

NORTH CAROLINA'S RESOURCE FOR PUBLIC OFFICIALS

# Popular Government

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*Also*

Can Public Employers Reduce Health Benefits?

ABC's of Performance Budgeting

# Popular Government

James Madison and other leaders in the American Revolution employed the term “popular government” to signify the ideal of a democratic, or “popular,” government—a government, as Abraham Lincoln later put it, of the people, by the people, and for the people. In that spirit *Popular Government* offers research and analysis on state and local government in North Carolina and other issues of public concern. For, as Madison said, “A people who mean to be their own governors must arm themselves with the power which knowledge gives.”

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*John Rubin completed his five-year tenure as editor of Popular Government with the special issue on poverty, Spring/Summer 2003. John B. Stephens began as editor with the Fall 2003 issue.*

## ON THE COVER

*A \$100 bill, calculator keys, and a Form 1120. Together they say “taxes.”*

## Zoning Affects 90 Percent of N.C. Citizens

Since North Carolina's cities and counties were granted the optional power to enact zoning ordinances to regulate land use, opinions on the need for local land use regulation have strongly diverged. Some citizens see zoning as intrusive, while others see it as an essential role of local government. Some argue that the state legislature should mandate implementation of land use regulation in every locality.

How many North Carolinians live in areas already covered by zoning? The best estimate is drawn from a 2002 survey of all 544 incorporated cities and all 100 counties in the state. Four hundred forty-one (68 percent) of the 644 jurisdictions in the state responded to the survey. Most of the nonresponding jurisdictions were cities with populations under 1,000.

Three hundred fifty-seven (81 percent) reported having a zoning ordinance. Among cities with populations greater than 1,000, 97 percent had zoning. Seventy-four of the state's 100 counties now have zoning for some or all of the area outside cities. These totals indicate that slightly more than 90 percent of the state's population lives in areas subject to zoning. So a state requirement that cities and counties enact zoning would largely be symbolic.

Information on other data gathered from the survey is available in a forthcoming Institute publication by David Owens and Adam Bruggemann, *A Survey of Experience with Zoning Variances* (Special Series No. 18). For more information, contact the Publications Sales Office, phone (919) 966-4119, e-mail sales@iogmail.iog.unc.edu.

## Civic Engagement News

### Forums Identify Priorities for Civic Engagement

Building on the North Carolina Civic Index, an analysis of youth and adult civic involvement (reported in the Fall 2003 issue of *Popular Government*, p. 4), the North Carolina Civic Education Consortium worked with six local planning teams to host eight Civic Index Community Forums across the state between September 22 and November 6. More than 150 young people joined 350 adults, including representatives of schools, government, business, and community organizations. Each of the eight forums developed its own top strategies to improve youth civic engagement. The most frequently occurring strategies were as follows:

- Bring more government officials into the classroom.
- Incorporate real-world or current events discussions into classroom activities.
- Enhance youth's opportunities for leadership (for example, service on boards or involvement in the political process).
- Involve parents and families in improving youth civic engagement.
- Initiate Kids Voting programs.
- Encourage voter registration.

The eight forums took place in Asheville, Charlotte, Cullowhee, Fayetteville, Greensboro, Greenville, Hendersonville, and Raleigh. For the top strategies of each forum, visit [www.civics.unc.edu/civicindex/aboutforums.htm](http://www.civics.unc.edu/civicindex/aboutforums.htm), and click on the forum of interest.

### Summit Recommends Strategies for Supporting Schools' Civic Mission

On December 4, 2003, the North Carolina Civic Education Consortium partnered with nine other organizations and agencies to host a Policy Summit on the Civic Mission of Schools. The summit convened policy makers, educators, and others to review the state of civic education in North Carolina and develop policy recommendations to support the civic mission of K-12 schools.

The working session featured Howard Lee, chair of the State Board of Education, and workshops showcasing best practices in civic education.

All participants had an opportunity to recommend policy strategies for supporting



NEWS & OBSERVATION / CHRIS STWARD

# Feedback on Property Tax Assessments

I read Michael Walden's article titled "Improving Revenue Flows from the Property Tax" (*Popular Government*, Fall 2003, p. 13). While Dr. Walden correctly identifies several problems with our current tax system, I suggest that the problems associated with his proposed solution far outweigh the advantages.

Members of the North Carolina Association of Assessing Officers (NCAAO) have discussed this concept several times over the past twenty years. Our conclusion has consistently been that mass adjustments by some type of single multiplier tend to exacerbate equity problems. The author addresses this issue by saying, "Standards and procedures would have to be established . . . Several issues would have to be addressed . . . Local leaders will have to decide if these issues can be easily overcome." The lack of acceptable standards and procedures for dealing with equity issues is precisely why this multiplier system has been consistently rejected by the NCAAO.

I also do not think the author fully anticipates the potential negative reaction that taxpayers might have to the improved revenue stream created by annual valuation adjustments with no adjustment to the tax rate. Many taxpayers will have no trouble reaching a conclusion that the improved revenue stream brought about by such adjustments is nothing more than another form of a tax increase. This type of system contributed to Proposition 13 in California and other "valuation freeze" initiatives across the country.

The author did not address the fact that annual reassessments will likely generate annual appeals. Most counties barely have sufficient staff to survive under our current system. Consider the impact on the staff of the Property Tax Division and the Property Tax Commission if all counties were even on a four-year reassessment cycle. Proper staffing levels would be needed at both the local and the state level if tax officials were to be asked to handle annual appeals.

The city or county elected body is responsible for determining spending priorities and is therefore responsible for selecting the property tax rate. Under the author's proposal, the tax rate remains constant, and the tax base theoretically shifts upward each year. The shifting of the responsibility for increased revenues from the governing body to the assessor's office places such responsibility in the wrong place.

I think we can agree that a much smaller net annual tax increase may be preferable to the sticker shock brought about every eight years. This is one of the reasons that many North Carolina counties have moved to a four-year revaluation cycle. We already have statutory authority to conduct more frequent revaluations, even annual ones if approved by the governing body. I submit that with proper staffing levels, high-quality databases, and sufficient computerization, all counties could revalue real property much more frequently.

—W. A. (Pete) Rodda, CAE

*The author, Forsyth County tax assessor/collector, has been an assessor/collector for more than twenty-two years. He currently serves as treasurer of NCAAO and is a past president of the North Carolina Tax Collectors Association.*

**Walden's Response** I appreciate Forsyth County Tax Assessor/Collector Pete Rodda's response to my article. In essence, Mr. Rodda believes that the "cure would be worse than the disease." This is entirely possible. In fact, I ended my article by stating, "Local leaders will have to decide if these issues [issues related to changing to a new property tax system] can be easily overcome. If not, then the current system, even with its flaws, may be the better alternative."

Nonetheless, I think it is crucially important that locally elected leaders and property owners be educated about the flaws in the current system because, as I tried to illustrate, those flaws have a profound impact on revenue flows from, and citizen acceptance of, the local property tax. I have always found it interesting that many individuals accept being taxed on their *current income* and *current spending* but not on their *current property value*.

Mr. Rodda and I do agree that with improved technology and proper staffing, more frequent revaluations may be the best practical solution.

—Michael L. Walden

schools' civic mission. The most frequently suggested strategies were as follows:

- Adopt policies beyond testing to hold schools accountable for their civic mission.
- Provide professional development for teachers and administrators on how to use interactive strategies, such as service-learning.
- Develop local or state curricula and strategies that encourage schools to interact with the community and the government (state or local).
- Adopt mandatory service-learning in K–12 schools.
- Incorporate into state standards the promising practices from *The Civic Mission of Schools* (a national report released in February 2003).
- Develop and promote funding for model programs that can be replicated.
- Allow more time in the standard course of study for teachable moments; focus on current issues.

Cosponsors of the summit were Communities in Schools, the Kenan Institute for Ethics (Duke University), the N.C. Campus Compact, the N.C. Center for Public Policy Research, the N.C. Congress of Parents and Teachers, the N.C. Department of Public Instruction, the N.C. School Boards Association, the Office of the Governor, and the Public School Forum. State Farm Insurance was a financial sponsor. For the full report, visit [www.civics.org](http://www.civics.org).

Journal

# Face-off on Tax Policy

*As April 15 approaches, taxes are in the news. However, North Carolina state representatives and senators, and legislators in cities, towns, and counties of the state, devote a lot of attention to taxes year-round, in good times and bad.*

*To help readers gain a better understanding of different philosophies and principles of taxation in North Carolina, we posed six questions to two policy analysts from organizations usually seen as opponents: the John Locke Foundation and the North Carolina Justice Center's Budget and Tax Center. The former is typically labeled "conservative," the latter "liberal."*

*The side-by-side answers that follow provide illuminating points of agreement, as well as points of disagreement. As North Carolina local and state elected officials consider their views on taxes, an examination of "first principles" of taxation, as well as opinions on some contemporary tax issues, is in order. —Editor*

**Roy Cordato** *is vice-president for research and resident scholar at the John Locke Foundation, in Raleigh.*

**Elaine Mejia** *is director of the North Carolina Budget and Tax Center, in Raleigh, a special project of the North Carolina Justice and Community Development Center.*

## Question 1.

**What are the key principles for guiding state tax policy? Are one or two principles most important?**

**Cordato:** Two kinds of principles should guide tax policy: moral and economic. The moral kind is more important because the entire fabric of the American political system is based on a particular ethic, namely individual liberty. For North Carolina the basic statement of this ethic is found in Section I of the North Carolina Constitution, Declaration of Principles. Following the U.S. Declaration of Independence but expanding on it as indicated by the phrase emphasized by me in the following quotation, the Declaration of Principles states:

*We hold it to be self evident that all persons are . . . endowed by their creator with certain inalienable rights: that among these are life, liberty, the enjoyment of the fruits of their own labor, and the pursuit of happiness.*

The difference between the statement in the Declaration of Independence and this statement has the most direct implication for tax policy. In North Carolina the citizens have an explicitly recognized right to "the enjoyment of the fruits of their own labor." This implies that they have a right to use their own income for their own purposes.

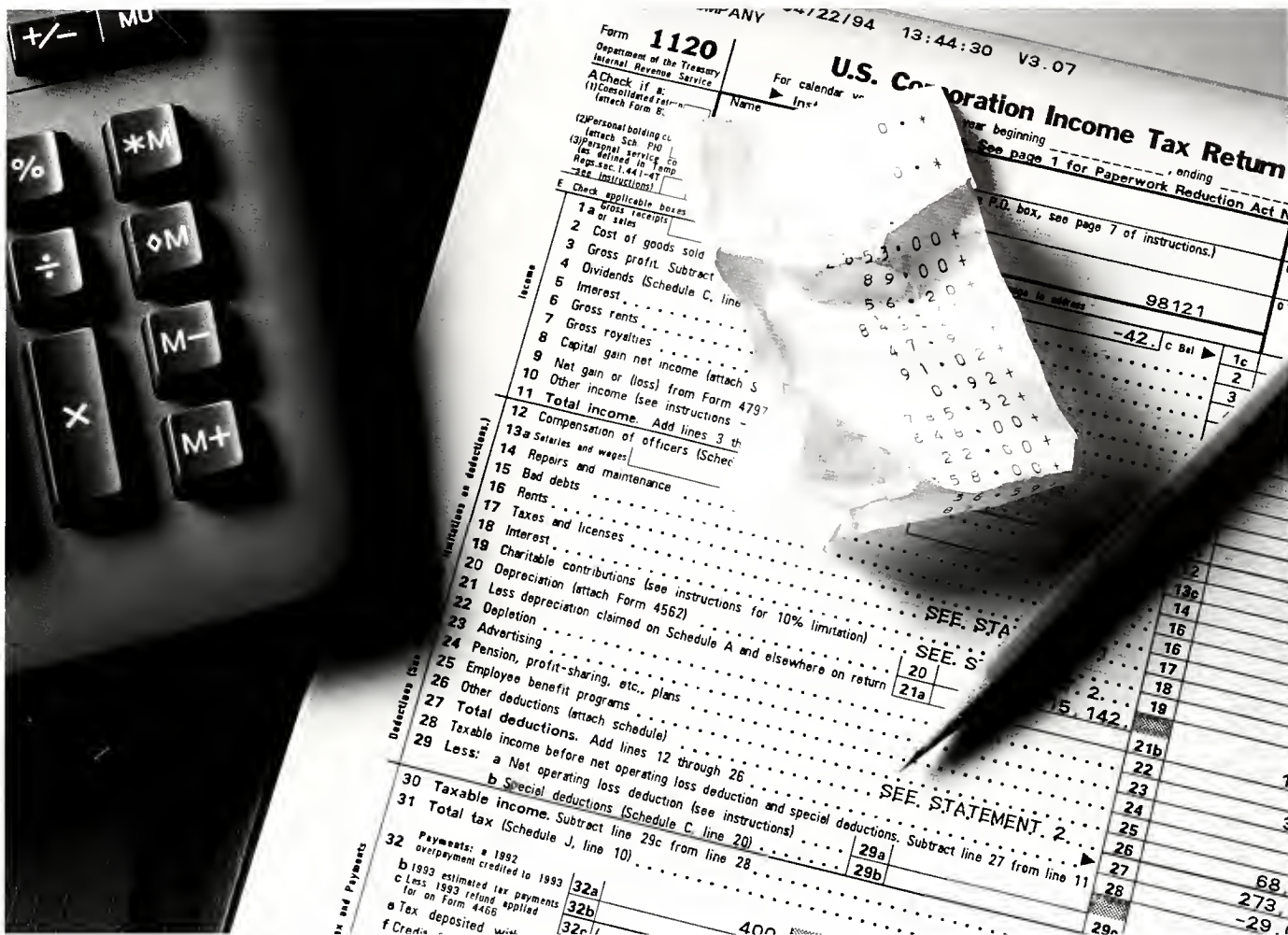
Contact the author at [rcordato@johnlocke.org](mailto:rcordato@johnlocke.org).

**Mejia:** In 1988 the National Conference of State Legislatures, in conjunction with the Lincoln Institute of Land Policy, put forth what remains the best set of core tax principles.<sup>1</sup> These five principles follow, along with brief descriptions.

**Principle 1: provision of appropriate (that is, adequate) revenues.** Taxes are a means to an end, which is to raise revenues to pay for government services, both today and in the future. To provide appropriate resources, a tax system must be *sufficient, stable, and certain*. This is particularly important for state governments, which, unlike the federal government, may not fund government with deficit spending. A "sufficient" tax policy raises enough revenues to pay for the programs and services that the majority of citizens and lawmakers demand, and remains flexible enough to adapt to a changing economy. A "stable" tax policy favors a diversified and broad-based tax structure. A "certain" tax policy requires that lawmakers avoid constantly changing tax laws except when necessary to reflect changes in economic and political circumstances.

**Principle 2: neutrality.** This principle recognizes that taxes should not unintentionally distort market decisions.

Contact the author at [elaine@ncjustice.org](mailto:elaine@ncjustice.org).



*Cordato continued*

Without this right the right to pursue happiness would be meaningless.

Because of its coercive nature, all taxation denies people this fundamental right. Policy makers, therefore, have an obligation to ensure that the North Carolina tax system encroaches on this right as little as necessary. This means that elected officials should not make tradeoffs between higher taxes, which violate a fundamental constitutional right, and government programs that are not constitutionally guaranteed.

Furthermore, the statement makes no distinctions based on income. "All persons" have an equal right to the fruits of their labor. This implies that policy makers have no moral authority to seek "progressivity" in the tax code (that is, taxing of larger incomes at higher rates). By its very nature, progressivity presumes that some people have fewer rights to the fruits of their labor than others.

Economic analysis gives rise to a second, complementary principle for guiding tax policy: policy makers should minimize taxation's negative impact on economic growth. In other words, the tax burden should be kept low. Taxation transfers control of resources from the forces of supply and demand in the private sector to the forces of political decision making in the government. This involves a transfer from an institutional setting where resources are used

*Mejia continued*

It also requires that the tax base be as broad as possible. Unfortunately the North Carolina tax code is riddled with exemptions, credits, deductions, and the like, introduced to encourage or sometimes discourag<sup>3</sup> specific behaviors by businesses and individuals. Although special treatment might be justified in some distinct cases, the tax system generally should not distort economic decisions.

**Principle 3: fairness and equity.** Tax fairness means different things to different people, but it probably is the reason most often cited for advocating specific changes in tax policies. Tax policy experts agree that tax fairness has two aspects: horizontal equity and vertical equity. "Horizontal equity" requires that similar taxpayers be treated similarly. That is, people with similar income and assets should pay approximately the same amount in taxes. This is far from reality in the current tax code, which gives preferential treatment to specific categories of individuals and businesses. "Vertical equity" demands that a tax system place at least proportional, if not progressive, burdens on taxpayers of varying economic means. At the very least, a tax system should not be "regressive." That is, it should not take a greater share of the income and wealth of low- and moderate-income taxpayers than it takes from wealthier taxpayers. Unfortunately, almost all state tax systems, including North Carolina's, fail this test.

*Cordato continued*

more efficiently to one where they are used less efficiently, leading to a reduction in economic growth and prosperity.

The principle of economic growth further implies that, to the extent possible, taxation should be neutral with respect to economic decision making. That is, tax policy should not penalize or subsidize some economic choices relative to others. These choices include decisions concerning consumption relative to saving and investment, leisure relative to work, investment in some kinds of industries relative to investment in other kinds, or purchase of certain kinds of goods and services relative to other kinds. The economy operates most efficiently when market forces (producers, consumers, investors, and entrepreneurs), not the tax code, determine resource allocation.

Finally, the tax system should be easy to comply with. This often is called the “principle of simplicity.” The diversion of people’s time and financial resources to comply with the tax system is itself a tax. It creates what economists call a “dead weight loss” to the economy. In other words, these resources are not contributing to overall productivity, and the economy grows at a slower rate than it would if compliance costs were lower.

*Mejia continued*

**Principle 4: ease and economy of administration.** Taxes should be as easy as possible for taxpayers to comply with and the least costly for government to collect. A complicated tax system leads some citizens to engage in aggressive tax planning in order to avoid paying taxes. It also leads to general dissatisfaction among taxpayers.

**Principle 5: accountability.** Tax collection officials should be efficient in their work and immune to corruption. Also, there should be strong enforcement of tax laws. Finally, tax policy should be made in an open, transparent manner. If policy makers do not clearly show taxpayers why they have made policy changes and who stands to benefit or lose as a result of those changes, they undermine trust in government and the willingness to pay taxes.

The principles of fairness and adequacy are the most important because they are the most essential to maintaining a democratic system of governance. Simply stated, adhering to these two principles means that the system should treat all taxpayers fairly and that government should provide the level of services that the public demands and lawmakers enact.

## Question 2. Which kinds of taxes are better for the government to use?

**Cordato:** Government should use the kinds of taxes that infringe the least on liberty and individual decision making and minimize damage to the economy. Further, it should avoid some forms of taxation altogether—those that are particularly inconsistent with liberty and economic growth.

Given the principle of neutrality, the state should avoid taxes that penalize some kinds of choices relative to others. These include specific excise taxes, such as those on tobacco, alcohol, hotel rooms, and rental cars. The tax code should treat all consumer choices equally.

On the basis of the same principle, the government should eliminate or reform the current income tax system. North Carolina’s approach to income taxes mirrors the federal tax code and is therefore inherently biased against work effort, entrepreneurship, and saving and investment. Taxes on income discourage income-generating activities, much as a tax on cigarettes discourages smoking or a tariff discourages imports. The income tax compounds this bias by applying higher “marginal rates” (that is, by applying higher rates to portions of income beyond a certain amount) as incomes increase. Progressive income taxes punish those who are the most productive. In a setting of free exchange, people generate income by providing goods and services that others want. This is what it means to be productive. Progressivity, in addition

**North Carolina’s approach to income taxes mirrors the federal tax code and is therefore inherently biased against work effort, entrepreneurship, and saving and investment.**

**Mejia:** Given the principles just discussed, the ideal state tax structure would grow with the economy, remain relatively stable during tough economic times, and be fair to all taxpayers. Therefore a state tax system should be diverse and should rely heavily on a progressive state income tax. Including property, consumption, and business income taxes diversifies and broadens the base of the tax system and provides some insurance against dramatic, harmful swings in revenues.

