

Tackling California's Budget Crisis: Raise Taxes, Cut Programs, or Form a Bank?

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In 2022, the state of California celebrated a record budget surplus of \$97.5 billion. Two years later, [according to the Legislative Analyst's Office](#), this surplus has plummeted to a record budget deficit of \$73 billion. Balancing the budget will be challenging. Unlike the federal government, the state cannot just drive up debt and roll it over year after year. [The California Balanced Budget Act](#), passed in 2004, requires the state legislature to pass a balanced budget every year.

The usual solutions are to cut programs or raise taxes, but both approaches are [facing an uphill battle](#). Raising taxes would require a two-thirds vote of the legislature, which would be very challenging, and worthy public programs are in danger of getting axed, including homelessness prevention and funding for low-income housing.

A third possibility might be to increase the income tax base and state income by stimulating the economy with a state-owned depository bank. The state-owned Bank of North Dakota, which has raised record profits for its state, is a stellar example. In a review of states with the healthiest budgets based on data from the PEW Charitable Trusts, [U.S. News & World Report puts North Dakota at No. 1](#) in Budget Balancing and #1 in Short-term Fiscal Stability.

California has an Infrastructure and Development Bank, which is already capitalized and has an established track record of prudent and productive lending, but it is not a depository bank and its reach is small. Transforming it into a depository bank would be fairly uncomplicated and could substantially increase its reach.

But first a look at what happened to the state's copious revenues.

Saga of a Budget Crisis

California's record surplus was largely due to tax windfalls and to \$43.5 billion received in American Rescue Plan money during the COVID crisis. Anticipating that these inflows would continue, the governor and legislature enacted a record budget for 2024-25 of [nearly \\$300 billion](#), the largest of any state. Much of the surplus was committed to expanding an array of social and educational services, including extending universal health care coverage to undocumented immigrants. When taxes came in, the tally showed a [revenue shortfall of \\$26 billion](#).

Tech industry woes were a major contributor. The [top 1% of earners pay nearly half](#) of California's income taxes, and 20% of its GDP comes from the tech industry. The collapse of Silicon Valley Bank, which financed startups and attracted venture capital, [speeded the sector's decline](#). Massive Silicon Valley layoffs occurred and tech stock lost value, cutting capital gains taxes. And there has been a [notable exodus](#) from the state not just among the ultra-wealthy but by businesses, due to the combination of high taxes, stringent regulations, and elevated costs for labor, utilities, and energy.

Another contributor to the budget deficit were huge payouts for unemployment benefits, which skyrocketed during the COVID lockdown and business shutdowns. The state's unemployment fund was exhausted, requiring a loan from the federal government. [Twenty-one billion dollars remains](#) to be repaid, and the interest rate on the debt has gone up. To meet the unemployment burden, California legislators are considering [quintupling unemployment taxes](#) and nearly doubling benefits, but the result could be more layoffs and more businesses leaving the state.

Plagued by Homelessness and Unemployment

Meanwhile, the wealth divide in California is enormous, with the [highest unemployment rate](#) and [homeless rate](#) in the country. This is despite \$24 billion being [spent on the unhoused](#) over the last five years. Thirty percent of the nation's homeless live in California, and nearly nine million Californians are on the brink of being homeless. Housing is too expensive for low-wage earners and there is a lack of available low-cost housing. But well-meaning legislation to help low-wage earners has had unintended consequences.

As of April 1, the minimum wage for fast food restaurant workers was raised by 25% to \$20 an hour triggered by a strike by their union. But the move has negatively impacted many of the workers. Fast food restaurant owners operate on thin profit margins; and to cover these new costs, they have had to reduce workers' hours, raise customer prices, engage in massive worker layoffs, move out of state, or close their businesses altogether. Almost [10,000 fast food jobs have been lost](#) in California just since the \$20 minimum wage law was signed.

As a result of these and other efforts to help low-wage earners, many vulnerable workers are suddenly finding or will find themselves out of a job.

