CALIFORNIA LEGISLATURE

1969 REGULAR SESSION

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1969, to June 30, 1970

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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LETTER OF TRANSMITTAL

STATE CAPITOL
Sacramento, March 1, 1969

THE HONORABLE STEPHEN P. TEALE, *Chairman*
and Members of the Joint Legislative Budget Committee
State Capitol, Sacramento

GENTLEMEN: In accordance with the provisions of Government Code, Sections 9140–9143, and Joint Rule No. 37 of the Senate and Assembly creating the Joint Legislative Budget Committee, defining its duties and providing authority to employ a Legislative Analyst, I submit an analysis of the Budget Bill of the State of California for the fiscal year July 1, 1969, to June 30, 1970.

The duty of the committee in this respect is set forth in Joint Rule No. 37 as follows:

> "It shall be the duty of the committee to ascertain facts and make recommendations to the Legislature and to the houses thereof concerning the State Budget, the revenues and expenditures of the state, and of the organization and functions of the state, its departments, subdivisions and agencies, with a view of reducing the cost of the state government, and securing greater efficiency and economy."

I should like to express my gratitude to the staff of the State Department of Finance and the other agencies of state government for their generous assistance in furnishing information necessary for this report.

The staff of your committee has worked with extraordinary diligence to complete this comprehensive report within the brief time available, and to these men and women I am especially grateful.

Respectfully submitted,

A. ALAN POST
Legislative Analyst

PRELIMINARY STATEMENT
of
BUDGET EXPENDITURES AND REVENUE

Form and Content of the Analysis

The Analysis of the Budget Bill is an annual report to the Legislature on the Budget of the State of California. It consists of two major sections.

The introductory section of the report contains a summary and general description of expenditures, particularly those of the General Fund, but also gives individual treatment to bond funds, federal funds and special funds. For the first time a number of copies of this section will also be separately bound as a partial printing for distribution to those who do not require the detailed analysis of individual budget items.

The section analyzes the estimated General Fund budget surplus and the cash position of that fund.

It contains a review of the revenues to the General Fund, including an evaluation of the economic assumptions and individual tax estimates.

State bonds, both authorized and outstanding, are described, including the relationship of bond financing to major construction requirements of such programs as higher education.

Federal aid is summarized and its trends and subject area applications compared with earlier years.

Following this introductory general description of expenditure and revenue aspects of the budget is a detailed analysis, with recommendations, of each appropriation item in the Budget Bill. These recommendations are primarily directed to specific efficiencies and economies capable of application in connection with Budget Bill appropriations, although the report also recommends changes in organization and improvements in management. While some of these proposals will require changes in statutes or in the Constitution, they are all within the power of the Legislature to effect or to initiate, and are presented in a manner which is intended to be responsive to the particular concerns and authority of the Legislature.

EXPENDITURE SUMMARY

Expenditure Program

Total state expenditures as proposed by the Governor, including bond funds, will reach $6,225.6 million in 1969–70. An additional $2,475.3 million in federal grants-in-aid and $448.2 million in federal reimbursements will be expended or subvened by state agencies. Together these programs total $9,149.2 million which the state will spend in 1969–70.

Bond expenditures and federal funds are not included in budget totals under standard accounting practices. These funds, however,

finance parts or elements of many programs listed in the budget and are separately identified and detailed in context with individual budget items in the budget document. In other cases bond and federal fund programs can be closely identified with separate state-budgeted programs. It is, therefore, important to group and summarize all these elements in order to show the total state involvement, a practice not followed in the budget document. Such a summary is shown in Table 1 for the 1967–68, 1968–69 and 1969–70 fiscal years.

Table 1

Combined Expenditure Program

	1967–68	*1968–69*	*1969–70*
State budget expenditures	$4,484,378,903	$5,455,580,386	$5,798,937,437
Bond Fund expenditures:			
State Construction Program and State Higher Education Construction Program Fund	137,623,594	83,483,863	11,688,737
Junior College Construction Program	23,985,995	17,234,533	29,158,625
California Water Resources Development Bond Fund	212,254,267	239,910,012	302,690,480
Central Valley Water Project Construction Fund	132,842,561	140,720,289	70,121,685
State Beach Park Recreational and Historical Facilities Fund	23,084,241	49,303,362	13,036,154
Total bonds	$529,790,658	$530,652,059	$426,695,681
Overall state expenditures	$5,014,169,561	$5,986,232,445	$6,225,633,118
Expenditures of federal funds:			
Grants-in-aid reimbursements and special projects	$2,507,997,723	$2,822,558,415	$2,923,519,665
Combined expenditure level	$7,522,167,284	$8,808,790,860	$9,149,152,783

A later section of this preliminary summary provides more data on the impact of federal funds on state programs. Another section on state bonded debt and debt service charges reflects the direct impact of bond programs on the General Fund. The inclusion of these over all expenditure totals here is for information only and conversely the immediately following sections exclude federal and bond funds and deal only with the General Fund and special fund expenditures which comprise the so-called state budget program.

Budget Totals and Distribution by Functional Categories

Total state budget expenditures which include the General Fund and special funds, but exclude bond funds, are proposed at $5,798.9 million for 1969–70 up $343.4 million, or 6.3 percent, over the $5,455.6 million estimated for 1968–69. This is $1,314.6 million more than the comparable budget total in 1967–68. The two-year gain is 29.3 percent, or an average of 14.6 percent a year taking the $4,484.4 million expenditure for 1967–68 as a base. The total amounts, as well as expenditures in the major functional categories are shown below for these three years.

	1967–68	*1968–69 (est.)*	*1969–70 (est.)*
State operations	$1,395,537,695	$1,606,433,243	$1,721,834,552
Local assistance	2,716,698,380	3,196,773,196	3,635,418,927
Capital outlay	372,142,828	652,373,947	441,683,958
Total Budget expenditures	$4,484,378,903	$5,455,580,386	$5,798,937,437

Local assistance is the fastest growing budget category, increasing $480.1 million, or 17.7 percent, from 1967–68 to 1968–69 and $438.6 million, or 13.7 percent, from 1968–69 to 1969–70. State operations increases $210.9 million, or 15.1 percent, from 1967–68 to 1968–69, and $115.4 million, or 7.2 percent, from 1968–69 to 1969–70.

Capital outlay comparisons, by years, is relatively meaningless and is, in fact, fictitious. This is because the middle year amount (1968–69 in this case) includes, in addition to regular expenditures, some continuing unspent special fund balances. Realistic budget practice would separate these fund balances, which are intended to be carried into the following year, from the true expenditure proposal. The largest individual budget in which this has been a continuing practice is that for the state highway program. This practice greatly distorts capital outlay comparisons, and in turn the budget totals are not relevant for interyear comparisons.

THE GENERAL FUND BUDGET

The major budget decisions are centered essentially in the General Fund. This is the major source of state financing for public schools, higher education, welfare and medical assistance, support for hospital and correctional institution populations, and other fast-growing programs. Because of the importance of the General Fund programs in the total state budget, we have endeavored to provide a perspective through more detailed discussion and analysis of the General Fund budget. The following sections will accordingly present information on:

1. Summary of General Fund expenditures.
2. Financing capital outlay for higher education.
3. Increases in major programs.
4. Why General Fund expenditures increase each year.
5. Specific program increases and their elements.
6. The financial condition of the General Fund.

Summary of General Fund Expenditures

The 1969–70 budget proposes $4,434.8 million in General Fund expenditures. This represents an increase of $435.0 million, or 10.9 percent, from the $3,999.7 million estimated expenditures for 1968–69. Compared to the actual General Fund expenditures of $3,272.8 million for 1967–68, it represents a two-year increase of $1,161.9 million, or 35.5 percent. These totals, as well as a functional breakdown by budget categories, are shown below:

	1967–68	*1968–69*	*1969–70*
State operations	$1,109,227,642	$1,275,924,768	$1,345,933,105
Local assistance	2,146,332,274	2,640,238,741	2,998,160,828
Capital outlay	17,249,378	83,550,104	90,656,758
Totals	$3,272,809,294	$3,999,713,613	$4,434,750,691

Here again, local assistance is the fastest growing category, increasing $493.9 million, or 23.0 percent, from 1967–68 to 1968–69 and $357.9 million, or 13.6 percent, from 1968–69 to 1969–70. The two-year growth for this category amounts to $851.8 million, or 39.7 percent.

For state operations the increase from 1967–68 to 1968–69 was $166.7 million, or 15.0 percent. From 1968–69 to 1969–70 a further increase of $70.0 million, or 5.5 percent, is anticipated.

Financing Capital Outlay for Higher Education

General Fund capital outlay expenditures have grown from $17.2 million in 1967–68 to an estimated $90.7 million in 1969–70. Most of this increase can be accounted for by the increasing demands on the General Fund for higher education capital outlay financing. This becomes evident if the proposed higher education outlay budget for 1969–70 is compared with that for 1967–68.

In the earlier year total such expenditures were $149.8 million. Of this, $145.7 million came from construction bond funds and $3.8 million was from special funds (tidelands oil); only $325,866 was from the General Fund.

In 1969–70 the proposed outlay total for higher education is $111.5 million, of which $29.2 million is from bond funds, and $13.0 million is from special funds (tidelands oil revenues), while $69.3 million is from the General Fund.

None of the bond fund financing for capital outlay in the 1969–70 budget is for the University of California or the state colleges because the proposed bond issue for this purpose failed to pass in 1968. All of it is scheduled for community colleges.

In spite of significantly higher construction costs anticipated in 1969–70, this budget includes only about $82.3 million (the combination of General Fund and tidelands moneys) for capital outlay for the University and the state colleges. This compares with the $125.8 million actually expended in 1967–68. The availability of General Fund financing has now become the critical factor in the capital outlay program as it is placed on a pay-as-you-go basis.

Aside from increasing the amount of money available, some of the major options that could be considered relative to capital outlay needs and resources are:

1. Improvement in utilization of existing facilities. This is discussed in the capital outlay section of this analysis.
2. Limitations on admissions.
3. Possibilities for reduced construction costs which would allow construction of more space for the same funding level. This is also discussed in the capital outlay section of the analysis.

Although the $82.3 million available for University and state college capital outlay in 1969–70 will not meet minimum requirements based on the current Coordinating Council for Higher Education space utilization standards, we believe it may be able to meet the needs of higher education if accompanied by a reasonable intensification of space utilization. This is discussed in our summary at the beginning of the capital outlay section in this analysis.

While intensification of space utilization standards might enable the proposed funding level to provide adequate space for the budget year and possibly for the 1970–71 fiscal year, it must be noted that this solution is temporary and that higher funding levels will probably be required thereafter to meet needs for academic student space, faculty offices, and auxiliary student space, based on projected enrollments.

Table 2

1969–70 Major General Fund Budget Changes From the 1968–69 Expenditure Level

	1969–70 Amount and Percent Increase Over 1968–69	
	(Millions)	*Percent*
Total increase in expenditures	$435.0	10.9%
The Major Program Increases		
Local assistance for public schools	$119.1	8.0%
Local assistance for social welfare	82.8	17.2
Salary increases	58.0[1]	—0.1[1]
Medical assistance	47.4	14.1
State colleges	35.5	14.8
Mental Hygiene, state support and local assistance	27.8	11.7
University of California	25.0	8.6
Correctional programs (Adult and Youth Authorities), state support and local assistance	15.2	10.4
Debt service on General Fund bonds and interest costs on short-term borrowings	15.4	11.7
Capital outlay	7.1	8.5
A Major Program Decrease		
Public Health, local assistance for hospital construction	—19.3	—100.0

[1] The salary increase amount approved for 1968–69 was $58.2 million.

Increases in Major Programs

Table 2 lists the General Fund items which show the largest expenditure increases between 1968–69 and 1969–70. It is apparent that the fastest growing areas of General Fund cost are education and welfare. If the various education and welfare components shown in the table are combined, they account for $309.8 million, or 71.2 percent, of the total increase of $435.0 million between the two years.

The following sections consider some of the factors which cause General Fund expenditures to rise, as well as some of the specific influences that directly bear on the major items listed in Table 2.

Why General Fund Expenditures Increase Each Year

The proposed increase of $435.0 million in General Fund expenditures in 1969–70 reflects numerous forces.

1. State Population. California's population will increase from an estimated 19,948,500 on January 1, 1969, to 20,296,000 on January 1, 1970. This is an increase of 347,500, or 1.7 percent. Although this represents an increase in people, it also reflects a continuation of the diminishing rate of population growth characteristic of the last few years. Moreover, all age groups of the population do not increase at the same rate. For instance, one of the fastest growing segments is college-aged youth. This group will grow from an estimated 2,380,600 on January 1, 1969, to 2,514,650 on January 1, 1970, an increase of 5.6 percent. In turn, this high rate of increase will be reflected in larger enrollments and higher expenditures for state institutions of higher learning.

2. Price Increases. The state is a major purchaser of various types of services. Prices of these and other items the state buys are increasing rapidly. This is illustrated for the latest available comparative months, a year apart, in the price indexes below based on a consumer price level of 100 in the base year period 1957–59.

	December 1967	December 1968	Increase	Percent
Consumer prices (U.S.)	118.2	123.7	5.5	4.7%
	November 1967	November 1968	Increase	Percent
Services (U.S.)	129.6	137.4	7.8	6.0%
Medical care (U.S.)	139.7	148.2	8.5	6.1%

3. Salary and Wage Rates. A large element of state expenditures is salary and wages either directly through the state payroll or indirectly through subventions and other programs. Comparative rates are rising very rapidly according to the last Personnel Board survey, which indicated a prevailing wage (comparative wages paid in private industry and government) increase of 3.9 percent between March and October 1968 and anticipates a total increase of over 6 percent from March 1968 to March 1969.

4. Program Augmentations. Program augmentations proposed in the 1969–70 budget total $235.8 million. Of this amount $189.9 million is for General Fund programs, $34.2 million is in special fund items and $11.6 million is financed from federal funds.

These augmentations as stated in the budget include "... all recommended expenditures for new programs and intensification or increase in services or other expansions." There is a workload element in varying degree in some of the augmentations, as for example, school apportionments and salary increases.

The following summary shows the functional categories containing the General Fund program augmentations and indicates General Fund expenditures proposed in each.

Education	$698,000
Higher education	3,709,827
Health and welfare	17,003,029
Corrections	531,668
Resources	1,840,592
Business and commerce	191,688
Administration and fiscal management	236,657
Other	2,173,046
School apportionments	105,500,000
Salary increases	58,041,430
Total	$189,925,937

Of this total, $72.3 million is in assorted items of state support, the major one being $58.0 million for salary increases. There is also $117.6 million in local assistance programs. The largest single augmentation is $105.5 million for workload and improvement in the level of service provided by school apportionments.

5. Fixed Expenditures. A large part of state expenditures is fixed by constitutional or statutory provisions. It is estimated that only $2,309.1 million, or 52.1 percent, of the proposed 1969–70 General Fund expenditures is subject to review by the Legislature in the Budget Bill. The remainder, which includes some of the fastest growing programs in relation to state costs such as debt service, school apportionments, welfare, and medical services, is fixed by formula and other provisions in the Constitution or in the statutes. Therefore, these increase proportionally to changes in the factors. Revision of the Constitution or statutes would be required to alter the situation.

