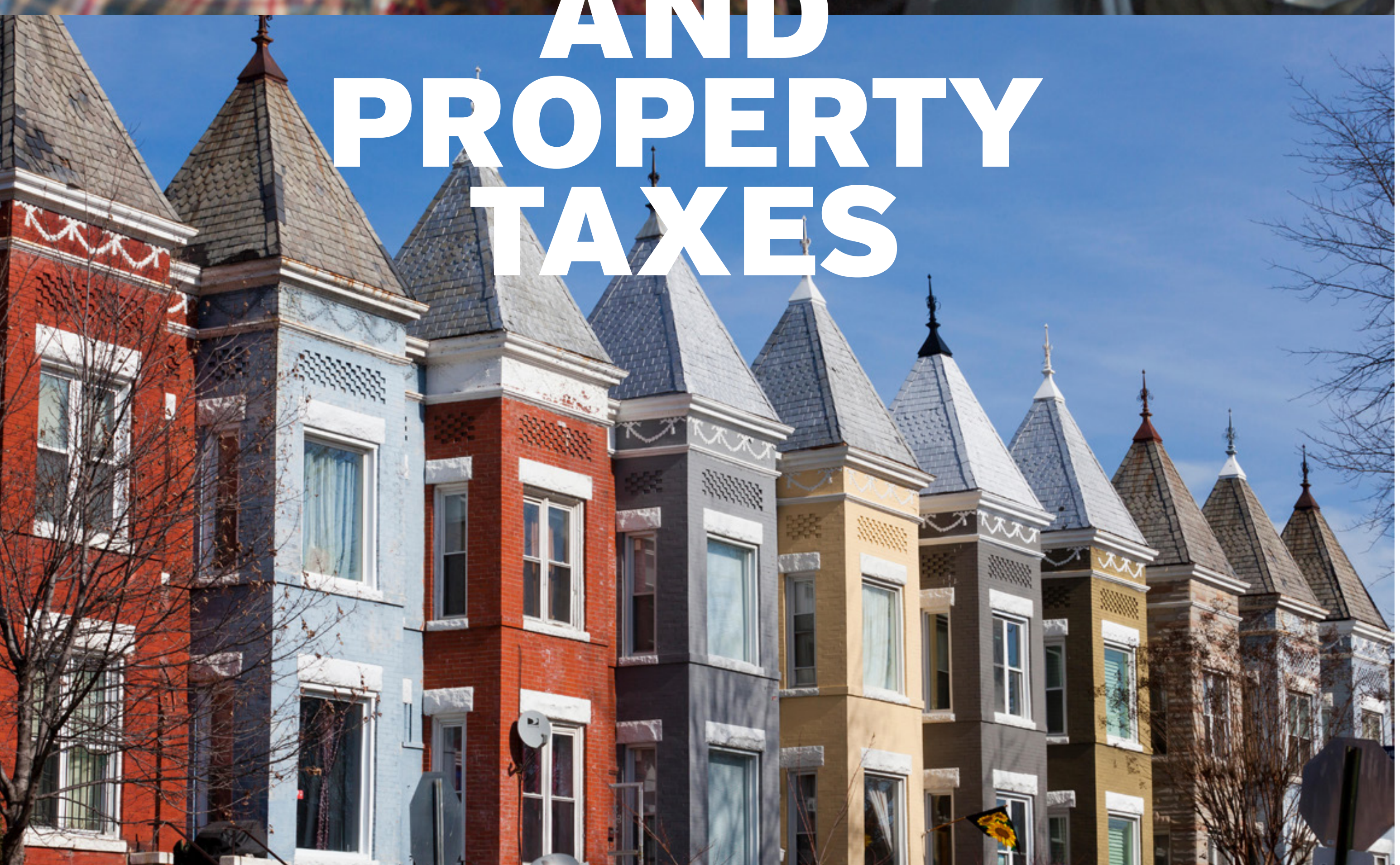
SCHOOL FINANCE AND PROPERTY TAXES



By Joan Youngman

This feature is excerpted from A Good Tax: Legal and Policy Issues for the Property Tax in the United States, *by Joan Youngman, scheduled for publication in April 2016.*

SOME OF THE MOST SIGNIFICANT POLICY DISCUSSIONS concerning the property tax do not deal with the tax itself but rather with the use of its revenue to support local public schools. This vigorous and long-running controversy highlights the role of the property tax, but the tax itself is of secondary importance to the substantive points at issue, such as the amount of total education spending, its distribution across school districts, and the levels of government that are to provide these funds. If income taxes constituted the primary local revenue source and property taxes were imposed at the state level, the school finance debate could continue as it stands, merely substituting the term "income" tax for "property" tax.

