup their income loss by working harder than before. Economic theory says nothing about which of these offsetting effects may dominate.

If economic theory is unkind to trickle-down proponents, the lessons of experience are downright brutal. If lower real wages induce people to work shorter hours, then the opposite should be true when real wages increase. According to trickle-down theory, then, the cumulative effect of the last century's sharp rise in real wages should have been a significant increase in hours worked. In fact, however, the workweek is much shorter now than in 1900.

Trickle-down theory also predicts shorter workweeks in countries with lower real after-tax pay rates. Yet

here, too, the numbers tell a different story. For example, even though chief executives in Japan earn less than one-fifth what their American counterparts do and face substantially higher marginal tax rates, Japanese executives do not log shorter hours.

Trickle-down theory also predicts a positive correlation between inequality and economic growth, the idea being that income disparities strengthen motivation to get ahead. Yet when researchers track the data within individual countries over time, they find a negative correlation. In the decades immediately after World War II, for example, income inequality was low by historical standards, yet growth rates in most industrial countries were extremely high. In contrast, growth rates have been only about half as large in the years since 1973, a period in which inequality has been steadily rising.

The same pattern has been observed in cross-national data. For example, using data from the World Bank and the Organization for Economic Co-operation and Development for a sample of 65 industrial nations, the economists Alberto Alesina and Dani Rodrick found lower growth rates in countries where higher shares of national income went to the top 5 percent and the top 20 percent of earners. In contrast, larger shares for poor and middle-income groups were associated with higher growth rates.[14] Again and again, the observed pattern is the opposite of the one predicted by trickle-down theory.

The trickle-down theorist's view of the world is nicely captured by a Donald Reilly cartoon depicting two well-fed executives nursing cocktails on a summer afternoon as they lounge on flotation devices in a pool. Pointing to himself, one says angrily to the other, "If those soak-the-rich birds get their way, I can tell you here's one coolie who'll stop" working so hard.

This portrait bears little resemblance to reality. In the 1950s, American executives earned far lower salaries and faced substantially higher marginal tax rates than they do today. Yet most of them competed energetically for higher rungs on the corporate ladder. The claim that slightly higher tax rates would cause today's executives to abandon that quest is simply not credible.

Now, our growing understanding of the incentive problems created by winner-take-all markets poses an even more decisive challenge to trickle-down theory. Society's highest incomes accrue to the top performers in winner-take-all markets, which, as noted, persistently attract too many contestants. To the extent that economic incentives matter at all (and it is the cornerstone of trickle-down theory that they do), the effect of higher taxes on top earners would be to cause fewer of our most talented people to compete for limited slots in winner-take-all markets. Moreover, the people most likely to drop out would be those whose odds of making it into the winner's circle were smallest to begin with. Thus, the value of what gets produced in winner-take-all markets would not be much reduced if higher taxes were levied on winners' incomes; and any reductions that did occur would tend to be more than offset by increased output in traditional markets.

The optimistic conclusion is that a more progressive tax structure may produce not only greater equality of incomes, but also higher economic growth.

Better Still: A Progressive Consumption Tax

Advocates of consumption taxes have stressed their positive impact on savings, their ability to capture revenue now lost to the underground economy, and their relative simplicity. These are important advantages, to be sure. Yet they pale in comparison to the advantages of using consumption taxes to counteract the inefficiencies that arise from winner-take-all markets.

For instance, a progressive tax on consumption, like a progressive income tax, would reduce the effective rewards of landing a superstar position. Like a progressive income tax, it would thus reduce overcrowding in winner-take-all markets.

A progressive consumption tax would also pay another dividend—namely, it would free up hundreds of billions of dollars of resources that are largely wasted through mine-is-bigger consumption arms races. Consider, for instance, a wealthy family's decision to build an 8,000-square-foot house. It does so not just because spacious living quarters are desirable in some absolute sense, but also because houses that size have become the norm for their income bracket. To have a smaller or less well appointed house than one's peers would entail social embarrassment. Yet, if *all* wealthy families had smaller houses (as indeed most do in cities like Manhattan and Tokyo), no one would be embarrassed in the least.

The standards that define acceptable wardrobes, cars, and a host of other important budget items likewise depend strongly on the amounts other people spend on them. This means that if others were to spend less, we, too, could spend less without any real loss in satisfaction.

Thus, if a consumption tax led wealthy families to buy 5,000-square-foot houses instead 8,000, and Porsche Boxsters instead of Ferraris, no one would really be worse off, and several hundred thousand dollars of resources per family would be freed up for more pressing purposes—deficit reduction, medical research, capital investment, job

[14] See Alesina and Rodrick, 1992.

training, school lunches, drug treatment programs, time for family and community, whatever. The elegant hidden feature of the progressive consumption tax is this ability to create resources virtually out of thin air.

Opponents of progressive consumption taxes will caution that such taxes will cause unemployment, citing the layoffs in the shipbuilding industry that followed imposition of a luxury tax on yachts in 1991. But that was a tax with a glaring loophole that exempted boats purchased outside the country. A general progressive tax on consumption would shift employment from some activities to others, to be sure, but that is precisely the objective. Full employment for carpenters can be achieved by the construction of small number of mansions for the well-to-do, or by the construction of a larger number of smaller houses for people with more modest incomes.

Proposals to tax consumption also raise the specter of citizens having to save receipts for each purchase, of politicians and producers bickering over which products are to be exempt, and so on. Yet a system of consumption taxation need entail no greater complexity than the usual systems of income taxation. Indeed, with the strategic elimination of certain deductions and loopholes, it could easily be made to entail less.

The need to keep receipts, for example, can be avoided by exploiting the simple accounting identity that a person's income is the amount she spends plus the amount she saves. This permits us to calculate overall consumption as the difference between current income, which must be reported under the current tax system, and current savings, which would document in much the same way that we currently document contributions to 401(k) retirement accounts. There is simply no need to add up the value of each item purchased.

