

The Promise and Peril of Government Intervention



Government policy interacts with private market activity in a wide variety of ways. The Federal Reserve, for instance, interacts with the banking system in both the execution of monetary policy and, more directly, as a regulator and supervisor of banking organizations. These interactions help the Fed pursue its macroeconomic goal, price stability, and to ensure the safety and soundness

of banks, a key ingredient in overall financial stability. This, of course, is just one small element in the array of public policies adopted in a large economy like ours.

At all levels of government — federal, state, and local — policies and actions are undertaken to influence the level, location, and composition of economic activity. Many of these aim to encourage more of an activity that the government or its constituents find desirable — or less of something deemed undesirable. In *Region Focus*, we have tried to write about such government initiatives in an objective way, providing arguments both pro and con. Sometimes when we do this, it becomes apparent that one side's case is stronger than the other's, but we try to save explicit statements of opinion for our back-page Opinion piece, or for this page, where I get to share my views with our readers.

This issue contains three notable examples of government promotion of activities, through three different mechanisms. Our story on eminent domain highlights its use by local governments to attract businesses to their jurisdictions in hopes of expanding employment and tax bases. We've written before about the controversy surrounding the use of incentives by states and localities to influence business location decisions. One lesson that emerges regarding such mechanisms is that, with a fair tally of the costs and benefits, they often are less attractive than at first blush.

Our cover story, on North Carolina's Smart Start program for early childhood education, deals with a topic that is gaining a lot of attention in the economic development community. This attention grows out of two findings from economic research. The first is the vital importance of a skilled work force for the continuing vitality of a region's economy. The second is that for long-term returns in building a skilled work force, early childhood education may provide more bang for the buck than many other forms of education and training. In particular, improvement in the early childhood services to low-income families can be a

strong complement to existing educational infrastructures at the elementary, secondary, and higher education levels. The evolution of early childhood policy is something we will watch with great interest.

Finally, we have a story that examines the issues surrounding Fannie Mae and Freddie Mac, two so-called "government-sponsored enterprises" (GSEs) in the mortgage market. These companies are part of a web of federal government policies aimed at promoting homeownership, from the home-mortgage tax deduction to the backing of mortgages for lower-income households by the Federal Housing Administration. But the GSEs are a peculiar part of this mix. They were originally formed as government agencies for the purpose of creating a secondary market for mortgages. A secondary market was seen as a way of lowering the cost of capital to mortgage providers and thereby lowering the cost of borrowing for home buyers. Once the secondary market existed, however, it proved difficult for the government to simply get out of the business. Instead, Fannie Mae and Freddie Mac were converted into private companies with an array of special privileges which clouded the public/private distinction and brought us to the current state of affairs, as described in our article.

The GSEs' size, financial complexity, and central place in mortgage markets, all of which result from their special history and special status, can make it hard to clearly assess the situation. But I think our article makes clear that the issue comes down to a simple trade-off. Their status gives the GSEs an implicit subsidy, some of which gets passed on to home buyers in the form of lower mortgage rates, thereby giving some inducement to homeownership. Against this benefit, the magnitude of which has been challenged by a number of studies, is the fact that their status also allows these companies to accumulate large concentrations of risk in a way that has proven difficult to monitor. There are legitimate questions about the desirability of continuing to subsidize housing finance in this day and age, and besides, there are other more effective tools for subsidizing homeownership if that is the objective. But if the GSEs' special status and implicit subsidy are not to be removed, then the public's ability to monitor and control their risk-taking must be improved.

A handwritten signature in black ink, appearing to read "Jeff M Lacker".

JEFFREY M. LACKER
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