

Counterpoint: Congress and The Estate Tax

Seven reasons why Congress should repeal, not fix, the death tax

The House and Senate may soon begin debate on what to do with the federal estate tax. Since Congress failed to act before January 1, 2010 and the estate tax expired for one year, if Congress does nothing by January 1 of next year, the estate tax will return in 2011 at a top rate of 55 percent and a \$1 million exemption of taxable estate.

The 2009 tax rate was 45 percent, and the 2009 exemption stood at \$3.5 million per taxpayer.

What should Congress do? Some members want to permanently "fix" the death tax by reducing the top rate to 35 percent, which some pro-death tax policymakers suggest is a rate wealthy taxpayers could "afford." However, this would be the wrong move for Congress to make. Instead, policymakers should do what their voters want them to do, as revealed in poll after poll: They should repeal this tax and kill it, once and forever.

Americans of all walks of life sense the deep injustice of federal death taxes and the fundamental immorality of bedrock public policies that tell people one thing and do another. Policymakers say, on the one hand, that that if you work hard, save your money and generally do the right things in your daily life, you will succeed in the U.S. economy. On the other hand, however, these same policymakers

support the federal death tax, which has the power to nearly confiscate their hard won economic gains once success is attained.

As members of Congress consider whether to retain federal death taxes, they should ponder the principal reasons why they should join prior Congresses and repeal this tax.

1. Death taxes discourage savings and investment.

For those Americans who think that their estates may one day pay federal death taxes, the tax sends a signal that it is better to consume today than invest and make more money in the future. Instead of putting their money in the hands of entrepreneurs or investing more in their own economic endeavors, Americans are encouraged to consume it now rather than pay taxes on it later.

2. Death taxes undermine job creation.

Not only do federal death taxes have a corrosive effect on the virtue of savings and prudent investment, but they also directly undermine job creation and wage growth. These latter effects make death tax repeal everyone's concern. Heritage Foundation economists estimate that the federal estate tax alone is responsible for the loss of between 170,000 and 250,000 potential jobs each year. These numbers do not appear in employment statistics because the investments that would have created these jobs are never made.

3. Death taxes suppress productivity and wage growth.

The estate tax discourages investment, which holds down wage growth. Businesses are less able to purchase new tools and equipment, which makes workers less productive, which means less wage and salary growth. It is through productivity growth that enhancements to economic and social well-being are made and the virtues of America's form of economic organization are most abundantly seen.

4. Death taxes contradict the central promise of American life: wealth creation.

Most Americans oppose death taxes because they seem so un-American. The central promise of American life is that if you work hard, save and live prudently, you will be assured the enjoyment of your economically virtuous life. There are few other places on the planet where this promise is made (let alone kept), and it - along with companion promises of political and religious freedom - has attracted millions of immigrants to the United States. The death tax contradicts the very promise that has attracted so many.

5. Death taxes hurt those who have tied their savings up in land.

Some Americans - such as farmers, ranchers and homeowners - have improved the land upon which their other assets sit, and the death

tax punishes them for this productivity. Others see their property value go up because of factors beyond their control, such as the population growth of cities. In this case, the death tax is fundamentally unfair.

6. Death taxes hurt African-American business owners.

Many Americans save in their businesses in order to pass an asset along to their children, and many of these businesses are owned by African-Americans and other minorities. The threat of seeing their life savings absorbed in a single tax bill is reason enough to demand permanent repeal.

7. Death taxes hurt women business owners.

Small businesses offer a way around the corporate glass ceiling for many women returning to the labor force after raising families or taking care of other obligations. The economy welcomes their enterprise and creativity, but the death tax makes their return more difficult.

The federal death tax is, indeed, the nightmare of the American dream. Not only does it undermine the promise of American economic life, but it strikes hard at those aspects of economic activity most important to those just starting their careers or struggling to climb up the economic ladder: It strikes at job creation and income growth.

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Q & A with Kevin Kliesen

Business Economist with the Federal Reserve Bank of St. Louis

IBJ: How does this recession/recovery compare to others?

Kliesen: Historically speaking, the deeper the recession, the stronger the recovery. But, that hasn't been the pattern of the last couple of recessions. The previous two recessions in 1990 - 1991 and 2001 - were relatively mild recessions. This time the recession was very deep, so the pattern



Kliesen

coming out of this recession has been unusually mild in terms of economic growth compared with previous deep recessions like 1981-82 or 1957-58.

