Designing State Aid to Education in the Presence
of Property Tax Exemptions
Part 1

A state education finance system consists of local property taxes, state aid to education, and perhaps other revenue sources. Each of these components alters both the decisions made by local school districts and the across-district distributions of educational outcomes and tax burdens. Proposed changes to any component of this system should be evaluated in terms of their impact on the system as a whole.

A dozen states, including New York and New Jersey, have state-funded homestead exemptions for school property taxes. Because these homestead exemptions are paid for by the state, they serve as a type of state aid and should be considered part of the education finance system. Unfortunately, however, these exemptions generally undermine one of the key objectives of an education finance system, namely fairness across school districts.

Consider the case of the School Tax Relief program, STAR, in New York (which is discussed in my June 2005 column). Because it does not apply to renters and because it gives larger exemptions in higher-wealth counties, STAR actually magnifies the education-finance disparities in New York State. As shown in Table 1, STAR savings per pupil are much higher in the wealthy downstate suburbs ($1,395) than in New York City ($320) or in the three large upstate cities ($564).

Table 1: STAR Savings Per Pupil, 2001-2002

Region	STAR Savings Per Pupil
New York City	$320
Yonkers	$1,289
Downstate Small Cities	$1,290
Downstate Suburbs	$1,395

Upstate Big Three	$564
Upstate Small Cities	$916
Upstate Suburbs	$1,048
Upstate Rural	$816
Average District	$1,055

The large, negative impact of a homestead exemption on the fairness of an education finance system could be eliminated if the associated state funding was recognized as a form of aid and integrated into the state aid formula. This column explains how this could be done.

States use many different formulas to provide education aid to their school districts. The most basic type of aid formula is called "foundation" aid. This type of formula is designed to ensure that every district has enough funding to provide a "foundation" level of spending. To meet this objective, each district's state aid is set equal to the difference between its foundation spending level and the amount of money the district is expected to raise on its own.

This approach is popular; 41 states distribute some of their aid, usually a large portion, through some type of foundation aid formula. Moreover, foundation aid formulas can be used to make sure that every school district has enough revenue to provide an "adequate" education, which is the focus of several recent state supreme court decisions, including one in New York. Not surprisingly, therefore, foundation aid programs have been a central component of recent education finance reforms in several states. (For more on foundation aid, see my December 2004 and January 2005 columns.)

A state-funded homestead exemption can be integrated into a foundation aid formula simply recognizing that revenue from the state helps a district reach its foundation spending level, regardless of whether it comes in the form of an intergovernmental grant or a reimbursement for a homestead exemption. Thus, the objective of a foundation formula can be met by setting total state payments, the sum

of grants and reimbursements, equal to the difference between the foundation spending level and the expected local contribution.

This simple idea preserves the benefits that local property tax payers receive from the homestead exemptions while eliminating a homestead exemption's perverse effects on the fairness of education finance funding. My next column will expand on this idea and discuss some of the issues that might arise if it were implemented.