V

Major Issues Facing the Legislature

TAKING ADVANTAGE OF NEW FEDERAL HIGHER EDUCATION TAX CREDITS

How Can the Legislature Respond to the Problems and Opportunities Created by New Federal Tax Credits for Higher Education?

Summary

Last August, President Clinton signed into law the Taxpayer Relief Act of 1997. Part of the act creates the "Hope Scholarship" and "Lifetime Learning" tax credits, which will dramatically lower the after-tax price of higher education fees for most middle-income students (or their parents) by lowering their federal taxes.

The credits create some unintended problems for the state:

- *The credits result in a much higher federal subsidy per student in other states than in California-particularly, for community college students.*
- *The Hope Scholarship credit will unintentionally shift enrollment away from our community colleges to the universities, at potentially great cost to the state and at cross-purposes to the state's higher education master plan.*
- *Due to interactions between the credits and recent state fee reductions, the state is unintentionally sending monies intended for students back to the federal government.*

The federal act also creates opportunities for the Legislature to increase the effective federal subsidy of higher education programs and use the additional resources to improve those programs and improve access. This strategy would require at least some fee increases. These increases, however, would be offset substantially-in some cases completely-by higher federal tax credits for students. For low-income students, fee increases could be offset fully by increased financial aid.

We identify several options that the Legislature has in responding to the problems and opportunities posed by the new tax credits.

BACKGROUND

Last August, President Clinton signed into law the Taxpayer Relief Act of 1997. The act creates several new higher education-related tax incentives, including the "Hope Scholarship" and "Lifetime Learning" tax credits. These tax credits will dramatically reduce the after-tax price of tuition and fees for most middle-income California students (or their parents) by lowering their federal taxes.

Figure 1 summarizes the key features of these credits. As the figure shows, the Hope Scholarship credit allows taxpayers to claim an annual credit of up to $1,500 per student for tuition and fee expenses paid on behalf of the taxpayer, the taxpayer's spouse, and/or dependents for the first two years of college. Thus, the credit would reduce taxes by up to $1,500 per student per year (see Figure 2). The Lifetime Learning credit covers a smaller percentage of costs, but it can be used by part-time students and by part-time and full-time students beyond the first two years of college.

The new tax credits present California with novel opportunities to effectively increase federal resources for the state's higher education programs in ways that can improve the quality of instruction and poor Californians' access to higher education. Given the state's current fee structure for the higher education segments, however, the passage of the federal tax credits also poses some problems.

PROBLEMS

Hope Scholarship Credit

Advantages Other States More Than California

The Hope Scholarship tax credit provides more advantage to other states-by providing a higher federal subsidy per student-than it does to California. This is most dramatically evident in the case of community colleges, as illustrated in Figure 3 (see page 120).

For the average state, the Hope Scholarship tax credit will pay $1,250 of the annual costs of a full-time community college student. For California, it will pay only $360 (starting in 1998-99). The reason for this significant discrepancy is that Congress designed the Hope Scholarship credit to largely (but not completely) offset the national average of community college fees-about $1,500 annually per full-time student. California's

Figure 1

Key Features of the Hope Scholarship and Lifetime Learning Tax Credits

	Hope Scholarship	Lifetime Learning
What years of college are covered?	First two years only.	Any year.
What students are eligible?	Must be at least half-time.	Part-time or full-time.
What costs are covered?	Tuition and fees only.	
What does the credit cover?	100% of first $1,000 in costs ($1,000). 50% of next $1,000 in costs ($500).	20% of up to $5,000 in costs (up to $10,000 in 2003).
What is the maximum credit amount?	$1,500 per *student*.	$1,000 per *tax return*.
Effective dates	Academic terms beginning after December 31, 1997.	Academic terms beginning after June 30, 1998.
Are there income limits?	Credits begin to phase out at $80,000 adjusted gross income (AGI) and phase out completely at $100,000 for joint tax returns. For single returns, phase out begins at $40,000 and is complete at $50,000 AGI.	
Will poor students benefit?	Generally not. Poor students (and their parents) tend not to have the federal tax liability needed to receive the credits. The credits generally benefit middle-class students and parents.	

Figure 2

Hope Scholarship Tax Credit Simple Example—UC Student

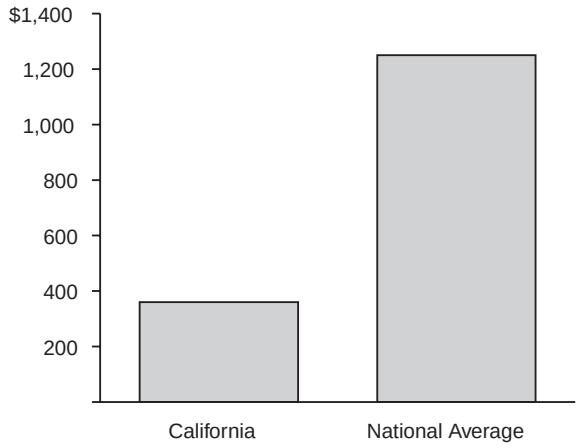
	1998-99
Systemwide resident fee	$3,609
Hope tax credit[a]	-1,500
Cost after taxes	**$2,109**

[a] Assumes student or parent qualities for full amount of credit.

annual full-time fee level of $360 is far below the national average and, in fact, is the lowest of all 50 states. Since the federal credit pays no more than the actual fees paid by a student, California's per-student credit is effectively “capped” at $360 (for a student taking 30 units a year).

Figure 3

Community College Fees Paid by Federal Hope Scholarship Credit[a]



[a] Annual full-time fees. Assumes student or parent can fully claim credit.

Credit Will Unintentionally Shift Enrollment Away From Community Colleges

The Hope Scholarship credit will dramatically reduce the after-tax fee differentials between the California Community Colleges (CCC), California State University (CSU), and University of California (UC) (see Figure 4). For example, at the start of 1997-98, there was a substantial difference (almost $1,200) between CCC fees and CSU fees. With the credit, the differential is only $253.

Absent corrective action by the state, more students will choose the universities over the community colleges for their first two years of instruction because the extra price of the universities-after taxes-will become so small. This would undermine the state's efforts to bolster the community colleges' role in baccalaureate instruction, and potentially impose major costs on the General Fund.

Figure 4

Fees After Taxes for Full-Time Undergraduates—Effects of Hope Scholarship Tax Credit[a]

System	1997-98 (Pre-Credit)	1998-99 (With Credit)
Community colleges	$390	—
CSU	1,584	$253
UC	3,799	2,109

[a] Hope credit is restricted to first two years of college. Above examples assume student or parent is able to take full advantage of the tax credit. Figures for 1998-99 include the impact of Chapter 853, Statutes of 1997.

State Will Unintentionally Send Money Back To the Federal Government

A significant portion of the benefits from the undergraduate fee reductions recently enacted by the Legislature in Chapter 853, Statutes of 1997 (AB 1318, Ducheny), will be lost to the federal treasury in a "reverse subsidy" effect. This is because the reductions, in most instances, will reduce the amounts of federal tax credit otherwise available to students and parents.

For example, although Chapter 853 reduces the "sticker price" of CCC courses from $13 per credit unit to $12 (or on an annual basis, from $390 down to $360), the after-tax price to the student is exactly the same at either sticker price-zero. Thus, the intended benefit of Chapter853's CCC fee reduction, which will be paid by the state's General Fund, effectively will go to the federal treasury, not CCC students. Specifically, for each CCC student receiving a Hope Scholarship credit, the fee reduction means:

- Annual cost to the student after taxes is unchanged.
- Federal cost falls by $30 per student (full-time basis).
- State cost increases by $30 per student (full-time basis) as state backfills lost fee revenue.

A similar reverse subsidy occurs with CSU fees. Chapter 853 interacts with the federal tax credit in a way that sends 50 percent of the nominal benefit of the CSU fee reduction back to the federal treasury. Thus, of the $78 reduction in the sticker price for a full-time academic year, students

will enjoy an after-tax reduction of only $39. Chapter853's fee reduction for full-time UC undergraduates using the Hope Scholarship credit is not dissipated. This is because UC's fees for a full-time academic year are well above the level at which the Hope Scholarship credit amount is maximized ($2,000).

OPTIONS

The new tax credits present California with opportunities as well as challenges. As a result of the federal Taxpayer Relief Act of 1997, the Legislature can increase the effective federal subsidy of California's higher education programs and use the additional resources to improve those programs and improve higher education access. This strategy would require at least some fee increases. These increases, however, would be offset substantially-in some cases completely-by higher federal tax credits for students and/or parents.

Revenue Options

The Legislature could structure fee increases in various ways to meet multiple state objectives. These options include:

Maximizing State Resources. The state could raise fees at the three segments in a way that maximizes the effective federal subsidy of California's higher education programs. State programs would, in effect, "capture" much of the after-tax benefit provided to students and parents by the tax credits. Many students would pay either the same or less, after taxes, than they have in recent years, but part-time and higher-income students could pay substantially more. Effective federal resources for the state's higher education programs could increase by $500 million or more annually.

