Private Capital through Political Cycles

A Webinar Sponsored by
Private Capital Project at Harvard Business School
and **The Private Capital Research Institute**

Panelists:

John Coates
John F. Cogan, Jr. Professor of Law and Economics,
Harvard Law School

Jonathan Lavine
Chair, Bain Capital

Moderators:

Victoria Ivashina
Lovett-Learned Professor, HBS

Josh Lerner
Jacob H. Schiff Professor, HBS

Summary

Elections can have profound economic impacts through regulatory changes and other direct economic policies, as well as broader economic and geopolitical implications. Many of these channels have the potential to affect the private capital industry. The impact of this upcoming presidential election on the industry is less likely to be certain, given the sharp political divisions in the nation. In addition, policy changes depend on a combination of factors beyond the presidency, including the composition of the Senate and the House and the interpretations of the U.S. courts. Furthermore, predicting how the markets will react to the election outcome is difficult. As a result, alternative industry investors must be prepared to anticipate and respond to a wide range of political and economic scenarios.

This webinar, held on September 9, 2024, provided insights into the evolution of the private capital industry through historical political cycles and discussed what changes might arise in the years ahead. The following are some key highlights from this webinar:

- Changes to the taxation of unrealized capital gains and carried-interest taxation are unlikely in the short term.
- Changes to taxation in the longer run will depend on the budget deficit, which is likely to be large under either Harris or Trump administration.
- Change in regulation could target specific activities (private debt or renewable energy).
- Firms are advised to manage leverage, diversify, and monitor peers to mitigate broader risks, particularly in private credit markets.
- The perception and public opinion of private capital under either party could be an important factor in shaping future industry policies.
- Preserving the independence of Federal Reserve is crucial to economic success.

Tax Implications

Taxation of investment returns have been a perennial topic of discussion. The panelists agreed that while new tax proposals, such as the taxation of unrealized capital gains, face challenges, changes to carried-interest taxation are more likely if Democrats take control. However, many Republicans are also proponents of this change.

Regardless of the election outcome, the panelists believe that taxes, in general, are expected to increase due to anticipated higher deficits under either administration. The specifics will likely depend on how fiscal policies evolve. Tariffs are also likely to increase, particularly on goods from China. Under a Trump administration, tariff increases would likely be broader, while under a Harris administration, the focus would be on more targeted measures.

The panelists expressed a preference for broad tax reform over the targeting of specific sectors or activities like carried interest. They also emphasized the need for tax reforms to prioritize deficit management and the establishment of clear guidelines for what should be taxed. They cautioned that public relations-driven policy decisions targeting specific behaviors or sectors could lead to unnecessary complexity and market distortions.

Lastly, the panelists remarked that implementing tax changes (except for tariffs) or introducing new regulations is a complex and lengthy process that involves more than just the Executive branch. Tax changes, in general, are challenging to implement due to the need for approval from multiple committees in Congress.

Regulatory Implications

The presidential election outcome will likely impact leadership in key regulatory agencies and cabinets. If Harris wins, significant changes are unlikely due to the continuation of many of the policies and personnel of the current Democratic administration. However, this could also bring about notable policy shifts in areas like renewable energy and enforcement of the Foreign Corrupt Practices Act (FCPA) and anti-money laundering laws. Regulatory power is influenced by Congress, which could create hurdles depending on the makeup of the House and Senate. The Courts could add further unpredictability, as rulings can limit or enable regulatory actions, complicating the regulatory environment and potentially allowing private equity players to capitalize on gaps.

Private Debt Systemic Risks

The private debt market is one area of growth in the private capital industry that faces potential regulation. After the 2008 financial crisis, the private credit market expanded, quickly approaching the size of the leveraged loan market. Opinions differ on the potential systematic risks of the asset class, but it has been a subject of discussion for policymakers worldwide.

On the one hand, some view private credit as a plain-vanilla debt class, raising money from diverse, sophisticated institutional investors. It offers flexibility in restructuring and has had historically low default rates, demonstrating its resilience through crises like the subprime mortgage crisis and the COVID-19 pandemic. Many of the institutional investors in private debt funds are highly sophisticated, with many public institutions using specialized consultants to manage risks and improve decision-making.

On the other hand, others see private debt as a highly leveraged and opaque investment activity. These critics believe that more data is needed to fully understand why private credit providers are surging and whether the industry is becoming more complex and over-leveraged. Furthermore, some newer institutional investors may lack the expertise in this asset class and simply be “trend chasing.” While the data suggests that private debt default rates have been relatively low over the past years, there is still worry that excess credit provision, in conjunction with a few bad actors in the industry, could lead to adverse economic outcomes in a downturn.

Fed Independence

One primary concern with the upcoming elections is preserving the independence of the Federal Reserve. The panelists agreed that undermining the Fed's independence, especially under political pressure, introduces long-term complexities and ambiguity into economic policy, negatively affecting the economy. The tools available to the Fed are imprecise, as shown in the recent battle with inflation, and compromising its independence could worsen its ability to guide the economy. As both a major producer and consumer of debt, the private capital industry has a strong interest in maintaining the Fed's largely apolitical role in managing inflation and setting interest rates.

Final Thoughts

As with any election, the private capital industry must be prepared to adapt to new regulatory and tax scenarios. While taxation is always at the forefront of the industry's mind, it is essential to remember that these changes generally take time to implement, no matter who sits in the Oval Office. Private capital firms can help themselves by being more transparent to reduce the fear of a financial crisis and improve the perception of the industry.

Lastly, the panelists noted that there is a potential for better policy outcomes for the private capital industry through collaborative discussions. However, fostering nuanced conversations in policy circles is challenging, as current discussions are often polarized. If properly governed and funded by Congress, regulatory agencies can play a role in addressing complex issues, but the traditional notice-and-comment process has become less effective. European regulatory frameworks are seen as better at facilitating transparent and nuanced discussions due to the need for collaboration between nation-states. In the U.S., more effort is needed to move beyond binary pro- or anti-regulation stances and encourage open, non-negotiation-based dialog. This effort would result in better policy outcomes, with regulators and industry leaders working together without fear of "gotcha" moments.