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Popular Government

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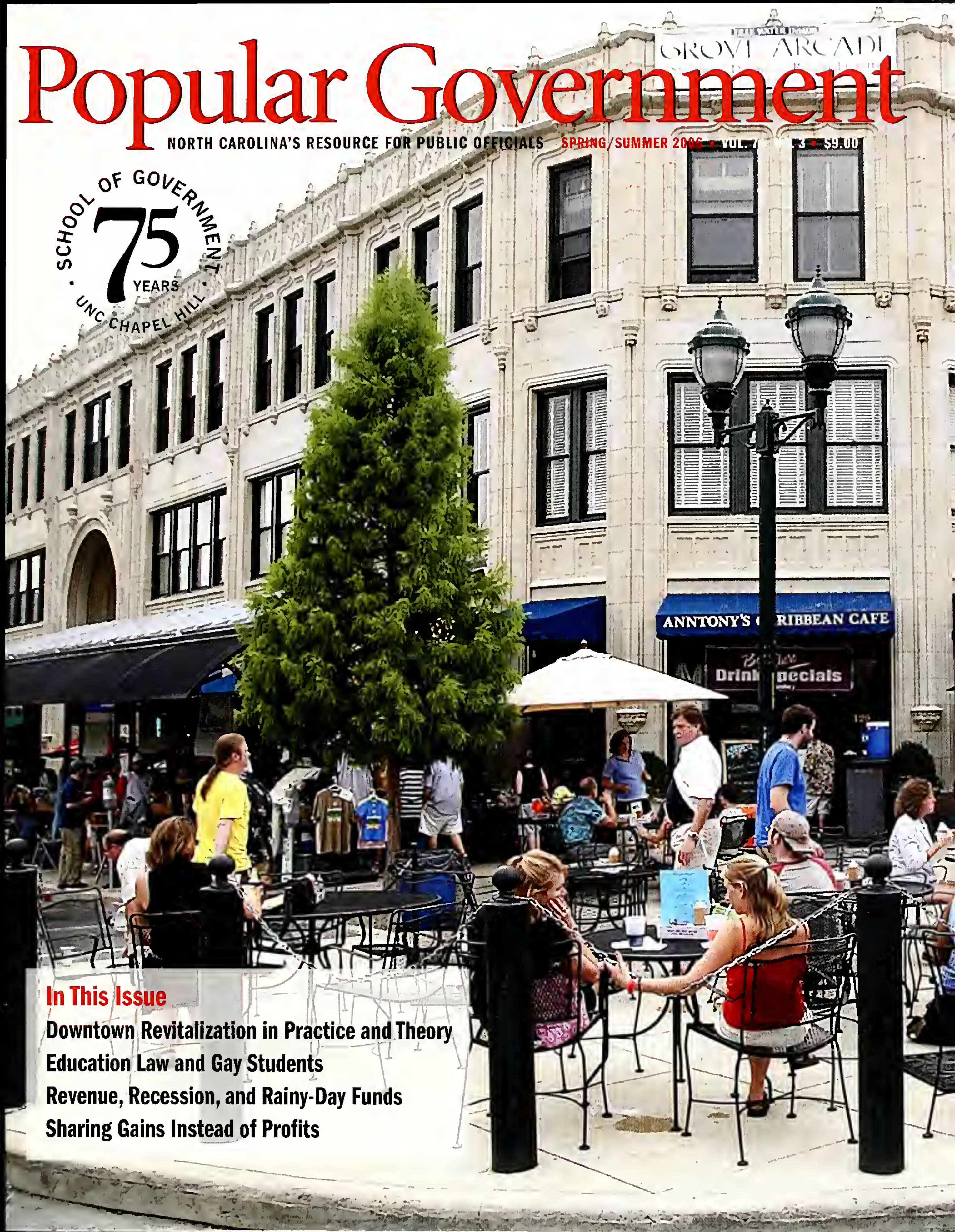
SCHOOL OF GOVERNMENT 75 YEARS • UNC CHAPEL HILL •



In This Issue

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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UNC
SCHOOL OF GOVERNMENT

School of Government, UNC at Chapel Hill

Established in 1931, the Institute of Government provides training, advisory, and research services to public officials and others interested in the operation of state and local government in North Carolina. The Institute and the University's Master of Public Administration Program are the core activities of the School of Government at The University of North Carolina at Chapel Hill.

Each year approximately 14,000 public officials and others attend one or more of the more than 200 classes, seminars, and conferences offered by the Institute. Faculty members annually publish up to fifty books, bulletins, and other reference works related to state and local government. Each day that the General Assembly is in session, the Institute's *Daily Bulletin*, available in print and electronic format, reports on the day's activities for members of the legislature and others who need to follow the course of legislation. An extensive website (www.sog.unc.edu) provides access to publications and faculty research, course listings, program and service information, and links to other useful sites related to government.

Operating support for the School of Government's programs and activities comes from many sources, including state appropriations, local government membership dues, private contributions, publication sales, course fees, and service contracts. For more information about the School, the Institute, and the MPA Program, visit the website or call (919) 966-5381.

Popular Government

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Andrew Spaulding, Reinhardt Architecture, Inc

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ON THE COVER *Residents and visitors relaxing at a sidewalk cafe in Asheville's revitalized downtown. Photograph by Bill Sanders.*

N.C. Journal

ISSUES, EVENTS, AND DEVELOPMENTS OF CURRENT INTEREST TO STATE AND LOCAL GOVERNMENT

Improving Service through Innovations in Technology

One way in which the School is commemorating its 75th anniversary is by asking how it can better serve the people of North Carolina. We believe that we can significantly improve our use of information and communication technology in our teaching, advising, and research. Therefore we are starting a two-year effort to identify and implement improvements in each of these areas. Faculty member Frayda Bluestein is leading the effort.

The initiative has many parts, but its main themes are how to improve productivity, accessibility, and responsiveness in the School's work with state and local government leaders. I am allocating funds for pilot projects and for investment in new staffing and technologies to support innovative proposals.

A significant part of the initiative involves meeting with public officials and their professional associations to find out how we can improve our use of technology to address their needs.

Anyone interested in learning about the progress of the initiative or in making suggestions or other contributions is invited to contact Bluestein at (919) 966-4203 or bluestein@sog.unc.edu.

Michael R. Smith, Dean, School of Government

New Legal Guide Available for Pregnant and Parenting Minors

The School of Government is offering a new, easy-to-read booklet, available in English or Spanish, that can be read and printed online without charge or registration. It answers questions about North Carolina and U.S. law affecting women seventeen years old or younger who are pregnant or parenting. Partners, parents, relatives, and guardians—anyone on whom a minor depends—also will find the guide useful.

Topics include whether a minor may legally raise a child, have (or refuse to have) an abortion, place a child for adoption, get married, drop out of school (or insist on staying), sign a lease, consent to health care, take out a restraining order, and get public assistance or a job. Also, it addresses what rights and responsibilities a baby's father and grandparents have.

A separate section describes the law relevant to immigrants, new citizens, and those not yet fluent in English.

The new guide is available at www.teenpregnancy.unc.edu or www.teenmother.unc.edu. It is the last in a series of four, all available at www.adolescentpregnancy.unc.edu. The first three were for health care providers, social services workers, and school personnel. Thanks to support from the School of Government and the Z. Smith Reynolds Foundation, about 14,000 North Carolina professionals, most of them working in public agencies, have received a copy of each guide.

Online Clearinghouse of Documents Open for Business

Why reinvent the wheel when drafting basic contracts, policies, forms, and the like? To help local government officials share good materials, the School has established the North Carolina Local Government Document Warehouse at http://nclgdocs.unc.edu/.

The purpose of the warehouse is to make available to public officials throughout North Carolina examples of documents that have been developed by North Carolina local governments for their own use. Anyone can submit a document that he or she thinks will be useful to colleagues. The website allows for searches.

Documents already submitted include policies on cell phones, an RFP for disaster recovery services after seventy hours, a policy on municipal procurement cards, and a form for informal construction quotes.

The warehouse's open-submission policy calls for each user to review and evaluate documents obtained from the warehouse to determine whether they are useful, appropriate, and legal for the user's particular need. The documents are not reviewed by School faculty, and the School strongly recommends that you consult with your local attorney before using any.

For more information, contact Frayda Bluestein, at (919) 966-4203 or bluestein@sog.unc.edu.

Construction Begins on Gladys Hall Coates Garden

To help celebrate the School's 75th anniversary, you are cordially invited to join in honoring the life and the contributions of a very special person in the history of the School and the state of North Carolina. The bare patch of ground that was once the side entrance to the Institute's auditorium is being transformed into a lovely courtyard garden dedicated to the memory of Gladys Hall Coates. A campaign goal of $40,000 has been set to help complete this timeless garden, which thousands of public officials, students, visitors, and employees of the School will enjoy for decades to come.

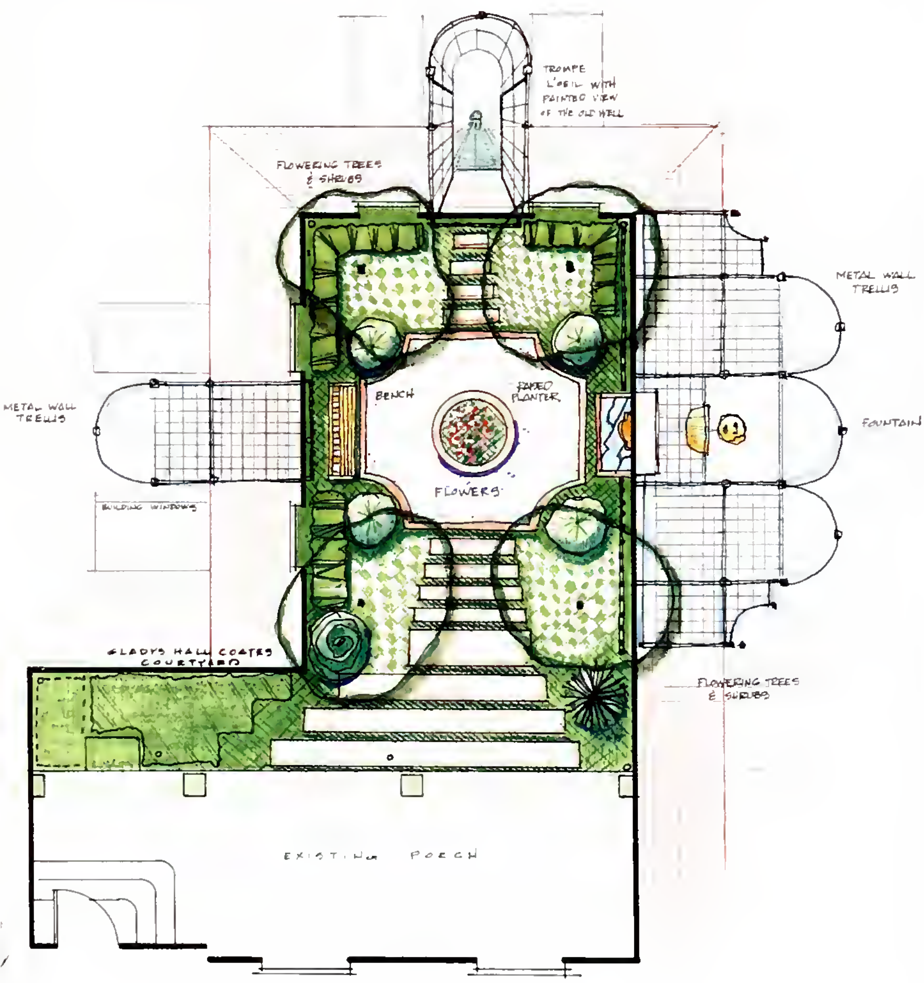
The wife of Albert Coates, the Institute's founder, Gladys was a true companion to him in the establishment and the growth of the Institute. Working together, they realized Albert's dream of a new type of institution in which students would learn about life in public service, and public servants would find the education and the other resources they needed to serve skillfully. In testament to the Coateses' vision, commitment, and sacrifice, the Institute has earned international commendation for its unique services. It recently was folded into the School of Government.

In 2001, Gladys, then ninety-nine years old, was awarded was awarded an honorary degree by UNC at Chapel Hill in recognition of her writing, publications, and contributions to the study of women and government. For decades she and Albert championed the accomplishments and the capability of women in public service and supported the growth of student government on campuses and in secondary schools across the state.

Gladys was a pivotal figure in many ways and will long be referenced in the University's history. At the School her memory will be tangible, beautiful, and ever alive as her courtyard garden grows and changes with each season.

Gifts to help the School finish the garden may be made online at www.sog.unc.edu (click on Supporting the School) or by sending a check to the SOG Foundation—Coates Garden, CB# 3330 Knapp-Sanders Building, UNC at Chapel Hill, Chapel Hill, NC 27599-3330.

To learn more about Gladys and the history of the Institute of Government, visit the School's 75th anniversary website at www.sog.unc.edu/75.

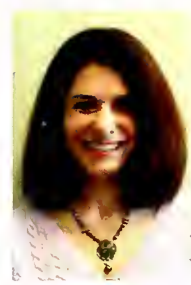


Millonzi, Mills, Morse Join School Faculty

The School welcomes three new members of its faculty: Kara Millonzi, Norma Mills, and Ricardo "Rick" S. Morse.

Millonzi joined the School in March as assistant professor of public law and government, specializing in local government finance. She works closely with faculty member David Lawrence. Formerly, Millonzi practiced law with Testa, Hurwitz & Thibeault, LLP, in Boston, and clerked for the Honorable Louis F. Oberdorfer of the U.S. District Court for the District of Columbia. She holds a B.A. in economics, summa cum laude, from the University at Buffalo, where she was elected to Phi Beta Kappa, and an M.A. in economics, specializing in public finance and economic modeling, from the University of Maryland at College Park. She earned a J.D.,

continued on page 38


Kara Millonzi


Norma Mills


Rick Morse

Public Leadership of Asheville's Downtown Revitalization

Leslie Anderson, Anita Brown-Graham, and Jennifer Lobenhofer

Imagine a city where gargoyles keep watch over an Art Deco downtown. Where smoke-blue mountain peaks not only accentuate the skyline—they dominate it. A city where you can drink cappuccino at a sidewalk cafe, browse through antique shops, or join an impromptu bluegrass jam . . . A city so special, it's rated as one of the "Top 10 Places to Live" by Outside *magazine, listed in Rand McNally's* Places Rated Almanac, *and referred to by travel writers as the "Paris of the South."*[1]

So says a local realtor about Asheville, North Carolina, and it is no coincidence that this promotion begins with a focus on the city's downtown. By all accounts, Asheville has masterfully leveraged its cultural and physical legacies to transform its center city into a thriving downtown where people want to live and spend time and money.

The story of the transformation of downtown Asheville is compelling and instructional for local governments in North Carolina and beyond. The value of the story, though, is not as a winning recipe for downtown development. Strategies for development must respond to the particularities of a downtown, and as downtown development professionals will quickly point out, "Downtowns are absolutely unique places: no two are alike in form, structure, or functional composition."

Anderson is an adjunct faculty member at the School of Government, specializing in economic development and civic education and engagement. For more than twenty years, she was employed by the City of Asheville, the last ten of them as director of Downtown (and later City) Development. Brown-Graham is a School faculty member specializing in affordable housing, community and economic development, and public liability. Lobenhofer is director of the School's Community and Economic Development Program. Contact them at lesliea@ioa.com, brgraham@sog.unc.edu, and lobenhofer@sog.unc.edu.

Rather, the value of the Asheville story lies in the inspiration it offers to local governments daunted by the prospect of creating leadership capacity within and through alliances with others to enhance the well-being of their communities. By focusing on the particular role of the public sector in revitalizing downtown Asheville, this article offers local governments insight into the multifaceted nature of downtown development efforts, describes a model of public leadership within the context of a public-private partnership for revitalization, and sets forth a general framework for considering the requirements for leading a change initiative.

The Asheville Story

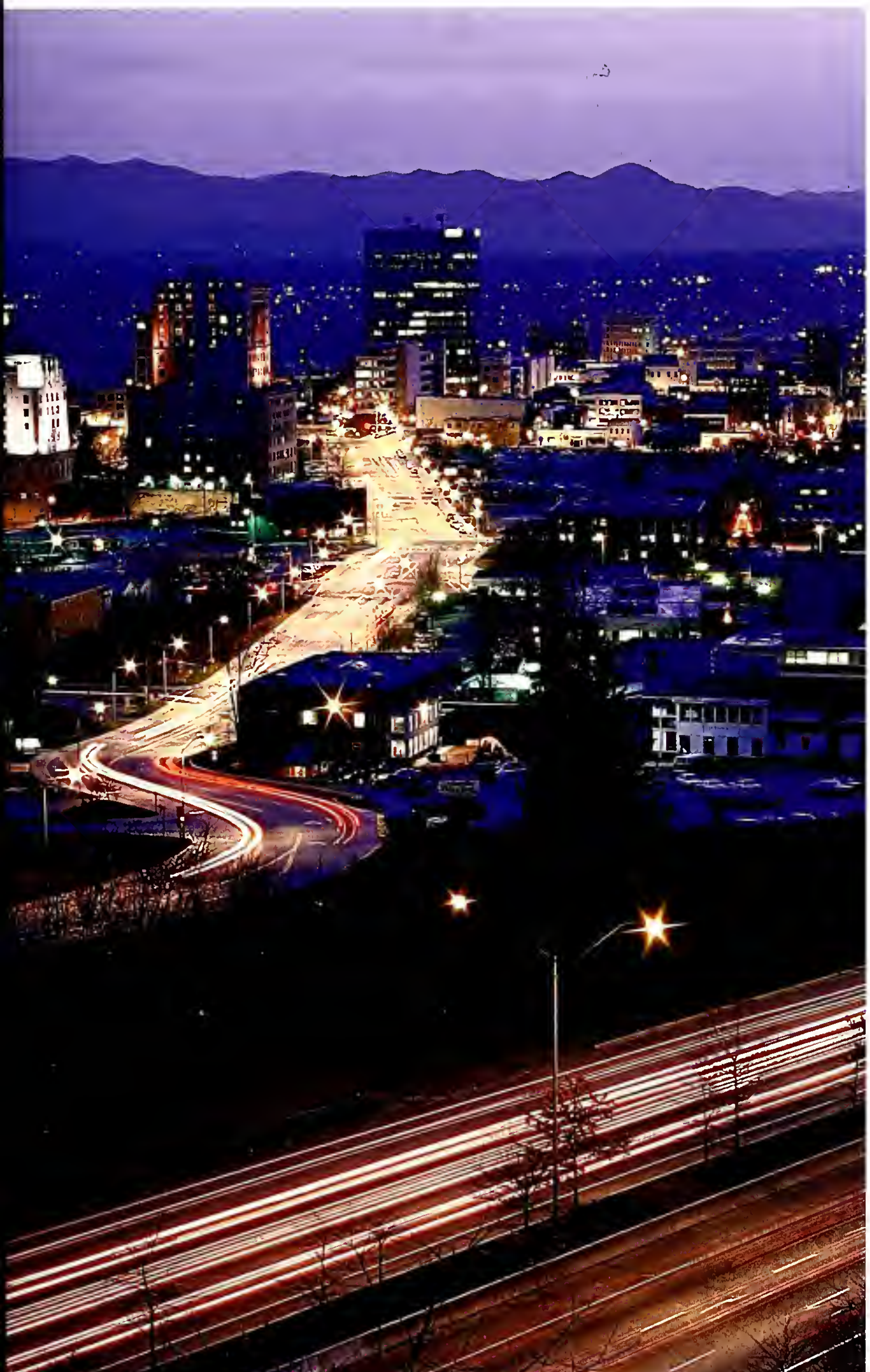
After decades of deterioration, many downtowns across the country are experiencing a marked resurgence.[2] As more and more communities begin to consider downtown development to be a key component of their overall economic development strategy, new optimism surrounds the economic potential of urban centers. An increasing number of public officials now proclaim with great excitement and fanfare their plans to revitalize their downtowns. However, many local officials are at a loss for specific public strategies to reposition their downtowns and attract new investment, business, and residents.

Although Asheville certainly did not act alone in transforming its downtown, the city's critical role in initiating and leading the revitalization stands without question. As one of the most successful private developers of downtown properties readily asserts, "It would not have happened had it not been for the city's involvement."[3] By serving as the effective, committed initial sponsor of the downtown turnaround, the city provided direction, resources, sacrifice, and the imperative for change in the critical early stages of the revitalization era.