Protecting Community College Role in Baccalaureate Education. Alternatively, the state could restore the after-tax fee differentials between the community colleges, CSU, and UC-needed to avoid a costly shift of students from the colleges to the universities-by establishing a lower division fee surcharge at CSU and UC. The Legislature could offset the fee surcharge later in a student's career by, for example, granting a refund of senior-year fees when the student graduates. This would act as an additional incentive for graduation.

A Win/Win Approach: More State Resources at No Cost to Students. Finally, the state could raise community college fees in a way that in-

creases California's federal subsidy yet at the same time leaves most, or all, of the after-tax benefit with students and parents. Under this approach the state could increase the flow of federal resources to California (by $100 million a year or more), with little or no after-tax fee increase for most students. For example, if the state increased annual full-time fees from the $360 authorized for 1998-99 to as much as $1,000, students able to use the Hope Scholarship credit would still pay-after taxes-nothing for courses. This is because Congress designed the credit as a dollar-for-dollar offset for the first $1,000 of annual fees. Figure 5 (see next page) shows the impact of such a fee increase.

Protecting Low-Income Students. Low-income students generally are unaffected by the tax credits because they lack the tax liability needed to use the credits. Generally, they also are unaffected by student fee changes (up or down) because current state policies (1) exempt them from fees-such is the case for 39 percent of all community college students-or (2) pay their fees with grants. The Legislature could readily modify these waiver and grant policies to make sure that no student who is too poor to use the tax credits would be affected by any fee increases.

Spending Options

The Legislature could spend the additional resources made possible by the combination of fee increases and federal tax credits in various ways, including:

- Increased financial aid for low-income California students unable to qualify for the federal tax credits (because they lack federal tax liability). This is the primary way the Legislature can enhance access with the added resources.
- Zero-interest loans to bridge student cash-flow problems that may exist between the time of fee payments and receipt of tax refunds.
- New program funding for the higher education segments linked to measured improvements in educational outcomes-such as improved retention of students, improved transfer of students from the CCC to the four-year colleges, and improved times-to-degree.

Figure 5

What is the Impact of Increasing CCC Fees to $1000 Per Year?

One State Option With the Federal Hope Scholarship Credit

	Impact	Comments
 **Full-Time Student**	Almost None	After taxes, almost all full-time students unaffected by fee increase. Low-income students would have fees waived, per current state policy.
 **State Budget**	None	No direct impact.
 **Federal Budget**	Increased Costs (Over $100 million annually)	Brings federal support for CCC more in line with other states.
 **CCC System**	Increased Funding (Over $100 million annually)	Could Support: • Program improvements • Financial aid • Zero interest "bridge" loans to ease student cash-flow concerns

CONCLUSION

The new federal tax credits for higher education have, in a sense, "changed the landscape" of how higher education programs in California can be funded. They have created unintended problems that the Legislature should address. But they also present the Legislature with opportunities to boost the effective federal subsidy of California's higher education programs in ways that can enhance access for low-income students and improve student success at all income levels. To do this will involve thinking about student fees and program funding in creative, nontraditional, ways. In this paper, we have illustrated some basic problems and opportunities resulting from the tax credits.

HIGHER EDUCATION ENROLLMENTS: IS A TIDAL WAVE COMING?

How Will Enrollment Growth in Higher Education Compare to Past Trends?

Summary

Much has been written of the growing enrollments in California's community colleges, California State University (CSU), and University of California (UC). Various reports characterize these future increases as the "baby boom echo" or "Tidal Wave II."

Projected Enrollment Growth Is Not of Tidal-Wave Proportions. *If 1996 college-participation rates among Californians continue, we project that total enrollments in 2005 will be 2,142,000, or 98,000 (4.8 percent) above the peak enrollments of 1991.*

- *This represents annual growth of 0.3 percent from 1991 to 2005. Such growth, rather than of tidal wave proportions, would actually be dramatically lower than the 2.7 percent annual growth in enrollments experienced by the three segments between 1970 and 1991.*
- *From the perspective of accommodating growth, the state faces less of a challenge than it has in the past.*

Enrollment Growth Is Not an Unmanageable Force. *Whereas tidal waves are natural phenomena beyond our control, enrollment growth in higher education can be managed.*

- *Public policies strongly influence who goes to college and which colleges students attend. By managing enrollment growth cost-effectively, the Legislature can maximize higher-education opportunities for Californians.*
- *The Legislature can manage growth, for example, through policies affecting (1) eligibility standards, (2) student fees and financial aid, (3) allocation and articulation of students among the three segments, and (4) priorities for educational offerings.*

INTRODUCTION

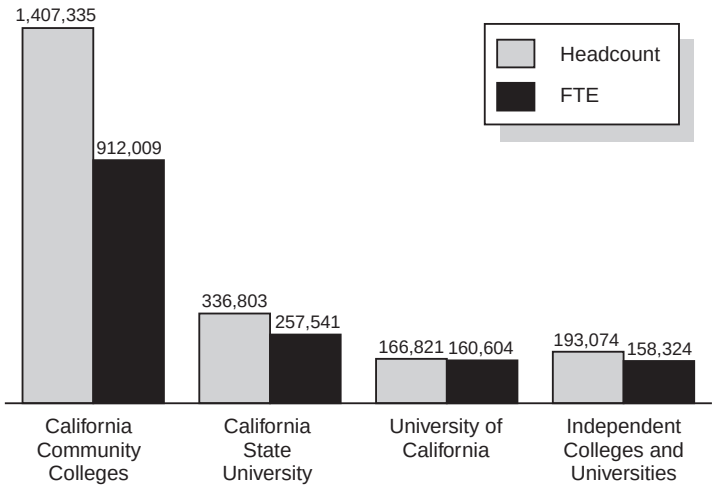
Higher education has been a growth industry in California. In 1958, while a state panel was preparing its *Master Plan for Higher Education in California*, there were 83 public and 72 private colleges and universities in California serving over 226,000 full-time-equivalent students. Today, there are approximately 138 public and 111 private colleges and universities serving over 1.5 million full-time-equivalent students. This represents annual growth in college enrollments of about 5 percent since 1958, compared to annual growth in the state's population of 2.2 percent during that time.

As Figure 1 shows, of the 2.1 million students attending a college or university in California in 1996-97, 1.9 million, or 91 percent, attended a state-owned college or university. (The numbers in Figure 1—and throughout the rest of this report—refer to *headcount* rather than *full-time-equivalent* enrollment. We describe these two terms in the accompanying text box.) Approximately 193,000 students, or 9 percent, attended independent colleges and universities in the state, and many of them received state financial aid. Given its significant role in higher education, the state needs information about enrollment demand with which it can construct higher education policies and budgets.

Figure 1

Total Headcount Enrollment at California Colleges and Universities

1996-97



Headcount Versus Full-Time Equivalent Enrollment

In this discussion, we generally refer to headcount enrollments, rather than full-time-equivalent (FTE) students. Headcounts treat each student attending college as one student, whether the student attends on a part-time or full-time basis. The FTE measure counts, for example, two half-time student as one FTE student. In 1996, one headcount enrollment equaled .96 FTE in UC, .76 FTE in CSU, and .65 in the community colleges. For UC and CSU, FTE per headcount enrollment has gone up or down by at most 3 percentage points. Over the past 20 years, the number of FTE per headcount enrollment in the community colleges has varied from a high of .65 (1996) to a low of .57 (1992). The ratio varies more for community colleges because they serve a higher percentage of part-time students, whose enrollment varies more with economic and social changes.

Although the FTE measure better reflects the operating and capital costs required to serve students—and is the measure the Legislature uses for state budgeting purposes—we use the headcount measure in this analysis to more easily compare our projections with the headcount enrollment projections of the DOF and CPEC. Therefore, unless we note otherwise, we refer to headcount enrollments.

In this piece, we:

- Project future enrollment based on projected population growth and current college-participation rates.
- Compare our projections with those of the Department of Finance (DOF) and the California Postsecondary Education Commission (CPEC).
- Discuss ways in which the state can manage student enrollment growth.

ENROLLMENT GROWTH IS NOT OF TIDAL WAVE PROPORTIONS

To estimate how the baby boom echo will affect enrollment in California's three higher education segments, we:

- Measured the rate at which Californians attended community colleges, CSU, and UC in 1996 for seven age groupings and four ethnicity groupings—a total of 28 cohorts.
- Applied these most recent participation rates to demographic projections of California population after 1996.

