The Reckoning
Tax Break May Have Helped Cause Housing Bubble
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"Tonight, I propose a new tax cut for homeownership that says to every middle-income working family in this country, if you sell your home, you will not have to pay a capital gains tax on it ever — not ever." President Bill Clinton, at the 1996 Democratic National Convention

Ryan J. Wampler had never made much money selling his own homes.

Starting in 1999, however, he began to do very well. Three times in eight years, Mr. Wampler — himself a home builder and developer — sold his home in the Phoenix area, always for a nice profit. With prices in Phoenix soaring, he made almost $700,000 on the three sales.

And thanks to a tax break proposed by President Bill Clinton and approved by Congress in 1997, he did not have to pay tax on most of that profit. It was a break that had not been available to generations of Americans before him. The benefits also did not apply to other investments, be they stocks, bonds or stakes in a small business. Those gains were all taxed at rates of up to 20 percent.

The different tax treatments gave people a new incentive to plow ever more money into real estate, and they did so. "When you give that big an incentive for people to buy and sell homes," said Mr. Wampler, 44, a mild-mannered native of Phoenix who has two children, "they are going to buy and sell homes."

By itself, the change in the tax law did not cause the housing bubble, economists say. Several other factors — a relaxation of lending standards, a failure by regulators to intervene, a sharp decline in interest rates and a collective belief that house prices could never fall — probably played larger roles.

But many economists say that the law had a noticeable impact, allowing home sales to become tax-free windfalls. A recent study of the provision by an economist at the Federal Reserve suggests that the number of homes sold was almost 17 percent higher over the last decade than it would have been without the law.

Vernon L. Smith, a Nobel laureate and economics professor at George Mason University, has said the tax law change was responsible for "fueling the mother of all housing bubbles."

By favoring real estate, the tax code pushed many Americans to begin thinking of their houses more as an investment than as a place to live. It helped change the national conversation about housing. Not only did real estate look like a can't-miss investment for much of the last decade, it was also a tax-free one.

Together with the other housing subsidies that had already been in the tax code — the

mortgage-interest deduction chief among them — the law gave people a motive to buy more and more real estate. Lax lending standards and low interest rates then gave people the means to do so.

Referring to the special treatment for capital gains on homes, Charles O. Rossotti, the Internal Revenue Service commissioner from 1997 to 2002, said: "Why insist in effect that they put it in housing to get that benefit? Why not let them invest in other things that might be more productive, like stocks and bonds?"

The provision — part of a sprawling bill called the Taxpayer Relief Act of 1997 — exempted most home sales from capital-gains taxes. The first $500,000 in gains from any home sale was exempt from taxes for a married couple, as long as they had lived in the home for at least two of the previous five years. (For singles, the first $250,000 was exempt.)

Mr. Wampler said he never sold a home simply because of the law's existence, but it played a role in his decisions and also became part of his stock pitch to potential customers who were considering buying the homes he was building in the desert. He would point out that the tax benefits would increase their returns on a house, relative to stocks.

"Why not put your money on the highest-yielding investment with the highest tax benefit?" he said recently.

During the boom years, he prospered. But today he owns 80 acres of land on the outskirts of Phoenix that he cannot sell. He owes $8 million to his banks, which may soon foreclose on his land.

"I am literally dying on the vine," he said.

The change in the tax law had its roots in a Chicago speech that Senator Bob Dole, Mr. Clinton's Republican opponent in the 1996 presidential election, gave on Aug. 5 of that year. Trailing Mr. Clinton in the polls, Mr. Dole came out for an enormous tax cut, including an across-the-board reduction in the capital-gains tax.

The proposal made Mr. Clinton's political advisers more nervous than almost anything else during the campaign. The campaign's chief spokesman, Joe Lockhart, traveled to Chicago to stand outside the ballroom where Mr. Dole was speaking and make the case that the Dole tax cut would cause the deficit to soar.

At the same time, Mr. Clinton's aides began scrambling to come up with their own tax proposal. Dick Morris, the president's chief outside political adviser, argued that Mr. Clinton could assure his re-election by matching Mr. Dole's call for a big cut in the capital-gains tax.

But members of Mr. Clinton's economic team, led by Treasury Secretary Robert E. Rubin, disliked that idea. They thought it would undo the tough work the administration had done to reduce the budget deficit. So they instead went looking for smaller tax cuts that would allow their boss to

campaign as both a fiscal conservative and a tax cutter.

