Chapter 3

Budgeting for Operating and Capital Expenditures

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Introduction

North Carolina counties, municipalities, and public authorities (collectively, local units) are required to budget and spend money in accordance with the Local Government Budget and Fiscal Control Act (LGBFCA), codified as Article 3 of Chapter 159 of the North Carolina General Statutes (hereinafter G.S.).[1] In fact, a local unit may not expend any funds, regardless of their source, unless the money has been properly budgeted through the annual budget ordinance, a project ordinance, or a financial plan adopted by the unit's governing board.[2] On the expenditure side, a local unit may spend public funds only for purposes specifically authorized by the state legislature, through general laws, charter provisions, or other local acts. Revenues and expenditures for the provision of general government services are authorized in the annual budget ordinance.[3] Revenues and expenditures for an internal service fund are authorized in the annual budget ordinance or in a financial plan.[4] 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.[5]

This chapter describes the legal requirements for budgeting for operating and capital expenditures. It also presents common budget tools and techniques for both the annual (operating) and capital budgeting processes. The chapter is divided into three sections. The first discusses how to prepare, adopt, and amend a unit's annual budget ordinance and presents various tools available to assist local officials during the budgeting process. The second briefly details the requirements for adopting and implementing a financial plan. Finally, the third section focuses on the adoption of a project ordinance for capital projects and expenditures. It also discusses common strategies for capital planning.

This chapter reflects the law as of May 1, 2023.

1. For a description of the types and functions of public authorities, see Chapter 2, "The Local Government Budget and Fiscal Control Act." As used in this book, the term "municipality" is synonymous with "city," "town," and "village."

2. There is an exception to this inclusiveness requirement. The LGBFCA permits the revenues of certain local government trust and custodial funds to be spent or disbursed without being budgeted. G.S. 159-13(a)(3). For example, many counties and municipalities set aside and manage moneys in a pension trust fund, for example, to finance special separation allowances for law enforcement officers. The employees and retirees for whom the local government is managing these moneys have ownership rights. Although a county or municipality must budget its initial contributions on behalf of employees into the pension trust fund, once the moneys are in the fund, earnings on the assets, payments to retirees, and other receipts and disbursements of the funds should not be included in the local government's budget. Municipalities sometimes maintain perpetual trust funds for the care and maintenance of individual plots in the unit's cemetery.

Another example is when a county or municipality collects certain revenue for another governmental unit and records this revenue in a custodial fund. Although the moneys are held temporarily by the county or the municipality, they belong to the other unit. The collections, therefore, are not revenues of the county or municipality collecting them and should not be included in its budget.

3. G.S. 159-13.

4. G.S. 159-13.1.

5. G.S. 159-13.2.

Annual Budget Ordinance

The annual budget ordinance is the legal document that recognizes revenues, authorizes expenditures, and levies taxes for a local unit for a single fiscal year. (Each unit's fiscal year runs from July 1 through June 30.)[6] The budget ordinance must be adopted by the unit's governing board. At its core, it reflects the governing board's policy preferences and provides a roadmap for implementing the board's vision for the unit. The Local Government Budget and Fiscal Control Act (LGBFCA), however, requires the board to include certain items in the budget ordinance and to follow a detailed procedure for adopting the budget ordinance.

Substantive Budget Ordinance Requirements and Restrictions

The LGBFCA imposes certain substantive requirements and limitations on the budget ordinance.

Balanced Budget

Perhaps the most important statutory requirement is that the budget ordinance be balanced. A budget ordinance is balanced when "the sum of estimated net revenues and appropriated fund balances is equal to appropriations."[7] The law requires an exact balance; it permits neither a deficit nor a surplus. Furthermore, each of the accounting funds that make up the annual budget ordinance (e.g., general fund, enterprise fund, etc.) also must be balanced.[8]

Estimated net revenues is the first variable in the balanced-budget equation; it comprises the revenues a unit expects to actually receive during the fiscal year, including amounts to be realized from collections of taxes or fees levied in prior fiscal years. (Typically, debt proceeds are not considered a form of revenue, but for budgetary purposes debt proceeds that are or will become available during the fiscal year are included in estimated net revenues.) The LGBFCA requires that a unit make reasonable estimates as to the amount of revenue it expects to receive.[9] A unit should have some demonstrable basis for its estimates, such as historical trends or other comparable data. The law places a specific limitation on property tax estimates. 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.[10]

Revenues must be budgeted by "major source."[11] This includes, at a minimum, property taxes, sales and use taxes, licenses and permits, intergovernmental revenues, charges for services, specific grant programs, and other taxes and revenues. A unit is free to group revenues in more-detailed categories.

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6. G.S. 159-8(b). The Local Government Commission (LGC) may authorize a public authority (as defined in G.S. 159-7) to have a different fiscal year if it facilitates the authority's operations.
7. G.S. 159-8(a).
8. For a description of the purpose and function of accounting funds, see Chapter 10, "Accounting, Financial Reporting, and the Annual Audit."
9. G.S. 159-13(b)(7).
10. G.S. 159-13(b)(6). The statute 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.
11. G.S. 159-13(a).

The second variable in the balanced-budget equation is *appropriated fund balance*. Appropriated fund balance is best understood as the amount of cash reserves needed to fill the gap between estimated revenues and appropriations. Only a portion of a local unit's fund balance is available for appropriation each year. The LGBFCA defines the fund balance available for appropriation 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."[12] Legally available fund balance is different from fund balance for financial reporting purposes as presented on the balance sheet of a local government's annual financial report. It includes only cash and investments, not receivables or other current assets. Legally available fund balance results when any of the following occurs: unbudgeted fund balance carries forward from prior years, actual revenues exceed estimated revenues in the current fiscal year, actual expenditures are less than appropriations in the current fiscal year, or actual revenues exceed actual expenditures in the current fiscal year. A portion of this fund balance usually is legally restricted to certain expenditures. A governing board may appropriate restricted fund balance only for those specified purposes.

The calculation for determining the amount of legally available fund balance that may be appropriated to cover new expenditures 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 will carry 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. 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 services on order. (Note that the board is required to appropriate this portion of the fund balance to cover the encumbered amounts that will be paid out in the next fiscal year.) 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.

A unit's governing board is not required to appropriate all the resulting fund balance, only that which is required, when added to estimated net revenues, to equal the budgeted appropriations for the fiscal year. The remaining moneys serve as cash reserves of the unit, to be used to aid in cash flow during the fiscal year. A unit also may use unappropriated fund balance to save money to meet emergency or unforeseen needs and to be able to take advantage of unexpected opportunities requiring the expenditure of money. And some units accumulate fund balance as a savings account for anticipated future capital projects, which also helps them maintain or improve their respective credit ratings.

