ARTICLE 17

Capital Planning, Budgeting, and Debt Financing

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PROVIDING THE CAPITAL INFRASTRUCTURE, facilities, and equipment needed for public services is among the most important responsibilities of county and city officials. The North Carolina General Statutes give counties and cities specific powers that are important in capital budgeting and debt financing. The Local Government Bond

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Act, G.S. Chapter 159, Article 4, authorizes general obligation bonds secured by taxing power for a broad range of capital purposes. G.S. Chapter 159, Article 5, authorizes revenue bonds secured by the net earnings of a self-supporting enterprise to finance capital projects for such enterprises. Under the security interests statute (G.S. 160A-20), installment purchase and certificate of participation debt, which is secured by the property financed with the debt, may be used to finance the acquisition or construction of capital assets. Special obligation debt, which is secured by revenues other than taxes of the issuer, are authorized by G.S. 159I-30 for county and city solid waste, water, and wastewater projects. G.S. 159, Article 6 and G.S. 158-7.3 authorize counties and cities to issue *project development* debt, secured by incremental property tax revenue, for certain economic development projects, and some counties and cities have issued variable rate debt under G.S. 159-79 to take advantage of market conditions favoring such debt. Beyond statutory powers related to debt issuance, G.S. 159-18 permits counties and cities to establish and fund capital reserves and to appropriate money for capital projects in project ordinances. Finally, one statutory duty of managers in counties and cities with the *manager form* of government is to prepare and submit a capital program [G.S. 153A-82(5) for counties and G.S. 160A-148(5) for cities].

Although these statutes grant important powers, they do not specify a process for local governments to use in planning, budgeting, and financing capital projects. This absence contrasts with annual budgeting, for which the Local Government Budget and Fiscal Control Act (G.S. Ch. 159, Art. 3) sets forth a process for counties, cities, and local public authorities to follow (see Article 15 of this volume).

What, then, is *capital planning, budgeting, and finance*? It may be defined as a process that has the following steps:

1. *Defining and classification of capital expenditures.* This consists of deciding what assets or property are in fact capital and whether expenditures for them belong in the capital budget, as well as making sure that specific expenditure items properly chargeable to a capital project or acquisition are so charged and others are not.
2. *Identification of capital needs.* This can involve capital asset management systems that identify needs for the renovation or replacement of existing infrastructure and capital assets, and long-term (five to twenty years or so) strategic or master planning to point to new capital facilities and technology needed to meet or spur development and growth.
3. *Prioritization of capital requests.* Specific prioritization approaches have evolved in capital budgeting for setting capital requests into priority. One involves the evaluation of requests in terms of *urgency of need* criteria, such as legal mandates and consistency with goals and objectives. Prioritization typically occurs in the capital improvement programming process.
4. *Capital improvement programming.* This is at the heart of capital planning. It involves planning for and scheduling major capital needs for approval, funding, and implementation over a future period—usually five to six years.
5. *Assessment and forecast of financial condition ability to finance capital needs.* This involves determining present financial condition and projecting the resources that will be available to finance both capital needs and future annual budget requirements over the same forecast period covered by the capital improvement program. Special attention is given to financial and debt ratios that bond rating agencies use to assess local government debt ratings.
6. *Selection of the financing source(s) for individual capital projects and expenditures.* Major capital projects are often financed by issuing bonds or other forms of debt. Other sources of capital financing include current revenues, capital reserves, impact fees or other charges to property, and grants.
7. *Maintaining or improving bond ratings.* Three national bond rating agencies—Fitch, Moody's, and S & P, and one state-level agency—The N.C. Municipal Council—evaluate the debt of North Carolina counties and cities that issue debt. Their ratings affect the interest rates charged on the debt and address the financial condition and practices and underlying economies of the debt issuers.
8. *Authorization of capital projects or expenditures and appropriation of funds for them.* Authorization and appropriation may occur together or in separate steps. Appropriation may be made in the annual budget ordinance or in one or more capital project ordinances.
9. *Obtaining and management of financing for projects.* This involves selling or placing debt, obtaining other capital financing, complying with federal regulations, construction financing, and other issues. Construction contracting and management are also critical to the successful implementation of capital plans and budgets. Construction methods authorized for North Carolina counties and cities are addressed in Article 20.

Before addressing in depth the above-listed steps involved in capital budgeting and financing, it is useful to consider why a county or city would use an elaborate process, consisting of many or all of these steps, for capital budgeting.

Why Capital Budgeting?

Why would a county or city establish a special process or set of procedures for planning, financing, authorizing, and implementing decisions about capital projects and acquisitions? One reason is the sheer magnitude of many capital projects, especially certain infrastructure improvements and building projects. Much money is at stake in decisions about these projects, and a county or city needs to make sure that the decisions are the right ones and that the money for them is spent wisely.

The consequences of capital budget decisions often extend far into the future, lasting as long as the useful lives of the projects or assets built or acquired. Much planning is needed to assure that capital facilities with useful lives of thirty years or more are cost-effective in meeting their intended purposes. If mistakes are made in selecting the location for such a project or in designing or constructing it, the county or city will have to live with the results of those mistakes for a very long time, or possibly spend a great deal of money correcting the mistakes.

Debt financing often is used to finance major capital projects. This creates annual principal and interest payment obligations on the debt for many years into the future—a fact that should cause officials to carefully plan and budget for the projects to be financed with the debt. Moreover, if the debt to be issued for a project is general obligation bonds, the bonds will most likely have to be approved by the county's or city's voters in a referendum. Officials taking a proposed bond referendum to the voters can use capital budgeting to make sure the projects to be financed with the bonds are well-conceived and planned.

Another reason for capital budgeting arises because major capital project or acquisition decisions do not recur each year. In the operating budget, most expenditures recur annually and officials can refer to recent experiences to help them make decisions for the coming year, thereby limiting the risks involved in these decisions. On the other hand, because major capital projects have long useful lives, the decisions to undertake them recur infrequently. As a result, officials usually do not have recent experiences to guide them in decisions they must make about major projects this year. Because the consequent risk of error is higher for these decisions, it is a good idea to have a special process for planning and making decisions about capital projects.

Capital budgeting can help a city or county provide for the orderly rehabilitation and replacement of public facilities. To assure the adequacy of public infrastructure and services, the facilities and equipment involved in providing the services must be repaired and renovated or replaced in a timely way. Capital renovation and replacement projects are too often postponed beyond the time when they should be undertaken. A capital budget can help officials focus attention on capital renovation and replacement needs.

Finally, providing adequate public infrastructure and facilities is typically a vital part of any economic development program. Many parts of North Carolina are growing rapidly, and the counties and cities serving these are hard-pressed to provide the water-sewer, transportation, schools, and other facilities needed to accommodate the growth. Other communities in the state, especially in more rural areas or where traditional industries have closed, have experienced economic decline or stagnation. Counties and cities serving these areas are undertaking economic development programs that include upgrading existing or providing new infrastructure to attract new businesses and jobs. Capital budgeting can be a vital part of the economic development programs of counties and cities.[1]

Definitions and Classification of Capital Expenditures

Broadly conceived, a *capital expenditure* is an outlay of significant value that results in acquisition or improvement of property or assets that have useful lives extending beyond a single year.[2] Such property or assets are called *capital assets* under generally accepted accounting principles and are distinguished from *current assets,* which are used up or expended within one year.

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1. A study of Florida municipalities suggests that infrastructure issues are significant in determining the outcomes of governing board elections. *See* Susan A. McManus, "'Bricks and Mortar' Politics: How Infrastructure Decisions Defeat Incumbents," *Public Budgeting and Finance* 24, 1 (Spring, 2004): 96–112.

2. Stephen Gauthier, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: Government Finance Officers Association of the United States and Canada, 2005), 680. The definition from this source specifies that "useful" life is

The capital assets that counties and cities own and use are commonly classified into the following categories:[3]

1. *Land*. The costs of land include the amount paid to acquire ownership, legal and other fees incidental to land acquisition, and costs to prepare land for use. Land also includes the costs of obtaining long-term easements or certain other rights to use land.
2. *Buildings and improvements to buildings*. Buildings are defined as relatively permanent structures that house persons or property. Costs here can include payments to contractors or costs incurred by a county's or city's own workforce to construct buildings, the amounts paid to buy buildings, and costs to acquire and install equipment that are made a part of a building and that cannot be removed without damaging the building. Such equipment items are commonly called *fixtures*.
3. *Infrastructure*. This classification consists of normally stationary and long-lived improvements (other than buildings) that add value to land. Examples are streets, sidewalks, storm water facilities, and water and sewer lines and systems.
4. *Equipment, machinery, and certain other permanent personal property*. Examples of equipment or machinery are automobiles, trucks, construction machinery, communications equipment or systems, computers, and office equipment and furniture. Equipment or machinery classified here must be movable rather than fixed or attached to a building or infrastructure. Other personal property can include works of art, historic treasures, or certain intangible property owned and used by a county or city.[4]
5. *Construction in progress*. This includes the costs of construction undertaken but not complete. These costs are reclassified under "buildings" or "infrastructure" when a construction project is finished.

Expenditures for capital assets owned and used by a county or city for general governmental purposes, for example, streets, public safety, and parks and recreation, should be budgeted for in the general fund, a capital projects fund, or another governmental fund, and then recorded or carried as *general capital assets* in the accounting system. Expenditures for capital assets used by a county or city for enterprise or proprietary fund activities should be budgeted for and recorded or carried as capital assets in the appropriate enterprise or proprietary funds.

The general definition of capital expenditure given above states that such an expenditure must be of *significant value*. *Significant value* in the definition refers to what accountants call the *capitalization threshold*. An expenditure above this threshold or amount for or on property that has a useful life longer than one year should be *capitalized,* that is, counted as a capital rather than a current or operating outlay, and added to *capital assets* in the accounting system. An expenditure less than the capitalization threshold is considered to be *immaterial* from a capital asset accounting perspective and is classified as a current or operating rather than a capital outlay, even if the expenditure is for or on property that is or will be used for more than one year. The selection of the capitalization amount is a local decision and can depend on the size of the county or city. The threshold for most counties and cities or towns, except very small ones, is now $5,000. Some large cities and counties use a higher threshold for improvements to buildings or infrastructure or general rehabilitation projects related to capital assets.

The capitalization threshold is typically applied on an item for item basis. Thus, if a jurisdiction with a $5,000 capitalization threshold purchases 30 office desks, each costing $500, the chairs would be charged as operating or supply items, that is, *expensed,* rather than recorded and carried in the accounting records as capital assets. Correspondingly,

meant as "initial" useful life. The definition also adds a qualification that the assets must be "used in operations." This is excluded from the definition here because governments acquire property or assets that are not used immediately in operations; for example, land that is not used when or shortly after it is acquired but several years later when a public facility is built on the land. The presumption of the definition provided in the text is that the assets are acquired because they immediately or eventually will be used by the government acquiring the assets.

3. This classification is based on the classification provided in Robert J. Freeman, Craig D. Shoulders, and Gregory S. Allison, *Governmental and Nonprofit Accounting: Theory and Practice,* 8th ed. (Upper Saddle River, N.J.: Prentice Hall, 2006), 348–49.

4. *Ibid.* Works of art, historic treasures, and certain intangible property are not included in the list of capital assets presented by Freeman, Shoulders, and Allison. They are added here based on their inclusion among capital assets by Gauthier, *Governmental Accounting, Auditing, and Financial Reporting,* p. 680, and because of their growing importance in local arts, museum, and historic preservation programs.

the expenditure to acquire the desks would be an operating rather than a capital expenditure, even though the useful life of the desks spans many years and the total outlay to acquire the desks is $15,000 (30 x $500), which is three times the capitalization threshold of $5,000. While the capitalization threshold should generally be applied on an item for item basis, there can be exceptions when purchases of certain lower cost, long-live assets or property, such as water or sewer pipe for a city utility system or books for a county library, become a component or part of a system or set of long-lived property with *material* value in excess of the capitalization threshold.

In the past, in governmental budgeting and accounting, only expenditures to acquire or improve *tangible* assets or property have recorded as capital.[5] Tangible assets are touchable or physical items; for example, land, buildings, and equipment. Expenditures to acquire *intangible* assets, such as a patent or a license to use a specific technology, have seldom been classified as capital outlays. Instead, the expenditures have been treated as current rather than capital outlays and the resulting assets fully expensed in the year of acquisition rather than included among capital assets in the accounting system. Today, generally accepted accounting principles allow for the capitalization of intangible, long-live assets,[6] and a growing number of North Carolina counties and cities are recording some expenditures for such assets as capital rather than current and carrying them as capital assets in the accounting system. For example, some counties and cities have purchased expensive computer software applications that run on different computer or communications systems that they use. They have recorded these purchases as capital expenditures and recorded the costs of the purchase as a separate capital asset, apart from the computer hardware that they have, in their accounting systems.

Not all capital expenditures have to be included in the capital budget. Lower cost capital expenditures and those that recur every year may be identified and reviewed in the annual budget process, approved in the annual budget ordinance, and accounted for in the general fund or in another operating fund. The meaning of *lower cost* will vary with the size of a county or city. A town with a population of 5,000 or less or a county with 25,000 or fewer people might establish a cost cutoff for this determination of anywhere from $10,000 to $25,000 or so, and include all capital assets with an acquisition or construction cost below this amount in its annual budget and all more costly capital assets in a separate capital budget. A medium-sized or large county or city would use a higher cutoff—for example, anywhere from $25,000 to $100,000 or even more—and put only capital assets that cost more than this amount in its capital budget.

