Volatility of Capital Gains Realizations

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This year’s unexpected decline in the federal budget deficit largely reflects unanticipated revenue growth. Although detailed 2004 tax year data are not yet available, one likely source of higher individual income tax revenues is higher capital gains realizations. Some commentators have suggested that the higher revenues demonstrate the success of recent tax cuts, especially the lower rates on capital gains and dividends.

Capital gains realizations, however, are highly variable over time, even in years when capital gains rates are stable. Between 1959 and 2003, net capital gains of individuals averaged 3.05 percent of gross domestic product, ranging from 1.87 percent in 1991 to 7.35 percent in 1986. (In 1986 investors realized unusually large gains in the last quarter in advance of a scheduled tax rate increase on January 1, 1987.) Realizations rose every year between 1991 and 2000, reaching 6.56 percent of GDP before dropping to 2.57 percent in 2002. In that period, there was one change in the top capital gains rate, a cut from 28 percent to 20 percent in 1997.

The figure displays the difference between the capital gains to GDP ratio and its mean value over the 45-year period as a percentage of the mean value. For comparison purposes, we show similar statistics for ratios of the Standard and Poor’s (S&P) Index to GDP and adjusted gross income to GDP. Capital gains realizations appear to track generally the S&P Index, except during the early 1980s when capital gains soared while the S&P remained stable. Both the capital gains to GDP and S&P to GDP ratios are highly volatile, with standard deviations near 40 percent of their mean values. In comparison, the ratio of AGI to GDP, a more complete measure of the size of the tax base, varies little in percentage terms from year to year.