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In December 2020, The Pew Charitable Trusts was invited to discuss county-level reserve funds by Rogers County, Oklahoma's Treasurer Jason Carini. Below, please find our notes in response to Treasurer Carini's request for input on proposed legislation to lift the state restriction on county reserve funds.

For state and local governments, reserve funds are often the first and best line of defense against extraordinary fiscal challenges stemming from recessions, natural disasters, etc. At a time when many states and localities are facing budget shortfalls as a result of the COVID-19 pandemic, reserves have proven critical for filling in lost revenue and meeting rising public health needs.

Based on conversations with the Government Finance Officers Association (GFOA) and Municipal Market Analytics (MMA), we believe that it is unusual for states to prohibit counties from creating their own rainy day fund. In New York, for example, counties are able to create capital reserve funds and contingency and tax stabilization reserve funds (although restrictions are placed on New York City). Utah allows counties to create a reserve fund for capital improvements and a tax stability and trust fund. Vermont allows counties to create an operations reserve fund and capital reserve fund.

Moreover, Oklahoma counties may be susceptible to larger revenue declines during economic downturns than the average U.S. county. They have a much greater reliance on sales tax revenue than many other local governments, which is more volatile than revenue from property tax and has been one of the revenue streams most impacted by the pandemic shutdowns. According to 2017 U.S. Census data, counties in Oklahoma rely on general sales taxes for 42 percent of their total tax revenue. Nationwide, only 17 percent of county revenue comes from general sales tax.

In the proposed legislation, Section 2A sets guidelines for deposits into the fund and the size of the fund, while Section 2B stipulates how the money can be used. Pew's research on best practices for rainy day funds informs all three components: optimal size, deposit rules, and withdrawal rules. In summary:

- The size of a rainy day fund should be based on evidence about the volatility of the county's revenue. The legislation would not restrict counties from setting such targets.
- Oklahoma's new reserve fund, passed in 2016, is an excellent example that counties can follow of how deposit rules can help ensure that saving money is a budgeting priority. Using only surplus funds as the main deposit mechanism is unlikely to ensure robust reserves.
- The legislation clearly recognizes the importance of setting guidelines for when savings can be withdrawn, but the specific restrictions may need to be reviewed to ensure that the savings can be accessed when needed most.

While including specific parameters can ensure a well-designed reserve fund, the state can consider giving counties more flexibility. This would allow each locality to structure their reserve fund in a way that makes the most sense for them.

Optimal Size

The optimal – or target – size of a rainy day fund should be based on evidence. Policymakers should study how revenues react to the ups and downs of the business cycle so they can align their savings target to their historical experience with volatility. As with most budgeting choices, there are trade-offs associated with putting money aside in reserves. An oversized fund locks away money that could be used for other purposes. But if too little is saved, policymakers may not have enough to offset typical downturns in the economy. A volatility study helps policymakers use evidence to balance these tradeoffs. A data-driven approach should also prompt policymakers to revisit targets on a regular basis as volatility may change over time.

A common practice is to set a cap, or limit, on the total balance of a rainy day fund that reflects an evidence-based savings target. The current bill language stipulates a cap of not more than 50 percent of the previous year's approved budget. This would provide sufficient flexibility for each county to conduct a volatility study to determine its fund's optimal size. As mentioned above Oklahoma counties are more dependent on sales tax revenue than the average U.S. county. Given that the sales tax is more volatile than property tax, counties should examine their unique revenue fluctuations to determine how much they may need in reserves.

Deposit Rules

The bill currently identifies surplus funds as the main deposit mechanism–"The rainy day fund shall be funded with surplus funds or monies receipted over and above the itemized estimate of needs for the general fund." One potential problem that Pew's research has identified with tying deposits to surplus is that because surpluses are determined after budgets are adopted, these contributions often then become the lowest priority in the budget process.

The bill also states that if a county has "excess funds," they may be deposited into the rainy day fund. This provision may give counties the freedom to set a more specific deposit rule that is tailored to their revenue volatility.

Pew's research has found that tying rainy day fund deposits to extraordinary or unexpected revenue increases ensures a consistent savings practice and that one-time funds are not used for recurring expenses. This can also help governments save more in high-growth years and less in leaner years. In 2016, the Oklahoma Legislature passed House Bill 2763, which established a new reserve fund that collects any above-average oil and gas production and corporate income tax revenue, and uses it to help balance budgets in years where the state ends with a budget deficit. This gave the state a new way to help mitigate revenue volatility from these sources. With a volatility study, Oklahoma counties can determine whether this practice is appropriate for their revenue structure and in which situations revenue volatility could prompt them to move money into savings.

Withdrawal Rules

Section 2B of the legislation specifies that counties can only use up to one-half of their reserve fund for expenses related to natural disasters declared by the Governor, Board of County Commissioners, or the federal government, up to one-eighth to supplement the county general budget when it is lower than the previous year's budget, and up to one-eighth to supplement current year revenue when collections come in shorter than estimated and revenue failure is declared.

To avoid setting guidelines that may be overly restrictive, Pew recommends that policymakers carefully consider the purpose of the reserve fund and align any withdrawal conditions to that purpose. Currently, the bill sets parameters around when reserves can be used and how much can be used. For the goal of budget stabilization, Pew recommends that the timing of withdrawals be based on revenue or economic volatility, allowing withdrawals at low points in the business cycle and preventing inappropriate use when the economy and revenues are healthy. This type of withdrawal condition allows lawmakers to use their reserves to smooth the ups and downs of the economy and minimize painful budget decisions that affect services and residents.

The approach to tie withdrawals to economic or revenue volatility is different from conditions that are based on changes in the budget or forecast error as the bill lays out. The current bill language may afford more flexibility. However, if the purpose of the rainy day fund is to counteract the business cycle, it should not be used to alleviate budget pressures that are not caused by cyclical revenue declines, such as forecast error, long-term demographic changes, or tax policy actions.

Policymakers should also be careful when setting a limit for the amount of reserves counties can use at one time. Only allowing one-eighth of the fund to be withdrawn for budget stabilization purposes may fall short of what a county needs when responding to extraordinary circumstances like the COVID-19 pandemic. Like determining a savings target, data on past revenue fluctuations could give lawmakers a better sense of how county budgets react to adverse events and the level of reserves that would effectively mitigate those impacts.

We hope you will consider Pew a resource as you continue to work on establishing county-level rainy day funds in Oklahoma. If you have any questions, please do not hesitate to email Angela Oh, senior manager (aoh@pewtrusts.org).