6. Incidence of Disease, Crime, Delinquency, and Other Social Problems. The state is heavily committed in providing services to these elements through mental hygiene, public health, welfare, and correctional agencies. Although some of these programs are included for legislative review in budget act appropriations, an important element is, nevertheless, the influence of population factors such as growth in admissions, and resident populations, and caseloads, which must be provided for and therefore limit legislative options for budget action. This growth reflects in program workload and unless it can be reduced by specific legislative action, the budgets will automatically increase each year.

Elements Involved in Specific Program Increases

The influence of the above factors on specific General Fund programs in which the major increases in expenditures for 1969–70 over 1968–69 are centered is illustrated in the following program summaries. More detailed information can be obtained by referring to the program discussions in appropriate sections of the analysis.

Education

	1968–69	*1969–70*	*Increase*	*Percent*
Local assistance for education	$1,480,823,306	$1,599,878,372	$119,055,066	8.0
1. School apportionments	$1,281,574,000	$1,392,243,600	$110,669,600	8.6
Includes program augmentation		($96,000,000)		
Average daily attendance				
K–8	3,253,240	3,255,000	1,760	0.1
9–12	1,251,825	1,305,000	53,175	4.2
13–14	308,183	345,000	36,817	11.9
Adults	125,141	135,000	9,859	7.9
Total a.d.a.	4,938,389	5,040,000	101,611	2.1
2. Compensatory education	$11,000,000	$11,000,000	--	--
Includes program augmentation		($9,500,000)		

An increase of $119.1 million over 1968–69 expenditures is proposed in local assistance for education. More than $110 million of this is for school apportionments and $7.5 million of the remainder is for contributions to the Teachers' Retirement Fund for which expenditures are proposed to increase from $71.5 million in 1968–69 to $79 million in 1969–70.

For the Compensatory Education program the budget shows expenditures of $11 million for 1968–69 and $1.5 million for 1969–70, plus a proposed program augmentation of $9.5 million. This is a fictitious augmentation in that it merely maintains the same level of expenditure as in 1968–69 by assuming continuation of statutory authorization.

Of the total increase of $110.7 million, or 8.6 percent in school apportionments, $96 million is a special augmentation item which includes $3.5 million in additional funds for the mentally gifted and $92.5 million for basic equalization supplemental aid. The latter figure of $92.5 million includes $16 million which is necessary because of a modification of federal legislation (PL 90-874). The federal change provides that federal funds can no longer be considered a measure of local ability for purposes of state equalization aid. The special augmentation amount proposed is also based on the assumption that a

5-percent limitation will be imposed on budget increases for the Educationally Handicapped and Special Education programs.

Attendance at the elementary level (K–8) is expected to remain about stationary between 1968–69 and 1969–70. On the other hand, an 11.9 percent increase is expected for junior college level a.d.a. These differences reflect the changing age group mix with a lower birth rate trend already influencing elementary enrollment and the impact of the population bulge after World War II tapering off at the high school level and now centering in the colleges.

Social Welfare

	1968–69	*1969–70*	*Increase*	*Percent*
Department of Social Welfare—State General Fund only				
Total local assistance	$479,185,523	$561,959,649	$82,774,126	17.3
Major welfare programs				
1. Old Age Security	$163,451,300	$173,098,600	$9,647,300	5.9
Average caseload	301,600	310,600	9,000	3.0
Average monthly grant amount	$104.75	$107.81	$3.06	2.9
2. Aid to Families with Dependent Children	$198,609,200	$255,757,600	$57,148,400	28.8
Family group—recipients	894,900	986,400	91,500	10.2
Average monthly grant amount per recipient	$50.15	$52.32	$2.17	4.3
Foster home—recipients	29,300	32,100	2,800	9.6
Average monthly grant amount per recipient	$118.00	$125.00	$7.00	5.9
3. Aid to Needy Disabled	$89,992,200	$102,965,200	$12,973,000	14.4
Average caseload	141,300	157,000	15,700	11.1
Average monthly grant amount	$118.67	$122.18	$3.51	3.0

State expenditures for the Department of Social Welfare are budgeted to increase by over $82 million or 17.3 percent, between 1968–69 and 1969–70. Most of the increase is centered in the three major programs identified above. Included in the above totals is a program augmentation of $1,874,500 for strengthening the special social service programs. The Aid to Families with Dependent Children program with an increase of over $57 million accounts for 69 percent of the total increase. This rapidly growing program is budgeted for a 28.8-percent increase in expenditures and a total increase in recipients of 94,300, or 10.2 percent, when the two groups of recipients are combined.

The Aid to Needy Disabled program is also expanding at a rapid pace with an increase of $13.0 million, or 14.4 percent. The caseload is slated to expand by 15,700, or 11.1 percent, and the average monthly grant is expected to increase by 3 percent.

A continued steady expansion in expenditures for an increase above 1968–69 of $9.6 million, or 5.9 percent, and a caseload increase of 9,000, or 3.0 percent, is budgeted for 1969–70 for the Old Age Security program. This does not include a program augmentation item totaling $1.5 million for unmet shelter needs.

Total State Employee Costs Increasing

Total salary and wage costs are a large and growing element of the state budget. Direct salary and wage costs including civil service, exempt, University of California, and state college employees are

shown in the schedule below together with estimated personnel man-years for the 1968–69 and 1969–70 fiscal years.

These figures include salary costs and man-years of personnel paid from both general and special funds. They represent, however, only salaries paid directly by the state. Not included are indirect salary costs which are funded through state subventions such as those for education and other purposes.

	1968–69	*1969–70*	*Increase*	*Percent*
Direct salary and wage cost estimates[1]	$1,603,660,622	$1,786,934,759	$183,274,137	11.4
Personnel man-years[1]	175,839	183,579.7	7,740.7	4.4

[1] Includes both general and special funds.

Health Care Services

	1968–69	*1969–70*	*Increase*	*Percent*
Medical assistance	$336,000,000	$383,395,793	$47,395,793	14.1
Program augmentation	--	4,000,000	4,000,000	--
Medi-Cal eligibles	1,647,400	1,809,200	161,800	9.8

The medical assistance program continues to be one of the fastest growing areas of state costs with a 14.1-percent increase in expenditures between 1968–69 and 1969–70. The increase amounting to $47.4 million reflects the 161,800 increase (of 9.8 percent) in Medi-Cal eligibles. Also of major significance affecting program costs are rapidly rising costs for hospital care, doctors' fees, and other medical services.

The 1969–70 budget proposes a program augmentation of $10 million for medical fees and related services cost increases. It is tentatively proposed that $4 million be allocated to the California Medical Assistance program as shown above. The remaining $6 million would go to other programs, mainly to the Department of Social Welfare.

Higher Education

	1968–69	*1969–70*	*Increase*	*Percent*
State colleges	$239,377,566	$274,833,736	$35,456,170	14.8
Enrollment (FTE)	165,170[1]	180,815	15,645	9.5

[1] This includes current-year overenrollment adjustment.

The proposed support increase for the state colleges of $35.5 million includes $1.3 million in a special augmentation item for instructional purposes such as sabbatical leaves, recruitment and instructional EDP applications. It also includes $100,000 for additional plant security.

Continued rapid expansion is evident in the state college program with enrollment increasing by 15,645, or 9.5 percent, and the total proposed expenditure program showing an increase of 14.8 percent over the 1968–69 level.

	1968–69	*1969–70*	*Increase*	*Percent*
University of California	$291,039,045	$316,000,000	$24,960,955	8.6
Average annual student enrollment (FTE)				
Lower division	30,851	31,546	695	2.3
Upper division	37,774	41,465	3,691	9.8
Graduate	34,884	34,819	—65	—0.2
Total	103,509	107,830	4,321	4.2

State expenditures for the University are proposed to increase by $25 million, or 8.6 percent. Matched against this is an increase in total

average student enrollment of 4,321, or 4.2 percent. The major portion of the student enrollment increase is in the upper division which accounts for 85 percent of the total enrollment increase. A small decline is estimated in the average number of graduate students.

A special augmentation in the amount of $1.3 million is included in the proposed budget increase. Of this amount $600,000 is for special projects in the urban crisis field and $300,000 is for improvement in organized research.

Mental Hygiene

Mental Hygiene	*1968–69*	*1969–70*	*Increase*	*Percent*
Support	$206,656,429	$117,641,784	—$89,014,645	—43.1
Local assistance	30,625,000	147,465,647	116,840,647	381.5
Totals	$237,281,429	$265,107,431	$27,826,002	11.7

The budget shows $147.5 million as local assistance attributable to Chapter 989 (AB 1454), Statutes of 1968. For clarification we have prepared the following breakout of the various programs which differs from the budget, especially in the amount for local assistance.

General Fund Support for Department of Mental Hygiene Activities
(In thousands)

	1968–69	*1969–70*	*Increase or decrease*
Administration and research	$7,070	$8,432	+$1,362
Neuropsychiatric institutes	11,737	13,168	+1,431
Cost of operating hospitals for mentally ill (including $3,777,000 program augmentation) [1]	127,605	127,907	+302
Closure of Modesto			—1,100
Hospitals for mentally retarded (includes $893,000 in program augmentation) [2]	60,335	62,774	+2,439
Local assistance	30,625	53,925	+23,300
Totals	$237,372	$266,206	+$27.734

[1] Of this, $2,674,983 is for additional treatment staff (238 new positions plus retention of 547 existing positions that would be dropped on a workload basis). An additional $520,192 is for 100 new positions for plant maintenance, and $450,000 is for increased operating expenses—personal care, clothing, housekeeping, etc.
[2] Of this, $307,273 is for additional treatment staff, $170,642 is for plant and maintenance personnel, and $200,000 is for operating expenses.

The breakdown of the $23.3 million increased local assistance is as follows:

	Millions
Conversion from 75%–25% cost sharing to 90%–10%	$6.8
Inflation	4.0
Program expansion, continuing jurisdictions	7.0
New jurisdictions	1.3
Transfer to Health Care Deposit Fund	1.0
Fourth-quarter adjustment	2.7
One cent per $100 of assessed valuation	0.5
	$23.3

The total General Fund increase of $27.7 million is misleading. The budget shows as a revenue the amount of state hospital cost which is to be paid by the counties. The county share is estimated to be $6,509,-239 for the 1969–70 fiscal year. In order to show accurately the increased General Fund support of mental hygiene activities, this $6.5 million should be deducted from the $27.7 million, leaving the actual net amount of $21.2 million.

Corrections

Correctional programs	1968–69	1969–70	Increase	Percent
1. Support				
Department of Corrections	$91,016,889	$95,071,600	$4,054,711	4.5%
Average daily population	28,703	28,965	262	0.9
Average per capita yearly costs	$2,736	$2,827	$91	3.3
The Youth Authority	$43,899,287	$47,729,400	$3,830,113	8.7
Average daily population	5,563	5,915	352	6.3
Average per capita yearly costs	$5,844	$6,091	$247	4.2
2. Local assistance				
Assistance to counties for special supervision programs	$7,465,735	$12,760,000	$5,294,265	70.9

The steady expansion of the correctional budgets in prior years will continue into 1969–70. While only a 0.9 percent increase in average daily institution population is estimated for the Department of Corrections, average yearly per capita costs will increase 3.3 percent. The Youth Authority is growing at a faster rate than the Department of Corrections in relation to both population and per capita costs. In fact the 8.7 percent overall growth rate in expenditures is almost double the 4.5 percent increase for the Department of Corrections.

Assistance to counties for special supervision programs is the most rapidly expanding element in correctional expenditures. The purpose of this program is to reduce commitments to state institutions by paying a subsidy to the counties for special probation supervision in lieu of committing them to state correctional institutions. This helps alleviate the need for construction of new state institutions.

Debt Service

Debt service costs	1968–69	1969–70	Increase	Percent
Bond interest and redemption	$131,849,625	$147,264,776	$15,415,100	11.7%
Interest on short-term loans	$2,234,000	$3,000,000	$766,000	34.3%

Debt service costs on bond programs represent both interest and redemption costs on state General Fund bonds such as those issued for state construction, higher education construction, beaches and parks, junior college construction, and the State General Fund share of school building aid bonds. Not included is debt service charges for water bonds, veterans bonds, and other programs in which program revenue is expected to liquidate all debt service charges.

Interest on short-term loans represents costs to the General Fund for money borrowed from other funds during periods of revenue shortages to meet expenditure requirements in the General Fund.

Capital Outlay

	1968–69	1969–70	Increase	Percent
General Fund total capital outlay	$83,550,104	$90,656,758	$7,106,654	8.5%
Higher education capital outlay	53,200,768	69,268,500	16,067,732	30.2
Construction cost index	*January 1968*	*January 1969*		
United States[1]	1,115	1,225	110	9.9
California[2]	401	430	29	7.2

[1] Engineering News Record Index, 1926-100.
[2] State Office of Architecture and Construction Index, 1946-100.

Of the $90.7 million in General Fund capital outlay expenditures proposed for 1969–70, $69.3 million, or 76.4 percent, is for higher

education capital outlay. The latter, together with approximately $13 million from the Capital Outlay Fund for Public Higher Education, will make a total of approximately $82.3 million for education. As we have noted this total will not meet minimum needs based on present coordinating council for higher education space utilization standards, but we believe that by reasonable intensification of space utilization it may meet the needs of higher education.

Construction costs are rising very rapidly as indicated by comparing the January 1968 and January 1969 levels both for the United States and for California. The increase in total General Fund capital outlay expenditures of 8.5 percent will be nearly offset if the cost index continues to rise at about the rate (7.2 percent) that it has in the recent past.

Justice

	1968–69	*1969–70*	*Increase*	*Percent*
Department of Justice (General Fund only)	$17,705,877	$20,041,619	$2,335,742	13.2%

The proposed General Fund increase of $2,335,742 for the Department of Justice includes a program augmentation of $1.7 million of which $1.2 million will be used to implement the Criminal Justice Information System (CJIS) while the remainder will be used to meet increased workload. It should be noted that an additional $346,048 from the Motor Vehicle Fund will also go to CJIS, bringing the total augmentation to $2,016,766 for this purpose.

General Fund Financial Picture

Changes in 1968–69 Surplus Picture

The General Fund financial picture for the 1968–69 fiscal year has brightened a great deal since the budget was originally presented a year ago. This has happened because the amount of General Fund revenue now expected to be collected for the year will substantially exceed that originally estimated. As adjusted for legislative changes during the session, the 1968–69 revenues were budgeted at $3,823.7 million. Since that budget was presented a year ago, revenue estimates for 1968–69 have been revised so that in the 1969–70 budget document they are shown at $4,068.1 million. This is $244.4 million, or 77.8 percent, more than the $314.2 million increase estimated in the original budget over the estimated revenues collected in 1967–68.

This adjustment has increased the General Fund free surplus from $9.3 million, as estimated in the original budget, to $247.2 million at June 30, 1969. It is now estimated by the Department of Finance that the cash balance in the treasury will total $239.7 million on June 30, 1969, as compared to the $1.1 million in cash estimated for that date in the original budget.

