

## NEXT SOCIAL CONTRACT INITIATIVE

# THE PUBLIC OPTION

## The Case for Parallel Public Banking Institutions

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For three years, the federal government's response to the financial crisis has been a parade of bailout programs for the largest banks and financial institutions, with precious little assistance for everyone else. In the United States and throughout Europe, the strategy has been to inject public funds into the banking system in hopes of restoring private lending to pre-crisis levels. This is reminiscent of the trickle-down approach of the Hoover administration at the start of the Great Depression. As in the 1930s, failure to achieve a strong and sustainable recovery should open the door to other alternatives.<sup>1</sup>

Previous generations created parallel public banking institutions, at both the federal and state levels, to fill the unmet credit needs stemming from failures in private banking. In banks that are owned by federal and state governments, there is far greater public accountability in the bank's oversight, direction, and lending practices than in private institutions. This so-called "public option" in banking has a rich tradition in American history and can serve as a model for reform today.

### Lessons from History

In the first years of the Great Depression, President Herbert Hoover also turned to bank bailouts while dragging his feet on public jobs programs for the unemployed. He directed the newly-created Reconstruction Finance Corporation (RFC) to channel more than \$1 billion to banks, railroads, and insurance companies.<sup>2</sup> Meanwhile, Hoover repeatedly objected to, and occasionally vetoed, public works and relief programs, instead waiting in vain for private sector initiative to fill the gap and put people to work.

In his 1932 presidential campaign, Franklin Roosevelt criticized this approach as "trickle-down" and demanded a recovery program "that builds from the bottom up and not from the top down."<sup>3</sup> Roosevelt called for using a portion of RFC funds for loans to small businesses, farmers, and homeowners facing foreclosure. As President, Roosevelt would eventually use billions in RFC funds for public works, mortgage modifications for millions of homeowners and farmers, and loans to states and local public school districts for school construction and teacher salaries.<sup>4</sup> This was the public option on a large scale, with the public interest claiming a role in decisions on the allocation of credit and capital.

Today, as in the 1930s, there is an urgent need for parallel public banking institutions. In both periods, market failures were met with bailout strategies that were not sufficient to restore private credit. By the day of Roosevelt's inauguration in March 1933, a nationwide run on the banks had led to nationwide bank holidays, which closed every state- and federally-chartered bank in the country. In the fall of 2008, the collapse was less visible, but no less real, as the global system of financial payments and interbank lending froze to a halt. The Troubled Asset Relief Program (TARP), passed in the waning days of the Bush

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administration, authorized the Treasury secretary to spend up to \$700 billion in purchasing troubled assets from the banks. When it became apparent there would be all kinds of practical and political difficulties in pricing their holdings of mortgage-backed securities, Treasury Secretary Timothy Geithner simply used TARP to pump hundreds of billions into the largest banks by purchasing non-voting shares of their common stock.

Geithner was also one of the architects of the Federal Reserve's bailout strategy. In 2008, when he was president of the New York Federal Reserve Bank, the Fed launched QE1, the first of its two so-called "quantitative easing" programs, in which it purchased some \$1.25 trillion in mortgage-backed securities from its private banking clientele. Less than two years later came QE2, as the Fed began purchasing some \$600 billion in long-term Treasury securities. It was hoped that the banks, awash in cash reserves, would use their increased liquidity to resume lending to industry, small businesses, and mortgage holders at pre-crisis levels. Unfortunately for most Americans, retail lending conditions remain constrained and face a painful period of deleveraging.

While Wall Street received trillions, the real economy – often referred to as Main Street – received only a small fraction of federal aid. The American Recovery and Reinvestment Act of 2009, the Obama administration's main fiscal stimulus package, provided roughly \$800 billion spread over two years -- about a third in tax cuts, a third in spending on roads and bridges, and a third in reimbursement to state and local governments, primarily for Medicaid expenses.<sup>5</sup> It has been said that the tax cuts, to the degree they were not simply hoarded or used to pay down debt, may have provided more stimulus to the Chinese economy than to the U.S. Moreover, as many economists warned at the time and since, the size of the stimulus was simply inadequate to the scale of the economic decline.

