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Individual and Corporate Capital Gains Are Highly Correlated

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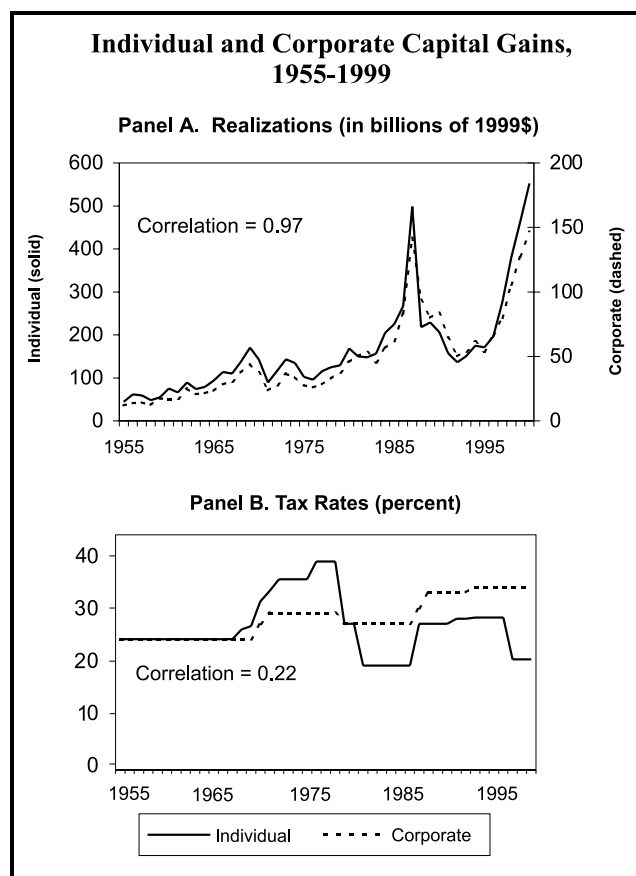
A perpetual policy debate surrounds the proper taxation of capital gains. One concern is that the tax creates a “lock-in effect.” That is, people will hold onto assets longer than they otherwise would in order to avoid the tax. If significant, the lock-in effect would represent an undesirable tax distortion in its own right. It might also mean that cuts in capital gains tax rates could pay for themselves, because the added revenues from induced realizations would offset the loss due to the rate cut.

Much empirical evidence exists on the importance of lock-in, but the debate is far from settled. Panel A below provides a simple alternative perspective on this old question. The figure shows that capital gains realized by individuals and corporations follow very similar patterns going back to 1955. The correlation between the two time series is 0.97. To remove spurious correlation, both series are adjusted for inflation. (The correlation is slightly higher if realizations are calculated as a percentage of GDP.) The close correspondence is very striking because tax rates on individual and corporate capital gains realizations do not usually change in tandem. For example, while rates on both corporate and individual capital gains increased together in 1986, the significant cuts in individual capital gains tax rates in 1978, 1981, and 1997 were unmatched by corporate tax changes. (See Panel B.) Thus, if tax rates were important determinants of individual or corporate capital gains, one would expect to see the two time series diverge when their respective tax rates do, but this pattern is not evident in the data.

It is also worth noting that the correlation is not driven by the huge surge in capital gains realizations in 1986 (in anticipation of the 1986 act’s rate increase) or the “irrational exuberance” of the 1990s. The correlation is unchanged if post-1985 data are excluded from the analysis.

The figures do not rule out a role for taxes in the determination of capital gains. But the high correlation between individual and corporate capital gains suggests that other factors, such as asset prices and investor expectations, may play a much larger role than tax rate changes.

For more information, see Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Brookings, 1999, and Plesko, “Omitted Variable Bias in Time Series Estimates of Capital Gains Behavior,” working paper, MIT Sloan School of Management, 2002.



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