General Fund Condition in 1969–70

The 1969–70 fiscal year will therefore begin with a large surplus. This together with anticipated General Fund income is expected to support an increased level of expenditure and to provide a free surplus balance of $40.1 million at the end of the 1969–70 fiscal year as shown in Table 3.

This in essence is the current appraisal of General Fund condition on the accrual basis as made by the Department of Finance. It is subject to further change as a result of:

1. Revised revenue estimates in both the current and the budget years.
2. Changes and adjustments in proposed expenditures as a result of legislative action on the budget or because of program cost revisions.
3. New legislation, revising taxes or altering program costs.
4. Changes in federal laws, regulations and procedures affecting California.

The estimated income to the General Fund for 1969–70 is comprised of $4,323.1 million in revenues, discussed in detail in later sections of this analysis, and $2.9 million in transfers into the General Fund from other state funds. The transfers consist of $2,652,479 from the Department of Employment Contingent Fund and $250,000 from the State Water Quality Control Fund.

The estimated total income of $4,326 million is reduced by $100 million to provide funds for the proposed income tax reduction. This would be a one-time reduction applying alone to the 1969–70 fiscal year. Net income of $4,226 million would therefore be available and apply against 1969–70 expenditures.

The $4,434.8 million in General Fund expenditures proposed for 1969–70 provides for continuing the property tax relief program initiated in 1968–69, and an increase in General Fund capital outlay expenditures of about $7.1 million to the $90.7 million level for pay-as-you-go capital outlay in lieu of bond financing. The remainder will finance on-going programs for the most part providing for formula or workload adjustments and for augmentations to increase the level of service or to provide new services in a number of General Fund supported areas. This includes $190 million for a proposed series of program augmentations.

A provision is also made to adjust resources at year and by $14 million in order to carry over this amount for expenditure commitments for which the actual cash funding will not be required until a later date.

The Department of Finance is continuing to adjust accrual revenues by including the $194 million so-called reserve for working capital in 1969–70. This is stated to represent ". . . . a budgetary reserve for working capital so that the General Fund will not have to borrow more than it can repay at the end of any fiscal year. It represents an amount of accrued revenue that cannot be appropriated for expenditure without leaving a cash deficit in the General Fund at the end of any fiscal year."

On the basis of the anticipated carryover surplus at the end of 1968–69, and the income and expenditure projections for 1969–70, a free surplus available for appropriation of $40.1 million on the accrual basis and a cash balance of $3 million is estimated by the Department of Finance on June 30, 1970. The estimate of General Fund condition as of June 30, 1970, on the accrual basis, as well as the components that are involved is shown in Table 3.

Table 3
Estimated General Fund Condition, 1969–70

	Millions
Prior-year resources (Including free surplus of $247.2 million)	$456.9
Income	4,326.0
Total resources	$4,782.9
Proposed income tax reduction	—100.0
Resources available	$4,682.9
Expenditures	4,434.8
Ending resources June 30, 1970	$248.1
Adjustments	
Reserve for working capital	—194.0
Committed reserves	—14.0
Free surplus June 30, 1970	$40.1

Appraisal of General Fund Year-End Cash Condition

The cash balance in the Treasury at June 30, 1970, is estimated to total $3 million in contrast to the $40.1 million estimated free surplus on the accrual basis. The estimated beginning cash balance, cash receipts and disbursements and this estimated ending cash balance are shown below:

	Millions
General Fund cash balance available June 30, 1969	$239.7
Total cash receipts during 1969–70	4,333.6
Total available	$4,573.3
Total disbursements during 1969–70	4,570.3
Ending cash balance June 30, 1970	$3.0

The above schedule shows the estimated cash requirements for the General Fund exactly as it is proposed in the budget. It is emphasized that any changes made to the budget during the session will have an influence on the cash as well as the accrual position of the General Fund.

In this respect it is appropriate to analyze the estimated $40.1 million accrual surplus, the $3 million cash balance and the $194 million reserve for working capital assuming that income and expenditure estimates for 1969–70 are valid. Several questions are raised:

1. Why is the so-called reserve for working capital continued in the same amount ($194 million) as in prior years?

2. Is the $194 million reserve the proper amount to insure cash liquidity and prevent a cash deficit?

3. What adjustments will take place in the $3 million cash balance in the General Fund if all or part of the so-called free surplus of $40.1 million is committed for expenditure in 1969–70?

These observations are made under the assumption that should General Fund expenditures be increased, thus utilizing a significant part of the $40.1 million surplus, it will cause cash disbursements to rise and a cash deficit to ensue at year end if this increase is more than

the $3 million cash balance estimated. It would appear illogical to expect that all the increase in cash requirements would come after the end of 1969–70. In fact usually only a small portion (depending on individual programs) of the bills generated from additional expenditures can be expected to come in after year end.

Under these circumstances the $194 million reserve appears to be inadequate to protect the cash balance of the General Fund and the so-called free surplus should not be classified as a surplus, at least not in the sense of being available for appropriation. A more realistic estimate of free surplus (accrual basis) would appear to be around the $10 million level if cash is to be properly protected and a year-end cash deficit is to be prevented. Of course, should the expenditure level not be increased to utilize the "surplus" this problem would not materialize. But, even so, it is a misnomer to call it a free surplus.

This indicates that there is no particular adequacy in the $194 million reserve for working capital just because it has been the figure used in the past. Perhaps for 1969–70 the amount should be increased to $225–$235 million if its purpose is to actually protect the cash position of the General Fund and prevent a cash deficit. This adjustment would accordingly reduce the so-called free surplus on the accrual basis to about the same level as the cash balance instead of the $40.1 million estimated by the Department of Finance.

There is also another question that arises should the actual cash balance at June 30, 1970, be only $3 million. What means will be used to raise the approximately $45 million in debt service charges due on a cash basis on July 1, 1970? Heretofore there has been a sufficient cash balance in the Treasury at June 30 of the prior year to meet this obligation when due or the Controller has reserved a sufficient sum of cash (excluded it from free surplus) to pay the debt service charges. If sufficient cash is not available on July 1, 1970, for this purpose, the General Fund will probably have to resort to immediate borrowing.

Appraisal of Expenditure Estimates

While considerable attention is focused on actual revenues compared with original estimates, far less attention is directed to comparing actual expenditures with the amounts estimated.

The proposed total expenditure in the budget as submitted, before legislative action on the budget and other cost bills, does not provide a very meaningful comparison with actual expenditures compiled after the year is completed. A more appropriate comparison can be made by using the reestimated expenditure amounts which show as the middle year in the budget document. This estimate is made one year after that budget was first submitted and about six months before the end of the fiscal year. It is usually affected only to a very limited extent by subsequent legislation—primarily deficiency appropriations.

These reestimated or "current-year" estimates are compared with actual expenditure totals in Table 4 for each year from 1950–51 to 1967–68, the last year for which actual figures are now available.

Table 4

General Fund Expenditures 1950–51 to 1967–68
(Mid-Year Estimates as Compared to Actual Expenditures)

	Reestimated total expenditures [1]	*Actual total expenditures*	*Actual as compared to reestimate*	*Percent change*
1950–51	$602,603,665	$588,508,776	$—14,094,889	—2.34%
1951–52	701,029,126	686,297,740	—14,731,386	—2.10
1952–53	870,512,611	846,314,812	—24,197,799	—2.78
1953–54	851,391,654	843,854,948	—7,536,706	— .09
1954–55	879,316,502	903,568,668	+24,252,166	+2.76
1955–56	954,012,232	941,966,322	—12,045,910	—1.26
1956–57	1,123,661,316	1,118,828,251	—4,833,065	— .04
1957–58	1,257,611,703	1,246,461,777	—11,149,926	— .09
1958–59	1,288,596,656	1,280,005,534	—8,591,122	— .07
1959–60	1,469,913,183	1,437,240,427	—32,672,756	—2.22
1960–61	1,717,690,140	1,683,842,533	—33,847,607	—1.97
1961–62	1,743,503,536	1,697,433,387	—46,070,149	—2.64
1962–63	1,919,109,887	1,881,134,298	—37,975,589	—1.98
1963–64	2,119,356,130	2,064,120,453	—55,235,677	—2.61
1964–65	2,389,496,433	2,344,841,208	—44,655,225	—1.87
1965–66	2,664,132,185	2,579,618,697	—84,513,488	—3.17
1966–67	2,998,946,029	3,017,197,433	+18,251,404	+ .06
1967–68	3,328,269,430	3,272,809,294	—55,460,136	—1.67
Net Total 1950–51 to 1967–68			$—445,107,860	
Average Net Difference Each Year			—24,728,214	

[1] Estimate made about six months before end of the fiscal year, and includes the effect of estimated budget savings.

The table indicates that in all but 2 of the 18 years compared actual expenditures were lower than the reestimated or current-year estimates. The net total overestimate for the entire period exceeds $445 million, with the yearly expenditures averaging $24.7 million less than the estimates.

For 1954–55 the estimate was $24.3 million lower than the actual and in 1966–67 it was $18.3 million lower. These are the only years in which the estimates were lower than actual expenditures. The most accurate estimate was for the 1956–57 fiscal year when the estimated amount was only $4.8 million, or 0.04 percent, higher than the actual. Conversely, the largest estimating error was made in 1965–66 when actual expenditures were $84.5 million, or 3.17 percent, less than the estimate.

Because these estimates are on the average too high by about $25 million, General Fund surplus estimates made at the same time are, therefore, on the average too low by this same amount. However, it must be recognized that it would be impractical to merely adjust the surplus estimates upward each year by the $25 million average figure cited because the range in deviations from the average expenditure estimates are between $59.8 million above the average and $49 million below the average. Also, in two years the actual was higher than the estimates and consequently surplus was lower than estimated when this factor is considered alone.

The implications for the current year, 1968–69, therefore, are that while the chances are good that actual expenditure totals will be lower than the estimated amount listed in the 1969–70 budget for 1968–69, this is no basis upon which to prescribe an increase in the estimated year-end surplus.

STATE GENERAL OBLIGATION BOND PROGRAMS AND GENERAL FUND DEBT SERVICE REQUIREMENTS

State Bond Debt Increases

State general obligation bonds outstanding totaled $4,797,934,000 as of December 31, 1968. This was an increase of $321,768,000 over the $4,476,166,000 outstanding at the end of 1967.

General obligation bonds consist of two types (1) General Fund bonds, and (2) self-liquidating bonds. In both cases the full faith and credit of the state is pledged to repay the bondholders even though revenues to be collected from the projects financed by self-liquidating bonds are anticipated to be sufficient to pay all debt principal repayments and interest costs. This includes such bond programs as water development, the veterans' farm and home purchase program, and harbor development. In the event revenues to be derived from these programs are insufficient, the General Fund would be responsible for any deficit.

The General Fund bonds consist of programs for which the debt repayment and interest costs are regularly paid from the General Fund. Major programs financed in this manner are state construction, higher education construction, state beaches and parks development, junior college construction assistance, and state aid for school building construction in which the public school districts as well as the state participate in repaying the bonds and the interest costs.

Other bonds are also issued by various state agencies but these are not general obligations of the state. That is, they have no guarantee that payment will be made from the General Fund in case of default. These are classified as revenue bonds and are issued for constructing toll bridges, water projects, University and state college housing, the California Exposition and other programs. These programs are mentioned only to indicate the various types of state bonds issued. The remainder of this section deals only with general obligation bonds and mainly with General Fund bonds because of their direct impact on the state budget.

The amounts outstanding as well as the amounts of bonds authorized by the people but as yet unsold (general obligation bonds must be approved by majority vote of the electorate) are shown in Table 5.

Table 5

General Obligation Bonds of the State of California by Purpose
As of December 31, 1968

Purpose	*Unsold*	*Outstanding*
General Fund Bonds		
California Tenth Olympiad of 1927 [1]	--	$75,000
State Construction	$60,000,000	855,000,000
Beaches, Parks, Recreational and Historical Facilities	75,000,000	71,300,000
State Higher Education Construction	80,000,000	148,400,000
Junior College Construction	50,000,000	15,000,000
School Building Aid	275,000,000	1,211,900,000
Totals	$540,000,000	$2,301,675,000
Self-Liquidating Bonds		
Water Resources Development	$600,000,000	$1,150,000,000
Veterans' Farm and Home	200,000,000	1,290,200,000
Harbor Bond Funds	8,197,000	56,059,000
Totals	$808,197,000	$2,496,259,000
Totals, All Bonds	$1,348,197,000	$4,797,934,000

[1] Although classified as a general fund bond program, debt service is actually being paid from sinking fund balances in the Olympic Bond Fund.

Bond Market Conditions in 1968

General obligation bond sales totaled $490 million during 1968, as compared to $585 million in 1967 and $500 million in 1966. Sales in 1968 were comprised of the following amounts in the programs indicated:

	Sales in Millions
Water Resources development	$200
Higher Education construction	100
State School Building Aid	60
State construction program	40
Veterans' Farm and Home program	75
Junior college construction	15
Total sales	$490

Reflecting tight monetary conditions and competition with bonds of other jurisdictions during the year, interest rates on sales of state general obligation bonds were at an extremely high level, varying between 4.27 percent and 4.62 percent. Continued marketing difficulty is expected in 1969 with water program bonds again leading in sales. The general trend in interest rates is evident when compared with a range of 2.87 percent to 3.30 percent on state bond sales in 1958.

Debt Service Costs on General Fund Bonds

It is important to consider the impact of the General Fund bond programs on the General Fund budget, and this depends upon the extent to which alternatives are utilized. If pay-as-you-go is used to finance capital outlay for state construction, bond costs are avoided but General Fund expenditures (supported by taxes) immediately rise to pay the costs. If, on the other hand, the General Fund bonding programs are continued, General Fund expenditures for debt service rise but after a delay and will remain at this higher level over about a 25-year period. The final cost is much higher because of interest costs. Some combination of these alternatives may be appropriate. In fact the state is currently funding the major part of higher education capital outlay directly from the General Fund. At the same time, however, the General Fund must now meet large debt service obligations as a consequence of past bonding programs as shown in Table 6.

A $65 million issue of bonds for junior college construction was approved by the people at the June 1968 primary election. However, a $250 million bond issue for higher education construction and urban school district construction aid was presented to the electorate in November 1968 and failed passage. No additional bond funds are, therefore, available for the University of California and state college construction needs in 1969–70. The capital outlay program for these agencies is consequently on a pay-as-you-go basis at a reduced level and is now financed primarily from the General Fund. A lower rate of bond sales as a result of the defeat of the proposed new issue last year and other factors will reflect in a gradual tapering off of outstanding bonds and a subsequent decline in debt repayment and interest costs borne by the General Fund.