Essentially this chapter of the Asheville story begins in 1981 with the emergence of a critical consensus about the future of the city's downtown and the city's consequent role as a change agent. The chapter closes in 1993 with the election of new members to the City Council and a significantly changed role for the city in downtown development. For purposes of setting a context and ensuring chronological accuracy, we briefly consider a number of actions that occurred before 1981 and after 1993.

Hitting Rock Bottom

Twenty-seven years ago, "downtown Asheville was a virtual wasteland. Most of the buildings were uninhabited, few people lived in town, and fewer still came downtown."[4] Seventy-five percent of the buildings stood vacant, and the minimal stirrings of street life and foot traffic included not one but two red-light districts.[5] The demise had been a long time in the making, but the opening of the Asheville Mall in November 1973 marked a real and symbolic acceleration in the physical


North Carolina Division of Tourism, Film, and Sports Development

and emotional abandonment of downtown.[6] As the department stores and other retail operations migrated to the mall over the next decade, downtown Asheville lay on the verge of decay. Former Mayor Louis Bissette recalls, "We used to say, 'You could shoot a rifle down the street any night, and you wouldn't hit a thing.'"[7] Downtown had hit rock bottom.

Asheville attempted to respond to the demise of its downtown. In 1977 the City Council created the Asheville Revitalization Commission. The commission published a revitalization plan in 1978, which noted,

> *The physical and economic condition of downtown Asheville has been unhealthy for several decades. Development of suburban shopping centers increased concern for the downtown's future. Recent construction of three new commercial buildings and a civic center did not seem to significantly improve the overall economic climate. Thus, it became the consensus of business, civic and political leaders that some form of local governmental intervention was needed.*[8]

The plan recommended a "villages concept" to promote the distinct character of the fourteen neighborhoods of downtown. Unfortunately, despite attempts at public participation in development of the plan, sufficient support failed to materialize. Dissatisfaction with downtown continued to build.

Although civic leaders in Asheville had begun to focus on downtown, there were no large-scale successes. Ironically, many people in Asheville point to a large-scale project that failed to be realized, as the watershed event in downtown revitalization. Without the proposal for this project, the efforts to revitalize downtown might well have withered on the vine.

Finding an Effective Catalyst

In 1980 a national developer approached city leaders with a proposal to build a seventeen-acre downtown mall and convention center. The plan, which would have necessitated leveling eleven city blocks in the heart of downtown, promised approximately 700,000 square feet of retail space, a hotel, 125,000 square feet of office space, and 3,500 parking spaces. Total project costs were estimated at $116 million, with the city's contribution pegged at $40 million.[9]

Some people in Asheville embraced this plan, but others cried out against it. Those in favor of it were buoyed by the developer's interest in downtown, and they pointed to the likelihood that the project would bring an increased tax base, more jobs, and many tourist and convention dollars to downtown. Those opposing the plan argued vehemently that it posed untenable losses of historic buildings, and risks to the environment and to small businesses already existing in downtown.

The proposed downtown mall provoked an important debate about the future of downtown and caused the citizens of Asheville to organize and become involved in downtown issues.

An intense civic debate ensued for months. Opponents emerged victorious in 1981 when they succeeded, by a 2-to-1 margin, in defeating a referendum that would have provided general obligation bonds for the project.

The proposed downtown mall provoked an important debate about the future of downtown and caused the citizens of Asheville to organize and become involved in downtown issues. However, in the wake of the referendum, there were deep, open wounds created by fiery, targeted civic discourse. This result was costly in many ways: years of friendships were severed, business relationships ended, and political allies turned on one another. Civic energy was depleted.

Ironically, out of this difficult period emerged an important positive legacy: a catalyzing of the historic preservation movement in Asheville. Loudly and clearly, voters sent the message that they favored saving downtown's existing building stock over constructing new buildings.

In the next twenty-five years, 135 income-producing buildings in Buncombe County were rehabilitated using federal and state tax-credit programs for historic preservation, the largest in number and dollar amount of any North Carolina county.[10] Most of the buildings are in downtown Asheville.

Stepping Out: The City Leads

The day after the 1981 referendum, the city hired Becky Williams (now Becky Anderson) as an economic developer for the Asheville Revitalization Commission. In addition, to respond to the deep divisions created by the referendum, the City Council appointed a Downtown Task Force to provide a forum for the various factions to talk and determine a process for moving the revitalization efforts forward.

The task force eventually recommended the establishment of a commission to focus exclusively on downtown. The City Council agreed and created the Downtown Commission in 1982, charging it to "develop the Central Business District as the region's primary office, retail, hotel and cultural center."[11] Originally the commission consisted of six members appointed by the City Council, plus the entire membership of the City Council itself. The composition changed in 1986 once the council determined that the basic elements of the plan to revitalize downtown were in place.

The change in composition created an opportunity for the council to appoint members who had the single focus of revitalization. Also, it provided an expanded role for the city's local government partner, Buncombe County. Thereafter the commission consisted of two representatives each from the City Council and the County Commission, and three others, two representing the private sector and a chairperson selected from the community. Many nonprofits and citizen groups were affiliated with and provided support for the commission.[12]

The commission's powers were direct and broad.[13] To carry out its purpose, the council gave the commission "the power to do all things, subject to limitations as may be imposed by the North Carolina General Statutes or by the ordinances of the City of Asheville, necessary and convenient to carry out the purposes of the Commission for the public welfare."[14]

Building the Capacity to Lead and Manage a Renaissance

Asheville's City Council took further decisive and unified action to ensure that the emerging vision and affinity for downtown would be implemented and sustained.[15] In April 1986 the council appointed Douglas Bean as manager of Asheville. Bean's hiring reflected a top priority of the council: hiring a manager with revitalization experience. Bean had led the successful downtown revitalization effort in Morganton, North Carolina, and had a reputation for bringing disparate interests together.

Almost as soon as he began the job, Bean realized that the private sector was neither organized nor leading the revitalization. Clearly the city would have to create a strong, coordinated effort to rejuvenate the downtown. Consequently Bean created a new city department, the Downtown Development Office (the name "Office" was intentionally used so as to seem less bureaucratic). With guidance from the commission, the Downtown Development Office was to serve as a catalyst for the public and private sectors as well as to be part of, and support for, a broader system of downtown groups.[16]

Within six months of his appointment as city manager, Bean selected Leslie Anderson, a coauthor of this article, to head the office.[17] Anderson went on to serve almost ten years as director of Downtown (and later City) Development.

After several years the Downtown Development Office moved from city hall to a storefront on a street that was formerly the "Fifth Avenue of Asheville." The office thus served as the physical hub of downtown revitalization activity.[18] It also served as the nonphysical hub. Downtown Development Office staff played a variety of roles, including project managers, planners, business recruiters, matchmakers, nonprofit managers,

The Griffin under construction.

Scott Dedman, Mountain Housing Opportunities, Inc

cheerleaders, party-givers, fundraisers, parking managers, marketers, and dreamers. The office had responsibility for coordinating projects and communicating with all partners and the general public. The staff coordinated some city projects directly, assisted other city departments in their projects, and supported allied organizations in their activities.

The city manager recommended that the revitalization effort incorporate the successful Main Street model of the National Trust for Historic Preservation. Although Asheville was too large to become a Main Street city, Downtown Development Office staff and volunteers availed themselves fully of the program's resources by attending conferences, studying the publications, and visiting thriving towns that had used the model. Task forces of citizens worked to put plans in place for each of the Main Street model's four arenas: economic restructuring, design, organization, and marketing/promotion.

Three of the Downtown Development Office's roles were particularly instrumental, albeit subtle. First, the office coordinated a large volunteer program that was inclusive and hands-on. It integrated people into an extensive array of responsibilities in the public and private sectors—for example, writing design guidelines, educating the public, organizing a historic walking trail, determining how to get big projects rolling, and working through political barriers.

Second, the Downtown Development Office responded to, and leveraged the skills and the influence of, civic leaders in Asheville. Chief among the advocates espousing high aspirations for downtown's development was the vocal and articulate Roger McGuire. McGuire and others fostered community conversations about the unique purpose and value of downtown. As former Asheville City Manager Bean said,

> *Roger was downtown's chief salesman. Roger preached, cajoled, worked, criticized, and wrote about what needed to happen. He was the conscience of downtown. He invested his own resources in downtown, brought experts to town, and challenged the city, informally and formally. Roger forced the city to choose higher standards than were natural for the city.*[19]

A third key role of the Downtown Development Office was to create the proper business-related climate for success. From the mid-1980s through the early 1990s, the availability of commercial and governmental incentives and tools was limited. Local banks were rarely inclined to make loans for renovation of downtown properties, and if they did, they required unrealistic amounts of collateral. To lower barriers, the Downtown Development Office responded in nonbureaucratic, entrepreneurial, and creative ways to any obstacle preventing private investment in downtown. Staff provided marketing analysis for businesses, served as their liaison to and advocate with other city departments, shepherded ordinance changes, expedited reviews and processes, and matched investors, property owners, and lessees. Staff generally opened doors and solved problems. They worked "outside the box" a lot.[20]

Strengthening the Public-Private Partnership

From the beginning, perhaps growing out of the severe division of the early 1980s, public-private partnership prevailed as the organizing principle for sustaining the revitalization. Key stakeholders determined that the Downtown Development Office should have a limited number of staff, thereby forcing the office to create opportunities for other city departments and groups outside of city government to be players.[21]

Soon after the 1986 reorganization of the Downtown Commission, the commissioners realized that although the commission consisted of community leaders and government representatives interested in and committed to downtown, few of them owned property or businesses downtown. Recognizing that revitalization needed to include those who would be most affected by the downtown efforts and had a financial stake in the outcome, they initiated creation of a private-sector partner, the Asheville Downtown Association (ADA). Over the next year, a citizens group studied models from other cities, and within a year the ADA held its first meeting (in June 1987). It formed as a 501(c)(6) organization, with its own board of directors and work priorities.

The city, through the Downtown Development Office, nurtured the development of the ADA. ADA staff were on the city's payroll for about a decade and were a part of the Downtown Development Office team. This created a symbiotic relationship that provided dedicated staff to pursue the merchants' interests while the city received input directly from the merchants. The arrangement "enabled the organization to get a lot accomplished and served both sides well. The merchants had direct access to a city department head and the Downtown Development Office had merchants who would help bolster their efforts to renovate buildings and attract businesses downtown."[22]

"They needed us and we needed them," said Mary Fierle, of the Development Office.[23]

Downtown merchants, property owners, advocates, and entrepreneurs were a crucial new addition to the cast of players. The ADA organized marketing and promotion efforts, supported leasing and business recruitment, and led problem-solving initiatives. It also was a recruiter and a conduit for community involvement. As Ashly Maag, one-time ADA director, said, "We were a hybrid organization: the city's private-sector partner and a voice and advocate to the city from the private side."[24]

Walking the Talk

The city determined that just as private-sector support for the revitalization effort needed to be broad-based, so did public-sector support. Municipal govern-

The Federal Housing Credit Program

An integral aspect of government's role in revitalizing downtowns is ensuring the availability of high-quality affordable housing. In addition to providing much-needed life after 5:00 P.M., affordable housing allows employees to live close to work and creates income diversity in the face of gentrification. One of the resources available to help local governments achieve these outcomes is the federal low-income housing tax credit—Housing Credit, for short—the nation's largest and most successful affordable-housing program. The Housing Credit brings governments, financial institutions, and developers together in a public-private partnership to create or rehabilitate rental housing for households that are at or below 60 percent of the area's median income. In Buncombe County, where Asheville is located, this is equal to $30,240 for a four-person household and a maximum housing expense of $600 plus utilities for a two-bedroom unit.

National Church Residences

Scaffolding on Battery Park Apartments in downtown Asheville during National Church Residences' recent renovation of the 122-unit former hotel.

ment reinvested in public property at a level of quality conducive to excellent development. The city kept city agencies downtown, created civic amenities, supported downtown events, paid for appropriate studies, improved public properties, and encouraged its employees to use downtown merchants. The city also constructed three new parking decks downtown, implemented a streetscape plan, created two Urban Redevelopment Areas, and supported creation of the Urban Trail. Perhaps the most symbolic of the city's efforts occurred with acquisition and rehabilitation of an old building in the revitalization area that became the Downtown Development Office.

In addition, the city manager conducted frequent walking tours with department heads, during which he encouraged coordination of downtown projects across departments. He made clear his expectation that each department would contribute to the revitalization, and he insisted that accountability for achieving the vision be built into department work plans and staff performance reviews.

The city convinced other levels of government also to walk the talk. Garnering county support was relatively easy. County government leaders, having participated in the Downtown Commission and the planning exercises, recognized that locating county agencies downtown would stimulate development and improve both the image and the tax base of the area. For county leaders, there could be no justifying the "standing concrete" of vacant buildings and their anemic contribution to the tax base.

City school officials were similarly supportive. When the school board needed to lease new central office space, it did so in a newly rehabilitated, prominent downtown building, although suitable less expensive space was probably available elsewhere in the city.[25]

County government leaders, having participated in the Downtown Commission and the planning exercises, recognized that locating county agencies downtown would stimulate development and improve both the image and the tax base of the area.

Reaping the Positive Results

The Downtown Development Office managed a festivals program that included Bele Chere (pronounced "Bell Share"), a festival encompassing the entire center city during the last full weekend in July. Today Bele Chere attracts more than 350,000 visitors, and in 2005 the festival's direct total spending was estimated to be $12.4 million.[26]

Events like Bele Chere were central to the downtown program, as evidenced by the marketing plan's positioning statement: "Downtown Asheville is the entertainment capital of the region [western North Carolina]."[27] Community-oriented events such as Light Up Your Holidays, Moonlight over Downtown, Tell It in the Mountains, Downtown after 5, Oktoberfest, July Fourth festivities, and First Night Asheville

In North Carolina overall, there are 1,500 Housing Credit properties, with more than 40,000 units. Each year the state allocates about $160 million in Housing Credits, which results in the annual addition, on average, of 40 properties and 2,500 units. Currently, Asheville is home to 17 Housing Credit properties, with a total of 1,121 units.

The program creates affordability through the Internal Revenue Code, otherwise known as the federal income tax statute. A full explanation of the Housing Credit is beyond the scope of this article. Following is a greatly simplified example:

- A sixty-unit property requires $5 million in total costs to acquire and develop.
- The property generates a $3.6 million reduction in federal income tax liability.
- In exchange for this tax credit, an investor contributes $3.2 million in equity.
- This equity replaces debt that would otherwise be necessary for construction.
- Payments on a $1.8 million loan ($5 million minus $3.2 million) are much lower than those on a $5 million loan, and these savings are passed along to the tenants.

The North Carolina Housing Finance Agency (NCHFA) is responsible for administering the Housing Credit program in this state. NCHFA is a self-supporting public agency with a mission to create affordable housing opportunities for North Carolinians whose needs are not met by the market. NCHFA awards Housing Credits through a highly competitive process.

Downtown Revitalization

The primary purpose of the Housing Credit program is to make investments in real estate that serves the housing needs of low-income families and individuals. However, NCHFA also is committed to helping local governments improve their communities. NCHFA's rental policies and practices demonstrate this commitment. Since 2000, more than one-third of North Carolina's federal Housing Credits have been awarded to proposals that have directly assisted in revitalizing neighborhoods. These properties have made a difference in more than fifty municipalities across the state.

Following are four fundamental principles for local government officials and nonprofit organization leaders to keep in mind when considering the use of Housing Credits for a downtown improvement effort:

1. Housing Credit properties are privately owned businesses. As with any prospective business, owners need to be certain that there is a market for their product—in this case, renters. Because the product is real estate, the other criterion owners should consider is location.

NCHFA's most frequent investment-related concern regarding site and market in downtowns is that Housing Credit properties not be the first activity in a neighborhood. Such properties are not suitable as "sparks." Instead, they were all launched from the mid-1980s to the early 1990s so that residents would come downtown, have fun, and see the progress.

The festivals also served an important organizational development function: they were a training ground for new and emerging leaders and allowed the city to celebrate its unique quality of life and civic spirit.

Far beyond the cultural and economic value of festivals such as Bele Chere, Asheville stands as an impressive example of what an economically viable downtown can mean to the tax base of an entire city and county. In 1982, one year after the beginning of the concerted efforts to revitalize downtown, the total value of property in the Central Business District was $48,237,500. In 2004, after more than twenty years of concerted work and tens of millions of dollars of private investment in the buildings, the taxable value was $386,834,500, an increase of 702 percent.[28] If an acre of land with improvements in downtown is compared with an acre of land with improvements in a rural or suburban area, today the value of Central Business District property per acre to Buncombe County's average tax yield is $44,887 per acre for Central Business District mixed-use, three- or four-story condominiums (with first-floor commercial use), versus only $1,716 and $1,236 per acre for city and county residential property, respectively.[29] The density adds residents to the city without increased costs for infrastructure.

Because of the city's foresight and commitment to the Central Business District, positive results abound. The approach of preservation and adaptive reuse honored Asheville's history, saved historic buildings, and provided unique spaces for entertainment, offices, living, and civic amenities. Twenty years after the formation of the Downtown Commission, downtown Asheville enjoys an explosion of new, urban construction, especially residential. Residents living downtown (in Census Tract 1) increased from 819 in 1990 to 1,351 in 2000.[30] In 2006 and 2007, four hundred apartments and condominium units will come on the market.[31] One challenge ahead is to provide affordable workforce housing. Only a small percentage of the upcoming units are moderately priced. Attracting developers to this niche is difficult (for information about a helpful resource, see the sidebar on page 8).

Business offerings of all types have expanded, including an increase from 2 galleries in the mid-1980s to 30 today and from 6 minority-owned businesses to 22-plus today. There is more than one million square feet of office space downtown, representing about 50 percent of all office uses within the city. There also are 200 retail shops, 80 restaurants and bars, 25 music venues, 12 churches and religious organizations, 5 museums, and 5 theaters.[32]

A Theory of Change

Examining the Asheville story in retrospect, one can discern the course of action that created downtown Asheville's resurgence. More difficult to ascertain is how those actions fit into a broader theory of economic change. If downtown development, like other economic

should complement other efforts. Having surrounding revitalization efforts well under way provides assurance that NCHFA's investment will not be the only one.

2. NCHFA's evaluation of proposed sites for new construction also looks to the other half of the purpose stated earlier: helping improve the lives of low-income households. Would the property be a nice place to live for senior citizens or families with children? In other words, does it make sense to create housing units at this location?

The site criteria assess whether the location has a neighborhood feel and ask about the quality and the proximity of surrounding shopping, services, and other amenities. Using the criteria, NCHFA staff apply penalties for problematic features. Downtown and infill areas often compete well in this evaluation. Concerns do arise when there is an expectation that economically vulnerable households will serve as residential pioneers, the only people inhabiting an area.

For rehabilitation proposals the concerns are very different than for new construction proposals because the question of whether to create housing already has been answered. Thus the quality-of-life issue for existing properties is whether the proposal will help those living in the worst conditions. NCHFA encourages rehabilitation of distressed projects, which can be part of the reason an area is in need of revitalization. The changes result in visible physical improvements and, in some cases, better management.

3. Every locality in North Carolina has access to federal funds for housing and community development. Adding these funds as additional sources for Housing Credit properties can make the difference between a successful project and one that struggles.

There are two ways to use these funds. The first is by offering below-market financing, which reduces the debt-service burden on the property and thus the burden on the tenants. The monthly payments on a loan with a 6 percent interest rate and a twenty-year term are twice as high as those on one with a 2 percent rate and a thirty-year term. For a sixty-unit property with a $1.8 million loan, the difference is $218 per unit per month in tenant rent versus $111 per unit per month—or $1,284 per year, a significant amount for low-income households.

The second use for local funds is to improve the area surrounding a proposed site. Repairing dilapidated homes, clearing abandoned structures, adding sidewalks, and building parks are among the many eligible activities that assist in the Housing Credit award process.

4. NCHFA always welcomes opportunities to work with local governments. The key is to communicate at an early stage in planning. At that point, NCHFA staff and prospective applicants can discuss how state policies fit with local priorities.

Properties in Asheville

Downtown Asheville offers several examples of successful Housing Credit properties representing both new construction and rehabilitation. Two of the most recently awarded projects are The Griffin and Battery Park Apartments.