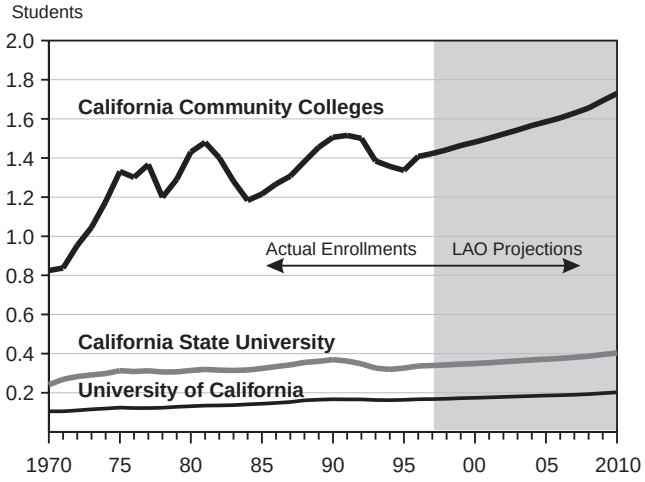
Enrollment Growth Slower Than Historic Rates

We project that if 1996-97 participation rates continue through 2005-06, enrollments will grow at a slower pace than they have historically. Total enrollment in the three public higher education segments would grow to 2,142,000 students, an increase of 231,000 students over enrollments in 1996-97. (Enrollments would increase by 177,000 in the community colleges, by 35,000 in CSU, and by 20,000 in UC.) Figure 2 shows our projections not only through 2005-06, but out an additional five years (also assuming that current participation rates continue).

Figure 2

LAO Projected Headcount Enrollment Increases[a] In California Public Higher Education

(In Millions)



[a] Assumes continuation of 1996-97 participation rates.

Effect on Operations Costs Should Not Be Extraordinary. The costs of operating state colleges and universities generally are proportional to the number of students that they serve. To anticipate future operating costs,

we can compare 1996-97 enrollments to the projections described above for 2005-06. If participation rates remain what they were in 1996-97, enrollments in each of the three segments would grow by a total of 12 percent by 2005-06, or 1.3 percent per year over this nine-year period. (The growth rates would be virtually the same through 2010-11.) By contrast, total enrollment in the three segments increased by an average of percent per year from 1970 to 1996. From this perspective, accommodating enrollment growth should not be any more of a challenge in the next nine years than it has been since 1970.

Capital Needs for Growth Should Be Lower Than in Past. To understand how enrollment growth will affect demand for additional campus space, buildings, and equipment, we can compare projected enrollments with prior peak enrollments. In 1991, total enrollment was at its highest level in history. At that time, the segments were able to accommodate a total of 2,043,000 students.

If current college-participation rates continue through 2005-06, we project that total enrollments in the three segments will be 98,000, or 4.8 percent, above total enrollments in 1991. This represents total growth of 0.3 percent per year from 1991 through 2005-06. By comparison, total enrollments grew by an average of 2.7 percent per year from 1970 through 1991. Viewed from this perspective, the capital demands of enrollment growth should pale in comparison to the two decades before recent peak enrollments in 1991.

The story is the same for each of the segments. If current participation rates continue through 2005-06, enrollments would be 69,000 (0.3 percent per year) higher in the community colleges, 3,000 higher in CSU (virtually the same), and 19,000 higher in UC (0.7 percent per year) than they were during the prior peaks in 1990 and 1991. (The UC and CSU peaks occurred in 1990. The community colleges peak occurred in 1991, as did the peak for total enrollment in the three segments.) For each segment, the projected rate of enrollment growth from their prior peak through 2005-06 is well below annual growth for the 20 years preceding the peak. Community colleges serve a more local market, however, than do UC and CSU. In some districts, the rate of enrollment growth will be above our statewide projections, while in others, it will be lower.

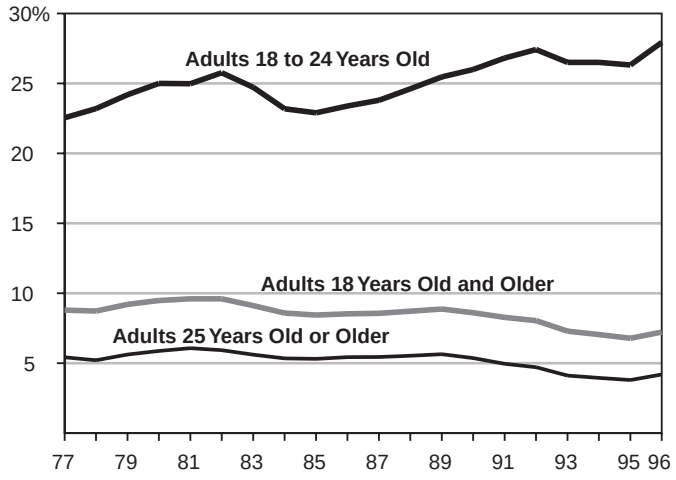
Slight Decline in Overall Participation Rates Masks Shifts in College Attendance

The percentage of adults (persons 18 years of age and older) attending California's public colleges and universities has declined slightly since

1970, which some have cited as a cause for concern. This, however, masks a long-term increase in participation among adults of college age (18 to 24 years old). In fact, these rates are at an all-time high. As Figure 3 shows, the participation rate of 18 to 24 year olds increased from 23 percent in 1977 to 28 percent in 1996. By contrast, the rate for those 25 years old and older fell from 5.4 percent to 4.2 percent during this same period. Because there are almost seven times as many adults 25 years old or older than there are in the 18 to 24 year old group and because the percentage of older adults in the population has increased significantly in the past 20 years, the overall participation rate for adults fell from 8.8 percent to 7.2 percent.

Figure 3

Participation of College-Age Students Has Risen While Overall Adult Participation Has Fallen[a]



[a] Percentage of Californians attending CCC, CSU, or UC.

The increase over time in participation rates among 18 to 24 year olds could at least in part explain why participation rates among older adults has fallen. In effect, the state's success in educating increasingly more adults when they are young means that the state faces reduced demand for education services from older adults. This phenomenon will tend to depress enrollment growth in the community colleges more than in CSU, and much more so than at UC. This is because the community colleges, and to a lesser extent CSU, have traditionally attracted those older adults who seek to begin college or augment previous college after starting their

careers. Undergraduate students in UC are, on average, younger than in the other segments and more often come directly from high school.

Enrollment Projections Are Sensitive to Assumptions About Participation Rates

We have based our projections on current college participation rates for each of 28 age-ethnic cohorts. These rates undoubtedly will vary in the future, as they have historically. Participation rates could go up, but they could also fall, depending on many difficult-to-measure factors. Factors that affect whether a person will attend college, for example, include:

- Prior college experience.
- Educational attainment and income of parents.
- Academic performance during K-12 schooling.
- Eligibility standards of higher education institutions.
- Prices of public and private higher education.
- General economic conditions.
- Preferences for immediate or deferred income upon high-school graduation.
- Differences in unemployment rates and wages among job categories.

Community College Projections Subject to Greatest Uncertainty. Of the three segments, it is most difficult projecting community college enrollments. This is because community colleges offer a broad range of curricula—academic, vocational, avocational, and recreational—to a much broader student population than does CSU or UC. The community colleges, for example, provide an assortment of personal development and recreational courses to attract older adults, many who participate in only one or a few classes in any year.

Also, it is much easier for students to enter and exit community colleges than it is at CSU and UC. As a consequence, enrollments in the community colleges are more sensitive to economic and social conditions than in the four-year colleges.

The ultimate accuracy of projections of total enrollment in the three segments will depend in large part on what happens to community college enrollments. This is because community colleges account for three

quarters of total enrollment in the three segments, and their enrollments are the most volatile and unpredictable.

Using Current Participation Rates Probably Will Produce Least Error in Projections. As noted above, we have used current participation rates to project enrollments. University of California officials compared several methods of projecting UC enrollments. By applying various projection techniques to historic data, they tested how well each method would have predicted eventual UC enrollment changes. They found that using the current participation rates at any time in history produced the smallest enrollment-projection errors.

Given the inherent uncertainty in projecting enrollments, it should not be surprising that projections of future enrollments vary. In the next section, we compare our projections with those of the DOF and the CPEC.

OTHER PROJECTIONS ALSO DO NOT SHOW A COMING TIDAL WAVE

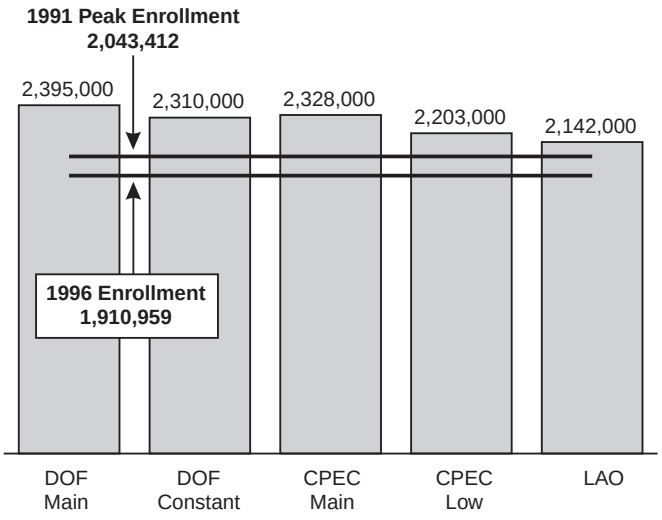
The DOF Demographic Unit each November publishes its projection of enrollments. We refer to this projection as the "DOF main" projection. The DOF also makes other projections based on various assumptions about college participation rates. It does this, in part, to show that enrollment projections are sensitive to assumptions about participation. In one projection, the department assumed that current participation rates would not change. We include this DOF projection, which we call the "DOF constant" projection, in our charts for comparison purposes because it is based on assumptions about participation that are similar to ours.

