COUNTY AND MUNICIPAL GOVERNMENT IN NORTH CAROLINA

ARTICLE 15

Budget Preparation and Enactment

by A. John Vogt and William C. Rivenbark

ISBN 978-1-56011-512-0. This article was last updated in 2006.

NORTH CAROLINA COUNTIES and cities are required to budget and spend money in accordance with the Local Government Budget and Fiscal Control Act (LGBFCA) (G.S. Ch. 159, Art. 3). Revenues and expenditures for the provision of general services are authorized in the annual budget ordinance (G.S. 159-13). Revenues and expenditures for capital projects or for projects financed with grant proceeds are authorized in the annual budget ordinance or in a project ordinance (G. S. 159-13.1). Revenues and expenditures accounted for in an internal service fund are authorized in the annual budget ordinance or in a financial plan (G.S. 159-13.2).

The fiscal control portions of the LGBFCA require North Carolina counties and cities to maintain their accounting systems in accordance with generally accepted accounting principles (GAAP) as well as the rules and regulations of the Local Government Commission (LGC). The LGC is an agency in the Department of State Treasurer that approves and sells local government debt and monitors financial and accounting practices in North Carolina local government.

This article describes the requirements of the LGBFCA that govern budget preparation and enactment in counties and cities. It also presents common budget approaches and techniques used in North Carolina local government for budget preparation, presentation, and adoption.

Definitions and Purposes of the Budget

The LGBFCA defines the annual budget as “a proposed plan for raising and spending money for specified programs, functions, activities, or objectives during a fiscal year” [G.S. 159-7(b)(1)]. Elected officials review the budget and enact it into law by adopting the annual budget ordinance, which the LGBFCA characterizes as “the ordinance that levies taxes and appropriates revenues for specified purposes, functions, activities, or objectives during a fiscal year” [G.S. 159-7(b)(2)]. The fiscal year of operation is July 1 through June 30, which is mandated by G.S. 159-8(b).

The definition of the annual budget as a plan suggests that one purpose of the budget is to allocate resources rationally. In this process, the objectives for a local government’s programs and services are established and ranked in priority, and then the expenditures to be incurred to reach those objectives are estimated and balanced with available resources. Local officials strive to make budgetary decisions that are cost-effective, that is, that yield the greatest benefit with the available resources.

The budget process in actual settings may not represent this ideal. Where there are major disagreements among local officials, the budget process is more of a political exercise than a planning one. In this case, budgeting involves bargaining among participants who represent different points of view, and the result may not be the most effective or rational allocation of resources, but a compromise that decision makers and different community groups resign themselves to live with for another year. This represents democratic government.

Whether the annual budget serves primarily as a planning vehicle or as a means of reaching political agreement about budgetary policies, it sets three legal limits on what a county or city may do:

1. An important legal limit concerns the property tax levy, the amount of property tax due, calculated by applying the tax rate—expressed as cents per $100 of taxable value—to the value of taxable property. Once the governing board sets the tax levy in the budget ordinance, it may not be changed during the fiscal year unless

ordered by a court of competent jurisdiction, required by a state agency having the power to compel the levy of taxes, or amended by the governing board before January 1 to account for an unanticipated increase or reduction in revenues (G.S. 159-15).[1]

2. The LGBFCA requires the annual budget ordinance to be balanced.
3. Appropriations made in the budget ordinance establish legal limits on what a local government may spend. The sum of expenditures and encumbrances charged to an appropriation may not exceed the appropriation. The governing board also may incorporate provisions in the budget ordinance that specify the manner in which appropriations are spent.

The annual budget also provides the opportunity for local officials to review and evaluate programs and services. During most of the year, officials are often hard-pressed to keep up with day-to-day duties and may not have time to examine all programs to determine whether they are making progress toward established objectives. Even if local officials make no changes after program review, and the budget remains the same for the following fiscal year, such a review is valuable. It gives local officials an overview of programs and a broader perspective for the decisions that they must make during the following year.

The annual budget hardly ever remains the same from one year to the next. Besides having to accommodate changes in costs for continuing programs, the budget also is used to expand, improve, reduce, revise, or eliminate existing programs or to authorize new programs.

The disadvantage of using the budget for this purpose is that preparing and approving cost estimates for just the existing programs is difficult and time-consuming; incorporating and executing many program or policy changes in the annual budget make budget preparation and enactment even more challenging. This problem can be avoided if major program changes are considered during the year before the budget process begins. Then the budget is used mainly to implement the changes, rather than to review, analyze, and implement them.

Finally, the budget can serve management purposes. By making appropriations to departments, divisions, and programs, the budget assigns or renews the assignment of responsibility for providing services for which the appropriations are made. An elected board also may review and approve goals and objectives to be achieved by programs as well as dollar authorizations for them in the budget. Such board-approved goals and objectives can be translated into very specific targets for managers and supervisors to achieve during the year. All these goals, objectives, and targets taken together can constitute a work plan that guides management efforts and for which managers can be held accountable.

The Public-Purpose Limitation

A fundamental restriction that underlies the LGBFCA is that public moneys, regardless of their source, may be budgeted and spent only for public purposes. This limitation is found in Article V, Section 2(l), of the North Carolina Constitution, enacted in 1936, which reads, “the power of taxation shall be exercised . . . for public purposes only.” Rulings from the state supreme court have applied the provision to all public moneys, not just taxes, and have forbidden both raising and spending public dollars for private purposes.[2]

The twentieth century was an era of expanding government responsibilities. Spurred by the needs and desires of citizens, questions have been raised about whether some newly proposed programs or expenditures serve public purposes. The courts, and ultimately the North Carolina State Supreme Court, determine what public purpose means. Until a court does decide, a county or city may rely on a legislative declaration that a particular activity serves a public purpose.

---

1. Amending the tax levy before January 1 is not a recommended course of action. For more information on this topic, see Shea Riggsbee Denning and William C. Rivenbark, “Statement of Revenue-Neutral Tax Rate and Provision for Mid-Year Property Tax Rate Change,” *Local Finance Bulletin* 32 (November 2004), Chapel Hill, N.C.: School of Government.

2. See, for example, Greensboro v. Smith, 241 N.C. 363, 85 S.E.2d 292 (1955), and the discussion of this case in David M. Lawrence, *Local Government Finance in North Carolina*, 2d ed. (Chapel Hill, N.C.: Institute of Government, The University of North Carolina at Chapel Hill, 1990), 3.

The courts have not tried to define what public purpose means in the abstract in deciding on whether specific expenditures serve a public purpose. They have decided public-purpose cases considering what have generally been accepted as legitimate and proper local government functions; yet, recognizing that conditions change and functions that are not currently considered public purpose may one day become one.

A basic principle at work in the public-purpose limitation is that some activities are reserved for the private sector. The courts have accepted as public purposes, traditional government functions, or activities that are perceived as extensions of traditional functions, and have maintained a cautious attitude toward government expansion into traditionally private-sector functions.

Expenditures often fail the public-purpose test because the benefits that they bring to particular persons or businesses significantly outweigh any benefit to the public at large. For example, in cases in which government sought to issue bonds to build facilities for private entities, the North Carolina State Supreme Court found the benefit to the private organizations to be paramount, significantly outweighing any public benefit and causing the proposed bonding programs to fail the public-purpose test.[3] These specific cases have since been reversed by narrowly drawn constitutional amendments,[4] but they still reflect the basic point that the public benefits of a particular expenditure or activity may be so slight that the courts will hold that the expenditure or the activity serves no essentially public purpose. In a 1996 decision, the North Carolina State Supreme Court upheld local government provision of economic development incentives to private firms as authorized in G.S. 158-7.1, as long as the incentives benefit the public interests of the jurisdictions giving them rather than just the private interests of the firms or their employees.[5]

The public-purpose limitation does not prevent a county or city from appropriating money to a private agency for the performance of a public activity. Article V, Section 2(7), of the state constitution permits the General Assembly to authorize local governments to "contract with and appropriate money to any person, association, or corporation for accomplishment of public purposes only." Pursuant to this constitutional provision, G.S. 153A-449 expressly authorizes counties to appropriate money to any person, association, or corporation to carry out any public purpose that the county is authorized by law to engage in. G.S. 160A-20.1 provides cities with the same authority.

Although counties and cities may contract with private agencies to provide public services, there are certain limitations or procedural requirements that they should respect or follow in doing so:

1. The activity must be one that the county or city itself is legally authorized to undertake.
2. In giving financial support to privately controlled agencies, a county or city should specify the purposes or the uses of the money.
3. The county or city should require the private agency to account for its expenditures of the money at the end of the fiscal period or year for which the money is given.[6]

A county or city may contract or cooperate with other local governments for the provision of authorized public services without raising a public-purpose issue as long as the jurisdiction's citizens benefit from the arrangement (G.S. Ch. 160A, Art. 20, "Interlocal Cooperation").

Budgeting and Accounting

Budgeting estimates future revenues and makes appropriations for expenditures to support an organization, a program, or a project, whereas accounting records revenues raised and expenditures actually made and reports on the resulting financial condition of the organization, the program, or the project. Budget estimation depends on accurate accounting data that are consistent from one period to the next. Three facets of governmental accounting have important implications for budgeting by counties and cities: fund accounting, budgetary accounting, and basis of accounting.

---

3. Mitchell v. Financing Auth., 273 N.C. 137, 159 S.E.2d 745 (1968); Foster v. Medical Care Comm'n, 283 N.C. 110, 195 S.E.2d 517 (1973); Stanley v. Department of Conservation and Dev., 284 N.C. 15, 199 S.E.2d 641 (1973).

4. N.C. Const. Art. V, §§ 8, 9.

5. Maready v. City of Winston-Salem, 342 N.C. 708, 467 S.E.2d 615 (1996).

6. Dennis v. Raleigh, 253 N.C. 400, 116 S.E.2d 923 (1960).

Table 15-1 Eleven Types of Governmental Accounting Funds

Governmental Funds	Proprietary Funds	Fiduciary Funds
• General fund • Special revenue fund • Debt service fund • Capital projects fund • Permanent fund	• Enterprise fund • Internal service fund	• Pension trust fund • Investment trust fund • Private-purpose trust fund • Agency fund

Fund Accounting

An accounting fund is a separate fiscal and accounting entity, with its own set of self-balancing accounts. More specifically, a fund has its own assets, liabilities, fund balance (equity), revenues, and expenditures (expenses).[7] Governmental financial transactions are grouped into funds essentially to isolate information for legal and management purposes. There are eleven types of funds that fall into one of three broad classifications. (See Table 15-1.)

G.S. 159-8(a) requires the annual budget ordinance to be balanced by fund, as well as for the local government as a whole. Individual funds may be balanced in part through interfund transfers.

G.S. 159-26(b) lists the types of funds that governments generally maintain and requires that funds be fixed by GAAP. Which funds and how many a particular local government maintains depend on what functions it performs and how it finances those functions, although to simplify accounting and reporting, a local government should maintain as few funds as possible.

General Fund

The general fund accounts for all transactions not accounted for in another fund. The general fund typically budgets and accounts for all or most property tax revenue, most sales and use tax revenue, state-shared tax revenue, and other revenues. For counties, it includes all appropriations and contributions to local schools and community colleges and all or most expenditures for human services, public safety, parks and recreation, and general administration. For cities, the general fund includes all or most expenditures for public safety, streets and transportation, parks and recreation, engineering and maintenance, and general administration. Counties and cities also may account for solid waste collection in the general fund if not accounted for in an enterprise fund.

Debt Service Funds

Debt service funds may be established for the payment of principal and interest on general obligation bonds and other debt-financing instruments. Alternatively, GAAP permit debt service payments on bonds or other debt to be made directly from the general fund or from the applicable operating fund. Although the use of debt service funds was common in the past, a debt service fund should be used only if a county or city is legally or otherwise required to set aside money for debt service payments. For general obligation bonds or other debt repaid from general revenues, debt service payments should generally be made from the general fund, or if bonds were issued for enterprise purposes, from the appropriate enterprise fund.

Special Revenue Funds

Special revenue funds account for the proceeds of revenue sources that are legally restricted to expenditures for specific purposes. The LGBFCA requires that a special revenue fund be established for activities supported in part or in whole with voted property taxes (property taxes levied pursuant to a voter referendum), for service districts, and for activities for which money is appropriated under grant project ordinances. Some cities may still use special revenue funds to budget and account for street maintenance and construction programs financed in whole or in part by Powell Bill revenue, which must be used for street-related expenditures. However, GAAP and policies of the LGC encourage the inclusion of restricted revenues like Powell Bill money in the general fund as long as a city's accounting system can track the receipt and the expenditure of the revenues in that fund.

7. Government Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: GFOA, 2001).

Capital Project Funds

Bond and debt proceeds may be used only for the purposes for which the bonds or debt instruments were authorized. Capital project funds are established for bond- or debt-financed projects to ensure proper expenditure of bond and debt proceeds. Such funds also are used to budget and account for the construction of most major capital improvements, whether or not bond or debt financing is involved. A single capital project fund may be used to account for multiple capital projects as long as a local government's accounting system can segregate the revenues and the expenditures for each of the projects.

Permanent Funds

Permanent funds are used to account for resources that are legally restricted to the extent that only earnings, and not principal, may be used to support governmental activities.[8] A permanent fund, for example, would be used to account for the perpetual endowment established for a cemetery or library, where only the interest earnings are available for annual maintenance and repair.

Enterprise Funds

A separate enterprise fund is established for each public enterprise operated by a county or city. An enterprise is a public service that is financed through charges (fees) to users or customers and that is operated in a proprietary or businesslike manner. Even when such fees cover only a portion of the cost of such a service, using an enterprise fund to account for it enables county or city officials to determine the extent to which the service is self-supporting. A county may establish enterprise funds for the following services: water supply and distribution, sewage collection and disposal, solid waste collection and disposal, airports, off-street parking, public transportation systems, and stormwater and drainage systems (G.S. 153A-274). A city may establish enterprise funds for the following services: water supply and distribution, sewage collection and disposal, solid waste collection and disposal, airports, off-street parking, public transportation systems, electric generation and distribution, gas production and distribution, cable television, and stormwater and drainage systems (G.S. 160A-311).

Internal Service Funds

Internal service funds account for activities that serve other departments or governments, rather than the public. Examples of activities often accounted for in internal service funds include central stores or warehouses, print shops, information technology units, and fleet services. Counties and cities may account for internal services either in the general fund or in one or more separate internal service funds. Counties and cities establish internal funds when the decision is made to operate an internal service like a business and charge other departments or governments that use the service. Internal service funds do not have to be included in the budget ordinance [G.S. 159-13(a)(2)] as long as they are approved by the governing board in a separate financial plan (G.S. 159-13.1).

Trust Funds (Pension, Investment, and Private-Purpose)

Trust funds are used to account for assets held in a trustee capacity, and therefore, cannot be used to support the government's own programs.[9] There are three types of trust funds used in local government: pension trust funds, investment trust funds, and private-purpose trust funds. Counties and cities would use a pension trust fund to account for pension resources that they hold in trust for members and beneficiaries. When a county holds investments on behalf of other local units, it accounts for those external resources in an investment trust fund. Counties and cities would use private-purpose trust funds to account for resources not accounted for in a pension trust fund or an investment trust fund, which often includes escheat property. Trust funds do not have to be included in the budget ordinance [G.S. 159-13(a)(3)].

8. Government Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: GFOA, 2001).

9. Government Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: GFOA, 2001).

Agency Funds

Agency funds are used to account for funds where one local government is serving as an agent or in a custodial role for other local governments. A common example is when a county government collects property taxes on behalf of other local units in the county. The funds are collected and placed in an agency fund until disbursed to the appropriate local units. Therefore, all assets reported in an agency fund are offset by a liability equal to those assets. Agency funds do not have to be included in the budget ordinance [G.S. 159-13(a)(3)].

Budgetary Accounting

Financial accounting does not require a private firm's budget to be recorded in its accounting system. The accounts record only actual revenues and expenses. In government, however, GAAP call for the approved budget to be entered into a governmental entity's accounting records.[10] The LGBFCA reflects this principle of governmental accounting by directing that a local government's accounting system show "appropriations and estimated revenues as established in the budget ordinance and in each project ordinance as originally adopted and subsequently amended" [G.S. 159-26(a)]. With appropriations and estimated revenues recorded in the accounting system at the beginning of the fiscal year, actual expenditures and revenues are then charged against the appropriations or the estimated revenues during the fiscal year. This whole process is called budgetary accounting.

Why do governments use budgetary accounting, while private firms do not? In the private sector, success is measured by profit or net earnings. The budget is useful as a guide to achieving that end, but meeting or staying within the budget is secondary to a private firm as long as revenues exceed expenses and a profit is earned. Thus in the private sector, revenues and profit rather than the budget generally serve to control or limit spending, and the budget is simply a management tool. Therefore the budget is not recorded in a firm's accounting system. In the public sector, the budget is both a plan and a legal limit on spending, and the budget is entered into a governmental entity's accounting system.

In government, many services are financed with taxes and either do not generate revenues at all or generate revenues only in amounts that cover a portion of the service's expenditures. For most public services, therefore, revenues cannot serve as a check or a limit on expenditures. Instead, governments rely on an approved budget to legally limit spending for such services. Because the budget in government serves this important legal role, GAAP and the LGBFCA require that appropriations and estimated revenues from the approved budget be recorded in a local government's accounting system, and that actual expenditures and revenues be charged against the budgeted amounts.

Under the LGBFCA, budgetary accounting is not required for financial plans for internal service funds [G.S. 159-13.1, -28(a)]. If a county or city accounts for an internal service in an internal service fund, it may "budget" revenues and expenditures for the fund either in the annual budget ordinance or in a separate financial plan. Although the county commission or city council must approve any such financial plan, the approved amounts for revenues and expenditures in the plan are estimates and not legal limits. While the LGBFCA does not require that these revenue and expenditure estimates be recorded in the unit's accounting system, a county or city may choose to record them.

Basis of Accounting

Basis of accounting has to do with when revenues and expenditures are recorded in the accounting records and reported in the financial statements. It is of particular significance for revenue and expenditure transactions that occur near the end of one fiscal year or at the beginning of the next one.[11] Basis of accounting provides criteria for determining the fiscal year in which such transactions should be recorded. There are three general bases of accounting:

1. Cash basis: revenues and expenditures are recorded when cash is received or disbursed.
2. Accrual basis: revenues are recorded when they are earned, regardless of when they are received in cash, and expenditures are recorded when the liability is incurred.

---

10. Government Accounting Standards Board, *Codification of Governmental Accounting and Financial Reporting Standards* (Norwalk, Conn.: 1995).

