

Government should not impose windfall profit tax on banks essay sample

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Introduction

The government has proposed imposing windfall profit tax on bank that benefited from Trouble Assets Relief Program (TARP) funds, as a mitigating factor to respond to the recent economic crisis. The recent economic crisis has been described as the worst since the Great depression. Since 2007, economic meltdown, which started with the housing sector, spread to the whole economy and among the first casualties were the financial institutions. Most financial institutions were forced out of the market as customer faulted on their loans and inter-bank lending became difficult as most financial institutions were not willing to expose their financial status. The country was faced with an imminent collapse of the whole economy as most banks tightened lending and it became difficult to access loans from financial institutions. Most financial institutions were forced to merge and those which were not lucky were dissolved.

The government moved in quickly. In order to save the troubled financial institutions from collapsing, the government instituted the Troubled Asset Relief Program (TARP) which would advance financial assistance to financial institution to strengthen their asset capital base. The program was initially scheduled to cost \$356 billion but it ended up costing the government \$89 billion. However, the financial package came with strict regulations since the government acquired stake in these institutions imposing various measures including regulation of executive pays and others. As the economic crisis settles, the government has proposed to impose windfall profit tax on those

institutions as move to recover some of the public funds that were invested in TARP.

Most of the institutions which benefited under TARP have been repaying back the amount they received to buy back the government stake and take charge of their operations again. Proponents of imposition of windfall profit tax on financial institutions argue that this would provide the government with addition revenue and redistribute it to the whole economy. However, as it can be learned through experience from earlier incidence of windfall profits tax on oil industry, windfall profit tax do not always meet the intended purpose. They are complex to administer and may have negative effect on the economy. The government should not impose windfall profit tax on financial institutions since this will hurt the recovering the economy.

Review of windfall profit tax

Windfall profit tax includes higher tax levied on profits, which ensues from a prompt windfall gain for a given industrial sector (Linda, 2004). This tax is levied on a given industry when the economic conditions improve to allow the industry to record above the normal profits. This tax is mostly levied to a targeted industry which has previously benefited from economic windfall in commodity or non-commodity based business (Thorndike, 2005). Through windfall tax, the government aims at getting more revenues which are then distributed to other sectors of the economy. Windfall tax has become a controversial issue every time the government institutes such measure because it is considered as an opportunistic move that is more likely to

reduce the initiatives taken by the industry to seek profits. Windfall tax is also controversial in economic lens since excess profit in any industry should be reinvested to ensure that the industry can sail through during the time of crisis. Excess profits should be reinvested in order to promote innovation that is likely to promote the growth of the economy in other industrial sectors.

Windfall taxes were first instituted on the oil industry in 1980 when the government enacted the Crude Oil Windfall Profit Tax Act. This was taken as an agreement between the Carter administration the Congress to institute measures to decontrol crude oil prices (Lazzari, 2006). The main intention of this legislation was to recoup the excess revenues that had been earned by oil producers which resulted from sudden sharp price increase resulting from oil embargo imposed by OPEC. This tax act was instituted during to many factors which included:

The congress became increasingly concerned with the trend in world oil industry. It was concerned that the domestic oil industry was going to get enormous revenues and superfluous profits due to oil price deregulations which would allow the domestic producers to rest world price levels (Thorndike, 2005). Therefore, congress did not see it fit for the redistribution of income from consumers to few producers.

Congressional studies had made the congress believe that the industry was not paying fair share of taxes (Thorndike, 2005). The oil industry had contributed low income taxes to the government and this could be traced to

two existing oil industry tax subsidies which included percentage depletion allowances and permits that allowed companies to expense intangible drilling costs.

The congress was also looking to increase government revenues in order to cover the deficits that had been experienced between 1961 and 1979.

Congress postulated that windfall tax on oil industry would generate excess \$393 billion (Lazzari, 2006).

