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LETTER OF TRANSMITTAL

SACRAMENTO, CALIFORNIA, February 21, 1949

*The Honorable W. P. Rich, Chairman,
and Members of the Joint Legislative Budget Committee
State Capitol, Sacramento, California*

GENTLEMEN: In accordance with your instructions and the provisions of Joint Rule 37 of the Senate and the Assembly creating the Joint Legislative Budget Committee, defining the duties of said committee, and giving it authority to employ a Legislative Auditor, I submit herewith an analysis and report on the State Budget and the Budget Bill for the Fiscal Year July 1, 1949, to June 30, 1950.

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."

In accordance with the instructions given by your committee the Legislative Auditor and his staff have worked closely with the Department of Finance during the budget hearings of the various state agencies. Through the courtesy of the Director of Finance, we have participated in these departmental budget hearings, and during the entire period that the Budget has been in preparation the fullest cooperation has been given to the staff by the Department of Finance. As we have pointed out in our prior reports, this procedure of being permitted to participate as if we were a part of the budget making process has enabled us to secure complete and authoritative information as to the basic justification for budget requests. It has at the same time increased the effectiveness of the Legislative Auditor in impressing upon the various agencies the instructions given to him by the Budget Committee, and in presenting suggestions for economy and efficiency. We believe that as a result of this procedure very substantial reductions have been made in the original budget requests of many of the state agencies as well as subsequently from the budget hearings which otherwise would not have been made.

BUDGET DOCUMENT IMPROVED

The present budget document shows a number of substantial improvements in form and principle to which we have made some modest contribution, and in this respect we wish to compliment the Department of Finance in preparing a budget which is outstanding, both as to method of presentation and in the degree of objective analysis given to the various requests.

On the whole there has been some improvement in workload data submitted and substantial refinements in techniques for presenting certain of the agency budgets. This is true, for example, with the Depart-

ment of Mental Hygiene. This improvement permits certain major phases of an agency's operations to be dealt with on the basis of an over-all policy, and to make adjustments accordingly, as well as to make additional adjustments based on the individual features of the particular operations.

BUDGET NOT RESTRICTED TO NECESSITIES

We recognize, however, that the Budget is the executive budget and therefore primarily reflects the financial policies of the Governor. Whereas many savings and many equities have been made in working out the details of the operating budgets of the state agencies, the policy of the Governor has made recommendations for many major items of expenditure which are not absolute necessities, and for this reason we believe that this Budget should not be called an economy budget.

Likewise, the fact that there are certain operations which are common to all agencies makes reductions possible through the establishment of an effective over-all policy with respect to this operation or by more effective fiscal controls over this type of operation. For example, all state agencies use telephones and all would therefore benefit from improvements in the method of determining the extent to which telephones should be used in any operation. The State of California is backward in establishing proper procedures for determining the necessity for long distance telephone calls, and for securing approval, and maintaining records of such calls and the reasons for which calls are made. *We recommend that a study be given toward establishment of a more adequate procedure designed to secure greater economy in the use of telephones.* Clearly formulated policy with respect to the use of state automobiles, teletype, and telegrams could effect substantial savings through all state agencies. More economical procedures for the ordering of supplies and equipment could reduce workload in almost every state agency, as well as in the Bureau of Purchases through its function of acquiring such supplies, in the Department of Finance through its fiscal control operations and in the Controller's Office by reducing the number of warrants issued.

Through our analysis of the various budget requests we have noted certain conspicuous examples where agencies are deficient in this respect. *However, it is our observation that savings could be made in every state agency by greater emphasis on a policy of economy in operating costs.*

PROCEDURE FOLLOWED IN OUR ANALYSIS

This analysis covers only the Budget Bill, in numerical sequence as the items appear in the bill and it is formulated in accordance with your instructions so it can be used by the Finance Committee of the Senate and the Ways and Means Committee of the Assembly in considering the Budget Bill.

We have followed your instructions to recommend reductions and elimination of those items which the State does not have to have to provide effective government so as to avoid if possible tax increases. We have done this in this report insofar as it is possible in considering all the Legislature has before it—the Budget Bill. *This does not carry out all of your instructions for the reason that two-thirds of the entire budget does not appear in the Budget Bill, and for this reason we are submitting*

a supplemental report suggesting a complete reforming of the government of the State of California which will cover the rest of your instructions to recommend every possible economy in the operation of the State Government so if possible to make unnecessary increased taxes.

