

# Towards a Just Finance Sector: *The Merits of State-Owned Banks*

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The finance sector<sup>1</sup> increasingly takes up space in the American economy. What originated as a means to an end (a middleman to collect and distribute funds) has for many become an end unto itself. Top students from prestigious universities across the globe desperately pursue jobs at investment banks, hedge funds, and private equity firms.<sup>2</sup> In fact, the finance, insurance, and real estate industries make up one-fifth of domestic GDP, more than any other sector.<sup>3</sup> At the same time, history is rife with examples of financial crises driven by these same industries. Nobel Prize-winning economist Joseph Stiglitz describes the financial sector's work as being at least partly "rent-seeking": an economic activity that redistributes wealth (often from the poor to the rich), but does not actually generate meaningful increases in overall economic growth.<sup>4</sup> In other words, financiers do not grow the pie — they simply take a larger slice of it.

This paper aims to investigate to what extent state-owned commercial banks could alleviate some of the major issues related to the financial sector. Section I discusses contemporary pitfalls in the commercial banking sector and relates these to a rationale for creating state-owned banks. Section II details the requirements for establishing a state-owned bank. Section III evaluates the German *Sparkassen*, an example of an existing state-owned banking system. Finally, Section IV summarizes contemporary efforts to establish government-owned commercial banks in the United States.

Throughout this paper, I make frequent use of the terms "liquidity," "public," and "bank." I define "liquidity" as the M2 money supply<sup>5</sup>: the amount of cash, checking and

savings deposits, and time deposits<sup>6</sup> in the economy at a given time. "Public" will refer to ownership of an entity by the government, rather than an entity being publicly traded on the stock market. Finally, "bank" will refer to the commercial kind unless otherwise noted. A commercial bank is one that services consumers and small businesses — it provides loans, facilitates checking and savings accounts, and offers very basic financial services.<sup>7</sup> This last distinction is important to draw, as many of the conclusions reached in this paper would not transfer to investment or merchant banks.

## I. The Rationale Behind a Public Bank

The U.S. commercial banking sector has a number of glaring issues, many of which became apparent during the 2008 financial crisis. The incentive structure of these banks encourages excessive risk-taking and predatory lending practices, and it has proven itself remarkably resistant to legislation.<sup>8</sup> A public bank could offer a solution to four distinct problems present in the banking sector: private control over the public money supply, problematic lending and financing practices, unfair savings rates, and risk-seeking behavior.

### A. The Money Supply

America has historically had a tumultuous relationship with private financial institutions. Andrew Jackson wrote that "if [Congress has] the power to regulate . . . currency, it was conferred to be exercised by themselves, and not to be transferred to a corporation."<sup>9</sup> Jackson referred

1 Taken to include the insurance, financial services, and real estate (when specified) sectors.

2 See, e.g., Chris Hopson, *The Draw of Consulting and Finance*, HARV. POL. REV. (July 15, 2018), <https://harvardpolitics.com/harvard/the-draw-of-consulting-and-finance/>.

3 *Gross Domestic Product by Industry: Second Quarter 2019*, U.S. BUREAU OF ECON. ANALYSIS (Oct. 29, 2019), <https://www.bea.gov/data/gdp/gdp-industry> (last visited Dec. 1, 2019).

4 See generally Joseph E. Stiglitz, *THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE* (W.W. Norton & Company 1st ed. 2012).

5 See, e.g., *M2 Money Stock*, FED. RESERVE BANK OF ST. LOUIS, <https://fred.stlouisfed.org/series/M2> (last visited Nov. 30, 2019).

6 Time deposits refer to deposits in a bank account that cannot be withdrawn before a set date.

7 In contrast, an investment bank advises businesses and other organizations on mergers and acquisitions and capital raising, and a merchant bank specializes in loan services and fundraising services for corporations and high net worth individuals. See generally Sean Ross, *Investment Banking vs Commercial Banking: What's the Difference?*, INVESTOPEDIA (last updated Apr. 18, 2019), <https://www.investopedia.com/articles/professionals/091615/career-advice-investment-banking-vscommercial-banking.asp> (last visited Dec. 1, 2019).

8 See, e.g., Alan Rappeport & Emily Flitter, *Congress Approves First Big Dodd-Frank Rollback*, N.Y. TIMES (May 22, 2018), <https://www.nytimes.com/2018/05/22/business/congress-passes-dodd-frank-rollback-for-smaller-banks.html> (last visited Dec. 1, 2019).

9 Andrew Jackson, Veto Message (July 10, 1832), *reprinted in President Jackson's Veto Message Regarding the Bank of the United States*, AVALON PROJECT, [https://avalon.law.yale.edu/19th\\_century/ajveto01.asp](https://avalon.law.yale.edu/19th_century/ajveto01.asp).

to what many contemporary economists consider to be a major flaw of the private banking system: control over the money supply.<sup>10</sup> Traditionally, it is assumed that the federal government has the ability to influence the money supply.<sup>11</sup> The Federal Reserve can control the money supply by trading Treasury notes with commercial banks,<sup>12</sup> or by more unorthodox techniques such as quantitative easing.<sup>13</sup> It is inherently desirable to have the government perform this function because without government oversight unchecked increases in the money supply would lead to devastating inflation and a loss of faith in currency.<sup>14</sup> Furthermore, the government is able to prevent liquidity from drying up in an economic crisis to some extent. Control over the money supply is a useful policy tool that should be wielded by the state with the interest of its constituents in mind.