IBJ: Why is this recovery unusually mild?

Kliesen: There are probably several reasons that we could point to. One is this time around we had a global recession. Most of the major economies of the world were in a recession or experiencing below-average growth. There are problems now developing in Europe. We also had this housing boom and bust, problems in the financial sector and problems in the automotive sector. Economists are coming to the conclusion that we have some significant structural changes in the economy that we need to get through, which will probably keep growth a little bit weaker than usual for a while. One of the ways to see that is with

the percentage of the labor force that has been unemployed for over six months. That's currently at a record high of a little over 4 percent. Clearly there's a relatively large percentage of the population that is having a difficult time getting a job - which suggests that maybe their skills need to be retooled to do something else.

IBJ: What are your expectations relative to employment as we go forward?

Kliesen: It looks like employment is starting to pick up. The economy has experienced three straight quarters of growth. It looks like the second quarter is going to be a little bit better than the first quarter. Private sector employment in April was the largest in four years, so that's a pretty good sign. In terms of the unemployment rate, it's probably going to remain elevated for awhile followed by a gradual decline. As the economy starts to improve, you start to see people coming back into the labor force and starting to look for employment. That has a temporary effect of boosting the unemployment rate.

IBJ: Do you think that the extension of the unemployment benefits that we've been doing actually prolongs unemployment because people have an alternative other than to go get a job?

Kliesen: The Federal Open Market Committee talked about this and concluded that it may have boosted the unemployment rate by about one

percentage point more than what it otherwise would be. These are only estimates that come out of the statistical models but clearly, if you reduce the opportunity costs of being unemployed, obviously that's going to give people an incentive to stay unemployed longer and try to find a job that more closely matches their skills.

IBJ: Are retail sales beginning to rebound?

Kliesen: As best we can judge, retail sales have been on an upward trend. Clearly as the economy recovers and people become less reluctant to spend, then they start perhaps reverting to past spending trends and consumer spending starts to pick up. Clearly it's difficult to have a very strong recovery in the short term without stronger consumer spending since consumer spending is about three quarters of GDP, give or take. Over time, though, clearly our saving rates probably are less than what we would like as the boomers start to retire - so over time you would expect, at least economists are hoping and expecting, that that saving rate starts to pick up.

IBJ: A few years ago, all of the talk was about upcoming labor shortages due to the retirement of the baby boom generation. Has this recession changed that?

Kliesen: A lot of people have seen their 401(k)s turn into 101(k)s and they started staring at life in retirement and with a much lower level of assets. That's probably influenced many people to either

go back into the labor force or remain in the labor force for a longer period of time. You reach a point where you can't physically work anymore, so that phenomenon will eventually occur - but it may have been pushed back a few years.

IBJ: It would seem that a boost in retail sales would trigger an overall boost in the economy. If sales go up, retailers would build more stores, triggering bank lending, making more work for engineers, architects, construction companies, realtors, etc. Should we expect a commercial building boom in the not-too-distant future?

Kliesen: That's traditionally been the pattern. But this time around, probably not so much. Not only did we have a building boom in residential housing, we had a building boom in commercial real estate construction as well.

IBJ: Do you think there's a lot of empty space out there that needs to be filled first?

Kliesen: I think that looks to be the case. Obviously it varies by geography. That may not be the case in some areas, but I think on balance if you look at the relatively weak growth of rents in commercial properties and very high nonperforming loans and commercial real estate loans, clearly that sector has a ways to go before we really start to see a boom in retail construction in the aggregate in the U.S. as a whole.

Illinois Business Journal

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Fannie & Freddie on the ropes, but bankers stress importance of secondary market

By ALAN J. ORTBALS

While some in Congress are calling for the abolition of the GSEs (Government-sponsored enterprise) Fannie Mae and Freddie Mac, community bankers are adamant that access to the secondary mortgage market must be maintained.

Federal National Mortgage Association (Fannie Mae) was created by Congress in 1938 to provide a secondary market for mortgages, thus increasing the amount of money available for lending. It was converted into a stockholder owned corporation in 1968. Later, the Federal Home Loan Mortgage Corporation (Freddie Mac) was created in 1970. As of 2008, the two either owned or guaranteed more than 50 percent of the nation's \$12 trillion mortgage market.