Interpreting your instructions to recommend every possible economy and Budget cut so if possible to make unnecessary increased taxes to also mean to transfer expenditures from the General Fund to other available funds where this is possible, we have therefore recommended in a number of places where appropriations are set up in the Appropriation Bill to come from the General Fund that they be taken from other available funds. Following these three procedures, that is, recommending reductions in appropriations, recommending elimination of services and appropriations, and recommending the transfer of appropriations from the General Fund to other funds, we have been able to suggest an expenditure program which provides adequately for the State needs and yet it will not require any additional taxes other than allowing the tax rates reduced in 1943 to go back to their former rates.

For the first time in our analysis of the Budget Bill we have classified systematically all budget items to show proposed increases which are based on a continuation of the existing level of service, and increases based on new or increased services. This makes it possible to determine more accurately the cost of the actual necessities of government.

There are, however, innumerable services which have already been established in many agencies which are not necessary to carry out the essential functions of government, and there are entire agencies which could be eliminated. We have also pointed out many of these services and recommended elimination accordingly. We have suggested alternative methods of carrying out certain functions at a substantial saving in costs. This is true, for example, in the case of the Franchise Tax Commissioner, the Board of Equalization, the Training School for the Adult Blind at Oakland, the Disaster Council, California Maritime Academy and others. Outright elimination of other functions, such as the Recreation Commission, Aeronautics Commission, Crime Commission, state support for Civil Air Patrol, and California Historical Association has been proposed. *We recognize that under a policy of even moderate austerity, additional reductions could be made, along with a greater coordination of state activities which we will cover in the supplemental report mentioned previously.*

SIZE OF THE BUDGET

The total amount of the Budget as introduced is stated by the Governor to be \$1,060,187,939. This amount apparently does not include all of Item 372 in the Appropriation Bill, although this entire item is made available for expenditures. The total amount of the Appropriation Bill is \$414,746,140, less error of \$1,000,000, leaving a total of \$413,746,140.

In the past the Budget Act or Appropriation Bill has run from 30 percent to 35 percent of the total budget. Due to the increase in capital outlay the Budget Bill is 39 percent of the \$1,060,187,939 Budget. Any increases over \$10,000,000 in expenditures made by the Legislature over and above the amount recommended by the Governor will require more taxes over and above the new taxes recommended by the Governor, or must be offset by corresponding reductions in the Governor's program.

While the Governor's program of expenditures is such as to require all the new taxes he recommends except \$10,000,000, he himself calls attention to the fact on page xii that nothing has been included for Child Care Centers, which he states required an appropriation of \$5,296,000 for the current fiscal year. On the same page in a following paragraph, he states that nothing has been included for school building for distressed school districts, and then he calls attention to the fact that the State has already appropriated \$55,000,000 for this purpose. The first of these items would require one-half of the proceeds of the new taxes over and above the Governor's Budget, and any additional expenditures over \$5,000,000 would require more taxes or place the State in the red. If some of the other items suggested by the Governor in his message to the Legislature are made effective, additional taxes will be required. Moreover, no consideration has been given to the Legislature if it feels that it is necessary to approve some special appropriation bills. The Legislature normally passes some \$25,000,000 to \$50,000,000 of special appropriation bills. Under the present financial plan suggested by the Governor all of these special appropriations will have to be financed by additional taxes or possible expenditures from reserves.

For these reasons it is safe to estimate that unless a real and effective program of economy is followed that the final expenditure for the State for 1949-50 will be in excess of the Governor's \$1,060,187,939 Budget recommendation, unless Budget reductions are at least equal to the added expenditure items.

It is consistent with past experience to have the final expenditure program of the State exceed the Governor's Budget as introduced. Last year the Governor's Budget in round numbers as introduced was \$914,000,000. It was adjusted by the Legislature through decreases and increases until it reached \$919,000,000, and then by transfer of appropriations and reductions it was finally approved for \$903,000,000. But subsequently, deficiency appropriations and added fixed charges resulting from No. 4 on the last ballot has brought the final expenditure program up to \$998,000,000. If the same course is followed the expenditure program of the State for 1949-50 is likely to exceed \$1,200,000,000, and all of the excess over \$1,070,000, which is not taken from reserves will have to be provided in additional taxes over and beyond the tax program recommended by the Governor.