11. Government Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: GFOA, 2001).

3. Modified accrual basis: revenues are recorded when they are measurable and available, and, as with the accrual basis, expenditures, with few exceptions, are recorded when the liability is incurred.

Practically speaking, the modified accrual basis, as applied to North Carolina local governments, records many revenues when they are received in cash. However, some revenues to be received within a month or two after the start of a new fiscal year may be assigned to the prior fiscal year if their amounts can be determined (measured) at the end of the prior year and if they will be available soon enough after the close of that year to pay liabilities (bills) for expenditures incurred that year. Liabilities for many items and services received near the end of one fiscal year are often not paid until after the beginning of the next fiscal year. The LGBFCA directs that counties and cities use the modified accrual basis of accounting except as otherwise provided by regulation of the LGC.

Basis of accounting, as applied to budgeting, has to do with the year to which revenues and expenditures are assigned or for which they are estimated. Generally, estimates of revenues and expenditures in the budget should use the same "basis" as the recording of revenues and expenditures in the accounting system. Thus most or nearly all counties and cities should use the modified accrual basis for budgeting revenues and expenditures. This means that counties and cities should assign most revenues, including the property tax, to the year when they are received in cash, or if they are received shortly after the start of one fiscal year but are measurable and available at the end of the prior fiscal year, to the prior year's budget; and they should assign expenditures to the year in which the liabilities arising from those expenditures are expected to occur.

The Inclusiveness Requirement

The inclusiveness requirement means that counties and cities may spend only moneys that have been budgeted [G.S. 159-8(a)]. Although the LGBFCA authorizes an exception for certain trust and agency fund moneys, the inclusiveness requirement applies to all moneys, regardless of source, including property taxes, other local taxes, state-shared revenues, user charges for specific services, federal and state grants, bond proceeds, fund balances, and any other money available to a county or city to fund its programs, activities, or projects. Counties and cities have several options for budgeting moneys: the annual budget ordinance, project ordinances, and financial plans. Governing board adoption is necessary for all these budgeting options.

Annual Budget Ordinance

Any moneys that a county or city spends may be budgeted in the annual budget ordinance. If a county or city does not use project ordinances or financial plans for internal service funds, all moneys that are spent must be included in the annual budget ordinance. All revenues that support recurring operating expenditures are generally included in the annual budget ordinance, which is enacted for a July 1–June 30 fiscal year.

Project Ordinances

Revenues and expenditures for the construction or the acquisition of capital assets or for projects that are financed in whole or in part with federal or state grants may be budgeted either in the annual budget ordinance or in one or more project ordinances. A project ordinance appropriates revenues and expenditures for however long it takes to complete the project rather than for a particular fiscal year or period (G.S. 159-13.2).

G.S. 159-13.2(a)(1) specifies that a capital project ordinance may be used to appropriate revenues and authorize expenditures for a project "financed in whole or in part by the proceeds of bonds or other debt instruments or a project involving the construction or acquisition of a capital asset." Practically speaking, counties and cities are authorized to use bond or other debt financing only for capital projects or acquisitions. Therefore the focus of attention is on the second part of this statutory language. What is a capital asset? According to GAAP, a capital asset is property of significant value that has a useful life of more than one year. Such assets include land, buildings, improvements other than buildings, and equipment. The amount that establishes significant value for the purpose of identifying capital assets is determined locally and varies by size of jurisdiction. It usually falls somewhere between $1,000 and $5,000. Although capital project ordinances may be used to appropriate revenues and expenditures for any capital asset, such ordinances are especially suitable and primarily used for capital improvements or acquisitions that are large relative to the annual resources of a county or city, that take more than one year to build or acquire, or that recur irregularly, that is, once every few years. Authorizing such large projects in the annual budget ordinance presents challenges that are more effectively addressed by the use of project ordinances. Expenditures for capital assets that are not expensive relative to a local government's annual budget or that recur annually can usually be handled effectively in the annual budget ordinance.

A grant project ordinance may be used to appropriate revenues and authorize expenditures for operating or capital purposes in a project financed wholly or partly by a grant from the federal or state government. According to GAAP, a grant is a gift of cash or other assets from one government or entity to another that must be used or spent for a specific purpose. A project is a temporary activity. Thus a grant project ordinance should be used only to appropriate moneys for federally aided or state-aided activities that serve specific purposes and are temporary in nature. Grant project ordinances are often used for multiyear grants that counties and cities receive. Grant project ordinances should not be used to appropriate state-shared taxes or other federal or state revenue or aid that is provided on a continuing basis to a local government. Such revenue or aid, even if it is earmarked for a specific purpose, should be budgeted in the annual budget ordinance.

A project ordinance must identify and authorize the project, identify the revenue sources for financing it, and make all appropriations necessary to complete the project. Like the annual budget ordinance, a project ordinance must be adopted by the governing board. A project ordinance may be adopted at any time during the year. A public hearing is not required in relation to the adoption of a project ordinance. Once a project ordinance has been adopted, it need not be readopted in subsequent fiscal years; it has a project life rather than an annual life. Correspondingly, a project ordinance is balanced for the life of the project rather than a fiscal year and may be amended at any time as long as it remains balanced.

A project ordinance authorizes all forecasted revenues and appropriated expenditures necessary for the completion of the project [G.S. 159-13.2(b)]. Revenues may include grants, bond proceeds, capital reserve fund transfers, annual revenues, fund balances, and other sources of revenue. Of course, bond proceeds and moneys from a capital reserve fund may generally be spent only for capital purposes. Annual revenues may be appropriated directly into a project ordinance, or they may be appropriated initially in the annual budget ordinance and transferred to the project ordinance. If property taxes are used to finance a project authorized in a project ordinance, such taxes must be levied in the annual budget ordinance and then transferred into the project ordinance. Appropriations for expenditures in a project ordinance may be a lump sum, that is, a single sum for the entire project, or they may be broken down into line-item or functional categories—for example, land, construction, and equipment.

The annual budget must include information about capital or grant project ordinances to be approved during the year and about previously adopted capital and grant project ordinances for which appropriations are available for expenditure in the budget year. Moneys appropriated and spent under grant project ordinances must be accounted for in a special revenue fund [G.S. 159-26(b)(2)]. Moneys appropriated and spent under a capital project ordinance in which bond or other debt financing is involved must be accounted for in a capital project fund [G.S. 159-26(b)(6)]. GAAP encourage the use of a capital project fund for any major capital project authorized under a project ordinance, even if bond or debt financing is not involved.

Financial Plans for Internal Service Funds

An internal service fund may be established to account for a service provided by one department or program to other departments in the same local unit, and in some cases to other local governments. If a county or city uses an internal service fund, the fund's revenues and expenditures may be included either in the annual budget ordinance or in a separate financial plan adopted specifically for the fund [G.S. 159-8(a), -13.1]. The governing board must approve any financial plan adopted for an internal service fund, with such approval occurring at the same time that the board enacts the annual budget. The financial plan also must follow the same July 1–June 30 fiscal year as the budget ordinance. In practice, the approval of a financial plan occurs simultaneously with the adoption of the annual budget ordinance; the ordinance may include a special provision indicating the approval of each financial plan. An approved financial plan must be balanced; according to the law, a financial plan is balanced when estimated expenditures do not exceed estimated revenues of the internal service fund [G. S. 159-13.1(a)]. An approved financial plan may be amended only with the approval of the governing board.

Estimated revenues and appropriated expenditures in an approved financial plan may be, but are not required to be, recorded in the local government's accounting system. They are planned, but strictly speaking, not legal limits on revenues and expenditures and therefore do not have to be included in the accounting system. Actual spending from an internal service fund is limited by revenues to the fund that arise from charges to the departments that use the fund's services. Such charges are expenditures of the using departments that the board has approved in the annual budget ordinance and that are recorded in the accounting system. Thus a governing board maintains control over expenditures in an internal service fund with its approval of the financial plan and with budgeted appropriations to the departments that use the internal service.

Moneys Not Having to Be Budgeted

The LGBFCA permits the revenues of certain local government trust and agency funds to be spent or disbursed without being budgeted [G.S. 159-13(a)(3)]. Many counties and cities set aside and manage moneys in a pension trust fund, for example, to finance special separation allowances for law enforcement officers. A few cities manage special pension systems for their law enforcement and fire service personnel and retirees. The employees and the retirees for whom the local government is managing these moneys have ownership rights to them. Although a county or city must budget its initial contributions on behalf of employees into the pension trust fund for such a benefit or pension system, usually calculated as some percentage of payroll, once they are in the fund, earnings on the assets, payments to retirees, and other receipts and disbursements of the fund should not be included in the local government's budget.

Another example would be when counties and cities collect certain revenues for other governmental units and record them in agency funds. Although these collections are held temporarily by the county or city, they belong to the other units. The collections are therefore not revenues of the county or city collecting them and should not be included in their budgets.

The Balanced-Budget Requirement

A fundamental requirement of the LGBFCA is that the annual budget ordinance and any project ordinance or any financial plan for an internal service fund be balanced. The next section discusses the balancing requirement for the annual budget ordinance, project ordinances, and financial plans.

Annual Budget Ordinance

G.S. 159-8(a) defines a balanced budget ordinance when "the sum of estimated net revenues and appropriated fund balances is equal to appropriations." This law requires an exact balance; it permits neither a deficit nor a surplus. Further, each of the accounting funds that together make up the annual budget—the general fund, a water and sewer fund, and so forth—must also be balanced [G.S. 159-13(b)(16)].

During budget preparation, each of the variables in the balanced budget equation (estimated net revenues, appropriated fund balances, and appropriations for expenditures) is an estimate. The law makes this explicit with regard to revenues by referring to them as "estimated." Both revenues and appropriations for expenditures remain estimates during budget preparation and through much of the budget year. Officials will not know whether their estimates for these variables are accurate until near the end of the budget year. The governing board can amend the budget ordinance to increase (assuming money is available) or decrease appropriations during the year in order to accommodate changing conditions.

Appropriated fund balance is taken from unrestricted money that is left over at the end of the current year and that is legally available to budget in the coming year. During budget preparation for the coming year, which takes place before the current year ends, legally available fund balance at the end of the current year also is an estimate. It does not become an actual figure until the end of the current year, after all revenues for the year have been collected and all expenditures have been made.

Estimated Net Revenues

Revenues. Generally, revenue is an increase in cash or in other financial resources, or in a few cases a decrease in liabilities, that increases an entity's net worth or fund balance and that can be made available in the budget to support spending.[12] An increase in cash or another financial resource that is balanced by an increase in one or more liabilities or by a decrease in other resources or assets does not increase an entity's net worth or fund balance and is therefore not revenue.

---

12. Government Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: GFOA, 2001).

For purposes of the LGBFCA, revenues or increases in financial resources (the equivalent of revenues under the LGBFCA) for a specific fund—for example, a capital project fund—may include proceeds from bonds or other debt that may be budgeted and spent from the fund, and transfers into the fund from other funds. However, what may be revenue or an increase in financial resources for one fund of a local government may not be revenue or an increase in financial resources for the local government as a whole. For instance, if a county or city issues bonds and deposits the bond proceeds into a capital projects fund, this increases that fund's cash and fund balance, and when budgeted, would be considered fund revenue or the equivalent under the LGBFCA. However, there is no increase in fund balance or net assets (assets minus liabilities) for the county or city as a whole because general long-term debt increases by the amount of the bond proceeds. Under GAAP, the term revenue does not include debt proceeds or transfers into a fund from another fund. GAAP refer to debt proceeds and such transfers as other financing sources rather than revenue.

Some increases in cash or financial resources may appear to be revenue, but are actually collections of receivables under GAAP and the LGBFCA. For instance, when a local government buys materials or equipment, it pays state sales taxes on such purchases and then files for reimbursement from the state for the state sales taxes. Such sales taxes should be recorded as receivables rather than expenditures when the purchases for which they are paid are made. When the local government receives reimbursement from the state for such sales taxes, it should classify the reimbursement as the collection of a receivable rather than as revenue under both GAAP and the LGBFCA. Such reimbursements should be budgeted neither as revenues nor as expenditures.

Net revenues. The LGBFCA refers to "estimated net revenues" in the balanced-budget equation. The word "net" refers to revenues levied or billed, less discounts or amounts that a county or city does not expect to collect of the totals levied or billed. G.S. 159-13(b)(6) specifically addresses net for property taxes—where the estimated percentage of property tax collection budgeted for the coming fiscal year cannot exceed the percentage of collection realized in cash as of June 30 during the fiscal year preceding the budget year.[13] G.S. 105-360(c) also allows counties and cities to give property tax payers discounts for paying taxes before September 1, which must be taken into account when estimating property taxes for the budget year.

The LGBFCA's explicit reference to net revenues in the balanced-budget equation directs counties and cities to budget only revenues that they expect to collect or have available to fund expenditures during the budget year. Although not required by the LGBFCA, the annual budget ordinance may show or refer to gross, levied, or billed revenues as well as net revenues. However, the estimates of revenues used for the balanced-budget equation should be net revenues only.

Budgeting of revenues by major source. G.S. 159-13(a) requires that the annual budget ordinance "show revenues by major source." GAAP as interpreted by the LGC define major source in this statute to include at least the following revenue categories for the general fund: property taxes, sales tax, licenses and permits, intergovernmental revenues, charges for services, and other taxes and revenues. The annual budget ordinances of counties and cities often show or appropriate revenues in more specific categories for general fund revenues.

Estimating revenues. For any revenue source that is listed separately in the budget ordinance, one estimate must be selected from a range of possible figures. However, local government officials should be conservative in estimating revenues. This means selecting an estimate for a revenue source that is somewhat below the midpoint of the range for that source. Some budget officials estimate revenues conservatively for all or most revenue sources. Others choose revenue estimates at the midpoint of the range for most sources, but are conservative on one or a few of the major sources, such as the property tax or the sales tax.

Property tax revenue may be estimated conservatively by underestimating the percentage of the levy that will be collected. Thus, if a 98 percent collection percentage is anticipated for the coming year, the property tax revenue estimate in the budget might be calculated in terms of only a 97 percent collection rate. As a result, property tax revenue estimated in the budget is somewhat less than what will probably be collected.

Local officials estimate revenues conservatively because the penalties for underestimating are usually less severe than those for overestimating. Probably the most significant penalty that sometimes results from underestimating is the accumulation of a fund balance that is excessive, angering taxpayers. In contrast, a range of unfortunate possibili-

13. G.S. 159-13(b)(6) provides for a different calculation when budgeting for property taxes on registered motor vehicles. The percentage of collection is based on the nine-month levy ending March 31 of the fiscal year preceding the budget year, and the collections realized in cash with respect to this levy are based on the twelve-month period ending June 30 of the fiscal year preceding the budget year.

ties awaits the local government that overestimates revenues. One possible consequence is reducing appropriations and planned services. If expenditures could not be reduced and additional revenues could not be raised to cover a shortfall caused by an overestimate of revenues, the year would end with a deficit to be funded from the next year's budget or from borrowing (strongly discouraged by the LGC). Either would likely hurt a local government's standing with creditors.

A local government can be too conservative in estimating revenues. There is a reasonable range of low to high forecasts for any revenue source, and budget officers should not place their estimates below this range. However, because selecting this range depends as much on judgment as on calculation, there is no simple or definitive norm for determining what is an appropriately conservative estimate for major revenue sources. The extent of conservatism in estimating revenues should depend on one or more of various factors, including the following:

1. Economic outlook. If economists project a strong economy for the coming year, the revenue estimates can be more optimistic. If the economy looks weak, however, and the weakness is likely to affect local revenues, revenue estimates should generally be more conservative.
2. Fund balance. If a local government is expected to close the current fiscal year with a significant general fund balance and/or significant working capital in enterprise funds that will be carried forward as unappropriated operating reserves into the next budget year, revenue estimates can be less conservative than they would otherwise be.
3. Contingency appropriation. A contingency appropriation can serve in place of an unappropriated fund balance as an operating reserve to support the budget, and although G.S. 159-13(b)(3) limits contingency appropriations to 5 percent of all other appropriations in a fund, a local government that includes contingency appropriations in its budget can be somewhat less conservative in estimating revenues.
3. Jurisdiction size. A large local government with considerable diversity in its revenue sources can operate closer to the margin in estimating revenue than a small local government with fewer revenue sources. On this basis alone, a large unit could therefore estimate its revenues somewhat less conservatively than a small one, other things being equal.

Appropriated Fund Balance

The second variable in the balanced-budget equation for the annual budget is appropriated fund balance. Legally available fund balance is money that is left at the end of one fiscal year that may be appropriated to finance expenditures in the next year's budget. G.S. 159-8(a) defines such fund balance as ". . . the sum of cash and investments minus the sum of liabilities, encumbrances, and deferred revenues arising from cash receipts, as those figures stand at the close of the fiscal year next preceding the budget year."

Legally available fund balance is calculated using this statutory formula. The calculation starts with an estimate of cash and investments at the end of the current year, and subtracts from them estimated liabilities, encumbrances, and deferred revenues from cash receipts at the end of the current year. All these figures are estimates because the calculation is being made for budget purposes before the end of the current year. If the estimate of available fund balance is for the general fund, typical liabilities are payroll owed for a payroll period that carries forward from the current year into the budget year, and accounts payable representing unpaid vendor accounts for goods and services provided to the local government toward the end of the current year. Such liabilities should be paid from the current year's revenues rather than the next year's; they will thus reduce cash and investments that would otherwise be part of available fund balance. Encumbrances arise from purchase orders and other unfulfilled contractual obligations for goods and services that are outstanding at the end of a fiscal year. They reduce legally available fund balance because cash and investments will be needed to pay for the goods and the services on order. Deferred revenue from a cash receipt is revenue that is received in cash in the current year, even though it is not owed to the local government until the coming budget year. Such prepaid revenues are primarily property taxes. They should be included among revenues for the coming year's budget rather than carried forward as available fund balance from the current to the coming year.

Legally available fund balance is different from fund balance, equity, or net worth or assets for financial reporting purposes as presented on the balance sheet of a local government's annual financial report. Legally available fund balance includes only cash and investments. It may not include any receivables or other current assets. By contrast, fund balance, equity, or net worth for financial reporting purposes is calculated considering all assets of the fund, and includes receivables as well as cash and investments. In calculating or estimating fund balance available for appropriation into next year's budget, local officials should use the legal formula provided in G.S. 159-8(a) rather than the accounting or balance sheet amount for fund balance.

