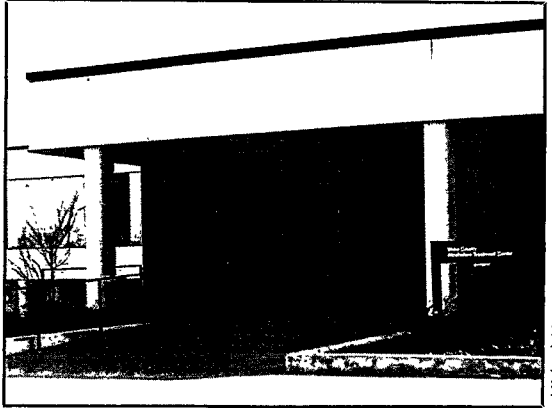


Courtesy: Town of Pink Hill



Michael Marros

Turner Memorial Library in Pink Hill and the Wake County Alcoholism Treatment Center: How much do they get from the state?

## Funding Formulas

# Slicing the Budget Pie

*How does the state distribute its revenues to the 100 counties and 513 municipalities? Answering this question might tell you more than the entire General Statutes, but it might take as many volumes. This introduction views the methods and madness of funding formulas as they incorporate philosophy and politics, calculations and common sense. The formulas fall into three categories: per-capita spending, an "equalization" approach, and some combination of the two.*

by Ken Eudy

**L**ong-time State Treasurer Edwin Gill, who died in 1978, was fond of saying of North Carolina, "We tax people according to their ability to pay and distribute money according to their needs." The simplicity of Gill's statement belies the complexity of accomplishing that goal — dividing the two-year \$13.25 billion state budget pie into equitable slices for six million North Carolinians.

State officials distribute appropriations among North Carolina counties, municipalities,

and special districts/authorities in three general ways: "per capita" formulas, "equalization" formulas, or some combination of these two methods. The latest listing of the formulas, compiled by the State Office of Budget and Management in 1981, runs 50 pages and covers 168 different programs, everything from "visiting artist" to "venereal disease."<sup>1</sup>

The majority of the state's General Fund

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dollars go to local governments through some kind of "per capita" approach, says Tom Covington, director of the legislature's Fiscal Research Division. Under this method, the General Assembly ties its appropriation either *to the population in a geographical area* (county, city, etc.) or *to the population receiving a particular service* (school children, elderly, etc.).

In general, "per capita" usually refers to the population of a geographical area, such as the "per capita" income of North Carolina. When discussing funding distribution formulas, however, "per capita" can also refer to the "per capita" recipients of a particular service — such as the number of school children or elderly or handicapped persons.

In contrast, equalization formulas generally are based on per capita wealth within a geographic area. Some county and municipal officials resent formulas that cause them to get back less in appropriations than they send to Raleigh in taxes. But the General Assembly and the state Constitution mandate that certain basic services should be available to all, regardless of where citizens live within the state.

"It's not like transferring money from Mecklenburg County [one of the state's wealthiest] to Jones County [one of the poorest,]" says Warren J. Wicker at the Institute of Government in Chapel Hill. "We transfer money from wealthy North Carolinians to poorer North Carolinians."

Some 35 states equalize resources in some fashion.<sup>2</sup> According to a 1980 study by the Advisory Commission on Intergovernmental Relations (ACIR), these states distributed about 45 percent of all their funds for local governments in some equalizing fashion.<sup>3</sup> Only 15 states distribute state money based solely on population, according to another study in 1981 by the Center for Governmental Research, Inc.<sup>4</sup>

At the federal level, an equalization approach has also been incorporated into many federal programs. For example, the major federal hospital construction program, the Hill-Burton funds, went to states for over three decades in inverse proportion to the wealth of each state. Despite such prominent examples as Hill-Burton, a recent ACIR analysis of the growth in the federal system questions the scope of equalization at the federal level. "A host of analyses have indicated that the Robin Hood principle of fiscal redistribution—'take from the rich, give to the poor'—has always received much more lip service than actual use in aid distribution . . . [F]ederal grant-in-aid dollars are commonly dispersed broadly among states and localities, including the relatively rich and poor alike."<sup>5</sup>

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In North Carolina, like many states, often a single agency uses some combination of formulas. The state Division of Mental Health, Mental Retardation, and Substance Abuse Services, for example, administers funds for 25 to 30 different programs, many of which have different distribution methods. This division uses a combination of per capita formulas for overall population, per capita formulas according to the number of recipients in a particular program, and equalization approaches.