Getting rid of capital gains on most home sales seemed like the perfect idea.

Treasury officials had become interested in that provision earlier in Mr. Clinton's term after Jane G. Gravelle, an economist at the Congressional Research Service, had called it to their attention, according to Eric J. Toder, an official in the tax policy office at the time. He and his colleagues were looking for ways to simplify the tax code, and Ms. Gravelle told them that eliminating capital-gains taxes on houses was an excellent candidate.

The tax forced homeowners to keep track of all their renovations over many years, because the cost of those renovations could be subtracted from their taxable gain. Even renovations on previous homes often qualified, as long as people had deferred the tax in the past by buying a new house at least as valuable as their old one.

"It was very hard for people to keep track of that information," said Leslie B. Samuels, the assistant Treasury secretary for tax policy from 1993 to 1996.

People could also avoid the tax under a one-time exemption, for profits of up to $125,000, if they were older than 55. Thus, the tax raised relatively little revenue — perhaps just a few hundred million dollars in today's terms. "It was the worst kind of tax system," Ms. Gravelle said recently. "It raised very little revenue, but it caused all these distortions and compliance problems."

Three weeks after Mr. Dole's speech, with support from top Treasury officials, the proposal made it into Mr. Clinton's speech at the Democratic convention. During the presidential debates that followed, he used it to parry Mr. Dole's calls for a big tax cut. The following summer, Mr. Clinton signed the provision into law.

At the time, Realtors and home builders lobbied for the provision and there was only scant opposition. Grover Norquist — a conservative activist and adviser to Newt Gingrich — said home sales did not deserve special treatment. But Republicans ended up voting for the bill by even wider margins than Democrats.

Today, it is the subject for considerably more debate. Ms. Gravelle and Mr. Samuels said they thought the law had done more good than ill. And William G. Gale, director of economic studies at the Brookings Institution, said he did not think that the change in the law was central to the bubble. Low interest rates, he said, were far more important.

The law's defenders say that it also removed at least one tax incentive that had pushed homeowners to trade up. Before 1997, people had to buy a house that was at least as valuable as their previous one to avoid the tax, or else take the one-time exemption. Now they could buy a smaller property or move into a rental.

But many economists say the net effect of the law was clearly to inflate the real estate market. Dean Baker, co-director of the Center for Economic and Policy Research, a liberal policy group in

Washington, criticized the exemption as “a backward policy” that “helped push more money into housing.”

A spokesman for Mr. Clinton declined to comment for this article.

Perhaps the most detailed analysis of the provision has been the study by a Federal Reserve economist, Hui Shan, who did the analysis while at M.I.T. Ms. Shan looked at homeowners with significant equity gains, before and after 1997, and compared the likelihood of their selling their house. Her study covered 16 towns around Boston and took into account a host of other factors, like the general rise in home prices at the time.

Among homes that had appreciated less than $500,000, she concluded that the change caused a 17 percent increase in sales in the decade after 1997. Before the law changed, many people apparently avoided paying the tax by simply staying in their homes.

Ms. Shan also found that sales actually declined among homes with more than $500,000 of gains after the law passed. (Under the new law, couples have to pay taxes on gains above $500,000, even if they roll all those gains into a new house.) Nationwide, however, less than 5 percent of home sales over the last decade had gains of more than $500,000, according to Moody’s Economy.com.

Despite the criticism, there has been little political support for trimming the tax breaks for housing. In 2005, a bipartisan panel of tax experts, which was appointed by President Bush and included Mr. Rossotti, concluded, “The tax preferences that favor housing exceed what is necessary to encourage homeownership.” Among other things, it recommended increasing to three years the amount of time people had to stay in homes to claim the tax break on a sale. But Mr. Bush and other policy makers largely ignored the panel’s report.

Geo Hartley, a lawyer who has lived in Los Angeles and Washington over the last two decades, captures the divergent effects that the law appears to have. Mr. Hartley, who is 59 and single, said he found the old law “weird,” because it led him to buy bigger houses than he wanted.

Since the law changed, Mr. Hartley has bought smaller homes. But he has also moved more frequently, knowing that most of the gains on his houses would not be taxed. He lived in one house in Los Angeles for a full decade before 2000. Since then, he has moved three times, making a handsome — and mostly tax-free — profit each time.

“It’s part of the thinking that gets you more motivated to buy and sell property,” said Mr. Hartley, who now lives in a town house in Washington that he is trying to sell, “and have the American dream of owning a home.”