The Impact of the FairTax on the Stock and Bond Markets

Replacing federal income, payroll and estate and gift taxes with a national sales tax would have a positive impact on the stock and bond markets.

What Determines Stock and Bond Values

The value of corporate stock or a corporate bond is the present discounted value of the expected future income stream (net of tax) of the stock or bond. Thus, a stock's value or a bond's value is a function of two things: the expected future income from owning the asset and the interest rate. If a firm's expected future income stream increases, then the stock will increase in value. If a firm's expected future income stream goes down, then the stock price will fall. If the expected future income stream from a bond declines due, for example, to a heightened risk of default, then the price of the bond will fall. Changes in interest rates also dramatically affect the price of stocks and bonds.

Stocks, Bonds and Interest Rates

The right to receive $1,000 now is worth more than the right to receive $1,000 five years from now. One would receive interest on the $1,000 received now and it would amount to more than $1,000 five years hence. Thus, a person purchasing the right to $1,000 five years from now would pay less than $1,000 (i.e., the present discounted value of $1,000 five years from now is less than $1,000).

Stocks and bonds provide the owner with the right to receive future income. Interest rates may be thought of as the relative price of money now compared to money in the future. If interest rates fall, then the price of the right to receive money in the future goes up. If interest rates rise, then the price of the right to receive money in the future goes down. Thus, when the bond market rises, interest rates are falling and vice versa.

Similarly, lower interest rates mean that the present value of the future income that a corporation is expected to earn will increase. Thus, lower interest rates cause stock prices to rise. When interest rates rise, the present value of the corporation's future income declines and stock prices decline.

The Impact of a National Sales Tax on Stock and Bond Markets

The replacement of the present tax system with a national retail sales tax will cause the stock market to appreciate. A sales tax will increase the expected future return on assets. Today, a corporation earning $100 million per year will typically pay about $35 million in federal corporate income taxes. Shareholders also pay taxes on dividends received from the corporation. To the extent that the corporation's stock appreciates due to the value of current retained earnings, higher expected future earnings, lower interest rates or, perhaps, other reasons, capital gains from the sale of the corporate stock are subject to tax at the individual income tax level. The economy-wide marginal tax rate on capital income is approximately 57 percent.[1] Even assuming that the sales tax is fully paid by the factors of production rather than consumers, the top marginal tax rate on capital income would be 23 percent under the FairTax (i.e., $23 million in our example) plus state level levies. Thus, the expected future return on corporate stock will increase and the value of corporate stock will increase.[2]

Not all firms' stocks will see the same appreciation because under the current tax system with its myriad of complex provisions, firms bear different marginal tax rates. Those that are bearing a relatively high tax burden today will benefit most from a neutral tax system like the FairTax being proposed byAmericans for Fair Taxation.

A federal sales tax will cause interest rates to decline 25 to 30 percent, thus moving them towards the level of the present tax-exempt rate.[3] Holders of taxable bonds, or other contractual obligations to pay a set sum, that cannot be renegotiated or called by the issuer will experience a significant gain in value equal to the present discounted value of the income tax that would have been paid on the income generated by the bond. Obligations that can be refinanced or bonds that can be called will be refinanced or called at the new lower interest rates and, therefore, bondholders will not experience a gain but simply be repaid.

Firms With Large Deferred Tax Assets or Liabilities

Most firms carry deferred tax assets or deferred tax liabilities on their balance sheets that result from temporary differences in financial and tax accounting. For some firms, deferred tax assets or liabilities can represent a large fraction of their equity. Generally, a deferred tax asset arises when:

- income is recognized for tax purposes earlier than for financial statement purposes;
- an expense is deductible later for tax purposes than recognized for financial purposes;
- when assets or liabilities have different initial values for tax and financial accounting purposes (most commonly in the case of acquisitions).

---

[1] In 1994. See, "Eating Out Our Substance (II): How Taxation Affects Investment," Gary and Aldona Robbins, Institute for Policy Innovation, Policy Report No. 134, November 1995, p. 8. The economy-wide average (as opposed to marginal) tax rate on capital income was 42.9 percent in 1994.

[2] The after-tax discount rate used to discount future income streams for present purposes and the interest rate used after the sales tax is implemented (where pre- and after-tax interest rates are the same) will be approximately the same (varying to the extent that borrower and lender marginal tax rates differ today).

[3] For a more detailed discussion of the impact on a national sales tax on interest rates see "Impact of the FairTax on Interest Rates," Americans for Fair Taxation. See also, John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?" Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27).

A firm that had a large deferred tax asset would generally experience relatively low effective tax rates in the future. The repeal of the income tax and its replacement with a sales tax would be of relatively little value to this firm, since their deferred tax asset represents aspects of current law that effectively shield them from income tax liability. Conversely, a firm that had a large deferred tax liability will generally experience relatively high effective tax rates in the future, and replacement of the income tax with a national sales tax would be of greater benefit to the firm.

Accounting standards that required firms to recognize the entire loss attributable to the elimination of a deferred tax asset, or the entire gain attributable to the elimination of a deferred tax liability in the year that the income tax is repealed, would have a dramatic impact on some firms' income statements and balance sheets in the first year after implementation of a national retail sales tax. Since deferred tax assets and liabilities represent the sum of the timing differences for many years, an accounting standard allowing amortization of these affects over the period during which they would have reversed is probably appropriate.

Undoubtedly, the elimination of these deferred assets and liabilities will affect the valuation of these firms in the marketplace. These items, along with current period-effective tax rates, and anticipated future taxes, represent a measure of the strikingly different impact that the current system has on different firms. In conclusion, because different firms today bear different tax burdens, the change to a neutral tax system will affect them differently.