Individuals and business firms in the United States have a significant amount of latitude in selecting financial institutions that will meet their needs for depository services. The choice may be made from any of the more than 14,000 commercial banks located in the 50 states, although in practice, most small account owners limit themselves to locally available alternatives. In addition, depository services are provided by approximately 5,000 savings and loan associations, more than 475 mutual savings banks, and more than 22,000 credit unions. While certain economic factors—such as transactions cost and travel time needed to conduct business—and non-economic considerations—such as convenience of location—tend to influence the private sector's selection of alternative financial institutions, there are few legal barriers that have a direct impact upon the depository selection process. The one important legal barrier that limits the choice is that nonbank financial institutions are prohibited in most states from offering demand deposit services.

On the other hand, state and local governments, in selecting institutions that will meet their needs for depository services, are subject to specific statutory and constitutional restrictions tending to limit their alternatives, usually as to type and location of institution. As such, laws that influence the allocation of public funds between and among various banks and other types of financial institutions have a definite impact upon the structure of banking. This article examines the legal framework influencing the allocation of state and local deposits and analyzes the impact of these laws upon the banking structure of the five Seventh District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin.

State and local deposit importance

In both absolute and relative terms deposits of state and local governments are becoming increasingly important items on the balance sheets of the nation's commercial banks.

In a 1961 study the Advisory Commission on Intergovernmental Relations noted that as of June 1959, "Of the approximately $14.2 billion on deposit by state and local governments $3.7 billion was on time deposit and $10.4 billion on demand deposit."1 By June 30, 1975 total deposits of state and local governments in commercial banks had grown to approximately $67.0 billion, of which $48.5 billion was in the form of time deposits and $18.5 billion was in the form of demand deposits.2 The data reveal that during the past 16 years (June 1959-June 1975) total state and local deposits held by commercial banks have grown at a compounded annual rate of approximately 10.2 percent, while individual, partnership, and corporate (IPC) deposits (i.e., private sector deposits) grew at only a 7 percent compounded annual rate. Of equal significance is the reversal of the composition of those deposits. Whereas in 1959 demand deposits constituted the major portion of total state and local deposits (approximately 73.3 percent), as of June 30, 1975 time deposits accounted for the major portion of total state and local deposits (approximately 72.4 percent). During the 16-year period state and local government demand deposits have

grown at a compounded annual rate of only approximately 3.6 percent, whereas, time deposits of state and local governments over the same period have grown at a compounded annual rate of approximately 17.5 percent, a 13-fold increase.

Figure 1 illustrates the growth and changing composition of state and local deposits over the 16-year period 1959-75. The change from demand to time deposits reflects the growing concern on the part of state and local governments to invest their idle cash balances so as to maximize earnings on public funds, a concern heightened by the increase in average interest rate levels over this period.

Further insight into the growing importance of state and local government deposits is revealed in the analysis of the overall composition of commercial bank deposits. In June 1959 state and local government deposits accounted for 6.8 percent of total deposits in insured commercial banks. By June 1975 state and local deposits constituted 8.8 percent of total deposits in all commercial banks.

Except for “small banks” (deposits less than $1 million) state and local deposits have become an increasingly important source of funds for banks of all sizes. As shown in Table 1, state and local deposits as of June 1959 amounted to over 11 percent of the total deposits in “small banks” but accounted for only 4 percent of total deposits held in the nation’s largest banks, i.e., those with deposits of $1 billion or more. Since 1959 state and local deposits have become less important deposit sources at “small banks” and increasingly important sources of deposits for “large banks.” In 1959 only one bank group (those with less than $1 million in deposits) had state and local deposits that constituted 10 percent or more of their total deposits. In 1975 two groups of banks held state and local deposits that represented about 10 percent of their total deposits, and in one group state and local deposits accounted for over 11 percent of the total deposits. Thus, state and local government deposits are becoming a more significant item on the balance sheets of commercial banks.