School funding challenges generally begin with one basic problem: how best to expand the revenue available to schools in impoverished districts whose own resources cannot support adequate public education, even at tax rates far higher than those imposed by more affluent jurisdictions. This is not a property tax problem, but a *local* tax problem. A needy area restricted to its own income tax or sales tax revenues would find it equally difficult to support a successful school system, no matter how high its tax rates. Some transfer of external resources is essential for districts that cannot fund their vital services independently. This statement may seem self-evident, but it sometimes represents the limit of consensus in this extremely heated debate.

By itself, this consensus only establishes that no local tax can serve as the sole support for basic services when the local tax base is inadequate for that purpose. This is a far cry

Left: The overwhelming majority of U.S. property tax collections fund local government operations, and the property tax remains the main source of autonomous revenue for most local jurisdictions, including school districts. Credit: Alamy.

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from demonstrating the unfairness of the property tax or any other local tax. But the traditional use of the property tax as a primary support for local schools has sometimes given rise to that implication.

Although the property tax generally functions as a local tax in this country and provides the largest share of independent local revenue, this has not always been the case. Before widespread adoption of state sales and income taxes in the twentieth century, property taxes were a major source of revenue at the state level. At the same time, many local jurisdictions also impose other taxes, such as sales or income taxes. Nevertheless, the overwhelming majority of U.S. property tax collections fund local government operations, and the property tax remains the main source of autonomous revenue for most local jurisdictions, including school districts. Therefore, debate over reliance on local resources to fund education generally questions the fairness of using property taxes as the primary means to finance local schools. It is important to clarify the extent to which the property tax itself is at issue in this debate, and the extent to which it is simply the most commonly used instrument for raising the revenue whose distribution and use is in question.

The Property Tax and Equalization of School Funding

Property taxes were most dramatically linked to the equalization of school funding in the 1971 California *Serrano* decision, which ushered in a

Per-pupil spending in California has plummeted since 1971, when the *Serrano v. Priest* decision decoupled school finance from the local property tax on the grounds that disparate property values in Baldwin Park (left) and Beverly Hills (right) led to constitutionally unacceptable variations in public school budgets. Credit: realtor.com.

new era of state constitutional challenges to education finance. In that case, the California Supreme Court found that divergent local property tax bases led to constitutionally unacceptable variations in school budgets: "The source of these disparities is unmistakable: in Baldwin Park the assessed valuation per child totaled only $3,706; in Pasadena, assessed valuation was $13,706; while in Beverly Hills, the corresponding figure was $50,885—a ratio of 1 to 4 to 13. Thus, the state grants are inadequate to offset the inequalities inherent in a financing system based on widely varying local tax bases."[1] Within a decade, California had pioneered a new system of centralized school finance. Instead of districts setting their budgets on the basis of local revenues, budget decisions were made for each district at the state level.[2] The initial phase of school finance reform in California focused strongly on equalization of basic funding, with the very first judicial decisions seeking to limit variations in per-pupil spending across the state to no more than $100.[3]

The same decade saw California voters lead a wave of property tax limitations with the passage of Proposition 13 in 1978. In the wake of this initiative, the state legislature changed the system for distributing property tax revenue as well. As a result of these measures, state law now governs the property tax rate, the budgets of local school districts, and the distribution of property tax collections. Approximately one-third of property tax revenue is allocated to K–14 school districts.[4] The California experience demonstrates that the property tax can be a tool for centralization and equalization of school finance as well as for decentralization and local variation.

