Introducing the Non Value Added Tax (NVAT)

In BBC interview during the crisis of 2008, a banker insisted, "We do embrace the odd scruple".

Thanks to the 24-hour news cycle and many sources for digging out and hacking into private information in these days of high-speed Internet, secrecy surrounding games people and corporations play to avoid paying taxes is no longer secure. Expanding awareness of egregious tax offenses such as the "carried interest tax loophole," and of their consequences on civilized society leads a public outcry for action[1]. The search is on for an optimum mix of tax proposals and regulations that will serve all the population and also survive the ideological battlefield of tax legislation. Now is the time to offer a simple, fair, easy-to-implement, and *self-regulating* solution we call the Non-Value-Added Tax (NVAT).

Value, Worth, Wealth

The name NVAT contains two key words, Value and Tax. We all have a good idea what tax is, but less of an idea about value.

What is Value? We refer to *Value,* as what a Producer puts into a product or service, which adds up to the *objective* cost-to-market (labor, materials and capital costs) that a sale price must recover for a Producer to break even. With this break-even cost recovery, the Producer pays for the labor that builds the product and the labor that provided the material and capital. Value is thus total labor cost. Producers know the Value of their product because they maintain an objective accounting of its costs.

A Consumer is willing to pay a Price greater than break-even Value, a price that incudes Profit, because of the *subjective* expectation of *Worth* a product or service signifies to that Consumer. That Consumers hold a variety of subjective expectations means their "willing-to-pay" Prices will vary; that is, Worth to one Consumer will not be the Worth to all.

Initiating a transaction transforms a Consumer's subjective expectation of future benefits into a Producer's objective recovery of Value and collection of Profit. In other words, the break-even portion of Price does the work of Value recovery. The difference between Worth and Value transforms a Consumer's subjective wishes into Profit, which gives the Producer a capacity to invest in the future.

Reinvesting profit into new production cost generates innovation, and produces new Value. Distributing profit in stock buyback, excessive executive compensation, and share dividends generates new *Wealth*, not new Value. We designate profits that grow Wealth, but not Value as Non Value Added.

Now, the story gets interesting.

Imbalance

The suppression of middle class wages through labor off-shoring, merger and acquisition consolidation, robotics growth, and uncompensated workforce productivity improvement produces excess profits. Raising prices to consumers, while reducing costs and lessening Value content by eliminating wages, increases the disparity of wealth from income among social classes.

This huge and growing imbalance is not a new observation; the voices of many economic schools express this concern. Many economists point out that the value distributed through wage increase has not kept up with profits distributed to the upmost classes for at least 30 years. We join with many others in asking: "How long can democracy sustain this imbalance?"

With growing segments of the population out of work, what is going to maintain the consuming necessary for society's economic health? Society is not served by wringing every dime out of costs in the name of "shareholder value". The savings robotics and other efficiencies bring to enterprise *must be shared* with those who built the enterprise, including those workers being displaced.

Measures to mitigate the Worth-Value imbalance are under discussion. Thomas Piketty in his excellent analysis on the evolution of inequality[2] suggests a wealth tax. We worry about the practicality of valuating wealth and generating liquidity to achieve significant collections from a wealth tax. We argue that the rapid diffusion of robotics into all enterprises promises to eliminate jobs at such a rate as to require a more reliable solution than can be provided by a wealth tax alone.

Profit lust and greed in the financial sector[3] have encouraged deceptive lending practices such as those that generate lucrative profits from the sales and re-sales of mortgage bundles, unconnected to actual new home sales. These bundles made profits by passing along risk rather than assuming it or reducing it, and neither produced new value, reduced prices, aided market stability, nor enhanced financial liquidity. We call these *Non-Value-Added Profits*.

Profits prestidigitated from previous profits obviously do not arise from value recovery, and tend not to be invested/sequestered in new value. Instead, they tend to produce bubbles of value-less profit that expand within a flimsy membrane of investor trust. As trust inevitably erodes, the membrane becomes brittle. Buyers of finance turn into panicked Sellers, depriving the financial system of its driving force. When bubbles burst, they release a current of chaos, and create panic as in 2008. Huge amounts of net worth disappeared in 2008, and with them the cash or "financial energy" necessary to rebuild the economy.

Panicked policy makers after 2008 preferred to manage the macroeconomy as a family farm during drought, instituting "austerity measures". There is no evidence from history that austerity helps collapsing economies[4]. Policy makers ignored that drought recovery on the farm requires stimuli from free sunshine energy and rain. Nothing in austerity delivers the energy equivalent of sunshine or rain to a parched macroeconomy. Austerity is ideology, not science. A large segment of the population has by 2016 yet to recover from 2008.

NVAT

This economic cycle catastrophe is not "inevitable". A graduated tax rate on Producers would reward those who provide Value while generating profit, and penalize those who don't. Many nations impose a VAT or Value Added Tax on products as they accrue value at stages-to-market before a final sale. This tax burdens the Consumer who pays %VAT at the point of sale, and does not relieve the Producer from paying income tax on profit as well. It makes at least as much sense to levy on Producers a Non-Value Added Tax (NVAT) on profits – not prices – that arise without recovering or creating value, thus liberating profit do its job of rejuvenation.