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development, must play on the unique context of each community, can other communities draw specific lessons from Asheville's experience? We think so.

The public-sector strategy for transforming Asheville's downtown reflects broad principles of effective leadership of change initiatives, which have implications beyond downtown redevelopment. As evidence, we point to the symmetry between the activities of Asheville's leaders and the principles for effective change set out by Harvard Business School Professor Rosabeth Moss Kanter. Although the city's leaders did not consider Kanter's work or any other explicit theory of change as they breathed new economic life into their downtown area, their actions strongly correlate with Kanter's theory. The parallels suggest that, whether change strategies are driven by the public sector or the private sector or both, and whether they are intentionally linked to change theory or not, effective ones call for certain essential ingredients.[33]

On the basis of her research on change theory, Kanter argues that leaders of effective change initiatives must set the direction, define the context, and help produce coherence. Leaders also must manage the culture, or at least the vehicles through which that culture is expressed. They must set the boundaries for collaboration, autonomy, and the sharing of knowledge and ideas; give meaning to events that otherwise appear random and chaotic; and inspire voluntary behavior—effort, innovation, and entrepreneurship.[34]

More particularly, Kanter suggests, leaders must ensure that their change efforts are doing the following:

- Tuning in to the environment
- Challenging the prevailing organizational wisdom
- Communicating a compelling aspiration
- Building coalitions
- Transferring ownership to a working team
- Learning to persevere
- Making everyone a hero

Tuning in to the Environment

Kanter writes, "As a leader you can't possibly know enough, or be in enough places to understand" everything that you need to know to give direction to your work.[35] She therefore suggests the strategy of creating listening posts—ways to actively collect information that suggests new approaches. Asheville did just that.

At the Asheville Revitalization Commission, the newly hired Williams received the following charge: "Be an ombudsman, an information mover, a presence in downtown, and spread the message: 'The city cares.'"[36] Ken Michalove, then the city manager, instructed Williams to eat breakfast every morning with someone about prospects for downtown, alternating companions between the two downtown-mall factions.

The city's tradition of setting up multiple and various types of listening posts continued into the mid and late 1980s. When the Downtown Development Office started, staff visited each business downtown and collected the concerns and the ideas of its employees. When

National Church Residences

Residents and guests exploring the restored ballroom during the grand reopening of Battery Park Apartments.

the time came to order new street furniture, organizers set up choices of benches, trash receptacles, and streetlights for people to try, and asked them to vote for their favorites. Organizers conducted "charrettes" (intense, creative work sessions) to gain input on the future of downtown. As the planning department's urban design planner picked up news about significant changes in the downtown environment, she shared it and took action. The city introduced a mounted police program that aided both public safety and community relations. All staff spent a lot of time with their feet on the street (and their eyes and ears alert).

Challenging the Prevailing Organizational Wisdom

According to Kanter, successful leaders of change develop "kaleidoscopic thinking," a way of constructing patterns from the fragments of data available, then manipulating them to form different patterns. This kind of thinking allows leaders to question their own assumptions about the correct solution to a problem.

Asheville set out to question its own and others' assumptions about how to develop downtown, and to explore a range of solutions to downtown's problems. The city sponsored ventures to other cities, asking voyagers to return with fresh ideas.[37] Also, local nonprofits brought experts to Asheville to share their experiences. When the French Broad River Garden Club sponsored a workshop and talk by Mary Means, the first director of the National Main Street Center of the National Trust for Historic Preservation, more than 500 people attended.[38]

The city was armed with new possibilities, but it was sobered by the realization that an even broader cross-section of community residents needed to grasp the stubborn problems of a decaying downtown and appreciate how a renewed downtown could advance their interests. As one strategy, in 1985 the city began a planning process for writing a new citywide comprehensive plan. The process, named Alternatives for Asheville, involved hundreds of participants from diverse perspectives and factions and resulted in the adoption of the Asheville City Plan 2010. The plan called for a revitalized downtown that would be the regional center of western North Carolina.

Communicating a Compelling Aspiration

Kanter writes, "You cannot sell change, or anything else, without genuine conviction, because there are so many sources of resistance to overcome."[39] At least initially, people tend to respond to change efforts with attitudes such as "We've tried it before, and it didn't work." To counter this resistance, the city and other advocates went to great lengths to communicate a consistent vision that illustrated the history, the desires, and the decisions of the city.

Out of the discourse emerged a vision that set a high yet attainable standard:

> *Renaissance Asheville—A downtown that functions for commerce through a rich mix of business types . . . projects an image of Asheville as a small, progressive Southern City . . . pulses with activity throughout the*

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The Griffin is a fifty-unit property located on Grove Street in the city's central business district, close to the businesses and luxury condominiums of the Grove Arcade. Construction will be completed in fall 2006. The developer is Mountain Housing Opportunities, Inc., a local nonprofit with broad experience in housing.

As a proposal, The Griffin earned one of the highest site and market scores ever in North Carolina—148 out of a possible 155 points. In addition to Housing Credits, the property will benefit from $426,000 in below-market financing from local government sources. The average rent will be under $450 per month (plus utilities).

Battery Park Apartments is a well-known 122-unit marquee property on Battle Square, also located in the central business district. The developer, National Church Residences, budgeted $30,300 per unit in construction costs to rehabilitate the existing structure, which was not severely distressed but was in need of improvement and modernization. Local governments made a loan of $225,000 and issued a $6.7 million tax-exempt bond. Equity for the Housing Credits covered the remaining costs. The grand reopening was held in August 2005.

Conclusion

With the right planning, federal Housing Credits are a powerful tool for downtown revitalization. By combining real estate fundamentals, quality-of-life considerations, local support, and early communication, local governments can strategically direct this resource for everyone's benefit.

—*Mark Shelburne*

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An architectural rendering of The Griffin.

Andrew Spaulding, Reinhardt Architecture, Inc.

day and evening . . . beckons and comforts children and older adults . . . honors our heritage, history, and mountain landscape . . . complements the high quality of life of the area . . . entices with its diverse offerings in fine dining, cultural opportunities, housing and retail . . . projects a strong, compelling sense of place—commitment to quality in details, authentic design, pedestrian oriented, urban character . . . [T]he social, financial, cultural, governmental, psychological, economic center of western North Carolina[,] which is open to diverse and creative possibilities yet unseen.[40]

To breathe life into the vision, city staff employed a variety of strategies. With the local newspaper, they produced monthly inserts promoting the vision of downtown as a viable district and giving updates on the progress of development. They conducted "hard hat tours" (tours of construction sites), organized unified retail-sales campaigns, told the downtown story at numerous gatherings, and gave away hundreds of toy yellow hard hats. Working with the Tourism Development Authority, they launched a marketing campaign for tourists with the theme, "Come See Downtown Revitalization in Action."

Building Coalitions

Kanter says that change leaders need the involvement of people who have the resources, the knowledge, and the clout to make things happen. In the early stages of planning, leaders must identify key supporters and sell their dream with the same passion and deliberation as entrepreneurs sell their products.

Understanding that public-private partnerships were pivotal to successful revitalization, the primary players immediately began working actively to foster such relationships. The Downtown Development Office served as the hub for them.

Coordination of the various partners occurred through the Downtown Commission. The commission was a forum for discourse, and it monitored and encouraged constant forward momentum and progress on projects. It supervised the creation and the implementation of the annual Downtown Action Plan. Members used their relationships and influence with the City Council to downtown's advantage. The commission also served as a sounding board and an idea incubator for staff.

The final key piece of the tripartite coalition was the ADA. It served as a liaison between the city and the downtown business community, and it provided much-needed private-sector support for the city's revitalization endeavors.

Transferring Ownership to a Working Team

Kanter asserts that a leader's job is to support the team, provide coaching and resources, and patrol the boundaries within which the team must operate freely. The city proved to be a masterful leader in its downtown revitalization effort.

One of the Downtown Development Office's first exercises was the construction of a sociogram. The visual representation of all the groups involved in downtown improvement and their relationship to one another clearly instructed the leadership about a chronic problem: there were too many groups independently doing their part and not related or connected. These realities led to the crafting of a public-private partnership model that was functional, trim, flexible, inclusive, manageable, and, ultimately, successful at building civic forces for change. Implementation of this model would not have occurred, however, without the leadership, the funding, and the sponsorship of city government.

The City Council, the city manager, and the Downtown Commission expected the Downtown Development Office to take the lead in creating a partnership environment within the revitalization program. They also expected that ultimately this partnership, rather than the city exclusively, would sustain the revitalization. Thus the continuing charge for the Downtown Development Office was "Orchestrate and coordinate the revitalization of downtown Asheville through a public-private partnership."[41]

By the mid-1990s, because of several factors, it was imperative that a transition occur to position the private sector as the dominant player. One project that assisted this transition was dubbed the Downtown Advantage. The city, the ADA, and certain developers worked together to tout the economic benefits of investing in downtown and locating there. Through a resource guide, newsletters, brochures, media stories, speaking engagements, and advertising, the campaign was promoted.

Learning to Persevere

As Kanter acknowledges in her study, "Every idea, especially if it is new or different, runs into trouble before it reaches fruition."[42] Forecasts run short, diversions are likely, momentum will slow, and critics will emerge. Former City Manager Bean readily admits that the city underestimated the resources needed to revitalize its downtown.[43] There also were diversions such as political squabbles, developer bankruptcies, and feelings in some neighborhoods that they had been left out. Momentum stalled.

Asheville had applauded its advantage in having elected officials and advocates in local government in partnership with the private and nonprofit sectors to transform downtown. However, as Kanter predicts, critics, skeptics, and cynics began to challenge the city by the early 1990s. Naysayers, led by the local Council of Independent Business Owners, criticized the city's involvement in real estate and business development, and the amount of city resources being dedicated to downtown.

As Kanter declares, "Roads curve." The downtown development effort was forced to navigate around roadblocks. For instance, to combat the negative statements by critics, advocates developed the Mythbusters campaign. The myths, rumors, and incorrect information circulated about downtown were restated and refuted with facts.

The backlash continued, however. The ads of certain candidates for City Council called the city's emphasis and investments in downtown a waste. Four new members of the seven-member City Council were elected in 1993. The surprising first action of a coalition of two new and two continuing council members was to fire Bean. Under a new city administration, the amount of city resources dedicated to downtown was diminished. The Downtown Development Office was absorbed by other city departments, and its clout and scope were diminished. Several staff left the city's employment. Within a few years the ADA became totally independent of the city. The Downtown Commission, however, continued its work.

All these changes were followed by a period of minimal investment, starting in 1995.[44] Two years later, though, development rebounded and then soared, buoyed by the strong, early momentum, the intentional transition to the private sector, and attractive investment opportunities. Redevelopment continued, fueled by significant investment by the private sector.

Making Everyone a Hero

Kanter cautions that remembering to recognize, reward, and celebrate accomplishments is critical to the success of any change effort. Asheville took many opportunities to celebrate the success of those laboring to transform downtown.

The ADA and the Downtown Development Office created the Downtown Hero awards. Periodically they would single out volunteers for unselfish contributions to the downtown effort. Each person received a large gold medallion on wide red ribbon, and the media and ADA publications acknowledged his or her contributions. The Preservation Society of Asheville/Buncombe County bestowed its Griffin Awards on owners and developers who rehabilitated and preserved historic buildings to high standards. Some people used donations to the Urban Trail to honor downtown contributors. Staff and volunteers organized open houses to show off new residences, offices, and galleries. The series of festivals and events held downtown showcased the district and celebrated progress made.

The city and the ADA made it a point to recognize their partners—dozens of people—who were the change agents of downtown. More recently the community has focused its recognition and appreciation primarily on a small number of private-sector catalysts.

Conclusion

The Asheville experience in downtown revitalization illuminates the success that is possible when a local government takes a leadership role in addressing a problem, while taking care to be inclusive and to engage key stakeholders continuously.

Asheville's leaders were clear that only a civic force including the private, not-for-profit, and public sectors would be strong enough to reverse decades of downtown decay and dysfunction. To rescue downtown Asheville for future generations, city leaders sought to create, but not to be the sole extent of, a human structure and culture needed to support downtown development. They understood that the city had to build a system larger than municipal government and innovate from within it.

Without a doubt many private- and nonprofit-sector leaders played pivotal roles in Asheville's downtown revitalization. However, describing the city's specific role in the revitalization makes its effective leadership immediately apparent and establishes the consistency of that role with characteristics set forth more generally for change efforts.

Notes

1. Century 21, Welcome to Asheville, North Carolina, available at www.century21asheville.com/About_Asheville_NC/page_262864.html (last visited Jan. 30, 2006).

2. Eugenie L. Birch, Who Lives Downtown (Washington, D.C.: Brookings Inst., 2005). During the 1990s, downtown populations grew by 10 percent. In contrast, downtown populations declined by 10 percent in the 1970s and stagnated (changed by only – 0.1 percent) in the 1980s.

3. Interview by Leslie Anderson and Anita Brown-Graham with L. Ted Prosser, President, Landmark Management, in Asheville (Apr. 2004).

4. Jennifer Carlile, Working Title, *A Downtown Mainstay Marks 20 Years of Independence*, Mountain Xpress (Asheville), May 29–June 4, 2002, at 42.

5. Alexandra J. Vrtunski, The Downtown Revitalization of Asheville, North Carolina: A Model from the Mountains (1999) (unpublished master's thesis, University of North Carolina at Chapel Hill) (on file with Leslie Anderson).

6. *Asheville Mall Opens Officially Tomorrow Morning*, Asheville Citizen-Times, Nov. 22, 1973, at 2. The official opening date was November 23, 1973, but some stores opened as early as January 1972.

7. Interview by Leslie Anderson and Anita Brown-Graham with Louis Bissette, Former Mayor, City of Asheville, in Asheville (Apr. 2004).

8. Asheville Revitalization Comm'n, A Revitalized Downtown—Citizen's Summary of the Asheville Revitalization Plan 6 (1978) (unpublished report, on file with the Asheville Planning Dep't).

9. Vrtunski, The Downtown Revitalization.

10. Interview by Leslie Anderson with John Horton, Former Restoration Specialist, Office of Archives & History, N.C. Dep't of Cultural Resources (Jan. 2005).

11. Asheville City Code, Ordinance 1287 (1982).

12. Active groups included the Asheville Downtown Association, the Preservation Society of Asheville/Buncombe County, the Asheville Area Arts Council, Asheville-Buncombe Discovery, the Asheville Urban Trail, and Bele Chere festival trustees.

13. Asheville City Code, Ordinance 1287, Asheville Downtown Commission (1982), replaced by Ordinance 1567 (1986). The commission could do the following:
- Enter into contracts with the approval of City Council
- Recommend land development policies to City Council
- Recommend public policy changes
- Identify urban design criteria
- Promote and facilitate downtown living
- Facilitate, and act as a liaison for, significant catalytic projects
- Actively encourage the involvement of the private sector and private capital
- Develop financial tools to provide financing for downtown redevelopment projects
- Identify developers/investors for downtown development
- Assist in business retention
- Develop overall development policy for downtown
- Prepare and recommend a Master Plan

14. Asheville City Code, Ordinances 1287 (1982), 1567 (1986).

15. The City Council made other efforts to involve the right people with the right set of skills. For example, to get the ball rolling and to provide an outside perspective, in 1983 the city hired the consulting firm of Zuchelli, Hunter & Associates. Its scope of work was to test the market and propose viable concepts and primary development sites. It brought Southeastern Historic Properties, developers from Winston-Salem, to the table. Other developers consulted the Zuchelli, Hunter & Associates market study as they considered investing in Asheville. Among them was Estelle Schneider of Schneider Nine, who initiated the large Pack Plaza project (and later defaulted). These outsiders were the first in a succession of important external players in this era of downtown Asheville's renaissance.

16. When the Downtown Development Office was launched, the recently appointed Downtown Commission was active in setting the charge, choosing the director, and leading the agenda.

17. The Downtown Development Office eventually consisted of a staff of five, including

the director, support staff, the festivals manager, and the Asheville Downtown Association manager. The city's parking function merged into the department early in the office's existence. That operation included about twenty-five people, full- and part-time. In addition, the office coordinated, nurtured, and managed approximately 1,500 invaluable volunteers.

18. The physical office was purposely designed to be transparent, with no blinds or curtains, so that people on the street could see the activity taking place inside, days, nights, and weekends. People could, and often did, drop in informally to see how things were progressing. Leslie Anderson.

19. Telephone Interview by Leslie Anderson with Douglas Bean, Former City Manager, City of Asheville (May 2, 2005).

20. Leslie Anderson, Personal Notes from City Council Orientation (Dec. 1993).

21. Initially there were just three people on the staff: the director, an administrative assistant, and a festivals manager, who implemented all the city's major events, most of which were held downtown.

22. Vrtunski, The Downtown Revitalization, at 15.

23. Interview by Leslie Anderson with Mary Fierle, Former Business Development Coordinator, City Development Office, City of Asheville, in Asheville (Jan. 2006).

24. Interview by Leslie Anderson with Ashly Maag, Director, Asheville Downtown Ass'n (1992–1995), in Asheville (Dec. 2004).

25. Asheville was not beyond using a stick to get support from other governments when a carrot failed. It uncovered little-known state statutes and federal executive orders and used them to remind the state and federal governments of their obligations to locate public agency offices in historic downtown areas. In North Carolina, House Bill 1151, entitled An Act to Promote the Acquisition by the State of Buildings and Space in Buildings Having Historic, Architectural or Cultural Significance, passed the 1977 session of the General Assembly and became Section 146-23.1 of the North Carolina General Statutes. That policy was used to leverage state government leases in the newly renovated Pack Plaza. The city worked with the Pack Plaza developer to seek leases for state agencies and challenged a competitor who had previously been awarded state leases for his shopping center south of town. The appeals went all the way to the North Carolina Council of State. The council voted to award the leases to Pack Plaza in support of the policy expressed in the state statute, and denied the proposed leases outside downtown. A similar strategy was used with federal government buildings and leases under federal Executive Order 12072. In one example, the city and its partners were successful in getting the National Climatic Data Center and attendant offices to vacate the center's beautiful and historic Grove Arcade building in favor of more public uses, remain downtown, and build a prominent new federal building. These strategies used public policy and relationships to the advantage of both the public and the private sector and produced a creative tension that served a positive purpose.

26. Parks and Recreation Dep't, City of Asheville, Report to City Council and the Community, Bele Chere 2005 (Jan. 2006) (unpublished report, on file with the Parks and Recreation Dep't).

27. Downtown Development Office—A Public/Private Partnership 2 (handout for a City Council presentation) (Nov. 1993) (on file with Leslie Anderson).

28. These data provide a snapshot of market value on January 1, 1982, compared with market value on January 1, 2004, as determined by the Buncombe County Tax Office. Therefore they are not adjusted for inflation. Interview by Leslie Anderson with Gary Roberts, Buncombe County Tax Assessor, in Asheville (Jan. 2006). Since 1982 the boundary of the Central Business District has expanded. The current taxable value of that area is $637,272,200. Interview by Leslie Anderson with Stephanie Monson, Urban Planner, Office of Economic Development, City of Asheville, in Asheville (Feb. 2006).

29. Interview by Leslie Anderson with Jamie Metsch, Planning Technician, City Development Office, City of Asheville, in Asheville (Dec. 2004).

30. Interview by Leslie Anderson with Brett Satz, Information Systems Specialist, Data Center Affiliate, & Webmaster, Land of Sky Regional Council, in Asheville (Feb. 2006).

31. Interview with Monson.

32. City Development Office, City of Asheville, Downtown Asheville, North Carolina 13 (Asheville: the Office, 2005).

33. Kanter's theory of change is based on her extensive research on change in the private sector, rather than on change led by the public sector. In comparing Asheville's actions with Kanter's change theory, this article also tests the generalizabilty of Kanter's theory.

34. Rosabeth Moss Kanter, *The Enduring Skills of Change Leaders,* 13 Leader to Leader 15 (1999), available at http://leadertoleader.org/leaderbooks/l2l/summer99/kanter.html. In a separate, seminal work on economic development, Kanter argues that for cities and regions to thrive in the global marketplace, they must possess both magnets and glue. Magnets are assets that attract a flow of external resources—new people or companies—to expand skills, broaden horizons, and hold up a comparative mirror against world standards. Glue, on the other hand, is a way of bringing people together to define common good, create joint plans, and identify strategies that benefit a wide range of people and organizations. Clearly Kanter's model of thriving communities begs the question of how a community moves from being one that flounders to one that flourishes economically—the question of how a community develops magnets and glue. *See* Rosabeth Moss Kanter, *Thriving Locally in the Global Economy,* Harvard Business Review, Aug. 2003, at 119.