The division, for example, distributes \$191 to local mental health agencies for each person in a local Adult Developmental Activity Program (ADAP). This is one kind of per capita formula for recipients — a certain amount of state money for each ADAP participant.

The same division uses an equalization approach in its *matching grants* to the 41 area agencies (which cover all 100 counties). These state funds, which must be matched by local areas, account for some \$30 million of the Division's \$100 million annual allocation to the area agencies. The state distributes this \$30 million in base amounts to each county according to various indices. For example, the higher an area's per capita income, employment rate, and education levels, the lower the state matching rate for locally contributed funds. In other words, the state "equalizes" the amount going to various parts of the state.

To get this \$30 million, the local area agencies have to put up matching money. In Mecklenburg County (a single-county mental health area), the county must put up 50 cents for every 50 cents from the state — a *one-for-one match*. But in the neighboring Sandhills Mental Health area (covering Anson, Hoke, Montgomery, Moore, and Richmond counties), the counties must appropriate 33 cents for every 67

cents in state funds — a *two-for-one match*. In North Carolina's poorest areas, counties must match 23 cents for every 77 cents in state money — a *two-and-a-half-to-one match*.

Why the difference? The rationale is that wealthier counties, areas like Mecklenburg, have a greater ability to pay for mental health programs. The N.C. General Assembly's intent is clear: All the state's citizens should have access to a basic standard of mental health care, whether they live in a relatively wealthy or poor county.

Many agencies, like the Division of Mental Health, Mental Retardation, and Substance Abuse Services, use a combination of formulas for distributing funds to local areas. Other state offices use primarily either a per capita or an equalization method. Below are some examples of per capita, equalization, and combination formulas.

### Per Capita

Distributing state money on a "per capita" basis may sound simple. Determine how many people live in a particular area or receive a particular service, multiply this number by some dollar amount, and presto — the allocation for a local program. In fact, per capita approaches are far from simple. Often, multiple formulas within a single program are based on per capita measurements. Below are two such examples.

**Day Care.** In FY 83-84, the N.C. Department of Human Resources (DHR) is distributing \$21 million in state and federal funds to local departments of social services and other agencies to help low-income persons who need day care. Most of this money (\$15.9 million) goes to county departments of social services, which provide and/or purchase day care within each county. The state also allocates \$4.6 million in day care funds to ten Appalachian Regional Day Care Projects covering 24 western counties, according to the number of children served by each project. Finally the state distributes a small amount, about \$400,000, to service organizations that provide day care to target groups (e.g., United Cerebral Palsy). During the course of a year, DHR examines the spending level of each agency which received day care funds. If an agency is not spending all of its day care allocation, the excess funds are transferred to agencies which need more money.

The departments of social services receive their \$15.9 million under two different systems. About \$8.5 million goes to these agencies according to total population within each county — a straight per capita system. (The federal government uses the same method to allocate Social Services Block Grant funds to the states,

the source for much of the federal day care funds.) The state distributes the other \$7.4 million available to county departments of social services through a more complicated formula, based mostly on per capita measurements, as explained below.

Each county receives a "base allotment," which has its roots in "an old, complicated approach called a fair share formula," says Ron Penny, assistant director for administration of DHR's Office of Day Care Services. The old "fair share" formula, as Penny calls it, weighed equally the general population of a county, the *public assistance population in the county*, and the previous year's *expenditure* (not allocation) in each county. In addition, the formula contained a kind of "hold harmless" provision, where a county's appropriation could not decrease (i.e., could not be "harmed").

As federal day care funds were cut by the Reagan administration through the Social Services Block Grant, the "hold-harmless" provision could no longer work, says Penny, because DHR had to reduce the amounts available to counties. DHR turned to a "base allotment" amount for the pot of money once distributed under the "fair share" formula. The base amount does not change each year, says Penny. It remains the same as it was when the "fair shares" were determined three years ago.

"The fair share formula was complicated and some people thought it was unfair," says Penny. "When a formula is complex, it is not

Day care center in Gates county.



