

**Sharing the Wealth: What Happens to Municipalities when Counties Decide to Change the Local Sales and Use Tax Distribution Method**

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**Executive Summary**

The state authorizes counties to levy a series of local sales and use taxes and requires that a portion of the revenue generated be shared with municipalities. Counties decide how this revenue is distributed to municipalities, on a per capita or ad valorem basis. A change in the distribution formula alters the amount of revenue allocated between the county and municipalities. This paper uses case studies to explore the financial impact that a change in the local sales and use tax distribution method has on small, rural municipalities and identifies strategies municipalities employ when they are negatively impacted by a change in the local sales and use tax distribution method.

## **Introduction**

North Carolina General Statute (N.C.G.S.) 105-472 authorizes county boards of commissioners to decide how revenue from the local sales and use taxes are distributed to its municipalities. Counties choose from one of two distribution methods—per capita or ad valorem—and may change the method as often as once per year. Changing the distribution method has varying financial impacts on municipalities; some municipalities lose revenue while others gain, and the scale of these losses and gains ranges from negligible to drastic.<sup>1</sup> This paper explores the financial impacts that a change in the local sales and use tax distribution method has on small, rural municipalities and identifies common strategies used by these municipalities to mitigate a revenue decline. Specifically, this paper provides case studies of the municipalities in four counties that recently switched from the per capita to the ad valorem distribution method, looks at the tax effort of the municipalities that lost revenue, and highlights policy implications resulting from the case studies.

## **Background**

North Carolina authorizes counties to levy five separate local sales and use taxes (local sales taxes), or up to a 2.5 percent local sales tax.<sup>2</sup> To date, all 100 counties levy at least a 2.25 percent local sales tax.<sup>3</sup> The state collects the local sales tax revenue and distributes it back to the counties and municipalities.<sup>4</sup> While counties are mandated to share the revenue from four of the five local sales taxes with its incorporated municipalities, N.C.G.S. 105-472 authorizes counties to decide how the shared revenue is distributed, either based on a per capita or ad valorem formula.<sup>5</sup> Pursuant to N.C.G.S. 105-472, county boards of commissioners determine which distribution method is used each year. If they decide to change the method, boards must do so prior to April 1 before the affected fiscal year.

The per capita formula allocates local sales tax revenue between the county and its municipalities based on relative populations. The population of the county is added to the population of the municipalities, creating a total population figure. The population of the county and each municipality is then divided into the total population figure and amount of local sales tax revenue distributed to each area reflects these proportions. The same principle used in per capita distribution formula applies to the ad valorem method. However, under the ad valorem method the amount distributed to the county and municipalities is based on relative property tax levies.<sup>6</sup>

## **Literature Review**

Three streams of literature are applicable to this research—literature on the impact of intergovernmental revenue, the limitations of small governments, and calculating fiscal effort.

*Intergovernmental Revenues:* Local sales tax revenue being shared by the county with its municipalities is a type of intergovernmental revenue. The literature regarding intergovernmental revenue addresses federal to state/local and state to local revenue sharing.<sup>7</sup> Research has shown that intergovernmental revenue stimulates local per capita spending, increases spending on operations, and provides a revenue source that cannot be duplicated.<sup>8</sup> Intergovernmental revenue can increase revenue diversity; however, it can lead to a decline in the tax effort of a jurisdiction.<sup>9</sup> In addition, local governments risk financial burden if the shared revenue is reduced or eliminated.<sup>10</sup>

*Limitations of Small Governments:* Small, rural local governments face limitations in revenue raising and administrative capacity.<sup>11</sup> Geographic isolation, low population, and resistance to innovation affect how small governments are governed and limit the financial resources available.<sup>12</sup> Small governments often do not have a professional budget officer and are less able to use the budget as a tool to set policy priorities.<sup>13</sup> These factors limit the ability of small rural governments to compensate for revenue shortfalls.

*Calculating Fiscal Effort:* Another component of this research is calculating the tax effort of municipalities that lost local sales tax revenue as a result of a change in distribution method. Fiscal effort is measured by looking at the revenue raised by a jurisdiction versus the jurisdiction's fiscal capacity, or maximum revenue that could be raised, while taking into account other conditions such as the current financial state.<sup>14</sup> Methods used to measure fiscal effort vary; however common methods use the average tax rates of a particular unit of government.<sup>15</sup>

## **Methodology**

The findings and implications discussed in this research are based on four case studies. As part of the case studies, the tax effort of municipalities that faced a decrease in local sales tax revenue due to a change in the distribution method was measured.

*Case Studies:* Four case studies focus on municipalities in Washington, Onslow, Henderson, and McDowell counties. These counties recently changed the method of local sales tax distribution from per capita to ad valorem. Each county is classified as rural,<sup>16</sup> and only two municipalities in the four counties have populations over 10,000. These two municipalities, Hendersonville and Jacksonville, are not included in the examination of strategies used to mitigate a local sales tax revenue loss due to being outliers. The population of Hendersonville is more than double of the rest of the municipalities in the county; as the literature shows, the administrative capacity differs from smaller municipalities. In Jacksonville, the large population and the presence of a military base make it a very unique case. The case studies include information from publicly available sources, including municipal budgets, newspaper articles, and minutes of elected official meetings.

The case studies for each county are presented in Appendices A-D. These case studies describe:

- Reasons the local sales tax distribution method changed
- Controversies surrounding a county's decision to change the distribution method
- Major fiscal impacts (winners and losers) of a change in the distribution method
- Tax efforts of municipalities that lost revenue
- Other significant budget changes made by municipalities where local sales tax revenue decreased

*Tax Effort:* Tax effort, for this research, is defined as the difference between the property tax rate needed to make up for lost revenue and the municipalities' actual property tax rate. A benchmark property tax rate is calculated in order to measure the tax effort of the municipalities suffering a revenue loss. The benchmark tax rate is calculated by comparing the revenue each municipality would receive under both local sales tax distribution formulas during the first fiscal year the county adopted ad valorem distribution.<sup>17</sup> (See Appendix E for calculations)

## **Limitations**

The main limitation of this research is distinguishing which municipal budgetary changes directly result from a switch in the local sales tax revenue distribution versus other events. Significant budget changes are usually influenced by a combination of factors, this it is difficult to be certain about direct causality in each case.

