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What if the government bailed out of the bailouts?

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What if the government got out of the bailout business?

The idea certainly seemed all right with throngs of Americans who were outraged by news that **American International Group** (nyse: AIG - news - people) paid out millions of dollars in executive bonuses after it was rescued with taxpayer cash.

But would no bailout be even worse? Financial analysts and federal officials have warned that doing nothing to save AIG - or banks or the auto industry - would be a catastrophe, an economic domino effect of bank losses, stock market chaos and job cuts. No one - at least no one in the government - has the stomach for that.

Here's what might happen if companies deemed "too big to fail" were allowed to do just that.

AMERICAN INTERNATIONAL GROUP

For bailout backlash, it's hard to beat AIG. The government has made four separate loans and cash infusions to the crippled insurer, including $30 billion earlier this month. Total tab: $170 billion.

Public outrage reached new heights when word spread that AIG had paid executives $165 million in bonuses. President Barack Obama ordered his treasury secretary to grab back what he could, and one senator even suggested the recipients kill themselves.

So why not pull the plug? Because AIG has 74 million customers and operates in 130 countries, and letting it implode would positively unhinge financial markets around the world.

AIG built a murky, unregulated business issuing insurance for mortgage-backed securities and other debt held by banks. When the housing bubble popped and those securities went bad, AIG was left on the hook for billions of dollars in claims it couldn't pay.

Letting AIG die would make all of that insurance worthless. Banks around the world would be forced to take massive losses. Some could collapse, unnerving markets, driving up unemployment and maybe turning the recession into a depression.

The U.S. got a taste of that scenario in September, when bad debt forced investment bank **Lehman Brothers** (nyse: LEHMQ - news - people) into the biggest bankruptcy in U.S. history. Thousands of other firms were exposed to Lehman's complex financial contracts, and the resulting fear and uncertainty sent stocks plunging.

And that was just a small taste.

"AIG is about five times bigger than Lehman Brothers, and we learned that Lehman Brothers should not have gone bankrupt," said Mark T. Williams, professor of finance and economics at Boston University and a former Federal Reserve bank examiner.

It's not just AIG's life at stake. Over the weekend, the company named the trading partners who indirectly benefited from the taxpayer rescue. Those partners included **Goldman Sachs** (nyse: GS - news - people) ($12.9 billion) and Merrill Lynch ($6.8 billion).

So by bailing out AIG, the government is essentially bailing out those and other financial institutions whose fate depends on AIG's survival, said Sung Won Sohn, an economics professor at California State University, Channel Islands.

"If the money dries up, we'd see a lot more bad banks," Sohn said.

AIG itself has predicted nothing short of a financial apocalypse unless it stays on government life support.

In a bleak report to the Treasury Department late last month, AIG said its collapse could batter credit markets, bankrupt the U.S. insurance industry, depress the dollar, increase U.S. borrowing costs and shatter consumer and business confidence everywhere.

"The failure of AIG," the company warns in the report, "would cause turmoil in the U.S. economy and global markets, and have multiple and potentially catastrophic unforeseen consequences."

"What happens to AIG has the potential to trigger a cascading set of further failures which cannot be stopped except by extraordinary means," the report adds.

Not everyone buys the doomsday scenario. Some critics, including billionaire investor Jim Rogers, say keeping the company on the public dole is ruining the U.S. economy.

And Phil Kerpen, director of policy for Americans for Prosperity, an antitax lobbying group, said the government "should stop throwing good money after bad" and allow AIG to go into bankruptcy.

"There might be some contagion. There might not be. But we know for certain that the course we're on now isn't working," he said.

The government says letting AIG fail simply is not an option.

Federal Reserve Chairman Ben Bernanke, speaking to legislators earlier this month, warned that the damage to the world economy of an AIG failure would run into the "multiples of trillions."

That doesn't mean the government hasn't at least considered a world without AIG. On its Web site, the Treasury Department tracks what it calls "Systematically Significant Failing Institutions." There's a single company on the list: AIG.

THE BANKS

So far, the government has invested $200 billion total in about 400 banks, and it says it stands ready to spend even more. Two titans of the industry, **Citigroup** (nyse: C - news - people) and **Bank of America** (nyse: BAC - news - people), have received $45 billion apiece.

And the banks may actually be stabilizing. **JPMorgan Chase** (nyse: JPM - news - people), Citigroup and Bank of America all say they were profitable in January and February. Citigroup stock, which traded below $1, has bounced back to more than $3.

For now, the government has a 36 percent ownership stake in Citigroup. If the government pulled its cash and investors lost confidence and drove the bank into bankruptcy, financial markets would be devastated.

The Federal Deposit Insurance Corp. points out that no American has ever lost a penny in a failed bank. But the FDIC has also never handled a failure as big as a Citigroup or a Bank of America.

Bert Ely, an independent banking analyst in Alexandria, Va., said pulling the plug on the banks could have a destructive impact on markets similar to the convulsions unleashed by Lehman Brothers' collapse.

Letting Citigroup and Bank of America go down in the same way would be "like taking a house that had some damage and burning it down," Ely said. "It's economic arson."

The concern, not unlike with AIG, is that letting a big bank go under would leave its trading partners saddled with huge losses, shattering confidence and leading investors to pull out the money they have left in the market.

But others say keeping the bailout money flowing is only making things worse.

Bill Seidman, a former chairman of the FDIC who ran the government bailout during the savings and loan crisis, said he does not believe letting failing banks die would trigger a brutal domino effect.

He's calling for a temporary nationalization that would end bailouts for insolvent banks, clean up their balance sheets and sell them back into the private sector.

"I don't think we would bring down the system by doing that," he said.

The White House isn't taking that chance. Obama's 2010 budget proposal sets aside up to $750 billion more in bailout money if banks fall deeper into the abyss. That's on top of the $700 billion bank bailout launched by the Bush administration.

In the meantime, the administration is urging patience.

"It is surely tempting to say the hell with them all," White House economic adviser Lawrence Summers said in a speech last month. But he added, "You can't responsibly govern out of anger."

THE AUTOMAKERS

General Motors (nyse: GM - news - people) and Chrysler have received more than $17 billion in government loans and asked to borrow $21.6 billion more. Their financing arms have received $6.5 billion on top of that.

The auto industry contends the failure of either of the two would set off a chain reaction that could ultimately cost 3 million jobs and suck $400 billion out of the economy over three years.

That's because hundreds of companies that supply parts to the Big Three, not to mention dealerships, would also be hurt. In fact, the Center for Automotive Research in Ann Arbor, Mich., heavily funded by the auto industry, contends that just 239,000 lost jobs would come from the automakers themselves.

The industry contends that if just one of the Big Three failed, 1.5 million jobs would disappear in a year. Ilhan Geckil, senior economist for the Anderson Economic Group, which also studied the impact of losing an automaker, said Michigan's unemployment rate would probably rise from the current 11.6 percent to as high as 14 percent.

The good news: The job pain would be eased somewhat because both the surviving Detroit automakers and foreign automakers who have plants in the United States would start to pick up the slack.

And some doubt the job losses would be so dire to begin with.

Susan Helper, a professor of economics at Case Western Reserve University in Cleveland who has studied the auto industry, says the chain reaction would be smaller - although suppliers of parts for certain car models might be out of luck.

"I think the auto supply base is fairly intertwined," she said in an e-mail. "I think it's unlikely that every single supplier would be forced to stop production."

AP Business Writer Stevenson Jacobs reported from New York. AP Auto Writer Tom Krisher reported from Detroit.