However, the windfall act was repealed in 1988 during the low oil prices. It was replaced with The Omnibus Trade and competitiveness Act 1988. There were many factors which were considered by the congress in repealing the windfall tax and enacting The Omnibus trade and Competitiveness Act 1988. One of the main issues that had shaped the debate for repeal of this act was the fact that original revenue forecast had been overestimated, which in general reflected overestimation of the crude oil prices. In one decade between 1980 and 1990, windfall tax revenues generated 80% less than the amount that had been projected (Lazzari, 2006).

This tax was also faulted on the grounds that it had increased national dependency on foreign oil since the tax was only imposed on domestic produced oil rather than the imported oil. Consequently, domestic oil producers increased their prices to cater for the tax and there was general increase in import of crude oil that did not attract the tax (Hargreaves, 2008). This tax also distorted distribution of resource in oil industry. The tax was imposed on drilling and therefore most investors shifted from

exploration and drilling, which were taxed, to refining and marketing. The tax also proved very difficult to collect and administer. After the tax was repealed, it has been abolished and introduced by the congress a number of times. Once the oil industry makes superfluous profit, the government imposes windfall profit tax. For example, between 2007 and 2008, more than nine bills were introduced by the congress imposing tax on windfall profits.

It seems the government has not learned lesson about imposition of windfall profit from the oil industry. After the disastrous performance of the financial sector during the economic crisis, the government rescued the sector through TARP funds. Two years later, the government is proposing to impose windfall profit tax on these financial institutions when they show signs of recovery. The call to tax banker's profit is unfortunate because the economy is just showing signs of recovery. The government is borrowing a leaf from Britain and France who plan to impose a 50 percent tax on banker bonuses (Harrop, 2010). From the experience with the oil industry, the government may be trending on dangerous path and this is a proposal that need to be shelved for the time being until such a time when the economy has fully recovered.

Why government should not impose windfall profit tax

The recent government proposal to impose windfall profit tax on financial institutions is misguided. In January 2010 the government released its "Financial Crisis Responsibility Fee" big bank tax which is expected to be rolled out in June (Recard, 2010). Government expects this windfall tax to

contribute more than \$90 billion in a period of 10 years and more than \$117 billion in 12 years (Kroll, 2010). The government also asserted that taxing the big banks won't go away until the TARP bailout money has been repaid to the full. This taxing will be applied to financial institutions that have more than \$50 billion consolidated asset value including the bank holding companies like Goldman Sachs, thrifts, and insurance companies like AIG renamed Chartis (Beam, 2010). Interestingly, these taxes will not be imposed on Fannie Mae and Freddie Mac and the automakers. The taxes have therefore been motivated by the large profits these financial institutions have reported in the recent past.

As analysts have point out, it shows a government that wants to stretch its muscles to almost all sectors of the economy and impose regulations that may hinder economic recovery. The fact that government assisted troubled financial institutions to recover from the impact of the economic crisis should not be used as a as excuse to regulate all bank operations. It is just two years since most of the financial institutions were granted funds to stabilize their operations. Although most of them have repaid back the funds they got from the government to buy their " freedom" from government regulations, the proposal to tax them may have long term impact on their stability and affect the rate of economic recovery. According to Republican National Committee Chairman, Mel Martinez, government proposed windfall profit tax is " The basis for [the bank tax] is populism. It's very popular to whack the banks and talk about bonuses and get every dime paid back even though it's already happening" (idebate. org, 2010) This means that planned

government taxation system is based on the desire to create populism and to react to public feeling. It is meant to make the public feel that the government is addressing the wrongdoings that have placed the country in its current economic predicament but it has little merits in terms of potential benefits to the economy.

Windfall profit tax is ill intended

During the economic crisis, in fear of eventual collapse of the financial sector, the government forced most financial institutions to apply for TARP. This means that even those institutions which were not at risk of collapse were enticed to take the money since there were no prior agreements that they would be eventually taxed (Tiffany's Blog, 2009). As a precautionary measure, most institutions were therefore forced to take up the funds even if they did not require extra funding because they were stable. Treasury used more than \$239 billion on 296 of the 8,000 banks in the country. The funds were given to small and big banks which desperately need to stabilize their operations. The top ten recipients of government TARP funds were financial institutions which included Citigroup (\$45 billion), AIG (\$40 billion), JP Morgan Chase (\$25 billion), Bank of America/Merrill Lynch (\$25 billion), Wells Fargo (\$25 billion), Goldman Sachs (\$10 billion), PNC Financial Services (\$7.58 billion), and U. S. Bancorp (\$6.6 billion) (Banking News, 2009).