Joe Vaughan

acceptable. The use of straight population as a basis for distributing day care money is a method most people can go along with. It's also easily understood."

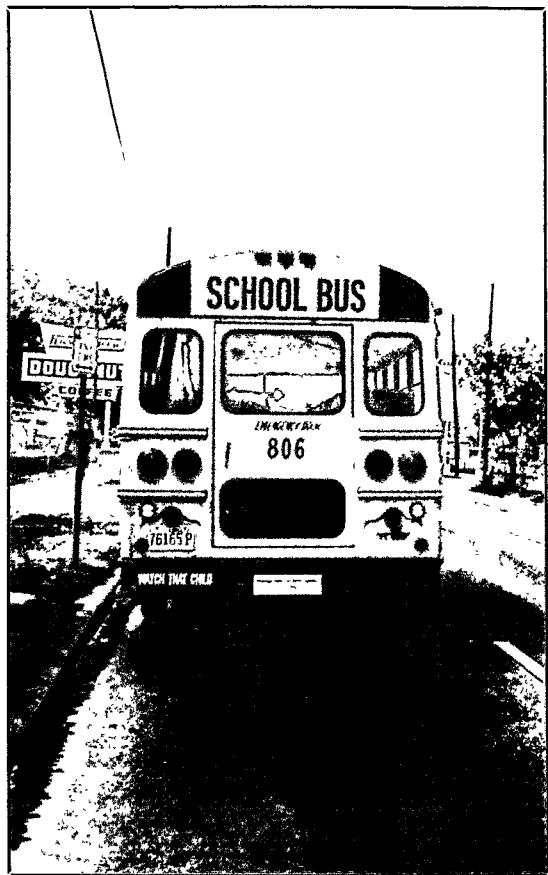
Some disagree with Penny's assessment that straight population formulas are generally acceptable. In a 1981 speech, Joe Gantt, the President of the Rural Day Care Association of Northeastern North Carolina, criticized the per capita formula. "We argue that the formula should distribute funds on the basis of the percentage of eligible children rather than the per capita population used at present."

Gantt's speech generated statewide discussion about the formula. "It seems logical to allocate the funds on the basis of eligibility (for day care assistance), not population," said Susan Law, then director of the Northwest Child Development Council, which operated 15 day care centers in Stokes, Forsyth, and Davie counties (see "What's Fair for Children," *North Carolina Insight*, Volume 4, Number 1).

**Public Schools.** One of the most prominent per capita funding approaches is the "average daily membership" (ADM) measurement among the 142 local school systems in the state. The General Assembly appropriates funds to the State Board of Education for public schools through "line-item" amounts for some 30 to 40 categories. For each category — ranging from instructional positions (by far the largest amount of money, about \$4 of every \$5 of state funds for public schools) to school buses to energy needs — a different funding formula determines the state appropriation. Most of the formulas, including the one for instructional positions, are based on a per capita approach — the average daily membership.

In North Carolina, unlike many states, far more of the overall per-pupil funding for education comes from state funds than from local funds (see article on page 30 for more on this). This emphasis on state-level funding of public schools stems from Article IX, Section 2 of the N.C. Constitution: "The General Assembly shall provide by taxation and otherwise for a *general and uniform system* of free public schools, which shall be maintained at least nine months in every year, and wherein *equal opportunities* shall be provided for all students" (emphases added).

Despite the language of the state Constitution and the formula structures, counties do not receive the same amount of money, per pupil, from the state. In 1981, for example, sparsely populated Graham County received \$1,462 per student in state funds. The nearby but more populous Buncombe County received \$1,291 per pupil — 12 percent less per pupil. If the state



Michael Marro

funding relies primarily on a per-capita approach, why the variation?

The difference lies mostly in salaries and fringe benefits for teachers and other personnel. The state, using the projected average daily membership of each school system, funds a certain number of instructional positions for each system. But the cost of each position varies from school system to school system, depending on certificates and degrees held and years of service. Hence, state funding varies among school systems according to such factors as a system's abilities to attract experienced teachers, to attract teachers with higher degrees, and to keep teachers in the system a long time.