## **Findings**

The four case studies provide insight into the financial impacts a change in the local sales tax distribution method has on small municipalities and how municipalities respond to a decrease in local sales tax revenue. While specific impacts were different for each municipality, the case studies suggest four main findings.

*First, small municipalities do not always suffer after the county adopts the ad valorem sales tax distribution method.* In Washington and Henderson Counties, all municipalities received less local sales tax revenue under the ad valorem distribution method. In Onslow County, however, the small municipalities gained local sales tax revenue under the ad valorem distribution formula, with the exception of Richlands, where the loss was negligible. Jacksonville, the largest municipality in Onslow County, lost the most local sales tax revenue as a result of the change in distribution method. In McDowell County, Old Fort benefited under the ad valorem formula, while Marion lost revenue.

*Second, municipalities rarely raise the property tax rate in the year following a switch to ad valorem local sales tax distribution.* Table 1 shows the benchmark rate and the actual tax rate adopted in municipalities that lost revenue under the ad valorem distribution.<sup>18</sup>

The difference between the benchmark rate and the actual tax rate in the previous year varies widely between municipalities. None of the municipalities with benchmark tax rates less than \$.05 per \$100 of valuation greater than the previous year rate (Richlands, Fletcher, and Laurel Park) increased property tax rates to make up for lost local sales tax revenue. Of the five municipalities with benchmark rates more than \$.10 per \$100 of valuation higher than their actual tax rate in the previous year (Creswell, Plymouth, Roper, Mills River, and Marion), two increased the property tax rate. Where there was a relatively large difference between the previous year tax rate and the benchmark rate, political and economic factors may have made closing the gap infeasible. Where this gap was small, municipalities may have found other ways to increase revenue or cut expenditures.

**Table 1: Benchmark vs. Actual Tax Rates in Municipalities Worse off with Ad Valorem Local Sales Tax Distribution**

Municipality	Year Ad Valorem Adopted	Actual Rate in Previous Year	Actual Rate After Switch	Benchmark Rate
<i>Washington County</i> <i>FY04-05</i> <i>FY03-04</i> <i>FY04-05</i>				
Creswell		0.5000	0.5000	0.7720
<b>Plymouth</b>		0.5500	0.7200	0.8405
<b>Roper</b>		0.6200	0.8200	1.2382
<i>Onslow County</i> <i>FY07-08</i> <i>FY06-07</i> <i>FY07-08</i>				
Richlands		0.3800	0.3800	0.3841
<i>Henderson County</i> <i>FY08-09</i> <i>FY07-08</i> <i>FY08-09</i>				
Flat Rock		.0750	.0750	0.1237
Fletcher		.2700	.2700	0.3144
Laurel Park		.2700	.2700	0.2873
Mills River		.0750	.0750	0.2257
<i>McDowell County</i> <i>FY08-09</i> <i>FY07-08</i> <i>FY08-09</i>				
Marion		.5100	.5100	0.6797

\*\*Entities in **BOLD** increased their property tax rate the year the sales tax distribution method was changed  
 \*\*Appendices A-D provide the difference in local sales tax revenue received by these municipalities under each distribution method

Reasons municipalities do not increase the property tax rate to the benchmark rate vary. In Marion and Mills River, it is a council goal not to increase the tax rate.<sup>19</sup> Small municipalities that are resistant to change or lack administrative capacity, as cited in the literature, may find it difficult to change the property tax rate. In addition, any municipality may find it difficult to decide to change the property tax rate between April, when the decision to change the local sales tax distribution method is made, and June, when the budget has to be passed. Municipalities also used other strategies in order to make up for the decline in local sales tax revenue.

*Third, various strategies were employed by municipalities to mitigate local sales tax revenue loss.* Because most of the municipalities that received less revenue under the ad valorem local sales tax distribution method did not increase the property tax rate, budgets of the small municipalities were examined to determine how municipalities dealt with a decrease in local sales tax revenue. Table 2 summarizes major policy and budgetary changes each municipality made in the first year the ad valorem distribution was adopted.

The strategies used by the municipalities varied. Some municipalities made few major changes while others made a number of budgetary changes to make up for lost local sales tax revenue. Factors such as the amount of local sales tax revenue decreased and the level of services each municipality provides likely influenced municipal actions.

**Table 2: Municipal Responses/Budget Changes in the Year the Local Sales Tax Distribution Method Changed\*\***

Municipality	General Fund Budget Decrease	STRATEGIES					
		Decrease Service Expenditure (i.e. Police)	Decrease Administrative Costs	Contract Out Services	Decrease Contracted Services	Enter Interlocal Agreement	End Interlocal Agreement
Creswell	✓	✓				✓	
Plymouth	✓	✓				✓	
Roper	✓	✓	✓			✓	
Flat Rock	✓	✓			✓		✓
Fletcher							✓
Laurel Park				✓			✓
Mills River	✓	✓	✓				✓
Marion						✓	

\*\* These actions indicated in the municipal budgets were not necessarily a direct result of a change in the sales tax distribution method

In some cases, municipalities were able to grow their general fund despite the decrease in local sales tax revenue. However, other municipalities saw their general fund decrease once the ad valorem distribution method was adopted. These municipalities were forced to cut services, such as police or planning budgets. Strategies less often used by these municipalities were to decrease administrative costs, contract out services, or end a service contract.

Interlocal agreements were used in each of the four counties studied.<sup>20</sup> Some interlocal agreements try to ease the local sales tax revenue decline for municipalities. Under other interlocal agreements, counties agree to adopt the local sales tax distribution method in the municipalities favor, and municipalities agree to remit money back to the county. These agreements are made under the auspices of N.C.G.S. 160A-461; however, the General Assembly does not explicitly authorize counties and municipalities to enter into agreements regarding local sales tax revenue. The interlocal agreements, in effect, allow counties to circumvent the distribution methods specified in N.C.G.S. 105-472 by creating hybrid methods.