Compare North Dakota

At the other end of the employment spectrum is North Dakota, which has the [lowest unemployment rate](#) in the country. As noted above, in a review of states with the healthiest budgets, [U.S. News & World Report puts it at No. 1](#) in Budget Balancing and #1 in Short-

term Fiscal Stability. North Dakota's budget for 2024-25 includes cuts in individual income taxes, including eliminating the state individual income tax for 60% of the population and a reduction in that tax for the other 40%. The result is projected to be [a 1.5% flat rate income tax](#), the lowest in the nation. Again compare that to California, where the [top state income tax is 14.4%](#), higher even than other states known for their tax burdens.

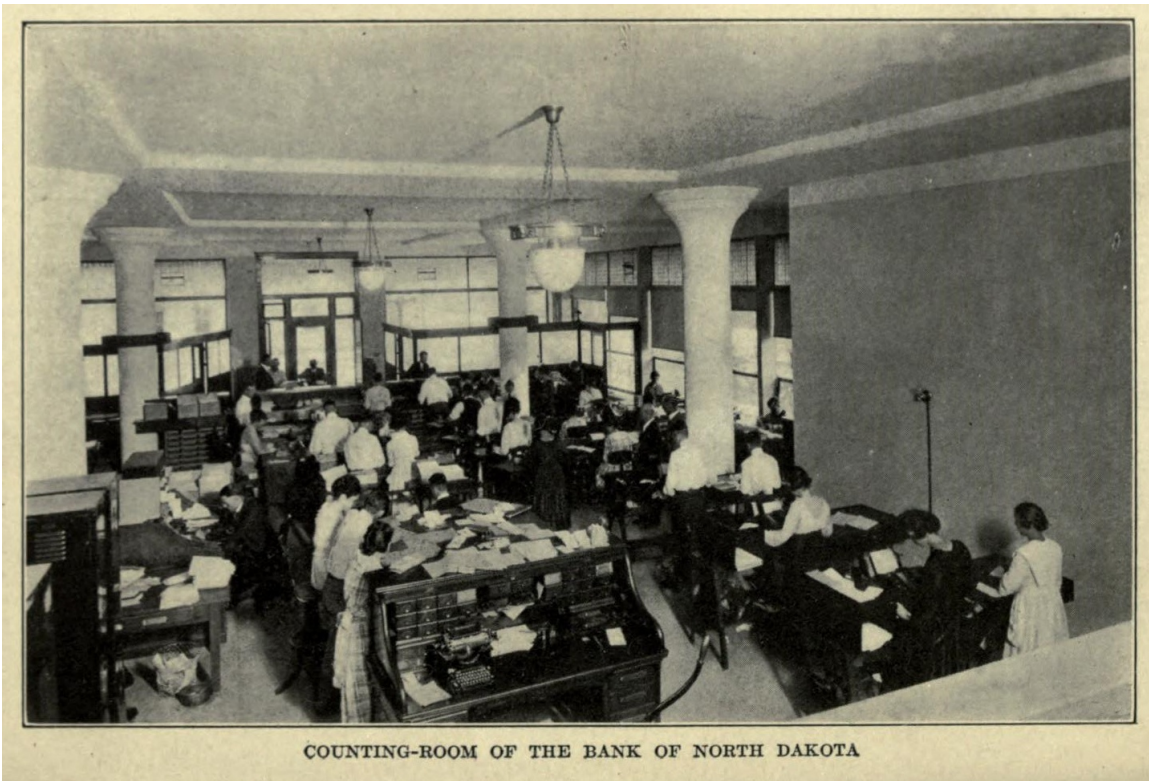
North Dakota was the only state to fully escape the 2008-09 credit crisis, never slipping into the red. When the state did go over budget in 2001-02 due to the dot-com bust, the Bank of North Dakota (BND), the nation's only state-owned bank, [acted as a rainy day fund](#). To make up the budget shortfall, the bank declared an extra dividend for its state owner, and the next year the budget was back on track.