12. G.S. 159-13(b)(16).

The third variable in the balanced-budget equation is *appropriations for expenditures*. An appropriation is a legal authorization to make an expenditure. But it is not an actual expenditure. An appropriation is a necessary predicate to incurring obligations (through contracts and agreements) and making expenditures. Only a governing board may authorize appropriations. The LGBFCA allows a governing board to make appropriations in the budget ordinance by department, function, or project.[13] For example, a board may appropriate total sums to the finance department, public works department, law enforcement department, planning and zoning department, and so on. Each department then has flexibility to fund its operational and capital expenditures from its budget allocation. The term "function" has two possible meanings for budgeting purposes. It allows a local government to group together multiple departments, such as law enforcement and fire under a broader budgeting category of "public safety." Alternatively, it allows a board to appropriate moneys for major expenditure categories within each department, such as salaries/benefits, utilities, supplies, insurance, capital, and the like. In this case, the budget officer/manager, department heads, and other staff may not exceed the amounts budgeted for each function category. The same is true if a board appropriates by project. A governing board may not make appropriations by line item or by an individual object of expenditure in the budget ordinance itself. The budget ordinance is a summary document that, for ease of exposition, aggregates expenditures. Many governing boards require submittal of more-detailed, line-item budgets by each department to justify the expenditures being requested. A board may require the manager or head of each department to follow the more-detailed budgets ("working budgets") during the fiscal year. The budget ordinance represents the legal appropriations of the unit, though.[14]

Required Budget Ordinance Appropriations

In addition to the balanced-budget requirement, the LGBFCA directs a governing board to include certain appropriations in its budget ordinance.[15] These requirements apply to the initial adoption of the budget ordinance as well as to any subsequent amendments.

Debt service. A governing board must appropriate the full amount estimated by the local government's finance officer to be required for debt service during the fiscal year.[16] During the spring, the LGC notifies each finance officer of that local government's debt-service obligation on existing debt for the coming year. If a county or municipality does not appropriate enough money for the payment of principal and interest on its debt, the LGC may order the unit to make the necessary appropriation; if the unit ignores this order, the LGC may itself levy the local tax for debt-service purposes.[17]

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13. G.S. 159-13(a).

14. This distinction is significant. For example, the statute governing disbursements of public funds requires that before an obligation may be incurred by a unit, the finance officer or a deputy finance officer must verify that there is an appropriation authorizing that particular expenditure. G.S. 159-28(a). The statute refers to an appropriation in the budget ordinance, not in more-detailed, working budgets.

15. Note that the budget ordinance requirements discussed in this chapter generally are limited to those imposed by the LGBFCA. Units must be mindful that other statutory provisions may place additional requirements or restrictions on the budget ordinance.

16. G.S. 159-13(b)(1).

17. G.S. 159-36. Note that the LGC may not require a unit to make appropriations for repayment of installment-financing debt incurred under G.S. 160A-20 because of the requirement of a

Continuing contracts. A governing board must make appropriations to cover any obligations that will come due during the fiscal year under a continuing contract, unless the contract terms expressly authorize the board to refuse to do so in any given budget year.[18] Continuing contracts are those that extend for more than one fiscal year.

Fund deficits. A governing board must make appropriations to cover any deficits within a fund. A deficit occurs if the amount actually encumbered exceeds appropriations within the fund. If a unit follows the provisions on expenditure control in the LGBFCA, a deficit should not occur. However, should a deficit occur, a governing board must appropriate sufficient moneys in the next fiscal year's budget to eliminate that deficit.

Property taxes. If a local unit levies property taxes (which it is not required to do), the governing board must do so in the budget ordinance.[19] The property tax levy is stated in terms of rate of cents per $100 of taxable value.[20]

Encumbered fund balance. If a local unit incurs obligations in the prior year that have not/will not be paid during the prior fiscal year, the unit must appropriate sufficient amounts to cover those expenditures in the new fiscal year. Once the fiscal year expires, there is no budget authority to disburse funds under the prior year's budget. The moneys must be included in the new budget ordinance before they can be disbursed. This often occurs when a unit orders goods or enters into service contracts toward the end of the fiscal year.

Limits on Appropriations

Other LGBFCA provisions place upper or lower limits on certain appropriations in the budget ordinance. The statute also specifies the types of funds that may (and sometimes must) be used.

Contingency appropriations. In each fund a governing board may include a contingency appropriation, that is, an appropriation that is not designated to a specific department, function, or project. The contingency appropriation may not exceed 5 percent of the total of all other appropriations in the fund, though.[21] The governing board may delegate authority to the unit's budget officer to assign contingency appropriations to specific departments, functions, or projects during the fiscal year.[22]

Tax levy limits. If a unit levies property taxes, the proceeds must be used only for statutorily authorized purposes. A governing board may not include an appropriation of property tax revenue that is not authorized by law. In addition, there is a $1.50 per $100 property valuation aggregate property-tax rate cap.[23] Furthermore, the estimated percentage of collection of

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non-appropriation clause. The provision also does not apply to contractual obligations undertaken by a local government in a debt instrument issued pursuant to G.S. Chapter 159G unless the debt instrument is secured by a pledge of the full faith and credit of the unit.

18. G.S. 159-13(b)(15).

19. G.S. 159-13(a).

20. The property tax levy process is described in greater detail in Chapter 4, "Revenue Sources," and Chapter 5, "Property Tax Policy and Administration."

21. G.S. 159-13(b)(3).

22. *See* G.S. 159-15.

23. G.S. 159-13(b)(4). Note that G.S. 160A-209 and 153A-149 authorize a municipality and a county, respectively, to seek voter approval to levy property taxes for purposes not authorized under general law. If a unit receives voter approval to expend property tax proceeds for another purpose, the total of all appropriations for that purpose may not exceed the total of all other unrestricted revenues and property taxes levied for the specific purpose. G.S. 159-13(b)(5). Voters also vote on levying tax rates for one or more purposes such that the combined total rate exceeds the $1.50 per $100 valuation cap.

property taxes used in the rate calculation may not exceed the percentage of the levy actually realized in cash as of June 30 during the prior fiscal year.[24]

Required funds. Each unit must maintain funds applicable to it according to generally acceptable accounting principles.[25]

Limits on Interfund Transfers

The annual budget ordinance sometimes includes appropriations to transfer money from one fund to another. 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.

Each of the limitations on interfund transfers discussed below is subject to the modification that any fund may be charged for general administrative and overhead costs properly allocated to its activities as well as for the costs of levying and collecting its revenues.[26]

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[27] and generally may not be transferred to another fund,[28] except to a capital reserve fund[29] (if appropriate).

Custodial Funds for Special Districts

A special district is a unit of local government, other than a county or municipality, "created for the performance of limited governmental functions or for the operation of a particular utility or public service enterprises."[30] Some units collect moneys on behalf of a special district. These moneys must be budgeted and accounted for in a custodial fund and are not part of the local unit's annual budget ordinance.[31]

Enterprise Funds

A governing board may transfer moneys from an enterprise fund to another fund only if other appropriations in the enterprise fund are sufficient to meet operating expenses, capital outlays, and debt service for the enterprise.[32] This limitation reflects the policy that enterprise revenues must first meet the expenditures and the obligations related to the enterprise. (Note that other

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24. For more information on calculating the property tax rate(s), see Chapter 5, "Property Tax Policy and Administration."