Three years after the start of the bailout strategy, we can see the failures of trickle down policy. The official unemployment rate remains above 9 percent. The Bureau of Labor Statistics publishes a wider measurement that shows nearly one in five Americans are now either unemployed or underemployed, including those working part-time and unable to find full-time jobs with health benefits and discouraged workers who have tired of looking for jobs that no longer exist. This contributes to a negative cycle that undermines private and public finances alike.

The lousy job market has been pushing more and more consumers underwater on their mortgages, undermining consumer and business confidence, and eroding the tax base. For instance, high unemployment and underemployment mean that more than twenty million Americans are no longer paying Social Security or Medicare taxes, and are paying far less in sales, income, property, and other taxes. Consequently, tax revenues have sharply declined or stagnated for federal, state, and local levels of governments. Unfortunately, attempts to resolve budget gaps by cutting government spending often exacerbate the problem by laying off taxpaying workers, further undermining housing markets and reinforcing negative expectations among consumers and businesses. Indeed, since the start of the recession in 2007, the number of government workers at all levels has declined by more than 250,000, though one would hardly know it in the public debates about deficits and debt.<sup>6</sup> Likewise, in the 1930s the combined spending cuts at state and local levels erased much of the federal New Deal fiscal stimulus.<sup>7</sup> That's why federal public works and jobs programs were so important in the 1930s, and why it took World War II federal spending to finally end the Depression.

Contrary to the conventional wisdom in Washington, the history of the 1930s and 1940s suggests that it is the public sector that must lead any economic recovery. Public finance is needed to help state and local governments stop the cycle of spending cuts

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and layoffs; to assist millions of underwater homeowners to modify their mortgages; and to mobilize jobs programs much like the New Deal programs that employed millions of Americans in the 1930s like the Civilian Conservation Corp (CCC), the Works Project Administration (WPA), and other public works programs. Public sector jobs programs, when operating on a mass scale, would help restore the tax base and firm up consumer and business confidence while rebuilding the country's declining physical infrastructure. Those who doubt the relevance of a CCC for today should pay heed to the enormous Wallow fire, already the largest in Arizona history, in an area of the state with more than 20 percent unemployment. The CCC used to prevent such fires by clearing underbrush, cutting fire lines, and containing fires quickly before they grew big. Robert Shiller, Yale University professor of economics and finance, has estimated that it would cost the federal government only \$30 billion a year to employ a million Americans in a new CCC.<sup>8</sup>

The fact is that there are public works to be done in every region of the country, but the lack of financing keeps men and women idle who could surely contribute to recovery. Meanwhile, this generation has seen a slow decline in the country's infrastructure, from roads and bridges, to airports and seaports, to water and sewage treatment facilities and much more. The first question is deciding the order of priority for such projects as high speed rail, clean energy, infrastructure, basic research and development, and education at all levels.

## The Public Option in Banking and Finance

The dilemma facing governments today is how to pay for stimulus and jobs programs without incurring new debt. Public banking institutions should point the way, in part for their ability to expand lending on a revolving basis without raising taxes or even borrowing from bond markets. For instance, public infrastructure banks in continental Europe and East Asia have long recognized the role of public finance to fund long-term development projects – “projects that generate economic benefits to the wider economy in excess of their private returns.”<sup>9</sup> Various proposals for a national infrastructure bank by the Obama administration and members of Congress, while a step in the right direction, are far too modest in scale and scope.<sup>10</sup>

At the state level, North Dakota has enjoyed the benefits of a public bank since 1919.<sup>11</sup> The Bank of North Dakota, the model of a state-owned bank, has operated continuously at a profit and according to conservative banking practices (including relatively modest compensation for the bank's management). The state deposits its tax revenues in the Bank which in turn ensures that a high portion of state funds are invested in the state economy. In addition, the Bank is able to remit a portion of its earnings back to the state treasury – more than \$300 million in the past decade.<sup>12</sup> Thanks in part to these institutional arrangements, North Dakota is the only state that has been in continuous budget surplus since before the financial crisis and it has the lowest unemployment rate in the country.

