

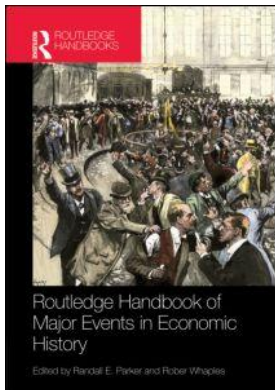
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GOVERNMENT BAILOUTS

Robert E. Wright

A bailout occurs when a government provides aid to (bails out) a financially distressed entity (business, industry, or government).¹ “Bailing out” evokes three relevant emergency-related metaphors: emptying water from a sinking boat, parachuting from a doomed aircraft, and getting out of jail. Government bailouts (hereafter simply bailouts) are a subset of government resource transfers called subsidies or, when directed to big businesses, corporate welfare (Adams and Brock 1987: 75; Glasberg and Skidmore 1997: 2–3; McGee 2008: 9). They can be differentiated from disaster relief, or aid designed to counteract distress caused by natural or manmade forces clearly outside of the resource recipient’s control (Auerswald et al. 2006).² Some bailouts are complete, entailing no losses to creditors, employees, managers, owners, or other stakeholders. Others protect only uninsured creditors or other preferred stakeholders (Kaufman 2004). Some bailouts are systemic while others aid only a specific entity or entities.

Bailout resource transfers can take numerous forms, including: asset purchases, cash, contract flexibility (e.g., allowing costs overruns or relaxing performance standards), criminal prosecution immunity, (subsidized) insurance, contract process manipulation (e.g., no bid), (unwarranted) deregulation, liability forgiveness, loans and loan guarantees, market power creation (e.g., cartelization), (compensated) nationalization, physical infrastructure (e.g., manufacturing plants), regulatory forbearance, (unwarranted) research grants, stock purchases, tariffs and other forms of protection from foreign competition, tax breaks, and welfare policies (Pierce 1983: 363–64; Adams and Brock 1987: 66–80; Glasberg and Skidmore 1997: 4; Gup 2004: 38–43; Rosas 2009: 6–8).

Governments and resource recipients justify bailouts by asserting that the expected costs of not bailing out a distressed entity exceed expected bailout costs (Forman 1981: 46; Freeman and Mendelowitz 1982: 448; Adams and Brock 1987: 63–65; Stern and Feldman 2004: xi–xii; McGee 2008: 2). Failure to bail out a distressed entity, they typically claim, will decrease economic output and employment, increase stress on government budgets by decreasing tax receipts and increasing social safety net expenditures, and induce the extinction of culturally, economically, and/or strategically important services, companies, or industries. Failure to bail out will also create so-called knock on or contagion effects that may cause the failure of stable

institutions and thereby spread distress across industrial sectors and national borders (Adams and Brock 1987: 68; Gup 2004: 43–44; Stern and Feldman 2004: 44–47).

Bailout decisions, however, are not based on precise cost–benefit analyses because the net costs of bailouts are difficult to assess (Webel, Labonte and Weiss 2009: 2, 7–8), even *ex post* (Stern and Feldman 2004: 23; Reinhart and Rogoff 2009: 163–64, 224; Rosas 2009: 3), a point discussed in more detail below. Some experts think that the risk of system-wide contagion is low, especially if the distressed entity is not a depository institution (Benston 1999: 8), but others believe contagion highly likely. The net costs of government cash grants, securities purchases, and loan guarantees are difficult to calculate because they involve assumptions about risk-adjusted returns and the opportunity costs of government funds. More indirect forms of aid are difficult to identify, let alone precisely quantify (Webel, Labonte and Weiss 2009: 2–3).

Bailouts have had a long, checkered history in the United States (Wright 2010), Canada (Gordon 1981, Trebilock et al. 1985), Mexico (Shull 2010: 13), Japan (Yabushita and Inoue 1993; Yokohama 2007), Europe – where the first recorded bailout occurred in 33 A.D. (Rosas 2009: 2) – and elsewhere (Gup 2004: 43; Shull 2010: 12–13). Some bailouts have clearly been salutary. Others exposed well-meaning but bungling government agencies. Still others appear to have been “bad” bailouts implemented by bureaucrats, for bureaucrats (Benston 1999: 33, 53–55; Stern and Feldman 2004: 43–44, 52–59; Shull 2010: 15; Skeel 2010: 11–12), or that unduly aided powerful special interests – a large corporation, influential industry, or potent combination of smaller interests³ – at the expense of taxpayers⁴ (Glasberg and Skidmore 1997: 138–40; McGee 2008: 7–8).

