

CALIFORNIA LEGISLATURE
1963 REGULAR SESSION

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1963, to June 30, 1964

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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LETTER OF TRANSMITTAL

STATE CAPITOL
SACRAMENTO, CALIFORNIA
February 15, 1963

THE HONORABLE GEORGE MILLER, JR., *Chairman*
and Members of the Joint Legislative Budget Committee
State Capitol, Sacramento, California

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, 1963, to June 30, 1964.

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 revenue, 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.

Respectfully submitted,

A. ALAN POST
Legislative Analyst

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I. PRELIMINARY STATEMENT

The Legislature's review of the budget of the State of California consists primarily of an examination of the Budget Bill, constituting that part of the total budget which must be acted upon by the Legislature each session to carry out the total expenditure program proposed by the Governor.

Approximately one-third of the total authorized state expenditure program will be contained in the Budget Bill. The remaining two-thirds of the State's expenditure program is appropriated for by existing statutes or by the Constitution.

Since this is a general session the major General Fund costs of state government—education and social welfare—will be the subject of legislation outside the Budget Bill. For this reason and in order that members of the Legislature may consider the expenditures provided for in the Budget Bill in proper relationship to the major expenditure items falling outside the Budget Bill, we have incorporated into this analysis discussion of broad financial issues related to these subjects. Thus, educational apportionments and welfare subventions are discussed in sections of this report which immediately precede the Budget Bill appropriation items for the education and social welfare agencies, respectively.

This analysis will also in the pages that follow provide a brief summary of the fiscal issues involved in balancing the budget and a description of the anticipated revenues accruing to the General Fund, including the Governor's proposals for tax adjustments increasing state General Fund revenues for the next two fiscal years.

BUDGET TOTALS

The Budget for 1963-64 totals \$2,945,027,761 compared with \$2,859,908,011 for 1962-63, and \$2,406,218,003 for 1961-62. These totals reflect an increase in the budget of \$85,119,750 or 3.0 percent over the current fiscal year 1962-63. The expenditure program proposed by the budget consists of three major sections of expenditures and increases as follows:

State Operations -----	\$963,197,235	up	\$76,949,337
Capital Outlay -----	\$329,870,530	down	\$144,852,490
Local Assistance -----	\$1,651,959,996	up	\$153,022,903

As we have pointed out in this analysis in the past, the comparison, especially in terms of percentage increase, between the expenditure level for the current year and for the budget year is considerably influenced by adjustments in the figures for the current year. Although the proposed budget for 1963-64 is 3 percent above the now revised estimate of the 1962-63 Budget, it is \$200 million, or 7.2 percent, above the Budget for 1962-63 as it was adopted by the Legislature in 1962, and as indicated by the Final Change Booklet issued by the Department of Finance on April 24, 1962.

It will be apparent from the summary table above that the largest adjustment has been in capital outlay, which appears to be down \$144 million from the current year. However, it will be noted that, where capital outlay for 1962-63 was shown in the Final Change Booklet at \$350 million, it is now shown in the new budget document at \$474 million for 1962-63 (exclusive of bond funds in both cases).

This revision of the current year's estimate for capital outlay is, in turn, largely attributable to the method of showing state highway expenditures. The impact of these revisions on the budget totals can be seen from the fact that for the last completed fiscal year, 1961-62, highway expenditures from state funds were originally budgeted at \$259 million, subsequently revised in the then current fiscal year to \$342 million, and are now shown on an actual basis for that fiscal year at \$219 million. These re-estimates do not affect the expenditure program since all highway funds are continuously appropriated for allocation for highway purposes. It can be seen, however, that the practice of carrying over large amounts into a revision for the current fiscal year significantly affects the percentage increase comparison between the budget as proposed and as estimated for the current year.