Many annually recurring capital expenditures are made to replace vehicles and equipment. For example, many counties and cities replace some law enforcement patrol vehicles annually. Because each patrol vehicle is generally used for more than one year and is of significant value—that is, it costs more than the minimum dollar amount, for example, $5,000, used for capitalization—each is a capital asset, and the expenditures to acquire one or more are capital. But annually recurring expenditures to replace patrol vehicles or other equipment or capital assets may be included in the annual budget. They can be reviewed and approved in the annual budget, which can accommodate them just as readily as expenditures for salaries, supplies, and operating items, which also recur yearly.

It is the very expensive, long-lived, and irregularly recurring capital projects and acquisitions that deserve the special treatment and planning called capital budgeting. Such projects and acquisitions are more cost-effective if they are identified years ahead of actual need and prioritized and planned through a multiyear capital improvement program. They require large amounts of financing, for which debt is often issued, and they are frequently budgeted in capital project ordinances and accounted for in special capital project funds.

Questions occasionally arise in deciding whether to charge specific items of cost to a capital project or expenditure. A capital project or acquisition should include all expenditures or items that are incurred to put the capital asset being built or acquired into operating condition. For construction projects these items would include all costs for labor and construction materials; planning as well as architectural and engineering design; legal services; the acquisition of land or other property for the project, including brokerage fees and the preparation of land for construction; easements; equipment and furnishings that are affixed to the project; interest and other financing charges during construction; and project administration charges. For equipment acquisitions the capital cost or expenditure includes not only the purchase price of the equipment per se, but also any transportation charges to move the equipment to its place of intended use and costs for installation and testing, if any.

5. The glossary of the 1994 edition of Gauthier, *Governmental Accounting, Auditing, and Financial Reporting*, defines capital (or fixed) assets as "long-lived, tangible assets," p. 330.

6. Gauthier, *Governmental Accounting, Auditing, and Financial Reporting*, p. 680.

Expenditures for certain items associated with a capital asset or facility may not be charged as a capital cost of the asset. Instead, they are operating expenditures. For example, although expenditures to buy land for a landfill and ready it for use are properly charged as capital costs for the landfill, expenditures for certain closure and post-closure purposes at a landfill are considered to be operating expenditures, according to interpretations of the bond statutes and generally accepted accounting principles, and may not be included among capital costs.[7] Furthermore, although expenditures for some maintenance and repair—for example, a major repainting project on a large building—are very expensive and may preserve the useful lives of capital assets, they should be budgeted and accounted for as operating expenditures.

Identification of Capital Needs

The identification of capital project and equipment needs occurs in the capital improvement programming process in many jurisdictions. County or city departments submit Capital Improvement Program (CIP) requests to replace or renovate facilities and equipment. They submit other requests for new facilities and equipment to improve services or meet growth. Community and business groups submit CIP requests related to neighborhood, community, or development needs.

Some counties or cities have long-term master or strategic plans that identify future capital needs. Such planning typically identifies needs in one or more specific functions, for example, street and sidewalk improvements, or across functional areas for particular geographic areas—the downtown or one or more neighborhoods. Strategic or master plans usually extend over a multiyear period that matches or exceeds the CIP forecast period. Some master plans identify capital needs as many as twenty years into the future. The master or strategic plans are often put together by planning task forces or groups composed of citizens, representatives of community and local business associations, and elected officials as well as staff of the county or city. Cost estimates for capital project needs identified in a master or strategic plan are typically general. After initially completed, a master or strategic plan can be updated annually or periodically to keep it current with changing conditions. Such updating may be done by the planning groups or task forces, if they remain intact, or by county or city officials. Such master or strategic planning can be an effective tool for identifying and defining many if not most of the capital project and equipment needs of a county or city.

Hickory provides one example of a city that has long-term master plans identifying capital public infrastructure and facility needs. These plans include a ten-year, citywide landscaping plan; a ten-year parks and recreation plan; a twenty-year sidewalk and bikeway plan; and several plans that address public improvement and service needs in specific city neighborhoods over multiyear periods. The city began facility and service master planning in the 1990s. Once initially formulated, a master plan is updated annually by city staff working with interested citizen groups. The city council reviews and generally approves each updated plan, and CIP project requests come from the master plans each year.

Capital renovation and replacement needs can too readily be neglected or put off beyond when they should be done. As a result, when such projects are eventually undertaken, the costs are much higher than if the projects were done in a timely way. To identify capital renovation and replacement needs, a growing number of counties and cities utilize “capital asset management” or other systems that serve similar purposes. Such systems rely on engineering-based analysis to evaluate the condition of streets and roads, water-sewer infrastructure, and other types of facilities or infrastructure. For example, Greensboro has utilized such a system to assess the condition of fire stations and other city-owned buildings for many years. The system has been used in conjunction with the city’s capital improvement program, and it projects when the renovation or replacement of facilities should take place and estimates the costs for such renovation or replacement. Greensboro is now in the process of revamping, extending, and strengthening this system for assessing and planning renovation and replacement projects.[8]

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7. *Ibid*., pp. 107–8.

8. This information about the Greensboro “capital asset management system” was provided by Larry Davis, the city’s budget director, and Rick Lusk, the city’s finance director.

Prioritizing Capital Project and Equipment Requests

Few, if any, counties or cities have sufficient resources to meet all their capital needs. Capital project and equipment requests compete with one another for available resources, and the requests have to be set into priority. Prioritization occurs after capital needs are identified and capital project and equipment requests are made in the CIP process. The results of prioritization or ranking include the allocation of the costs of capital project and equipment requests among the years of the CIP forecast period, with projects or spending that are ranking higher in priority allocated to the first few years of the forecast period and capital projects or spending ranked lower in priority put into the latter years of the CIP or altogether excluded from it.

Different approaches are used to prioritize capital project and equipment requests. Officials can rank requests based on their judgment about the relative need for different projects. While prioritization based on the judgment of experienced officials is a key part of any decision-making or budget process, prioritization based solely on experienced-based judgment often falls short under certain conditions: capital needs and requests are numerous, the dollar amount of the requests are great relative to available resources, some of the requests involve complex technologies or technical considerations, there are multiple officials involved in prioritization and they come to the task with different values or frames of reference, or when it is especially important for priorities and decisions to be explained to the broader community, regulators, or investors.

One or more of these conditions typically prevail in capital budgeting, and officials turn to approaches, ranking criteria, or systems to help them prioritize requests. One approach to prioritizing capital requests is to do so in terms of functional or program priorities or goals. The philosophy here is that the same program priorities and goals should drive both the capital and the operating or annual budgets. Thus, if the governing board decides that transportation and public safety needs are a jurisdiction's top priorities, this should weigh heavily if not determine priorities among capital project and equipment requests. Projects in the transportation and public safety areas would generally be approved and funded ahead of projects in other program or functional areas. Similarly, if a county or city governing board sets specific program goals and ranks such goals into priority, the prioritized goals would influence or determine priorities among project and equipment requests in the CIP as much as among operating budget requests in the annual budget process. For example, if a local governing board sets goals to reduce traffic congestion in the downtown and to increase recreational opportunities for youth and makes these goals high priorities, project or equipment requests responding to these goals would presumably have a high priority.

When program priorities or goals are used to prioritize capital requests, it is usually sufficient for officials just to identify their top priorities and goals, and not to label some programs or goals as low in priority. Doing the latter runs the risk of generating criticism from those working in or served by the "low-priority" programs. It can also make it more difficult for officials to fund a few projects in the so-called low-priority program areas.

Specific ranking criteria or systems have been developed for capital budgeting and are used by officials in a growing number of counties and cities to prioritize CIP project and equipment requests. Many of these systems make use of so-called urgency of need criteria. The following are some of the urgency of need criteria found in CIP ranking systems:

- reduces or eliminates threats to public health and safety
- legally mandated
- remedies facility or service deficiency
- consistent with governing board goals
- results in more efficient operations
- promotes economic development
- takes advantage of grant or other outside funding
- linked to other projects
- supported by community

Officials in Chatham County, which is experiencing rapid growth and faces major capital needs, use these and additional urgency of need criteria in a weighted rating system to prioritize capital project and equipment requests (see Table 17-1). County officials have used the rating system, or slight variations of it, for more than ten years. The

Table 17-1. *County Weighted Rating System for Prioritizing Project Requests*

Rating Criteria	Definition/Explanation	Maximum Points	Percentage Weighting
Goals/objectives	Extent to which project meets goals and objectives of county commissioners.	25	15.9
Safety	Extent to which project eliminates, prevents, or reduces an immediate hazard to safety.	14	8.9
Mandates	Extent to which project helps county meet existing or new mandates.	13	8.3
Timing/linkages	Extent to which project is timely, a continuation of a project currently under way, related to other high-priority projects, etc.	12	7.6
Economic impact	Extent to which project enhances economic development in county, or directly or indirectly adds to the tax base.	11	7.0
Efficiencies	Extent to which project contributes to savings in county operating or capital spending.	10	6.4
Maintaining current level of service	Extent to which project is necessary for county to continue to provide one or more services at current standards	9	5.7
Improving access	Extent to which project improves citizen access to current services.	8	5.1
Service improvement	Extent to which project improves the quality of existing services.	7	4.5
Service addition	Extent to which project increases the quantity of existing services.	3	1.9
Operating budget impact	Projects that lower future operating expenses receive a positive score, ranging from 0 to 15. Projects that have no effect on operating expenses receive a score of 0. Projects that increase operating expenses score anywhere from 0 to –15	0 to 15, 0, or 0 to -15	9.5
Community support	Extent to which project has broad and/or strong support from the community.	10	6.4
Financing	Extent to which project can be financed with non-general fund revenue sources.	15	9.5
Timeliness of submission	Extent to which project request is submitted in a timely way.	5	3.2
Maximum points, all categories		157	100.0

system's criteria, their definitions, and weightings were developed by the county manager and staff and approved generally by the county commissioners. The county manager and staff budget team used the system to help prioritize requests and develop the recommended CIP.[9]

The rating system in Table 17-1 includes a criterion for "consistency with commissioner goals/objectives." While this criterion is the most important factor in the system, weighted at 25 points or 15 percent of total points, it is only 1 of 14 rating criteria. Thus, urgency of need criteria and weighted rating systems for prioritizing capital projects can

9. The assistant county manager, who also serves as budget director, developed the system. It is also used by the county's "budget team" to help prioritize operating requests in the annual budget process. The specific criteria and weights shown in Table 17-1 are those for the system when it was first devised and used. The main difference between the original system and the one currently used is that the current system does not have a category for "consistency with commissioner goals/objectives." The removal of this criterion, worth 25 points, occurred in 2000 because the commissioners stopped setting explicit goals and objectives then. The current system has only 132 points due to the absence of this criterion.

be structured to include governing board program or functional priorities and goals. However, such priorities and goals are usually just one of many bases for prioritizing capital projects using an urgency of need criteria and/or a weighted rating system. Other considerations are legal mandates, threats to public health and safety, availability of outside funds, and so forth. Moreover, governing board goals and objectives generally and in a weighted rating system for capital budgeting can include not only program or functional priorities and goals but other types of goals that bear little or no relation to prioritization of requests for the CIP or annual budget.

Ranking criteria or rating systems provide officials with a common framework for setting projects into priority and explaining project decisions to the public. The criteria or systems do not determine the priorities or decisions, nor do they make prioritization an "objective" process. The prioritization process and resulting rankings remain subjective in that officials select some ranking criteria and not others, and if weightings are used, vary the ratings for different criteria based on the officials' perceptions of the relative importance of the criteria. The use of urgency of need criteria and rating systems for prioritizing capital projects helps officials consider a range of factors in ranking projects and approach prioritization in an organized manner. Finally, it is important to note that the relative importance or weights of different urgency of need criteria can or may need to vary from one functional area to another in the prioritization process. For example, while commissioner goals may be uppermost in determining priorities for downtown development projects, environmental (legal) mandates may effectively drive priorities among water-sewer projects.

Capital Improvement Program

The capital improvement program is at the center of planning for capital projects and acquisitions and is a basis for recommendations to authorize and implement projects. The CIP is also a critical element in financial planning for a county or city. A CIP is a multiyear forecast of: (1) major capital infrastructure, building, and equipment needs that a city or county faces; (2) the project appropriations or spending that are or will be incurred to make those needs a reality; (3) the sources of financing for the projects; and (4) the impact of the projects on future operating budgets. The CIP is essentially a plan with projects and spending in the first year of the CIP typically becoming the recommended capital budget for that year.

Most CIPs forecast five or six years into the future. Experience suggests that this provides sufficient time to identify and plan most capital projects and arrange financing for them, yet it is not so long as to result in too much "wish-listing." While five or six years is the norm, some counties and cities find it useful to extend the CIP forecast period to ten years or so. These are usually fast-growing jurisdictions that face major new capital improvement needs. For example, both Cary and Pitt County have ten-year CIPs, reflecting these jurisdictions' efforts to plan for the substantial growth occurring now and expected in the future. The out-year projections in these CIPs are typically more general than the projections for the near-term years. A county or city with a five- or six-year CIP can accommodate needs in the years beyond that period by including a list of projects that are not in the CIP but that remain "under consideration." Some smaller local governments have CIP planning periods of just three or four years. Such a forecast period can work effectively when most capital projects are modest in size.