Bailout results vary partly because representative governments typically concede less to special interests than authoritarian governments do (Rosas 2009: 8–11), ostensibly because they are more responsive to taxpayers and the bailed out entity’s rivals (Gordon 1981: 153). Democracies countenance bad bailouts because their largest cost, increased moral hazard (post contractual asymmetric information),⁵ is difficult to quantify precisely. Belief that bailouts greatly increase moral hazard is strong because economists suspect that entities that expect to receive a bailout if they encounter difficulties will be inclined to earn higher profits by assuming higher levels of risk (Stern and Feldman 2004: 23–24; Mishkin 2006, 2007: 48). Bankers who expect a bailout, for example, will benefit by building riskier loan portfolios and insured depositors will benefit by reducing their monitoring efforts (Benston 1999: 32). U.S. history strongly suggests that most types of bailouts do, in fact, increase future risk taking.

Before the Great Depression, the U.S. government minimized bailout expectations by providing emergency aid on only a handful of occasions (Perkins 1994: 249–50; Cowen 2000: 153–59, 178 n. 96; Leathers and Raines 2004: 4–5; Kamensky 2008; Ventruco 2009; Shull 2010: 12). Most important were the actions of Treasury Secretary Alexander Hamilton, who in 1792 teamed up with the first Bank of the United States (1791–1811) to squelch a financial panic (Sylla, Wright and Cowen 2009), and Nicholas Biddle, who in 1825 as president of the second Bank of the United States (1816–1836) successfully prevented a financial crisis from spreading to America from Britain. Both of those system-wide bailouts followed the Hamilton–Bagehot Rule. According to Hamilton (and later Walter Bagehot, founding editor of *The Economist* magazine, who until recently had received exclusive credit for developing the Rule), central banks should act as a lender of last resort (LLR) during financial panics by lending at a penalty rate to any entity that could post “what in ordinary times is reckoned a good security” (Bagehot 1873/1962: 97). Such actions stop panic and contagion by reassuring solvent (assets greater than liabilities) but

temporarily illiquid (insufficient cash) firms that they can borrow from the LLR regardless of money market conditions. The Rule also prevents losses to taxpayers by requiring ample collateral and minimizes moral hazard by allowing entities that assumed excessive risks to fail and their creditors to suffer losses (Wright 2010: 21–23; Rosas 2009: 4–7, 171–77). It is analogous to allowing a house fire to rage while preventing the conflagration from spreading to nearby buildings (Acharya et al. 2010: 135).

Despite the success of the Hamilton–Bagehot Rule, the government opted not to use it for the better part of a century. Between the demise of the second Bank in 1836 and the opening of the Federal Reserve (Fed) in November 1914,⁶ the Treasury did little to act as a LLR during financial panics beyond depositing some of its funds in money center banks (Bruner and Carr 2007: 136). Private alternatives, including bank clearinghouses and investment bankers (e.g., J.P. Morgan in 1907), filled some of the void (Leathers and Raines 2004: 18–19; Bruner and Carr 2007) but Bagehot (1873/1962: 162) considered the “American system ... faulty” in both “its very essence and principle.” Most Americans, however, did not consider bailouts in “the general interest” of the LLR function sanctioned by the U.S. Constitution. Several state constitutions even explicitly forbade state governments from lending to, or guaranteeing the debts of, individuals or businesses (Smith 1853/1966: 260). Finally, many Americans considered waves of commercial bankruptcies salutary. They argued:

As one after another goes down, there is one less engaged in the scramble for money, and the survivors experience the same sort of relief as men in a crowd do when some of them faint and are carried out.