Table 6

Debt Service Costs to the General Fund for State General Obligation Bond Programs—1960–61 to 1969–70
(In thousands of dollars)[1]

	Total	*School Building Aid Bonds*[2]	*State Construction and Other Bonds*[3]
1960–61	$36,484	$20,387	$16,097
1961–62	42,877	26,401	16,476
1962–63	59,198	36,770	22,428
1963–64	62,694	35,690	27,004
1964–65	75,865	45,411	30,454
1965–66	87,402	50,110	37,292
1966–67	103,114	52,574	50,540
1967–68	115,429	52,452	62,977
1968–69 est.	131,304	53,678	77,626
1969–70 est.	147,386	55,057	92,329

[1] Cash basis for all years.
[2] Includes only State General Fund portion of total debt service charges for these bonds.
[3] Includes State Construction Program bonds, State Higher Education Construction bonds, State Beach, Park, Recreational and Historical Facilities bonds, junior college construction bonds, and several small bonding programs that were paid off before 1966–67.

The annual bond debt service costs supported by the General Fund have grown from a total of $36.5 million in 1960–61 to an estimated $147.4 million in 1969–70. This is an increase of $111 million or about three times in 10 years. Debt service costs include both interest and bond redemption payments. A separation of General Fund bonds into these two categories as estimated for 1969–70 is shown in the following schedule.

	Total Debt Service Charges	*Interest*	*Redemption*
School Building Aid Bonds[1]	$55,057,033	$23,123,973	$31,933,060
State Construction Program and other bonds	92,329,120	46,504,120	45,825,000
Totals	$147,386,153	$69,628,093	$77,758,060

[1] Includes only State General Fund portion of total debt service charges.

Debt service charges on the school building aid bonds are shared by the state and the individual school districts that are eligible and participate in the program. The total combined state and school district debt service charges on these bonds for 1969–70 is estimated at $97,957,033. Of this the State General Fund's portion, $55,057,033, is 56 percent and the districts' portion, $42,900,000, is 44 percent. In 1960–61 the school districts paid 45 percent of the total.

Only school districts that have issued their own bonds to the extent of 95 percent of the maximum for which each district is qualified, or within $25,000 of this 95-percent requirement, may apply for state loans supported by the State School Building Aid Bonds. The loans are repaid on the basis of a formula involving a district's assessed valuation and computed debt service payments for each fiscal year. The state permits the districts to repay over a 30-year period and in certain instances, based on reduced ability, an additional 10 years may be added to the repayment period.

Bond Program Balances Available for Appropriation

The amount of unsold bonds shown in Table 5 for each program is not equivalent to the amount of bond funds available for appropriation in those cases in which these funds are appropriated in the budget act. In many instances, nearly all these funds, even though the bonds have not all been sold, have already been appropriated in prior or current budgets. Sales are made only as actual cash is needed and this at times may involve extended delay after the funds are actually committed by the budget act. The schedule below shows the amount of surplus anticipated to be available for appropriation on June 30, 1970, in the various bond funds for which the expenditures are appropriated through the budget act.

	Balance Unappropriated 6-30-1970
State construction program	$11,397,434[1]
Beaches, parks, recreational and historical facilities	15,722,913
State higher education construction	1,161,977
Junior college construction	18,606,842

[1] Of this amount $11,291,362 is available for the state facilities program, not exclusively for higher education, and $106,072 is earmarked for junior college construction.

STATE PARTICIPATION IN FEDERAL AIDS

Federal grants-in-aid, reimbursements, contracts and other programs in which the state participates with the federal government are becoming an increasingly important element for consideration in relation to the state's own budget program. These federal aid expenditures, which are anticipated to reach $2,923.5 million in 1969–70, have a direct impact on state and local programs. In many cases, these programs are enmeshed directly with expenditure of state funds so that changes made by the Congress or the State Legislature interact and have an effect on the obligation of the other governmental entity.

This section provides perspective on the historical growth trends in federal aids in which the state expends or subvenes the funds, and compares these federal aids with the level of state budget expenditures. This is done (1) on the basis of overall budget and federal aid expenditure trends, and (2) for specific programs in which the federal element is becoming increasingly a paramount consideration in the continued operation of the program. There is (3) also a short summary indicating new federal aid programs passed by the second session of the 90th Congress. This includes important new authorizations that can be expected to have an increasing impact on the state in coming years.

Recent Trends in Federal Aid

By the 1969–70 fiscal year, the total of federal aid (1) expended directly and (2) subvened by the state will have increased nearly five times that of the 1959–60 fiscal year. By comparison over that same period, state budget expenditures excluding bond funds will have almost tripled. Table 7 lists the amounts and relative increases in state expenditures and subventions of federal aid for selected budgeted categories and in total for the fiscal years 1959–60 and 1969–70.

Table 7

Amounts of Aid and Change in Selected Federal Aid Expenditures, Fiscal Years 1959–60 and 1969–70
(In Millions)

	Actual 1959–60	*Estimated 1969–70*	*Amount of increase*	*Percent change*
Public Assistance (Including Medi-Cal)	$222.9	$1,179.9	$957.0	429.3
Transportation: State Highway Program	265.3	415.1	149.8	56.5
Higher Education: University of California	[1]	383.0	383.0	–
Elementary and Secondary Education	25.1	158.3	133.2	530.7
Other	92.3	787.2	694.9	752.9
Total Expenditures of Federal Aid	$605.6	$2,923.5	$2,317.9	382.7

[1] No federal funds were shown for this item in the 1961–62 Governor's Budget for 1959–60.

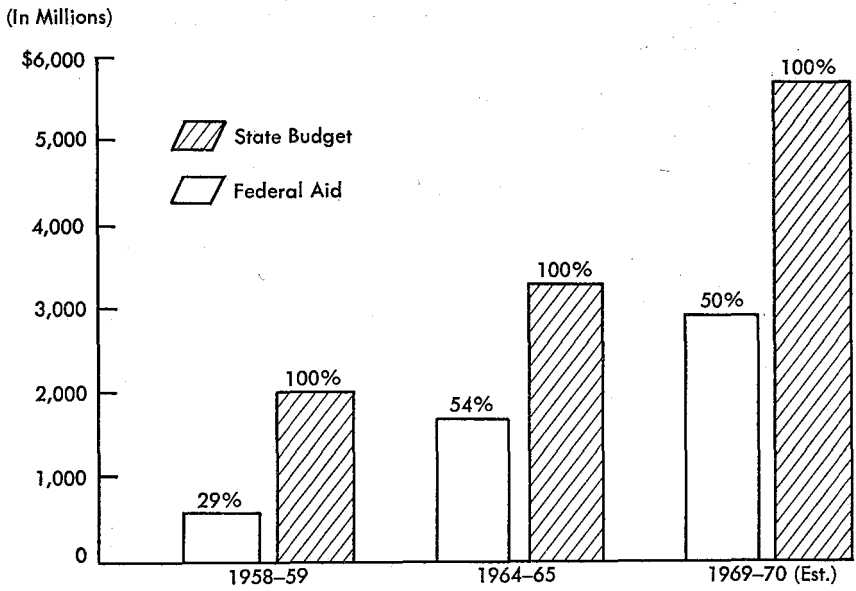
The table shows a total federal aid expenditure of $605.6 million in which the State was involved in the 1959–60 fiscal year and an estimated $2,923.5 million in the 1969–70 fiscal year. This rapid growth is further emphasized in Chart I when it is compared with the state budget on a relative basis. In the 1959–60 fiscal year, federal aid amounted to 29 percent as much as the state budget excluding bond funds. In the 1964–65 fiscal year, the figure rose to 54 percent and in the 1969–70 fiscal year it is estimated that federal aid will equal one-half as much as the proposed state budget excluding bond funds.

In the 1959–60 fiscal year the aid programs in transportation, public assistance, and elementary and secondary education at $513.3 million made up 85 percent of the total expenditures of federal funds excluding unemployment benefits. In the 1969–70 fiscal year these programs, including Medi-Cal and higher education at $2,136.3 million will constitute 73 percent of the total expenditure, again excluding unemployment benefits. This change in composition is indicative of the proliferation of federal programs in all functions of government. At the national level the estimated number of individual grant authorizations rose from 161 at the end of 1962 to 379 at the close of 1966. At the present time the number is probably well over 400.

Over the 10-year period public assistance has become the largest grant-in-aid program group. This group includes such programs as Aid to the Blind, Aid to Families with Dependent Children, Aid to the Disabled, Old Age Security and Medi-Cal. Expenditures of federal funds were $222.9 million in 1959–60 for this group. For the budget year, the category totals $722.0 million excluding Medical Assistance. This figure is increased by $457.9 million to $1,179.9 million when Medi-Cal is added. On the other hand the state expenditures for public assistance were $201.8 million in 1959–60 and in 1969–70 will increase to $946.5 million, including $383.4 million in Medi-Cal. Expenditures of federal aid in 1969–70 are, therefore, anticipated to be 25 percent higher than state expenditures in this same category. Federal funds

Chart I

Growth in State Expenditures of Federal Aid as Compared to the State Budget[1]



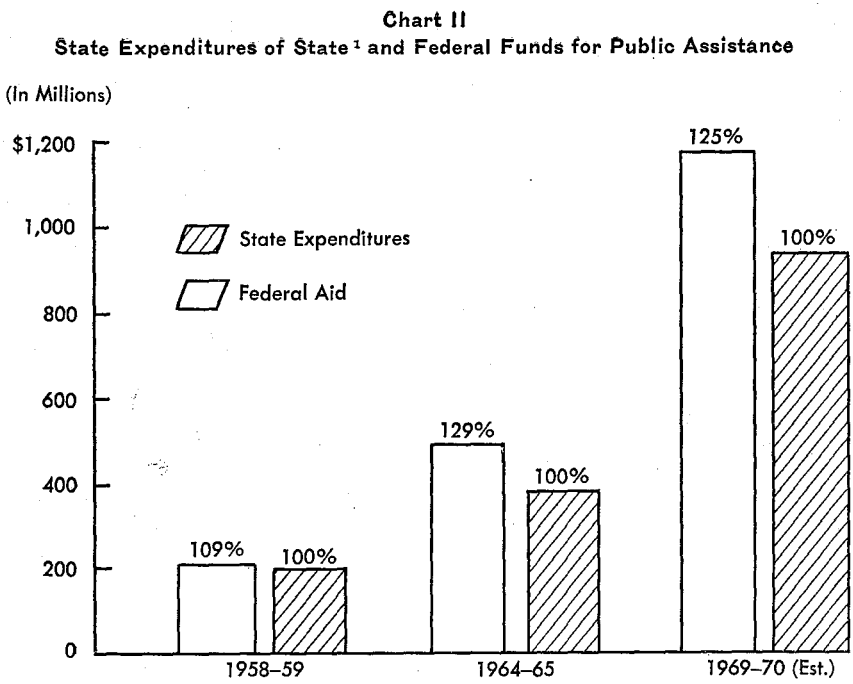
Note: Percentage figures indicate ratio of federal aid expenditures to the state budget.
[1] Excluding bond funds.

were 109 percent of a much smaller state expenditure for public assistance in 1958–59 and 129 percent in 1964–65. Chart II portrays federal aid and state growth in these expenditures in the 1959–60, 1964–65 and 1969–70 fiscal years. This is pictured in total amounts, with the percentage of federal funds to state funds also indicated.

State expenditures of federal aid for transportation, principally the state highway program (the largest category in the 1959–60 fiscal year) have grown only 56.4 percent since the 1959–60 fiscal year. Total federal aid to elementary and secondary education in California is estimated to be $158.3 million in the 1969–70 fiscal year as compared to $25.1 million in the 1959–60 fiscal year. The six-fold increase in this area can be attributed to the expansion of programs in vocational education and compensatory education, which together account for $121.4 million of the total expenditure in the 1969–70 fiscal year. State budget expenditures in this area have not grown as fast relatively as federal aid. In absolute amounts, however, state expenditures continue to grow faster and much larger sums are involved. At the beginning of the period, the state budgeted $722.3 million of its own funds for elementary and secondary education. This has grown to $1,621.6 million for the fiscal year 1969–70.

Chart II

State Expenditures of State[1] and Federal Funds for Public Assistance



Note: Percentage figures indicate ratio of federal aid expenditures to the state budget.
[1] Includes general and special fund expenditures by the Department of Social Welfare, and the Office of Health Care Services, but excludes bond funds.

Action on Grant-in-Aid Programs by the Second Session of the 90th Congress

The second session of the 90th Congress initiated legislation that has and will have a direct impact on grant-in-aid programs in California. Funds were appropriated for new federal grants in several areas including housing and urban development, highway safety, juvenile delinquency prevention and control, and crime control. Other action was taken to repeal the freeze on eligibility for the Aid to Families With Dependent Children Program, to liberalize requirements for obtaining unemployment compensation under the Unemployed Fathers' Program, to extend the date for states to buy into Part B of Medicare and to require fair hearings and legal assistance for welfare recipients. In an administrative ruling, states were denied the use of federal funds obtained under the impacted areas program for computing district wealth in state school apportionments. This will result in $16 million added state costs in 1969–70. A federal district court injunction of April 29, 1968 against imposition of California residency requirements in determining welfare eligibility remains in force. The removal of the requirement will cost the State General Fund approximately $12 million in 1969–70. Substantive legislation was also passed to improve the administration of grants and congressional review of existing grant programs.

The Housing and Urban Development Act extends and broadens existing housing programs to promote public housing, rent supple-

ments, urban development and model cities and $5.3 billion was authorized for these programs. The program also provides a block grant to governors for multicounty rural planning. The Juvenile Delinquency Act authorizes grants to states, localities and public nonprofit agencies to prevent juvenile delinquency and rehabilitate young offenders. The Department of the Youth Authority, under the direction of the California Council on Criminal Justice is currently preparing an application for funds under this act. The Omnibus Crime Control and Safe Streets Act includes $400 million for grants to states over a two-year period for planning, research and training in law enforcement. All of the planning grants and 85 percent of the action grants are to be allocated in block grants. Under this act California has received $673,000 for the 1968–69 fiscal year in a project grant for the criminal justice information system.

The Intergovernmental Cooperation Act makes a number of significant procedural changes for improving the administration for grants-in-aid. It provides that the Governor or Legislature of a state be informed by a federal agency of the purpose and amount of any grant received by the state. It further states that a federal agency may waive the federal requirement that a single state agency be designated to administer a particular grant.

REVENUE ESTIMATES

California's major tax sources such as retail sales, personal income, bank and corporation and inheritance taxes are very sensitive to changes in both state and national economic conditions. When the economy expands rapidly, these tax receipts grow faster than their normal patterns. The reverse is also true. Therefore, it is necessary to review economic conditions during calendar year 1968 to understand the bases for the revised 1968–69 revenue estimates in the Governor's Budget, and to analyze the economic assumptions for 1969 to judge the validity of the revenue estimates for the budget year. This section of the analysis will provide the necessary background information by:

1. Reviewing national and California economic conditions during both 1968 and 1969, and
2. Analyzing the Department of Finance's revenue forecast for the current and budget years.