Table 17-2 presents a prototype CIP with a six-year forecast period. The prototype form lists functional areas for projects characteristic of a city's general fund. The essential feature of a CIP is the apportionment of project spending, financing, and operating budget impacts among the years of the CIP forecast period. The columns in Table 17-2 designated "Prior years" and "Current year" are for capital projects that are in process. These were for projects that were previously approved and for which spending is occurring in these years. The "Year 1—budget" is for capital projects and spending that will occur in the upcoming budget year. Such projects and spending may be considered to be the recommended capital budget for that year. They may be for projects previously approved and for which spending will occur in the budget year, or for projects to be undertaken or getting underway in the budget year. The columns for "Year 2" through "Year 6" are for capital projects and spending that are planned for one or more of those years. Some of the spending in those years may be coming forward from the budget of an earlier year. Other spending will be for projects expected to start in one of the planning years.

The CIP is conceived of as an annual process, and most jurisdictions with a CIP repeat the process each year. Annual repetition provides for a recurring assessment of capital needs and updates the CIP every year to account for new needs or circumstances. Use of a CIP presumes that capital needs are foreseen and requests are placed initially in the CIP in one of the distant planning years. Then the requests are reviewed each year when the CIP is repeated. When the requests that survive reach the budget year, they are approved and funded, rejected, or perhaps postponed another

Table 17-2. *CIP Summary Form—General Fund*

Item	Prior years	Current year	Forecast period						Years beyond year 6	Totals
			Year 1 budget	Year 2 plan	Year 3 plan	Year 4 plan	Year 5 plan	Year 6 plan		
Project and acquisition expenditures by function										
Public safety										
Street and transportation										
Recreation and culture										
Community development										
Technology										
General government										
Total project expenditures										
Financing sources										
Operating revenues										
Fund balance										
Capital reserves										
Equipment/vehicle replacement fund										
General obligation bonds/debt										
Capital lease debt										
Other bonds or debt										
Impact/development fees										
Grants										
Other sources										
Total financing sources										
Impact on operating budget:										
Debt service: bonds & COPs										
Capital lease payments										
Increased operating costs										
Decreased operating costs										
Increased/decreased revenues										
Total operating impact										

year. Not all capital needs can be recognized five or six years ahead of the time they are needed. Some will have to be approved almost immediately upon first request. However, if this happens for many requests, the CIP loses much of its value as a planning tool.

As Table 17-2 shows, the CIP also identifies the financing sources for capital projects or acquisitions and the impact on future operating budgets. The CIP can be valuable by helping officials identify and arrange or secure capital financing for projects. The larger the project is the more challenging financing becomes. The CIP can provide officials the time to pursue grants or other outside financing or to arrange or negotiate financing that saves the county or city significant money. The CIP can also help officials coordinating the capital and operating budgets. This could involve changing or customizing projects in terms of operating budget limits in the future, or planning to ready the operating budget for the implications of going ahead with major capital projects. Subsequent sections of the article discuss capital financing and financial planning.

The CIP also allows time for the design of projects, giving architects and engineers the opportunity to more carefully define project scope, prepare plans, and estimate project costs. The CIP can provide officials with time to find suitable sites for projects and negotiate for the purchase of land on favorable terms. A CIP can help officials spot the relationships among different projects and plan and schedule them for implementation in a way that saves money.

The CIP process usually involves the review of requests by different officials and public bodies from different perspectives. The county or city planning board and planning staff may make one review that focuses on the needs that requests fulfill and their conformity with development plans and restrictions. The county or city manager and budget or finance staff review CIP requests in terms of their feasibility, benefits, costs, source(s) of financing, impact on future annual budgets, need relative to other requests, and alternative ways to meet the needs. The governing board of a county or city makes a final review of CIP requests considering benefits, costs, relative need, and of course the impact of projects on future tax rates, utility charges, and so forth. The governing board may hold one or more public hearings as it considers the CIP and proposed capital projects, although there is no statutory requirement for a public hearing on a CIP. When its review is finished, the governing board usually adopts a resolution approving the CIP. This formalizes and adds to the legitimacy of the CIP process. However, such a resolution neither authorizes nor appropriates funds for projects. Governing board authorization or appropriation of money for projects occurs by board enactment of projects ordinances or by the inclusion of projects and spending for them in the annual budget ordinance. A resolution approving the CIP is basically a statement of governing board intent to move in the general direction implied by the CIP.

Assessment and Forecast of Financial Condition

Any county or city capital budget process needs to involve an assessment of the jurisdiction's current financial condition and a forecast of its capacity to fund future needs, including on-going services or programs, future debt service, and planned capital projects or acquisitions included in the capital improvement program.

Analysis of current financial condition and trends. A county's or city's financial condition depends on growth or change in annual or recurring revenues, spending commitments for services or programs, fund balances and other reserves, and payment obligations on existing debt. Financial practices also of course underlie or affect financial condition and prospects.

Annual or recurring revenues, including taxes, sooner or later support all spending including expenditures for capital projects. Such revenues provide resources to pay operating spending for services and programs, to support pay-as-you-go capital financing, and to cover debt service or lease payments on bonds or debt and lease obligations incurred to finance capital projects. The growth or change in major annual tax or other revenue sources, such as the property tax, sales tax, state shared revenues, and, for cities, utility revenue, should be tracked and graphed over a period of past years. Doing this over an historical period of ten years or so can help officials identify trends in revenue growth or change. Such growth can be compared with growth or change in a county's or city's population and in spending for major services or needs. The analysis of growth or change in specific revenues in the past should distinguish among growth or change in the tax or revenue base attributable to economic expansion or change, redefinitions of the tax or revenue base, and changes in the tax or revenue rate. If some tax or revenue sources are not growing or growing slowly, the causes should be identified.

Expenditures for salaries, wages, and fringe benefits account for the largest share of operating spending for many county or city services. Growth or change in spending for such items should be tracked, graphed, and analyzed over the same ten or so years that major revenues are tracked. Spending for other major operating budget categories or items—such as Medicaid and school current expense funding for counties and public safety, transportation, and utility spending for cities—should be similarly plotted over the same historic periodic. Analysis of spending for such operating budget items or categories should identify rate or pace of growth, address the causes or reasons for the spending growth, and compare such growth with growth or change in the major revenue sources. If spending growth is outpacing revenue growth, the analysis should consider alternative policies for closing the gap.

Calculation and analysis of available general and other operating fund balances is critical in a county's or city's financial condition. Legally available fund balance for a North Carolina county or city is defined as the sum of cash and investments less (current) liabilities, encumbrances, and revenues collected in advance (deferred revenues). Article 15 provides a full explanation of this formula for calculating fund balance. Suffice it to say here that general and other operating fund balances support both the operating and capital budgets. They support the operating budget by providing *working capital* to be able to meet payment obligations on time and to fund cash flow shortfalls during the fiscal year. They also serve as rainy day funds to cover unanticipated or emergency operating spending. General and other operating fund balances support the capital budget in so far as they often become a source of pay-as-you-go financing, especially for smaller and more conservative counties and cities. The bond rating agencies like to see local governments carry significant operating fund balances, which is an important factor in their rating analyses. The analysis of available operating fund balances should relate the balances to spending and to the risks or uncertainties that a county or city faces. Available fund balance levels, in dollar terms and as a percent of spending, should be tracked over the same ten or so years that revenues and spending are tracked, and the causes or reasons for increasing or decreasing fund balances should be identified.[10]

An analysis of outstanding debt, including capital lease obligations, is another critical component in any assessment of a county's or a city's financial condition. If a county or city is already heavily in debt and is making large annual debt service payments, its ability to incur additional debt to finance new capital projects requested in the capital improvement program is limited. Various debt ratios are used to assess a jurisdiction's debt burden and capacity. One set of such ratios relates to *net debt.* Generally, such debt can be thought of as debt issued to finance *governmental* public improvements and infrastructure, such as streets, roads, parks, libraries and museums, and general office buildings. Net debt is typically repaid from general revenues and taxes. Several ratios are used to measure and evaluate the incidence of net debt, most notably, net debt per capital, debt as a percent of taxable valuation, and annual debt service on net debt as a percent of general fund and related spending. The analysis of a county's or city's financial condition should calculate these or other relevant net debt ratios and track them over the same ten-year historic trend or tracking period used for revenues and spending. The ratios for any particular county or city should also be compared to those for similar sized or situated counties or cities.

Financial practices, of course, sooner or later affect a local government's financial condition. A county or city's budget, accounting, and tax and revenue administration practices need to be tracked over time and compared with these same practices of similar sized or situated jurisdictions and/or with accepted benchmarks for the practices. For example, the analysis can compare actual spending within budgeted appropriations and actual revenue collections with budgeted estimates in recent years, note whether accounting and financial reporting practices comply in all *material* respects with generally accepted accounting and financial reporting principles, and track tax and revenue collection percentage periods over the trend period, for example ten years, used in the analysis.

Preparation of a financial forecasting. A financial forecast builds on the analysis of current financial condition and trends, considers likely changes in the local economy over the forecast period, analyzes the effect of likely changes in the economy on county or city finances, and projects future county or city annual revenues, spending, and fund balances. A financial forecast generally extends over the same future period that the CIP covers. It supports the operating budget as well as the CIP or capital budget. For any year during the forecast period, annual revenues less annual operating spending and contributions to operating fund balances or capital reserves leaves the amount that is available to support pay-as-you-go capital financing, contributions to capital reserves, and annual debt service payments that year.

A county or city can prepare a multiyear financial forecast using a format like that presented in Table 17-3. The format is for a city's general fund. It uses the same yearly format as the CIP summary form in Table 17-2. A similarly organized form, albeit with different revenue and spending lines, could be used for a county multiyear financial forecast or to forecast public enterprise fund revenues, spending, and fund balances for a county or city.

10. Then bond rating agencies refer to general fund and other operating fund balances in assessing a local government's financial condition. For example, see Karl Jacob and Jennifer L. Rosso, "Annual Review of 'AAA' Rated U.S. Municipalities," *Public Finance* (June 9, 2005).

Table 17-3. *Financial Forecast—General Fund*

Item	Prior years	Current year	Forecast period						Years beyond year 6	Totals
			Year 1 budget	Year 2 plan	Year 3 plan	Year 4 plan	Year 5 plan	Year 6 plan		
Beginning fund balance										
Revenues										
Property taxes										
Sales & use taxes										
Intergovernmental revenue										
Fees & charges										
Other revenues										
Transfers in										
Total revenues										
Expenditures										
General government										
Public safety										
Streets & transportation										
Cultural & recreation										
Debt service, existing debt										
Other expenditures										
Total operatinng expenditures										
CIP impact on general fund										
Debt service, new bonds & debt										
Operating expenditures										
Revenues										
Net annual impact of CIP										
Forecast “bottom lines”										
Annual urplus or deficit										
Ending fund balance										
Ending fund balance as % of spending										
Debt, existing & new debt										
Debt service, existing & new, as % of general fund										
Tax rate impact of surplus or deficit										

A forecast of annual revenues is based on revenue trends over recent years and, as mentioned above, considers how local expected economic growth or change over the forecast period will affect revenues during that period. Because different revenues grow at different rates and may be affected differently by economic change, a separate forecast is needed for each major revenue source. The same revenue sources analyzed separately in assessing current financial condition can be projected separately for the forecast: property tax, sales tax, certain intergovernmental revenues, utility income for cities. The forecast of some of the major revenues, for example, the property tax, can project changes in the tax base, such as taxable valuation or building permit values for the property tax, and use these projections to estimate future revenues from such sources. Less important taxes and revenues can be combined and projected together based mainly on past trends. In forecasting, present tax or revenue rates would generally be assumed to continue through the forecast period, unless a policy is in place or a decision has already been made that provides for changing one or more tax or revenue rates during the forecast period.

Once annual revenues are projected, the amounts needed to finance operating services and spending each year during the forecast period are estimated. A spending forecast can be organized by major *line-item or object categories* —salaries, wages, and fringe benefits; contractual services; contributions to outside agencies (for counties, the schools); debt service; and so on. Alternatively, a spending forecast can be organized by functional or program area or by department, or by using some combination of line-item and program, functional, or departmental categories. If the forecast is by line-item categories, forecasted amounts are less likely, because they are at an aggregate, jurisdictionwide level, to become a basis for annual budget requests from county or city departments. On the other hand, functional, program, or department forecasts are likely to be more meaningful to most officials. The forecast in Table 17-3 projects spending by function. Any spending forecast should separately set forth debt service. Like annual revenues, the forecast of future operating spending should be based on past trends. For many categories of spending, the trends can simply be carried forward and projected into the forecast period. For others, analysis must be done to judge how project changes in the local economy or other known or likely future developments will affect spending change or growth during the forecast period.