25. G.S. 159-26.

26. G.S. 159-13(b).

27. G.S. 159-26(b)(2).

28. G.S. 159-13(b)(10).

29. A unit may establish and maintain a capital reserve fund to save moneys over time to fund certain designated capital expenditures. G.S. 159-18. For more information on capital reserve funds, see Chapter 7, "Financing Capital Projects."

30. G.S. 159-7(b)(13).

31. G.S. 159-14(b).

32. G.S. 159-13(b)(14). Note that "[a] county may, upon a finding that a fund balance in a utility or public service enterprise fund used for operation of a landfill exceeds the requirements for funding the operation of that fund, including closure and post-closure expenditures, transfer excess funds accruing due to imposition of a surcharge imposed on another local government located within the State for use of the disposal facility, as authorized by G.S. 153A-292(b), to support the other services supported by the county's general fund." *Id.*

statutory provisions further restrict or prohibit a unit from transferring moneys associated with certain public enterprises.)

Although transferring money from an enterprise fund to another fund is legally allowed, it may result in negative consequences. It may, for example, negatively impact a local unit's credit rating or disqualify the unit from certain state loan and grant programs.[33]

Reappraisal Reserve Fund

A reappraisal reserve fund is established to accumulate money to finance a county's next real property revaluation, which must occur at least once every eight years. Appropriations to a reappraisal reserve fund may not be used for any other purpose.[34]

Service District Funds

A service district is a special taxing district of a county or municipality. Although a service district is not a separate local government unit, both the proceeds of a service district tax and other revenues appropriated to 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.[35]

Optional Budget Ordinance Provisions

The annual budget ordinance must contain revenue estimates, appropriations for expenditures, and, if applicable, the property tax levy. The ordinance must show revenues and expenditures by fund and demonstrate a balance in each fund. A governing board, however, is free to include other sections or provisions in the ordinance. For example, it might include instructions on its administration. 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 and set rates or fees for public enterprises or other governmental services.

Adoption of Annual Budget Ordinance

In addition to imposing certain substantive requirements related to the annual budget ordinance, the LGBFCA also prescribes a detailed process for adopting the ordinance.

Role of Budget Officer

Before discussing the specifics of the budget process, it is important to understand the role of the budget officer. The governing board of each unit must appoint a budget officer.[36] In a county or municipality having the manager form of government, the manager is the statutory budget officer. Counties that do not have the manager form of government may impose the duties

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33. *See* G.S. 159G-37; *see also* Kara Millonzi, "Transferring Money from an Enterprise Fund: Authority, Limitations, and Consequences," *Coates' Canons: NC Local Government Law* blog (June 5, 2015).

34. G.S. 159-13(b)(17).

35. G.S. 159-13(b)(18). This restriction also applies to any other revenues that the local unit has appropriated to the service district.

36. G.S. 159-9.

of budget officer on the finance officer or on any other county officer or employee except the sheriff or, in counties with a population greater than 7,500, the register of deeds. Municipalities not having the manager form of government may impose the duties of budget officer on any municipal officer or employee, including the mayor if he or she consents. A public authority or special district may impose the duties on the chairperson of its governing board, on any member of that board, or on any other officer or employee.

The LGBFCA assigns to the budget officer the responsibility of preparing and submitting a proposed budget to the governing board each year. 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 unit's overall priorities. In many units, the statutory budget officer 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 employee performing these duties under the direction of the statutory budget officer. Under the law, the budget officer retains full responsibility for budget preparation.

Once the budget ordinance is adopted, the budget officer is charged with overseeing its enactment. As discussed below, the governing board also may authorize the budget officer to make certain limited modifications to the budget ordinance during the fiscal year.

Budgeting Process

Before the budgeting process begins, the budget officer, often with guidance from the governing board, establishes an administrative calendar for budget preparations 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. The LGBFCA specifies certain target dates for the key stages in the budgeting process, which should be incorporated into the budget officer's plan.

A budget officer's calendar often includes other steps that, though not statutorily required, are integral to an effective budgeting process. For example, many units kick off the annual budget process with one or more budget retreats or workshops for governing board members, department heads, and others. This allows governing board members to set policy for the coming year and provide directives to the budget officer and department heads about budget requests at the outset of the budget process.

Sometimes a budget officer will need to include other boards, organizations, or citizens in the budgeting process. Counties must provide funding for several functions that are (or may be) governed by other boards, such as public schools, community colleges, elections, social services, mental health, and public health. These boards have their own processes for formulating proposed budgets and requesting funds from the county. In addition, both counties and municipalities routinely receive requests from nonprofits, other private organizations, or citizens for appropriations to support certain community activities and projects. (A county or municipality generally does not have authority to make grants to private entities (including nonprofits). The county or municipality may, however, enter into a contract with a private entity and pay it to perform a function on behalf of the local government.[37]) The budget officer often serves as the liaison between these other boards, private entities, and citizen groups and the governing board. The budget officer should work with the governing board to establish an organized process for the board to receive and evaluate these various requests.

Budget Calendar

By April 30: Departmental Requests Must Be Submitted to the Budget Officer

The LGBFCA directs that each department head submit to the budget officer the revenue estimates and budget requests for his or her department for the budget year. Each department, or the unit's finance officer, also must submit information about current-year revenues and expenditures. The budget officer should specify the format for, and detail of, these submissions.[38]

By June 1: Proposed Budget Must Be Presented to the Governing Board

The budget officer must compile each department head's revenue estimates and budget requests and submit a proposed budget for consideration by the governing board.[39] Generally the proposed budget must comply with all the substantive requirements previously discussed. A governing board, however, may request that the budget officer submit a budget containing recommended appropriations that are greater than estimated revenues.[40] This affords the board a ready opportunity to discuss different expenditure options.

When the budget officer submits the proposed budget to the governing board, he or she must include a budget message.[41] The message should contain a summary explanation of the unit's goals for the budget year. It also should detail important activities funded in the budget and point out any changes from the previous fiscal year in program goals, appropriation levels, and fiscal policy.

If a revaluation of real taxable property in the unit occurs in the year preceding the budget year, the budget officer must include in the proposed budget a statement of the revenue-neutral tax rate, "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."[42] While the LGBFCA is silent on where the revenue-neutral tax rate must be included in the proposed budget, an appropriate place would be the budget message.[43] The 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.

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37. G.S. 153A-449 (counties); 160A-20.1 (municipalities).
38. G.S. 159-10.
39. G.S. 159-11(a).
40. G.S. 159-11(c).
41. G.S. 159-11(b).
42. G.S. 159-11(e).
43. *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* No. 32 (Nov. 2004).

After Proposed Budget Presented to Governing Board but before Its Adoption: Notice and Public Hearing

When the budget officer submits the proposed budget to the governing board, a copy must be filed in the office of the clerk to the board, where it remains for public inspection until the governing board adopts the budget ordinance.[44] The clerk must publish a statement that the proposed budget has been submitted to the governing board and is available for public inspection.[45] The LGBFCA does not specify where or when the statement must be published. The clerk should follow the general provisions for legal advertising in Article 50 of G.S. Chapter 1. The clerk also must make a copy of the proposed budget available to all news media in the county. It may be helpful, though it is not legally mandated, for a unit to also post the proposed budget on its website.

