Do State-owned Banks Violate Constitutional Prohibitions Against Lending the State's Credit? No.

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The recent interest in state-owned banks has provoked challenges on grounds that they violate state constitutional prohibitions against lending the credit of the state. The argument is not valid for several reasons:

(1) The U.S. Supreme Court has already considered it and rejected it.

(2) A number of states have owned banks historically; and many have infrastructure banks today, which are specifically authorized by 23 U.S. Code Section 610.

(3) The argument misconstrues the nature of banking. All states deposit their revenues and invest their capital in banks. This does not mean they are "lending the state's credit." The bank lends its own credit. If the state can put its capital and revenues in a privately-owned bank, it can put them in a publicly-owned bank.

The U.S. Supreme Court Has Considered the Constitutional Argument and Rejected It

State constitutions typically have provisions forbidding the government to "give or lend the credit of the state." California's constitution, for example, provides at Article 16 (Public Finance), Section 6:

> The Legislature shall have no power to give or to lend, or to authorize the giving or lending, of the credit of the State, or of any county, city and county, city, township or other political corporation or subdivision of the State now existing, or that may be hereafter established, in aid of or to any person, association, or corporation, whether municipal or otherwise, or to pledge the credit thereof, in any manner whatever, for the payment of the liabilities of any individual, association, municipal or other corporation whatever . . . .

In the Washington State constitution, the prohibition is in Article VIII, Section 5 (a provision unchanged since 1889):

> CREDIT NOT TO BE LOANED. The credit of the state shall not, in any manner be given or loaned to, or in aid of, any individual, association, company or corporation.

In the Colorado state constitution, Article XI, Section 1 prohibits the state from pledging its "credit or faith thereof" in favor of "any person, company, or corporation, public or private." Article XI, Section 3, prohibits the state from contracting "any debt by loan in any form."

The Constitution of North Dakota has similar provisions:

> ARTICLE X: FINANCE AND PUBLIC DEBT
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> Section 18. The state, any county or city may make internal improvements and may engage in any industry, enterprise or business, not prohibited by article XX of the constitution, but neither the state nor any political subdivision thereof shall otherwise loan or give its credit or make donations to or in aid of any individual, association or corporation except for reasonable support of the poor, nor subscribe to or become the owner of capital stock in any association or corporation.

North Dakota has had a state-owned bank since 1919, along with a state-owned granary. In 1920, the legislation that enabled the Bank of North Dakota was challenged by a consortium of Minneapolis banks on behalf of 42 North Dakota taxpayers on grounds that it violated state constitutional provisions and the Fourteenth Amendment. In GREEN V. FRAZIER, 253 U. S. 233 (1920), the U.S. Supreme Court rejected this challenge. It held . . .

> that legislation which provides for engaging the state in the businesses of manufacturing and marketing farm products, and of providing homes for the people, and which appropriates money, creates a state banking system, and authorizes bond issues and taxation for carrying the scheme into effect is not unconstitutional as respects taxpayers.

The Court noted that the constitutionality of the legislation had been sustained by the Supreme Court of North Dakota. The decision was therefore conclusive, so far as it rested on state grounds. The only question left for the U.S. Supreme Court was the attack under the Fourteenth Amendment, alleging a deprivation of the plaintiffs' right to property (their taxes) without due process of law. The court observed:

> This legislation was adopted under the broad power of the state to enact laws raising by taxation such sums as are deemed necessary to promote purposes essential to the general welfare of its people. . . .
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> [T]he Supreme Court of North Dakota held . . . concerning what may in general terms be denominated the "banking legislation," that it was justified for the purpose of providing banking facilities . . . .
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> As to the Home Building Act, that was sustained because of the promotion of the general welfare in providing homes for the people, a large proportion of whom were tenants moving from place to place. It was believed and affirmed by the Supreme Court of North Dakota that the opportunity to secure and maintain homes would promote the general welfare, and that the provisions of the statutes to enable this feature of the system to become effective would redound to the general benefit.