(Smith 1853/1966: 245)

That is not to argue, however, that *laissez-faire* ideology dominated early American political economy. Nineteenth-century U.S. governments transferred significant resources to specific enterprises and industries. Most of those transfers – copyrights, corporate charters, patents and other monopoly rights; land grants to railroads and settlers; tariffs – were general subsidies, not bailouts. Early state governments subsidized private transportation corporations such as toll bridges, canals, turnpikes, and railroads, and some of the aid could be considered bailouts because it went to distressed firms (Mason and Schiffman 2004: 49–50). Some emergency payments of cash (or securities purchases), however, are better described as disaster relief because they were made to repair damage caused by floods or other natural catastrophes (Wright forthcoming; Moss 2002). After the Civil War, government takeovers of privately-owned transportation corporations became increasingly frequent but few could be considered bailouts because stockholders received little or no compensation as the improvements escheated to some level of municipal government (Wright forthcoming). The postbellum federal government continued to subsidize railroads with land grants and other concessions and manufacturers with tariffs but few of its actions could be considered bailouts, which were politically anathema and, in an age of dynamite-throwing anarchists, potentially physically dangerous for recipients (Gage 2009).

In the twentieth century, however, government bailout activity increased dramatically due to the tremendous stresses caused by both World Wars, the Cold War, the Great Depression, and the demise of fixed exchange rates. Bailout expectations initially proved sticky (resistant to change) but by the early twenty-first century a feedback cycle was clearly in place: more bailouts increased bailout expectations which induced more risk-taking

which increased the number and severity of crises and hence the need for more bailouts. That cycle began to develop, slowly, as early as World War I. The War Finance Corporation (WFC, 1918–1929) was more of a general subsidy program than a bailout vehicle per se (Rosenfield 1985: 355) but it did incidentally aid distressed companies. Moreover, it set a precedent for the Reconstruction Finance Corporation (RFC) (Leathers and Raines 2004: 19–20). The RFC (1932–1957) at first made loans only to distressed financial institutions and railroads but the government soon allowed it to lend to distressed municipal governments and manufacturers (Leathers and Raines 2004: 21–26; Mason and Schiffman 2004; Levitin 2010: 54). Many New Deal programs can be interpreted as attempts to bail out specific groups, including depositors (FDIC), farmers (AAA), financiers (SEC), homeowners (HOLC), and various other entities through cartelization, price supports, and other anti-competitive measures (NRA) as well as direct transfers (Mahoney 2001; Shlaes 2007).

Although unprecedented in scale and scope, New Deal bailouts were seen as aberrations and hence did not radically increase bailout expectations. Moreover, the RFC essentially followed the Hamilton–Bagehot Rule because it lent at a penalty rate and under stringent collateral valuation rules (Leathers and Raines 2004: 23). According to a late New Deal monograph on government corporations like the WFC and RFC, “the protection of government credit cannot be implied.” In other words, “unless a positive guaranty is included in the act,” the Treasury could not be held responsible for the debts of *government-owned and operated* corporations, much less private businesses (McDiarmid 1938: 65–66, 216). By the 1980s, however, investors believed that the bonds of government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac were de facto backed by the full credit of the U.S. Treasury even though Congress had not authorized an explicit guarantee. Just thirty years later, many lenders believed that taxpayers would reimburse them if any foreign government or large private corporation, financial or not, defaulted, and leading experts on central banking publicly wondered if “monetary policymakers might be tempted to ‘follow the markets’ slavishly, essentially delivering the monetary policy that the markets expect or demand” (Blinder 2004).

The sea change in sentiment occurred because during and after World War II the government became an increasingly potent economic force (Higgs 1987). Under Bretton Woods, the Fed began actively managing the money supply (or interest rates). American governments at all levels stepped up the direct regulation of prices (during the war, during the Nixon administration, and with rent controls and minimum wage laws) and increasingly attempted to mandate specific economic outcomes (Moss 2002). The public and private sectors became so “completely intertwined” that “no clear distinction” between them could be made (Reich 1982: 878). In 1970, the government awarded Penn Central Railroad \$125 million in loan guarantees while it was in bankruptcy because it considered the company a public utility that provided rail service rather than a private business (Rosenfield 1985: 355). Shortly thereafter, the troubled Conrail received \$3 billion in aid for essentially the same reason (Freeman and Mendelowitz 1982: 452; Rosenfield 1985: 356).