The governing board is required to wait at least ten days after the budget officer submits the proposed budget before adopting the budget ordinance. This is true even if the board makes no changes to the proposed budget.[46] This interim period affords citizens time to review the proposed budget and to voice their opinions or objections to governing board members.

The governing board also must hold at least one public hearing on the proposed budget before adopting the budget ordinance. During the public hearing any person who wishes to be heard on the budget must be allowed time to speak. The board should set the time and place for the public hearing when it receives the proposed budget, if not before. This information should be included in the notice published by the clerk. Sometimes a board holds a series of budget review meetings and briefings on each of the major budget categories. These do not satisfy the statutory requirement. The law requires that at least one public hearing be held on the entire 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.

By July 1: Governing Board Must Adopt Budget Ordinance

After the governing board receives the proposed budget from the budget officer, it is free to make changes to the budget before adopting the budget ordinance. In fact, based on citizen input, as well as that from other boards and department heads, the governing board often makes adjustments to the proposed budget before finalizing and adopting the budget ordinance. Questions often arise when a board makes changes to the proposed budget about whether and to what extent it must make the changes known to the public before adopting the budget ordinance. The statute requires only that the budget officer's proposed budget be made available for public inspection and that one public hearing be held after the proposed budget is submitted to the board. A unit is under no legal obligation to formally solicit public input of modifications to the proposed budget before its adoption.

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44. G.S. 159-12(a).

45. G.S. 159-12(a). The notice also must specify the date and time of the public hearing to be held on the budget.

46. G.S. 159-13. The ten-day period begins to run the day after the notice is published. Weekend days and legal holidays count toward the total number of days. However, the ten-day period may not end on a Saturday, Sunday, or legal holiday. It must instead end on the next weekday that is not a legal holiday. *See* Rule 6, N.C. Rules of Civil Procedure, G.S. 1A-1.

The LGBFCA allows a budget ordinance to be adopted at any regular or special meeting, at which a quorum is present, by a simple majority of those present and voting.[47] The board must provide sufficient notice of the regular or special meeting, according to the provisions in the applicable open meetings law.[48] The budget ordinance is entered in the board's minutes, and within five days of its adoption, copies are to be filed with the budget officer, the finance officer, and the clerk to the board.[49]

Once the board adopts the budget ordinance, it may not repeal it. Any modifications are made pursuant to G.S. 159-15 (discussed below). This is true even if the board adopts the budget ordinance before July 1.[50]

Interim Appropriations

Missing the April 30 or June 1 deadline does not invalidate the budgetary process or budget ordinance. There are some consequences to missing the July 1 deadline, though. After June 30, a unit has no authority to make expenditures (including payment of staff salaries) under the prior year's budget. If a board does not adopt the budget ordinance by July 1 and needs to make expenditures, it must adopt an interim budget, making "interim appropriations for the purpose of paying salaries, debt-service payments, and the usual ordinary expenses" of the unit until the budget ordinance is adopted.[51] This is a stopgap measure. An interim budget should not include appropriations for salary and wage increases, capital items, and program or service expansion. It may not levy property taxes, nor should it change or increase other tax or user fee rates. The purpose of an interim budget is to temporarily keep operations going at current levels. An interim budget need not include revenues to balance the appropriations. All expenditures made under an interim budget are charged against the comparable appropriations in the annual budget ordinance once it is adopted. In other words, the interim expenditures eventually are funded with revenues included in the budget ordinance.

LGC Action for Failure to Adopt a Budget Ordinance

At some point, if a local unit's governing board refuses or is unable to adopt its budget ordinance, the LGC may take action. State law empowers the LGC to "assume full control" of a unit's financial affairs if the unit "persists, after notice and warning from the [LGC], in willfully or negligently failing or refusing to comply with the provisions" of the LGBFCA.[52] If the LGC takes this action, it becomes vested "with all of the powers of the governing board as to the levy of taxes, expenditure of money, adoption of budgets, and all other financial powers

47. 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 160A-75 for municipalities.

48. *See* G.S. 143-318.12. However, G.S. 159-17 specifies that "no provision of law concerning the call of special meetings applies during [the period beginning with the submission of the proposed budget and ending with the adoption of the budget ordinance] so long as (i) each member of the board has actual notice of each special meeting called for the purpose of considering the budget, and (ii) no business other than consideration of the budget is taken up."

49. G.S. 159-13(d).

50. *See* Kara Millonzi, "Amending a Newly Adopted Budget Ordinance before July 1," *Coates' Canons: NC Local Government Law* blog (June 13, 2011).

51. G.S. 159-16.

52. G.S. 159-181(c).

conferred upon the governing board by law."[53] LGC takeover will only occur in extreme cases, though. Most of the time, a unit's governing board is left to work out any differences and adopt its budget ordinance.

Budgetary Accounting

The LGBFCA requires local units to maintain an accounting system with applicable funds as defined by generally accepted accounting principles (GAAP).[54] Local units enter their adopted budgets into their accounting systems at the beginning of the fiscal year; this allows them to accurately track the difference between an appropriation and the accumulated expenditures and encumbrances applied against that appropriation. Budgetary accounting is considered a best practice for several reasons. It provides the foundation for budget-to-actual variance reports, providing critical information to departments for remaining within their budgets and to elected officials who possess the ultimate fiduciary responsibility of the organization. It also provides the information needed for managing budget amendments and for complying with the pre-audit requirement.[55] Finally, it provides the needed information for following GAAP when local units issue their annual financial statements.

Amending the Budget Ordinance

The adopted budget ordinance encompasses a unit's legal authority to make all expenditures during the fiscal year. Before a unit may incur an obligation (order goods, enter into service contracts, or otherwise incur obligations of the unit), the finance officer or a deputy finance officer must ensure that there is an appropriation authorizing the expenditure and that sufficient moneys remain in the appropriation to cover the expenditure.[56] Events during a fiscal year may cause 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 address these situations the local unit may need to amend the budget ordinance.

The budget ordinance may be amended at any time after its adoption.[57] A governing board may modify appropriations for expenditures, recognize additional revenue, and/or appropriate fund balance to cover new expenditures. As amended, however, the budget ordinance must continue to be balanced and comply with the other substantive requirements previously discussed. Although not legally required to do so, a governing board also may amend the budget ordinance to reflect changes in revenue estimates during the fiscal year.