In Washington and McDowell County, interlocal agreements were established after the county decided to adopt the ad valorem distribution method. The reasons these agreements were put into place after the decision was to “lessen the blow” for municipalities that received significantly less local sales tax revenue after the distribution method was changed. In Henderson County, the nullification of previous interlocal agreements led to the change in the distribution method. Henderson County and its municipalities entered into an interlocal agreement in which municipalities made payments to Henderson County and the County distributed local sales tax revenue on a per capita basis. The municipalities nullified this agreement and no longer have to remit money back to the County. In Onslow, the County nullified the agreement it had with the City of Jacksonville and in order to adopt the ad valorem distribution method. As a result, most of the small municipalities in the County benefited.

*Fourth, property revaluations shift the amount of local sales tax revenue counties and municipalities receive under the ad valorem distribution method.* Property revaluation impacts a jurisdictions’ tax levy, which changes the amount of local sales tax revenue distributed to municipalities and the county. Of the four case studies in this report, Washington County was the only county to have a revaluation since the

local sales tax distribution method changed. This has altered the amount of local sales tax distributed to the County and the municipalities over time. Plymouth and Roper, for example, increased their property tax rates once the ad valorem method was adopted; however, they have been able to lower their current tax rates because of the property revaluation and gain a share of the local sales tax (see Appendix A).

### **Policy Implications**

The case studies provide examples of the risks of intergovernmental revenue—when intergovernmental revenue is reduced, it forces municipalities to deal with revenue shortfalls. However, in thinking about the policy implications of these case studies it is important to keep several things in mind. First, the purpose of allowing counties to levy a local sales tax is to give them an opportunity to add a source of revenue to meet their growing financial needs.<sup>21</sup> Second, changes in the local sales tax distribution methods have varying impacts on different municipalities, preventing a one-size-fits-all policy solution to issues surrounding local sales tax revenue distribution in North Carolina.

Several policy implications do arise from the case studies. First, to avoid conflict counties and municipalities should maintain open communication when a county is considering changing the local sales tax distribution method. In addition, maintaining open communication can help the county make decisions that are in its best interest and the interest of its municipalities. In doing this, counties can explain the reasoning for changing the distribution method to the municipalities and potentially give municipalities more time to make the budgetary adjustments necessary to ease the impacts of a decline in local sales tax revenue. Municipalities can also educate the county of the financial impacts of a change in the distribution method. While this may not influence a county's decision, it may lead to other arrangements or collaboration between the county and municipalities.

Local governments may want to seek explicit authorization from the General Assembly to enter into the interlocal agreements that, as evidenced by the case studies, are commonly used. While the interlocal agreements regarding local sales tax have not yet been challenged, the legality of them is open to interpretation. By obtaining authorization from the General Assembly, the interlocal agreements that already exist will be less susceptible to legal challenges. This will also give counties and municipalities the authority to form the hybrid distribution methods that already exist, and formally provide another strategy municipalities can use to make up for a decline in local sales tax revenue resulting from a change in the distribution method.<sup>22</sup>

Finally, municipalities do not often increase their property tax rate in response the county adopting the ad valorem distribution method. One reason for this is because council goals include maintaining a certain rate. However, by adopting the ad valorem distribution method, counties give municipalities the incentive to raise the property tax rate in order to increase ad valorem levies and gain local sales tax revenue in the future. Therefore, municipalities may want to be cautious about policies restricting their own future tax effort in order to help ease some of the problems associated with a decline in intergovernmental revenue.

### **Conclusion**

Counties decide how revenue from the local sales tax is distributed to municipalities. When a change in the distribution method causes a municipality to lose revenue, municipalities respond in a variety of ways, including cutting services. Municipalities do not often increase the property tax rate as a response to a local sales tax revenue loss. It is common for municipalities and counties to enter into an interlocal agreement, creating a hybrid distribution method. The General Assembly should explore explicitly authorizing, and perhaps providing guidelines for, these types of interlocal agreements

## Endnotes

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<sup>1</sup> “A Resolution Requesting the North Carolina League of Municipalities Make Reformation of North Carolina General Statute 105-472 Part of Their Legislative Platform” Adopted July 14, 2008.

<sup>2</sup> N.C.G.S. Chapter 105, Articles 39, 40, 42, 44, and 46.

<sup>3</sup> Lawrence and Millonzi 2008

<sup>4</sup> How the State distributes the local sales tax revenue back to counties depends on which Article the tax was collected under (Article 39, 40, 42, 44, or 46).

<sup>5</sup> N.C.G.S. 105-472.

<sup>6</sup> Another difference between the per capita and ad valorem distribution method is that under the ad valorem distribution method “Each county and municipality receiving a distribution of the proceeds of the tax levied under this Article shall in turn immediately share the proceeds with each district in behalf of which the county or municipality levied ad valorem taxes in the proportion that the district levy bears to the total levy of the county or municipality.” N.C.G.S. 105-472(b)(2).

<sup>7</sup> Johnston, Pagano, and Russo 2000; Oates 1999; Lyons and Morgan 1977; Bradford and Oates 1971; and Wright 1975

<sup>8</sup> Lyons and Morgan, 1977; Bradford and Oates, 1971; and Wright, 1975.

<sup>9</sup> Hendrick 2002

<sup>10</sup> Krane, Ebdon, and Bartle 2004

<sup>11</sup> Dougherty, Klase, and Song 1999; Honadle and Lloyd-Jones 1998; and Honadle 1983

<sup>12</sup> Honadle 1983

<sup>13</sup> Honadle and Sokolow 1984

<sup>14</sup> Honadle and Lloyd-Jones 1998; Sjoquist, 1996; and Kloha, Weissert, and Kleine 2005

<sup>15</sup> Hy et al 1993; Sjoquist 1996; Chernick and Reschovsky 2001; and Advisory Commission on Intergovernmental Relations 1990

<sup>16</sup> The North Carolina Rural Economic Development Center.

<sup>17</sup> Local Government Sales and Use Tax Distribution Reports from the North Carolina Department of Revenue.

<sup>18</sup> N.C.G.S. 105-472 specifies that the ad valorem tax levy figure used in the ad valorem distribution formula is from the previous fiscal year. Therefore, the property tax rate needed to make up for the loss of local sales tax revenue in the first fiscal year of ad valorem distribution has no bearing on how much local sales tax revenue is allocated to municipalities using the ad valorem formula in that year. A change in the municipal tax rate impacts the local sales tax revenue allocated to the municipality in the following fiscal year.