Some legally available fund balance, as defined by G.S. 159-8(a), may be restricted or reserved for particular purposes by other statutes. An example for cities would be Powell Bill or state gasoline tax moneys that may be spent only for street construction and maintenance. Available fund balance attributable to Powell Bill moneys will generally be reserved to show that it is not available for general purposes. It is a part of legally available fund balance under G.S. 159-8(a), but it is available only for street-related spending and not for general spending in the next year's budget. Other portions of legally available fund balance may be designated by local officials for particular purposes—for example, future capital improvements—and therefore may also not be available for general purposes in the next year's budget unless local officials remove the designations.

Sources of fund balance. Legally available fund balance at the end of the current fiscal year can originate from unbudgeted fund balance carried forward from prior years, from conservative revenue estimates where actual revenues exceed estimated revenues, and from actual expenditures being less than appropriations in the current year's budget.

Appropriated and unappropriated fund balance. Fund balance that is legally available at the end of the current year that is otherwise unreserved or undesignated does not have to be appropriated into the next year's budget, with one exception. If part or all of it is needed to balance the next year's budget, considering estimated revenues and appropriated expenditures for the coming fiscal year, at least that much of the available fund balance must be appropriated, which is referred to as appropriated fund balance. Otherwise, none of the legally available fund balance need be budgeted, legally speaking, which is referred to as unappropriated fund balance. A local government may choose to appropriate some or all of available and unrestricted fund balance for any purpose for which the local government is authorized to spend money. The local government also might budget available fund balance in a contingency appropriation; the amount of this appropriation, however, may not exceed 5 percent of all other appropriations in a fund.

Reasons for fund balances. Counties and cities carry significant fund balances to provide working capital to pay vendors and others in a timely way, to meet emergency or unforeseen needs, and to be able to take advantage of unexpected opportunities requiring the expenditure of money. If a local government with low fund balance attempts to issue bonds, its bond rating may be hurt because of inadequate fund balance, causing the local government to pay more in interest than it otherwise would. Without fund balances, some counties and cities would face a cash-flow deficit during the first half of the fiscal year because most property tax revenue, the most important general revenue source, is not received until December, whereas expenditures are evenly distributed throughout the year. With LGC approval, such a deficit may be funded by borrowing against anticipated tax or other revenues, but there are interest costs with such borrowing, and tax anticipation notes are discouraged by the LGC. Counties and cities in North Carolina have traditionally used end-of-year fund balances rather than borrowing against anticipated tax or other revenues to meet cash-flow shortfalls in the first part of the budget year. Finally, even in periods of low interest rates, a local government with significant fund balance can earn investment income to finance service delivery.

Recommended amount of available fund balance. The LGC recommends that counties and cities end a fiscal year with legally available general fund balance equal to at least 8 percent of general fund expenditures for that year. Commission staff members consider the 8 percent level to be a floor, representing only about one month's expenditures to meet operating or working-capital requirements. Therefore, they encourage counties and cities to maintain fund balances larger than this. If a local government's end-of-year general fund balance falls below 8 percent of general fund expenditures or materially falls below the percentage average for similar-sized governments, commission staff members send local officials a letter noting this fact and advising them to rebuild available general fund balance at least to the 8 percent level. If local officials fail to do so, the county or city may be unable to secure the commission's approval in selling bonds or other debt instruments.

In deciding how much available general fund balance a local government should carry, officials should consider the experiences of other similar size local units. Generally, small local governments carry larger available fund balances as a percentage of their expenditures as compared to their larger counterparts. It is not uncommon for municipalities with populations under 2,500 to have available general fund balances equal to 50 to 100 percent of general fund expenditures, for example. While these percentages may seem excessive, small local governments often rely on pay-as-you-go financing of capital improvements and build general fund balance for financing future capital needs. Statistics on available fund balance for counties and cities of different sizes are compiled and available on the website of the N.C. Department of State Treasurer.

The amount of available general fund balance that a particular local government carries should depend on a variety of factors, including how conservatively it estimates revenues, how tightly it budgets expenditures, whether it faces a cash-flow deficit during the first half of the fiscal year, and how it finances capital projects.

Presentation of fund balance information in the budget. The LGBFCA explicitly requires that any appropriation of fund balance be shown in the annual budget ordinance [G.S. 159-8(a), -13(a)]. The recommended budget, which must be balanced unless the governing board authorizes the budget officer to submit an unbalanced budget, also must show any appropriation of fund balance that the budget officer proposes to use to balance the budget. There are, however, no additional requirements for the budget or the budget ordinance to present fund balance information. As a matter of local policy, the recommended budget for a county or city should include the budget officer's estimate of legally available fund balance at the close of the current year as well as any amount of this fund balance that the budget officer is proposing for appropriation in the coming year's budget. The recommended budget also should include a brief discussion of the fund balance policies that the proposed budget is following. Because available fund balance on June 30 can only be estimated at the time of budget preparation, the presentation of current information is only tentative. Nonetheless, such information represents a very important dimension of the budget and should be dealt with explicitly at the time of budget presentation. A local government's annual financial report eventually reveals actual fund balance on June 30 for the fiscal year preceding the budget year and the changes in the local government's fund balance during that year.

Appropriations for Expenditures

The third variable in the balanced-budget equation is appropriations for expenditures. An appropriation is an estimate of future expenditures, a legal authorization to spend, and a ceiling on expenditures. Only the governing board can establish appropriations; neither the budget officer nor any other administrative official may do so. The expenditure figures that appear in the budget officer's recommended budget are only proposed appropriations and breakdowns of those appropriations.

An appropriation is a specified dollar amount set forth in the annual budget ordinance or in a project ordinance. Financial plans for internal service funds estimate and authorize expenditures. However, the estimates and the authorizations are not ceilings for expenditures and therefore are not appropriations under the LGBFCA (G.S. 159-13.1).

Lump-sum or detailed appropriations. G.S. 159-13(a) provides that appropriations in the annual budget ordinance shall be by department, function, or project. This raises the question of how general or specific appropriations should be. A very detailed budget ordinance makes appropriations by line item or by individual object of expenditure. The line items or the objects of expenditure are taken from the expenditure accounts in a local government's accounting system. Small local governments often have annual budget ordinances with detailed line-item appropriations, which require board approval for line-item transfers. Although such appropriations increase the control of the governing board over departmental expenditures, they can cause the governing board to become enmeshed in the details of budget administration and correspondingly neglect the broader issues of budget development and execution.

Most medium and larger local governments typically make appropriations by department or by function. This level of appropriation seems to be favored by G.S. 159-13(a), specifying that the annual budget ordinance "shall make appropriations by department, function, or project and show revenues by major source." With departmental, functional, or project appropriations, the governing board delegates control over expenditures by line item to the budget officer, who is responsible for reviewing and approving expenditures from line-item accounts and transfers of money from one such account to another within the same departmental or functional appropriation. Usually this system works well because control over expenditures by line item is usually a management responsibility. However, the governing board must still approve a budget transferred from one department or function to another as shown on the adopted budget ordinance unless specific authority is granted to the budget officer by the board to make such transfers (G.S. 159-15).

In some jurisdictions, the budget officer delegates to department heads the authority to approve most transfers among line-item accounts within each departmental or functional appropriation, reporting such transfers to the budget or finance officer as they are made. In return for this flexibility, department heads are held accountable for achieving specific performance targets or objectives within appropriated funds. In units where such budget flexibility is practiced, certain transfers involving salaries and wages may still have to be approved by the budget officer or staff before being made.

A lump-sum appropriation for the general fund or any fund from which more than one department or function is financed is too broad and is not in keeping with the intent of G.S. 159-13(a). Appropriation by fund is legally permissible only for a fund that finances the activities of just one department or function.

Nondepartmental appropriations. Some appropriations authorize expenditures for nondepartmental purposes or items—for example, premium payments for property and general liability insurance, and contributions to nonprofit organizations that carry out functions on behalf of the local government. While this is standard practice, the LGBFCA's provision for "appropriations by department, function, or project" favors the allocation of expenditures among departmental, functional, program, or project appropriations in the annual budget ordinance. Moreover, GAAP require that nondepartmental appropriations be held to a minimum.[14]

Allocation of appropriations for shared services. General fund departments often provide certain services to other funds. For example, the finance department, which is typically budgeted and accounted for in the general fund, often prepares and mails utility bills and processes utility payments for the water and sewer fund. Both the general fund and the water and sewer fund share the services of the finance department. Water and sewer and other utility funds should reimburse the general fund for utility billing, mailing, and collection services provided by the finance department to the utility funds. Such reimbursements should be budgeted and accounted for as expenditures for the utility funds. On the general fund side of the transaction, some counties and cities mistakenly budget and account for such reimbursements as revenues or "other financing sources." GAAP call for these reimbursements to be accounted for as reimbursements of general fund expenditures. To avoid having to make the reimbursements, a local government may allocate or split the appropriation for the finance department between the general and utility funds based on the estimated use of finance department services by each fund. Such split or allocated appropriations are in accord with GAAP.

Required appropriations. Although counties and cities enjoy broad legal discretion over what programs they choose to provide, and at what levels, there are limits on this discretion. First, the full amount estimated by the local government's finance officer to be required for debt service during the budget year must be appropriated [G.S. 159-13(b)(1)]. During the spring the LGC notifies each finance officer of that local government's debt service obligations on existing debt for the coming year. If the county or city does not appropriate enough money for the payment of principal and interest on its debt, the commission may order the county or city to make the necessary appropriation; if the county or city ignores this order, the commission may itself levy the local tax for debt service purposes (G.S. 159-36).

Second, sufficient appropriations must be made for continuing contracts [G.S. 159-13(b)(15)]. Continuing contracts are those that extend over more than one fiscal year. G.S. 153A-13 requires that in each fiscal year of such a contract, the county commission shall appropriate sufficient funds to meet the contractual payments that come due. G.S. 160A-17 contains the same language for cities. G.S. 159-13(b)(15) of the LGBFCA simply repeats that requirement.

Third, the full amount of any deficit in each fund must be appropriated [G.S. 159-13(b)(2)]. Three types of deficits may occur to which this requirement applies:

1. Despite the LGBFCA's provisions to the contrary, expenditures occasionally occur without an appropriation or exceed appropriations, which may create a deficit for the entire fund. If this occurs and if the legally available fund balance in the affected fund falls below zero, a deficit exists, and sufficient moneys must be appropriated in the next fiscal year's budget to eliminate the deficit.
2. Revenue estimates may turn out to be higher than actual revenue collections for a year. Although expenditures may not exceed the revenue estimates, they may exceed revenue collections. If this occurs and if the legally available fund balance in the affected fund falls below zero, a deficit exists, and sufficient moneys must be appropriated in the next fiscal year's budget to eliminate the deficit.
3. A deficit is created when a local government appropriates more fund balance in the budget than is legally available on June 30 of the fiscal year preceding the budget year. If such an over-appropriation of fund balance occurs, the budget ordinance must be amended to correct this situation.

Limits on Appropriations. Several LGBFCA provisions place upper or lower limits on certain appropriations. First, contingency appropriations for each fund are limited to 5 percent of the total of all other appropriations in that fund [G.S. 159-13(b)(3)].

Second, G.S. 159-13(b)(4) requires that tax limits and earmarked revenues be respected. For example, cities must use state street aid or Powell Bill revenues for street-related expenditures only.

Third, G.S. 159-13(b)(5) states that the total of all appropriations for purposes that require voter approval for expenditure of property tax moneys under Article V, Section 2(5) of the North Carolina Constitution must not exceed the total of all estimated non-property-tax revenues (not including nontax revenues required by law to be spent for specific purposes) and property taxes levied for such purposes pursuant to a vote of the people.

---

14. The Local Government Commission and independent public accountants discourage the use of nondepartmental appropriations.

Restrictions on appropriations for interfund transfers. The annual budget ordinance often makes appropriations to transfer money from one fund to another. A contribution, or transfer-out, from one fund becomes a financial resource, or transfer-in, to the receiving fund. A common interfund transfer moves surplus from enterprise funds to the general fund. The LGBFCA generally permits appropriations for interfund transfers, but it sets some restrictions on them, each designed to maintain the basic integrity of a fund in light of the purposes for which the fund was established. In addition, the LGBFCA prohibits certain interfund transfers of moneys that are earmarked for a specific service. The LGBFCA's restrictions on interfund transfers address voted property tax funds, agency funds for special districts, capital project funds involving bond or other debt proceeds, enterprise funds, service district funds, overhead costs, and reappraisal reserve funds.

1. Voted property tax funds. Proceeds from a voted property tax may be used only for the purpose approved by the voters. Such proceeds must be budgeted and accounted for in a special revenue fund and may not be transferred from such a fund [G.S. 159-13(b)(10)].
2. Agency funds for special districts. Moneys collected by a local government for a special district belong to that district, not to the local government, and such moneys may not be appropriated from the agency fund for the district to any other fund of the local government [G.S. 159-14(b)].
3. Capital projects funds involving bond or other debt proceeds. Bond or other debt proceeds may be spent only for the purposes for which the bonds or the debt was authorized. Therefore the statutes permit the appropriation or the transfer of bond proceeds only (1) for the purposes stated in the bond order, (2) to a debt service fund to pay debt service on the bonds, or (3) to a capital reserve fund for eventual expenditure for the purpose stated in the bond order [G.S. 159-13(b)(13)]. Expenditure of the proceeds of debt instruments other than bonds is more circumscribed; such proceeds may be spent only for the project or the purpose for which the debt was approved and issued [G.S. 159-13(b)(19)].
4. Enterprise funds. Appropriations to transfer moneys from an enterprise fund to another fund may be made only if other appropriations in the enterprise fund are sufficient to meet operating expenses, capital outlays, and debt service for the enterprise [G.S. 159-13(b)(14)]. This limitation reflects the policy that enterprise revenues must first meet the expenditures and the obligations related to the enterprise. Enterprise revenues are not absolutely earmarked, however; once all enterprise expenditures have been funded by appropriations, the law permits any remaining moneys to be transferred to another fund.
5. Service district funds. Although a service district is not a separate government, specific taxes and other revenues raised within it for the district belong to the district. Therefore no appropriation may be made to transfer moneys from a service district fund except for the purposes for which the district was established [G.S. 159-13(b)(18)].
6. Overhead costs. Each prohibition or limitation on interfund transfers discussed in this section, except the one relating to capital projects funds, is subject to the modification that any fund may be charged for general administrative and overhead costs properly allocable to its activities, and for the costs of levying and collecting its revenues [G.S. 159-13(b)]. A transfer of money to reimburse one fund for administrative or overhead services that it provides to other funds should be budgeted and accounted for as a reimbursement of expenditures rather than as a revenue or as "other financing sources" in the fund receiving the reimbursement. Alternatively the appropriations for departments that serve other funds as well as their own fund may be budgeted or allocated initially between the respective funds.
7. Reappraisal reserve fund. A reappraisal reserve is established to accumulate money with which to finance the county's next real property revaluation, which must occur at least once every eight years. Appropriations may not be made from a reappraisal reserve fund for any other purpose [G.S. 159-13(b)(17)]. Although contracting with a private appraisal company is a commonly used means of conducting a revaluation, counties have the authority to do the work with their own staff. If an in-house revaluation capacity exists, personnel and other costs associated with it will be a part of the regular annual budget. Start-up costs, such as computer acquisitions for the reappraisal, may be paid from transfers of money from a reappraisal reserve fund.

Project Ordinances

The LGBFCA requires a capital or grant project ordinance to be balanced for the life of the project, specifies that such an ordinance is balanced when "revenues estimated to be available for the project equal appropriations for the project," and requires the ordinance to identify the revenues for financing the project and to make the appropriations necessary to complete the project. A project ordinance may be amended at any time as long as the ordinance remains balanced (G.S. 159-13.2).

The key characteristic of a project ordinance is that it has a project life, which means that the balancing requirement for such an ordinance is not bound by or related to any fiscal year or period. Estimated revenues and appropriations in a project ordinance must be balanced for the life of the project, but do not have to be balanced for any fiscal year or period that the ordinance should happen to span.

A project ordinance does not have to be readopted after it is initially enacted, and spending authority created by a project ordinance continues in force for however long it takes to complete the project authorized by the ordinance. A project ordinance may be amended to change the scope of the project, to keep revenues and expenditures for the project in balance, or to accomplish other purposes.

Estimated revenues for a project ordinance may include bond or other debt proceeds, federal or state grants, revenues from special assessments or impact fees, other special revenues, and annually recurring revenues. Annually recurring revenues may be budgeted initially in the annual budget ordinance and then transferred to a project ordinance, or appropriated directly into the project ordinance. If property tax revenue is used to help finance a project ordinance, it must be levied initially in the annual budget ordinance before being transferred to the project ordinance.

Appropriations for expenditures in a project ordinance may be general or detailed. A single lump-sum appropriation for a project fulfills the requirements of the LGBFCA. However, project ordinances for major capital improvements or large grant-financed projects generally break down appropriations into expenditure categories. For improvement projects, the common categories are planning and design, land, construction, equipment and furnishings, and administrative and legal expenses. If a capital projects ordinance includes more than one project, the revenues and appropriations should be listed separately and balanced for each project. Appropriations for grant-financed programs for operating purposes are often made by function or purpose authorized under the grant, by general line-item category, or some combination.

Fund balance is not part of the balanced-budget equation for project ordinances. Because project ordinances do not have fiscal year or period lives, they do not generate fund balances. Of course, projects are sometimes completed with appropriated revenues remaining unspent. Practically speaking, such excess revenues are equivalent to a project fund balance. However, because a project ordinance's authority ends with the completion of the project, the LGBFCA's silence about such remaining project revenues suggests that any remaining project revenues would be transferred to another appropriate project, fund, or purpose at the project's completion. Annual revenues budgeted in a project ordinance that remain after a project is finished may be transferred back to the general fund or another fund included in the annual budget ordinance. Bond proceeds remaining after a project is finished should be transferred to the appropriate fund for other projects authorized by the bond order or to pay debt service on the bonds.

Financial Plans for Internal Service Funds

The LGBFCA requires any approved financial plan for an internal service fund to be balanced. It specifies that such a plan is balanced when "estimated expenditures do not exceed estimated revenues."

Internal service fund revenues are principally charges to county or city departments that use the services of an internal service fund. These charges are financed by appropriated expenditures of the using departments in the annual budget ordinance. Internal service fund revenues or other resources also may include an appropriated subsidy or transfer unrelated to specific internal service fund services, which would come from the general or some other fund to the internal service fund. Such a subsidy is often made during the start-up years of an internal service fund. It should be shown as a transfer-in rather than revenue for the internal service fund. Internal service fund revenues also may include investment income and income from other sources.