A budget ordinance may be amended by action of a simple majority of governing board members so long as a quorum is present. There are no notice or public hearing requirements. Alternatively, a governing board may delegate to the budget officer the authority to make certain changes to the budget. This authority is limited to (1) transfers of moneys from one appropriation to another within the same fund or (2) allocation of contingency appropriations to certain

53. G.S. 159-181.
54. G.S. 159-26.
55. See G.S. 159-15 for budget amendments. See G.S. 159-28 for the pre-audit requirement.
56. *See* G.S. 159-28(a).
57. G.S. 159-15. Sometimes a board adopts the budget ordinance before July 1. The budget ordinance is not effective until July 1; however, it may be amended at any time after its adoption subject to the limitations set forth in G.S. 159-15.

expenditures within the same fund. All other changes to the budget ordinance, including any revenue changes, must be made by the governing board.

Changing the Property Tax Levy

Local government units are limited in their ability to legally change the property tax levy or otherwise alter a property taxpayer's liability once the budget ordinance has been adopted. The property tax levy includes the general property tax rate plus any special taxing district rates. A board may alter the property tax levy only if (1) it is ordered to do so by a court, (2) it is ordered to do so by the LGC, or (3) the unit receives revenues that are substantially more or less than the amount anticipated when the budget ordinance was adopted.[58] A board may change the tax levy under the third exception only if it does so between July 1 and December 31.

Common Budgeting Tools and Techniques

Local units may adopt any budgeting process that facilitates effective decision making for adopting a balanced budget ordinance so long as it complies with the legal requirements of the LGBFCA. Local units, historically, have approached the budget process as a financial exercise, focusing primarily on the financial inputs and outputs of the organization. Today, however, local units often take a broader perspective of the budgeting process and include information derived from their strategic plans and performance-measurement systems to help guide budgetary decision making. The goal, as articulated by the reinventing government movement of the early 1990s, is for local units to make decisions that enable them to steer the boat rather than just row it.[59]

Line-Item Budgeting

Line-item budgeting places the focus of decision making on revenue estimates by each revenue category and on appropriations by each expenditure account. This form of budgeting is often criticized for its incremental approach to decision making, resulting in an adopted budget for the forthcoming fiscal year that merely reflects the current year's budget with slight adjustments, the assumption being that the group of services contained in the current year's budget should continue for the following fiscal year. While line-item budgeting is often criticized for this reason, it nonetheless provides the foundation of budgetary accounting. Local units prepare line-item budgets to accurately appropriate the necessary resources for each expenditure account contained in the categories of personnel, operations, and capital outlay; to record the line-item budgets in the local unit's financial management system to track budget-to-actual variances over the course of the fiscal year; and ultimately to document budgetary compliance as required by the LGBFCA.[60]

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58. G.S. 159-15. This limitation applies once the budget ordinance is adopted, even if that occurs before July 1.

59. David Osborne and Ted Gaebler, *Reinventing Government* (New York: Penguin, 1992).

60. G.S. 159-26(a).

Strategic Budgeting

A management tool that local units often use to embrace long-term decision making is the creation and adoption of a strategic plan. As previously mentioned, local units often begin their budgetary processes with budget retreats or workshops for elective officials. At these events, officials tend to focus on how the forthcoming budget will help advance the long-term goals contained in their local unit's strategic plan. For example, a local unit may want the annual budget process to focus on infrastructure because economic development is a long-term, community goal. Broadening the budget process to include the organization's strategic plan enables the local unit's leadership to shift the focus from individual line-item accounts to long-term strategic goals that impact the direction of the community.

Performance Budgeting

Another common management tool used by local units to track service efficiency and effectiveness is performance measurement, wherein individual programs adopt mission statements, goals, objectives, and performance measures to demonstrate the outputs, efficiencies, and outcomes of service delivery. For example, a major output for public safety is the number of service calls. A major outcome is the timeliness of these service calls as tracked by response time. An advantage of performance budgeting, or the incorporation of performance-measurement information in the budget, is that it enables the local government unit to make resource-allocation decisions based on efficiency and effectiveness measures.[61] Returning to the public safety example, performance budgeting represents the process of deciding whether or not to add an additional officer based on the objective of responding to 95 percent of service calls within four minutes rather than solely on the local unit's ability to afford an additional position.

Zero-Based Budgeting

A technique that is commonly cited for its advantage of eliminating or reducing incremental budget decisions is zero-based budgeting. This budgeting technique, in theory, requires that every line item be reviewed and justified from a base budget of zero rather than from the current year budget. Zero-based budgeting, in practice, requires each department to submit three budget packages for review: its current-year budget, a reduced budget, and an expansion budget.[62] Departments are ranked based on the priorities of the organization and, based on that ranking, assigned one of the three budget packages, thereby reducing the probability that all departmental budgets reflect current year budgets with slight adjustments. However, reviews on the effectiveness of zero-based budgeting for eliminating or reducing incremental decision making have been mixed.

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61. Janet M. Kelly and William C. Rivenbark, *Performance Budgeting for State and Local Government*, 2nd ed. (Armonk, N.Y.: M. E. Sharpe, 2011).

62. Robert L. Bland, *A Budgeting Guide for Local Government*, 2nd ed. (Washington, D.C.: International City/County Management Association, 2007).

Balanced Scorecard

The balanced scorecard is designed specifically to help local units translate their visions and missions into tangible objectives and outcomes.[63] Originally designed for the private sector, the balanced scorecard was adopted in the public sector as part of administrative reform and is now used as a management tool that helps local units broaden their budgeting processes during the preparation, implementation, and evaluation stages. The balanced scorecard requires a local unit to track the collection of metrics within the four quadrants of citizens, operations, financial resources, and employees, thereby providing local units with a broader, more balanced context in which to make budgetary decisions.

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. A service often accounted for in an internal service fund is fleet maintenance. If a local unit 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.[64]

Adopting a Financial Plan

The governing board must approve any financial plan adopted for an internal service fund, with such approval occurring at the same time the board enacts the annual budget ordinance.[65] The financial plan also must follow the same July 1 to June 30 fiscal year as the budget ordinance. An approved financial plan is entered into the board's minutes, and within five days after its approval, copies of the plan must be filed with the finance officer, the budget officer, and the clerk to the board.

Balanced Financial Plan Requirement

A financial plan must be balanced. This is accomplished when estimated expenditures equal estimated revenues of a fund.[66]

Internal service fund revenues are principally charges to county, municipality, or authority 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 fund or some other fund to be shown as a transfer in, rather than as revenue for the internal service fund.

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63. William C. Rivenbark and Eric J. Peterson, "A Balanced Approach to Implementing the Balanced Scorecard," *Popular Government* 74, no. 1 (Sept. 1, 2008): 31–37.

64. G.S. 159-8(a), -13.1.

65. At the same time he or she submits the proposed budget to the governing board, the budget officer must also submit a proposed financial plan for each intragovernmental service fund that will be in operation during the budget year.

66. G.S. 159-13.1.

Expenditures from 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 depreciation charges on equipment or facilities used by the fund.

In adopting the annual financial plan for an internal service fund, a 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 fund or another fund in the budget ordinance or to a project/grant ordinance for an appropriate use. A unit should avoid amassing in its financial plans large fund balances that are unrelated to the specific needs of the internal service fund.

Amending a Financial Plan

A financial plan may be modified during the fiscal year, but any change must be approved by the governing board.[67] Any amendments to a financial plan must be reflected in the board's minutes, with copies filed with the finance officer, the budget officer, and the clerk to the board.

