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Promises of Public Banks Don't Match Reality

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The big-bank bailouts during the financial crisis angered many people, including myself. Some have suggested that state- or city-owned banks could be a substitute for big banks and eliminate many of the problems associated with them, ranging from bailouts to consumer abuses, conflicts of interest and sometimes outright corruption.

Public banking options are currently under consideration in a number of cities and states including Colorado, Seattle and Santa Fe. But while we must search for a sustainable solution to the flaws in our financial system, government banks would be a cure worse than the disease.

Public banks have a long history dating back to 1408, when the first such known institution was established in Genoa, Italy. Its mission statement could have been taken from Occupy Wall Street: among its purposes was “to eradicate certain bad practices of bankers, who are so devoted to their own interest that they barely blush as they ruin the public good.”

Like many public banks that followed, Genoa’s Banco di San Giorgio later failed, in part because of losses on loans to its sponsoring government.

The first American public bank was established in Vermont in 1806. It failed six years later, costing the citizens of Vermont the equivalent of almost $3 billion in today’s dollars. Seven other states established public banks in the 1800s, with the last of these, the Bank of the State of Indiana, closing in 1859.

These banks were characterized by rampant corruption. As South Carolina legislator John Felder reflected in 1846, “Whenever … such cohabitation exists, the bank runs into politics and politicians run into the bank and foul disease and corruption ensue.”

The recent history of Fannie Mae and Freddie Mac, quasi-public banks at the federal level, illustrates that mismanagement and corruption are alive and well at the intersection of the public and private. We can also look abroad for foreboding examples. Germany has an extensive system of public banks, the most prominent being the *Landesbanken.* These banks are owned by Germany's state governments, much like the current proposal currently being explored in Colorado. Despite the fact that *Landesbanken* are a minority of Germany’s financial system, the bulk of losses related to the 2008 subprime crisis arose from these public banks.

Years before the crisis, the International Monetary Fund had warned of risks hidden in Germany’s public banking system. Unfortunately, these warnings were ignored.

Proponents of public banking might point to the Bank of North Dakota, currently the only state-run and state-owned American bank. The Bank of North Dakota is generally a well-run institution. It is also a massive subsidy to the fossil fuel industry.

One need only look at its annual reports to see that much of its below-market lending has been to the fossil fuel industry. This is typical of government-owned banks, which tend to subsidize the powerful and connected. Additionally, much of the bank's credit risk is ultimately shifted to the federal government, particularly through its federally guaranteed student loans.

Another issue is that the vast majority of funding for the Bank of North Dakota comes from the state's deposits, much of which is generated from tax and fee revenue. The bank is able to offer below-market rate loans to borrowers because it pays the state less interest on its deposits.

This is essentially a hidden subsidy. Had North Dakota kept its deposits with private banks, it would have received more interest on its deposits. The setup therefore functions as a transfer from taxpayers to borrowers. Rarely is such a lack of transparency in the interests of the general public.

Academic research confirms the undesirability of government-owned banks. The most comprehensive study, from economists at Harvard University, finds “that higher government ownership of banks is associated with slower subsequent development of the financial system, lower economic growth, and, in particular, lower growth of productivity.” Keep in mind that productivity ultimately drives wage growth. This research has been extended in a recent paper that finds that political interference in bank lending decisions generally results in worse economic outcomes.

When the government owns the banks, lending decisions become increasingly driven by politics rather than economics. Resources flow to those with influence. Government-owned banks also tend to under-price risk in order to appeal to voters. If there is one lesson we should take away from the recent crisis, it is that when you intentionally under-price risk, bad things happen.

Public anger at Wall Street is well founded. But Americans have plenty of options beyond Wall Street. If they want a small, community-based institution, there are over 2,000 depositories in the U.S. that are under $100 million in assets, and another 4,000 under $1 billion in assets. That’s not to mention the growing number of alternative financial services options like peer-to-peer lending and crowdfunding.

Borrowers and savers have lots to choose from — with the emphasis on choice. There’s no good reason to force these institutions to compete with a subsidized, state-owned “political” bank.

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