<sup>19</sup> Marion and Mills River FY08-09 Budget Message

<sup>20</sup> The legality of interlocal agreements between counties and cities regarding sales tax distribution is open to interpretation. To date, No entity has challenged the existence of these agreements.

<sup>21</sup> N.C.G.S. 105-464.

<sup>22</sup> In fact, identical Bills House Bill 63 and Senate Bill 81 are currently open in 2009 Legislative Session. If passed, The Onslow County Board of Commissioners will have the option to distribute local sales tax revenue in one of three ways—per capita, ad valorem, or a combined method using both the per capita and ad valorem method, neither of which being used to distribute less than 40 percent of the net proceeds of the tax.

## Appendix A: Washington County Case Study

*Description:* Washington County is a rural county located in the northeastern North Carolina. In 2007, the population of the county was estimated to be 13,214, a decrease of about 4 percent since the 2000.<sup>1</sup> The County poverty rate in 2007 was 23.6 percent, the eight highest in the State.<sup>2</sup> Because of its small size and economic situation, the County's budget is relatively small, around 20 million dollars. The same

**Table 1A: Washington County Municipalities Descriptive Statistics**

Entity	Population (2000)	Population (2007)	Percent of Individuals Below Poverty Level (2000)	Total Housing Units
Washington County	13,723	13,214	21.8	6,174
Creswell	278	254	26.1	137
Plymouth	4,107	3,961	37.5	1,793
Roper	613	620	27.1	268

population and poverty patterns seen in the County are also similar in Washington County's three incorporated municipalities, as seen in Table 1A.

*The Switch to Ad Valorem Distribution:* Washington County Commissioners voted on the ad valorem local sales tax distribution effective in FY04-05. The reason for this switch was because population was decreasing and the economy was slowing.<sup>3</sup> The change in distribution method created tensions between the County and municipalities, which continue today. The municipalities believe the switch in the distribution method and the subsequent revenue loss has hindered their ability to address problems within the municipalities and has hurt the County-Town relationship.<sup>4</sup>

*Impacts and Responses:* In Washington County, the ad valorem distribution method favors the county at the expense of all the municipalities. Table 2A shows the difference in local sales tax revenue received in FY03-04 and FY04-05. Table 3A shows the difference in per capita and ad valorem distribution of revenue in FY04-05.

None of the municipalities made up for the lost local sales tax revenue through tax effort alone. The municipal budgets give some insight into what the towns did in the year and years following the change in the local sales tax distribution method.<sup>5</sup> Table 4A summarizes the budget situations in each municipality between FY03-04 and FY04-05.

**Table 2A: Washington County Local Sales Tax Distribution (FY03-04 to FY04-05)**

Entity	FY03-04	FY04-05	Difference
Washington County	\$1,976,658.00	\$2,541,555.04	\$564,897.04
Creswell	34,008.33	20,242.97	-13,765.36
Plymouth	509,268.57	303,012.22	-206,256.35
Roper	73,820.65	32,742.75	-41,077.90
Total	2,593,755.55	2,897,552.98	303,797.43

**Table 3A: Washington County Local Sales Tax Distribution FY04-05: Ad Valorem vs. Per Capita**

Entity	Ad Valorem	Per Capita	Difference
Washington County	\$2,541,555.04	\$2,126,007.74	\$415,547.30
Creswell	20,242.97	42,583.24	-22,340.27
Plymouth	303,012.22	629,601.10	-326,588.88
Roper	32,742.75	99,360.90	-66,618.15

<sup>1</sup> North Carolina Office of State Budget and Management, Population Estimates

<sup>2</sup> US Census Bureau, Small Area Estimates Branch

<sup>3</sup> Washington County Board of Commissioners Recessed Meeting Minutes, June 6, 2007

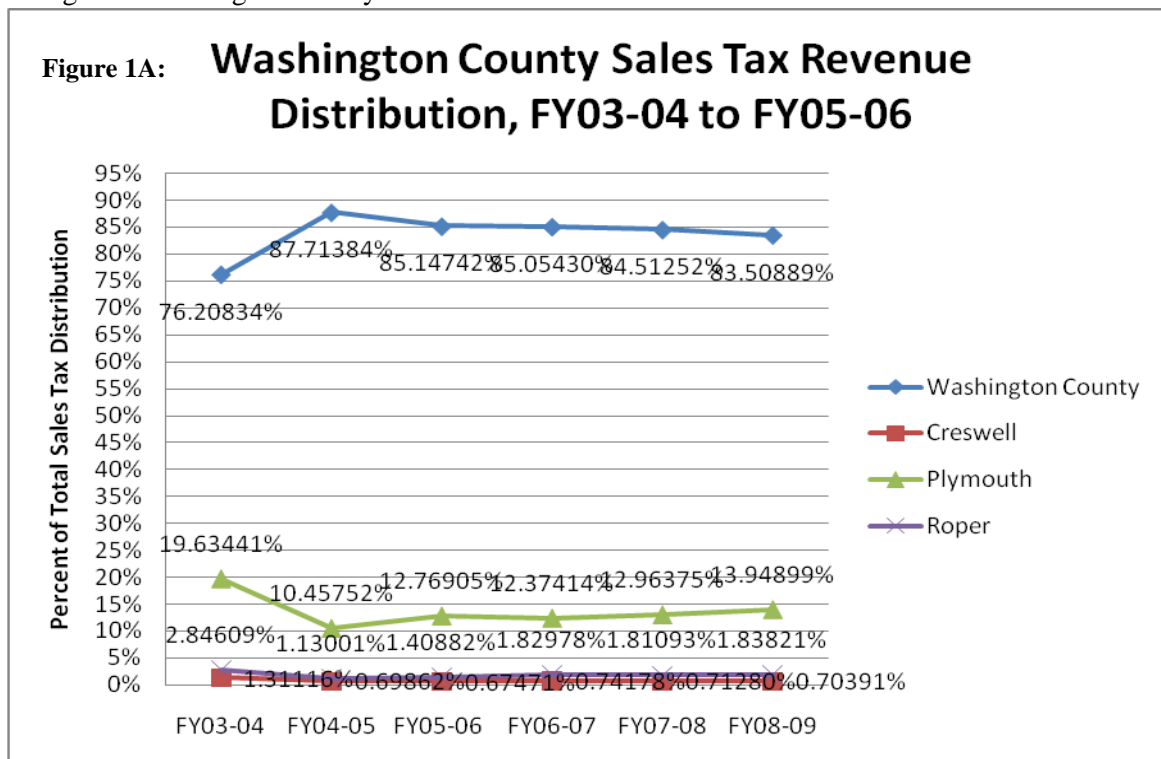
<sup>4</sup> Washington County Board of Commissioners Recessed Meeting Minutes, June 6, 2007