A multiyear financial forecast should highlight the impact of CIP projects on future annual budgets, especially on future yearly spending. The prototype general fund forecast shown in Table 17-3 does this. The major operating budget impact for most CIP projects to be financed with debt will be new annual debt service payments. Increased operating expenditures for new positions or other recurring items are also likely to result from some capital projects, for example, the construction of a new recreation center, approved in the CIP. Some CIP projects, after approval and implementation, may incorporate technology, take advantage of economies of scale, or otherwise allow for a reduction of operating outlays in future years, and others may generate additional annual revenues for the county or city. A multiyear financial forecast should include estimates or at least point to all likely impacts that CIP projects will have on the future annual budgets covered by the forecast.

To be more meaningful or useful for decision-makers, a financial forecast should show one or more "bottom lines." The general fund forecast in Table 17-3 depicts several bottom lines for each year of the forecast: the annual surplus or deficit resulting from projected revenues and spending for the year, the dollar amount of ending fund balance at the end of the year, year-ending fund balance as a percent of operating spending for the year, the dollar amount of annual debt service on existing and new debt, such annual debt service as a percent of operating spending for the year, and the change in the property tax rate with the annual surplus (reduction in tax rate) or deficit (increase in the tax rate). Showing one or more of these projected "bottom lines" can entail some risk. Elected officials and others need to understand that any projected annual surpluses or deficits are just an estimate and assume no changes to existing policies, practices, and programs. Similarly, explanations of the tax rate implications of the projected annual surpluses or deficits must make clear that tax rate changes are not planned and the rate changes are shown to depict the implications of existing revenue, spending, and CIP plans, if there are no changes in plans or practices or adjustments in the annual budgets addressed by the multiyear financial forecast.

Capital Financing Methods

Local governments, like individuals, have essentially four methods for raising the money necessary to finance capital projects:

1. *Payment from current income*. Revenues earned during the current fiscal year are used to finance projects undertaken during that fiscal year.

2. *Payment from savings*. Revenues earned in earlier fiscal years have been set aside, or reserved, and after a sufficient amount has been accumulated, these savings are used to finance capital projects undertaken during the current fiscal year.
3. *Payment from gifts*. Moneys given to the local government (including state and federal grants) are used to finance capital projects.
4. *Payment from borrowed moneys*. Moneys borrowed by the local government, to be repaid in future fiscal years, are used to finance capital projects undertaken during this fiscal year.

The most important of these methods is the last, borrowing. If the capital project is at all large, it will almost always be financed, in whole or in part, by borrowing. Neither current revenues nor reserved moneys are likely to be sufficiently large to finance such a project without borrowed funds; and with the large-scale cutback in the number of federal grant programs, it is unlikely that large amounts of money will be acquired by gift. Therefore this section focuses on borrowing, briefly addressing current revenues and capital reserve funds at the end.

Forms of Security

A county or city that borrows money has a contract with its lenders, whether they are banks or brokerage houses that lent the money and retained the loan, or holders of bonds or certificates of participation. Under that contract the local government agrees to pay the principal and the interest on the loan as they come due and to honor any other promises that it has made as part of the loan transaction. One of the most important provisions of the loan contract is the pledge or the designation of one or more forms of *security*, to which the lender may look to compel repayment.

North Carolina counties and cities currently may choose among five basic forms of security when they borrow money, although a single loan may offer more than one type. It is appropriate to begin this section with a description of these forms of security because many of the other features of borrowing flow from the choice that is made with respect to security. The form of security affects what form the loan transaction takes, whether voter approval is required, whether the Local Government Commission or the borrowing unit sells the debt securities, what the credit rating on the loan is and thus what interest rate the borrower will have to pay, and even whether bond counsel is necessary for the loan.

The General Obligation

The strongest form of security that a county or city can pledge for debt is its full faith and credit, making the debt a *general obligation* of the borrowing government. All the resources of that government stand behind such a pledge, but specifically, a full-faith-and-credit pledge of a North Carolina county or city is a promise to levy whatever amount of property tax is necessary to repay the debt. (The property tax is singled out because it is the major revenue source over which counties and cities have control; the state's general obligations are in effect secured largely by the state's income and sales taxes.) Because by law there is no statutory limit on the rate of property tax that may be levied for this purpose, such a promise is a pledge of unlimited taxing power.

Three statutes permit counties and cities to incur general obligation debt. G.S. 159-43 through -79, the Local Government Bond Act, authorizes the issuance of general obligation *bonds*; G.S. Chapter 159, Article 9, Part 1 (G.S. 159-160 through -165), general obligation *bond anticipation notes*; and G.S. 159G-18, general obligation *debt instruments*. (Neither general obligation bond anticipation notes nor general obligation debt instruments may be issued without a government's having followed the procedures and met the requirements of the Local Government Bond Act.) These three authorizations are exclusive: G.S. 159-45 provides that "no unit of local government in this State shall have authority to enter into any contract or agreement, whether oral or written, whereby it borrows money and makes an express or implied pledge of its power to levy taxes as security for repayment of the loan," except pursuant to one of the three statutes. A local government may issue general obligation bonds for any capital purpose.

The Pledge of the Financed Asset

The second form of security available to North Carolina local governments is a pledge of the asset being financed with the proceeds of the loan. Thus a county might secure a loan to construct a new jail or build an office building by pledging the jail or the office building. A city might secure a loan to purchase a fire truck or construct a water tower by pledging the truck or the tower. Unlike other sources of security, this source is not a stream of revenues. Although the lender will receive the asset if the borrower defaults, that occurs only if there is in fact a default. Both the lender and the borrower have to look elsewhere for the actual payment of the loan; and as a practical matter both will look to the general revenues of the local government. Therefore the bond market treats loans secured by the financed asset as if they were general obligations, although weaker than the real general obligations of the borrowing government.

No lender wants to rely on the asset as the real security for such a loan. The market does not judge the attractiveness of asset-secured loans on the basis of the suitability of the pledged asset for private use. Rather, the market rates such loans on its perception of the willingness or the unwillingness of the borrower to lose the asset. If the asset is perceived as essential to the continued operation of the county, the loan will be a stronger credit than if the asset is perceived as one the county or city could lose without much harm to basic operations.

The debt market perceives the security for asset-secured debt as weaker than the security for general obligation debt, so it normally demands of such debt some additional safeguards. If the loan is offered publicly—that is, if it is sold to investors—the borrowing government is almost always required to establish a debt service reserve fund, which usually is initially supplied with money from the loan proceeds. Proceeds of asset-secured debt may also have to be used to pay interest during project construction. Whether this is necessary depends on the market's response to that particular financing.

Four current statutes authorize loans to be secured by a pledge of the financed asset. The most important is G.S. 160A-20, which expressly permits counties, cities, and a variety of other local government agencies to borrow money for purchases and for construction and to give as the sole security a lien in the financed asset. If the borrowing government defaults on the loan, the lender's sole recourse is to repossess or foreclose on the asset; it may not bring an action to sue the borrowing government for any difference between the amount due and the value of the asset. Under G.S. 160A-20, a borrowing government may use this form of financing for any capital construction project or capital purchase. The other three statutes permit giving a security interest as back-up to other, primary security—revenue-backed obligations, special obligations, and project development borrowings. These other statutes are mentioned in the sections describing those other forms of security.

Use of a Nonappropriation Clause

Normally if a local government borrows money and then during the life of the loan fails to make a scheduled payment of debt service, the government is considered in default on the loan. With asset-secured loans authorized by G.S. 160A-20, however, the loan documents will usually give the local government the annual choice of appropriating money to meet debt service requirements that year or not appropriating money. If the government chooses not to appropriate money, it will obviously be unable to make its debt service payments that year, and it may lose the asset that secures the loan. Because the loan contract permitted it to make the choice, however, failure to pay debt service in these circumstances is not a default on the loan, but the exercise of a contractual right. The contract provision that gives this right to the borrowing government is known as a *nonappropriation clause*.

Nationally, nonappropriation clauses have become a standard part of asset-secured financing. The market does not exact much of a price for including them in such financing because it does not expect any local government borrower to make use of the clause. If local governments began to exercise this right with any frequency at all, it would quickly become an expensive addition to any financing.

The Revenue-Backed Obligation

A traditional form of security, although much more common nationally than in North Carolina, is a pledge of revenues generated by the debt-financed asset or by the system of which that asset is a part. For example, revenue bonds might be issued for a parking garage and secured by the revenues from charges for parking in the garage; or they might be issued for an expansion of a water system and secured by revenues of the entire system. By law (G.S. 159-91) such a pledge creates a lien on the pledged revenues in favor of the bondholders, and normally the bondholders have the contractual right to demand an increase in the user charges generating the revenues if those revenues prove inadequate to service the debt. If the revenue pledge is the only security, however, the bondholders do not have any right to demand payment from any other source, or to require an increase in taxes, if facility or system revenues continue to be inadequate even after charges are increased.

The nature of the security in a revenue-secured transaction leads to some uses of loan proceeds that are not found in general obligation loans. Two of these are using loan proceeds to pay any interest due to the lenders during the period of construction and to establish a reserve for future debt service payments. One effect of these uses of loan proceeds is that a local government borrowing money secured by revenues will normally have to borrow more than it would have had to do had it financed the same project with general obligation debt.

Because the security for the debt is the revenues from the debt-financed asset (or the system of which it is a part), the lenders are naturally concerned about the construction, the operation, and the continued health of that asset or system. This concern is expressed through a series of *covenants*, or promises, that the borrowing government makes to the lenders as part of the loan transaction. The most fundamental of these is the *rate covenant*, under which the borrowing government promises to set and maintain the rates, the fees, and the charges of the revenue-producing facility or system so that net revenues will exceed annual debt service requirements by some fixed amount. For example, a common requirement is that the rate structure generate annual net revenues at some specified level—usually between 120 and 150 percent—of either the current year's debt service requirements or the maximum annual debt service requirements during the life of the loan. This margin of safety required by the rate covenant is referred to as *times-coverage* of the loan. Generally, as long as net revenues continue to maintain the required coverage, the borrowing government may modify the rate structure as it pleases. If net revenues fall below the required coverage, however (even if they are still adequate to service the debt), the covenant typically requires the government to engage an independent consultant to study the operation of the revenue-producing facility or system and recommend changes in the rate structure and in operations necessary to return net revenues to a level above times-coverage. Often the covenant further requires the government to revise its rate structure in conformity with the consultant's recommendations and permits the trustee (who represents the bondholders) or some percentage of lenders to sue the government to force such a rate revision.

A variety of statutes permit counties to borrow money and secure the loan by a pledge of asset- or system-generated revenues. The principal statute is the State and Local Government Revenue Bond Act, found at G.S. Chapter 159, Article 5 (G.S. 159-80 through -97), which authorizes the issuance of revenue bonds. G.S. 159-161 permits any government authorized to issue revenue bonds under the aforementioned statute also to issue revenue bond anticipation notes. The purposes for which the statute permits issuance of revenue bonds are set out in Appendix 17-1. (The Revenue Bond Act also permits a borrowing government to add to the borrowing the additional security of a pledge of the financed asset.) In addition, G.S. 159G-18 permits counties and cities to borrow moneys from the Clean Water Revolving Loan Fund for the capital needs of water or sewer systems and to give debt instruments, payable to the state, in evidence of the loan. Among the kinds of security that the borrowing government may give for the loan is a "pledge [of] user fee revenues derived from operation of the benefited facilities or systems." (A local government can also add a revenue pledge to special obligation bonds, described in the next section.)

The Special Obligation

The defining characteristic of the special obligation lies in what it is not: a general obligation. A special obligation is secured by a pledge of any sort of revenue source or asset available to the borrowing government, as long as that pledge does not amount to a pledge of the government's taxing power. Neither the General Assembly nor the courts have definitively established what sorts of pledges, other than a pledge of property taxes, constitute a general obligation, but there is a working understanding in the state's finance community. This understanding focuses on the general obligation as a pledge of the government's taxing power and holds that as long as a county or city does not pledge *any local tax under its control*, it has not created a general obligation.

Thus in this broad sense a revenue bond is a special obligation because it pledges project revenues and does not pledge taxes of any sort. It is only one kind of special obligation, however; indeed, the term *special obligation*, as used in North Carolina, generally refers to debts secured by something other than project revenues. That something else has usually been the proceeds from one or more nontax revenues or from one or more kinds of taxes that are levied by some government other than the government making the pledge. Thus, for example, a county might pledge proceeds from fees charged for building permits; or it might pledge taxes levied by the state and shared with local governments. Or a city might pledge proceeds from the local government sales tax, which is levied by the county.

What are the lender's rights under a special obligation pledge if the borrowing government does not meet its debt service obligations? Because the borrower does not control the levy of any tax that is part of a special obligation pledge, the lender cannot force an increase in the amount or the rate of the tax. Rather, the sole recourse of the lender is to exercise its lien and in essence to attach the pledged moneys on their coming into the possession of the borrower. Thus if the pledge was of a city's share of the state's electric franchise tax, the lender would take possession of those moneys and direct their first, and if necessary exclusive, use to pay debt service. If the moneys were inadequate, the lender would have no other recourse. Because of this, lenders usually demand that the revenues pledged as security for special obligation bonds amount to several times maximum annual debt service.

