An LAO Report

A Primer on the Vehicle License Fee

Introduction

The revised revenue estimate included in the Governor's May Revision has given the state over $4 billion in unexpected revenues for 1997-98 and 1998-99 combined. A number of proposals, including the Governor's spending plan, have called for part of these resources to be used to fund a cut in the vehicle license fee (VLF). The VLF is a fee on the ownership of a registered vehicle that provides nearly $4 billion in annual revenues. This report is intended to answer a number of questions related to the VLF and these proposals.

This document is a follow up to our *1998-99 Budget: Perspective and Issues* analysis entitled "A Perspective on the Vehicle License Fee." That review provides a more in-depth background on this major revenue source.

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What Is the VLF?

The VLF is an annual fee on the ownership of a registered vehicle in California, in place of taxing vehicles as personal property. The VLF is paid to the Department of Motor Vehicles (DMV) at the time of annual vehicle registration. The fee is charged in addition to other fees, such as the vehicle registration fee, air quality fees, and commercial vehicle weight fees. Figure 1 shows a sample of the various fees that a vehicle owner might pay to the DMV as part of the registration renewal process. The various proposed VLF tax cuts would only affect the license fee (shaded in Figure 1) and would not affect these other DMV fees.

How Is the VLF Calculated?

The fee rate is 2 percent of a vehicle's current estimated value and calculated on the basis of the current owner's purchase price (see Figure 2). For each year the vehicle is owned, the fee paid declines in accordance with a statutory depreciation schedule—to reflect the declining value of the vehicle. Figure 3 shows the depreciation schedules for vehicles and trailer coaches (trailer coaches have a different schedule due to their longer expected life span and higher values). When an individual purchases a used car, the new owner pays the VLF based on the price paid when acquiring the car and the depreciation schedule returns to year one.

Figure 1

Sample DMV Renewal

FEES	
REGISTRATION FEE	$30
LICENSE FEE (may be income tax deductible)	$257
WEIGHT FEE	$0
SPECIAL PLATE FEE	$0
COUNTY/DISTRICT FEES	$7
OWNER RESPONSIBILITY FEE	$0
TOTAL DUE ON OR BEFORE 07/20/98	$294

Why Is the VLF Not Subject to Proposition 13?

Proposition 13, passed in 1978, set the tax rate for *real* property (homes, buildings, land, etc.) at a 1 percent rate statewide. Because the State Constitution also requires *personal* property (furniture, other household possessions, etc.) to be taxed no higher than real property, Proposition 13 effectively limits the tax rate for both real and personal property. However, motor vehicles were exempt from the personal property tax over four decades before the

Figure 2

Example of How the Vehicle License Fee Is Calculated

Step	Sample Calculation
1. Purchase price	$22,050
2. Round value to nearest odd hundred dollar	22,100
3. Multiply rounded value by depreciation percentage:	
• Year 1: 100%	22,100
• Year 2: 90%	19,890
• Year 3: 80%	17,680
4. Multiply by 2 percent rate:	
• Year 1	442
• Year 2	398
• Year 3	354

Figure 3

Vehicle License Fee Depreciation Schedules

Year of Registration	Vehicles[a]	Trailer Coaches[a]
1	100%	85%
2	90	70
3	80	55
4	70	45
5	60	40
6	50	35
7	40	30
8	30	25
9	25	24
10	20	23
11	15	22
12	15	21
13	15	20
14	15	19
15	15	18
16	15	17
17	15	16
18 and subsequent years	15	15

[a] Percentages are applied to purchase price.

passage of Proposition 13. In 1935, the VLF was created and the tax rate was set at 1.75 percent—which approximated the average property tax rate at the time. The VLF rate was increased to 2 percent in 1948, and has not changed since then. As a result, the relative connection to the property tax rate has not been maintained.

Where Do the Revenues Go?

In 1998-99, the VLF is expected to raise about $3.9 billion in revenues under current law. In general, the revenues are distributed to cities and counties for two purposes:

- ***Base VLF.*** About three-fourths of the funds sent to local governments can be used for any spending purpose. These funds are mostly distributed on a per capita basis.

