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Designing State Aid to Education in the Presence of Property Tax Exemptions Part 2

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It's Elementary

A Monthly Column by EFAP Director John Yinger

December 2005

Designing State Aid to Education in the Presence of Property Tax Exemptions Part 2

Many states provide homestead exemptions from the property tax. When states compensate school districts for these exemptions, they undermine the equity of their education finance system. In my last column, I argued that this inequity can be eliminated by incorporating this state compensation into a foundation aid formula. This column explains this proposal in more detail.

A standard foundation aid formula is designed to ensure that every district has enough revenue for the spending it needs to meet the state's performance standards after raising an expected minimum amount itself. The following table describes this formula. All entries in this and the following tables are expressed in per-pupil terms.

Standard State Foundation Aid	Equals	Foundation Spending Amount	minus	Expected Local Contribution
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States that compensate school districts for homestead exemptions add this compensation to foundations aid. It follows that

Standard Total State Aid	equals	State Compensation for Homestead Exemptions	plus	Standard State Foundation Aid
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Standard Total State Aid	equals	State Compensation for Homestead Exemptions	plus	Foundation Spending Amount
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Thus, state compensation for homestead exemptions draws a significant share of the state aid budget away from the objective of the foundation formula. This is inequitable because the districts that benefit from this compensation are districts that have few renters or, in the case of New York, are located in high-wealth counties.

My proposal is to devote all state aid toward ensuring that each school district has the resources it needs to meet state performance standards. This proposal can be expressed as follows:

Proposed Total State Aid	equals	Foundation Spending Amount	minus	Expected Local Contribution
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Because total state aid equals foundation aid plus compensation for homestead exemptions, this proposal implies that

Proposed State Foundation Aid	equals	Foundation Spending Amount	minus	Expected Local Contribution	minus	State Compensation for Homestead Exemptions
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Two key issues arise in implementing this proposal. First, the compensation a school district receives for homestead exemptions depends on the tax rate the district selects. State officials do not know what this rate will be when they pass the state-aid budget. This uncertainty can easily be eliminated by basing state foundation aid on the previous year's compensation for homestead exemptions. Because local property tax rates do not make large jumps from year to year, this simplification does not in any way undermine the benefits of this proposal.

Second, a literal application of this formula could lead to negative foundation aid in some districts. A reasonable way to handle this possibility is through a type of hold-harmless provision that enables each district to retain some or all of its compensation for homestead exemptions. Under this approach, some wealthy districts would not receive any foundation aid, but their total state aid, in the form of compensation for homestead exemptions, would still be positive.

Finally, it should be emphasized that this proposal preserves the main objective of a homestead exemption, namely to provide progressive relief from local property taxes. In other words, this proposal does not alter the tax relief provided to individual homeowners. Instead, this proposal simply recognizes that state compensation for homestead exemptions is an important part of the state education finance system and shows how state education aid can be adjusted so that these exemptions support, rather than undermine, this system's key objectives.