Capital Budgeting

In North Carolina, local units may budget revenues and expenditures for the construction or acquisition of capital assets (capital projects) or for projects that are financed in whole or in part by federal or state grants (grant projects) 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 capital or grant project rather than for a single fiscal year.[68]

Capital Projects

The Local Government Budget and Fiscal Control Act (LGBFCA) defines a capital project as a project that (1) is financed at least in part by bonds, notes, or debt instruments or (2) involves the construction or acquisition of a capital asset. Although a capital-project ordinance may be used to recognize revenues and appropriate expenditures for any capital project or asset, it typically is used for capital improvements or acquisitions that are large relative to the annual resources of the unit, that take more than one year to build or acquire, or that recur irregularly. Expenditures for capital assets that are not expensive relative to a unit's annual budget or that happen annually usually can be handled effectively in the budget ordinance.

67. G.S. 159-13.1(d).
68. G.S. 159-13.2.

Grant Projects

A grant-project ordinance may be used to budget revenues and expenditures for operating or capital purposes in a project financed wholly or partly by a grant or settlement funds from the federal government, the state government, or a private entity. This budgeting vehicle is most appropriate for multi-year grants, but it can be used even for single-year grants and may provide better documentation for grant compliance than the annual budget ordinance. A grant-project ordinance should not be used to appropriate state-shared taxes provided to a unit on a continuing basis, though. Such revenue or aid, even if earmarked for a specific purpose, should be budgeted in the annual budget ordinance.

Creating a Project Ordinance

A governing board may adopt a project ordinance at any regular or special meeting by a simple majority of board members so long as a quorum is present. This can be done at any time during the year. The ordinance must (1) clearly identify the project and authorize its undertaking, (2) identify the revenues that will finance the project, and (3) make the appropriations necessary to complete the project.[69]

Each project ordinance must be entered in the board's minutes, and within five days after its adoption copies of the ordinance must be filed with the finance officer, the budget officer, and the clerk to the board.

The budget officer also must provide certain information about project ordinances in the proposed annual budget submitted to the governing board each year. Specifically, the budget officer must include information on any project ordinances that the unit anticipates adopting during the budget year. The proposed budget also should include details about previously adopted project ordinances that likely will have appropriations available for expenditure during the budget year.[70] This is purely informational. The board need take no action to reauthorize a project ordinance once it is adopted.

Balanced Project-Ordinance Requirement

The LGBFCA requires a capital or grant project ordinance to be balanced for the life of the project. A project ordinance is balanced when "revenues estimated to be available for the project equal appropriations for the project."[71]

Estimated revenues for a project ordinance may include bond or other debt proceeds,[72] federal or state grants, revenues from special assessments or user fees, other special revenues, and annually recurring revenues. If property tax revenue is used to finance a project ordinance it must be levied initially in the annual budget ordinance and then transferred to the project ordinance. Other annually recurring revenues may be budgeted in the annual budget ordinance and transferred to a project ordinance or appropriated directly in a project ordinance.

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69. A local unit should adopt a separate project ordinance for each capital project or each grant.
70. G.S. 159-13.2(f).
71. G.S. 159-13.2(c).
72. As with the annual budget ordinance, debt proceeds are treated as revenues for budgeting purposes. A local unit may include debt proceeds that it reasonably expects to receive to fund a project. If a bond issuance requires voter approval and/or LGC approval, it likely is not reasonable to include the debt proceeds in the revenue estimate until the local unit has obtained those approvals.

Appropriations for expenditures in a capital project ordinance may be general or detailed. A project ordinance may make a single, lump-sum appropriation for the project authorized by the ordinance, or it may make appropriations by line item, function, or other appropriate categories within the project. Appropriations in a grant-project ordinance should be specific enough to align with applicable grant-compliance requirements. For federal grants, that likely requires appropriations to occur at the cost-item level for each project.

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.

Amending a Project Ordinance

A project ordinance may be amended at any time after its adoption but only by the governing board.[73] If expenditures for a project exceed the ordinance's appropriation, in total or for any expenditure category for which an appropriation was made, an amendment to the ordinance is necessary to increase the appropriation and identify additional revenues to keep the project ordinance balanced. A board also may amend a project ordinance to change the nature or scope of the project(s) being funded.

Closing Out a Project Ordinance

Unlike the annual budget ordinance, a project ordinance does not have an end date. It remains in effect until the project is finished or abandoned. There are no formal procedures for closing out a project ordinance when a project is done. Projects sometimes are completed with appropriated revenues remaining unspent. Practically speaking, such excess revenues are equivalent to a project fund balance. The remaining moneys should 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 to 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. Note that any earmarked revenues in a project ordinance retain the earmark when transferred to another project or fund.

Justification for Capital Budget

The National Advisory Council on State and Local Government Budgeting encourages the adoption of a comprehensive policy for successfully implementing and managing the various aspects of capital budgeting.[74] A common question in local government is why local officials need to manage two budgeting processes, one for the operating budget and another for the capital budget. There are several reasons for implementing and managing a separate capital budgeting process.[75]

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73. G.S. 159-13(e).

74. National Advisory Council on State and Local Government Budgeting, *Recommended Budget Practices* (Chicago: Government Finance Officers Association, 2003).

75. Bland, note 62 above.

The first reason involves the lasting impact of decisions. For example, a decision to expand bus routes during the current operating budget process can be changed during the operating budget process for the following fiscal year. A decision to expand a police station, however, is more permanent in nature, requiring a level of review beyond incremental adjustments to the operating budget.

A second reason, which builds on the first, is that debt financing is often used to acquire capital assets. The issuing of debt has a long-term impact on a county or municipality because the law requires that debt-service payments be appropriated as part of the budget ordinance.[76] The processes and procedures for capital budgeting can provide a more structured review for a critical decision, such as issuing debt, where additional debt-service payments may impact the organization's financial condition and possibly reduce future operating budget flexibility.

A third reason for implementing and managing a separate capital budgeting process can be traced back to state law. The budget ordinance adopted by counties and municipalities in North Carolina covers a single fiscal year beginning July 1 and ending June 30.[77] The acquisition of major capital assets or the completion of infrastructure projects often extends over multiple fiscal years from approval to completion. State law allows local units to adopt their capital budgets with a capital-project ordinance, which authorizes all appropriations necessary for project completion and prevents project proceeds from having to be re-adopted in subsequent fiscal years.

A final reason is the variation in assets and costs as compared to the operating budget, wherein decisions are often incremental from one fiscal year to the next. In any given fiscal year during the capital budgeting process, local officials may be faced with using cash reserves for anything from purchasing a new fire truck for $750,000 to issuing $20 million of debt for infrastructure improvements. Capital budgeting allows for the use of specific techniques for evaluating and prioritizing capital requests in terms of organizational need, capacity for acquisition, and community impact.