35. Kanter, *The Enduring Skills.*

36. Interview by Leslie Anderson with Becky Williams Anderson, Former Economic Developer, Asheville Revitalization Comm'n, in Asheville (Dec. 2004).

37. A local nonprofit organized a bus trip that took community leaders to nearby Winston-Salem to learn about the arts and downtown, and then to Roanoke, Virginia. Roanoke, Asheville's sister city at the other end of the Blue Ridge Parkway, is known for its success with Center in the Square, in the heart of downtown, where a variety of arts resources are located. Community leaders in both locations taught and inspired Asheville leaders. This trip also facilitated team spirit and generated many ideas, including what became Pack Place Education, Arts & Science Center on Pack Square. The City Council took a trip to Greenville, South Carolina, and also studied Charlotte's Fourth Ward project. All these cities were ahead of Asheville in their revitalization.

38. In addition, Asheville-Buncombe Discovery, a now-defunct nonprofit, sponsored presentations by Robert McNulty, of Partners for Livable Places, Washington, D.C., and Mayor Joseph Riley, of Charleston, South Carolina, during this period.

39. Kanter, *The Enduring Skills.*

40. Downtown Development Office, City of Asheville, Asheville Downtown: 2010 Action Plan 1 (Asheville: DDO, Jan. 1991).

41. Leslie Anderson, Personal Archives. Several priorities were present from the beginning:

- Actively engage downtown merchants and property owners in revitalization. Create a private-sector partnership
- Bring to fruition the downtown plans outlined in Asheville City Plan 2010
- Use the Main Street model and its reliance on historic preservation and other resources to implement programs that work
- Build an active pool of volunteers engaged in downtown activities
- Facilitate rehabilitation and development of downtown buildings by property owners, investors, and developers
- Create interlocking interests and accountabilities among all the groups interested in downtown
- Produce a few, quick visible victories—completed projects

42. Kanter, *The Enduring Skills.*

43. Interview with Bean.

44. Downtown Development Office, City of Asheville, An Update on Downtown Asheville (Asheville: DDO, 2003).

Schools' Legal Obligations to Gay Students

Laurie L. Mesibov

Schools should be safe places. Students who are safe, respected, and valued are more likely to learn and achieve than students who are not.[1] Current North Carolina statutes and policies express the same view—for example:

> *The General Assembly finds that all schools should be safe, secure, and orderly.*[2]

> *It is the priority of the State Board of Education to provide each and every student in North Carolina's public schools and public charter schools with a safe, orderly, and caring learning environment that is free from harassment, bullying, and discrimination.*[3]

> *Character education must be incorporated into the standard curriculum and should address several traits. Two of these traits are respect . . . and kindness.*[4]

> *Local school boards are encouraged to include instruction on students' responsibility for school safety and for helping to create a harmonious school atmosphere . . .[,] and for cultivating an orderly learning environment . . . .*[5]

These statements apply to all schools and to each and every student. "Each and every" includes students who are not heterosexual, are not perceived as heterosexual, or are unsure of their sexual orientation, as well as the vast majority of students who are heterosexual. It also includes "transgendered" students—that is, those who feel that their gender does not correspond to their biological sex.

An increasing number of young people are openly identifying themselves as gay, lesbian, bisexual, or transgendered.[6] Other young people are questioning their sexual orientation or gender identity.[7] Not surprisingly, controversies involving sexual orientation and gender identity have sprung up in public schools across the country. Controversies may occur over peer harassment of students based on real or perceived sexual orientation; First Amendment issues, including dress codes; or establishment of a gay/straight alliance.

Controversies involving sexual orientation and gender identity have sprung up in public schools across the country. School officials are being called on to explain and defend their responses in court, in the media, and in their community as well as at school.

School officials are being called on to explain and defend their responses in court, in the media, and in their community as well as at school. School officials' responses are likely to be appropriate if school boards have reviewed their policies with these controversies in mind. In addition, school boards must take affirmative steps to stop known harassment of gay students, both to prevent injury and avoid potential liability, and to provide students with a safe learning environment. Attention to these issues helps students learn and achieve and also may affect rates of dropping out, substance abuse, depression, homelessness, and poor health.

Sexual orientation and gender identity are complicated issues for many school officials and employees. Some wish that

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schools could ignore these issues altogether. Others want more acknowledgment of and support for gay students. Still others have strong religious beliefs or private feelings that seem to be at odds with their public obligations.

The issues also are complicated because schools do not exist in a vacuum. Issues related to gay students occur partly in response to conditions external to schools.

In recent years, significant changes have occurred in health professionals' views of sexual orientation, in popular culture, in businesses seeking both customers and employees, in political discourse, in some religious institutions, and in the number of gay parents involved in their children's education. Across the country, some states, political subdivisions, and school boards have adopted nondiscrimination statutes, ordinances, or policies. Many universities, private organizations, and corporations have adopted similar policies. (For guidance from professional associations on sexual orientation and youth, see the sidebar on page 18.)

Changes have taken place in the legal culture too, with increases in the number of openly gay attorneys, the number of advocacy groups, the amount of pro bono work done by lawyers, and the number of law school courses dealing with issues affecting gay people. Further, the law itself has evolved, most notably with two Supreme Court decisions based on the Fourteenth Amendment to the Constitution. In the first decision, the Court said that the Equal Protection Clause does not permit a state to prohibit all legislative, executive, or judicial action, at any level of state or local government, designed to protect homosexual persons.[8] In the second decision, the Court held that the Due Process Clause protects homosexual acts by consenting adults in the privacy of their

Guidance from Professional Associations on Sexual Orientation and Youth

Barbara L. Frankowski and Committee on Adolescence (American Academy of Pediatrics), *Sexual Orientation and Adolescents,* 113 Pediatrics 1827 (2004), available at http://pediatrics.aappublications.org/cgi/content/full/113/6/1827 (last visited June 5, 2006)

Excerpts

Young people whose sexual orientation is not heterosexual can have risks to their physical, emotional, and social health, primarily because of societal stigma, which can result in isolation. . . .

. . . .

Human sexual orientation most likely exists as a continuum from solely heterosexual to solely homosexual. . . . The mechanisms for the development of a particular sexual orientation remain unclear, but the current literature and most scholars in the field state that one's sexual orientation is not a choice . . . .

. . . .

. . . . If their environment is critical of their emerging sexual orientation, these adolescents may experience profound isolation and fear of discovery, which interferes with achieving developmental tasks of adolescence related to self-esteem, identity, and intimacy. . . .

. . . .

Nonheterosexual youth are represented within all populations of adolescents, all social classes, and all racial and ethnic groups. . . .

. . . .

. . . . It is critical that schools find a way to create safe and supportive environments for students who are or wonder about being nonheterosexual or who have a parent or other family member who is nonheterosexual.

Just the Facts about Sexual Orientation & Youth: A Primer for Principals, Educators and School Personnel (Washington, D.C.: American Psychological Association, 2006), available at www.apa.org/pi/lgbc/publications/justthefacts.html (last visited June 5, 2006)

This publication was developed and is endorsed by the American Academy of Pediatrics, the American Counseling Association, the American Association of School Administrators, the American Federation of Teachers, the American Psychological Association, the American School Health Association, the Interfaith Alliance Foundation, the National Association of School Psychologists, the National Association of Social Workers, and the National Education Association.

Excerpts

Sexual orientation is one component of a person's identity. . . .

Sexual behavior does not necessarily equate to sexual orientation. . . .

Gay, lesbian, and bisexual adolescents follow a developmental path that is both similar to and different from that followed by heterosexual adolescents. All teenagers face certain developmental challenges . . . . Gay, lesbian, and bisexual youth must also cope with prejudiced, discriminatory, and violent behavior and messages in their families, schools, and communities. Such behavior and messages negatively affect the health, mental health, and education of lesbian, gay, and bisexual young people. These students are more likely than heterosexual students to report missing school due to fear, being threatened by other students, and having their property damaged at school. . . .

For these reasons, the experience of gay, lesbian, and bisexual teenagers is often one of isolation, fear of stigmatization, and lack of peer or familial support. . . . Because of their legitimate fear of being harassed or hurt, gay, lesbian, or bisexual youth are less likely to ask for help. Thus, it is important that their environments be as open and accepting as possible, so these young people will feel comfortable sharing their thoughts and concerns. To be able to provide an accepting environment, school personnel need to understand the nature of sexual orientation development and be supportive of healthy development for all youth.

Dealing with Legal Matters Surrounding Students' Sexual Orientation and Gender Identity (Nat'l Sch. Bds. Ass'n, n.d.), available at www.nsba.org/site/docs/34600/34527.pdf (last visited June 5, 2006)

This publication provides practical guidance on schools' legal rights and responsibilities with respect to students, programs, and curriculum.

homes, with the result that adults may not be criminally prosecuted in these circumstances.[9]

This article's goal is to introduce a rapidly developing area of education law, not to review all relevant issues and cases.[10] The law is still developing and expanding, and laws differ from one jurisdiction to another. No reported case has involved a North Carolina school. North Carolina does not have a state statute barring discrimination on the basis of sexual orientation, and most school boards have no policy protecting gay students (or employees) against discrimination.[11] At the same time, gay students attend school in every jurisdiction, and some may face situations similar to ones that have led to lawsuits in other places (for an example, see the sidebar on page 21). Understanding the law helps school board members and employees meet their responsibilities and helps the larger community understand the constraints within which school officials must make decisions. The following discussion of peer harassment, First Amendment issues, and gay/straight alliances is intended to promote that understanding.[12]

Peer Harassment Based on Actual or Perceived Sexual Orientation

Although every case has different facts, the story lines are remarkably similar. A student who is gay or perceived to be gay alleges that he or she has been subjected to harassment by other students, ranging from teasing to severe physical assault. The student reports that harassment to school officials, who do not adequately respond. Their inadequate response allegedly causes injury to the student. The student then sues, claiming a violation of Title IX, the Equal Protection Clause, the Due Process Clause, or some combination of them.

Several cases have decided only whether a particular lawsuit may proceed. Such cases still may be resolved before a trial, be withdrawn, be settled, or go to trial. Settlements may involve damages, attorneys' fees, court costs, policy review and modification, and instructions for students and training for employees. Settlements may be substantial.

Title IX Claims

Title IX of the Education Amendments of 1972 prohibits discrimination on the basis of sex in any education program that receives federal financial assistance.[13] It applies to all public elementary and secondary schools. One kind of prohibited discrimination is sexual harassment.[14] In *Davis v. Monroe County Board of Education*, the U.S. Supreme Court spelled out the elements required for a school board to be liable for student-student harassment under Title IX.[15] When student-student sexual harassment is alleged, Title IX permits a student to recover damages from a school board when (1) the school board has actual knowledge of the harassment, (2) the board acts with deliberate indifference to known acts of harassment, and (3) the harassment is so severe, pervasive, and objectively offensive that it effectively bars the victim's access to an educational opportunity or benefit. The Court limited any liability to circumstances in which the school board exercises substantial control over both the harasser and the context in which the known harassment occurred.

Jesse Montgomery, a student in Minnesota, sued his school district for its alleged failure to respond when he informed them that he was harassed because of his gender and perceived sexual orientation.[16] He claimed that he was subjected to daily harassment by his peers—name-calling, pushing, kicking, tripping, punching, and grabbing—from kindergarten through the tenth grade, when he transferred to another district. Montgomery further claimed that the harassment infringed on his access to significant portions of the educational environment because to avoid harassment, he stayed home sometimes, did not participate in sports, and tried not to use the cafeteria, the school bathroom, and the school bus. He reported the incidents of harassment to a variety of school officials, including teachers, bus drivers, principals, counselors, and personnel in the superintendent's office. Some school officials did not respond. Others did respond, but Montgomery claimed that their responses were inadequate.

The court identified as a key issue the defendant's argument that the harassers were motivated by hostility to homosexuals, not by sexual desire. Because Title IX prohibits discrimination based on sex, not sexual orientation, a student cannot bring an actionable claim under Title IX for discrimination based solely on sexual orientation or perceived sexual orientation.[17] However, the court ruled, Title IX could be construed to prohibit discrimination based on the claimant's failure to meet stereotypes associated with his or her sex. Thus, Montgomery's lawsuit was allowed to proceed.[18]

This Title IX theory of gender stereotyping was successful in a recent case from Kansas. Dylan Theno sued his school district on the basis of the district's alleged deliberate indifference to same-sex harassment while Theno was in junior and senior high school. The court denied the district's motion for a ruling in its favor before trial.[19] The case went to trial, and the jury returned a $250,000 verdict against the district. The district then asked the court to enter judgment in its favor in spite of the verdict. The court denied this motion.[20]

The court explained that the trial record contained adequate evidence for the jury to have found that (1) Theno was harassed because of his gender—that is, because he did not conform to stereotypical gender expectations for a teenage boy in his community; (2) the harassment was so severe, pervasive, and objectively offensive that it effectively denied his access to educational opportunities or benefits; and (3) the school district acted with deliberate indifference to known acts of harassment. The court noted, "The record reflects that a sufficiently significant number of school administrators essentially turned a blind eye to the harassment by ignoring, tolerating, or trivializing the harassment."[21]

Equal Protection Claims

In cases of student-student harassment, equal protection claims arise when a school district allegedly treats same-sex harassment differently from opposite-sex harassment (offering more help in opposite-sex situations) or treats harassment of males differently from harassment of females (offering more help to females).

Nabozny v. Podlesny was the first case to rely on an equal protection theory to grant relief to a gay student subjected to peer harassment at school.[22] Starting in the seventh grade, Jamie Nabozny was open about his sexual orientation. He alleged that this resulted in persistent verbal and physical harassment by his peers. Nabozny repeatedly reported the problems to counselors and principals and a school police liaison, but the problems, including serious physical assaults, continued for years. He claimed that his two suicide attempts and post-traumatic stress disorder were caused by the situation at school and the failure of school officials to respond properly to his requests for help.

Nabozny sued, alleging that the school denied him equal protection of the laws on the basis of gender and sexual orientation. To succeed, he had to show intentional or purposeful discrimination. Nabozny presented evidence that the school district responded more aggressively to complaints of male-female sexual harassment than to his own complaints of male-male sexual harassment. The court found that a school district's departure from its established policy of punishing perpetrators of (female-male) harassment may establish discriminatory intent. A two-day trial followed, resulting in a jury verdict for Nabozny. After the verdict the school district and Nabozny settled the case for more than $900,000.[23] At least two other federal courts have adopted the *Nabozny* rationale.[24]

Due Process Claims

Some gay students have attempted to use the Due Process Clause of the Fourteenth Amendment to impose liability on school boards for failure to address peer harassment.[25] They have not been successful because courts have ruled that local school administrators have no affirmative due process duty to protect students from other students.[26]

Some gay students have attempted to use the Due Process Clause of the Fourteenth Amendment to impose liability on school boards for failure to address peer harassment. They have not been successful because courts have ruled that local school administrators have no affirmative due process duty to protect students from other students.

However, in *Nabozny* (discussed earlier), the court left the door open for a due process claim in some future case. Nabozny alleged that because the school district did not punish the students who harassed him, the district increased the risk that he would be harmed, and therefore the district had an affirmative duty to protect him. The court did not find sufficient evidence that the district's actions placed Nabozny in danger or increased any preexisting danger. However, the court did not rule out the possibility that the Due Process Clause might apply if a plaintiff's evidence showed that the school created a risk of harm or exacerbated an existing risk.

First Amendment Issues

In some situations, schools may take adverse actions against students who are open about their homosexuality, encourage students to hide their homosexuality, regulate attire that has references to sexual orientation, or make other decisions based on a student's expressed homosexuality. In these circumstances the board may find itself facing a lawsuit alleging infringement of the student's First Amendment rights.

Dress Codes

Local boards of education in North Carolina are required to adopt a reasonable dress code for students.[27] Their authority to determine what is reasonable is limited by students' First Amendment rights. The First Amendment protects student dress only if it communicates a message that is understood by others and so is properly considered "speech." Most private (non-school-sponsored) student speech at school may be restricted by boards only if they can show that the speech would materially and substantially interfere with discipline at school or the rights of others (or could reasonably be forecast to do so).[28]

In *Chambers v. Babbitt*, a high school student in Minnesota wore a T-shirt that said "Straight Pride" on the front and bore a symbol of a man and a woman holding hands on the back. He was told not to wear it again because it offended some students and because of safety concerns.

Elliot Chambers sued and asked for a preliminary injunction declaring that the principal's decision violated his First Amendment right to express his religious beliefs. Although the school presented evidence of incidents that reflected tension around the issue of homosexuality, the court granted him a preliminary injunction against the principal's ban of the shirt.[29] The court noted that maintaining a school community of tolerance includes tolerance of such viewpoints as expressed by "Straight Pride" as well as tolerance of homosexuality.

In April 2002, Natalie Young, a middle school student in New York, was sent home for the day when she refused to change her "Barbie Is a Lesbian" T-shirt. Young sued the school district, claiming that she had a First Amendment right to wear the shirt. The suit was settled for $30,000.[30]

Speech about Homosexuality

In *Henkle v. Gregory*,[31] a gay student appeared on a local television show discussing the experiences of gay high school students. Following the broadcast, Derek Henkle alleged that he was regularly harassed by his classmates during school hours. He reported the problems but allegedly was told to keep his sexuality to himself and to remove buttons supporting homosexuality from his backpack. He was reassigned to an alternative high school, where, Henkle alleged, the principal told him to "stop acting like a fag." He was transferred to a third high school and again told to keep his homosexuality to himself. Then he was transferred yet again to an adult education program at a local community college.

Henkle sued, claiming that school officials tried to suppress his constitutionally protected speech and then retaliated against him for engaging in it. The court allowed his claims to go forward. Henkle's case ultimately was settled (for $451,000), so the court never resolved the First Amendment issues.[32] However, the settlement did include a requirement that the school district amend its policy on student expression to include a statement that students' freedom of expression includes the right to discuss their sexual orientation and issues related to sexual orientation at school (subject, of course, to limitations imposed on other non-school-sponsored student speech).

Gay/Straight Alliances

"Gay/straight alliances" are student-initiated groups that include students irrespective of sexual orientation working together to improve the school climate for gay students and promote respect for all students.[33] These alliances (and clubs with similar aims that go by other names) exist in secondary schools across the country.[34]

A federal statute, the Equal Access Act (EAA), has come to play the key role in defining a school's obligation to students seeking to create an alliance.[35] If the statute applies, it prohibits a secondary school from discriminating against student-initiated groups on the basis of "the religious, political, philosophical or other content" of their speech.[36] The EAA covers only secondary schools that receive federal funds and choose to create a "limited open forum" by allowing one or more non-curriculum-related student groups to meet on school premises during noninstructional time.[37] A school board that allows only curriculum-related clubs is not affected by the EAA.[38]

The EAA has been the basis for successful lawsuits by students attempting to establish gay/straight alliances when school boards have attempted to deny them recognition as official noncurriculum clubs.[39] Students' claims of EAA violations have been allowed to proceed in at least six cases. The court ruled in favor of the school district in only one case.[40] In that case, students wanted to post fliers containing links to Internet

Recent Developments in North Carolina

Opposition to a Gay/Straight Alliance

When students at South Rowan High School established a Gay/Straight Alliance early in 2006, many community members and some outside organizations strongly opposed the action. On April 10 the Rowan-Salisbury Board of Education voted 7-0 "to adopt a board policy to ban all sexually oriented clubs, gay/straight or otherwise, and to address any student emotional issues concerning the above with our guidance counselors, if the creation of the club would materially and substantially interfere with the orderly conduct of educational activities within the school" (pp. 3–4 of the minutes). Many people and media reports apparently assume that this motion automatically bans the alliance. However, it is not yet clear whether that is the motion's effect or whether any formal legal challenge will be made to the board's action if the board bans the alliance.

Minutes of the school board meeting summarize the discussion. They are available at www.rss.k12.nc.us/BOE/0506BOEMnts/BOE4-10-06.pdf (last visited June 14, 2006).