Over the long term, the personal income tax is the strongest of any of the major revenue sources and is most likely to ensure long-term adequacy of revenues to meet spending requirements and avoid deep structural deficits. At the same time, a highly progressive income tax makes the tax system equitable, offsetting the regressive nature of consumption and property taxes. Although most states rely to some degree on income taxes, only three states maintain an overall tax system that takes the same or less, as a share of income, from the top 20 percent of taxpayers as it does from the bottom 20 percent.<sup>2</sup> All three have a highly progressive personal income tax structure. North Carolina’s tax system has a moderately progressive personal income tax, but from a fairness standpoint, it is far outweighed by the system’s reliance on sales and property taxes.

Of North Carolina’s primary taxes, the retail sales tax is the most in need of substantial reform. After adjustments for inflation and new exemptions, sales tax revenues per penny have been decreasing over time. The two chief culprits are the proliferation of remote out-of-state and online retailers and the shift in the economy from purchases of goods toward purchases of services. Failing



*Cordato continued*

to denying equality of rights, punishes productivity and discourages economic growth.

North Carolina's policy makers should reform the state's income tax so as to minimize these biases. The state should switch to a "flat-rate consumed-income tax." The economics literature has shown that this kind of tax eliminates the bias against saving and investment and reduces the bias against work effort and entrepreneurship.

To introduce such a tax, first, policy makers should convert the current five-rate system (0.00, 6.00, 7.00, 7.75, and 8.25 percent) to a single rate that treats all taxpayers equally. If policy makers desire a progressive tax code for political reasons, they can introduce it by using a large zero-tax bracket at the bottom end of the income distribution.

Second, policy makers should exempt from taxation all income that is saved or invested until it is withdrawn and used for consumption. (This often is referred to as "universal IRA treatment.") At the point of withdrawal, they should tax both the principal and the interest or other return at the normal (flat) rate. All income would ultimately be taxed, but only once, when it was used for consumption.

Sales taxes display the same economic properties as the flat-rate consumed-income tax. Because of this, the state should rely most heavily on some combination of these two forms of taxation.

Further, in the name of both economic efficiency and political honesty, the state should abolish the corporate income tax. The tax adds an additional layer of bias against investment and entrepreneurship, hurting overall economic performance. Just as important, the tax is dishonest because it is a hidden tax on corporate shareholders, employees, and customers. Corporations as legal entities cannot pay taxes; only people can. Every dollar that a corporation takes in, whether it is kept and reinvested or paid out in dividends, accrues to the benefit of one or some combination of three groups: the corporation's stockholders (its owners), employees, and customers. If every dollar that comes into a corporation benefits one of these three groups, then every dollar that a company pays in taxes comes from one of these three

groups. Stockholders pay corporate taxes in the form of fewer dividends and reduced capital gains; employees pay them in the form of lower wages; and customers pay them in the form of higher prices. To claim that corporations are taxed is a charade. Those who call for higher corporate taxes are in effect advocating higher prices, reduced wages, and smaller capital gains and dividends. This last is a tax on workers' pension funds and retirement accounts, with an especially negative impact on the income of the elderly.

**The state should switch to a "flat-rate consumed-income tax." The economics literature has shown that this kind of tax eliminates the bias against saving and investment and reduces the bias against work effort and entrepreneurship.**



*"I see no new taxes, followed by some new taxes."*

*Mejia continued*

to include remote sales and services in the sales tax base violates the tax principles of neutrality, equity, and adequacy. Along with several other states, North Carolina is working at the national level to require remote sellers such as catalog and online vendors to collect sales taxes, but that effort will take years to bear fruit. The state has made less progress in expanding the sales tax base to include services. The combined effect of these developments is that sales tax revenues have not tracked economic growth. To compensate, lawmakers have more than doubled the combined state and local sales tax rate since the 1970s.

After the retail sales tax, business taxes should be next in line for overhaul. Businesses, like individuals, benefit greatly from government spending and should pay their fair share for the benefits. Determining what represents their fair share has become increasingly difficult. Large corporations have taken advantage of the complexity of the tax code and the wide variation in business taxes from state to state to lower their tax liability. In July 2003 the nonpartisan Multi-State Tax Commission released a report showing that North Carolina lost \$301 million in the 2000–01 fiscal year alone because of corporations' use of tax shelters. Currently, corporate income and franchise tax revenues combined make up only 8 percent of general fund revenues. This proportion is far less as a share of total state revenues than in the past, yet some advocates are adamant that North Carolina needs to cut business taxes. Two first steps in reversing these trends would be to move to "combined reporting" of corporate taxes (corporations reporting on all of their business activity to the North Carolina Department of Revenue, as opposed to their making their own determination of the share of their income that is attributable to doing business in the state) and to close corporate tax loopholes that already have been identified.

### Question 3. Should fees be used more and taxes reduced?

**Cordato:** A principle of taxation that I did not discuss in my response to question 1 is the “benefit principle.” This is the idea that benefits and payments should be linked. In markets this benefit-payments link is one of the factors that help ensure economic efficiency in production and consumption. When policy makers can easily identify specific beneficiaries and segment the market, it makes sense for them to finance government activities with user fees rather than general taxation. This includes not only charging admission to museums, parks, concerts, and so forth but also charging tuition to state universities so that a greater proportion of the actual cost of an education is covered.

The second part of this question, “and taxes reduced,” is important. The moral reason for using fees is to avoid forcing some people to subsidize other people’s consumption, investment (for example, education), and leisure activities (for example, using campgrounds or attending concerts or art exhibits). When policy makers use these fees to substitute for general taxation, they should return the money that is saved to the taxpayers and not use it to create new government programs or expand existing ones. The latter is a danger whenever new revenues become available. The tendency is to find new ways to spend the money. Rarely do policy makers think first about ways of returning saved revenues to the taxpayer. In accordance with the constitutional principle I discussed in my answer to question 1, a legislator has a moral responsibility to

**The moral reason for using fees is to avoid forcing some people to subsidize other people’s consumption, investment, and leisure activities.**

**Mejia:** User fees, sometimes called “user charges,” certainly serve a legitimate purpose in today’s government. Governments generally, and local governments particularly, are looking aggressively to user fees to raise needed revenues. According to the latest Census data, North Carolina ranked twenty-first in the use of nontax revenue to fund state and local government in fiscal year 2000.<sup>3</sup> Although local governments typically rely more heavily on revenue from user fees, state governments, including North Carolina’s, have been looking toward user fees for new revenues. In the 2003 legislative session, North Carolina raised user fees for visiting state parks, increased charges for various professional licenses, and boosted tuition for higher education. (The actions cover fiscal years 2003–04 and 2004–05.)

The central concern with the growing use of user fees is that on their face they violate the equity principle because they are generally assessed without regard to a user’s ability to pay. Unlike broad-based taxes, user fees are set at a flat amount regardless of the income of the user. Therefore, when they are raised explicitly to replace property tax revenues, the result is a regressive shift in the burden of paying for government.

In addition to raising equity concerns, user fees generally violate the principle of being easy and economical to administer because collecting them generally costs more per dollar than levying taxes does. This is yet another reason to develop strict guidelines for determining when to charge user fees for government services.

**User fees ... violate the equity principle because they are generally assessed without regard to a user’s ability to pay.**

## *Governor’s Commission to Modernize State Finances*

*Benjamin Russo*

**I**n 2002, Governor Mike Easley appointed the Commission to Modernize State Finances. He charged it to study whether North Carolina’s tax revenue system is fair and sufficient and to examine the volatility and the predictability of state tax revenue in light of developments in the new economy, in particular, growth in the services sector and in the Internet. Chaired by Judge Thomas Ross, executive director of the Z. Smith Reynolds Foundation, the commission consisted of fifteen members. It issued its final report in December 2002.

### **Principles Underlying the Commission’s Recommendations**

The commission established six principles to guide its formulation of recommendations:

1. **Equity.** As far as practicable, the tax burden should be a “fair and equitable” share of income and wealth. Taxpayers with similar incomes should face similar tax liabilities, and the proportion of income that taxpayers owe in taxes should increase as their income increases. Beneficiaries of government

services should pay fees that approximate the social costs of providing services.

2. **Competitiveness.** The tax system should not reduce a state’s ability to compete with other economies and should contribute to sustainable economic development, job creation, and growth.

3. **Sufficiency.** Tax revenue should be adequate to finance essential government services, with a minimum of short-term variation in revenue collections.

4. **Simplicity.** The tax rules should be relatively easy for taxpayers to understand and comply with, and for government officials to administer.

5. **Efficiency.** The tax system should minimize interference in individual consumers’ and producers’ decisions.

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keep taxes as low as possible. User fees are a way of pursuing this goal.

Fees for certain activities do not fall under the benefit principle. For example, some argue that businesses should pay a user fee when filing certain forms in compliance with regulations. This is inappropriate. Typically the purpose of regulations—for example, zoning laws or regulations related to the environment—is to benefit society, not the party complying with them. If the general citizenry is the beneficiary of the activity, then the general citizenry should bear the cost of it.



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Thoughtful application of user fees does have some advantages. User fees are appropriate when government provides services that also are provided by the private sector, especially if they are not core government services (such as law enforcement), or when the person receiving the services obtains a clear substantial benefit (such as a college education). User fees also can promote conservation of scarce resources such as water and electricity. Further, user fees link government spending for particular programs directly to their funding source, thus enabling government to recoup an established percentage of the cost of providing particular services.

Most tax policy experts agree, however, that user fees are not appropriate as a way to finance core government services, particularly social services and education programs. In these areas, government provides services and benefits on the basis of social objectives such as reducing poverty or providing equal educational opportunities.

One recent and controversial development in employment of user fees by local governments in North Carolina is the “impact” or “development” fee. This is a flat fee assessed when a new home is built. Unlike other types of user fees, it is not directly linked to the amount of government services that the particular owners of the new home will require. Because it is not, and because it is set at a flat amount regardless of economic means, this “fee,” in reality, is a flat tax, thus raising strong concerns regarding fairness. Although the state currently allows only a few localities to charge this type of fee, many other local governments are expressing interest. This type of fee will likely become a major tax policy controversy in North Carolina.

**6. Appropriate federalism.** Each level of government should have revenue sources tailored to its level, and fiscal tools to finance its particular responsibilities.<sup>1</sup>

Guided by these principles, the commission offered an overarching recommendation for tax policy and specific recommendations to reduce inequities and inefficiencies in the tax system that have developed as North Carolina’s economic structure has evolved. The extraordinary and continuing economic restructuring that has taken place over the past seven decades has benefited North Carolinians enormously. It also has made the tax system obsolete. The system the state has inherited is out of sync with the modern, knowledge-based services economy.

#### Commission Recommendations

The commission’s overall recommendation is for a broader tax base and lower tax rates. The social benefits of these changes are illustrated by the case of special exemptions to the sales tax.

Sales tax exemptions complicate compliance by retailers and administration by tax collectors. A broader tax base would **simplify the tax system** by eliminating special exemptions.

A properly structured broadening of the sales tax base would tend to **improve fairness**, as well. North Carolina’s retail sales tax falls most heavily on consumers and producers of tangible goods. Most services are not taxed. The proportion of income spent on services tends to increase with income, so taxing more services would increase the likelihood that the proportion of taxes owed by taxpayers would increase with income.

Item	Tax Type	Purchases for Use
1. North Carolina (Do not include tax collected)		
2. Sales for Resale (Do not include on Line 1)		
3. Receipts Exempt From State Tax (Include sales exempt from State tax such as food for home consumption)		
4. Receipts Subject to Tax (Line 1 Minus Lines 2 and 3)		
5. 4.5% State Rate		
6. 4% State Rate		
7. 3% State Rate		
8. 2% State Rate		
9. 1% State Rate		
County Rate		

#### Question 4.

### Taxes often are seen as affecting the economic performance of businesses in North Carolina. Should tax policy address specific economic development objectives?

**Cordato:** Tax policy should address one specific economic development objective. Tax policy can have a profound effect on economic performance, and, as noted earlier, that effect is always going to be negative. Policy makers need to be very mindful of this fact. It means that they should construct taxes to minimize damage to the state's economy. They should leave as small a footprint on the state's private sector as possible. I discussed how they might do this in my answer to question 2. Generally speaking, though, policy makers should construct tax policy to stay out of the way. In fact, in terms of economic development, this should be a guide for all state policy.

Unfortunately, what has come to be known as economic development policy, and in particular the tax policy component of it, is guided by a false principle that runs contrary to sound economic analysis. This principle starts with the premise that, through incentives and implicit penalties, policy makers should use tax policy to encourage some kinds of investments and discourage others. I describe this approach as "corporate socialism" because it accepts the guiding premise of a socialist economy—namely that the state should have an important role in determining resource allocation. It is "corporate" socialism because it accomplishes this task by granting special favors to selected businesses and corporations, necessarily at the expense of others.

Corporate socialism has the same problems as other forms of socialism. First, it is destructive of individual liberty because it uses government power to influence

**Mejia:** Manipulation of tax policy specifically to encourage business development and relocation generally violates the principles of good tax policy discussed earlier. Despite this fact and overwhelming evidence that tax incentives are ineffective overall in generating new economic activity, the last twenty-five years have witnessed a steady increase in interstate competition to attract new business. Almost since the beginning of American government, lawmakers have seen a tremendous political premium in creating jobs. Often, however, in creating jobs by manipulating the tax code, lawmakers have succeeded only in violating most key tax principles, distorting the private marketplace by subsidizing certain industries and creating unfair advantages, and wasting valuable public resources.

Certainly, some level of fair competition between states is beneficial because it encourages efficiency and innovation as states try to maintain and enhance the quality of public services and keep costs in check. However, the attempts to stimulate investment and create jobs often are narrowly targeted, thus violating the principles of horizontal and vertical equity, accountability, simplicity, and unnecessary decreases in the tax base.

North Carolina has numerous examples of such well-meaning yet misguided efforts. A prime one is the cigarette export credit, which gives cigarette manufacturers a special credit against their tax bill for exporting cigarettes manufactured in North Carolina. The state does not give tax credits to any other type of industry for exporting its product. The credit diverts millions of dollars from

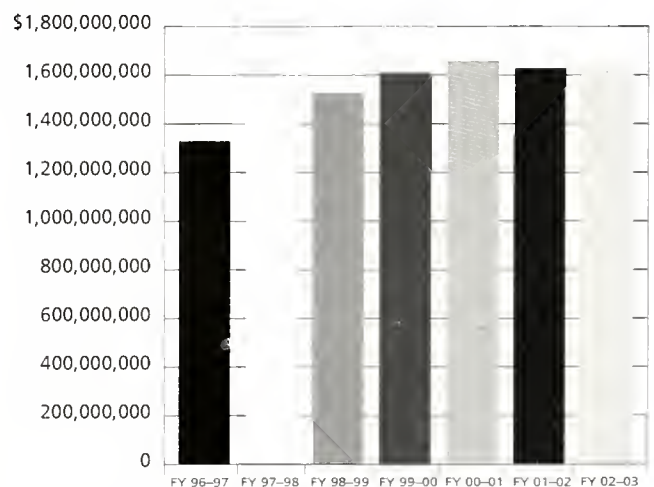
Including more services in the sales tax base also would **increase stability** in tax revenue collections during economic downturns, because spending on services is relatively less responsive to cyclical declines in income than spending on tangible goods. Long-run sufficiency of tax revenue would be improved because spending on services grows as a proportion of total spending.

Taxing more services would tend to **improve economic efficiency**. Taxes are inefficient because they interfere with consumption and production decisions. Taxing a good, such as a new refrigerator, but not a service, such as refrigerator repair, causes substitution of services for goods, reducing economic value. Taxing more services would reduce the inefficiency. It also would reduce the sales tax-induced competitive disadvantage currently suffered by manufacturers.

A broader tax base generates a given level of revenue at a lower tax rate. Tax economists have shown that inefficiency diminishes faster than tax rates. Therefore a broader tax base would **produce an efficiency "bonus"**

(For a graphic illustration of changes in sales tax revenue of local governments in recent years, see Figure 1.)

Figure 1. Local Sales Tax Revenue, FY 1997–2003



Source: Adapted from Rebecca Troutman, Sales Tax Perspectives (slide show) (Raleigh: North Carolina Ass'n of County Commissioners, n.d.).

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what should be freely made decisions based on entrepreneurial insights and the personal preferences of consumers. Second, it reduces economic welfare because it substitutes the decisions of policy makers and bureaucrats for those of private market participants. These government decision makers have neither the incentive nor the intimate market information necessary to allocate resources efficiently. What

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general fund revenues and does nothing to stop the natural shift in the state's economy away from tobacco growing and manufacturing. To compensate for the loss, other businesses and individuals have to pay higher taxes.

Another example, which has cost hundreds of millions of dollars in lost revenue, is the William S. Lee corporate tax incentive initiative, begun in 1996. This program pro-



The commission's primary recommendations are as follows:

1. Sales tax

- a. Eliminate differentials in sales and use tax rates and in caps on sales and use tax liabilities.
- b. Eliminate sales tax exemptions.
- c. Consider expansion of the sales tax base to include more services.
- d. Adopt changes required to comply with the Streamlined Sales and Use Tax Project.<sup>2</sup>
- e. Simplify administration of local sales taxes.

2. Individual income tax

- a. Tie the state income tax more closely to the federal tax code.
- b. Adopt strategies to help low-income taxpayers.

3. Corporate income/franchise taxes

- a. Eliminate or simplify tax credits.
- b. Move to combined reporting by related entities.<sup>3</sup>
- c. Modernize the franchise tax.
- d. Consider establishing a throw-out provision.<sup>4</sup>
- e. Tie the state corporate income tax more closely to the federal definition of corporate income.

- f. Consider returning to equal weights on payroll, property, and sales in apportionment.<sup>5</sup>

4. Other finance issues

- a. Increase fees to cover the costs of selected services provided by the state.
- b. Substantially increase the target on North Carolina's Rainy Day Fund.<sup>6</sup>
- c. Replace the practice of cutting tax rates and creating credits and exemptions when tax revenue expands faster than expenditures, with a policy that returns budget surpluses to citizens via tax rebates.<sup>7</sup>

An unedited electronic version of the commission's final report is available at [www.osbm.state.nc.us/files/pdf\\_files/final\\_rpt\\_gov\\_comm.pdf](http://www.osbm.state.nc.us/files/pdf_files/final_rpt_gov_comm.pdf).

**Notes**

1. Not all levels of government are equally suited to use particular revenue sources. For example, correct assessment of property values is easier for local officials than for state officials, so property taxes are easier to collect at the local level. See *STATE AND LOCAL GOVERNMENT RELATIONS IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT STATUS* (Charles D. Liner ed., Chapel Hill: Institute of Gov't, Univ. of N.C. at Chapel Hill, 1995).

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makes private markets efficient is that businesses, consumers, and entrepreneurs are using and risking their own money. If they fail or exercise bad judgment, they bear the costs and learn from their mistakes. If their judgment is correct, they reap the rewards. This system of profit and loss leads to an efficient learning and decision-making process. State policy makers face none of these incentives.

