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Regional Effects of the Thrift Bailout

The billions of dollars of government debt being raised to resolve the problems of hundreds of insolvent thrift institutions have drawn attention to the possible regional effects of the so-called "thrift bailout." Regional effects are at issue because the insolvent institutions are concentrated in a few states, such as Texas, while the government obligations incurred to protect depositors fall on the nation as a whole.

It has been argued that the states with large concentrations of ailing thrifts will experience stronger economic growth at the expense of the other states. This *Letter* takes a somewhat different view. While government deposit insurance protection should have a salutary effect on the economies of states experiencing thrift insolvencies, it is not necessarily at the expense of current taxpayers in other regions.

Two issues

At least two interesting questions arise when evaluating the regional consequences of government deposit insurance and the thrift bailout. First, for a given set of losses, how are regional economic growth rates affected when the federal government protects depositors compared with a situation in which the losses are borne regionally? Second, how does the financing of the deposit insurance claims affect interregional spending patterns, and hence regional economic growth rates?

Regional effects of deposit insurance guarantees

In a state plagued with thrift insolvencies, the economy would be stronger with a federal government guarantee than if depositors (or others) in the state had to absorb all of the losses. During the past several years, as conditions in the thrift industry have deteriorated, insured depositors in the affected states have had no reason to reduce spending. In contrast, if all deposits had been uninsured, depositors would have been more concerned about the risky activities that thrifts were undertaking. This added concern might have helped to limit the losses among thrifts. More importantly for the purposes of this *Letter*, for a given set of losses, uninsured depositors in an affected state would have reduced their spending (increased saving) in response to their loss of wealth. In effect, deposit insurance has insulated depositors from the thrifts' losses, and, thus, has blunted the negative economic effects of the thrift crisis in the states with high concentrations of insolvencies.

However, the realization of this benefit in regions with high concentrations of thrift failures does not occur when the government actually pays out its deposit insurance obligations. As pointed out in a previous *Letter* (May 12, 1989), for all intents and purposes, the wealth transfer to the depositors of the troubled thrift institutions took place long before the government's explicit decision to finance the thrift bailout. Depositors of insolvent thrifts, for the most part, have behaved all along as if they were protected. Most, if not all, of the positive effects of deposit insurance protection already should be reflected in the economies of the states plagued with thrift insolvencies. This means that the government's outlay of billions of dollars to acquire the assets or to accommodate takeovers of insolvent thrifts should not provide a further boost to the economies of these states.

Nevertheless, the expenditures made to resolve the status of the ailing thrifts may allow unfinished projects that had been lying idle to be started up again as assets are sold off. To the extent that such projects are geographically concentrated, the bailout might have some impact on economic growth regionally. Also, to the extent that there is any friction in interregional capital flows, the ongoing thrift bailout could have some impact on the regional distribution of funds. However, these effects are likely to be small and do not stem from wealth transfers *per se*.

Thus, the answer to the first question is that the economies of regions with high concentrations of thrift problems are better off with deposit insurance than they would have been in the absence

of federal deposit insurance. However, this benefit derives from the government's deposit insurance guarantees, and the actual payment of bailout funds should have little additional stimulative effect on these regions' economies.

Paying the piper

Paying off actual deposit-insurance obligations requires the federal government to raise funds, whether through raising current taxes or issuing debt. It is this need to raise funds to pay for the bailout that has led some to argue that funding the thrift bailout hurts the economies of states with few thrift insolvencies.

Economies in regions with few thrift insolvencies would be hurt if taxes were raised to cover thrift losses as institutions became solvent. The payments from the insurance funds would be regionally concentrated, while the taxes to cover the expenditures would be spread throughout the country. Taxpayers as a group would reduce their spending on private goods and services as their tax obligations rose. If the bailout were financed in this way, then the positive effects of deposit insurance for depositors in some states would indeed come at the expense of current taxpayers in other states.

Debt financing

In practice, however, most of the expenses incurred by the deposit insurance system are being financed with government debt, rather than with current taxes. Moreover, the debt being issued to cover the cost of the thrift bailout merely makes explicit what had been implicit obligations of the government.