The BND is [more profitable](#) than [some of the largest Wall Street banks](#). Its [latest Annual Report](#) (for 2022) states that it had a record net income of \$191.2 million that year, up \$47 million from 2021. Its asset size also set a record, at \$10.2 billion. The return on investment was a healthy 19%. As the BND's principal depositor, the state must keep its funds in the bank by law, thus protecting the bank from a run on its deposits. The [Standard & Poor's credit rating](#) for the BND is A+/stable. The S&P report states, "BND has one of the highest risk-adjusted capital (RAC) ratios for rated U.S. banks."

BND's profitability has helped strengthen community banks and credit unions in North Dakota by making loans in partnership rather than in competition with them. In the Great Recession, it also bought loans from stressed local banks to prevent bank failures and keep the economy running smoothly. BND operates with very low overhead and stresses productive and local lending rather than lending to buy existing assets, the sort of speculative lending that leads to bubbles and busts.

The State's Deposits Are Safer in Its Own Bank

The Bank of North Dakota was established in 1919 by a populist party of farmers who felt their farms were being foreclosed on unfairly by out-of-state bankers. They succeeded in bringing their state revenues back into their own bank, serving their own communities.



Counting-room of the Bank of North Dakota, c. 1920 (From the Public Domain)

North Dakota's revenues are safer in its own bank than in the largest Wall Street banks, which "insure" their capital [with interconnected derivatives](#) backed by rehypothecated collateral. The Financial Stability Board has [declared that practice to be risky](#), "as highlighted during the 2007-09 global financial crisis." The five largest Wall Street depository banks hold [\\$223 trillion in derivatives, or 83 percent](#) of all the derivatives at 4,600 banks; and they have a combined [half trillion dollars in commercial real estate loans](#), also very risky in the current financial environment.

Today most government funds are deposited in these SIFIs (Systemically Important Financial Institutions), putting the deposits at risk. Under the Dodd Frank Act of 2010, a SIFI that goes bankrupt will not be bailed out by the government but will be recapitalized by "bail ins" - confiscating the funds of the bank's creditors, including "secured" depositors such as state and local governments. Under the Bankruptcy Act of 2005, derivative and repo claims have seniority and could easily wipe out all of the capital of a SIFI. The details are complicated, but the threat is real and imminent. See my earlier articles [here](#) and [here](#), David Rodgers Webb's [The Great Taking](#), and Chris Martenson's excellent series drilling down into the obscure legalese of the enabling legislation, concluding [here](#).

Even if the SIFIs remain solvent, they are not using state deposits and investments for the benefit of the people; and often they are betting against us. The BND, by contrast, is mandated to use its revenues for the benefit of the North Dakota public.

California Could Replicate the BND Model with Its Infrastructure and Development Bank

California already has an Infrastructure and Economic Development Bank (I-Bank), but it is not a true depository bank able to take deposits and leverage its capital. According to [its website](#):

IBank was created in 1994 to finance public infrastructure and private development that promote a healthy climate for jobs, contribute to a strong economy, and improve the quality of life in California communities. IBank is located within the Governor's Office of Business and Economic Development and is governed by a five-member Board of Directors. IBank has broad authority to issue tax-exempt and taxable revenue bonds, provide financing to public agencies, provide credit enhancements, acquire or lease facilities, leverage state and federal funds and provide loan guarantees and other credit enhancements to small businesses.

Its [Infrastructure State Revolving Fund \(ISRF\) Program](#) provides loans only to public entities (municipalities, counties, Joint Power Authorities, pension funds), but it also has a [Small Business Financing Center \(SBFC\)](#) that provides loan guarantees through independent agencies for businesses and farms having trouble accessing loans, among other outreach services. The ISRF is a revolving fund, limited to lending its base capital. It engages to some extent in leverage, but it's the riskier version called "rehypothecation" (relending of existing collateral). As explained by Stan I-Bank's first Executive Director Stan Hazelroth in [a 2013 article](#):

When you loan \$100 to an electric utility, say, to build new infrastructure, they take money from ratepayers and pay that loan back over time. These payments, based on the history of utility ratepayers over decades, are very reliable—so reliable, in fact, that bond buyers will loan money secured by the promise of those ratepayers to pay the utilities back over time.

