GOVERNMENT FINANCE
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Is A State Bank A Useful Economic Development Tool With Future Promise?

Introduction

The COVID-19 pandemic and related economic downturn have created substantial fiscal pressure for state and local governments throughout the United States. Governments faced unexpected revenue declines as much economic activity suddenly halted due to the spread of COVID-19 and because of policies aimed at mitigating its spread, including prohibiting in-person retail shopping and dining. At the same time, governments faced increased spending pressure for a range of needs, like purchasing personal protective equipment for public workers, the larger public health response, and increased need for safety-net services. Projected revenue declines and increased demand for services led many governments to cut costs where possible.

The $350 billion of the American Rescue Act money that's designated for state and local governments is going to ease things up significantly for these governments. But the pressures brought about by the pandemic have created an environment conducive for the creation of innovative approaches to government finance and new ways to build the capacity necessary to help states and localities ride through difficult times. One of these is the notion of creating state banks.

Banks play a major role in America, by facilitating transactions, allocating credit and more. There's no question that the banking system in this country is essential to a well-functioning economy.

Still, beyond their essential role in the economy as a whole, there's been a long-standing concern about whether private banks operating in private markets actually serve the public interest as fully as they might.

Interest in creating a banking system better suited to meeting more of the public's needs has led four states to introduce legislation to create state banks in 2021: New Mexico, New York, Oregon and Washington. In 2019, similar legislation was enacted in California, with a bill that repealed the prior prohibitions on municipalities and counties opening a public bank and depositing funds in such an institution.

The one long-standing experience with a state bank has been in North Dakota, where such an institution has been in existence for over 100 years and is held by many to be the prototype of a successful state bank.

Economic development is a key motivating factor for starting a state bank. It takes the form of assistance to small businesses, students, and underserved communities, promoting infrastructure investments, or targeting critical sectors that will lead to sustained growth.

Of particular importance at a time when there's been disproportionate economic impact of the pandemic on underserved communities – often segregated areas comprising people of color with low average incomes – a state bank has the potential of evening the playing field for people throughout a state.
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Underserved Communities

Perhaps the key motivation for a state bank is that it will be able to assist underserved communities especially in providing loans and credit. Offering such assistance has been an ongoing policy goal for at least five decades, beginning with President Lyndon Johnson's 1964 "War on Poverty."

Unfortunately, geographically targeted or place-based programs "… often fail to benefit the places and people they are intended to aid" because they are poorly targeted and poorly tailored to community needs, according to a February 2, 2021 Pew Charitable Trusts report, *How States Can Direct Economic Development to Places and People in Need*.

Providing credit in underserved areas is one of the primary functions for which a state bank might have a unique and constructive role to play in underserved communities. But under what circumstances can a state bank allocate credit at lower cost to the existing pool of actual and potential borrowers?

Supporting credit to those in need

There are three central factors that determine loan costs: operating costs, loan defaults, and the cost of funds. Insofar as operating costs are concerned, it's likely that private banks have the advantage over state-run institutions. That's because private banks are likely to be larger than a newly-established state bank, which provides for economies of scale and scope. Additionally, large private banks would also have access to borrowed funds at a lower interest rate. These factors have the potential to provide them with cost advantages.

When it comes to loan defaults, however, a state-run bank seems to have the edge. Lending is risky business, and loan defaults are expected. A state bank may be better embedded into neighborhoods, have superior knowledge about its customers, and hence may suffer fewer loan defaults. When loan defaults are lower, banking institutions can lend at lower rates.

State banks can also have an advantage when it comes to the costs of xx deposited funds. In the course of discharging its routine tasks, a state generates a large amount of core deposits. Usually, they are deposited in private banks. State deposits channeled to a state bank would be an important and inexpensive source of funds for a state bank.

To summarize, a private bank may have cost advantages due to lower operating costs and a low cost of borrowed funds. State banks may benefit from lower default rates and greater access to state deposits, both of which lower its cost of making loans.

Challenges to state banks

State banking is risky business, as is any banking venture. For example if a state bank becomes financially distressed, it may have to be bailed-out by the state, and hence its taxpayers. While state deposits would create a low-cost source of funds, they come with a hidden cost; the value of the services that were being provided by private banks. These costs must be quantified and considered in an overall evaluation of a state bank.

Moreover, a state bank could be tempted to direct funds to sectors or projects deemed to be critical for growth, effectively trying to pick winners and losers. Such industrial policies have had a mixed record of success.

While the sustained profitability of the Bank Of North Dakota is impressive, the general applicability of this model is limited because the financial sector in many states is quite well developed and the population of North Dakota of 762,000 residents is quite small, only seven percent larger than that for a typical congressional district.

The political history of some states raise serious concerns for any activities where politicians might influence lending decisions that may be based on non-economic criteria. While banks that operate in the private sector are largely motivated by the simple logic of profit and loss, there is reason for concern about the politicization of credit and “mission drift” in banks operated by governmental entities.

The conventional approach to addressing these concerns is to follow the lead of the Bank of North Dakota. As the bank’s president and chief executive, Eric Hardmeyer, stated in a 2011 interview with *American Banker* “If you are going to have a state-owned bank, you have to staff it with bankers. If you staff it with economic developers you are going to have a very short-lived, very expensive experiment. Economic developers have never seen a deal they didn’t like. We deal with that every day.”

A more radical approach has its basis in naked economic interests. Consider the possibility that a state-owned bank can generate surplus funds that can be employed to address various social issues outside the scope of private markets.

The idea is to have several state stakeholders with a financial interest in maximizing the size of this surplus. Consider the possibility of creating a consortium of six independently created state banks for the Upper Midwest states -- Minnesota, Wisconsin, Illinois, Indiana, Michigan, and Ohio -- that would undertake lending activity in the following manner:

1. Each state forms a state bank whose primary purpose is to allocate capital via lending.
2. The state banks are funded by state deposits and state-provided equity capital. Each state is assigned a share determined by its contribution of deposits and equity.
3. At the end of each fiscal year, the profits of all six state banks are aggregated and distributed according to shares. In a given state, these surplus funds will be further divided between an additional contribution of x% to equity (i.e., retained earnings or accumulated surplus) and y% to a special social account that is segregated from the deposits and equity provided by each state.
4. Based on its contributed deposits, equity, and accumulated surplus, each state bank proposes lending decisions but, importantly, the loans must be approved by at least four of the six state banks.
5. Each state bank can invest the special social account funds as they wish, perhaps in projects with a high social return but a low private return that would not meet the market test. The size of the special social account can be adjusted by altering y% in subsequent years.

This approval process provides financial incentives that states reject sub-standard, politicalized projects because they result in a lower aggregate surplus and hence lower shares to all states. Moreover, these questionable projects do not provide, to any important degree, political or other non-pecuniary benefits to those outside the state.

The proposed approach may not deter corruption and mission creep fully. But some mechanism is needed if a state bank is to be sustainable and largely unaffected by political pressures, and hence a useful economic development tool with future promise.

Read the full report here or on the GFRC site.