Expenditures for an internal service fund are typically for items necessary to provide fund services, including salaries and wages; other operating outlays; lease, rental, or debt service payments and/or depreciation charges on equipment or facilities used by the fund; and other internal service expenses. Estimates of fund expenditures might be by purpose or function within the fund rather than by line item.

The LGBFCA makes no mention of internal service fund balance and reserves or the equivalent (fund equity), even though the approved financial plan for any such fund is for the same fiscal year as the annual budget and even though an internal service fund's revenues may exceed its expenses in a year, creating fund balance or reserves for that year and possibly over time. In adopting the annual financial plan for an internal service fund, the governing board must decide what to do with any available balance or reserves remaining from any previous year's financial plan. The law permits fund balance or reserves to be used to help finance fund operations in the next year, or if the balance is substantial, to fund long-term capital needs of the fund. Alternatively, fund balance may be allowed to continue accumulating for the purpose of financing major capital needs of the fund in the future, or it may be transferred to the general or another fund for an appropriate use. GAAP discourage the buildup of internal service fund balance unrelated to specific needs of the fund.[15] Accumulation of large balances or reserves also may create problems if internal service fund expenditures are charged to federal grant programs. Federal regulations prohibit excessive charges to federal programs, and unexplained internal service fund balances or reserves may be interpreted by auditors as resulting from excessive charges.

The Budget Officer

Authorities on budgeting distinguish between a budget prepared by a governing board or legislative body and one prepared by or under the direction of a jurisdiction's chief executive officer. When a local governing board formulates the budget, departmental budget requests flow directly to the board; it estimates revenues, balances the requests against available revenues, and then enacts the budget. This is called a legislatively prepared budget. On the other hand, an executive budget is one prepared by a jurisdiction's chief executive officer, who receives departmental budget requests, reviews and balances the requests against available revenues, and submits a recommended and balanced budget to the governing board for its review and approval.

The LGBFCA provides for an executive budget. It calls for each local government to appoint a budget officer to be responsible for budget preparation (G.S. 159-9 and -11). By law the county or city manager is the budget officer. The law gives the manager this responsibility because the budget is the basis for managing and providing public services. In counties or cities without the manager form of government, the governing board must appoint a budget officer to serve at its pleasure. Any officer or employee, including a governing board member or the jurisdiction's finance officer, may serve as the budget officer—except for counties, the sheriff and, in counties with more than 7,500 people, the register of deeds. In counties or cities with an administrator rather than a manager, the administrator typically serves as budget officer.

Having one official who is responsible for budget preparation focuses responsibility for timely preparation of the budget, permits a technical review of departmental estimates to ensure completeness and accuracy, and allows for administrative analysis of departmental priorities in the context of a local government's overall priorities. This centered responsibility for budget preparation means that the governing board receives a budget already reviewed by someone who shares its overall perspective and who has first-hand knowledge to evaluate and recommend services and priorities.

In reality, however, the manager often delegates many of the duties associated with budget preparation to another official or employee, for example, the finance officer or a separate budget director or administrator. This is strictly an administrative arrangement, with the official or the employee performing these duties under the direction of the manager. Under the law, the manager retains full responsibility for budget preparation.

The Annual Budget Preparation Process

The LGBFCA provides for three general stages of annual budget preparation and enactment: formulation of expenditure requests and revenue estimates by department, preparation of a recommended budget by the budget officer, and governing board review and enactment of the annual budget ordinance.

15. Government Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: GFOA, 2001). The Local Government Commission also discourages the accumulation of fund balances in internal service funds.

Initiation of the Budget Process

Before the budget process begins, the budget officer, often with direction and advice from the governing board, establishes an administrative calendar for budget preparation and prescribes forms and procedures for departments to use in formulating requests. Budget officers often include fiscal or program policies to guide departmental officials in formulating their budget requests.

Calendar for Budget Preparation

The LGBFCA specifies the dates by which each stage in the annual budget process is to be completed (G.S. 159-10 through -13). Departmental requests must be submitted to the budget officer before April 30. The recommended budget must be given to the county commission or city council no later than June 1, and the governing board must enact the budget ordinance by July 1, when the fiscal year begins. The most important of these dates is the last one.

Even if the budget ordinance is not enacted by July 1, its legal validity is not impaired once it is enacted. Similarly, even if the departments and the budget officer miss their target dates, neither the budget process nor the budget is invalid in any way. The failure of a local government to enact its annual budget by July 1, however, may suggest that it is experiencing problems in managing its fiscal affairs. The LGC and the bond rating agencies look unfavorably on such a failure if it happens year after year. If a local government fails to enact its annual budget ordinance by July 1, it must enact an interim budget to provide legal authority for expenditures made from July 1 to when the budget ordinance is finally approved.

The statutory dates of April 30, June 1, and July 1 for budget preparation serve as targets for establishing an administrative calendar for annual budgeting. This calendar can be established by working back from the statutory dates. It should specify who is responsible for doing what in annual budget preparation and enactment.

Several key issues arise in setting the administrative calendar. The most obvious one is how much time the calendar should provide overall for budget preparation. The larger and more complex the budget, the more controversial the issues addressed in it, and the more departmental and citizen participation in the process, the longer the calendar needs to be. Large and many medium-sized counties and cities allow for at least six months for budget preparation and enactment. Budget preparation and enactment spans three or four months in many small counties and cities.

A second issue concerning the administrative calendar for budget preparation is whether the governing board and the budget officer should, at the very start of the process, set guidelines for departments to follow in making budget requests. Although the LGBFCA does not expressly address this early role for the governing board and the budget officer, it does not prohibit such a practice, and more counties and cities are using it. Such a procedure enables elected and top administrative officials to take more initiative in setting policy in the budget. It also saves time for department heads: guidelines tell them early what priorities and intentions are; therefore they need not waste time generating requests that have no chance of being funded.

Budget Forms and Procedures

Forms are unavoidable in budgeting: they are necessary to calculate estimated revenues and appropriations; they are important because by structuring information, they can influence the outcome of budget decisions. The budget officer has the authority to prescribe the forms and the procedures for departments to use in preparing their requests. As contained in G.S. 159-10, requests “shall be made in such form and detail, with such supporting information and justifications, as the budget officer may prescribe.” A common practice in larger jurisdictions is for the budget officer to prepare a budget manual—including forms, instructions, and sample requests—and to provide other information such as historical data for departmental officials to use in making their requests.

Several types of forms are basic and are found in almost any budget preparation system, regardless of a jurisdiction’s size and approach to budgeting. One type contains positions and corresponding salaries and wages. A second type contains budget requests by object and line item. In addition to budget requests for the coming fiscal year, G.S. 159-10 also requires that the finance officer or department heads prepare and forward to the budget officer information on actual expenditures for the prior fiscal year and estimated expenditures for the current fiscal year. Counties and cities often use additional request forms that are tailored to their needs in budget preparation. The information from the various forms used for preparing budget requests is usually consolidated as the budget process moves from the request stage through the recommended budget and enactment stages.

Departmental Requests

A departmental budget request typically includes expenditures for salaries, fringe benefits, operating supplies, and capital items. It may include requested money for new positions or improved or new services, and it may show a service plan focusing on program goals and objectives, including performance measures. In some jurisdictions, departmental budget requests distinguish between expenditures to continue services at current levels and those to expand or improve services. If budget reductions are to be made, departmental budget requests often identify where the budget cuts should be made or what services should be reduced.

Departmental Receipts

G.S. 159-10 requires that the budget request for a department include all revenues that it expects to collect in the budget year. The request must show such receipts whether they are available for financing general services or earmarked by law. In many counties and cities, the finance officer actually makes the estimates of revenues to be collected by a department. If departmental officials make these estimates, they should be reviewed by the county or city finance officer before they become part of the budget.

Line-Item Expenditures

Salaries and wages make up the largest share of expenditures in most departmental budget requests. To estimate these requirements, departmental officials typically start with a list of existing authorized positions. A budget request should not overlook special salary payments such as overtime, premium pay for work on holidays or on second or third shifts, and longevity pay if authorized. Decisions on salary and wage increases or adjustments are usually made on an organizationwide basis; therefore the money to fund them is usually not included in departmental budget requests. That money initially remains outside the budget or is budgeted initially in a nondepartmental account. The money is transferred to departmental salaries-and-wages accounts after the governing board approves the increase or the adjustment.

Fringe benefits are an increasingly expensive component of most departmental budgets. Such benefits include time away from work (for example, vacations and sick leave). Although time away from work may not require specific cash outlays by a local government and therefore does not of itself have to be budgeted, it may create the need for expenditures for temporary employees or even other permanent positions, which, of course, do have to be budgeted. Fringe benefits also include contributions for Social Security, health and other insurance, retirement benefits, and other employee benefits, which all must be budgeted. Because of increasing fringe benefit costs for permanent employees, some counties and cities are relying more on temporary or part-time employees (for whom they must usually pay only Social Security contributions) or on private contractors to perform certain functions or work.

Supplies and operating expenditures are another component of departmental budget requests. In this category, inflation must be taken into account. On the items that a local government buys, like gasoline or uniforms, inflation may run higher or lower than increases in the general consumer or wholesale price indexes. In budgeting for inflation, a local government should refer to one or more of the special price indexes available to measure cost increases for supplies or services that local governments use. Some counties and cities require departments to use a single percentage-increase allowance to budget for inflation for all items; others permit departments to use percentage-increase allowances that vary from item to item. The percentage-increase allowance(s) can be based on knowledge of what inflation has been over the most recent fiscal year or twelve-month period, or on a forecast of what it is projected to be in the budget year.

Acquisitions of capital assets such as equipment, vehicles, and furnishings also are a significant part of most departmental budget requests. A capital item is one that is held or used for more than one year and is of significant value, for example, worth $1,000 or more. In budgeting for capital outlay, counties and cities find it useful to distinguish between items that replace existing equipment, vehicles, or furnishings, and items that are in addition to existing items. Replacements of capital items are usually more likely to be approved and funded in the budget than additional ones. The difficulties of budgeting for expensive capital or permanent property in the annual budget have been eased somewhat with the wide availability of lease and installment purchase arrangements for financing capital items. In the past a local government had to pay cash in one lump sum up front to acquire most capital or permanent property items. Now a local government has the choice of paying for capital items in cash or in installments, including interest costs, over several years under leases or installment purchase contracts.

Service Plans

Counties and cities often require departments to include annual service plans with their budget requests. These plans establish the desired level of performance for departmental services, including performance measures of output, outcome, and efficiency. Quantifiable objectives, which state the desired level of performance, are used to monitor the progress toward obtaining organizational and programmatic goals. A service plan can be the starting point—or one of them—in preparing a budget request. Too often the only formal starting point for a departmental budget request is its current year's budget. Elected officials are increasingly asking about the quantity, efficiency, and quality of services, and departmental service plans help answer these questions.

Continuation and Expansion Expenditures

Departmental budget requests may distinguish between continuation and expansion expenditures. Continuation expenditures are generally those that are made just to provide the same level of service in the coming budget year that the department is providing in the current year. Such expenditures typically include outlays in the current year that will repeat in the budget year with adjustments for salary and wage increments, inflation or deflation on items to be purchased, rate changes on contractual obligations, necessary replacement of capital equipment, and certain nonrecurring items. Expansion expenditures typically include requests for new positions, for additional capital equipment or assets, and for program growth or new services. Expansion expenditures are highlighted in almost any budget request and must usually be well justified to be approved and funded. The justification should refer to any law or contract that will be violated if the request is not funded; use statistics, if available, to show the need for what is being requested; indicate whether other jurisdictions are funding the service or the item being requested; and include a forecast of probable expenditures for the request for several years beyond the coming budget year.

The Recommended Budget

The LGBFCA requires that the budget officer's recommended budget be balanced unless the governing board insists that an unbalanced budget be submitted [G.S. 159-11(c)]. In the latter instance, the budget officer could simply forward the departmental requests and revenue estimates at current rates to the governing board, noting the property tax rate that would have to be levied to balance the budget. Even in this circumstance, however, the budget officer should conduct at least a technical review, checking the accuracy and the completeness of departmental requests.

This minimal role for the budget officer in compiling departmental budget requests and estimating revenues does not fulfill the intent of the LGBFCA. The budget officer should be much more than a clerk who compiles budget figures and passes them on to the board. The LGBFCA calls on the budget officer to prepare a balanced budget for the local government. Until this happens, the various components of the budget may exist, but the budget for the local government as a whole has yet to be created. Developing a balanced budget for the whole organization requires the budget officer to exercise both judgment and skill with regard to fiscal requirements, program needs, and the political environment. In short, the budget officer's role in preparing a budget is a crucial one. A governing board should expect the budget officer to review departmental requests substantively, examine revenue estimates, recommend needed changes in service levels and revenue rates, and present a budget that balances the needs and the resources of the local government.

The Budget Officer's Review of Requests

In setting the administrative calendar for budget preparation, the budget officer can require that requests be submitted all at once or on staggered dates. Having the requests come in on a staggered basis over several weeks spreads the work of budget review.

What, specifically, should be the focus of the budget officer's review of departmental requests? First, the budget officer or staff should make sure that all expenditure items included in the base on which departments have built their budget requests are needed. The base for building a budget request is most often an updated estimate of expenditures for the current year. This base is generally calculated by starting with the current year's budget as enacted on last July 1, adjusted for amendments and actual expenditure experience from July 1 to date, and further adjusted by a revised forecast of expenditures for the remainder of the current year. In jurisdictions facing fiscal constraints, the budget base may be reduced to an amount equal to 95 percent or less of the revised estimate of the current year's expenditures. In some cases, the base may include all expenditures necessary to continue services at current levels for the coming budget year. In most situations this would provide a base somewhat above the revised estimate of the current year's expenditures.

Second, the budget officer should make sure that every additional dollar included in a budget request over the base is accounted for. Thus if the base—that is, the revised current year's estimated expenditures—for a particular department or program amounts to $4,200,000, and the budget request for next year for the department or the program is $4,500,000, the request should make clear how the additional $300,000 will be spent, and the budget officer should make sure that the additional money is needed.

Third, any new permanent position or capital requests should be scrutinized. Although the cost of a new permanent position may be modest relative to the entire budget, approving a new permanent position represents a long-term commitment that will be expensive over time. The substantial acquisition or financing costs for most capital improvements and major equipment items require them to be examined, especially if they are associated with program expansion or the start-up of a new program, or if they will have a significant impact on current and future operating budgets.

Fourth, the budget officer must look carefully at the revenue side of the budget. The budget officer should make certain that revenues estimated for each source are realistic. G.S. 159-13(b)(7) states that the annual budget ordinance "shall include only those revenues reasonably expected to be realized in the budget year." The budget officer also should make sure that revenues that will not recur in future years are used only for nonrecurring types of expenditures and also that any alternative revenue sources that are locally available are not overlooked.

Fifth, the budget officer should formulate or review recommendations and options for salary and wage increases or adjustments. Such increases or adjustments can take various forms. The traditional alternatives are cost-of-living and merit pay adjustments (performance). Some local governments also use bonuses. Both cost-of-living and merit pay increases are typically added to the salary-and-wage base and continue in that base each year thereafter. Bonuses, on the other hand, are usually not built into the salary-and-wage base and therefore are not continuing commitments in subsequent years. Cost-of-living or merit pay increases can be made effective on July 1 or later during the fiscal year on the employee's anniversary date.

Finally, the budget officer must decide what property tax rate to recommend to the governing board. The tax rate is almost always the focal point of any budget. In selecting a tax rate to recommend, the budget officer must resolve the following questions:

1. Should the property tax rate remain the same? If so, what effect will the unchanged rate have on fund balance and services?
2. Should the tax rate be lowered? If so, by how much, and what effect will the lower rate have on fund balance and services?
3. Should the tax rate be raised? If so, by how much, and how will the additional tax revenue be spent? Will it finance new or expanded services or be used just to finance existing services? Can the property tax rate be raised given the views of the governing board and the citizens?

Submission of the Recommended Budget

The budget officer must submit a recommended budget to the governing board "not later than June 1." Because this should be an occasion for summarizing and explaining the budget to both the board and the public, the law urges that the budget be submitted at a formal meeting of the board, when the explanation is most likely to reach the public. Many boards hold a regular meeting during the first full week of each month, and this meeting in June is often the occasion for budget submission, even though the meeting date will only rarely fall on June 1. This is acceptable because like April 30, June 1 is primarily a guideline, a checkpoint on the way to adopting the budget by July 1. The budget is commonly submitted well before June 1.

When submitting the budget, the budget officer must include a budget message. This message should introduce and summarize the budget. Thus the message should emphasize the major features of the proposed budget, especially significant changes or additions from the current year's budget. G.S. 159-11(b) states that the message should include the following:

- a concise explanation of the governmental goals fixed by the budget for the budget year,
- important features of the activities anticipated in the budget,
- reasons for stated changes from the previous year in program goals, programs, and appropriation levels, and
- any major changes in fiscal policy.

Although a written format for the budget message is not explicitly required, it is preferable to a simple oral statement. An oral statement summarizes the budget only for those who are present. The larger public does not benefit from the statement except to the extent that they learn of it in the press. Normally the budget message takes the form of a letter from the budget officer to the governing board and is bound with or attached to the document presenting the full budget.

It is common practice for the budget to be presented in a budget document that includes tables and graphs showing revenues by fund and source and expenditures by fund, department, function, or program. Some budget documents also contain organizational charts; statements of policies that have guided preparation of the budget; goals, objectives, and performance measures for departments and programs; and lists of positions authorized in the budget. The document should present explanations of changes or increases in the recommended budget from expenditures for the current year. It also may contain special sections that highlight specific challenges facing the local government, such as a slow-growing property tax base and the need to rely more on user fees.

On the day that the budget officer submits the budget to the governing board, he or she must file a copy with the clerk to the board. The clerk must then make the copy available for public inspection and available to all news media in the county [G.S. 159-12 (a)]. In practice, the budget officer often sends a copy of the budget to each of the major news media that cover the county or city.

The board must schedule a public hearing on the budget after it is submitted but before the budget ordinance is adopted [G.S. 159-12(b)]. After the budget is filed and the date for the hearing is set, the clerk to the board must publish, in a newspaper with general circulation, a legal notice stating that the budget has been submitted to the board and that a copy is available for public inspection in the clerk's office. The notice should also give the time, the date, and the place of the budget hearing. While not required, the notice may include a summary of the proposed budget. The statute requires no specific minimum number of days between the date on which the notice appears and the date on which the hearing is held; however, the notice should be timely enough to allow for full public participation at the hearing.

