

Box 7

The effect of stock price changes on budgetary balances

The sharpness of recent declines in stock prices has sparked investigations into the effects of financial asset prices on public finances. In principle, stock price changes affect public finances via direct and indirect channels. Direct effects stem mainly from the taxation of capital gains or tax-deduction of capital losses, which affect both capital gains tax revenues and personal and corporate income tax receipts. Most euro area Member States tax capital gains in some form while also permitting the deduction of capital losses. Moreover, some countries tax the purchase and sale of stocks and/or stock-based wealth. Indirect effects may arise when stock price increases (or decreases) change households' net wealth and people adjust their consumption patterns, which then affects tax revenue.

The magnitude of the fiscal effects depends first on the tax system. A country with significant capital gains taxation and generous loss deduction is likely to experience stronger fiscal effects than a country without such rules. In addition, the stock market valuation and the dispersion of ownership influence the fiscal effect of stock price changes via both direct and indirect channels. For example, if stock market valuation is high relative to the size of the economy and if stock ownership is widespread, the effects of capital gains on revenue are likely to be more relevant. Moreover, the magnitude and the perceived duration of stock price changes can influence fiscal effects. The timing of fiscal effects can also differ: wealth-effect induced changes in consumption impact on revenues very quickly, while capital losses may only affect the following year's revenue, after personal or corporate tax declarations have been made.

From a policy perspective, the assessment of fiscal outcomes and the fiscal stance would benefit from a proper distinction between asset price effects, automatic budgetary reactions to macroeconomic fluctuations and discretionary policy influences. However, the above observations suggest that fiscal effects of stock price changes differ significantly across countries and over time. Moreover, the classification of tax revenue in official statistics often does not allow a distinction to be made between the sources of revenue (e.g. capital gains or wealth versus profit or income as sources of direct taxes). This makes an empirical assessment very difficult, and few quantitative studies have been undertaken in this regard.

Nevertheless, there is evidence that stock price changes can significantly affect budgetary positions and increase the variability of fiscal balances in some countries. The disappointing development of capital gains tax and corporate income tax receipts in 2001 and 2002 in a number of euro area countries is partly due to capital losses incurred in the financial and corporate sectors in the recent stock market downturn. The wealth effects on consumption and related taxes, however, are hard to quantify with sufficient precision.