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In September 1981 we projected that inflexible interest rates, a depressed automotive industry, increasing unemployment and the resultant higher demand for social service programs, federal funding cuts, and overstated expectations for the federal income tax cut would force a $650 million downward revision of the state's fiscal 1981-82 general fund budget. As the economy worsened, we adjusted our estimate of the shortfall to $950 million. While each of these projections held, we still underestimated the magnitude of Michigan's economic and fiscal distress. Fiscal 1982 expenditures were originally established at $4,588.5 million. Four executive orders reduced general fund outlays by $810.8 million, while additional general fund expenditures of $680.6 million were required to compensate for unanticipated welfare costs, shortfalls in school aid revenues, and additional funding requirements for other state programs. This left a final general fund expenditure level of $4,456.3 million. As the economy continued to deteriorate, state officials were obliged to reduce their revenue estimates from the original projection of $4,740.6 million to $4,157.9 million. Imposition of a temporary income tax surcharge was projected to generate $295 million in new revenue, thereby balancing revenues and expenditures.

We believe this year's more realistic assessment of revenue prospects, combined with a disciplined approach to the 1982-83 budget make repetition of last year's massive readjustments unlikely. The $4.6 billion general fund budget merely restores the original expenditure level of last year. Moreover, lower inflation rates, declining interest rates, and reduced business borrowings have positioned the economy for a slow but sustained recovery starting late this fall, and this should improve the state's revenue prospects.

This $4.6 billion budget is an austerity budget. As shown in the attached table, funds have been reallocated among programs. Some areas were cut back to provide the means to pay for expanded programs within other budget areas. For instance, after restoration of 1981-82 funding cuts community colleges received a 10.9% increase over last year. Colleges and universities recouped $80 million lost in budget cuts in fiscal 1981-82 in addition to funds appropriated for higher education for use in this fiscal year. Approximately $1 million has been reserved for transition costs associated with the new administration. These increased expenditures were made possible by offsets in the social service budget, general fund outlays for school aid, interest payments on state borrowings, wage restraint, and expenditures for contractual services, supplies and materials.

Lower interest rates and reduced state borrowing will shrink state interest payments. We expect declining unemployment will reduce general assistance and AFDC payments with a lag of approximately 8 months, providing slight relief in fiscal 1983 but greater relief in fiscal 1984. Furthermore, Medicaid provider cost escalation is unlikely to present the same problem it presented in previous years. Lower inflation will help maintain prices of materials and supplies. This moderately optimistic economic scenario permitted reshuffling of program elements within the budget in a manner intended to prevent major program disruption.

The economy is inseparably linked to the state's fiscal condition. We believe the economy will stage a modest recovery starting late this year and continuing throughout 1983, enabling the state to realize both its revenue and expenditure projections. We would concede there are still downside risks to the recovery. Since the current recession has been atypical of all other postwar recessions, it is possible

These systems are funded from two primary sources: (1) earned income derived from investment of retirement funds; and (2) annual appropriations from the state, the amount of which is determined by a consulting actuary and paid to the system as a fixed percentage of payroll. In fiscal 1981, the state appropriated $433.0 million to the systems; earnings on invested assets provided an additional $426.0 million.

After a series of negotiations, the retirement boards agreed to increase the projected annual interest rate on the invested funds from 6% to 8%. The revised interest assumption reduced the state's required contribution by one-fourth or $100 million per year, a substantial part of the then projected 1981-82 deficit. This interest assumption change materially increased the projected future value of current assets, narrowed the existing shortfall between assets and liabilities, and reduced the percentage of payroll the state is required to submit to cover future liabilities for current members. Should the state's assumptions prove incorrect, it legally will be required in subsequent years to make up the resultant deficiency. A recent survey by Charles D. Spencer & Associates found that 116 major corporations projected a lower average rate of return on their pension investment fund assets, 7.581%.

The fiscal viability of the system is dependent upon the accuracy of the actuarial assumptions and projections with regard to several factors, including: (1) the number of employees who will vest, (2) their years of service, (3) their average salary at the time of retirement, (4) the retiree's life expectancy, and (5) the rate of return on investments. Many of these factors require the actuary to look decades into the future, a process fraught with fallibilities.