Revenue-Neutral Tax Rate

G.S. 159-11(e) requires each county, city, or other local unit levying a property tax to publish a revenue-neutral tax rate as part of its budget for the fiscal year following the year when a revaluation of real taxable property occurs. Such publication provides board members and citizens with comparative information on property tax rates. G.S. 159-11(e) states that "the revenue-neutral tax rate is the rate that is estimated to produce revenue for the next fiscal year equal to the revenue that would have been produced for the next fiscal year by the current tax rate if no reappraisal had occurred." The revenue-neutral tax rate is calculated as follows:

1. Determine a rate that would produce revenues equal to those produced for the current fiscal year.
2. Increase the rate by a growth factor equal to the average annual percentage increase in the tax base due to improvements since the last general reappraisal.
3. Adjust the rate to account for any annexation, de-annexation, merger, or similar events.

There are several places within the budget document that could be used by the budget officer to present and explain the revenue-neutral tax rate, including the budget message, the budget summary or the revenue section of the budget document, or a provision in the proposed budget ordinance if it accompanies the recommended budget. It is recommended that the budget officer use the budget message for providing a statement of the revenue-neutral tax rate. The budget message highlights important features of the budget and changes or differences between the current and budget years; the reappraisal of real property, its effect on the tax rate, and the recommended tax rate for the budget year are important features of any local budget presentation.[16]

Enactment of the Annual Budget

Board Review

Once the proposed budget is before the governing board, several general legal provisions apply to board review and adoption of the budget ordinance. First, at least ten days must elapse between submission of the budget and adoption of the budget ordinance [G.S. 159-13(a)]. Second, during the interval between submission and adoption, the board may conduct its review at both regular and special meetings. The particular notice requirements of G.S. Chapter 153A and of any local act applying to a county and of G.S. Chapter 160A and of any local act applying to a city may be ignored. However, the notice requirements of the open meetings law (see G.S. 143-318.12) must be met; each governing board member must be notified of any budget review meeting to be held, and only budget matters may be discussed at such meetings (G.S. 159-17). Third, the open meetings law (Article 33C of G.S. 143) applies to the budget preparation and enactment process. There is no provision allowing closed sessions for the local budget process.

Board practices in reviewing the budget vary across jurisdictions. The board may hold the one statutorily required public hearing and stop there, accepting with little question the budget officer's recommendations. The review may last only a day or a few days. Most boards, however, take several weeks to review the budget with a series of briefings or meetings. Ordinarily, each meeting addresses one part of the budget, and the budget officer, often with help from budget staff, the finance director, and department heads, briefs the governing board on that part. Citizens and repre-

16. For more information on this topic, see Shea Riggsbee Denning and William C. Rivenbark, "Statement of Revenue-Neutral Tax Rate and Provision for Mid-Year Property Tax Rate Change," *Local Finance Bulletin* 32 (November 2004), Chapel Hill, N.C.: School of Government.

sentatives of organizations or groups in the community also often comment on particular parts of the budget at these meetings. The board may make decisions on particular requests as the meetings progress, or it may hold its decisions until the review is finished.

Whether the board's review is short or long depends very much on what the recommended budget includes—that is, whether it requests new positions and programs, makes cuts in existing programs or activities, calls for a tax rate increase, and so on. The length of the review process also may depend on personal or political considerations. For example, if members of the board essentially agree on major issues and have confidence in the budget officer, their review may well be short. If the opposite is true, however, review by the board may be long and difficult.

Public Hearing(s) on the Budget

Although the governing board may hold a series of budget review meetings or briefings, they do not satisfy the requirement for a budget hearing under G.S. 159-12(b). This law expects at least one hearing on the entire budget, primarily to allow citizens to speak to the board. As with most of the budget process, the law permits variety and flexibility in conducting the required budget hearing. The hearing may be the culminating step in the board's review of the budget. Even when this is not the case, the hearing is usually held nearer to adoption than to submission of the recommended budget. Of course, the board may hold more than the one statutorily required hearing on the budget after submission and before enactment of the budget.

Enactment of the Annual Budget Ordinance

G.S. 159-13(a) directs that the budget be adopted by July 1. If this does not occur and expenditures must be made before the annual budget ordinance is adopted, G.S. 159-16 requires that the governing board adopt an interim budget, making "interim appropriations for the purpose of paying salaries, debt service payments, and the usual ordinary expenses" of the local government until the budget ordinance is adopted. An interim budget should not include appropriations for salary and wage increases, capital items, and program or service expansion. An interim budget may not levy property taxes, nor should it change or increase other tax, user fee, or other revenue rates. The purpose of an interim budget is to keep operations going at current levels without funding new or expanded programs or changing fiscal policy. Although there must be cash available to fund interim appropriations, the interim budget need not include revenues to balance the appropriations. All expenditures made under an interim budget must be charged against the comparable appropriations in the annual budget ordinance once it is adopted. In other words, the interim expenditures are eventually funded with revenues included in the annual budget ordinance. If the annual budget ordinance will be adopted a few days late but before any payroll is due or other expenditures must be made, an interim budget may be unnecessary.

The LGBFCA specifically provides that the budget ordinance may be adopted at any regular or special meetings at which a quorum is present, by a majority of those present and voting (G.S. 159-17). Adoption of the budget ordinance is not subject to the normal ordinance-adoption requirements of G.S. 153A-45 for counties and G.S. 160A-75 for cities.

The budget ordinance must contain revenue estimates, appropriations for expenditures, and any property tax levy. The ordinance must show revenues and expenditures by fund and demonstrate a balance in each fund. The property tax levy is stated in terms of a rate of cents per $100 of taxable value. The stated rate also may be accompanied by the dollar amount of the levy, the taxable value to which the rate is applied to produce the dollar amount of the levy, and the percentage of the levy that is estimated to be collected. The estimated collection percentage used for the property tax in the budget may not exceed the percentage of the property tax levy collected in the year preceding the budget year. Typically the annual budget ordinance devotes a section to appropriations and revenues for each fund and one to the levy of property taxes.

Although these sections are sufficient, the annual budget ordinance may contain other sections or provisions as well. For example, it might include instructions on its administration. If the ordinance makes appropriations very broadly, it might direct that expenditures comply not only with the ordinance but also with the more detailed budget document on which the ordinance is based. If a fund contains earmarked revenues and general revenues, or supports a function for which property taxes may not be used, the ordinance might specify the use of the earmarked funds or direct which non-property-tax revenues are to support the function in question. The ordinance also may authorize and limit certain transfers among departmental or functional appropriations within the same fund pursuant to G.S. 159-15, put certain restrictions on interfund loans within the year (the governing board should approve interfund loans that remain outstanding from one fiscal year to the next), and set rates or fees for public enterprises or other governmental services.

Finally, G.S. 159-13(d) directs that the budget ordinance be entered in the board's minutes and that within five days after it is adopted, copies be filed with the budget officer, the finance officer, and the clerk to the board. Because the LGBFCA itself requires that this filing take place, the ordinance need not restate the filing requirements.

Budget Modification and Amendment

The adopted budget ordinance is not merely a financial plan for the coming fiscal year. It represents the legal gauge against which expenditures must be measured. Expenditures are authorized by an appropriation in the ordinance, and sufficient moneys must remain in the appropriation to cover all expenditures. Obviously, events during a fiscal year may occasion greater or less spending than anticipated for some activities, or needs may arise for which there is no appropriation or for which the existing one is exhausted.

To meet these situations, three types of changes to the annual budget may be made: first, certain budget modifications may be made without changing the ordinance; second, expenditures may be made from contingency appropriations; third, the annual budget ordinance itself may be amended. The next three sections discuss these types of changes.

An adopted project ordinance also is a legal gauge against which expenditures are measured, as well as a plan for the project. Although an approved financial plan for an internal service fund provides only estimates of fund revenues and expenditures, the LGBFCA addresses modifications to such plans. Later sections discuss amendments and modifications to project ordinances and financial plans for internal service funds.

Modifications in the Annual Budget

The budget normally exhibits greater detail than the budget ordinance. Thus an ordinance may make appropriations by department within the general fund, while the budget on which the ordinance is based may break down departmental totals into line-item categories or accounts. For example, the budget might show the following breakdown for a recreation department for the fiscal year:

Recreation Department	$401,400
Personnel services	$249,000
Contractual services	$41,000
Operating expenses	$74,250
Capital outlay	$37,150

If only the total departmental figure of $401,400 appears in the annual budget ordinance, it is only that figure against which expenditures are compared by law. In other words, as long as the recreation department's expenditures do not exceed $401,400, there is no violation of the annual budget ordinance.

To continue the example, events during the year result in these actual recreation department expenditures:

Recreation Department	$396,200
Personnel services	$262,400
Contractual services	$41,000
Operating expenses	$47,600
Capital outlay	$45,200

Even though two of the accounts (personnel services and capital outlay) have been overspent, the annual budget ordinance has not been violated because the budget ordinance's appropriation for the department of $401,400 has not been exceeded.

Contingency Appropriations in the Annual Budget

Contingency appropriations are intended for funding unanticipated expenditures. Moneys may be transferred from contingency appropriations and spent by direct authorization of the governing board or by order of the budget officer with express delegation from the governing board [G.S. 159-13(b)(3)]. If the budget officer is given the authority to approve transfers from and expenditures of contingency appropriations, he or she must report any such expenditure to the governing board at its next regular meeting, and the report must be recorded in the board's minutes. Money transferred from a contingency appropriation and spent is charged to the departmental, functional, or project appropriation for which it is spent and not to the contingency appropriation.

Amendments to the Annual Budget Ordinance

A governing board has broad flexibility to amend the budget ordinance. However, there is a legal limitation on amending the tax levy after the budget ordinance is adopted. G.S. 159-15 permits the governing board to reduce or increase the property tax levy before January 1 by amending the budget ordinance to account for the unanticipated increase or reduction in revenue. There are practical concerns with changing the tax levy during the first half of the fiscal year, which can create problems for the administration and collection of property taxes and lessen the credibility of a local government with taxpayers and citizens. Therefore, this is generally not a recommended course of action.[17] If the budget ordinance sets rates or fees for other taxes or revenue sources, the LGBFCA imposes no restrictions on amending the rates or fees during the fiscal year, although practical difficulties may be involved. Thus the privilege license tax schedule may be revised during a year, but a change would not be effective until the next license year begins in July. On the other hand, user fees and charges—such as water rates, admission fees to public recreation facilities, or landfill tipping fees—may be changed via an amendment to the budget ordinance and become effective at any time. Another change possible on the revenue side of the ordinance is the appropriation of additional fund balance if it is legally available.

If revenue estimates are increased or decreased, appropriations for expenditures or appropriated fund balance must be correspondingly adjusted so that all funds and the total annual budget ordinance remain in balance. In amending the budget ordinance, the governing board enjoys the same freedom from the procedural requirements set forth in G.S. 153A-45 for counties and in G.S. 160A-75 for cities. Any amendment to the annual budget ordinance must be by ordinance. Budget amendments may be adopted by a simple majority of board members as long as a quorum is present and do not require either notice or public hearing requirements.

As with contingency expenditures, the governing board may delegate to the budget officer the authority to make certain amendments to the budget ordinance. Subject to restrictions set by the board, the budget officer may be permitted to transfer moneys from one appropriation to another within the same fund (G.S. 159-15). Two elements of this statutory authorization should be emphasized. First, the transfers must be within the same fund; transfers between funds by the budget officer are not permitted. Second, the transfers must be between appropriations; the budget officer may not make changes on the revenue side of the budget, such as increasing the amount of appropriated fund balance. By extension, this means that total fund appropriations may not be increased or changed by the budget officer or any other administrative official. If the power to amend pursuant to G.S. 159-15 is delegated to the budget officer, each amendment must be reported to the board at its next regular meeting, and it must record the report in its minutes.

Amendments to Project Ordinances

A project ordinance may make a single, lump-sum appropriation for the project authorized by the ordinance, or it may make appropriations in detail by line-item, function, or other appropriate categories within the project. If the ordinance makes a single project appropriation, actual expenditures may exceed estimated expenditures in any budget or account category by which expenditures for the project may be classified without violating the project ordinance, as long as total expenditures do not exceed the total project appropriation. On the other hand, if the project ordinance makes appropriations by expenditure category, actual expenditures for a category may not exceed the appropriation for it without violating the project ordinance. If expenditures for a project exceeds the ordinance's appropriation, in total or for any expenditure category for which an appropriation was made, an amendment to the ordinance will be necessary to increase the appropriation and identify additional revenues to keep the project ordinance balanced. Only the governing board may amend a project ordinance.

Modifications to Financial Plans for Internal Service Funds

A financial plan for an internal service fund only estimates annual revenues and expenditures for the fund. The estimates are not legal limits on spending and therefore are not required to be recorded in a local government's accounting system. Thus no violation of the LGBFCA occurs when actual expenditures exceed a financial plan's estimated expenditures, by category or in total. Such spending flexibility is one of the reasons for including revenues and expenditures for an internal service fund in a financial plan rather than in the annual budget ordinance.

Nevertheless, G.S. 159-13.1(d) directs that any change in a financial plan be approved by the governing board. Because a financial plan does not control expenditures, one interpretation of this provision is that it requires the budget officer or staff to report to the board differences between actual revenues and expenditures and the board-approved fi-

17. For more information on this topic, see Shea Riggsbee Denning and William C. Rivenbark, Statement of Revenue-Neutral Tax Rate and Provision for Mid-Year Property Tax Rate Change, *Local Finance Bulletin* 32 (November 2004), Chapel Hill, NC: School of Government.

nancial plan for the internal service fund. A narrower interpretation is that it requires board approval of major changes in internal service fund financing, especially those affecting departmental usage of and expenditures for fund services, and, correspondingly, internal service fund revenues and spending.

Line-Item and Performance Budgeting

Line-item budgeting and performance budgeting refer to general systems or approaches for budget preparation, presentation, and review. Although not mutually exclusive, they are often viewed as alternative budget systems. A line-item budget organizes information principally by expenditure account or object of expenditure, that is, by the items or the resources that a government must acquire to provide public services. In other words, its focus is on inputs. A performance budget organizes information principally in terms of the services to be provided or the objectives to be achieved. In other words, its focus is on outputs, outcomes, and efficiencies. Depending on the stage of development and the particular emphasis given to it when used, performance budgeting has been called by various names: program budgeting, planning-programming-budgeting system, results-oriented budgeting, service budgeting, and, most recently, outcome-based budgeting.

The LGBFCA permits counties and cities to select the particular system or approach for budgeting that they wish to use. Most of the state's small jurisdictions rely essentially on line-item budgeting systems, although a growing number are incorporating aspects of performance budgeting into these systems. Most medium and large jurisdictions use what can be characterized as mixed line-item and performance budgeting systems.

Line-Item Budgeting

A line-item or object-of-expenditure budget emphasizes the amount of money budgeted for each expenditure account. The items or the objects are expenditure accounts that are taken from an entity's accounting system, and they are typically organized into the conventional categories of salaries and wages, benefits on salaries and wages, operating supplies, contractual services, and capital or permanent property. Office supplies, for example, would be a line item or object within the operating supplies category. A line-item budget can present information by object or line-item category, providing a consolidated line-item budget, or by individual line-item or object accounts, creating a very detailed line-item budget. Some line-item budgets are so detailed as to show expenditures for individual positions in the proposed and even in the enacted budgets.

A line-item budget is principally a control tool. It provides information that elected and top administrative officials can use to make sure that revenues are spent only for personnel or items that they approve in the budget. By reviewing requested and recommended expenditures by line, they seek to prevent the misapplication of public moneys and generally to encourage frugality in the use of public funds. The line-item budget's main tool is the departmental accounting system, with its detailed listing of expenditure accounts within each department. These line-item accounts become the categories for budgeting as well as accounting, and in a pure line-item budget format, they are not complemented by information about departmental goals, objectives, or activities.

Performance Budgeting

Performance budgeting emphasizes the relationship between money budgeted and the services to be provided by spending those dollars. This type of budgeting attempts to be specific about the demand for public services, the level (quantity) and the quality at which services are provided, and the results obtained from providing the services. In performance budgeting, mission statements and general goals are established by the governing board to guide budget preparation. Objectives and performance targets based on the mission statements and general goals are formulated by program managers in making their budget requests and are approved by top administrators and the governing board when reviewing and approving the budget. Performance measures relating to the objectives and the performance targets also are identified in the budget. Then, while the budget is being executed, data on these measures are collected to determine the extent to which the program objectives and the performance targets have been achieved. In a full-fledged performance budgeting system, expenditure or cost data are related to performance measures to produce cost-performance ratios that officials can use for budget and management control.

Whereas line-item budgeting is oriented more toward administration and management, performance budgeting is oriented more toward policy or decision making. Because line-item budgeting shows expenditures by line or object, it emphasizes the trade-offs between spending money for one item (such as salaries and wages for permanent positions) and spending that money for another item (such as contractual services). Such trade-offs have more to do with administration and budget execution than with policy making. A performance budget, on the other hand, emphasizes the trade-offs between spending money for one program (like law enforcement) and spending it for another program (like street maintenance). The fundamental directions that a local government takes in providing public services are often at stake in these program trade-offs. Thus the performance budget tends to be more of a policy-making tool as compared to the line-item budget.

Interest in performance budgeting has grown over the last decade and promoted by the following three sources:

1. The books *Reinventing Government* (1992) and The Price of Government (2004) recommend that governments become mission and goal driven and that budgeting systems identify measurable objectives to be achieved with the funds that are budgeted.[18]
2. The Governmental Accounting Standards Board (GASB), which establishes GAAP, has issued a concepts statement recommending that governmental entities develop and include service effort and accomplishment measures in their external financial reports.[19] While there are issues and potential problems associated with including nonfinancial performance data in audited external financial reports, the GASB continues to do research on service efforts and accomplishment reporting and encourages state and local governments to develop and make greater use of such data. This is likely to cause many local governments across the nation, including those in North Carolina, to adopt one form or another of performance budgeting.
3. The Government Finance Officers Association of the United States and Canada (GFOA) has adopted two recommended policies on the use of performance information in their budgeting systems.[20] The GFOA also sponsors a Distinguished Budget Presentation Awards Program for state and local government budgets. In this program, budget documents are evaluated as policy documents, financial plans, operational guides, and communication devices. Some of the specific criteria in several of these general areas are related to performance budgeting and have the effect of encouraging governments seeking the award to incorporate aspects of performance budgeting into their budgeting systems.

