A FairTax℠ White Paper

The impact of the FairTax on the stock and bond markets

Replacing federal income, payroll, and estate and gift taxes with the FairTax has 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 retail sales tax on stock and bond markets

The replacement of the present tax system with the FairTax causes the stock market to appreciate. The FairTax increases 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 FairTax 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 increases and the value of corporate stock increases.[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 benefit most from a neutral tax system like the FairTax being.

The FairTax causes 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 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 do not experience a gain but are simply 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
- Assets or liabilities have different initial values for tax and financial accounting purposes (most commonly in the case of acquisitions)

A firm that has 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 the FairTax is of relatively little value to this firm, since their deferred-tax asset represents aspects of current law

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[1] In 1994. See Robbins, Gary and Aldona, "Eating Out Our Substance (II): How Taxation Affects Investment," 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 FairTax is implemented (where pre- and after-tax interest rates are the same) are 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 of a national sales tax on interest rates see FairTax.org white paper, "The impact of the FairTax on interest rates." See also Golob, John E., "How Would Tax Reform Affect Financial Markets?" *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter, 1995. He estimates a 25 to 35 percent drop (p. 27).

that effectively shield them from income tax liability. Conversely, a firm that has a large deferred-tax liability will generally experience relatively high effective tax rates in the future, and replacement of the income tax with the FairTax is of greater benefit to that firm.

Accounting standards that require 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 the FairTax. Since deferred-tax assets and liabilities represent the sum of the timing differences for many years, an accounting standard allowing amortization of these effects 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 the FairTax affects them differently.

What is the FairTax Plan?
The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?
FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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