There are 16,092 local governments in the Seventh Federal Reserve District, including county, municipal, and township governments, and school and special districts. This represents about 20.6 percent of all local

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**Figure 1. State and local deposits held by all commercial banks in the United States**

![Graph showing the growth of state and local deposits held by all commercial banks in the United States from 1958 to 1975.](image)

SOURCE: Assets and Liabilities of Commercial and Mutual Savings Banks, FDIC, various years.
Governments in the United States. Illinois, with 6,385, leads the Seventh District and the nation in the number of local governments. Indiana, Michigan, Wisconsin, and Iowa have, respectively, 2,792, 2,649, 2,448, and 1,818 local governments. As of June 30, 1975 state and local deposits held by all insured commercial banks within the Seventh District states aggregated approximately $12 billion. As such, state and local deposits represent approximately 9.3 percent (see Table 2) of all deposits held by insured commercial banks within these states, slightly above the national average of 8.8 percent.

Of the $12 billion of state and local deposits held by commercial banks in the five states, 74.3 percent was held in time accounts and 25.7 percent was held in demand accounts. Relative to the nation as a whole, these figures indicate that, in the aggregate, state and local governments in the district states tend to hold a slightly larger proportion of their total deposits in the form of time or savings accounts (the national average is 72.4 percent). Table 2 further reveals a considerable degree of variance in the importance of state and local deposits as a source of funds to commercial banks in the five states. For example, state and local deposits constitute only about 6.7 percent of total deposits held by insured commercial banks in Iowa but 13.4 percent of total bank deposits held by Indiana commercial banks. Also, Indiana, relative to the four other states, holds the lowest percentage of state and local deposits in the form of time and savings deposits (60.3 percent). State and local governments in Michigan, on the other hand, maintain about 79.4 percent of their total deposits in time and savings accounts.

**Major concerns**

Governmental bodies, just like businesses and private individuals, are faced with the problems of investing their idle funds. For state and local governments “idle funds” are created by the lack of synchronization between the receipt of revenues and the outflow of cash expenditures. Since state and

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**Table 1**

<table>
<thead>
<tr>
<th>Deposit size of banks</th>
<th>(1) Total deposits (millions)</th>
<th>(2) Total state and local deposits (millions)</th>
<th>(2) - (1) (percent)</th>
<th>(3) Total deposits (millions)</th>
<th>(4) Total state and local deposits (millions)</th>
<th>(5) - (4) (percent)</th>
<th>(6) Relative change 1959-1975 (5) - (3) (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $1 million</td>
<td>897.5</td>
<td>117.7</td>
<td>14.6</td>
<td>866.6</td>
<td>6.3</td>
<td>7.3</td>
<td>+ 0.3</td>
</tr>
<tr>
<td>$1 to 10 million</td>
<td>3,992.3</td>
<td>3,312.8</td>
<td>9.7</td>
<td>31,954.5</td>
<td>3,199.7</td>
<td>10.0</td>
<td>+ 0.3</td>
</tr>
<tr>
<td>$10 to 100 million</td>
<td>53,425.6</td>
<td>4,283.4</td>
<td>8.0</td>
<td>215,510.8</td>
<td>22,169.4</td>
<td>10.3</td>
<td>+ 2.3</td>
</tr>
<tr>
<td>$100 to 1 billion</td>
<td>63,650.9</td>
<td>4,297.5</td>
<td>6.8</td>
<td>212,500.5</td>
<td>23,747.5</td>
<td>11.2</td>
<td>+ 4.4</td>
</tr>
<tr>
<td>$1 billion or more</td>
<td>54,634.3</td>
<td>2,142.2</td>
<td>3.9</td>
<td>297,624.8</td>
<td>17,771.1</td>
<td>6.0</td>
<td>+ 2.1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$206,705.7</strong></td>
<td><strong>$14,154.1</strong></td>
<td><strong>6.8</strong></td>
<td><strong>$757,718.2</strong></td>
<td><strong>$66,894.1</strong></td>
<td><strong>8.8</strong></td>
<td><strong>+ 2.0</strong></td>
</tr>
</tbody>
</table>

Note: Data for 1959 is for insured banks, whereas data for 1975 is for all banks. Numbers may not add due to rounding.

local government revenues are not received in sufficient amounts on the day they are required to meet an expenditure, funds must be accumulated prior to actual expenditure or the governmental unit must be able to borrow needed funds. Most state and local governments have little if any excess idle cash at the start of their fiscal years. However, idle cash may begin to accumulate later as revenues begin to exceed expenses. At this point the governmental body must decide how to invest these funds. Traditionally, public finance doctrine has specified that consideration be given to four factors: legality, safety, liquidity, and yield. Some governments have added a fifth factor to this list: the promotion of particular social goals.