THE APPROPRIATION BILL ONLY BEFORE THE LEGISLATURE

May we point out again that the Appropriation Bill is all that the Legislature has before it to act upon to make the Governor's Budget effective. That is, the Legislature considers 39 percent of the Budget, the remaining 61 percent is made up of what is commonly called fixed charges. These are either established by Constitution or by continuing legislation.

There has been some misunderstanding in considering that the Legislature can do nothing about these fixed charges. The purely constitutional fixed charges cannot be affected greatly by the Legislature, but even here some of them can be affected, that is, reduced or increased. For example, the Constitution requires an appropriation of \$120 for

average daily attendance in the schools but it is certainly within the power of the Legislature to define what will be average daily attendance, and also to determine the length of the school term, and in this way the amount of money can be materially raised or lowered. Certainly, a definite procedure controlling the arbitrary allowance of average daily attendance and the allowance of average daily attendance for certain specified lectures or nature walks or social gatherings can be determined by the Legislature.

There are other constitutional appropriations such as the requirement under Article XXV of the Constitution, the Aid to the Aged, that cannot be controlled in amount or in certain requirements that applicants must meet. But, there are some considerations that the Legislature can act upon, for example, the Legislature could determine just how the assessed value on the real property should be calculated, and they might set up requirements as respects the transfer of property by an applicant prior to the time he became an applicant, and there are possibly other provisions and requirements that the Legislature might set up within the constitutional limitations.

The other division of so-called fixed charges are those that are set up solely by continuing legislation, and of course, all of these can be reviewed by each succeeding Legislature. This list includes such items as Judges' salaries, subsidies for tuberculosis, aid to orphans, and many other subsidies to local government. To change these so-called fixed charges will require legislation, but they are all under the control of the Legislature. Some of them are no more fixed charges than are the requirements to continue governmental functions such as the Controller's Office, the Office of the Governor, or the Legislature itself. If we have government, we must have these agencies, and although the appropriations are not fixed by law, they are at least on a minimum basis by fact.

In order to present some factual basis of just what is before the Legislature and the various relationships between the Budget and the Budget Bill and the general, special and reserve funds, we present herewith the following tabulation.

**COMPARISON OF BUDGET FOR 1949-50 WITH APPROPRIATION BILL
FOR 1949-50 BY FUNDS**

Governor's Budget	
Grand Total all Funds.....	\$1,060,187,939
Total General Funds.....	619,575,098
Total Special Funds.....	291,428,139
Total Reserve Funds.....	149,184,702
Percent General Funds to Total Budget.....	58.44%
Percent Special Funds to Total Budget.....	27.49%
Percent Reserve Funds to Total Budget.....	14.07%

Appropriation Bill 1949-50

Grand Total all Items Appropriation Bill -----	\$414,746,140
Less : Error Item 110 -----	*1,000,000
Total General Fund Items -----	†\$413,746,140
Total Special Fund Items -----	234,023,140
Total Reserve Fund Items -----	59,761,477
Percent General Fund Items to Total Appropriation Bill -----	†119,961,523
Percent Special Fund Items to Total Appropriation Bill -----	56.56%
Percent Reserve Fund Items to Total Appropriation Bill -----	14.44%
Percent Total Appropriation Bill to Total Budget ----	29.00%
Percent General Fund Items in Appropriation Bill to General Fund Total in Budget -----	†39.03%
Percent Special Fund Items in Appropriation Bill to Special Fund Total in Budget -----	37.77%
Percent Reserve Fund Items in Appropriation Bill to Reserve Fund Total in Budget -----	20.51%
	†80.41%

* Item 110 of the Appropriation Bill provides \$1,000,000 for capital outlay expenditure. This is in error as Item 324 provides the same appropriation.

† Included in Reserve Fund appropriations is Item 372 which makes available \$116,950,000 from the Postwar Employment Reserve for capital outlay expenditures. This amount having been heretofore transferred to reserves from the General Fund. However, only \$32,847,427 are needed from this appropriation to meet the total amount of \$241,122,553 budgeted for capital outlay expenditures for 1949-50. Thus, on an adjusted basis, reducing Item 372 by \$84,102,573 to \$32,847,427, the Appropriation Bill total would be \$329,643,567 or 31.09 percent of the budget total. Also, on this basis the total General Fund items would be 70.99 percent of the total Appropriation Bill; total Special Fund items would be 18.13 percent of the total Appropriation Bill, while total Reserve Fund items would be reduced to \$35,853,950 or 10.88 percent of the total Appropriation Bill and 24.04 percent of the Reserve Fund total in the Budget.

