

SECTION III

ANALYSIS OF THE ESTIMATES OF REVENUE OF THE 1947-48 BUDGET

(Pages A-4 to A-9 and Schedule 11-A Page A-4 and Schedule V
Pages A-14 to A-23, Inclusive)

Introduction

We have conferred at various times with the finance officers of the Department of Finance concerning their study and estimates of revenues which would accrue for the current Fiscal Year 1946-47, and for the Budget Year 1947-48. We have analyzed the final estimated revenues in the 1947-48 Budget and in general we concur in these estimates. We agree with the Budget Officers that the revenue accruals to the State depend to a large degree on business activity. If business activity is accelerated beyond the estimates made, revenues will accrue in excess of the estimates. On the other hand, if business activity declines, there will be a drop in revenues so that the total will be less than the estimates made.

Accuracy of Revenue Forecasts Improve With Annual Budget

The most definite benefit derived from the Annual Budget will be the improved accuracy in the Budget revenue forecast. We are hopeful that this will not be the only improvement manifest.

Receipts during the Fiscal Year beginning July 1, 1947, will to a large degree be determined by business conditions existing in the calendar year 1947. This means that part of the business from which revenues are received, will actually be accomplished and measurable before the beginning of the Budget period. In fact, the Legislature will be in session considering the Budget and the revenue estimates therein, while some of the business is being done that yields the revenue. Adjustments can be made if business conditions vary from the estimates used as a base for figuring revenues.

More accurate and closer information is available for revenue estimates for this Budget than could have been secured for a biennial budget. We should not forget, however, that the estimates still must be made six months or more in advance of the beginning of the Budget period, and there is still opportunity for business changes in this short period, particularly at this time when we still have inflation conditions and with the expectation that deflation will follow.

Revenues Anticipated

Revenue estimates have been made on the basis of continuing the temporary tax reductions through the Budget Year. The Budget estimate places the total revenues for 1947-48 at \$581,757,239. Of this amount \$425,424,111 will be credited to the General Fund and the remainder, \$156,333,128, will accrue to the various special funds. Some of the receipts

into the special funds depend upon the rates which will be applied, and some of these are subject to change effective for the Budget Year based on appropriations.

Receipts at an All-time High

The total revenue estimate and the estimated receipts for the two divisions, the general and special funds, will constitute new record levels of state income despite the fact that revenues have been estimated on the basis of continuing the temporary tax reduction measures first enacted in 1943 and reenacted in 1945.

The total receipts estimated to accrue from existing sources include those amounts which will be shared with the local governments, but do not include subventions from the Federal Government which are estimated to total \$118,738,169.

Receipts for 1945-46, 1946-47, and 1947-48 Compared

So that we may have a quick comparison of the revenues received for 1945-46, and the estimated revenues for 1946-47 and 1947-48, we present the following tabulation:

	1945-46	1946-47	1947-48
Total revenues-----	\$496,846,907	\$571,677,261	\$581,757,239
General fund-----	364,402,016	423,376,432	425,424,111
Special fund-----	132,444,892	148,300,829	156,333,128

Special Fund Receipts More Stable Than General Fund

Experience has demonstrated that receipts into the Special Funds which are derived primarily from taxes and fees paid on motor vehicles, or the operation thereof, withstand economic reversals better than those taxes levied for the General Fund. Reference to our tax receipts table in Section I will illustrate this point.

At this time of transition with new motor vehicles becoming available in greater number, there is every reason to believe that receipts from this source will be at an all-time high. We believe it quite possible that receipts from this source will be somewhat in excess of the estimates made by the Department of Finance although they show an increase in the motor vehicle fuel tax of 7.2 percent, or up \$5,100,000 from revenues of \$70,900,000 for 1946-47. We believe that this may be exceeded by an additional \$1,000,000. We are also of the opinion that collections from motor vehicle registration fees at present rates may exceed the estimates given by approximately \$500,000. The amount of the estimates of revenue in the Budget below our estimates is not enough to make an appreciable difference in the total, however, of special fund revenues.