In reality, the money supply is heavily influenced by the decisions of commercial banks. Economists have reached a consensus on something called the “fractional reserve” theory of money creation.<sup>15</sup> This theory states that banks lend out a percentage of each deposit they receive, equal to the total deposit minus the reserve requirement — an amount set by the Federal Reserve that banks are required to retain of each deposit as an insurance against bank runs. After the bank lends out this percentage of a deposit, the person who receives the loan theoretically deposits that money in another account, where a part of it is loaned out, *ad infinitum*. Every person in this chain now has additional money in their account; their spending decisions will be made accordingly. The original deposit was multiplied; money was “created.” Conversely, banks may also decide to call back their loans or refuse to issue new ones. In effect, this equates to a removal of money from the money supply.

The unfortunate truth is that this method of money creation exacerbates any swings in the wider economic environment. When the economy is heating up (and thus is experiencing inflationary pressures), banks will be more eager to lend money, which in turn will increase the money supply, thereby further increasing inflation. When the economy is in a rut, fewer loans will be extended, contracting the money supply and further pushing down spending and aggravating potential deflation. When banks follow “rational incentives,” the economy does

not always benefit. A valid counterpoint is that the Fed is tasked with preventing these swings. During economic booms they raise interest rates, which curb lending, and during busts they lower them, which in turn boost spending.<sup>16</sup> The problem is that the government is forced to resort to indirect and imprecise manipulations of currency, instead of maintaining direct control over its creation.

### B. Lending and Financing

Commercial banks’ role as distributor of liquidity has other downsides as well. Because commercial banks are asked to maximize shareholder value, they are incentivized to extend capital only to those who are likely to repay it. Individuals or businesses that are deemed high-risk are penalized by high interest rates and other unfavorable loan terms. This aligns with prevailing economic theory. The bank is assuming the risk, and for taking on higher risk it should be eligible to receive a larger reward.

However, a closer examination reveals the perversity behind this idea. Access to capital is essential for a number of activities that can lead to prosperity. Home ownership, starting a business, or going to college all typically require some form of lending. Low-income individuals are thus required to pay a higher price, both in absolute and relative terms,<sup>17</sup> for these opportunities. It is morally bankrupt, as well as socially undesirable, to make loans more expensive for those who already have very little. Studies have shown that low-income individuals on average pay more for every kind of loan.<sup>18</sup> The Federal Reserve found a positive correlation between income and credit scores,<sup>19</sup> and a number of other studies have shown that minorities typically have lower credit scores, even when the data is controlled for disparities in income.<sup>20</sup> There is a strong negative correlation between credit scores and interest rates payable on loans — the lower your score, the more you are asked to pay. It is understandable that banks employ this system, but that does not mean that it is beneficial to society as a whole. In essence, the credit score system is a regressive tax. There is substantial evidence that this system contributes to the so-called “poverty trap;”<sup>21</sup>

10 See, e.g., Philipp Bagus & David Howden, *Fractional Reserve Banking: Some Quibbles*, 4 Q. J. AUSTRIAN ECON. 29 (2010).

11 See, e.g., N. GREGORY MANKIW, *MACROECONOMICS* 86 (Worth Publishers 8th ed. 2012) (1991).

12 The Federal Reserve is henceforth also referred to as “The Fed.”

13 Quantitative easing refers to a central bank directly providing liquidity to the economy by purchasing large quantities of financial assets. See, e.g., Kimberly Amadeo, *How Central Banks Create Massive Amounts of Money With Quantitative Easing*, THE BALANCE, <https://www.thebalance.com/what-is-quantitative-easing-definition-and-explanation-3305881> (last visited Dec 4, 2019).

14 See, e.g., MANKIW, *supra* note 11, at 82.

15 See Joseph Huber, *Modern Money Theory and New Currency Theory*, 66 REAL-WORLD ECON. REV. 38, 38 (2014).

16 See, e.g., MANKIW, *supra* note 11, at 84.

17 The interest they are asked to pay is higher in absolute terms, but it also makes up a larger share of income than a similar loan would for high-income individuals.

18 Diana Elliott & Ricki Granetz Lowitz, *What Is the Cost of Poor Credit?*, URBAN INST. (Sept. 18, 2018), <https://www.urban.org/research/publication/what-cost-poor-credit>.

19 Rachael Beer, Felicia Ionescu & Geng Li, *Are Income and Credit Scores Highly Correlated?*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Aug. 13, 2018), <https://www.federalreserve.gov/econres/notes/feds-notes/are-income-and-credit-scores-highly-correlated-20180813.htm>.

20 Caroline Ratcliffe & Steven Brown, *Credit Scores Perpetuate Racial Disparities, Even in America’s Most Prosperous Cities*, URBAN INST. (Nov. 20, 2017), <https://www.urban.org/urban-wire/credit-scores-perpetuate-racial-disparities-even-americas-most-prosperous-cities>.

21 BRUCE KATZ & MARGERY A. TURNER, BROOKINGS INST., *RETHINKING U.S. RENTAL HOUSING POLICY: BUILDING ON STATE AND LOCAL INNOVATIONS* 2 (Feb. 28, 2007), [https://www.brookings.edu/wp-content/uploads/2016/06/PB\\_Housing\\_Katz.pdf](https://www.brookings.edu/wp-content/uploads/2016/06/PB_Housing_Katz.pdf).

the poorer you are, the more you pay.<sup>22</sup>

A public bank could step in and resolve this issue. It could extend loans not with the intent of making a profit but rather of stimulating the economy. This might mean providing loans to low-income communities at break-even interest rates, as they are likely to spend that money in a way that benefits the wider economy.<sup>23</sup> A public bank could also act as a tool for policymakers. If politicians want to stimulate homeownership and reduce carbon emissions, mortgages could become cheaper and car financing more expensive. A public bank would provide a direct way of injecting money into desirable areas of the economy.