The decision of the Supreme Court of North Dakota upholding the legislation was therefore affirmed. The Bank of North Dakota (BND) has operated successfully ever since, serving largely as a "banker's bank" within the state.

Many States Already Own Banks

Although North Dakota is the only state to own such a bank today, a number of states have owned them historically; and many states, including California, now own infrastructure banks. A July 2011 release by the Council of State Governments observed:

> More than 30 states and Puerto Rico have created a state infrastructure bank, a type of revolving infrastructure investment fund that can offer loans and credit assistance to public and private sponsors of certain highway construction, transit or rail projects. Five states--Florida, Georgia, Kansas, Ohio and Virginia--have established banks or accounts within their banks that are capitalized solely with state funds.

If state funds can be used to capitalize a state infrastructure bank without violating state constitutional provisions, they can be used to capitalize a state-owned bank on the model of the Bank of North Dakota without violating those provisions.

Banks Advance Their Own Credit, Not the Credit of Their Depositors

The contention that a state-owned bank would "lend the credit of the state" misconstrues the nature of banking. Banks do not actually lend the deposits of their depositors. If they did, the state would not be able to deposit its revenues in Bank of America or Chase Bank without violating state constitutional provisions. As the **Federal Reserve Bank of Dallas** explains on its website:

> *Banks actually create money when they lend it.* Here's how it works: Most of a bank's loans are made to its own customers and are deposited in their checking accounts. Because the loan becomes a new deposit, just like a paycheck does, the bank . . . holds a small percentage of that new amount in reserve and again lends the remainder to someone else, repeating the money-creation process many times.

As Michael Sauvante explains it on the website of the Commonwealth Group:

> The number one privilege enjoyed by banks is their ability to create new money, in the form of credit granted to their borrowers. Banking laws permit a bank to create that credit based on the assets of the bank (generally defined by the Basel II Accord). This credit is not extracted from those assets (which remain untouched in the process), nor is it drawn from any other pool of money, but rather the assets serve strictly as the basis for calculating the total amount of new money that the bank is allowed to issue in the form of credit. That amount (usually a multiple of the assets, typically in the range of 10-12 times the value of the assets) is governed by regulators, and varies from bank to bank.

A state-owned bank would not lend the state's credit but would accept the state's revenues as deposits, just as Bank of America does now. The state's revenues would simply be shifted from one deposit account to another.

Some small portion of its capital would also be shifted from one investment to another. Some idle rainy day fund, for example, might be used. This would be an investment in equity, not an expenditure. It would not cost the state money but rather would make money for the state. The Bank of North Dakota has reported a return on equity in recent years ranging from 19% to 26%.

This is also true for the state's deposits: they would not be spent or lent but would remain at all times deposited in the bank.

The state-owned bank would then do what all banks do: leverage this capital into credit backed by deposits. And because the bank would be publicly owned and would have a mandate to serve the public, it could be expected, like the BND, to advance this credit conservatively for creditworthy local projects and needs. Banking "would become boring again."

In North Dakota (population 647,000), the Bank of North Dakota has $2.7 billion in deposits, or $4000 per capita; and virtually all of these deposits are drawn from the state's own revenues. The bank has nearly the same sum ($2.6 billion) in outstanding loans.

California has 37 million people. On the same scale, California might amass $148 billion in deposits. Assuming an 8% capital requirement, with $12 billion in capital, this $148 billion in deposits could generate $133 billion in credit for the state (subtracting 10%, or 14.8 billion, to satisfy reserve requirements).

If that credit were used, for example, to purchase $133 billion in municipal bonds paying 5% interest, the state would have made nearly $7 billion annually on its investment. This is new revenue for the state, acquired without spending a penny more in taxes.

If it is constitutional for the Bank of America to make this income by leveraging the state's capital and deposits for the benefit of the bank's investors, it is constitutional for the state-owned Bank of California to do it for the benefit of the state and its people.