GENERAL FUND FINANCIAL PICTURE PRESENTED BY THE BUDGET

The budget problem is essentially a General Fund problem since special fund functions are financed by revenues earmarked for those special purposes. In our analysis of the Budget Bill for the current fiscal year which will end June 30, 1963, we pointed out the growing problem presented by a more rapid increase in state government cost than in the State's economy and tax base. The financial problems occasioned by the more rapid expansion in costs than revenues are brought to a head in this budget. The Governor's revenue proposals which accompany this budget clearly illustrate the problem. The State will begin the budget year with an expected balance on hand of only \$18.8 million. It is proposed to spend \$2,106.1 million, which leaves \$2,087.3 million to be financed by our revenue system. Actually, unless the revenue system is changed we can anticipate only \$1,934.4 million. To meet this prospective gap of \$152.9 million, the Governor has proposed law changes which accelerate and increase the collection of state revenues to provide an additional \$165.3 million in the coming fiscal year. This will not only cover the prospective deficit but will leave a small \$4 million balance plus committed reserves of \$8.4 million to be carried over into the following fiscal year.

This financial picture is presented in tabular form as follows:

Beginning surplus	\$18.8 million	
Current income and transfers under existing tax laws	1,934.4 million	
Proposed tax measures	165.3 million	
Total resources		\$2,118.5 million
Proposed outgo	\$2,106.1 million	
Committed reserves	8.4 million	
Total outgo and committed reserves ..		2,114.5 million
Ending surplus		\$4.0 million

THE BUDGET BILL

The Budget Bill, containing approximately one-third of the state expenditure program, consists of 445 individual appropriation items covering the support and capital outlay appropriations for almost all the state operating agencies and includes as well a small number of local assistance items which are closely related to functions performed by state agencies. In addition there are a number of miscellaneous items which require annual appropriation and are therefore included in the Budget Bill.

Starting with page 1 in this report we provide a detailed analysis of each of the Budget Bill items, with recommendations.

RECOMMENDED REDUCTIONS

While legislation to provide substantial increases in state revenues appears to be inevitable this year if the budget is to be balanced, there appears to be a course of action open to the Legislature which may avoid the imposition of the full tax revision program proposed by the Governor. The recommendations contained in this analysis have been designed not only to identify areas of possible economy and improved efficiency where our studies indicate they are possible, but also to point out as a policy consideration for the Legislature certain options which would provide substantial reduction in the total proposed expenditure increase.

It should be said at the outset that the propriety of restricting major expenditure increases at this time seems clear. Since the tax proposals of the Governor afford essentially only a one-time pickup of revenue, the fundamental problem of fiscal balance remains unsolved, and any reductions in proposed appropriation increases not only may serve to avoid this year the need to impose certain of these tax measures but will also reduce the size of the ultimate tax rate increase required in 1965. The fact also cannot be overlooked that the State's recent policy of financing needed construction outlays almost entirely from bond funds obscures the absence of tax revenues to pay for these costs which, it should be stressed, are in addition to those reflected in the current deficit which the added tax program is designed to meet. While it may be argued that bonds are a suitable method for spreading the cost of a certain portion of such capital expenditures, the almost complete reliance upon borrowings year after year leads only to a compounding of the inevitable tax increases needed to pay the debt. Certainly, no one denies that substantial annual appropriations will continue to be required for capital outlay during the foreseeable future, and that if the cost is not met currently by raising tax revenues, it will be paid for as bond interest and redemption in a few years by similar tax increases, only the tax increases will be larger by virtue of the added interest requirements. These bond service costs are mounting rapidly. This budget already includes over \$25 million to service the existing state building program bond issues, over half of which is for bond interest.

The recommendations made in our Analysis of the Budget Bill suggest reductions in proposed expenditures totaling \$35 million from the General Fund. The recommendations reflect not only the results of a

yearlong review of the ongoing operations of state agencies and subventions program with suggested economies, but \$21 million of this sum represents a proposal that the State hold up on any salary increases for state employees in the budget year. Since this is proposed on a broad policy basis, the reasons for which are outlined below and also in detail in connection with the Budget Bill items for salary increases, we believe that the State could also appropriately hold up on adding any amounts to school apportionments beyond the sums needed to meet added costs for school enrollment growth at the existing formula for state participation. If this were done, a total of \$65 million could be reduced from the tax proposals made by the Governor as needed to balance the budget.

