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Free Enterprise: Paulson's proposal a costly experiment

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One can add another ailment to the numerous ones that have recently befallen the U.S. economy. This one, however, is of a more psychological nature and has to do with self-discovery or even schizophrenia.

It was brought on by the Treasury secretary: A system built on free-market principles is hardly in tune with the songbook from which Henry M. Paulson Jr. was singing this week. The screeching sound in the wake of his various announcements was that of a 180-degree turn by a usually laissez-faire White House.

In hearings before Congress, Paulson outlined a plan to bail out the mortgage giants, Fannie Mae and Freddie Mac, with explicit guarantees backed by taxpayer money. The extent of that guarantee and the "blank check" request by Paulson are staggering.

According to his testimony, the Treasury seeks temporary authority from lawmakers to provide, if necessary, credit of an unspecified magnitude to the two companies as well as permission to directly buy an ownership stake if the situation requires it. Taking into account that the two firms own or guarantee approximately half of the nation's mortgage market, which is estimated to amount to $12 trillion, such authority would expose the treasury - and by extension the taxpayers - to financial risks at an incredible level.

Of course, the defenders of this plan emphasize that permitting those two firms to fail would not only pose a grave danger to the U.S. economy, but may also have a dreadful effect around the world. Many investment portfolios abroad include financial instruments issued by the two companies. Given their size, so goes the argument, failure is simply not a viable option.

This line of reasoning, however, ignores that the way the firms grew so large is the actual problem and that "bailing them out" with taxpayer money will only put a band aid on a hemorrhaging wound. Both mortgage giants scaled such heights because their establishment via a federal law gave them the status as "government-sponsored enterprises."

All protestations by successive administrations notwithstanding, that implied a responsibility of and willingness by the federal government to step in if they were in danger of failing. Because of this backup scenario, the firms were able and exceedingly willing to raise capital at lower costs than comparable private

institutions. They also got away with ridiculously low liquidity reserves as a percentage of outstanding debt.

Alas, even opponents of the plan have admitted over the past few days that it is likely to be nodded through by Congress. However, having for the first time faced the - even if remote - possibility that taxpayers could be on the hook for approximately $5 trillion in debt (more than half of the current national debt), now is the time for the beginning of the end of this socialist experiment.

In the bill currently moving through Congress, lawmakers should require the two companies to - in the long run - gradually reduce their credit exposure by purchasing fewer mortgage loans from banks and to increase liquidity reserves to satisfactory levels. Furthermore, any credit promises, especially unlimited ones, must truly be temporary while simultaneously proscribing such financial bailouts by the public in the future.

That would be a first but important step toward ending this Janus-faced setup of - de facto - nationalized firms in a free-market system.

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