Why the Education Bubble Will Be Worse Than the Housing Bubble

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Absent congressional action, the interest rates on federally subsidized student loans will double to 6.8 percent on July 1. Both President Barack Obama and former Gov. Mitt Romney have urged Congress to act before that deadline, but no one seems willing to state the obvious: The problem is not the interest rate but that the federal government subsidizes student loans at all.

To understand the impending fallout from government intervention in higher education lending, consider the recent housing bubble.

The anatomy of the mortgage crisis is simple. The government, in a fit of social engineering spanning decades, established Fannie Mae and Freddie Mac to make real the dream of home ownership for working class Americans. Beginning in 1996, the Department of Housing and Urban Development told Fannie and Freddie that more than 40 percent of their loans had to go to low-income borrowers. Tax breaks followed. Finally, starting in the early 1990s, the Federal Reserve pushed interest rates to historically low levels, making mortgages cheaper.

[See a slide show of 6 ways to fix the housing market.]

The net result of this was very predictable: People took out more mortgages, increasing numbers of mortgages went to low-income people, and the government became a major lender in mortgage markets. In 1990, Fannie and Freddie held one of every four outstanding mortgages. By 2003, they held almost half of all mortgages. Between 2001 and 2006, the fraction of new mortgages that were subprime tripled.

And housing prices soared—just as one would expect from a market flooded with cheap money. With the government using Fannie and Freddie to transfer mortgage risk from private banks to U.S. taxpayers, and with the U.S. Congress minding the store, mortgage lenders didn't have to care about the riskiness of the loans they made. All private banks had to do was to make loans, pocket the profit, and push the loans down the line where the government waited to pass the default risk on to taxpayers.

The student loan crisis is no more complicated (as explained in the following Economic Freedom Project video):

[See a collection of political cartoons on the economy.]

Were bankers greedy? Sure, but that wasn't the problem. Bankers were just as greedy before the bubble. The difference is that, before the bubble, bankers were also cautious. Profit appealed to their greed. Risk appealed to their caution. The balancing forces of greed and caution—

profit and risk—are what cause a free market to produce the right amount of loans. What changed was that government meddling removed caution by separating loan profits from loan risks. The government forced taxpayers to shoulder mortgage risks while allowing banks to keep mortgage profits.

Government created the conditions for wholesale failure. And failure ensued.

Just as the government sought to engineer people into houses, it now seeks to engineer them into higher education. Congress established Sallie Mae in 1972 to encourage banks to loan more money for college. The Affordable Care Act of 2010 allowed the government to loan money directly to students. The following year the Taxpayer Relief Act extended tax breaks to student loan borrowers. Predictably, the Federal Reserve kept interest rates at historically low levels, making college loans cheaper.

[See the 10 best cities to find a job.]

And the price of a college education soared—just as one would expect from a market flooded with cheap money. By law, lenders cannot even deny Stafford and Perkins loans (types of federal student loans) based on the borrower's credit or employment status. What other reason is there to deny a loan? And just as home buyers took out loans to speculate on houses they could never hope to afford, students are taking out loans to cover educations they often cannot complete and which often do not hold value in the market even when completed. Government meddling has again separated profit from risk. Universities get to keep the tuition profits while taxpayers are forced to shoulder the risk of students not paying back their loans.

Once again government has created the conditions for wholesale failure, and failure is upon us.

From 1976 to 2010, the prices of all commodities rose 280 percent. The price of homes rose 400 percent. Private education? A whopping 1,000 percent.

[See a slideshow of the 10 U.S. cities with the highest real incomes.]

In the end, this bubble will be worse than the last. Even when homeowners got hopelessly behind on their mortgages, two options helped. First, they could declare bankruptcy and free themselves of their crippling debt; second, they could sell their houses to pay down most of their loans.

Students don't have either of these options. It's illegal to absolve student loan debt through bankruptcy, and you can't sell back an education.

The simple fact of the matter should be obvious by now: Government created this mess, in both instances, by forcing the market to provide loans it would not have granted otherwise. As is its custom, government did by force what no private lender would have ever done by choice. This is the breeding ground for bubbles, and this one will burst just as they all do. As with the last bubble, politicians will blame the "greed" of the marketplace. How many more bubbles must we endure before we realize that the problem isn't greed and it isn't markets? The problem is government interference.

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