California Dreamin': How the State Can Beat Its Budget Woes

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As goes California," says the adage, "so goes the nation." All eyes are therefore on the Golden State as it attempts to solve its $26 billion budget deficit. The world's eighth largest economy is not going quietly into that pit of debt and devastation that has devoured Third World countries whole. The State's voters have drawn a line in the sand against further tax hikes, while Democratic leaders have drawn a line at further cuts in services or selloff of public assets. State legislators are deadlocked, caught between the rock of tax ceilings and the hard place of debt limits.

"Expect the best and accept nothing less," says another adage that typifies the attitude sometimes called "California dreaming." You create your own reality. Instead of trying to prop up an old model that has failed, you can dream up a new one. If anyone can come up with an original solution to the problem, Californians should be able to. But what? While waiting for developments, Governor Arnold Schwarzenegger has started paying the State's bills with IOUs ("I Owe You"s evidencing debt, technically called "registered warrants").

Hmm … Pay the bills with IOUs. Not a bad idea! That was, in fact, the original innovation that got the American colonists out of their financial straits back in the 18th century, when they lacked the silver and gold used in the Old World for conducting trade. Money, after all, was just a medium of exchange, an acknowledgment of goods and services delivered or a debt owed. The notion that the government could pay in paper receipts was first hit on by the governor of the province of Massachusetts in 1691, when he needed money to fund a local war. The use of a paper currency had been suggested in an anonymous British pamphlet in 1650, but the proposal was modeled on the receipts issued by London goldsmiths and silversmiths for the precious metals left in their vaults for safekeeping. The problem for the colonies was that they were short of silver and gold. The Massachusetts Assembly therefore proposed a different kind of paper money, a "bill of credit" representing the government's "bond" or IOU. The paper money of Massachusetts was backed only by the "full faith and credit" of the government.

Other colonies followed suit with their own issues of paper money. Some were considered government IOUs, redeemable later in "hard" currency (silver or gold). Others were issued as "legal tender" in themselves. They were "as good as gold" in trade, without bearing debt or an obligation to redeem the notes in some other form of money later. The new paper money not only made the colonies independent of the British bankers and their gold but actually allowed the colonists to finance their local government *without taxing the people*. Colonial assemblies discovered that provincial loan offices could generate a steady stream of revenue in the form of interest income *by taking on the lending functions of banks*.

The same solution was employed in other countries later. When Argentina's government workers were faced with massive layoffs, their unions persuaded six state governments to pay them instead with state bonds or IOUs in small denominations. The IOUs could then be used to pay for state services and taxes, and everyone in the local economy accepted them in trade.

There's Just One Problem…

Why couldn't California do the same thing? The problem with calling its IOUs "legal tender" today is that the ruse violates the U.S. Constitution. Article I, Section 10, says, "No State shall . . . coin money [or] emit bills of credit." The Cornell University Law School "Annotated Constitution gives this definition:

"Within the sense of the Constitution, bills of credit signify a paper medium of exchange, intended to circulate between individuals, and between the Government and individuals, for the ordinary purposes of society."

U.S. Supreme Court cases are cited from the 1830s, in which "interest bearing certificates, in denominations not exceeding ten dollars, which were issued by loan offices established by the State of Missouri and made receivable in payment of taxes or other moneys due to the State, and in payment of the fees and salaries of state officers, were held to be bills of credit whose issuance was banned by this section."

That all seems pretty clear cut, until you read a bit further. Article I, Section 10, also says that no State shall "make any Thing but gold and silver Coin a Tender in Payment of Debts." When was the last time any State paid its bills only in gold and silver coin? The States could argue that the Constitution needs to be updated.

They could make some other compelling arguments. The States agreed to give up their right to issue their own currencies because they delegated that power to Congress. Article I, Section 8, enumerates among the powers given to Congress, "To coin Money [and] regulate the Value thereof." Scholars continue to argue about the meaning of "to coin money," but the Constitution clearly gives no entity *except* Congress the power to create money and regulate its value, and Congress failed to properly husband that authority. It issued coins, but it allowed privately-owned banks to issue "banknotes," which soon made up the bulk of the nation's money supply. Bankers, not Congress, thus "regulated the value" of the currency, through the laws of supply and demand: the more notes they created, the smaller the value of each. In 1913, Congress went so far as to allow a privately-owned central bank called the Federal Reserve to issue its own Federal Reserve Notes and call them the exclusive national paper currency. These notes were then *lent* to the U.S. government, at interest.

Today, however, Federal Reserve Notes compose only about 3% of the money supply (M3). The other 97% is issued by private banks in the form of loans. "Bank credit" is created simply by entering numbers into the accounts of borrowers, as many authorities have attested. One of the most clear statements of this process came from Graham Towers, Governor of the Bank of Canada from 1935 to 1955, who acknowledged:

"Banks create money. That is what they are for….The manufacturing process to make money consists of making an entry in a book. That is all…. *Each and every time a*

Bank makes a loan … new Bank credit is created — brand new money."