The focus of commercial banks on generating returns for their shareholders is costly to society in other ways as well. A significant share of Americans have their checking and saving accounts with one of the major banks — 37.6% of all deposits are placed with one of the five largest banks, and 30.82% are placed with one of the three largest.<sup>24</sup> Today's financial sector can accurately be described as an oligopoly — a few key players control such a significant share of the market that they are able to work together and set rates in a way that is favorable to them.<sup>25</sup> In the American financial system, savings rates are artificially held down. As mentioned before, banks make money off each dollar they receive in deposits. Unfortunately, almost none of that money returns to their clients. Savings accounts at most commercial banks generate negligible interest, and checking accounts frequently cost money for those who deposit under a certain amount.<sup>26</sup> Interest rates offered on savings accounts remain low, even as the Fed has increased its discount rate.<sup>27,28</sup> Many banks further exacerbate inequality by providing a higher rate of return on savings accounts with greater deposits.<sup>29</sup>

22 Jill Cornfield, *Low-income Americans Get Double Squeeze from Poor Credit And High Fees*, CNBC (Sept. 19, 2018), <https://www.cnbc.com/2018/09/19/poor-credit-keeps-low-income-people-paying-higher-fees-and-stiff-interest-rates.html> (last visited Nov. 9, 2019).

23 Christopher Carroll et al., *The Distribution of Wealth and the Marginal Propensity to Consume*, 8 QUANT. ECON. 977 (2017).

24 *Total Assets, All Commercial Banks*, FED. RESERVE BANK OF ST. LOUIS, <https://fred.stlouisfed.org/series/TLAACBW02SBOG> (last visited July 31, 2019).

25 See, e.g., Mei Dong et al., *A Macroeconomic Theory of Banking Oligopoly* (May 2017) (unpublished manuscript) (available at <https://www.rse.anu.edu.au/media/1944983/Mei-Dong-Paper.pdf>).

26 *Weekly National Rates and Rate Caps - Weekly Update*, FDIC (2019), <https://www.fdic.gov/regulations/resources/rates/> (last visited Nov. 9, 2019).

27 This refers to the interest charged by the Federal Reserve to institutional lenders, which is closely correlated with interest rates on commercial loans. See generally *The Discount Rate*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (last updated Nov. 26, 2019), <https://www.federalreserve.gov/moneypolicy/discount.htm> (last visited Dec. 1, 2019).

28 Bd. of Governors of the Fed. Reserve Sys. (US), *Effective Federal Funds Rate*, FED. RESERVE BANK OF ST. LOUIS (1954), <https://fred.stlouisfed.org/series/FEDFUNDS> (last visited Nov. 9, 2019).

29 See, e.g., *Savings Account - Open an Advantage Savings Account Online*, BANK OF AMERICA (2019), <https://www.bankofamerica.com/deposits/savings/savings-accounts/> (last visited Nov. 9, 2019).

### C. Savings

A public bank whose primary aim is to further the public interest rather than make a profit would be more likely to offer a savings rate that closely mirrors the discount rate. Not only would this provide customers with a better alternative to the rates offered by commercial banks, it might also force banks to match that rate if they want to retain their clients. In effect, this would constitute a redistribution of wealth from the banks and their shareholders to average account holders. Although online banks already offer higher interest rates on savings accounts,<sup>30</sup> they are rather niche and lack visibility to threaten the larger banks. A public bank would be backed by a state or city and have physical branches, allowing for increased visibility. Further, a public bank would have the benefit of targeting a specific, rather than a diffuse, audience. An accessible, well-known public bank could succeed where these online banks have failed and significantly drive up the average interest rate on savings accounts.

### D. Risk-seeking Behavior

A lack of profit incentive would also reduce a public bank's exposure to risk. In the years leading up to the Great Recession, nearly every bank filled its balance sheet with subprime mortgages and risky derivatives even though the industry was aware of the risks associated with these products.<sup>31</sup> Banks simply could not explain to their shareholders that they were going to hold off on products that were generating sizeable returns for their competitors — doing so would have constituted economic suicide.<sup>32</sup> The profit incentive of commercial banks has at times generated genuine financial innovation, but more often it has caused them to cut corners and harm communities. Wells Fargo, for example, was recently convicted of engaging in predatory lending throughout the United States in the years leading up to 2008.<sup>33</sup> The bank knowingly extended credit to those who were unlikely to pay it back, charging high upfront fees and then passing on the actual debt to other firms. Wells Fargo knew the risks involved but ultimately decided short-term profits were more important. Unlike traditional banks, a public bank would not answer to shareholders, but rather to elected officials who are held accountable by their constituents. Research has already shown that banks who are responsible to a large number of shareholders are more risk-averse than those who answer only to a select group of the corporate elite.<sup>34</sup> These findings could be extrapolated to infer that a bank that answers to the general population would be significantly more risk-averse than current financial institutions.

30 See *Best Online Savings Accounts of November 2019*, BANKRATE (Nov. 2019), <https://www.bankrate.com/banking/savings/rates/> (last visited Nov. 9, 2019).

31 See generally Matthias Hanauske et al., *Doves and Hawks in Economics Revisited: An Evolutionary Quantum Game Theory Based Analysis of Financial Crises*, 389 PHYSICA A 5084 (2010).

32 JOHN CASSIDY, *HOW MARKETS FAIL: THE LOGIC OF ECONOMIC CALAMITIES* 296 (2009).

33 *County of Cook v. Wells Fargo*, 115 F. Supp. 3d 909 (N.D. Ill. 2015).

34 Simon H. Kwan, *Risk and Return of Publicly Held Versus Privately Owned Banks*, 10 FRBNY ECON. POL'Y REV. 97, 102–05 (2004).