Furthermore, corporate socialism is inherently a win-lose proposition. Any business that is subsidized through tax favors or direct payments gains at the expense of others whose taxes must pick up the slack. Although business may expand in the area targeted by the tax breaks, it will contract in other areas of the economy. In spite of this effect, such programs are politically popular because the expansion that occurs is highly visible and easy for politicians to take credit for, while the contractions are not easily identifiable or directly attributable to the policy. Nearly all studies of such programs show that they do little or nothing to advance economic growth.

Examples of corporate socialist programs in North Carolina are the Golden LEAF, a program for channeling tobacco settlement money to particular businesses; the William S. Lee Act and the North Carolina Stimulus and Job Creation Act, both of which are programs that give tax breaks to attract new businesses to the state; and the recently passed Job Growth and Infrastructure Act, which gives a host of tax privileges and direct subsidies to specific pharmaceutical and cigarette manufacturers. Policy makers should abolish all such programs and, instead, lower taxes across the board. This will aid all businesses and help North Carolina become a business- and investment-friendly state.

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**In creating jobs by manipulating the tax code, lawmakers have succeeded only in violating most key tax principles, distorting the private marketplace by subsidizing certain industries and creating unfair advantages, and wasting valuable public resources.**

vides tax credits to certain types of businesses, such as manufacturers, that invest in particular types of preferential activities—for example, hiring more workers or supporting research and development. A study released in 2003 and commissioned by the state's Department of Commerce reveals that 96 percent of state-subsidized business activity would have taken place without the tax credits. Furthermore, this initiative is clearly unfair to small businesses,

violating the principle of horizontal equity. Also, the credits are difficult to police, thereby violating the accountability principle.

At a minimum the state should limit its support of specific industries to those that will be profitable in the long run and will not grow, or will grow more slowly, without the tax preference. This type of crystal-ball tax policy will never be an exact science. Therefore some of the state's investment always will be wasted. Generally it is better to maintain competitiveness by trying to provide the best public services while keeping the over-all tax burden within a reasonable proximity of competitors. In the long run, that approach will have the broadest and longest-lasting positive impact on economic development.

2. Complications resulting from the more than 7,000 tax jurisdictions in the United States contributed to a U.S. Supreme Court decision, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), precluding state and local governments from requiring out-of-state vendors to collect use taxes, without the consent of Congress. If Internet sales continue to grow rapidly, they could threaten sales and use tax bases. In the late 1990s, state and local government officials began work on the Streamlined Sales Tax Project (SSTP) to simplify sales and use taxes sufficiently to gain congressional consent. For a copy of the SSTP Agreement, see [www.geocities.com/streamlined2000/](http://www.geocities.com/streamlined2000/). For a summary of state legislative action on SSTP, see [www.ncsl.org/programs/fiscal/stateactionchart2.htm](http://www.ncsl.org/programs/fiscal/stateactionchart2.htm).

3. Currently, out-of-state subsidiaries of North Carolina corporations are treated as separate entities for tax purposes; that is, income earned by separate entities is not included in taxable North Carolina income. Combined reporting would make subsidiary income taxable in North Carolina and reduce the ability of North Carolina companies to avoid taxes by transferring income from intangible capital, such as trademarks and patents, to low tax jurisdictions. For discussions of combined reporting, see *FINANCING STATE GOVERNMENT IN THE 1990s* (Ronald Snell ed., Washington, D.C.: National Conference of State Legislatures and National Governors' Ass'n, 1993); Richard D. Pomp, *The Future of the State Corporate Income Tax. Reflections of a Tax Lawyer*, in *THE FUTURE OF STATE TAXATION* (David Brunori ed., Washington, D.C.: Urban Inst., 1998),

and MICHAEL MAZEROV, *CLOSING THREE COMMON CORPORATE TAX LOOPHOLES COULD RAISE ADDITIONAL REVENUE FOR MANY STATES* (Washington, D.C.: Center on Budget and Policy Priorities, May 2003), available at [www.cbpp.org/4-9-02sfp.htm](http://www.cbpp.org/4-9-02sfp.htm).

4. *FINANCING STATE GOVERNMENT* describes throw-out rules and their costs and benefits.

5. On the use of apportionment formulas in state taxation of business income, see RONALD C. FISHER, *STATE AND LOCAL PUBLIC FINANCE* ch. 17 (Chicago: Richard Irwin Publ'g, 1996; reprint, New York: McGraw-Hill, 2000); NEIL BRUCE, *PUBLIC FINANCE AND THE AMERICAN ECONOMY* ch. 19 (Reading, Mass.: Addison Wesley Longman, 2001); and the entry for "apportionment" in JOSEPH CORDES ET AL., *ENCYCLOPEDIA OF TAXATION AND TAX POLICY* (Washington, D.C.: Urban Inst., 1999).

6. In 1991 the General Assembly established a Rainy Day Fund in North Carolina as insurance against revenue shortfalls. Currently the fund's target each year is 5 percent of the previous year's expenditures. For a detailed discussion, see BENJAMIN RUSSO, *REPORT ON NORTH CAROLINA'S STATE REVENUE SHORTFALLS AND BUDGET STABILIZATION FUND* (manuscript prepared for the Governor's Commission to Modernize State Finances, Univ. of N.C. at Charlotte, June 2002).

7. Cutting tax rates during economic expansions can create structural deficiencies in the tax system that become apparent during economic contractions, because revenue falls with the level of economic activity.

## Question 5.

### Should there be a requirement to have a supermajority, or other types of limits, for setting taxes?

**Cordato:** As I discussed in my answer to question 1, because of its coercive nature, taxation inherently violates North Carolinians' constitutionally guaranteed and creator-endowed right to use the fruits of their labor as they see fit. Given this, tax increases should be viewed very differently than tax cuts. Tax increases erode rights; tax cuts restore them. From a legislative perspective, then, legislators always should consider tax increases more carefully than they consider tax cuts, and tax increases should be more difficult to pass. Furthermore, tax increases should be a last resort. Legislators should not pass tax increases as long as the budget includes items that are not constitutionally guaranteed or federally mandated. For example,

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the state allocates more than \$300 million a year to corporate socialism programs of the nature discussed earlier. The allocations include subsidies to the film industry, tourism, biotechnology, fisheries, and tobacco processing, among many others. None of these involve constitutionally guaranteed rights, so legislators should eliminate all of them before considering any tax increase. Because of this, a constitutional amendment requiring some kind of supermajority to increase taxes, possibly two-thirds of each legislative chamber, makes sense. Such an amendment should be coupled with a constitutional check on spending increases. Governor Mike Easley took a timid step in this direction in his budget proposal in 2003 by asking for a budget limitation that would hold spending to a ten-year rolling average of increases in per capita income (so that, as incomes rise, state spending rises proportionately).

Although this proposal should be applauded, it still allows for significant increases in the size and scope of state government. A better approach is to limit the growth in spending to the population-adjusted inflation rate. This proposal, referred to as the Tax Payer Protection Act, was introduced several times in the North Carolina General Assembly during the 1990s. It would effectively freeze the budget, forcing the legislature to prioritize spending.

States such as Colorado that have had this kind of constitutional restraint in place have avoided the severe budget problems experienced by North Carolina. If North Carolina had had such a constitutional amendment beginning in the mid-1990s, state spending would have been \$1.5 billion lower in 2001–02. That amount would have been more than enough to offset the budget shortfalls that the state government has experienced.

**Mejia:** North Carolina does not need any new restrictions on taxes or spending, for such limits can be extremely detrimental to the maintenance of public investment in popular and critical programs such as education, health care, roads, and law enforcement. Tax policy is set under constraints already in place, which require a majority of both houses of the General Assembly and, more recently, the consent of the governor. Both houses also operate under rules that limit expedited consideration of legislation affecting tax policy.

In the last few years, during the much-talked-about fiscal crisis in North Carolina, lawmakers have continuously struck a balance between spending cuts and new revenues, only sometimes looking to tax increases. The sole state taxes to be raised during the current crisis were enacted in 2001, bringing in about \$500 million annually in new general fund revenues. That represents just 3 percent of current general fund revenues, compared with annual revenue shortfalls of approximately \$2 billion, or around 13 percent of total general fund spending. Clearly, North Carolina lawmakers, even without new restrictions, are fiscally conservative, preferring tax increases only when absolutely necessary.

States with tax and spending limits are in no way immune to fiscal crises. California, Colorado, and Oregon, three states with expenditure limits, are experiencing sizable annual shortfalls. Often when they face growing demand for public services, these states turn to user fees and other tricks such as debt financing and spending "off budget" to avoid deep cuts in state programs and to keep pace with public demand. If locally elected officials make government taxing and spending decisions with sufficient public input and transparency, there is no need for these types of limits. Fortunately the public distrust of lawmakers that is so evident in other states is not the norm in North Carolina.



*Bernard Shusterman*

*"Welcome aboard. You are now exempt from federal, state, and local taxes."*

## Question 6: Is North Carolina a "high-tax state"?



**Cordato:** In comparison with the states with which North Carolina most directly competes for business and job opportunities, yes. North Carolina has tax rates and a tax burden that are well above average. Among southeastern states, North Carolina has by far the highest top marginal income-tax rate (the rate applied to the top income earners), 8.25 percent; the highest corporate tax rate, 6.9 percent; and the second-highest sales tax rate, 4.5 percent. Tennessee is the only southeastern state with higher sales taxes, but it has no income tax. North Carolina's sales tax rate is higher than that of Florida, which also has no income tax.

In terms of economic impact, corporate and personal income taxes are the most damaging. The high rates of these taxes have the strongest impact on investment, entrepreneurship, and business expansion. Most small business owners are not incorporated and therefore have their business income taxed at the extraordinarily high 8.25 percent personal tax rate. In addition, any significant capital gains, such as those resulting from the sale of a business or a family farm, are taxed at this rate.

Also, North Carolina's tax burden as a percentage of its citizens' personal income now

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**Mejia:** People typically answer this question by comparing North Carolina's total state and local taxes with those of other states, either on a per capita basis or in relation to the size of the state's economy as measured by gross state product or total personal income. However, given the tax policy principle of appropriate level of resources, answering this question simply by comparing North Carolina with other states hardly seems fair. There is no widespread dissatisfaction with the level of government services provided in this state. Indeed, the demand for government services continues to grow. The level of government services approximates the will of the majority of the citizens, regardless of how the level compares with that of states whose citizens may have different needs and desires for government programs. By this standard, North Carolina is not a high-tax state.

**North Carolina ranked thirty-seventh nationally in combined state and local taxes as a percentage of personal income and thirty-first in total taxes per capita in 2000.**

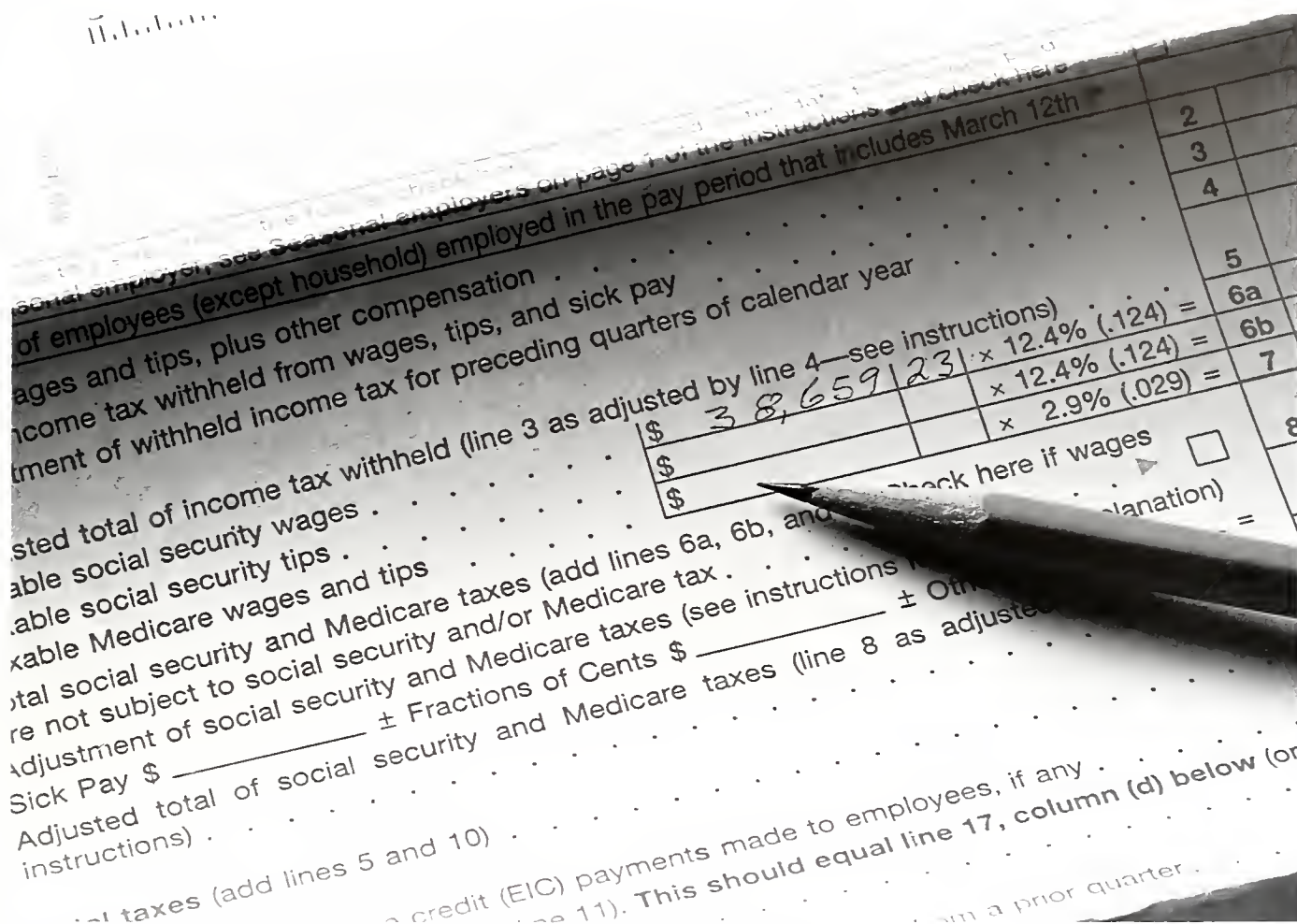
Even responding to this question by comparing North Carolinians' tax burden with that of other states, however, the answer to the question is no. In fact, North Carolina's total state and local taxes continue to rank in the bottom half of states. The latest unbiased government statistics to give total combined state and local taxes are from fiscal year 1999–2000. These data make

clear that, overall, North Carolina is not a high-tax state when compared with its neighbors or the rest of the nation. The new data show that North Carolina ranked thirty-seventh nationally in combined state and local taxes as a percentage of personal income and thirty-first in total taxes per capita in 2000.<sup>4</sup>

True, some categories of taxes are higher in North Carolina than the national average. For example, the personal income tax is approximately the tenth highest overall. However, this tax is offset by the state's comparatively low reliance on property taxes. Moreover, as noted previously, North Carolina's reliance on income taxes is consistent with sound tax policy principles.

Any discussion about high- versus low-tax states must account for the fairness of current tax policy and any proposed changes. Although, as a general proposition, North Carolina is not a high-tax state, taxes on low-income taxpayers, who pay the greatest share of their income in state and local taxes, are clearly too high. Currently there is no requirement that lawmakers discuss the relative burden of proposed tax policy changes before they are made. The focus that some groups give to marginal rates ignores this great injustice in the current tax code—that the bottom 20 percent of North Carolina's taxpayers, with an average income of only \$9,100, pay 43 percent more in state and local taxes as a share of income than the top 1 percent of taxpayers, with an average income of \$814,000, after





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stands at 9.5 percent. This is well above the average for the region, which is about 8.9 percent. North Carolina's burden is second only to that of Georgia, which has the highest tax burden in the Southeast at 9.9 percent. This is not new. North Carolina's tax burden has been well above the regional average for the last decade. However, the gap has widened considerably with the tax increases of the last few years. North Carolina is the only state in the country to have implemented tax increases in each of the last three years.

Clearly, though, how high taxes are is a function of how large state government is, and this relationship is at the root of the state's tax and budget problems. Inflation-adjusted general fund spending has increased by more than \$200 per person since the 1995-97 budget cycle. Although many blame the state's budget deficits on tax cuts in the mid-1990s, these cuts were not enough to compensate for the tax increases of the early 1990s. During the 1990s, net taxes increased, but even the increases could not compensate for the spending binge that the state engaged in between 1995 and 2000.<sup>1</sup>

**Note**

1. All the statistics in this paragraph were calculated by the John Locke Foundation using data from North Carolina state budget documents, the U.S. Census Bureau, and the Consumer Price Index.

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accounting for federal deductions.<sup>5</sup> Despite this fact, talk of tax cuts continues to focus on "high" personal and corporate tax rates. The evidence is overwhelming that the highest overall rates actually are paid by those with the least ability to afford such a burden.

**Notes**

1. DAVID BRUNORI, *STATE TAX POLICY: A POLITICAL PERSPECTIVE* 15-27 (Washington, D.C.: Urban Inst., 2001).
2. INSTITUTE ON TAXATION & ECONOMIC POLICY, *WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES* (2d ed., Washington, D.C.: the Institute, Jan. 2003), available at [www.ctj.org/itep/whopays.htm](http://www.ctj.org/itep/whopays.htm).
3. The data are from U.S. Census Bureau, Government Finance Series, available at [www.census.gov/govs/www/estimate.html](http://www.census.gov/govs/www/estimate.html), and U.S. Department of Commerce, Bureau of Economic Analysis, available at [www.bea.gov](http://www.bea.gov). In fiscal year 1999-2000, North Carolina ranked twenty-first in Charges (for example, higher education tuition and public hospital fees) and Miscellaneous revenue (for example, interest earnings) as a percentage of total personal income, twenty-fourth in Charges and Miscellaneous revenue per capita.
4. *New Data Show North Carolina not a "High Tax" State*, BTC REPORTS (published by the N.C. Budget and Tax Center), Jan. 2003, available at [www.ncjustice.org/btc/2003reports/03\\_jan\\_1Rpt.pdf](http://www.ncjustice.org/btc/2003reports/03_jan_1Rpt.pdf).
5. INSTITUTE ON TAXATION & ECONOMIC POLICY, *WHO PAYS?*

# Can Public Employers Eliminate or Reduce Health Benefits?

*Diane M. Juffras*

**F**or most employers, personnel costs represent a substantial and increasing share of the budget. What employer hasn't "gulped" at the escalating costs of health insurance? What employer hasn't seriously considered either reducing health benefits or reducing other benefits to offset the increased cost of health insurance?

Many public employers assume that because private employers may reduce the health benefits of retirees, they too may do so. That assumption is erroneous because public-sector employee benefits are subject to different laws than private-sector employee benefits. Public employers should carefully review the terms under which they have offered health and other benefits to past and present employees before they make any changes to their benefits policies. The experience of public employers in other states suggests that if they fail to do so, at least some of them are likely to be sued and to face significant liabilities—liabilities of the kind that they attempted to eliminate from their budgets in the first place.<sup>1</sup>

## The Different Laws Governing Private and Public Employee Benefits

Private employers' retirement and welfare benefits plans (of which health insurance is one example) are governed by the Employee Retirement Income Security Act of 1974 (ERISA).<sup>2</sup> ERISA sets minimum standards for the administration and funding of private-sector

pension plans and for the information that must be provided to private-sector employees participating in employer-sponsored pension and welfare benefits plans. It also establishes fiduciary duties for those involved in administering pension and welfare benefit plans.

Government pension and welfare benefits plans are *not* subject to ERISA. Instead, they are governed by state contract law. In North Carolina that law appears to be more protective of retirees' expectations than ERISA is. So how and when may a North Carolina public employer reduce the health benefits of employees and retirees? This article uses a hypothetical case featuring an imaginary North Carolina city to discuss the legal issues that North Carolina public employers should take into account in attempting to control the costs of health benefits for both current employees and retirees.