Other factors in various formulas also account for the variation in per-pupil state funds among the systems. Base requirements for administrators (superintendents, supervisors, etc.) result in very small systems, like Graham County, getting more per pupil than larger systems, like Buncombe County. Other factors, such as varying needs for buses (e.g., rural counties) and heat (e.g., colder mountain counties) also affect the final per-pupil differences among the 142 systems.<sup>6</sup>

But the fine points of the state's average daily membership formula are only one factor

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—N.C. Constitution, Article IX, Section 2

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causing the growing divergence among the counties in per-pupil spending. In recent years, counties have greatly increased their local funding supplements — kicking in local money over and above state funds. By the 1982-83 school year, counting federal, state, and local funds, the Durham City School System led the state in total per-pupil spending (\$2,626). Davidson County ranked last among the 142 public school systems at \$1,731 per pupil, only 66 percent of the Durham City total.

The growing disparity among the counties in per-pupil funding represents just one of many school finance issues now being examined by various legislative groups (see article on page 30). In considering any action, the legislature will undoubtedly start from the average daily membership concept — a per capita funding approach which until recently appears to have satisfied the constitutional mandate for “a general and uniform system” providing “equal opportunities . . . for all students.”

### **Equalization Formulas**

**Roads.** The state builds and maintains roads under four general programs — urban construction, primary construction, federal aid construction, and secondary construction. Many rural counties receive very little benefit from the first three programs. But North Carolina, which has long prided itself as “the Good Roads State,” spends a lot of money on secondary roads — some \$43 million for FY 83-84. And all counties — rich or poor, urban or rural — benefit from these funds because of an equalization approach.

The formula is based on the number of unpaved miles of rural roads in a county. For example, Wilkes County, with 535 miles of unpaved roads, will get \$1.25 million in secondary roads money this year. Nearby Forsyth County pays far more into the Highway Fund, supported by the state’s 12.25 cents-a-gallon gasoline tax. But Forsyth will get only \$474,160 for secondary roads because it has only

202 miles of unpaved rural roads.

“The formula has an equalization element,” says State Highway Administrator Billy Rose. “In the other highway programs, the urban or most densely populated areas get the biggest part of the funds. But everybody gets something under the secondary roads program. For example, in the last 10 years, Alexander County, mostly a rural area, has gotten very little from the other three programs. But it always benefits from the secondary roads program.”

Jim Newlin, an analyst with the General Assembly’s Fiscal Research Division, agrees that the secondary roads formula “ensures geographic distribution.” But calling this an “equalization” formula can be misleading, says Newlin. “Equalization usually refers to wealth,” says Newlin, “especially the way Edwin Gill used to talk about equalization.” The secondary roads money goes according to the number of unpaved roads, not according to wealth, Newlin points out. “The counties with the most unpaved secondary roads may or may not be the poorest counties.”

**Social Services Equalization Fund.** This fund, in operation since the 1930s when many counties went bankrupt, helps poorer counties pay for state-mandated services such as Aid to Families With Dependent Children (AFDC), Medicaid, and food stamps. The Equalization Fund, administered by DHR’s Division of Social Services, assists counties that rate high in average monthly number of AFDC recipients per capita, and that rate low in average collection of property taxes and sales and use taxes.

In 1979, the Alamance County Board of Commissioners sued the Department of Human Resources, challenging the fairness of the Equalization Fund formula used by the social services division. Under the formula, Alamance was entitled to no equalization funds. Bladen County, according to the formula, got \$48,544. The Alamance commissioners argued that the formula inadequately measures a county’s ability to pay.

The Equalization Fund formula measures a county's wealth through per capita tax *collection* rather than per capita tax *valuation*. The total value of Alamance's land in 1979 divided by the county's population, was \$9,813 per capita. In Bladen, the same measure yielded per capita property values that were higher — \$10,040 per person. But for the Equalization Fund, the state doesn't consider property tax values. It uses property tax collections.

Alamance taxed land at a higher rate in 1979, so that tax collections amounted to \$92 a person. Tax collection per capita in Bladen, because of a much lower property tax rate, was \$66 a person. Bladen's lower tax collections per person was why the county got equalization money.

"It just wasn't fair," says Colleen Foust, Alamance's assistant county manager for fiscal affairs. "Why cut our state funding because we are more progressive and wanted to do more?"