The need to debate which, if any, consumption categories ought to be exempt can be avoided by having a large standard deduction—by making the first, say, $30,000 of each family's annual consumption expenditures exempt from taxation. This feature would serve two purposes: it would shield necessities like food, health care, basic clothing, shelter, and transportation-- from taxation; and it would make the tax progressive. Further progressivity could be achieved by having tax rates that rise with consumption, just as we now have tax rates that rise with income. The so-called "Unlimited-Savings-Allowance" proposal by Senators Nunn and Domenici in the mid-1990s, was a tax with all these features.

The so-called "flat tax" favored by many conservatives is itself a consumption tax, and that is a point in its favor. Yet its adoption would move us in precisely the wrong direction. By reducing the tax rates on top earners by more than half, it would steer even more of our best and brightest students into winner-take-all markets that are already overcrowded. By giving the top earners much more disposable income, it would also fuel the growth of wasteful consumption expenditures, both by the rich and by others who emulate them. And most important, it would worsen the social strains of income inequality.

The nation's current tax policies rest on an outmoded understanding of the forces that allocate both talent and reward in a winner-take-all society. These forces suggest that equity and growth are more likely to be complements than substitutes. This is a hopeful conclusion, indeed, for it means that the very same policies that promote both fiscal integrity and equality are also likely to spur economic growth.

References

Alesina, Alberto and Dani Rodrick. "Distribution, Political Conflict and Economic Growth: A Simple Theory and Some Empirical Evidence," in A. Cukierman, Z. Hercovitz and L. Leiderman (eds.), *The Political Economy of Business Cycles and Growth,* M.I.T. Press, Cambridge, MA, 1992.

College Board, "Trends in College Pricing 2004," http://www.collegeboard.com/prod_downloads/press/cost04/041264TrendsPricing2004FINAL.pdf.

Frank, Robert H. and Philip Cook. *The Winner-Take-All Society,* New York: The Free Press, 1995.

Frank, Robert H. and Adam Levine. "Expenditure Cascades," Cornell University mimeograph, 2007.

Johnson, Dirk. "When Money Is Everything, Except Hers," *New York Times,* October 28, 1998: A1.

Murphy, Kevin M., Andrei Shleifer, and Robert W. Vishny. "The Allocation of Talent: Implications for Growth," *Quarterly Journal of Economics,* CVI, May, 1991: 503-530.

Smith, Adam. *The Wealth of Nations*, New York: Random House, 1937.

Solnick, Sara J. and David Hemenway. "Is More Always Better? A Survey on Positional Concerns," 37 *Journal of Economic Behavior and Organization*, 373, 1998.

U.S. Department of Education, National Center for Education Statistics, The Condition of Education 2004, Indicator 14, Table 14-1. http://nces.ed.gov//programs/coed/2004/pdf/14_2004.pdf.

Testimony of Douglas Lowenstein
President, the Private Equity Council
Before the House Financial Services Committee
Washington, DC
Wednesday, May 16, 2007

Mr. Chairman and members of the committee: Good morning. My name is Douglas Lowenstein and I am president of the Private Equity Council, a new organization that represents ten of the leading private equity investment firms in the United States.[1]

Thank you for providing us the opportunity to be part of this Committee's effort to better understand the role of the private equity industry in the U.S. economy. This hearing marks the Private Equity Council's first presentation to a congressional committee, and we hope it represents the start of a continuing dialogue on issues of mutual interest.

Before addressing the issues the Committee has raised, I think it would be helpful to take a moment to demystify private equity. While some have a perception that private equity is a form of black box finance practiced by a small cadre of New York investors, the truth is that private equity is about hundreds of thriving companies contributing to the economy in numerous positive ways. When you buy coffee in the morning at Dunkin' Donuts, you're interacting with private equity; when you see a movie produced by MGM Studios and buy your kids ice cream at Baskin-Robbins afterwards, you're interacting with private equity. When you shop at Toys R Us for the hottest new video game or the latest "must have" doll, or when you buy a new outfit at J. Crew, you're touching private equity. When you buy pet food and supplies for your dog or cat at Petco, that's private equity, too.

Private equity is not just about household brand names. When you make online plane and hotel reservations for your vacation, you may be relying on private equity. Many of us work in office buildings owned by private equity firms, and drive cars and fly in airplanes that rely on parts and equipment made

[1] Apollo Advisors, Bain Capital, The Blackstone Group, The Carlyle Group, Kohlberg, Kravis & Roberts, Hellman & Friedman, T. H. Lee Company, Providence Equity, Silver Lake Partners, and TPG Capital.

by private equity-owned firms; even the power that lights our homes in some parts of the country is delivered by private equity companies.

Further, private equity investments directly and indirectly benefit tens of millions of Americans. Public and private pension funds, foundations and university endowments have chalked up returns from private equity investments that far exceed those available from the stock market. Between 1991 and 2006, private equity firms worldwide created more than $430 billion in net value for these and other investors. These returns translate into stronger public employee pension programs, more funds for college financial aid and scholarships, and more funds for research and other causes supported by charitable foundations.

Private equity is intrinsic to American capitalism. Venture capital, for example, is a form of private equity used at the start-up phase of a business. By contrast, the transactions under review by this Committee are more typical for companies in later stages of their development. These transactions may take many forms. They may involve the acquisition of a private company with the intent of providing its founders the capital necessary to take its performance to the next level. They may involve the acquisition of a division of a large company, with the purpose of offering the newly independent business the management focus and resources needed to achieve a new mission. They may involve "privatizing" a public company in an effort to undertake improvements that would be difficult to achieve with the short-term earning focus of the public markets.

Academics and business leaders have recognized for years that the public markets sometimes distort the incentives for companies to put in place sound long-term business strategies. Because the managers of publicly-owned companies are forced to keep a close eye on quarterly earnings to maintain their stock price, they sometimes are hesitant to make the often substantial investments in new processes, personnel or equipment required to drive strong, long-term growth, but that can depress earnings and lower share prices in the short term.

Private equity firms, on the other hand, can take a longer view. Without the pressures from outside public shareholders looking for short-term gains, owners and managers can focus in a laser-like way on what is required to improve the medium to long-term performance of the company. This structure also

makes it far easier to align the interests of owners with those of managers who also have a direct stake in the success of the company.