Perhaps the most important example of the melding of government and business interests, however, was the “military-industrial complex” that emerged from World War II and matured during the Cold War. Close ties between the Pentagon and its arms manufacturers created a cadre of mismanaged defense contractor firms that believed that “if adversity strikes” they could “count on government bailouts” (Adams and Adams, 1972: 284). Some defense contractor bailouts were done quietly through the award of

major contracts of dubious necessity, some as aid to foreign allies like Iran (Kurth 1973: 43–46), some as contractual modifications favorable to the distressed firm (Ramey and Erlewine 1954), and some as new, comfortably-padded contracts (Higgs 1993: 40). A few, like the government’s \$250 million loan guarantee for Lockheed in 1971, were explicit and justified on the grounds of employment and national defense (Kurth 1973: 36–37; Freeman and Mendelowitz 1982: 451–52).

Senator William Proxmire warned Treasury Secretary John Connally that “Lockheed’s bailout ... is not a subsidy ... it is the beginning of a welfare program for large corporations” (Jasinowski 1973: 8). He was right that an important corner had been turned (Adams and Brock 1987). Lockheed and other bailouts, including the “special tax relief” extended to the American Motor Corporation in 1967 and large loan guarantees and import restrictions provided to dying steel companies in the 1970s, prompted Chrysler to ask for federal assistance when it faced bankruptcy in the late 1970s (Freeman and Mendelowitz 1982: 447, 451; Rosenfield 1985: 355–56; Adams and Brock 1987: 66). Chrysler chairman Lee Iacocca justified his aid request by arguing that “free enterprise died a while back” (Rosenfield 1985: 353) and that the bailout was “amply precedented” (Adams and Brock 1987: 65). Although Chrysler’s case was arguably much weaker than those of previous bailout recipients, the government relented, ostensibly because the scorn of unemployed workers would be more powerful at the ballot box than the gratitude of those taking the new jobs that would have been created eventually if Chrysler was shuttered (Freeman and Mendelowitz 1982: 451–53; Rosenfield 1985: 354; Adams and Brock 1987: 65; Bickley 2008: 2).

Chrysler’s aid package, worth an unprecedented \$3.5 billion (Rosenfield 1985: 353), further pried open the lid of a “Pandora’s box” of bailouts (Hoffman 1980: 871; Rosenfield 1985: 356). Increasingly un-sticky expectations about the government’s willingness to provide emergency assistance induced yet other troubled firms to seek government bailouts and they of course “cited the Chrysler bailout as a plausible reason why they ought to have one” (Hoffman 1980: 869). A wave of bailout requests, some successful, ensued. For example, manufacturers of TRIS, a flame-retardant chemical banned from use in children’s sleepwear after its carcinogenic properties were discovered, successfully lobbied for federal funds in late 1982 (Garmon 1983: 22; Painter 1984: 1073–74). In 1984, the government bailed out forest product companies that had bid too much for timber cutting rights (Mattey 1990). Soon after, Dennis Carney, the president of a bailed out steel firm, claimed that “you can’t win the game with free enterprise anymore” (Rosenfield 1985: 357), and Wharton professor Edward Herman sneered that the government had birthed a form of “crybaby capitalism” that rewarded the most vocal complainants (Rosenfield 1985: 354). By the mid-1990s, the federal government had bailed out over 400 non-financial corporations (Glasberg and Skidmore 1997: 3, 138) and its support of distressed defense contractors continued (Weber 2001). The number and size of sovereign (e.g. Latin American debt crises) and municipal government bailouts (e.g. loan guarantees to New York City in 1975 and 1978) also increased in the 1970s, 1980s, and 1990s (Adams and Brock 1987: 65–66; Reinhart and Rogoff 2009; Webel, Labonte and Weiss 2009: 8).

After a long postwar lull during which only a handful of very small banks failed, inflation, technological change, and overly ambitious deregulation began to take its toll in the 1970s and 1980s. Unsurprisingly, bank bailouts increased in number and size, mostly in the form of FDIC purchase and assumption agreements and Federal Reserve LLR actions (e.g., Union Bank in 1971, Bank of the Commonwealth in 1972, Franklin National in 1974, and First Pennsylvania Bank in 1979) (Sprague 1986: 35–106; Shull 2010: 6–7). Those

bailouts overwhelmed the effect of “two potential bailouts that never happened,” Penn Square and Seafirst (Sprague 1986: 107–45), increasing the bailout expectations of bankers and inducing them to “take riskier actions than if government intervention was unlikely” (Shapiro 1982: 730). By the early 1980s, bankers had substituted expensive equity with low-cost “implicit insurance provided by government bailout activities” (Kane 1980: 360). The bailouts, most of which left even uninsured depositors unscathed, also greatly reduced large depositors’ incentives to monitor their banks (Shull 2010: 7).