Listed by gross margin, all business sectors report a wide range of profit as a percent of revenue. The financial sector is noteworthy among them. Of the 32 companies listed at the highest level of gross margins (between 90% and 100%) during 2014, 29 were in finance[5].

We thus concentrate on finance when exploring how to implement NVAT.

On the short list of investor worries is High Frequency Trading (HFT), which dominates daily activity on stock markets. The stock market specialist[6] trading system maintains liquidity by completing trades when the supply-demand flow of securities is not quick enough. Because HFT participates in no such responsibility, many regard it as insider trading[7] or simple "skimming". Promoters of HFT look to the Invisible Hand to balance their actions, even though HFT operates outside of the supply-demand, specialist mechanism. Profits accrued from HFT should be taxed more aggressively than economic activity performed by providers of goods and services. The same applies to bank trading activity where the purpose is not to satisfy customer needs to reduce risk but, rather, to take advantage of such needs through inventory speculation and unnecessary leveraging of capital. We would apply NVAT to tax such trading as gambling with other peoples' money.

Fitting into the same category of activity that deserves higher taxes is the creation and marketing of highly complex, difficult to understand and impossible to unwind securities, where the upfront fees are high, spreads are hidden and responsibilities of the issuer are minimal to non-existent. Higher taxes on unnecessary and speculative activities by financial institutions without the responsibilities inherent in a provider/consumer relationship will help subdue such activity and create income to the government for services that can be useful to those in the market with legitimate purpose. Just as we differentiate between taxation of short-term and long-term profits, we may distinguish NVAT from a tax on profits earned while providing liquidity.

Our approach differs from the Volcker approach in that the activity is allowed, whether performed by "too-large-to fail" banks, normal sized banks, industry traders, speculators and/or gamblers. It is an approach used successfully to tax, rather than prohibit, smoking. Like the tax on cigarettes or gasoline, the monies raised could be diverted toward useful purposes related to the activity being taxed.

Note that NVAT applies to profit, not to price. The NVAT is very different from financial transaction taxes based on price, such as the Tobin tax[8] or Spahn tax[9], suggested during the past several decades to curb excesses in the currency market. NVAT differs from the Bank tax, suggested to be levied against balance sheets. It also differs from a Financial Activities Tax (FAT) on the sum of bankers' excessive remuneration and bank profits (without regard to their value-added content).[10] Common among all such financial taxation ideas other than NVAT is the problem that implementation policies depend jointly on ideology and political will. NVAT, which we next indicate is based on objective calculations, brings the clout of science into the discussion.

How might taxing authorities judge the nature of Value content[11] in a transaction? With Value content equal to the cost to bring a product or service to market, we offer a simple indicator called Value Recovery Ratio (VRR). The VRR indicates the ratio of Value (V) to Profit (P) contained in a transaction at point of sale, that is, VRR = %V/%P at each price. Such data are already recorded and almost instantaneously available; no new accounting procedures or bureaucracies are needed. Profits from low value-added transactions, such as sales of bundled mortgages disconnected from liquidity provision, would rate a low VRR and thus be subject to a high NVAT; those from transactions connected to high production cost value recovery and/or to providing liquidity, rate a high VRR and a correspondingly lower NVAT.

Careful application of NVAT will reduce chaos-forming pressures in financial markets, reduce bubble-formation dynamics, and stave off dangerous financial fluctuations from “tipping points”. A less obvious but important use of such a tax is to bring attention to the fact that there are "value-added" and "non-value-added" activities, which have quite different effects on our financial system and the economy as a whole. When economists, Wall Streeters, regulators and legislators understand this, we will have gone a long way toward reducing the risk of 2008 happening again.[12]

Balance

Many blame the 1999 removal of Glass-Steagall (G-S) Acts, which over decades regulated American banking, for unleashing the greed that led to the 2008 collapse. As proof they point to lack of such events during the G-S term as law. Others argue that G-S neither banned nor regulated activities linked to the financial crisis. Congress, attempting to find solution to (or at least mitigation of) the problem, could not decide to re-enact G-S, to submit a new approach, or to do nothing. The "final" result was the Dodd-Frank Wall Street and Consumer Protection Act, which included the Volker Rule. Its more than 400 regulations require multiple, new enforcement agencies that critics contend contribute more to bureaucracy than to problem solving. Complaints on burdens of compliance seem to balance complaints of "loopholes" allowing avoidance of the law.[13]

We suggest that NVAT, as a *self-regulating encouragement to eliminate non-value-added profit*, can assume the role of protecting against greed formerly attributed to Glass-Steagall.

Imagine that such an NVA Tax were in place prior to the blow-up of the housing market. Any profits made from trading in the negligibly value-added, bundled mortgage securities market would have been taxed at the highest rates, say 90+%, like marginal income tax rates after WWII during which our economy flourished. This would not outlaw or even regulate such trading vehicles; it would just make the Government (the Public) a partner in their "upside" potential by collecting revenue to counter any "downside" that the public is forced to cover as a result of collapse.