## Trouble in Paradise

Paradise, North Carolina, is a medium-sized city with a population of about 40,000. Like many North Carolina jurisdictions, it is struggling to balance its budget. The city council has concluded that it must reduce the costs of employee compensation. It has considered and



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rejected both across-the-board pay cuts and a salary freeze, believing that such actions would seriously harm employee morale and hurt current recruiting efforts. Instead, the council has decided to reduce health benefits for both current employees and retirees.

Paradise has a personnel ordinance that provides for health insurance coverage of current employees and their families. The city pays the full cost of the employees' premiums and half of the cost of the premiums for the employees' spouses and dependents. The employees pay the other half.

The personnel ordinance also provides for continued coverage, at no cost, of employees who have twenty years of service with the city at the time of their retirement. Retirees may continue coverage of spouses and dependents by paying the full cost of the premiums themselves. Once a retiree reaches age sixty-five and qualifies for Medicare, coverage under the city's plan ceases. The ordinance does not specify a particular health insurance plan or a particular set of benefits in the case of either current employees or retirees.

The city council asks the manager to suggest the best way to reduce health insurance costs. The manager makes two proposals: first, eliminate retiree health benefits for current employees who have

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not yet retired; and second, require current retirees to pay half of the cost of their premiums. This proposal seems reasonable to the council, so both council members and the manager are caught up short when the city attorney expresses serious reservations about whether such changes are legal.

### Elimination of Retiree Benefits

Does North Carolina law permit a government employer to eliminate or reduce retiree health benefits? That question

(TSERS) and the Local Government Employees' Retirement System (LGERS).<sup>3</sup> The *Bailey* case is, at its heart, an employment contract case. The principles on which it was decided are directly applicable to when and how a public employer like Paradise can change its retiree health benefits plan. Paradise is limited in the changes it may make, despite the fact that public employers are not required to offer health insurance to their current or retired employees in the first place.<sup>4</sup>

Every employee has an employment

earned in the present, but payment is deferred to a later date. The court in the *Bailey* case reaffirmed this long-standing rule in holding that the state had made a legally enforceable promise to state and local government employees to exempt their retirement income in its entirety from state income tax. The employees had worked in government service with the understanding that (1) part of their compensation would be paid after retirement and (2) the amount of their deferred compensation would not be



*Health benefits are critically important to many retirees. Without benefits, some may have to choose between medication and food.*

has never been directly addressed by any North Carolina state or federal appellate court. The city attorney's hesitation is based on the North Carolina Supreme Court's decision in *Bailey v. State of North Carolina*, which limits the right of the state, as a government employer, to change the terms governing payment of retirement benefits under the Teachers' and State Employees' Retirement System

contract, the city attorney explains to the Paradise council and manager. The contract is usually oral, not written, and its terms often are merely implied rather than expressly stated.<sup>5</sup> Most employment contracts expressly cover only the employee's duties, hours of work, and compensation. In North Carolina (as in most other states), retirement benefits are a form of compensation. They are

diminished by the imposition of the state income tax. The state tried to cap the amount exempted from tax. The North Carolina Supreme Court held that to do so would deprive those employees of compensation that they already had earned.<sup>6</sup> As the court said,

*A public employee has a right to expect that the retirement rights*

*bargained for in exchange for his loyalty and continued services, and continually promised him over many years, will not be removed or diminished.*<sup>7</sup>

In the law of contracts, this expectation, along with wages and other benefits, is referred to as “consideration” for the services an employee renders. Consideration is necessary for a contract to be binding.

Retirement benefits therefore are not gratuities, or “freebies,” as the city attorney puts it more colloquially. Earlier, in *Faulkenberry v. Teachers and State Employees Retirement System of North Carolina*, a case dealing with disability retirement payments, the state had argued that retirement benefits were gratuities, but the North Carolina Supreme Court held that they were not.<sup>8</sup> This is an important point. The North Carolina Constitution prohibits the state and its political subdivisions from paying any person any money whatsoever except in payment for public services.<sup>9</sup> However, as the court explained, because retirement income benefits are not gifts or gratuities but a form of deferred compensation for which employer and employee have bargained and to which both have agreed, payment of those benefits does not violate the state constitution.

No North Carolina cases offer a basis for distinguishing retiree health benefits from pension payments, and courts in other jurisdictions that have considered the question have generally concluded that retiree health benefits are deferred compensation.<sup>10</sup> So the North Carolina courts would likely hold that under the *Bailey* case, the health benefits that Paradise has provided for its retirees are a form of deferred compensation.

### **Reduction of Benefits Previously Promised**

The city attorney’s explanation of the *Bailey* case doesn’t entirely answer the Paradise City Council’s and manager’s question. They now rephrase it as follows: “Okay, we owe our retirees their health benefits because they are a form of deferred compensation. But do we owe retiree health benefits to our current employees who have worked for

the city for the minimum twenty-year period but not yet retired? And may we require our current retirees at least to pay half of the premium? After all, when the ordinance was adopted, no one expected health insurance costs to increase as much as they have, and the retirees will still be getting health benefits, which is what they bargained for.”

### **The Concept of Vested Benefits**

It is easy to understand how employers owe employees who already have retired, that part of their compensation represented by pension and health insurance benefits. But what about employees with five, ten, or twenty years’ service who have not yet retired but have worked and continue to work in expectation of retirement health benefits? Do their employers owe them anything? How does one quantify what they are owed? Employers may raise and lower the salaries of current employees. Why can’t they make changes to prospective retirement benefits?

From the perspective of a mid-career government employee, however, such changes do not seem fair. Imagine such an employee’s learning on Wednesday that her rate of pay is being cut and that her paycheck for the entire week—that is, for work done on Monday and Tuesday, as well as for work done Wednesday through Friday—is being calculated at the new, reduced rate. Changing retirement benefits for employees already in the workforce is a little like that.

In North Carolina the law protects the expectations of employees in their retirement benefits through the concept of vested rights. “Vesting” occurs when an employee has fulfilled all the prerequisites to enjoyment of a benefit. For example, by statute, employees participating in both TSERS and LGERS must complete a minimum of five years of government service before they are eligible to receive retirement payments. On the date on which the employee completes five years of service, his or her right to retirement benefits vests. In *Bailey* and earlier cases involving retirement payments, the state argued that employees had no contractual right to particular service or disability retirement benefits until they actually retired or became disabled. The courts disagreed,

holding that employees have a *contractual* right to rely on the terms of the retirement plans *as the terms exist at the moment their retirement rights vest*.<sup>11</sup> In the *Bailey* case, the court found that the state could have capped the state income tax exemption for state and local government employees who had not yet vested in their respective retirement systems, but that it could not do so for employees who had satisfied the minimum service requirement but not yet retired.<sup>12</sup>

Thus the city attorney’s response to the council members and manager is that Paradise may not eliminate its retiree health benefits for employees who have met the twenty-year vesting requirement because they have an enforceable contract right to those benefits. However, Paradise is apparently free to eliminate the benefits for both new hires and current employees with less than twenty years of service (that is, employees who have not yet vested).<sup>13</sup>

### **The Right to a Particular Health Insurance Plan**

One of the city council members objects. He argues, not unreasonably, that the city never intended to enter into a contract with any employee to provide retiree health benefits. Further, because the retiree health insurance plan is part of the city’s personnel ordinance, the council should be able to amend it like any other part of the ordinance, provided that proper procedures are followed. Even if the retiree health provision of the ordinance is a contract, the council member continues, Paradise, as a government entity, may breach the contract as long as it does so for the public good. In the council member’s opinion, saving the city money so that it can maintain services without raising taxes is clearly for the public good.

The *Bailey* case directly addresses these issues too, the city attorney explains. The court in that case held that laws can act as contracts. When a statutory provision becomes the basis for an individual’s decision to act (in this instance, to work for the government employer), the statutory provision becomes part of a contract between the government and the individual. Even if the statute is repealed or amended, the



contract remains good and enforceable.<sup>14</sup> As the North Carolina Supreme Court said earlier, in a decision addressing the right of the state to make changes in the way disability retirement benefits were calculated,

*At the time the plaintiffs' rights to pensions became vested, the law provided that they would have disability retirement benefits calculated in a certain way. These were rights they had earned and that may not be taken from them by legislative action . . . We believe that a better analysis is that at the time the plaintiffs started working for the state or local government, the statutes provided what the plaintiff's compensation in the way of retirement benefits would be. The plaintiffs accepted these offers when they took the jobs. This created a contract.<sup>15</sup>*

#### Justifiable Impairments of Contracts

As for the council member's observation that a local government may breach a contract for an important public pur-

pose, the city attorney responds that it is an oversimplification. Article I, Section 10, of the U.S. Constitution, the "Contract Clause," says, "No state shall . . . pass any . . . law impairing the Obligation of Contracts." This clause is applicable not only to state governments but also to local governments and other political subdivisions of the state.<sup>16</sup> It is not, however, an absolute prohibition. The U.S. Supreme Court has held that a state may pass legislation or take other official action that impairs its contracts without violating the Contract Clause, when it does so to protect the general welfare of its citizens and when the impairment is "reasonable and necessary to serve an important public purpose."<sup>17</sup> Thus not every impairment violates the Contract Clause. As with ordinary breaches of contract, when a state takes an action that impairs its contracts, the impairment, like a breach, must be *substantial*.<sup>18</sup> Minimal impairments, or actions that effect changes incidental to the basic contract, will not violate the Contract Clause.<sup>19</sup>

There are two additional questions, then, about Paradise's plan to eliminate retiree health benefits for current employees who have a vested and enforceable contractual right to them but have not yet retired. The first question is whether their elimination would be a *substantial* impairment of the city's contract with affected employees. The answer is undoubtedly yes. The *Bailey* case establishes that the extent of the impairment is to be determined by the overall impact of the change in the law and the estimated loss of expected benefits to retirees in the aggregate, rather than by the change's impact on individuals.<sup>20</sup> Premium payments of several thousand dollars per retiree per year, multiplied by even a small number of eligible retirees and by, for example, an average of five years of payment before Medicare eligibility, add up to a significant amount fairly quickly.

Even if the court considered the impact of the change on individuals, rather than in the aggregate, the argument that the impairment would be substantial is

strong.<sup>21</sup> For a retiree on a fixed income, a few thousand dollars can determine whether he or she can meet a mortgage payment, put enough food on the table, or heat the house during the winter. As a court in another jurisdiction commented in a case that involved a municipality's attempt to terminate the retiree health benefits promised in a collective bargaining agreement,

*An economic consideration that cannot be swept under the rug is that many retirees live solely on their retirement benefits. Retirees with fixed incomes are generally ill-prepared to meet additional financial obligations that were unanticipated and that may be incrementally modified without notice.*<sup>22</sup>

Indeed, research for this article has found no cases involving an attempt by a public employer or a government retirement plan to reduce either retirement income or health benefits, in which the court has found the impact not to be substantial.<sup>23</sup>

The second question to ask about Paradise's plan is whether it is "reasonable and necessary to serve an important public purpose." If so, it will not violate the Contract Clause, the city attorney advises the council. The council members argue, "Doesn't the elimination of Paradise's retiree health benefit plan serve an important public purpose if it allows the city to maintain programs and services at current levels and obviates the need for layoffs, salary freezes, or tax hikes?"

"Probably not," says the city attorney. Or perhaps more accurately, he continues, eliminating retiree health benefits may serve an important public purpose in the context of a city budget stretched to the limits, but the courts are unlikely to find it "necessary."

Although courts determine whether an impairment of a contract is reasonable and necessary to serve an important public purpose on a case-by-case basis, North Carolina case law suggests that "reasonable and necessary" is a difficult standard to meet. Both the U.S. Supreme Court and the North Carolina Supreme Court have rejected the notion that the courts should defer to a legislature's or governing board's assessment of what is reasonable and

necessary, noting that the legislative body has an inherent conflict of interest in making this determination.<sup>24</sup> As the U.S. Supreme Court observed,

*[A] governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.*<sup>25</sup>

In the *Faulkenberry* case, the first on this issue that the North Carolina Supreme Court decided, the state argued that a change in the method of calculating disability retirement payments served the important purpose of encouraging people to remain employed even after they incurred a disability. The old method of calculating payments, the state claimed, encouraged employees to take disability retirement.<sup>26</sup> The North Carolina Supreme Court gave short shrift to this argument, noting with impatience,

*We do not believe that just because the pension plan has developed in some ways that were not anticipated when the contract was made, the state or local government is justified in abrogating it. This is not the important public purpose envisioned which justified the impairment of a contract.*<sup>27</sup>

In the *Bailey* case, the court deemed the General Assembly's "revenue neutral" approach to equalizing the state income tax exception for state and local government retirees with that for federal retirees as no more than a "legislative convenience" that would allow it to avoid having to cut programs or raise taxes. Legislative convenience, the court said, is "not synonymous with reasonableness."<sup>28</sup> The court thus sig-

naled that attempts to balance government budgets at the expense of retirees will face close scrutiny and will likely be found "reasonable and necessary" only when there are no other alternatives.

In Paradise the council rejected layoffs and salary freezes and did not discuss either cutting programs or raising taxes as a way of offsetting its increased health insurance costs. Council members ask, "Would it have made a difference if we had implemented some or all of these measures but still found it difficult to absorb the cost of health benefits?"

"Possibly," replies the city attorney. He explains. When Baltimore, Maryland, reduced the annual salaries of its employees by a little less than 1 percent, the city's teachers and police officers sued, claiming that the reduction was an impermissible impairment of their collective bargaining agreements and their individual employment contracts. In *Baltimore Teachers Union v. Mayor and City Council of Baltimore*, the Fourth Circuit Court of Appeals

**The court thus signaled that attempts to balance government budgets at the expense of retirees will face close scrutiny and will likely be found "reasonable and necessary" only when there are no other alternatives.**

(the federal appeals court whose jurisdiction includes both Maryland and North Carolina) agreed that the salary reduction was a substantial impairment of the teachers' and police officers' contracts but found that it was nonetheless permissible under the Contract Clause as reasonable and necessary to serve an important public purpose. Baltimore already had instituted a round of layoffs, eliminated positions, and encouraged early retirement. It also had sold some city property, dipped into its general fund balance, and delayed going to the bond market in an effort to save on interest costs. When it initiated the salary reductions, it did so in response to a second set of cuts in state aid that were made halfway through the fiscal year. The court accepted the city's claim that it was at the point of cutting basic services and "initiating the breakdown of government." Also important to the court's analysis was the temporary nature of the salary reduction. Baltimore, in

# Employee Health Benefits: The Law in Brief

## Preferred Care Plan 1 Summary of Benefits

The benefits described in this booklet have been designed for you and your covered dependents. The basis of payment will be determined by the provider of services and benefit program selected. The explanation below will outline the benefits.

SERVICES	PREFERRED PROVIDER	NON-PREFERRED PROVIDER
Deductible	\$300 per calendar year (maximum \$900 per family)	\$600 per calendar year (maximum of \$1,800 per family)
Out-of-Pocket	\$2,500 per member \$5,000 per family	\$3,500 per member \$7,000 per family
Lifetime Maximum	\$2,000,000 per member	

health benefits to their employees. Sections 160A-162(b) and 153A-92(b) of the North Carolina General Statutes authorize cities and counties respectively to offer health insurance and other benefits to their employees if their governing boards so choose.

### **Why do public employers offer health benefits if they aren't required to do so?**

For two reasons. First, for employees it is a valuable form of compensation. Through group insurance plans, the employer can make health insurance available to employees at a more affordable rate than the employees could find on their own. Second, because it is common for private-sector employers to provide health insurance benefits, public employers must do so to remain competitive in the labor market.

### **May public employers offer to pay some or all of the cost of their employees' health insurance after they retire?**

Yes. Payment of retirees' health insurance premiums is considered a form of deferred compensation—that is, payment made after retirement for services the retirees provided before retirement.

### **If a public employer has promised to pay all or some of the cost of health insurance premiums for its retirees, may it change its mind and cease paying premium costs?**

Probably not. When the employer told employees before they retired that it would pay a certain level of the premium costs after retirement, it entered into a contract with the employees (even though the contract did not take the form of an actual contract document). Generally speaking, the government cannot disavow such a contractual obligation. To do so would be an "impairment of contract" that violates the U.S. Constitution.

### **May a public employer reduce the amount of the premium contribution it makes for retired employees?**

Probably not, for the same reasons.

### **How about employees who have not yet retired but have "vested," or fulfilled a minimum service requirement to qualify for employer-paid retiree health benefits? Can a public employer eliminate or reduce its premium contributions on their behalf?**

Again, probably not. The contract to provide retirement health benefits is formed when the employee vests, not when the employee actually retires.

### **Must public employers provide health benefits to employees?**

No. There is no legal requirement that public employers provide

### **May public employers reduce the coverage provided to retirees under the health insurance plan as long as they continue to pay the promised part of the health insurance premium? Can they increase deductibles or require co-payments?**

This is an open question right now. The North Carolina courts have not yet addressed the issue. One possibility is that the courts would say that as long as the public employer meets its obligation to pay its promised share of the premium, it may reduce coverage. More likely, the courts would say that the coverage does not have to stay exactly the same but that the overall benefit to the employee does. That is, if there is an increased deductible or co-payment (a disadvantage to the employee), it must be offset by some corresponding advantage (increased coverage of certain conditions, for example).

### **Are public employers forever locked in to promises made to employees in better economic times?**

Only with respect to current retirees and current employees who have vested in the retiree health benefit. Public employers may give notice now to new employees or current employees who have not yet vested that they will receive different health benefits in retirement.

### **What about current employees? May a public employer reduce the amount it pays toward a current employee's health insurance premium or reduce the coverage provided?**

Yes. The employer may change these whenever it sees the need, provided that it gives adequate notice of the change.

### **Why is the law that governs changes in health insurance benefits different for retirees and current employees?**

Because current coverage for current employees is not deferred compensation. It is not the promise of doing something in the future in return for work done today. Current coverage for current employees is current compensation for current work. Generally speaking, employers, including public employers, can increase or decrease the compensation of their employees at their discretion.

### **In short, what are public employers to do?**

Public employers should continue to fulfill the promises that they have made to retirees and currently vested employees to provide health benefits in retirement. These have become contractual commitments. For the future, public employers might wish to consider the extent to which they want to commit themselves to providing retiree health benefits. They must balance fairness to employees and the needs of recruitment and retention against an uncertain, unmeasurable future liability.

fact, discontinued the salary reduction once it became clear that the budget shortfall would not be as dire as expected.<sup>29</sup>

The decisions in the *Bailey* and *Baltimore Teachers Union* cases may appear to be inconsistent, the city attorney notes, but they are not.<sup>30</sup> In the *Bailey* case, the North Carolina Supreme Court emphasized the potential for state and local governments to avoid making hard choices by declaring impairment of their contracts necessary for

an important public purpose. In the *Baltimore Teachers Union* case, the Fourth Circuit Court of Appeals noted that it could *always* be said that a city could have shifted the burden from another government program or could have raised taxes, in which case *no* impairment of a government contract could ever be found necessary for an important public purpose.<sup>31</sup> Read together, the decisions in the *Bailey* and *Baltimore Teachers Union* cases highlight the case-by-case approach that the courts take in deciding

this issue and the stringent standard of financial necessity that a jurisdiction seeking to impair its employment contracts must meet. That Paradise may not eliminate its retiree health insurance program for vested employees does not mean that no jurisdiction may ever do so.