The National Economy in 1968

Inflation plagued the economy during 1968. In current dollars the economy grew by 9 percent. This strong advance paralleled the boom years of 1955 and 1966. In real terms, however, the economy grew by only 5 percent in 1968 (the other 4 percent represented inflation) and this rate of expansion was healthy but not spectacular. The sources of growth in 1968 were quite different from the experience in 1955 and 1966. Table 1 shows that in current dollars consumer spending dominated the 1968 acceleration while private investment was a key factor in the 1955 boom. Both investment and government spending (espe-

cially military) were strong forces in the 1966 advance. The fact that real growth in 1968 was not spectacular is understandable because this was the eighth year of continuous prosperity and it is more difficult to achieve large real increases in one year when the resources of the economy are fully utilized.

Table 1

Sources of the Growth in GNP During Three Prosperous Years

Percentage growth in GNP	*1955*	*1966*	*1968*
Real growth—constant dollars	7.6%	6.3%	5.0%
Inflation	1.5	2.8	4.0
Current dollars	9.1%	9.1%	9.0%
Sources of the growth		*Current dollars*	
Consumer expenditures	4.9%	4.8%	5.2%
Private investment	4.3	1.8	1.7
Net exports	0.1	—0.3	—0.3
Government purchases	—0.2	2.8	2.4
Total	9.1%	9.1%	9.0%
		Constant 1958 dollars	
Consumer expenditures	4.6%	3.2%	3.0%
Private investment	3.9	1.5	1.1
Net exports	--	—0.3	—0.3
Government purchases	—0.9	1.9	1.2
Total	7.6%	6.3%	5.0%

Growth patterns were uneven during 1968. Table 2 shows that consumer expenditures accounted for $17.2 billion (at annual rates) or 85 percent of the GNP gain in the first quarter. This quarterly advance was the largest on record for this sector. Part of the growth in these expenditures reflected a makeup in auto sales which had been limited by the strikes in late 1967. Business-fixed investment, both structures and equipment, also registered strong advances in the first quarter. Business inventories, by contrast, declined by $6.2 billion. Government purchases made their most rapid advance since the first quarter of 1967.

In the second quarter of 1968, business inventories turned about and gained $8.7 billion. This change occurred partly as a result of an accumulation of steel stocks to provide a hedge against a possible summer strike, and also because of a slowdown in consumer expenditures. Both personal income and savings advanced rapidly during this period. In reaction to mounting inflationary pressures, Congress enacted the 10-percent surtax and placed a ceiling on certain federal expenditures. The new surtax withholding rates on income went into effect in mid-July.

The initial impact of the federal surtax fell heavily upon savings rather than on consumer expenditures. The exuberance of consumer expenditures reappeared in the third quarter. This sector rose by $13.2 billion despite a $10 billion rise in personal taxes. Outlays for automobiles were particularly strong. Business investments, primarily equipment, also advanced during this period. Inventories declined as users worked off earlier accumulations. Table 2 shows that federal expendi-

tures, both military and nonmilitary, grew very slowly during the last half of 1968.

In the fourth quarter, consumer spending increased by only $5.2 billion, even though disposable income advanced by $10 billion. This sluggish growth was general for the entire consumer sector and included a leveling off in auto purchases and a decline in household durables. Nondurables registered their weakest increase of the year. By contrast, all elements of the private investment sector were strong in the fourth quarter. Business equipment gained $3.1 billion, and residential construction grew by $2.3 billion. As a reaction to the slowdown in consumer expenditures, there was an increase in business inventories.

During the first half of 1968, the burden of dampening the economic expansion fell on monetary policy. During the summer, after the passage of the federal surtax and expenditure limitations, the Federal Reserve Board eased credit conditions in order to avoid an "overkill" in fiscal restraint. In the late fall, when it became evident that consumer and business spending were not slowing down as anticipated, credit restraint increased.

In summary, consumer expenditures were overly strong during the first and third quarters of 1968. The combination of tighter credit and the federal surtax appears to have dampened this sector by the end of the year. Private investment, especially business equipment and residential construction, was very strong in the last half of the year. However, restrictive monetary policy will probably depress this sector in the first part of 1969. In contrast to prior periods, federal purchases were low in the last half of 1968.

A more detailed examination of each of the GNP components follows:

Table 2

Quarterly Changes in GNP During 1968 *

Billions of Current Dollars (Annual Rates)

	I	*II*	*III*	*IV*
Consumer expenditures:				
Durables	$4.8	$2.0	$4.1	−$0.3
Nondurables	8.1	1.7	4.5	0.8
Services	4.3	4.8	4.7	4.6
Subtotal	$17.2	$8.5	$13.2	$5.2
Private Investment:				
Fixed investment	$4.1	−$1.1	$3.1	$6.4
Nonresidential	3.6	−1.6	3.1	4.1
Residential	0.6	0.4	0	2.3
Changes in business inventories	−6.2	8.7	−3.3	2.5
Subtotal	−$2.1	$7.6	−$0.2	$9.0
Net exports	−$1.9	$0.5	$1.3	−$0.3
Government purchases:				
Federal				
National defense	$2.2	$2.2	$0.6	$0.4
Other	1.3	0.7	0.5	0.1
State and local	3.4	2.2	2.8	2.4
Subtotal	$7.0	$5.2	$3.9	$2.9
Total GNP	$20.2	$21.7	$18.1	$16.8

* Figures may not add due to rounding in the original source material.

Consumer Expenditures

During 1968, consumers' after tax (disposable) income grew by 7.8 percent, but consumer spending advanced at an even more rapid pace, 8.4 percent, to register the largest percentage gain for this sector since 1947. Higher prices accounted for about half of this increase. Table 3 shows automobiles had the largest increase, 20.1 percent. New car sales, after being static for two years following the heavy purchases in 1965, increased by 1.2 million units in 1968 to a record total of 9.6 million. Imports accounted for almost one million of these sales, a 28 percent increase over the prior year. Furniture and clothing each gained 9 percent, while housing and household operations registered somewhat smaller increases. Food expenditures continue to be a declining proportion of total consumer spending, and they increased only 6.6 percent during 1968.

Table 3

Consumer Expenditures

(in billions)

	1967	*1968*	*Percentage increase*
Durables:			
Autos and parts	$30.4	$36.5	20.1%
Furniture and household equipment	31.4	34.3	9.2
Other	10.9	11.7	7.3
Subtotal	$72.6	$82.5	13.6%
Nondurables:			
Food and beverages	$109.4	$116.6	6.6%
Clothing and shoes	42.1	45.8	8.8
Gasoline and oil	18.1	19.8	9.4
Other	46.2	48.0	3.9
Subtotal	$215.8	$230.2	6.7%
Services:			
Housing	$70.9	$76.2	7.5%
Household operation	29.0	31.2	7.6
Transportation	15.0	16.6	10.7
Other	88.9	97.0	9.1
Subtotal	$203.8	$221.0	8.4%
Total Consumer Expenditures	$492.2	$533.7	8.4%

Private Investment

This sector includes business investments in plant and equipment, institutional construction such as hospitals, residential building and changes in business inventories.

Nonresidential investments increased by 7.6 percent during 1968, with the main portion of the growth occurring in the last half of the year. Most of this upsurge in spending was on equipment rather than structures, and not all industries shared in this growth. Durable goods manufacturers, for example, recorded a slight decline in their investments for the second straight year, reflecting their relatively low (83 percent) rate of utilization of existing equipment. By contrast, public utilities and nonrail transportation firms recorded investment gains of roughly 15 percent, also for the second straight year.

Residential construction increased by 21.9 percent during 1968, and this included a sharp rise in housing costs, a shift to higher-quality

housing, along with a 15 percent increase in the number of housing starts to about 1.5 million units. The upsurge centered in multiple-housing units, which accounted for 40 percent of total starts in 1968, as against only 20 percent at the beginning of the decade. Despite these increases during 1968, the volume of new housing was still below the amount required for new family formations plus the replacement of obsolete structures. Vacancy rates have fallen to their lowest level in 10 years, and pressures on home prices and rents have increased. The tightening of the mortgage market and the increase in interest rates late in 1968 dampens the housing outlook for 1969.

The $7.6 billion increase in business inventories during 1968 reflected the rising price of materials, plus the desire to beat future price increases, along with the inflation-based expectation of a continued increase in consumer spending. Manufacturers accounted for the major part of the overall inventory accumulation, but their $4 billion increase in stock was lower than their 1967 additions. By contrast, inventories of trade firms rose $2.8 billion in 1968, which was considerably higher than their $0.5 billion increase in 1967.

Table 4
Private Investment
(in billions)

	1967	*1968*	*Percentage increase*
Nonresidential:			
Structures	$27.9	$29.2	4.7%
Producers equipment	55.7	60.8	9.2
Subtotal	$83.6	$90.0	7.6%
Residential	$24.6	$30.0	21.9%
Change in business inventories	6.1	7.6	24.6
Total	$114.3	$127.5	11.5%

Governmental Purchases

In 1967, national defense purchases rose by 20 percent. Table 5 shows that the 1968 increase was less than half the prior year rate. This deceleration was primarily attributable to a slower growth in the delivery of goods. The strength of the armed forces increased by about 150,000 men through the first half of the year, peaking at 3.5 million in June. However, from June to November, there was a decline of over 100,000 men. Civilian employment in the Defense Department remained static at about 1.1 million employees. Nondefense spending rose by a record 15.9 percent. This increase was due to a $2 bilion increase in Commodity Credit Corporation purchases, primarily for wheat and soybeans, and to higher wages for federal employees.

State and local purchases increased by 10.6 percent and about half of this advance was attributable to higher employee compensation. Employment by these governments increased over 500,000 last year, with about two employees being added in education for each employee added in all other functions combined. New construction outlays advanced over $2 billion, with educational expenditures showing signs of leveling off while expenditures for mass transit systems, highways, and hospitals moved up sharply.

Table 5
Government Purchases
(in billions)

	1967	1968	Percentage increase
Federal:			
National defense	$72.4	$78.9	9.0%
Other	18.2	21.1	15.9
Total Federal	$90.6	$100.0	10.4%
State and local	87.8	97.1	10.6
Total Government Purchases	$178.4	$197.1	10.5%

Income and Savings

Personal income grew by 9.1 percent in 1968, the largest increase in percentage terms since 1951. The very large expansion in payrolls contributed heavily to the 1968 income advance, but transfer payments and nonwage incomes also made notable gains. Transfer payments grew by $7 billion which was nearly as high as the unusually large increase in 1967, the first full year that medicare payments were in effect. Interest income rose $5.3 billion, which was the largest gain on record.

Personal income taxes jumped by $14.4 billion in 1968 (Table 6). The federal portion of this increase was $12 billion, of which $3.5 billion was attributable to the surtax, while the remainder reflected the taxes on higher incomes. As the result of higher taxes, disposable income increased only 7.8 percent. The growth in consumer spending during 1968 resulted in a drop in the personal savings rate, but at 6.9 percent it still exceeds the average for this decade.

Table 6
Income and Savings
(in billions)

	1967	1968	Percentage increase
Personal income	$628.8	$685.8	9.1%
Minus personal income taxes	82.5	96.9	17.5
Equals disposable income	$546.3	$598.0	7.8%
Personal savings	$40.2	$40.8	1.5%
Savings as a percentage of disposable income	7.4%	6.9%	

Employment and Profits

Employment. The civilian labor force increased by 1,400,000 (1.8 percent) during 1968, but the number of new wage and salary workers grew even faster, 2,105,000 (3.2 percent), with a resulting decline in unemployment. Manufacturing employment grew by 300,000, continuing the expansion that started in 1962. Although this advance was larger than the 1967 growth rate, it was far short of the 790,000 increase in 1965 and the 1,150,000 advance in 1966. Table 7 shows that state and local governmental employment had the largest growth rate, during 1968, and federal employment had the smallest.

Table 7
Wage and Salary Workers in Nonagricultural Establishments
(in thousands)

	1967	1968	Increase Amount	Increase Percent
Manufacturing	19,434	19,734	300	1.5%
Mining	616	625	9	1.5
Construction	3,203	3,256	53	1.7
Transportation and utilities	4,271	4,346	75	1.8
Wholesale and retail trade	13,613	14,115	502	3.7
Finance, insurance and real estate	3,217	3,357	140	4.4
Services	10,060	10,504	444	4.4
Government:				
Federal	2,719	2,736	17	0.6
State and local	8,897	9,462	565	6.4
Total	66,030	68,135	2,105	3.2%

Unemployment fell to its lowest level since 1953. The overall rate for 1968 was 3.6 percent, but it declined to 3.3 percent in November and remained at that level through January 1969. Table 8 shows that nonwhites still experienced an unemployment rate that was double the rate for whites. Teenagers had the largest unemployment rate, while married men had the lowest.

Table 8
Unemployment Rates—By Categories During 1968

	Rate
All workers	3.6%
By color	
White	3.2
Nonwhite	6.7
By age	
16 to 19 years	12.7
Selected groups	
Married men	1.6
Experienced workers	3.4

Wage Increases. There was an unusually large number of union contracts negotiated during 1968, and the median first-year increase in wages and fringe benefits amounted to 7.5 percent, as against 5.6 percent in 1967. These 1968 wage increases reflect "front loading" or the tendency to concentrate increases in the first year of long-term contracts. This tendency apparently reflects labor's concern over the rapid price increase.

Corporate Profits. Strong market demands for both consumer goods and producers equipment resulted in an 11.1 percent increase in corporate profits (before taxes) during 1968. This rate of advance has been surpassed only by the 14.7 percent increase secured in 1965. Profits were higher for all the broad industry groups, but the rise was most pronounced in manufacturing, particularly durable goods (Table 9).

Corporate tax liabilities rose very sharply in 1968, partly because profits were higher, but mainly because of the federal surtax. After tax profits were only $3 billion or six percent higher than 1967.

Table 9
Corporate Profits Before Taxes
(in billions)

Corporate profits (before taxes)	*1967*	*1968*	*Percentage Increase*
Financials	$10.3	$11.5	11.6%
Manufacturing:			
Nondurables	18.0	19.9	10.6
Durables	21.2	24.4	15.1
Transportation and utilities	11.8	12.8	8.5
All Other	19.0	20.6	8.4
Total Corporate Profits	$80.3	$89.2	11.1%
Compensation of employees	$277.0	$301.7	8.9%

Prices and Financial Conditions

Consumer Prices. A combination of high demand, rising costs of production, and a buildup of inflationary expectations led to the most sizable overall price increase in 1968 since the outbreak of the Korean War. Prices of virtually all consumer goods and services rose in 1968, unlike 1967, when near stability in food prices dampened the overall increase. Table 10 indicates that total consumer prices rose by 4.2 percent in 1968. The 7.75 percent increase in fruit and vegetable prices was primarily responsible for the increase in food prices. After several years of near stability, the prices of durables including new cars, rose by 3 percent in 1968. Nondurables increased by almost 4 percent, but the retail prices of clothing and shoes advanced almost 6 percent, which was the largest rise in this category since the "scare" buying during the Korean War. Service prices continue to be the most rapidly rising component of this price index, and these increases reflect changes in labor costs. Medical costs advanced by 7 percent, which is a modest decline from the 8.75 percent increase in 1967.