Capitalization and Capital Budget Thresholds

An important policy decision for local units is establishing a capitalization threshold, which dictates how the costs associated with the acquisition of capital assets are reported in the annual financial statements as required by G.S. 159-25(a)(1). The Government Finance Officers Association (GFOA) defines *capital assets* as tangible items (e.g., land, buildings, building improvements, vehicles, equipment, and infrastructure) or intangible items (e.g., easements and technology) with useful lives that extend beyond a single reporting period.[78] The GFOA recommends that local governments adopt a capitalization threshold of no less than $5,000 for any individual item, which means that capital assets costing $5,000 or less are reported as expenditures or expenses in the period in which they are acquired. Capital assets costing more than $5,000 are reported on the balance sheet and depreciated based on their estimated useful lives.

It is a professional practice for counties and municipalities to establish a financial threshold to determine what capital requests are considered part of the operating budget process and what

76. G.S. 159-13(b)(1).

77. G.S. 159-8(b).

78. GFOA, "Establishing Appropriate Capitalization Thresholds for Capital Assets," approved by the GFOA executive board on February 24, 2006.

capital requests are considered part of the capital budget process—referred to as the *capital budget threshold*. This threshold is often based on the size of the local government. For example, a smaller local government with a population of approximately 20,000 might establish a capital budget threshold of $50,000, meaning that capital assets costing $50,000 or less would be part of the operating budget process and capital assets costing more than $50,000 would be part of the capital budget process. An additional criterion often used in determining this threshold is the estimated useful life of the capital asset; this is because capital assets with longer estimated useful lives are more appropriate for the capital budget than for the operating budget. A reason for applying this additional criterion is that debt is often used to finance capital assets, and debt payments should never exceed the estimated useful life of the asset.[79]

Common Capital Budgeting Tools and Techniques

As with the annual budgeting process, a local unit may adopt any capital budgeting process that facilitates effective decision making so long as it complies with the legal requirements of the LGBFCA. An essential component of any well-designed capital budgeting process is planning. Many units have adopted a formalized capital improvement program (CIP) to facilitate the planning process. And, increasingly, units are relying on more sophisticated analysis relating to the financial condition of the unit to make accurate budget forecasts.

Capital Improvement Program

A CIP is a forecast of capital assets and funding sources over a selected period of time. While local officials often refer to the capital budget and CIP as one and the same, they are separate management tools. The capital budget covers one fiscal year and is adopted by ordinance.[80] The CIP, which commonly contains five years of proposed capital assets and funding sources beyond the capital budget, is approved as a long-term plan that local officials update on an annual basis.

There are numerous reasons why local officials prepare and approve a CIP in conjunction with their capital budget. It provides a schedule for the replacement and rehabilitation of existing capital assets, which is fundamental to all capital improvement programs. It allows time for project design and for exploring financing options, both of which are critical to evaluating the merits of a capital asset from a cost-benefit perspective. It also is the primary vehicle for providing the necessary infrastructure to support economic and community development in a coordinated manner, which is fundamental to land use and master plans. As well, a CIP has the potential to help a local government maintain or improve its credit rating due to the premium that bond-rating agencies place on planning.

Table 3.1 provides an example of a capital budget for a local government. The capital budget of $900,000 is adopted by ordinance for fiscal year 2022, appropriating the necessary financing sources to fund the capital assets aggregated by functional area. The major capital project for fiscal year 2022 is the expansion of the public safety building, which is funded by $100,000 from annual operating revenue and $400,000 from general obligation (GO) bonds. The $200,000 of

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79. Justin Marlow, William C. Rivenbark, and A. John Vogt, *Capital Budgeting and Finance*, 2nd ed. (ICMA Press, 2009).

80. The phrase “capital budget” refers to appropriations for capital outlay in a single fiscal period. A government board may make these appropriations in the annual budget ordinance or in a capital-/grant-project ordinance.

Table 3.1 Capital Budget and Capital Improvement Program (CIP)

Item	Capital Budget	CIP				
	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
Capital Assets by Function						
Public safety	500,000	50,000	50,000	50,000	50,000	50,000
Environmental services			250,000			250,000
Streets and transportation	200,000			400,000		
Parks and recreation			100,000			
Water and sewer	200,000	50,000			200,000	
Total	**900,000**	**100,000**	**400,000**	**450,000**	**250,000**	**300,000**
Financing Sources						
Operating revenue	100,000	50,000	50,000	50,000	50,000	50,000
Capital reserve fund		50,000	250,000			250,000
Grants			100,000			
General obligation bonds	600,000			400,000		
Revenue bonds	200,000				200,000	
Total	**900,000**	**100,000**	**400,000**	**450,000**	**250,000**	**300,000**

asphalt maintenance (streets and transportation) is funded from the remaining GO bonds, and revenue bonds will be used to fund an expansion of the water and sewer system.

Table 3.1 also provides an example of a five-year CIP for the local government, beginning with fiscal year 2023. While the CIP represents a plan and is updated on an annual basis as new requests are considered, it gives local officials time to prepare for future events. In fiscal year 2024, for example, $100,000 is allocated for a new park, giving local officials the time required to negotiate with multiple landowners to secure the necessary property. And in fiscal year 2025, $400,000 is allocated for general obligation (GO) bonds, giving local officials time to prepare for a bond referendum. These two examples highlight another critical reason why local officials prepare CIPs: doing so allows them to anticipate how the funding of capital assets will impact future operating budgets. Once the park is functional, adequate proceeds must be appropriated in the annual operating budget for additional park maintenance. The operating budget also must appropriate the debt-service payments for the issuance of the GO bonds as required by G.S. 159-13(b)(1). Preparing CIPs enables departments to consider the impact of proposed capital assets on their operating budgets when evaluating and submitting capital improvement requests.

Financial Condition and Forecasting

The CIP is a management tool that facilitates long-term planning for the acquisition of capital assets in local government. There are two additional management tools that support the capital budgeting process from a financial perspective, financial condition analysis and financial forecasting. This is critical given the ways in which the acquisition of capital assets can impact an organization's current financial condition and future operating budget flexibility.

Financial Condition Analysis

The first of these additional management tools, financial condition analysis, allows local officials to move beyond reporting on the financial position of the organization with an unmodified audit opinion of its annual financial statements to analyzing and interpreting the financial statements in order to determine and report on the financial condition of the organization. The reason financial condition analysis is so important to capital budgeting and finance is that acquiring and financing capital assets has the potential to drastically change the financial condition of a county or municipality; therefore, it is imperative to monitor these changes on an annual basis for the financial sustainability of the local government.

Fortunately, local officials have access to two Web-based dashboards that provide key financial ratios for analyzing the financial condition of any county or municipality in North Carolina. The Local Government Commission (LGC) benchmarking tool, which is located on the North Carolina Department of State Treasurer's website (www.nctreasurer.com), provides selected financial ratios for a local unit's governmental activities, general fund, water and sewer fund, and electric fund. The tool calculates the ratios over a five-year period and benchmarks them against other local governments. The North Carolina water and wastewater rates dashboard, which is located on the Environmental Finance Center's website at the School of Government (www.efc.sog.unc.edu), provides selected operations, debt service, and liquidity financial ratios for water and wastewater activities.