Incremental Budgeting and Zero-Based Budgeting

Incremental Budgeting

Budgeting in government over the past half-century has focused on the changes in the budget from year to year, especially on the ways in which additional funds are to be spent. Additional revenue resulting from growth in the tax base, occasional increases in the tax rate, and generally modest but continuous increases in other revenues have provided the increments to allow annual growth in expenditures. Some of the additional revenue available in any year is typically applied to finance increasing costs for existing programs. The rest may be used to finance improvement or expansion in existing services or start-up of new services, or it may be returned to the taxpayers by lowering taxes. Incremental budgeting focuses on these issues. Expenditures for existing services in the current year that repeat in the budget year, and the revenues that finance them, are the base in an incremental budget, and they are usually approved and funded after limited review. Precedent enters into play in this situation: if expenditures were made in the past and are being incurred in the current year, budget makers are generally willing to approve them again for the next budget year.

---

18. David Osborne and Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector* (Reading, Mass.: Addison-Wesley Publishing Company, 1992); David Osborne and Peter Hutchinson, *The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis* (New York: Basic Books, 2004).

19. Governmental Accounting Standards Board, *Concept Statement No. 2 on Service Efforts and Accomplishment Reporting* (Norwalk, Conn.: GASB, April 1994). The *Concept Statement* is a draft recommendation of the GASB; it does not constitute GAAP.

20. Government Finance Officers Association of the United States and Canada, *Recommended Practices for State and Local Governments* (Chicago: GFOA, 2001).

A growing number of citizens and taxpayers question whether the base—roughly the current year's budget—should be accepted so readily in preparing the next year's budget. They point out that the need for an existing program may have diminished, and if so, budget makers should challenge its continuation and perhaps cut it back or eliminate it altogether. Such a course would permit revenues that would have been spent for the program to be reallocated to higher-priority existing programs or to new programs, or to be returned to the taxpayers in tax reductions.

Zero-Based Budgeting

Zero-based budgeting has been advocated for reducing expenditures in existing programs and applying the money to other, more pressing needs, or lowering taxes. In this kind of budgeting, the base is zero rather than the current year's expenditure and revenue level, and the current year's expenditures are not accepted as a given in preparing the next year's budget. In zero-based budgeting theory, all continuing or current-year expenditures must be justified each time the budget is prepared and approved.

Zero-based budgeting can be understood more fully by making two comparisons of what it calls for in theory and what it has actually achieved in practice. First, in zero-based budgeting, according to the theory, the starting point is zero, and review efforts are spread over the entire budget rather than concentrated on any one part of it. In practice, where zero-based budgeting has been tried, the starting point has not been zero but some level below the current year's budget or expenditure level—10 percent below the current expenditure level for example. This base may represent what officials consider to be a minimum level of effort for a service or a program if it is to be provided at all.

Second, in zero-based budgeting, in theory, no priorities exist when the budget process begins, and all requests, whether for ongoing programs or continuing expenditures or for new ones, are ranked during the budget process. In practice, the minimum level of service in zero-based budgeting—90 percent of the current year's expenditure level—has top priority, even at the beginning of the budget process. The process is then used to establish priorities among the requests for program expansion beyond the 90 percent and for new programs.

Putting zero-based budgeting into practice entails some practical problems. First, it requires more time and work than incremental budgeting. The justification and the review of requests in zero-based budgeting focus not only on the changes from the current year's budget, but also on at least some current year's expenditures. Second, zero-based budgeting involves some political risks that are not as present in incremental budgeting. Because existing services stand to be reduced or eliminated in zero-based budgeting, the clients who benefit from these services and the employees who provide them are likely to object to proposed reductions identified in the budgeting process. If such reductions must or should be made, this ought not to dissuade the budget officer and the governing board from using zero-based budgeting to select and make them. However, these officials should be prepared to cope with the political repercussions.

A few governments have applied the thorough budgetary review characteristic of zero-based budgeting to only a few programs each year. After five or six years, all departments have been examined in such a thorough review. This practice is a rotating approach to zero-based budgeting. The reasons for undertaking it may have as much to do with the need periodically to assess and update departmental policies, organization, and methods as with any need to reduce budgets.

A local government can of course cut existing services or shift funding among them without resorting to zero-based budgeting or a modified version of it. For example, officials can simply ask departments to rank existing services, activities, or items according to priority, thereby identifying expenditures that they would cut first if they had to make budget reductions. Alternatively officials can review programs and budgets and identify areas where they can make improvements in productivity, thereby saving money without intending to cut services. However, a caution is in order: significant and true improvements in productivity often cannot be achieved without at least some initial investments of money.

Multiyear Financial Forecasting

A multiyear financial forecast projects revenues and expenditures over a future planning period, usually for a term of somewhere from five to ten years. If a local government has a multiyear capital improvement program, the forecast usually covers the same future period as that program.

Multiyear financial forecasting helps local officials plan more effectively for the future. A forecast can be useful to officials in anticipating long-term program needs and thinking through the most cost-effective ways to meet those needs, and it can provide a context for long-range management planning. A multiyear forecast is especially important for public utilities and enterprises, which are often capital intensive and for which long lead times are needed to plan and put infrastructure, facilities, and equipment into place. Multiyear forecasting is useful for any local government that is undertaking major capital improvements. Regardless of how capital projects are financed initially, through debt or from current revenue and reserves, they must ultimately be paid for from operating revenues. Future operating revenues must cover not only future operating expenditures but also annual principal and interest payments on bonds and other debt issued to finance capital projects, as well as capital projects and outlays financed on a pay-as-you-go basis directly from future operating revenues. A multiyear forecast can reveal a local government's ability or inability in the future to cover these future debt service, capital, and operating requirements.

The LGBFCA does not require a local government to prepare a multiyear financial forecast. Preparing one is a matter of local policy. In jurisdictions where multiyear revenue and expenditure forecasts are prepared, the forecasts are generally presented to the governing board. The forecast may be included in a special section of the annual budget document or in an altogether separate document.

The methodology for a multiyear financial forecast typically carries forward revenue and expenditure trends from prior years and adjusts them for events that officials know or expect will affect the trends during the forecast period. The forecast of revenues is typically by fund and by major source within each fund. For the general fund, separate forecasts would ordinarily be made of revenues from the property tax, the sales and use taxes, major intergovernmental revenues, and other sources. For utility or enterprise funds, separate forecasts would be made of revenues from each major operating or user charge and from other sources. The forecast of some revenues should involve a projection of the tax base—for example, taxable value for the property tax—with the forecast resulting from application of the current or an adjusted tax rate to the projected base. Most forecasts assume the continuation of current tax or revenue rates through the forecast period. The advantage of this is that it avoids assumptions about board actions during the forecast period to increase rates or charges. The disadvantage is that the forecast could show imbalances between revenues and expenditures for particular years. Some multiyear forecasts assume and provide for changes in the property tax rate or other charges that the forecast shows will be necessary to balance revenues and expenditures in years during the forecast period.

The forecast of expenditures is typically by fund and by department or function within each fund. Forecasts of expenditures can be based on carrying current expenditures into the forecast period, on analyzing probable changes in expenditures in each expenditure category, or some combination of these approaches. An expenditure forecast based partly or wholly on an analysis of probable changes or increases in expenditures would have to make some assumptions about salary and wage adjustments, inflation or deflation, replacement of capital equipment and property, creation of new positions, expansion of existing programs and creation of new ones, and acquisition or construction of new capital infrastructure during the forecast period.

Appropriations to Nonprofit Organizations

Counties and cities seldom provide all the local public services in their communities that citizens want or need. Nonprofit organizations also provide services to citizens. Some of these organizations provide services such as homeless shelters or soup kitchens to disadvantaged persons or groups. Others, such as local arts councils or historical societies, sponsor cultural programs, events, or exhibits that are open to the public. Still others, like chambers of commerce or downtown business associations, promote economic development in the community or administer certain civic programs. Many of these nonprofit organizations seek funding from counties and cities on an annual basis to help fund service provision.

Under the public-purpose limitation, a county or city is authorized to contribute money to nonprofit or other organizations to carry out any public purpose that the county or city itself is authorized by law to undertake.[21] Despite statutory authorization, members of governing boards may disagree philosophically on whether the local government should provide funds for social or other programs administered by nonprofit organizations. Some board members may argue that funding such agencies is the responsibility of the private sector. Other board members may believe that local government support of nonprofit organizations is necessary to address specific community problems.

How counties and cities handle funding requests from nonprofit organizations in the budget process is important. It is recommended that counties and cities adopt a standardized process to handle external requests from nonprofits.

21. N.C. Const. Art. V, § 2(7); G.S. 153A-449.

Once the funding request is approved, a written contract or agreement between the local government and the nonprofit should be required. The contract should specify the purpose of the funds and should require accounting documentation on how the funds were spent. If the contribution to an agency is more than $1,000 during a fiscal year, the local government may require an audit of the agency's finances [G.S. 159-40(a)]. However, certain nonprofit organizations, such as volunteer fire departments and rescue squads, are exempt from this requirement [G.S. 159-40(d)]. Of course, a local government is not legally required to make contributions to nonprofit organizations, and a local government may require an annual audit of any nonprofit to which it gives funds subject to the limitations of G.S. 159-40, as a contractual condition of the contribution.

In sum, local government officials must decide on the following issues:

1. Whether and to what extent they will contribute to the support of nonprofit organizations
2. What budget procedures they will require nonprofit organizations to follow in making requests for local government funding
3. What contractual and expenditure-control requirements they will impose on nonprofit organizations to which they make contributions.

Budgeting for Federal and State Grants

Counties and cities follow certain administrative procedures to address the challenges involved in budgeting financial resources from federal and state grants. One is to require departmental officials to secure the manager's or the board's approval before applying for any such grant. The budget officer should carefully analyze any requirements for local matching funds for federal or state grants that departments apply for. Once the local government receives notice of a grant award, it can budget it by amending the annual budget ordinance or by adopting a grant project ordinance at that time. Another precaution in budgeting federal and state grants is for a local government to maintain a locally funded contingency or reserve for programs or projects funded with federal or state grants, which can be part of the unappropriated fund balance. Such a contingency or reserve can provide a ready source of matching funds if the local government is unexpectedly awarded a federal or state grant. Alternatively, if federal or state moneys are unexpectedly cut for an existing grant-funded program, but the local government wishes to continue the program, the contingency or reserve gives the local government the ability to continue services until permanent funding for the program is secured.

Finally, some grants are provided on a letter-of-credit basis, by which federal funds are wired to a local government to pay expenditures as they are incurred. Other grants are provided to counties and cities on a reimbursement basis, under which a local government must incur and pay expenditures for a program or a project with its own money and then apply for reimbursement of payment from the federal or state government. In these latter instances, a local government must have a contingency or reserve to undertake the program or the project.

County Budgeting and Appropriations

Education

A major portion of every county's budget funds public education—public schools and community colleges. The North Carolina General Statutes divide the responsibility for county budgeting of local education among the board of commissioners (who have general control of the county's fiscal policy), the county board(s) of education (most counties have only one school system and board of education; a few counties have two or three school systems and boards of education), and the community college board of trustees (many counties have their own community college; some are served by the community college of a neighboring county).[22] Ideally, these boards would agree among themselves each year on the best allocation of scarce resources for local public schools and community college programs.

22. For more information on public schools, see Article 45. For more information on community colleges, see Article 46.

In practice, consensus is often elusive. Boards of education and community college trustees are especially sensitive to citizen demands for better schools. Boards of county commissioners are especially sensitive to citizen demands concerning taxes.

The county board of commissioners is the local tax-levying authority for school administrative units (often referred to as school districts) and community colleges. The fiscal affairs of school administrative units are governed by the School Budget and Fiscal Control Act (G.S. Ch. 115C, Art. 31). Similar provisions for community colleges appear in G.S. Chapter 115D, Article 4A. The budget portions of these statutes roughly parallel the LGBFCA. Both school administrative units and community colleges adopt and administer their own annual budgets independently (mostly—commissioners' approval for certain budget amendments is required) of the county government, but both depend on county appropriations for a significant portion of their total annual revenues.

The following list provides an overview of several important requirements that govern this relationship:

1. Request deadline for school and community college requests [G.S. 115C-429(a) and G.S. 115D-55(a)]. The school and community college budgets must be submitted to the board of commissioners no later than May 15, unless the board of commissioners agrees to a later date. The May 15 deadline is late in the county budget preparation calendar and gives the county budget officer and staff little time to review budget requests and formulate a recommended county budget for submission to the board of commissioners, which must occur no later than June 1. The statutes require submission of the school and community college budget request directly to the board of commissioners rather than to the county budget officer. In most counties, however, the county commissioners expect the budget officer to review these requests and recommend action to the board of commissioners.
2. Allocation of public school appropriations [G.S. 115C-426 and -429(b)]. County appropriations to a school administrative unit are made to the unit's school current expense fund and school capital outlay fund. The current expense fund includes instruction, support, and other operating expenditures of the school system. The capital outlay fund includes appropriations for site acquisition, new buildings and renovations of existing ones, vehicles, and other capital assets. The board of commissioners may make lump-sum appropriations to these two funds, or it may allocate all or part of its appropriations to particular purposes or functions in the current expense fund or to specific projects in the capital outlay fund. Purposes, functions, and projects are defined in the uniform budget format prescribed by the State Board of Education for all school administrative units.
3. Continuing contracts for school capital outlays [G.S. 115C-441(c1) and G.S. 115C-528]. When a school administrative unit enters into a contract for multiyear capital projects, the county commissioners must approve the contract. Approval of the contract by the board of commissioners obligates it to appropriate funds in future fiscal years to pay the amounts due under the contract in those years. There are statutory exceptions to the need for commissioner approval. A local school board does not have to obtain board of county commissioner approval of a multiyear lease- or installment-purchase contract under the continuing contracts statute if (1) the contract is for automobiles, school buses, mobile classroom units, copiers, or computer hardware or software; (2) the contract has a term of less than three years; and (3) the total amount financed under the contract is below the lesser of $250,000 or an amount equal to three times the local school system's annual allocation from the state for classroom materials and equipment.
4. School supplemental taxes. Under G.S. Chapter 115C, Article 36, the voters of a school administrative unit may approve the levy of supplemental taxes, subject to statutory maximum rates, for "any item of expenditure in the school budget." If the voters have approved such a supplemental school tax, the board of county commissioners, as the tax-levying authority for the administrative unit, levies the supplemental tax. When the board of education submits its proposed budget to the board of commissioners, the school board includes its requested rate for the supplemental tax. The board of commissioners may not exceed this rate in setting the rate for the supplemental tax. The board of commissioners may set a lower rate for the supplemental tax than the rate requested by the school board. Even though school supplemental taxes are levied and collected by the county government, they are revenues of the school administrative unit, not county revenues appropriated to the school unit. Therefore, the commissioners' authority to allocate appropriations by purpose, function, and project does not extend to revenues from voter approved supplemental taxes.
5. Apportionment of county current expense appropriations in counties with multiple school systems. In counties with two or more school administrative units, G.S. 115C-430 requires that the board of commissioners appropriate exactly the same amount per pupil to each unit for current operating expenses. This uniform per

pupil apportionment requirement does not apply to current expense fund money raised from supplemental taxes levied in only a portion of the county. Capital outlay appropriations also need not be so apportioned on a per pupil basis.

6. Resolving disputes over county appropriations to schools (G.S. 115C-431). The locally elected school board is responsible for setting local education policy and administering the schools, yet the board of county commissioners has the responsibility for levying the taxes and providing the local money needed to support the schools. This creates an opportunity for a conflict between citizens' demands for improved education and their demands for holding down the tax rate. North Carolina law (G.S. 115C-431) provides an unusual process for a board of county commissioners and a school board to resolve a formal dispute over the county appropriations to the school board. This process may involve formal mediation, although ultimately a court may determine the amount of county funds needed to "maintain a system of free public schools."
7. Appropriations to community colleges. County appropriations to a community college are made to its current fund and its plant fund. As with the schools, the board of commissioners has the power to allocate its appropriation to the community college by purpose, function, or project. The allocation process and its consequences are virtually identical to those that apply to school administrative units. With respect to the community college, however, the commissioners are essentially free to exercise their budgetary discretion without possible review by the courts.

Human Services

County appropriations for human services programs go predominantly to three agencies: the county social services department; the county health department (or for some counties a district health department authority that serves the county); and to the area mental health authority or agency serving the county. Except in Mecklenburg County, each such agency has an appointed board that exercises statutory responsibilities in relation to programs administered by the agency, appoints the agency's chief administrative director, and establishes policies or advises the director and sometimes the board of county commissioners about policies in the areas of work performed by the agency. In the state's largest county—Mecklenburg—the board of county commissioners has assumed the powers, duties, and responsibilities of the social services, public health, and mental health boards as authorized under G.S. 153A-77. Pursuant to the same statute, the state's second largest county—Wake—has created a consolidated human services agency and assigned policy-making, rule-making, and administrative authority to a consolidated human services board.[23]

County appropriations to these human services agencies must address complicated funding streams, involving federal, state, as well as local sources; frequent federal and state changes in eligibility and program requirements; market-driven changes for certain health and mental health services; accountability and performance measurement challenges; and divided responsibility between the boards of county commissioners and their staff, on the one hand, and the appointed boards, the directors, and staff directly involved in administering human services programs.

Social Services

Spending for social services occurs in three major categories: public assistance for low-income recipients; service programs for dependent children, disabled adults, and others; and administration. This discussion addresses five questions related to county budgeting for social services programs.[24]

1. Responsibility for preparing social services budget request [G.S. 108A-9(3) and (4)]. The county director of social services is responsible for "planning budgets" and preparing the budget request to the county for the department of social services. The social services board is responsible for assisting the director with preparing the budget and for presenting it to the board of commissioners. In some counties, the social services budget request goes directly to the county commissioners, who then refer it to the county manager for analysis and recommendation before the commissioners themselves review the request. In other counties, the social services request goes initially to the county manager, who reviews it and then passes the request along with the manager's recommendations to the commissioners.

---

23. This article's discussion of human services programs was written with the assistance of the School of Government faculty members specializing in human services law: Janet Mason, Jill Moore, and Mark Botts.