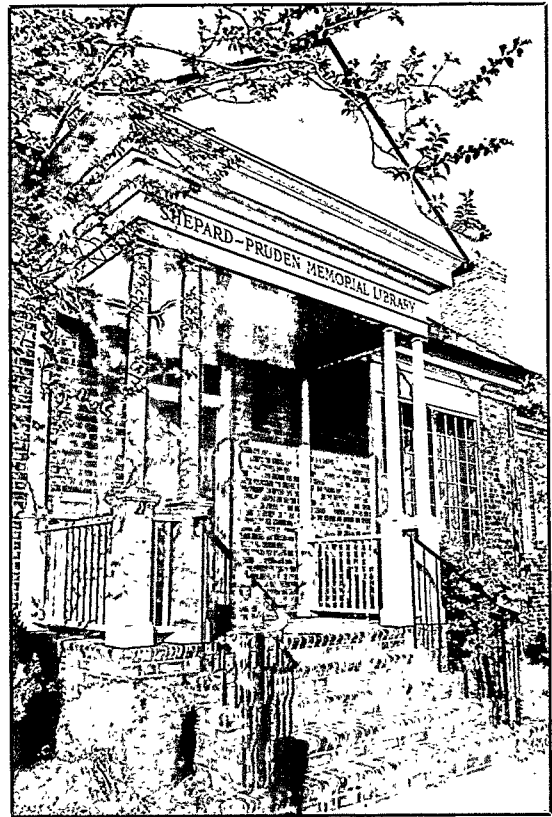
The N.C. Social Services Commission agreed to appoint a study committee to review the equalization formula and recommend appropriate changes. The study committee recommended a new formula that eliminated tax collections as a consideration. But the N.C. Social Services Commission, which establishes rules for this fund, refused to adopt the new formula. The Alamance suit against the state continued, but the District Court and later the N.C. Court of Appeals ruled in favor of the state. The same formula challenged by Alamance County in 1979 remains in existence today.

### Combination Formulas

Many of the 168 different programs listed by the Office of State Budget and Management in 1981 involve a combination of formulas.

**Community Based Alternatives.** The allocation formula for state funds going to community based programs for delinquent youth involves two factors: first, each county receives a base amount; and second, the remaining state funds are allocated according to the number of youth aged 10 to 17 in each county. In addition, counties must contribute a local "match" to the program to receive these state funds. This local match is determined in still another fashion, using the Social Services Equalization formula explained above to rank the counties in terms of relative wealth. The one-third most wealthy counties must provide a 30 percent local match; the one-third next most wealthy must provide a 20 percent local match; the one-third poorest counties must provide a 10 percent match.

**Local Libraries.** North Carolina has 114



Shepard-Pruden Memorial Library in Edenton, a member of the Pettigrew Regional Library.

Courtesy: Pettigrew Regional Library

local library systems—municipal, single county, and multi-county or regional systems. The state uses two approaches in distributing funds to these local libraries.

First, half of the state's total library aid goes in equal grants to each county. In 1983, every county — the most populous and the least — got a basic grant of \$34,164, whether it was in a single-county or multi-county library system. A regional library got the \$34,164 for each county within its region, plus another \$34,164 because it is a regional library.

So the New Hanover County Library, which serves 105,591 persons, according to the state librarian's office, gets the \$34,164 basic grant. The Pettigrew Regional Library, which serves four counties up the Atlantic coast (Chowan, Perquimans, Tyrrell, and Washington), gets \$170,820 in basic grants for serving 41,081 persons.

The other half of the formula, with both per capita and equalization elements, is still more complicated. This half goes out in inverse proportion to the average individual income in the area served by the library. In other words, the library system in North Carolina's wealthiest area gets exactly half the per capita grant that the library in the state's poorest area gets.

The Pettigrew Library serves an area with a \$4,940 annual per capita income and gets \$32,595, or 79 cents a person. New Hanover, with a per capita annual income of \$6,741, receives \$61,342, or 58 cents a person.

When the basic grants are coupled with the per capita grants, Pettigrew gets \$4.95 per person in state aid; New Hanover receives 95 cents per person. Is that fair?