In its 1995 report *A Capacity for Growth*, the CPEC published two projections of enrollment growth. The press and others have frequently cited the higher of CPEC's projections, which we call the "CPEC main" projection. We also include the lower CPEC projection, which we call the "CPEC low" projection, in our charts for comparison purposes.

The main projections of total enrollments of both DOF and the CPEC are higher than the LAO projections. Nevertheless, the DOF and CPEC projections are comparable to historic trends. As Figure 4 shows, DOF's main projection for total enrollment in 2005 is 2,395,000. This is 253,000, or 12 percent, higher than the LAO projection. CPEC's main projection for 2005 is 2,328,000. This is 186,000, or 8.7 percent, higher than the LAO projection.

Figure 4

Projections of Total CCC, CSU, And UC Headcount Enrollment in 2005



The DOF main projection represents annual growth of 2.5 percent from 1996 to 2005, and 1.1 percent from 1991 to 2005. The CPEC main projec tion represents annual growth rates of 2.2 percent and 0.9 percent, respectively. Again, for comparison purposes, actual growth averaged 1.9 percent per year from 1970 through 1996, and averaged 2.7 percent between 1970 and 1991. Even if the higher growth projections of DOF or CPEC occur, the rate of growth will not be significantly higher than has occurred in recent history.

The CPEC Figure Overstates Growth for Capital Planning. In its 1995 report, CPEC said that its main projection of 2,328,000 represented growth of 455,000 students by 2005. Although frequently cited in the press, this number is very misleading for purposes of assessing the state's higher-education capital needs. To derive this 455,000 growth number, CPEC compared its main 2005 projection with enrollments in 1993. Enrollments in that year, however, were 171,000 *below* 1991 levels. The projection of 2,328,000 is only 285,000 higher than the 1991 peak. This number is more relevant when evaluating the capacity for growth within the segments because it represents growth above the number of students that the existing capacity had successfully accommodated.

The DOF and CPEC Assumed Increasing Rates of College Participation. The DOF and CPEC main enrollment projections are higher than ours primarily because they assumed that college participation rates would increase significantly from 1996 through 2005, reaching their highest levels in recent history for some groups. Our projections assume that 1996 participation rates will continue into the future. We are not aware of any analytical basis for using rates that are different than the most recent.

The CPEC Alternative Projection Comparable to LAO's. In its report, CPEC also published projections for which it assumed that participation rates would grow at roughly half the rate it assumed for the CPEC main projection. As Figure 4 shows, the CPEC low projection of total enrollment in 2005 is 2,203,000. This projection is 2.9 percent above our projection. (Our projection differs from CPEC and other forecasters due to different assumptions about participation rates and for other methodological reasons.)

The DOF Projections Highest for Each Segment. As Figure 5 shows, the DOF's projections are consistently higher than CPEC's and LAO's across all three segments. It projects that community college enrollment will grow to 1,765,000 by 2005. This is 11 percent higher than the LAO projection. It projects that CSU will grow to 431,000, and that UC will grow to 199,000. These are 16 percent and 7.4 percent greater than the LAO projections for CSU and UC. As Figure 5 shows, UC's projection of enrollments in 2005 is slightly lower than ours.

Despite the differences among the DOF, CPEC, and LAO, none of the projections are sufficiently large to suggest enrollment growth will be of tidal wave proportions.

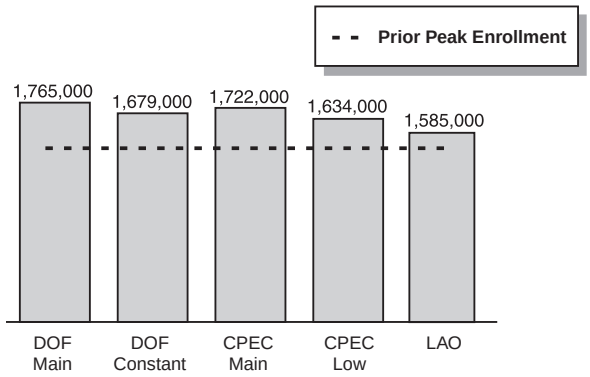
Improving Information on State Enrollment Forecasts

The DOF annually publishes its projections for higher education enrollments. By contrast, CPEC does not routinely publish projections. Despite the importance of enrollment projections to the budget process, the three segments do not provide the Legislature with analyses of enrollment changes on a routine basis. Moreover, the independent colleges and universities in California do not publish projections or plans for accommodating enrollment growth that are publicly available.

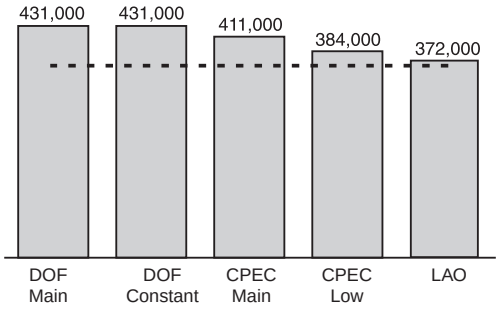
Given the uncertainty in future enrollment demand, we recommend that the segments provide the Legislature with alternative enrollment projections, and describe the policy implications associated with each. For each alternative enrollment projection, the segments should:

Figure 5

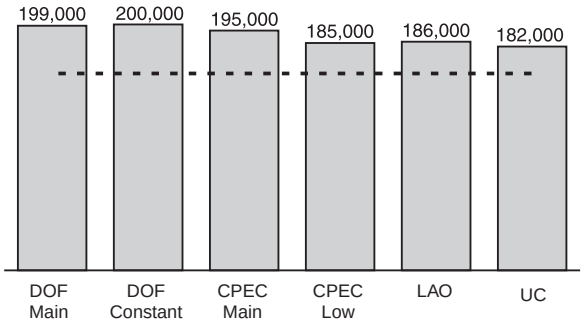
Projections of CCC,CSU, and UC Headcound Enrollment in 2005



California Community College



California State University



University of California

- ***Explicitly Describe Assumptions.*** The segments should explicitly describe their key assumptions about student eligibility, participation, persistence, and other key variables underlying each projection. If a segment assumes in a projection, for example, that a growing proportion of older adults will enroll in their system, then it should explain how this might occur.
- ***Describe the Potential Operating and Capital Costs.*** There are many costs associated with growing enrollments. Each segment should provide the Legislature with five-year and ten-year plans for accommodating alternative projections of enrollments. These plans should explore various options for accommodating growth. For example, the segments should explore ways to use existing capacity more fully, as well as consider new capacity.
- ***Suggest Options for Funding Enrollment Growth.*** So that the Legislature can assess the budget implications of enrollment growth, the segments should suggest options for funding the costs of enrollment growth—such as through productivity improvements that reduce the marginal cost of educating students.

By having this type of information, the Legislature will be better able to address issues related to the likely enrollment growth. In the next section, we examine ways in which the Legislature can manage growth.

THE LEGISLATURE CAN MANAGE HIGHER EDUCATION ENROLLMENTS

The variation in college participation rates over time suggests that Californians respond to many factors in making choices about college. Better understanding these factors can help the Legislature craft policies affecting the availability, quality, cost, and price of higher education. In this section, we discuss the effect on enrollment demand of:

- Eligibility standards.
- Student fees and financial aid.
- Articulation between the segments.
- Course offerings in the community colleges.

Rethinking Eligibility Targets

Enrollments in each of the segments are determined, in large part, by the number of high school graduates who are eligible to attend UC and CSU. For example, increasing the percentage of high school graduates that are eligible for UC and CSU shifts some enrollments from community colleges and independent colleges and universities to UC and CSU. Lowering the pool of eligible students has the opposite effect. Legislative policies regarding eligibility criteria for the segments, therefore, significantly affect the allocation of enrollments among the segments.

Master Plan Called for Flexible Eligibility Targets. The 1960 Master Plan stated ". . . admission requirements are valid for any one college if, first, they serve to qualify for admission those applicants whose educational purposes are properly met by the college and whose abilities and training indicate probable scholastic success in the college and, secondly, they serve to eliminate applicants not meeting these requirements." The Master Plan recommended that segments each year statistically analyze and report on the validity of their entrance requirements. The plan said that the segments should evaluate entrance standards based on the scholastic success, persistence, rate of dismissal, and standardized test scores of their students. The 1973 *Report of the Joint Committee on the Master Plan for Higher Education* stated ". . . we propose that the Legislature initially define the undergraduate eligibility pools for all public segments and that changes in the pools be subject to approval by the Postsecondary Education Commission." The Master Plan, then, views eligibility targets as fluid, subject to ongoing determinations of which students are best served by each segment.