<sup>5</sup> Washington County and Washington County Municipalities Budgets from North Carolina Department of State Treasurer

Table 4A: Washington County Municipalities: Budget Changes from FY03-04 to FY04-05 <sup>6</sup>		
Municipality	Actions	Reasons
Creswell	Cut spending on public safety by over \$40,000	Loss of sales tax revenue; loss of intergovernmental revenue
Plymouth	Increased property tax rate; decreased spending on public safety by \$250,000	Increase in property tax
Roper	Increase property tax rate; decrease in police salaries and administrative costs	Loss of sales tax revenue; loss of intergovernmental Federal revenue (community development)

In addition to changing the local sales tax revenue distribution method, other things happened in the County that impacted municipal revenue. After the change in the distribution method, the County made Local Sales Tax Grants to the towns to lessen the local sales tax revenue loss.<sup>7</sup> In FY06-07, the Sales Tax Grants were as follows: Plymouth, \$74,646; Roper, \$13,996; and Creswell, \$4,665.<sup>8</sup> The Local Sales Tax Grants began in FY04-05. The grants were phased out completely in FY08-09.<sup>9</sup>

Another significant source of income for each municipality was the 2005 property revaluation. Because the revaluations and tax rate changes affected the tax levy of each entity, the percent of local sales tax allocated to the municipalities shifted over time. Figure 1A shows how the local sales tax distribution has changed in Washington County since FY03-04.



<sup>6</sup> Actions not necessarily a direct result of sales tax revenue

<sup>7</sup> Washington County Board of Commissioners Recessed Meeting Minutes, June 6, 2007.

<sup>8</sup> Washington County Board of Commissioners Recessed Meeting Minutes, June 6, 2007.

<sup>9</sup> Washington County Board of Commissioners Recessed Meeting Minutes, June 6, 2007.

## Appendix B: Onslow County Case Study

*Description:* Onslow County is located on the coast of southeastern North Carolina. As of 2007, Onslow County had the 11<sup>th</sup> largest population in the state, 169,302. Within Onslow County are six incorporated municipalities, including

**Table 1B: Onslow County Municipalities Descriptive Statistics**

Entity	Population (2000)	Population (2007)	Percent of Individuals Below Poverty Level (2000)	Total Housing Units
Onslow County	150,355	169,302	12.9	55,726
Holly Ridge	831	863	24.1	498
Jacksonville	66,715	77,301	14.1	18,312
North Topsail Beach	843	898	8.6	2,085
Richlands	928	1,093	24.5	424
Surf City*	292	310		
Swansboro	1,459	1,997	11.9	770

part of Surf City. Many of the municipalities in Onslow are small beach communities. The largest municipality in the County is Jacksonville, whose 2007 population estimate was 74,614. Part of Jacksonville is Camp Lejeune, the Marine Base that was partially annexed by Jacksonville in 1990.

Today, about 40,000 of Jacksonville's population can be attributed to the Camp Lejeune annexation. The other municipalities in the County are much smaller than Jacksonville, as seen in Table 1B.

*The Switch to Ad Valorem:* Onslow County adopted the ad valorem local sales tax distribution method beginning FY07-08. Onslow County originally adopted the per capita method because of an agreement made with Jacksonville in FY92-93.<sup>10</sup> In this agreement, the County agreed to adopt the per capita distribution method. In return, Jacksonville made annual payments to the County equal to the difference between what the County received in local sales tax revenue under the per capita distribution and what they would have received under ad valorem distribution.<sup>11</sup>

The ad valorem method favors the small municipalities and the County and became even more favorable to the small municipalities after the 2006 revaluation greatly increased property value. Many issues surrounded Onslow County's decision to switch to ad valorem local sales tax distribution, including the fact that Jacksonville's population figure is inflated because of the presence of Camp Lejeune. Much controversy surrounded the decision to change the local sales tax distribution method and these controversies continue today.<sup>12</sup>

<sup>10</sup> Jacksonville's 2007 population estimate was 74,614. Part of Jacksonville is Camp Lejeune, the Marine Base that partially was annexed by Jacksonville in 1990, drastically increasing the population of the City. Today, about 40,000 of Jacksonville's population can be attributed to the Camp Lejeune annexation. This is the reason the per capita distribution method heavily favored Jacksonville. (Onslow County Board of Commissioners Special Meeting April 27, 2006 Video)

<sup>11</sup> Onslow County Board of Commissioners Special Meeting April 27, 2006 Video.

<sup>12</sup> Kelley Chambers "Jacksonville Plans Big Tax Rate Hike," *jdnews.com*, May 30, 2007.

Jerry A. Bittner, Letters to the Editor. "The Right Question on Sales Tax Distribution." *jdnews.com*, October 15, 2008. [http://www.jdnews.com/opinion/county\\_60094\\_\\_\\_article.html/tax\\_sales.html](http://www.jdnews.com/opinion/county_60094___article.html/tax_sales.html)

*Impacts and Responses:* As a result of the change in distribution methods, only Richlands and Jacksonville lost local sales tax revenue; however, the amount of local sales tax revenue lost by Richlands was negligible. Table 2B shows the difference in local sales tax revenue distributed in FY06-07 and FY08-08. Table 3B shows the difference in the revenue generated under each local sales tax distribution method in FY07-08.

Jacksonville’s General Fund decreased by over 12 percent in the first year of ad valorem distribution. However, Jacksonville is a special case relative to typical strategies small municipalities use in response to a revenue loss. Jacksonville has a large population and the presence of Camp Lejeune makes service provision of the City different from other municipalities in the sample. Therefore, a discussion of Jacksonville’s responses to a change in the distribution method falls outside the scope of this research.

