THE ECONOMICS OF IDLE PUBLIC FUNDS POLICIES: A RECONSIDERATION: A REPLY

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IN an earlier issue of this *Journal*, it was suggested that for state and local governments to maximize returns from their idle funds it *might* be necessary that they accept from local financial institutions a direct yield lower than that paid by acceptable alternative investments which cause the funds to leave their areas of origin.[1] In essence the argument was as follows: If a state uses its idle funds to purchase investments on the open market there would result a net loss of reserves by the state's banking system. A net loss of reserves would tend to have a restrictive effect on both the banks' willingness and ability to extend local credit, viz., loans, the result of which would be a reduction in local spending. Since state tax receipts are closely related to the level of economic activity, investment policies which adversely affect local spending could cause the effective return on the idle funds to be less than if the state had accepted the lower direct rate paid by local financial institutions.[2] Therefore, if the state desires to obtain a maximum yield from its idle funds, it should contrast the aggregate yield rather than the immediate, direct yield with that earned from open market alternatives.

In a recent issue of this *Journal*, Professor S. Kerry Cooper has questioned the validity of the assumptions upon which the above argument rests.[3] If Cooper's criticisms were correct, the validity of our conclusions would be impaired.[4] However, it will be contended that these criticisms are based upon assumptions which lead to incorrect conclusions.

1. The first criticism deals with the assertion that there is no net gain in funds (reserves) for the state's banking system when tax payments, made with the private sector's demand deposits, are redeposited as time deposits by a state treasurer. Therefore, a net increase in costs for the banking system occurs. While Cooper agrees that there would be no net increase in bank reserves, he correctly points out that an increase in the net costs of funds is predicated on the assumption that a sizable proportion of the funds will be retained as demand deposits if left in the hands of the private sector. Cooper apparently believes that the portion of the public tax payments made from time deposits would be sufficient to eliminate any significant cost increase for banks.

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[1]L. Wayne Dobson, "A Note on the Alternative Uses and Yields of Idle Public Funds," *National Tax Journal*, September 1968, pp. 304-313.

[2]A restatement of the implicit model used in Dobson's article which indicates the types of parameters that should be estimated to provide the essential information for a rational decision was made by Jerry Hollenhorst, "Alternative Uses and Yields of Idle Public Funds: Comment," *National Tax Journal*, December 1969, pp. 557-558.

[3]S. Kerry Cooper, "The Economics of Idle Public Funds Policies: A Reconsideration," *National Tax Journal*, March 1972, pp. 97-99.

[4]While it may not have been his intention, Professor Cooper implies that Dobson suggests that states *should* keep their funds deposited in local financial institutions in the name of equitable treatment of banks. This seems evident when he states: "Therefore it does not seem that considerations of equitable treatment of banks dictate that state and local governments forego an interest-revenue-maximization policy for idle funds." (p. 98). This implication is incorrect; the objective was to suggest a type of investment policy that would be consistent with other policies and at the same time maximize the yield from idle funds. For some of the techniques available to insure states are getting the maximum direct payments from local banks, see L. Wayne Dobson, "Techniques for Managing Public Funds at Commercial Banks," *Bankers Magazine*, Vol. 152, No. 4 (Autumn 1969), pp. 70-75. Regarding the "equitable" treatment of banks, it was explicitly stated that nonbank depositories should be considered as well as commercial banks. Dobson, *op. cit.*, p. 312.

In reply, two points should be emphasized. First, tax payments are recurrent and required expenditures fully anticipated by the public and should be included in any rational portfolio horizon. Hence they should be considered as a charge against current income and not as an expenditure from planned portfolios or wealth. Second, if left in his hands, one can assume that the taxpayer would have used these funds in essentially the same way he would respond to a tax reduction, i.e., the bulk would be spent for current goods and services. While there would undoubtedly be some increase in private time and savings deposits, most of the funds would be used for purchasing goods and services; in addition, it could not be assumed that banks would acquire all of the savings.