When the Master Plan was first released in 1960, its authors recommended that UC draw from the top 12.5 percent of high school graduates and that CSU draw from the top third, as determined by the segments. (All high school graduates are eligible to attend community college.) At the time, the authors of the plan noted that UC had been drawing from 15 percent of high school graduates and CSU had been drawing from approximately 50 percent. In recommending that the eligibility pools be reduced, the Master Plan stated, "The position of the Master Plan Survey Team is that so long as any high school graduate can be admitted to a junior college . . ., it will not reduce that opportunity for students able and willing to meet the requirements for transfer to the upper division in the state colleges and the University of California." The 1973 and 1987 updates to the Master Plan have reaffirmed that UC and CSU should draw from the top 12.5 percent and 33.3 percent of high school graduates, respectively.

Determining the Appropriate Targets Today. If these eligibility targets were appropriate when the Master Plan was released in 1960, we do not know if they are today. This is because little is known about the success of students as a function of their academic preparedness and method of articulation through college. (Interestingly, the authors of the Master Plan pointed to a similar lack of information before settling on the eligibility targets that are referenced to this day.)

In order for the Legislature to comprehensively address the issue of enrollment growth, it needs information on the validity of current entrance requirements for UC and CSU based on the performance of students while in college. With this information, the Legislature can better allocate enrollment among the segments. We recommend, therefore, that the Legislature:

- Require the segments, as part of their annual request for funding of proposed enrollments, to report on the validity of eligibility criteria, and the effect that alternative criteria might have on the allocation of students among the segments.
- Increase or decrease eligibility targets for UC and CSU, based on its determination of where the state can best serve new students.

Where Are the Segments Relative to Their Targets?

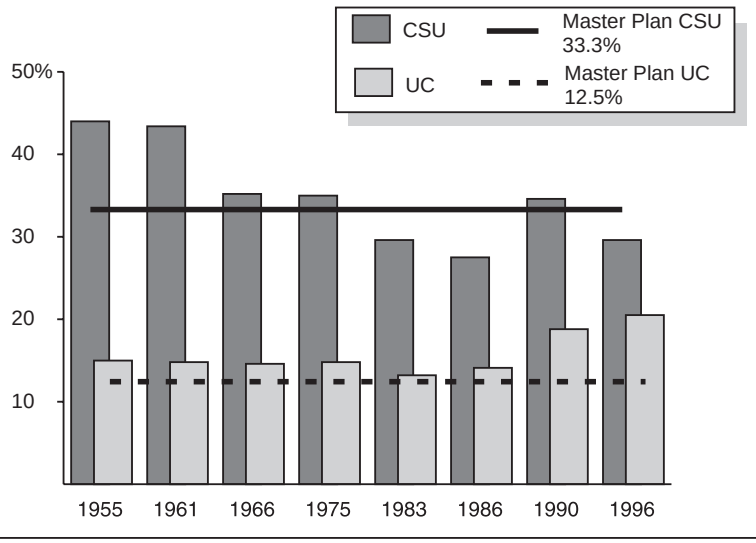
University of California Above Existing Eligibility Target. Growth in enrollments at UC can be explained in part by the increasing pool of high school graduates from which it is drawing. As Figure 6 shows, the eligibility pool for UC has grown significantly in recent years. In 1996, UC drew from the top 20.5 percent of high school graduates. This is a level that is almost two-thirds higher than envisioned by the Master Plan. (See box on page 142 on the issue of determining the eligibility pool.)

According to the UC, to reduce the eligibility pool from 20.5 percent to 12.5 percent, it would have to increase the required minimum high school grade-point-average (GPA) from 3.3 to 3.65. Approximately 36 percent of entering UC freshmen in 1997 had high school GPAs below 3.65. If UC had not admitted these students, the students would nevertheless have been eligible to attend CSU, a community college, or many of the independent colleges and universities. For various reasons, this does not mean that freshmen enrollments at UC would fall by the full 36 percent if the university raised its high school GPA requirement to 3.65. Nevertheless, reducing the eligibility pool to the Master Plan target of 12.5 percent of students would reduce freshman enrollments and increase transfer enrollments at UC. It is important to note that the maximum possible GPA for

Figure 6

Size of Eligibility Pools for UC and CSU

Percent of High School Graduates Eligible



many classes has increased from 4.0 to 5.0. The increase in UC's eligibility pool might have resulted in part because the university has not adjusted for this change.

California State University Below Existing Eligibility Target. As Figure 6 shows, CSU is drawing from the top 29.6 percent of high school graduates—slightly below the level envisioned by the master plan. While UC has consistently exceeded its level, CSU has fluctuated above and below its target. If CSU drew instead from the top 33.3 percent of students, enrollments at CSU would increase by an unknown amount. Presumably, this would also reduce the number of students that would go to community colleges and independent colleges and universities.

The UC and CSU Should Report to Legislature on Current Eligibility Criteria. As noted above, we do not know whether the existing eligibility targets are appropriate, and we recommend that the segments report each year to the Legislature on their validity. Nevertheless, if the targets are to be meaningful, then the Legislature should require UC to meet its Master Plan target. The UC should also evaluate for the Legislature what the implications are for meeting it. Similarly, CSU should meet its Master Plan target, and describe what the implications are for meeting it. Without holding the segments accountable for meeting eligibility targets, the Legislature will be less able to manage higher education enrollments.

A Note on Measuring the Eligibility Pool For UC

In its November 1997 report *Eligibility of California's 1996 High School Graduates for Admission to the State's Public Universities*, CPEC described the eligibility pool for UC in two ways. It said that 20.5 percent of high school graduates in 1996 were "potentially eligible" for UC because they had achieved the required 3.3 grade-point average on UC-preparatory classes. It said that 11.1 percent of high school graduates were "fully eligible" for UC, the number UC also uses to describe the pool from which it draws. These fully eligible students, according to CPEC and UC, were those students who both achieved a 3.3 grade point average (GPA) and took the SAT I and three separate SAT II achievement tests. The university requires students to take these tests, but does not use the test scores to determine a student's eligibility if their GPA is 3.3 or above. (High school graduates with GPAs between 2.82 and 3.3 can become eligible for UC if their SAT I scores are sufficiently high. Few students become eligible this way.) (The UC does use the test scores to allocate students among its nine campuses.)

Top high school graduates that choose to attend CSU rather than UC do not need to take either the SAT I or SAT II, and many probably do not. Similarly, top high school graduates that choose to attend other top universities in the country do not need to take SAT II tests, and many probably do not. By excluding such students when it identifies top high school graduates, UC significantly understates the size of the pool from which it draws freshmen. It is much more accurate to say that UC is drawing from the top 20.5 percent of high school graduates.

Student Fees Affect Enrollment Choices

Student fees affect choices students make about whether and where to attend college. By charging students fees which cover only a portion of total costs, the state subsidizes the education of every student attending UC, CSU, and the community colleges. Fees affect overall enrollment demand—lower fees encourage more students to attend college. The relative size of this subsidy for each segment, in effect, establishes state policy about (1) the overall level of college enrollments, and (2) where the state wants students to enroll among the three segments and independent colleges and universities.

New Federal Tax Credit for Tuition Costs Will Dramatically Reduce Education Costs for Many. The recently enacted federal Taxpayer Relief Act of 1997 creates significant incentives for higher education enrollment across the nation, including California. The "Hope Scholarship" and "Lifetime Learning" tax credits reduce the after-tax price of tuition and fees for most middle-income California students (or their parents). The Hope Scholarship credit, for example, will for many reduce the after-tax price of tuition in each of the first two years of college by $1,500 at UC, by $1,292 at CSU, and by $390 at community colleges. Chapter 853, Statutes of 1997 (AB 1318, Ducheny), which lowered student fees, will have the additional effect of reducing the after-tax price of tuition in each of the first two years by $190 at UC and by $39 at CSU. (The federal law already drops the after-tax cost of community colleges to zero for students that qualify for the Hope Scholarship credit, so Chapter 853 would have no additional effect on what these students pay.)

The Lifetime Learning credit will, for many upper-division students, reduce the after-tax costs of tuition each year by $760 at UC and $317 at CSU. The state-fee reductions reduce the after-tax costs by an additional $152 at UC and $62 at CSU for upper-division students.

Changes in Tuition Costs Could Significantly Shift Enrollments. The federal tax credits will change enrollments in two important ways:

- ***More Students Will Attend College.*** Lowering the after-tax price to attend college will encourage an unknown number of additional students to attend both public and private colleges and universities.
- ***Students Will Shift From Community Colleges to Four-Year Colleges.*** The federal law reduces the fee differential between the universities and the community colleges. This will shift an unknown amount of enrollment from community colleges to UC and CSU, where the state subsidies per student are significantly higher.

State Should Review Fee Policies in Light of Federal Tax Credit. The federal tuition tax credits create both opportunities and concerns for California. It provides an opportunity for California to increase resources for higher education without significantly affecting the after-tax price of higher education for students and their families. At the same time, however, it could cause significantly fewer students to articulate through the community colleges to four-year colleges and universities, contrary to existing state policy.

We recommend that the Legislature evaluate student-fee policies in light of the opportunities and concerns that the new federal tax credits create for state higher education policy. (We evaluate the implications of

the recent federal tax credits in greater detail in another LAO analysis to be released in February 1998.)

