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1966 REGULAR SESSION

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1966, to June 30, 1967

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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INTRODUCTORY STATEMENT

FORM OF THE ANALYSIS

This Analysis of the Budget again this year takes a form which has as its primary objective furnishing the Legislature with a broad overview of the principal financial and program features of the Governor's Budget as they relate to legislative action on the Budget Bill, as well as providing a detailed review of the financial issues associated with each of the separate items of the Budget Bill. Since about two-thirds of the state expenditures are not in the Budget Bill, the Analysis also includes appropriate discussion of major budget programs which appropriately also must be considered by the Legislature.

Again this year our analysis of the financial requirements of the various activities of state government makes a definite effort to improve our statements of the functions and activities of agencies by organizing data so far as is possible in program terms. This cannot be done uniformly because of the absence of an accounting system which permits complete program budgeting and program review, but where accurate and meaningful data can be organized in such a way as to facilitate review by the Legislature on an improved program basis we have elected to do so.

Despite steps taken in each of the last three sessions of the Legislature to advance the collection of revenues and thereby forestall the imposition of major tax increases, the Governor's Budget this year will require \$143 million in added taxes or the alternative of equivalent reductions in expenditures. Our Analysis again this year distinguishes between recommendations as to reductions in agency budget requests based on efficiency and economy and suggested reductions which called for a significant change in established state policy. These latter suggestions are identified as "Policy Options" which are placed following the discussion of our specific recommendations for reductions.

It should also be pointed out that the 1965 Legislature reduced the Governor's Budget by over \$61 million below what was finally proposed by the Governor including the augmentations contained in his special so-called Phase II programs.

Since about \$40 million of this was in General Fund items, reductions of this magnitude obviously have a material bearing on the policy alternatives which the Legislature is able to consider in relation to the issue of how and in what degree additional taxes must be instituted.

It is difficult to identify a meaningful total of the reductions recommended in this Analysis for the reason that there are a number of major proposals in this budget which have not as yet been adequately formulated to permit effective review. We have not recommended approval of such items but have called for special legislative review, at which time the additional information which we hope to be able to develop can be presented to the legislative committees accompanied by specific recommendations.

OVERALL EXPENDITURE TOTALS

For 1966-67 the total state expenditure level is estimated at \$4,617,913,743. This includes \$569,353,102 in bond funds. The total expenditure for bond programs is divided among the following separate categories:

State Construction Program Fund -----	\$175,006,614
California Water Resources Development Bond Fund -----	134,322,300
Central Valley Water Project Construction Fund -----	198,343,411
State Beach, Park, Recreational and Historical Facilities Bond Fund -----	61,680,777
Total -----	\$569,353,102

It is not standard state accounting procedure to include bond funds in the budget expenditure totals. Therefore, the inclusion here is for comparative purposes only and subsequent sections on budget expenditures and totals exclude these bond funds.

GENERAL BUDGET SUMMARY

The 1966-67 Budget proposes total outgo at \$4,048,560,641 (excluding bond funds). This is a gain of \$234,321,615 or 6.1 percent over the estimated total of \$3,814,239,026 for 1965-66. The continued rapid growth in outgo is evident in the following table which shows for the latest three fiscal years a breakdown into the major categories as well as the budget totals and changes during the period.

	<i>Total Outgo</i>	<i>Support</i>	<i>Local Assistance</i>	<i>Capital Outlay</i>
1964-65 -----	\$3,337,474,194	\$1,035,547,263	\$1,918,352,348	\$383,574,583
1965-66 -----	3,814,239,026	1,181,996,274	2,141,728,623	490,514,129
1966-67 -----	4,048,560,641	1,352,377,899	2,325,070,807	371,111,935
1966-67:				
Amount of change from				
1965-66 -----	+234,321,615	+170,381,625	+183,342,184	-119,402,194
Percent change	+6.1	+14.4	+8.6	-24.3
1966-67:				
Amount of change from				
1964-65 -----	+711,086,447	+316,830,636	+406,718,459	-12,462,648
Percent change	+21.3	+30.6	+21.2	-3.3

A large drop is indicated in capital outlay expenditures between 1965-66 and 1966-67 as well as a large increase between 1964-65 and 1965-66. This is misleading in that the 1965-66 year includes large carryover balances in special funds, much of which will likely again be carried forward in subsequent budgets. This process is illustrated for the 1964-65 fiscal year showing the complete adjustment cycle.