In the 1980s and early 1990s, the trickle of bank failures became a torrent. The entire savings and loan (S&L) industry collapsed, Continental Illinois failed (Sprague 1986: 149–99), the Bank of New England reeled under bad real-estate loans, and Citibank wavered on the brink of insolvency. All received bailouts, ranging from regulatory forbearance to Fed discounts to FDIC guarantees of uninsured deposits to the purchase of underperforming assets by a taxpayer-funded “bad bank,” the Resolution Trust Corporation (RTC) (Benston 1999: 78; Murphy and Weibel 2009: 7). In 1987, the Farm Credit System, a GSE, also received a \$4 billion bailout (Nickerson and Phillips 2004; Hill 2010). In all, over \$150 billion (some 2 percent of GDP) was redistributed (Stern and Feldman 2004: 23–24).

New legislation (Financial Institutions Reform, Recovery, and Enforcement Act – FIRREA in 1989 and Federal Deposit Insurance Corporation Improvement Act – FDICIA in 1991) attempted to limit future bailouts by reducing regulators’ discretion about when and how to resolve failed banks (Shull 2010: 8). The government also refused to bail out junk bond giant Drexel Burnham in 1990 (2010: 477–81) and both MJK Clearing and Superior Bank in 2001 (Stern and Feldman 2004: xi–xii; Gup 2004: 43). Those exceptions and the new laws, however, did little to decrease market participants’ belief that the government intended to follow a policy of “too big to fail” (TBTF). Beginning with the 1984 bailout of Continental Illinois, policymakers explicitly⁷ promised free, unconditional aid to the eleven (and later a deliberately ambiguous number of the) largest banks (later, financial institutions of any sort) under the supposition that they were too big, important, or interconnected to be allowed to remain insolvent (Sprague 1986: 259). “The assumption that big banks will not be allowed to fail ... contributed to imprudent lending” (Rosenfield 1985: 357), as did the erosion of economic incentives, especially the franchise value of financial institutions, that had traditionally limited risk-taking (Stern and Feldman 2004: 24–26, 149–58).

At the same time, market participants learned that they could maintain high levels of risk regardless of their size or the macroeconomic climate because if the entire financial system encountered difficulties the Fed stood ready to provide ample, timely, and inexpensive aid. Instead of following the Hamilton–Bagehot Rule as it traditionally had at least given lip service to (Meltzer 2003: 75–76, 113–14, 125–26, 730–31), at the outset of crises the Fed under Alan Greenspan increased market liquidity by purchasing bonds in the open market and lowering interest rates for banks, both the overnight bank-to-bank target rate and the rate it charged at its own discount window (Axilrod 2009: 162, 169–70; Hetzel 2008: 227–33; Mishkin 2007: 48; Norberg 2009: 14). Relaxation of the Hamilton–Bagehot Rule increased moral hazard and risk-taking at all banks (Bordo and Schwartz 1999: 8–9) and TBTF policy induced financial institutions to grow large as quickly as possible to receive the free insurance (Kaufman 2009). In 1987, the Greenspan Fed stopped a stock market rout by supporting banks that lent to distressed broker-dealers. In 1997 and 1998 it lowered interest rates in response to the Asian financial crisis, the Russian default, and the failure of Long-Term Capital Management, the sale of which Greenspan brokered and implicitly guaranteed (Axilrod 2009: 146–50; Hetzel 2008: 206–26). The Fed also injected

cash into the economy in late 1999 to prevent panic in the event of Y2K-related problems and did so again in the wake of the terrorist attacks in September 2001. More dubiously, the Fed lowered interest rates for a considerable period to buffer the economy, and investors, from the bursting of the dotcom bubble in early 2000 (Levitin 2010: 53). In addition to increasing confidence in the existence of a so-called “Greenspan put,” long periods of low real interest rates invited increased leverage and other forms of risk-taking implicated in the subprime mortgage crisis of 2007 (Woods 2009: 25–29).