Problems Described in School Climate Reports

In 2005 the Gay, Lesbian and Straight Education Network's Research Department published *From Teasing to Torment: A Report on School Climate in North Carolina*, which is based on student interviews conducted in December 2004. Students reported frequently hearing homophobic and sexist remarks as well as negative remarks about gender expression. They also reported hearing "biased" language from some faculty and school staff, and said that some faculty and school staff did not intervene when they heard biased language from students. Some students reported that they were bullied, called names, or harassed because of personal characteristics, especially their physical appearance, actual or perceived sexual orientation, or nontraditional gender expression. Also, according to the report, some school employees did not take "appropriate action" when students reported harassment or assault. The report is available at www.glsen.org/cgi-bin/iowa/all/news/record/1881.html (last visited June 14, 2006).

Safe Schools NC is a statewide partnership of organizations and individuals dedicated to eliminating bullying, harassment, and discrimination on the basis of actual or perceived sexual orientation and gender identity in North Carolina schools. It recently published a report on homophobic language and verbal harassment in high schools, based on student reports at six high schools in Orange, Durham, and Wake counties. The report also makes recommendations for schools. It is available at www.safeschoolsnc.com/Docs/SafeSchoolsNC-Research-Report-2006.pdf (last visited June 14, 2006).

sites that contained sexually explicit material and to educate students about safe sex, AIDS, and hatred, as well as to establish an alliance. The school district had an abstinence policy for all students. The court ruled in favor of the district before trial, explaining that sexually explicit material available through links on a website and the goal of discussing sex fell within the purview of "indecent speech," which could be barred on the campus without violating either the First Amendment or the EAA. The court found that restrictions on student-initiated clubs made because of concerns about safety, potential harassment based on sexual orientation, and interference with teaching the curriculum are valid under the EAA.

Unless unusual facts justify a departure from the general rule, a school subject to the EAA must allow students to establish a gay/straight alliance on the same terms as it allows students to establish other non-curriculum-related clubs. Although equal access is not required if the student group itself substantially interferes with the school's ability to maintain order and discipline, a school may not deny equal access to a gay/straight alliance merely because of concerns about opposition from within the school or from the community.

Conclusion

In responding to these new developments, school boards and employees are best guided by old principles of fairness and neutrality. School officials' behavior that might have been unchallenged in the past may now become the basis for a legal challenge. Even if that does not happen, the impact on students and others of the handling of controversies involving sexual orientation is real. Everyone benefits from having safe, welcoming schools where teachers and students can concentrate on teaching and learning.

Notes

1. Three of many possible references substantiating this statement are as follows: Stefanie DeLuca & James E. Rosenbaum, Are Dropout Decisions Related to Safety Concerns, Social Isolation, and Teacher Disparagement? (Northwestern Univ., Dec. 2000), available at www.civilrightsproject.harvard.edu/research/dropouts/dropouts_papers.php (last visited Mar. 19, 2006); Jeffrey Grogger, *Local Violence and Educational Attainment*, 32 JOURNAL OF HUMAN RESOURCES 659 (1997); and Harris Interactive, Inc. & Gay, Lesbian & Straight Education Network, From Teasing to Torment: School Climate in America. A Survey of Students and Teachers (2005), available at www.glsen.org/cgi-bin/iowa/all/library/record/1859.html (last visited Mar. 19, 2006).

2. N.C. GEN STAT. § 115C-105.45 (hereinafter G.S.).

3. N.C. State Bd. of Educ., *Policy SS-A-007* (July 1, 2004), in POLICY MANUAL (Raleigh: NCSBE) (emphasis added), available at http://sbepolicy.dpi.state.nc.us/ (follow "NCSBE Policy Manual Table of Contents" hyperlink; then follow "SS Series" hyperlink; then follow "SS-A" hyperlink (last visited Mar. 12, 2006).

4. G.S. 115C-81(h).

5. G.S. 115C-81(h1).

6. This article uses the term "gay" to cover gay, lesbian, and bisexual students. Issues specific to transgendered students are not discussed.

7. "Sexual orientation refers to an individual's pattern of physical and emotional arousal . . . In contrast, gender identity is the knowledge of oneself as being male or female." Barbara L. Frankowski and Committee on Adolescence [of the American Academy of Pediatrics], *Sexual Orientation and Adolescents*, 113 PEDIATRICS 1827 (2004), available at http://pediatrics.aappublications.org/cgi/content/full/113/6/1827 (last visited Mar. 12, 2006).

8. Romer v. Evans, 517 U.S. 620 (1996).

9. Lawrence v. Texas, 539 U.S. 558 (2003).

10. Significant issues beyond the scope of this article include harassment of employees, state tort claims, and criminal law.

11. I know of 2 (of 115) school boards in North Carolina, Chapel Hill–Carrboro City Schools and Guilford County, that have adopted policies prohibiting discrimination on the basis of sexual orientation or gender identity. There may be others, but the number still would be very small.

12. A new resource, Public Schools and Sexual Orientation: A First Amendment Framework for Finding Common Ground, recommends a process for dialogue about gay students. This document has been endorsed by the American Association of School Administrators, the Association for Supervision and Curriculum Development, BridgeBuilders, Christian Education Association International, the First Amendment Center, and the Gay, Lesbian & Straight Education Network. It is available at www.firstamendmentcenter.org/PDF/sexual.orientation.guidelines.pdf (last visited Mar. 19, 2006).

13. 20 U.S.C.A. § 1681(a) (2003).

14. "Sexual harassment is unwelcome conduct of a sexual nature . . . [and] can include unwelcome sexual advances, requests for sexual favors, and other verbal, nonverbal, or physical conduct of a sexual nature. Sexual harassment of a student can deny or limit, on the basis of sex, the student's ability to participate in or to receive benefits, services, or opportunities in the school's program." U.S. DEP'T OF EDUC., OFFICE FOR CIVIL RIGHTS, REVISED SEXUAL HARASSMENT GUIDANCE: HARASSMENT OF STUDENTS BY SCHOOL EMPLOYEES, OTHER STUDENTS, OR THIRD PARTIES: TITLE IX (Washington, D.C.: OCR, 2001), available at www.ed.gov/offices/OCR/archives/shguide/index.html (last visited Mar. 12, 2006).

15. Davis V. Monroe County Bd. of Educ., 526 U.S. 629 (1999). For a comprehensive discussion of harassment issues, *see* OFFICE FOR CIVIL RIGHTS, U.S. DEP'T OF EDUC. & NAT'L ASS'N OF ATT'YS GEN., PROTECTING STUDENTS FROM HARASSMENT AND HATE CRIME (Washington, D.C.: OCR, 1999), available at www.ed.gov/offices/OCR/archives/Harassment/harassment.pdf (last visited Mar. 12, 2006). Page 6 of this document has a useful checklist of steps in a comprehensive approach to dealing with harassment.

16. Montgomery v. Indep. Sch. Dist. No. 709, 109 F. Supp. 2d 1081 (D. Minn. 2000); *see also* Henkle v. Gregory, 150 F. Supp. 2d 1067 (D. Nev. 2001); Doe v. Perry Cmty. Sch. Dist., 316 F. Supp. 2d 809 (S.D. Iowa 2004).

17. Most claims of sexual harassment involve a heterosexual student who alleges harassment by a student of the opposite sex. A gay student subjected to same-sex harassment also may bring a claim of discrimination based on sex.

18. A student whose school fails to address peer harassment may seek an administrative remedy under Title IX. In 1998, William Wagner filed a sex discrimination complaint with the U.S. Department of Education's Office for Civil Rights (OCR), the agency responsible for enforcing Title IX. Wagner alleged that school officials did not address harassment. OCR investigated and created an enforcement agreement that required the school district to recognize various forms of sexual harassment, including sexual harassment directed at gay students, and to revise its policies on sexual harassment, develop procedures, and conduct inservice training for faculty, staff, and students, with written progress reports due to OCR through June 1999. Commitment to Resolve, Fayetteville Pub. Sch., OCR Case No. 06971182 (June 8, 1998). For a discussion of this complaint, *see* Joan E. Schaffner, Recent Development, *Approaching the New Millennium with Mixed Blessings for Harassed Gay Students*, 22 HARVARD WOMEN'S LAW JOURNAL 159, 205 (1999).

19. Theno v. Tonganozie Unified Sch. Dist. No. 464, 377 F. Supp. 2d 952 (D. Kan. 2005).

20. Theno v. Tonganozie Unified Sch. Dist. No. 464, 394 F. Supp. 2d 1299 (D. Kan. 2005).

21. *Id.* at 1311.

22. Nabozny v. Podlesny, 92 F.3d 446 (7th Cir. 1996).

23. *See* Lambda Legal Defense and Education Fund, Nabozny v. Podlesny: Victory, www.lambdalegal.org/cgi-bin/iowa/cases/record?record=54 (last visited Mar. 12, 2006). Nabozny also alleged that the school district intentionally discriminated against him on the basis of his sexual orientation. The court agreed that homosexuals are an identifiable minority and used the existence of a Wisconsin statute expressly prohibiting discrimination on the basis of sexual orientation to show that the school was aware that homosexuals were an identifiable minority. Therefore, to rebut Nabozny's claims, the school district would have to show that it had some rational basis for its conduct. The court could find no rational basis for permitting one student to assault another student on the basis of the victim's sexual orientation.

24. *Montgomery*, 109 F. Supp. 2d 1081; Flores v. Morgan Hill Unified Sch. Dist., 324 F.3d 1130 (9th Cir. 2003). *Flores* was settled for approximately $1 million. Press Release, Morgan Hill Unified Sch. Dist. (Jan. 6, 2004) (on file with author). Some school districts have argued that a gay student cannot pursue both Title IX and constitutional claims based on the same set of facts, on the theory that Title IX's remedies preclude a constitutional claim.

25. *Montgomery*, 109 F. Supp. 2d 1081.

26. In a case from North Carolina that involved an injured student but did not involve sexual orientation as an issue, the court agreed with this general rule. Stevenson v. Martin County Bd. of Educ., 93 F. Supp. 2d 644 (E.D. N.C. 1999), *aff'd*, 8 Fed. Appx. 25, 2001 WL 98358 (4th Cir. 2001) (unpublished per curiam), *cert. denied*, 534 U.S. 821 (2001).

27. G.S. 115C-391(a).

28. This standard was established in Tinker v. Indep. Sch. Dist., 393 U.S. 503 (1969). Two other Supreme Court cases also set out limits on student speech: Bethel Sch. Dist. No. 403 v. Fraser, 478 U.S. 675 (1986), authorizes schools to discipline students for offensively lewd and indecent speech. Hazelwood Sch. Dist. v. Kuhlmeier, 484 U.S. 260 (1988), sets out limits on schools' regulation of the content of speech that is, or is reasonably perceived to be, sponsored by the school.

29. Chambers v. Babbitt, 145 F. Supp. 2d 1068 (D. Minn. 2001).

30. Vanessa Juarez, *They Dress to Express*, NEWSWEEK, Oct. 4, 2004, at 62.

31. Henkle v. Gregory, 150 F. Supp. 2d 1067 (D. Nev. 2001).

32. Press Release, Lambda Legal Defense and Educ. Fund, Groundbreaking Legal Settlement Is First to Recognize Constitutional Right of Gay and Lesbian Students to Be Out at School & Protected from Harassment (Aug. 28, 2002), available at www.lambdalegal.org/cgibin/iowa/documents/record?record=1119 (last visited Mar. 12, 2006).

33. Some opponents of alliances say that the groups intend to recruit students to a "gay lifestyle," but alliances themselves do not identify this as a goal.

34. A state-by-state listing of gay/straight alliances is available at the Gay, Lesbian & Straight Education Network's website, www.glsen.org/cgi-bin/iowa/student/student/index.html (last visited Mar. 12, 2006). In March 2006 the network listed nearly fifty gay/straight alliances in North Carolina public and private schools. Melissa Weiss, executive director of Safe Schools North Carolina, says that her organization hopes to see a gay/straight alliance started in every Triangle-area high school and middle school. Mindy B. Hagen, *Gays, Straights, Allies at Riverside*, HERALD SUN (Durham), Nov. 28, 2004, at B1.

35. 20 U.S.C. §§ 4071–74 (1999).

36. 20 U.S.C. § 4071(a) (1999).

37. In 1990 the U.S. Supreme Court upheld the constitutionality of the EAA and set out criteria for courts and schools to use in determining whether a group is curriculum related. Bd. of Educ. of Westside Cmty. Sch. v. Mergens, 496 U.S. 226, 239–240 (U.S. 1990). A student group relates directly to a school's curriculum if (1) the subject matter of the group is actually taught in a regularly offered course, (2) the subject matter of the group concerns the body of courses as a whole, (3) participation in the group is required by a regularly offered course, or (4) participation in the group results in academic credit. A court will look at a school's practice, as well as its formal policy, in making that determination.

38. Students in this situation may ask the court to rule on a First Amendment claim.

39. East High Gay/Straight Alliance v. Bd. of Educ., 81 F. Supp. 2d 1166 (D. Utah 1999); East High Sch. Prism Club v. Seidel, 95 F. Supp. 2d, 1239 (D. Utah 2000); Collin v. Orange Unified Sch. Dist., 83 F. Supp. 2d 1135 (C.D. Cal. 2000); Gay-Straight Alliance Network v. Visalia Unified Sch. Dist., 262 F. Supp. 2d 1088 (E.D. Cal. 2001); Franklin Cent. Gay/Straight Alliance v. Franklin Township Cmty. Sch. Corp., 2002 WL 32097530 (S.D. Ind. 2002); Boyd County High Sch. Gay Straight Alliance v. Dept. of Educ., 258 F. Supp. 2d 667 (E.D. Ky. 2003). The parties in *Boyd County* entered into a consent decree that required, among other things, that the school put into effect written antiharassment policies and conduct diversity training for staff and students. A significant portion of the training was about issues of sexual orientation and gender harassment. The student training was mandatory, and failure to attend resulted in an unexcused absence. Several students and parents sued the school board, alleging that the school's policies and practices violated their right to free speech, equal protection, and free exercise of religion, as well as the parents' right to direct the ideological and religious upbringing of their children. The court, ruling on pretrial motions, rejected these claims. Morrison v. Bd. of Educ. of Boyd County, 419 F. Supp. 937 (2005).

40. Caudillo v. Lubbock Indep. Sch. Dist., 311 F. Supp. 2d 550 (N.D. Tex. 2004).

Financing Government: Revenue Variability and the Role of Rainy-Day Funds

Gary A. Wagner

The term "financing government" can take on a variety of interpretations regarding the services that government *should* provide and how it *should* raise revenue. Further, given that raising revenue is a basic function of government, people's perception of taxes plays a major role in shaping their political values. What is taxed, how much, and who is affected has been a central part of public policy debates since colonial times.

The 2001 recession, which followed the longest period of continuous growth in U.S. history, refocused attention on these important issues. In North Carolina in 2002, Governor Mike Easley created the Commission to Modernize State Finances. He charged it with ensuring that "the state's revenue system [is] more stable, fair and sufficient over the long term."[1] The commission recommended specific reforms in many sources of tax revenue, including the sales, use, individual income, and corporate income taxes.

The prospect of financing government requires dealing with both the long- and the short-term changes in economic activity. Understanding how different revenue sources react to the economy and what potential trade-offs may exist is beneficial.

The goal of this article is not to address how the government should raise revenue nor to advocate for or against any particular tax reforms. Rather, it is to deepen readers' understanding of the issues involved in the long-term sufficiency (or sustainability) of different revenue sources for state governments, the short-run stability (or variability) of revenue, and associated strategies that may be used to lessen the sting of recessions. Specifically the article discusses the composition of

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Table 1. **State Government Revenue Sources, Fiscal Year 2002–2003**

Source	All 50 States Amount (in millions)	All 50 States % of Total	North Carolina Amount (in millions)	North Carolina % of Total
Tax revenue	$548,991	42	$15,849	53
Federal aid	361,617	28	10,279	34
Current charges	106,357	8	2,560	9
Utility and liquor store revenue	17,036	1	0	< 1
Insurance trust revenue	166,274	13	– 128	< 1
Miscellaneous revenue	95,384	7	1,484	5
Total revenue	**$1,295,659**	**100**	**$30,043**	**100**

Source: U.S. Census Bureau, State Government Finance, available at www.census.gov/govs/www/state.html. Current charges include a wide array of charges for such activities as the sale of milk and school lunches; student or parent payments for transportation and tuition; revenue from athletic contests; fees of state schools for the blind, deaf, and handicapped; fees and tuition from state vocational-technical schools; fees related to public hospitals; reimbursements for street construction and repairs; fees from toll roads, bridges, ferries, and tunnels; state parks and recreation fees; and fees from sanitation and solid waste management.

Note: These data may not coincide with a given state's definitions of the categories listed in the table. The categories reflect the definitions of the Census Bureau and are designed to be compatible over time and across states.

Table 2. **Shares of State Government Revenue Contributed by Taxes, Fiscal Year 2002–2003**

Tax	All 50 States Share of Total Revenue (%)	All 50 States Share of Tax Revenue (%)	North Carolina Share of Total Revenue (%)	North Carolina Share of Tax Revenue (%)
Property	0.81	1.91	0.00	0.00
Individual income	14.04	33.14	23.60	44.73
Corporation net income	2.19	5.17	2.99	5.67
Estate and gift	0.52	1.22	0.44	0.83
Other	0.91	2.16	0.13	0.25
Sales and gross receipts	21.13	49.88	22.47	42.60
General sales	14.25	33.62	13.33	25.27
Selective sales	6.89	16.25	9.14	17.33
Alcoholic beverages	0.34	0.80	0.66	1.26
Amusements	0.35	0.82	0.04	0.07
Insurance premiums	0.97	2.28	1.39	2.63
Motor fuels	2.49	5.88	3.85	7.30
Public utilities	0.81	1.92	1.07	2.03
Tobacco products	0.89	2.09	0.14	0.27
Other	1.02	2.40	1.99	3.78
Licenses	2.77	6.53	3.12	5.91
Alcoholic beverages	0.03	0.06	0.04	0.08
Amusements	0.02	0.04	0.00	0.00
Corporation	0.47	1.12	1.04	1.97
Hunting and fishing	0.09	0.21	0.05	0.09
Motor vehicle	1.24	2.92	1.39	2.63
Motor vehicle operators	0.13	0.31	0.24	0.45
Public utility	0.03	0.07	0.00	0.00
Occupation and business	0.72	1.70	0.36	0.68
Other	0.04	0.10	0.01	0.02

Source: U.S. Census Bureau, State Government Tax Collections, available at www.census.gov/govs/www/statetax.html.

North Carolina's revenue, examines the long- and short-run elasticities of various revenue sources, and addresses the role of rainy-day funds and savings in mitigating recessions.

Economic Activity and Trends in Tax Revenue

Economic activity in the United States and North Carolina tends to grow over time, but the growth is not steady and predictable. Short-term disruptions in economic activity (which are called "business cycles") occasionally push the amount of economic activity temporarily above its average rate of growth (creating a boom) or temporarily below its average rate of growth (causing a recession). These effects are important from the standpoint of financing government because sources of revenue are connected to both the average rate of growth and the business-cycle swings in the state's economy.

To complicate matters, two revenue sources may react quite differently to changes in the state's economy over the long or short term. Also, a single revenue source, such as the corporate income tax, may react differently to short- and long-term changes in the state's economy.

Thus the prospect of financing government requires dealing with both the long- and the short-term changes in economic activity. Understanding how different revenue sources react to the economy and what potential trade-offs may exist is beneficial.

Current Sources of Revenue for State Governments

All states derive the majority of their revenue from two sources: federal government aid and "own-source" taxes—that is, their own tax bases (see Table 1). Thus the degree to which tax reform will enhance a state's ability to mitigate long- and short-term financial problems will depend, in part, on the importance of different sources of revenue in the budget process. For example, a small change in a source that constitutes 30 percent of total revenue could have a much more noticeable effect on the budget than a major reform in a source that generates only 4 percent of total revenue.

North Carolina relies more on federal aid and tax revenue than the typical state does, with 34 and 53 percent, respectively, coming from these sources, for a total of 87 percent. For the typical state, federal aid and tax revenue account for 28 and 42 percent, respectively, for a total of 70 percent.

Further, the typical state, at least in 2003, relied less on own-source tax revenue than North Carolina did (42 percent compared with 53 percent) and more on insurance trust revenue (13 percent compared with less than 1 percent). The latter is revenue generated from public employee retirement contributions, workers' compensation contributions, and investments related to these contributions. North Carolina's insurance trust revenue, as defined by the U.S. Census Bureau, accounted for an average of 14 percent of revenue from 1999 through 2002. (The decline to less than 1 percent in 2003 was not due to any major differences between North Carolina and other states. It simply reflected one-time investment losses in that particular year.)

