COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report

Third Quarter Fiscal Year 2009

Governor's Office for Economic Analysis

Office of State Budget Director

Office of State Budget Director
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Frankfort, Kentucky 40601

Steven L. Beshear
Governor

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Mary E. Lassiter
State Budget Director

Governor's Office for Policy and Management
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April 30, 2009

The Honorable Steven L. Beshear
Governor
Commonwealth of Kentucky
State Capitol Building
Frankfort, KY 40601

Mr. Robert Sherman, Director
Legislative Research Commission
Room 300, State Capitol
Frankfort, Kentucky 40601

Ms. Laurie Dudgeon, Director
Administrative Office of the Courts
100 Millcreek Park
Frankfort, KY 40601

Dear Governor Beshear, Mr. Sherman and Ms. Dudgeon:

The attached Quarterly Economic and Revenue Report summarizes the revenue and economic statistics for the third quarter of Fiscal Year 2009 (FY09). It also includes an interim economic and revenue forecast for the next three fiscal quarters, as required by KRS 48.400(2).

General Fund receipts for the third quarter of FY09 totaled $1,888.8 million, resulting in a 4.3 percent decrease compared to the same period in FY08. Road Fund revenues totaled $283.4 million, a decrease of 9.2 percent from the third quarter of FY08.

General Fund revenues totaled $6,217.1 million through the first three quarters of FY09, an amount nearly equal to the first three quarters of FY08 to yield a growth rate of 0.0 percent. A General Fund decline of 7.1 percent is anticipated for the fourth quarter of FY09, followed by a 0.2 decline in the first half of FY10.

Road Fund growth rates for the fourth quarter of the current fiscal year and the first six months of FY10 are forecasted to be -4.8 percent and 0.4 percent, respectively. The FY09 full-year forecast reflects a decline in total receipts of 6.3 percent as compared to FY08 collections.

We will continue our vigilant monitoring of the economic and fiscal conditions of the Commonwealth during these trying economic times. We will keep you apprised as further updates become available.

Sincerely,

Mary E. Lassiter

Mary E. Lassiter
State Budget Director

Attachment

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Executive Summary . . .

In accordance with KRS 48.400(2), the Office of State Budget Director has prepared a Quarterly Economic and Revenue Report for the third quarter of FY09. In accordance with the statutes, this report includes a synopsis of the current economic and fiscal conditions of the Commonwealth, as well as an outlook for the next three fiscal quarters. This report also highlights the differences between the April 2009 interim estimates and both the enacted budgeted revenues and the official estimates adopted by the Consensus Forecasting Group (CFG) in November 2008 as modified by actions of the Kentucky General Assembly in the 2009 Regular Session.

THIRD QUARTER RECEIPTS

General Fund

After positive revenue growth in the first two quarters of FY09, third quarter collections turned negative. Total receipts in the third quarter were $84.4 million less than in the previous year. Third quarter collections were dragged down primarily by individual income, sales and use, tobacco, and inheritance tax collections. Major accounts that showed positive growth for the quarter include coal severance, limited liability entity tax (LLET), and telecom taxes.

Receipts in the third quarter totaled $1,888.8 million compared to $1,973.2 million received in the third quarter of FY08. The resulting growth rate was -4.3 percent, and compares to a growth rate of 1.2 percent for the same quarter last year. Collections in the major revenue categories are shown in summary form in Table 1 on page 11. Detailed information on these and other accounts is available in the Appendix.

Total sales and use tax receipts for the quarter were $691.4 million, compared to $711.8 million in the third quarter of FY08. The $20.4 million shortfall translates to a 2.9 percent rate of decline.

The individual income tax posted receipts of $615.5 million, compared to last year's third-quarter receipts of $701.3 million. Receipts were 12.2 percent, or $85.8 million, less than the third quarter of last year. Receipts were down in all four components of the tax. Declarations were off $26.4 million, withholding came in $21.8 million lower, and net returns were $36.5 million less favorable than last year.

Combined corporation income and LLET receipts registered positive growth in the third quarter of the fiscal year. Revenues of $52.8 million were 1.3 percent higher than year-earlier figures of $52.1 million. The increase in the combined category is completely attributed to LLET tax collections which were up 94.4 percent.

Coal severance tax revenue growth continued its strong pace in the third quarter, surging 24.9 percent. Collections of $69.7 million compare to the FY08 third quarter total of $55.8 million. Tax receipts in the third quarter of FY08 rose by 8.1 percent.

Receipts for the cigarette tax of $39.3 million in the third quarter of FY09 failed to match last year's total of $43.6 million. The $4.2

million decrease amounted to a 9.8 percent decrease.

Third-quarter property tax receipts were flat compared to the third quarter of FY08.

Road Fund

The Road Fund reported a decline of 9.2 percent in the third quarter of FY09. This is the fourth consecutive quarterly decline in Road Fund collections with each quarter getting progressively worse this fiscal year. Receipts totaled $283.4 million and compare to $312.1 million from the third quarter of last year. Summary data are contained in Table 2 on page 13 and detailed data are shown in the Appendix.

Motor fuels tax receipts, usually a reliable source of Road Fund growth, grew at a rate of only 0.5 percent during the third quarter. Receipts were $145.9 million and compare to $145.3 million collected during the third quarter of last year.

The motor vehicle usage tax continued to magnify the underlying weakness in the economy, with receipts falling by 22.0 percent. Receipts during the third quarter of FY09 totaled $77.6 million and compare to $99.6 million collected during the same period last year. With national vehicle sales continuing to set new lows, pent-up demand will continue to mount as the age of the vehicle fleet matures.

REVENUE OUTLOOK

General Fund

Two bills were enacted by the 2009 General Assembly with significant fiscal implications for this quarterly revenue report. First, HB 144 made several changes to alcohol and tobacco taxes. The cigarette tax rate was doubled from 30 cents per pack to 60 cents and tax rates on other tobacco products doubled as well. An inventory tax accompanied the tax increase in order to adjust existing inventories of stamped cigarettes to the new rate of $0.60 per pack. Finally, HB 144 imposed the Kentucky sales tax on package alcohol sales, which were previously taxed at the wholesale level but not at retail. The fiscal impact of the entire package was $52.2 million in FY09, most of which would be brought in during the final quarter. The annualized impact of these changes in FY10 computes to $158.8 million.

The second significant piece of legislation was HB 374, which preserved the existing variable tax rate on motor fuels. The statutory floor of the average wholesale price used to compute the variable tax rate on motor fuels was adjusted. The fiscal impact of HB 374 was scored at $8.7 million in FY09 and zero for subsequent years.

Projected General Fund revenues for the next three quarters are shown in the Executive Summary Table A and Table 5 on page 21. General Fund revenues totaled $6,217.1 million through the first three quarters of FY09, an amount nearly equal to the first three quarters of FY08 to yield a growth rate of 0.0 percent. A decline of 7.1 percent is anticipated for the fourth quarter of FY09. The April projections are $10.0 million more than the official CFG estimates as modified in the 2009 Regular Session of the General Assembly.

The outlook for the first half of FY10 predicts a General Fund decline of 0.2 percent compared to the first half of FY09. The individual taxes can be seen in Table 5 on page 21. Of the major revenue sources, the individual income and sales taxes are projected to be relatively similar to FY09 levels. Corporation and coal tax projections reveal weaknesses present in the underlying economy.

While the first half of FY10 appears to have a moderated rate of decline relative to the fourth quarter of FY09, it should be noted that first-half receipts will benefit greatly by the revenue enhancement in HB 144. Roughly half of the $158.8 million FY10 fiscal impact of HB 144 will hit during the period July-December 2009. This additional revenue will inflate first-half receipts beyond what might be projected on the basis of the underlying economy alone.

Several major taxes are projected to post fourth quarter growth at a much lower pace than during the first three quarters of FY09. Most notably, the individual income tax is running slightly ahead of the pace set in FY08, but the interim outlook calls for a 15.2 percent decline in FY09:4. All components of that tax seem poised for a fourth quarter correction. The gains accumulated in the early part of the year in withholding have been steadily eroding as the fiscal year has progressed.

The April projections for the sales and use taxes call for a 1.1 percent decline in the fourth quarter of FY09. The rate of decline would have been much steeper but for the impacts of HB 144. Higher retail cigarette prices and imposition of the sales tax on package alcohol are expected to enhance sales tax collections in the fourth quarter, but this modest help is fighting an undertow of economic data that will overwhelm the revenue stimulus of that legislation.

Another category of taxes that seems to be particularly affected by the current recession is property taxes, normally a very stable revenue source. Property taxes in aggregate are still expected to rise a net of 3.0 percent in FY09, but the level of nominal receipts are projected to fall $11.8 million short of the modified CFG estimates. Real property and the tangible property tax on motor vehicles have shown the greatest signs of weakness.

On the brighter side, three taxes continue to outperform their November CFG estimates: corporation income, LLET, and coal severance. The combination of corporation income taxes and LLET are projected to exceed the official estimates by $59.1 million – but still fall by 25.3 percent in FY09 compared to receipts in FY08. Coal severance tax revenues are expected to beat the official estimate by $16.0 million in the current year before falling sharply in response to lower coal prices, more renegotiated contracts for delivery, and lackluster global demand for productive capacity.

Aside from the sales tax, tobacco taxes were most affected by HB 144. Anticipated receipts include revenue from the inventory tax that was enacted in HB 144, an extra $3.3 million from the tax increase on other tobacco products, and the higher receipts from the doubling of the cigarette stamp tax. All told, the tobacco taxes are anticipated to increase by 97.3 percent in the fourth quarter and an additional 22.4 percent in the first half of FY10.

Finally, the forecast for KY Lottery receipts has been lowered $5.0 million in the current year in recognition of the impact of the recession on expected lottery dividends. In addition to weakness in disposable income, the KY Lottery Corporation was beset with some exogenous factors that impacted receipts. For example, the ice storm that decimated the Commonwealth in late January crippled the lottery system in areas of the state that lost electricity for a prolonged period.