Recent large scale layoffs and a hiring freeze have reduced the number of employees. Most of those laid off are relatively young with less than ten years of service. The slowed economy has also reduced the turnover of public employees. The result is that a greater percentage of employees remaining in the systems will become vested. While only one-third of the current workforce is vested, they account for 83.1% of the total accrued liability. Although we expect further reductions in the size of the workforce with a minimal rise in the state's accrued liabilities, the increasing number of vested employees should produce a rapid rise in the state's total liability for future retirement benefits.

The two systems utilize a modified model of the Group Annuity Mortality Table for 1971. Experience studies to determine how actual mortality rates among retirees conform with these figures have not been performed. In the general population, life expectancy at age 60 increased one year in the last decade. If this trend continues, we can expect a further increase of at least two years before the year 2000. A major breakthrough in preventing either or both of the leading causes of death, heart disease and cancer, could raise life expectancy even further. If vested employees and retirees experience a comparable improvement, they will collect an additional $1 billion in pension payments between now and the end of this century. The actuary's modification of the mortality table covers 75% of this cost, leaving a potential unfunded liability of $250 million.

The Department of Treasury, which handles investments for the two systems, has maintained a policy of holding investments to maturity. Money turnover therefore has been limited to 3-5 percent a year, which provides little opportunity for capital growth or increasing the rate of return on investments. Because of legal constraints and administrative decisions, over 80% of the systems' portfolios consist of long-term, low-interest instruments such as bonds and mortgages. Many of these earn an annual the pattern of recovery will also differ. At this early stage we have no basis for sharing the pessimism of some observers. Even under a worse case scenario, fiscal 1983 revenues are unlikely to fall more than $250 million short of projections or expenditures to grow more than $150 million. A $400 million problem would require the same type of adjustment as in fiscal 1982, although it would be less extreme because the amount at risk is considerably smaller. However, the economic situation is still very fluid. More conclusive information on its course will be available after December, and readers will be alerted to any new developments at that time.

Comparison of 1982 General Fund Expenditures
and 1983 Appropriations (Millions of $)

Department	1982 Actual Expen-ditures	1983 Statutory Budget	Increase/ Decrease from 1982	% Change from 1982
Executive	$ 2.4	$ 2.3	-0.1	-4.2
Legislative	45.5	50.1	+4.6	+7.7
Judicial	53.8	54.4	+0.6	+1.1
Attorney General	13.5	14.3	+0.8	+5.9
State	9.6	8.6	-1.0	-10.4
Treasury	46.5	42.9	-3.6	-7.7
Management & Budget	58.0	77.3	+19.3[b]	+33.3
Civil Service	6.2	6.2	0.0	0.0
Civil Rights	7.4	7.8	+0.4	+5.4
Education	24.9	23.9	-1.0	-4.0
School Aid	392.3	289.7	-102.6	-26.2
Community Colleges	123.5	137.0	+13.5[c]	+10.9
St. Colleges & Univ.	576.2	808.0	+231.8[d]	+40.2
Public Health	86.9	93.3	+6.4	+7.4
Mental Health	512.5	537.7	+25.2	+4.9
Social Services	1743.8	1685.5	-58.3	-3.3
Corrections	214.6	229.5	+14.9	+6.9
State Police	116.4	120.4	+4.0	+3.4
Military Affairs	6.2	8.9	+2.7	+43.5
Natural Resources	48.7	44.7	-4.0	-8.2
Agriculture	18.4	18.3	-0.1	-0.5
Labor	36.7	52.1	+15.4	+42.0
Licensing & Regulation	12.6	12.6	0.0	0.0
Commerce	69.3	72.5	+3.2	+4.6
Transportation	0.0	0.0	0.0	0.0
Debt Service	150.2	112.5	-37.7	-25.1
Capital Outlay	63.1	24.2	-38.9	-61.6
Data Processing	33.2	36.6	+3.4	+10.2
TOTAL	$ 4472.4[a]	$ 4571.3	+98.9	+2.2

SOURCE: Based on information from the House Fiscal Agency.

[a]Retirement adjustment of $16.1 million reduces this to $4456.3 million, for a total year-to-year percent increase of 2.6%.

[b]Includes $26.0 million for repayment of state building bonds which are normally classified under capital outlay.

[c]Includes restoration of $7 million cut in last executive order.

[d]Includes restoration of $80 million in 1982 executive order reductions.