Ultimately, the mangers of private equity firms understand that they must improve the underlying value of the companies they own over time to continue to attract the capital they need. By better aligning owner-manager interests and by instituting a nimbler operating style that fosters greater innovation and long-term investment, private equity owners are leaders in spurring improved productivity and competitiveness.

Private equity is not a silver bullet, nor is it the right solution for every company. In the end, it is nothing more than a flexible form of ownership that, in appropriate circumstances, can create a successful operating environment for companies at different stages and in different conditions.

The Committee has asked that we address three issues: first, whether firms acquired through private equity make the investments in technology, capital equipment, and research essential to long run productivity growth; second, do workers find themselves disadvantaged through financial or other restructuring, and third, what are implications of private equity profits for growing income inequality in this country.

Private Equity and Growth

It is important to understand one central fact about private equity: private equity firms seek to improve the performance and increase the value of the companies in which they invest. Any other approach would defy common sense, because the entire business model rests on selling investments at a gain. That's why those who claim that private equity is all about asset stripping are missing the point: it is rather difficult to strengthen an underperforming business if you first vaporize the assets and the workforce. Bear in mind that after a private equity fund returns a company to public ownership, it usually maintains a very substantial equity stake in the company. In other words, if it adopts a short-term mentality, it takes money out of its own pocket by undermining the value of its own long term investment.

There has been much discussion about the degree to which private equity firms use debt as a tool in their transactions, and this is the premise for the Committee's question about private equity's

commitment to long-term growth. In today's intensely competitive environment, the use of efficient capital structures remains important. Adding debt does promote fiscal discipline, discouraging wasteful spending on things like "country club" corporate headquarters. However, a strategy of simply adding more debt to an "underleveraged" balance sheet – which once might have sufficed to allow private equity firms to recognize substantial gains with only modest performance improvements – no longer works.

In the leveraged buyout wave of the 1980s, financing was often 90 percent or more debt and 10 percent or less equity. Since 2002, PE deals average in the range of 60 to 66 percent debt, though there have been more recent deals with higher debt levels due to the unusually low interest rate environment we've enjoyed the past few years.

In any event, regardless of the debt levels, to succeed today, a private equity firm needs to bring much more to the table than financial creativity. The PE firm must add new capabilities to the company it buys (by adding new products), increase competitiveness (by reducing waste and improving operations) and grow revenues (by entering new markets or finding new customers) in order to make any money for itself or its investors. And it needs to develop, implement and successfully execute a compelling strategy to do so. The best private equity firms today must bring to the table much more than capital. They deliver deep expertise in the sector in which the investment is being made; managerial and functional (IT, for example) capabilities; a performance culture that rewards entrepreneurship and results; and an ownership structure that allows even the toughest decisions to be made quickly.

A recent analysis by McKinsey & Company of more than 220 transactions using primary data collected from firms in the U.S. and Europe that were held by PE firms for three and one-half years or more showed that PE fund performance is disproportionately driven by the very best and the very worst transactions in each fund. And for these outlier transactions, company performance is the main factor driving returns. In the very best transactions (with annualized returns of more than 60 percent), 70 percent of the value created came from improving company performance. In those that did not produce significant returns, the failure was caused by the general partner's inability to make fundamental improvements to the company's operations.

Consider the private equity acquisition of SunGard, a major software developer and vendor which was under tremendous pressure from public shareholders to increase its earnings. SunGuard CEO Cristobal Conde has said that under private equity ownership, the company plans to complete 53 new research projects in 2007, up from about 10 annually pre-PE acquisition. Under the new ownership, SunGuard's common services architecture program is thriving, covering 60 SunGard products, compared to four before the private equity acquisition. The firm is annually training about 800 programmers, up from 50 prior to the transaction, as part of a focused effort to streamline software development and distribution and reduce the cost of rolling out products and make it easier to integrate SunGard software with other vendors' products.

Or take The Carlyle Group's 2005 acquisition of a company called AxleTech International Holdings, Inc., which designs and manufactures drive train components for growing markets in the military, construction, material handling, agriculture and other commercial sectors. AxleTech was a solid business, but it was focused on the low-margin, low -growth commercial segment of the market. Under Carlyle's strategic direction, AxleTech undertook a concerted business development initiative to offer its axle and suspension solutions to military vehicle manufacturers in need of heavier drive train equipment to support the heavy armored vehicles required to protect American soldiers in Iraq and Afghanistan. At the same time, AxleTech expanded its product and service offerings in its high-margin replacement parts business while continuing to grow its traditional commercial business. Since Carlyle's acquisition, AxleTech sales have increased 16 percent annually and employment has increased by 37 percent, from 425 to 568. New jobs were created in AxleTech's facilities in Troy, MI, Oshkosh, WI, and overseas. AxleTech is one of the very few U.S. automotive-related companies that are growing in today's challenging industry environment. AxleTech's job growth does not take into account the ripple effects on AxelTech's suppliers who are experiencing new hiring and capital investments.

Finally, KKR's acquisition of ITC Holdings, an electric power transmission company in Michigan, offers a third case study of how private equity firms invest in the long-term health of their companies. When KKR acquired the company, it had a capital budget of $10 million and 28 direct employees; since being acquired, ITC has invested $400 million to rebuild and upgrade the transmission grid in its service area of southeast Michigan. ITC's annual capital budget is now $200 million, and employment has grown to 230

direct employees. In January, 2007 Michigan Governor Jennifer Granholm commended ITC for its "commitment to enhancing electric reliability" and for "investing in our electric transmission infrastructure to ensure that electricity will be delivered to millions of Michigan citizens as well as customers in other Midwest states."

Private equity is not perfect, nor does it always deliver the results predicted for its portfolio companies. Sometimes, firms do add too much leverage; sometimes, management cannot deliver successful growth strategies. But there are literally hundreds of positive stories similar to the ones I have described here. And overall, in the most thorough research on the impact of private equity to date, a study by the British Venture Capital Association found that PE companies in the UK grew sales faster than public firms and that their investment and R&D outlays grew at an average annual rate of 21 percent, results I expect are replicated here in the U.S.