Complexities of Centralized School Finance

Although Proposition 13 closely followed school finance reform in California, the causal connection between the two remains controversial. One perspective considers centralized, standardized school finance and administration to erode homeowners' support for the property tax.[5] "Homeowners were willing to pay higher property taxes if they were convinced this led to quality schools. The school finance litigation movement essentially breaks this tie—local property tax revenues tend now to be redistributed statewide and not directed, on the margin, to local schools."[6] At the same time, other scholars vigorously contest this hypothesis on statistical and historical grounds: "[T]he evidence does not support the claim that *Serrano* caused Proposition 13."[7]

Whatever their connection, these two elements—constitutional challenges and property tax limitations—reinforced one another in shifting authority and responsibility for school funding from localities to the state government. This process also exposed school budgets to new political pressures. At the local level, school spending is often the single most important element of the budget, but wider state needs include public health and safety, transportation, corrections, and higher education. Centralization also carries the challenge of maintaining parental contact and involvement if crucial educational decisions are perceived to be the province of state or other higher-level officials.

The California experience has demonstrated that these concerns should be taken seriously. In 1969–1970, before centralization of its school finance and the introduction of Proposition 13, California ranked 11th among all states and the District of Columbia in per-pupil K–12 spending. By 2013, it had fallen to 36th.[8] Its shortfall in spending is even greater than per-pupil figures indicate, because California teacher salaries, to be competitive, are above the national average. Eric Brunner and Jon Sonstelie observe, "California students performed considerably better in the period before the transformation from local to state finance. . . . This apparent decline in average performance would be less troubling if it were accompanied by equalization across districts and income groups. There is little evidence of equalization across school districts, however." They note that the decline in performance cannot be attributed to resources alone. "The dismal performance of California students on achievement tests is a disappointment, but that performance is due more to the inefficiency with which funds are deployed than to the paucity of those funds."[9] This situation is the result of many complex factors, but it is clear that state support for local education in California has not fulfilled the high expectations of early proponents of school finance reform.

Michigan undertook a major centralization of its school finance system in 1994, but the state's continuing economic difficulties have diminished its ability to maintain funding levels. As in California, changes in school funding were part of a set of sometimes contradictory goals, including educational improvement, enhanced equity, and tax relief. Michigan's 1994 "Proposal A" reduced property taxes dramatically and substituted a number of other sources, such as portions of state income tax collections and revenue from state sales tax increases, for school purposes.

Ten years later, two analysts who judged the results of Michigan's centralization to be "decidedly positive" nonetheless expressed concern that the state's revenue base for its school aid fund was "dangerously vulnerable to cyclical fluctuations."[10] In 2010, the Citizens Research Council of Michigan reported:

> Given the practical realities of the current financing system, state-controlled revenues (directly or indirectly) comprise nearly 85 percent of the total operating funding for local schools. As a result, state, not local, policy makers control the purse strings of Michigan's local schools. . . . In addition to the fiscal challenges posed by Michigan's near-decade-long economic malaise, which have been exacerbated by the Great Recession, public education finances also face another serious long-term problem. Since the early 2000s, the state has failed to come to grips with the dual structural deficits affecting its major operating funds, General Fund and School Aid Fund.[11]

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In a little-noticed provision of Michigan's 1994 legislation, typical of the intricacies of such enactments, the state government's former annual payments to the school retirement fund became a local responsibility.[12]

A shift to centralized school finance does not in itself address the issues of adequacy and efficiency crucial to education reform, no matter what tax is utilized as the source of education revenue. The substantive challenges of education reform are larger than the choice of a tax instrument.

Property Taxes and Local Supplementary Spending

Local taxes can also be controversial when they are used to supplement centrally set spending levels. No state is likely to fund all schools at the level the wealthiest districts might set for themselves if they made these budgetary decisions independently. This presents a choice when a state intervenes to ensure that less wealthy districts receive necessary funding. The state may direct resources to needy districts without guaranteeing them a per-pupil budget equal to that of the highest-spending jurisdictions. Alternatively, it may impose spending restrictions that limit the ability of affluent districts to supplement their budget from their own resources. Under the former approach, use of the property tax to increase the local school budget would be acceptable; under the latter, it would not. For example, Michigan does not permit local districts to seek additional tax revenue for school operations. High-spending districts that have seen their funding decline brought a new dimension to school finance litigation by considering legal action against the state.[13]

Excellent school systems can be expected to increase local property values, providing an incentive even for homeowners without children in local schools to support effective education spending.

One of the attorneys who filed the original challenge to California education funding argued that it is unfair to permit parents to raise funds for local schools: "If we have a lousy education system, then the parents of the rich have to be just as concerned as the parents of the poor."[14] The opposing position considers some variations in spending a reflection of legitimate local choice, particularly if parents who cannot supplement baseline budgets may withdraw from the public school system altogether and instead send their children to private schools.