Under Greenspan’s successor as Fed chairman, economist Ben Bernanke, the Fed also reduced interest rates when trouble struck, eventually lowering nominal overnight rates to zero and keeping them there into 2012 while also indicating they intended to have them remain there until 2014. As the intractability of the subprime mortgage crisis became increasingly apparent, the Fed invoked its emergency authority under section 13–3 of the Federal Reserve Act (which granted it broad powers during “unusual and exigent circumstances”) to implement an unprecedented array of novel policies, most of which did not impose large direct burdens on taxpayers (Congleton 2010: 30). The rescue of investment bank Bear Stearns in March 2008, however, exposed taxpayers to up to \$29 billion in losses and effectively extended TBTF expectations to all large financial institutions (Jickling 2008).

In September 2008, the new Federal Housing Finance Agency took troubled GSE mortgage lenders Fannie Mae and Freddie Mac into conservatorship and the Treasury explicitly guaranteed some \$5 trillion of their debt in exchange for a 79.9 percent stake in the companies, effectively (re)nationalizing them (Congleton 2010: 18). Shortly thereafter, Lehman Brothers failed, triggering a run on money market mutual funds that the Treasury and FDIC stopped by guaranteeing that investors would not lose money. Soon after that AIG, a large, shaky financial conglomerate, received from the Fed an \$85 billion line of credit, at a penalty rate of interest, again in exchange for a 79.9 percent stake in the company (Webel, Labonte and Weiss 2009: 4–5). The Treasury later purchased \$40 billion in AIG preferred stock via the Troubled Assets Relief Program (TARP) enacted in early October as part of the Emergency Economic Stabilization Act (Congleton 2010: 21–22). Despite early indications that the \$700 billion of TARP funds would be used to purchase bad assets, most of the appropriation funded the purchase of the preferred stock of troubled financial institutions by the Treasury, which apparently decided it would leave the technically difficult and politically dangerous process of defining and pricing “toxic” assets to the Fed (Norberg 2009: 118–19; Congleton 2010: 23–24, 30–31).

Also in early October 2008, the Fed opened a Commercial Paper Funding Facility that bought hundreds of billions of short-term bonds directly from non-financial businesses. The FDIC liquidated the enormous failed thrift Washington Mutual but the government pushed the “assisted purchases” of Wachovia by Wells Fargo and Merrill Lynch by Bank of America, which in January 2009 itself received a massive and complex bailout (Webel, Labonte and Weiss 2009: 3–4). In November 2008, Citigroup was also bailed out by the Fed, Treasury, and FDIC (Jickling 2008; Graham 2010: 119–21). In November, the Fed introduced TALF (Term Asset-Backed Securities Loan Facility) to reinvigorate the market for asset backed securities composed of student, auto, credit card, and home equity loans (Agarwal et al. 2010).

In the American Recovery and Reinvestment Act of 2009, the new Obama administration authorized an additional \$800 billion of expenditures, including some \$200 billion for cash-strapped state governments, and various Keynesian stimulus programs (Congleton 2010: 28–29). It also bailed out two major automakers, GM and Chrysler. In addition

to their finance wings receiving billions in TARP funds (Webel, Labonte and Weiss 2009), both auto giants continued to operate despite filing for bankruptcy because of U.S. government loan guarantees and capital infusions worth over \$50 billion (Canis et al. 2009: 20; Congleton 2010: 25–26). The government justified the intervention by claiming that shuttering both companies would have reduced real GDP by 1 percent and increased unemployment by one million people (Canis et al. 2009: 31–33).

Proponents of the 2007–09 bailouts argued that a depression was imminent (Graham 2010: 119; Congleton 2010: 16, 27, 35). Chairman Bernanke claimed that if bailouts were not implemented “we may not have an economy on Monday” (Norberg 2009: 99–100), even though experts familiar with his work on the causes of the Great Depression of 1929–33 (Bernanke 2000) – namely deflation brought on by strict adherence to the gold standard, widespread unit banking, high trade barriers, and a relatively inflexible wage structure – believed otherwise (Labonte 2009). Ironically, the apparently unduly (Woods 2009: 49–50) pessimistic sentiments emanating from key policy figures probably worsened the crisis by further frightening investors. The uncertainty fostered by frequent changes in policy also negatively impacted businesses (Congleton 2010: 19, 23–24 n.22; Woods 2009: 54).