Perhaps the best indicator that private equity firms build stronger businesses is revealed in research by Harvard Business School's Josh Lerner. In a recent study, Lerner found that the stock prices of companies operated by private equity firms for more than a year outperform the stock prices of industry peers that remained in public ownership. In other words, if we believe that the public markets reward the best-run companies, the Lerner study offers undisputed evidence that private equity creates significant value in the companies they owned.

Private Equity and Workers

The second question raised in the Committee notice regards the impact of private equity on working men and women. While data on private equity investment's impact on employment in the U.S. is anecdotal, a void the PEC hopes to fill in time, research in Europe suggests that PE investments do indeed result in long term job growth. A study by the international management consulting firm A.T. Kearney found earlier this year that PE firms generate employment, on average, at a much faster pace than comparable, traditionally-financed firms. Research by the BVCA on both venture and private equity portfolio companies found that during the last five years, businesses backed by private equity increased employment an average of nine percent per year compared to one to two percent for public companies. Earlier this year, the Financial Times studied the 30 largest European private equity transactions in 2003-04 and reported that "overall, jobs were more likely to have been gained than lost

as a result of private equity- backed buys." I cannot say definitively that the same outcomes occur in the U.S., but there is little reason to think differently.

That said, the recent increase in private equity activity is part of a larger and pervasive domestic and international economic wave that is driving changes across all classes of American companies, regardless of their capital and ownership structure. Profound forces unrelated to private equity are reshaping the American economy. In his work on the New Democratic Network's Globalization Initiative, economist Rob Shapiro has noted that while we have been in a period of sustained economic growth since the 2001 recession, as measured by GDP and productivity rates, wages for American workers have been flat or declining when adjusted for inflation. At the same time, job creation is occurring at a lower rate than after prior recessions.

I am not here to analyze the reasons for these unusual trends, nor am I qualified to do so. I raise it because it is important to understand the larger context in which private equity operates, and not to view it in a vacuum as if it can be isolated from these larger forces. Private equity is not causing these economic changes; but neither can it operate in a business environment isolated from them. The simple truth is that, as with any other acquisition involving public or private companies, private equity transactions can result in layoffs. In other cases, they may be short term layoffs until job growth over the long term increases as the business grows stronger. In still other cases, they may involve immediate employment growth. Even when some layoffs are essential, private equity has probably preserved hundreds or thousands of jobs that might have otherwise been lost by underperforming or failing businesses. In the end, this much I know: there is no evidence that private equity firms are more likely to cut jobs than any other form of ownership.

In fact, in the last months, we have read about a stream of layoffs at companies not involved in private equity acquisitions of any kind: Ford Motor Company, Circuit City and Citicorp, to name a few. Of course, if you're a worker, a lost job is no less painful regardless of the cause. And the point I am making is that demonizing private equity as a uniquely causative factor for job losses in this country is not just inaccurate, it diverts us from developing a more comprehensive national economic policy to deal with the evolving world in which we live. And as I said earlier, the entire business model of private equity is predicated on increasing value, not destroying it.

Private Equity and Income Disparity

The final area of interest to the committee is the impact of private equity on income inequality in this country. Undeniably, there are those in private equity who are doing very well. Fundamentally, this reflects the fact that they are good at what they do and that they have built significant value in their own businesses and in the companies that they acquire. Their personal success is directly tied to whether they in fact acquire companies, grow them, increase their value, and sell them for a gain. If they fail to do so, their access to investors' capital would dry up and they would be out of business. Moreover, there is no guarantee they will succeed, and the landscape is littered with private equity firms that crashed and burned precisely because there are real risks in PE investing. Not everyone does it well.

Equally undeniable is the fact that we have an income inequality issue in this country. But I submit to this Committee that the forces contributing to this go far beyond private equity, as do the solutions. Private equity is not the reason American companies are being pressured to lower costs, restructure, and employ new strategies to better compete with China, India and other emerging economies. And private equity alone cannot confront the forces contributing to the growing income disparity. But the members of the Private Equity Council are prepared to be part of a national dialogue about how to reverse this trend.

At the same time, it is important to point out how private equity is benefitting Americans from all walks of life. While the impact of PE on jobs is one important measure of its worth, it is not the only measure of private equity's impact on both workers and other Americans inside and outside the companies acquired. The beneficiaries of private equity include tens of millions of Americans whose retirements are made more secure by the very strong returns earned by public, private and union pension funds that invest in private equity ventures; they include the thousands of young people who obtain financial aid or scholarships to public and private colleges because of the high returns earned by university endowments investing in private equity; and they include those of us who may one day benefit from research to cure or treat a disease funded by a foundation generating above-average returns from private equity.

In fact, public pension funds, university endowments, and leading foundations accounted for one-third of all capital allocated to private equity in 2006. The 20 largest public pension funds for which data is available[2] - including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration - currently have some $111 billion invested in private equity on behalf of 10.5 million beneficiaries.

These investors seek out private equity because the return on investments made in private equity funds far outstrips that delivered by many other investment opportunities, including the public markets. Between 1980 and 2005, top-quartile private equity firms, on average, delivered to pension funds and other limited partners annualized net returns of 39 percent. During the same period, the S&P 500 posted returns of 12.3 percent. In the past five years, returns on investments made in companies by top quartile private equity firms averaged 20 percent, compared to seven percent for the S&P 500.

Let me give you a concrete example of what these numbers mean to real people. The Washington State Investment Board, which is responsible for more than $75 billion in assets in 16 separate retirement funds that benefit more than 440,000 public employees, teachers, school employees, law enforcement officers, firefighters and judges, has been a major private equity investor for 25 years. In that time, the WSIB has realized profits on its private equity investments of $9.71 billion. Annual returns on private equity investments made by the board since 1981 have averaged 15 percent, compared to 10.1 percent for the S&P 500. Put another way, the excess returns generated by private equity investments during that period are worth $26,000 per retiree; or expressed another way: these returns have fully funded retirement plans for 10,000 WSIB retirees.