Because the debt market perceives the security for special obligation debt as weaker than the security for general obligation debt, the market normally demands of special obligation debt some of the same safeguards demanded of revenue bonds. Therefore if the loan is offered publicly—that is, if it is sold to investors—the borrowing government will almost always be required to establish a debt service reserve fund. As with the fund for revenue bonds, this fund will be supplied initially with money from the loan proceeds. Proceeds of special obligation debt may also have to be used to pay interest during project construction. Whether this is necessary depends on the particular revenues pledged to repayment.

The principal statute permitting special obligation pledges is G.S. 159I-30, which permits a county or city to issue special obligation bonds for three sorts of projects—solid waste, water, and wastewater—and which in addition permits cities to issue this sort of bond for any project within a municipal service district. Also, G.S. 159I-13 permits a local government that borrows money from the state's Solid Waste Management Loan Fund to secure the loan, among other ways, from "any available source or sources of revenue" as long as the pledge "does not constitute a pledge of the [borrowing] unit's taxing power."

Although the principal security for a special obligation bond is the set of nontax revenues pledged as security, the statutes also permit a borrowing government to give the additional security of a lien on the asset being financed.

Incremental Taxes

In 2004 the state's voters approved an amendment to the state constitution that permits a form of financing labeled *project development financing* (although this sort of financing is more commonly known as *tax increment financing* in other states). The process of issuing this form of debt begins with the government defining an area, known as the project development district, and determining the assessed value, for taxes, of property within the defined area. This is the base value of the district. The government then issues project development bonds and constructs some sort of public project in the district or for the benefit of the district. Thereafter, as the government levies property taxes on property within the district, the taxes attributable to the base value of property are returned to the government. But if there has been new development in the district, so that some parcels are assessed at a higher value than their base value, the taxes on the difference between the current and the base value—the increment—is placed in a special fund, and that fund is the principal security for the project development debt. If a project development district is within a city, the county can also agree that the incremental increase in its taxes will be placed in the special fund and used to retire the city's debt.

Obviously this form of security is speculative, dependent on new development taking place after the debt is incurred. Therefore the statutes permit a government issuing project development bonds to add additional security to the debt. First, the government may enter into an agreement with the owner of property within the district, under which the owner agrees that the property will be valued for taxes at a minimum level, even if the planned construction to justify that minimum level never takes place. Such an agreement is recorded and is binding on later owners of the land. Second, the government may pledge nontax revenues to secure the debt, in effect making it a special obligation debt. And finally, the government may offer the financed asset itself as still further security for the debt.

Appendix 17-2 sets out the purposes for which project development bonds may be issued.

The Structures of the Borrowing Transaction

If a private person wants to borrow money to buy a car or a house, he or she simply goes to the bank and does so, signing a note as evidence of his or her debt. If a county or city wants to borrow money, however, it can never proceed as simply as that. This section describes the common forms that loan transactions take.

A generation ago, if a North Carolina local government borrowed money, it did so through the issuance of bonds. No other structures for borrowing money were available or used. That is no longer true. Although bonds remain a common loan form, North Carolina local governments currently borrow money through a variety of transactional structures.

General Obligation Bonds

The traditional mechanism by which local governments borrow money is the issuance of *bonds*. A bond itself is simply an evidence of a debt, a fancy IOU, in the same way that the note a person gives his or her bank is the evidence of the bank's mortgage loan to him or her. Historically the bond differed from other evidences of debt in that it bore the seal of the borrower. In current local government finance the essential difference between a bond and a *note* is the length of time for which the underlying debt is outstanding. A note evidences a debt that will fall due in a short time—a few months to a year or, rarely, somewhat longer. A bond evidences a longer debt—from a few years to thirty-five or forty years.

The general obligation bond is the simplest form of borrowing generally available to local governments. The promise of the borrowing government is straightforward—it will levy whatever amount of tax is necessary to pay principal and interest—and can be enforced by the legal action of any bondholder. Furthermore, the promise is relatively unaccompanied by the additional promises characteristic of other forms of security. Therefore the documents generated by a general obligation bond issue are considerably fewer and shorter in length than those generated by other forms of borrowing.

The central document of the proceeding to secure local authorization of a general obligation bond issue is the *bond order*, which is adopted by the governing board. The order serves a double purpose. First, it authorizes issuance of the bonds, stating the purpose for which the proceeds will be spent and the maximum amount of bonds that may be issued. If a county or city is proposing bonds for more than one purpose, it will need a separate bond order for each purpose. Second, the order publicizes the bond issue, not only setting out purpose and amount but also indicating the security for the bonds. As the North Carolina Supreme Court has said, the bond order is "the crucial foundation document which supports and explains" the issue.[11]

The statutory procedure that leads to adoption of a bond order is intended to serve two primary purposes: (1) it concludes with the governing board's formal authorization of the bond issue; and (2) it provides an opportunity for the public to learn of and comment on the proposed issue and the project or projects it will finance. In fact, however, the procedure is usually a *pro forma* exercise. It does not begin until the county or city has met informally with the Local Government Commission's staff and received informal approval of the proposed borrowing. The necessary documents are prepared by bond counsel, who also suggest a schedule for the statutory procedure. That schedule is normally established by setting a tentative date for the bond referendum, if one will be necessary, and then counting back from that date. Generally, then, by the time it begins the formal procedure, the governing board has already decided to adopt the bond order. Occasionally testimony at the public hearing will cause a board to modify, delay, or drop its plans, but the real opportunity for citizens to comment on the bond issue is the referendum.

Revenue and Special Obligation Bonds

North Carolina law also permits bonds to be issued with two of the other forms of security besides the general obligation: (1) revenue bonds, which primarily pledge revenues from the bond-financed project; and (2) special obligation bonds, which primarily pledge any revenues available to the issuing government that will not create a general obligation pledge. Because of the nature of their security, neither of these types of bonds requires voter approval. For that reason the careful statutory procedure that must be followed to issue general obligation bonds (and which is intended to provide public notice of the issue) has no counterpart with these other kinds of bonds. The statutes contain no required procedures at all for board authorization of revenue or special obligation bonds, and as a result, the authorization process is legally simple. The documents that underlie such a bond issue, however, are anything but simple, and again the reason is the nature of the security behind the bonds. Furthermore, also because of the nature of the security, revenue and special obligation bond issues require the participation of new entities not necessary to a general obligation issue.

The most important new entity is the *bond trustee*, normally a bank, which represents the interests of the bondholders. When the bonds are issued, the proceeds are paid to the trustee, who controls disbursement of the moneys. Furthermore, the borrowing government is normally required regularly to pay debt service through the trustee rather than directly to bondholders. Finally, the borrowing government is often required to secure the trustee's approval of various operational matters, such as changes in consulting engineers or amount of insurance coverage.

As noted earlier in the discussion of security, borrowings secured by revenues or special obligation moneys require that the borrowing government agree to a variety of special covenants that protect the lenders. The major part of the issuance process for revenue or special obligation bonds is negotiating these covenants with the *underwriters*, who will sell the bonds, and sometimes with the rating agencies. Once the documents are prepared, the governing board simply approves them, and the loan is thereby authorized.

Project Development Bonds

Although there is no requirement of voter approval for project development bonds, which are primarily secured by the proceeds of property taxes on incremental increases in value in the project development district, the statutes do establish a complicated procedure for the bonds' approval. Once the borrowing government has established a project development district, it must prepare a project development plan, which generally describes the district, the proposed public investment that will be financed by the project development bonds, and the amount of anticipated private investment generated by the bond project. Before approving the plan, the governing board must hold a public hearing. In

11. Rider v. Lenoir County, 236 N.C. 620, 631, 73 S.E.2d 913, 921 (1953).

addition, the borrowing government must seek approval of the plan from the Secretary of Commerce and the Secretary of Environment and Natural Resources. Finally, if a city is the borrowing government, it must give notice of the plan to the county within which the district is located, and the plan cannot go forward if the county disapproves of it.

As with revenue and special obligation bonds, project development bonds will involve a bond trustee and a variety of special covenants given by the borrowing government to protect the interests of bondholders.

Bond Anticipation Notes

Sometimes a county or city will authorize a bond issue, but will not wish to borrow the full sum at one time. Alternatively, if the local government plans to sell the bonds to U.S.D.A. Rural Development, the bond sale will not take place until the project is fully constructed. In either case the government might decide to borrow, pursuant to the bond authorization, on a short-term basis. If it does so, it will issue *bond anticipation notes*. These are short-term notes, usually maturing in a year's time, that are primarily secured by the proceeds of the eventual bond issue itself. Because such notes are issued in anticipation of the eventual issuance of bonds, there is no separate authorization process for the notes. The county or city must, however, receive the approval of the Local Government Commission before the notes are issued, and the commission will sell the notes on the government's behalf.

Installment Financing Agreements

If the loan is to be secured by the financed asset and issued under G.S. 160A-20, it will be structured not as a bond issue but as an *installment financing agreement* (sometimes called a *lease purchase agreement* or, somewhat less often, a *capital lease*). Even though the government has in fact borrowed money and agreed to pay it back, the documents will describe a transaction in which the government has purchased an asset, agreeing to pay for it over time. The installment payments, however, will be divided into principal and interest components, and they are the equivalent of debt service payments on bond issues. The original reasons for this transactional disguise are no longer necessary, but the form continues from habit.

The statutory procedures incident to entering into an installment financing agreement are only slightly more elaborate than the total lack of procedure associated with revenue and special obligation bonds. G.S. 160A-20 requires that if the installment financing agreement involves real property (either acquisition or construction), the county or city must hold a public hearing on the financing. Otherwise there are no local steps required of the borrowing government, and once the documents are prepared, the governing board may simply approve them and authorize the transaction.

The documentation for an installment financing agreement varies depending on whether the county or city borrows from one lender or a few, or from the broad investing public. If the former, which is likely if the loan is to acquire equipment of some sort, the basic document will be the installment financing agreement itself, often executed on forms developed by the vendor of the equipment or the financing bank.[12] If the loan is larger, however, which is likely if it is to finance a construction project, the transaction can become considerably more complex.

Certificates of Participation

Under the Internal Revenue Code, a local government is able to borrow directly from a bank only if it will borrow, in total, less than $10 million in the calendar year. A government under that amount is *bank qualified*. Most installment financing agreements are placed directly with banks, because most local governments in North Carolina are in fact bank qualified in most years. If a local government is not bank qualified, however, either because a particular installment financing transaction is greater than $10 million, or the total of several borrowings during the year is greater than $10 million, any installment financing has to be publicly sold. That is, rather than the government borrowing the money from a single bank or vendor, the government has to turn to the bond market itself and the millions of individuals, companies, and mutual funds that invest in the market. To reach the market, however, the loan must be divided into much smaller units, affordable by the various participants in the bond market. With a standard bond issue those smaller units are the bonds themselves, normally issued in denominations of $5,000. As noted earlier, however, a bond is direct evidence of a debt of the unit; because of the transactional form of the installment financing agreement, bonds cannot be issued. Therefore some other investment instrument is necessary, and that instrument is the *certificate of participation*.

12. If such forms are used, the borrowing government should review them carefully because they are likely to be particularly protective of the vendor's or lender's interests.

The *certificate of participation* (COP) entitles its holder to a share in the periodic payments made by the government under the installment financing agreement; the investor participates in receiving those payments, and the certificate is the evidence of his or her right to do so. Although the legal nature of the COP differs from that of the bond, it has been fully accepted by investors, and the bond market treats COPs as more or less interchangeable with true bonds.

If a local government borrows through COPs, the documentation for the transaction is probably the most complicated of any of the forms of borrowing. Typically a nonprofit corporation is established to enter into the financing agreement with the borrowing government. This agreement is considerably more complicated than an installment financing agreement made directly with a vendor or a single lender. In addition, there is a thick trust indenture, under which the corporation (not the government) issues COPs and assigns its rights to payments, under the installment financing agreement, to a trustee; the trustee is then in charge of making payments to the certificate holders.

Voter Approval of Borrowing

Article V, Section 4, of the state constitution requires voter approval before a local government may borrow money and secure the loan by a pledge of its faith and credit—that is, before it may borrow money secured by a pledge of its taxing power. The constitution does not require voter approval if any other form of security is used, and therefore voter approval is never necessary for loans secured by revenues, by special obligations, or by the financed asset. In fact, voter approval is not even always necessary for general obligation loans. The following section describes the rules for determining when the voters must, or need not, approve general obligation debt.

Rules for Determining Need for Voter Approval

Refunding Bonds

Refunding bonds are issued to refinance existing debt, usually because interest rates have fallen and the county or city wishes to reduce its debt service payments. No new debt is being created; rather, one evidence of a single debt is being replaced by another. Therefore the constitution excuses refunding bonds from the requirement of voter approval.

Two-Thirds Rule

Almost all new general obligation debt is subject to the *two-thirds rule*, under which counties or cities may incur relatively small amounts of such debt without voter approval. (The exceptions are set out in the next section.) This rule allows a county or city to issue bonds in an amount up to two-thirds of the amount by which its outstanding general obligation indebtedness was reduced in the preceding fiscal year. For example, if a county reduces its net general obligation indebtedness by $900,000 in year 1, then it may incur general obligation debt up to $600,000—two-thirds of $900,000—in year 2 without voter approval. The simple thrust of the limitation is to prevent an increase in a government's total indebtedness unless the voters have approved the increase.