The recent bailout wave has raised important questions (Tarr 2009). Not much work has been done on bailout ethics, but one leading business ethicist argues that most types of bailouts are unethical (McGee 2008). Most critics question the fairness, effectiveness, and/or overall effects of bailouts, particularly those that do not follow the Hamilton–Bagehot Rule (Rosas 2009: 171; Rosenfield 1985: 356–57). A bailout, noted Freeman and Mendelowitz (1982: 444):

is seen as costly because society is being asked to subsidize that which the marketplace has specifically rejected, and unfair because the government provides windfalls to a privileged group of creditors, stockholders, and employees associated with the failing firm.

Numerous observers note that bailouts redistribute wealth “from the poor to the rich” (Mahmud 2010), effectively socializing risk while allowing profits to remain largely private (Adams and Brock 1987: 80; Rosenfield 1985: 357; Wright 2010: 18). As Rosenfield (1985: 358) put it, bankers appear:

free to make marginal loans in good times and to keep the profits, but they can be confident that the federal government will prevent these marginal loans from becoming outright losses when recession strikes.

Bailout incidence (analogous to tax incidence, the entities ultimately receiving aid) is not, however, always clear cut. Bailouts of governments by the IMF and World Bank, for example, primarily benefit the distressed governments’ creditors, typically large institutional investors, banks (Roubini and Setser 2004; Stiglitz 2002: 201–05), and cronies (Faccio, Masulis and McConnell 2005). Similarly, Chairman Bernanke claimed with some justification that AIG’s bailout accrued to consumers’ retirement accounts and insurance policies as well as to banks (Levitin 2010: 63–64). Obscure incidence and the case-by-case nature of bailout policies create perceptions of favoritism, some well-founded (Faccio, Masulis, and McConnell 2005). Proponents retort that ad hoc policies restrict bailouts to a few exceptional cases (Schultze 1983: 11), a point that suggests that case-by-case discretion may at times block “good” bailouts. Americans may dislike bailouts so much, for example, that the government

may not implement one even if it is warranted (expected benefits clearly exceed expected costs) for fear of a political backlash (Rosas 2009: 9–10; Levitin 2010: 58–61).

Of course, as mentioned above, the net costs of bailouts are much disputed and never precise, even after the fact (McGee 2008: 5). The total gross costs of the most recent bailouts will not be known for some years and early estimates vary by *trillions* of dollars (Tarr 2009: 3–4; Congleton 2010: 19, 27). Moreover, the bailouts' benefits will always be a matter of conjecture because we can never know for certain what would have transpired in their absence. Unemployment, for example, doubled to 10 percent during the 2007–09 crisis but Chairman Bernanke claimed that it could have hit 25 percent if aid had been withheld (Congleton 2010: 35 n.41).

Econometricians have used comparative statistical techniques to try to parse out the economic effects of bailouts but a consensus has yet to emerge due to the enormous complexity of the problem. Some studies find that bailouts increase the stability of bailed out firms and their creditors (see, e.g., Faff, Parwada and Tan 2010) and that Fed programs like TALF helped reduce risk spreads and increase liquidity (Agarwal et al. 2010). But most such studies do not attempt to assess the fiscal costs of bailout packages, the bailouts' longer term consequences, or their effects on specific groups (McGee 2008: 2–3). Bailouts, for example, advantage sunset over sunrise industries because the former enjoy considerably more political clout (Walters 1983: 31). RFC loans did not restore railroads to economic or financial health and probably hastened their long-term decline (Mason and Schiffman 2004). The failure of Continental Illinois, scholars now believe, would *not* have caused a significant ripple effect among its creditors. More generally, many episodes of apparent contagion were actually the well-justified withdrawal of support from shaky institutions, not blind panics that indiscriminately ruined solid companies (Stern and Feldman 2004: 48–49).