Vermont experimented with a unique approach to the issue of above-average spending after the state's Supreme Court overturned its method of school funding.[15] The legislature responded with Act 60, which from 1999 to 2004 provided a uniform statewide allowance for all elementary and secondary students. At the time, 90 percent of Vermont's school districts were already spending more than that standard amount per pupil. However, under Act 60, districts that chose to spend more had varying amounts of these additional local funds allocated to a state pool to benefit poorer areas. The wealthier a district, the greater the amount that was allocated to this "sharing pool." The state could reallocate more than two-thirds of the funds raised from the wealthiest districts to support schools in poorer districts. As reported in 2004, "Roughly 91 percent of Vermont's school districts receive more funding under the new scheme, and the residents of property-poor districts have actually experienced tax reductions. Taxes have more than doubled in the wealthiest districts, though, and per pupil spending in those districts has decreased. These results engendered an intense response from Vermont's wealthier districts, sparking civil disobedience, local withholding from the state education fund, circumvention of the 'sharing pool' through the use of tax deductions, and an unsuccessful lawsuit challenging the constitutionality of Act 60."[16]

This controversy was a major reason for later legislative change. In Vermont, as in other states, limitations on school budgets also led to extensive private fundraising and the use of charitable foundation grants to replace tax revenues lost to local schools. In California, for example, private voluntary nontax contributions to public schools accounted for $547 million in 2011 alone.[17]

To some observers, the ability of affluent parents to purchase extra educational resources for their children's schools signals a return to the situation that gave rise to education finance court challenges in the first place. A New York teacher expressed the view that the very concept of public education "suppresses all distinctions between groups of individuals as inherently unjust."[18] On the other hand, the opportunity for local support can help foster a broad-based commitment to the public schools.

From Equalization to Adequacy

A 1986 California decision in the long line of related *Serrano* cases offered another perspective on the problems faced by spending equalization. "The adverse consequences of years of effective leveling down have been particularly severe in high spending districts with large concentrations of poor and minority students. Some of the state's most urban districts, with high concentrations of poor and minority students, are high-revenue districts."[19] As this opinion noted, "high wealth" jurisdictions with large amounts of commercial or industrial property can be home to low-income urban residents who could actually lose funding under a strict equalization approach. Many large cities with poor students need to spend more, not less, than the statewide average per student on public education.[20]

Efforts to address the needs of underserved students have shifted the focus of school finance reform from equalization to provision of sufficient funds for adequate achievement. "In 1989, the Kentucky Supreme Court declared the entire state system of public elementary and secondary education unconstitutional and held that all Kentucky schoolchildren had a constitutional right to an adequate education. The decision resulted in a dramatic overhaul of the state's entire public school system, and sparked what many scholars have called the 'adequacy movement.'"[21] Yet it is far easier to calculate differences in funding than to provide an operational definition of an adequate education. This influential decision by the Kentucky Supreme Court interpreted the state's constitutional requirement of "an efficient system of common schools" in terms of seven fairly abstract goals, including "sufficient oral and written communication skills to enable students to function in a complex and rapidly changing civilization" and "sufficient self-knowledge and knowledge of his or her mental and physical wellness."[22]

In the absence of a federal constitutional claim to equality in school finance[23], these cases

Efforts to address the needs of underserved students have shifted the focus of school finance reform from equalization to provision of sufficient funds for adequate achievement. Credit: Christopher Futcher.

are left to state courts. However, challenges to state systems cannot address the most important source of nonuniformity in education spending: differences in spending across states. These are far more significant than differences among districts in any individual state. "[R]oughly two-thirds of nationwide inequality in spending is between states and only one-third is within states, and thus school-reform litigation is able to attack only a small part of the inequality."[24]

Complexities of Per-Pupil Spending

The shift in focus from strict equalization in spending to directing adequate resources to needy districts can weaken the argument against allowing localities to choose to tax themselves to supplement state-mandated revenues. If many disadvantaged and low-performing urban districts need to spend far more than the average per-pupil budget, uniformity will not be an optimal outcome.