Several points should be made about the two-thirds rule. First, in determining the amount of debt reduction during a fiscal year, a local government counts only principal payments; interest paid is irrelevant. In addition, it is not the amount of principal retired that is counted; rather, it is the net reduction in principal owed. If a county or city borrows during a fiscal year, it may actually have a net increase in outstanding debt and therefore no two-thirds capacity at all. Second, the local government must use its two-thirds capacity in the fiscal year immediately following the year in which the debt was reduced. If it is not used in that immediately following year, the chance to use it is lost; two-thirds capacity cannot be accumulated from year to year. Finally, in using its two-thirds capacity, the government is not restricted in any way by the purposes for which the retired debt was issued. That is, if all a city's outstanding bonds were issued for water or sewer purposes, so that all reductions are in water and sewer debt, a city may still issue two-thirds bonds for any authorized purpose (except those listed below as always requiring voter approval). To continue the example, the two-thirds bonds could be issued for streets, park acquisition, a new fire station, and so on.

New General Obligation Debt for Certain Purposes

By statute the General Assembly has required that new general obligation debt incurred for a few purposes always be approved by the voters. (That is, debt for these purposes may not be incurred under the two-thirds rule, discussed next.) The purposes in this category are auditoriums, coliseums, stadiums, convention centers, and like facilities; art galleries, museums, and historic properties; urban redevelopment; and public transportation.

Public Funds in a Referendum Campaign

A frequent question is: To what extent may a county or city use public moneys in the campaign for voter approval of a proposed general obligation bond issue? No North Carolina statute deals with this question, but the law nationally is well settled, has been recognized by the North Carolina court of appeals,[13] and is commonly observed in this state. The basic rule is quite simple: public funds may be used to provide information about a bond issue and the proposed project for which the bonds will be issued; public funds may not be used to urge voters to vote yes in the referendum. Obviously differences of opinion may arise about whether a particular expenditure is informational or promotional; counties and cities should be careful to err on the side of caution. There have been a number of cases in other states in which the officials responsible for improper expenditures have been required to repay the money personally. (There do not, however, appear to be any cases in which improper expenditures threatened the validity of a successful vote.)[14]

State Approval of Borrowing

North Carolina is quite unusual among the states in requiring state approval before most local government borrowing transactions. The approval is the responsibility of the Local Government Commission, an agency in the Department of State Treasurer. The commission was created during the Great Depression, when North Carolina had more local governments in default on debt than any other state in the United States except Florida. The commission's initial task was to help those defaulting governments out of their fiscal troubles; its task since then has been to ensure, as much as possible, that such a situation does not arise again. Thus the commission's responsibility is to review the borrowing plans of local governments, to judge whether the governments are borrowing only an amount that they will be able to afford to repay, and to approve the borrowing only after it is assured that repayment is indeed within the local government's means.[15]

For most forms of borrowing transactions, commission approval is always necessary; the only forms of borrowing for which it may not be necessary are some instances of loans secured only by the asset being financed. Two complementary rules determine when the Local Government Commission must approve loans secured by an asset. First, if the proceeds of the loan will be used to finance improvements to real property, commission approval is always necessary. That is, any *construction* project so financed requires state approval. Loans that finance *acquisition* of property, whether real or personal, are subject to the second rule. Under this rule, such financings must have state approval if they meet both of two conditions:

1. The agreement must extend for at least five years, or sixty months.
2. The total amount paid by the county or city under the agreement (which includes both principal and interest) must be larger than a threshold amount: the lesser of $500,000 or 0.1 percent of the total appraised value of property subject to taxation by the borrowing government.

Again, both conditions must be met. If an agreement is for only fifty-nine months, it does not require state approval, regardless of the amount of money to be paid by the county or city. If the amount to be paid is less than the threshold, state approval is unnecessary, regardless of the length of the loan.

There is one final exception: the statute provides that state approval is never necessary for agreements or bonds that finance the acquisition of either motor vehicles or voting machines.

13. Dollar v. Town of Cary, 153 N.C. App. 309 (2002).

14. The rules on expenditure of public funds in bond referenda are discussed at length in David M. Lawrence, *Financing Capital Projects in North Carolina* at pp. 87–90.

15. Cities are subject to one other statutory mechanism that is intended to ensure they do not borrow more than they can repay: the *net debt limitation*. A city determines its net debt by adding together all general obligation debt and installment purchase debt, then subtracting debt incurred for water, electricity, and gas. The resulting sum of outstanding debt may not exceed 8 percent of the appraised value of property in the city subject to taxation. In fact, however, it is quite rare for a city's net debt to exceed 2 percent of its tax base; therefore, as a practical matter, the net debt limitation is unimportant.

Other Methods of Capital Financing

The introduction notes other forms of capital financing. Any county or city will finance some capital assets from current revenues. In a small unit, such assets may be no more expensive than motor vehicles, whereas in a large one, more expensive personal property may be paid for from current revenues. These kinds of expenditures are treated no differently than any other expenditures included in the annual budget ordinance.

A county or city might also receive capital financing from a grant or a gift, although this is much less likely now than during the 1970s or earlier. When that occurs, the grantor or the donor normally will specify what uses may be made of the money, and the local government is bound to those specifications. Once received, such moneys are fully public moneys and must be appropriated and accounted for in the same manner as any other public funds.

Finally, G.S. 159-18 permits counties and cities to establish capital reserve funds for any capital purpose. A governing board does this by adopting an ordinance or a resolution that includes at least four points: the purpose or purposes for which moneys will be reserved; the length of time for which moneys will be accumulated; the approximate amounts to be accumulated for each purpose; and the source of the reserved moneys. The board may amend this ordinance or resolution at any time, including changing the purpose for which moneys have been reserved. Moneys may be removed from the fund only for a designated purpose; because only capital purposes can be designated, moneys may not be removed and used for operating expenses. Otherwise, a county or city has complete flexibility in the use of capital reserve funds.

Bond Ratings

A debt or bond rating generally evaluates the capacity and the willingness of the issuer to repay debt and to make timely interest payments on debt.[16] North Carolina's counties and cities are rated by three national bond rating agencies —Standard & Poor's (S & P), Moody's Investors Service (Moody's), and Fitch Ratings (Fitch)—and by one state-level rating organization—the North Carolina Municipal Council. The council, which is a component of the Carolinas Municipal Advisory Council, is composed of banks, investment banking firms, securities dealers, certain other firms, and regulatory agencies that are involved in the municipal debt market in North Carolina. The council's counterpart, the South Carolina Municipal Council, issues credit reports on South Carolina local government debt.

National Bond Rating Agencies

All three of the national rating agencies have their headquarters in New York, although each also has regional offices in different parts of the country. S & P and Moody's rate nearly all North Carolina local government debt that is sold nationally. Fitch rates some but not all North Carolina local government debt that is marketed nationally. The national agencies evaluate the creditworthiness of a county or city issuer with regard to a specific bond or debt offering or, in the case of general obligation (G. O.) bonds, to that type of debt of the issuer. In other words, the rating applies to a specific bond or debt issue or to the G. O. bonds of the issuer, rather than to the entity issuing the debt. Despite this, the rating on the debt, especially if it is G. O. debt, depends heavily on the strength and the prospects of the issuer.

A national debt or bond rating addresses not only the ability and willingness of the issuer to make debt service payments but also the legal protection afforded by the bond or debt contract to investors. Such protection is a function of the contract and of the statutory and constitutional provisions that authorize and regulate the debt. A national rating may also take into account credit support, if any is provided, from bond insurance or other sources of guaranty for a debt or bond issue. Bond insurance guarantees to investors the payment of interest and the repayment of principal on an insured bond or debt issue. Insurance from a highly rated national bond insurance company gives the insured debt

16. The information presented about the national debt rating agencies draws on A. John Vogt, *Capital Budgeting and Finance: A Guide for Local Governments* (Washington, D.C.: International City/County Management Association, 2004), chap. 8 on "Bond Ratings"; Standard & Poor's, *Municipal Finance Criteria 2003* (New York: S & P, 2003); and information provided in conversations with staff to the North Carolina Local Government Commission.

the rating of the insurance company. The national bond rating agencies evaluate all types of municipal debt: general obligation bonds or notes, revenue bonds, certificates of participation, special obligation bonds, variable rate debt, and different types of short-term debt.

The national rating agencies use letter-rating systems for bonds and other long-term debt. For instance, S & P uses ten general rating categories: AAA, AA, A, BBB, BB, B, CCC, CC, C, and D. The ratings from AA to CCC may be modified by the addition of a plus or minus sign (+ or –) to indicate relative quality within the general categories. The four highest categories, AAA through BBB, are referred to as *investment grade* or *bank eligible* ratings. Laws, regulation, and/or institutional charters prohibit or limit certain financial institutions, including banks and many municipal bond mutual funds, from investing in local government or other debt that is otherwise a permissible investment for them unless the debt has an investment grade rating. Bonds or other long-term debt rated BB or below by S & P are regarded as speculative (popularly called *junk bonds*). Debt rated D by S & P is in default. Fitch's rating categories are the same as S & P's, except Fitch uses three categories for bonds or debt in default: DDD, DD, D.

Moody's uses a somewhat different rating system for bonds and long-term debt. It consists of nine general categories: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, and C. Debt in each of the Aa through B groups carries an additional rating symbol of 1, 2, or 3 to indicate relative quality within the general categories. Debt in the first four general rating groups is investment grade. Debt in the lower-rated groups is considered to be speculative.

To secure a rating from a national rating agency for new bonds or debt, a county or city or any other issuer generally must request it. The Local Government Commission recommends that a North Carolina local government obtain at least one national rating when it sells $1 million to $2 million in debt. Very few bond or debt issues that are sold publicly are this small. The Local Government Commission recommends at least two ratings when a debt issue exceeds $2 million. Most of the state's larger counties and cities and many medium-sized ones obtain three ratings when they sell debt. Having two or three ratings generally broadens the market for the debt and helps to hold down or actually lowers the interest rates and costs for the debt. The national rating agencies charge from around $5,000 to about $30,000 per rating, depending on the size of an issue, for a rating on general obligation bonds. Ratings of revenue bonds, certificates of participation, and special obligation bonds are usually, but not always, somewhat more expensive than ratings of general obligation bonds. Ratings of a very large bond or debt issues—more than $100 million—can cost from $50,000 to $70,000 or so, depending on the types of debt, its complexity, and so forth.[17]

To maintain a national rating, a county or city must send the rating agency annual financial reports, budgets, CIPs, and other positive or negative information that bears on its financial condition and prospects and therefore on the rating. If the rating agencies do not receive such information regularly, they will most likely suspend or withdraw their rating for the county's or city's debt. If there is any material change in the county's or city's financial condition, its rating may change. S & P provides *rating outlooks* for debt that it rates. These forecast the potential direction of an entity's debt rating. A rating outlook may be *negative*—the rating may be lowered; *stable*—the rating is unlikely to change; or *positive*—the rating may be raised. The other national rating agencies use similar approaches to indicate whether a rating is likely to increase, remain the same, or decrease.

Different factors are considered by the national rating agencies in evaluating different types of long-term debt that North Carolina counties and cities issue. General obligation bond ratings from the national rating agencies are based on similar criteria, which fall into four areas: economic base, financial performance and flexibility, debt burden and management, and administration and governance. Revenue bond ratings depend on the profitability and financial strength of the public enterprise for which the revenue bonds are issues, the financial performance generally of that type of enterprise, and bond or debt indentures or legal provisions that protect the interests of the investors. Certificate of participation or other property secured debt is rated in terms of the essentiality to the issuer of the project or purpose for which the debt is issued and the general credit worthiness of the issuer. Special obligation bonds or debt are rates in terms of strength and consistency of the revenues pledged to secure and pay the debt. Bond or debt indentures or contract provisions are also very important to both certificates of participation and special obligation debt.

17. An analysis of the costs, including bond rating costs, involved in selling specific G. O., revenue, and certificate of participation debt issues appears in A. John Vogt, *Capital Budgeting and Finance*, pp. 325–33. The costs cited in the text are based on that analysis, as updated based on advice provided by Local Government Commission staff at the time of this writing.

North Carolina Municipal Council

The North Carolina Municipal Council is located in Raleigh.[18] It rates counties, cities, and special-purpose local governments in the state that have outstanding general obligation bonds or other debt, such as certificates of participation, issued to finance general-purpose public improvements.[19] The council does not rate revenue bonds or debt. Currently the council maintains ratings on all 100 North Carolina counties, 261 cities and towns, and 33 special purpose districts in the state.[20] Council ratings apply to the jurisdiction issuing debt rather than to a specific bond or debt issue. Because of this, council ratings do not reflect bond insurance or other guarantees for specific debt issues. Council ratings focus on the ability and the willingness of the issuer to repay debt and make timely payments of interest. The council uses a numeric rating system that ranges from 0 to 100, with 100 being the highest or best rating. Bonds or debt of a county or city with a council rating of 75 or more are considered to be investment grade securities. The council does not charge a local government for its rating service. Members of the council pay for ratings through membership fees and assessments. The council reviews and updates its rating for any unit with outstanding, rated debt at least once every three years or sooner if a unit is marketing new general obligation or publicly offered general purpose debt. Council staff typically visit a county or city whenever the council is reviewing the rating.