Our estimates from the same sources for the current biennium were some \$5,000,000 in excess of those made by the Department of Finance and some \$12,000,000 over those made by the Division of Highways. Our estimate, which was the highest, was exceeded by a considerable amount in actual collections due to the fact that the war ended earlier than anticipated, and rationing on gasoline was removed earlier than anticipated.

Economic Conditions Influence Tax Yields

Everyone who reviews California's General Fund revenues must conclude they are related directly to economic conditions in the State and in the Nation. They are so closely geared in fact to business, that we feel the Department of Finance is sound in their statement that General Fund revenues may show a variation from a low of \$395,000,000 to a high of \$475,000,000, depending entirely upon business conditions. If there should be a serious economic readjustment downward in 1947, the estimates in the Budget are overly optimistic. If the present high level of business activity continues or should it increase but slightly, then the revenue estimates in the Budget will be low.

The Department of Finance has carefully presented its case showing the assumptions made as to economic conditions serving as the basis for its revenue estimates. When we note that 80 per cent of the total General Fund revenue is derived from taxes on retail trade, personal income and corporate net income, then we must recognize just how sensitive these revenues are to business. We have stated before that a decline in business will affect revenues immediately and that a decline will effect a reduction in revenues greater than an increase in business would show in increases in revenues. When business falls off, the margin of profit is reduced and net incomes and sales decline. In addition there is an immediate hedging, taxes are paid less willingly, and tax avoidance becomes more important and more general.

Tax Collections Lag Behind Business

Sales tax receipts are usually two months behind taxable transactions, and sometimes more than three months, depending on when they are reported in. The first tax installment from personal and corporate incomes is due four months after the close of the income year. Insurance taxes are levied on business of the prior year so that more than a year elapses between the taxable transaction and the actual remittance to the State. In the case of the inheritance tax, payments are usually made six months and frequently a year after the tax is due. In the case of large estates, the time may be even longer.

Only approximately 15 percent of the general tax revenue comes from taxes on alcoholic beverages, inheritances and the insurance business. These again are directly geared to business.

Volume of Business in United States and California

Business activity in the United States, and in California in particular, enjoyed unprecedented levels in 1946. Wages and salaries and other payments to individuals, classified as individual incomes, totaled \$165,000,000,000 for the Nation in that year, and during the period from October to the end of the year, increased to an annual rate of \$174,000,000,000. This was an increase of 160 percent over the prewar average. It is generally estimated that California enjoys between eight and one-third and eight and one-half percent of the national income, so that we can estimate that the income to individuals in California for 1946 was between \$13,500,000 and \$14,000,000. This is by far the largest amount in the State's history.

Any thinking person must harbor some doubts as to whether such peak income will continue very far into 1947. It certainly does not seem prudent when estimating revenues as the basis for a Budget, not to allow for a recession from such a peak, particularly in view of the accumulating evidence of a recession. We concur with the Budget makers of the Department of Finance that as a matter of prudence, such allowances must be made.

Employment in California

A high level of business activity depends to a large degree on full employment which yields high purchasing power adequate to maintain business output. The employment record for 1946 shows that California had 3,600,000 persons gainfully employed. This almost equalled the total number of employees at the peak of the war's activity. Practically every business activity during the last quarter of 1946 exceeded by substantial margins the prior record established in 1945. The significant thing for this Budget is that the State entered 1947 on about the same plane. This is the business volume on which the taxes for the Budget year will be levied.

Revenue Estimates Based on Purchasing Power Used

We are particularly pleased to note that the Department of Finance has based its revenue estimate on the probable purchasing power of the people in California and not on the potential demands to be satisfied, which appeared to be the basis for estimates made by the Reconstruction and Reemployment Commission. At the same time sufficient weight has been given to the accumulated or backlog needs of our increased population.