While the details of financial condition analysis are beyond the scope of this chapter, two financial ratios associated with the general fund and two financial ratios associated with an enterprise fund are discussed below to highlight the critical connection between acquiring financial capital assets and the financial condition of a local government.[81]

General Fund Financial Ratios

A financial ratio from the general fund's statement of revenues, expenditures, and changes in fund balance is the *debt service ratio*, which is calculated by dividing principal and interest by total expenditures. This ratio provides feedback on the percentage of annual expenditures being committed to annual debt service, which impacts service flexibility. The International City/County Management Association (ICMA) cautions local governments not to exceed 10 percent;[82] however, counties in North Carolina often exceed this percentage because of school financing. This ratio plays an important role when local officials are making the decision to issue additional debt for capital assets. Another financial ratio from the general fund's balance sheet is *fund balance as percentage of expenditures*. This ratio provides feedback on the solvency of the general fund, which is extremely important to monitor as cash reserves often are used to finance capital assets.

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81. For more information on financial condition analysis, see William C. Rivenbark, Dale J. Roenigk, and Gregory S. Allison, "Communicating Financial Condition to Elected Officials in North Carolina," Popular Government 75, no. 1 (Fall 2009): 4–13.

82. International City/County Management Association, *Evaluating Financial Condition*, 4th ed. (Washington, D.C.: International City/County Management Association, 2003).

Enterprise Fund Financial Ratios

Two critical ratios calculated from the financial statements of an enterprise fund are the *debt coverage ratio* and the *capital-assets-condition ratio*. The enterprise fund's debt-coverage-service ratio is calculated by dividing net income of the enterprise by annual debt service—for example, a ratio of 1.25 means that net income exceeded debt service by 25 percent. This ratio is an important indicator of the financial condition of an enterprise fund. It is also important to creditors and bond-rating agencies, particularly when local officials seek to issue revenue bonds. The capital-assets-condition ratio provides feedback on the accumulated depreciation of the capital assets assigned to an enterprise fund (the ratio is 1.0 minus accumulated depreciation divided by capital assets being depreciated). A high ratio suggests that a county or municipality is investing in its capital assets; a low ratio, that a local unit needs to review its annual investment in capital assets.

Financial Forecasting

Financial condition analysis provides extremely important information about capital budgeting and finance; however, financial ratios are typically calculated from audited financial statements (historical data). The second management tool, which is more aligned with the CIP, is financial forecasting—a projection of revenues and expenditures (expenses) over a selected period of time to show the future operating results of a fund on the basis of an agreed-upon set of assumptions.[83] Research has shown that a five-year model is standard in local government, which reconciles with the typical CIP.[84] The implementation of a capital budget and CIP, as previously discussed, addresses the operating results of the respective funds based on additional debt-service payments, changes in positions and operating expenses, and additional revenue. Financial forecasting provides local officials with a methodology to estimate how the acquisition of capital assets contained in the CIP will affect the relationship between the inflow and outflow of resources in a fund over the selected forecast period.

Table 3.2 presents an example of a five-year financial forecast for a local government's general fund. The forecast of all revenues and expenditures is based on a 2 percent growth rate, except for property taxes and debt service. The forecast for property taxes is based on a 3 percent growth rate, and the forecast for debt service is based on amortization schedules. The current fiscal year (CFY) balance, as noted, is an estimate based on nine months of annualized data; however, the estimate shows that revenues are expected to exceed expenditures by $5,449 for the CFY, increasing fund balance by that amount. The forecast shows that estimated revenues are expected to exceed estimated expenditures for the following two fiscal years, increasing fund balance to $134,947 at the end of fiscal year 2024. The forecast then shows that estimated expenditures are expected to exceed estimated revenues for the remaining three fiscal years, reducing fund balance to $79,935 at the end of fiscal year 2027. The reason for the reverse in trend is that the local government expects to double its debt-service payment from $50,000 to $100,000 in fiscal year 2025 due to the implementation of its CIP.

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83. Larry Schroeder, "Local Government Multiyear Budgetary Forecasting: Some Administrative and Political Issues," *Public Administration Review* 42, no. 2 (1982): 121–27.

84. William C. Rivenbark, "Financial Forecasting for North Carolina Local Governments," *Popular Government* 73, no. 1 (Fall 2007): 6–13.

Table 3.2 Five-Year Financial Forecast for General Fund

	CFY*	Forecast				
Item	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 2027**
Fund balance, beginning	**$100,000**	**$105,449**	**$117,006**	**$134,947**	**$109,551**	**$91,112**
Revenues						
Property taxes	500,140	515,144	530,598	546,516	562,911	579,799
Local option sales taxes	101,985	104,024	106,105	108,227	110,391	112,600
Permits and fees	52,444	53,492	54,562	55,653	56,767	57,902
Intergovernmental	50,000	51,000	52,020	53,060	54,121	55,204
Sanitation fees	74,785	76,280	77,806	79,362	80,949	82,568
Total	779,354	799,940	821,091	842,818	865,139	888,073
Expenditures						
Administration	100,691	102,705	104,759	106,854	108,991	111,171
Public safety	246,123	251,045	256,066	261,188	266,411	271,740
Environmental services	182,654	186,307	190,033	193,834	197,711	201,665
Transportation	98,585	100,557	102,568	104,619	106,712	108,846
Parks and recreation	95,852	97,769	99,724	101,719	103,753	105,828
Debt service	50,000	50,000	50,000	100,000	100,000	100,000
Total	773,905	788,383	803,150	868,214	883,578	899,250
Difference	**5,449**	**11,557**	**17,941**	**(25,396)**	**(18,439)**	**(11,177)**
Fund balance, ending	**$105,449**	**$117,006**	**$134,947**	**$109,551**	**$91,112**	**$79,935**

*Current fiscal year (CFY) balance is an estimate based on nine months of annualized data.

The five-year financial forecast shown in Table 3.2 gives local officials time to begin discussing how the county or municipality can afford the additional debt-service payment schedule for fiscal year 2025. Changes can be made to operating revenues and expenditures, for example, or to the capital budget and CIP to reduce the impact of taking on more debt. Local officials need information on the different ways in which counties and municipalities in North Carolina can use pay-as-you-go strategies to acquire capital assets and on how they can issue and structure debt to accommodate the needs of the organization and community.

Summary

Local units in North Carolina are required to budget and spend money in accordance with the Local Government Budget and Fiscal Control Act (LGBFCA), which provides a comprehensive legal framework for preparing, adopting, and amending the units' annual budget ordinance, financial plans, and project ordinances. Most of this chapter, as a result, focused on interpreting the numerous statutes in the LGBFCA, including the definition of a balanced budget ordinance, the limits on appropriations and interfund transfers, the adoption and amending of the budget ordinance, and the use of financial plans and project ordinances. After a brief overview of budgetary accounting, the chapter presented management tools and processes used by local government to make budgetary decisions within the broader context of the organization.