A council rating is based on three general factors: general obligation and other general-purpose debt burden relative to wealth; administrative and financial record, which encompasses budgetary operations, accounting, level of taxes compared with similar units, tax collection, and other areas of financial operations; and payments program and resources, which considers debt structure and ability to make debt payments.[21]

North Carolina County and City Ratings

North Carolina's counties and cities are among the highest rated in the country. As of this writing four North Carolina counties have triple-A general obligation bond ratings from all three national rating agencies: Durham, Forsyth, Mecklenburg, and Wake. Other North Carolina counties with triple A G. O. ratings are Guilford (AAA, S & P) and Orange (AAA, Fitch). Six North Carolina cities have triple A G. O. bond ratings from all three rating agencies: Cary, Charlotte, Durham, Greensboro, Raleigh, and Winston-Salem. In addition, Chapel Hill has an Aaa rating from Moody's.[22] More than twenty-five of the state's counties and cities have double A ratings from one or more of the national rating agencies. Because of the importance of wealth or economic size and diversity in determining a G.O. bond rating, it is very difficult for medium- and smaller-sized counties or cities to secure a triple-A rating. Most North Carolina counties and cities with national bond ratings have single A ratings. Some have BBB or Baa ratings, the lowest investment grate rating; these are typically units that are smaller in size and that have experienced significant economic challenges. All counties and cities in the state that have general obligation bond ratings from one or more of the national rating agencies have investment grade ratings.

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18. Information about the North Carolina Municipal Council is based on the council's web page, www.carolinasmac.com, and conversations at the time of this writing with Tony L. Blalock, President, North Carolina Municipal Council.

19. If certificates of participation are issued to finance a general public improvement, e.g., a new county office building, the money for debt service on the certificates is likely to come from tax or other general revenues, even though the certificates are secured by the county office building rather than taxing power. The council rates counties and cities that issue certificates of participation or privately placed installment-purchase debt for general public improvements because debt service comes from taxes or general revenues, regardless of the security or pledge for the debt.

20. These data were provided in phone conversation by Tony L. Blalock, President, North Carolina Municipal Council; they are current as of this writing.

21. *Ibid.*

22. The references in this paragraph to triple-A-rated North Carolina counties and cities and generally to the numbers of counties and cities with one or more other national ratings is based on a list, current as of February 2006, of all North Carolina counties and cities with national ratings that was provided to the authors by staff to the Local Government Commission.

The North Carolina Municipal Council's rating system results in few ratings in the 90s. As of spring of 2006, the council rated only 5 of the state's counties and 8 cities in the 90s. Three counties and 43 cities or towns had ratings below 75. All of these units are small in size, and many are in more remote locations in the state. Most of the state's counties and cities have ratings in the 80s and the upper 70s.

Because of their generally excellent bond ratings, North Carolina's counties and cities are able to sell their bonds and debt at lower interest rates than local governments in most any other state. The generally excellent credit of the state's counties and cities enables them to save millions of dollars in interest costs.

What accounts for the good debt ratings and strong credit of North Carolina's counties and cities? The state's economy continues to grow and become more diverse. Local government financial management in North Carolina is professional and recognized throughout the country. Good local leadership, the prevalence of the county- and city-manager forms of government, and conservative yet forward-looking budgeting and financial planning also underlie the good bond ratings of the state's local governments. Last but certainly not least, Local Government Commission oversight of debt policies and management, accounting and financial reporting, and budgeting and financial management has contributed greatly to the high local government ratings.[23]

Capital Project and Spending Authorization and Appropriation

Authorization versus Appropriation

Authorization in this context refers to approving a capital project or acquisition; *appropriation* refers to making revenues or financing available for expenditure on it. Authorization often occurs by an appropriation, as when annual revenues or fund balances are appropriated in the annual budget ordinance to finance equipment acquisitions. In such a case the appropriation serves as authorization and provides the funding as well.

In contrast, when bonds are issued to finance a capital project, authorization of the project and appropriation of moneys for it usually take place in separate steps and at different times. For a project financed by general obligation bonds, authorization might be thought to occur when the voters approve the bonds. However, the governing board may still choose not to issue the bonds; final authorization occurs only with the decision to issue the bonds, which is typically associated with the letting of major contracts for the project. Once bonds are issued and contracts are let for a project, there is no turning back. Although issuance of bonds constitutes final project approval, it does not of itself appropriate or legally make the bond proceeds available for expenditure. This must occur in the annual budget ordinance or in a capital project ordinance.

Authorization of capital projects and acquisitions and appropriation of moneys for them also often occur separately when a county or city has a CIP. In such a case the governing board may pass a resolution approving capital projects and expenditures listed in the first year of the CIP as the capital budget for the year. This resolution may be part of a broader resolution approving the entire CIP. Although such a resolution may authorize the projects and the outlays, by itself it does not appropriate moneys for them; this may be done, again, only in the annual budget ordinance or in a capital project ordinance. Of course, if board approval of the projects and the expenditures in the first year of the CIP occurs by incorporation of the projects and the expenditures in the annual budget ordinance, or by enactment of one or more capital project ordinances, then project authorization and appropriation effectively take place in one step and at one time.

Generally, the larger a capital project is, the more likely authorization is to take place in multiple steps and authorization and appropriation to be distinct steps in the overall approval process. Governing board approval of a major project might first occur at a very general level the first time the project is included in the CIP. More specific approval of the project in concept could occur when the project has reached the first or budget year of the CIP, and the board approves the capital projects and spending in that year as that year's capital budget. That approval may be based not only on the CIP but also perhaps on feasibility studies that have been done and that recommend that the jurisdiction go ahead with the project. Next the board would need to approve architectural and engineering plans for the project including specific or detailed cost estimates. On that basis, the board might approve a bond order proposing authorization of general obligation bonds to finance the project. If or after the voters approve the bonds, the governing board could enact a capital projects ordinance to

23. The rating agencies have specifically recognized the central contribution of the Local Government Commission. For example, see Richard P. Larkin and Jeff Schaub, "State of North Carolina Local Government Commission," *Fitch IBCA Public Finance* (March 29, 1999): 1–6.

appropriate the bond proceeds and any other revenue available for the project. Then, nearing the end of the authorization process, the governing board would have to approve construction projects for the project, issuance of the bonds, and probably provide several other approvals, for example, perhaps purchase of land, related to overall authorization of the project. The sequence among the steps in project authorization may well vary from project to project and differ from the sequence described here. Moreover, some projects will have fewer steps; for example, voter approval of general obligation bonds is involved in only some projects. Nonetheless, the point is that governing board authorization of major projects is generally a lengthy process involving many steps, and such projects can usually be redefined, changed, or stopped from going forward through the early and middle stages and sometimes even near the end of the authorization process.

Counties and cities occasionally undertake major capital construction projects that take several years to complete. If a multiyear project is financed partly with revenues that are appropriated in the annual budget ordinance each year during the construction period, project authorization and the appropriation of at least this part of the funds for the project occur separately. The governing board authorizes the full project the first year when it begins the project, but it appropriates from the annual budget ordinance only the money needed from this source for expenditures that year. Then as construction proceeds, the board appropriates enough funds from each year's annual budget to cover project expenditures for that year. This practice is sometimes called *cash-flow budgeting* because appropriations for a project in any year are based on expenditures to be made for the project in that year. Cash-flow budgeting is a less-than-conservative approach to capital budgeting because contracts are let for the full or nearly the full project amount in the year of the project's inception, but appropriations enacted for the project that year cover only expenditures to be made in the year. Nevertheless, such budgeting is legal under the continuing contracts and pre-audit statutes [G.S. 153A-13, G.S. 160A-17, and G.S. 159-28(a)].

In this last example, if annual revenues are appropriated in a capital project ordinance rather than as part of the annual budget ordinance, authorization and appropriation of the full amount of revenues needed for the project occur at the same time, that is, when the capital project ordinance is passed. Of course, even then, funds can be raised and appropriated initially in the annual budget ordinance and then transferred by governing board action to the capital project ordinance on a year-to-year basis. Such transfers to the capital project ordinance fund the appropriations already there, not increase them.

Use of Capital Project Ordinances

Counties and cities may use their annual budget ordinance or one or more capital project ordinances to appropriate moneys for capital projects or expenditures. If a county or city appropriates all revenues or financing for capital projects and expenditures in the annual budget ordinance or by amendment to it, this helps to ensure that capital expenditure decisions are coordinated with operating budget decisions. Moreover, because appropriation authority in the annual budget ordinance lasts for only a year, this practice helps to insure periodic review of capital projects under construction.

The disadvantages of appropriating money for capital projects and expenditures in the annual budget ordinance apply mainly to large multiyear projects. One drawback is the incongruity of appropriating funds for a project for only a year at a time, when in fact spending for it will take several years. A more difficult problem is that including major capital projects in the annual budget ordinance can cause the annual budget to fluctuate greatly in amount from year to year so that confusion arises about what amount is budgeted for ongoing operating programs annually.

These disadvantages are addressed by using a capital project ordinance. Such an ordinance continues in force until the project is complete—a capital asset is acquired or built. Also, by separating appropriations for capital projects from appropriations for operating expenditures, the distinction is clearer between current expenditures, with their immediate benefits, and capital projects and expenditures, with their long-term benefits.

In general, funds for relatively smaller or for annually recurring capital expenditures should be appropriated in the annual budget ordinance, usually on capital or permanent property spending lines by department or nondepartmentally in the general fund or another operating fund. On the other hand, revenues or other resources for major capital projects should usually be appropriated in project ordinances and accounted for in a capital project fund. The dividing line between these types of capital expenditures and projects will differ from jurisdiction to jurisdiction, depending on jurisdiction size, whether debt proceeds are involved, and generally how a jurisdiction differentiates between capital and operating budgeting.

G.S. 159-13.2(c) specifies the content of a capital project ordinance. It must "identify and authorize the capital project to be undertaken, identify the revenues that will finance the project, and make the appropriations necessary for the project." The project ordinance should identify each revenue source and specify the amount from each one to be spent for the project. If a project will extend over more than one year and the county or city includes annual revenues from several years in estimating project revenues, it is recommended that the project ordinance should specify the amount of such revenues that will come from each year's receipts. The Local Government Budget and Fiscal Control Act (G.S. Ch. 159, Art. 3) says nothing about the level of detail for appropriations in a project ordinance. G.S. 159-13(a), however, permits appropriations in the annual budget ordinance to be by project. This would seem to permit a comparable appropriation in a project ordinance—that is, a single, lump sum appropriation for the project, one for each project included in a project ordinance. A county or city may, of course, appropriate in greater detail. Indeed, most project ordinances for large construction projects make appropriations by general line-item categories—planning and design, land acquisition and preparation, construction, equipment and furniture, and contingency.

A separate capital project ordinance may be used for each individual project, or one comprehensive capital project ordinance may be enacted for all new projects authorized by the governing board in a particular year. Such a comprehensive capital project ordinance might be passed annually when the board approves new projects in the capital budget for the year. This budget may be taken from the CIP and consist of projects and expenditures in the budget year of the multiyear forecast made by that program (see Table 17-3 presented earlier in this article). In a few counties and cities, the governing boards enact a comprehensive capital projects ordinance each year that appropriates money by function for projects and spending in the first or *capital budget* year of their CIP. These local governments are typically raising and providing money to fund their capital budgets or CIPs on a *cash flow* basis, only raising the money just as it is needed and thereby saving interest costs when the projects and spending are financed with debt. Since G.S. 159-13(a) permits appropriations in the annual budget ordinance to be by function or department, as well as by project, making appropriations in a capital project ordinance by function is most probably consistent with the intent of G.S. 159-13.2, the statute authorizing county and city use of project ordinances.

Implementation: Financial Issues

This last section addresses issues involved in obtaining and managing debt and other sources of financing for capital projects. Failures here can limit the effectiveness of the program, project, and financial planning undertaken earlier in the capital budget process. Important facets in the financial part of implementation are obtaining and managing financing that will be used for a capital project or expenditure; compliance with federal arbitrage regulations, use of commercial paper for construction financing, cash flow planning or modeling for project or capital program implementation, and the use of *capital project accounting funds* to track project revenues and spending. Construction contracting and management are also vital to the successful implementation of capital plans. Laws and the general methods authorized for construction contracting and management for North Carolina counties and cities are addressed in Article 20.

Obtaining and Managing Capital Financing

The building or the acquisition of capital assets must be timed so that money from the financing sources is on hand to make payments to vendors and contractors as the payments fall due. For a capital project or acquisition financed in significant part or wholly with annual revenues on a pay-as-you-go basis, this can mean scheduling start-up of the project or the acquisition for the second half of the fiscal year, after most property tax revenue has been collected. If a capital project is to be built and the financing will come entirely or in major part from fund balances or capital reserves, such balances or reserves may have to be accumulated over several years before enough of such financing is available for the project. A capital improvement program can be very useful in planning for the accumulation of fund balances and reserves for capital projects.

If a major capital project is to be financed with bonds or debt, time must be allowed for the authorization and then the placement or sale of the bonds or debt. If a county or city issues less than $10 million of debt in a calendar year's time, it is likely to be able to place debt issued that year with a bank. Such a private placement can typically be done without an official statement or bond ratings, at a low to very modest issuance cost, and within a month to several month's time, depending on issuer and bank familiarity with one another and with the type of debt being used. Privately placed debt placements of up to $10 million can be a very cost-efficient form of capital financing for smaller cities and counties generally, and for medium sized and even larger units in years when they issue less than $10 million in debt. Financing of these amounts can be used to finance expensive equipment, for equipment renovation, and for small to modest-sized construction projects.