Road Fund

Road Fund revenues are forecasted to continue their decline in the final quarter of FY09 before showing modest growth in the first two quarters of FY10 as shown in Executive Summary Table B and Table 6 on page 24. Growth rates for the fourth quarter of the current fiscal year and the first six months of FY10 are forecasted to be -4.8 percent and 0.4 percent, respectively. The FY09 full-year forecast is $45.6 million, or 6.3 percent, less than the official CFG revenue forecast as modified by the General Assembly in HB 374.

Motor fuels tax collections are forecasted to grow by 1.7 percent over the final three months of FY09, due primarily to the preservation of the tax rate on motor fuels that went into effect for wholesale gallons sold after July 1, 2008. Receipts in the first two quarters of FY10 are projected to continue their tepid growth, increasing by 1.1 percent as the variable portion of the tax rate is projected to remain unchanged and consumption continues to wane due to sluggish demand.

Motor vehicle usage tax collections are expected to continue their recessionary pace over the remainder of the fiscal year with a 15.7 percent decline in the fourth quarter. However, vehicle sales should rebound modestly in the first two quarters of FY10 with anticipated growth in receipts of 1.4 percent. Growth in FY10 is more a reflection of FY09 weakness than a turnaround in economic conditions.

Master Settlement Agreement (MSA)

In the third quarter of FY09, as part of an ongoing process and negotiation, the major tobacco companies allowed a release of a portion of the escrowed funds held in abeyance pending a resolution to the Non-Participating Manufacturers (NPM) adjustment issue. For the Commonwealth of Kentucky, the result was a payment of $9.5 million in early March 2009.

The projection for the fourth quarter of FY09 was a total of $116.3 million in MSA payments from the participating tobacco manufacturers. The actual payments received in mid-April totaled $117.0 million. The amount received was larger than expected due to the inclusion of revised payment requirements covering the 2001-2008 payments. Nationally, the extra payments totaled over $42.8 million, with the Commonwealth receiving approximately $700,000.

The enacted estimate for MSA payments in FY09 was $119.7 million but that estimate was revised in November 2008 to equal $118.5 million. Actual receipts for FY09 have totaled $126.5 million or $8.0 million more than the official CFG estimate. No further payments are expected for FY09. To date, Kentucky has received $1,118.5 million from the MSA.

ECONOMIC OUTLOOK

National Economy

The outlook presented here is for the three-quarter period from April to December 2009. This period represents the final quarter of FY09 and the first half of FY10. Three scenarios are available with different assumptions regarding the most probable path of the national economy. This report is based on the "control" scenario but there are three scenarios available for consideration: Optimistic, or "Green Shoots" (20% probability); Control (60% probability); and Pessimistic (20% probability). The primary distinctions among the scenarios include the duration of the recession, the rebound in aggregate demand, and the ability to sustain and nurture any “green shoots” that sprout up over the next several quarters.

Note on the National Economy: *The forecast of all national variables is provided by Global Insight, an economic forecasting firm used by a majority of states for macroeconomic consulting.*

In the quarterly report released by OSBD in January, it was projected that the “bottom” would begin to form and the recovery phase would begin to emerge in FY10:1. The current outlook delays the beginning of any recovery phase to a later period, possibly FY10:2 or FY10:3. In addition, GDP and personal income are now predicted to experience deeper lows than were projected in January. Year-over-year GDP is now expected to fall 3.5 percent in the first half of FY10. It is now anticipated that we will witness six consecutive quarters of declines, including declining GDP in each quarter of this interim outlook.

The duration and depth of the current recession already rival the GDP declines witnessed in all previous post-war recessions (See Figure 5 on page 27). All of the key economic measures have reported significant declines, including automobile sales and production, capital investment, equipment spending, and new home starts.

The projected path to the economy's eventual recovery is foreshadowed by the name for the April optimistic scenario - “green shoots”. Signs of the first upshoot can be seen in consumption demand, which has been the lone glimmer of hope in recent news. Before consumption can blossom into prosperity and higher production, inventories must be worked down. Once inventories have abated, producers will re-evaluate aggregate demand. If demand proves sustainable, the wheels of industry will react with increased production, which can only be accomplished through the increased utilization of labor, producers equipment/investment spending, or increases in factor productivity. Unfortunately, improvements in the embattled labor sector are at the end of the process, so relief for employment (and personal income from wages and salaries) will lag the beginning of the recovery in production.

The foregoing analysis about the path of recovery notwithstanding, it should be noted that the economy still has a long way to fall before the recovery can gain traction.

U.S. personal income projections shown in Tables 7 and 8 on page 28 suggest that the worst of the recession remains ahead. Since the Bureau of Economic Analysis (BEA) first collected personal income data in 1959, personal income has never been negative on a quarter-over-same-quarter basis. The Global Insight projections call for that streak to end in FY10:1, as U.S. personal income is projected to decline 0.5 percent. Expressed in terms of quarter to quarter growth, U.S. personal income fell in FY09:2 and is projected to show declines in FY09:3 and FY10:1. Personal income has only fallen twice on an adjacent-quarter basis since 1959. Both of these occurrences were in the mid-1990’s, and each time the decline was sandwiched between adjacent quarterly increases. In short, these declines in the 1990’s were not indicative of prolonged and systemic recessions.

One silver lining that should not be ignored is the potential pent-up demand created by the current economic downturn. Families need houses and cars. Businesses need to make investments and replace equipment.

Many consumers have delayed major purchases because of uncertainty in their employment situation, even though they may have current savings and income that would support these transactions. When concerns over sustained employment are alleviated, conditions are ripe for a healthy rebound. Interest rates and housing prices are low; inflation is muted. While credit is currently tight, the Federal Reserve is taking active steps to weaken the stranglehold on access to funds. Businesses, like consumers, may also have the financial resources to hire workers and invest. When the recovery gains traction, the pent-up demand from this prolonged downturn will create the potential for a nice rebound.

Kentucky Economy

In comparison to the January outlook, both the employment and personal income projections have worsened due to an appreciably more negative national outlook from Global Insight. While the worst is not yet behind Kentucky, the green sprouts have emerged on the consumer side of the state economy. Pent-up demand will eventually fertilize these sprouts, but the germination period extends beyond the current three-quarter forecasting horizon.

Many of the national patterns identified above are projected to replicate themselves in the Kentucky economy. While Kentucky was comparatively insulated from the effects of the housing collapse, Kentucky's emphasis on manufacturing is projected to slightly prolong the recovery in employment. Peak-to-trough declines are projected to be less pronounced in Kentucky, but employment is still expected to contract 2.9 percent over the three-quarter forecasting horizon. Employment averaged 1,825.9 thousand in the most recently completed quarter (See Table 4 on page 17). By the first half of FY10 aggregate employment is projected to dip to 1,791.8 thousand – a contraction of an additional 34,100 jobs over the three quarters.

Kentucky personal income is projected to inch forward by 0.6 percent in the final quarter of FY09 followed by 0.6 percent growth in the first half of FY10. Both figures compare favorably to national trends. However, the most recent personal income data suggest an unfavorable mix in the components of personal income. Transfer payments are up sharply, climbing 14.0 percent. Wages and salary income fell marginally during the same period, while proprietors income and dividends fell sharply.

The three-quarter employment outlook by sector reveals widespread weakness, with the goods-producing industries suffering the brunt of the job losses in percentage terms. Service-providing industries are expected to fall over the forecasting horizon, by 2.4 percent in the current quarter and 2.2 percent in the first half of FY10. Weakness in Kentucky and national personal income growth is expected to dampen aggregate demand and hence employment in wholesale and retail trade.

Executive Summary Table A
General Fund Interim Estimates FY09
($ millions)
April 2009

	Enacted		Nov. 2008 CFG*		Apr. 2009 Interim		
	Estimate	% Chg	Estimate	% Chg	Estimate	% Chg	$ Diff
Sales & Use	2,977.8	3.5	2,889.1	0.4	2,870.9	0.2	-18.2
Individual Income	3,472.8	-0.3	3,365.4	-3.4	3,335.9	-4.2	-29.5
Corporation Inc & LLET	622.3	16.6	339.6	-36.4	398.7	-25.3	59.1
Coal Severance	223.7	-4.0	275.3	18.2	291.3	25.1	16.0
Tobacco	178.6	0.1	215.8	21.0	212.3	19.0	-3.5
Property	518.9	3.7	527.2	5.3	515.4	2.9	-11.8
Lottery	198.5	5.9	198.5	5.9	193.5	3.2	-5.0
Other	693.5	3.5	671.2	0.1	674.1	0.6	2.9
Total General Fund	**8,886.0**	**2.6**	**8,482.1**	**-2.1**	**8,492.1**	**-2.0**	**10.0**
Impact of HB 144			**52.2**		**52.2**		
Total FY09 without HB 144			**8,429.9**		**8,439.9**		

Difference from Enacted

	Nov. 2008 CFG*	Apr. 2009 Interim
Sales & Use	-88.7	-106.9
Individual Income	-107.4	-136.9
Corporation Inc & LLET	-282.7	-223.6
Coal Severance	51.6	67.6
Tobacco	37.3	33.8
Property	8.3	-3.5
Lottery	0.0	-5.0
Other	-22.3	-19.4
Difference from Enacted	**-403.9**	**-393.9**

* As modified by the 2009 General Assembly

Executive Summary Table B
Road Fund Interim Estimates FY09
($ millions)
April 2009

