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State-Local Cooperation: The Local Government Investment Pool

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IN RECENT YEARS state and local government officials have increased their cooperation in financial management. Municipal bond banks, in which muncipalities may voluntarily market their debt to quasi-state agencies, have been established in Vermont, Maine, Alaska, and Puerto Rico. North Carolina's Local Government Commission provides an array of financial services to localities, and municipal debt advisory commissions have been created in several States.

A promising innovation in intergovernmental fiscal cooperation is investment of localities' idle reserves by state investment officials. Mechanisms for state investment of municipal funds, initiated by officials in Oregon in late 1974, were subsequently adopted in Wisconsin and Illinois, and in September 1976 became law in California.

These state-local cooperative efforts represent a major advance over other types of cooperation: direct economic benefits may accrue to state government in addition to the indirect benefits of having more fiscally sound local governments. The Wisconsin program, one of two examined here, has already enabled state officials to avert a temporary state cash flow predicament through use of municipalities' surplus funds. Investment of municipalities' reserves may also engender a higher investment return on the State's short-term investments.

OPERATION OF A POOLED INVESTMENT FUND

In February 1976 a bill was enacted in Wisconsin which created two local government investment funds to be managed by the State's investment board: a trust fund and a pooled investment fund.[1] The local government pooled investment fund is a vehicle for short-term investments by localities. It is a completely voluntary arrangement by which counties, cities, towns and villages may deposit with the State Treasurer any state-shared taxes, local revenues, or idle reserves for investment by the investment board. A municipality's funds, while credited to an individual account for accounting purposes, are pooled with other municipalities' funds and with the State's short-term funds.

A municipality's interest earnings are equivalent to the average rate of return, determined quarterly, for all short-term investments of the board.[2] Each locality's earnings are based on its average daily balance as determined by

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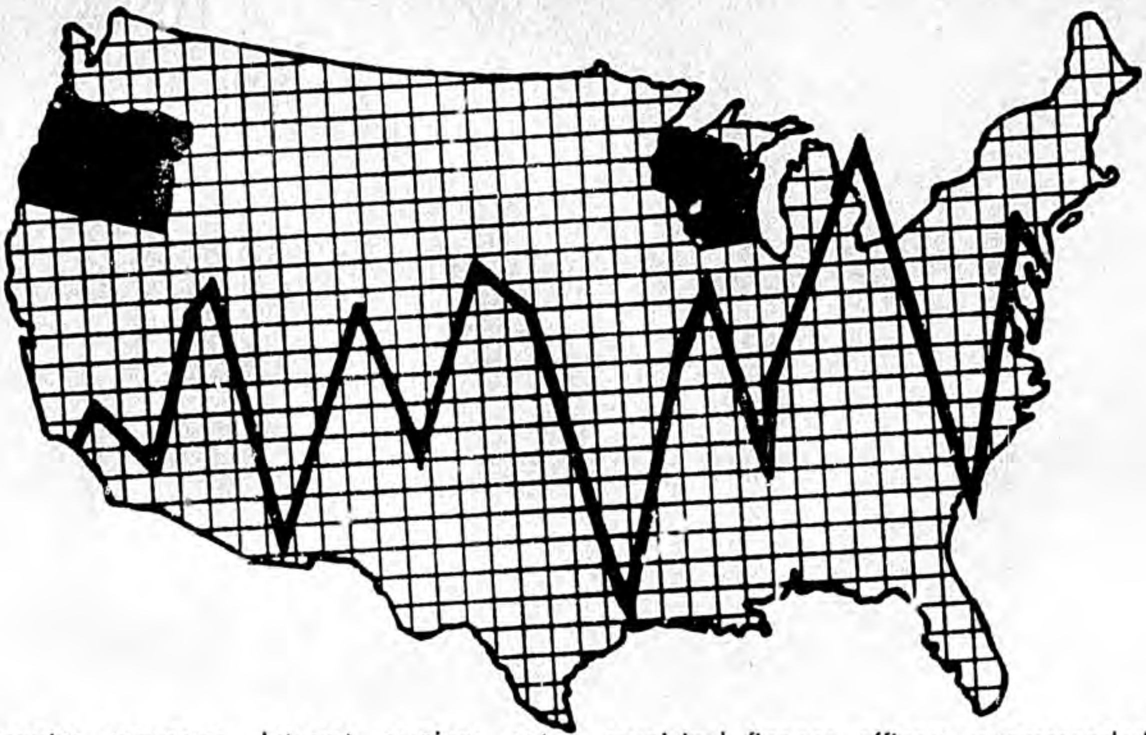

computer programs. Interest earnings not withdrawn are added to each town's original principal for investment during the next quarter.