We believe that it would be appropriate for the Legislature, for one year at least, to defer salary increases for public employees financed by state budgets. We believe it may logically do this because California has generally in relation to others maintained its pay scales at the very highest level of compensation. It has maintained salaries of state civil service employees at a level which will be equal in April of 1963 to the salary actually paid to the individual state employee's counterpart in outside employment as measured by the data collected by the State Personnel Board. In this respect we are not in agreement with the State Personnel Board finding that state employees will be 5 percent behind in April because of what we believe to be a serious defect in the technique of using the survey data to express a direct comparison between the level of salaries received by employees of the State and by their counterparts in private industry. The details of this may be found in our discussion of item 277. Similarly, the salaries of personnel in the State's institutions of higher learning have been maintained at parity with the institutions which represent the highest salaried group in the country. For the university, comparison is made with a small group dominated by the privately endowed eastern universities, principally Harvard, and salaries are therefore traditionally higher than other public universities, as well as almost all of the nation's privately endowed universities. By objective standards the state colleges are maintained at parity with a group which reflects at least an equally favorable level of compensation, when due consideration is given to the differences between the university and the colleges in respect to program and faculty qualifications.

In the area of school apportionments, the budget proposes legislation which will increase both local and state taxes, beyond the amounts required at existing program levels solely for increased enrollments. The net result will inevitably be largely to finance salary increases for teachers and school administrators. The State might, with consistency, elect to hold the line here, too. Salaries of teachers in California, similar to state civil service and academic employees, stand at the highest level in the country. Its teachers salaries are exceeded only by Alaska, which reflects unusual employment conditions. Thus, the average salary of instructional staff in the public schools, as reported for 1961-62, shows the leaders, in order, to be Alaska, \$7,650; California \$7,325; New York \$7,000; Connecticut \$6,400; Michigan \$6,362; Illinois \$6,327; and New Jersey \$6,295.

The net effect of adopting a policy of holding the line this year on salaries and otherwise achieving economies reflected in the recommendations of this report would be to produce budget reductions totaling approximately \$65 million. This can be considered in relation to tax increases proposed by the budget of \$165.3 million. Or it might equally be considered in relation to the approximately 100-million-dollar budget deficit, mentioned in the Governor's message, as a possible tax increase issue in 1965, a figure which might objectively be regarded as a minimum possible deficit, barring adoption of a policy, such as is suggested here, of limiting major expenditure increases.

REVENUE ESTIMATES

Total state revenues are estimated at \$2,883,738,093 for 1963-64. This represents an increase of \$248,638,662, or 9.4 percent, above the expected total of \$2,635,099,431 for 1962-63. These collection estimates are for all state funds. The General Fund portion for 1963-64 is estimated at \$2,079,711,412, an increase of \$234,359,659, or 12.7 percent, over 1962-63.

These estimated large increases, especially in General Fund revenue, are closely tied to the realization of two major factors:

1. Changes in 1963-64 and 1964-65 state tax collection procedures for the personal income tax, the bank and corporation tax, the insurance tax and others.

2. A reduction in federal tax levies starting in mid-1963 which has been proposed by the President as a means of stimulating personal spending and business investment.