FACTORS CAUSING BUDGET GROWTH

Analysis of the tabulation of the Governor's Budget and Budget Bill and the final expenditure program of the State indicates an extraordinary period of growth. He shows that the total expenditure program for the two-year period was \$556,000,000 10 years ago, and it is now over \$1,000,000,000 for one year, or approximately four times the annual rate of expenditures. Some of this increase in cost is attributable to increases in prices, including salaries and wages, and some of it is also due to the growth in population of the State from approximately 6,900,000 people in 1940 to 10,350,000 persons estimated for 1949-50. At the same time, however, the increase also reflects substantial growth in services rendered by the State, both through the expansion of existing functions and the creation of new functions.

COSTS DUE TO NEW ACTIVITIES

We pointed out in our previous report that the cost of the State Government had been increased greatly during the war years due to new activities that the State had undertaken, and we presented at that time a list of war-time activities that were being continued. A survey of the present Budget will indicate that practically all of these items are

still included, however, our recommendations that follow suggest the abolishment of a number of them. The Governor, himself, has left out Child Care Centers, but has suggested that the Legislature consider it. The Research Division in the Governor's Office, which received no appropriation in the current Budget, is left out of the Budget, but appears again in special appropriation bills.

The number of new additional activities that were listed in our previous analysis again appear, and for all of those that do not reappear there are new agencies and activities to take their place. Those agencies that just got under way in the current Budget are asking for additional appropriations for 1949-50.

In our analysis we have recommended the abolishment of a number of the new agencies that appeared for the first time in the current Budget. We have set forth in each item all of the new agencies that have been established, and in the older agencies we have set forth all of the new or enriched services, so that the Legislature may see what they are and know how much they will cost.

State employees increase in number and cost of salaries higher. Concurrently with the increase in the State's activities, the number of State employees has expanded until the total number of positions provided for in the 1949-50 Budget total 62,695. This is an increase of 7,260 positions over those provided for in the 1948-49 Budget. Approximately 3,500 of this increase resulted from the approval of No. 4 of the last general election ballot adopting Article XXV of the Constitution. The salaries and wages provided for in the 1949-50 Budget are approximately \$204,400,000; or an increase for the one year of \$21,800,000. When we consider the number of employees added in the current Budget and the increased cost, the figures are startling.

State employees' salaries have had three rounds of increases. The third round increase, which was a general salary increase retroactive to September 1, 1948, was initiated by the Personnel Board, first with funds made available for this purpose in the Appropriation Act of 1948. The money available did not cover all of the employees who were equally entitled to a salary increase, so that the present Legislature, in the first month of its session, was practically forced to supplement the salary increase fund by an emergency appropriation which has proceeded the consideration of the Budget Bill. The continuation of the salary ranges for 1949-50 is provided for by a special Item in the Budget Bill, No. 279, in the sum of \$5,300,000. In addition, the Governor has considered, and apparently recommended that there will be a fourth round of salary increases and has included Item 280, in the sum of \$6,100,000, for this purpose. Changing economic conditions, which have become manifest since the beginning of the preparation of the Budget we believe clearly indicates that this fourth round of salary increase is not likely to materialize. We have suggested therefore that this Item of \$6,100,000 be reduced to \$500,000 for the sole purpose of adjusting inequities in established salaries.

PRICES ON WAY DOWN

The Budget is based on the assumption that most prices of commodities purchased by the State will remain substantially unchanged. *Food prices are budgeted to decline*, but prices of metal goods are

expected to rise somewhat higher. It has been recognized that the present price structure is precariously high, and may fall sharply whenever the long-expected break comes. *For that reason we point out that when these price declines occur, savings should be made.* Already substantial declines have taken place in many lines, and further declines can be expected in the 1949-50 Fiscal Year ending June 30, 1950. *In view of the mounting evidence of a full scale buyer's market, we believe that the price estimates which were made in August, 1948, and appear in the Budget, will probably be too high and that substantial savings can and should be made by the various departments.* We again recommend that efforts be made to see that these savings, where they accrue, are not spent for unbudgeted items, but that the amounts are returned to the fund from which they were appropriated.