	Enacted		Nov. 2008 CFG*		Apr. 2009 Interim		
	Estimate	% Chg	Estimate	% Chg	Estimate	% Chg	$ Diff
Motor Fuels	661.4	8.6	649.2	6.6	616.0	1.2	-33.2
Motor Vehicle Usage	411.9	1.5	340.2	-16.2	337.1	-16.9	-3.1
Motor Vehicle License	109.5	17.1	95.8	2.4	94.4	0.9	-1.4
Motor Vehicle Operators	15.5	0.8	16.3	6.0	15.2	-1.1	-1.1
Weight Distance	85.9	1.8	79.6	-5.6	77.3	-8.4	-2.3
Investment	5.8	-70.2	10.9	-44.0	9.0	-53.8	-1.9
Other	34.8	2.0	36.8	3.6	34.2	-3.7	-2.6
Total Road Fund	**1,324.8**	**4.9**	**1,228.8**	**-3.4**	**1,183.2**	**-6.3**	**-45.6**
Impact of HB 374			**8.7**		**8.7**		
Total FY09 without HB 374			**1,220.1**		**1,174.5**		

Difference from Enacted

	Nov. 2008 CFG*	Apr. 2009 Interim
Motor Fuels	-12.2	-45.4
Motor Vehicle Usage	-71.7	-74.8
Motor Vehicle License	-13.7	-15.1
Motor Vehicle Operators	0.8	-0.3
Weight Distance	-6.3	-8.6
Investment	5.1	3.2
Other	2.0	-0.6
Difference from Enacted	**-96.0**	**-141.6**

* As modified by the 2009 General Assembly

Executive Summary Table C
Master Settlement Agreement Receipts
($ millions)
April 2009

	FY09 Q3	FY09 Q4	FY09
Budgeted MSA Receipts	2.2	117.5	119.7
Estimated MSA Receipts	2.2	116.3	118.5
Actual MSA Receipts	9.5	117.0	126.5
Difference (Actual - Est)	7.3	0.7	8.0
Difference (Actual - Budgeted)	7.3	-0.5	6.8

NOTE: Cumulative receipts to date are $1,185.8 million.

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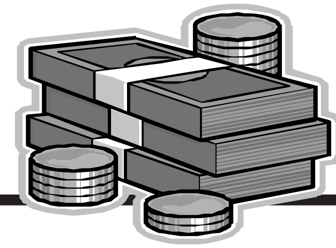
Revenue Receipts . . .



GENERAL FUND

After positive revenue growth in the first two quarters of FY09, third quarter collections turned negative. Total receipts were 4.3 percent, or $84.4 million, less than in the previous year. Third quarter collections were dragged down primarily by weak corporation and individual income tax, sales and use, cigarette, and inheritance tax collections. Major accounts that showed positive growth for the quarter include coal severance, LLET, and telecom taxes.

Receipts in the third quarter totaled $1,888.8 million compared to $1,973.2 million received in the third quarter of FY08. Collections in the major revenue categories are shown in summary form in Table 1. Detailed information on these and other accounts is available in the Appendix.

Table 1
Summary General Fund Receipts
Third Quarter FY08/FY09
($ millions)

	FY09 Q3	FY08 Q3	Diff ($)	Diff (%)
Sales and Use	691.4	711.8	-20.4	-2.9
Individual Income	615.5	701.3	-85.8	-12.2
Corp Inc. & LLET	52.8	52.1	0.7	1.3
Coal Severance	69.7	55.8	13.9	24.9
TobaccoTaxes	41.4	45.6	-4.2	-9.2
Property	139.7	139.7	0.0	0.0
Lottery	50.0	47.5	2.5	5.3
Other	228.3	219.4	8.9	4.1
TOTAL	**1,888.8**	**1,973.2**	**-84.4**	**-4.3**

Variations in the quarterly receipts are often affected by differences in the timing of payments into revenue accounts. While timing differences were not as prevalent as in the past, property tax receipts continue to record fluctuations because of these differences.

Total **sales and use tax** receipts for the quarter were $691.4 million, compared to $711.8 million in the third quarter of FY08. The $20.4 million shortfall translates to a decline of 2.9 percent compared to 2.8 percent growth for the third quarter of last year.

Individual income tax posted receipts of $615.5 million, compared to last year's third-quarter receipts of $701.3 million. Receipts were 12.2 percent, or $85.8 million, less than the third quarter of last year. Receipts were down in all of the main components of the tax. Declarations were off $26.4 million, withholding came in $21.8 million down, and net returns were $36.5 million less than last year.

Combined **corporation income and limited liability entity tax (LLET)** receipts were positive in the third quarter of the fiscal year. Revenues of $52.8 million were 1.3 percent higher than year-earlier figures of $52.1 million. LLET tax collections were up 94.4 percent with collections of $26.5 million while corporation income tax receipts were down 31.6 percent.

Coal severance tax revenue growth continued its strong pace in the third quarter, with receipts up by 24.9 percent. Collections of $69.7 million compare to the FY08 third quarter total of $55.8 million. Tax receipts in the third quarter of FY08 rose by 8.1 percent.

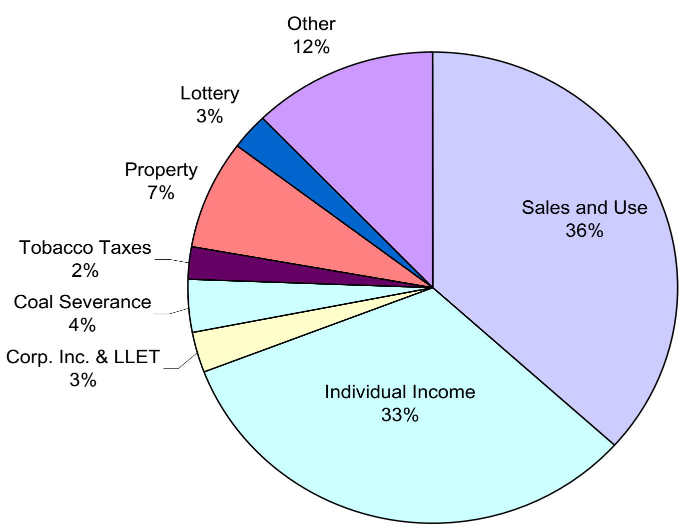
Tobacco tax receipts of $41.4 million in the third quarter of FY09 failed to match last year's total of $45.6 million. The $4.2 million decrease amounted to a 9.2 percent decline.

Third-quarter **property tax** receipts posted revenues that were unchanged from the third quarter of FY08. FY09 third-quarter receipts of $139.7 million matched the FY08 third quarter total.

Lottery receipts were $50.0 million, which was 5.3 percent higher than last year's third-quarter total of $47.5 million.

The **"other"** category, which represents the remaining accounts of the General Fund, increased $9.0 million, or 4.0 percent, in the third quarter. Third quarter receipts for FY09 were $230.4 million and compare to $221.4 million in FY08.

Figure 1
Third Quarter, FY09
General Fund Receipts



ROAD FUND

The Road Fund reported a decline of 9.2 percent in the third quarter of FY09. This is the fourth consecutive quarterly decline in Road Fund collections with each quarter getting progressively worse this fiscal year. Receipts totaled $283.4 million and compare to $312.1 million from the third quarter of last year. Summary data are contained in Table 2 and detailed data are shown in the Appendix.

Motor fuels tax receipts, usually a foundation of Road Fund growth, grew only at a rate of only 0.5 percent during the third quarter. Receipts were $145.9 million and compare to $145.3 million collected during the third quarter of last year.

Motor vehicle usage tax continued to decline in the third quarter, with receipts falling by 22.0 percent. Receipts during the third quarter of FY09 totaled $77.6 million and compare to $99.6 million collected during the same period last year.

Motor vehicle license tax receipts decreased 5.7 percent, or $1.6 million, in the third quarter of FY09 to $27.1 million.

Motor vehicle operators license tax receipts were essentially unchanged with collections of $3.6 million.

Weight distance tax receipts of $17.8 million represent a 14.0 percent decrease compared to receipts of $20.7 million during the third quarter of FY08.

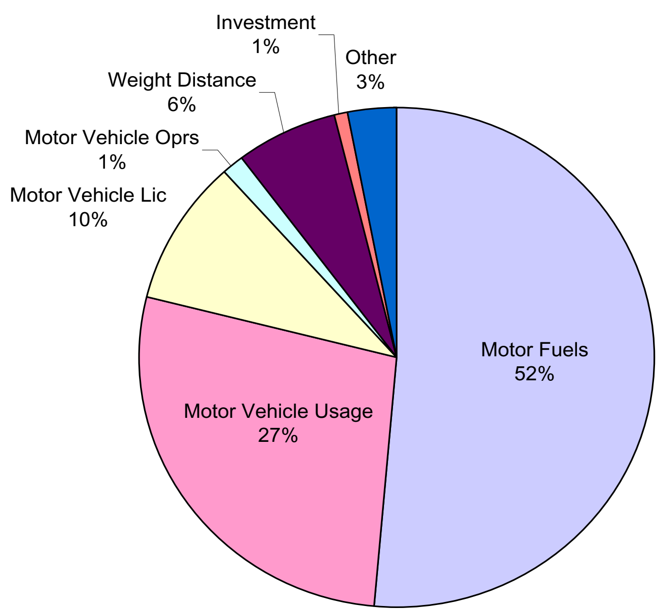
Investment income receipts of $2.4 million were down $3.2 million, or 57.1 percent, over the total collected in the third quarter of FY08.

The remainder of the accounts in the Road Fund combined for an increase of 3.8 percent from a year earlier. In the **"other"** category, revenues of $8.9 million compare to $8.5 million in the third quarter of FY08.

Table 2
Summary Road Fund Receipts
Third Quarter FY08/FY09
($ millions)

	FY09 Q3	FY08 Q3	Diff ($)	Diff (%)
Motor Fuels	145.9	145.3	0.7	0.5
Motor Vehicle Usage	77.6	99.6	-22.0	-22.0
Motor Vehicle License	27.1	28.7	-1.6	-5.7
Motor Vehicle Operators	3.6	3.7	0.0	-0.9
Weight Distance	17.8	20.7	-2.9	-14.0
Investment Income	2.4	5.7	-3.2	-57.1
Other	8.9	8.5	0.3	3.8
TOTAL	**283.4**	**312.1**	**-28.8**	**-9.2**

Figure 2
Third Quarter, FY09
Road Fund Receipts



MASTER SETTLEMENT AGREEMENT (MSA)

In the third quarter of FY09, the Commonwealth received a distribution of funds from the escrow account for disputed payments. The MSA contains a provision called the Non-Participating Manufacturers Adjustment (NPM Adjustment). The provision allows for the reduction of payments to the settling states if the states do not fully enforce their duties and provisions contained in the MSA. Since this determination is a long and lengthy legal decision, the funds under dispute are placed into an escrow account until adjudication. As part of an ongoing process and negotiation, the major tobacco companies ordered a release of some of the escrowed funds to the settling states. For the Commonwealth of Kentucky, the result was a payment of $9.5 million in early March 2009.