- ***Realignment VLF.*** The remaining quarter of local government VLF revenue is restricted for funding "realignment" programs (various health and social services programs). The state increased VLF revenues in 1991 (by changing the depreciation schedule) and dedicated these additional revenues to realignment programs.

Figure 4 shows the proposed distribution of VLF revenues for 1998-99 under current law.

What Type of Vehicles Are Subject to the VLF?

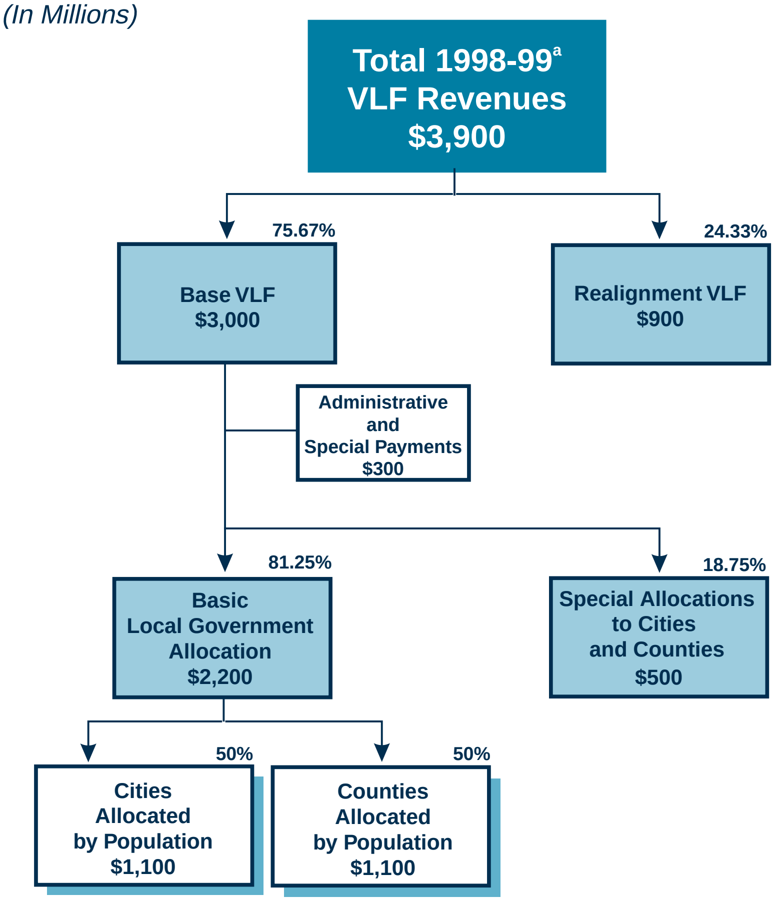
Generally, any vehicle required to be registered with the DMV is also required to pay the annual VLF. The DMV groups these vehicles into four categories—automobiles, motorcycles, commercial/trucks, and trailers. In 1997, about 23.5 million vehicles paid the VLF. Figure 5 shows the various DMV classifications, including an estimate of the average fee paid by each vehicle type.

The DMV "commercial/trucks" classification includes larger pick-up trucks, based on their weight—regardless whether they are used as a commercial or personal vehicle. In addition, the automobiles classification contains all passenger vehicles, including those used for commercial purposes (such as a rental car or a corporate fleet vehicle).

Figure 4

How VLF Revenues Are Distributed

1998-99 (Proposed Under Current Law)
(In Millions)



[a] Excludes trailer coach and delinquent collections.

Which Vehicles Provide The Most Revenues?

The VLF is a tax on a vehicle's value. As a result, vehicles with higher current values will provide more revenues than vehicles with lower values. Figure 6 shows the distribution of the *automobiles* classification by purchase price (the value upon which the fee is based). Although more than a quarter of the state's cars were purchased for less than $5,000, these vehicles account for only 3 percent of the automobile VLF

Figure 5

Vehicles Registered And VLF Paid, 1997

Classification	Number of Vehicles (In Millions)	Percent of Total	Estimated Average VLF Paid
Automobiles	16.8	71%	$171
Motorcycles	0.4	2	57
Commercial/trucks	4.5	19	137
Trailers	1.9	8	21
Totals/average	**23.5**	**100%**	**$151**

revenues. In contrast, only 8 percent of cars were purchased for more than $25,000, yet they account for almost 30 percent of the revenue.