We recommend that the Department of Finance be required to take more effective means through budgetary control to recapture all of the possible savings that will accrue in the Fiscal Year 1949-50 through price reductions. The departments concerned will always find ways to spend any savings. Our field investigations have recently shown us instances where considerable amounts were expended that should have been saved through price reductions and the elimination of the purchase of budgeted items.

For the first time, we have made some careful examinations of equipment and articles for which replacements are requested in the Budget. In many instances, we found that such equipment was entirely serviceable and should not have been up for replacement. In other instances, the equipment that was to be replaced could not be located at all by the agency and had not been in use for a long period of time. In one instance, a hand operated mimeograph machine was to be replaced by an electric machine. The agency no longer used the hand operated machine for it already had one electric machine. If the same percentage of savings can be achieved through the entire Budget that we have discovered in our preliminary survey, it will amount to a large sum. *We recommend that the Department of Finance, in allowing for the replacement of equipment, determine before allowance is made that the equipment really should be replaced, and the equipment to be replaced actually exists in the possession of the agency and is accounted for.* We suggest that, if necessary, such equipment be turned in to a central place to be disposed of by the Department of Finance when replacements are made. This procedure, particularly in the case of typewriters and automobiles, should yield the State a much larger return.

CAPITAL OUTLAY

An examination of the capital outlay items in the Budget will show that a large part of the money previously appropriated and made available for capital outlay was not expended or obligated, and a considerable sum was carried over and is available in the current Budget. Much of it is not reappropriated since it is still available. A program of capital outlay of \$241,000,000 is set up in the Budget. In addition to this, further sums are appropriated in the Budget Bill. It is most difficult to determine just what the total amount available for capital outlay will be if the Appropriation Bill is approved as presented. We suggest, therefore, that

the Legislature require the Department of Finance to present a detailed schedule showing the following :

1. The capital outlay items that are now under construction, the sum obligated to complete them, and the estimated balances that can be reverted.

2. The capital outlay items for which plans are completed and can be gotten under way by the close of the current fiscal year, an estimate of the sums that must be obligated for their completion, and a schedule of dates showing when these particular items will be scheduled for completion.

3. A schedule of capital outlay items that are in the planning stage, and for which the plans can be completed by the end of the current fiscal year, and the amount of money necessary to complete these projects, together with the estimated dates when each will be completed.

4. A schedule showing the balance in all reserve funds available for capital outlay after the prior mentioned items are taken care of. This schedule to show the items where funds are definitely allocated, the items where funds are not yet allocated, and their estimated costs. Including in the schedule a statement of funds for capital outlay that are available over and beyond those already mentioned above that are available but remain to be appropriated.

5. A schedule showing exactly all of the items in the Budget that the administration maintains can be planned and gotten under way during the Fiscal Year 1949-50, with an indication of the date when each probably can be completed ; also an indication of the source of the funds for each.

6. A statement showing the balance in all capital outlay reserve funds after all prior items mentioned have been taken care of.

7. A statement of the capital outlay items provided for in the Budget Bill, source of the funds, when the plans for these items can be completed, and when they themselves are likely to be completed.

8. A schedule of the balances that are remaining in all building funds appropriated or will remain unallocated as of June 30, 1950.

9. A schedule showing an estimate of the capital outlay needs, as yet unprovided for, as of June 30, 1950, and an estimate of cost therefor.

It is only by considering such schedules as this that a complete and accurate picture of the moneys available for capital outlay and the programs under way and contemplated that the remaining reserves can be determined.

In making our recommendations for the capital outlay items in the Budget Bill, we have been guided by the instructions of the Budget Committee that appropriations for capital outlay or provisions for capital outlay should only be recommended for those items that definitely can be gotten under way and obligated during the Fiscal Year 1949-50.

Moreover, whenever the items requested fall within the State's capital outlay program for institutions that require capital outlay under the provisions of the Postwar Employment Reserve as provided in Section 4.5 of Chapter 486 of the Statutes of 1947, "Appropriation Bill." Such sum "*to be expended for construction, improvement and equipment for state agencies as may hereafter be authorized by the Legislature.*" We have recommended that such expenditures be made from this reserve. We further recommend that any remaining funds in the Postwar Employ-

ment Reserve that have not been authorized specifically for expenditures for specific items by the Legislature shall remain in this reserve, subject to the same provisions that they may not hereafter be expended until authorized specifically by the Legislature.