The projection for the fourth quarter of FY09 was a total of $116.3 million in MSA payments from the participating tobacco manufacturers. The actual payments received in mid-April totaled $117.0 million. The amount received was larger than expected due to the inclusion of revised payment requirements covering the 2001-2008 payments. Nationally, the extra payments totaled over $42.8 million, with the Commonwealth receiving approximately $700,000.

The enacted estimate for MSA payments in FY09 was $119.7 million but that estimate was revised in November 2008 to $118.5 million. Actual receipts for FY09 have totaled $126.5 million or $8.0 million more than the official CFG estimate. No further payments are expected for FY09. To date, Kentucky has received $1,118.5 million from the MSA.

The Economy . . .

NATIONAL ECONOMY

The U.S. still remains deeply rooted in the recession which started in December 2007. This recession seems to be both deep and potentially long-lasting. Real Gross Domestic Product (real GDP), the broadest measure of the national economy, declined by 2.7 percent in the third quarter compared to third quarter of FY08. Since 1959, only one other quarter was lower or equal to this, a 2.7 percent decline in the first quarter of 1983. The third quarter FY09 decline is the second consecutive decline in real GDP. Real GDP fell by 0.8 percent in the second quarter. Real GDP in the first quarter was already quite weak with only 0.7 percent growth. For perspective, the average quarterly growth rate in the post-war era is 3.3 percent. The impacts on real GDP of any given recession varied as much as the circumstances which created them.

The last five recessions were remarkably different from one another. The 1973 recession lasted 16 months, was moderately deep, contained five consecutive quarters of quarter-over-same-quarter-last-year negative growth and fell $135.7 billion (3.1 percent) from peak to trough. The 1980 recession was only six months long, was deep given its duration, contained two consecutive negative quarters and fell $113.9 billion (2.2 percent). The 1981 recession was 16 months long, also moderately deep, contained four consecutive negative quarters and fell $152.7 billion (2.9 percent). The 1990 recession was eight months long, relatively shallow for its duration, contained three consecutive negative quarters and fell $90.0 billion (1.3 percent). The 2001 recession was even more unusual; it was eight months long and contained no negative quarter-over-same-quarter-last-year growth at all. It did however contain three non-consecutive adjacent-quarter declines. The 2001 recession exhibited more of an extended plateau-shape than a true U- or V-shaped contraction. Adjacent-quarter growth alternated signs for six consecutive quarters from fourth quarter FY00 to second quarter FY02, where the positive growth quarters following a decline more than made up the losses, giving it a jagged slightly upward-trending shape. (See Figure 3 on page 18) The current recession has already outstripped the 1980 and 1973 recessions in terms of percentage losses. Real GDP peaked in the fourth quarter of FY08 at $11,727.4 billion. To date, real GDP has fallen by $401.2 billion (3.4 percent) from peak to present. As the economic outlook will report, it does not appear that the bottom has been established for real GDP.

Real GDP is made up of five components. To understand how real GDP is changing, it is often enlightening to understand the components. Consumption in the third quarter of FY09 declined by 1.4 percent compared to the same quarter in FY08. (See Table 3 on page 17) However, recent quarters suggest that consumption is flattening out to near zero growth. Adjacent quarter growth for the third quarter of FY09 was 0.3 percent, but was preceeded by two consecutive quarters of declines (-1.0 and -1.1 percent, respectively).

Investment exhibited the largest percentage decline among the components, falling by 22.5 percent. Investment declined by a net $395.0 billion, a decline which makes up 3.5 percent of real GDP for the third quarter. Meanwhile government expenditures rose by 1.7 percent as transfer payments and social insurance outlays increased. Both imports and exports declined sharply as personal income and disposable income fell globally. One small glimmer of light can be seen in this, as exports fell by a smaller percentage than imports, shrinking the trade deficit from $462 billion to $339 billion.

U.S. personal income has been depressed for several quarters. While quarter-over-same-quarter-last-year growth has not yet turned negative, the growth rate has fallen sharply in the last six quarters. (see Figure 4) The growth rates were 5.8, 4.2, 5.0, 3.8, 2.2 and 0.9 percent, respectively. Meanwhile, adjacent-quarter growth rates have been negative for the last two consecutive quarters with declines of 0.4 and 0.5 percent, respectively. Both sets of growth rates are substantially below the norm. U.S. personal income has a historical average of 1.7 percent adjacent-quarter growth since 1959. In fact, it is quite unusual for U.S. personal income to decline on an adjacent-quarter basis, much less on a quarter-over-same-quarter-last-year basis. U.S. personal income has only declined on two other occasions since 1959. It declined in the third quarter of FY93 with -1.6 percent growth and also in the third quarter of FY94 with -0.4 percent growth.

The recession officially started in December 2007, according to the National Bureau of Economic Research, the federal body charged with pinpointing the turning points in the business cycle. U.S. personal income growth is one of the indicators that this body examines when determining turning points, so it is not surprising that the official turning point and U.S. personal income match up so well, despite real GDP being moderately positive throughout FY08.

U.S. non-farm employment has been impacted by the decreased demand even more than U.S. personal income. (see Figure 4) U.S. non-farm employment has fallen by 4.3 million (3.1 percent) since the second quarter of FY08, when it last peaked. The credit market crisis and high and erratic prices are making consumers more hesitant to make large purchases like housing and automobiles. When aggregate demand decreases, firms cannot continue to produce at their pre-recessionary levels. Prolonged decreases in aggregate demand lead to decreased hours and layoffs. In some industries, like automobiles, where there is both a large labor market and a tight horizontal market for intermediate goods, this prolonged decrease in demand can lead to even greater layoffs as the first round of layoffs decrease aggregate demand even further. Non-farm employment declined by 3.1 percent in the third quarter, while U.S. manufacturing employment declined by 9.1 percent over the same quarter in FY08.

Table 3
Summary of US Economic Series
Third Quarter FY08/FY09
April 2009

	FY08 Q3	FY09 Q3	% Chg
Real GDP	11,646.0	11,326.2	-2.7
Real Consumption	8,316.1	8,197.7	-1.4
Real Investment	1,754.7	1,359.7	-22.5
Real Govt. Expenditures	2,039.1	2,074.3	1.7
Real Exports	1,500.6	1,305.7	-13.0
Real Imports	1,962.6	1,644.3	-16.2
Personal Income ($ billions)	11,960.5	12,068.4	0.9
Consumer Price Index (percent change)	2.13	2.13	NA
Industrial Production Index (percent change)	112.0	99.2	NA
Civilian Labor Force (millions)	153.7	154.0	0.2
Total Nonfarm Employment (millions)	137.9	133.7	-3.1
Manufacturing Employment (millions)	13.7	12.5	-9.1
Unemployment Rate (percent)	4.9	8.1	NA

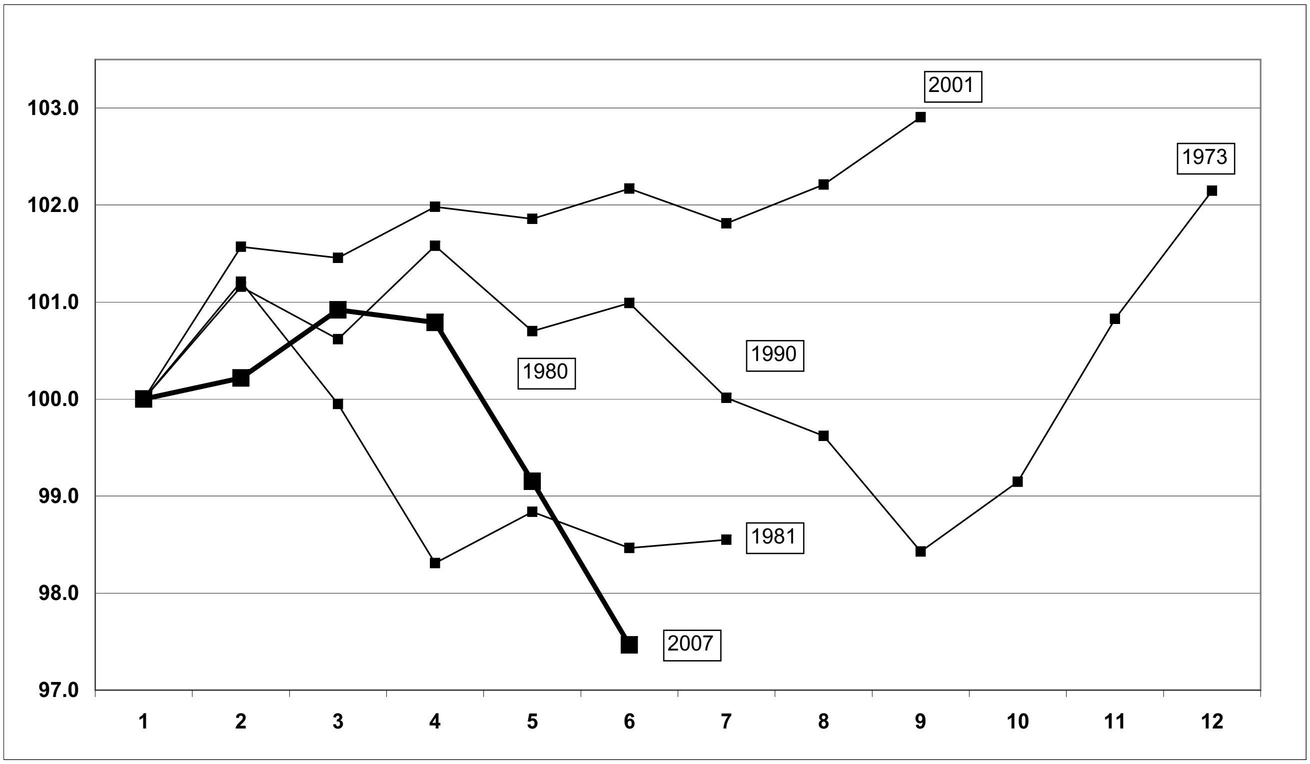
Not Seasonally Adjusted. Real series are in billions of chained 2000 dollars.
GDP components may not sum due to rounding at lower levels of detail.
Data for FY09 Q3 are April 2009 estimates.
Source: IHS Global Insight Inc., April 2, 2009 data release

