Sunday, April 27, 2008; B07

The Washington Post

Don't Blame All Borrowers

By Robert H. Frank

After more than a decade of steep growth, home prices peaked last year and have been falling rapidly. Over 9 million mortgages are "under water," meaning that more is owed on them than the home is worth. As foreclosures mount, additional homes come on the market, intensifying downward pressure on prices.

Congress is debating loan guarantees that would help homeowners renegotiate mortgages in default. In his initial response to the proposed legislation, Sen. John McCain argued that "it is not the duty of government to bail out and reward those who act irresponsibly, whether they are big banks or small borrowers."

Many share McCain's concern. But while Congress clearly should not rescue borrowers who lied about their incomes or tried to get rich by flipping condos, such borrowers were at most a minor factor in this crisis. Primary responsibility rests squarely on regulators who permitted the liberal credit terms that created the housing bubble.

Hints of how things began to go awry appeared in "The Two-Income Trap," a 2003 book in which Elizabeth Warren and Amelia Warren Tyagi posed this intriguing question: Why could families easily meet their financial obligations in the 1950s and 1960s, when only one parent worked outside the home, yet have great difficulty today, when two-income families are the norm? The answer, they suggest, is that the second incomes fueled a bidding war for housing in better neighborhoods.

It's easy to see why. Even in the 1950s, one of the highest priorities of most parents was to send their children to the best possible schools. Because the labor market has grown more competitive, this goal now looms even larger. It is no surprise that two-income families would choose to spend much of their extra income on better education. And because the best schools are in the most expensive neighborhoods, the imperative was clear: To gain access to the best possible public school, you must purchase the most expensive house you can afford.

But what works for any individual family does not work for society as a whole. The problem is that a "good" school is a relative concept: It is one that is better than other schools in the same area. When we all bid for houses in better school districts, we merely bid up the prices of those houses.

In the 1950s, as now, families tried to buy houses in the best school districts they could afford. But strict credit limits held the bidding in check. Lenders typically required down payments of 20 percent or more and would not issue loans for more than three times a borrower's annual income.

In a well-intentioned, but ultimately misguided, move to help more families enter the housing market, borrowing restrictions were relaxed during the intervening decades. Down payment requirements fell steadily, and in recent years, many houses were bought with no money down. Adjustable-rate mortgages and balloon payments further boosted families' ability to bid for housing.

The result was a painful dilemma for any family determined not to borrow beyond its means. No one would fault a middle-income family for aspiring to send its children to schools of at least average quality. (How could a family aspire to less?) But if a family stood by while others exploited more liberal credit terms, it would consign its children to below-average schools. Even financially conservative families might have reluctantly concluded that their best option was to borrow up.

Those who condemn them see a different picture. They see undisciplined families overcome by their lust for cathedral ceilings and granite countertops, families that need to be taught a lesson.

Yet millions of families got into financial trouble simply because they understood that life is graded on the curve. The best jobs go to graduates from the best colleges, and because only the best-prepared students are accepted to those colleges, it is quixotic to expect parents to bypass an opportunity to send their children to the best elementary and secondary schools they can. The financial deregulation that enabled them to bid ever larger amounts for houses in the best school districts essentially guaranteed a housing bubble that would leave millions of families dangerously overextended.

Congress should not bail out speculators and fraudulent borrowers. But neither should it be too quick to condemn families that borrowed what the lending system offered rather than send their children to inferior schools.

Robert H. Frank, an economist at the Johnson Graduate School of Management at Cornell University, is the author of "Falling Behind: How Rising Inequality Harms the Middle Class."