This is particularly desirable at this time of falling prices, for a considerable larger amount of the contemplated capital outlay program may be secured from funds already available than is now contemplated. For example, almost \$500,000 will be saved below the estimated cost of building certain ward buildings at Agnews State Hospital. That is a saving from bids below the estimates. The University of California will realize on a recent bid a saving of approximately \$300,000 which should be returned to the appropriation from which it was received.

The State Architect has recently taken note of the improved situation in competitive bidding, and he has reduced his estimates approximately a flat 10 percent. There is every possibility that further reductions in building constructions will accrue during the remainder of the current fiscal year, and will continue through the Fiscal Year 1949-50. *We recommend that these savings be returned to the Postwar Building Reserve for further consideration by the Legislature.*

REVENUE ESTIMATES

The Governor's Budget has estimated General Fund revenues will amount to \$571,993,782 for 1949-50. These estimates were accurately drafted, and based on the best information and authorities available at the time they were made. However, it must be recognized that economic conditions are rapidly approaching a turning point and the State's principal sources of revenue will be vitally affected if there should be a decline in the general level of business.

The Budget points out that a decline of 15 percent in individual incomes would reduce receipts to the General Fund by some \$50,000,000. Considering the fact that all but about \$234,000,000 of the General Fund expenditures in the Budget are fixed costs, a decline of \$50,000,000 would require impossible retrenchment by the operating departments of the Government. Deficit financing would be the only solution unless the Legislature was called into special session to provide a remedy by further economies or more taxes.

California's tax structure is particularly vulnerable to changes in economic levels. The same factors that reaped such enormous revenues during the inflationary period, will work in reverse and curtail revenues during a deflationary period. *Eighty percent of State General Fund revenue is produced by the Sales Tax, the Bank and Corporation Franchise Tax, and the Personal Income Tax.* Each of these is dependent, directly or indirectly, on the amount of individual or corporation earnings. Any reduction in earnings will diminish the tax base and the tax yield accordingly. *California is in the position of having a highly variable source for its major revenues, while having to support an enormous load of relatively fixed charges.*

Eight percent of California's General Fund revenue comes from the Inheritance and Gift Taxes and Insurance Premiums Taxes. These will show a smaller variation with changing economic levels.

The State has separated its sources of revenue to the effect that those taxes which show the least reaction to economic changes are the source of revenue to local government, while the more sensitive taxes have been retained by the State. Property taxes, motor vehicle "in lieu" taxes and liquor license fees are examples of those sources of local government funds which will be least affected by a decline in individual incomes.

GENERAL FUND EXPENDITURES EXCEED INCOME FROM PRESENT TAXES

The General Fund requirements of the Budget total \$619,575,098. The difference between this amount and the estimated revenues of \$507,268,782 is \$112,306,316. The Governor proposed to obtain funds to make up this difference by utilizing the General Fund surplus of \$27,335,857 anticipated as of July 1, 1949, leaving a deficit of \$84,970,459.

This is the sum of the deficit which would accrue by the end of the fiscal year if all the expenditures included in the Budget were made, and if no economies or reductions occurred, and if no additions were made and, of course, if revenues accrued as estimated. This is the sum then that the Governor says should be provided for by additional taxes, and which he says should be raised, and that the present state reserves for the various purposes should be allowed to remain intact. He particularly points out that the "Rainy Day Fund" or deficiency reserve of \$75,000,000 should be retained to make up any deficiencies that might occur in revenues if our economic condition disintegrates. We have already pointed out that it is possible that our business conditions may decline during 1949-50 and if they do revenues will decline proportionately.

The Governor recommends three steps be taken to balance the General Fund expenditures and revenues. They are that the tax reductions made in 1943 other than those that were made permanent be ended, and the rates return to the prior level. This would produce for the fiscal year \$64,725,000, or approximately \$21,000,000 less than that yielded for a full year. This is for the reason that the corporation and personal income tax rates would not become collectible until January 1, 1950. This \$64,725,000 of added taxes would still leave a deficit of \$20,245,000. To close this gap the Governor suggests three additional taxes: a cigarette tax of 2 cents per package to produce \$23,300,000 per year but yielding only \$18,000,000 for the budget year; an added liquor excise tax of 80 cents per gallon to yield \$9,150,000 for the budget period; and \$4,000,000 of additional revenue from horse racing. The total yield would be \$31,150,000. This would finance the remaining General Fund deficit and would leave a little over \$10,000,000 available for constitutional appropriation in excess of the budget estimate and for special appropriations which the Legislature might authorize.