Although some of the banks that received TARP funding deserved, there were many banks which received the money while in real sense they were not in dire need for stabilization. Political patronage was a factor in accessing

TARP for most institutions (Palleta & Enrich, 2009). In addition, this money was not distributed equally among all the major banks. Some received in excess of \$45 billion while others received as little as \$1.5 million.

Statistical analysis shows that about 67 percent of TARP funds went to only eight institutions that government thought were at risk of imminent collapse while only 33 percent went to other institutions (Palleta & Enrich, 2009).

Right from the start, it is evident that the distribution of the fund was highly skewed and some of the institutions that received these funds did not deserve them. For those banks which were in dire need of funding, it is possible that they have not stabilized and continuing to tax them would prove disastrous to their stabilization.

The government claims that the main reason for windfall profit tax is to help the government recover funds that were used in TARP. TARP was funded from public coffers and windfall profit tax is aimed at distributing this money to the public again. However, this is a misguided fact considering that most of the banks have made headway to return the funds that were given by the government. As was highlighted earlier, the government put in place strict rules that were to be followed by the financial institutions to ensure that the funds were well managed. As part of financial sector regulation, the government instituted strict measures including regulation of executive pay. As a result, most institutions that had taken the funds were not independent and were highly regulated by the government.

A number of institutions moved fast to buy out the government stake to buy back their “freedom”. Most of the banks that are currently targeted by the

government windfall profit tax have already repaid a large part of the funds they received from the government. In June 2009, JP Morgan, and other nine banks which had been targeted by the government acknowledged that they had already paid back the money they had received in TARP. JP Morgan acknowledged to have returned more than \$25 billion plus the interest to the government. Jamie Dimon, the Chief Executive Officer of the JP Morgan acknowledged that the bank did not require the money in the first place (New York Times, 2010). Goldman Sachs Group Inc has also returned \$10 billion that it had received from TARP, with approximately 23 percent of this money returned back to the taxpayers (Gogoi & Hagenbaugh, 2009). Therefore, the call by the government to impose windfall profit tax on the leading banks in order to recover the public money that had been spent under TARP is misguided because most of the financial institution had already repaid the money they had borrowed.

The government is not to recover the TARP money but rather to impose higher tax on the financial institutions based on the profits they are making. If the aim of the government was to recover the money it had lent to these banks, those banks which had repaid the amount borrowed from the government would be exempted from the tax bracket. The projected recovery from these banks, which adds up to \$90 billion in a period of ten years, is more than the amount that these banks received under TARP. The government needs to come out clear and outline the main reason why it needs to impose windfall tax to all these banks while some has actually

returned the money they had been given under TARP with the accrued interest.

Windfall tax will hurt economy and negatively affect taxpayers and banks

As was reviewed in earlier experience with the oil industry, it is not always that that windfall tax will meet its target and it is most likely to hurt the stability of the industry. Windfall profit tax that had been imposed in 1980s by the government had to be repealed in late 1980s after it was realized that the tax was negatively affecting the U. S economy and the industry. In a period of 10 years, the government had collected 80 percent less the intended amount from windfall tax. Congressional research established that most local oil producers had increased their cost of oil in a bid to recover the high amount of charges imposed by the government on their profit. This means that these companies were forced to pass on their cost to consumers.