Financial Aid Policies Also Affect Enrollment Demand

Whereas state support to the segments subsidizes all students indirectly—by reducing what students pay to go to college—financial aid targets the subsidy to specific students. Dollar-for-dollar, financial aid increases student access to higher education more than do general fee reductions. This is because financial aid targets students least able to afford college. In addition, financial aid that can be used at any college or university in California, such as CalGrants, increases the ability of students to choose between public and private institutions.

In recent years, the Legislature has increased the amount of financial aid provided directly to students through the Cal Grant program. From 1990 to 1998-99 (proposed), for example, it has increased state appropriations for Cal Grants from $162 million to $310 million. As a result, the number of Cal Grant awards increased from 78,000 to 97,000 in that period. The maximum Cal Grant award for students attending private colleges and universities also increased from $5,250 to $8,184, an increase of 56 percent.

The UC, CSU, and community colleges also give their students financial aid beyond the amount given by the state directly to students through Cal Grants. For 1998-99, UC estimates that it will provide $240 million in financial aid to its students from general purposes funds. The CSU estimates that it will provide $120 million, and the community colleges estimate that they will provide $130 million for financial aid from general purpose funds. Most of the aid the community colleges give is in the form of student-fee waivers, particularly for low-income students.

Given that financial aid, like fees, affects whether and where students will attend college, the Legislature should carefully consider the effects financial aid has on enrollments among the segments. As discussed above, the Legislature has two important policy levers to affect enrollments:

- ***Whether to Provide Direct Financial Aid or Fee Reductions.*** Direct financial aid, rather than subsidies to public colleges and universities (in the form of across-the-board fee reductions), gives students a broader choice of higher-education opportunities. Direct financial aid increases the number of students who choose to attend independent colleges and universities. As noted earlier, direct financial

aid also increases student access to higher education more than across-the-board fee reductions.

- ***Whether to Provide Cal Grants or College-Specific Aid.*** The Cal Grant program allows students to use aid at any college or university in California. Financial aid provided by UC, CSU, and the community colleges is available only to students attending those public colleges. Financial aid provided through Cal Grants, then, provides students with broader choices, and shifts more students to independent colleges and universities.

Articulation Policies Affect the State's Ability To Accommodate Enrollment Growth

Other levers that the Legislature can use to manage enrollment growth include policies affecting student articulation between the segments. The Master Plan emphasized the importance of articulation between community colleges and four-year colleges and universities. It called for CSU and UC to allocate no more than 40 percent of undergraduate enrollments for lower-division levels (freshmen and sophomores) and at least 60 percent for upper-division levels (juniors and seniors), and to do so by admitting students transferring from community colleges. In 1996-97, UC met the Master Plan goal, while CSU exceeded the goal with 70 percent of its students in the upper division and 30 percent in the lower division.

Of the 33,895 new students enrolling in UC in 1996, 69 percent were first-time freshmen and 26 percent were transfer students from community colleges. (The remaining 5 percent transferred from other colleges and universities.) Of the 68,725 new students CSU admitted in 1996, 42 percent were first-time freshmen and 47 percent were from community colleges.

If the state encouraged more students to pursue their lower-division course work in community colleges, it could shift some enrollment growth from UC and CSU to the community colleges. Shifting enrollments from UC to CSU or community colleges, and shifting enrollments from CSU to community colleges might allow the state to serve student needs more cost-effectively. The *1997-98 Budget Act*, for example, appropriated $7,000 to UC from the General Fund for each increase in full-time-equivalent (FTE) enrollments for the year. It appropriated $4,936 per FTE to the CSU and $3,300 per FTE student taking college-credit courses at a community college.

The Legislature has recognized the importance of intersegmental transfers in promoting access to the four-year colleges and reducing the

overall cost of higher education. Current state law, for example, requires the segments to ". . . jointly develop, maintain, and disseminate a common core curriculum in general education courses for the purpose of transfer."

Course Offerings and the Mission of Community Colleges

The Legislature can also affect enrollments at the community colleges through its policies relating to curricula. The Master Plan and state law give the community colleges many roles:

- Offer—as a primary mission—academic and vocational instruction at the lower division level.
- Provide remedial instruction, instruction in English as a second language, adult noncredit instruction, and support services which help students succeed at the postsecondary level.
- Offer community services courses and programs, such as various avocational and recreational classes.

For the Legislature to manage enrollment growth in the community colleges, it needs to know how enrollments most likely would be allocated among college-level, remedial, personal development, vocational, avocational, and recreational courses. With such information, the Legislature could evaluate how well state funds were being allocated among the various missions of the colleges, and could change the allocations through the budget, fee policies, or other mechanisms.

The ability of the Legislature to manage community college enrollments is limited to some extent by the existing community college governance structure. Although the state General Fund provides twice as much support for community colleges than do local property tax revenues, most of the decisions affecting community colleges occur at the local level, within the community college district boards. Nevertheless, the Legislature can adopt and has adopted policies that affect enrollments.

To manage how community colleges grow, for example, the Legislature can vary state funding and/or student fees for enrollments, based on the categories of courses in which enrollments occur. For example, the Legislature could require colleges to charge fees to cover the full costs of recreational courses that are not required for a degree. The Legislature could also vary student fees by the type of student enrolling in the colleges. The recently discontinued $50-per-unit surcharge for students who already had at least a bachelors degree is an example of such a policy.

CONCLUSION

The number of Californians attending college in the near future will grow as the children of the "baby boom" move through their college-age years. While many have referred to this development as Tidal Wave II, our review indicates that the metaphor is misplaced. Unlike a tidal wave, enrollment growth will be steady and moderate (especially by historical standards), and manageable. While the Legislature will need to dedicate more resources to higher education (especially capital resources), it has several policy levers available to manage the coming growth.

A PERSPECTIVE ON THE VEHICLE LICENSE FEE

What Is the Vehicle License Fee and How Are its Revenues Used? What Factors Should the Legislature Consider Regarding Any Potential Changes to the Fee?

Summary

The vehicle license fee (VLF) is one of the state's major revenue sources, with collections expected to near $4 billion in 1998-99. Vehicle owners pay the fee on an annual basis, in lieu of paying property taxes on vehicle ownership.

This piece provides background information on the fee, including:

- *How the fee is calculated.*
- *Changes to the fee since its inception in 1935.*
- *To which governments and for what purposes the fees are distributed.*
- *How other states tax vehicles.*

A number of mechanisms to change the VLF have been proposed—such as implementing an exemption or changing the depreciation schedule or tax rate. We describe these various mechanisms, as well as some key considerations for the Legislature to take into account prior to making any such change. For instance, the VLF is one of local governments' primary sources of discretionary revenue.

INTRODUCTION

The motor vehicle license fee (VLF) is a fee on the ownership of a registered vehicle in California, in place of taxing vehicles as personal property. The VLF is paid in addition to other fees, such as the vehicle registration fee, air quality fees, and commercial vehicle weight fees.

Recently, the fees and taxes that residents pay to register and own their vehicles have received increasing attention across the country. This piece provides a perspective on the VLF: its history, distribution of revenues, and the issues involved with potentially changing its rate or distribution.

WHAT IS THE VEHICLE LICENSE FEE?

The VLF is administered by the Department of Motor Vehicles (DMV). A vehicle owner pays the VLF on an annual basis, in lieu of paying property taxes on the ownership of the vehicle and based on the vehicle's sale price. For those vehicles brought into California from out of state, the fee is based on the vehicle's value at the time of its initial registration in California. The owner pays a two percent fee, based on the vehicle's current estimated value. The fee is deductible for federal tax purposes for those vehicle owners who itemize their tax returns.

Calculating the Fee

The vehicle's current value is estimated by a statutory depreciation schedule. For each year the vehicle is owned, the VLF is assessed at a lower percentage of the vehicle's original value. When a vehicle is resold, the calculation of the fee begins again at year 1 of the schedule using the new sale price as its base. Figure 1 shows the current depreciation schedules for both vehicles and trailer coaches.

Figure 2 (see page 152) shows how the VLF for a vehicle is determined for a sample automobile. The vehicle's sale price is first rounded to the nearest odd hundred dollar. The rounded purchase price is multiplied by the depreciation factor, based on its year of ownership. This estimated current value is then multiplied by two percent to determine the fee owed. The final fee is also rounded to the nearest dollar.

Vehicles Subject to the Fee

Generally, any vehicle (cars, trucks, and motorcycles) required to be registered is also required to pay the VLF. Various classifications of specialized vehicles are exempt from the VLF and instead subject to the property tax. These classifications include farm trailers, firefighting vehicles, and forklifts. Other vehicles, while required to be registered, are exempt from both the VLF and property taxes. This group includes government vehicles, privately owned school busses, and vehicles owned by disabled veterans.

Figure 1

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.

Trailer Coaches. Trailer coaches, also known as mobile homes and manufactured homes, are generally treated as homes subject to the property tax. However, prior to 1980 these mobile homes were considered vehicles and subject to the VLF. As a result, those trailer coaches that have been owned and have maintained their registration since 1980 or earlier can still choose to pay the VLF. Due to the longer expected life span of mobilehomes and their higher values as compared to automobiles, mobilehomes have a different statutory depreciation schedule than other vehicles (see Figure 1).