In addition, Bordo and Schwartz (1999: ii) found, after accounting for the self-selection problem and controlling for other important variables, that “participation in an IMF program has a significant and negative effect on member countries' real growth.” And Rosas and Jensen (2010: 134) concluded from a statistical examination of a large, global sample of late-twentieth-century cases that bank bailouts on average do not improve macroeconomic conditions, a major problem given that the fiscal costs alone of bank bailouts typically range from around 2 percent (U.S. during S&L crisis; Norway in 1987) to 50 percent (Argentina in the early 1980s and Indonesia in 1997) of GDP (Honohan and Klingebiel 2000; Reinhart and Rogoff 2009: 164; Rosas 2009: 2–3). Rosas found that, on average, democracies implement less costly and more economically justified bailouts than authoritarian regimes do (2009: 5, 172–73).

If Rosas is correct, the United States and other democracies should seek to break the bailout-expectation cycle. Academics including Ayotte and Skeel (2010), Balleisen and Moss (2010), Graham (2010), Hillinger (2010), Hoenig, Morris and Spong (2009), Shull (2010), Jackson (2009), Stern and Feldman (2004), Wilmarth (2010), Wright (2008, 2010), and numerous others have made proposals ranging from radical restructuring of the financial system and/or its regulatory apparatus to more modest reforms like increased use of bankruptcy laws and debtor-in-possession (DIP) financing to liquidate hopelessly insolvent institutions and restructure salvageable ones. To date, however, few have been adopted despite the criticism heaped upon the U.S. government's first major post-crisis financial reform attempt, the Dodd–Frank Wall Street Reform and Consumer Protection Act of July 2010 (Acharya et al. 2010; Black 2011; Skeel 2010). Future crises and bailouts, therefore, can be expected.

Notes

- 1 For so-called stock bailouts, see Metzger (1968). For the long-term (relational) contract adjustments known as bailouts, see Ramey and Erlewine (1954). Other meanings can be traced via the *Oxford English Dictionary*.
- 2 Application of those definitions requires some discretion. For instance, some observers consider the loan guarantees (and some direct loans) extended to the airline industry after the September 2001 terrorist attacks as a bailout (Gup 2004: 36–39; Webel, Labonte and Weiss 2009: 8) because the airlines were partly responsible for the success of the attacks and because they were already in financial trouble. Others place most blame for the attacks and the airlines' woes on the government and hence see the aid as more closely akin to disaster relief. The difficulty is compounded by the incentive of entities to appear closer to the relief than the bailout end of the spectrum (Mattey 1990: 10–14). General Motors (GM) and Chrysler, for example, claimed that they were victims of the financial crisis of 2008–09, which made borrowing and raising capital more expensive, and the ensuing deep recession, which decimated new car sales (Canis et al. 2009: 1–2). Other famous examples include the San Francisco (1906) and Kanto (1923) earthquakes, both of which helped to cause financial panics (1907 in the U.S. and 1927 in Japan) (Odell and Weidenmier 2002; Yabushita and Inoue 1993: 394).
- 3 Bailout lobbying often creates seemingly odd bedfellows, as when the NAACP backed the Chrysler bailout (Adams and Brock 1987: 65; Levitin 2010: 65–66).
- 4 Money for government bailouts comes mostly from the Treasury, which is funded by taxpayers, and the Federal Reserve, which is self-funded through the expansion of its monetary liabilities (notes and deposits). Taxpayers suffer, however, when the Fed's profits decline because it credits the Treasury with its profits (net of dividends to member banks). In addition, excessive money creation stimulates inflation, which essentially taxes all domestic holders of dollars, and depreciation, which taxes unhedged holders of dollars abroad. Relatively small amounts come from the FDIC, which is funded by prudent banks (through their insurance premiums) and taxpayers (Benston 1999: 6–8; Ennis 2009; Webel, Labonte, and Weiss 2009).
- 5 Moral hazard occurs when one party to a contract uses superior information to extract resources from the other party. Arson of an insured building is a classic example. Agency problems, such as employee slacking or executive embezzlement, are also examples of moral hazard.
- 6 The Fed was chartered in 1913 but took almost a year to organize and begin operations (Meltzer 2003: 72–82).
- 7 TBTF had long been implicit (Sprague 1986: 242–44; Gup 2004: 30–32), even in the bailout of non-financial companies (Adams and Brock 1987) like railroads (Mason and Schiffman 2004), as it is easier to justify the bailout of larger, and hence ostensibly more important, entities.

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