Nevertheless, uniform spending will always have an intuitive appeal. In California, decades of centralized school finance have effectively broken the connection between education spending and local property wealth. However, a 2011 report by the Center for Investigative Reporting's "California Watch" illustrated the ways in which per-pupil spending continued to vary widely across districts. The report quoted the president of the Alameda Education Association: "For us not to receive the same amount as other districts near us is like saying, 'We are going to value one child more than another.'" This report went on to describe California's post-*Serrano* funding system:

> In the landmark 1971 *Serrano v. Priest* ruling, the court found that using local property taxes to fund schools resulted in vast differences between a wealthy district like Beverly Hills and Baldwin Park, a low-income community east of Los Angeles.
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> The Supreme Court ruled that differences in the basic amount spent per student—so-called "revenue limit" funding—had to be within $100 across all districts. Taking inflation into account, the permissible difference is now $350 per student. Although larger differences remain among some districts, disparities in the basic amount districts receive from the state have been substantially reduced.
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> But that reduction has been wiped out by local, state, and federal funds for close to a hundred different programs. A large part of the money is based on formulas established in the 1970s for meals, transportation, and other services that often have little connection to current student needs.
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> The inequities the court sought to alleviate with its *Serrano* ruling persist. About two-thirds of districts now spend at least $500 above or below the state average, according to California Watch's analysis.
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> "What happened since the *Serrano* case is that we tried to equalize base funding for students across the state," said [Julia] Brownley, the Santa Monica assemblywoman. "But since then, we have instituted hundreds of different categorical funds that added to the base. That has taken it to another level and skewed spending again."[25]

Several aspects of this report are noteworthy. From a property tax perspective, perhaps the most significant conclusion is that continuing disparities in district budgets are not the result of differences in local property tax collections, since the allocation of property tax revenue is determined by the legislature and the governor.

Moreover, the goal of equalizing spending to within a few hundred dollars per student across a state as vast and varied as California is inappropriate. Costs of goods and services differ dramatically across regions, and between urban and rural centers. One of the major criticisms of Michigan's centralization of school finance concerned its failure to account adequately for cost differentials faced by school districts in different areas serving different populations.[26] The same criticism was applicable to California.

Many shortcomings of the post-*Serrano* funding system in California were addressed in landmark legislation signed by Governor Jerry Brown in 2013, "the most sweeping changes to the way California funds its public schools in 25 years."[27] This legislation seeks to direct more funds to needy districts, such as those serving low-income students and nonnative English speakers, rather than to equalize spending among districts.

As a numerical measure, per-pupil spending can sometimes offer a misleading suggestion of exactness. The calculations vary according to a multitude of choices about the figures to be included, such as capital expenditures, debt service, adult education, after-school programs, retirement contributions, and state administrative expenses, to say nothing of the many ways in which enrollment may be measured.[28] Appropriations may differ from budgeted amounts, and both may differ from actual spending. Thus, it is possible for the U.S. Census Bureau to calculate New York City's 2011 per-pupil spending as $19,770 and for the City's Independent Budget Office to find that figure to be under $8,000.[29] Comparisons of individual school district budgets can also be distorted if a few very small or remote districts necessarily incur very high per-pupil costs. And of course it goes without saying that the use of school funds, and not the amount of spending alone, is critical to improving instructional results.

All of these crucial issues are far removed from property tax policy, yet property taxes are still used as a convenient target in seeking blame for poor school performance. A 2013 *New York Times* editorial considering the reasons for this country's low ranking in international math and science tests took this position:

> American school districts rely far too heavily on property taxes, which means districts in wealthy areas bring in more money than those in poor ones. State tax money to make up the gap usually falls far short of the need in districts where poverty and other challenges are the greatest. . . .
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> . . . Ontario [Canada], for example, strives to eliminate or at least minimize the funding inequality that would otherwise exist between poor and wealthy districts.

In most American states, however, the wealthiest, highest-spending districts spend about twice as much per pupil as the lowest-spending districts, according to a federal advisory commission report. In some states, including California, the ratio is more than three to one.[30]

> Efforts to reduce schools' reliance on property tax revenue may draw as much or more support from anti-tax activists as from those motivated by a belief that these steps can foster greater equity or educational effectiveness.

After more than four decades of extremely ambitious school finance reform, centralization, and equalization, the deficiencies of California's educational system are not the fault of the property tax. An easy resort to criticism of the tax evades the enormously challenging and far more complicated problems of improving educational outcomes.