**Table 2B: Onslow County Local Sales Tax Distribution (FY06-07 to FY07-08)**

Entity	FY06-07	FY07-08	Difference
Onslow County	\$30,671,578.75	\$34,689,596.17	\$4,012,218.84
Holly Ridge	218,165.93	241,435.47	25,142.25
Jacksonville	13,588,582.14	8,808,064.45	-4,776,625.61
North Topsail Beach	255,321.26	1,274,110.51	1,019,485.63
Richlands	203,696.00	199,393.02	-4,318.18
Surf City*	127,770.08	900,781.28	772,226.41
Swansboro	353,312.62	585,952.08	232,776.87
Total	45,418,426.78	46,699,332.98	1,280,906.20

**Table 3B: Onslow County Sales Tax Distribution FY07-08: Ad Valorem vs. Per Capita**

Entity	Ad Valorem	Per Capita	Difference
Onslow County	\$ 34,683,797.59	\$ 31,403,578.24	\$ 3,280,219.35
Holly Ridge	243,308.18	160,076.60	83,231.58
Jacksonville	8,811,956.53	14,338,448.46	-5,526,491.93
North Topsail Beach	1,274,806.89	166,568.70	1,108,238.19
Richlands	199,377.82	202,738.96	-3,361.14
Surf City*	899,996.49	57,501.44	842,495.05
Swansboro	586,089.49	370,420.58	215,668.91

Onslow is an example of a county where the ad valorem distribution method actually benefits most of the smaller towns and the County. This situation may be an exception to the rule because most counties in North Carolina do not have high-valued beachfront property, large seasonal population changes, or a large military base.

## Appendix C: Henderson County Case Study

*Description:* Henderson County is located in southwest North Carolina and is part of the Asheville Metropolitan Statistical Area. There are five incorporated municipalities in Henderson County, several

**Table 1C: Henderson County Municipalities Descriptive Statistics**

Entity	Population (2000)	Population (2007)	Percent of Individuals Below Poverty Level (2000)	Total Housing Units
Henderson County	89,193	102,143	9.7	42,996
Flat Rock	2,565	3,193	1.5	1,459
Fletcher	4,185	6,168	7.4	1,816
Hendersonville	10,569	12,747	16.8	5,181
Laurel Park	2,017	2,249	3.3	1,115
Mills River**	5,693	6,334		
Saluda*	4	6		

\*\* The Town of Mills River was incorporated in 2003 and 2000 census data is not available for this municipality

other unincorporated towns, and 13 fire districts. The population of Henderson County is quickly growing, and has increased about 14.5 percent since 2000. The City of Hendersonville, the County seat, is the largest municipality while the other municipalities are less than half Hendersonville's size, as seen in Table 1C.

*The Switch to Ad Valorem:* The local sales tax distribution method in Henderson County has been subject to several interlocal agreements over the past several years.

- 2004 Agreement between County, Flat Rock, and Mills River: The County would not vote on ad valorem distribution if Flat Rock and Mills River made payments to the County.<sup>13</sup> This agreement was made because Mills River and Flat Rock levy very few ad valorem taxes. Switching to the ad valorem method would have caused them either to lose the majority of their total revenue or would have forced them to levy higher taxes.
- 2006 Agreement between County and all municipalities: The County would keep the per capita distribution method and the municipalities made payments to the County.<sup>14</sup>
- 2008: The 2006 agreement was nullified, first by Laurel Park and then the other municipalities.<sup>15</sup> Laurel Park felt the hybrid distribution method was not sound public policy because it encouraged non-urban areas to incorporate while providing few municipal services.<sup>16</sup> The County voted to adopt the ad valorem distribution method and entered into an agreement with the fire districts.<sup>17</sup>

Table 2C was adopted from Henderson County. It describes what the County believed the local sales tax revenue distribution would look like under the various distribution methods and with and without the 2006 agreement in place. Because under the County has to give a portion of the local sales tax revenue to the fire districts under the ad valorem distribution method, the County felt they were losing revenue when the 2006 agreement ended.

<sup>13</sup> 2004 Interlocal Agreement between Henderson County, the Town of Mills River, and the Village of Flat Rock. <http://www.hendersoncountync.org/agendas/November%2016,%202005/DI.C.pdf>

<sup>14</sup> Letter from the Mayor of the Town of Laurel Park to the Henderson County Board of Commissioners, February 26, 2008. <http://www.hendersoncountync.org/agendas/March%206,%202008/DI.A.pdf>

Town of Laurel Park Special Meeting Minutes, February 26, 2008.

<sup>15</sup> Letter from the Mayor of the Town of Laurel Park to the Henderson County Board of Commissioners

<sup>16</sup> Laurel Park Newsletter, April 2008. "Summary—Laurel Park Sales Tax Position" Henry Johnson, Mayor.

<sup>17</sup> Agreement between Henderson County and the Fire and Rescue Districts within the County, May 2008.

<http://www.hendersoncountync.org/agendas/May%2021,%202008/CA.J.pdf>

County will not adjust the tax rates in the fire protection districts and the fire districts will give all their sales tax revenue to the County

**Table 2C: Henderson County Local Sales Tax Distribution FY08-09 Estimated, With and Without Agreement**

Entity	Per Capita	Payment to County Under Agreement	Net After Payment	Pure Ad Valorem	Difference
Henderson County	\$20,174,883.67	\$0.00	\$21,304,378.61	\$20,458,047.73	\$846,330.88
Flat Rock	722,515.03	223,467.30	499,047.73	275,580.43	223,467.30
Fletcher	1,236,910.54	126,050.86	1,110,859.68	984,808.81	126,050.87
Hendersonville	2,893,532.63	156,223.81	2,737,308.82	2,581,085.02	156,223.80
Laurel Park	516,016.02	24,302.02	491,714.00	467,411.99	24,302.01
Mills River	1,456,142.11	599,450.95	856,691.16	257,240.21	599,450.95
Fire Districts	0.00	0.00	0.00	1,975,825.81	-1,975,825.81
Total	27,000,000.00	1,129,494.94	27,000,000.00	27,000,000.00	

*Impacts and Responses:* Under the ad valorem method of local sales tax distribution, all the municipalities in the County end up losing local sales tax revenue. The amount of local sales tax revenue decline faced by Flat Rock and Mills River was greater than the decline of revenue in the other municipalities. For example, the loss to Laurel Park was less severe. This fact could be one of the reasons they were willing to void the agreement in place with the County. Table 3C shows the percentage of local sales tax revenue received by each entity in FY07-08 through FY08-09. In this case, looking at how the revenue is distributed on a percentage basis is useful because it is not certain how much total local sales tax revenue will be generated in this fiscal year.<sup>19</sup> Table 4C shows the different amount of local sales tax revenue allocated to each entity under the per capita and ad valorem method in FY08-09.