In contrast, California is the largest state economy in the nation, yet without a state-owned bank, is unable to steer hundreds of billions of dollars in state revenues into productive investment within the state. Instead, California deposits its many billions in tax revenues in large private banks which often lend the funds out-of-state, invest them in speculative trading strategies (including derivative bets against the state's own bonds), and do not remit any of their earnings back to the state treasury. Meanwhile, California suffers from constrained private credit conditions, high unemployment levels well above the national average, and the stagnation of state and local tax receipts. The state's only response has been to stumble from one budget crisis to another for the past three years, with each round of spending cuts further weakening its economy, tax base, and credit rating. The relationship between public banking institutions and economic development has not been lost on organized labor. The California Assembly recently passed AB 750, a bill that would create a commission to study the feasibility of chartering a state-

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owned bank, with the support of the California Labor Federation, the Service Employees International Union, the International Brotherhood of Teamsters, the California Nurses Association and California Firefighters. The measure, now pending in the State Senate, is part of a growing trend to follow the North Dakota model. Similar proposals to create state-owned banks have been introduced in more than a dozen other states across the country.

While state-owned banks could play an important role in reinvesting resources in state and local economies, given the scale of the fiscal crisis, federal solutions are also needed. The federal government is primarily responsible for wrecking the states' economies by deregulating Wall Street, preempting state predatory lending and anti-usury laws, and fueling the bubble economy. Moreover, only the federal government has the resources to put a floor under state and local budgets through federal revenue sharing programs. The federal government had a highly successful revenue sharing program that provided block grants and considerable policy discretion to the states from 1972 until it was dismantled late in the Reagan era. The federal government has the ability to firm up state budgets, prevent another round of spending cuts and tax increases, and thereby help firm up regional economies around the country. In fact, Washington could underwrite the combined deficits of all the states for a small fraction of the cost of all the banking bailouts by the Federal Reserve and Treasury combined.

## **TARP: From Wall Street to Main Street**

However, all these federal strategies would require action by Congress at a time when House Republicans are disinclined to vote for public financing or public jobs programs. The Obama administration now finds itself at the mercy of House Republicans and, like Hoover, waiting in vain for the private sector to start hiring in large numbers. But prior to last summer, there was one policy tool still available to the administration: the TARP program which was used to prop up the banks and help General Motors and Ford get back on their feet. Like the Reconstruction Finance Corporation during the 1930s, TARP could be used to fund public works and jobs programs at the federal level, help underwater consumers modify their mortgages, and make loans to state and local governments to pay for teacher salaries and meet other essential needs.

Unfortunately, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 reduced the TARP spending cap from its original \$700 billion to \$475 billion, prevents the administration from spending any TARP funds that were received from repayment of principal on earlier TARP loans, and even prevents TARP spending for programs initiated after the enactment of Dodd-Frank.<sup>13</sup> The Emergency Economic Stabilization Act that created TARP in 2008 gave the Treasury Secretary broad discretion in purchasing assets when it was time to bailout Wall Street. The Obama administration or some future administration would need to go back to Congress to undo the constraints imposed by Dodd-Frank on spending TARP funds to help Main Street.

The logic of this approach is based on the lessons of history, that the only sustainable recovery in an upside down economy is a bottom up recovery – one that reduces private debt burdens by creating jobs on a mass scale, expanding the ranks of the middle class, and raising middle class incomes – and the only way to finance such a recovery is with strong public banking institutions that bypass the short-term fixations of private capital markets. The public banking institutions that were used so effectively in the New Deal and during World War II, such as the RFC, in addition to state banks, provide compelling models with proven track records for a renewed system of public finance.