It is important to note that a lack of profit incentive cannot be assumed for any public bank. Governments may want to create a bank that generates money to be used for other public policy projects or simply a state's rainy-day fund. The fundamental difference remains that even if consumers do not directly benefit from higher interest rates on savings accounts or cheaper loans, the profits that a public bank generates will eventually benefit them. This is not the case for larger commercial banks, whose profits flow to shareholders.

### *E. Concluding Remarks*

Public banks offer a solution to many of the issues our financial system struggles with today. A wholly different incentive structure would allow a public bank to deploy capital where it would stimulate the economy, rather than just where it would generate profits. The absence of responsibility to shareholders would lead to higher interest rates on savings accounts and the adoption of a more sustainable risk profile. As a competitor to commercial banks, a public bank would realign the industry to be more concerned with the needs of its customers.

That said, the United States is home to just one public bank, whose assets total seven billion dollars — about 0.004% of total commercial bank assets.<sup>35</sup> The next section will investigate the steps required to create a public bank and discuss potential hurdles.

## **II. Creating a Public Bank**

A number of states and cities — including Vermont, New Jersey, Massachusetts, Los Angeles, and San Francisco — have conducted or are in the process of conducting feasibility studies for the creation of regional public banks.<sup>36</sup> As such, there is a substantial range of literature available with detailed descriptions of the steps required to start such a bank. Although many studies focus on public banks providing capital for infrastructure investment and state financing needs rather than functioning as consumer-serving institutions,<sup>37</sup> the basic principle behind their construction remains the same.

The technicalities of a bank's creation are rather simple. The bank needs to have sufficient assets to begin lending, employees, and possibly a few physical branches. Feasibility studies generally assume the city or state responsible for creating the bank would move its current cash reserves to the new bank, thereby providing capital without the need for loans or other costly financing techniques. The only existing American public bank — the Bank of North Dakota — was initially financed by a two-million-dollar bond offering in 1919, which would amount to about

twenty-nine million dollars today.<sup>38</sup> Research suggests that due to the increased complexity of the contemporary economy, the required capitalization to form a state bank would be closer to \$325 million.<sup>39</sup> Since most states hold a multiple of that amount in commercial banks currently, it is unlikely that a bond offering would be necessary today. California, for example, holds nearly \$15 billion in its rainy-day fund.

A public bank would have either a state or a city as its sole shareholder, and any returns it made would be returned to its home state or city.<sup>40</sup> As such, public banks would prevent capital drain to out-of-state bondholders and keep profits within the local economy.

The creation of a public bank would thus be relatively uncomplicated, and a variety of feasibility studies have cited high potential upsides. For example, a public bank in New Jersey would generate about sixteen to twenty-one million dollars in additional state output and raise state income by about four to five million dollars for every ten million dollars lent out. Furthermore, for every ten million lent out, the bank would add roughly sixty to ninety-three new jobs.<sup>41</sup> Yet strong opposition to public banks exists. In Maine, a bill to commission a study on the effects of a public bank failed to pass the state legislature, even though seventy-two percent of small businesses and farmers in the state supported the creation of a state-owned bank.<sup>42</sup> Opponents argue that public banks could pose increased risk to state assets and that there is currently adequate credit available through commercial channels.<sup>43</sup> Internationally, the idea has also fallen out of favor with economists, who claim that public banks are often inefficient and influenced by political pressures.<sup>44</sup> The next section of this paper will investigate a current example of a state-owned banking system to determine the merits of these arguments.

## **III. Germany's Public Banks: Sparkassen**

Germany's commercial financial sector consists of three pillars: commercial banks, cooperative banks (owned by their customers), and public banks. The last consists of

35 *Total Assets, All Commercial Banks*, *supra* note 24.

36 *See, e.g., Studies & Reports*, PUB. BANKING INST., <https://www.public-bankinginstitute.org/studies-reports/> (last visited Dec. 1, 2019).

37 *See, e.g.,* DEBORAH M. FIGART, STOCKTON UNIV., *EXPLORING A PUBLIC BANK FOR NEW JERSEY: ECONOMIC IMPACT AND IMPLEMENTATION ISSUES* (2018), <https://stockton.edu/hughes-center/documents/2018-0326-exploring-a-public-bank-for-new-jersey-economic-impact-and-implementation.pdf>.

38 *Overview of BLS Statistics on Inflation and Prices*, BUREAU LAB. STAT., <https://www.bls.gov/bls/inflation.htm> (last visited Nov. 9, 2019).

39 YOLANDA K. KODRZYCKI & TAL ELMATAD, NEW ENGLAND PUB. POL'Y CTR., *THE BANK OF NORTH DAKOTA: A MODEL FOR MASSACHUSETTS AND OTHER STATES?* 19 (2011), <https://www.bostonfed.org/publications/new-england-public-policy-center-research-report/2011/the-bank-of-north-dakota-a-model-for-massachusetts-and-other-states.aspx>.

40 *See, e.g.,* VERMONTERS FOR A NEW ECONOMY, GUND INST., *EXPLORING A PUBLIC BANK FOR VERMONT* (Dec. 2013), <https://publicbanking.files.wordpress.com/2014/01/public-banking-1-13-2014.pdf>.

41 FIGART, *supra* note 37, at 10.

42 *Id.*

43 *See, e.g.,* Anjelica Tan, *A Public Bank Is Risky Business*, THE HILL (Oct. 19, 2018, 4:00 PM), <https://thehill.com/opinion/finance/412278-a-public-bank-is-risky-business> (last visited Jul. 31, 2019).