Assumptions Used in Estimating Revenue

The detail of assumptions used in estimating revenue as presented on page A-6 of the Budget are here reviewed briefly to indicate our agreement or disagreement and reasons:

(1) *Economic Activity*: It is assumed that a moderate adjustment will take place in the next 12 months, but this readjustment will start from the high levels existing at the close of 1946 and decline throughout the year, reversing the pattern of business activity of 1946.

In general we agree with this, although we believe that there will be a continuance of economic conditions on a plateau for a short period then a gradual falling off followed by a sharp dip, and a leveling off in the fall of 1947. The average, in our opinion, will be slightly below the 1946 average.

(2) *Income of Individuals*: The Department of Finance estimates that income to individuals will be approximately the same as for 1946, or in other words that there will be a decline of 12.5 percent from the current annual rate of \$174,000,000,000 for the Nation to \$152,000,000,000 at the close of the year, with total income payments of \$163,000,000,000 as compared with \$165,000,000,000 for 1946. Our estimate does not differ greatly, except that we believe that agriculture

in the aggregate, and particularly specialty crops, will show a much greater decline than other income groups and to that extent California may be adversely affected to a greater degree than the national average. We likewise feel that the national average income will not be more than \$161,000,000,000.

Normally we would concur that the income to persons in California will be above the corresponding figure for 1946, except for the uncertainty in the market for our specialty crops and the probability that the market will not absorb all of our citrus, our canned fruit and canned vegetables, or our fresh vegetables at the 1946 price level.

(3) *Surpluses may Accumulate*: The assumption of a total income of \$13,500,000,000 to Californians for 1947 allows some margin for shrinkage, but we doubt if it is quite enough if the decline in our specialty crops does occur. The income level then would probably not exceed \$12,500,000,000.

The estimated yield of the sales tax of the Budget is based on the assumption that federal income taxes will be reduced 10 percent, that savings will be expended in the sum of \$500,000,000 and that short term credit will be expanded by \$400,000,000. These assumptions do not appear to be out of line.

(4) *Price Levels*: The assumption that prices will recede from the current high point is generally conceded, and the assumption that the 1946 level will be the average for 1947 in our opinion is conservative unless unmanageable surpluses accumulate.

(5) *Population*: The estimate that the population will continue to grow at the prewar rate appears to be sound. The tabulation showing the estimated population and other pertinent data in relation to income payments and expenditures of individuals in the Budget is very useful for comparative purposes. The population estimates appear to be in line.

The total income estimated for individuals is a little optimistic. The total of taxable sales likewise is a little over our estimate. Our estimate of General Fund revenues are approximately the same as used by the Department of Finance. The estimate of revenue per capita is a little optimistic, our figure being approximately \$44.50.

On the whole when coordinated these assumptions are not out of line.

General Fund Revenues

In general we agree with these estimates in the Budget.

We feel that the volume of taxable sales on meals and drinks will decline at least the 15 percent as estimated, and probably a little more. This is for the reason that we anticipate a decline in the total volume and in prices.

We concur that there will be an increase in the volume of sales in motor vehicles, building materials, home furnishings and commercial equipment.

Building is certain to increase during 1947 over 1946. Sales of most durable goods including automobiles should increase during the year with a fall off toward the end of the period. Personal income taxes should

equal the 1945 total which is approximately the base for the Budget estimates.

Motor vehicle transportation license tax collections are at a high point for the current Fiscal Year and probably will show a decline for 1947-48. We believe the Department of Finance is safe in assuming this rather than in forecasting a further increase.

General Fund Trends and Ratios

The careful study and use of General Fund trends and ratios of tax collections to individual incomes is in our opinion a forward step in estimating revenues. When this is tied in with actual information secured from the principal taxpayers, the adjusted estimates should be reasonably reliable. This method the Department of Finance has pursued.

Special Fund Revenues

Since three-fourths of the total revenue for the Special Fund represents taxes upon the ownership and operation of motor vehicles, the accuracy of estimating this income depends primarily on the estimate of the number of registered vehicles. The Department of Finance has estimated that there will be 3,700,000 registrations for December 31, 1947 and 3,950,000 by the end of the following year. These estimates do not appear to be out of line. In fact we estimate the total for December 31, 1947 at 3,725,000.