Table 10
Changes in Consumer Prices During 1968

	Index, 1957–59 = 100		*Percentage increase*
	1967	*1968*	
All items	116.3	121.2	4.2%
Food	115.2	119.2	3.5
Durables	104.3	107.4	3.0
Nondurables	113.1	117.5	3.9
All services	127.7	134.0	4.9
Medical services	145.6	155.8	7.0

Monetary policy started to tighten in November 1967, and it became progressively tighter in the first half of 1968 as the expectation of a tax increase diminished. The Federal Reserve discount rate moved from 4 percent to 5½ percent in three steps between November 1967 and April 1968. Reserve requirements against certain demand deposits were raised in January 1968.

The midyear passage of the federal surtax and expenditure limitations signaled a modest reversal in monetary policy to avoid an "overkill", because the fiscal restraint package enacted by Congress was the stiffest anti-inflation measure ever adopted. However, the failure of the tax increase to brake the rate of economic expansion caused a tightening of monetary policy in December 1968.

Interest rates reached their highest levels in several decades during 1968. Ninety-day treasury bills increased by 19 percent, from 4.99 percent in January to 5.94 percent in December. Longer term federal securities also increased, but at slower rates. These advances carried over into January 1969, when the banks prime rate jumped to 7 percent, and when FHA and VA mortgage rates rose to 7.5 percent.

The California Economy in 1968

Last year California outpaced the nation in employment growth, corporate profits and consumer price increases, but registered a slightly lower growth in personal and disposable income.

Employment

A comparison of Tables 7 and 11 indicate that in percentage terms California outpaced the nation in employment growth, in all categories except governmental employment. California was particularly strong with its 4.4 percent increase in construction compared to the national increase of only 1.7 percent. Manufacturing employment grew faster than the national rate despite our decline in the aerospace sector. California's unemployment rate of 4.5 percent for 1968 was still higher than the national rate of 3.6 percent, but our rate dropped to 4.1 percent in December 1968, which is the lowest it has been since July 1957.

Table 11
California Employment by Type of Industry
(in thousands)

Industry	*1967*	*1968*	*Increase* *Amount*	*Increase* *Percent*
Mining	33	33	0	0%
Agriculture	318	320	2	0.6
Construction	339	354	15	4.4
Finance	370	389	19	5.1
Transportation and utilities	445	460	15	3.4
Government	1,273	1,334	61	4.8
Services	1,474	1,538	64	4.3
Trade	1,554	1,620	66	4.2
Manufacturing	1,639	1,677	38	2.3
Total Employment	7,445	7,725	280	3.8%
Unemployment	389	366	-23	-5.9%
Civilian labor force	7,834	8,091	257	3.3%

Residential Construction

The number of residential housing units increased by 44 percent during 1968, from 110,000 to 158,000. The growth in multiple units which accounted for almost half of the total starts was primarily responsible for this upsurge. Lumber prices scored their largest increases in years, reaching 40 to 50 percent above 1967 levels. These unusual price advances were caused by a rapid growth in exports to Japan, a large domestic and military demand, and the inelastic supply condition. Two-thirds of the timber production in the three western states comes from federally owned land and this production is not designed to vary with changes in market conditions. As a result, when demand grows rapidly the increased supply must be obtained at higher prices from the remaining one-third of the timber area which is privately owned.

Retail Sales

Taxable retail sales advanced by 11 percent in 1968, the largest increase since 1959. The building material group led the advance with a 21 percent increase over 1967. Part of this gain was attributable to the substantial increase in housing starts, while the remainder reflected a sharp increase in prices. The automobile sector registered a 16.1 percent increase which was lower than the national gain of 20.1 percent (Table 3). One reason for this disparity is that California consumers probably purchase a larger proportion of foreign cars than the national average, and these cars typically have lower unit prices than do domestic models. Consumer prices advanced by 4.4 percent in California during 1968, which was a steeper increase than the national rate of 4.2 percent (Table 10).

Income and Profits

Personal income in California advanced by 8.4 percent during 1968, which was slightly lower than the gain registered nationally. This pattern has existed since 1965.

Taxable corporate profits in California increased by $745 million, or 11.4 percent, during 1968. Mining and oil production led the increase with a 35.2 percent gain over 1967. Manufacturing also registered a large gain. A comparison of Tables 9 and 12 indicate that California's corporate profits increased slightly faster than the national growth.

Table 12
Taxable Corporate Profits in California
(in millions)

Industry	*1967*	*1968*	*Percentage increase*
Agriculture	$81	$89	9.9
Construction	174	185	6.3
Mining and oil production	247	334	35.2
Real estate and other financials	401	389	—3.0
Service	422	458	8.5
Financials subject to bank tax	476	528	10.9
Utilities	994	1,081	8.8
Trade	1,153	1,268	10.0
Manufacturing	2,574	2,934	14.0
Other	3	4	33.3
Totals	$6,525	$7,270	11.4

Agriculture

California's farm production in 1968 was a record 40.2 million tons, up 4 percent from the previous (1964) record harvest, and 13 percent above the 1967 output of 35.5 million tons. Aggregate production of vegetable crops was the largest in the state's history, and field crops were second only to the 1964 harvest.

Total cash receipts from farming, including $104 million in government payments, will be a record $4.35 billion in 1968, an increase of $358 million over the prior year.

The record farm production in 1968 was attributed to an unusually favorable growing season, with the exception of severe freeze losses which plagued the citrus industry. New production records were registered for canning tomatoes and rice, and substantial output increases were made by cotton and sugar beets.

A Review of the Department of Finance's 1968 Economic Forecasts

There are two distinct steps in the revenue estimating cycle of the Department of Finance. The first and most critical step consists of preparing economic forecasts for both the national and state economies, covering such elements as personal income, employment, corporate profits, taxable sales, housing construction, automobile sales and the general price level. In the second step, these economic data are fed into a variety of mathematical equations which produce the individual revenue estimates.

The economic forecasting process starts in October when the department's technicians attend a revenue estimating conference sponsored by the National Association of Tax Administrators. These conferences have been held each year since 1946 and the program consists of nationally recognized economists reviewing each major segment of the economy and presenting their opinions on what changes will possibly occur during the following year.

Following the national conference, the department prepares its own national and state economic forecasts which are incorporated into a memo (about 25 pages) that is sent to a group of leading California economists including representatives from the major universities, the banks including the Federal Reserve, the large utilities, petroleum, construction and trade industries. In late November of each year, this group of economists meets with the department to discuss and evaluate the economic assumptions contained in the memo. Based upon these discussions (1½ days), which have been held annually since 1946, the department prepares the economic forecasts which are used to estimate individual taxes and which are presented in the budget document (page A-13 of the 1969–70 Budget).

Table 13 shows the Department of Finance's original economic forecasts which were printed in the 1968–69 Budget, and the revised estimates used for the May 20, 1968 revenue adjustments. These estimates are compared with the actual results for 1968. This table also includes selected estimates that were published in the 1968 Economic Report of the President. As a matter of policy, the Council of Economic Advisers does not publish a complete list of its economic projections.

The Table 13 comparison shows that the Department of Finance, along with most other forecasters, underestimated the growth of the 1968 economy. The original February 1968 estimate of GNP was off by —1.4 percent. In its national estimate, the department's widest underestimation was in the private investment sector (—4.2 percent) and its closest prediction was total government spending (—0.9 percent). In California data, housing starts were underestimated by 23 percent, new car sales by 9 percent, and total taxable sales by 4 percent. The closest prediction was total employment where the deviation was only —0.4 percent. This table also shows that the May 1968 revisions by the Department of Finance generally (an exception being new car sales) moved in the right direction, and resulted in an overall improvement in the forecasts, even though they still were too low.

Table 13

Comparison of Department of Finance's Original and Revised Economic Forecasts for Calendar Year 1968 with Actual Results

	Department of Finance estimates [a]			*Council of Economic Advisors* [a]
	Original Feb. 1698	*Revised May 1968*	*Actual* [b]	*Feb. 1968*
Gross national product	$848.4	$853.2	$860.7	$851.0
Personal consumption expenditures	526.2	530.5	533.7	525.6
Gross private domestic investment	122.3	123.4	127.5	127.5
Net exports	4.8	3.0	2.4	4.8
Government purchases of goods and services	195.3	196.3	197.1	193.3
Federal	98.7	99.8	100.0	96.8
National defense	79.8	79.9	78.9	--
Other	18.9	19.9	21.1	--
State and local	96.6	96.5	97.1	96.5
Personal income	670.7	676.6	685.8	--
Disposable income	578.2	581.7	589.1	--
Savings	37.3	36.1	40.5	--
Corporate profits	87.3	89.0	88.9	--
Consumer price index	120.4	121.0	121.2	--
Employment (000)	75,743	75,800	75,920	--
California data:				
Personal income	$75.1	$75.4	$76.1	--
Disposable income	66.0	66.2	66.8	--
Taxable corporate profits	7.0	7.0	7.3	--
Employment (000)	7,690	7,690	7,720	--
Number of housing starts (000)	126	127	155	--
New car sales	866	851	945	--
Taxable sales	37.5	37.5	39.0	--
Consumer price index	121.5	122.8	123.2	--

[a] Adjusted for changes made in these series by the U.S. Department of Commerce, as reported in the July 1968 issue of the Survey of Current Business.
[b] Preliminary—national data by U.S. Department of Commerce.

Analysis of 1968–69 General Fund Revenue Estimates

Total General Fund revenues for the current fiscal year, as revised in the proposed budget, are $244 million above the original (February 1968) estimates after adjusting for 1968 tax legislation. The rapid acceleration in the 1968 economy was the main factor causing these upward revisions. The Department of Finance, in its May 1968 revenue changes, accounted for only 31 percent of the total final revisions.

Personal income taxes had the largest upward revision, a total increase of $99.1 million. There were two reasons for this change: (1) personal incomes grew faster than anticipated (i.e., an 8.4 percent actual growth rather than the 7 percent estimate), and (2) there has been a pronounced acceleration in the movement of taxpayers into the middle and higher income groups. With our progressive rate structure, and the use of tax credits, this change in the mix of taxpayers accelerates the growth in these revenues.

Retail sales taxes were increased by $45.5 million, with the rapid growth in automobile sales and building materials accounting for a large portion of this increase. Table 14 shows that the Department of Finance originally estimated that taxable sales would increase by 7.1 percent in 1968, but actual sales were up 11 percent, the largest percentage increase since 1959. In the third quarter of 1968, taxable

sales set a record by reaching almost $10 billion, which surpassed the Christmas quarter of the prior year. This feat has occurred only three times in the 35-year history of the sales tax.

Table 14
Taxable Sales in California
(in millions)

		1968			
Category	*1967*	*Dept. of Finance estimate Feb. 1968*	*Increase over prior year*	*Actual*	*Increase over prior year*
Retail stores	$16,544	$17,600	6.4%	$18,050	9.1%
Autos and parts	5,770	6,150	6.6	6,700	16.1
Building materials	3,335	3,675	10.2	4,035	21.0
Manufacturing and wholesaling	8,251	8,900	7.9	8,880	7.6
Business and personal services	1,221	1,275	4.4	1,335	9.3
Totals	$35,121	$37,600	7.1%	$39,000	11.0%

The Department of Finance originally estimated that corporate profits would increase by 7.7 percent in 1968, but the actual increase was 11.4 percent. This difference is the main reason these revenues have been increased by $46.9 million.

In the other income category, receipts from the Health Care Deposit Fund were up almost $25 million because Medi-Cal coverage was extended to mentally retarded persons over 18. The sharp increase in interest rates during 1968 was partially responsible for the $8.1 million upward revision of interest income.

Table 15 contains a history of the 1968–69 General Fund revenue estimates.

Analysis of the Department of Finance's 1969 Economic Forecasts

Last year most forecasters predicted GNP would grow 7.5 percent during 1968 and consumer prices would increase 3 percent. These estimates were too conservative. GNP actually rose 9 percent and consumer prices advanced 4.2 percent.

This year there is wider disagreement on the prospects for 1969. The Department of Finance estimates there will be an appreciable slowdown in the growth rate during the first three quarters of 1969, and GNP will grow by only 6.4 percent. The department predicts that consumer prices will advance by 3.7 percent and the unemployment rate will increase from 3.6 percent (in 1968) to 3.9 percent. Table 16 shows that the Bank of America is even less optimistic with its prediction that GNP will grow only 6 percent in 1969. By contrast, the United California Bank and the President's (Johnson) Council of Economic Advisers estimate a 7 percent growth in GNP.

In evaluating these forecasts, the reader should be aware that economic conditions have been volatile during the last few months, and as a result, some of the earlier forecasts (e.g., United California Bank) that were published before the results of the fourth quarter of 1968 were available, tend to be more optimistic than subsequent predictions.

Table 15
History of Department of Finance's 1968–69 General Fund Revenue Estimates
(in thousands)

					1968–69 as revised in the 1969–70 Budget		
	Original budget estimate	*Revisions during 1968*				*Changes from*	*Changes from*
Taxes	*Feb. 1968*	*May 1968*	*Legislation*	*Total Dec. 1968*	*Amount*	*Dec. 1968 estimate*	*original estimate after legislation*
Alcoholic beverage	$109,081	—$1,281	--	$107,800	$106,800	—$1,000	—$2,281
Bank and corporation	548,000	17,000	—$880	564,120	594,000	29,880	46,880
Cigarettes	166,530	4,170	--	170,700	169,400	—1,300	2,870
Horseracing	52,587	—1,372	--	51,215	50,725	—490	—1,862
Inheritance and gift	147,730	3,870	—800	150,800	153,300	2,500	6,370
Insurance	126,600	100	--	126,700	128,000	1,300	1,400
Personal income	1,018,000	64,000	—42,100	1,039,900	1,075,000	35,100	99,100
Private car	3,700	--	--	3,700	3,865	165	165
Sales and Use	1,574,500	—11,600	—33	1,562,867	1,620,000	57,133	45,533
Total Taxes	$3,746,728	+$74,887	—$43,813	$3,777,802	$3,901,090	$123,288	$198,175
Other Revenues							
Interest on investments	$34,450	$550	--	$35,000	$42,550	$7,550	$8,100
Penalties on traffic violations	13,000	--	--	13,000	13,635	635	635
Receipts from Health Care Deposit Fund	22,110	--	--	22,110	47,087	24,977	24,977
Pay patient board charges	16,879	1,400	--	18,279	17,477	—802	598
All other	30,427	—60	3,965	34,332	46,281	11,949	11,889
Total Other Revenues	$116,866	+$1,890	+$3,965	$122,721	$167,030	$44,309	$46,199
Total Revenues	$3,863,594	+$76,777	—$39,848	$3,900,523	$4,068,120	$167,597	$244,374

The main areas of disagreement among these forecasts are:

1. *Consumer expenditures.* Both the Department of Finance and the Bank of America estimate that this sector will increase by 5.6 percent in 1969, compared to an 8.4-percent growth in 1968. The United California Bank and CEA estimate a 6.4-percent advance for 1969. At the present time, it appears that the federal surtax and tight monetary policy are having a depressing effect on consumer spending and therefore the lower estimate appears more realistic.

