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## Capital Gains Tax Rates, Stock Markets, and Growth

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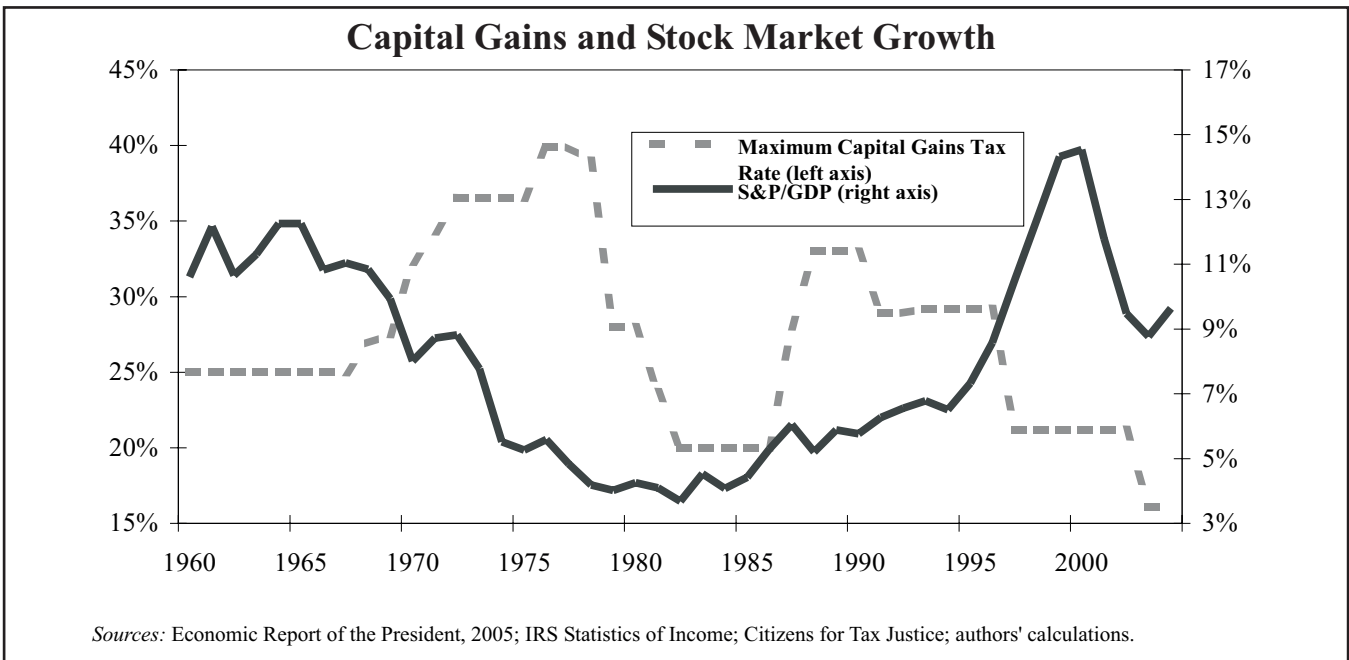
The Jobs and Growth Tax Relief Reconciliation Act of 2003 temporarily reduced the maximum long-term capital gains statutory tax rate from 20 percent to 15 percent, the lowest level since the Great Depression. The Senate Finance Committee is considering extending the reduced rates past their scheduled 2008 expiration, in part because of concern about the effect on the stock market of allowing the rates to increase.

Tax rates affect the after-tax rate of return, which in turn affects stock prices. But tax rates are only one factor in the after-tax rate of return; the expected level of and the growth rate in profits, for example, are very significant. Many stock market participants, such as pension funds and foreign investors, are unaffected by individual income taxation in the United States. Thus, capital gains tax (CGT) rates can increase significantly, as they did following the 1986 Tax Reform Act, and have little

apparent effect on the stock market. Likewise, the stock market can fluctuate even when rates remain unchanged. Overall, the correlation between the maximum CGT rate and the ratio of the Standard and Poor's Index to gross domestic product is about -0.35 over the last half-century, indicating a weak negative relationship.

Arguments that the maximum CGT tax rate affects economic growth are even more tenuous: Capital gains rates display no contemporaneous correlation with real GDP growth during the last 50 years. Although the effect of capital gains on economic growth may occur with a lag, Burman (1999)<sup>1</sup> tests lags of up to five years and finds no statistically significant effect. Moreover, any effect is likely small as capital gains realizations have averaged about 3 percent of GDP since 1960 and have never been more than 7.5 percent.

<sup>1</sup>Burman, Leonard E., 1999. *The Labyrinth of Capital Gains Tax Policy*. Washington, D.C.: Brookings Institution. p. 81.



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