"I'm not sure it's fair, but it has done a lot for us," says Veronica Furlough, the secretary-bookkeeper for the Pettigrew Library. "In the big counties, they can make out pretty well," without as much state aid.

Sen. J.J. "Monk" Harrington (D-Bertie), whose district includes part of the Pettigrew region, adds "It's more expensive to operate in a rural area. We're so widespread, and bookmobiles make it more expensive. It means so much to that 68-year-old retired woman who can't make it to town 20 miles away and get a book, to be able to get it from the bookmobile."

But Judith Sutton of Charlotte, who chairs the public libraries section of the N.C. Library Association, is not happy with the formula. "In theory, there is a basis for equalization," Sutton says. "In reality, I'm not sure it's sifting out. With equalization, there's the assumption that rural libraries need to be brought up to standard, and that's not necessarily true."

## The Politics of Formulas

In the 1983 General Assembly, county and municipal officials lobbied hard for a new, local-option, half-cent sales tax. The local governments needed assistance for capital projects, particularly schools and water and sewer systems. After the legislative groundwork had been laid for authorizing the new tax, a stumbling block remained — how would the tax revenues be distributed?

The local-option, one-cent sales tax, in existence since 1971, goes to counties according to where the tax was collected. (The mandatory, statewide three-cent sales tax goes to the General Fund.) The distribution method for the one-cent tax awards retail centers, i.e., urban areas, where a larger portion of the tax is collected. But the legislative leadership favored an equalization approach for the proposed new half-cent tax. The state Department of Revenue would collect the tax and then distribute the revenues to the counties (and their municipalities) according to population — not according to point of collection.

The semantics of this proposed approach could be confusing — an "equalization" approach based on a "per-capita" system (i.e., spreading the tax among all the counties based

on population, not point of collection). But the legislators were worrying less about terminology than about revenues.

Legislative leaders defended the method of distribution in part because portions of the revenues had to be spent for water and sewer and public school construction. But some urban legislators objected to the proposed distribution formula. Regional retail centers, like Wake County, would not enjoy the same benefits as it did with the existing fourth-cent, general sales tax. This is because shoppers from surrounding counties such as Johnston or Franklin leave their one-cent share of the state sales tax in Wake.

In 1984, the half-cent tax would amount to \$6 million in revenues for Wake County, and would climb to \$6.75 million in 1985, says Assistant Wake County Manager Richard Stevens — *if* Wake could enact the tax and *if* the tax were distributed according to point of collection. But under the equalization approach, distributing to all counties according to population, Wake County would receive only \$4 million of the new revenues in 1985 — \$2.75 million less than under the point-of-collection formula.

Urban leaders fought the proposed formula at first. But the legislative leadership, many of them from rural areas, held a trump card. Urban counties wanted the General Assembly to enact a local-option three percent hotel-motel occupancy tax. Budget leaders from rural counties promised support on the hotel-motel tax in exchange for urban counties' support for the half-cent sales tax.

"They coerced our delegation into going along with it," says Sen. Craig Lawing, a Democrat from Mecklenburg. The half-cent tax passed easily, with the distribution formulas favoring non-urban counties. The same tax bill included a three percent, local-option, hotel-motel tax for *all cities* and also authorized this tax for five counties (Buncombe, Forsyth, Haywood, Mecklenburg, and New Hanover).

While the urban/rural split appeared to be a major consideration during legislative debate, 96 of 100 counties have now enacted the local-option tax. Forsyth County was one of the first, and Mecklenburg recently voted in the tax. On May 21, 1984, the Wake County commissioners voted 6-0 to implement the tax, beginning July 1, 1984. As of June 1, only four counties have not approved the tax.<sup>7</sup>

As complicated as the politics were over the half-cent tax distribution formula, the negotiations over a *new* formula for an *existing* program can be even more intense. Federal budget cuts have required some state agencies to cut back throughout the state. In some cases, these

cutbacks have resulted in an equalization component in a formula losing out to a "base allocation" for each county. "Those programs which are providing high quality services find it very difficult to accept the fact that they must cut back or terminate in order to allow other programs in the state to begin or to expand," explains Ron Penny, referring to the day care funding debates discussed earlier in the article.