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

Historical Evolution of the VLF

The VLF has undergone a number of important changes since its creation. These changes are summarized in Figure 3. Originally, motor vehicles were subject to the property tax, which is administered by local governments. However, in 1935 vehicles became subject to a state-imposed VLF and were exempted from property taxes. It was felt that a state-imposed system would be simpler to administer, given the variation of assessment practices across counties and the relative ease of avoiding vehicle property taxation. In general, these fee revenues were returned to local governments as a replacement for the revenues they would have received if vehicles were on their property tax rolls.

In the early 1980s, low state revenues and the complicated post-Proposition 13 landscape caused the state to change many of its fiscal relationships with local governments. As part of the state's budget actions from 1981 to 1983, the state retained a total of over $700 million in VLF revenues that otherwise would have been sent to local governments. Subsequently, Proposition 47 was passed by the voters in 1986, which ensured VLF revenues would be designated for local governments. However, the state retains authority over both the *amount* of revenues that are collected and the *method of their distribution*. Moreover, Proposition 47 did not apply to trailer coach license fee revenues.

Figure 3

Vehicle License Fee—Historical Milestones

Year	Event
1935	Vehicles became subject to a 1.75 percent license fee, in lieu of local property taxes. Revenues generally distributed to local governments.
1948	License fee raised to 2 percent.
1981-1983	Facing low revenues, the state reduced VLF payments to local governments by $700 million over three years, about one-third of the fee's revenues over that time.
1986	Proposition 47 passed, constitutionally guaranteeing VLF revenues to local governments.
1991	As part of the realignment of state and local health and social services programs, a portion of VLF revenues is designated for the funding of realignment programs. The depreciation schedule is changed in order to increase revenues.

In 1991, as part of the major realignment of state and local health and social services programs and funding, the VLF depreciation schedule was amended to its current form. The change slowed the rate of depreciation for vehicles and therefore increased revenues. The new revenues were dedicated to the funding of local governments' realignment programs.

WHERE DO THE FEES GO?

The 1998-99 Governor's Budget projects total VLF revenues that approach $4 billion. Figure 4 (see next page) shows for 1996-97 through 1998-99 how these revenues are distributed. About three-fourths of the total revenues are distributed through what we refer to as "base VLF," with the realignment VLF accounting for most of the remainder.

Figure 4

Distribution of Vehicle License Fee Revenues

(In Millions)

	Actual 1996-97	Estimated 1997-98	Proposed 1998-99
Base VLF:			
Administrative	$177.1	$208.0	$229.2
Cities	1,022.1	1,061.2	1,110.0
Counties	1,481.8	1,538.5	1,609.3
Subtotals	($2,681.0)	($2,807.7)	($2,948.5)
Realignment VLF	864.6	908.2	953.1
Trailer Coach VLF	35.8	35.9	36.3
Totals	**$3,581.4**	**$3,751.8**	**$3,937.9**

The distribution of VLF funds is a complicated process that has evolved from a number of budget agreements and other legislative actions. Figure 5 provides an overview of the allocation process, using actual 1996-97 data. The distribution of funding is discussed in greater detail below.

Realignment Portion

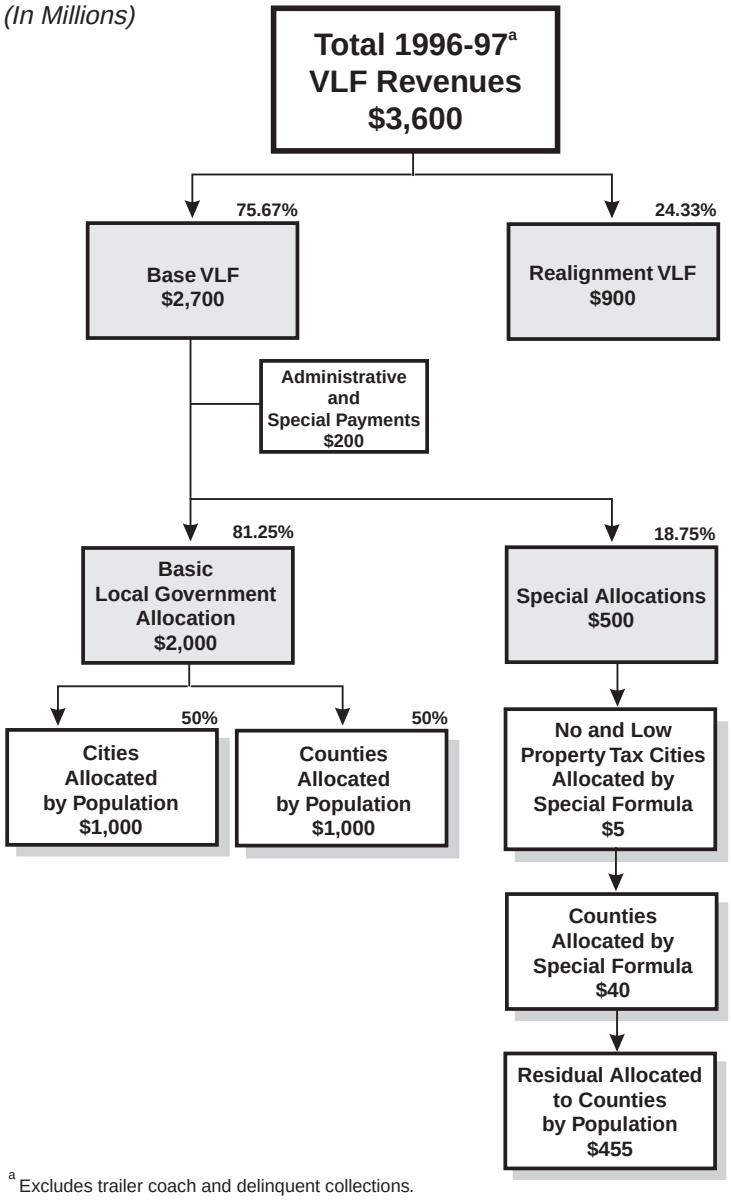
Of the total VLF revenues collected by the Department of Motor Vehicles, 24.33 percent of the funds are designated for realignment funding. The monies are deposited in the Local Revenue Fund and then allocated to two accounts:

- The ***Vehicle License Fee Account*** is allocated the same amount of funds as the previous year's *total realignment* VLF revenues. From this account, each jurisdiction receives an amount equal to its previous year's total realignment allocation.
- Any amount by which the realignment VLF revenues have grown over the past year is deposited into the ***Vehicle License Fee Growth Account***. These funds are distributed to jurisdictions based on a schedule developed by the Department of Finance, in consultation with the California State Association of Counties. This schedule is intended to approximate local increases in realignment program caseloads.

Figure 5

How VLF Revenues Are Distributed

1996-97
(In Millions)



[a] Excludes trailer coach and delinquent collections.

Base VLF Portion

The remaining VLF revenues—75.67 percent—are the base VLF funds. First, revenues are used to cover two specific expenses:

- ***Administrative Costs***. The DMV and the Franchise Tax Board (FTB) receive an allocation for their costs in collecting the fees.
- ***Special Local Government Payments.*** $50 million is allocated to cities and counties based on the proportion of property taxes lost during the property tax shifts of the early 1990s. Cities and counties each receive $25 million of this allocation.

The remaining revenues are split into two portions—81.25 percent and 18.75 percent shares of the funds.

81.25 Percent Share. This portion of the VLF revenues is split into two equal amounts for cities and counties. Then the funds are distributed to each jurisdiction on a population basis. For cities that have incorporated since 1987, the jurisdictions' population is determined by taking the larger of its estimated current population or three times the number of registered voters at the time of incorporation.

18.75 Percent Share. Of the 18.75 percent share, there are three special payments made to local governments:

- ***No Property Tax Cities***. Cities that did not levy a property tax in 1977-78 are eligible to receive an allocation based on three local subventions that no longer exist—the liquor license fee, highway carriers' uniform business tax, and financial aid to local agencies. Only three cities (Foster City, Lancaster, and Victorville) continue to receive an allocation under this provision, totaling over $400,000 in 1996-97.
- ***Low Property Tax Cities***. "Eligible cities"—those cities incorporated before 1987 that receive a relatively small portion of property tax revenues—also are eligible to receive an allocation. In 1996-97, $4.8 million was allocated to 77 cities under this provision.
- ***Counties.*** Counties receive an allocation based upon the funds they received in 1982-83 under a number of property tax relief programs that no longer exist (related to motion picture, business inventory, livestock, and cotton). In 1996-97, about $40 million was distributed to counties using these formulas.

Any remaining funds, over $400 million in 1996-97, are distributed to counties in the same manner as their 81.25 percent share (on a population basis).