---

[2] California Public Employees Retirement System, the California State Teachers Retirement System, New York State Common Retirement Fund, Florida State Board of Administration, New York City Retirement System, Teacher Retirement System of Texas, New York City Teachers Retirement System, New York State Teachers Retirement System, State of Wisconsin Investment Board, New Jersey State Investment Council, Washington State Investment Board, Regents of the University of California, , Ohio Public Employees Retirement System, Oregon State Treasury, State Teachers Retirement System of Ohio, Oregon Public Employees Retirement Fund, Pennsylvania Public School Employees Retirement System, Michigan Department of Treasury, Virginia Retirement System, Minnesota State Board of Investment.

Overall, between 2000 and 2006, private equity firms distributed $181 billion in profits to their limited partners in the U.S. alone. A corollary benefit from these exceptional returns is that dozens of states have been able to avoid budget cuts or tax increases that would have been required to meet their legally-mandated pension obligations to retirees who have devoted their careers to public service.

The bottom line:

Private equity makes significant contributions to the American economy. Through superior investment returns, it delivers important financial support for universities, research institutions and pension funds that benefit tens of millions of Americans. With infusions of capital, talent and strategy, private equity firms improve the productivity, performance and financial strength of the companies in which they invest. Private equity is not a silver bullet, neither is it a dark force. It is an innovative, flexible financial tool that has proven very successful in responding to the global challenges faced by American businesses today.

STATEMENT OF JON L. LUTHER, CEO OF DUNKIN' BRANDS, INC BEFORE THE COMMITTEE ON FINANCIAL SERVICES OF THE HOUSE OF REPRESENTATIVES, MAY 16, 2007

Chairman Frank and Members of the Committee, my name is Jon L. Luther. I am chairman and chief executive officer of Dunkin' Brands, the parent company of Dunkin' Donuts, Baskin-Robbins, and Togo's. I appreciate this opportunity to share with you Dunkin' Brands' experience with private equity ownership.

Our talented team of executives and employees—together with our thousands of franchisees and licensees, predominantly small businesspeople—has built a $6.4 billion enterprise operating in 47 U.S. states and 50 countries. Thanks to their effort and commitment, our brands are known and loved by consumers around the world.

When I joined Dunkin' Brands in January 2003, we were owned by Allied Domecq, a publicly traded spirits and wine company headquartered in the U.K. In November 2005, Allied Domecq was acquired by Pernod Ricard, a spirits and wine company based in France. Shortly thereafter, because Dunkin' Brands was not a core asset, Pernod put our company up for auction. In March 2006, we were acquired by a consortium of three U.S.-based private equity firms: The Carlyle Group, Bain Capital Partners LLC, and Thomas H. Lee Partners, L.P.

During the period in which we were an Allied Domecq subsidiary, we were considered a "cash cow." We were assigned yearly growth targets. We were usually last in line for attention and certainly for capital. Significant decisions required that I go to London. Our cash was swept every night and the focus was usually on the next quarter's numbers.

Our acquisition by Carlyle, Bain and Thomas H. Lee liberated our company. Our new owners expressed confidence in our management team, our strategies, and our vision. Our three key goals are to take Dunkin' Donuts national, transform Baskin-Robbins, and expand internationally. Rather than tell us to change our goals and our plans to achieve them, our new owners asked how they could support us. Finally, we had the attention and the resources we needed to realize our goals.

The benefits of our new ownership to our company have been enormous. Their financial expertise led to a ground-breaking securitization deal that resulted in very favorable financing at favorable interest rates. This has enabled us to make significant investments in our infrastructure and our growth initiatives. In addition, they have helped us to create a new franchisee financing program that will provide flexible, convenient and competitive financing options to franchisees of every size in all markets.

They have opened the door to opportunities that were previously beyond our reach. For example, they introduced us to a real estate development firm that is assisting our Baskin-Robbins franchisees in finding attractive real estate opportunities. Initial results have been so successful that we are now looking at using their services to support our Dunkin' Donuts development.

Our acquisition and the expansion plan for which we now have the resources have put us in the national spotlight. Countless news stories about us have caused us to be sought out by many potential employees and franchisees.

As a result, our franchising efforts, the engine of our growth, have taken off. We are a 100%-franchised enterprise. Every Dunkin' Donuts and Baskin-Robbins store that opens represents the achievement of a dream for an entrepreneur somewhere. A new Dunkin' Donuts means approximately 25 new jobs, and a new Baskin-Robbins approximately 12 jobs.

Over the next fifteen years, we would expect to add 250,000 jobs--jobs for young people, and jobs with good career paths in restaurant management, making possible for thousands the achievement of the American dream.

Our new owners have never asked us to cut costs or reduce our headcount. Any reductions in staffing that we've had over the past four years have been a result of our efforts to be more productive and less bureaucratic. This year, we also expect to divest of Togo's, our California sandwich chain, which generates approximately $200 million in annual revenues.

This decision, which our management team had considered prior to our being put up for auction, was finally made last summer. The decision was a function of Togo's size relative to our entire organization, and our inability to give it the kind of attention it required versus our two, much larger brands.

Recently, I was asked by a *Boston Globe* columnist whether Dunkin' Brands would follow the path of many companies and move to a location where the costs of doing business would be lower. I was pleased to say that Massachusetts is our home. We're not going anywhere.

We believe in strong community roots. Last year, together with our franchisees, we established our Dunkin' Brands Community Foundation. The mission of our Foundation is to support those who serve our communities, especially in times of crisis. This mission is true to our brand heritage, and the values of our entire system: employees, franchisees, and our customers.

As a result of our relationship with Carlyle, Bain and Thomas H. Lee, our business has benefited, our franchisees and their employees have benefited, and wealth-creating opportunity has been spread among hundreds of entrepreneurs and careerists associated with Dunkin' Brands.

# # #

Statement of
Andrew L. Stern
President
Service Employees International Union, CTW, CLC
To the U.S. House of Representatives Committee on Financial Services
"Private Equity's Effects on Workers and Firms"
May 16, 2007

Mr. Chairman and members of the Committee, thank you for the opportunity to appear before you today to discuss this critical issue facing our nation.