**Table 3C: Percent of Local Sales Tax Revenue Distribution, Henderson County FY07-08 and FY08-09<sup>18</sup>**

Entity	FY07-08 (Per Capita)	FY08-09 (Ad Valorem)	Difference
Henderson County	77.2466%	84.5980%	7.35%
Flat Rock	2.4083%	0.9051%	-1.50%
Fletcher	4.1229%	3.2745%	-0.85%
Hendersonville	9.6447%	8.8692%	-0.78%
Laurel Park	1.7200%	1.4650%	-0.26%
Mills River	4.8536%	0.8648%	-3.99%
Saluda*	0.0039%	0.0233%	0.02%

**Table 4C: Henderson County Local Sales Tax Distribution FY08-09: Ad Valorem vs. Per Capita**

Entity	Ad Valorem	Per Capita	Difference
Henderson County	\$ 24,931,896.66	\$ 22,660,056.07	\$ -2,271,840.59
Flat Rock	266,742.91	708,362.47	441,619.56
Fletcher	965,042.05	1,368,361.95	403,319.90
Hendersonville	2,613,848.35	2,828,791.05	214,942.69
Laurel Park	431,761.81	498,937.42	67,175.61
Mills River	254,869.78	1,405,188.81	1,150,319.02
Saluda*	6,867.29	1,331.09	-5,536.19
Total	29,471,028.85	29,471,028.85	0.00

None of the municipalities who lost local sales tax revenue as a result of the decision to change the local sales tax distribution

method made an effort to make up for this loss by increasing their property tax rate. Some municipalities employed other strategies in response to the loss of local sales tax revenue (Table 5C). These strategies include reducing administrative costs and contracting out services. Other municipalities made no drastic

<sup>18</sup> Ad Valorem Percentages from the North Carolina Department of Revenue, Letter to All Municipalities, RE: Percentage of Population and Ad Valorem Levies, December 10, 2008. [http://www.dornrc.com/publications/population\\_advalorem\\_10-08.pdf](http://www.dornrc.com/publications/population_advalorem_10-08.pdf)

<sup>19</sup> Henderson County FY08-09 Budget Message projects sales tax revenue to be lower because of the current economic situation in the United States.

changes; however, all municipalities saw a decrease in expenditures because they no longer had to reimburse the County as a result of the nullification of the 2006 agreement.

<b>Table 5C:Henderson County Municipalities: Budget Changes from FY07-08 to FY08-09 (projected)<sup>20</sup></b>		
<b>Municipality</b>	<b>Actions</b>	<b>Reasons</b>
Flat Rock	Decrease in service contracts; decrease in planning expense; loss of law enforcement account	Loss of sales tax revenue; decrease in interest income; no more reimbursements to County
Fletcher	No new personnel; contract out Fire and IT services	Increase in property value; no more reimbursements to County
Hendersonville	Added positions; no major changes in General Fund expenditures	Loss of sales tax revenue; no more reimbursements to County; increase in property value
Laurel Park	No major changes in General Fund expenditures	Increase in property value because of construction projects; no more reimbursement to County
Mills River	Council goals include not changing the property tax rate; decrease in expenditures on fringe benefits; decrease in budgets for planning, fire, and streets; large decrease in reserves	Anticipate a \$600,000 sales tax revenue loss; no more reimbursements to County; did have reserves

<sup>20</sup> Actions not necessarily a direct result of sales tax revenue

## Appendix D: McDowell County Case Study

*Description:* McDowell County is a growing county located in western North Carolina. Currently, the

Entity	Population (2000)	Population (2007)	Percent of Individuals Below Poverty Level (2000)	Total Housing Units
McDowell County	42,151	44,064	11.6	18,377
Marion	4,934	7,107	17.3	2,351
Old Fort	963	976	17.0	496

population of McDowell County is about 44,000 people—4.5 percent higher than in 2000. Table 1D provides a description of the County and its two incorporated municipalities.

*The Switch to Ad Valorem:* Historically, McDowell used the per capita method to distribute local sales tax revenue to the municipalities because it favored the County. However, because of a growing population within Marion resulting from natural growth and annexations, the ad valorem method of distribution is now in the County's favor.<sup>21</sup> The County adopted the ad valorem method beginning in FY08-09. This caused controversy between the County and Marion. Marion feels they are facing a serious budget crisis that jeopardizes their ability to provide services.<sup>22</sup>

*Impacts and Responses:* In March and April when the County discussed changing the local sales tax distribution method, the County anticipated a 460,000 dollar increase in local sales tax revenue for them

Entity	FY07-08 (Per Capita Distribution)	FY08-09 (Ad Valorem Distribution)	Difference
McDowell County	84.42%	88.62%	4.20%
Marion	13.69%	9.25%	-4.44%
Old Fort	1.88%	2.12%	0.24%

and an over 20,000 dollar increase for the Town of Old Fort.<sup>24</sup> The increase to both the Town and the County comes at the expense of Marion. Table 2D shows the change in percent of local sales tax revenue distributed to each entity between FY07-08 and FY08-09 resulting from the change in the distribution method. To lessen the

severity of this loss, a one-year agreement was made where the County will keep \$100,000 of the local sales tax revenue that would have been received by Marion under the per capita distribution method.<sup>25</sup> Currently, the City and the County are discussing possible options for a new interlocal agreement that so Marion does not face a large loss in FY09-10.<sup>26</sup>

Marion made no effort to try to make up for the loss of local sales tax revenue through the property tax. One reason is because of the interlocal agreement between Marion and the County. Another reason Marion did not increase their property tax rate may be because Marion has not increased their property tax rate for 41 consecutive years, and an increase now could create controversy in the community.<sup>27</sup>

In addition to large loss in local sales tax revenue, Marion is suffering from the 2008 closing of two plants which decreased property tax and utility revenue. Strategies Marion has employed in anticipation of

<sup>21</sup> County of McDowell Board of Commissioners Meeting Minutes, April 14, 2008.