2. *Private investment.* The Department of Finance estimates that private investment will increase by 6.9 percent in 1969 compared to an 11.5-percent growth in 1968. Both the Bank of America and the United California Bank are less optimistic and predict only a 4.3-percent growth in 1969. Information released since the department made its estimate indicates that plant and equipment expenditures were substantially below earlier anticipations. In January 1969, the housing boom continued, but practically all of these starts were committed before the recent increase in interest rates and the tightening of monetary policy. We are more pessimistic on the outlook for private investment than the Department of Finance.

3. *Government purchases.* Both the Bank of America and CEA predict a 6.9-percent increase in government purchases in 1969, compared to a 10.5-percent growth in 1968. The Department of Finance estimates an 8.6-percent advance for 1969, while United California Bank anticipates a 10.1-percent increase. A cease-fire in Vietnam probably will not reduce defense spending appreciably during 1969; the savings would be realized in subsequent years. The California economy is not overly dependent upon the procurement expenditures for this

Table 16

Comparison of 1969 Economic Forecasts
(in billions of dollars)

National data	*Department of Finance Feb. 1969*	*Bank of America Feb. 1969*	*United California Bank Dec. 1968*	*CEA * Jan. 1969*
Gross National Product	$916.0	$911.9	$920.0	$921
Consumer expenditures	563.4	563.7	568.0	568
Private investment	136.3	133.0	133.0	--
Net exports	2.3	4.5	5.0	--
Government purchases	214.0	210.7	217.0	210
Personal income	730.4	730.2	733.0	--
Disposable income	618.4	618.0	623.0	624
Savings	39.7	39.1	37.0	--
Corporate profits	91.8	89.7	--	--
Consumer price index	125.7	125.7	125.0	--
Employment (000)	76,880	--	77,500	--
Unemployment rate	3.9	4.0	4.3	--
California Data				
Personal income	$81.5	$80.9	$82.1	--
Disposable income	70.9	--	--	--
Taxable corporate profits	7.6	--	--	--
Employment (000)	7,930.0	--		--
Housing starts (000)	165.0	--	190.0	--
New car sales (000)	900.0	900.0	--	--
Taxable sales	41.0	--	--	--
Consumer price index	127.8	--	--	--

* President's Council of Economic Advisers.

war and therefore we would be less affected than other states from a reduction in military expenditures for ordnance, munitions, combat vehicles and clothing.

4. *Unemployment.* Both the Bank of America and the United California Bank are more pessimistic than the Department of Finance about the change in the unemployment rate. We share this pessimism. The present rate of inflation evidently is unacceptable to the national administration, which appears to be willing to adopt restrictive fiscal measures that will result in higher unemployment. Table 8 showed that teenagers and nonwhites currently have higher unemployment rates than the total labor force, and these unskilled groups will be disproportionately affected by any increase in unemployment.

CALIFORNIA REVENUE ESTIMATES, 1969–70

Table 17 shows that General Fund revenues are estimated to increase by $255 million, or 6.3 percent during 1969–70. This modest growth rate would be higher except for the provision in the Governor's 1967 tax bill (Chapter 963) which provided that starting in June 1970, the prepayment rate for banks and corporations will be reduced from 50 to 30 percent. This reduction in the prepayment rate will postpone the collection of $57 million in corporation tax revenues. If this provision were not to be effective in the budget year, then General Fund revenues would increase by $312 million in 1969–70, or 7.7 percent which is a healthy growth rate.

Retail sales taxes are estimated to increase by $110 million in the budget year. This increase assumes that the economy will slow down in the first part of 1969, then regain vigor in the fourth quarter, and the higher growth rate will continue into 1970.

Personal income taxes are estimated to increase by $148 million, or 13.8 percent. This is our most elastic tax source, and the rapid gain in the budget year is attributable to the accelerated movement of taxpayers into the middle and higher income groups. This acceleration could increase and produce additional revenues if last year's inflationary trend were to continue.

No change between the current and budget years is anticipated for cigarette tax revenues. The Department of Finance estimates that the increase in population will just offset the decline in per capita consumption.

The other General Fund taxes are increasing at their historical rates.

Special Fund revenues are estimated to increase by $55.3 million, or 4.2 percent. Motor vehicle license fee revenues are anticipated to increase by 5.1 percent. This estimate is partly based on the assumption that 900,000 new cars will be sold in 1969.

In general, we believe that the basic economic assumptions of Department of Finance and their conversion into revenue estimates for 1969–70 are as reasonable and accurate as possible at this time with the exception that we are slightly more pessimistic than the department over the growth in private investments, and this could adversely affect sales tax revenues.

Table 17
Estimated State Revenue Collections During 1969–70
(in millions)

General Fund	*1968–69*	*1969–70*	*Increase Amount*	*Increase Percent*
Sales and use	$1,620.0	$1,730.0	$110.0	6.8%
Personal income	1,075.0	1,223.0	148.0	13.8
Bank and corporation	594.0	539.0	-55.0	-9.3
Cigarette	169.4	169.4	0	0
Inheritance and gift	153.3	171.0	17.7	11.5
Insurance	128.0	137.0	9.0	7.0
Alcoholic beverage	106.8	111.4	4.6	4.3
Horseracing	50.7	53.8	3.1	6.1
Other sources	170.9	188.5	17.6	10.3
Total General Fund	$4,068.1	$4,323.1	$255.0	6.3%
Special Fund				
Motor Vehicle:				
Fuels	$609.7	$637.2	$27.5	4.5%
Registration, weight	249.3	259.0	9.7	3.9
License (in lieu)	216.7	227.8	11.1	5.1
Transportation	22.0	24.0	2.0	9.1
Cigarette	72.6	72.6	0	0
Alcoholic beverage	12.0	12.6	0.6	5.0
Horseracing	9.5	9.2	-0.3	-3.2
Other	113.2	117.9	4.7	4.2
Total Special Funds	$1,305.0	$1,360.3	$55.3	4.2%
Totals	$5,373.1	$5,683.4	$310.3	5.8%

TAX REFORM

Summary of Conclusions

1. The state's General Fund budget periodically becomes unbalanced because expenditures typically grow faster than tax revenues. A greater reliance upon elastic tax sources such as personal income, inheritances or insurance premiums would help bridge this gap in growth rates.

2. Both state and local governments are caught in a price and productivity squeeze. These governments pay salaries which are generally comparable to those in the private sector, but the productivity of all service type employees, both public and private, has grown at a much slower rate than the productivity of the goods producing sector of the private economy. Government expenditures are largely for such service-type employees.

3. The most pressing tax reform problem in California is to mitigate the wide variations in local property tax burdens. These variations are caused by the unequal distribution of assessed valuation among taxing jurisdictions, and unique expenditure pressures in certain communities.

4. Because the state has its own revenue problems, local governments should not be optimistic about receiving additional state aid unless the taxpayers are willing to pay higher state taxes in order to reduce the reliance upon the local property tax.

5. It is possible, however, to mitigate the differences in local property tax burdens without increasing state taxes. This could be accomplished by changing school taxing formulas, and by reallocating local sales taxes and state-shared revenues on a need basis.

Introduction

The cry for tax reform is heard at all levels of government. A special study by technicians in the U.S. Treasury Department was submitted to Congress recently. Last May, Governor Reagan appointed the State Controller as head of an Advisory Commission on Tax Reform, and its report will released shortly. Proposition No. 9 (the Watson initiative) on the November 1968 ballot reflected citizen discontent over the level and composition of local property taxes.

While most people favor the concept of tax reform, the term has a wide variety of meanings to different groups. For example:

1. A senior citizen living in the family residence, and having limited income, would view a reduction in property taxes as tax reform. These persons usually do not have to pay state income taxes and their purchasing habits are such that the state and local sales tax is not burdensome. Therefore, their resentment against the present tax structure focuses on the property tax, especially the portion (schools) from which they will receive no direct future benefit.

2. A young married couple which spends a large portion of its income on new furniture, one or more automobiles, and baby clothes probably is more resentful of the sales tax, and would view an exemption for baby items as tax reform.

3. A middle-income taxpayer, who is single and lives in an apartment, is dismayed when he observes that any of his income over $15,000 a year is subject to the maximum 10-percent state income tax rate. He probably thought that only "wealthy taxpayers" paid the maximum rate. Tax reform to this person would be a widening of the income tax brackets.

4. The president of an interstate corporation would prefer to locate a California plant close to its markets, in a community with amenable living conditions for his employees including quality schools and other public facilities, but also where property taxes are low. Tax reform to this businessman, ideally, would be low state and local taxes on both his property and profits.

5. A local governmental official (e.g., a city manager or school administrator) sees tax reform as new state or federal revenue which he can use to increase the local level of expenditures without raising the property tax.

Needless to say it is impossible to design a tax reform package which will satisfy all groups, because each one seeks a tax reduction. However, the essence of tax reform is deciding which tax sources to employ and determining how the total burden will be allocated among different categories of taxpayers and levels of government. Tax reform is not synonymous with tax reduction. A permanent general tax reduction can only be achieved if the cost of government is reduced. A temporary tax reduction is possible when governments accumulate a surplus. Except for these two situations, any tax reduction for one segment of taxpayers must result in an increase for other taxpayers.

This section of the Analysis will outline some of the major issues confronting California in attempting to reform our state and local tax structure.

There are several basic characteristics of the California state tax structure. For example:

1. California currently levies practically every major source of taxation used by the various states.[1] We have broad based levies on retail sales, personal and corporate income, inheritances and gifts, and a variety of special excise taxes. As a result, tax reformers will be forced to rely mainly upon changes within the existing tax structure rather than adopting new levies.

2. Since 1933, the retail sales tax has been the major source of state General Fund revenue. In some years (e.g., 1949–50), this tax provided over 60 percent of the total General Fund taxes. In 1969–70, the ratio will be 42 percent, because the General Fund has increased its reliance upon personal income and cigarette taxes.

Two special features of our sales tax are: (1) about 30 percent of the revenue comes from nonretail sales, and (2) food and prescription medicines are exempt. An interstate comparison of the Internal Revenue Service's "sales tax deduction guidelines" clearly demonstrates that these California sales tax exemptions have reduced (but not entirely eliminated) the regressive nature of this tax.

3. Prior to 1959, California placed only modest reliance upon the personal income tax; it typically produced between 10 and 12 percent of total General Fund taxes. As a result of the last two tax increases (1959 and 1967), this source will provide about 28 percent of the General Fund revenue during 1969–70. The burden of this tax, however, does not extend to the low income groups. A married couple with two children must have income over $7,300 before there is any tax liability.

4. Only about a third of the General Fund revenue is used to support typical state functions, the other two-thirds are used to finance such local activities as education, social welfare and property tax relief.

The internal composition of a tax structure evolves over decades and reflects the attitudes of both the executive and legislative branches of government. Table 1 shows that California and New York will raise approximately the same amount of state revenue from broad based levies, but New York places heavier reliance upon the personal income tax. This table also indicates that New York's state taxes are higher in each category. During 1966–67 (the latest data available), California's local property taxes were $653 million higher than those in New York (primarily because personal property is exempt in New York), but our other sources of local revenue (sales and cigarette taxes) were $537 million lower. These figures indicate: (1) that state and local tax structures should be viewed as a unit when making interstate comparisons, and (2) the internal composition of a tax structure, within limits, is a policy decision of the state and local taxpayers and their elected representatives.

[1] While California does not levy a special severance tax on natural resources, these products are subject to local property taxes. The question of severance taxation, therefore, is one of total tax burden and which governmental level shall receive the tax proceeds.

Table 1

A Comparison of State and Local Taxes in California and New York

1968	*California*	*New York*
Population (thousands)	19,782	18,078
Personal income (millions)	$76,100	$74,400
*State Taxes *1968–69 (millions)*		
A. *Broad based levies*		
Personal income	$1,075	$2,100
Retail sales	1,620	700
Subtotal	$2,695	$2,800
B. *Excise taxes*		
Cigarettes	$169	$262
Alcoholic beverage excise	100	93
Alcoholic beverage license fees	18	50
Horseracing	60	151
Subtotal	$347	$556
C. *Business levies*		
Bank, corporation and insurance	$772	$792
Unincorporated business tax	–	65
Subtotal	$772	$857
D. *Other*		
Death and gift	$153	$148
Lottery	–	28
Other taxes	4	8
Subtotal	$157	$184
Total State Taxes	$3,971	$4,397
Local Taxes 1966–67 (millions)		
Property taxes	$3,936	$3,283
Nonproperty taxes	519	1,056
Total Local Taxes	$4,455	$4,339

* Excludes Highway Taxes.

With the above material as background, we will now explore the major problem areas of California's state tax structure.

Major Problem Areas

1. *Elasticity.* Every few years the state faces a new "tax crisis" because General Fund expenditures grow faster than revenues. Expenditures typically increase by 10 to 11 percent a year while revenues grow a little over 7 percent annually. This disparity in growth rates creates a revenue gap which periodically must be closed by an increase in tax rates.

Part of the reason expenditures grow so rapidly is that both state and local governments are caught in a price and productivity squeeze. During the last decade the prices these governments had to pay for goods and services rose more than twice as fast as those in the private sector. These increases occurred because:

(a) About 57 percent of state and local expenditures consist of salaries which are comparable to those in the private sector. However, the productivity of all service type employees, both public and private, has grown at a much slower rate than the productivity of the goods producing sector of the private economy. As a result, service type em-

ployees have not been able to increase their output in order to offset their higher costs. By contrast, employees in goods producing industries have been able, through better technology and equipment, to produce a greater volume of output, at higher wage levels, but the prices of their products in many cases have remained stable.

(b) About 26 percent of state and local expenditures consist of new construction, whose prices have increased more than twice as fast as consumer prices. This combination of growing personnel and construction costs, which accounts for 83 percent of total state and local expenditures, is the basic reason for the disproportionate increases in the cost of these areas of government.

The annual growth rate of General Fund revenues depends upon the elasticity of individual taxes. Elasticity is defined as the average growth rate of a tax (or the total tax structure) compared to the average change in the incomes of Californians. For example, over the last 12 years the personal incomes of Californians have grown at an average annual rate of 7.2 percent. General Fund taxes are growing at an average annual rate of 7.6 percent. Therefore our tax structure has a growth rate slightly in excess of the growth in personal incomes, and this elasticity relationship is expressed as 1.05 (i.e., growth in taxes is 105 percent of personal income growth).

Table 2 indicates that there are wide variations in the growth rates of individual taxes. At one extreme is the rapidly growing personal income tax with an elasticity factor of 1.55, while at the other end is the sluggish cigarette tax. California would have to make the personal income and inheritance taxes the dominant sources of its tax structure in order to match, on a permanent basis, the growth in revenues with that of expenditures. However, it is possible to make less dramatic changes by placing more (but not total) reliance upon the elastic tax sources, and such a change would postpone, but not eliminate the need for periodic tax rate increases. Tax reformers also should realize that the adoption of inelastic tax measures, such as the cigarette tax, will not provide a revenue source that meets growing expenditure needs unless the tax rates are continually increased.

2. *Equity.* There are two facets to the problem of "equity": (a) the equal treatment of taxpayers in the same economic condition, and (b) a "fair" distribution of the total tax burden among taxpayers with different levels of income, wealth and family status.