Operationally, the deposit and withdrawal system is simple. If a local unit of government is depositing money in the pooled fund from its state-shared taxes, that government provides the State Treasurer written instructions as to the amount which the State should retain. If a locality deposits idle cash from its own treasury, the local treasurer asks the local government's commercial bank to transfer funds to the State Treasurer. A municipality's funds are then added to the State's short-term cash balances, and the board is informed daily of the total amount available for short-term investments.

For withdrawals, a similar process is used. If notice of a partial or total withdrawal is made by 10 a.m., the State Treasurer's office will issue a check that same day to the local government. The check will be dated for the next day which allows the government unit to receive interest earnings from the pool for the next day. (If the local government deposits the treasurer's check by 2 p.m. the next day in its local bank, it would receive interest from the bank as well.)

Conceptually, the Oregon local investment pool is similar to Wisconsin's, but differences do exist. In Oregon, only municipal funds are pooled, and a Local Government Investment Board advises the State Treasurer and Investment Council regarding management of the pool. This five-member board includes three municipal finance officers recommended by municipal organizations. Interest earnings are computed monthly instead of quarterly as in Wisconsin. Finally, correspondent banks are involved in transferring funds, all deposits are made by telephone and later confirmed by mail, and withdrawals of amounts in excess of $1 million require one day's notice.

ADVANTAGES TO LOCAL GOVERNMENTS

Because of inadequate financial expertise or insufficient monetary balances, many local governments cannot enter short-term money markets. Often, a locality's funds earn little or no interest as they have been deposited in noninterest-bearing demand accounts in local banks.[3] State management of local funds resolves both problems.

In Wisconsin the investment board invests in high-yielding, short-term investments such as bankers' acceptances, commercial paper, treasury bills, repurchase agreements, and reverse repurchase agreements.[4] Very few communities possess expertise for such activity, and others are prohibited legally: Oregon localities may invest only in collateralized certificates of deposit of Oregon banks, in municipal securities of adjoining States, and in U.S. Treasury and agency debt.

An investment pool allows local governments to contribute uneven, small surpluses, thereby encouraging even the smallest villages to invest. Moreover, because all local governments receive an identical rate of return regardless of whether they invest $2,000 or $200,000 (there is dollar averaging across units), smaller government units achieve a higher interest than if their accounts were invested separately. In addition, investment risks are reduced since each municipality has a share in many different short-term instruments.

The flexibility of pooled investment funds in both Oregon and Wisconsin permits an integration of local governments' investment programs with their cash flow systems. Municipal funds can be withdrawn almost on demand and transfer of funds is rapid; no municipality will be caught in a cash flow emergency because of nonliquid investments. The pooled investment fund, in short, operates as a checking account which pays a high rate of return on low-risk investment instruments.

ADVANTAGES TO STATES

A constant flow of new short-term capital from Wisconsin local governments has enabled investment in those fiscal instruments providing the best current rates of return. While it is very difficult to calculate the precise impact of these better investments on the overall rate returned on the State's short-term investments, these yields normally will be superior. Furthermore, economies of scale in short-term investment costs may be realized: larger purchases and proportionately lower dealer fees.

Establishment of a local government pooled fund proved enormously beneficial in another respect. A temporary provision, which will expire 30 days after the enactment of the 1977-79 biennial budget, provided Wisconsin state officials the authority to use, with localities' permission, local government funds to alleviate a short-term cash flow problem. This temporary cash flow difficulty resulted from large payments to local governments which were legally mandated and not from problems in normal operation expenditures. Nineteen local units of government left $61.5 million of their state-shared taxes in the pooled fund for 10 days and received a 7.44 percent average annual rate of return. In other States which prohibit interfund transfers and borrowing for current obligations (Wisconsin is limited to $100,000), temporary use of localities' funds in a pooled investment fund might prove beneficial as well—provided (1) local governments voluntarily loan money, and (2) corrective action is initiated to integrate cash flow considerations with policy decisions through better scheduling of state expenditures, especially state aid to municipalities.

In States such as Oregon, in which municipalities' funds are not commingled with short-term state investments and which have not utilized the pooled fund for a cash flow emergency, benefits are more indirect. Increasing the financial stability and wealth of local governments and furthering trust among state and local officials are long-term endeavors. Nevertheless, these benefits should not be discounted because when municipal fiscal problems become acute, state governments may become involved.