My name is Andy Stern and I am President of the Service Employees International Union (SEIU). With 1.8 million members, SEIU is America's largest union of health care workers, property services workers, and the second largest union of public services workers. A top priority of SEIU members is to unite working families, business leaders, community leaders, policy-makers, and other unions to find solutions to the challenges facing workers and our nation as our economy undergoes the most rapid transformation in history.

As the private equity buyout industry grows in size and influence, the impact of its practices on American workers, industries, the financial markets, communities and the nation as a whole must be examined more closely and I applaud the Chairman and this Committee for taking on these issues.

Today's economy and its impact on workers

The story America's success is a story of work and working people. The hard work of nurses, teachers, janitors, food service workers, home health and care workers, and millions in other professions have made our economy into the most successful, productive, innovative, and prosperous in the history of the world.

The greatness and promise of America has always been that, if you work hard, you will have your work valued and rewarded. You will be able to provide for your family, have a decent home, access to affordable health care, a secure retirement and time to spend with your family. You will have the opportunity to achieve the American Dream.

And throughout our history, this promise has driven millions to our shores. Every generation has done better than the last. But we are now at a moment in our history when the promise of the American Dream is in jeopardy.

Today, a majority of Americans say they believe their children will actually be worse off than they are, according to recent polling by Lake Research, which also found that an astounding 65 percent of working Americans now feel negative or uncertain about the American Dream.

Survey after survey tells us that Americans of all political persuasions think the nation is headed in the wrong direction. One poll last month conducted on behalf of *NBC News* and *The Wall St. Journal*, found that 66 percent of Americans feel this way.

Today's economy is simply not working for working people.

- More than 46 million Americans do not have health insurance. Tens of millions more are underinsured. More than 9 million American children have no health care coverage.
- Pensions are disappearing and retirement security is becoming a thing of the past.
- Schools are crumbling and failing our children—and not only in low-income communities, but in middle class communities too.
- Wages for working Americans are stagnant. In 2006, private sector wages dropped to 43 percent of national income, the lowest level in more than half a century.
- We have the highest rate of income inequality in this country since 1928. According to a recent study by the economists Thomas Piketty and Emmanuel Saez, the top 300,000 Americans have almost as much income as the bottom 150 million Americans combined.

People are working harder and longer for less. Opportunities that have always been there for Americans who work hard and build the value of our economy are disappearing.

But what is so puzzling to working people is that this is all happening during a time of unprecedented prosperity in America, a time that some are calling America's new "Gilded Age."

- Productivity is continuing to rise
- Corporate profits have more than doubled since 2000. In 2006, profits as a share of national income were at their highest level ever.
- The five largest companies in the world, Wal-Mart, General Motors, Exxon Mobil, Royal Dutch/Shell, and BP are each financially larger than all but 24 of the world's nations.
- CEO salaries are at record levels—the average CEO makes more than 431 times the amount of compensation of the average worker, a gap that has been growing steadily.

Productivity is up, but wages are not. Profits are up, but business investment is not. This is an economy that is not lifting all boats—just the luxury liners—and that's not good for our country.

Private equity is at the center of the today's economy

Private equity is a major driver of this economy. And while there are a number of private investment vehicles in the financial markets, including venture capital and hedge funds, today Mr. Chairman I am addressing the issues surrounding private equity leveraged buyouts.

Today, private equity is buying and selling larger and larger companies and reshaping whole industries. The buyout industry, armed with more than a half-trillion dollars of capital, is today engineering financial deals on a scale that until a few years ago seemed unimaginable.

- There were a record $197 billion worth of private equity mergers in first quarter of 2007.
- In the last five years, the volume of private equity deals has grown 600 percent—from $42 billion to $250 billion.
- The biggest five private equity deals together are larger than the annual budgets of all but 16 of the world's nations.
- The annual revenue of the largest private equity firms and their portfolio companies would give private equity four of the top 25 spots in the Fortune 500.
- Private equity firms control companies that employ more than 5 million workers. If the industry continues to grow at just half the rate it has grown in the last five years, by 2012 one out of every eight private sector workers – more than 15 million Americans—could work for a company owned by a private equity firm.

But the story of private equity is the incredible wealth being created for the small number of individuals at the top of the industry. As leveraged buyouts worth billions become more and more commonplace, private equity firms are extracting fees of hundreds of millions of dollars from the companies they buy and often generating profits of 20 percent or more.

In short, the income being accumulated by private equity is a major contributor to the concentration of wealth among the top 1 percent of Americans.

Private equity executives claim that while they are doing well, the wealth they are generating is helping fund retirement benefits for millions of public employees, university endowments, and foundations that support worthy causes. That is true. But make no mistake, there is more than enough money in the booming private equity industry for the firms to continue to do very well, for pension funds to continue to benefit, but also to make sure workers share in the economic opportunities being created by private equity.

Concerns about private equity

Against the backdrop of this record accumulation of wealth, private equity's practices are helping drive forces that raise significant concerns about their impact on workers, companies, and the financial markets.

Risky Deals Put Workers and Companies at Risk

A cornerstone of private equity is the corporate restructuring that follows a typical buyout. The industry claims it creates efficiencies in companies and helps turn around underperforming operations, building the long-term value of these companies and increasing the overall productivity in the economy. But the manner in which these restructurings are often undertaken raises serious concerns for workers and the companies themselves.

The high degree of leverage involved in buyout deals can create significant pressures to cut costs that are counter-productive to the stated goals of private equity firms and investors to create long-term value and productivity in the companies they buy.

In a highly leveraged buyout of a nursing home chain or hospital company for example, increased debt payments could squeeze capital expenditures necessary to maintain and update vital medical equipment. And what happens to operating budgets that go toward maintaining the staffing levels necessary to provide quality patient care? As private equity buys the market leaders in major service industries such as health care, the impact of private equity restructurings may create a ripple effect creating downward pressure on standards of care and potentially harming the long-term value and productivity of whole industries.