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<sup>1</sup> Many were disappointed in 2010 when health care reform did not include a public health insurance option to control costs and provide comprehensive coverage. Paul Krugman. "Medicare Saves Money." *New York Times*. June 12, 2011. Page A23.

Likewise, the public option in banking would provide significant benefits: loans to state and local governments to prevent more layoffs; help to underwater consumers in modifying mortgages; and the financing of public works and jobs programs that are so urgently needed to put people back to work and restore confidence.

<sup>2</sup> David M. Kennedy. *Freedom From Fear: The American People in Depression and War, 1929-1945*. Oxford University Press. 1999. Page 84.

<sup>3</sup> Nathan Miller. *F.D.R.: An Intimate History*. Signet. 1983. Page 262.

<sup>4</sup> Broadus Mitchell. *Depression Decade: From New Era through New Deal, 1929-1941*. Holt, Reinhart and Winston. 1947. Appendix IX, Page 442. The New Deal approach to public finance had its antecedents in the Wilson administration, including its War Finance Corporation, a new federal credit institution that helped finance railroads, banks, and utilities. Jordan A. Schwartz. *The New Dealers: Power Politics in the Age of Roosevelt*. Vintage. 1993. Page 18. They too [the Wilsonians] abhorred socialism or unwarranted intervention in the marketplace, but when capital was timid or crisis threatened, bold and visionary men in Washington recalled that government itself was enterprise. . . Thus began the emergence of American state capitalism." (Schwartz, 14).

<sup>5</sup> "Implementation Summary: As of June 24, 2011," HHS.GOV/Recovery, at: <http://www.hhs.gov/recovery/overview/index.html>; "State and Territories Medicaid Program Awards," HHS.GOV/Recovery, at: <http://transparency.cit.nih.gov/RecoveryGrants/grant.cfm?grant=Reinvestment>

<sup>6</sup> Joe Light. "Many Graduates Delay Job Searches." *Wall Street Journal*. June 4-5, 2011. Page A4. Available Online. <http://online.wsj.com/article/SB10001424052702303657404576363783070164132.html> (click on "View Full Image" for graph for "May's Jobs Report").

<sup>7</sup> E. Cary Brown. "Fiscal Policy in the 'Thirties': A Reappraisal." *American Economic Review*. 46 (December 1956): 857-879.

<sup>8</sup> Robert Shiller. "What Would Roosevelt Do?" *New York Times*. Aug. 1, 2010. Page BU5.

<sup>9</sup> Robert Skidelsky and Felix Martin. "A way out of Britain's growth dilemma." *Financial Times*. March 21, 2011. Page 11.

<sup>10</sup> "A Bank to Rebuild America?" New America Foundation event featuring Senators John Kerry (D-MA), Kay Bailey Hutchison (R-TX) and Mark Warner (D-VA) as well as Congresswoman Rosa DeLauro (D-CT-3). June 8, 2011. Information and video available online. [http://growth.newamerica.net/events/2011/a\\_bank\\_to\\_rebuild\\_america](http://growth.newamerica.net/events/2011/a_bank_to_rebuild_america)

Also see Michael Lind. "Public Purpose Finance." New America Foundation. September 9, 2010. Available Online. [http://www.newamerica.net/publications/policy/public\\_purpose\\_finance](http://www.newamerica.net/publications/policy/public_purpose_finance)

<sup>11</sup> Public Banking Institute website at: <http://publicbankinginstitute.org/state-info.htm>

<sup>12</sup> Written Testimony of Ellen Brown, before the Senate Committees on Economic Development & Technology and Commerce & Consumer Protection on California Assembly Bill 750, May 2, 2011, available at link for Public Banking in California: Latest Analysis, at: <http://www.publicbankinginstitute.org/home.htm>

<sup>13</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376, P.L. 111-203 (July 21, 2010), Section 1302 (amending Section 115(a) of the Emergency Stabilization Act of 2008), at: <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>



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