Table 4
Selected Kentucky Economic Series
Third Quarter FY08/FY09
April 2009

	FY08 Q3	FY09 Q3	Diff	% Chg
Total Personal Income ($ millions)	133,718	136,351	2,633	2.0
Wages and Salary Income ($ millions)	72,514	72,209	-305	-0.4
Total Nonfarm Employment (thousands)	1,866.0	1,825.9	-40.1	-2.1
Construction	84.6	81.4	-3.2	-3.8
Natural Resources & Mining	22.5	25.2	2.7	11.8
Manufacturing	252.1	235.9	-16.2	-6.4
Trade, Transportation & Utilities	384.0	371.7	-12.3	-3.2
Information	29.9	29.6	-0.3	-0.9
Finance	92.4	90.9	-1.5	-1.6
Business Services	185.4	177.3	-8.1	-4.4
Educational Services	242.3	247.3	5.0	2.1
Leisure and Hospitality	172.8	170.1	-2.7	-1.6
Other Services	75.3	74.3	-1.0	-1.4
Government	324.6	322.2	-2.4	-0.7

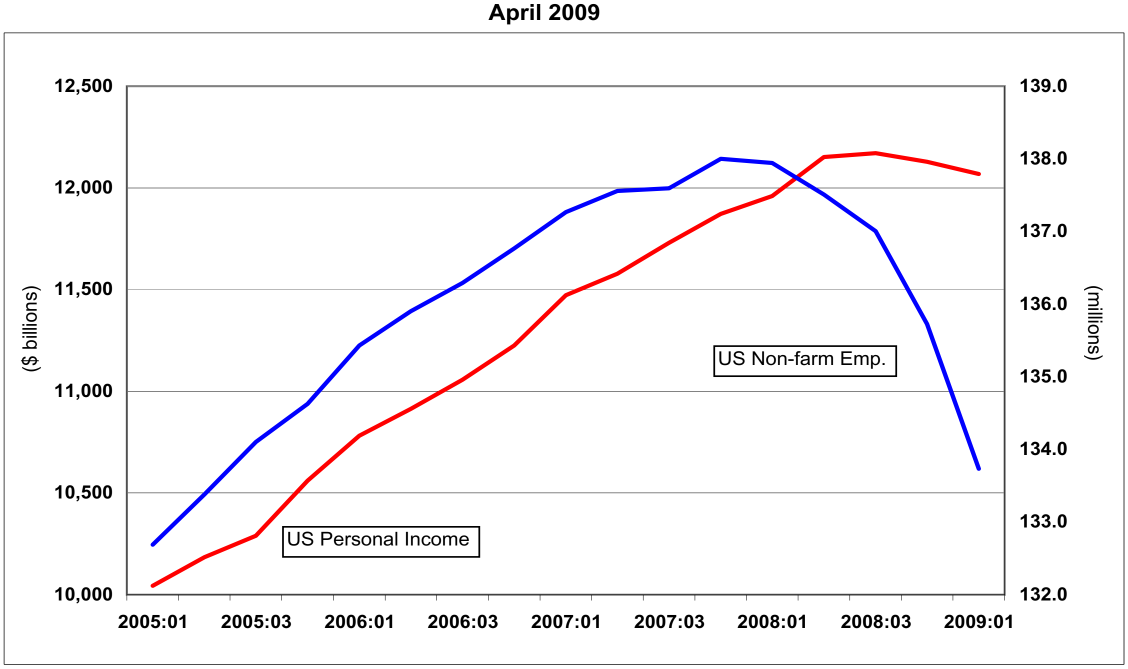
Kentucky Personal Income and Wages and Salary data are shown in nominal dollars.
Total Nonfarm Employment and its components are seasonally adjusted.
Source: US Bureau of Economic Analysis, US Bureau of Labor Statistics.
The FY09:3 data for all series are Kentucky MAK model estimates.

Figure 3
Real GDP During Last Six Recessions
Quarterly data indexed to quarter prior to recession start date
April 2009



Source: Bureau of Economic Analysis and National Bureau of Economic Research.

Figure 4
US Personal Income (left axis) and US Non-farm Employment (right axis)
Quarterly data
April 2009



Source: IHS Global Insight, Inc., April 2, 2009 data release.

STATE ECONOMY

Kentucky's personal income is estimated to be $136.4 billion for the third quarter of FY09, an increase of 2.0 percent from the same quarter a year ago. U.S. personal income grew only 0.9 percent during the same period. Kentucky wages and salaries constitute a little over half of personal income. Income derived from wages and salaries in Kentucky is estimated to have declined by 0.4 percent. The three sectors that account primarily for Kentucky's sub-par income growth are manufacturing; trade, transportation and utilities; and business services. Together these sectors account for about 43 percent of total employment.

The apparent disconnect between personal income growth and a nominal decline in the wage and salary component can be largely explained by the robust 14.0 percent increase in transfer payments. Transfer payments amounted to about $30.6 billion of the total $136.4 billion in Kentucky personal income, or a little over 22 percent. The three segments of personal income most closely tied to economic growth — wages and salaries (-0.3 percent), proprietors income (-2.5 percent), and interest/dividend income (-5.0 percent) — were all decidedly negative and more in tune with the waning performance of the Kentucky labor markets.

Employment data is commonly used to gauge the strength of the state's economy, primarily because of its timely availability and its impact on consumer spending and overall confidence. Kentucky is estimated to have shed 40,100 jobs during the third quarter compared to a year ago. Kentucky's decline of 2.1 percent was better than the national average of -3.1 percent, but was the eighth consecutive quarter in which employment growth has slowed and the fourth consecutive quarter that employment has declined. Nine of Kentucky's eleven employment categories saw a decline in the quarter, which is not surprising given that Kentucky's unemployment rate currently stands at 9.8 percent, a 25-year high. The categories that added jobs were educational services and natural resources and mining.

Manufacturing jobs in Kentucky continue to decline as companies restructure to remain competitive. During the third quarter of FY09, total manufacturing employment declined 6.4 percent. The loss of 16,200 jobs was a continuation of the trend in the first six months of the fiscal year when employment fell by 5.7 percent. As the economic outlook will report, the recent trend of job losses does not appear to have completely played itself out. Further weakness in the Kentucky labor market seems probable as low aggregate demand continues to discourage businesses from investment in productive capacity and payroll.

The trade, transportation and utilities sector accounts for one-fifth of all employment in Kentucky. The number of jobs lost since the third quarter of FY08 in this sector was 12,300, or 3.2 percent. Kentucky's construction employment decreased by 3.1 percent during the first half of the year and has now slowed to 3.8 percent. The apparent culprit is once again a lack of total aggregate demand, as these sectors typically mirror the overall performance of the industrial sector.

Approximately 63 percent of Kentucky's nonagricultural jobs are in the services sectors. These sectors are listed in detail in Table 4. Overall employment for these sectors was down -2.6 percent for the third quarter. The most substantial gains were in educational and health services with an increase of 2.1 percent for an addition of 5,000 jobs. Service employment has been the engine of growth for labor in recent years, so a decline in Kentucky service employment is convincing testimony to the magnitude and depth of the current national recession.

Interim Outlook . . .

GENERAL FUND

Two bills enacted by the General Assembly in 2009 have significant fiscal implications for this quarterly revenue report. First, HB 144 made several changes to alcohol and tobacco taxes, including an increase in the cigarette tax which doubled the rate from 30 cents per pack to 60 cents. Also included was a tax increase on other tobacco products that amounted to a doubling of those tax rates as well. An inventory tax accompanied the tax increase in order to adjust existing inventories of stamped cigarettes to the new rate of $0.60 per pack. Finally, HB 144 imposed the Kentucky sales tax on package alcohol sales, which were previously taxed at the wholesale level only. The entire package is expected to produce an additional $52.2 million in FY09, most of which would be realized during the final quarter. The annualized total for these changes in FY10 computes to $158.8 million.

Second, HB 374 was signed into law on March 13, 2009. That legislation preserved the existing variable tax rate on motor fuels by adjusting the statutory floor of the average wholesale price used when computing the variable tax rate. The fiscal impact of HB 374 was scored at $8.7 million in FY09 and zero for subsequent years.

When depicting revenue collections and projected collections, it is appropriate to include the fiscal impacts resulting from acts of the General Assembly that either enhance or lower the latest official estimates. This exercise has been continued in this report in Table 5 and Table 6.