Another example is the case of the Bain Capital buyout of KB Toys, which was featured in SEIU's recent report "Behind the Buyouts: Inside the World of Private Equity." [Report available at www.BehindtheBuyouts.org] In 2000, Bain Capital purchased KB Toys in a highly leveraged buyout worth nearly $300 million. Bain's $18.1 million in equity accounted for only about 6 percent of the cost of the purchase—the rest was financed by loans and IOUs.

In 2002, Bain engaged in the increasingly common practice of a leveraged recapitalization of KB Toys. The company added additional debt to KB Toys—in order to pay Bain and several KB Toys executives a special dividend worth $120 million. Such dividend recaps increase a company's vulnerability to potential operational fluctuations or external changes that could result in either bankruptcy or restructuring.

In the case of KB Toys, the result was a bankruptcy filing in January 2004. As a result, more than 4,000 employees lost their jobs and 600 stores closed, the harsh result of a risky debt-driven business strategy.

Despite the cautionary tale of KB Toys, leveraged recaps increased from $3.9 billion in 2002 (the year Bain used the strategy at KB Toys) to $40.5 billion in 2005, according to Standard & Poor's. That's a lot of risk private equity is putting on these companies to pay themselves special dividends.

As we have seen most recently from the results of job cuts at Circuit City, layoffs are not the panacea many corporate managers would like them to be. Instead of viewing workers exclusively as a line-item on a balance sheet, or a cost to be cut, private equity must view workers first as the women and men who build the value of their companies and are the backbone of economic and civic life in their communities.

Private Equity "Exuberance"

The economy today has a case of buyout fever. Private equity firms raised $215 billion in 2006— the most ever. The total exceeds the amounts raised during the last private equity bubble, in 2000. With all this capital being raised, it increases the competition for deals,

adding to the likelihood some firms will overpay for deals or do deals that are far more risky. A significant downturn in the public equity markets would severely impair the ability of private equity to exit deals that were poorly conceived, highly leveraged, or overvalued.

If even one major deal fails, very serious concerns have been raised about its impact on the credit markets, on investors such as pension funds, and not least, the workers at the affected company.

Quick Flips and Sell-Offs

The industry advertises its ability to achieve long-term business growth, free of the scrutiny of the public markets. But in recent years, private equity has sought to increase its funds' investment returns by liquidating part or all of their investment more quickly than the traditional time period of three to five years. To accomplish this, firms engage in "quick flips," relisting companies within a year or two of taking them private, with more leverage, but few if any operational improvements.

In the case of the buyout of Hertz car rental by the firms Carlyle Group, Clayton Dubilier & Rice, and Merrill Lynch, Hertz was taken public less than a year after being bought by the private equity firms. The Initial Public Offering for Hertz raised $1.3 billion, more than 95 percent of which paid for special dividends for the firms, which recouped more than half the equity they invested. Far from producing long-term growth, Hertz reported a 2006 decline in net income of two-thirds and this year announced an initiative to eliminate more than 1,500 jobs.

Conflicts of Interest

The managers and directors of a public company owe a fiduciary duty to maximize returns to shareholders. But when private equity invites those same managers or directors to participate in a leveraged buyout, their interest shifts to helping the private equity group get the lowest price possible for the company.

This conflict of interest, which unfortunately is all too common in buyout deals today, raises significant questions about the deals that are being put together and whether or not the companies being bought are being adversely affected over the long term. It has been suggested by more than one commentator that management participation in buyouts should be prohibited.

For example, in the proposed $6.1 billion Cerberus buyout of Affiliated Computer Services, questions are being raised about the role of ACS Chairman Darwin Deason's role in the offer. Cerberus has an exclusive agreement with Deason to negotiate a take-private transaction of the company, which has led ACS's lead director to raise questions about how competitive a bid can be.

At the very least this is a matter that requires much more study, as private equity buyouts occur with larger and more prominent companies that serve important public interests.

Transparency and Disclosure
Unlike publicly traded companies that are subject to securities laws, it is well known that private equity buyout firms operate out of the public eye, with little oversight. With the pressures of high debt levels and the increasing practice of quick flips and sell-offs, it is critical that the industry provide more transparency and disclosure so that the people who might be affected by a given deal—workers, community members, shareholders and others—are aware of the potential impact on their lives.

Though the list may vary depending on the circumstances, a given private equity firm could disclose at the time of a deal and then periodically thereafter, information such as total debt, employment levels, management or other fees, any potential conflicts of interest, and/or major business decisions they plan on making at the company.

This would be a step in the right direction for workers who now have almost no voice in the deals, little information about their new employers, and no say about the plans that could negatively impact their lives.

Missed opportunities
Perhaps most importantly, buyout deals present real opportunities for our country. For all the hundreds of millions of dollars in fees and billions in profits taken out in these deals by the private equity firms, the workers at most of the portfolio companies receive no increases in pay or benefits—not even a more generous 401(k) contribution. The same goes for the contract workers—the janitors, security officers, food service workers, and others—who provide valuable services. Their jobs are controlled by these companies, but they are paid mostly poverty-level wages and more often than not have no affordable health care, sick days, or retirement benefits of any kind.

Take for example the Blackstone Group's recent $39 billion buyout of Equity Office Properties, the nation's largest office landlord. Less than a month after the deal had closed Blackstone had sold $21 billion worth of the Equity portfolio.

It is easy to see how Blackstone benefited from the deal—but what about the tens of thousands of property services workers—janitors and security officers—who work hard every day and build the value of these properties—but who may be struggling to provide for their families.

The $360 million in transaction fees from the Equity deal could have provided health insurance for one year for more than 150,000 property services workers.

The $4.4 billion in fees paid to private equity firms in the 10 largest buyout deals of the last two years would pay for family health plans for 1 million American workers.

I would ask you Mr. Chairman and the members of the Committee to imagine the economic impact on families, on hard-hit neighborhoods and whole cities if these billion-dollar private equity deals were structured in such a way to ensure that workers and

communities shared in the economic benefits of deals involving companies they helped to make successful.

Private Equity: The Opportunity

When it comes to private equity buyouts there have been both hits and misses. But for working people, there unfortunately have been far more misses than hits.

We could argue over a lot of issues, including whether or not private equity creates more total jobs than it destroys. The fact is there is not enough reliable information to make that determination across the board.