Because own-source tax revenue represents more than half of North Carolina's revenue, it is valuable to examine the specific sources of tax revenue and their relative importance (see Table 2). The most important sources of tax revenue are general sales taxes and individual income taxes. For the typical state, general sales and individual income taxes account for 66.76 percent of tax revenue and 28.29 percent of total revenue. North Carolina is slightly more dependent on these two revenue sources, with 70.00 percent of tax revenue and 36.93 percent of total revenue coming from them in 2003.

The broader category of sales and gross receipts (which includes general sales tax revenue and revenue from selective sales taxes on particular items, such as motor fuels, tobacco products, and alcoholic beverages) contributes 49.88 percent of the typical state's tax revenue and 42.60 percent of North Carolina's tax revenue. The most important selective sales tax is motor fuels, which is 5.88 percent of total tax revenue for the typical state and 7.30 percent of tax revenue for North Carolina.

In the remaining major tax categories, North Carolina mimics the behavior of the average state quite closely. The two largest categories, licenses and corporate income taxes, account for 6.53 and 5.17 percent, respectively, of tax revenue for all states and 5.91 and 5.67 percent of North Carolina's tax revenue.

There are some notable differences between North Carolina and the typical state. For instance, individual income and sales and receipts taxes account for 46.07 percent of total revenue and 87.33 percent of tax revenue in North Carolina, compared with 35.17 percent and 83.02 percent for the typical state. This is an important distinction, for North Carolina depends more on tax revenue than the average state (see Table 1). The state's revenue stream is much less diversified than it would appear to be from analyzing tax revenue. North Carolina has opted to rely much more heavily on the individual income tax than most states do, but because more than half of total revenue for the state comes from own-source taxes, individual income and sales and gross receipt taxes each account for more than 20 percent of the state's total revenue. Thus any tax reforms that target individual income and sales and receipt taxes could have a substantial impact on the state's budget.

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Reforms to other tax revenue sources, such as corporate income, estates and gifts, and licenses, may be desirable or undesirable for a number of reasons. However, such changes will likely have a negligible impact on the state's ability to generate revenue and provide services.

Revenue Variability

"Revenue variability" is a general term that relates to how different sources of revenue react to changes in economic activity. There is a subtle but important aspect of revenue variability that can best be illustrated with a simple example. The revenue generated from a general sales tax depends on (1) the sales tax rate and (2) the tax base. Policy makers frequently change sales tax rates (especially during downturns), so examining how sales tax *revenue* changes over time is not particularly insightful. A rate increase will "bump" revenue beyond where it would have been in the absence of the rate change. However, examining how a *tax base* changes with the state's economic activity reveals how revenue from a given tax would fluctuate if the tax rate remained constant. The tax base is nothing more than the sales of goods and services that are taxed. In North Carolina the sale of nonprescription drugs is subject to the state sales tax, so these items are part of the tax base. In contrast, more than ten states exempt nonprescription drugs from their sales tax bases.

Thus the analysis of revenue variability is really an analysis of tax base variability. Tax bases, which are specific elements of state-level economic activity, such as retail sales or earned income, change as the level of economic activity in a state changes. Most tax bases are "procyclical," which means that they tend to grow as the state's economy grows and contract as the state's economy contracts.

The variability of specific revenue sources can be assessed by estimating their "elasticity," which is a measure of the responsiveness of a given tax base to overall economic activity, expressed in percentage terms. For example, if the elasticity of a given tax base equals 2, for every 1 percentage point increase (or decrease) in a state's economic activity, this tax base will expand (or contract) by 2 percent.

In general, tax base elasticities may be positive, negative, or zero. A positive elasticity means that the tax base is procyclical. A negative elasticity means that the tax base is "countercyclical" (it contracts when overall economic activity expands and expands when economic activity contracts). A zero elasticity implies that the tax base remains con-

Table 3. **Long- and Short-Run Elasticities of Major State Tax Bases**

Tax Base	Long-Run Elasticity	Short-Run Elasticity
Individual income tax	1.215	1.164
Corporate income tax	0.670	3.369
Retail sales	0.660	1.039
Non-food retail sales	0.701	1.377
Motor fuels usage	0.996	0.729

Source: Condensed from Randall G. Holcombe & Russell S. Sobel, Growth and Variability in State Tax Revenue: An Anatomy of State Fiscal Crises tbl. 5.3 (Westport, Conn.: Greenwood Press, 1997). Reprinted by permission.

Note: Figures are estimated using data for all 50 states.

Table 4. **Long- and Short-Run Elasticities of Major North Carolina Revenue Sources and Tax Bases**

Revenue Source or Tax Base	Long-Run Elasticity	Short-Run Elasticity
Total general fund revenue	0.945	0.665
Total tax revenue	1.063	1.223
Individual income	1.023	1.313
Retail sales (excluding food)	0.788	1.436
Retail sales (including food)	0.713	1.407

Source: From Randall G. Holcombe & Russell S. Sobel, Growth and Variability in State Tax Revenue: An Anatomy of State Fiscal Crises tbls. 6.2, 6.4, 7.1, 7.3, 7.4 (Westport, Conn.: Greenwood Press, 1997).

Note: General fund revenue = intergovernmental revenue (primarily federal aid) + tax revenue + current charges + miscellaneous revenue. Tax revenue = general sales taxes + selective sales taxes + license taxes + individual income tax + corporate income tax + all other taxes.

Table 5. **Short-Run Elasticities for Different Income Brackets**

Income Range	Short-Run Elasticity
$0–4,999	0.14
$5,000–$9,999	0.22
$10,000–$14,999	0.32
$15,000–$24,999	0.43
$25,000–$34,999	0.67
$35,000–$49,999	1.08
$50,000–$74,999	1.49
$75,000–$99,999	1.84
$100,000 and up	4.21

Source: Adapted from Richard F. Dye & Therese J. McGuire, *Block Grants and the Sensitivity of State Revenues to Recession*, in Proceedings of the Ninetieth Annual Conference on Taxation, 1997 tbl. 2 (Washington, D.C.: Nat'l Tax Ass'n, 1998).

stant as the overall level of economic activity changes.

A useful feature of assessing revenue options via elasticities is that it is possible to estimate both a long- and a short-run elasticity for a given tax base. The long-run elasticity estimates how the tax base changes relative to a change in overall economic activity over a long period. This indicator provides insights into the long-term sustainability of a given tax. On the other hand, the short-run elasticity measures how the same tax base changes relative to a change in economic activity over a short period, such as one year. This indicator yields information about the role of different taxes in year-to-year revenue swings that are associated with business cycles, and recessions in particular.

A Closer Look at North Carolina

A recent study estimated the long- and short-run elasticities for each major state tax base (individual income, corporate income, retail sales, nonfood retail sales, and motor fuel usage) using combined data for the fifty states and state-level data (see Table 3 for all states, Table 4 for North Carolina). The estimates reflect how the specific tax bases (as opposed to revenue collections) vary with the U.S. economy.

All the elasticities are positive, so these tax bases are procyclical from the perspective of changes in economic activity. Among the long-run elasticities, those of the corporate income tax base and the retail sales tax base (both with and without food) are noticeably less than 1. This observation is important for two reasons. First, the positive elasticity implies that the tax base for these revenue sources will grow over time as the U.S. economy grows, so revenue from these taxes will increase over time even when tax rates are unchanged. However, because the elasticities are less than 1, the increased revenue (resulting from growth of the tax base) will not keep pace with growth in the economy. If the growth in spending matches the long-run growth in the economy (or exceeds it), then regularly increasing the tax rates associated with these revenue sources will be necessary to maintain a balanced budget because revenue from them tends to expand at a slower rate than the state's economy. In contrast, the motor fuel usage and individual income tax bases grow as fast as, or slightly faster than, the economy. A long-run elasticity of 1 or greater means that revenue from these sources will increase at roughly the same pace as the economy (or slightly faster) without additional changes in tax rates.

The short-run elasticities yield a slightly different perspective. With the exception of the elasticity of motor fuel usage, all the elasticities are at least as volatile as, if not more volatile than, the economy as a whole. The short-run elasticity is arguably most relevant for recessions, when economic activity contracts. If economic activity contracts by 2 percent, revenue from sales taxes and individual income taxes will decline by 2 percent (or slightly more) without a change in the tax rates. If food is not part of the sales tax base, then the short-run elasticity of sales tax revenue increases by roughly 20 percent, which means that sales tax revenue will decline even more during a downturn if the tax rate is held constant.

The most volatile revenue source in the short run is the corporate income tax base, which is more than 3 times as volatile as the economy. Thus, a 2 percent increase (or decrease) in economic activity will lead to a 6 percent increase (or decrease) in corporate income tax revenue. From the perspective of maintaining pre-recession government services during downturns, revenue sources with short-run elasticities closer to 0 will generate revenues closer to prerecession levels.

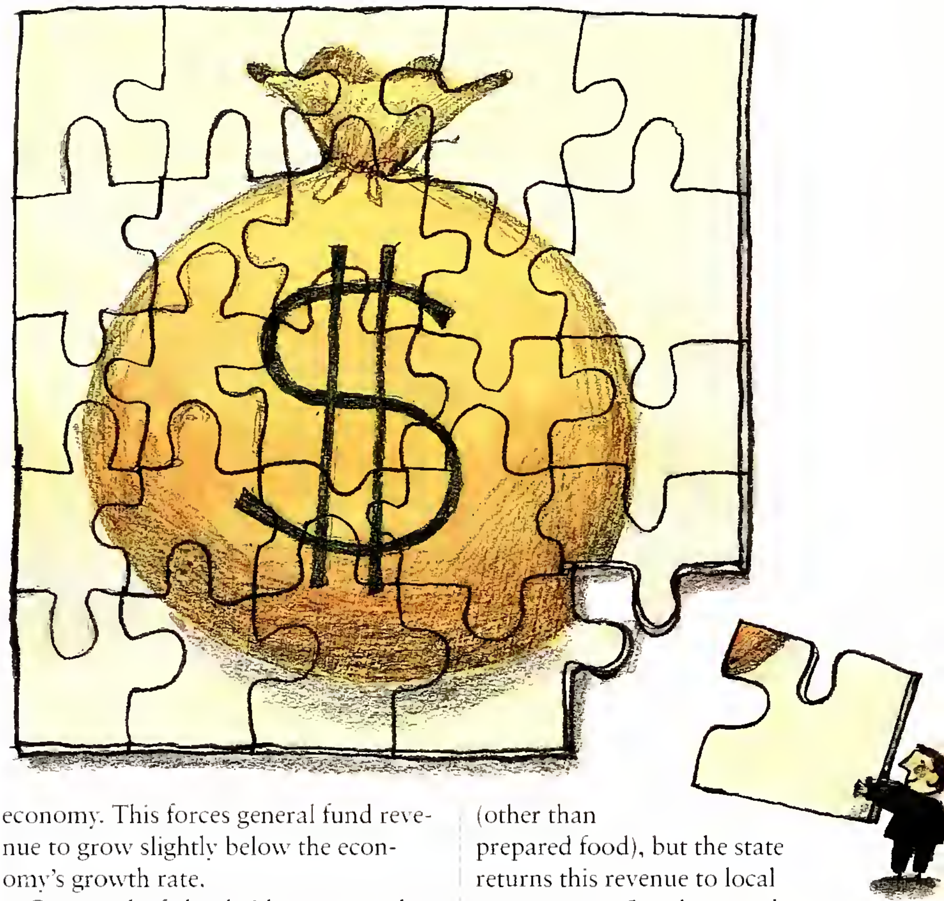
Several general conclusions may be drawn from the estimates just examined. First, shifting reliance toward the individual income tax and away from other revenue sources will enhance a state's ability to generate revenue over the long run. However, it will do little to reduce year-to-year revenue variability.

Second, including food as part of the retail sales tax base will not improve a state's long-term revenue outlook. However, the short-run variability of revenue will be considerably lower if food is part of the base.

Finally, less reliance on corporate income taxes and more reliance on motor fuel taxes may help promote both long- and short-run stability.

Estimates of North Carolina's elasticities present a similar picture (see Table 4). Nearly 90 percent of North Carolina's tax revenue is derived from the retail sales and individual income tax bases, so these are the most relevant ones. Estimates of the elasticity of the state's total tax revenue and total general fund revenue also are presented to provide information regarding the overall variability of the state's revenue portfolio. "General fund revenue," which is roughly 90 percent of a state's total revenue, is defined as total revenue minus utility revenue, insurance trust revenue, and revenue from the sales and associated products of liquor stores owned and operated by state and local governments. Many experts consider it to be a better measure than total revenue of the revenue that is available for the provision of government services.

The long-run elasticities of North Carolina's general fund revenue and tax revenue, which are 0.945 and 1.063 respectively, show that overall tax revenue for the state tends to grow at the same pace as the state's economy but general fund revenue grows at a slightly slower rate. Because the bulk of the difference between general fund revenue and tax revenue is federal aid, it is safe to infer that growth in federal aid tends to be slightly less robust than the state's



economy. This forces general fund revenue to grow slightly below the economy's growth rate.

Conversely, federal aid appears to be enhancing the year-to-year revenue fluctuations in the state. Because the short-run elasticity of general fund revenue is 0.665 and the short-run elasticity of tax revenue is 1.223 (and tax revenue is roughly half of all state revenue), nontax components of revenue (of which federal aid is by far the largest) must be more stable in the short term to reduce the state's overall revenue variability.

Unlike the case for all states, North Carolina's sales tax revenue would not benefit from including food in the sales tax base. Although the typical state could expect a noticeable reduction in the short-term variability of revenue by including food in the sales tax base, the short-run elasticities of North Carolina's tax bases are virtually identical when food is included or excluded. Because the inclusion of food in the base does not substantially improve long-term sustainability (and may in fact reduce it), the state would gain little long- or short-term revenue stability over the business cycle if it added food to its sales tax base. Individual consumers in North Carolina pay a 2 percent sales tax on the purchase of most food (other than prepared food), but the state returns this revenue to local governments. In other words, food is part of the sales tax base for local governments in North Carolina but not part of the base for the state.[2]

The long- and short-run elasticities of North Carolina's individual income tax base are fairly close to the elasticities of this base for the fifty states combined. The income tax base expands at least at the same rate as the state's economy in the long run, but the base is more volatile than the economy over the short term. Much like the data from all states, this information implies that increasing reliance on individual income taxes would improve North Carolina's revenue sustainability over the long term but could reduce the state's ability to maintain government services during recessions.

Although the individual income tax base for both North Carolina and the typical state appears to be a sustainable revenue source over the long term, a study reported in 1998 found that the short-run elasticity of the individual income tax base affects individuals in different tax brackets differently (see Table 5).[3] Clearly, income variability rises with income level. Because states with more progressive income-tax systems tax income in higher brackets more heavily, the more progressive the individual-income-tax system is, the more variable the revenue will be in the short run. Given that more progressive income-tax systems will tend to generate more revenue over the long term (because a progressive tax system is applied to the income tax base, which expands at the same rate as the economy), there appears to be a substantial trade-off between long- and short-term stability.

For instance, if North Carolina switched from a progressive income tax to a proportional (or flat) income tax, over the long term it would be reasonable to expect revenue collections to increase at roughly the same rate as the economy. In contrast, a progressive income tax would generate revenue over the long term at a faster rate than the economy. North Carolina's individual income tax is progressive because as a taxpayer's income increases, he or she pays a higher tax rate on that income. In 2004, for example, a single taxpayer in North Carolina paid 6.00 percent on each dollar of taxable income earned from $0 through $12,750; 7.00 percent, from $12,751 through $60,000; 7.75 percent, from $60,001 through $120,000; and 8.25 percent, above $120,000.

A proportional income tax, which is currently used in Illinois, Indiana, Michigan, and Pennsylvania, is different in that every dollar of taxable income is taxed at the same rate. The definitions of taxable income vary somewhat from state to state, but the 2004 proportional tax rates ranged from a low of 3.0 percent in Illinois to a high of 3.9 percent in Michigan.

The 1998 study cited earlier suggests that the average elasticity of 1.15 could potentially be reduced to 0.87 by using a proportional income tax. Once again, such a change may be desirable or undesirable for a variety of policy reasons.

The Role of Savings and Rainy-Day Funds

Although options exist for shifting reliance toward revenue sources that are more sustainable over the long term, the problems associated with short-term revenue variability may be more formidable. The only tax base that has historically grown at the same rate as the state's economy and exhibited less short-run variability is motor fuel usage. Every other source, regardless of its sustainability over the long term, is at least as variable as (if not more variable than) the state's economy in the short term. Moreover, relying on revenues from motor fuel usage to promote short-term stability in the future is suspect because of the growing fuel efficiency of automobiles (hybrid vehicles). Policy makers may wish to consider saving surplus funds in the general fund, or more formally in a rainy-day fund, during periods of growth, as part of an ongoing strategy to mitigate recessions.

Short-term revenue variability depends on the short-run variability of a state's economy, the short-run variability of the national economy, and the composition of the state's revenue portfolio. A study of the changes in aggregate state-level revenue since World War II found that several of these factors have worked in opposite directions on revenue variability over the past thirty years, so it is difficult to draw general conclusions.[4] For example, both the North Carolina and the U.S. economy have become more balanced since World War II and less dependent on sectors of the economy that tend to be more volatile, such as manufacturing. The trend away from a manufacturing-based economy to a knowledge- and service-based economy has been associated with less rapid but considerably more stable growth.

Thus, if state revenue portfolios maintain their current mix of taxes, it is reasonable to expect short-term volatility to diminish because of the increased stability in overall economic activity. Unfortunately, since World War II, the trend in state revenue portfolios has been noticeably away from revenue sources that are more stable in the short run, such as motor fuel usage, and toward revenue sources that are more volatile in the short run, such as individual income and retail sales. One consequence of this trend is that short-term revenue variability has become more sensitive to recessions than in the past.

In response to economic downturns, policy makers often reduce expenditures, increase taxes, or use a combination of the two to satisfy the requirement of a balanced budget. In North Carolina the law prohibits legislators from carrying a budget deficit into the next fiscal year. From a strictly economic perspective, such policies may harm, and at a minimum will not aid in, recovery efforts for the state's economy. Expenditure reductions and tax increases are contractionary policies that, in the short term, may contribute to the duration of a recession. Theoretically, there are several channels through which contractionary policies may extend downturns, but there is little empirical evidence at either the state or the national level about the potential magnitude of such effects.

In response to economic downturns, policy makers often reduce expenditures, increase taxes, or use a combination of the two to satisfy the requirement of a balanced budget.

The use of savings, in the form of a general fund surplus or a rainy-day fund balance, to offset revenue losses during downturns may be an appealing alternative to expenditure reductions and tax increases for several reasons. First, adequate savings can reduce the overall level of fiscal uncertainty that is associated with recessions. Second, modifying existing expenditure programs or tax structures involves considerable effort by policy makers, which may be partially avoided when sufficient reserve funds are available. Third, reducing tax increases or increasing expenditures during downturns is an expansionary policy. Such actions may aid a recovery. At a minimum they will not contribute to a longer recession.

A state's ability to use savings to smooth out revenue or expenditure fluctuations during downturns depends on the amount of savings that it has built up during expansions. Given that all states routinely maintain surplus monies (or savings) in the general fund, this ability boils down to the sum of the rainy-day fund and the general fund balance.

Several studies have examined how states use rainy-day funds. They found that the greatest benefit comes from structuring such a fund properly.[5] Simply put, states that require deposits to the rainy-day fund during periods of growth and limit the use of such funds to recessions reap the largest benefits in terms of lower long-term borrowing costs, greater savings, and less volatile expenditures.

North Carolina's rainy-day fund, adopted in 1991, is formally known as the Savings Reserve Account. The law governing it requires that one-fourth of any unreserved balance at the end of the fiscal year be deposited into the fund, and allows monies to be withdrawn only by an act of the General Assembly. The fund is capped at 5 percent of the previous year's general fund expenditures.

In contrast, Michigan's rainy-day fund, known as the Countercyclical Budget and Economic Stabilization Fund, operates under very strict mathematical formulas regarding when monies may be deposited and withdrawn, and how much money may be involved in such transactions.