- **Legality.** State constitutions and statutes frequently specify the types of institutions and financial instruments in which public funds may, or may not, be employed. For example, the Michigan Constitution precludes savings and loan associations from acting as depositories for state funds. Thus, public officers must be aware of the legal limitations involved when they invest public funds.

- **Safety.** Speculation with public funds is prohibited by law, and state statutes frequently specify that only the safest and most secure types of investments be permitted. For example, the Indiana courts have noted that a public depository law was adopted primarily for the security and protection of public funds against the “devious methods and rascality of dishonest public officials.”

- **Liquidity.** Money must be available when needed. If public funds are invested in long-term obligations, which are not readily marketable and which fluctuate greatly in value, a public body faced with a decline in revenue may be forced to borrow funds at an unfavorable rate.

- **Yield.** After complying with legal requirements, providing for safety and ensuring liquidity, investments that will produce a maximum yield may be considered.Obviously,

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**Table 2**

Deposit composition of insured district banks as of June 30, 1975

<table>
<thead>
<tr>
<th></th>
<th>Illinois (billion dollars)</th>
<th>Indiana (billion dollars)</th>
<th>Iowa (billion dollars)</th>
<th>Michigan (billion dollars)</th>
<th>Wisconsin (billion dollars)</th>
<th>Total (billion dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total demand deposits</td>
<td>20.218</td>
<td>5.924</td>
<td>3.794</td>
<td>9.113</td>
<td>4.592</td>
<td>43.641</td>
</tr>
<tr>
<td>Total time deposits</td>
<td>37.902</td>
<td>10.972</td>
<td>7.129</td>
<td>19.905</td>
<td>9.834</td>
<td>57.720</td>
</tr>
<tr>
<td>Total deposits</td>
<td>57.720</td>
<td>16.896</td>
<td>10.923</td>
<td>29.018</td>
<td>14.428</td>
<td>128.983</td>
</tr>
<tr>
<td>Demand deposits of state and local governments</td>
<td>1.022</td>
<td>.895</td>
<td>.241</td>
<td>.646</td>
<td>.264</td>
<td>3.088</td>
</tr>
<tr>
<td>Time deposits of state and local governments</td>
<td>3.565</td>
<td>1.361</td>
<td>.494</td>
<td>2.491</td>
<td>.852</td>
<td>8.053</td>
</tr>
<tr>
<td>Total state and local deposits</td>
<td>4.577</td>
<td>2.256</td>
<td>.735</td>
<td>3.137</td>
<td>1.526</td>
<td>11.981</td>
</tr>
<tr>
<td>State and local deposits as a percent of total deposits</td>
<td>3.53</td>
<td>13.16</td>
<td>6.73</td>
<td>10.81</td>
<td>8.73</td>
<td>5.27</td>
</tr>
</tbody>
</table>

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ly, after complying with the first three constraints, the scope of investment options available with regard to type of financial institution and type of financial instrument is somewhat limited. For small governmental bodies with small amounts of funds to invest, the alternatives frequently narrow down to time deposits at commercial banks and short-term U.S. Treasury obligations.

• Social goals. Certain state and local governments may and do invest their funds in order to achieve or promote certain social goals. For example, some governments may desire (or be required by law) to invest and deposit idle funds only with banks located in-state, in-county, or in-city with the intention of fostering local development and economic growth. The rationale is that state and local government funds will be used by local banks to promote local investment, which will generate more local income and employment and thus tax revenues. Whether this developmental objective will be achieved depends on the use banks make of these funds (i.e., whether or not they are locally invested) and the size of the income multiplier associated with locally used funds.