24. For more information on welfare and social services programs, see Article 42.

2. Information from the state (G.S. 108A-88). Before February 15 of each year, the state Department of Health and Human Services informs county directors of social services, county managers, and county commissioners of the amounts of federal and state aid that are likely to be available for public assistance and social services programs in the coming fiscal year, an estimate of related administrative expenditures, and the percentage of county participation that will be required in each program. These estimates are revised as necessary when the General Assembly or Congress changes eligibility requirements or the level of state or federal funding.
3. Mandated county spending for public assistance and social services programs (G.S. 108A-90 and -93). Within the direct public assistance and services categories are programs that are mandated and others that are discretionary. Medicaid is the most expensive mandated program for counties. Other mandated programs include Work First for needy families (also referred to as Temporary Assistance for Needy Families, or TANF), child and adult protective services, adoption services, foster care, guardianship of certain incompetent adults, and others. The county's budgetary discretion varies from virtually none with respect to some mandated programs to complete discretion with respect to local discretionary programs. State notification of a county's percentage contributions to the costs for mandated programs requires the county to appropriate sufficient funds for these programs. If the county fails to pay its full share of public assistance costs, the governor, as director of the state budget, has authority to withhold distribution of money appropriated from the state general fund for public assistance in the county, and may also withhold revenues from the beer and wine tax that the state collects and shares with counties.
4. Estimating the county's share of costs for public assistance, services, and administrative costs. Counties face certain challenges when preparing budgets for public assistance, services, and related administrative costs. First, although federal and state moneys cover much of these costs, county contributions take a significant portion of the county budget. Second, county appropriations for public assistance, services, or administration can increase substantially and sometimes unpredictably when the federal government or the state increases benefit levels or opens the programs to new recipients. Third, funding for Medicaid and some other mandated public assistance programs is open-ended, with total expenditures by each level of government, including the county, dependent on the number of eligible recipients. That is, any person who meets eligibility criteria for one of these programs is entitled to assistance, which must be provided even though the moneys appropriated for the program are insufficient to cover the program's total costs. As a result, a county can face actual outlays for these programs that are in excess of the budgeted or state forecasted amounts. The LGBFCA recognizes this state of affairs by authorizing contingency appropriations for public assistance programs in an amount greater than the 5 percent limit that applies to other contingency appropriations [G.S. 159-13(b)(3)].
5. Capped federal and/or state aid for service programs and for Work First. Federal and/or state funding for some mandated programs, for example, protective services for children and adults, are capped at certain dollar levels. Because the programs are mandated, counties must have the staff and resources necessary to carry out these mandates, regardless of whether there is federal or state financial participation in covering the costs, causing the county share of the costs for these services to increase. Besides the mandated services, counties may provide and fund, with only county money, services that are not mandated. Federal and state funding for the Work First program, which is both a public assistance and services program, also are capped, which means that counties would be fully responsible for the costs of any Work First benefits or services in excess of the federal and state money available for this program.

Public Health

The board of commissioners may provide public health services in the county through the county's own public health department, by participation in a district health department that serves the county as well as one or more other counties, through a public health authority, or by contract with the state or other entities.[25] This brief discussion highlights some issues that county officials must consider in budgeting for public health programs.

---

25. For more information on local public health services, see Article 41. In counties with more than 425,000 in population, G.S. 153A-77 authorizes the board of county commissioners to abolish the board of health and assume its duties. Mecklenburg County has done this; the county still has a county health department (but a unique one because most of its services are provided through a contract with Carolinas Medical), but the board of commissioners acts as the board of health.

1. Mandated public health services. The statutes do not explicitly require boards of county commissioners to appropriate minimum levels of funding for public health, although county appropriations, when added to revenues from the state and other sources, must be sufficient to support mandated services. The mandated services include some functions that the local public health department must provide directly, for example, conducting communicable disease control activities and enforcing standards for individual water supply sites; and services that the county must either provide or assure are otherwise available in the county, such as certain child health services.
2. Consolidated agreement. State funding for county public health services is provided under a consolidated agreement between the state and the county health department or the district or authority serving the county. If the health department, district, or authority fails to fulfill the terms of the contract, the state can reduce or eliminate state funding for the program that is not in compliance with the contract.
3. Fees for public health services or programs. Fees may be charged to help cover the costs of public health medical services and the costs of certain regulatory programs. Fees charged by county health boards must be based on a plan submitted by the local health director and approved by the county board of health and the board of county commissioners; or for a district, by the district health board and the boards of county commissioners in all counties served by the district [G.S. 130A-39(g)]. The board of a public health authority may establish a fee schedule for public health services [G.S. 130A-45.3(a)(5)]; under this statute, there is no authorization or requirement for county commissioner approval of the schedule. Fees are prohibited for immunizations (G.S. 130A-153); sickle cell syndrome testing and counseling (G.S. 130A-130); examination and treatment of tuberculosis and sexually transmitted diseases [G.S. 130A-144(e)]; HIV testing and counseling [10A NCAC 41A.0202(9)]; and for any programs for which local health department employees act as agents for the state [G.S. 130A-39(g)]. The last prohibition does not apply to on-site wastewater and swimming pool programs and to inspections of tattooing businesses. Like other fees for services, public health regulatory fees must not unreasonably exceed the cost of providing the services for which the fees are charged. Generally, the fees generated in a public health program must be spent for that program. Any fees not restricted to the specific programs generating them must nonetheless be spent for public health [G.S. 130A-39(g)].
4. Public health fund balances. Certain public health programs have generated so much fee revenue that the programs in some counties may have significant fund balances. These balances, like the fee income that produced them, are generally restricted to spending for the fee-supported services and are not available for other public health services or general county needs.
5. Nonsupplant requirements. Finally, boards of county commissioners may consider reducing county appropriations for public health services when revenues from fees or from state or federal sources increase. Although there is no general statutory prohibition against this practice, "nonsupplant" statutes exist (G.S. 130A-4.1 and -4.2) that seek to prevent boards of commissioners from doing this when the state increases funding for health promotion and maternal and child health programs. Also, the consolidated agreement prohibits cuts in county appropriations when revenues from fees and charges increase during the term of the contract. The contract's term is annual.

Mental Health

The vast majority of North Carolina counties administer local mental health services through local agencies called area mental health, developmental disabilities, and substance abuse authorities.[26] Presently, 94 of the state's 100 counties are served by a single-county or multicounty area authority whose governing body, the "area board," has independent governing authority over many matters including area authority services and personnel.[27] For example, the area board rather than the board of county commissioners is the governing body responsible for deciding what services to provide to meet the mental needs of area residents and hiring an area director to administer area services (G.S. 122C-117, -121). In regard to budget and fiscal control, however, the degree to which area boards operate independently of county government depends on whether the area authority serves a single-county or multicounty area. Area authorities that serve a single county area are departments of county government for budget and fiscal control purposes (G.S.

---

26. For more information on local mental health services, see Article 44.

27. The counties of Mecklenburg, Wake, Pitt, Orange, Chatham, and Person provide mental health services through organizational arrangements other than area authorities, which are described in Article 44.

122C-116), meaning that the area authority's budget is subject to review by the county budget officer and approval by the board of county commissioners. Further, the single-county area authority's operations must follow the budget set by the county commissioners in the county's budget ordinance. Multicounty area authorities, in contrast, are considered "public authorities" responsible for their own budgeting and financial management and for appointing their own budget and finance officers. This discussion focuses on four issues that are important to county budgeting for area authorities.

1. County influence over the area authority budget. The ability of the board of county commissioners to approve the budget of single-county area authorities gives the commissioners a substantial role in determining the budget, the scope of services available to county residents, and the number of personnel that the area authority may have. Because all counties must appropriate funds to the area authority serving their county [G.S. 122C-115(b)], boards of commissioners in counties served by multicounty area authorities, though they do not adopt or administer the area authority budget, do shape or influence this budget when determining the level of county appropriations that the county commissioners make for area authority services. Further, to keep counties apprised of the multicounty authority's budget policy and financial status, the multicounty area authority must submit its approved budget and annual audit to the participating boards of county commissioners for information purposes (G.S. 122C-117). Both single-county and multicounty areas authorities must submit financial reports to their respective boards of county commissioners each quarter and as otherwise requested by the county commissioners.
2. Memorandum of agreement. At one time, state law required each area authority to enter into an annual memorandum of agreement (MOA) with the state Secretary of Health and Humans Services for the purpose of insuring that the area authority spent state funds and provided services in accordance with state service priorities and payment policies. Now the law requires the parties to enter into an MOA for the purpose of insuring that state funds are used in accordance with priorities expressed in the area authority's business plan [G.S. 122C-115.2(d)]. This legal requirement is apparently indirectly fulfilled through a practice whereby the area authority and the state enter into a "performance contract" that expresses general funding principles and expectations. For example, the agreement outlines the area authority's duty to submit fiscal monitoring reports and an annual cost finding to the Department of Health and Human Services, addresses fund balances and year-end reconciliation of expenditures, and lists area authority functions for which the state will pay.
3. Fees for area authority services and salaries for area authority employees. In the case of both single-county and multiple-county area authorities, the area authority and its contractual agencies, rather than the board of commissioners, approve fee schedules for mental health services (G.S. 122C-146); this statute prohibits the charging of fees for services to eligible infants, children, and their families that are required to be free under "The Amendments to the Education of the Handicapped Act." The area authority establishes the salary plan that sets salaries for area authority employees (G.S. 122C-156). However, this plan for a multicounty authority may not exceed the highest paying salary plan of the counties served by the authority, and the salary plan for a single-county area authority may not provide for higher salaries than those authorized in the county's salary plan. These limitations on authority salary plans may be exceeded if the area authority board and the board or boards of county commissioners agree to this.
4. Nonsupplant requirements. Counties must not reduce county appropriations and expenditures for current operations and on-going services of area authorities because of the availability of state-allocated funds, fees, capitation amounts, or fund balance to the area authority. Counties may reduce county appropriations from the amount previously appropriated for one-time or nonrecurring special needs of the areas authority. While the "nonsupplant" restriction on reductions in county appropriations for on-going services limits the ability of boards of commissioners to reduce appropriations to area authorities in response to the availability of funding from other sources, counties may allocate little or no new county money to area authority programs that receive substantial amounts of "new" revenue from other sources.

City Budgeting and Appropriations

Public Enterprises

Budgeting for public enterprises presents special issues for cities because they are accounted for in separate funds and are supported in whole or in part with user fees. Revenues from enterprise or utility fees are the largest revenue source of North Carolina's cities, accounting for more than 30 percent of statewide municipal revenue. While many counties operate public enterprises, they contribute only around 5 percent of statewide county revenue.[28] Nonetheless, the points covered in this discussion are relevant for county enterprises as well.

The most common public enterprises that cities operate are for water, wastewater or sewer, electric, and natural gas services. North Carolina cities operate 371 water, sewer, or combined water-sewer systems, 70 electric systems, and 8 natural gas utility systems.[29] The electric and gas systems buy power or natural gas wholesale and distribute it to their customers living within and just outside their boundaries. A few of the larger municipal electric cities also generates power to meet peak load demands. Other public enterprises that cities are authorized to operate include public transportation, solid waste collection and disposal, cable television, off-street parking, airports, and stormwater management (G.S. 160A-311). Public enterprises for transportation are mainly public bus systems operated by large and some medium-sized cities. A growing number of cities operate solid waste collection services as a public enterprise. Some cities have municipal airports, which are commonly operated as public enterprises. Only one city operates its cable system as a public enterprise—Morganton. Stormwater is the newest public enterprise. Federal regulations are leading many cities to separate stormwater management activities from the general fund into a public enterprise fund. Counties are authorized to provide water, wastewater, solid waste collection and disposal, airports, off-street parking, public transportation, and stormwater management services as public enterprise services (G.S. 153A-274). The most important county public enterprises are for water systems that serve parts of the county and for solid waste collection and disposal services and facilities (landfills and solid waste drop-off sites). Charlotte and Mecklenburg County and Winston-Salem and Forsyth County each operate joint city-county water-sewer utilities. Finally, some cities and counties organize still other services as public enterprises, for example, convention or civic centers, sports arenas or stadiums, public golf courses, and fairgrounds.

Important issues relating to budgeting for public enterprises concern pricing or setting enterprise fees, costing enterprise services, and the transfers of money between an enterprise fund and the general or other funds. Capital budgeting and financing issues also are important to public enterprises and are discussed in Article 17 on "Capital Budgeting and Debt Financing."

Fee setting or pricing. The General Statutes authorize cities and counties to charge fees for public enterprises services (G.S. 160A-314 for cities and G.S. 153A-277 for counties). These statutes permit variation in fees by class of service or customer. For example, separate fee schedules may be developed and used for a public enterprise's residential, commercial, and industrial customers. Such classification and variation in fees among classes of customers should have a reasonable basis, for example, reflecting differences in costs to serve different classes of customers or variations in market or competitive conditions for different classes. Counties may vary fees among areas of the county for the same class of customers. Cities are not authorized to vary the fees for the same class of customer or service in different areas of a city. Both counties and cities are authorized to charge higher fees to customers of their enterprise systems who reside outside the county's or the city's boundaries. Charging higher rates to "outside" customers can reflect higher costs that a city enterprise incurs to serve outside customers because of sparser development plans outside the city limits. Higher outside rates also may reflect the fact that city residents, as owners of the enterprise, bear the risks and potential liabilities of ownership as compared to customers outside of city limits. Furthermore, city residents may have contributed capital for startup of the enterprise system that outside customers did not contribute.[30]

---

28. North Carolina Department of State Treasurer website: www.nctreasurer.com/lgc/units/. Utility revenues are tabulated separately and accounted for 32 percent of total statewide municipal revenue in 2004–5. Utility or public enterprise revenue is not tabulated separately for counties but is included in county "sales and service" revenues, which account for 9 percent of North Carolina county revenue. It is estimated that about half of such sales and services revenue is attributable to public enterprises.

29. North Carolina Department of State Treasurer, "Statistical Information, Water Sewer Operations," April 15, 2005, and "Statistical Information Electric System Operations," April 28, 2005. These reports can be found on the State Treasurer's webpage: www.nctreasurer.com.

30. In 2005, legislation was enacted by the General Assembly requiring the city of Asheville to charge equal fees to city water utility customers living outside and within the city limits. *See* General Assembly of North Carolina, 2005 Session Laws, S. L. 2005-139 (House Bill 1064).

Structuring fees and charges involves various issues that often arise in budgeting for public enterprises.[31] First, a single, overall fee per unit or episode of use may be charged, or the fee charged may consist of components that are calculated and shown separately, for example, an account service or administrative overhead charge, a volume or usage charge, and capital recovery component. The latter is done typically only for utility services provided on an ongoing basis to customers. Second, if a fee consists of components and one is a usage or volume charge, the charge per unit of consumption may be the same for all levels of consumption, or it may vary in blocks with the level of consumption. If the usage charge varies by level of consumption and the price per unit of consumption is less for higher levels of consumption, this may reflect the existence of excess or unused capacity in the enterprise system. Lower per unit fees are charged for higher volume usage to encourage use of the enterprise service. Lower per unit charges for high levels of consumption also may recognize economies of scale in the provision of service; it costs less to serve one high-volume user than many small-volume users. On the other hand, if a public enterprise charges a higher fee per unit of consumption to higher-volume than to lower-volume, this may be done because the enterprise is operating at or near capacity and there is a need to encourage conservation to avoid having to build or acquire expensive new capacity. Third, fee-setting for enterprise services must consider how changing fee levels or prices will affect the demands for a service. If fees are raised, will the demand for the service remain the same, resulting in increased revenue? Here, pricing is said to be inelastic—demand remains the same despite increasing (or decreasing fees). On the other hand, if fees for an enterprise service are raised, and demand and use falls off, pricing and revenues are elastic—with demand changing as fees are increased or decreased. Fourth, some fees may be charged not for the primary purpose of generating revenue but to discourage certain usages by an enterprise customer. For example, a city sewer system may impose a special fee on industrial customers who make it difficult to treat waste discharged into the sewer system. The special charge is set high enough to be an incentive for the industry to pretreat the waste before putting the waste into the public sewer system. The fee is not intended to produce revenue on an ongoing basis but to stop or limit usage that is very expensive to accommodate.

While most fees of public enterprises relate to use of enterprise services, the fees for a few public enterprises are based on the availability of services or facilities. North Carolina cities and counties are authorized to charge fees for the availability of solid waste disposal facilities (G.S. 160A-314.1 and G.S. 153A-292). Such facilities consist mainly of landfills, drop-off convenience sites for waste and recycling materials, and solid waste transfer stations. Availability fees for such facilities are charged to the owners of improved property (parcels of property with buildings or other structures or improvements on them). With certain exceptions, the owners of all improved property are presumed to benefit from the availability of the facilities, and therefore, the owners of such property pay the fee regardless of service consumption. The statutes allow for two exemptions from the fees. Availability fees may not be charged to property owners who pay for waste collection provided by local government or private firms who use and pay for the solid waste facilities for which the availability fees are charged. Second, availability fees for city or county solid waste facilities may not be charged to property owners if waste from their properties is collected by contractors who deposit the waste in private solid waste disposal facilities. Revenues from solid waste availability fees may be used to pay for the ongoing operating costs as well as the capital improvement cost for solid waste facilities. The fees are usually added as a separate charge to the annual property tax bills or to monthly water-sewer bills of property owners subject to the fee. Stormwater facility or management fees charged per residential unit or property parcel, regardless of residence or property size or drainage run-off from the property, are a type of availability fee, even though the statutes do not refer to them as such [G.S. 160A-314(a1) and G.S. 153A-277(a1)]. The owners of residential units or property parcels pay the same fee regardless of the amount or contaminants in the stormwater draining from their properties. Like availability fees for solid waste facilities, stormwater facility and management fees are usually included as a separate charge on property tax or water-sewer bills. Stormwater fees that are based on square footage of impervious surface of property or some other measure of the quantity and quality of stormwater draining from property are more like user fees than availability fees.

31. For more information on public enterprise and pricing issues, see Article 15.

Costing enterprise services. Cost calculation is very important for public enterprise. Enterprise fees are set in reference to cost, and cost estimation or accounting is needed to determine whether or to what extent revenues from fees cover costs. A legal test or principle of reasonableness for user fees provides that revenues from public enterprise fees should not “unreasonably” exceed the costs of furnishing enterprise services.[32]

The statutes authorizing availability fees for solid waste facilities and fees for stormwater facilities and management explicitly state that the revenues from such fees may not exceed the costs of providing these facilities or services [G. S. 153A-292(b) and -277(a1) and G. S. 160A-314.1 and -314(a1)]. In two cases involving solid waste availability fees of one county, the North Carolina court of appeals has ruled that G.S. 153A-292(b) requires that revenues from the fees not exceed the county’s costs of providing solid waste facilities.[33] These cases may apply to stormwater fees as well given the comparable statutory limitation on revenues not exceeding costs.