Additional Revenues

Delinquent Collections. In 1993, the authority to collect delinquent VLF revenues was transferred from the DMV to the Franchise Tax Board. The FTB holds greater administrative authority to collect these delinquent fees, using actions such as issuing bank and wage levies. The first $14 million collected by the FTB in new delinquent fees is deposited into the Vehicle License Collection Account of the Local Revenue Fund. This money is then distributed to counties for mental health programs, as part of realignment. The distribution schedule is developed by the State Department of Mental Health, in consultation with the California Mental Health Directors Association. Any funds over the $14 million are added to the 81.25 percent share of the base VLF distribution.

Trailer Coach Fees. Since the 1992-93 budget agreement, revenues collected from trailer coach VLFs have been deposited into the state's General Fund. The estimated total of trailer coach fees in 1998-99 is $36 million. Only coaches that initially registered in 1980 or earlier are eligible to pay the VLF instead of property taxes. Previously, these fees were distributed to cities, counties, and school districts based on the geographic location of the registrations.

SOME KEY CONSIDERATIONS

What Do Other States Do?

The taxation of vehicles is not uniform across the United States. In fact, each state has a unique system of taxing vehicles and imposing various fees. Figure 6 (see next page) compares the taxation systems (based on vehicle values) of the 20 western and major industrial states of the country. Each of these states also has additional mechanisms to tax driving—such as registration fees, drivers' license charges, and sales taxes on vehicle purchases.

California is among seven of these states that have a vehicle tax system in lieu of a property tax. These taxes are based on an estimate of the vehicle's value and are collected on an annual basis. Ten states exempt vehicles from the property tax, with no comparable replacement tax. Three states subject vehicles to local property taxes.

Figure 6

Comparison of Western and Industrial States: Value-Based Taxation of Vehicles[a]

Form of Taxation	Western and Major Industrial States[b]																				
	AK	AZ	CA	CO	FL	HI	ID	IL	MA	MI	NV	NJ	NM	NY	OH	OR	PA	TX	UT	WA
Exempt from value-based taxation	□	□	□	□	■	■	■	■	□	□	□	■	■	■	■	■	■	□	□	□
Subject to local property tax	■	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	■	■	□
Subject to state fee/tax in lieu of property tax	□	■	■	■	□	□	□	□	■	■	■	□	□	□	□	□	□	□	□	■

[a] Symbols indicate under which system vehicles are taxed (■ Yes □ No).

[b] Abbreviations for states are as follows: AK: Alaska; AZ: Arizona; CA: California; CO: Colorado; FL: Florida; HI: Hawaii; ID: Idaho; IL: Illinois; MA: Massachusetts; MI: Michigan; NV: Nevada; NJ: New Jersey; NY: New York; OH: Ohio; OR: Oregon; PA: Pennsylvania; TX: Texas; UT: Utah; WA: Washington.

Source: National Conference of State Legislatures (January 1998).

The VLF as a Cost of Vehicle Ownership

The VLF is only one of many costs of owning and maintaining a vehicle. Among the other major costs are vehicle insurance (required by California law), gasoline, maintenance, and any car loan payments. Figure 7 shows these estimated costs for an average-priced new vehicle in a driver's first year of ownership. The VLF represents only about 6 percent of this sample owner's costs. While the VLF is a relatively minor portion of a vehicle's annual costs, it is one of the costs of driving that the Legislature can most readily change. The VLF is also a particularly visible cost of vehicle ownership, since it must be paid in a single payment at the time of annual vehicle registration.

A Local Revenue Source

While the VLF's revenues and distribution are controlled by the Legislature, the ultimate recipients of the fees are cities and counties. Therefore, any change to the VLF would substantially affect the revenues of these local governments. This is because the base VLF represents about 10 percent of cities' tax revenues and about 25 percent of counties' tax revenues. Along with the property tax and their portion of the sales tax, the VLF represents one of the major general purpose revenue sources for local governments.

Figure 7

Sample First Year Costs For a New $22,000 Vehicle

Item	Estimated Costs	Percent of Total
VLF	$440	6%
Gas/oil	1,080	14
Maintenance	520	7
Insurance	1,110	14
Car payment	4,800	60
Total	**$7,950**	**100%**

Source: Runzheimer International and LAO calculations. Assumes 15,000 miles traveled.

Percentages may not add due to rounding.

Consequently, if the Legislature were to consider a *reduction* in VLF revenues, it would have to take into account its impact on local government finances. Basically, the Legislature would be faced with whether or not to "backfill" the lost local government revenues. If the Legislature did not backfill the loss, it is doubtful that most local governments would be able to replace the lost VLF revenues. Property tax rates are already capped at the Proposition 13 limit of one percent. Furthermore, Proposition 218, passed in 1996, has made it more difficult for local governments to raise other revenues to finance government efforts.

CONSIDERING CHANGES TO THE VLF

As interest in the VLF has grown in recent months, a number of mechanisms have been suggested to alter the fees paid by Californians. If the Legislature wished to consider making changes to the VLF, two factors should be taken into account.

- First, because the VLF is tax-deductible for Californians who itemize on their federal tax returns, the full impact of a fee reduction would not be received by those itemizing taxpayers. Instead, part of any reduction in VLF revenues would be offset by increased income tax revenues. For instance, a California taxpayer currently paying federal taxes at the highest marginal rate would only realize about three-fifths of any VLF reduction.

- Second, the use of VLF revenues to help fund realignment programs complicates any effort to reduce the license fee revenues. Changing the manner in which realignment programs are funded would affect historical agreements between the state and local governments. However, changes to the VLF could be made while holding realignment "harmless." With each of the mechanisms discussed below, provisions could be made to continue realignment funding in its current form while altering only the base VLF revenues.

Below, we describe three mechanisms for changing the VLF.

Altering the Depreciation Schedule

In order to raise or lower VLF revenues, the Legislature can alter the rate at which vehicles' values are depreciated. The Legislature took this approach in 1991 when it implemented the current depreciation schedule. The new schedule was put in place to increase VLF revenues to help pay for the realignment of various health and social services programs. By slowing the rate that vehicles' values are depreciated, the new schedule maintains a greater base of vehicle values each year upon which to assess the two percent fee, thereby increasing VLF revenues.

The schedule has served as a convenient mechanism for avoiding assessing each vehicle on an annual basis. Each vehicle under the statutory depreciation schedule depreciates at the same rate. However, in reality vehicles depreciate individually based on their make and model, miles driven, and condition. For vehicles that actually depreciate in value *faster* than the schedule, owners *overpay* VLF (relative to an "ideal" system). Conversely, for vehicles that depreciate *slower* than the schedule, owners *underpay*.

Our brief review of the current depreciation schedule indicates that it is a reasonable approximation of vehicle depreciation. While no schedule will depreciate each vehicle in the state perfectly, the current schedule appears to generally mirror the pattern of vehicle values. At the same time, if the Legislature chose to alter the depreciation schedule in order to change VLF revenues, it could consider an in-depth effort to ensure that any new schedule is based on real vehicle depreciation.

Changing the Tax Rate

Vehicles were originally taxed as a form of personal property, subject to the property tax. However, vehicles have been exempt from this form of taxation since the 1935 creation of the VLF. In 1935, the VLF tax rate was set at 1.75 percent, which approximated the average property tax rate

at the time. In 1948, the Legislature raised the VLF tax rate to two percent—reflecting the gradual increase in property tax rates. The VLF rate has not been changed since 1948, and the relative connection to the property tax rate has not been maintained.

Vehicles are not subject to the one percent rate cap imposed by the passage of Proposition 13 in 1978. Consequently, while homes are currently subject to a one percent property tax rate, vehicles are subject to a two percent fee.

Although the VLF rate has not been changed in 50 years, the rate can be lowered or raised by the Legislature. Changing the VLF rate for all vehicles would result in the same percentage change for each vehicle owner's fee. If the Legislature wished to raise or lower the VLF rate, revenues would change by about $200 million for each one-tenth of 1 percent change in the rate.

Exemptions

A final mechanism for changing the amount of VLF revenues would be to create an exemption for a certain level of a vehicle's value. For instance, Virginia recently enacted such an exemption for its taxation of vehicles.

With an exemption, a vehicle owner does not pay a fee on all of the vehicle's value. For example, with a $5,000 exemption, the first $5,000 of a vehicle's value would not be subject to a fee. Consequently, the owner of a $22,000 car would pay fees only on $17,000 of its value. In California, a $5,000 exemption would lower revenues by about $1.2 billion in 1998-99. At this exemption level, about one-third of all vehicles would pay no VLF.

CONCLUSION

The VLF is one of the state's major revenue sources, with collections expected to near $4 billion in 1998-99. Its collection procedure makes the fee quite visible, as it is due annually in a lump sum payment.

The Legislature could consider changes to the VLF either as a way of altering the cost of driving or as a means of providing general tax relief to Californians. A number of mechanisms—such as creating an exemption or changing the depreciation schedule or tax rate—exist to provide such a change.

The Legislature, however, should consider the implications for local governments of any VLF reductions. Most of the fees are sent to cities and counties as discretionary revenue. With many of their other revenue-raising mechanisms limited by law, VLF revenues are an important source of general purpose funds for local governments.