44 *See, e.g.,* Marcia Millon Cornett et al., *The Impact of State Ownership on Performance Differences in Privately-owned Versus State-owned Banks: An International Comparison*, 19 J. FIN. INTERMEDIATION 74 (2010).

the aforementioned *Sparkassen*, as well as *Landesbanken*, which engage in wholesale banking,<sup>45</sup> and the *LBS Bayerische Landesbausparkasse*, a public sector building and loan association. *Sparkassen* are a unique example of state-owned, easily accessible banks that offer basic commercial banking services to consumers and small- to medium-sized enterprises (SMEs). They have been operating since 1778 and were originally founded by merchants with the intent of supporting local communities.<sup>46</sup> Today, there are over fifteen thousand *Sparkasse* branches collectively controlling over two trillion euros in assets. They operate in a decentralized manner with strong geographic boundaries; each city or region has its own *Sparkassen* branches that serve local clients and provide loans for local investments. In addition to local government being their main shareholder, *Sparkassen* are backed by a national organization that maintains a “rainy-day fund.” When a region of Germany is experiencing financial distress, it can tap into this fund to obtain support from *Sparkassen* in prospering regions.<sup>47</sup>

Germany’s *Sparkassen* are mandated by law to serve the public interest and promote regional development. Their success is measured not by returns generated for shareholders or profit, but by their impact on the communities they serve.<sup>48</sup> Stakeholder value rather than *shareholder* value is the key metric by which these banks are judged. The banks are highly popular, with about seventy percent of all SMEs obtaining their financing from a *Sparkasse*. About sixty percent of all Germans deal with the banks in some way, and low-income families specifically make up the largest part of *Sparkasse* customers. This broad reach is partly because of the system’s indiscriminate approach to banking — *Sparkassen* are mandated not to deny anyone a savings account, and they provide the same rate of return for each customer. This stands in stark contrast to the practices of many commercial banks, who stratify customers based on wealth and offer a return rate proportional to the size of a customer’s deposits. Furthermore, the German legislature explicitly states that *Sparkassen* are supposed to “satisfy the credit demands of local businesses,”<sup>49</sup> meaning that they must fulfill the loan requests of small and medium-sized local businesses, and theoretically, should not deny any local business a loan. Besides serving customers and enterprises, *Sparkassen* fund socially desirable projects with the express intent of

promoting the public interest. The banks together provided €488 million (about \$550 million) to social projects<sup>50</sup> in 2018 alone,<sup>51</sup> and a 2015 report estimated that the banks added about twenty billion euros in value to local communities that year,<sup>52</sup> equal to about 0.66% of Germany’s GDP in 2015.<sup>53</sup> They also provide significant funding for start-ups, infrastructure repairs, and other socially desirable activities.

Notwithstanding the several benefits associated with the *Sparkassen* system, the banks have been regularly criticized by European and American economists alike.<sup>54</sup> Many find fault with the idea of a state-owned bank rather than with a specific issue present in the system,<sup>55</sup> but others have identified some salient flaws in the way the *Sparkassen* are run, specifically relating to their entanglement with local politics.

Political involvement in the day-to-day operations of the banks has been and remains one of the key points of concern. A study by the Brussels-based think tank Bruegel notes that in eight states surveyed,<sup>56</sup> eighty-three percent of the *Sparkassen*’s board chairs were current county heads or municipality heads. In five out of eight states, every single board chair was a current politician. More broadly, eighteen percent of board members were politicians. Moreover, in the only state where politicians publicly declare their income, board chair fees made up an average of twelve percent of a politician’s income.<sup>57</sup> The mayor of Regensburg, the fourth-largest city of Bavaria, is currently standing trial for accepting significant campaign donations from a real estate developer, allegedly in exchange for a favorable loan from the *Sparkasse* where the mayor held a board seat.<sup>58</sup> Such cases are admittedly rare,

45 Wholesale banking refers to merchant banking services provided by the wholesale banker for large clients such as insurance providers or commercial banks.

46 CÉLINE CHOLET, BNP PARIBAS, GERMAN SPARKASSEN: A MODEL TO FOLLOW? 4 (Apr. 2016), <https://economic-research.bnpparibas.com/html/en-US/German-Sparkassen-model-follow-4/29/2016,28761>.

47 Claudia Irigoyen, *Sparkassen Savings Banks in Germany*, CTR. PUB. IMPACT (Mar. 27, 2017), <https://www.centreforpublicimpact.org/case-study/sparkassen-savings-banks-germany/>.

48 *Id.*

49 STEPHEN L. CLARKE, CIVITAS, GERMAN SAVINGS BANKS AND SQISS CANTONAL BANKS, LESSONS FOR THE UK 11 (2010), [http://www.civitas.org.uk/reports\\_articles/german-savings-banks-and-swiss-cantonal-banks-lessons-for-the-uk/](http://www.civitas.org.uk/reports_articles/german-savings-banks-and-swiss-cantonal-banks-lessons-for-the-uk/) (last visited Nov. 9, 2019).

50 These include educational programs, museums, sports clubs, and other local initiatives deemed beneficial to the community.

51 *Financial Report 2018 of the Savings Banks Finance Group*, FINANZGRUPPE DEUTCHER SPARKASSEN-UND GIROVERBAND, <https://financialreport.dsgv.de/> (last visited Dec. 1, 2019).

52 FINANZGRUPPE DEUTCHER SPARKASSEN-UND GIROVERBAND, REPORT TO SOCIETY 2015: OUR COUNTRY-OUT CONTRIBUTION 16 (2015), [http://archiv.im-auftrag-der-gesellschaft.de/\\_Downloads/Downloads\\_2016/DSGV\\_Report\\_Society\\_2015.pdf?m=1467731001](http://archiv.im-auftrag-der-gesellschaft.de/_Downloads/Downloads_2016/DSGV_Report_Society_2015.pdf?m=1467731001).