Because of federal budget cuts, inequities in existing formulas, or other reasons, the legislature and executive branch agencies do try to rewrite various formulas. Often, a "hold-harmless" provision is inserted into a formula to begin equalization efforts from a standardized base and to keep a local program from losing funds. Such provisions are politically popular but can have the effect of undermining the reform efforts around a particular formula (see "'Hold-Harmless' to Equitable Distribution — Who Gets State Special Education Funds?" *North Carolina Insight*, October 1983).

Politics affects the shaping of distribution formulas for state funds to local governments in North Carolina, just as politics shapes most actions by the General Assembly. "But it's not merely politics that dictates the type of formula," says Don Liner of the Institute of Government at the University of North Carolina at Chapel Hill. "In some cases per capita formulas or formulas based on various indicators of need for the service are called for, whereas in other cases equalizing grants that vary with the fiscal capacity of local governments are called for."

Inevitably, funding formulas have more behind them than first meets the eye — especially when considered in the political and economic context of when the formula comes into existence or is altered. From mental health to day care to libraries to schools, simple terms like "equalization" and "per capita" only suggest the complex policy issues and political context below the surface. Nevertheless, labels like "equalization" and "per capita" serve as useful points of departure.

Ultimately, state funding formulas are fair to the entire state, says Speaker of the House Liston Ramsey (D-Madison). A per capita formula ensures that most money goes where the most people are, while the equalization method provides money, as Gill put it, according to their ability to pay.

For example, Ramsey says, "The folks in Charlotte have a fine university [the University of North Carolina at Charlotte] they can send their children to. The children can stay at home, so a college education doesn't cost as much [as it does] for kids from small, rural counties who have to pay to stay in a dormitory."

North Carolinians who live in Mecklenburg might end up paying more taxes to the state than say, North Carolinians who live in nearby Anson county, says Ramsey. But amenities such as community colleges or universities which the state builds in wealthy areas offsets the extra taxes those areas must pay. A UNC-C student from Mecklenburg County can stay at home, but the Anson County student would have to pay for a UNC-C dorm room or commute.

To Edwin Gill's theory of taxing according to ability and distributing according to need, add Ramsey's corollary: "As far as I'm concerned, we don't have islands in this state. It's all one state."□

#### FOOTNOTES

<sup>1</sup>"Summary of State Financial Assistance to Local Governments in North Carolina," prepared by the Office of State Budget and Management, March 1981. The office tentatively plans to prepare a similar compilation of how state funds go to local programs prior to the 1985 legislative session.

<sup>2</sup>Don Liner of the Institute of Government at the University of North Carolina at Chapel Hill explains that responsibility for financing government is more centralized in North Carolina than in other states. Consequently, North Carolina uses fewer equalizing grants than do other states, says Liner. Other states that rely more on local governments to finance services, but still want to assist them, tend to rely more on equalizing grants because their objectives are different — they want to equalize the ability of the units to provide the services rather than to determine the need for funds.

<sup>3</sup>"The State of State-Local Revenue Sharing" Advisory Commission on Intergovernmental Relations (ACIR), 1980. The ACIR, a permanent, bipartisan and independent agency created by Congress in 1959, conducts research on intergovernmental issues and makes recommendations for reform regarding the federal form of government. See bibliography on page 75 for more.

<sup>4</sup>"Intra-State, Intra-Regional, Intra-County General Revenue Sharing Formulas: An Inventory," Center for Governmental Research, Inc., 1981, p. 11. The Center for Governmental Research, based in Rochester, N.Y., is a non-partisan, private agency promoting efficiency in government, especially local government.

<sup>5</sup>"The Federal Role in the Federal System: The Dynamics of Growth — An Agenda for American Federalism: Restoring Confidence and Competence," Advisory Commission on Intergovernmental Relations, June 1981, p. 48.

<sup>6</sup>"The most important variation comes about because some of the rural school units have less turnover, and therefore their teachers receive higher pay. Differences in heating costs and transportation costs contribute to the differences, but I believe they are not as important as differences in pay," says Don Liner of the Institute of Government.

The Constitutional provision does not necessarily call for per capita grants. In fact, per capita grants are not used (ADM is an eligible population measure), and the Department of Public Instruction has been studying grants that are based on differences in costs of providing different services, says Liner.

<sup>7</sup>The four counties are Alamance, Burke, Durham, and Person.