Special Funds Capital Outlay Expenditures for 1964-65 *Millions*

As proposed in 1964-65—Governor's Budget Document -----	\$297.8
As reestimated in 1965-66—Governor's Budget Document -----	474.7
Actual as shown in 1966-67—Governor's Budget Document -----	383.6

It is evident from the above comparisons of the same expenditure category that the midyear estimate was not very accurate. The similarly inflated reestimate for 1965-66 as shown in the 1966-67 Budget docu-

With a steadily expanding economy in California the 1966-67 revenue level as estimated at \$2,738.9 million (including the proposed increase in income taxes) by the Department of Finance has reasonable prospects of being fulfilled. Some of the economic prospects relevant to the revenue picture are discussed in the following sections.

Economic Situation in 1965

Steady growth characterized the national economy during 1965. Gross national product for the year is estimated at \$675.6 billion, up \$46.9 billion or 7.5 percent from \$628.7 billion in 1964. Some of the major forces behind the advance were further stimulus from the 1964 tax reductions, new reductions in excise taxes during 1965, retroactive payments of social security benefits in September, continued high sales of consumer goods, especially of automobiles, plus expanding investment in new plant and equipment by industry.

The expanded action in Viet Nam was one of the most important of the elements tending to raise GNP during the year. A slight slowdown during the last half of 1965 had been generally anticipated a year ago as the result of expected large inventory accumulations, high consumer debt ratios and other factors. Demand however continued greater than expected so that the inventories built up (especially for the steel strike) did not become an important drag on current production, and demand for all kinds of credit continued to expand strongly; resulting in an increase in the discount rate by the Federal Reserve Board in December to dampen demand. Of especial significance has been the drop in the national unemployment rate from about 5 percent a year ago (seasonally adjusted basis) to just above 4 percent by the end of the year.

The economy in California also moved ahead during 1965. The aircraft industries with defense and commercial contracts which had declined during 1964, turned around in 1965, and activity was strongly increasing by year's end. Although total construction in the state was above 1964, the housing segment continued to decline as the surplus was being reduced. Unemployment in California remained higher than the national rate during the year but declined from the near 6 percent level characteristic of the last several years to 5.7 percent (seasonally adjusted) by December, and moved down further to a preliminary estimated 5.4 percent for January 1966.

National Economic Outlook for 1966

The economy is entering 1966 in an expansive mood. Although other factors are pertinent the course of the war in Viet Nam as it is reflected in government spending, level of employment and availability of consumer and other goods is of prime importance. The economic picture is clouded by uncertainty of the course of action that will be followed in respect to the military operations especially if this causes expenditures to accelerate more than expected.

Assuming that there will not be any drastic change in the build up of military operations, a strong economic expansion emphasizing both "guns and butter" during 1966 is in prospect. Limiting factors appear to be further shortages of trained workers as the unemployment rate moves under 4 percent as well as stronger inflationary forces with the economy operating at close to practical capacity and credit resources already strained.

Some of the significant considerations and assumptions within this general framework are discussed as follows:

1. **Governmental Expenditures.** Federal expenditures are expected to move up sharply because of the Viet Nam situation. State and local expenditures are anticipated to continue their steady yearly rise with an increase of between 7 and 8 percent. Federal defense expenditures are currently estimated at from \$56 billion, to \$60 billion in the 1967 budget year as compared to a range of between \$50 and \$53 billion presently estimated in the current year. The \$60 billion level seems to be near the prospective limit, in view of likely budget deficits and inflationary consequences, that can be contemplated without additional new taxes or wage and price controls and other anti-inflationary measures—and assuming no large new expenditure programs for other purposes.

2. **Credit.** Prospects are for a continued increase in credit during 1966. Added to the currently high levels this will require nimble fiscal management to prevent inflationary excesses as well as on the other hand implementing an orderly expansion. Credit has continued to be available since the increase in the discount rate in December, 1965, although at a higher price. A continuation of these policies of availability of credit closely regulated by its cost appears likely during the year. The present high level of consumer debt, which increased by 12.1 percent from November, 1964 to November, 1965, adds a cautionary element to large further increases in this type of credit.

3. **Prices.** Price levels rose more sharply during 1965 than had characterized previous years. Wholesale prices accelerated during the closing months of 1965 and a continuation into at least the first few months of 1966 seems likely. For 1966 an increase in the overall price level of 2 to 2.5 percent is assumed. This is above the increase of about 2 percent during 1965 as shown by the consumer price index.