This is not realistic, for as we have mentioned, the Legislature will normally approve from \$20,000,000 to \$50,000,000 in special appropriation bills, and possible appropriation items mentioned by the Governor for the Legislature's consideration equal at least this amount.

The Governor suggests that the Legislature make the 3 percent sales tax and the liquor and cigarette taxes effective April 1, 1949. This would produce approximately \$22,500,000 more in revenue, thus giving to the General Fund a surplus of approximately \$32,000,000. This sum still falls short of the amount that the Legislature has appropriated in special appropriations during each of the last sessions of the Legislature.

Unless the Legislature does enact these several taxes, effective April 1, 1949, the Governor's suggested taxes would leave an excess of only \$10,904,541 over the amount required for General Fund expenditures. This is an extremely small margin with which to take care of apparent impending changes in economic levels and legislative appropriations. It is obvious, therefore, that if the Legislature passes the Governor's Budget as presented, it will be required to provide revenue, not only for its own appropriations over and above the Budget, *but possibly will have to raise more taxes than have been recommended by the Governor to insure adequate financing of the Budget he proposes.*

The *new revenue measures proposed by the Governor*, namely an increase in the distilled spirits excise tax, a cigarette tax, and increased license fees on horse racing meets *are strictly luxury taxes.* The first two will be imposed on selected groups of consumers. Since both products are linked to firmly established habits and standards of living, it is not likely that a recession will reduce these revenues much under the estimated amounts. It is extremely likely that the increased horse race license fees will reflect economic trends and might fall even faster than general economic conditions. *This particular source of revenue is the least predictable of the three proposed new sources.*

The horse racing license income has held up relatively well in California as compared to such income in other states. It is likely that this source will react to a greater extent than any other source of state revenue in the event of a recession. For this reason, increased license fees recommended by the Governor are an unknown quantity and may not produce the anticipated revenue to the General Fund, although Special Fund income will approach estimates, since the Special Fund taxes are based on the first part of the pari-mutuel betting, and General Fund revenues come from betting exceeding the basic amounts.

Special Fund revenues are estimated at \$286,199,925. Of this amount, \$254,971,206 will be raised by taxes, \$29,678,486 will come from interest on investments, royalties, and miscellaneous charges and fees, and \$1,550,233 interest on the Postwar Unemployment and Construction Fund, and the Flood Control Fund of 1946.

Taxes for Special Fund purposes are almost entirely on motor vehicle users. Ninety-one percent of special fund tax revenues are from direct taxes on automobile owners or users, and transportation revenue. Six percent is derived from horse racing and 3 percent from liquor licenses.

Changes in economic levels will not affect the motor vehicle taxes, or the liquor license revenues in the same proportion as it will the General Fund revenues. Automobile and truck usage is largely a matter of necessity and will react more slowly to reduced income payments. Liquor license revenues are linked to population rather than consumers' incomes; therefore, this revenue may even increase despite lower economic levels.

REDUCED APPROPRIATIONS OR INCREASED TAXES

It is apparent that any reduction in expenditures from the General Fund will make possible avoiding just that much in an added tax burden. Our recommendations are made with this in mind. The reductions recommended are sufficient to avoid the necessity of levying any added state taxes over and beyond allowing the taxes reduced in 1943 to go back to their former level, and reserves for specific purposes will not be used for current General Fund expenditures. In addition there can be left—depending on how fully our recommendations are adopted—a modest sum for special appropriations on an austerity basis. Deeper cuts are possible than our recommendations set forth but will mean greater reduction in governmental service.

The reductions recommended will not, in our opinion, impair essential state services. Every agency of the State where we have suggested a reduction in appropriations will probably disagree with us.

We wish to express our thanks to the Director of Finance and his staff for the wholehearted cooperation extended to our staff during the past year, and we extend our thanks and appreciations to the many officers and employees in all agencies of the State who have cooperated and assisted us so willingly even when we leveled strong criticisms of procedures and conditions which we found. Your entire technical and stenographic staff deserves the highest praise for their knowledge and skill and untiring work, both preparing for and producing the analysis and report which we present herewith.

Respectfully submitted,

ROLLAND A VANDEGRIFT
Legislative Auditor

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