Table 2

Elasticity of General Fund Tax Revenues

Tax	*Elasticity factor*	*Average annual revenue increase*
Personal income	1.55	11.2%
Inheritance and gift	1.50	10.9
Insurance	1.25	9.0
Retail sales	.85	6.2
Bank and corporation	.85	6.2
Alcoholic beverage	.80	5.8
Private car	.75	5.4
Horseracing	.60	4.3
Cigarettes	.40	2.9
Totals	1.05*	7.6%

* Weighted average.

The first category is usually referred to as horizontal equity. Under this principle, taxpayers with the same level of income and family status should pay the same amount of state taxes. It is very difficult to design a perfectly horizontal tax structure. For example, a young married family will typically spend a larger proportion of its income on items subject to the retail sales tax than will an older family with the same level of income. The sales tax, however, applies to individual transactions and does not distinguish between different levels of total taxable transactions. The personal income tax probably comes closest to meeting this principle. By contrast, there are certain features of our tax structures which are intentionally designed to treat taxpayers differently. The sumptuary levies on cigarettes, alcoholic beverages and horseracing are prime examples of this type of treatment. The state has made the policy decision that if taxpayers wish to spend their money on these goods and activities, then they will have to pay a special tax.

Most of the debate on tax reform centers on horizontal equity. Some of the current controversies are: (1) should capital gains be taxed at the death of the owner, (2) should some minimum tax be imposed on wealthy persons with tax-free income, (3) does the depletion allowance give natural resource owners a competitive advantage over other types of businesses, and (4) should the sales tax be applied to certain services.

In our view, the quest for better horizontal equity is a continuous process. There will always be certain deficiencies in any tax structure. However, California's tax structure probably achieves a higher degree of horizontal equity than the tax structures of most states.

The second equity category is usually referred to as vertical. Under this principle, the state tax burden should be either proportional or progressive (depending upon one's philosophy) as it relates to taxpayer income. Among economists, there is not unanimity over the classification of California's existing tax structure. Some contend that the structure is basically proportional, while others state that it is regressive for the lower income groups. This disagreement arises because reliable information is not available on the distribution of tax burdens by income groups. There also are differences of opinion on what portions of indirect (business) taxes are shifted forward to consumers in the form of higher prices.

3. *Cash Flow.* During 1967–68, the General Fund faced a serious cash flow problem because only 35 percent of the revenues were expected in the first half of the fiscal year, but half of the expenditures would be made in the same time period. This disparity arose because most of the personal income and corporate franchise taxes were collected during the second half of the fiscal year (January to June). To overcome this cash flow problem, the 1967 Legislature required the approximate top 10 percent of income taxpayers to make a special prepayment each October, and corporations to make an additional prepayment in November (calendar year firms). These changes temporarily solved the cash flow problem, however they did not provide a permanent solution. In 1969–70, about 42 percent of General Fund revenues will be collected in the first half of the year, but 47 percent of the expenditures will be made in the same time period. There will be a

$285 million difference between revenues and expenditures during this time period, and it is possible, that at some future date, the General Fund will once again face a cash flow problem.

The Local Tax Structure

The major problems of the local tax structure are:

1. There are wide disparities in the distribution of property tax wealth among local governments. As a result, some of the poorer communities have to impose high property tax rates to obtain a moderate level of expenditures, while others with a richer proportion of assessed valuation can obtain a high level of services with moderate or low tax rates.

2. Some communities have special expenditure problems which cause high property tax rates. For example, the per capita cost of police and fire protection in certain urban areas is much higher than in neighboring communities. Another example would be the disparity in the property tax effort necessary to support local welfare costs.

3. The formulas for distributing Bradley-Burns local sales taxes, and state shared revenues, are not designed to place these funds where they are most needed.

4. The residential property tax burden for low income families is regressive. However, Proposition 1A on the November 1968 ballot, and the senior citizens property tax assistance program, have reduced the regressive nature of the residential property tax.

5. Some local officials have developed a mental attitude where they are willing to seek almost any source of additional revenue, other than the property tax, to finance the increasing costs of local government.

Any discussion of the local tax structure invariably starts with an examination of the property tax. Table 3 shows that schools received 53.4 percent of these revenues during 1967–68, and total property taxes increased by 9.1 percent over the prior year. This growth rate was slightly below the 10 percent average of recent years because the 1967 Legislature, with the passage of AB 272, substantially increased the state support for local education. Local assessed values (adjusted for a common assessment ratio) increase at about 7 percent a year, and tax rate increases account for the other 3 percent growth. Therefore, local governments face about the same elasticity problems as the state government. The only difference is that property tax rates tend to be increased annually, while state tax rates are increased periodically.

One of the common misconceptions about the property tax is that single family owner-occupied homes constitute the major portion of the tax base. Table 4 shows that this is not true. The best information available on this subject is two studies by the U.S. Department of Commerce. The 1962 study, which examined the 1961 tax roll, showed that residential property was only 46.1 percent of the total property tax base. By using 1960 housing census data for California, we were able to estimate that only 30.2 percent of the base consisted of single-family owner-occupied homes. We presented this information to the 1967 Legislature. In the fall of 1968, the Department of Commerce released its latest study which covered the 1966 tax roll, and it showed a slight decline in the proportion of single-family dwellings and an increase in the proportion of multiple units.

Table 3

Distribution of Local Property Taxes in California by Type of Governmental Unit
Amounts in Millions

Fiscal year	*Cities*	*Counties*	*School districts*	*Special districts*	*Total*
1963–64	$366	$871	$1,414	$159	$2,810
1964–65	384	945	1,551	179	3,059
1965–66	409	999	1,763	202	3,373
1966–67	448	1,088	1,999	232	3,767
1967–68	476	1,190	2,196	249	4,111
1967–68					
1. Percentage Distribution	11.6%	28.9%	53.4%	6.1%	100%
2. Increase over prior year					
Amount	$28	$102	$197	$17	$344
Percent	6.2%	9.4%	9.9%	7.3%	9.1%

Table 4

Distribution of Assessed Valuation in California by Type of Property

Type of property	*1961*	*1966*
Single-family residences		
Owner-occupied	30.2%	28.3%
Rented	10.1	9.5
Multifamily residences	5.8	9.9
Total residential	46.1%	47.7%
Nonresidential		
Farms	8.6%	8.1%
Vacant lots	2.3	2.9
Commercial and industrial	30.0	30.4
Railroads and public utilities	13.0	10.9
Total nonresidential	53.9%	52.3%
Total property tax roll	100.0%	100.0%

Sources: U.S. Department of Commerce studies "Taxable Property Values," 1962 and 1968, and the 1960 Census of Housing for California.

The claim that property taxes are highly regressive has been made so often that most people accept it as fact. We disagree. Table 5 shows that the owner-occupied residential portion of this tax is somewhat regressive (after the adoption of Proposition 1a) for taxpayers with incomes below $5,000, but it is roughly proportional for taxpayers with adjusted gross incomes of between $5,000 to $25,000 a year. However, these statistics relate only to 28.3 percent (owner-occupied homes) of the total property tax base, and cannot be used to describe the entire tax. The incidence of this tax depends primarily upon how the nonresidential portion of the tax burden is shifted, and we have never seen a definitive study which explains this question.

The next part of this discussion will explore possible solutions to the problems of the local tax structure.

1. *School taxes.* In January of this year we submitted a proposal to the Legislature to change the method of taxing property for public

Table 5

The Effect of the Homeowners' Exemption on the Regressive Nature of the California Property Tax

Adjusted gross income class	*Average AGI*	*Before Proposition 1a Property taxes* [a]		*After Proposition 1a Property taxes* [b]	
		Amount	*Percent of AGI*	*Amount*	*Percent of AGI*
$0– $2,000	$1,589	$185	11.6%	$115	7.2%
2,000– 3,000	2,562	200	7.8	130	5.1
3,000– 4,000	3,523	220	6.2	150	4.3
4,000– 5,000	4,643	234	5.0	164	3.5
5,000– 6,000	5,574	244	4.4	174	3.1
6,000– 7,000	6,540	267	4.1	197	3.0
7,000– 8,000	7,520	279	3.7	209	2.8
8,000– 9,000	8,500	316	3.7	246	2.9
9,000– 10,000	9,495	334	3.5	264	2.8
10,000– 11,000	10,490	365	3.5	295	2.8
11,000– 12,000	11,491	376	3.3	306	2.7
12,000– 13,000	12,484	431	3.4	361	2.9
13,000– 14,000	13,465	429	3.2	359	2.7
14,000– 15,000	14,470	464	3.2	394	2.7
15,000– 20,000	16,969	528	3.1	458	2.7
20,000– 25,000	22,143	707	3.2	637	2.9
25,000– 50,000	33,223	956	2.9	886	2.7
50,000– 100,000	65,621	1,488	2.3	1,418	2.2

[a] Based upon a special study by the Franchise Tax Board of itemized property tax deductions on 1965 California personal income tax returns filed by married couples. This study was released in December 1967. Property taxes for income groups below $5,000 were estimated by extrapolating 1966 federal income tax data.

[b] Obtained by stubtracting $70 from the before Proposition 1a data. This information does not show the effect of eliminating the property tax on household personal effects.

schools. The key element of our proposal would be a division of the total property tax base into two major classes: (1) residential and (2) all other classes of property (i.e., business property). Under this proposal the state would levy a uniform statewide tax on business property which would be based on the average tax rate currently levied on business property. The proceeds from this tax would be combined with existing State School Fund money and would be apportioned to school districts to support a more meaningfully defined "guaranteed or foundation program" reflecting the unit cost of a representative classroom situation. Local school districts would be required to finance all educational services in excess of the guaranteed program from taxes levied on residential property.

The major advantages of this proposal are that it would (1) eliminate the effect of variations in wealth with respect to that portion of the tax rolls which exhibits the greatest variation (nonresidential), (2) insure certainty for businesses that they would pay public school taxes at a uniform rate, regardless of the location of their plants or offices, and (3) place upon the residential sector the burden of educational expenditures above the guaranteed level, thus giving more meaning to the concept of local options.

2. *Local Social Welfare Costs.* During the current fiscal year, counties will spend about $237 million for their share of social welfare costs. However, there are wide variations in the property tax rates needed to finance these costs. The following tabulation shows that, in the larger counties, the tax rates range from a low of 13 cents in Orange County to a high of 78 cents in San Francisco County.

Estimated County Property Tax Rates to Support Social Welfare Costs

County	*Tax Rate*
Alameda	$0.51
Fresno	.73
Los Angeles	.52
Marin	.29
Orange	.13
Sacramento	.68
San Francisco	.78
San Mateo	.21
Ventura	.19

If either the state or the federal government absorbed these local social welfare costs, the greatest property tax benefit would accrue to those counties which currently bear the heaviest tax rate burden. This type of property tax relief would benefit all types of property, not just homeowners (Table 4). In assuming these costs, the state would add to its expenditure problems, because this is a rapidly growing expenditure category. For example, the Governor's 1969–70 Budget indicates that these county social welfare costs will increase by $40.5 million or 17 percent in the budget year.

3. *Urban Problems.* Table 6 compares the police, fire and other municipal costs of three cities with almost identical populations. These data indicate that Oakland and San Jose have approximately the same level of assessed valuation, but Oakland's police department costs twice as much as San Jose's, and Oakland's fire department was 60 percent more expensive. As a result, Oakland's city property tax rate was $3.16, one of the highest in the state, compared to $1.70 in San Jose.

Crime statistics for Oakland were about twice the level of San Jose, and this was the main reason for the differences in police expenditures. Fire protection costs were higher in Oakland largely because of the industrial and age composition of the structures in that city.

Long Beach had a higher level of assessed valuation and lucrative income from oil properties, therefore it could support high expenditures for the police department and parks and recreation, with a property tax rate of only $1.48.

This table also indicates that these three cities received almost identical shares of the state collected motor vehicle in lieu fees, and Oakland received the largest share of state collected local sales taxes. However, Oakland's higher level of sales taxes did not compensate for the differences in its police and fire protection costs.

These comparisons illustrate one of the basic problems facing some of our urban centers, i.e., they have high expenditure requirements but lack the revenue flexibility to finance these needs without imposing high property tax rates. As a result, some cities constantly are seeking new sources of nonproperty tax revenues. The trend following World War II was to adopt local sales taxes. A new cycle started a few years ago with the adoption of local cigarette taxes. The next cycle probably will be local income taxes.

The formulas used by the state to distribute local sales, cigarette and motor vehicle in-lieu taxes have not helped this situation. On the contrary these formulas have given large amounts of revenue to cities which have very modest or no local property taxes. A better method would be to distribute these taxes on a basis which more accurately reflects needs. During 1969–70, the municipal share of sales, cigarette

and motor vehicle in-lieu taxes will be about $500 million, or about 90 percent of what the cities will collect in property taxes. Therefore, the state has a tool with significant impact that could be used, like school equalization aid, to compensate for differences in local property tax wealth and expenditure needs. To implement this type of a subvention program, the locally imposed but state-collected retail sales tax would have to be abolished, and replaced by an increase of 1 percent in the state sales tax rate.

Table 6

A Comparison of City Revenues and Expenditures in Oakland, San Jose and Long Beach

1966–67 Data

	Oakland	*San Jose*	*Long Beach*
Population (thousands)	385.7	384.4	387.6
Total assessed valuation (millions)	$732.9	$742.2	$1,112.7
Per capita assessed valuation	1,900	1,931	2,871
City Tax Rate	3.16	1.70	1.48
Expenditures (millions)			
Police protection	$9.6	$4.5	$7.3
Fire protection	7.0	4.3	4.6
Public works	11.2	8.7	10.6
Parks and recreation	5.8	2.1	17.7
Bond interest and redemption	2.2	5.5	2.8
All other	15.1	11.0	26.0
Total Expenditures	$50.9	$36.1	$69.0
Revenues (millions)			
Property taxes	$23.1	$14.0	$16.9
Sales taxes	8.7	6.4	6.7
Motor vehicle in lieu	2.4	2.4	2.4
State gasoline tax	2.6	2.6	3.1
Current service charges	2.3	3.9	6.0
Interest, rents and royalties	1.4	0.7	26.7
Other revenues	12.2	7.6	11.7
Total Revenues	$52.7	$37.6	$73.5

4. *Other Possible Solutions.* To relieve the pressures on the local property tax, the state could also assume the cost of functions with a major state concern, such as junior colleges, or superior courts. The former would cost about $250 million a year, while the latter would cost between $20 million and $30 million a year depending upon which auxiliary functions such as court clerks, law libraries, jury fees, etc., were also absorbed.

Two other alternatives would be to: (1) increase the value of the homeowner's property tax exemption, or (2) allow local governments a new source of nonproperty tax revenue. A larger homeowner's exemption would be the only method of granting relief strictly to owner-occupied residential property. Business properties with the preponderance of assessed value, would be the main beneficiaries, at least initially, of other proposals which provide relief to all property taxpayers.

If cities imposed local income taxes, then the communities with the wealthiest residents would be the main beneficiaries of this change, and normally these communities are not the ones with the highest property tax rates or the most pressing expenditure needs.