This is likely to happen in the current situation if the government imposes windfall tax on financial institutions. Increased taxing on their profits will force the affected banks to pass the cost to consumers which will translate to higher cost of transaction and higher lending rate. This is likely to undo the gains that have been made in the economy if it becomes costly to borrow money. Higher taxes will translate to higher cost of operation and higher prices of services. Customers will have to bear some of the burden in a cost sharing model that is likely to be adopted by most banks. Instead of supporting the government in getting extra revenues to bridge the current deficit, the proposed taxes will affect the rate of economic recovery since the

bank spread the increased cost to consumers. It will raise less revenue than has been projected. “ The tax will not fall solely or even mainly on its desired political target, the shareholders and highly paid executives of large financial firms. The true burden of a tax often lands far from its intended target as the target attempts to shift the burden” (Miron, 2010). Miron acknowledges that in most cases, the tax burden does not land on the intended recipients.

This means that while the recent government proposal may be aimed at taxing huge bonuses on executives and their shareholders, it will end up affecting other people who are not directly targeted. In most cases, the consumer ends up being the victim of such orchestrated government schemes since it is the consumer who bears the burden of the taxes. One of the major problems facing the country currently is offshoring, which has seen most companies relocate to countries where the cost of production is low. As the government struggles to create more jobs, it should be wary of such measures that will eventually result in an increase in the cost of operation and likely drive investors out of the country. Banks may be forced to seek operations overseas where the cost of operation is bearable if the government pushes on with windfall profit taxes.

Windfall profit tax will have a larger impact on the job market and competitiveness of the American banks in the world. The most devastating impact of the financial crisis has been the accrued loss of jobs. The rate of unemployment is standing at an all-time high in the history of the country (Amadeo, 2010). Economists postulate that there will be no meaningful economic recovery without job creation. While the government speaks daily

of doing all it can to fix the economy and create more jobs, the future of American jobs would remain bleak with such policies like windfall profit taxes. This is because instead of encouraging job creation, they are going to lead to more job losses. Bank tax will nip job creation in the bud and may even lead to loss of the jobs which have already been created by bank taxpayers. Job market is sensitive to economic condition and employers rely on laying people off in order to survive during harsh economic conditions. For larger institutions, it can take months to come up with a constructive lay off plans and most companies are reluctant to hire new workers when the economy improves since they are uncertain of the future trends in the market. According to Massachusetts state senator Scott Brown he is “opposed to higher taxes, especially in the midst of a severe recession. [...] Raising taxes will kill jobs.” (idebate. org)

This is an evidence that the move that has been taken by the government will be disastrous to the job market as it will kill jobs not only in the job market but also in the wider industry. The growth of the economy is pegged on the ability of different businesses to access loans. Difficulties in accessing credits were one of the factors that lead to the economic crisis. Therefore, if windfall profit taxes will increase lending rates, it implies that most businesses and individuals will not be able to expand while new entrepreneurs will not be access credit to start their own business. This will be a great hindrance to current efforts to create more jobs. In addition, the government targets to continue taxing the big banks, which are key pillars of our economy for a longer period 10 years.

This means that the government would be operating under heavy burden of tax while banks in other countries enjoy a free operation environment.

According to Scott Talbott, one of the chief lobbyist for Financial Services Roundtable that represent banks, " Imposing new taxes on top of the increased regulatory costs will weaken the industry, just when the industry is helping lead the economic recovery"(Liberto, 2010). Eventually, this may have an impact on competitiveness of the U. S. banks in the global market. As the world economy become integration, it is evident that U. S banks may suffer a big blow in the bid to compete with other banks in the world.

Windfall profit tax is discriminatory

As has been discussed earlier, windfall profit tax is being implemented in a discriminatory manner. When the government wanted to stabilize the financial sector, it appealed to all banks to take funds to stabilize their operation. However, when it has come time to tax banks, the policy has been discriminatory and is targeting only few banks. The issues becomes complicated by the fact that most big banks which are targeted the government have already repaid back the amount of money they had been give under TARP. In addition, TARP fund were available to almost all sectors of the economy that were perceived to be at a higher risk of collapsing. Why is the government targeting the financial sector alone?