Bonds or debt issued for major or large projects or debt that is sold as a part of major on-going capital improvement programs typically is sold publicly to interested investors. A public sale of debt requires at least ninty days. Usually up to twice this time or more should be planned before a county or city can get the actual proceeds from a public sale of debt. The Local Government Commission actually sells the bond bonds on behalf of the issuing county or city. Public sales of general obligation debt occur in a *competitive sales* process, with underwriters bidding against one another, on an interest rate basis, to buy the bonds. The commission selects the underwriter or underwriting group offering the lowest average interest rate. The underwriter then resells the bonds or debt to interested investors. A negotiated process is used for public sales of other types of county and city debt: revenue bonds, certificates of participation, and special obligation bonds. In a negotiated sale, the Local Government Commissioner and the county or city issuer first select an underwriter, based on qualifications and experience as well as expected cost, to sell the debt. The underwriter works with the borrowing government to structure the debt and then sells the debt to its customers. Various bond market professionals are involved in a public sales process. Besides the underwriters, others involved are a bond counsel, an underwriters' counsel, the rating agencies, perhaps a financial advisor, perhaps a bond insurer, for revenue bonds a consulting engineer, and often others. Substantial documents, most importantly, the *official statement,* is prepared for public sales of debt. The public sales process, the involvement of many market professionals in the process, and the documentation that must be prepared account for the months needed to sell such debt and obtain the debt proceeds.

If federal, state, or other outside grant money will finance part of a project but be provided after project spending has occurred on a reimbursement basis, a county or city must have its own money to start the project and finance spending until reimbursements start arriving. Such up-front money for grant-financed projects usually comes from county or city fund balances or capital reserves. Although counties and cities have rarely used grant anticipation notes, they may issue them (G.S. 159-171) to pay for capital projects for which federal or state grant commitments have been obtained. The amount of the notes may not exceed 90 percent of the portion of the grant commitments yet to be received in cash by the county or city, and the notes must mature within twelve months of completion of the project financed with the notes. The Local Government Commission must approve and sell the notes.

Complying with Federal Arbitrage Regulations

If tax-exempt bond or debt proceeds are used to finance a capital project, federal arbitrage regulations must be followed to preserve the tax-exempt status of the interest paid on the bonds or the debt. Generally, *arbitrage* refers to profit earned or loss incurred by selling securities and investing the resulting proceeds in other securities. *Positive arbitrage* is profit made on such a transaction. *Negative* arbitrage is a loss resulting from such a transaction. In the case of tax-exempt debt, positive arbitrage occurs when a governmental or other tax-exempt entity borrows money by selling its tax-exempt debt at a relatively low interest rate, and invests the proceeds in taxable securities that carry higher yields or interest rates.

Federal arbitrage restrictions, which became effective in 1969, and arbitrage rebate requirements, which are based on regulations developed pursuant to the Tax Reform Act of 1986, generally prohibit positive arbitrage on tax-exempt debt—profits made by investing the proceeds of tax-exempt debt in higher-yielding taxable securities.[24] However, under certain conditions, the earning of such arbitrage profits does not violate federal law. Even though arbitrage profits may be earned on the proceeds of certain tax-exempt debt in the first three years after the issuance of such debt, federal arbitrage rebate requirements provide that such profits be rebated to the United States Treasury unless the issuer of the debt qualifies for one of the following exemptions:

- *Tax-exempt exemption*. The issuer invests proceeds from the tax-exempt debt in tax-exempt obligations.
- *Small issuer exemption*. The issuer has general taxing power and issues no more than $5 million of tax-exempt debt in a calendar year and spends the proceeds on government projects or activities. For school project expenditures, this small issuer exemption is increased to $15 million if the tax-exempt bonds were issued in 2002 or later.
- *Six-month exemption.* The issuer spends the gross proceeds from a tax exempt issue, except retainage that does not exceed the lesser of $100,000 or 5 percent of the issue, within six months after issuance. Any portion of the $100,000 or 5 percent that is not spent within six months must be spent within twelve months after

24. Arbitrage restrictions and rebate requirements are found in Section 148 of the Internal Revenue Code. A good summary is provided by Public Financial Management, Inc., *Arbitrage Primer: The Basics* (San Francisco: Public Financial Management, Inc., 2000). Also see Terence P. Burke, *Guide to Arbitrage Requirements for Governmental Bond Issues* and *1994 Supplement to the Guide to Arbitrage Requirements for Governmental Bond Issues* (Chicago: Government Finance Officers Association, 1992 and 1994).

issuance. Gross proceeds do not include money from the issue put into reasonably required reserves. Such reserves may not exceed the lesser of 10 percent of the gross proceeds, maximum annual debt service on the issue, or 125 percent of average annual debt service. Rebate calculations would have to be done for such reserves, possibly leading to the rebate of arbitrage profits earned by investing the reserves.

- *Eighteen-month exemption.* The issuer spends 15 percent of the gross proceeds of a tax-exempt issue within six months, 60 percent within twelve months, and all gross proceeds, less retainage not to exceed 5 percent of the issue, within eighteen months of issuance. As with the six-month exemption, gross proceeds do not include proceeds from the issue that go into reasonably required reserves, limited in the same way as for the six-month exemption. Rebate calculations would be necessary on such reserves, possibly leading to the rebate of arbitrage profits earned by investing the reserves. Any retainage must be spent within twenty-four months of issuance.
- *Construction or two-year exemption.* This exception allows for the *bifurcation* of a debt issue into two components: a nonconstruction portion to be used for land or other acquisitions, which must be spent within six months to avoid rebate; and a construction component, which must be at least 75 percent of the total debt issue. The issuer must spend at least 10 percent of the available construction proceeds within six months of issuance, 45 percent within twelve months, 75 percent within eighteen months, and 100 percent, less retainage not to exceed 5 percent of the construction proceeds, within two years of issuance. Any retainage of construction proceeds must be spent within thirty-six months of issuance. If the issuer fails to spend the required proportion of available construction proceeds by any six-month interval, it will have to either rebate to the United States Treasury all arbitrage profits earned on the full debt proceeds or to pay to the Treasury a penalty equal to 1.5 percent of any portions of the proceeds that should have been spent but were not spent by each six-month interval. The issuer must choose between these options—rebating or paying the 1.5 percent penalty—at the time that it issues or sells the debt.

Besides the exemptions listed here, there are additional, less important exemptions to arbitrage rebate requirements. Clearly, federal arbitrage regulations are very complex. Moreover, they have been modified from time to time over the years. Therefore counties and cities should seek advice from bond counsel, the Local Government Commission, and other competent sources in trying to meet arbitrage rebate requirements and in devising an investment plan for tax-exempt bond or debt proceeds. If a county or city does not comply with federal arbitrage regulations, it might have to pay penalties and interest to the federal government, and if the county or city fails to rebate arbitrage profits pursuant to regulations, the unit's debt could lose its tax-exempt status retroactively to the date of issuance.

Because of federal arbitrage regulations and its own longtime practice, the Local Government Commission urges that bonds or almost any form of debt not be sold or issued at least until a county or city has advertised for and opened the construction bids on the bond- or debt-financed project. The commission needs about ninety days to sell bonds or other debt and deliver the proceeds to a county. A county should contact the commission for the sale at least thirty days before it expects to receive bids on the project. The sale of the bonds will occur about sixty days after this initial contact, and the county will have the bond proceeds about thirty days after that, or not more than sixty days after the bid opening.

Construction Financing: Commercial Paper and Bond Anticipation Notes

Some North Carolina counties and cities have begun to issue tax-exempt commercial paper to finance the construction of capital projects. Commercial paper is short-term debt, with a term of 270 days or less. Under federal securities regulations, commercial paper may be issued without an official statement and with only limited procedural requirements. The units using commercial for construction financing determine the amount needed for construction financing for a period up to nine months (270 days) and issue only that amount. Typically it is spent within that period. If project construction continues after that period, the original commercial paper issue is rolled into a new commercial paper issue and an amount is added to the issue equal to construction spending in the next period up to nine months. This process continues until the project is done. At that point, the permanent long-term bonds or debt that are authorized for the project are issued, and the proceeds are used to pay off the final, commercial paper debt amount outstanding at the end of the project. The Local Government Commission must approve the use of commercial paper by any county or city.

The use of short-term commercial paper for construction financing has at least three advantages. First, it enables and almost insures that a tax-exempt issuer will be able to meet one of the eighteen-month or two-year exceptions to federal arbitrage rebate requirements. Proceeds from any commercial paper issue are spent within at least nine months. Second, commercial paper is relatively simple to issue. Third, short-term debt, like commercial paper, usually carries a lower interest rate than long-term debt. As a result, a county or city issuing short-term commercial paper for construction, rather than the long-term debt authorized for the project, can normally lower or hold down interest charges during the construction process. Of course, there are times when the interest rates on short-term debt are higher than on long-term debt, and on these occasions, the use of commercial paper will result in higher interest costs during construction. Another disadvantage of using commercial paper for construction financing arises when long-term interest rates rise between the time construction on a project begins and when the project is finished. In such a case, a county or city using commercial paper for construction financing has lost the opportunity to lock up the lower, long-term interest rates at the time construction commenced and will have to pay the higher long-term rates prevailing when construction is finished and the long-term permanent debt is issued.

Bond anticipation notes are also used to provide construction financing for some projects. The U.S. Department of Agriculture (USDA) provides debt financing at below market interest rates and for long terms for certain capital projects undertaken by counties and cities in more rural areas, which are generally smaller jurisdictions. Such USDA financing is not provided until after a project is constructed. Therefore, counties and cities with debt financing commitments from the USDA for projects must obtain construction financing to build the projects. The Local Government Commission issues bond anticipation notes (BANs) for terms of nine months or less to provide such financing. With a term less than nine months, an official statement does not have to be prepared in relation to the note issuance. If the construction project goes on beyond nine months, the notes are reissued or "rolled" and increased as needed up to the total financing commitment from the USDA. When the project is finished and approved by the USDA, the Local Government Commission issues the long-term debt, on behalf of the county or city, places it with the USDA, and uses the proceeds to pay off the BANs. A few North Carolina counties and cities have used bond anticipation notes in a similar fashion in relation to conventional financing for capital projects. For example, one town has a sidewalk improvement program for which general obligation bonds have been authorized by referendum. The program is taking place over a period of several years, and the town is issuing BANs to provide construction financing while the sidewalk improvement program is in process. When it is finished, the town will issue the G. O. bonds to pay off the BANs and provide long-term financing for the project.

Cash Flow Modeling for Project Implementation

Adequate management of the financing or revenue proceeds for a major capital project can be aided by use of a cash flow and investment model or plan for the project. The model should

1. cover the period from the date when cash proceeds for the project begin to be received, to the date when the final disbursement is made;
2. show project receipts, disbursements, and cash balances available by month or quarter;
3. lay down a general strategy to guide the investment of balances that are not immediately needed for project payments at any point; and
4. estimate the approximate interest earnings on the investments, calculate arbitrage rebate requirements, if any, and provide for the use of the net earnings.

Some larger cities counties and cities employ this type of cash flow model for all projects or a particular group of projects, for example, water-sewer or school, that the county or city is building. These units are likely to be using commercial paper for construction financing and to issue or add to long-term debt, as authorized, as projects are finished or completed.

Capital Project Accounting Funds

One or more *capital project (accounting) funds* are used to account for the construction or acquisition of major capital improvements or facilities. G.S. 159-26(b)(6) requires counties and cities to use such a fund when bond or other debt proceeds finance part or all of a project. Capital project funds are ordinarily not used to account for equipment acquisitions that are modest in amount, recur annually or fairly regularly, and are financed with annual revenues or from the annual budget. Such capital spending is normally budgeted and accounted for in the general fund or another operating fund. A separate capital project fund need not be established for each major project. Multiple projects can be accounted for in one capital project fund. Indeed, a single capital project fund can be used to account for all major general public improvements. However, one or more separate capital project funds should be used for major enterprise system projects.

Additional Resources

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Appendix 17-1. *Purposes for Which Revenue Bonds May Be Issued*

Authorized Purposes of Revenue Bonds	
Water facilities	Electric facilities
Gas facilities	Public transportation
Solid waste facilities	Airports
Parking	Hospitals
Marine facilities	Stadiums
Auditoriums	Recreation facilities
Convention centers	Storm water drainage
Economic development	Facilities for the federal government
Sewer facilities	

Appendix 17-2. *Purposes for Which Project Development Bonds May Be Issued*

Authorized Purposes for Project Development Bonds		
Purposes Available to Both Cities and Counties		
	Affordable housing	Public transportation projects
	Airport facilities	Rail corridor preservation
	Auditoriums, coliseums, etc.	Sewer projects
	Economic development projects	Stormwater projects
	Hospital facilities	Urban redevelopment
	Museums and historic preservation	Water projects
	Parking facilities	
Purposes Available Only to Counties		
	Private streets improvements	
Purposes Available Only to Cities		
	Electric system projects	Public streets
Gas system projects	Telephone system projects	