The differences between a rule-oriented rainy-day fund such as Michigan's and a less-rule-oriented rainy-day fund such as North Carolina's may seem minor. However, numerous studies have found that the fiscal benefits accruing to states with rule-oriented funds are substantial when compared with the benefits accruing to states with less-rule-oriented funds *and* states without such funds. For example, the studies have found that states with rule-oriented funds save more and face significantly lower long-term borrowing costs.[6] Further, during the 1990–91 recession, such states were able to reduce their reliance on expenditure reductions and tax increases by 17 percent.[7] Also, one study examined the cyclical variability of state expenditures since 1969 and found that rule-oriented funds provide considerable support in maintaining expenditures over the business cycle.[8]

Conclusion

Cyclical fluctuations in economic activity create difficult problems for state governments because the demand for public-sector services tends to be countercyclical, whereas revenue growth is procyclical. This article has briefly outlined, from both a long- and a short-term perspective, how different revenue sources react to changes in economic activity.

Although it is challenging to reduce the variability in revenue streams that results from business-cycle swings, research has identified a number of potential strategies to reduce cyclical variability. First, broadening tax bases will tend to have minimal effects on the long-term sustainability of a given revenue source but may result in smaller year-to-year swings.

Next, because more progressive individual-income-tax systems produce more volatile revenue streams in the short run but more rapid revenue growth in the long run, there appears to be a trade-off between long-run growth and short-term variability. A more progressive system will generate revenue growth in excess of the state's economic growth and a revenue stream that is more volatile than the state's economy, while a less progressive (or more proportional) system will generate less growth in the long run but more stable revenue in the short run.

Notes

1. State of North Carolina, Final Report: Governor's Commission to Modernize State Finances (Raleigh: the State, Dec. 2002), available at www.osbm.state.nc.us/files/pdf_files/final_rpt_gov_comm.pdf.

2. As of January 1, 2005, twenty-seven states excluded the sale of food from their general sales tax base, and seven included it as part of the base but taxed it at a lower rate.

3. Richard F. Dye & Therese J. McGuire, *Block Grants and the Sensitivity of State Revenues to Recession*, in Proceedings of the Ninetieth Annual Conference on Taxation, 1997, at 15 (Washington, D.C.: Nat'l Tax Ass'n, 1998).

4. Thomas A. Garrett & Gary A. Wagner, *State Government Finances: World War II to the Current Crisis*, 86 Federal Reserve Bank of St. Louis Review no. 2, at 9 (2004).

5. Russell S. Sobel & Randall G. Holcombe, *The Impact of State Rainy Day Funds in Easing State Fiscal Crises during the 1990–1991 Recession*, 16 Public Budgeting and Finance no. 3, at 28 (1996); Gary A. Wagner & Erick M. Elder, *The Role of Budget Stabilization Funds in Smoothing Government Expenditures over the Business Cycle*, 33 Public Finance Review 439 (2005); Gary A. Wagner, *Are State Budget Stabilization Funds Only the Illusion of Savings? Evidence from Stationary Panel Data*, 43 Quarterly Review of Economics and Finance 213 (2003); Gary A. Wagner, *The Bond Market and Fiscal Institutions: Have Budget Stabilization Funds Reduced State Borrowing Costs?* 57 National Tax Journal 785 (2004).

6. Sobel & Holcombe, *The Impact of State Rainy Day Funds*; Wagner, *The Bond Market and Fiscal Institutions*.

7. Sobel & Holcombe, *The Impact of State Rainy Day Funds*.

8. Wagner & Elder, *The Role of Budget Stabilization Funds*.

Gainsharing in Local Government

David N. Ammons and William C. Rivenbark

Employee bonuses and other forms of rewards are standard practice in the private sector. When a company has a profitable year, employees hope to enjoy some of the fruits of the success. If the company has a profit-sharing plan, a formula prescribes the employee's share. Companies without formal profit-sharing systems may distribute bonuses in hopes that employees will appreciate their gesture of gratitude, will respond with loyalty, and will be motivated to expand profits in the future. Profit-sharing plans, whether formal or informal, help attract and retain talented employees and provide a personal incentive to increase the company's net revenues.

Profit-sharing and other incentive plans are hardly novel in the corporate world. They are regarded simply as good business—good for employees and good for the company and its shareholders.

The public sector is different. Profit sharing technically is impossible in the public sector, for governments have no profit to share. Nevertheless, governments do have budgets and balance sheets, and actions that trim costs without reducing service quality can improve the bottom line, even if the improvement is not called profit. Increasingly, governments

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in North Carolina and across the nation are experimenting with a system called "gainsharing."[1]

This article describes gainsharing and distinguishes it from profit sharing. The article examines gainsharing as a performance management strategy and highlights examples of its use.

An Explanation of Gainsharing

Some people suggest simplistically that gainsharing is the public sector's version of profit sharing, as if the public sector exclusively owns gainsharing. Actually, gainsharing and profit sharing both originated in the private sector, and both are found there today.[2] A key distinction between the two systems is in their scope, profit sharing's being broad compared with the relatively narrow scope of gainsharing. Profit sharing focuses on a company's bottom line, which may seem far removed from the efforts of a single contributing unit. A host of factors and accounting maneuvers can influence the profit line on a company's income statement and may seem distant and unintelligible to most employees. Yet in profit-sharing systems, the employees' bonuses are tied to that line. Employees' rewards rise and fall with company fortunes, but executive decisions and outside forces may have a greater influence on company profits in a given year than the performance of rank-and-file workers. Sometimes workers have difficulty seeing how their ideas and efforts relate to their bonus checks.

Employees' rewards rise and fall with company fortunes, but executive decisions and outside forces may have a greater influence on company profits in a given year than the performance of rank-and-file workers.

Gainsharing narrows the scope from company profit and loss to a target that appears more concrete and manageable to employees of an organization, department, or program. Gainsharing challenges employees to reduce costs or expand revenues in their corner of the operation while maintaining or improving the quality of products and services. They must achieve these results through their ideas and energy, not through price or fee increases. If they succeed, they receive a share of the resulting gains. Good results by the gainsharing unit should contribute favorably to the company's bottom line, but the gainsharing bonus of a given unit does not depend on bottom-line profit. It depends instead on results more fully within the control of the gainsharing unit.

Model gainsharing programs exhibit three characteristics: (1) they focus on opportunities to reduce costs or increase revenues, and this allows them to be self-funded; (2) they feature meaningful employee participation, not simply in submitting suggestions but also in collaborating with other workers and management in brainstorming and decision making; and (3) employees receive bonuses based on group success in securing desired gains.[3]

Although many gainsharing programs have included all three characteristics, others have departed from the model, typically by incorporating less employee participation and relying instead on suggestion programs with management review, or on employee implementation of management strategies for cost reduction. Gainsharing experts advocate implementation of the full model, marshalling the motivating power of employee participation in combination with the motivating power of pay-for-performance.[4]

Consistency with Current Management Thinking

Profit-sharing and gainsharing plans adhere to notions of employee motivation long accepted in the private sector.[5] Also, they coincide with current management thinking about the importance of encouraging employee initiative as organizations strive for continuous process improvement. Advocates of Total Quality Management and its variants argue that no process or pattern of service delivery is ever perfect or even good enough. Each deserves constant scrutiny, and employees should be encouraged to find better tools, better processes, and better options to meet the needs of customers and citizens.[6] Gainsharing is a method of providing this encouragement.

Furthermore, gainsharing is consistent with the management concepts associated with the reinvention movement, initiated by David Osborne and Ted Gaebler's *Reinventing Government* and developed further in subsequent books on the topic.[7] The reinvention philosophy emphasizes a focus not on effort, activities, or promises but on results. By methods embodied in a "consequences strategy," public officials are encouraged to raise the stakes for success and failure. They are encouraged not only to provide real incentives for achieving the desired results but also to raise the prospect of negative consequences for departments or programs that consistently fall short. Greater managerial flexibility as a reward for high achievers, the selection of service producers through managed competition, and gainsharing are among the featured tactics in the reinventor's arsenal.

Greater managerial flexibility may take the form of increased discretion in operating methods and limited freedom from bureaucratic rules governing budget procedures, hiring practices, and purchases. In some cases it even allows the carryover of budget savings from one year to the next and puts a stop to the year-end spending spree that a "spend-it-or-lose-it" budget rule often spurs. This flexibility comes to managers not as a gift but as a trade. In exchange they must promise results and deliver on the promise. Departments or programs agree to be accountable and to provide full documentation of the results that they achieve. In return, those that demonstrate the ability to achieve and sustain favorable results are freed from a few of the rules that many managers regard as bureaucratic straitjackets.

Examples of North Carolina local governments adopting various forms of the greater-flexibility-for-greater-accountability exchange include Catawba County and Davidson County, as featured in the Winter 2005 issue of *Popular Government*.[8] Since 1993, Catawba County has extended greater management flexibility with budget and personnel (that is, the ability to shift funds, adjust positions, and carry over a portion of unspent

funds from one year to the next) to departments willing to commit to, and able to achieve, ambitious objectives and high levels of service. More recently, Davidson County has followed Catawba County's lead and begun rewarding volunteering departments with similar managerial flexibility in exchange for results.

Another tactic in the consequences strategy is managed competition, which requires government departments to vie with private, nonprofit, and other government competitors for the privilege of delivering various government services. When a given service is subjected to managed competition, each competitor, including the government's own department, submits its bid for the service, and each bid is evaluated for service quantity, quality, and cost.[9] Local governments choosing this tactic do so not because they favor private-sector production of services but because they desire the best services at the best price, whether produced by contractors or the government's own employees. Employees in such governments recognize the importance of focusing on service quality, costs, and results, and they understand the consequences of failing to do so.

Government departments and programs that find themselves engaged in managed competition enjoy some advantages relative to their private competitors but also confront some disadvantages. Chief among the advantages are freedom from taxes, freedom from the necessity of making a profit, and favorable access to capital. Private competitors must build taxes, profit, and higher capital costs into their bids. On the other hand, private competitors are widely regarded to have the advantages of greater managerial flexibility, greater willingness to innovate, greater willingness to invest in new technology, and greater freedom to offer incentives that engage the creative energy, enthusiasm, and commitment of their employees. These private-sector advantages prompt public-sector managers, especially those engaged in managed competition, to appeal for a level playing field.

Gainsharing is perceived to be a major leveler of the playing field. It allows government units to give their workers a personal stake in their unit's bottom-line success, an incentive akin to what vendors competing with a government unit might give their employees.

Typically, funds for gainsharing bonuses in local governments are drawn from savings during a given year. If a department just recently won with the low bid in a managed competition, that bid can serve as the baseline. Lower-than-expected expenditures would constitute savings and create a gainsharing pool. If no actual bid competition is involved, a local government that offers its employees a gainsharing incentive establishes its baseline (that is, the expected expenditure) through the budget process. The gainsharing award is drawn from the difference between the projected expenditure and the actual expenditure. The distribution to employees may include the entire amount, but more often it is a fixed proportion such as 50 percent. If, for example, total annual savings come to $100,000 and the gainsharing plan calls for a distribution of 50 percent, then $50,000 would be apportioned to employees, and the other $50,000 would be returned to the fund balance (equity in the case of enterprise funds). Typically, gainsharing payouts are conditioned not only on savings but also on the achievement of specified objectives or the continuation of services at previous levels or greater. Work units that fail to meet these standards forfeit their gainsharing payments.

Controversy over Gainsharing

In some places, gainsharing plans are controversial. Opponents in some states have challenged their legality, arguing that they deviate from authorized forms of payment to public employees.[10] Even where they are legal, as in North Carolina, gainsharing plans have stirred negative as well as positive sentiment. Generally, detractors may be divided into two camps: those who oppose gainsharing on philosophical grounds and those who oppose it for practical reasons. Some detractors oppose gainsharing out of anxiety over how it will look to the public, though they usually express their opposition on philosophical or practical grounds.

Philosophical opposition often centers on the belief that the wages being paid to local government managers, supervisors, and other employees already oblige them to share their most creative ideas and contribute their most diligent efforts. In the view of these opponents, the local government should not have to pay a bonus to receive from employees what they were hired to do. Of course, the same could be said of private-sector employees with regard to profit-sharing plans.

Philosophical opposition often centers on the belief that the wages being paid to local government managers, supervisors, and other employees already oblige them to share their most creative ideas and contribute their most diligent efforts.

Gainsharing proponents argue simply that the incentive works and that the stimulus for new ideas and government savings creates a win-win situation for taxpayers and employees.

People opposing gainsharing for practical reasons worry that resources intended for other purposes will be diverted to gainsharing payments and that the emphasis on cutting costs will interfere with efforts to sustain or even improve service quality. They also are concerned that undeserving employees will get a free ride on the coattails of others and receive gainsharing bonuses even when their contribution has been minimal.

In response, proponents point out that gainsharing bonuses do not come from budgeted funds: they come from savings. If there are no savings, there are no payments. If there are savings and if the payments are tied to a predetermined percentage less than 100 percent, then the ability of the local government to provide resources to priority programs is increased, not reduced.

Concern that service quality might suffer as workers cut expenditures—and corners—in hopes of creating a substantial gainsharing pool is countered by arguments that mechanisms can be put in place to hold any such tendencies in check. Chief among these mechanisms is an accountability system that ensures achievement of key objectives and maintenance of quality-of-service standards.

Gainsharing plans address the problem of free riders in various ways. Some disqualify employees who have unsatisfactory individual performance reports. Others tie awards to a combination of group and individual performance factors. An employee serving on a successful team receives a gainsharing bonus, but an employee with a mediocre individual performance rating receives a smaller bonus than one making a stronger contribution to the team's success. Still other local governments, though, base the award entirely on group achievement, insisting that the gains from developing team spirit and cooperation more than offset an occasional free-rider problem.

Bid to Goal

Although managed competition brings the advantage of competitive prices for local services, it also carries risks. Engaging in managed competition can be threatening to local government employees and can jeopardize morale. When an outside contractor wins the bid, the displacement of employees must be handled with sensitivity and care to avoid long-term damage to the government's employee relations. Follow-through also is important. Contract management must be aggressive and thorough to ensure that contract promises are kept.

Local governments wishing to enjoy many of the benefits of managed competition without incurring the potential disruption and risks associated with it have begun to experiment with a process called "bid to goal." Coupled with gainsharing, this process can provide a powerful incentive for innovation and cost-effective service delivery.

The bid-to-goal process begins with the hiring of a consultant who is an expert in a given local government function. The consultant prepares a cost estimate for performing that function in the client's jurisdiction, based on his or her familiarity with companies that provide this service. In essence, this estimate is the consultant's prediction of a competitive contractor's bid, if bids were being sought.

Once the consultant's figure has been received and the government is satisfied as to its reasonableness, the department responsible for producing the service is invited to match or even beat the bid. If the department cannot do so, the local government is likely to seek outside bids. On the other hand, if the department streamlines its operations and beats the consultant's estimate, the department retains responsibility for producing the service. The department's bid becomes its budget, and if gainsharing is authorized, employees are encouraged to find additional savings with the promise of bonuses if expenditures come in below the budget. In fact, department managers facing the prospect of privatization often consider gainsharing to be an essential device in designing and delivering a competitive operation.[11]

Examples of Gainsharing across the Nation

Many local governments across the country have ventured successfully into gainsharing. For instance, in the late 1990s, a gainsharing plan for the wastewater treatment operation serving the Seattle area produced savings of $2.5 million over a four-year period, without a decline in effluent quality.[12] Under provisions of the plan, employees received half of the savings.

In 1997, using a bid-to-goal approach, San Diego's metropolitan wastewater department persuaded the union to agree to a set of operating revisions that promised to reduce cost by $78 million over a six-year period while achieving compliance with environmental standards. A gainsharing plan, distributing

Table 1. **Charlotte's Gainsharing Program**

Fiscal Year	Savings	Gainsharing Distribution	Individual Gainsharing Awards
Managed-Competition Projects			
2000	$ 35,000	$ 17,359	$1,073–$1,690
2001	195,000	97,406	$282–$3,797
2002	387,000	193,253	$157–$1,113
2003	325,000	162,709	$322–$4,055
2004	5,000	2,551	$386–$1,380
2005	12,000	5,993	$205–$449
Optimization Projects (Cost Savings without Managed Competition)			
2000	$ 469,000	$154,770	$124–$3,822
2001	1,339,000	441,901	$28–$3,501
2002	2,170,000	715,267	$84–$6,497
2003	1,670,000	551,998	$177–$3,334
2004	2,000,000	660,283	$32–$5,610
2005	3,650,000	119,046	$205–$3,812

Source: Information provided by Kim Eagle, Eval. Manager, Budget & Eval. Dep't, City of Charlotte.

50 percent of any savings beyond the target, to a maximum of $4,500 per employee annually, provided an additional incentive. By the sixth year, cumulative savings had surpassed $109 million, and employees had enjoyed gainsharing checks every year, ranging from a low of $1,500 to the $4,500 maximum.[13]

In 1997 a consultant hired by East Lansing, Michigan, concluded that the city's wastewater treatment facility could reduce costs by 20 percent if it eliminated eight positions and adopted best practices.[14] The department and its employees devised a plan to achieve these savings over a six-year period, relying on attrition rather than layoffs and introducing a gainsharing plan calling for the distribution of 25 percent of savings to employees. The targeted reduction was reached in just two years rather than six.

The managed-competition efforts of Indianapolis under Mayor Stephen Goldsmith earned national acclaim. Underlying Indianapolis's efforts was a gainsharing program that helped reverse union opposition and produced employee bonus checks as high as $1,750 a year. Osborne and Hutchinson report, "[U]nion officials were quietly approaching managers and suggesting functions that could be outsourced, to reduce costs. Since their members could now share in the savings, their interests were aligned with the mayor's."[15]

Other cost savings and program innovations have been credited to gainsharing programs in Baltimore County, Maryland, and College Station, Texas.[16]

Gainsharing in North Carolina Local Governments

At least four North Carolina local governments have introduced gainsharing plans: Charlotte, High Point, Pitt County, and Zebulon. Of this group, only Zebulon has chosen to discontinue the incentive.

Charlotte

Charlotte features two varieties of gainsharing. First, some departments, called "business units" in Charlotte, compete with the private sector in managed competition. When they win the bid, they can enjoy the benefits of gainsharing if they can find ways to spend even less than their bid amount. Employees share 50 percent of the additional savings, provided that performance objectives are met.

For example, in the mid-1990s, Charlotte-Mecklenburg Utility employees won the managed competition for the opportunity to operate a water treatment facility and a wastewater treatment facility. Gainsharing bonuses were conditioned not only on achieving additional savings but also on complying fully with all environmental standards and suffering no lost-time accidents.[17]

In managed competition the operating strategies of the public sector are subjected to the test of competition, and the risks to public-sector employees are significant. When municipal employees win the competition and subsequently find ways to reduce costs further, the gainsharing rewards—at 50 percent of additional savings in Charlotte—can be substantial.

When program officials in Charlotte come up with ideas for improving operations, sometimes gleaned from the lessons of competition, and proceed to implement these ideas without actually facing managed competition, the process is called "optimization." These optimization projects also can qualify for gainsharing bonuses, but because the ideas have not stood the test of actual managed competition, the gainsharing pool is established at a lesser rate, 33 percent of savings. Nevertheless, the savings and gainsharing payouts from these optimization projects can be substantial. (For gainsharing savings and payouts arising from managed competition and optimization projects in recent years, see Table 1.)

The second version of gainsharing in Charlotte has an even greater scale.[18] Each year the city manager sets a savings goal for the general fund. If the goal is met or surpassed, 50 percent of the savings becomes available in the gainsharing pool. Only half of this pool is distributed to all employees automatically. The distribution of the other half depends on whether or not a given employee's business unit meets its key objectives for the year. These objectives are called "incentive targets" and typically are tied to customer service, efficiency, quality, time standards, and safety. If the business unit meets four out of five incentive targets, employees receive an 80 percent share of this second component of the gainsharing pool. Employees in units meeting all their targets are eligible for a full share of both components—generally $300–$650.[19]

High Point

In 1999, High Point embraced gainsharing as part of its bid-to-goal initiative in the public services department.[20]

Table 2. **Gainsharing at High Point's Westside Treatment Plant**

Fiscal Year	Bid-to-Goal Prescribed Savings	Actual Savings	Gainsharing Distribution	Individual Gainsharing Awards
1999–2000	$290,000	$336,142	$17,496	$1,458
2000–2001	290,000	303,229	5,568	464
2001–2002	290,000	255,960	0	0
2002–2003	290,000	362,874	1,164	97
2003–2004	355,744	514,556	6,768	564

Source: Information provided by Chip Vanderzee, Pub. Serv. Analyst, Pub. Serv. Dep't, City of High Point.