Understanding why it may not eliminate its retiree health benefits except for new hires and for those who have not yet vested in the benefits, the Paradise City Council also realizes that it may not require current retirees to contribute to their premiums: the retirees were promised health insurance until age sixty-five at no cost to themselves, and the decision in the *Bailey* case says that employees have contractual rights to the terms of their retirement plans as those terms existed at the moment that the employees' rights vested.<sup>32</sup> To require a 50 percent—or any—premium contri-

bution would be to change the terms of the employment-compensation agreement. The impairment-of-contract analysis would be almost identical to the one the city attorney did with respect to the elimination of the retiree health benefit plan for vested current employees.

### **Change in the Coverage but Not the Cost**

One of the Paradise council members has another question: "Can we offer a less generous package of health benefits to retirees? What I mean is, can we replace the current plan with one that seeks to control use of medical care more closely so as to reduce costs, with savings passed on to us in the form of less expensive premiums? We could look for a plan with higher co-payments or co-insurance, that omits coverage of experimental procedures and requires prior approvals for a greater number of accepted procedures and for use of nongeneric drugs."

The city attorney sighs. He is not sure

what to tell council members, for the North Carolina courts have never addressed this issue. "The vested rights approach to retirement income that the North Carolina Supreme Court adopted in the *Faulkenberry* and *Bailey* cases," he says, "doesn't translate well when you try to answer this particular question." The decisions in the *Bailey* and *Faulkenberry* cases and in *Simpson v. Local Government Employees Retirement System* all stand for the proposition that at the moment of vesting, an employee "locks in" to the terms under which the benefit is being offered at that particular time. That makes sense for a pension—a cash benefit, established by a formula. But the world of medicine changes rapidly, and health insurance changes almost equally rapidly. Locking in to a specific health benefit does not seem desirable: new conditions and new treat-

ments for existing conditions may not be covered. Neither does it seem practical: either the health insurance product or the health insurance company or both may not exist in several years' time, or the company may cease to write health insurance policies in the relevant market.

Should this issue reach a North Carolina appellate court, the law in this area might go one of two ways. The court might decide that the vested rights approach does not apply in the health benefits context, or it might decide that the approach does apply but must be modified to reflect the changing nature of health insurance.

Given the court's reasoning in the *Bailey* case, it is hard to see the basis on which a court might distinguish retiree health benefits from pension payments and find that the vested rights approach does not apply. The cost of an individual health insurance policy for someone of retirement age is beyond the reach of many retirees, and for some, the retiree health benefit is worth more than the retirement income benefit. The court in the *Bailey* case recognized the importance of retirees' expectational interests, and for that reason it seems unlikely that the North Carolina courts would reach a different conclusion with respect to vested rights in health insurance benefits than they did on retirement income benefits.

Alternatively, the court might extend the rule of the *Bailey* case and the related vested rights cases to health benefits. But in recognition of the practical problem posed by the changing nature of health insurance, it could borrow the "disadvantages v. new advantages" approach adopted by California and a number of other states for resolving issues such as this. The "California Rule" holds that even when pension rights are contractual, they may be modified by a legislature when doing so is necessary and reasonable. The singular feature of this approach is that to be reasonable, any disadvantages effected by the changes must be offset by comparable new advantages.<sup>33</sup>

The Alaska Supreme Court applied the California Rule to the question of retiree health benefits in 2003 in *Duncan v. Retired Public Employees of*

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CODE	NEW PATIENT	CPT	FEE	COD
505	Office Visit (Limited)	99201		57
509	Office Visit (Expanded)	99202		58
511	Office Visit (Detailed)	99203		PE2
513	Office Visit (Comprehensive)	99204		PE3
515	Office Visit (Comprehensive/High Complex)	99205		444
186	Vasectomy Consult	99241		445
<b>ESTABLISHED PATIENT</b>				446
516	Office Visit (Brief)	99211		
518	Office Visit (Limited)	99212		35
519	Office Visit (Expanded)	99213		36
520	Office Visit (Detailed)	99214		37
521	Office Visit (Comprehensive)	99215		38
390	History & Physical (Pre-op)	99215		39
473	Brief History & Physical (Pre-op)	99214		40
<b>OFFICE/OUT PATIENT-NEW OR ESTABLISHED</b>				41

*Alaska, Inc.* The Alaska Constitution, like a number of other state constitutions,<sup>34</sup> explicitly protects the accrued retirement benefits of public employees from being diminished or impaired. The Alaska courts have interpreted this provision of the constitution as including retiree health benefits.<sup>35</sup> Although in Alaska, the right to benefits vests at the moment employment begins, there, as in California, the courts allow reasonable modifications to promised benefits if changes that result in disadvantages to employees are accompanied by comparable new advantages. In assessing the plaintiff retirees' challenge to changes in their health benefits package, the Alaska Supreme Court noted that one reason the U.S. Congress had exempted the health insurance plans of private-sector

employers from ERISA's vesting requirement was that the cost of such plans fluctuates in response to unpredictable variables. In contrast, the actuarial decisions behind the fixed annuities offered by pension plans are based on fairly stable data.<sup>36</sup>

The Alaska Supreme Court concluded that in the context of health insurance, "the natural and ordinary meaning of 'benefits'"—that is, the measure of whether retirees are getting the benefits for which they contracted—is the coverage provided, not the cost to the government employer of providing the insurance. What the retirees have, the court said, is a vested right to a reasonable health insurance package, "one which is in keeping with the mainstream of such packages, as they are negotiated

and implemented for similarly situated employees over time."<sup>37</sup>

Where does this leave the Paradise City Council? The city attorney feels comfortable telling council members that they could change the retiree health benefits package, because, in fact, they already have done so several times in the last twenty years and because the original plans in which several employees and retirees vested are no longer even offered by health insurers. He can point to no North Carolina case law prohibiting the council from reducing the substantive benefits offered. But he suggests that in light of the California Rule and the *Duncan* case, the least risky and perhaps fairest course of action is to give retirees the same coverage offered to city employees currently on the payroll.

#### Health Benefits as Current Compensation

The council now asks the city attorney whether it can reduce the health benefits the city provides to current employees. "For heaven's sake, we've already changed plans, increased co-payments, and limited the network of doctors from whom they may seek care, all within the last three years!" exclaims one council member. The council member's confusion and exasperation are understandable. The city attorney assures the council that with respect to current employees, public employers can almost certainly change health plans, ask employees to share the cost of premiums, or, where they already are sharing the cost, ask them to contribute more. Benefits may be reduced in scope, prior approvals may be required, and co-payments may be added.

What accounts for the different treatment of health insurance benefits of current employees and those of retirees? Health insurance benefits are universally regarded as a form of *current* compensation for employees who still are on the payroll.<sup>38</sup> With the exception of employment agreements for a specific term (such as those that cities and counties frequently enter into with their managers), public employers are generally free to increase or decrease employee compensation as they see fit. For North Carolina cities and counties, the authority to do

Date of Service	Rx Number	Amount Submitted	Amount Approved	Deductible Applied	Cop App
01/15/2002	0859551	94.99	94.99	94.99	0.0
04/17/2002	0859551	94.99	94.99	2.26	20.0
06/04/2002	0883787	94.99	94.99	94.99	0.0
08/08/2002	0893498	9.11	7.76	7.76	0.0
08/08/2002	0893497	99.20	99.20	0.00	20.0
08/08/2002	0893499	9.02	8.79	0.00	8.7
<b>PATIENT TOTAL</b>		402.30	400.72	200.00	48.7
<b>STATEMENT TOTAL</b>		402.30	400.72	200.00	48.7

#### EXPLANATION CODES:

03 - THIS CLAIM WAS PROCESSED TO MEET YOUR PLAN'S LIMIT  
 05 - YOUR PLAN COPAYMENT IS 100% OF THE APPROVED AMOUNT

so comes from the General Statutes.<sup>39</sup> Public employees have on occasion challenged reductions to their rate of pay or to other forms of compensation, but the courts have routinely rejected the notion that a public employee has a vested right in any rate or method of compensation.<sup>40</sup>

Although a health benefit may be part of an employee's total current compensation, certain rules apply to benefits that are not applicable to wages. As

public employers well know, when personnel policies are set forth in a personnel manual or a policy enacted by resolution of the governing board, no property interest either in continued employment or in the terms and conditions of employment is created. To create a property interest in employment, a personnel policy must be adopted by ordinance.<sup>41</sup> This is consistent with the broader rule adopted by the North Carolina courts, applicable to both public- and private-sector employment, that an employer's issuance of a personnel policy manual or handbook for employee use does not create an implied contract of employment incorporating the document's terms.<sup>42</sup> One exception to this rule is relevant in this context: when a handbook or a manual has promised employees certain benefits, the promise is enforceable, and the employer must provide the benefits promised.<sup>43</sup>

This principle does *not* mean that employers may not alter or eliminate a benefit promised in a handbook. Rather, it means that employers must provide the benefit as long as the provision and the handbook that contains it remain in effect.

For example, an employee manual represented that certain management employees were entitled to a severance payment if their employment was terminated without cause. The court ruled that it was the employer's burden to prove that it had eliminated the benefit and communicated the change to employees before a particular plaintiff's termination.<sup>44</sup>

Similarly, an employer promised in its handbook that employees could maintain coverage under the employer's group health plan in the event that they became permanently disabled during their employment. The court ruled that the promise was enforceable even when changes in the terms of the group health plan made the cost of covering a disabled employee much more expensive than anticipated.<sup>45</sup>

Therefore, when a public employer changes some aspect of its health insurance benefit for current employees—for example, the contribution rate, the availability of coverage for spouses and dependents, or the scope of benefits—it should clearly communicate the change to employees. If information about the benefit is contained in an employee handbook, manual, or policy, the employer should ensure that it records the change there.

### **Maintaining the Ability to Change Health Benefits**

What can a public employer do to maintain flexibility in providing retiree and employee health benefits? The North Carolina cases on retirement income benefits, taken with cases from other jurisdictions that address the issue of retiree health benefits, suggest that public employers should continue to provide health insurance to retirees and to current employees who have vested in the benefit on the same terms as they have previously promised to do. They also should maintain the same premium contribution rates unless they have reserved the right to change the rates.

As for the provisions of the plan itself, an employer is unlikely to be able indefinitely to offer the health insurance plan that was in effect at the time of an employee's vesting. It therefore should provide retirees with a plan that has generally comparable coverage or, at a minimum, that offers the same benefits provided to current employees.

**To position themselves better for the future, public employers should take a fresh look at what they want to offer employees in the way of both current and retiree health benefits in light of existing and projected resources.**

To position themselves better for the future, public employers should take a fresh look at what they want to offer employees in the way of both current and retiree health benefits in light of existing and projected resources. They then should undertake a comprehensive review with legal counsel of all the documents—policies, resolutions, ordinances, handbooks, and memoranda—that set forth the terms under which they now offer health benefits to current employees. If they do not wish to make a contractual commitment to providing retiree health benefits to current employees when they retire, they must clearly reserve the right to alter or eliminate the benefits in the appropriate documents.

There is no “right” decision. Some employers may view a promise of retiree health benefits as an important tool for recruitment and retention and make an enforceable promise to provide them. Within that group, some may reserve the right to change the plan or to ask for increased retiree contributions to cover the cost of the premium. Other employers may simply not have the option of firmly committing themselves to a retiree health benefit. They may need to eliminate it altogether for the future. Alternatively, they might consider offering it with the proviso that the employer may eliminate it at any time in its sole discretion or subject to the availability of funds.<sup>46</sup>

Public employers should take the same approach with health insurance for current employees. Although the law generally allows an employer to change current compensation (including health benefits) prospectively, it would be prudent—as well as fair to employees—to make clear that the offer of health benefits is not absolute and unchanging but can be modified in response to economic conditions, medical advances, and employees' needs.

The legal holdings and principles discussed in this article are applicable to other forms of employee benefits, such as supplemental retirement programs [for example, jurisdiction-specific public safety supplemental retirement benefits or the North Carolina 401(k) Plan], as well as to longevity pay and life insurance benefits. For further discussion of

these issues, see *Public Personnel Law Bulletin* #30.<sup>47</sup>

## Notes

1. Cases in other states that have addressed public employers' rights to reduce health insurance benefits include *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882 (Alaska 2003); *Bates v. City of Richland*, 51 P.3d 816 (Wash. Cr. App. 2002); *Davis v. Wilson County*, 70 S.W.3d 724 (Tenn. 2002); *Roth v. City of Glendale*, 614 N.W.2d 467 (Wis. 2000); *Emerling v. Village of Hamburg*, 680 N.Y.S.2d 37 (N.Y.A.D. 1998); *Thorning v. Hollister Sch. Dist.*, 15 Cal. Rptr. 2d 91 (Cal. App. 4th 1992); *Weiner v. County of Essex*, 620 A.2d 1071 (N.J. Super. 1992); *Bernstein v. Commonwealth of Pa.*, 617 A.2d 55 (Pa. Commw.), *order aff'd*, 634 A.2d 1113 (Pa. 1992); *Omer v. Tagg et al.*, 455 N.W.2d 815 (Neb. 1990); *Colorado Springs Fire Fighters Ass'n, Local 5 v. City of Colorado Springs*, 784 P.2d 766 (Colo. 1989); *Township of Tinicum v. Fife*, 505 A.2d 1116 (Pa. Commw.), *appeal denied*, 544 A.2d 1344 (1986); *Singer v. Topeka*, 607 P.2d 467 (Kan. 1980); *Betts v. Board of Admin. of the Public Employees' Retirement Sys.*, 582 P.2d 614 (Cal. 1978).

2. ERISA is codified at 29 U.S.C. §§ 1001-1461. For the exclusion of government pension and welfare benefit plans from the statute's coverage, see sections 1002(32) and 1003(b)(1).

3. *Bailey v. State of North Carolina*, 348 N.C. 130 (1998).

4. See N.C. GEN. STAT. §§ 160A-162(b), 153A-92(d). Hereinafter the General Statutes are referred to as G.S.

5. See *Hallowell v. Department of Conservation and Dev.*, 206 N.C. 206, 208 (1934); *Archer v. Rockingham County*, 144 N.C. App. 550, 557 (2001), *disc. rev. denied*, 355 N.C. 210 (2002).

6. *Bailey*, 348 N.C. at 150-51. The plaintiffs in this case were retired state and local government employees whose payments from the various state-run retirement systems had been exempt from state income taxation before 1989. Retired federal employees living in North Carolina had not enjoyed the same privilege. In 1989 the U.S. Supreme Court held that a state could not tax the income of state and local government employees differently than it taxed the income of federal employees. See *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). Rather than extend the state tax exemption to federal retirees in its entirety and suffer a reduction in tax revenue, the General Assembly amended the North Carolina tax code to place a \$4,000 cap on the amount of annual pension payments exempt from state income taxation and to make the \$4,000 exemption available equally to state, local, and federal government retirees. See *Bailey*, 348 N.C. at 152, 153.

7. *Id.* at 141, quoting *Simpson v. Local Gov't Employees' Retirement Sys.*, 88 N.C. App. 218, 224 (1987), *aff'd per curiam*, 323 N.C. 362 (1988).

8. *Faulkenberry v. Teachers and State Employees Retirement Sys. of N.C.*, 345 N.C. 683, 690-91 (1997).

9. More precisely, Article I, Section 32, of the North Carolina Constitution states, "No person or set of persons is entitled to exclusive or separate emoluments or privileges from the community but in consideration of public services." In several earlier cases, the North Carolina Supreme Court had expressly held that pension payments, as deferred compensation, are not in violation of Article I, Section 32. See *Harrill v. Teachers' and State Employees' Retirement Sys.*, 271 N.C. 357 (1967); *Great American Insurance Co. v. Johnson*, 257 N.C. 367 (1962); *Bridges v. City of Charlotte*, 221 N.C. 472 (1942). *Cf. Leete v. County of Warren*, 341 N.C. 116 (1995) (holding that severance payment awarded after county manager's resignation violated Article I, Section 32).

10. See, e.g., *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882, 888 (Alaska 2003); *Calabro v. City of Omaha*, 531 N.W.2d 541, 548-49 (Neb. 1995); *Booth v. Sims*, 456 S.E.2d 167, 183 (W.Va. 1995); *Thorning v. Hollister Sch. Dist.*, 15 Cal. Rptr. 2d 91, 95 (Cal. App. 4th 1992); *Omer v. Tagg et al.*, 455 N.W.2d 815, 817 (Neb. 1990); *Township of Tinicum v. Fife*, 505 A.2d 1116, 1119 (Pa. Commw.); *Yeazell v. Copins*, 402 P.2d 541, 545 (Ariz. 1965). See also *Emerling v. Village of Hamburg*, 680 N.Y.S.2d 37, 38 (N.Y.A.D. 1998) (implied); *Weiner v. County of Essex*, 620 A.2d 1071, 1071 (N.J. Super. 1992).

11. *Bailey*, 348 N.C. at 144; *Faulkenberry*, 345 N.C. at 690; *Simpson*, 88 N.C. App. at 223-24.

12. *Bailey*, 348 N.C. at 152-53.

13. See *id.* at 152. See also *Pritchard v. Elizabeth City*, 81 N.C. App. 543, 551-53, *disc. rev. denied*, 318 N.C. 417 (1986) (holding that oral representations to municipal employees regarding accrual of vacation pay benefit constituted contractual agreement by which city was bound, but finding no impairment of contract because change to benefit applied prospectively).

14. As the court in the *Bailey* case put it, "A legislative enactment in the ordinary form of a statute may contain provisions which, when accepted as the basis of action by individuals or corporations, become contracts between them and the State within the protection of the clause of the Federal Constitution forbidding impairment of contract obligations; rights may accrue under a statute or even be conferred by it, of such character as to be regarded as contractual, and such rights cannot be defeated by subsequent legislation. When such a right has arisen, the repeal of the statute does

not affect the right or an action for its enforcement." 348 N.C. at 145, quoting *Ogelsby v. Adams*, 268 N.C. 272, 273-74 (1966), quoting 16 AM. JUR. 2D *Constitutional Law* § 442 (1966).

15. *Faulkenberry*, 345 N.C. at 690. Although most jurisdictions that have considered the issue have found an offer of pension benefits to be a binding contractual obligation once an employee has met the applicable service prerequisites and has vested in the retirement system, a few take a different approach. Under Colorado law, for example, a statute or an ordinance is considered a contract (and subject to the provisions of the Contract Clause) only when its language and the surrounding circumstances manifest a legislative intent to create private contract rights enforceable against the state or the municipality. The presumption is that a law governing government employee benefits merely declares a policy that will be followed until that law is changed. See *Colorado Springs Fire Fighters Ass'n, Local 5 v. City of Colorado Springs*, 784 P.2d 766, 773 (Colo. 1989), citing *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938), *Dodge v. Board of Educ.*, 302 U.S. 74, 79 (1937).

16. See *Northern P.R. Co. v. Minnesota ex rel. Duluth*, 208 U.S. 583 (1908); *Hogan v. City of Winston-Salem*, 121 N.C. App. 414, 418 (1996).

17. *See U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 21 (1977).

18. When a person, a corporation, or a public entity fails to perform one of its promises or duties under a contract, the person or the entity is said to be in "breach" of the contract. The ordinary remedies for breach of contract are either money damages or an order from the court to the breaching party to perform its promise. When a state or local government takes an official action that has the effect of diminishing the value of its contractual obligation to the point that the contract becomes invalid or the other party loses the benefit of the contract, the action is said to be an "impairment" of contract. See BLACK'S LAW DICTIONARY (7th ed. 1999) under "breach of contract" and "impair."

19. *Bailey*, 348 N.C. at 151, citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978).

20. *Bailey*, 348 N.C. at 151. In that case the court estimated the loss in expected income to retirees in the aggregate to be in excess of \$100 million.