4. **Investment.** A continuation of the strong trend in capital investments for plant and equipment is indicated during the first half of 1966. Credit restrictions and labor shortages may curtail outlays somewhat during the latter part of the year but a significant increase within the range of 10 to 15 percent is generally expected for 1966 over 1965.

5. **Consumption Expenditures.** These outlays are expected to continue strong during 1966 tempered by the availability of credit and the heavy load of debt repayments now being carried. A continuation of the high level of sales of automobiles and some other consumer durables is generally anticipated to be a major supporting element.

6. **Construction.** The level of total outlays for construction is generally predicated at moderately above the 1965 level. Housing one of the major components of the industry has been declining for two years but there are indications that new starts may be bottoming out with the prospect that depending on credit availability 1966 could run slightly higher than 1965.

7. **Employment, Unemployment and Productivity.** The uptrend in employment during 1965 resulted in a reduction in the unemployment rate of about 1 percent to near 4 percent by December, 1965. Some further gains are expected reducing the unemployment rate for 1966 to slightly under 4 percent. However, inflationary risks are heightened

as unemployment moves under this level. Higher employment has brought less skilled workers and increased wages, consequently the productivity gain for 1965 is estimated at not over 2.5 percent compared to an average of above 3 percent in the previous five years. A further increase in productivity of only 2 to 2.5 percent is likely for 1966.

A great many other factors will bear on the economic outcome for 1966. The international balance of payments, inventory trends, corporate profits, the increased social security taxes which began January 1, and medicare benefits beginning July 1, as well as proposals for new taxes are only a few of these. The considerations and course of events relative to the defense factor however overshadow these other elements for 1966. The situation thus presents a narrow path between economic stimulus and inflationary excess which may require additional expenditures as well as increased taxes during the year.

An increase in gross national product to a total of between \$715 billion and \$725 billion appears reasonable for 1966 under these circumstances. This would indicate an increase of between about \$40 and \$50 billion over the 1965 level estimated at \$675.6 billion. This amounts to a percentage increase of from 5.8 to 7.3 percent. An increase of 6.6 percent would carry GNP to the \$720 billion level. The increase for 1965 over 1964 amounted to 7.5 percent.

California Economy

The California economy has grown less rapidly than usual during the past two years. Two of the major factors in this slowdown have been reductions in defense-oriented expenditures and a declining residential construction industry. The unemployment rate has averaged higher than the nation as a whole.

The total population of the state is expected to reach 19,324,000 by July 1, 1966, an increase of 568,000, or 3 percent, from the 18,756,000 estimated for July 1, 1965. This rate of increase is about double that for the nation as a whole.

Economic activity in the state began gaining momentum during the last half of 1965 with stepped-up defense expenditures providing the main impetus. Solid gains in most areas of economic activity therefore appear in prospect for California in 1966.

Although many of the economic forces in the state that will shape the 1966 economic picture are merely reflections of the national situation, the impact is however frequently quite different. This is indicated by the fact that California is growing faster than the national average and that defense-oriented industries are proportionately a much more important force in the economy. With new emphasis on defense activities, relatively greater stimulus should result to California. This is coming at a time when there is also added slack in the California economy. For instance, the unemployment rate for the state at the level of 5.7 percent estimated for December, 1965 (seasonably adjusted) compared to the national rate of 4.1 percent on the same basis for that month. The added economic activity should reduce the average unemployment rate for California to near 5 percent for 1966 and could go well under this level toward the end of the year.

Although the construction industry in the state has continued at about the same level in 1965 as 1964, the components of the industry have taken decidedly different trends. There were strong gains in office building construction as well as above average gains in educational and religious structures. In contrast, there has been a steep decline in residential construction. For 1966 an increase in the level of total construction is expected with the possibility that residential construction will turn around and be gradually expanding during the latter part of the year.

Trends in other major economic forces in the state should more closely parallel the national situation during 1966.

Relative to the assumptions as outlined above, personal income for the state is expected to reach between \$63 and \$65 billion for 1966 as compared to \$59.7 billion estimated for 1965. At an estimated \$64 billion the increase for 1966 over 1965 would amount to \$4.3 billion, or 7.2 percent.