RESULTS

The primary indication of success for any voluntary program is participation. During the first year of the pool's operation in Oregon, local governments maintained an average of approximately $100 million in the fund. By November 1975, this amount ballooned to nearly $350 million, and the pool's minimum balance during 1976 was $230 million. Oregon treasury officials projected a balance of approximately $450 million by January 1977. Two hundred separate local government units, including 50 cities, 26 counties, and 86 school districts, are participating.

In Wisconsin, the pooled investment fund became effective on March 1, 1976. By December, localities had contributed approximately $56 million of their funds. Sixty-one local units of government maintained accounts.

Participation in local government pooled funds can be attributed to two causes: improved liquidity, and a superior rate of return over returns from commercial institutions. Local governments in Wisconsin earned 7.44 percent during March and 6.57 percent during April, May, and June. During the period April to June, local governments in the pool earned at least 23 percent more than they could have received from commercial institutions. During the July 1-September 1 quarter, the rate of return was even more remarkable: 7.89 percent. This outstanding return is expected to evoke a major increase in both the amount of municipal assets and the number of municipalities participating in the pool.

The Oregon local pool returned 6.28 percent during the first three months of 1976 and 6.18 percent during the second quarter. This was 20 percent more than commercial institutions were providing in short-term investments. Oregon officials have calculated that for the first eight months of 1976, local governments earned \$2.2 million more by participation in the pool than if normal commercial institutions had been utilized. Direct deposit in the pool account of certain taxes (highway tax, and liquor and cigarette taxes) which are collected by the State but shared with municipalities adds four days' worth of interest by quicker investment. This direct deposit feature alone has provided localities over \$100,000 more in revenues during the first year's operation.

Superior interest earnings are due to higher-yielding short-term investments and minimal costs. In Wisconsin, local governments incur only miniscule costs in transferring funds to the State Treasurer. As stipulated in the legislation, the investment board may deduct a maximum of one quarter of one percent of earned interest for administrative expenses. Officials anticipate actual administrative expenses will be significantly less since no additional personnel were hired. In Oregon the management fees have recently been reduced from 1 percent to one half of 1 percent of earnings. Therefore, if the gross interest earned is 6 percent, localities receive 5.97 percent (.06-.003 which is the product of .06x.005).

IMPLICATIONS

The pooled investment fund benefits both state and local treasuries in Wisconsin. In Oregon there are immediate economic benefits to localities while long-term benefits accrue to the State. Administratively, the pool possesses two attributes: personnel additions may be unnecessary and results are easily evaluated. Therefore, if the program proves unsuccessful, it can be rapidly terminated.

Not all state governments may desire to provide these additional financial services. Given an appropriate investment framework and expertise in short-term investments, however, the pooled investment fund has been a mutually beneficial intergovernmental program. A program which generates additional revenues for state and local governments without extracting these resources from taxpayers cannot be easily dismissed.

Creation and operation of a pooled investment fund suggest two additional conclusions. First, government investment procedures are definitely amenable to improvement by analysis of private sector investment strategies. Some government activities have no counterparts in private industry, and attempts to install private sector procedures prove counterproductive. Not so with money management.

There are other implications arising from pooled investment funds. Some government activities can be accomplished better at particular levels of government because specialization or economies of scale are available at those levels. The pooled investment fund is one such example. It is significant also because a realignment of functions and duties among American governmental levels might prove most successful if undertaken on a voluntary basis.

When state and local officials seek improvements in government programs, they must not overlook the possibility of their being achieved more effectively on another level. Intergovernmental fiscal cooperation is well under way. State and local cooperation in other fields should prove equally fruitful.

Footnotes

1. The trust fund, conceived primarily for long-term investments, permits localities to establish their own investment accounts and have their funds placed in designated investments for specific periods of time by the investment board. This fund will not be discussed because guidelines have not yet been set by the board.

2. Municipalities also receive interest on state funds; a daily check float averaging about \$3.5 million is invested by the board and investment earning are distributed to all participants in the short-term investment fund.

3. Officials in Wisconsin's Department of Administration discovered that 81 cities and 67 percent of the State's town and village governments received no interest income in calendar year 1974. Oregon officials, in a very rough estimate of uninvested idle funds, thought there may have been nearly \$100 million sitting idle prior to inception of the pool.

4. Oregon officials have placed some of the pool's funds in negotiable certificates of deposit and corporate bonds. The Wisconsin Investment Board has not. Neither invests funds of their pools in common stocks.