They also anticipate that gasoline tax collections per registration will amount to \$20.50 in the current year and for 1947-48 compared with \$19 in 1945-46. This is estimating there will be a consumption of 683 gallons of gasoline per year per registration. This does not appear to be excessive, although we find that Senator Collier, Chairman of the Collier Fact-Finding Committee, in supporting his proposal for increasing taxes on the people objects to an estimate this high although the present rate of consumption is in excess of this.

The reduction of approximately \$4,000,000 in receipts from horse race taxes we believe to be on the conservative side, in light of the fact that there will be one additional track and possibly two operating during the year and this may cause increased betting.

Contingencies

The Department of Finance has rightfully given weight to the adverse conditions created by an adverse business psychology and the possibilities of industrial disputes, and have stated that in the event that either or both of these conditions occur, the State's revenues will be considerably below the forecast. If there are no such adverse conditions and business continues at the 1947 rate now prevalent, the revenues will be considerably above the forecast.

Results of Economic Reversal

If there is a serious economic reversal early in 1947, it will adversely affect the revenues for 1947-48. If it does not come until well into 1947, it will not affect the revenues materially until 1948-49. In fact, revenues for 1947-48 have to a considerable extent been determined by the prosperity

of 1946. This prosperity will keep up corporate and personal income tax collections in 1947. The insurance premiums collected in 1946 will pay the tax of 1947. The lag in revenue collections will carry some payments over from the first part of 1947 into the Budget year. In considering revenues into the State Treasury, we must remember that it is really business being done by the close of 1946 in some cases and in others in the first part of 1947 that determines what is collected for the Budget year.

Detailed Estimates Omitted

We are not presenting in this report detailed estimates of revenues comparable with those we presented in our last report for the reason that revenue estimates are now on an annual basis and can be calculated with greater certainty. In addition to this, during the past year, we maintained a closer contact with the estimates being made by the Department of Finance and worked with those in the department responsible for estimating revenues.

Some of the Basic Principles Involved

We are in general accord that the principles used are sound. Our only differences are based on the estimates made as to the volume of business activity and particularly the profits in certain types of business peculiar to California. The total sum of our differences is not such as to materially affect the support of the annual Budget.

Caution Advised

We do wish to offer a word of caution and emphasize that these revenue estimates covering only the one year are naturally short-time estimates. They do not have the conservative feature imposed by the uncertainties of having to make estimates on an additional year's business. On the other hand, many of the expenditures of the State are for services entered into on a long-time basis. Frequently these entail increasing fixed charges which are certain to increase each year in the future, even in times of adverse conditions. Such charges of government do not decline with a decline in business and in tax receipts into the Treasury. It is well to note this fact and to consider whether or not the future revenue receipts of the State will carry the future obligations of the State. It is important to note if there is any leeway or margin or elasticity in the taxes that are levied, so that they can be safely increased with a decline in business conditions to meet the continuing increasing load of fixed charges and expanding government, together with the added cost of relief which always appear with declining prosperity.

Surpluses Accumulated From War Prosperity

The maximum revenue yields of 1945 and 1946 assisted in building up the present unprecedented surpluses and reserve funds. The experts in the Department of Finance in making their budget estimates for the first time on a short period basis have felt it necessary to allow for a continual decline from the 1946 peak. On this basis revenue yield still exceeds the appropriations from the funds collected. It should be noted

however that if the reserve funds were not available for building and for other purposes, additional taxes would have been required to carry the recommended building program. That is to say, current revenues to the General Fund could not have covered all appropriations. Fortunately, these reserves were and are available for the very purpose for which they were appropriated. Should not the prudent man ask, "Will the tax yield for 1948-49 and possibly for 1949-50 be sufficient to pay the cost of operating the State for these periods, or will it again be necessary to draw from reserves? And how long will these reserves be sufficient to make up the difference in revenue receipts and the expenditure program?"