How Does VLF Paid Vary by Income?

In considering tax proposals, it is always helpful to know the "incidence" or burden of a particular tax. This is usually done by showing the tax paid as a percentage of household income, across income groups. Unfortunately, data limitations prevent a thorough examination of this relationship between income and VLF paid. However, two data sources do exist that provide some insight into the relationship. First, for Californians who itemize on their personal income tax forms, the VLF is tax-deductible on the personal property tax line on their tax forms. As a result, income tax returns provide information on VLF paid, but only for those taxpayers taking advantage of the tax deduction. Second, the U.S. Census Consumer Expenditure Survey collects vehicle expenditure data by income group on a national basis.

While acknowledging the less-than-perfect data, our review of these two sources does allow us to draw the following conclusions:

- ***The VLF Paid Rises With Income.*** The amount of VLF paid increases with income. This is because higher-income Californians tend to own more cars, newer cars, and more expensive cars than lower-income residents.

Figure 6

Automobiles by Purchase Price[a]

Purchase Price	Automobiles: Number (In Millions)	Automobiles: Percent of Total	Percent of VLF Paid	Estimated Average VLF Paid
Less than $5,000	4.6	27%	3%	$18
$5,000-$10,000	3.8	23	10	73
$10,000-$15,000	3.1	19	17	157
$15,000-$20,000	2.5	15	23	264
$20,000-$25,000	1.4	8	19	382
$25,000-$30,000	0.6	4	11	478
$30,000-$35,000	0.3	2	7	587
Over $35,000	0.4	2	11	768
Totals/average	**16.8**	**100%**	**100%**	**$171**

[a] Price that current owner paid for vehicle. Data as of January 1998.

- ***The VLF Paid Does Not Rise as Fast as Income.*** Although VLF paid increases with income, fees paid increase at a slower rate than income. Therefore, lower-income Californians pay a higher share of their income in VLF than do higher-income residents.

What Is the Governor's VLF Proposal?

In his May Revision, the Governor proposed to reduce the current 2 percent VLF tax rate. Beginning January 1, 1999, the rate would be reduced to 1 percent. Each owner's fee would therefore be cut in half. Then, beginning January 1, 2002, the rate would be halved again—to 0.5 percent. The revenue losses resulting from the Governor's proposal are shown in Figure 7.

The Governor proposes to hold local governments and realignment "harmless" from the tax reduction by using General Fund revenues to backfill the foregone VLF revenues. The funds to repay local governments would be continuously appropriated and would not need to be approved in the annual budget process.

What Are the Other VLF Proposals?

Another proposal to provide a VLF tax reduction is contained in AB 1776 (McClintock). (A similar proposal is contained in SB 1723, [Haynes].) This bill would phase-out the VLF over five years, so that the fee would be eliminated beginning January 1, 2003 (see Figure 7 for estimated revenue losses). The phase-in of this tax reduction would use an exemption on vehicle purchase price. Beginning January 1, 1999, each vehicle's purchase price would be reduced by $5,000. For instance, for a vehicle purchased for $22,100, the owner would only pay the VLF on $17,100 of value. In the following three years, the exemption would increase to $10,000, $15,000, and $20,000, successively.

Assembly Bill 1776 proposes to reimburse local governments for all lost revenues by using the state's sales tax revenues. Once the VLF was eliminated, the DMV would continue to calculate the amount of revenues that would have been collected—in order to accurately replace foregone local revenues.

Figure 7

Comparison of VLF Proposals

(In Billions)

Fiscal Year	Expected VLF Revenues (Current Law)	Reduction in VLF Revenues: Governor's Proposal	Reduction in VLF Revenues: AB 1776 (McClintock)
1998-99	$3.9	$1.0	$0.6
1999-00	4.1	2.1	1.8
2000-01	4.3	2.2	2.9
2001-02	4.6	2.8	3.7
2002-03	4.8	3.6	4.5
2003-04	5.0	3.8	5.0

There are many other ways that a tax cut could be provided through changes to the VLF. By changing any combination of the tax rate, the depreciation schedule, and a value exemption, the VLF can be altered to provide a given amount of tax relief. For instance, SB 1998 (Hurtt) proposes to return to the depreciation schedule in effect prior to 1991.