Statewide Property Taxes

The fairness of the property tax is an issue in this debate only to the extent that local funding is deemed unfair—and then only when the property tax serves as the local tax source. Therefore, a *statewide* property tax would not be judged unfair in the same way. Some states impose a small surtax on local property taxes and use the proceeds to fund education. But statewide property taxes can encounter serious problems when they are imposed on property values computed through nonuniform local assessment practices.

This was the situation faced by New Hampshire when its school funding system, which relied primarily on the local property tax, was ruled unconstitutional by the state Supreme

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Court in 1997.[31] New Hampshire is the only state in the nation without either a statewide sales tax or a general income tax, leaving the property tax as an essential mainstay of public services. In response, the state imposed a tax on real property at a rate of .66 percent, based on locally assessed values equalized by the New Hampshire Department of Revenue Administration. A superior court ruled that a statewide tax could not be based on nonuniform local assessments.[32] However, a sharply divided state Supreme Court quickly reversed this decision, finding that a violation of the state's uniformity clause could only be established by "specific facts showing a 'widespread scheme of intentional discrimination.'"[33]

Other states have also made use of local property taxes to fund centralized school budgets. In Michigan, a property tax on nonhomestead property, such as vacation residences and second homes, is dedicated to the state school aid fund. This is not formally a statewide property tax, but districts that do not impose the tax do not obtain full state funding of their education grant. As in New Hampshire, a locally administered tax has become in substance a state levy.

In California, property tax assessments and collections remain a local responsibility, but the state legislature determines the use of the funds. With regard to education, the state determines funding according to a formula known as the revenue limit. As the state Department of Education explains, "A district's total revenue limit is funded through a combination of local property taxes and state General Fund aid. In effect, the State makes up the difference between property tax revenues and the total revenue limit funding for each district."[34] In 2009–2010, the average per-pupil revenue of California school districts was $8,801, and the average property tax received per pupil was $2,210, with state aid accounting for the difference. An increase in property tax revenue would cause a corresponding decrease in state aid. The property tax functions as an instrument of centralized state school finance. As noted, this has by no means eliminated objections to funding disparities between school districts. A report found that, among small elementary districts, the highest revenue limit funding per pupil in 2005–2006 was $31,237, and the lowest was $4,727.[35]

Impacts of Capitalization

School finance sometimes stands in a unique relationship to the property tax through the process of capitalization. The benefits of superior local public services clearly can have a positive influence on the value of real property within a jurisdiction. It is intuitively clear that if two houses are comparable in other respects, including their tax liabilities, the one in a municipality that enjoys a higher level of public services will command a higher price. At the same time, equivalent houses in different municipalities that receive similar services but bear unequal tax liabilities will command prices that reflect this difference in tax payments.

These two aspects of capitalization—the enhancement in price caused by superior services and the diminution in price caused by increased taxes—affect the school finance debate.[36] Excellent school systems can be expected to increase local property values, providing an incentive even for homeowners without children in local schools to support effective education spending. This also offers a reason to oppose wasteful or ineffective spending that may reduce the value of local property. There is no similar financial incentive for homeowners to support state-funded school spending, because their state tax payments do not affect their local property values. This is one potential advantage to local participation in school funding and operation decisions, and one reason for the hypothesis that centralized school finance helped gain support for Proposition 13 in California.

Clarifying the Debate

School finance reform is an immense challenge involving questions ranging from fundamental definitions of adequacy to legal interpretations of state mandates and measurement of costs. Public officials must balance sometimes competing concerns for equalization, adequacy of funding, centralization, and local autonomy. Moreover, school finance reform is only one part of the much larger challenge of improving educational outcomes. In many cases, the role of the property tax is only incidental to these overriding issues. The operation of the tax and the use of its revenues can be structured to support any of a number of desired financing outcomes, and a focus on the property tax as the cause of educational deficiencies can be a distraction from the essential and daunting task of improving school quality. Efforts to reduce schools' reliance on property tax revenue may draw as much or more support from anti-tax activists as from those motivated by a belief that these steps can foster greater equity or educational effectiveness. Debate on the property tax should proceed on its own merits and clearly distinguish between issues concerning its operation and the use of its proceeds.

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