The Department of Finance estimate of General Fund revenues for 1963-64, as compared to 1962-63, assumes that the 1963-64 state tax collection revisions will be made as proposed by the Governor and that the federal tax reduction will be accomplished substantially as proposed by the President. Under these assumptions the anticipated revenues are shown for the 1962-63 and the 1963-64 fiscal years in the following table:

	General Fund Revenues		Increase	
	1962-63	1963-64	Amount	Percent
Sales and use tax -----	\$794,500,000	\$847,000,000	\$52,500,000	6.6
Bank and corporation tax ----	306,500,000	386,500,000	80,000,000	26.1
Personal income tax -----	324,200,000	382,000,000	57,800,000	17.8
Insurance tax -----	76,250,000	103,250,000	27,000,000	35.4
Inheritance and gift tax ----	95,000,000	100,750,000	5,750,000	6.1
Cigarette tax -----	71,000,000	73,250,000	2,250,000	3.2
Alcoholic beverages taxes ----	61,600,000	64,525,000	2,925,000	4.7
Horseracing tax -----	32,649,864	32,606,921	-42,942	-.1
Other sources -----	83,651,889	89,829,491	6,177,602	7.4
Total -----	\$1,845,351,753	\$2,079,711,412	\$234,359,659	12.7

Of the \$234,359,659 increase in total General Fund revenues shown in the above table, \$164,800,000 or 70.3 percent is contained in the three categories—personal income tax, bank and corporation tax, and insurance tax. These are the taxes for which the major changes in collection and other procedures are proposed during a two-year program starting

in 1963-64. In addition to these revenue increases the Department of Finance is proposing the transfer of \$20 million from the California Water Fund into the General Fund for educational purposes. The total General Fund receipts increase therefore is \$254,359,659 when this transfer is included.

The tax revisions which are being recommended together with the revenue changes that would result, as estimated by the Department of Finance, are shown in the following schedule:

	<i>(In millions)</i>	
	1963-64	1964-65
<i>Bank and corporation tax</i>		
Eliminate installment payment privilege effective January 1, 1964	\$82.5	\$10.8
Provide for payment of estimated tax on current business profits, with credit offset for double tax in second year of operation in California	-	32.0
Adopt present federal limitations on business deductions for gifts, entertainment, club dues, etc.	1.0	1.2
Totals, bank and corporation	\$83.5	\$44.0
<i>Personal income tax</i>		
Eliminate tax liability below \$5 (single) and \$10 (married or head of household)	-\$2.5	-\$2.5
Eliminate installment payment privilege effective January 1, 1964	35.0	4.7*
Adopt withholding procedures and estimated tax declarations effective July 1, 1964, with forgiveness of one-quarter of the tax due on 1964 incomes	-	96.2
Adopt present federal limitations on business deductions for gifts, entertainment, club dues, etc.	0.5	0.7
Totals, personal income	\$33.0	\$99.1
<i>Insurance tax</i>		
Provide for quarterly remittance of tax after January 1, 1964	\$22.0	\$15.*
Eliminate principal office deduction	†	5.3
Transfer surplus line brokers' tax to the General Fund	-	.7
Eliminate constitutional rate provision	†	‡
Totals, insurance	\$22.0	\$7.5
<i>Gift tax</i>		
Conform with Federal law by reducing the annual exemption from \$4,000 to \$3,000	\$0.5	\$0.5
Totals, revenue	\$139.0	\$151.1
<i>Oil royalties</i>		
Redistribute royalty income in order to make unneeded balances available for education	\$26.3	No estimate
Grand totals, all sources	\$165.3	\$151.1

* Increase due to annual growth in the tax base.

† Requires constitutional amendment.

‡ No change anticipated at this time.

The estimated increase in General Fund receipts for 1963-64 to result from the tax changes and adjustments listed in the preceding schedule is \$165.3 million with \$83.5 million coming from the bank and corporations franchise tax, \$33 million from the personal income tax, \$22 million from the insurance tax, and \$20 million to be transferred into the General Fund for school purposes from the California Water Fund. For 1964-65, an additional \$151.1 million or more would be collected mainly from withholding on the personal income tax and related changes to the bank and corporation tax.

In addition to the \$165.3 million estimated increase owing to tax changes and adjustments for 1963-64, \$89.1 million is estimated to accrue from the gradual expansion of the present tax base. Therefore, total General Fund receipts or income for 1963-64 is projected at \$2,099,711,412, or \$254,359,659 (13.8 percent) above the 1962-63 level. The estimated per capita tax payments to the General Fund would be raised to \$110.83 for 1963-64 from \$101.76 in 1962-63 if all these proposed changes are effected.