53 *Germany*, OECD, <http://data.oecd.org/germany.htm> (last visited Sept. 11, 2019).

54 See, e.g., Kahl, et al., *How Germany’s Little Savings Banks Threaten Big Financial Woes*, BLOOMBERG (Oct. 5, 2018), <https://www.bloomberg.com/news/articles/2018-10-05/germany-s-sparkassen-little-banks-big-worries> (last visited Dec. 1, 2019).

55 See Todd Buell, *Germany’s Banking Problem Is Bigger Than Deutsche Bank*, WALL ST. J. (Oct. 12, 2016), <https://www.wsj.com/articles/germanys-banking-problem-is-bigger-than-deutsche-bank-1476264606> (last visited Nov. 9, 2019).

56 Germany has a total of sixteen federal states.

57 Jonas Markgraf & Nicolas Véron, *Germany’s Savings Banks: Uniquely Intertwined with Local Politics*, BRUEGEL (July 18, 2018), <https://bruegel.org/2018/07/germanys-savings-banks-uniquely-intertwined-with-local-politics/> (last visited Nov. 9, 2019).

58 Jan Friedmann, *Spendenaffäre um Oberbürgermeister: Der Fast-Freispruch von Regensburg*, SPIEGEL ONLINE (July 3, 2019), <https://www.spiegel.de/politik/deutschland/regensburg-joachim-wolbergs-bleibt-in-spendenaffae-re-straffrei-a-1275607.html>.

but the degree of entwinement between politicians and public banks is certainly cause for concern. Little research has been done on inefficiencies in the *Sparkassen* system caused by political entanglement, so the severity of these findings remains unclear. An American public bank could certainly model itself after the *Sparkassen*, but it might benefit from an explicit separation between currently serving politicians and the bank itself, if only to maintain public trust in the system.

Critics have further claimed that the *Sparkassen* “distort competition” and limit the business volume available to commercial banks by absorbing market share.<sup>59</sup> The reasoning behind this claim is that *Sparkassen* benefit from a supposedly implicit government guarantee, and consumers therefore feel confident placing their deposits there. There is some validity to this claim. During the 2008 financial crisis, Germany’s *Landesbanken* faced serious balance sheet issues, and the *Sparkassen* were expected to provide liquidity in order to stabilize them. However, the government stepped in and used public funds to bail out the *Landesbanken*, thereby absolving the *Sparkassen* of the financial costs associated with a bailout.<sup>60</sup> Although the *Sparkassen* never required a government bailout, they were indirect beneficiaries of one. Bailouts like this do create moral hazard,<sup>61</sup> and were they to be unique to public banks, one could credibly claim that bailouts create unfair competition. In reality, however, multiple commercial German banks received government funds during the last financial crisis,<sup>62</sup> suggesting that this “implicit government guarantee” applies to all banks equally.

Aside from the merits and demerits of the *Sparkassen*, there is an issue of transferability associated with them. The *Sparkassen* both enable and are enabled by the financial context in which they operate. At 9.9% in 2017, Germany has a far higher household savings rate than the European and American average (3.25% and 6.9%, respectively).<sup>63</sup> Furthermore, Germans place a larger percentage of their savings in savings accounts (as opposed to investing) than residents of many other countries.<sup>64</sup> The *Sparkassen* are able to provide high returns, transfer liquidity between regions, and remain financially stable due to their sizeable deposit base.<sup>65</sup> A similar system in the

United States may suffer from the relatively low percentage of household savings placed into savings accounts. The *Sparkassen* form a successful example of a state-owned banking system in their local context, and they provide a number of lessons that could be useful to an American public bank. The banks provide financing for individuals and SMEs at low rates, do not discriminate in the provision of financial services, and reinvest proceeds in their local communities. Their decentralized structure partly insulates them from economic shocks and reduces their reliance on continuous revenue streams. Political entanglement and moral hazard are issues of which to be wary, but they do not present sufficient reason to simply write off the *Sparkassen*.

#### IV. Looking Forward: Public Banking Initiatives in the United States

The public banking movement has seen a resurgence of sorts in the last decade, and a number of states and cities have introduced legislation to either establish a public bank or conduct feasibility studies. Most notably, current New Jersey Governor Phil Murphy ran his campaign partly on the promise of establishing a public bank,<sup>66</sup> and he sponsored a bill on his first day in office to achieve that goal.<sup>67</sup> Maine,<sup>68</sup> Vermont,<sup>69</sup> and New York<sup>70</sup> have also voted on bills to establish state banks.

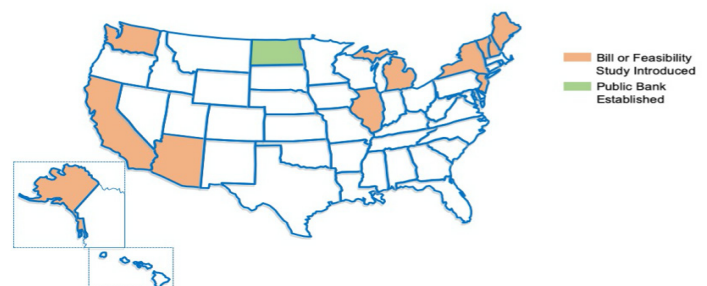


Figure 1: Public Banking Efforts by State

Feasibility studies have generally predicted positive results. For example, a 2011 feasibility study predicted that a public bank would generate 3,500 new jobs in Maine;<sup>71</sup> a 2013 study found that a public bank would create about

59 CHOLET, *supra* note 46.

60 Laura Noonan, *The Landesbanken: Inside Germany's Trillion Euro Banking Blind Spot*, REUTERS (Sept. 17, 2013), <https://www.reuters.com/article/banking-germany-landesbanken-idUSL6N0H211D20130917> (last visited Nov. 23, 2019).