The utility with the right to be paid back \$100 can pledge those aggregate payments and secure an additional loan of, say, \$80. When that loan begins to be paid back, bond buyers will loan you another, say, \$60, which can also be loaned out. With just \$100 in cash, in other words, you can loan out \$240.

Thus a contract becomes a security, which can act as collateral for another loan and another for the lender. But reuse of the same asset for multiple loans can go only so far. Chartered at a 10% capital requirement, depository banks can issue up to ten times their capital in loans. (In 2020 the Fed lifted the capital requirement altogether, but 10% is still considered a prudent ratio.)

Banks do need to back withdrawals with reserves, which they acquire from their incoming deposits or by borrowing from other banks or the Federal Reserve; but the state has plenty of deposits to serve that function. Any bank in which the state deposits its revenues will back its loans with those deposits, and the I-Bank's loans are actually safer and better for the public interest than those of the big Wall Street banks. If the I-Bank were to become the state's banker and its reserve account were overdrawn, it would have the same protections afforded by the Federal Reserve system to all chartered banks: it could borrow reserves from other banks, the repo market, or the Fed itself. The BND is not a member of the Federal Reserve but has a master account with it, allowing the bank to transfer funds with other banks in the system and to act as a "mini- Fed" for the state, providing correspondent banking services to North Dakota's many community banks.

One thing California and North Dakota have in common is that they are both big agricultural states. The [BND helps its farmers](#) with a variety of low-interest loans. Although most of its loans are in collaboration with local banks, two loans it makes directly are the Beginning Farmer Real Estate Loan and Established Farmer Real Estate Loan. California's struggling

farmers could benefit from that sort of direct aid as well.

The state itself could also realize significant savings from its I-Bank if the bank's loan capacity were expanded. I was unable to nail down the current comparative figures for loans, but here is an example from an [article I wrote in Yes Magazine](#) in 2018:

Financing infrastructure through the municipal bond market accounts for [half the cost of infrastructure](#) due to the debt load involved. One example where this is made clear is with [Proposition 68](#), a statewide ballot measure that voters approved in the June 5 primary election which authorizes \$4.1 billion in bonds for parks, environmental, and flood protection programs. The true cost of the measure is \$200 million per year over 40 years in additional interest, bringing the total to \$8 billion. California's IBank, which funds infrastructure at 3 percent, could finance the same bill over 30 years for \$2.1 billion—a nearly 50 percent reduction.

The Golden State as Trendsetter: Time to Form a Bank

In 2019, two bills were brought to convert California's I-Bank into a depository bank, one in the Senate, [SB 528](#) (Hueso), and one in the Assembly, [AB 310](#) (Santiago). SB 528 sought simply to convert the I-Bank to a depository bank. It passed the first two committees but was "suspended" in Appropriations. The second bill, AB 310, sought to extend the I-Bank's services directly to underserved individuals and businesses. It was opposed by the state treasurer and the state controller on grounds that it was too risky, and it failed. But California State Treasurer Fiona Ma said in her opposition letter to AB 310 that she was sympathetic to its goals, and that "I respectfully propose AB 310 be amended, replacing the current language with a mandate to develop a feasibility study to be conducted by an independent, apolitical expert source. The technical experts in my office can assist to build the framework of the study as the state's banker."

There is actually no need to change the I-Bank's existing programs, since it already has a variety of programs that help the underserved indirectly. Simply converting it to a depository bank would extend the reach of its existing services (for which there is currently excess demand), expand its profitability, reduce the cost of infrastructure and development for state and local government agencies, and protect any revenues deposited in it from a sudden crisis in the conventional banking system.

The remedy for unemployment is employment, and the remedy for the unhoused is affordable housing. An I-Bank expanded into a state-owned depository bank could provide both.

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