21. The North Carolina Court of Appeals considered such an impact in *Hogan*, 121 N.C. App. at 420. In that case the court found that the change in Winston-Salem's disability retirement terms for police officers had a substantial impact. Under the plan as it existed at the time his rights vested, Hogan was entitled to disability retirement after an injury in the line of duty. Under the amended plan (that is,

the one in existence at the time he became disabled), he would not have been allowed to retire but would have been transferred to other unsworn duties in the police department.

22. See *Roth v. City of Glendale*, 614 N.W.2d 467, 473 (Wis. 2000). This case was brought and decided on a theory of breach of contract, rather than on a theory of unconstitutional impairment of contracts.

23. See *Bailey*, 348 N.C. at 151; *Faulkenberry v. Teachers and State Employees Retirement Sys. of N.C.*, 345 N.C. 683, 692-93 (1997); *Miracle v. North Carolina Local Gov't Employees Retirement Sys.*, 124 N.C. App. 285, 291 (1996), *disc. rev. denied*, 345 N.C. 754 (1997); *Hogan*, 121 N.C. App. at 420; *Board of Admin. of the Public Employees' Retirement Sys. v. Wilson*, 61 Cal. Rptr. 2d 207, 234-38 (Cal. Ct. App. 1997); *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (Neb. 1995); *Weincke v. City of Indianapolis*, 429 N.E.2d 295, 298 (Ind. Ct. App. 1981). See also *Booth v. Sims*, 456 S.E.2d 167, 186-88 (W.Va. 1995) (based on provision of W.Va. Constitution).

24. *Bailey*, 348 N.C. at 151-52, *citng* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25-26 (1977).

25. *U.S. Trust*, 431 U.S. at 25-26, *quoted* by the N.C. Supreme Court in *Bailey*, 348 N.C. at 151-52.

26. *Faulkenberry v. Teachers and State Employees Retirement Sys. of N.C.*, 345 N.C. 683, 693-94 (1997).

27. *Id.* Similarly, in the *Hogan* case, the city claimed that the purpose of the change to its disability retirement plan was to permit disabled officers to transfer to another position and to continue employment with the city at the same salary and with the same possibility of pay increases that they would have had in their original sworn positions. The court said that although the city might have good intentions, there was no evidence that this justification was reasonable and necessary to protect an important government interest. See *Hogan*, 121 N.C. App. at 420.

28. *Bailey*, 348 N.C. at 152. See also *U.S. Trust*, 431 U.S. at 26; *Miracle*, 124 N.C. App. at 291; *Wilson*, 61 Cal. Rptr. 2d at 238.

29. See *Baltimore Teachers Union, AFT Local 340, AFL-CIO v. Mayor and City Council of Baltimore*, 6 F.3d 1012, 1021-22 (4th Cir. 1993), *cert. denied*, 510 U.S. 1141 (1994).

30. Strictly speaking, the *Bailey* and *Baltimore Teachers Union* cases do not have to be consistent, since the *Bailey* decision is based on a combination of North Carolina law (the contract issue) and federal law (the Contract Clause issue) and was decided by a

North Carolina court, while *Baltimore Teachers Union* is a federal appeals court case addressing an issue of federal law (the Contract Clause issue). Neither is binding on the other.

31. *Cf. Bailey*, 348 N.C. at 151-53, with *Baltimore Teachers Union*, 6 F.3d at 1019-20.

32. See *Simpson v. Local Gov't Employees' Retirement Sys.*, 88 N.C. App. 218, at 223-24.

33. See *Allen v. Board of Admin. of the Public Employees' Retirement Sys.*, 665 P.2d 534 (Cal. 1983), *cert. denied*, 465 U.S. 1015 (1984); *Betts v. Board of Admin. of the Public Employees' Retirement Sys.*, 582 P.2d 614 (Cal. 1978). Like North Carolina's vested rights approach, the California Rule was first adopted in the context of retirement income benefits. For other states that have adopted this approach, see, e.g., *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882 (Alaska 2003); *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (1995); *Booth v. Sims*, 456 S.E.2d 167, 184-86 (W.Va. 1995). For a survey of approaches taken by other states as of 1987, see *Simpson*, 88 N.C. App. at 222.

34. See, e.g., ILLINOIS CONST. art. XIII, § 5; MICHIGAN CONST. art. IX, § 24; NEW YORK CONST. art. V, § 7; HAWAII CONST. art. XVI, § 2. See also *Opinion of the Justices*, 303 N.E.2d 320, 327 (Mass. 1973) (interpreting MASSACHUSETTS CONST.).

35. ALASKA CONST. art. XII, § 7. See also *Duncan*, 71 P.3d at 888.

36. See *Duncan*, 71 P.3d at 886.

37. See *id.* at 888-89, 891, *quoting* *Studier v. Michigan Public Sch. Employees Retirement Bd.*, File 00-92435-AZ, Cir. Ct. for Ingham County, Mich., Ct. Order of Feb. 21, 2001.

38. Despite that universal understanding, very few legal cases stand for such a proposition. This is due, in part, to the fact that under ERISA, which governs almost all private-sector health insurance benefit plans, "welfare benefits plans" (of which health insurance is one example) are distinguished from "compensation," which is generally limited to payment of cash wages. See 29 CFR §§ 2510.3-1(a)(2), (b). In public-sector employment, how each state defines "compensation" in its statutes varies. See, e.g., *Police Ass'n of Mount Vernon v. New York State Public Employment Relations Bd.*, 510 N.Y.S.2d 742, 744 (N.Y. App. Div. 1987); *Slattery v. City of New York*, 686 N.Y.S.2d 683, 691-92 (N.Y. Sup. Ct. 1999), both of which held that health insurance is a form of current compensation within the meaning of the NEW YORK PUBLIC LAWS.

39. G.S. 160A-162(a) grants to municipal councils the power to "fix or approve the schedule of pay, expense allowances and other compensation for all city employees . . ." G.S. 160A-162(b) gives them the authority to "purchase life, health, and any other forms of insurance for the benefits of all or any class of city employees and their dependents." G.S. 153A-92(a) and (d) grant identical authority to county boards of commissioners with respect to county employees.

40. See, e.g., *Abeyounis v. Town of Wrightsville Beach*, 102 N.C. App. 341, 344 (1991) (holding that town may increase or decrease salary of its police officers in its discretion); *Keeling v. City of Grand Junction*, 689 P.2d 679, 680 (Colo. App. 1984) (holding that firefighters and police officers do not have vested contract right and could reasonably have relied on continuance of particular rate or method of compensation); *Chicago Patrolmen's Benevolent Ass'n v. City of Chicago*, 309 N.E.2d 3, 6 (1974) (holding that public employees have no property rights in continuance of any specific rate or method of compensation). *But cf.* *Baltimore Teachers Union, AFT Local 340, AFL-CIO v. Mayor and City Council of Baltimore*, 6 F.3d 1012, 1015-16 (4th Cir. 1993), *cert. denied*, 510 U.S. 1141 (1994) (holding that inclusion of wage rate negotiated by teachers' and police officers' unions with city in city budget ordinance created contractual right to that rate of compensation for life of budget).

41. See *Pittman v. Wilson County*, 839 F.2d 225 (4th Cir. 1988); *Kearney v. Durham County*, 99 N.C. App. 349 (1990).

42. See *Rucker v. First Union Nat'l Bank*, 98 N.C. App. 100 (1990); *Smith v. Monsanto Co.*, 71 N.C. App. 632 (1984); *Griffin v. Housing Auth.*, 62 N.C. App. 556 (1983).

43. See, e.g., *Brooks v. Carolina Telephone*, 56 N.C. App. 801 (1982) (severance payments); *Welsh v. Northern Telecom, Inc.*, 85 N.C. App. 281, *disc. rev. denied*, 326 N.C. 601 (1987) (vacation and retirement benefits); *White v. Hugh Chatham Mem'l Hosp.*, 97 N.C. App. 130 (1990) (extended insurance benefit).

44. See, e.g., *Brooks*, 56 N.C. App. at 804.

45. See *White*, 97 N.C. App. at 131-32.

46. *Cf. Norris v. City of Wilmington*, 110 F.3d 60 (4th Cir. 1997), 1997 WL 159532 (unpublished opinion).

47. *Public Personnel Law Bulletin* #30 is available on the School of Government's website at [www.nchr.unc.edu/pdfs/200401pubperlaw30.pdf](http://www.nchr.unc.edu/pdfs/200401pubperlaw30.pdf) or from the Publication Sales Office at (919) 966-4119.

# Defining Performance Budgeting for Local Government

*William C. Rivenbark*



*By collecting data on the output and the efficiency of their program to service cars, trucks, and other vehicles, local governments can determine whether they are accomplishing their goals and objectives in this area.*

City council members and county commissioners regularly struggle with the most basic question of public budgeting: “On what basis shall we decide to allocate  $x$  dollars to activity A instead of activity B?”<sup>1</sup> In response to this question, these elected officials typically make modest, incremental adjustments to the previous year’s budget. Less frequently, they systematically link allocations of financial resources to operational accountability.

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This more powerful approach, called “performance budgeting,” answers the question, “Did allocating  $x$  dollars to activity A accomplish what we intended? If not, should we adjust the allocation to activity A?”

Local government officials, professional organizations, consultants, and academicians promote performance budgeting for its ability to link allocation of resources to the performance of service delivery. This ability alone has prompted many local governments to adopt performance budgeting, as reported in national surveys.<sup>2</sup>

The same surveys, though, reveal that performance budgeting has not become

a meaningful part of organizational cultures in local government. Why? One explanation is that the meaning of performance budgeting varies substantially among the local officials who are responsible for implementing it.<sup>3</sup> In fact, there has never been an agreed-on definition of performance budgeting.<sup>4</sup>

This article defines performance budgeting, describes what it means for local government, and addresses the major misconceptions that have hindered its success. The article also presents a framework for performance budgeting that localities of all sizes in North Carolina can adopt, and it explains how the framework relates to the budget preparation process

mandated by state law.<sup>5</sup> Further, the article suggests some uses of performance data to support management decisions.

### Definition of Performance Budgeting

“Performance budgeting” is a process for budget preparation and adoption that emphasizes performance management, allowing decisions about allocation of resources to be made *in part* on the efficiency and the effectiveness of service delivery. Performance management occurs when department heads and program managers use data derived from performance measurement systems to support decisions related to planning, organizing, staffing, developing, coordinating, budgeting, reporting, and evaluating—the core functions of management.<sup>6</sup> Performance budgeting occurs when department heads and program managers use performance data to support and justify budget requests during the annual budget preparation process.

The preceding definition emphasizes the words “in part” because they represent the reason that performance budgeting often fails in local government. Numerous factors affect budget decisions, including the adopted budget of the current year, organizational and investment decisions made in prior years, political mandates, fiscal constraints, and organization-wide goals.<sup>7</sup> Performance data must compete with these and other factors, and that necessity creates an important distinction between allocation decisions that are *determined* by performance and those that are *informed* by performance. Expecting all budget decisions to be *totally* determined by performance is not real-

istic because decision makers must consider all factors impinging on a decision about allocation of resources before making it. The goal is to inform budget decision making with applicable performance information regardless of how other factors affect budget preparation and adoption and regardless of how resources are finally distributed across programs of service delivery.

A city’s or county’s program for servicing its cars, trucks, and other vehicles—called “fleet maintenance”—provides an excellent illustration of placing performance budgeting in the context of local government administration. A fleet manager regularly collects performance data for calculating the number of “rolling stock units” (vehicles, heavy equipment, trailers, etc.—output), the number of orders for service completed by an individual worker (output/efficiency), the cost per service order (efficiency), the percentage of service orders completed within twenty-four hours (outcome), and the percentage of rolling stock units available per day (outcome). Over the past several years, the local government has increased the number of rolling stock units and the number of service orders completed per worker. These increases have affected the outcome measures by decreasing the percentage of service orders completed within twenty-four hours and the percentage of rolling stock available per day.

The fleet manager has used the available performance information to schedule preventive maintenance, to reorganize the fleet maintenance staff, and to coordinate his program with other programs. He now decides to employ the information to justify a request, through the budget preparation process,

### For More Information on Performance Budgeting

Readers seeking more information on performance budgeting might consult the text on which this article is based: *PERFORMANCE BUDGETING FOR STATE AND LOCAL GOVERNMENT*, by Janet M. Kelly and William C. Rivenbark (Armonk, N.Y.: M. E. Sharpe, 2003). It describes performance budgeting as the integration of the components of performance management—planning, performance measurement, benchmarking, and evaluation—into the framework of state and local government budgeting. The authors present performance budgeting not as a stand-alone technique but as an extension of the traditional budget process that combines financial and operational accountability.

for another technician position in the coming fiscal year. The budget director and the county manager will analyze this request along with all other requests and make a recommendation to the county commissioners in the proposed budget. Thus the budget director, the county manager, and the county commissioners will make an allocation decision in part on the basis of the performance of service delivery. In other words, the decision is informed by performance results.

### Misconceptions of Performance Budgeting

Since the early 1950s, when the federal government first embraced it, performance budgeting has been hindered by

Table 1. Unit Costs for a Hypothetical Building Inspection Program

Type of Inspection	FY 2001–02 Budget	No. of Inspections	FY 2001–02 Unit Cost	Projected No. of Inspections	FY 2002–03 Budget
Building	\$485,900	4,920	\$98.76	5,100	\$503,676
Electrical	346,800	4,242	81.75	4,400	359,700
Mechanical	157,411	2,372	66.36	2,400	159,264
Plumbing	125,640	2,680	46.88	2,550	119,544
<b>Total</b>	<b>\$1,115,751</b>	<b>14,214</b>	<b>—</b>	<b>14,450</b>	<b>\$1,142,184</b>



*Knowing their unit costs—the cost of a single inspection—helps managers of building inspection programs improve efficiency. But to produce a budget, managers must disaggregate the unit costs into line items and introduce data to reflect such factors as inflation and replacement of capital equipment.*

JACK HAGGERTY

numerous misconceptions.<sup>8</sup> The primary misconception is that it begins in the budget office. On the contrary, it begins with performance management in the programs of service delivery. This requires adoption and implementation of a performance measurement system in local government. Performance measurement involves the creation of mission statements, service delivery goals, objectives, and performance measures at the program level.<sup>9</sup>

A second misconception of performance budgeting, often presented in textbooks, is that it requires a standard

unit cost, focusing primarily on the efficiency of service delivery.<sup>10</sup> Under performance budgeting, staff determine the budget for a coming fiscal year by multiplying the unit cost of a particular service by the projected number of units for that fiscal year. For example, one can calculate the unit costs for a building inspection program by dividing the current-year budgets by the number of inspections by type (see Table 1). One then multiplies the unit costs by the projected number of inspections by type for the coming fiscal year (FY 2002–03 in the table), providing a building

inspection budget for that fiscal year (\$1,142,184 in Table 1).

This approach to planning provides powerful information for program managers, forming the base for tracking and projecting output measures (for example, the number of building inspections by type) and efficiency measures (for example, the cost per building inspection by type). The information also sets the stage for “continuous process improvement,” a technique by which the program represented in Table 1 can strive to lower its unit costs.

However, the approach falls short of providing all the information required to produce the following year’s budget.<sup>11</sup> At some point, managers must disaggregate the unit cost information so that they can adjust the necessary line items to produce accurate and reliable budget figures—figures that reflect such factors as inflation and the need to replace capital equipment (see Table 2). Doing that produces a budget for the coming fiscal year that is different from (in Table 2, \$65,837 higher than) the budget derived from the unit cost methodology.

Calculating unit costs for programs that provide well-defined services does support performance budgeting by producing efficiency information. However, unit costs are not required for per-

**Table 2. A Line-Item Budget for a Hypothetical Building Inspection Program**

Line Item	FY 2001–02 Budget	Percentage Adjustment	Reason for Adjustment	FY 2002–03 Budget
Personnel	\$769,451	3.0	Cost of living	\$792,534
Benefits	194,920	5.5	Medical inflation	205,640
Supplies	60,481	2.0	Consumer Price Index	61,690
Training	10,500	—	No change	10,500
Fleet	64,777	10.0	Current fuel price	71,254
Risk	15,622	5.0	Actuarial analysis	16,403
Capital	—	—	Fleet replacement	50,000
<b>Total</b>	<b>\$1,115,751</b>	<b>—</b>	<b>—</b>	<b>\$1,208,021</b>

formance budgeting, as suggested by previous research.

A misconception that stems from the previous one is that performance budgeting replaces line-item budgeting. G.S. 159-26 mandates that accounting systems show assets, liabilities, equities, revenues, and expenditures in detail. Local governments use structured and detailed charts of accounts to comply with this statute, and these form the basis of their general ledgers. "Line-item budgeting" is the process of creating the following year's budget by adjusting the individual line items contained on the organization's general ledger. In other words, local governments produce line-item budgets that parallel their accounting systems.

Beyond the legal requirements, omission of line-item budgeting would be unrealistic, as shown with the building inspection example. This format also allows program managers to track budget-to-actual variances by line item, providing them with the necessary information to make adjustments during the fiscal year that would be extremely difficult with the unit-cost format shown in Table 1.

Still another misconception of performance budgeting is that it fails if programs do not receive additional resources when performance data clearly show need. Suppose that, on the basis of an increase in call volume (output) and dispatch time (outcome), the program manager of emergency communications requests another call taker. The city council denies the request and allocates the resources instead to a downtown development project. Does this represent successful performance budgeting? Yes, because the decision to deny the request is informed by performance results. The decision suggests that the program must attempt to handle the projected call volume and maintain a favorable dispatch time without the benefit of an additional call taker. The program's success or failure to achieve these objectives will be documented in the next year's performance budget.

A fifth misconception is that adding performance measures to budget documents before publication—a common practice of local government budget directors to make the document look

professional—constitutes performance budgeting. Presenting performance measures in budget documents is appropriate, but localities should first embrace them farther upstream in budget preparation (in budget requests and at budget workshops).

Other misconceptions of performance budgeting are that it takes the politics out of budgeting, that it can solve a fiscal crisis, and that it is a new budgeting or management technique. In a representative democracy, performance budgeting cannot and should not take the politics out of budgeting. Elected officials make decisions on the basis of political ideologies and the perceived needs of their constituents. The goal is to provide them with the information necessary to consider performance. Performance budgeting offers process improvement and cost savings; however, it cannot solve a fiscal crisis. Managers and elected officials always will face the possibilities of having to raise more revenue and eliminate programs. Finally, promoting performance budgeting as the latest management technique sets the stage for failure. It allows employees to take the posture of "waiting it out" until the next technique arrives. Performance budgeting simply represents good management.

### **A Framework for Performance Budgeting**

One approach to performance budgeting is to ask program managers to submit some performance measures along with their budget requests. These provide some insight into operational accountability, allow the budget director to add measures to the budget document for presentation, and suggest that performance budgeting begins in the budget office (see the first misconception of performance budgeting).

Another approach is to implement a comprehensive framework that includes program review, financial alignment, performance measurement, and timing issues. This planned approach establishes the necessary "infrastructure," or foundation, for performance budgeting and builds on performance management within the programs of service delivery.

### **Program Review**

Performance budgeting begins with defining programs of service delivery within the organization. This is the most important part of the framework, given that the financial management system (financial accountability) and the performance measurement system (operational accountability) will be structured according to program definitions. North Carolina localities commonly design their organizational structures around programs of service delivery. Local officials are encouraged, however, to review their program definitions before implementing performance measurement systems and to review them regularly afterward for accuracy.<sup>12</sup>

A common definition of "program" is a group of activities, operations, or organizational units directed at the attainment of common goals.<sup>13</sup> Programs in local government often represent departments, divisions, or programs, depending on the size of the locality, the scope of the services provided, and the capacity of the financial management system. In one jurisdiction, for example, the human resources department is a program in itself; the fire department includes a fire suppression division (program) and a fire prevention division (program); and the solid waste department includes a residential and commercial refuse program, a recycling program, and a yard waste program. The primary consideration in establishing a program structure is the information needs of management.<sup>14</sup>

### **Financial Alignment**

Once the program infrastructure is in place, the performance budgeting framework requires a supporting financial infrastructure. The goal is to ensure that inputs (dollars) are tracked at the program level. This may require localities to adjust their current account structures in order to align program inputs with program outputs.

