

RESEARCHBUZZ

All Deficits Are Not Created Equal

Author Summary

BY DR. JOHN A. TATOM

john.tatom@isunetworks.org

Recent academic and popular discussions of budget deficits rely on a simplistic—and largely false—conception of the effects of deficits. This literature ignores the fact that the effects of deficits depend on their source and on private-sector responses to them. Also significant are whether budget changes arise passively through the workings of the business cycle and whether deficit-inducing policy actions are permanent or transitory.

As to source, on the one hand, large movements in U.S. budgets deficits/surpluses are principally a result of the business cycle. Deficits caused by downturns in the business cycle are associated with interest rate reductions and boost aggregate demand, thereby limiting the extent of cyclical decline. Deficits caused by tax reductions also can be beneficial. For example, they can lead to offsetting changes in private saving and investment. Deficits caused by tax incentives for capital formation can be even more beneficial because their incentive effects can boost investment, productivity, and growth. Moreover, deficits associated with cuts in individual income tax rates can lower market interest rates and expected market rates of return. On the other hand, deficits caused by increased government spending can be harmful because of their crowding-out effects, even when these effects are not brought about by higher real interest rates and/or by an increase in the value of the dollar.

Correct theory and evidence show that deficits are typically not related to higher real interest rates. Usually, they are associated with lower interest rates, because the rate of return to capital is depressed or the tax wedge between market yields and the after-tax rate of return to investors is reduced by tax rate cuts. In either case, market in-

terest rates fall when deficits increase.

Finally, the widely popular idea that current account deficits arise from budget deficits is also not correct, at least for the U.S. economy during the past 25 years. Current account movements are related to international capital flows that respond more to incentives for domestic investment than to budgetary developments.

Not surprisingly, the key expectations of simple theories now circulating—especially about interest rates, the current account deficit, and the dollar—are precisely opposite to what modern theory and evidence indicate. Investment and asset allocation decisions that rely on the popular misrepresentations of why and how deficits matter do material damage to investor interests.

You can read the full article in the [Financial Analyst Journal](#) (May/June 2006, Vol. 62, No. 3: 12-19.)

■ Tatom is Director of Research at Networks Financial Institute.

An update on Indiana's banking sector

BY OZER ERDEM

oz.erdem@isunetworks.org

The total number of FDIC-insured commercial banks and savings institutions has been declining since 1994 in Indiana and in the nation. Between 2000 and 2005, it has decreased by 10.5 and 13.1 percent respectively. Consolidation of banks has been a major trend in the banking industry. However, the number of bank branches and total domestic deposits has kept increasing during the same period. There were a total of 2,345 branches of FDIC-insured commercial banks and savings institutions present in Indiana by June 2005 up from 2,228 in June 2000.. These branches had total deposits amounting to \$84.5 billion.

of branches operated and total amount of domestic deposits kept in those branches. In a 2004 study by the FDIC, it is argued that physical banking branches provide customers a certain amount of convenience and customers like it.¹ So, this could be one of the reasons behind the rapid increase in the number of branches operated by out-of-state commercial banks and savings institutions.

Out-of-state savings institutions made up 6.8 percent of state savings institutions. Although the number of branches operated by them constituted about 10.4 percent of total number of savings institutions branches in Indiana in 2005, only 5 percent of all domestic deposits held in savings institutions were being kept in their branches.

In 2005, Indiana-based commercial banks and savings institutions had a market share of 70.5 percent of the total amount of deposits held in Indiana. Compared with 94.8 percent market share of Indiana companies in 1996, this represents a 24.3 percent decline in market share. After the mega merger between JPMorgan Chase and Bank One, market share of Illinois-based companies dropped to 0.2 percent in 2005 compared to 13.6 percent in 2004. Likewise, the same merger gave Ohio-based commercial banks and savings institutions the largest market share in Indiana among the out-of-state companies. After the merger between Tennessee-based Union Planters and Alabama based Regions in 2005, there were no Tennessee based commercial bank or saving institutions operating in the state. Indiana gained its first Alabama-based financial institutions.

Indiana-based commercial banks and savings held about \$4.4 billion in deposits and operated

Table 2: Indiana-based commercial banks and savings institutions operating outside of the state, in 2005.

	Total Deposits (\$000)	Number of Branches	Market Share
IL	1,537,934	44	0.51%
KY	1,396,617	56	2.44%
MI	628,769	19	0.45%
NV	427,907	2	0.89%
OH	88,586	6	0.04%
TN	171,956	5	0.18%
UT	103,541	1	0.09%
Total	4,355,310	133	

Source: FDIC Summary of Deposits

about 133 branches in other states in 2005. Compared with about \$25 billion in domestic deposits held by out-of-state banks and savings institutions and 724 branches operated by them in Indiana, Indiana-based commercial banks and savings institutions' operations outside of the state seem considerably smaller.

The next step in this analysis is to look at the factors affecting banks decision when choosing a location for their headquarters and to look at the reasons that makes Indiana commercial banks attractive targets for merger and acquisition by out-of-state institutions. We will look at these issues in the coming issues of [ResearchBuzz](#).

¹ Spieker, Ronald L. "Bank Branch Growth Has Been Steady – Will It Continue?" Future of Banking Study FOB-2004-08.1 Federal Deposit Insurance Corporation

■ Erdem is Research Associate at Networks Financial Institute.

Upcoming Events:

Don't miss NFI's next financial forum series titled "**The Health Care Financing Bomb: Where's the Money (or the Solution)?**" on Tuesday, August 29, 2006.

Keynote Speaker:

Douglas J. Holtz-Eakin, Director of the Maurice R. Greenberg Center for Geoeconomic Studies, Council on Foreign Relations.

Panelists:

John Goodman, President of National Center for Policy Analysis since 1983.

David Gratzer, Senior Fellow at the Manhattan Institute

Dr. Thomas R. Saving, Director of the Private Enterprise Research Center at Texas A&M University.

Contact Person: Linda Beckwith

Contact Phone: 317-536-0281

Contact Email: linda.beckwith@isunetworks.org

If you would like your articles or articles summaries to be published on the upcoming issues of ResearchBuzz, please send them to ozier.erdem@isunetworks.org