61 See Lammertjan Dam & Michael Koetter, *Bank Bailouts, Interventions, and Moral Hazard* (Deutsche Bundesbank Discussion Paper, Series 2, No. 10, 2011), <https://www.econstor.eu/bitstream/10419/50000/1/667625526.pdf>.

62 See, e.g., Matthias Sobolewski & Paul Carrel, *Germany Adopts 500 Billion Euro Bank Rescue Package*, REUTERS (Oct. 13, 2008), <https://www.reuters.com/article/us-financial-germany-idUSTRE49C5PX20081013>.

63 *Household Savings*, OECD (2019), <http://data.oecd.org/hha/household-savings.htm> (last visited Dec. 1, 2019).

64 *Id.*

65 Irigoyen, *supra* note 47.

66 *A Public Bank – Investing in New Jersey Not Wall Street*, MURPHY FOR GOVERNOR <https://www.murphy4nj.com/issue/a-public-bank-investing-in-new-jersey-not-wall-street/> (last visited Nov. 10, 2019).

67 State Bank of New Jersey Act, S. 885, 218th Leg. (N.J. 2018).

68 An Act to Establish a State Bank, S.P. 83, 128th Leg. (Me. 2017).

69 An act relating to creating the Commission on the State Bank of Vermont, S. 48, 2017-2018 Legis. (Vt. 2018).

70 S. 1778, 2019-20 Leg. (N.Y. 2019).

71 Heather C. McGee & Jason Judd, *Putting Maine Money to Work for Maine*, DEMOS (May 3, 2011), <https://www.demos.org/research/putting-maine-money-work-maine>.

2,500 new jobs and \$200 million in added value to the economy in Vermont;<sup>72</sup> and a study for the city of Santa Fe found that every one million dollars in lending from a public bank would generate an additional ten jobs in the local economy.<sup>73</sup> Exceptions are the feasibility studies for California and the District of Columbia. Both studies found that establishing a public bank would be legally difficult and capital-intensive. The D.C. study heavily relied on advice from the Federal Reserve, which stated that the income a city or state can gain by having a public bank is “relatively minor” and that the risk of losses is “real.”<sup>74</sup> It is important to note that the Federal Reserve might have an inherent aversion to public banks, as these are not placed under the Fed’s supervision, in turn giving them less control. Aside from this criticism, the D.C. study also found that public banks would spur local economic development and infrastructure investment, as well as reduce risk exposure of the financial system.<sup>75</sup> The final version of the D.C. report is still being edited and is due to be released sometime later this year.

California’s study was born out of rather unique circumstances, and as such it may not be representative of the actual feasibility of a public bank in the state. California’s public bank was designed to accommodate the cannabis industry, which is unable to make use of federally overseen banks as long as cannabis remains a Schedule 1 drug under federal law.<sup>76</sup> The study found that there were less complex ways of providing financing to dispensaries and growers, such as “improving access to banking services by the California legal cannabis industry . . . through facilitation, communication, and coordination.”<sup>77</sup> The report did not consider other merits of a public bank, and it determined that the main drawback was potential litigation associated with having a bank that would explicitly provide financing for a federally illegal industry.<sup>78</sup>

Feasibility studies have produced mixed results, but there has been nothing mixed about the legislative response to the idea of public banks. Maine’s bill was sent back from committee with a majority saying it should not pass.<sup>79</sup> Vermont’s bill to establish a public bank did not pass either (although the legislature did approve \$350 million in local investment instead),<sup>80</sup> and New Jersey seems to have

put its plans for a public bank on hold. New York is the sole exception — its bill has passed the state Senate and is now awaiting assembly approval.<sup>81</sup> As of today, North Dakota remains the only state with a public bank. The idea is seen as socialist by many<sup>82</sup> and as overly complex and costly by others.<sup>83</sup> The D.C. feasibility study claimed that direct government spending towards socially beneficial programs would be far less complex and costly than establishing a public bank<sup>84</sup> — an argument to which many lawmakers subscribe.

Legal challenges also cause many legislators to view public banks unfavorably. Specifically, many state constitutions have provisions against lending state credit.<sup>85</sup> However, the Supreme Court’s ruling in *Craig v. Missouri* holds that such provisions “[do] not interfere with the power of a state to authorize banks to issue bank notes in the form of due-bills or of similar character, intended to pass as currency on the faith and credit of the bank itself, and not of the state which authorizes their issuance.”<sup>86</sup> As such, banks, public or commercial, are able to provide credit that passes as currency as long as they are not printing currency themselves. In *Briscoe v. Bank of Commonwealth of Kentucky*, the Court held that Kentucky’s state bank did not violate the Constitution, as its loans contained “no pledge of the faith of the state for the notes issued by the institution.”<sup>87</sup> The issue at hand here is whether activities that are at the core of the bank’s operations (lending, investing, etc.) are explicitly backed by a government guarantee. If so, public banks would have an unfair advantage over private banks. So far, no proposal for a state bank has indicated that the bank would rely on such a state-sanctioned “pledge of faith.” Consequently, it is unlikely that the constitutionality of a public bank could be challenged on these grounds. Furthermore, the Bank of North Dakota is evidence that it is constitutionally possible to operate a public bank.