STATE GENERAL OBLIGATION BOND PROGRAMS

The bonded debt of the state as represented by general obligation bonds outstanding totaled \$3,583,135,000 on November 30, 1965. All general obligation bonds are backed by the full credit and faith of the state for payment of debt service charges. There are, however, two categories of bonds included. The first group consists of those bonds on which the operating revenues of the programs are expected to fully meet debt service requirements. This comprises bonds for the following purposes: water development, San Francisco harbor improvement, small craft harbors, and veterans farm and home loans. These are classified as self-liquidating bonds. The second category consists of those bonds for which the General Fund fully or partially meets the debt service charges. The debt service is fully paid from the General Fund for state construction program bonds and state beach, park, recreational and historical facilities bonds. Over one-half of the debt service charges are paid from the General Fund on the state school building aid bond program, with the local jurisdictions paying the remainder. These comprise the second group which are classified as General Fund bonds.

In addition various agencies of the state have authority to issue what are called revenue bonds for various purposes. For these bonds only the revenues from the programs involved are pledged to back payment of the bonds and thus are not classified as general obligation bonds of the state. Agencies authorized to issue such bonds are the Toll Bridge Authority, Water Project Authority, Board of Harbor Commissioners, State Fair and Exposition, World Trade Center Authority, state colleges and the University of California.

A summary showing the amounts of general obligation bonds authorized, unsold, and amounts outstanding as of November 30, 1965, for each of the programs involved is presented below:

General Obligation Bonds State of California
Bond Status on November 30, 1965

<i>General Fund Bonds</i> ¹	<i>Total</i>	<i>Unsold</i>	<i>Outstanding</i>
California Tenth Olympiad -----	\$150,000	--	\$150,000
State School Building Aid -----	1,360,300,000	\$210,000,000	1,150,300,000
State Construction Program -----	997,000,000	300,000,000	697,000,000
State Beach, Park, Recreational, and Historical Facilities -----	150,000,000	125,000,000	25,000,000
Totals -----	\$2,507,450,000	\$635,000,000	\$1,872,450,000
 <i>Self-liquidating Bonds</i> ²			
California Water Resources Development -----	\$1,750,000,000	\$1,400,000,000	\$350,000,000
Harbor Bonds -----	70,442,000	18,197,000	52,245,000
Veterans' Farm and Home Building Fund -----	1,508,440,000	200,000,000	1,308,440,000
Totals -----	\$3,328,882,000	\$1,618,197,000	\$1,710,685,000
 Totals All Bonds -----	 \$5,836,332,000	 \$2,253,197,000	 \$3,583,135,000

¹ School districts of the state pay part of the debt service on the school building aid bonds. A sinking fund balance is available to pay the charges on California Tenth Olympiad of 1927 bonds. The General Fund pays full debt service charges on the state construction and beach and parks bonds.

² Revenues from the facilities constructed from these bond proceeds are intended to pay the full cost of debt service. All bonds in this category, however, remain an obligation of the General Fund to the extent these revenues fail.

Proposed New Bond Issues

There are two bond programs proposed for presentation to the electorate during 1966. Additional bonding capacity in the amount of \$260 million is proposed for State School Building Aid to be placed on the ballot at the June primary. Of this total, \$20 million would be earmarked for the purchase of portable classrooms to help implement reduced class sizes in depressed areas. New authorizations totaling \$280 million are requested for the State Construction Program Bond Fund to be placed on the November ballot.

The estimated balance of uncommitted funds on June 30, 1966, for state construction program bonds stands at \$85.8 million. Of this, \$58.2 million would be available for state construction projects and \$27.6 million for junior college assistance. Should the proposed new school building aid bond proposal not be approved in the June primary the balance of unapportioned funds in that program is estimated to total about \$50 million on June 30, 1966.

General Fund Bond Debt Service

Debt service on general obligation bonds which are serviced from the General Fund (excludes water bonds, veterans' bonds and other bond programs for which revenues from the operations are expected to pay the debt service costs) is expected to total \$102.5 million for 1966-67. This is an increase of \$14.8 million from the 1965-66 level. Of the total about \$53.6 million is for payment of interest charges. As shown in the following table debt service costs on these bonds have been rising very rapidly. In 1957-58 the total was \$12.7 million or 1.1 percent of the General Fund budget for that year. By 1966-67 the total of \$102.5 million as estimated represents a sevenfold increase and comprises 3.5 percent of the total 1966-67 General Fund budget.