Cost is not defined in these statutes. Cities and counties budget and account for expenditures rather than costs. GAAP define expenditures as a reduction in net current assets (mainly cash and other relatively liquid resources), while a cost (or “expense”) is a reduction in total, economic assets (cash and other liquid resources plus capital or long-lived assets).[34] The expenditures for a service consist mostly of outlays for salaries, wages, and benefits for personnel and other operating items directly involved in providing a service. Costs or expenses include such outlays plus depreciation charges for the use of equipment and other capital assets used in providing a service and an allocation of overhead costs for administrative staff or functions that indirectly support the service. Court decisions and statutes limiting the fees for public enterprises to the costs of providing enterprise services or facilities can be interpreted to mean that revenues from the fees may not exceed full economic costs of providing the services or facilities. Such full costs include not only direct expenditures for personnel and operating items for the service or facility but also depreciation or capital recovery charges and overhead or indirect costs for the services or facilities. Moreover, if a fee is suppose to cover the full cost of a service or a specified portion of full cost, it should be calculated to include not only direct costs or expenditures but also depreciation of capital assets and overhead or indirect costs.

The fees for some public enterprises are usually set at levels below full cost recovery. Fee revenue for such enterprises may cover only the direct expenditures or costs for a service or just a portion of such expenditures or costs. This is often done for public enterprises for bus and public transit services, downtown parking systems, and an airport that serves business and industry. Fees for such public enterprises are, as a matter of policy, set below full-cost recovery levels to keep the services affordable for users, promote downtown development, or provide incentives for businesses to remain or locate in the city or county. Revenues from other sources, for example, federal or state grants, general fund taxes, and surplus earnings from another enterprise fund—are transferred to such an enterprise to make up the difference between the revenues generated by its fees and its costs. The calculation or estimation of full cost is needed for such an enterprise to determine the extent to which its fees cover costs and how much of a subsidy is needed from other revenue sources.

Fee setting for some public enterprises must consider not only costs but also what businesses that provide the same services are charging for them. Such businesses may be located within the jurisdiction, or they may provide the service in a neighboring or the surrounding area. Competitive pressures may keep the fees that a city or county charges for such public enterprises below full cost recovery if the private competitors have lower costs than the city or county in providing the enterprise services. On the other hand, the prices that a private sector provider charges for such a service may be above the full-cost recovery price that a city or county is able to charge for the service. This may create pressure on the city or county to charge such a higher fee or price. This in turn would yield a surplus for the public enterprise. Revenues from such surpluses could be maintained in the enterprise fund to help finance future capital improvements or equipment, or it could be transferred to the general or another fund to support needs or operations in those funds. A city or county that has a public enterprise that regularly yields annual surpluses must make sure that the surpluses do not unreasonably exceed the costs of the services or facilities provided by the public enterprises.

---

32. *See* David M. Lawrence, *Local Government Finance in North Carolina,* 2d ed. (Chapel Hill, N.C.: Institute of Government, The University of North Carolina at Chapel Hill, 1990), 61.

33. Manning v. County of Halifax, N. C. App. (No. 03-1118, Halifax—9/7/04); and Elliott v. County of Halifax, N. C. App. (No. 03-1055, Halifax—9/7/04) (unpublished cases).

34. For definitions of expenditure, expense, and cost, see Robert J. Freeman, Craig D. Shoulders, and Gregory S. Allison, *Governmental and Nonprofit Accounting*, 8th ed. (Saddle River, N.J.: Prentice Hall, 2006).

Enterprise fund transfers. Budgeting for enterprise funds often involves questions about transfers between a public enterprise fund and the general fund or between different enterprise funds. The law allows North Carolina cities and counties considerable flexibility in making such transfers. Unrestricted tax or other revenue may be transferred from the general fund to a public enterprise fund and spent there. Such transfers may be contributions of capital needed to get a newly established public enterprise underway. After a few initial years, these transfers may be ended as the enterprise reaches full operating capacity and becomes self-supporting. Thereafter, the general fund may make occasional contributions of capital to help the enterprise fund expand as needed to meet growth or otherwise improve the enterprise. The general fund may make annual transfers to a public enterprise fund to support the enterprise fund's operations. In this cast the local policy is to hold the enterprise's fees and charge below full-cost or cash recovery level and make up the difference with general revenue. Such ongoing general fund subsidies of an enterprise fund are most likely to occur for public transportation, parking, and airport enterprises. They are unusual for most other types of city or county public enterprises. Capital contributions or operating subsidies from the general fund to a public enterprise fund must be weighed against the use of such resources to meet general fund needs such as public safety, street maintenance, and so forth.

Some public enterprises, especially many city electric and natural gas utilities, yield cash surpluses in most years, with annual revenues from fees exceeding operating expenditures, debt service, and recurring capital outlay. The statutes [G.S. 159-13(b)(14)] allow such an enterprise to transfer excess cash from the enterprise fund to the general or another fund, including another enterprise fund to help support the fund receiving such a transfer. Transfers of so-called surplus cash from a public enterprise fund to the general or any other fund should be limited or guided by certain principles. First, if the general fund or the other fund provides services to the enterprise fund making the transfer, the transfer is simply a payment for those services and may be legally made even if the enterprise fund from which the transfer is made is not self-supporting [G.S. 159-13(b)]. Second, a transfer may be made as a "contribution in lieu of taxes." Some city electric and gas systems have policies authorizing annual contributions in lieu of taxes from annual cash surplus to the general fund. The rationale for the transfer is that if the city electric or gas system were a private enterprise, it would pay the electric utility franchise tax or the piped natural gas excise tax to the state and the city would share in the proceeds of these taxes. A calculation is made of what these taxes would yield for the city if these public enterprises were private, and a contribution is made from these enterprise funds to the general fund for this amount, and it is called a payment in lieu of taxes. Any transfer from a public enterprise fund to the general fund or any other fund must consider the effect of the transfer on the long-term financial viability of the enterprise fund, the need of that fund for cash resources to fund a portion of future capital improvements on a pay-as-you-go basis, the competitive pressures on the enterprise fund, and the pros and cons of having the general fund or another fund rely on ongoing transfers of resources from the enterprise fund.

Annexation

Article 4A of G.S. 160A establishes statewide requirements for cities to meet when annexing territory. One requirement is that a city provides municipal services to any area that it annexes generally on the effective date of annexation and substantially on the same basis and in the same manner as it provides such services in the rest of the city. New infrastructure for water and sewer services does not have to be in place for a year or two after annexation takes effect [G.S. 160A-31(e)].

Except for annexations pursuant to petition of those being annexed, the statutes require a city annexing territory to prepare a plan showing how the city will serve the area to be annexed (G.S. 160A-35, -47). Such a plan should be prepared for any annexation that requires a city to make significant capital or operating expenditures to extend services to the area to be annexed. Any such plan needs to include a cost-revenue analysis, showing the impact that the annexation will have on the city's expenditures and on estimated taxes and other revenues to be collected from property and residents in the area. The plan should also identify the types and the amounts of investments in new infrastructure and equipment that the city will have to make to serve the area, including sources of financing for such investments.

Annexations of areas with substantial industrial or commercial property are generally economically beneficial for a city. The annual taxes and revenues that a city derives from such an area are usually likely to more than cover the city's recurring expenditures to extend services to the area. Annexations of areas that are predominantly residential may present break-even situations, at best, with annual taxes and revenues from such areas just covering or not covering recurring expenditures to serve them. However, an annexation of a residential area with very expensive houses or apartments is likely to yield more annual revenues than expenditures for the annexing city. If a city annexes an area for which it must build or acquire major new infrastructure, the costs of such investments plus the city's recurring expenditures to serve the area are likely to exceed city taxes and revenues generated from the area during the first several years after annexation. Only after several years will such an annexation begin to pay for itself. If a city is without substantial capital reserves or fund balances to finance major capital needs associated with an annexation, the city may have to incur debt to finance them. If such debt is needed for major infrastructure and the voters must approve the debt (G.O. bonds), a successful bond referendum must precede the effective date of the annexation [G.S. 160A-37(e)(3), -49(e)(3)].

Regulation of development in its extraterritorial planning areas can help a city avoid or reduce major expenditures for public infrastructure when annexation occurs. Through such regulation a city can require developers of subdivisions there to provide and finance streets, water and sewer lines, and certain other public infrastructure to city standards. Then when the city annexes such subdivisions, it will not be faced with the need to spend large sums to bring inadequate public infrastructure in the subdivisions up to city standards.

Many cities often extend water and sewer services to persons who live in the developing areas just outside their borders. City policies that allow for or encourage extensions ease the challenges of providing utility infrastructure to these areas when the city annexes them. Such policies can spread out the city's expenditures for infrastructure over many years as development occurs and help the city avoid having to spend major amounts for the infrastructure at or shortly after the time of annexation.

Many annexations will require the annexing city to make additional expenditures to extend law enforcement, fire protection, solid waste collection and disposal, street maintenance and improvement, and other municipal services to the newly annexed area. A city may begin to spend money to prepare to serve an area proposed for annexation once the city council passes the final annexation ordinance (G.S. 160A-40, -52).

A city annexing an area that is served by one or more rural fire departments or private waste haulers may have extra payments in relation to the city's provision of fire and solid waste collection services to the area. If an area is to be annexed without a petition—that is, if the annexation is involuntary—and if the area is part of a rural fire protection, fire service, or fire insurance district that is served by a rural fire department, the city can expect either to contract with that department to provide fire protection in the annexed area for at least five years after annexation, or to compensate the rural fire department for annual revenue loss directly attributable to the annexation over the same five years. The statutes provide alternative ways for calculating such revenue loss. If the city does not contract with the rural fire department to provide service to the annexed area, or if such a contract ends or the city ceases making payments in lieu of a contract, then the city has to pay annually a share of any debt service payments for facilities or equipment of the rural fire department if the debt existed on the effective date of the annexation. An annexing city is responsible for a pro-rata share of such debt service even if the annexation is voluntary (that is, occurring pursuant to a petition of the property owners being annexed). The city's share of such debt service would be in the same proportion that the taxable value of property in the annexed area bears to the taxable value of property in the entire fire district on the date of annexation (G.S. 160A-37.1, -37.2, -49.1, -49.2).

Similarly, if an area to be annexed is served by a private solid waste collection firm when annexation occurs, the annexing city must either contract with the firm to serve the area or the portion of it that the firm had previously served for a period of at least two years after annexation, or pay the firm, in lieu of a contract, a sum equal to one year's loss that the firm experiences as a result of not having a contract to serve the annexed area (G.S. 160A-37.3, -49.3).

Effects of the Annexation Date on Revenues

A city realizes additional tax and other revenues from most annexations that it makes. The effective date of an annexation can be very important in determining when an annexing city begins to receive such revenues. Generally an effective date of June 30 is most advantageous for expediting revenue flow to a city from an annexation.

Property tax revenue. Property tax revenue usually constitutes a major portion of additional revenues from an annexation, and an annexation's effective date can affect the amount and the time of receipt of property tax revenue in the first year or two after annexation. If an annexation becomes effective on June 30 (or on any date during June), the city may levy and collect a full year's property taxes from the annexed area for the fiscal year beginning on July 1. If an annexation becomes effective sometime between July 1 and September 1, property taxes due from the annexed area for that fiscal year are prorated for the portion of the year that the annexation is effective, and they must be paid that year. The proration is based on the number of full months after the effective date of the annexation relative to the number of months in the fiscal year. If an annexation becomes effective on September 2 or later in the fiscal year, property taxes from the annexed area are again prorated for the year, following the proration method just described. However, property owners in the annexed area do not have to pay the property taxes that they owe for that year until the following fiscal year (G.S. 160A-58.10).

Sales tax revenue. A city annexing territory is likely to receive additional sales tax revenue as a result of the annexation.[35] The additional sales tax revenue depends in part on the method that the county selects for the allocation of sales tax revenue among specific local governments in the county. This intra-county allocation can be based on the populations of the specific governmental entities or on their property tax levies. If a county uses the per capita basis of allocation, and a city in the county annexes an area that significantly increases the city's population, the annexation is likely to increase the city's sales tax revenue significantly. This increase comes at the expense of county government and other city governments in the county. Similarly, if a county uses the ad valorem tax basis for distributing sales tax revenue, and a city in the county annexes an area that significantly increases its taxable valuation, the city is likely to receive significant new sales tax revenue as a result of the annexation. This increase also comes at the expense of county and other local governments in the county. In either case the county commissioners could change the intra-county basis for distributing sales tax revenue in order to avoid the loss of some or all of its sales tax revenue resulting from the annexation.

Because counties generally rely more heavily than cities on the property tax, changing to an ad valorem basis for allocating local sales tax revenue can typically increase the county's portion of the tax and reduce the various municipalities' shares of the tax. In a few counties where this situation has arisen, the county, the annexing city, and other municipalities in the county have entered into a revenue-sharing agreement to limit or mitigate local sales tax revenue shifts among the county and municipal governments in the county resulting from annexation and/or county change of the allocation basis for the local sales tax. Although some authorities question whether the statutes authorize such revenue-sharing arrangements, several counties have them.

If a county uses the per capita basis for distributing sales tax revenue among city and county governments in the county and if an annexation is effective on or before July 1, the annexing city begins accruing sales tax revenue for the annexed area for sales starting on that July 1. The state updates its population estimates for local governments once a year effective on July 1, and population from an area that is annexed on or before July 1 will be included in the state's revised population estimate for the city for the fiscal year beginning on July 1. The state distributes local sales tax revenue collections. The collection and distribution process spans three months. For example, the state collects the sales tax on July's sales in August, analyzes and credits these collections in September, and distributes them to counties and cities in October. Thus a city annexing territory effective on or before July 1 receives its first installment of sales tax revenue from the annexed area in October. The city receives the next installment, based on August sales in November, and so forth. In the first year, the city will receive nine monthly amounts or three quarters of the full amount of additional sales tax revenue due to the annexation. If an annexation is effective after July 1—for example, on August 31—the annexing city will not begin to accrue sales tax revenue from the annexed area until the following July 1, and it will not receive any sales tax revenue from the annexed area until the following October.

If a county uses the ad valorem tax basis for intra-county allocation of sales tax revenue, such revenue resulting from an annexation will not start accruing to the annexing city until the fiscal year after the one in which the city begins taxing property in the annexed area. This is because the ad valorem tax basis of distribution uses property levies from the prior year for calculating the distribution of sales tax revenue for any year and because the state department of revenue does not certify local tax levies for a fiscal year until March or toward the end of that year. Thus if a city annexes territory effective on June 30 and levies taxes on property, including that in the annexed area, for the fiscal year beginning July 1, the city will not begin to accrue sales tax from the annexed area until April of the following fiscal year. Such taxes will be based on April sales and will be collected in May. The city will not receive any sales tax revenue from the area until July, more than a full year after the effective date of the annexation of that year.

State gasoline tax revenue. Many annexations also yield additional Powell Bill, or state gasoline tax, revenue for the annexing city. The state distributes three-quarters of such revenue among cities based on city population and one-quarter based on city-maintained street mileage. An annexation increasing a city's population or non-state-system street mileage increases its Powell Bill revenue; this assumes that the annexation increases the city's share of nonstate street mileage and population among all municipalities that receive Powell Bill revenue, and that total Powell Bill revenue for municipalities remains the same or grows rather than declines in the years after the annexation. This increase comes at the expense of other cities across the state. The state distributes Powell Bill revenue to cities once a year on or

35. This discussion of the effect of annexation on the annexing city's sales, gasoline, and other state collected municipal taxes is partly based on Lee Mandell's "State-Collected Local Taxes: Basis of Distribution," available on the website of the North Carolina League of Municipalities (NCLM). Dr. Mandell is Director of Information Technology and Research for the NCLM.

just before October 1. If an annexation is effective on July 1 or before, the annexing city receives increased Powell Bill revenue from the annexation with the next October 1 distribution. An annexation that is effective after July 1 will not yield additional Powell Bill revenue for the annexing city until October 1 of the following fiscal year.

Other tax revenues. Many annexations also increase the annexing city's share of several state-levied taxes that are shared with cities: the franchise tax on electric utility gross receipts, the piped natural gas excise tax, the telecommunications sales tax, and the beer and wine tax.

Annexation increases a city's revenues from the first three electric utility and natural gas taxes generally to the extent that companies subject to the tax serve customers in the annexed area. The increase occurs at the expense of the state and depends on sales by electric and natural gas companies in the annexed area after annexation. The state allocates revenues from these taxes to cities quarterly—on the 15th of September, December, March, and June, with the cities' share of collections in one quarter allocated in the next quarter. A city annexing territory must notify the state Department of Revenue and the electric and natural gas companies serving customers in the annexed area that the city is due a share of these taxes from sales in the annexed area. After annexation has become effective and such notification has occurred, the annexing city can begin to accrue revenues from these taxes in the annexed area on the first of the month following the notification. The city would begin to receive this additional tax revenue on the 15th day of the third month of the next quarter. Because of delays in notification, a city may not begin to accrue additional tax revenue from these sources in an annexed area for a quarter or two after an annexation becomes effective.

An annexation will not increase the annexing city's share of the telecommunications sales tax. Each city's share of that tax is set statutorily in proportion to the city's share among all municipalities when the tax was enacted and replaced the telephone franchise tax in 2001. A city's growth in population or in any other way, resulting from annexation or any other cause does not increase the city's share of the telecommunications tax.

An annexation is likely to increase a city's beer and wine tax revenue insofar as it increases the city's population. This increase occurs at the expense of the county in which the annexed property is located given that the county only receives credit for its unincorporated population. If the county is dry, the increase occurs at the expense of all counties and cities that permit the sale of beer and wine in their jurisdictions. This assumes that the annexing city's population grows proportionately, due to the annexation, among all counties and cities sharing in beer and wine tax revenue and that beer and wine tax collection grows or remains the same, rather than declines, after annexation. The state allocates beer and wine tax revenue once a year within sixty days of March 31. The annual allocation is based on population estimates as of July 1. Thus a city annexing territory effective on or before July 1 receives additional beer and wine tax revenue from the annexed area within sixty days of the following March 31. If the annexation is effective after July 1, the annexing city neither accrues nor receives any beer and wine tax revenue from the annexed area until the latter half of the fiscal year following the year when the annexation is effective.

Water and sewer service revenue. Water and sewer service revenue can increase or decrease as a result of annexation by a city. To the extent that annexation adds customers to water and sewer systems, such revenues will increase. However, this increase may occur only gradually over several years following annexation as the city extends water and sewer lines to residents in the annexed area. If a significant number of residents in the annexed area are already customers of the city's water and sewer system and are paying rates that are, for example, double those paid by the water and sewer customers in the city, the annexation may actually cause a decline in city water and sewer service revenues, at least for a few years after annexation. Moreover, any increase in water and sewer service revenues may be partly or wholly absorbed by increased expenditures that the city incurs to serve customers who hook up to its water and sewer system as a result of annexation.

A. John "Jack" Vogt and **William C. Rivenbark** are School of Government faculty members who specialize in budgeting.