Fortunately, localities in North Carolina typically follow the chart of accounts recommended by the Local Government Commission. The commission also recommends a process for structuring the chart of accounts on the basis of defined operations of service delivery (programs) for line-item budget-to-



actual comparisons. This supporting financial infrastructure is line-item budgeting at the program level.

Tracking inputs at the program level also allows localities to embrace what is commonly known as program budgeting, in which line items are grouped in the categories of personnel, operating, and capital costs for management purposes. Program budgeting focuses on total program inputs for decision making, as opposed to individual line-item inputs. This is an extremely useful format when combined with performance measurement.<sup>15</sup> It also gives program managers the ability to disaggregate their program budgets to the individual line items when needed, returning to the alignment of program inputs with program outputs.

### Performance Measurement

The performance infrastructure of the performance budgeting framework is a performance measurement system for tracking outputs, outcomes, and efficiencies of service delivery at the program level. This ability to align program inputs (financial accountability) and program outputs (operational accountability) is fundamental to the success of performance budgeting.

The elements of performance measurement are mission statements, service delivery goals, strategic goals, objectives, and performance measures. For an example of this information for Durham, North Carolina's building inspection program, see the sidebar on this page.<sup>16</sup> Programs start with a mission statement, defining the purpose of their existence. They create service delivery goals from the mission statement, providing overall direction for the program. They then construct quantifiable objectives from the service delivery goals, allowing them to track their progress toward the goals. Service delivery goals commonly have multiple quantifiable objectives. Finally, programs establish performance measures for tracking the quantifiable objectives and other service dimensions deemed important by the program manager. This process ensures that the focus is on outcome measures, tracking the quality of service delivery.

The sidebar also contains strategic goals for the Durham building inspection program. Although the mission state-

## *A Performance Measurement System for the Durham Building Inspection Program*

### Mission

To provide a cost-effective level of service designed to assure the adequate protection of the health and safety of the citizens through assertive enforcement of the various state building, electrical, plumbing, and mechanical codes and local zoning ordinances.

### Service Delivery Goal, Objective, and Measure

Goal: To provide for the safety and health of citizens by ensuring that all construction meets the North Carolina state building codes.  
Objective: Perform two quality control inspections per inspector per month.  
Measures: Quality control inspections per inspector per month  
Percent inspections found to be accurate

### Service Delivery Goal, Objective, and Measure

Goal: To provide accurate and prompt plan review.  
Objective: Review 90 percent of all residential plans within 4 working days.  
Measures: Percent of residential plans reviewed in 4 days  
Percent of plan errors found in field

### Service Delivery Goal, Objective, and Measure

Goal: To provide timely response to customer request.  
Objective: Respond to requested building inspections within 24 hours  
90 percent of the time.  
Measures: Percent of inspections performed within 24 hours  
Inspections per inspector per day

### Workload Measures

- Number of quality checks
- Number of residential plans reviewed
- Number of inspections
- Number of inspections of public schools

### Highlights (Strategic Goals)

- Implement program for on-line permit applications for other divisions.
- Develop program to code inspection results for other divisions.
- Continue active participation in the city's "eyes and ears" program.
- Continue to actively enforce provisions of the resource protection ordinance.
- Provide input to ensure one-stop shopping software application meets program requirements.
- Study plan review process for "walk-in" permit applications.

Source: CITY OF DURHAM, N.C., FY 2001-02 BUDGET.

ment, service delivery goals, quantifiable objectives, and performance measures remain relatively stable over time, strategic goals (sometimes referred to as "annual strategies" or "strategic priorities") are updated annually. They are strategies to expand the capacity of the program and to provide a link to organization-wide goals, responding to the blurred relationship that often exists between program planning and organizational planning. Strategic goals form

the basis for what is commonly referred to as "annual work plans" (sometimes called "annual action plans").

Smaller jurisdictions may question their capacity to adopt a performance measurement system. Although performance measurement systems may not be common in smaller organizations, research has demonstrated that localities of all sizes in North Carolina measure and report performance.<sup>17</sup> Knightdale, with a population of 6,014,

is an excellent example of a small organization embracing performance measurement.

### Timing Issues

Once the program, financial, and performance infrastructures of the performance budgeting framework have been established, timing issues must be considered to coordinate collecting, analyzing, and reporting performance data with the annual budget process. This is a critical step in performance budgeting that is rarely discussed in the literature. G.S. 159-8(b) requires North Carolina localities to operate on a fiscal year beginning July 1 and ending June 30 and to produce a balanced budget on the following timeline:

- Departmental requests to be sent to budget officer by April 30 (G.S. 159-10)
- Budget and budget message to be submitted to governing board by June 1 [G.S. 159-11(b)]
- Budget ordinance to be adopted by July 1 [G.S. 159-13(a)]

Given the preceding timeline, performance results would have to enter the process before April 30 because they should be reflected in departmental requests. In reality, however, program managers must collect and analyze performance data well before this deadline so that they can identify strategies for program expansion, reduction, or realignment. This allows them successfully to support their budget requests and strategic goals with performance results when the budget office distributes the annual budget worksheets (typically during January or February of each fiscal year). The primary issue surrounding timing is how often performance data should be collected and reported in the form of performance measures. This framework proposes a semiannual basis.

When local officials develop annual budgets, financial data are available on actual expenditures for the prior year, budgeted expenditures for the current year, and results for the current year to date. Program managers in conjunction with the budget director must analyze these data to produce the following



*Managers of building inspection programs can measure performance using such indicators as the number of quality-control inspections per inspector per month, the percentage of inspections found to be accurate, the number of inspections performed within twenty-four hours, and the number of residential plans reviewed.*

JACK HAGGERTY

**Table 3. A Program Budget for the Durham Building Inspection Program**

Appropriations	Actual FY 1999-00	Adopted FY 2000-01	Estimated* FY 2000-01	Adopted FY 2001-02
Personal Services	\$2,319,464	\$2,358,013	\$2,400,471	\$2,421,109
Operating	426,438	500,643	487,366	221,583
Capital	34,868	4,773	28,434	—
Total Appropriations	\$2,780,770	\$2,863,429	\$2,916,271	\$2,642,692
Full-Time Positions	45.0	45.0	45.0	45.0
Part-Time Positions	0.5	0.5	0.5	0.5

Source: CITY OF DURHAM, N.C., FY 2001-02 BUDGET.

\*"Estimated" means based on a projection of year-to-date results.

year's proposed budget, which then is approved by the elected officials. (For an example of how the city of Durham displays this information in its budget document for the building inspection program, see Table 3.)

Collecting, analyzing, and reporting performance measures semiannually allows an organization to align inputs with outputs of service delivery during the annual budget process, providing the necessary information to engage in performance budgeting. [For an illustration of how managers of Durham's building inspection program align performance measures with the prior-year actual results, and how they align adopted (target) measures with the current-year adopted budget, see Table 4.]

During the annual budget preparation process, program managers update their performance measures with performance data collected as of December 31. This provides them with current information for performance budgeting and for estimating what their year-end results will be (the Estimated column in Table 4). Program managers then project adopted measures for alignment with the program budget for the following fiscal year.

The framework to allow performance budgeting now is in place. A line-item budget has been restructured to support a program budget (Table 3), and a

performance measurement system has been implemented at the program level (Table 4). An important aspect of this framework is its flexibility. Although program budgeting and performance measurement focus on total program inputs and total program outputs, program managers must regularly disaggregate the program data to analyze details. For example, given the design of the account structure at the program level, the framework allows a program manager to move from aggregated program inputs (personnel, operating, and capital costs) to disaggregated inputs (line items).

As stated earlier, state law mandates that localities in North Carolina follow a certain process of budget preparation. The administrative and technical details of budget preparation and adoption processes, however, vary widely across jurisdictions. The same holds true for performance budgeting. Most localities engaged in performance budgeting follow the overall structure of the framework presented in this section, but the details for collecting, analyzing, and using performance and financial data vary widely across jurisdictions. For example, the framework calls for collecting and reporting performance data semiannually. Some localities do this monthly, quarterly, or annually. Localities should adapt and implement the framework on the basis of their organi-

zational capacity—leadership, commitment, time, resources, experience, and training—for meaningful performance and budget reform.

### Data Analysis

Between the framework for performance budgeting and the philosophy of using performance data, there is a critical link. In Tables 3 and 4, program managers have aligned the inputs and the outputs for the building inspection program. However, they must analyze the data and the processes that produce those data in order to create information for supporting program expansion, reduction, or realignment. In local government, data analysis is directly linked to organizational capacity. It requires people with the necessary process knowledge, time, and analytical skills to create strategies for change on the basis of the inputs and outputs of service delivery.

People engaged in data analysis should not limit their review to the kind of information presented in Tables 3 and 4. Program managers commonly track performance measures beyond the statistics they collect and report for the annual budget process. The next section presents several management techniques that increase the likelihood of data use. Data analysis is a prerequisite for each technique presented. This missing component may be one reason why local

**Table 4. Performance Measures for the Durham Building Inspection Program**

Measures	FY 1999–00 Actual	FY 2000–01 Adopted	FY 2000–01 Estimated	FY 2001–02 Adopted
Quality control inspections per inspector per month	2.4	2.2	2.0	2.0
Percent inspections found to be accurate	99%	99%	98%	98%
Percent of residential plans reviewed in 4 days	93.6%	91%	90%	90%
Percent plan errors found in field	0.3%	.07%	1.0%	1.0%
Percent of inspections performed within 24 hours	97%	92%	90%	90%
Inspections per inspector per day	14.7	15	14	14
Number of quality checks	737	713	648	648
Number of residential plans reviewed	2,610	2,632	2,632	2,632
Number of inspections	81,585	85,000	80,000	80,000
Number of public school inspections	84	84	84	84

Source: CITY OF DURHAM, N.C., FY 2001–02 BUDGET.

## Analyzing Data

Supporters of performance management have successfully documented how localities are collecting and reporting performance measures. What now needs documentation is how localities are analyzing performance and financial data to create meaningful and usable information. Performance measures are primarily designed to monitor the performance of selected service dimensions. It is the responsibility of management to analyze the processes that produced the results and identify strategies for performance improvement.

The most comprehensive source of analytical techniques and examples of routine performance analysis is *Tools for Decision Making: A Practical Guide for Local Government*, by David N. Ammons.<sup>1</sup> It covers an array of techniques for analyzing performance and financial data in the context of local government administration, including central tendency analysis, correlation, cost-effectiveness analysis, demand analysis, floating averages, process flow charts, regression, sensitivity analysis, and work distribution analysis.

A common measure reported by fire suppression programs—the number of calls for fire service—provides an excellent example of how to use one of these techniques, demand analysis (a fairly detailed examination of workload patterns), to analyze data. Following are the number of actual calls for service over the past four fiscal years in a hypothetical city fire department:

FY 1999–2000	FY 2000–01	FY 2001–02	FY 2002–03
13,698	14,202	14,501	15,062

An analyst calculates the increase in demand for service that the fire suppression program experienced between FY 1999–2000 and FY 2002–03: 10 percent. She asks, “Why is the overall demand for fire service calls increasing? Are resources deployed in the most efficient and effective manner? Are strategies available to help stabilize the increase in demand?”

One of the most important steps in demand analysis and other analytical techniques is to disaggregate data to reveal

what may or may not be driving outputs and outcomes of service delivery.<sup>2</sup> The analyst disaggregates the data by type of service call:

Type of Call	FY 1999–2000	FY 2000–01	FY 2001–02	FY 2002–03
Fire	4,998	4,854	5,012	4,885
Medical	5,148	5,095	5,165	5,635
False alarm	2,700	3,348	3,489	3,667
Other	852	905	835	875
<b>Total</b>	<b>13,698</b>	<b>14,202</b>	<b>14,501</b>	<b>15,062</b>

Analysis reveals that the type of call driving the overall demand rate is false alarm, which has increased by about 36 percent between FY 1999–2000 and FY 2002–03. The number of calls regarding actual fires has remained relatively stable over the same period. Calls involving medical response have increased by 9.5 percent, prompting the analyst to disaggregate those data by service zone. That analysis reveals that a particular service zone of the city has been driving the demand for emergency medical calls.

On the basis of her analysis, the analyst, in consultation with the fire chief, constructs three strategies. First, in the zone experiencing a high demand for emergency medical calls, she increases the shift coverage by two firefighters per shift. Second, she makes a budget request to purchase a quick-response vehicle for the same zone. Third, she forwards a request to the budget director and the city manager to increase the false alarm fee. This strategy has the potential of slowing the demand rate for calls involving false alarms.

Each of these strategies has significant implications for performance budgeting. All are based on performance data. The change in shift coverage has the potential of increasing the effectiveness of fire suppression with the same level of resources. Greater efficiency may occur with this change, as well. A new quick-response vehicle will be a one-time investment, as opposed to a recurring cost. An increase in the false alarm fee has the potential of increasing the city's revenue.

### Notes

1. DAVID N. AMMONS, *TOOLS FOR DECISION MAKING: A PRACTICAL GUIDE FOR LOCAL GOVERNMENT* (Washington, D.C.: CQ Press, 2002).
2. HARRY P. HATRY, *PERFORMANCE MEASUREMENT* (Washington, D.C.: Urban Inst. Press, 1999).

governments have not used performance measures as successfully as they have collected and reported performance data. (For more information on data analysis and on disaggregation of performance data at the program level, see the sidebar on this page.)

### Use of Data

The success of performance budgeting hinges on a change in managerial

philosophy. Managers must become accustomed to using both performance and financial data to support their budget requests and daily management decisions. Most jurisdictions report that the only time they use performance data is when they are making budget decisions.<sup>18</sup> Localities should be commended for using performance measures whenever they do so. However, the reason for adopting performance measurement is to support performance management

throughout the year. Managers who routinely use performance data will create the information they need to support their annual budget requests.

This discussion is not intended to be a comprehensive explanation of how to use performance and financial data to support decision making by management or to identify ongoing strategic goals for performance improvement. It merely provides a few examples of how localities can use data to support man-

agerial decisions, including how they can link the data to their annual budget preparation.<sup>19</sup>

*Strategic planning* at the organization-wide level is becoming more common in local government.<sup>20</sup> It typically involves creation of an overall mission statement, identification of core values, and specification of organizational goals by the organization's stakeholders. Specific objectives, performance measures, and performance targets often are missing at this level. Administrators and managers must develop annual work plans containing this information as they identify specific strategies for goal achievement. They use performance data to construct, justify, and track the success of their

work plans over time, allowing performance budgeting to occur when their plans contain budget implications. The "balance scorecard" offers another approach to building annual work plans and to linking specific strategies to organization-wide goals.<sup>21</sup>

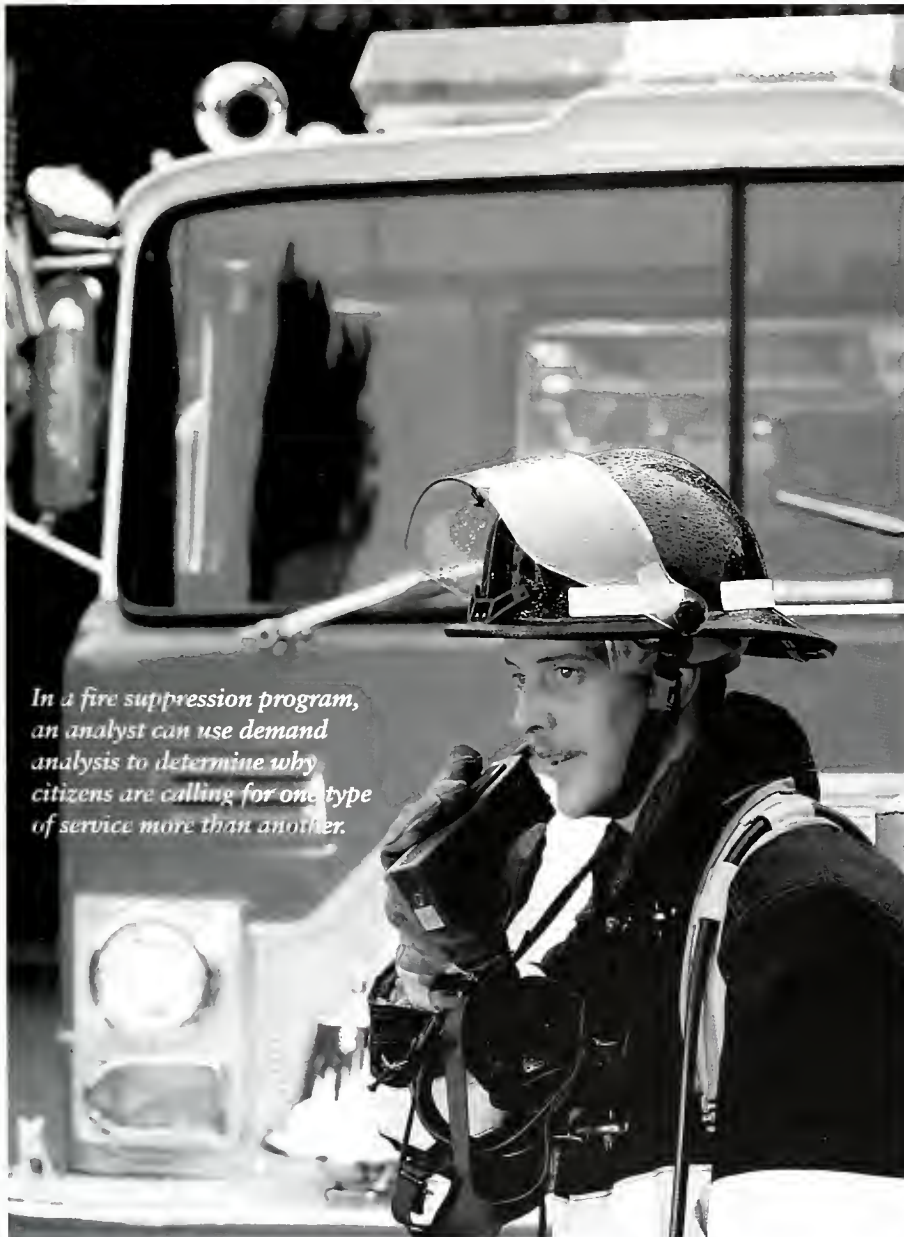
Using data should be an ongoing management approach to service delivery. One of the best approaches to using data is *continuous process improvement*. It requires managers first to analyze processes in order to determine the current levels of performance. Next, they establish performance targets and identify strategies to close the gap between the current levels of performance and the targets. This requires perfor-

mance management outside the budget process and sets the stage for performance budgeting. (An example of these strategic goals for building inspections can be found in the sidebar on page 31.) Some will have direct budget implications; others will not. The long-term goal is to change the organizational culture so that program managers are constantly searching for ways to improve service delivery.

*Benchmarking* offers localities an excellent way to place their performance measures in the context of other jurisdictions. An example of a formal benchmarking process is the North Carolina Benchmarking Project, managed by the Institute of Government.<sup>22</sup> In local government, program managers commonly contact neighboring jurisdictions on an informal basis to obtain comparable performance data. Either way, the program managers' goal is to identify gaps in the performance results of their programs as compared with those of other jurisdictions. Once program managers have identified the causes through process analysis, they construct strategies to close the performance gap on the basis of the policies and processes of other jurisdictions. Performance management occurs as managers use internal and external data. Performance budgeting occurs when identified strategies have budget implications.