Table 5
General Fund Interim Forecast
($ millions)
April 2009

	FY09 Q1, Q2 & Q3		FY09 Q4		FY09 Full Year		FY09 Nov. 2008 CFG*		FY 10 Q1 & Q2	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff	Estimate	% Chg
Sales & Use	2,159.1	0.1	711.8	-1.1	2,870.9	-0.2	2,889.1	-18.2	1,453.2	-1.0
Individual Income	2,351.7	1.3	984.1	-15.2	3,335.9	-4.2	3,365.4	-29.5	1,744.5	0.5
Corporation Inc & LLET	259.5	-28.1	139.2	-19.4	398.7	-25.3	339.6	59.1	196.2	-5.1
Coal Severance	217.9	30.7	73.4	10.8	291.3	25.1	275.3	16.0	123.9	-16.4
Tobacco	126.9	-6.1	85.4	97.3	212.3	19.0	215.8	-3.5	132.5	55.1
Property	458.9	3.4	56.5	-0.5	515.4	3.0	527.2	-11.8	319.2	0.0
Lottery	141.5	1.2	52.0	9.0	193.5	3.2	198.5	-5.0	93.2	1.8
Other	501.5	8.9	172.6	-4.1	674.1	0.6	671.2	2.9	257.2	-5.8
Total General Fund	**6,217.1**	**0.0**	**2,275.1**	**-7.1**	**8,492.1**	**-2.0**	**8,482.1**	**10.0**	**4,320.0**	**-0.2**
HB 144 2009 RS					**52.2**		**52.2**			
Total Without HB 144					**8,439.9**		**8,429.9**			

* As modified by the 2009 General Assembly

Projected General Fund revenues for the next three quarters are shown in Table 5. General Fund revenues totaled $6,217.1 million through the first three quarters of FY09, an amount nearly equal to the first three quarters of FY08 to yield a growth rate of 0.0 percent. A decline of 7.1 percent is anticipated for FY09:4, resulting in a projected revenue decline of 2.0 percent for the entire fiscal year. In nominal terms, the April projections are $10.0 million more than the official estimate as modified in the 2009 Regular Session of the General Assembly.

The outlook for the first half of FY10 predicts a General Fund decline of 0.2 percent compared to the first half of FY09. The individual taxes can be seen in Table 5 on page 21. Of the major revenue sources, the individual income and sales taxes are projected to be relatively similar to FY09 levels. Corporation and coal tax projections reveal weaknesses present in the underlying economy.

While the first half of FY10 appears to have a moderated rate of decline relative to the fourth quarter of FY09, it should be noted that first-half receipts will benefit greatly by the revenue enhancement in HB 144. Roughly half of the $158.8 million FY10 fiscal impact of HB 144 will hit during the period July-December 2009. This additional revenue will inflate first-half receipts beyond what might be projected on the basis of the underlying economy alone.

Several major taxes are projected to post fourth quarter growth at a much lower pace than during the first three quarters of FY09. Most notably, the individual income tax is running dead even with the pace set in FY08, but the interim forecast calls for a 15.2 percent decline in FY09:4. All components of that tax seem poised for a fourth quarter correction. Withholding tax, which makes up 92 percent of the individual income tax, performed ahead of expectations in the first half of FY09 but has markedly slowed in recent months. The gains accumulated in the early part of the year have been steadily eroding since late fall. March posted another decline in withholding and the forecast calls for withholding to mimic the negative patterns projected in the labor market to end FY09 in negative territory. The balance on returns and declaration payments make up the bulk of the projected decline in the income tax, as the levels witnessed in FY08:4 were historically anomalous.

Sales and use tax receipts fell 2.9 percent during the FY09:3. A decline was anticipated, but the magnitude of the decline exceeded earlier projections. The April projections call for a 1.1 percent decline in the current quarter, an amount that would have reflected a greater rate of loss but for the impacts of HB 144. Both the cigarette taxes and imposition of the sales tax on package alcohol were expected to enhance sales tax collections in the fourth quarter, but the increases will not be sufficient to overcome the direction of the underlying economy.

Another category of taxes that seems to be particularly affected by the current recession is property taxes, normally a very stable revenue source. Property taxes in aggregate are still expected to rise 3.0 percent in FY09, but the level of nominal receipts are projected to fall $11.8 million short of the modified CFG estimates. Real property and the tangible property tax on motor vehicles have shown the greatest signs of weakness.

On the brighter side, three taxes continue to outperform their November CFG estimates: corporation income, LLET, and coal severance. The combination of corporation income taxes and LLET are projected to exceed the official estimates by $59.1 million

– but still fall by 25.3 percent in FY09 compared to receipts in FY08. Coal severance tax revenues are expected to beat the official estimate by $16.0 million in the current year before falling sharply in response to lower coal prices, more renegotiated contracts for delivery, and lackluster global demand for productive capacity.

Aside from the sales tax, tobacco taxes were most affected by HB 144. Anticipated receipts include revenue from the inventory tax that was enacted in HB 144, an extra $3.3 million from the tax increase on OTP, and of course the higher cigarette taxes that will accrue from the doubling of the stamp tax. All told, the tobacco taxes are anticipated to increase by 97.3 percent in the fourth quarter and an additional 22.4 percent in the first half of FY10.

Finally, the forecast for KY Lottery receipts has been lowered $5.0 million in the current year in recognition of the impact of the recession on expected lottery dividends. In addition to weakness in disposable income, the KY Lottery Corporation was beset with some exogenous factors that impacted receipts. For example, the ice storm that decimated the Commonwealth in late January crippled the lottery system in areas of the state that lost electricity for a prolonged period. Furthermore, the online games (such as Pick-3, Pick-4, and Kentucky's POWERBALL) have had a run of winning numbers by the players. That is great luck for the players but detrimental to the bottom line for the Kentucky Lottery Corporation.

ROAD FUND

Road Fund revenues are forecasted to continue their decline in the final quarter of FY09 before showing modest growth in the first two quarters of FY10 as shown in Table 6 on page 24. Growth rates for the fourth quarter of the current fiscal year and the first six months of FY10 are forecast to be -4.8 percent and 0.4 percent, respectively. The FY09 full-year forecast is $36.9 million less than the official revenue forecast as approved by the CFG in November 2008, after adjusting for 2009 General Assembly actions.

Motor fuels tax collections are forecasted to grow by 1.7 percent over the final three months of FY09, due primarily to the preservation of the tax rate on motor fuels that went into effect for wholesale gallons sold after July 1, 2008. Receipts in the first two quarters of FY10 are predicted to continue their tepid growth, increasing by 1.1 percent as the variable portion of the tax rate is projected to remain unchanged and consumption continues to wane due to sluggish demand.

Motor vehicle usage tax collections are expected to continue their recessionary pace over the remainder of the fiscal year with a 15.7 percent decline in the fourth quarter. However, vehicle sales should rebound modestly in the first two quarters of FY10 with anticipated growth in receipts of 1.4 percent. Growth in FY10 is more a reflection of FY09 weakness than a turnaround in economic conditions.

To estimate the growth of all other components of the Road Fund, officials of the Kentucky Transportation Cabinet and staff of the Governor's Office for Economic Analysis together assessed recent growth patterns as well as administrative and statutory factors.

Motor vehicle license taxes are forecasted to increase by 18.3 percent in the final quarter of FY09 (due to timing issues) and by 5.9 percent in the first two quarters of FY10. Motor vehicle operators' licenses are projected to fall by 8.0 percent in the remainder of the fiscal year and continue declining in the first six months of FY10, falling 9.9 percent. Weight distance tax revenue should fall by 7.6 percent for the remainder of the fiscal year and 5.4 percent over the first two quarters of FY10. Investment income is projected to fall by 72.6 percent over the remainder of the fiscal year and by 57.6 percent in the first half of FY10 due to lower fund balances. All other revenues should combine for a decline of 12.2 percent during the last three months of FY09 but increase 0.3 percent in the first two quarters of FY10.

Table 6
Road Fund: Interim Forecast
(millions of dollars)
April 2009

	FY09 Quarters 1, 2 & 3		FY09 Quarter 4		FY09 Full Year		FY10 Quarters 1 & 2	
	Actual	% Chg Year Ago	Interim Estimate	% Chg Year Ago	Interim Estimate	% Chg Year Ago	Interim Estimate	% Chg Year Ago
Motor Fuels	461.6	1.0	154.4	1.7	616.0	1.2	319.3	1.1
Motor Vehicle Usage	251.4	-17.3	85.7	-15.7	337.1	-16.9	176.2	1.4
Motor Vehicle License	60.1	-6.9	34.3	18.3	94.4	0.9	35.0	5.9
Motor Vehicle Operators	11.6	1.2	3.6	-8.0	15.2	-1.1	7.2	-9.9
Weight Distance	58.5	-8.6	18.8	-7.6	77.3	-8.4	38.5	-5.4
Investment	7.4	-45.6	1.6	-72.6	9.0	-53.8	2.1	-57.6
Other	24.7	0.0	9.5	-12.2	34.2	-3.7	15.9	0.3
Total Road Fund	**875.4**	**-6.8**	**307.8**	**-4.8**	**1,183.2**	**-6.3**	**594.2**	**0.4**

ECONOMY

The economic outlook presented here is for the three-quarter period from April to December 2009. This period represents the final quarter of FY09 and the first half of FY10. Three scenarios are available, with different assumptions regarding the most probable path of the national economy. This report portrays the "control" scenario. The weights on Global Insights three scenarios are as follows: Optimistic, or "Green Shoots" (20% probability); Control (60% probability); and Pessimistic (20% probability). The primary distinctions among the scenarios include the duration of the recession, the rebound in aggregate demand, and the ability to sustain and nurture any "green shoots" that sprout up over the next several quarters.

National Economy

The forecast of all national variables is performed by Global Insight, an economic analysis firm used by a majority of states for macroeconomic consulting.

The duration and depth of the current recession already rival the GDP declines witnessed in all previous post-war recessions (See Figures 3 and 5). All of the key economic measures have reported significant declines, including automobile sales and production, capital investment, equipment spending, and new home starts. Perhaps the most striking of these declines has been new home starts. In calendar years 2002-2007, new home starts averaged 1.8 million units per year. By 2008 that figure had been halved to just over 900,000 new homes being produced; in 2009, the forecast now stands at 550,000 annual starts. The market for new home building is indicative of a major theme occurring in the macro economy: inventory adjustments. In retrospect, pundits now say that the nation experienced a protracted period of overbuilding. The inventory of existing homes produced in that period of overbuilding, or the current state of over-supply, now presents the greatest obstacle for the homebuilding industry.