The 1962-63 Budget document last year estimated General Fund receipts at \$1,723,909,189 for 1961-62 and \$1,882,681,495 for 1962-63. The actual collections for 1961-62 of \$1,728,221,900 are \$4,312,711 higher than the estimate. Collections for 1962-63 are re-estimated in the 1963-64 Governor's Budget document at \$1,845,351,753, a reduction of \$37,329,742, or 2 percent. This failure in 1962-63 to reach estimates has been attributed to the generally sluggish condition of the national economy during 1962. A more vigorous expansion in economic activity had been expected—reaching an average level of about \$560 billion in gross national product for the year—instead of the approximately \$554 billion which appears likely at this time.

The realization of state General Fund income at the level projected for 1963-64 is directly predicated on the assumptions: (1) that federal taxes will be cut in sufficient amount and early enough in 1963 to provide a strong expansion basis for spendable income and thereby state tax collections, and (2) that the level of economic activity will continue at a strong and an expanding pace.

There is no certainty at this time that federal taxes will be reduced in 1963. If they are reduced there is the possibility that the form of the reduction may be drastically altered as well as the amount. Should the reduction be postponed until 1964 this presents still another consideration as to the effect on the economy. The Department of Finance has assumed that the federal tax reduction program will amount to \$6 billion in 1963, and that the effect of this will be to increase personal income in California by \$375 million for 1963-64 over what would otherwise be the case. This in turn will add \$13.5 million to the State's General Fund revenues. Any altering of the legislation or the time of its effective date will, of course, have a material effect upon these revenue assumptions. We estimate that if the tax reduction is not made effective in time for its impact to be felt in 1963-64 the reduction in personal income could be as much as \$750 million, in which case the loss of General Fund revenues below estimates would be in the magnitude of \$28 million rather than the \$13.5 million estimated by the Department of Finance.

In addition to this factor, there are the usual hazards in projecting economic data relative to a General Fund budget of over \$2 billion even under more normal conditions. Should General Fund income, for instance, fall short by \$40 million which represents approximately the difference between the estimate made a year ago by the Department of Finance and the current re-estimate for 1962-63, it would carry severe fiscal implications, yet be less than 2 percent off from the actual total. In addition to this risk of estimating error for 1963-64, there is the added problem of the impact of an as yet uncertain federal tax change.

ECONOMIC CONDITIONS

A continuation of the slow growth pattern characteristic of 1962 in the first half of 1963 appears likely. The state of the economy in the second half of 1963 will be directly affected by tax legislation. Should Congress approve the President's tax reduction as recommended expansionary forces providing an upward thrust to the economy can be expected, the magnitude depending on the people's inclinations between spending and saving the increased income.

If tax legislation fails or the effective date is postponed, a plateau or recessionary tendencies may characterize the national economy in the second half of 1963.

Under the assumption that the federal tax reduction will be adopted to stimulate the economy in 1963, the Department of Finance has projected Gross National Product at \$575 billion for the year. This assumes a strong boost to activity in the final quarter raising the annual rate of production more than \$30 billion above the fourth 1962 quarter level.

The Department of Finance estimates California personal income at \$52 billion for 1963. This would represent an increase of \$2.8 billion or 5.7 percent from the 1962 level. The State continues to grow at a rapid pace with a population of 17,688,000 forecast for mid-1963—up 594,000 or 3.5 percent from 1962.

Federal defense and space exploration expenditures are scheduled to rise significantly this year, and California is expected to continue to gain relatively. The State currently accounts for more than one-fourth in dollar value of all military prime contracts (awarded to state firms) and more than two-fifths of defense and space oriented research and development.

In spite of the generally more progressive nature of the California economy many problems remain. A particularly chronic one is unemployment both in the State and the nation. This is expected to average more than 6 percent of the labor force in California in 1963.