2. Cooper's argument that there might not be a net loss of funds resulting from investments outside of the state is based on the assumption that a large percentage of the funds will flow back into the state. This could occur either because of loans made to local residents by outside institutions or by increased nonresident spending within the state. There is no reason to assume the latter; however, if the funds that a state invests outside its area of origin subsequently flow back into the state, there would be no ultimate loss in funds. Cooper seems to believe this will occur; he states ". . . if the State of Texas were to use inactive State funds to purchase U.S. Treasury securities in the New York Money Market, these purchases would supply reserves to New York banks. If these banks used their increase in primary reserves to extend loans to Texas-based petroleum firms, the funds could come back to Texas." (p. 99) That this type of transaction could occur is unquestionable, that it would occur with such frequency and magnitude to return the funds to their area of origin is unlikely. There is no reason to assume that money market banks will wind up with these funds as primary reserves unless their portfolios are in a disequilibrium position prior to the initial transaction, which is an entirely different issue. Cooper does not accurately describe the mechanics of the bond-dealer function of money market banks.[5] Assume the state purchases securities in the open market, this will initially result in a reduction in the inventories of securities of bond dealers (many of which are nonbanking departments of large banks). This will be only a temporary gain in funds for the accounts of the bond dealers, because they will proceed to bring their inventories back to the desired level. This will be accomplished by purchasing securities from wherever they are offered; it would be reasonable to assume the funds will be broadly dispersed. The recipients of these funds may then purchase other types of assets or spend the funds directly for goods and services. To assume that the state will ultimately receive more than a small percentage of funds does not appear to be reasonable, because this implies that the state has a comparative advantage after the outflow of funds that it did not have previously.

In addition, large money-market banks normally lend to nationally known firms, not the locally-oriented type of enterprise.[6] Any reduction in credit which results from the state withdrawing its idle funds from local financial institutions would tend to be concentrated among those borrowers whose activities have the greatest impact on local spending.

Cooper is essentially correct when he infers that much of the validity of our models would be lost if the banks losing public funds were to simply compensate by continuing to make the same volume of loans. In many instances, this could be done by selling securities, by reducing excess reserves when they exist or by engaging in some form of liability management such as purchasing federal funds. However, if one assumes that banks had the approximate desired asset structure prior to the withdrawal, the loss of reserves would elicit a realignment of the balance sheet items. One

[5]This purchase need not be directly from a bond dealer; the results are essentially the same.

[6]Other considerations which would impede the mobility of funds are statutes and regulatory agencies' attitudes regarding loans made outside trade areas, especially the latter where smaller banks are concerned.

result of this adjustment would undoubtedly be a reduction in lending. Banks would not reduce lending in a one-to-one relationship in the immediate time period because of the way in which they allocate their resources and the need to accommodate their customers, but except in the most transitory manner it is difficult to accept the implication that banks alter their balance sheet items in favor of loans when they are losing funds. It is also the *willingness* of banks to compensate for loss of funds as well as their numerical ability to do so.

3. Finally, Cooper is obviously correct in asserting that we have used a sectored model. However, in our earlier articles we tried to incorporate in our models existing institutional and legal constraints. On a higher level of abstraction, there is no *a priori* reason why the public funds could not flow back to their areas of origin. But given the number of governmental units that exist and the apparent desire for decentralization, it is our belief that this is not a reasonable assumption.[7] In addition, we also question whether there is a sufficient degree of interregional mobility of bank credit to sustain Cooper's assumptions. The important point is that these questions are empirical and answers are not readily available.[8]

[7]For a discussion of the effects of decentralization see, Case M. Sprenkle, "The Uselessness of Transactions Demand Models," *Journal of Finance*, December 1969, pp. 835-848.

[8]It is worth noting that Cooper ignores the possibility that idle funds deposit policy of the state can influence the out-of-state leakage of funds. For example, in Illinois the State Treasurer gives preference in the depositing of idle funds to banks that commit high proportions of their loan portfolios to local or in-state borrowers.