A similar story could be told in most major sectors of manufacturing. Production exceeded demand, inventories accumulated, a global recession hit, aggregate demand plummeted, existing inventories prohibited the engines of industry from building out of the recession. The existing stock of cars must be liquidated before producers will feel confident returning to pre-recessionary production levels.

The most likely scenario for the eventual turnaround is foreshadowed by the name for the Global Insight April optimistic scenario - "green shoots". The analogy plays out as follows: the first sprout is consumption demand, which has been the lone glimmer of hope in recent news. Before consumption can blossom into prosperity and higher production, inventories must be worked down. Once inventories have abated, producers will re-evaluate aggregate demand. If demand proves sustainable, the wheels of industry will react with increased production, which can only be accomplished through the increased utilization of labor, producers equipment/investment spending, or increases in factor productivity. Unfortunately, improvements in the embattled labor sector are at the end of the process, so relief for employment (and personal income from wages and salaries) will lag the beginning of the recovery in production.

The foregoing analysis about the path of recovery notwithstanding, it should be noted that according to Global Insight the economy still has a long way to fall before the recovery can gain traction.

In the quarterly report released by the Office of State Budget Director in January, it was projected that the "bottom" would begin to form and the recovery phase would begin to emerge in FY10:1. The current outlook delays the beginning of any recovery phase to a later period, possibly FY10:2 or FY10:3. In addition, GDP and personal income are expected to experience deeper lows than were projected in January. Year-over-year GDP is now expected to fall 3.5 percent in the first half of FY10. It is now anticipated that there will be six consecutive quarters of declines, including declining GDP in each quarter of this interim outlook. A similar number of declines occurred during the 1973 recession, but the current recession is predicted to surpass the 1973 recession in terms of the normalized depth of the downturn. In terms of GDP declines, this recession is now projected to be the deepest since the Great Depression. These projections are displayed in Figure 5 on page 27.

U.S. personal income projections shown in Tables 7 and 8 on page 28 suggest that the worst of the recession remains ahead. Since the BEA first collected personal income data in 1959, personal income has never been negative on a quarter-over-same-quarter basis. The Global Insight projections call for that streak to end in FY10:1, as U.S. personal income is projected to decline 0.5 percent. Expressed in terms of quarter to quarter growth, U.S. personal income fell in FY09:2 and is projected to show declines in FY09:3 and FY10:1. Personal income has only fallen twice on an adjacent-quarter basis since 1959. Both of these occurrences were in the mid-1990's, and each time the decline was sandwiched between adjacent quarterly increases. In short, these declines in the 1990's were not indicative of prolonged and systemic recessions.

One silver lining that should not be ignored is the potential pent-up demand created by the current economic downturn. Families need houses and cars. Businesses need to make investments and replace equipment. Many consumers have delayed major purchases because of uncertainty in their employment situation, even though they may have current savings and income that would support these transactions. When concerns over sustained employment are alleviated, conditions are ripe for a healthy rebound. Interest rates and housing prices are low; inflation is muted. While credit is currently tight, the Federal Reserve is taking active steps to weaken the stranglehold on access to funds. Businesses, like consumers, may also have the financial resources to hire workers and invest. When the recovery gains traction, the pent-up demand from this prolonged downturn will create the potential for a nice rebound.

State Economy

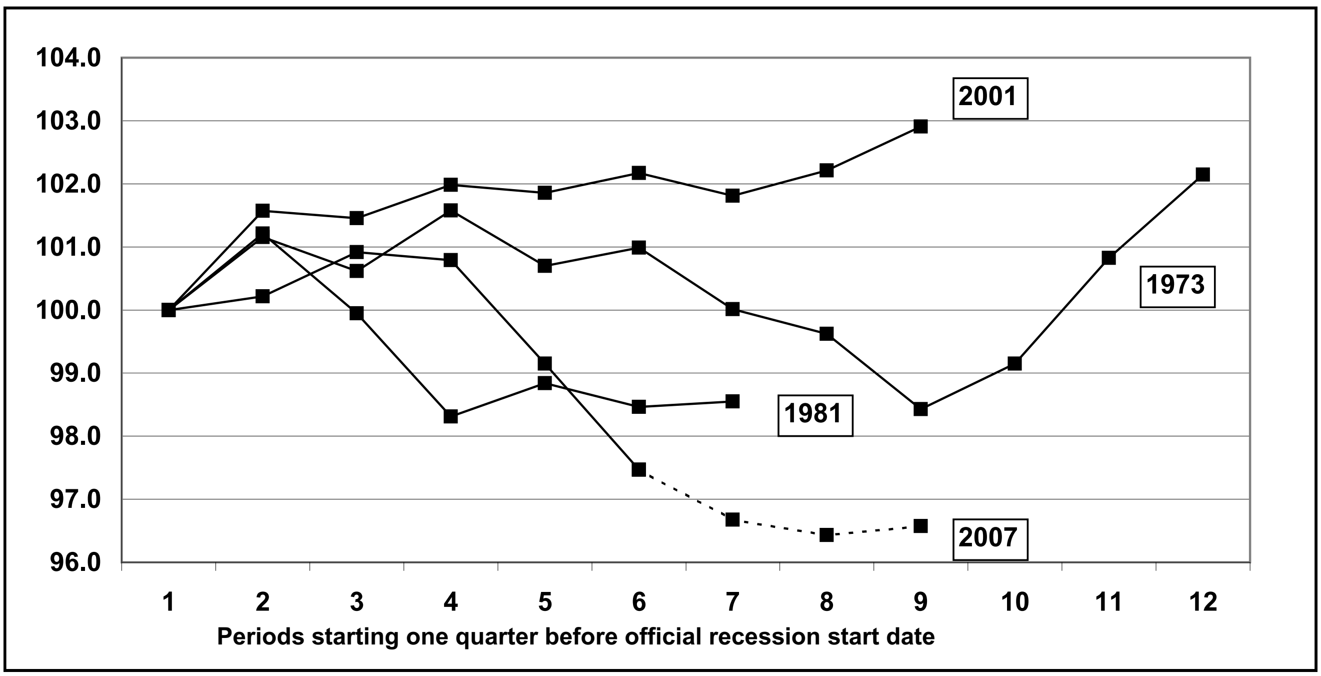
Many of the national patterns identified above are projected to replicate themselves in the Kentucky economy. By way of comparison, Kentucky was relatively insulated from the effects of the housing collapse. On the other hand, Kentucky's emphasis on manufacturing is projected to slightly prolong the recovery in employment. Peak-to-trough declines are projected to be less pronounced in Kentucky, but employment is still expected to contract 2.9 percent over the 3-quarter forecasting horizon. Employment averaged 1,825.9 thousand in the most recently completed quarter (Table 4). By FY10:2, aggregate employment is projected to dip to 1,791.8 thousand – a contraction of an additional 34,100 jobs over the three quarters.

Kentucky personal income is projected to inch forward by 0.6 percent in the final quarter of FY09 followed by 0.6 percent growth in the first half of FY10. Both figures compare favorably to their U.S. counterparts. However, the most recent personal income data suggest an unfavorable mix in the components of personal income. Transfer payments are up sharply – 14.0 percent. Wages and salary income fell marginally during the same period, while proprietors income and dividends fell sharply.

The three-quarter employment outlook by sector reveals widespread weakness, with the goods-producing industries suffering the brunt of the job losses in percentage terms. Service-providing industries are expected to fall over the forecasting horizon, by 2.4 percent in the current quarter and 2.2 percent in the first half of FY10. Anemic growth or declines in Kentucky and national personal income growth is expected to dampen aggregate demand and hence employment in wholesale and retail trade.

In comparison to the January outlook, both the employment and personal income projections have worsened due to an appreciably more negative national outlook from Global Insight. While the worst is not yet behind Kentucky, the green sprouts have emerged on the consumer side of the state economy. Pent-up demand will eventually fertilize these sprouts, but the germination period extends beyond the current three-quarter forecasting horizon.

Figure 5
Real GDP During Select Recessions Includes FY09/FY10 Forecast
Quarterly Data
April 2009



Source: IHS Global Insight Inc., April 2, 2009 data release.

Table 7
Economic Outlook
Fourth Quarter FY08/FY09
April 2009

	FY08 Q4	FY09 Q4	% Chg
United States			
Real GDP	11,727.4	11,234.1	-4.2
Personal Income ($ billions)	12,152.2	12,161.0	0.1
Consumer Price Index (1992-99=100)	2.15	2.12	-1.6
Industrial Production Index (2002=100)	110.7	98.0	-11.5
Nonfarm Employment (millions)	137.5	132.3	-3.8
Manufacturing Employment (millions)	13.5	12.0	-11.6
Unemployment Rate (percent)	5.4	8.9	NA
Kentucky			
Personal Income ($ millions)	137,006.0	137,859.7	0.6
Wage & Salary ($ millions)	73,160.0	71,785.3	-1.9
Nonfarm Employment (thousands)	1,860.5	1,806.0	-2.9
Goods Producing (thousands)	357.4	331.3	-7.3
Service Providing (thousands)	1,180.5	1,152.0	-2.4
Government (thousands)	322.6	322.7	0.0

Real series are in billions of chained 2000 dollars.
Source: IHS Global Insight, Inc. and Kentucky MAK model.

Table 8
Economic Outlook
First Half FY09/FY10
April 2009

	FY09 Q1 & Q2	FY10 Q1 & Q2	% Chg
United States			
Real GDP	11,617.3	11,214.3	-3.5
Personal Income ($ billions)	12,149.0	12,126.3	-0.2
Consumer Price Index (1992-99=100)	2.16	2.12	-1.8
Industrial Production Index (2002=100)	106.3	96.8	-8.9
Nonfarm Employment (millions)	136.4	131.1	-3.9
Manufacturing Employment (millions)	13.2	11.4	-13.9
Unemployment Rate (percent)	6.5	9.7	NA
Kentucky			
Personal Income ($ millions)	136,384.5	137,161.8	0.6
Wage & Salary ($ millions)	73,212.5	71,476.1	-2.4
Nonfarm Employment (thousands)	1,844.7	1,791.8	-2.9
Goods Producing (thousands)	347.7	319.7	-8.1
Service Providing (thousands)	1,176.6	1,150.2	-2.2
Government (thousands)	320.4	322.0	0.5

Real series are in billions of chained 2000 dollars.
Source: IHS Global Insight, Inc. and Kentucky MAK model.