A better question for today, perhaps, is what kind of jobs are being created by private equity? In this economy, too often the jobs created are part time with low wages and no benefits. These are jobs with no future that cannot support families.

There is no argument, however, over the correlation between unions and good jobs and good jobs and increased opportunity for American families.

It would be best if the industry made changes itself and took steps to ensure that private equity works for working people and the rest of the country.

- That means making sure workers and communities that are impacted have a voice in the deals and benefit from their outcome.
- It means the industry should play by the same set of rules as everyone else and provide for more transparency and disclosure.
- It means they should eliminate conflicts of interest.
- It means that unions, if one exists at a company being bought, should be at the table as soon as possible when a buyout deal is being put together.
- If no union exists, private equity firms should see to it that they and their new portfolio company remain neutral on the question of unionization and allow workers to choose to form a union using the majority sign-up process.

But if private equity firms will not take steps to change, Mr. Chairman, Congress should legislate.

America has been at its best when a broad group of people have shared in the prosperity being created in the economy. We've gotten away from that in recent years.

It is ridiculous in America that everyone cannot share in the success and prosperity they helped create.

There is more than enough wealth in the buyout business for private equity firms to continue to prosper while also adapting their existing business model to expand opportunities to benefit workers, communities, and the nation. Everybody can win if we set our sights on that goal.

Improving the jobs of millions of Americans whose companies are involved in leveraged buyouts will have an impact on reducing the income inequality that is weakening our country, undermining our democracy, and harming the long-term sustainability of our financial markets.

The incredible wealth that exists in the private equity buyout industry presents a historic opportunity. It's time to repair the broken promise of the American Dream.

I thank the Chairman and the members of the Committee for their time.

###

The New York Times

ABOUT NEW YORK
Metropolitan Desk; SECTB

Unkind Cut For Janitors At Hilfiger

By JIM DWYER
792 words
16 May 2007
The New York Times
Late Edition - Final
1
English
Copyright 2007 The New York Times Company. All Rights Reserved.

On Thursday, Gloria Coreas took the subway from Jackson Heights, Queens, to 23rd Street, then a crosstown bus to the western edge of Manhattan, and spent her usual eight hours cleaning the office at the Tommy Hilfiger company.

At the end of the day, she was called to the fifth floor, along with the eight other men and women who make the daily mess disappear.

"A supervisor said, 'I'm going to give you bad news,' " Ms. Coreas said. "The job was ending."

Nine people, who came by subway and bus to scrub Tommy Hilfiger's toilets, mop his floors, dust his shelves, were out of work. They made about $19 an hour, union wages. The Hilfiger operation found a new company to provide these services for about $8 an hour, said Chuck Santiago, one of the people who lost his job and tried to get hired by the new cleaning contractor.

Yesterday, black Town Cars lined up in the fine spring sunshine outside the Hilfiger office on West 26th Street to collect young designers and executives while their former cleaning women and men handed out fliers and accepted condolences from people on smoke breaks.

Gustavo Aguinaga said: "Thursday night, they tell us the job is over on Friday. They tell us they're coming the next day to pick up the tools."

"No notice," Ms. Coreas said. "We were in shock."

The Hilfiger company sells clothes around the world stamped with variations on Tommy Hilfiger's name; last year, the company was bought for what was reported to be $1.6 billion by a private equity company called Apax Partners. (What is $1.6 billion? Here's a scale: One million seconds is about 11 days. One billion seconds is about 32 years.)

Besides cashing in his own stake of $66 million, Mr. Hilfiger will be paid a minimum of $14.5 million a year through 2010, then receive a share of the sales.

For workers in their 40s and 50s, a job that pays $8 an hour was a nightmare. "Rent in Jackson Heights is unbelievable now," Ms. Coreas said. "It's more than a thousand dollars."

"We're not asking for raises," Mr. Santiago said. "We're not asking for anything, except to let us work."

As they spoke, Andy Hilfiger, the brother of Tommy, stepped outside. "I think they came with the building," he said of the laid-off cleaning people. No, he was told, the cleaners had moved with Hilfiger to 26th Street from offices a few blocks away. "Oh, they did?" he said. "I'll try to find out something." He got on a cellphone, then drifted away.

Yesterday, Marybeth Schmitt, speaking for the people who own the Hilfiger name, called.

"I have a statement," she said.

Hold on.

Had her space been cleaned satisfactorily, the bathroom tidy, and so on?

"I would have to get back to you on that," she said.

Couldn't she say whether her trash can had been properly emptied? Without conferring with other executives?

"I don't think this is personal," she said. "This is a corporate matter."

Sigh.

Before getting to the statement, it's worth noting that on its Web site, Hilfiger says that garment manufacturers who work under contract for the company must treat their workers fairly.

Hilfiger used a contractor, Shepard Industries, to clean its space in Manhattan, and Ms. Schmitt's initial statement seemed to blame Shepard for the loss of jobs, saying the contractor had "ended its relationship with Tommy Hilfiger USA Inc."

That leaves out an important detail. "We have not been paid by Tommy Hilfiger for the last six months," said Joan Taylor, the director of operations for Shepard. "We have paid our employees."

So Tommy Hilfiger, a name owned by the global private equities firm Apax with $20 billion in assets under management, did not pay the company that paid the people who cleaned its bathrooms?

Asked about this, Ms. Schmitt said yes, it was true that Hilfiger had stopped paying the cleaning contractor in December, but only because it reduced its office space by half in November and disputed the contractor's bills. Hilfiger "is currently seeking a union employer to take up this contract," she said.

The first contractor contacted by Hilfiger, IBS Services Group, did not respond to inquiries.

On Friday morning, Gustavo Aguinaga and Gloria Coreas and the others came to work. At day's end, their tools were hauled away: buffing machines, vacuums, brooms, dusters, rags, Windex, Fantastik, degreaser, carpet shampoo.

"We packed it all up," Mr. Aguinaga said.

Why?

"They asked us," he said.

E-mail: dwyer@nytimes.com

Document NYTF000020070516e35g0003m

© 2007 Factiva, Inc. All rights reserved.