Is the VLF Tax Deductible?

The VLF is tax deductible for the roughly 40 percent of Californians who itemize on their tax returns. As a result, the full impact of a fee reduction would not be received by those itemizing taxpayers who claim the amount paid. Instead, part of any reduction in VLF revenues would be offset by increased income tax revenues paid to both the federal government and the state. For instance, a California taxpayer currently paying federal taxes at the highest marginal tax rate would only realize about three-fifths of any VLF reduction.

In a review of recent income tax data, it appears that many taxpayers who itemized did *not* claim the personal property tax deduction for the VLF. A percentage of these itemizers may not own a vehicle. However, many other itemizing taxpayers are either: (1) claiming the deduction as a business expense, (2) not claiming a deduction for which they are eligible, or (3) incorrectly claiming the deduction elsewhere on their tax form. Given this finding, it is unclear exactly what percentage of any VLF reduction would be offset by increased income tax revenues. However, our best estimate is that less than 15 percent of the total VLF reduction for all taxpayers would be offset by increased federal income tax payments.

Would Local Governments Be Affected by a VLF Tax Cut?

The VLF is local governments' third largest source of general purpose tax revenues (after the property and sales taxes). Proposition 47, passed by the voters in 1986, constitutionally guarantees that VLF revenues are sent to local governments. However, the state retains authority over both the amount of revenues that are collected and the method of their distribution. As such, the Legislature holds the authority to alter the level of VLF revenues. Local governments hold no constitutional authority to their current *level* of revenues, only that the state cannot choose to keep VLF revenues which are collected.

Recognizing that VLF revenues represent an important source of general purpose revenues for cities and counties, both the Governor and AB 1776 propose to backfill local governments for any lost VLF revenues. The Governor's proposal is to continuously appropriate General Fund revenues in order to repay local governments for lost revenues. Assembly Bill 1776 specifies that state sales tax revenues would be used for the same repayment purpose.

In both cases, the local government backfill mechanism would occur automatically without being subject to the annual budget process. However, as statutory mechanisms, the Legislature would retain the ability to alter the method or amount of the backfill. Local governments have expressed concern that under both of these proposals the state would have an incentive during difficult economic times to reduce the level of these backfill funds provided to local governments. In the early 1980s, before the constitutional protection of VLF revenues to local governments, the state did reduce VLF payments to local governments in order to help balance the state budget.

As a means of helping ensure that the state did not change the annual backfill amount at a future date, it has been suggested that the State Constitution be amended to include the backfill provision. For instance, ACA 45 (McClintock) includes the same provisions as AB 1776, but the placement of these provisions in the Constitution would require a vote by the people for future changes. As such, the Legislature's fiscal flexibility over the state's annual budget would be restricted.

WOULD REALIGNMENT BE AFFECTED?

The stated intention of both the Governor and the AB 1776 VLF proposals is not to affect the current realignment funding mechanism. By backfilling the amount of lost realignment VLF revenues with General Fund monies on a "dollar-for-dollar" basis, the realignment programs should not be affected. With a tax rate reduction proposal, like the Governor's, determining the amount of lost revenues to replace is a simple calculation. Under AB 1776, the DMV would continue to calculate the amount of revenues that would have been collected under current law.

WOULD PROPOSITION 98 BE AFFECTED?

The stated intention of both the Governor and the AB 1776 VLF proposals is not to affect the Proposition 98 education funding guarantee. Because VLF revenues are special fund revenues, their reduction would *not* have a direct impact on the calculation of the minimum funding guarantee for K-14 education. These proposals, however, significantly increase General Fund spending to backfill the VLF losses to local governments. This commitment of resources would make fewer resources available if the Legislature wanted to overappropriate the minimum funding guarantee in the future. Similarly, fewer resources would be available for other non-Proposition 98 General Fund spending in the future.

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