Primary factor influencing allocation

Every state and local government has differing investment objectives; some are faced with staffing restrictions and others have
differing management philosophies, all of which have an impact upon the allocation of state and local deposits. However, state and local laws comprise the primary factor that influences the allocation of state and local deposits. In every state a body of laws has evolved that determines the types, location, and size of institutions as well as types of instruments in which public funds may be invested. For the most part these laws emphasize safety. Public officials charged with handling public funds determine the specific allocation based upon the legal guidelines, of which their power, however, is
a residual. For example, if the law specifies that public funds may be deposited only in commercial banks within the state, then public officials may select one or a number of banks to hold the deposits, based upon safety, liquidity, and yield. Assuming that all available choices offered equal safety and liquidity, the bank paying the highest yield would be chosen as the depository. Clearly, the more specific the legal guidelines, the smaller will be the residual prerogatives and discretion allowed public officials.

The laws that influence the allocation of public funds vary greatly from state to state and within the states. For example, Illinois, for example, is the only Seventh District state that employs a true bidding system by which to allocate state funds. Indiana, on the other hand, does not use a bidding system to allocate state funds; rather, the law calls for the proportional allocation of state funds among those banks which apply to be public depositories. In Michigan the Con-
Chapter 453 of the Iowa Statutes sets forth the major provisions concerning the deposit of the state's public funds. In Iowa there is no bidding system per se that determines the allocation of state funds. In general, all deposits made by the treasurer of state, who may nominate banks to act as depositories, must be in banks in Iowa. For both the state and its political subdivisions, funds not needed for current operating expenses may be invested in U.S. Government or agency guaranteed obligations, or time or savings deposits in approved commercial banks and insured savings and loan associations. When state funds are deposited, they must be at the rate established on a monthly basis by a committee composed of the state's superintendent of banking, commissioner of insurance, and treasurer of state. The law does not explicitly limit the amount of state funds that may be placed in one bank or on deposit in one bank. However, the law does limit the deposit of state funds to banks organized under state or national banking laws. Savings and loan associations may not act as depositories for state funds.

As in the case of the state, banks must be approved by the appropriate governing authority before they can act as depositories for Iowa's political subdivisions. The approving board is required to specify the name of each bank approved and the maximum amount that may be placed on deposit in each bank. County funds must be placed in banks located in the respective or adjoining counties, city funds in banks located in the city, but if no bank is in the city, then any other bank located in the state may act as a depository. The interest rates paid for deposits are determined by the public officials of the political subdivisions, but the law does not limit the interest rates.

Illinois held total IPC deposits of approximately $8 billion, which represented 16.3 percent of the total IPC deposits held by all commercial banks in Illinois, but its $395 million in state and local deposits represented only 8.6 percent of such deposits held by all commercial banks in Illinois. In two of the five states (Iowa and Wisconsin), the five largest commercial banks hold a significantly larger proportion of state and local deposits than they do IPC deposits. In Wisconsin, for example, the five largest commercial banks, which control approximately 16.8 percent of total IPC deposits, control 35.4 percent of total state and local deposits. Clearly, this is the result of the interaction between the law allowing for the establishment of a working bank and the Wisconsin Investment Board's selection (after bidding) of the largest commercial bank to act as the sole working bank.

In Indiana the law calling for the proportional allocation of state and county funds among designated public depositories is reflected in the relative shares of public and private deposits held by the five largest commercial banks. The largest commercial bank in Indiana holds approximately 7.3 percent of

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Michigan depository laws

Michigan is unique, being the only state in the Seventh Federal Reserve District that has a constitutional provision concerning the deposit of public funds. Article 9 of the Michigan Constitution specifies that state funds may not be deposited in any banks other than those established under national and state banking laws. This precludes their deposit in savings and loan associations. Further, the Constitution specifies that deposits of state money cannot exceed 50 percent of the capital and surplus of the depository.

No bidding system for state funds has been established in Michigan. The law merely indicates that state depositories must pay a rate of interest which the state treasurer “shall deem best for the interest of the state.” Furthermore, the state treasurer is required to obtain “good and ample security” before a bank can become a depository of state surplus funds. No collateral is required for public monies which are insured by the FDIC. Under current FDIC regulations, total IPC deposits and 7.2 percent of total state and local deposits. In the aggregate Indiana’s five largest commercial banks hold about 22 percent of total IPC deposits and about 24 percent of total state and local government deposits, which tends to indicate that the goal of proportional allocation is being achieved.