Congress has not only reneged on its agreement to create the national money supply, but it has refused to front the funds to bail out California from its relatively modest $26 billion budget shortfall. Californians are justifiably upset, since Congress hardly batted an eye before earmarking some *$700 billion* in bailout money for the private banking system, and the Federal Reserve has committed trillions more for that dubious purpose. Nearly ten times the sum needed by California was allotted to bailing out AIG, a private insurance company; and half the sum needed by California went to pay off the gambling debts of AIG to Goldman Sachs, *a single bank*. California underwrites a substantial portion of the federal government's budget, sending a dollar in tax revenue for every 80 cents it gets back. Yet the federal government has even rejected California's request for a loan guarantee, which could have saved the State hundreds of millions of dollars in interest. The clear message is, "You're on your own."

Creative Problem Solving

The situation looks pretty dire, but it may just need some thinking outside the box. The law does not allow the States to issue "bills of credit," but it *does* allow them to create another form of money called "checkbook" money. All a State has to do is to form its own bank. Quoting again from the Cornell University Law School Annotated Constitution:

"*Bills issued by state banks are not bills of credit; it is immaterial that the State is the sole stockholder of the bank*, that the officers of the bank were elected by the state legislature, or that the capital of the bank was raised by the sale of state bonds."

If private banks can create credit on their books, so can the world's eighth largest economy. Indeed, there is longstanding precedent for this approach. The State of North Dakota has owned its own bank for nearly a century. North Dakota is one of only two States (along with Montana) that are not currently facing budget shortfalls. North Dakota has beaten the Wall Street credit freeze by generating its own credit. By law, ever since 1919 the State's revenues have been deposited in its own bank, the Bank of North Dakota (BND). Using the "fractional reserve" lending scheme open to all banks, these deposits are then available to be used as the "reserves" for creating many times their face value in loans. Other banks in the State do not see the BND as a threat, because it partners with them and backstops them, serving as a sort of central bank for North Dakota. BND's loans are not insured by the Federal Deposit Insurance Corporation (FDIC) but are guaranteed by the State.

If California followed suit, it would not need to meet the FDIC's capital requirements but could designate state-owned property (parks, buildings and so forth) as its capital base. Applying the "multiplier effect" by which capital is lent and relent many times over, this base could then generate hundreds of billions of dollars in "credit." The State could deposit its revenues in the State bank and pay its payroll through it, generating an even larger deposit base for making new loans. Enough credit could be generated to allow the State not only to meet its short-term budget needs but to buy back its outstanding bonds (or debt). Bond interest and redemption costs on California's General Fund for the current year are estimated at nearly *$5 billion* — about 20% of the budget shortfall. All of that money could be saved in interest, since the State would be paying interest to itself.

The State could do more than just chase the wolf from its door. It could generate enough credit to engage in the sort of economic "stimulus" being undertaken by the federal government. It could create jobs for the 11.5% of the State's population that are currently unemployed, augmenting the tax base and supplying the incomes necessary to prop up the languishing housing market. Loans for income-producing projects (transportation, energy, housing) could be repaid with the profits generated by the funded projects. And if some of the newly-issued loans were not paid back, they could simply be refinanced. The federal government has been rolling over its loans ever since 1835, the last time the federal debt was actually paid off (under Andrew Jackson).

In boom times, this approach could result in unwanted inflation. But today the economy is suffering from a serious *shortage* of money, because virtually all of our money comes from bank loans, and bank lending has dried up. Since neither the federal government nor the Federal Reserve has stepped in to fill the void, the States must do it themselves; and like the 18th century colonial governments, they can do it by taking over the lending functions of banks.

California's taxpayers and legislators are doing the right thing digging in their heels and drawing the line at further austerity measures. California is being watched not only by the nation but by the world. We the people did not precipitate this credit crisis; the banks did. We should not have to pay for the damage with increased taxes *or* decreased services *or* our public parks and parking meters. Like the American colonists, we can replace the old model with something better. If California legislators act quickly, they can have a State-owned bank up and running before their 45-day IOUs run out. With today's new online banking possibilities, the State would not even need to invest in a "brick and mortar" building. The whole business could be done by computer. Weary legislators trying to agree on a budget could all shake hands and go home, without budging an inch from their respective platforms. They could have it all, and so could we the people.

Ellen Brown developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her earlier books focused on the pharmaceutical cartel that gets its power from "the money trust." Her eleven books include Forbidden Medicine, Nature's Pharmacy (co-authored with Dr. Lynne Walker), and The Key to Ultimate Health (co-authored with Dr. Richard Hansen). Her websites are www.webofdebt.com and www.ellenbrown.com.