## V. Conclusion: An Uncertain Future

There is a strong case to be made for the establishment of regional public banks throughout the United States. Pub-

72 VERMONTERS FOR A NEW ECONOMY, *supra* note 40.

73 CITY OF SANTA FE, PUBLIC BANK TASK FORCE FINAL REPORT (2018), [https://www.santafenm.gov/public\\_bank\\_task\\_force](https://www.santafenm.gov/public_bank_task_force).

74 D.C. DEP’T OF INS., SEC. & BANKING, PUBLIC BANK FEASIBILITY STUDY 6 (June 27, 2019), <https://disb.dc.gov/node/1332801>.

75 *Id.*

76 See, e.g., *Why Marijuana Retailers Can’t Use Banks*, ECONOMIST (Jan. 22, 2018), <https://www.economist.com/the-economist-explains/2018/01/22/why-marijuana-retailers-cant-use-banks>.

77 LEVEL 4 VENTURES ET AL., CALIFORNIA STATE BACKED BANK FEASIBILITY STUDY REPORT 6 (Dec. 24, 2018), <https://www.treasurer.ca.gov/comm-external-urls/cannabis-feasibility-full-report.pdf>.

78 *Id.* at 10.

79 See An Act to Establish a State Bank, *supra* note 68.

80 Alexis Goldstein, *Vermonters Lobby for Public Bank — And Win Millions for Local Investment Instead*, YES! (Jan. 7, 2015), <https://www.yesmagazine.org/commonomics/vermonters-lobby-public-bank-win-millions-for-local-investment> (last visited Nov. 10, 2019).

81 S. 1778, *supra* note 70.

82 See, e.g., Mark Calabria, *Public Banking Hurts Economic Growth*, N.Y. TIMES (Oct. 1, 2013), <https://www.nytimes.com/roomfordebate/2013/10/01/should-states-operate-public-banks/public-banking-hurts-economic>.

83 See, e.g., Mark Hallerberg & Jonas Markgraf, *The Corporate Governance of Public Banks before and after the Global Financial Crisis*, 9 GLOBAL POLICY 43 (2018).

84 DEP’T OF INS., SEC. & BANKING, *supra* note 74.

85 Ellen Brown, *Are Public Banks Unconstitutional? No. Are Private Banks? Maybe*, WEB OF DEBT BLOG (May 18, 2014), <https://ellenbrown.com/2014/05/18/are-public-banks-unconstitutional-no-are-private-banks-maybe/>.

86 *Craig v. Missouri*, 29 U.S. (4 Pet.) 410, 410 (1830).

87 *Briscoe v. Bank of Commonwealth of Kentucky*, 36 U.S. (11 Pet.) 257, 320 (1837) (emphasis added).

lic banks would allow for increased control over the money supply, greater access to affordable loans for low-income families and small businesses, higher returns on savings accounts, and a lower risk profile of the financial sector. As it stands, commercial banks largely engage in rent-seeking behavior. Predatory lending practices, low interest on savings accounts, and high credit card rates serve to generate profits for large banks by taking money from the economically vulnerable. The International Monetary Fund has found that as the financial sector grows relative to the size of the economy, inequality increases.<sup>88</sup> Recent research by economists at Columbia University confirms this relationship, and further finds that this effect is not significantly offset by the easier access to credit which financial markets supposedly provide.<sup>89</sup>

Encouraging progress is currently being made in many places. Feasibility studies are an important first step in moving the idea of public banking into the mainstream, and we might soon see a bill to establish a state bank pass in New Jersey. However, the unfortunate truth remains that lawmakers view public banks unfavorably. Beyond the practical hurdles associated with establishing one, there seems to be a general sentiment that a public bank would not fit with the capitalist ideals of the United States.

I would argue that a public bank is fundamentally American. It is a state apparatus that enables the government to more efficiently support entrepreneurship, local communities, and infrastructure. A public bank, if given proper direction, could better facilitate the achievement of the elusive American Dream. The Founders vocally opposed monopolies, championed a stable currency, and believed that all should be able to acquire property and benefit from public infrastructure.<sup>90</sup> According to Stiglitz, “[r]ather than justice for all, we are evolving into a system of justice for those who can afford it. We have banks that are not only too big to fail, but too big to be held accountable. . . The only true and sustainable prosperity is shared prosperity.”<sup>91</sup>

Commercial banks today are hurdles keeping us from innovation, wealth creation, and achieving equality. A bank should facilitate the dreams of entrepreneurs from all backgrounds, not just those backed by venture capital. It

should not charge the poor more than the rich. In many ways, by contributing to immense inequality commercial banks violate some of this country’s supposed core values. In short, there is nothing un-American about a state bank.

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88 ERA DABLA-NORRIS ET AL., INTERNATIONAL MONETARY FUND, CAUSES AND CONSEQUENCES OF INCOME INEQUALITY: A GLOBAL PERSPECTIVE 20 (June 2015), <http://www.deslibris.ca/ID/247027>.

89 Alberto Botta et al., *Inequality and Finance in a Rent Economy*, J. ECON. BEHAV. & ORGAN. 30 (2019).

90 See, e.g., Thomas G. West, *The Economic Principles of America’s Founders: Property Rights, Free Markets, and Sound Money*, HERITAGE FOUND. (Aug. 30, 2010), <https://www.heritage.org/political-process/report/the-economic-principles-americas-founders-property-rights-free-markets-and>.

91 Joseph E. Stiglitz, *The People Who Break the Rules Have Raked in Huge Profits and Wealth and It’s Sickening Our Politics*, ALTERNET (Sept. 11, 2013), <https://www.alternet.org/2013/09/joe-stiglitz-pople-who-break-rules-have-raked-huge-profits-and-wealth-and-its-sickening-our/> (last visited Nov. 10, 2019).