In Illinois and Michigan the five largest banks in each state tend to hold less than a proportional amount of state and local deposits relative to their holdings of IPC deposits. In Illinois the five largest commercial banks hold approximately 39 percent of total IPC deposits in the state and approximately 26.5 percent of state and local government deposits. Two features in Illinois law tend to explain this less-than-proportional relationship between private and public deposits. First, the five largest banks are precluded from competing for state funds allocated under the Basic Deposit Program. Secondly, the “linked-deposit” allocation schemes used by the state tend to favor small- or medium-sized banks, which have or will make specific state-approved loans. The larger banks tend to be “money center” banks which derive a significant share of their deposits and make a significant share of their loans on a national or regional basis.

With respect to Michigan, the reason for the less-than-proportional allocation between private and public funds is less clear than it is for Illinois. Part of the explanation may lie in the state’s ability and preference for using commercial paper as a short-term investment vehicle relative to certificates of deposit and time accounts. The state, on average, tends to invest about 60 percent of its short-term funds in commercial paper. The requirement that counties keep their funds in county banks might further prevent the flow of public funds to the five largest banks, which are located in but two counties.

Conclusion

The laws that affect the allocation of state and local government deposits within the Seventh District tend to limit the flexibility of the state and local officials who are responsible for the management of public funds and may necessitate a trade-off between various
Wisconsin depository laws

Relative to the other Seventh District states, Wisconsin is unique in that it has a seven-member board responsible for the allocation of state funds. Known as the Investment Board, it is required to designate public depositories for the deposit of public moneys coming into the hands of the state treasurer, allocate the deposits of all public moneys coming into the hands of the state treasurer, and limit the amount of such public moneys which may be deposited in any public depository so designated. Local government idle funds may also be managed by the Investment Board. Any national, state, or mutual savings bank in the state can act as a public depository. Recently, the law was amended to allow savings and loan associations to act as depositories of public funds. The Investment Board is responsible for fixing the rates of interest paid on deposits of the state treasurer. There is no statutory limit on the amount of state funds which may be deposited with any one bank. With respect to state funds the depositories selected must be located in Wisconsin.

Under Wisconsin law the Investment Board has the authority to establish "working banks" which hold state deposits ("active deposits") on which checks are drawn to conduct the daily affairs of the state. This system is similar to the active bank concept used by Illinois counties. The working bank is primarily responsible for providing the state with its necessary banking services. This system is similar to the active bank concept used by Illinois counties. The working bank is primarily responsible for providing the state with its necessary banking services. The establishment of more than one working bank is permitted. The Investment Board concluded that the efficiencies and potential for higher earnings surrounding the use of one bank outweigh using a number of banks. The working bank is selected on the basis of bids submitted by Wisconsin banks. Due to the amount of work involved in handling the state account and the amount of deposit variability (which may vary from $2 million to $100 million on any given day) only a well-staffed and highly computerized bank is able to handle the account.

Chapter 34 of the Wisconsin Statutes states that public depositories are not required to give collateral for public deposits. As in the cases of Indiana and Iowa, Wisconsin has an established state deposit guarantee fund to insure public deposits, thus eliminating the requirement that banks pledge collateral for public deposits.

For the most part the requirements of designating and allocating funds of political subdivisions are the same as for the state. One difference is that the designation of public depositories is the responsibility of the governing board of each subdivision—the governing board for counties being the county board, for cities the city council, for villages the village board, and for towns the town board. As in the case of the state, no security is required for subdivision funds. No geographic restrictions are placed on public depositories for subdivision funds other than that the banks designated must be located within the subdivision.

The results of this study reveal that states which tend to stress efficiency in managing state and local funds to achieve maximum returns on invested funds (e.g., Wisconsin) may have to forego certain social goals which may be achieved by allocating idle funds, such as promoting in-state (or in-county) development and statewide bank participation in the use of public funds. If the governmental body decides to select the goal of maximizing its return on the investment of public funds, then the costs and benefits will be easily measurable in dollar terms. However, if the selected goal involves the achievement of social goals (e.g., promoting development), then the costs and benefits may be more nebulous and harder to define given the fungible nature of money. Since money is a free-flowing object of trade which ignores political boundaries, attempts to use state and local deposits to promote social goals and objectives may be of little avail.

David R. Allardice