Tracking performance data over time (trend analysis) is an excellent way for a program manager to identify programs, functions, and processes that are prime candidates for *program evaluation* or *performance auditing*.<sup>23</sup> The purpose is to collect and analyze performance data to support recommendations for change, including specific implementation guidelines for process realignment. This allows allocation decisions to be informed by performance because the recommendations derived from program evaluations or performance audits that have budget implications are constructed on the performance of service delivery.

A final approach to using performance data is only recently gaining attention in local government. *Performance data auditing* requires local officials periodically to verify the accuracy and reliability of performance data.<sup>24</sup> They identify strategies for improving the data's



*In a fire suppression program, an analyst can use demand analysis to determine why citizens are calling for one type of service more than another.*

integrity and the processes that produce the data by examining data collection and reporting methodologies and by tracking the details of service delivery.

Returning to a misconception of performance budgeting, simply placing performance measures in a budget document does not constitute performance budgeting. However, performance results placed in budget documents should be accurate and reliable for the users of this information, providing another need for performance data auditing.

## Conclusion

Performance budgeting occurs when the results of service delivery inform decisions about allocation of resources. Using performance data to inform decision making within the core functions of management requires leadership, management, analytical skills, and communication skills and a continuous commitment to providing efficient and effective service delivery.

One of the major misconceptions of performance budgeting is that it is a stand-alone budgeting technique. The performance budgeting framework presented in this article requires line-item budgeting, program budgeting, performance measurement, and performance management to link inputs to outputs successfully. Line-item budgeting provides the necessary infrastructure for budgeting and accounting for financial resources at the level of detail required for accurate and reliable information. Program budgeting requires the alignment of inputs with programs of service delivery—where the functions, activities, and processes are located for service provision. Performance measurement provides the necessary infrastructure for tracking outputs, outcomes, and efficiencies at the program level. Performance management is used to support an extremely important core function of management in local government—the annual budget preparation and adoption process.

A final aspect of performance budgeting is that it requires ongoing leadership from all levels of the organization for successful adoption and implementation. This is especially critical for senior managers and elected officials, who

play an important role in changing the organizational culture to accommodate performance budgeting. Numerous jurisdictions in North Carolina are committed to performance budgeting. Hickory is one city where an organizational culture change has occurred. During meetings and workshops, Hickory's program managers, department heads, and elected officials commonly use financial and performance data to analyze service delivery, identify strategies, and support decisions.

## Notes

1. V. O. Key, *The Lack of a Budgetary Theory*, 34 AMERICAN POLITICAL SCIENCE REVIEW 1137 (1940).

2. XiaoHu Wang, *Assessing Performance Measurement Impact*, 26 PUBLIC PERFORMANCE & MANAGEMENT REVIEW 26 (2002).

3. Katherine Barrett & Richard Greene, *Coming to Terms*, GOVERNING, Mar. 2003, at 56.

4. Philip G. Joyce, *Appraising Budget Appraisal: Can You Take Politics out of Budgeting?* PUBLIC BUDGETING AND FINANCE, Winter 1996, at 21.

5. N.C. GEN. STAT. §§ 159-10 through -13 (hereinafter G.S.).

6. Output measures indicate the amount of work performed, outcome measures the degree to which performance objectives have been achieved or reflect the quality of performance. Efficiency measures reflect the relationship between work performed (outputs) and resources required to perform it (inputs). DAVID N. AMMONS, MUNICIPAL BENCHMARKS (Thousand Oaks, Cal.: Sage Publications, 2001).

7. David N. Ammons, *Productivity Improvement in Local Government: Its Place among Competing Priorities*, 43 PUBLIC ADMINISTRATION REVIEW 113 (1983).

8. The misconceptions discussed in this section are drawn from JANET M. KELLY & WILLIAM C. RIVENBARK, PERFORMANCE BUDGETING FOR STATE AND LOCAL GOVERNMENT (Armonk, N.Y.: M. E. Sharpe, 2003).

9. AMMONS, MUNICIPAL BENCHMARKS.

10. JEROME B. MCKINNEY, EFFECTIVE FINANCIAL MANAGEMENT IN PUBLIC AND NONPROFIT AGENCIES (Westport, Conn.: Quorum Books, 1995).

11. Another problem is that dividing the total program budget (personnel, operating, and capital costs) by the number of outputs is a crude methodology for determining unit cost. For more information on cost accounting, see DAVID N. AMMONS, TOOLS FOR DECISION MAKING: A PRACTICAL GUIDE FOR LOCAL GOVERNMENT (Washington, D.C.: CQ Press, 2002).

12. Although making periodic program changes is a natural part of doing business,

making constant changes once programs are defined diminishes the value of historical trend data (financial and performance).

13. STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING (Chicago: Government Finance Officers Ass'n, 2001).

14. PLANNING, PROGRAMMING, BUDGETING (Fremont J. Lyden & Ernest G. Miller eds., 2d ed., Chicago: Markham Publ'g Co., 1972).

15. THOMAS D. LYNCH, PUBLIC BUDGETING IN AMERICA (4th ed., Englewood Cliffs, N.J.: Prentice-Hall, 1995).

16. The building inspection program is a consolidated function of the City of Durham and Durham County. The program was specifically selected for this article because it is a common function in both municipal and county governments.

17. David N. Ammons, *Performance Measurement in North Carolina Cities and Towns*, POPULAR GOVERNMENT, Fall 2001, at 11.

18. LYDIA BJORN LUND, BEYOND DATA: CURRENT USES OF COMPARATIVE PERFORMANCE MEASUREMENT IN LOCAL GOVERNMENT (Washington, D.C.: International City/County Management Ass'n, 2000).

19. For examples of how localities across the United States use information derived from performance results, see *id.*

20. For more information on strategic planning and the annual budget preparation process, see NATIONAL ADVISORY COUNCIL ON STATE AND LOCAL BUDGETING, RECOMMENDED BUDGET PRACTICES (Chicago: Government Finance Officers Ass'n, 1998).

21. The "balance scorecard" is a management system that uses financial and non-financial information for enhancing goals, objectives, measures, and strategies by assessing organizational performance across four dimensions: financial, internal business, innovation and learning, and customer. Charlotte is an example of a local government in North Carolina that is using this system.

22. For a recent report issued by the project, see WILLIAM C. RIVENBARK & MATTHEW H. DUTTON, FINAL REPORT ON CITY SERVICES FOR FISCAL YEAR 2001-02: PERFORMANCE AND COST DATA (Chapel Hill: Institute of Gov't, Univ. of N.C. at Chapel Hill, Feb. 2003), available from the Publications Sales Office, e-mail sales@iogmail.iog.unc.edu, phone (919) 966-4119.

23. Social scientists created program evaluation to identify a program's impact as gauged by its purpose. Accountants created performance auditing to analyze the economy and efficiency of a program. They both are used to identify findings and to make recommendations for improving decision-making processes and service provision.

24. William C. Rivenbark & Carla M. Pizzarella, *Ensuring the Integrity of Crucial Data*, POPULAR GOVERNMENT, Winter 2002, at 28.



PHOTOS BY KYLE GRAY

## Knapp-Sanders Building Reopens for Business

**A**fter four years of demolition, expansion, renovation, and renewal, the School of Government's Knapp-Sanders Building opened for classes on January 8, 2004.

The new building features 21 new class and seminar rooms, updated technology, improved parking, and plenty of networking and meeting space. In its first week of business for the new year, it hosted participants in A. John (Jack) Vogt's Budget and Financial Planning course and Section I of the Municipal and County Administration courses.

The faculty and staff of the school extend their deepest thanks and gratitude



KYIE GRAY



to the many supporters and friends who helped with financial and other contributions to the building during its construction. The school's \$4 million capital fund-raising goal has nearly been met. Financial contributions are being sought in 2004 to complete the final \$500,000, which will purchase the remaining furniture, landscaping, and information technology equipment needed for the building.

*Save the Date*  
Dedication Scheduled for  
September 10, 2004

Mark your calendar now for Friday, September 10, 2004, and plan to celebrate in Chapel Hill with your friends and colleagues as the School of Government formally dedicates the new Knapp-Sanders building. Festivities will begin at 9:00 a.m., and culminate in an afternoon open house. Watch for more information later in the year.

### Vogt Receives National Award

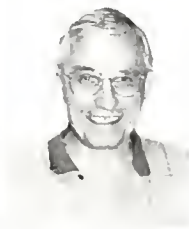
School of Government professor A. John (Jack) Vogt has received national recognition for his thirty-year contribution to public finance.

The American Society for Public Administration's Association for Budgeting and Financial Management presented the Kenneth Howard Career Achievement Award to Vogt at its national conference in Washington, D.C., on September 19. Vogt was recognized for his research, pub-

lications, teaching, and service to North Carolina local government officials.

Vogt joined the School of Government in 1973 and through its Institute of Government has taught budgeting and finance in the Municipal and County Administration courses, which he directed from 1990 to 1995; in programs for newly elected mayors, city council members, and county commissioners; and in special programs for local budget and financial officials. Vogt also has advised state legislative committees on capital budgeting. He recently finished a new book, *Capital Budgeting and Finance: A Guide for Local Governments*, which will be published in 2004. Vogt holds a Ph.D. in public administration from Cornell University.

S. Kenneth Howard, for whom the career achievement award is named, was a faculty member at UNC Chapel Hill in the 1960s, holding a joint appointment in the Political Science Department and the Institute of Government. He played a key role in establishing the University's Master of Public Administration Program before holding positions as North Carolina state budget director,



Wisconsin state budget director, and then executive director of the U.S. Advisory Commission on Intergovernmental Relations, in Washington, D.C.

### Hunt Receives Lewis Award, Is Appointed International Committee Chair



School of Government faculty member Joseph E. Hunt was honored with the Henry W. Lewis Award at the fall conference of the North Carolina Association of Assessing Officers (NCAAO) in Charlotte in November. NCAAO President John C. Petoskey presented the award, which the NCAAO gives periodically to recognize people for "their service to the citizens of North Carolina by providing dedicated leadership and knowledge to the North Carolina Tax Assessors and the Institute of Government." The award was last presented in 2001 to William A. Campbell, also a faculty member at the School.

Earlier, Hunt was appointed by President Fred Chmura of the International Association of Assessing Officers (IAAO) to chair the organization's Ethics Committee. This committee develops, maintains, and publishes an ethical code and standards of professional practice, and addresses ethical complaints. The ethical code and standards conform with the Appraisal Foundation's Uniform Standards of Professional Appraisal Practice. Together, these ethics and standards describe a pre-





ANGELA WILLIAMS



KYLE GRAY

ferred model of ethical and professional behavior for the property tax professional.

The NCAAO is an organization of North Carolina state and county assessing officials that works to achieve and maintain a high level of performance in property tax assessment administration through professionalism, education, and communication. Its members number about 350.

The IAAO is an educational and research association of people in the assessment profession and others with an interest in property taxation. Its mission is to promote innovation and excellence in property appraisal and property tax policy and administration through professional development, education, research, and technical assistance. Membership, which currently totals about 8,500, is open to anyone and includes people working in government, private industry, and academe and members of the general public.

## Center and Project Honored with Friends of Northeast Award

The Institute of Government's Center for Public Technology and an eight-county demonstration project of the Institute entitled Developing Economically Competitive Rural



Communities in North Carolina recently received Friends of the Northeast awards from the Roanoke Chowan Partners for Progress (RCPP) in recognition of outstanding and professional support in the state's northeastern region.

The RCPP presented the awards at its second annual Community and Economic Development Awards Gala, held in December 2003 in Ahoskie, Hertford County. Kevin FitzGerald, planning director of the center, accepted them on behalf of the Institute.

FitzGerald and the center were recognized for their assistance with RCPP's strategic planning process and successful organizational development. The strategic planning process evaluated regional needs and developed a long-term vision statement. The organization's goals focus on information technology, housing, business and organization development, and retention of the region's youth.

The Center for Public Technology, established in 2000, is dedicated to improving local and state government information technology management.

The demonstration project was undertaken by Anita Brown-Graham, associate professor at the School of Government, and James Johnson, professor at the UNC Kenan-Flager Business School. Funded by a grant from the Golden LEAF, it covered four western counties in addition to the four eastern counties in the RCPP region.

The RCPP is a five-year-old consortium of organizations from Bertie, Gates,

Hertford, and Northampton counties formed to coordinate economic development efforts of nonprofits, grassroots organizations, community-based organizations and local governments in the region. It includes more than 200 organization and individual members.

For additional information, contact FitzGerald, (919) 962-4301 or kfitz@iogmail. iog.unc.edu, or Brown-Graham, (919) 962-0595 or brgraham@iogmail. iog.unc.edu, as appropriate.

## Publications Staff Receives Editing and Design Awards

The Society for Technical Communications has presented three publishing awards to the School of Government in recognition of its excellent design treatment of technical material.

*Motor Vehicle Law and the Law of Impaired Driving in North Carolina*, by School faculty members Ben F. Loeb Jr. and James C. Drennan, was recognized with a Distinguished Award in Technical Publishing at the national competition. The judges were especially impressed that the School offers the publication in both paperback and





searchable CD-ROM format.

This publication later received a Best in Show award in the society's international competition.

*Popular Government*

also received a Distinguished Award in Technical Publishing. The judges evaluated an entire volume of the magazine and praised the overall effectiveness of its layout and design. They commented on how well the design accommodates a wide variety of technical material without sacrificing its appealing format.

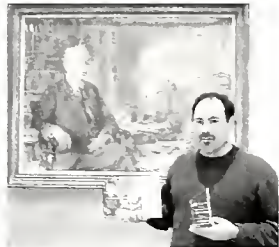
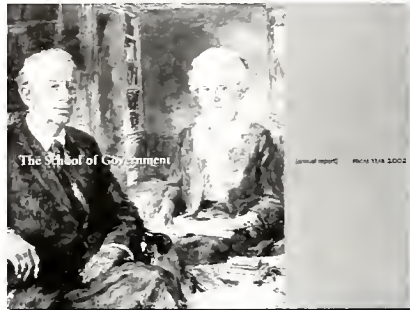
Congratulations to the entire Publications staff for their award-winning work on these publications. Congratulations also to Teresa Perrien and John Rubin, at the time the designer and the editor, respectively, of *Popular Government*.

### School of Government Annual Report Wins PICA Award

The judges bestowing PICA awards deemed the School of Government's fiscal year 2002 annual report to be the best "combination annual report" (four-color cover and one- or two-color interior) produced and printed in the Carolinas this year, based on quality of design and production.

PICA awards have been the premier symbol of excellence for the graphics industry in the Carolinas since 1966. Printers submit their best-realized projects for consideration, and each submission is judged by a number of criteria, including overall effectiveness, success in achieving the stated objectives, clarity of the message, visual impact, and production values. The judges represent a mix of business-to-business marketing professionals, including manufacturers and agency personnel as well as PICA bureau members.

Congratulations to all those who contributed to this success: Angela Williams and Ann Simpson (managing editors), Robby Poore (designer), Katherine Kopp



*Robby Poore, annual report designer*



*Lisa Wright (desktop publisher), Roberta Clark (editor), Katrina Hunt (assistant marketing and sales manager), Lucille Fidler (editor), Jennifer Henderson (editor), Angela Williams (director of publications), Robby Poore (designer), and Dan Soileau (designer). Not pictured: Nancy Dooly (editor), Christopher Toenes (bookstore manager/marketing and sales assistant), and Elaine Welch (desktop publisher).*

(writer), Nancy Dooly and Lucille Fidler (editors), Chamblee Graphics (printer), members of the annual report editorial board, and the faculty and staff of the School of Government.

### Denning Joins Faculty

Shea R. Denning joined the School of Government in October 2003 as assistant professor of public law and government, specializing in property tax law. Before joining the School faculty, she served as assistant federal public de-

fender in the Office of the Federal Public Defender, Raleigh. Earlier, Denning worked for the King and Spalding law firm in Atlanta and was judicial clerk for U.S. District Judge Malcolm J. Howard in Greenville, N.C. She holds both a B.A. and a J.D. from The University of North Carolina at Chapel Hill. Denning can be contacted at [denning@iogmail.iog.unc.edu](mailto:denning@iogmail.iog.unc.edu) or (919) 843-5120.



### Environmental Finance Center Taps New Director

Jeff Hughes has succeeded Richard Whisnant as director of the UNC Environmental Finance Center (EFC), a joint project of the School of Government and the Kenan-Flagler School of Business, Office of Economic Development. Before this appointment, Hughes served as associate director of the center.

In announcing the transition, Whisnant said, "Jeff has shown that he has the knowledge, skills, and drive to build the EFC in a way that will fit quite well with the mission of the school and the Institute of Government." Whisnant will continue to work with the EFC as a senior adviser and on a project-by-project basis.

The EFC is part of a national network of university-based centers that work in a variety of environmental areas, including water resources, solid waste management, air quality, and land conservation. The EFC assists local communities; provides training and policy analysis; and disseminates tools and resources on topics such as environmental cost accounting, rate setting, and development of sustainable cost recovery and institutional management systems.

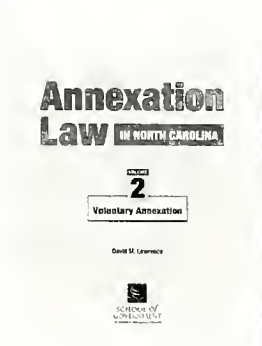
Information about the EFC is available at [www.efc.unc.edu](http://www.efc.unc.edu).

*More news and information about School of Government faculty, staff, and recent activities, and copies of the School's annual report and Friends of the Institute newsletter, are available online at [www.sog.unc.edu](http://www.sog.unc.edu). Click on "About the School."*

# Off the Press

## Annexation Law in North Carolina, Volume 2, Voluntary Annexation

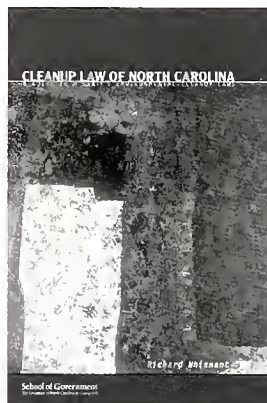
David M. Lawrence  
2004 • \$30.00\*



The second of three volumes on North Carolina annexation law. Volume 1 addresses topics that are relevant regardless of the statutory annexation procedure used by a city. Volume 2 addresses voluntary annexation, and Volume 3 will address involuntary annexation.

## Cleanup Law of North Carolina: A Guide to a State's Environmental Cleanup Laws

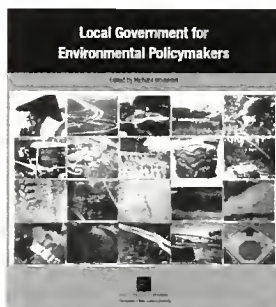
Richard B. Whisnant  
2003 • \$35.00\*



Analyzes and discusses the laws that govern the cleanup of property contaminated by some form of pollution. Looks beyond statutes and appellate decisions to the actual administrative programs that put these laws in place. For people who want to know how cleanup laws really work, including owners, buyers, sellers, neighbors, and attorneys involved with property that may be contaminated.

## Local Government for Environmental Policymakers

Richard B. Whisnant  
2003 • \$55.00\*



Provides environmental policymakers with a fundamental understanding of how local governments work: how they are structured, how they are funded, what their powers are, and what drives their decision making. Although there is a focus on North Carolina, the structures and methods discussed can largely be applied to other states.

## Recent Publications

### Accountability in Local Government-Nonprofit Relationships

Gordon P. Whitaker,  
Margaret F. Henderson,  
and Lydian Altman-Sauer  
2003 • \$16.95\*

Published by International City/County Management Association

### North Carolina Child Support Statutes, November 2003

Compiled by John Saxon  
2003 • \$35.00\*

### Arrest, Search, and Investigation in North Carolina

Robert L. Farb  
Third edition, 2003 • \$35.00\*

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