Table 3. **Gainsharing in Pitt County's Employee Suggestion Program**

Fiscal Year	Savings	Gainsharing Distribution	Individual Gainsharing Awards
2001–2002	$95,678	$2,004	$250–$1,504
2002–2003	5,957	753	$250–$253
2003–2004	6,933	943	$154–$279
2004–2005	25,900	2,590	$2,590

Source: Information provided by Michael Taylor, Chief Info. Officer, Mgmt. Info. Sys., Pitt County.

The department submitted a bid for operation of the wastewater treatment plant that shaved 30 percent from its previous operating expenses and met the consultant's bid-to-goal target. A three-year contract then was signed, specifying performance and safety standards and authorizing gainsharing in the form of quarterly bonuses for cost savings beyond the department's bid. Half of any additional savings would be retained to increase fund equity. The other half would be distributed to employees as gainsharing bonuses.

High Point's bid-to-goal system has since been expanded from the wastewater treatment plant to other operations. Contracts based on the bid-to-goal methodology now are in place for other divisions of the public services department, including the water filtration plant, central lab services, the industrial pretreatment program, and maintenance services. (For savings and gainsharing distributions at the Westside Treatment Plant, see Table 2.)

Pitt County

The employee incentive program adopted by Pitt County in 2001 invited employee suggestions that would "save money [or] increase revenues without reducing services or increasing taxes or fees" and good ideas that would improve services or provide intangible benefits.[21] The awards have differed across these two categories. Employees whose suggestions provide benefits but produce no savings or additional revenues earn $250 and a certificate of appreciation. Awards in this category are limited to twenty-five per fiscal year. Employees whose suggestions produce savings or additional revenue receive 10 percent of the first year's savings, up to $10,000 per suggestion. (If a group of employees makes the suggestion, the award is shared equally among the group members.) These awards are not restricted in number because the savings create their own gainsharing pool.

Employees submit their suggestions to their immediate supervisors. The supervisors forward the suggestions to Pitt County's monetary awards review committee, which considers whether a given suggestion does one or more of the following:

- Identifies and reduces safety hazards
- Saves money or increases revenues
- Increases productivity or efficiency
- Improves conditions
- Improves services to the public
- Conserves resources
- Increases employee morale

Once approved, a suggestion is implemented and monitored for twelve months to confirm its value. If a team submits a suggestion, all team members must be identified at the time of the suggestion, and the monetary award is divided equally among them. (For savings and gainsharing distributions in recent years, see Table 3.)

Pitt County's approach to its larger monetary rewards requires monitoring and documentation of success. Through this single program, Pitt County has simultaneously encouraged employee suggestions, performance measurement, and program evaluation.

Gainsharing has been shown to produce favorable results in local governments that are willing to establish a substantial gainsharing pool and are prepared to monitor the pool's distribution rigorously. Gainsharing programs that are self-funded by savings in local government operations offer the opportunity for a win-win result.

Zebulon

Gainsharing in Zebulon was initiated in 1992, when town officials sought an alternative to a merit-pay system that seemed driven less by merit considerations than by the need for cost-of-living adjustments.[22] Gainsharing was introduced in hopes of encouraging and rewarding greater efficiency and excellent employee performance.

Zebulon's gainsharing pool was modest relative to others described in this article. Only 5 percent of any end-of-the-year savings went into the pool. The other 95 percent went to the fund balance.

Two factors determined employees' eligibility for gainsharing bonuses. One was performance on annual organizational goals set by the town council and the town manager, although exceptions were granted even when targets were not met. The other was satisfactory performance on individual employee performance appraisals, judged to be a performance rating of 2.95 or higher on a 5-point scale.

The town council eliminated the gainsharing initiative in Zebulon in 2000, following the recommendation of a new town manager to replace gainsharing with an annual contribution of 5 percent to 401(k)'s for all employees.[23] The gainsharing program was thought to have little employee support, and it was only loosely anchored in a set of organizational goals produced with little, if any, employee participation and little employee buy-in. With the establishment of 401(k) contributions from the city, the passing of the gainsharing program stirred little sentiment.

The rise and fall of gainsharing in Zebulon should not be regarded as especially unusual. Some private-sector management experts note that fewer than half of all gainsharing plans survive beyond five years and many appear to begin losing effectiveness after two or three years.[24] Some, however, exhibit much longer staying power.

Conclusion

Gainsharing has been shown to produce favorable results in local governments that are willing to establish a substantial gainsharing pool and are prepared to monitor the pool's distribution rigorously. Gainsharing programs that are self-funded by savings in local government operations offer the opportunity for a win-win result. That is, they produce bonuses for employees while expanding, rather than drawing down, local government resources.

Notes

1. Mark Michaels, *The New Game of Motivation,* 101 American City & County 36 (1986); Katherine C. Naff & Raymond Pomerleau, *Productivity Gainsharing: A Federal Sector Case Study,* 17 Public Personnel Management 403 (1988); U.S. General Accounting Office, Gainsharing: DOD Efforts Highlight an Effective Tool for Enhancing Federal Productivity (Washington, D.C.: USGAO, Sept. 1986), available at http://161.203.16.4/d4t4/131110.pdf; Scott Wilson, *Counties Try Productivity Bonuses,* Washington Post, Mar. 26, 1998, at M1.

2. Most management authorities trace gainsharing to the 1930s, the steel industry, and the introduction of the gainsharing Scanlon Plan, named for union official and subsequent Massachusetts Institute of Technology lecturer Joseph Scanlon. A few trace it back farther, to 1896, when Henry Towne coined the term "gainsharing." *See* Susan Hanlon et al., *Consequences of Gainsharing: A Field Experiment Revisited*, 19 Group & Organization Management 87 (1994); Kenneth Mericle & Dong-One Kim, Gainsharing and Goalsharing (Westport, Conn.: Praeger, 2004); J. L. Zalusky, *Labor's Collective Bargaining Experience with Gainsharing and Profit Sharing,* in Proceedings of the 39th Industrial Relations Research Association Annual Meeting (Madison, Wisc.: IRRA, 1986).

3. Robert Masternak, Gainsharing: A Team-Based Approach to Driving Organizational Change (Scottsdale, Ariz.: World at Work, 2003); Richard S. Saver, *Squandering the Gain: Gainsharing and the Continuing Dilemma of Physician Financial Incentives,* 98 Northwestern University Law Review 145 (2003); Carl G. Thor, Gainsharing: Creating and Sharing Success (Menlo Park, Cal.: Crisp Publ'ns, 1999).

4. Brian E. Graham-Moore & Timothy L. Ross, *Understanding Gainsharing,* in Gainsharing: Plans for Improving Performance 3 (Graham-Moore & Ross eds., Washington, D.C.: Bureau of National Affairs, 1990); Saver, *Squandering the Gain,* at 149.

5. Corporations have regarded incentive plans as the positive side of a rewards-penalties coin. On the negative side of the coin are terminations for poor individual performance and broader layoffs for poor company performance. Although various limitations apply, governments have these negative options too, but typically have been less inclined and slower to exercise them.

6. Steven Cohen & Ronald Brand, Total Quality Management in Government (San Francisco: Jossey-Bass, 1993); Steven Cohen & William Eimicke, Tools for Innovators: Creative Strategies for Managing Public Sector Organizations (San Francisco: Jossey-Bass, 1998).

7. David Osborne & Ted Gaebler, Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector (Reading, Mass.: Addison-Wesley, 1992); David Osborne & Peter Plastrik, Banishing Bureaucracy: The Five Strategies for Reinventing Government (Reading, Mass.: Addison-Wesley, 1997); David Osborne & Peter Plastrik, The Reinventor's Fieldbook: Tools for Transforming Your Government (San Francisco: Jossey-Bass, 2000); David Osborne & Peter Hutchinson, The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis (New York: Basic Books, 2004).

8. William C. Rivenbark & David N. Ammons, *Rewarding Greater Accountability with Increased Managerial Flexibility in Davidson County,* Popular Government, Winter 2005, at 12.

9. Pamela A. Syfert & David Cooke, *Privatization and Competition in Charlotte,* Popular Government, Winter 1997, at 12.

10. John M. Greiner et al., Productivity and Motivation: A Review of State and Local Government Initiatives (Washington, D.C.: Urban Inst. Press, 1981).

11. Barry M. Gullet & Douglas O. Bean, *The Charlotte Model for Competition: A Case Study,* Popular Government, Winter 1997, at 19.

12. Osborne & Hutchinson, The Price of Government.

13. *Id.*

14. *Id.*

15. *Id.* at 328.

16. *See* James Fox & Bruce Lawson, *Gainsharing Program Lifts Baltimore Employees' Morale,* 112 American City & County 93 (1997), and the following websites: www.cstx.gov and www.co.ba.md.us.

17. Gullet & Bean, *The Charlotte Model.*

18. Information on Charlotte's citywide gainsharing program is based on a telephone interview with Ann White, budget manager (Feb. 25, 2004).

19. Osborne & Hutchinson, The Price of Government.

20. Public Services Dep't, City of High Point, Bid-to-Goal Proposals (May 2000).

21. Pitt County, Pitt County Employee Incentive Program Policy (Nov. 2001).

22. Kevin R. Patton & Dennis M. Daley, *Gainsharing in Zebulon: What Do Workers Want?* 27 Public Personnel Management 117 (1998).

23. E-mail Correspondence with Rick Hardin, Town Manager, Town of Zebulon (Feb. 18, 2004).

24. Jeffrey B. Arthur & Lynda Aiman-Smith, *Gainsharing and Organizational Learning: An Analysis of Employee Suggestions over Time,* 44 Academy of Management Journal 737 (2001).

continued from page 3
with highest honors, from UNC at Chapel Hill's School of Law, where she served as editor-in-chief of the *North Carolina Law Review* and was inducted into the Order of the Coif and the James E. and Carolyn B. Davis Society. Millonzi is a member of the North Carolina State Bar and the Bar of the Commonwealth of Massachusetts.

Mills joined the faculty in July as a lecturer in public law and government. Her work focuses on local government law, state government law, and emergency management law. Mills was most recently chief of staff to Senator Marc Basnight, president pro tempore of the North Carolina Senate, having returned to that position in 2005 after two years as Dare County attorney. She also has served as general counsel to Basnight, assistant attorney general in the North Carolina Department of Justice, and staff attorney for North Carolina Prisoners Legal Services. In addition, she was an adjunct faculty member at UNC at Chapel Hill's School of Law from 2000 to 2002. Mills holds a B.S. in administration of criminal justice and psychology from UNC at Chapel Hill and a J.D. from the University's School of Law, where she won numerous academic awards, including induction into the James E. and Carolyn B. Davis Society and the UNC Order of the Grail/Valkyries.

Morse joined the School's faculty in July as assistant professor of public administration, specializing in public leadership. He came to the School from Iowa State University, where he served as assistant professor in the Public Policy and Administration Program of the Department of Political Science. In Iowa, Morse led the Olive Tree Project, an innovative intergovernmental collaboration that brings local and state officials together with other community stakeholders to define common plans for the future. Earlier he served as adjunct instructor, research associate, and project manager in the Department of Urban Affairs and Planning and the Institute for Policy Outreach at Virginia Polytechnic Institute and State University. Morse holds a B.A. and an M.A. in public policy from Brigham Young University (Utah) and a Ph.D. in public administration and public affairs from Virginia Tech.

MPA Program Graduates Twenty-Six

The School of Government congratulates the following graduates of the Master of Public Administration Program at UNC at Chapel Hill. The program's commencement ceremonies took place on Sunday, May 14, at the School. Richard T. "Stick" Williams, vice-president of Diversity and Employee Development for Duke Energy and former chair of UNC at Chapel Hill's Board of Trustees, delivered the commencement address.

Erin L. Aloan
Rudolph Alexander Ashton IV
Adam D. Basch
David Nathaniel Branscome
Crystal L. Bridgeman
Jonathan David Bundy
Fatema Zaman Choudhury
Stephanie Coplin
Jessica Lynn Dorrance
Richard Garland Grogan
Ashley E. Haynes*
Erin S. Higgins
Brandon P. James
Marta Agin Lorenz
Timothy Thomas Love
Alicia Elizabeth Moore
Katherine Heath Pekman*
Courtney Renee Reid
Christina Riordan
Jamie Azi Roberts
Jesse Arlon Springer
Audrey Jane Sprung
Mary Frances Vigue
Brittany Friars Whitmire
Martina Michelle Williams
Sara L. Yanosy

*Anticipated graduation August 2006.


Left to right:* *Gregory Allison, Selena Coffey, and Arthur Mouberry

Municipal and County Administration Courses Graduate Ninety-Four

Ninety-four students graduated from the 2006 Municipal and County Administration courses on March 30, 2006, at the William and Ida Friday Center for Continuing Education, in Chapel Hill.

Participants in the courses are municipal and county officials from across North Carolina who study at the School of Government one week per month for eight months. They represent many fields of public service. More than 2,500 municipal officials and 1,150 county officials have completed the courses since they began in 1954 and 1964, respectively.

During the graduation, Arthur Mouberry, assistant town manager, Fuquay-Varina, received the George C. Franklin Award, and Selena D. Coffey, budget and management director, Henderson County, received the Edwin M. Gill Award. The North Carolina League of Municipalities and the North Carolina Association of County Commissioners present the awards each year to the municipal and county class members with the most distinguished records. The municipal award is given in honor of a former general counsel of the League of Municipalities, the county award in honor of a former state treasurer and chair of the North Carolina Local Government Commission.

Sam Misenheimer, president of the Municipal and County Administration Courses Alumni Association, presented a special gift of $400 to the School of Government Foundation in memory of Jake Wicker, a former director of the courses. Also, the Class of 2006 presented a gift in honor of Gregory Allison, current course director, and Brian Newport, course manager.

Behind the Scenes at the School of Government

When you call the School of Government on the switchboard or at the parking gate, the calm and helpful voice that you hear on the phone or the intercom belongs to Patricia Connor, receptionist.

The School could not do without Ray Hockaday, media technician, who is constantly on call to equip classes with projectors, sound, and now "digital video capture," as needed.

Every time you log onto www.sog.unc.edu, the expertise of Philip Young, director of NCINFO and instructional technology facilitator, is evident. Young keeps more than twenty-five listservs up and running, oversees hundreds of pages of course and institutional resource material, manages online registrations, and makes sure that your online donations get to the right place.

The registration office makes sure that you get the classes you sign up for. Staffers are, left to right, Julie Seger, registration assistant; Danielle Lehner, assistant registrar; and Iris Hopkins, registrar.

The error-free operation of the School's 220-plus computers, servers, e-mail and online-course-registration systems, and myriad other information-management tasks is ably carried out night and day by, left to right, Carolyn "Carrie" Holbert, applications programmer; James Balfour, technical support analyst; John Gullo, information technology services manager; and Jonathan Herz-Midler, technical support analyst.

Coming into the University

SCHOOL OF GOVERNMENT 75 YEARS UNC CHAPEL HILL

In the eight years from its launch in 1931 to the dedication of its first building (at 223 East Franklin Street) in 1939, the Institute of Government earned the respect of North Carolina's public officials and a national reputation. By 1944, Institute founder Albert Coates had been offered but had turned down a proposal by DeWitt Wallace, owner and editor of *Reader's Digest*, to finance him "for a year or more to go to every state in the union to get a similar program going in them all."

Still, throughout the late 1930s and early 1940s, Coates was plagued by inadequate finances, which threatened the existence of the independent Institute and its staff. The Institute building was constructed with gifts from Winston-Salem businessmen Will Reynolds and Gordon and Bowman Gray, and the personal endorsement of a mortgage loan by Julian Price, president of the Jefferson Standard Life Insurance Company, in Greensboro. Payments on the loan, however, were Coates's responsibility, as were salaries and the Institute's daily operating expenses.

Annual dues paid by cities and counties and Coates's law school teaching salary helped with the operating costs. Local businessmen extended and re-extended credit for gasoline, telephone, and food. But as Coates recalled, there was a "mortgage on the building, and I had the personal responsibility of meeting yearly payments. I found that I could rake, scrape, and borrow no longer. I was at the end of my rope."

In 1940, William D. Carmichael, the newly appointed comptroller of the University, visited Coates, complaining that he was unable to find provisions for the Institute in the University's budget. When Coates explained that the Institute was a private venture supported by "private individuals supplemented by city and county membership dues," Carmichael determined to bring it into the University, "where it belongs." UNC President Frank Graham agreed.

Photograph provided by the North Carolina Collection; photographer, Lavergne of Chapel Hill

William D. Carmichael

Frank Graham

Tax supervisors attending a course at the Institute, early 1940s.

The state budget commission, chaired by James H. Clark, voted to retire Coates's "personal obligations incurred in keeping the Institute going," and Governor J. Melville Broughton agreed to "recommend that the General Assembly appropriate $15,000 a year for five staff members at $3,000 a year—a living wage in those days. He did this in recognition that the Institute was serving the state no less than cities and counties." Therefore the state would match the annual membership dues paid by local governments.

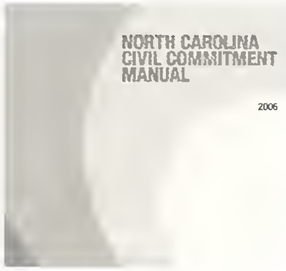
Still, the Institute needed $20,000 to guarantee its operations for a year—until the General Assembly could vote on the appropriation in early 1943 (at that time the legislature met only in odd-numbered years). In winter 1941, at the urging of his sister Cornelia, the president of Burlington Mills, Spencer Love, provided the needed gift.

"The financing plans were approved by the Executive Committee of the Board of Trustees in December 1941, and the Institute of Government became part of the University of North Carolina on January 26, 1942."

Note: Quotations and facts are from *The Story of the Institute of Government*, by Albert Coates.

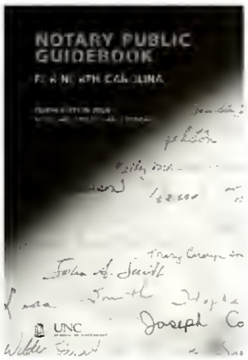
Off the Press

North Carolina Civil Commitment Manual
Forthcoming Summer 2006 • $65.00*
Lou A. Newman



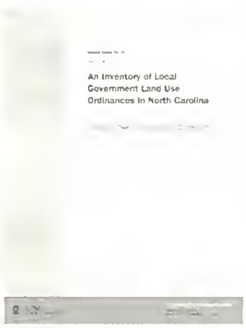
Designed to assist attorneys representing respondents or minors in civil commitment proceedings, this manual reviews North Carolina mental health and substance abuse laws pertaining to inpatient and outpatient commitments and admissions. Analyzes in depth the relevant statutes in Chapter 122C of the North Carolina General Statutes and applicable case law. Also discusses the collateral consequences of commitment and the special provisions on commitment of respondents involved with the criminal justice system. Although the manual focuses on proceedings requiring the appointment of counsel, it is a clear, usable resource for anyone who works in this challenging area of law.

Notary Public Guidebook for North Carolina, Tenth Edition, 2006
Forthcoming Early Fall 2006 • $16.00*
Charles A. Szypszak



This convenient reference work contains laws, practices, and forms essential to notaries public in North Carolina. Also valuable for registers of deeds, clerks of superior court, and practicing attorneys. Contains updated text and forms since publication of the ninth edition, 2004, including changes to laws affecting North Carolina notaries made by Session Law 2005-391. This law has a new Chapter 10B, Notary Public Act, which makes substantial changes to the prior notary public law and introduces a new Electronic Notary Act.

An Inventory of Local Government Land Use Ordinances in North Carolina
Spring 2006 • $16.50*
David W. Owens and Nathan Branscome



This report, Special Series #21, summarizes the responses of North Carolina cities and counties to a survey asking about their adoption of ordinances related to land use. Each local government was asked whether it had adopted zoning, subdivision regulations, housing codes, and related regulations. The appendix includes two large charts showing the status of ordinance adoption for each county and city that responded to the survey.

Recent Publications

North Carolina Experience with Municipal Extraterritorial Planning Jurisdiction
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David W. Owens

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