It is interesting to note that the government admits to the fact that other than the financial sector, other major borrowers are not likely to repay the money they had been given under TARP. Treasury Secretary, Tim Geithner,

admitted that the government risk losing more than \$30 billion it had advanced to General Motors and Chrysler (New York Times, 2010). In addition, the government has lost more than \$30 billion to AIG, which has since then collapsed. This means that the government risk losing more money from other industries that had received TARP funding more than they has spent on the financial sector. If the government is serious about making the concerned institution to take “ responsibility” for financial crisis, why not tax all banks and industries alike? Why should the government target only big banks and allegedly make them take “ responsibility” and not other institution?

The government has become increasingly reliant on the Wall Street to fix the financial problem of the nation while it was the same Wall Street that fuelled the financial crisis. While the government is targeting the large financial institutions, how can it leave out the Fannie Mae and Freddie Mac out of the taxation? Although the role these institutions played in the financial crisis remains controversial, it is evident that they played a role in the crisis, as far as the role of Wall Street is debated. They have turned to be darling of the government overnight and are not included in the “ big” financial institution.

This is despite the fact that they had not paid a dime of the money they were given under TARP. Contrary, the two are requesting the government to pump \$10.6 billion more to these institutions. Why should the government increase funding to these institutions while taxing others? The fact that smaller banks have been exempted from the windfall tax can be considered as a discriminatory measure that does not align with the capitalist economy

(Nixon, 2010). The windfall profit tax will be applied to only large banks that have a capital of at least \$50 billion and small banks like City National Bank, East West Bank, and other which also benefited from TARP have been exempted. This is not only a discriminatory policy but it is likely to disadvantage the large banks which have already repaid the money that was given by the government because it would give small banks an added advantages in the competitive financial market. If the government was aimed at recovering the money that was given to financial institution through TARP, every bank, big or small, should be allowed to carry its own burden and return all the funds it had received plus the accrued interest.

Conclusion

The government decision to impose windfall tax on the banker's bonuses is a misguided idea that is likely to hurt the pace of economic recovery and job creation. The idea has been guided by populism demand rather than consideration of its impact on the economy. Windfall profit tax is a tax that is imposed on the higher than normal profits that are made in an industry. The theory behind imposition of windfall tax is the desire to spread the benefits to other sectors of the economy rather than to specific individuals. Windfall tax was first imposed in 1980s in the oil sector with an aim of getting extra funds to fill budget deficit. However, windfall profit tax on the oil industry ended up being one of the most complex taxes to administer and it collected 80 percent less of the expected revenues. This may be a nightmare that the government is driving at. Packaged as Financial Crisis

Responsibility Fee, windfall profit tax is targeted at the big banks which have asset base of more than \$50 billion.

The main idea behind imposing windfall tax is to make the big banks take responsibility for the financial crisis since they were major players in the financial crisis. The government aims to recover about \$90 billion in 10 years and \$117 billion in a period of 12 years. However, windfall tax is ill intended, discriminatory, and will hurt the economy impacting on the rate of economic recovery negatively. Windfall tax is ill intended because learning from the lesson of the previous windfall tax on oil industry it may never collect the targeted revenues. The main aim of the government is not really to collect tax and recover the money which these banks were given under TARP since most of them have already returned the money they had received and the accrued interest. This means there is a sinister motive behind targeting the large banks alone.

Most of the banks were forced to take the TARP money even when they did not need it since the government arraying fear of collapse of the financial market. If the intention of the government is to get money these bank were paid under TARP, they should collected the specific amount given to each bank plus the interest. In addition, the design of the windfall tax is also discriminatory because it is targeting only few banks while the TARP money was given to even the auto industry. The banks that are being targeted by the government have already repaid the money they had taken from the government and yet the government wants to continue and tax them for the next 10 years while no action is being taken to institutions, which have not

paid of dime of the money they got from TARP. Windfall tax will make the cost of operation for banks higher and this cost will be passed on the consumers. This will increase lending rate and hurt the recovering economy. In addition, continued taxing for ten years will affect the competitiveness of the U. S banks in the world. It will lead to job losses and hurt economic recovery. Therefore, the government should not impose windfall profit tax on financial institutions since this would hurt the recovering the economy.

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