The impact of the debt-financed bailout on the saving and spending decisions of current taxpayers depends on whether current taxpayers view themselves as bearing the burden of the debt, and whether the volume of the debt is significantly different from what current taxpayers previously had expected. Only if current taxpayers assume they will bear the cost of the bailout, *and* if the cost is appreciably higher than expected, will they increase their rate of saving further and cut back on consumption. Otherwise, current spending will be little affected by the bailout itself.

"Same as raising taxes?"

If taxpayers explicitly recognize the future tax liability that is necessary to finance the thrift-related government debt, then as information about the size of the required expenditures becomes available, they would adjust their saving enough to cover the change in their expected future tax payments. Thus, if current taxpayers assume they will bear the cost of the bailout, and if the cost is appreciably higher than previously anticipated, they will increase their rate of saving further and cut back on consumption. However, even in that case, the adjustment in spending would hold for taxpayers in all states, including those that have realized the benefits of deposit insurance.

Under these circumstances, we would have what economists call "Ricardian equivalence." That is, when current taxpayers recognize how much of the government's deposit insurance obligations will be funded, they reduce their spending on private goods and services to compensate for their share of the funding. When the funding is debt-financed, the adjustments are the same as if the obligations were funded through current tax revenues. This means that, if Ricardian equivalence strictly holds, deposit insurance would hurt the economies of states with few insolvent thrifts as much if the deposit insurance obligations are funded by debt issuance as it would if funded by higher current tax revenues.

...or intergenerational transfers?

On the other hand, if current taxpayers do *not* adjust their rate of saving to cover higher future tax burdens, the deposit-insurance related obligation would not be taken into account in private decision making. Neither insured depositors nor current taxpayers would change their spending patterns in response to the thrift losses. Thus, current consumption would be higher and saving would be less than they would be if tax revenues were increased or if the Ricardian equivalence were to hold. Moreover, as Herbert Stein points out in a recent article (*Wall Street Journal*, June 25, 1990), a lower rate of saving would mean that the capital stock would grow more slowly than it would if the thrift losses did affect the spending and saving decisions of current taxpayers or depositors.

In this case, the burden of the debt incurred in the thrift bailout would be shifted to future generations. Higher current consumption would be made possible at the expense of future consumption, since future taxpayers would inherit more debt, as well as a smaller capital stock with which to service the debt.

This implies that the net benefit of deposit insurance for some states would not represent a burden on current taxpayers in states with few thrift failures, but rather would represent a burden on future taxpayers in all states. Thus, in this case, current economic growth in regions with few thrift failures would not suffer due to the cost of the bailout, but future growth throughout the nation eventually would be slower than it would have been in the absence of the thrift bailout.

Which scenario?
There are differences of opinion concerning the extent to which current taxpayers adjust consumption and saving in response to higher government debt. This is part of a broader question about the economic impact of government deficits. However, to the extent that individuals do not fully incorporate higher future debt obligations into their current spending and saving decisions, the importance of changes in spending by current taxpayers associated with the deposit insurance expenses is reduced.

Thus, the burden of paying for debt-financed deposit insurance will retard spending and economic growth in states with healthy thrifts only if taxpayers incorporate the future costs of debt financing in their current spending and saving decisions. If taxpayers do not incorporate the future debt servicing costs in their current decisions, then the debt-financed bailout will have little negative impact on current economic conditions in states with few insolvent thrifts.

Conclusion
The rash of thrift insolvencies has been geographically concentrated, raising concerns that the economies of states with high concentrations of thrift failures may benefit at the expense of states that have few thrift problems. Deposit insurance has helped the economies of the states affected the most by thrift insolvencies by maintaining the wealth of thrift depositors. However, this benefit was associated with government obligations to depositors, and does not occur as the government writes the checks to fulfill its obligations. Therefore, the funding of the bailout should have relatively little further effect on the economies of states with large concentrations of thrift failures.

Moreover, since debt financing has been used to cover the losses registered at thrifts, the costs of the bailout maybe borne by future taxpayers throughout the nation, rather than by current taxpayers in states that are relatively free of thrift failures. Thus, the concerns about negative effects on the current economies of regions that have few thrift problems may turn out to have been overstated.

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