The two GSEs were hammered by the collapse of the mortgage market and were taken under conservatorship by the Federal Housing Finance Agency in September 2008.

Congress is now working on reforming the banking industry. What will happen with the two agencies is unclear.

In April, the Independent Community Bankers Association issued a press release that laid out its views on the subject: The secondary mortgage market must be impartial and provide equitable access and pricing to all lenders; it has to be focused on supporting residential and multi-family housing; the conflicting requirements of a public mission with private ownership should be ended; there should be more than one secondary market provider; and, it needs to maintain its government ties.

"Whether they would be redone and go forward or some other secondary

market entity goes forward," said Ann Grochala, vice president of lending and accounting policy for the ICBA, "what's really important is for community banks to have access to an impartial secondary market where they can sell their loans. By impartial, we mean that they need some place to sell their loans that won't compete with them, because if they sold to certain institutions that are in the private sector, they would steal their customers away from them. One of the benefits that Fannie and Freddie have brought to the table is that they don't do any retail lending, so they're not in direct competition with community banks," she added.

The Community Bank Association of Illinois supports that view.

"I think dissolving the GSEs is serious and ill advised, particularly for community banks," said David Schroeder, vice president of federal governmental relations for the CBAL. "The larger institutions - the too-big-to-fail banks - could make a go of it without Fannie and Freddie and they have a large branch network. They can aggregate a number of loans. They can get them securitized and they can get them sold off into the secondary market. But community banks need Fannie and Freddie to be able to sell those loans to them, put them out into the secondary market and recycle those loan dollars. I think that's critically important for community banks," added Schroeder.

Dennis Terry, president of First Clover Leaf Bank, says it reminds him of the savings and loan crisis of the early 1980s. At that time, the S&Ls were sitting on long-term, fixed-rate

mortgages while interest rates on CDs shot up to as high as 17 percent - a combination which spelled doom for many. Terry says that if banks don't have institutions like Fannie Mae and Freddie Mac to sell their mortgages to, they could find themselves in the same situation again.

"If you don't have a marketplace for these documents to be traded, nobody in their right mind is going to want to take the full interest rate risk associated with a 30-year, fixed-rate mortgage," Terry said. "I doubt that there's anybody in this country paying 7 percent or 8 percent on their mortgages today. They're all below that. The only way that rates can go is up. The interest rate risk associated with that would make holding a large portfolio of mortgages a very risky move."

Dale Oberkfell, president and chief operating officer of Reliance Bank, says one of the ideas that is being talked about is to create an entity more like the Federal Home Loan Bank system. Oberkfell serves as vice chairman of the Federal Home Loan Bank in Des Moines. It has 1,200 members within a five-state area and there are 12 such systems across the country. The members own the bank and operate it as a cooperative in support of its members which are banks, credit unions and insurance companies.

"At one time Freddie Mac was part of the Federal Home Loan Bank system," Oberkfell said. "In the late 80s when the savings and loan crisis hit, Freddie Mac was pulled out of there. The powers that be thought that a for-profit structure might work more effectively. But today,

I think, they've concluded that that structure created more opportunity for risk taking, which is obviously not in the taxpayers' beneficial interest, and now we're paying for the problems."

Oberkfell says a key component of any system going forward is that the originators of mortgages have to keep "skin in the game," meaning that they have to retain a certain percentage of the loans in their own portfolio.

"If you have a mortgage broker out there who is simply living today to get a commission and gone tomorrow, their sole goal is to get the mortgage done and get away," Oberkfell said. "If you have some risk, some skin in the game, you'll be less reluctant to engage in that type of activity. That approach works for a bank which has the liquidity to do that, but it doesn't work really well for a mortgage broker who is out there on his own. And across our country we have a lot of mortgage brokers who would not be capable of sustaining their business if they had to put skin the game."

Oberkfell says the United States is unusual in offering 30-year, fixed-rate mortgages. Most European countries, he says, go with much shorter terms and variable interest rates. But switching to that kind of system would put a real damper on the housing industry, he adds.

"Our economy needs a good strong system to support housing finance because it makes up such a significant part of our economy," said Oberkfell. "I think the solution that we have to come up with has to maintain the 30-year mortgage and we have to figure out a way to make that work so that people don't take undue risk."



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