Debt Service on General Fund Bonds *
1957-58 to 1966-67

	<i>Total</i>	<i>State construction, etc. ¹</i>	<i>State portion school building aid bonds</i>
1957-58 -----	\$12,668,558	\$2,817,025	\$9,851,533
1958-59 -----	17,089,186	3,813,060	13,276,126
1959-60 -----	25,536,661	9,353,413	16,183,248
1960-61 -----	36,483,872	16,097,231	20,386,641
1961-62 -----	42,877,526	16,476,370	26,401,156
1962-63 -----	59,197,558	22,427,966	36,769,592
1963-64 -----	62,693,676	27,004,141	35,689,535
1964-65 -----	75,865,547	30,454,111	45,411,436
1965-66 (est.) -----	87,679,769	37,174,407	50,505,362
1966-67 (est.) ² -----	102,482,475	50,821,025	51,661,450

* Includes bond programs for which payment of debt service charges are a direct obligation of the General Fund.

¹ Major components are State Construction Program Bond Fund and State Beach, Park, Recreational and Historical Facilities Bond Fund.

² Estimated interest payments for 1966-67 ----- School Building Aid Bonds \$23,666,110
State Construction, etc.---- 29,921,025

Estimated Total Interest \$53,587,135

It is noted that the debt service payments are separated into two categories in the above table. Only the state portion of debt service charges are shown for the school building aid bonds. The remainder is paid by local school districts. The state share has comprised a gradually increasing portion of the total charges, reaching an estimated 65 percent of the total by 1965-66. For 1966-67 the Department of Finance is projecting a major reversal of this trend and has estimated the state part at 60.9 percent of the total. This factor accounts for the relatively small yearly increase from 1965-66 to 1966-67 as compared to previous years. If the higher (65 percent state) level were used the increase between the two years would be on the order of \$3.5 million (instead of near \$1 million, as projected) and the increase in General Fund debt service between the two years would total over \$17 million as compared to the \$14.8 million increase projected in the budget. Two major reasons given for the reversal of the trend are (1) the recent and anticipated large upward reassessments of local property, thereby raising the total assessed value used in computing the local rate of repayments, and (2) the current slump in housing construction which tends to relieve the pressure on suburban districts. Also the level of future bond sales should have an influence on the trend tending toward a lower state ratio if bond sales slack off, or a higher ratio if sales increase.

The other major component as listed in General Fund debt service charges is the State Construction Program Bond Fund, although there is also included about \$2.9 million for the new State Beach, Park, Recreational and Historical Facilities Bond Fund for 1966-67. Debt service requirements on these issues are met fully by the General Fund.

For the major bond programs requiring General Fund debt service the projected expenditure levels during the next 10 years average around \$140 million per year for the state school building aid program and from \$150 million to \$175 million per year for the State Construction Program Bond Fund. The state beach, park, recreational and historical facilities bond program sales will probably be accelerated until the full \$150 million authorized is expended to finance proposed acquisitions and other programs.

The 1965 Legislature reserved the single amount of \$25 million in a special tax measure (A.B. 1, First Extraordinary Session) to be committed on the specific authorization of the Legislature for providing a portion of pay-as-you-go in lieu of bond financing.

Market for State General Obligation Bonds

With the very high sales of state bonds in 1964 (totaling \$630 million) the state again moved into an adverse position relative to interest rate differentials as measured against the Bond Buyers Index. The state's adverse position continued in 1965 during which sales totaled \$535 million. This index forms a yardstick against which an agency may roughly compare its position in the bond market. If the agency's rate for comparable bonds is above the index the position is adverse and if below it is favorable.

Total amounts of bonds sold by an agency appear to directly affect the market position of the agency. The state interest cost had been below the index in 1962 with \$204 million in bond sales and in 1963 with \$200 million in bond sales.

Based on the last sale on February 2, 1966, amounting to \$100 million of regular (25-year maturity) state construction program bonds, the state rate was about 12 basis points above the index (this equals 12/100 of 1 percent). The differential is higher for water bonds but these have 50-year maturities and special provisions relative to the amortization schedule.

The steep increase in bond interest rates characterizing the bond market during 1965 is another factor that has changed bond marketing conditions. The interest cost appears to have increased about 40 basis points from May 1965 (when \$100 million was sold for school building aid) to the sale in February 1966 of \$100 million in state construction program bonds. This increase in itself adds around \$5.5 to \$6 million to the total interest cost of a \$100 million issue of bonds with a regular 25-year maturity schedule.