<sup>22</sup> Brit Combs, "City to County: Share the Wealth." (The McDowell News. November 25, 2008)

<sup>23</sup> Ad Valorem Percentages from the North Carolina Department of Revenue, Letter to All Municipalities, RE: Percentage of Population and Ad Valorem Levies, December 10, 2008. [http://www.dornrc.com/publications/population\\_advalorem\\_10-08.pdf](http://www.dornrc.com/publications/population_advalorem_10-08.pdf)

<sup>24</sup> County of McDowell Board of Commissioners Meeting Minutes, March 10, 2008.

<sup>25</sup> The City of Marion Budget Message, FY08-09.

<sup>26</sup> Mike Conley, "County, City Tax Deal in the Works?" (The McDowell News. January 13, 2009); Marion State of the City Presentation PowerPoint

<sup>27</sup> The City of Marion Budget Message

decreased local sales tax revenue and in response to plant closings includes delaying filling open positions, cutting back on travel and training, and postponing capital projects.<sup>28</sup>

Because the change in the local sales tax distribution method occurred in McDowell County in the current fiscal year, the impacts of the change have not been fully realized. In addition, the current economic situation in the United States is further complicating public finances.

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<sup>28</sup> Marion State of the City Presentation PowerPoint, January 22, 2009.

## **Appendix E: Calculating the Benchmark Tax Rate**

The benchmark rate is the property tax rate a municipality would have to adopt to make up for lost local sales tax revenue. In order to calculate the benchmark tax rate for municipalities that lost revenue under the ad valorem distribution method data from the North Carolina Department of Revenue Local Government Sales and Use Tax Distribution Reports, the North Carolina Office of State Management and Budget, the North Carolina Department of the State Treasurer, and municipal budgets were used.

In order to calculate the benchmark tax rate, the difference between the local sales tax revenue allocated to municipalities under the per capita and ad valorem method in the first year the ad valorem method was adopted was calculated. Assuming a 95 percent collection rate, the additional tax levy needed to make up for the difference in local sales tax distribution was calculated. The tax rate needed to generate the additional tax levy was calculated and added to the property tax rate of the municipality in the previous fiscal year in order to calculate the benchmark tax rate. The benchmark tax rate calculations can be found on the following page.

The methodology used for calculating the benchmark tax rate for municipalities in Washington and Onslow County differed slightly from the methodology used for Henderson and McDowell County. This is because Henderson and McDowell adopted the ad valorem local sales tax distribution method beginning in FY08-09 and the full FY sales tax distribution data is not available for municipalities in these counties. The figure used for total local sales tax revenue in Henderson and McDowell County was the FY07-08 total local sales tax. Using this figure in absence of the actual total local sales tax revenue is appropriate because many jurisdictions are predicting zero or negative sales tax growth for FY08-09 as a result of the current economic climate.

Other sources of revenue, such as increased user fees, were not taken into account when looking at the fiscal tax effort of municipalities. In addition, it is outside the scope of this paper to determine if it is feasible for a municipality to adopt benchmark tax rate calculated, or if the benchmark tax rate is not attainable because of current financial conditions and predicted future fiscal distress.

<b>Table 1E: Benchmark Tax Rate Calculation Process</b>								
	<b>Ad Valorem Distribution</b>	<b>Per Capita Distribution</b>	<b>Difference</b>	<b>Levy Needed to Generate Difference</b>	<b>Assessed Value</b>	<b>Tax Rate Needed to Generate Levy</b>	<b>Previous Year Tax Rate</b>	<b>Benchmark Tax Rate</b>
Calculation Process	Ad Valorem Distribution	Per Capita Distribution	Per Capita – Ad Valorem	Difference/0.95  <i>Assumes a 95% collection rate</i>	Assessed Value	(Levy Needed/ Assessed Value) * 100	Previous Year Tax Rate	Tax Rate Needed + Previous Year Tax Rate

<b>Table 2E: Calculating The Benchmark Tax Rate</b>								
<b>Entity</b>	<b>Ad Valorem Distribution</b>	<b>Per Capita Distribution</b>	<b>Difference</b>	<b>Levy Needed to Generate Difference</b>	<b>Assessed Value</b>	<b>Tax Rate Needed to Generate Levy</b>	<b>Previous Year Tax Rate</b>	<b>Benchmark Tax Rate</b>
<i>Washington County</i>					<i>FY04-05</i>		<i>FY03-04</i>	
Creswell	\$ 20,242.97	\$ 42,583.24	\$ 22,340.27	\$ 23,516.07	\$ 8,644,454	0.2720	0.5000	0.7720
Plymouth	303,012.22	629,601.10	326,588.88	343,777.77	118,342,624	0.2905	0.5500	0.8405
Roper	32,742.75	99,360.90	66,618.15	70,124.36	11,342,713	0.6182	0.6200	1.2382
<i>Onslow County</i>					<i>FY07-08</i>		<i>FY06-07</i>	
Jacksonville	8,811,956.53	14,338,448.46	5,526,491.93	5,817,359.93	2,653,624,114	0.2193	0.5516	0.7708
Richlands	199,377.82	202,738.96	3,361.14	3,538.04	87,024,407	0.0041	0.3800	0.3841
<i>Henderson County</i>					<i>FY08-09</i>		<i>FY07-08</i>	
Flat Rock	266,742.91	708,362.47	441,619.56	464,862.69	955,242,105.26	0.0487	0.0750	0.1237
Fletcher	965,042.05	1,368,361.95	403,319.90	424,547.26	955,700,000.00	0.0444	0.2700	0.3144
Hendersonville	2,613,848.35	2,828,791.05	214,942.69	226,255.46	1,723,000,000.00	0.0131	0.3800	0.3931
Laurel Park	431,761.81	498,937.42	67,175.61	70,711.17	408,187,134.74	0.0173	0.2700	0.2873
Mills River	254,869.78	1,405,188.81	1,150,319.02	1,210,862.13	803,350,000.00	0.1507	0.0750	0.2257
<i>McDowell County</i>					<i>FY08-09</i>		<i>FY07-08</i>	
Marion	1,057,456.67	1,594,644.39	537,187.72	565,460.7541	333,177,130	0.1697	0.5100	0.6797

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