Table 9
History and Outlook for US Economic Series
Annual Growth Rates (%)
April 2009

	FY09			FY10	
	Q2	**Q3**	**Q4**	**Q1**	**Q2**
Real GDP	-0.8	-2.7	-4.2	-4.3	-2.6
Real Consumption	-1.5	-1.4	-2.1	-0.9	0.8
Real Investment	-10.4	-22.5	-25.7	-26.6	-20.9
Real Govt. Expenditures	3.2	1.7	1.1	0.1	-0.1
Real Exports	-1.8	-13.0	-16.1	-18.3	-13.5
Real Imports	-7.5	-16.2	-16.2	-14.2	-8.4
Personal Income ($ billions)	2.2	0.9	0.1	-0.5	0.1
Consumer Price Index (percent change)	1.5	-0.2	-1.6	-3.0	-0.6
Industrial Production Index (percent change)	-6.6	-11.5	-11.5	-10.2	-7.6
Civilian Labor Force (millions)	0.7	0.2	-0.3	-0.5	-0.6
Total Nonfarm Employment (millions)	-1.6	-3.1	-3.8	-4.1	-3.6
Manufacturing Employment (millions)	-5.2	-9.1	-11.6	-13.8	-13.9
Unemployment Rate (percent)	6.9	8.1	8.9	9.5	10.0

Not Seasonally Adjusted. Real series are in billions of chained 2000 dollars.
Data for FY09 Q3 through FY10 Q2 are April 2009 estimates.
Source: IHS Global Insight Inc., April 2, 2009 data release

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APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	Third Quarter FY 2009	Third Quarter FY 2008	% Change	Year-To-Date FY 2009	Year-To-Date FY 2008	% Change
TOTAL GENERAL FUND	**1,888,783,211**	**1,973,167,233**	**-4.3%**	**$6,217,076,623**	**$6,216,498,410**	**0.0%**
Tax Receipts	1,810,321,906	1,899,483,341	-4.7%	$5,986,163,877	$5,983,235,161	0.0%
Sales and Gross Receipts	820,725,582	845,711,924	-3.0%	$2,503,963,505	$2,506,378,145	-0.1%
Beer Consumption	1,396,243	1,404,030	-0.6%	4,766,175	4,847,095	-1.7%
Beer Wholesale	11,308,746	10,779,909	4.9%	38,391,194	36,861,675	4.1%
Cigarette	39,309,008	43,558,952	-9.8%	120,297,469	128,529,418	-6.4%
Distilled Spirits Case Sales	26,725	27,266	-2.0%	81,004	78,290	3.5%
Distilled Spirits Consumption	2,646,309	2,675,827	-1.1%	7,987,403	7,805,802	2.3%
Distilled Spirits Wholesale	7,002,705	6,979,729	0.3%	20,846,469	19,958,913	4.4%
Insurance Premium	45,401,022	48,101,459	-5.6%	86,037,875	89,102,485	-3.4%
Pari-Mutuel	460,106	519,812	-11.5%	2,407,598	2,641,374	-8.9%
Race Track Admission	2,921	3,660	-20.2%	196,579	181,075	8.6%
Sales and Use	691,419,777	711,797,499	-2.9%	2,159,142,170	2,158,003,755	0.1%
Wine Consumption	618,556	626,774	-1.3%	1,793,650	1,785,206	0.5%
Wine Wholesale	3,184,693	3,247,807	-1.9%	9,303,184	9,037,972	2.9%
Telecommunications Tax	15,806,908	13,976,992	13.1%	46,122,026	40,919,336	12.7%
OTP	2,141,829	2,012,207	6.4%	6,590,677	6,625,749	-0.5%
Floor Stock Tax	35	0	---	35	0	---
License and Privilege	192,173,394	152,822,281	25.7%	$422,766,391	$333,988,390	26.6%
Alc. Bev. License Suspension	100,300	217,140	-53.8%	263,800	650,310	-59.4%
Coal Severance	69,706,820	55,818,093	24.9%	217,930,637	166,721,196	30.7%
Corporation License	4,156,512	(1,540,951)	---	8,312,346	2,194,213	278.8%
Corporation Organization	0	50,491	-100.0%	34,065	236,191	-85.6%
Occupational Licenses	36,181	26,685	35.6%	141,404	89,454	58.1%
Oil Production	825,992	2,426,616	-66.0%	7,098,885	6,811,470	4.2%
Race Track License	3,675	4,725	-22.2%	301,875	194,510	55.2%
Bank Franchise Tax	78,264,364	70,519,371	11.0%	73,050,284	70,292,713	3.9%
Driver License Fees	132,756	150,516	-11.8%	438,321	464,486	-5.6%
Minerals Severance	2,171,991	2,731,016	-20.5%	10,393,068	12,659,132	-17.9%
Natural Gas Severance	10,285,719	8,789,153	17.0%	36,213,643	23,039,052	57.2%
Limited Liability Entity	26,489,084	13,629,426	94.4%	68,588,063	50,635,665	35.5%
Income	641,790,584	739,760,215	-13.2%	$2,542,667,569	$2,632,224,634	-3.4%
Corporation	26,294,520	38,453,588	-31.6%	190,926,762	310,281,749	-38.5%
Individual	615,496,064	701,306,627	-12.2%	2,351,740,807	2,321,942,885	1.3%
Property	$139,659,854	$139,662,313	0.0%	$458,882,480	$443,876,736	3.4%
Building & Loan Association	14,612	141,669	-89.7%	223,978	235,501	-4.9%
General - Real	82,215,311	78,934,693	4.2%	233,494,545	228,933,223	2.0%
General - Tangible	49,184,214	48,465,360	1.5%	167,913,551	160,735,503	4.5%
Omitted & Delinquent	5,845,088	8,381,603	-30.3%	16,995,108	18,867,448	-9.9%
Public Service	1,875,196	3,217,079	-41.7%	39,102,470	34,065,974	14.8%
Other	525,434	521,910	0.7%	1,152,828	1,039,087	10.9%
Inheritance	$7,926,153	$12,532,279	-36.8%	$29,944,496	$39,177,097	-23.6%
Miscellaneous	$8,046,340	$8,994,330	-10.5%	$27,939,436	$27,590,159	1.3%
Legal Process	5,735,831	5,806,277	-1.2%	17,888,047	18,343,730	-2.5%
T. V. A. In Lieu Payments	2,279,819	3,165,484	-28.0%	10,012,861	9,223,859	8.6%
Other	30,690	22,569	36.0%	38,527	22,569	70.7%
Nontax Receipts	$75,939,679	$72,028,383	5.4%	$227,747,424	$226,560,832	0.5%
Departmental Fees	9,419,512	8,233,075	14.4%	23,189,468	22,626,119	2.5%
PSC Assessment Fee	17,297	70,288	-75.4%	9,374,179	10,671,543	-12.2%
Fines & Forfeitures	7,563,088	7,017,212	7.8%	21,668,203	21,421,267	1.2%
Interest on Investments	271,381	297,158	-8.7%	2,350,308	1,110,908	111.6%
Lottery	50,000,000	47,500,000	5.3%	141,500,000	139,761,591	1.2%
Sale of NOx Credits	0	9,535,600	-100.0%	0	9,535,600	-100.0%
Miscellaneous	8,668,401	(624,950)	---	29,665,267	21,433,803	38.4%
Redeposit of State Funds	$2,521,627	$1,655,510	52.3%	$3,165,322	$6,702,418	-52.8%

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	Third Quarter FY 2009	Third Quarter FY 2008	% Change	Year-To-Date FY 2009	Year-To-Date FY 2008	% Change
TOTAL ROAD FUND	**$283,366,277**	**$312,126,351**	**-9.2%**	**$875,395,883**	**$939,393,949**	**-6.8%**
Tax Receipts-	$275,049,996	$300,159,206	-8.4%	$851,799,769	$907,979,273	-6.2%
Sales and Gross Receipts	$223,593,157	$244,859,309	-8.7%	$713,067,149	$761,079,180	-6.3%
Motor Fuels Taxes	145,943,992	145,259,293	0.5%	461,622,810	456,944,570	1.0%
Motor Vehicle Usage	77,649,165	99,600,017	-22.0%	251,444,339	304,134,610	-17.3%
License and Privilege	$51,456,839	$55,299,897	-6.9%	$138,732,620	$146,900,093	-5.6%
Motor Vehicles	27,074,832	28,717,421	-5.7%	60,120,472	64,553,657	-6.9%
Motor Vehicle Operators	3,625,525	3,657,741	-0.9%	11,614,204	11,475,607	1.2%
Weight Distance	17,777,961	20,678,657	-14.0%	58,495,309	64,000,667	-8.6%
Truck Decal Fees	49,046	9,889	396.0%	125,820	60,358	108.5%
Other Special Fees	2,929,476	2,236,189	31.0%	8,376,814	6,809,804	23.0%
Nontax Receipts	$7,658,901	$10,618,576	-27.9%	$22,712,002	$29,945,563	-24.2%
Departmental Fees	4,894,647	4,499,147	8.8%	14,188,152	14,804,231	-4.2%
In Lieu of Traffic Fines	239,126	280,459	-14.7%	721,218	848,182	-15.0%
Investment Income	2,439,638	5,682,583	-57.1%	7,391,032	13,582,803	-45.6%
Miscellaneous	85,491	156,386	-45.3%	411,601	710,348	-42.1%
				$0	$0	
Redeposit of State Funds	$657,380	$1,348,569	-51.3%	$884,112	$1,469,113	-39.8%