More interesting perhaps is applying NVAT collections to help fund a guaranteed minimum income[14] (GMI) favored by many economists in the 1960s as a measure to combat poverty[15]. Concerns about permanent unemployment and significant, additional, middle class collapse following rapid robotics expansion into the service sectors drive new efforts to introduce this solution[16]**.** We propose NVAT can complement GMI; it can be a natural damping force against the over-extension of GMI. That is, if the proportion of labor content (aka Value Added) diminishes with elimination of jobs, NVAT collections will increase to fund additional demand for GMI outlay. With proper division of tax tiers, NVAT rates then act as counter-force that encourages job creation, which in turn lessens need of GMI. It is thus a self-compensating tax / benefit system.

We may also note that the NVAT solution need not interfere with the Federal Reserve Board's charter and monetary approaches to control inflation. The Fed's Open Market Operations function buys and sells government securities to influence money supply and short-term interest rates. With similar authority to raise or lower the NVAT (perhaps as a fee), the Fed would have a laser-like instrument to control excessive, non-value-added activities, such as those that brought about the financial breakdown in 2008.

Endnotes

1 See for example: Judith Lewis Mernit / Capital and Main, "How the Hedge Fund Billionaires Get Away With Obscene Tax Avoidance", in Alternet.org, June 21, 2016.

2 Thomas Piketty, "Capital in the Twenty First Century", Translated by Arthur Goldhammer, Harvard University Press, 2014.

3 According to director Oliver Stone, Gordon Gekko's "Greed is Good" speech in "Wall Street" made the leap from its movie screen character to stockbrokers on trading floors.

4 Austerity's record of dismal failures continues in both U.S. and EuroZone: "The evidence piles up: Austerity poisons economic growth", Michael Hiltzik, Los Angeles Times, Oct. 20, 2016.

5 See for example: http://csimarket.com/screening/index.php?s=gm. Rankings vary quarterly. Financial sector ranked 7th in 2015 and 4th in Q2, 2016.

6 "A specialist is a member of a stock exchange who acts as the market maker to facilitate the trading of a given stock. The specialist holds an inventory of the stock, posts the bid and ask prices, manages limit orders and executes trades. If there is a large shift in demand on the buy or [supply on the] sell side, the specialist steps in and sells off his own inventory as a way to manage large movements and to meet the demand until the gap between supply and demand narrows." (www.investopedia.com/terms/s/specialist.asp)

Being paid for keeping markets orderly and liquid, specialists provide value-added service to the trading floor.

7 Insider trading in the supercomputer age takes on meaning not completely comprehended in legal definitions. The clamor to set up server farms in immediate proximity to information sources for sub-microsecond advantage argues for expanding "Insider" definition to include such physical closeness.

8 James Tobin (July/October 1978). "A Proposal for International Monetary Reform". *Eastern Economic Journal*: 153–159.

9 Paul Bernd Spahn (June 16, 1995). "International Financial Flows and Transactions Taxes: Survey and Options". University of Frankfurt/Main; Paper originally published with the IMF as Working Paper WP/95/60.. Retrieved 2010-01-13.

10 FAT Tax discussion appears in International Monetary Fund (April 16, 2010). "A Fair And Substantial Contribution By The Financial Sector Interim Report For The G-20". International Monetary Fund; Copy/paste link to full report as a PDF http://news.bbc.co.uk/2/shared/bsp/hi/pdfs/2010_04_20_imf_g20_interim_report.pdf - republished online by Global Print Monitor on April 22, 2010. Retrieved 25 June 2011.

11 Statisticians and econometricians now perform value-added analyses for more complicated applications than financial transactions. See W. L. Sanders "Comparisons Among Various Educational Assessment Value-added Models", Oct. 16, 2006. http://www.sas.com/resources/asset/vaconferencepaper.pdf

12 This section mostly written for us by Donald E. Weeden, Member of the Board, Weeden & Co., Greenwich, CT.

13 Mixed reviews of Dodd-Frank efficacy: A) Two cheers for the Dodd-Frank Act – but Wall Street culture needs radical change. https://www.theguardian.com/business/2015/jul/19/two-cheers-dodd-frank-act-wall-street-culture-radical-change, The Guardian**,** Jul 19, 2015. B) After Five Years, Dodd-Frank Is a Failure - WSJ, www.wsj.com/.../after-five-years-dodd-frank-is-a-failure-1437…, The Wall Street Journal. Jul 19, 2015.

14 Thanks to suggestion by Michael Jonath.

15 See list: Guaranteed Minimum Income advocates, https://en.wikipedia.org/wiki/Guaranteed_minimum_income#cite_note-5

16 Among others, Martin Ford, *Rise of the Robots: Technology and the Threat of a Jobless Future*, Basic Books, 2015, suggests using a form of guaranteed minimum income to protect the displaced and the economy.

Author Bios

http://www.profitandentropy.com/about-us/