

Preliminary report of fiscal year close-out

To the Interim Joint Committee
on Appropriations and Revenue

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State Budget Director
July 12, 2007

Dashboard highlights

Good news, with qualifications

- ✓ Estimated General Fund budget surplus = \$138 m
- ✓ GF revenue exceeded budget by \$182 m
- ✓ GF revenue grew by 2.4% (following two years at 9.6%)
- ✓ Nonfarm employment hit record high in March
- ✓ But growth rate has slowed, largely due to manufacturing concentration
- ✓ 2 of 3 rating agencies have improved our credit outlook

Economic developments



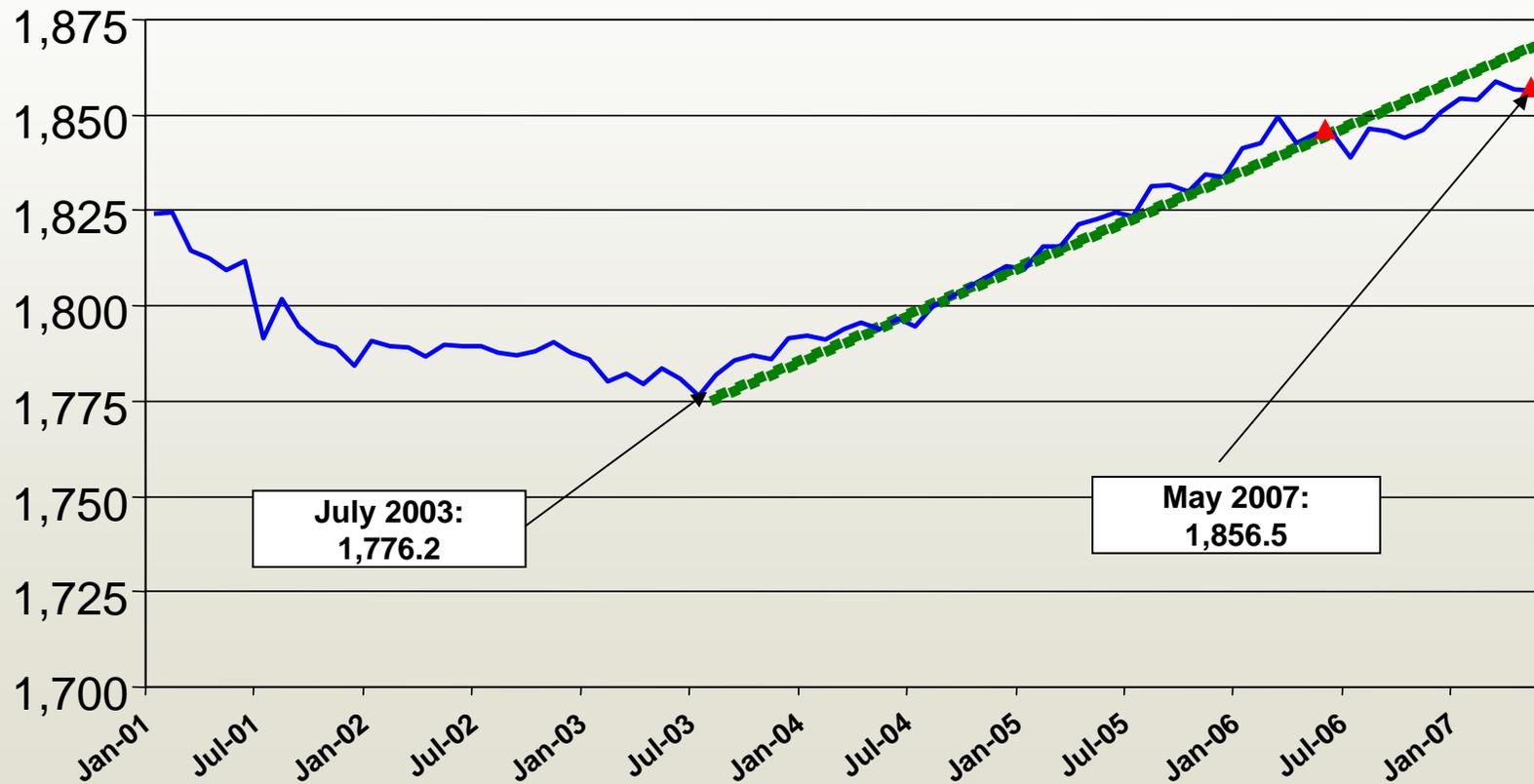
Economic developments

Growing, but slower

- ✓ Nonfarm employment hit a historic high in March 2007
- ✓ Nonfarm employment rose 0.6% in May (1.2% last year)
- ✓ Manufacturing employment declined 1.8% since last year
- ✓ US and Kentucky corporate profits are very high
 - U.S. Corporate profits up 6.5% in January – March quarter
 - Nationally, state corporation income taxes rose 14% in January – March quarter
- ✓ CPI (2.7% in May) is under control despite energy prices
- ✓ May 2007 unemployment rate is 5.5% (5.7% a year ago)

Economics developments

Nonfarm employment growth has slowed



in thousands, seasonally adjusted

General Fund revenue growth



General Fund revenue growth

What about FY07 General Fund revenue?

- ✓ General Fund receipts increased 2.4%
 - \$182.7 million more than 2006 enacted revenues
 - \$36.2 million less than the Jan 2007 CFG estimate
- ✓ Tax cuts (HB 272 from 2005; Small Business Tax Cuts in HB 1 in 2006) were a major cause of reduced revenue growth

General Fund revenue growth

FY07 General Fund revenue over FY06

	Million \$		Difference	
	FY07	FY06	(mil. \$)	(%)
Sales and Use	2,817.7	2,749.8	67.9	2.5
Individual Income	3,041.5	2,918.6	122.9	4.2
Corp. Inc. & License	999.8	1,045.1	-45.3	-4.3
Coal Severance	222.0	224.5	-2.5	-1.1
Tobacco Taxes	177.4	184.2	-6.8	-3.7
Property	492.5	502.5	-10.0	-2.0
Lottery	186.6	190.0	-3.4	-1.8
<u>Other</u>	<u>636.3</u>	<u>561.4</u>	<u>74.9</u>	<u>13.4</u>
TOTAL	8,573.8	8,376.1	197.7	2.4

General Fund revenue growth

FY07 GF Revenue exceeded budget

2006-08 Enacted Estimate	\$ 8,391.1
FY07 General Fund Receipts	<u>8,573.8</u>
Surplus FY07 Revenue	\$ 182.7

In millions \$

General Fund revenue growth

FY07 GF revenue vs Jan 2007 CFG forecast

	<u>Actual</u>	<u>Estimate</u>	<u>Diff.</u>	<u>Diff. (%)</u>
Sales and Use	2,817.7	2,832.6	-14.9	-0.5%
Individual Income	3,041.5	3,120.1	-78.6	-2.5%
Corp. Inc. & License	999.8	984.3	15.5	1.6%
Coal Severance	222.0	225.5	-3.5	-1.6%
Tobacco Taxes	177.4	177.7	-0.3	-0.2%
Property	492.5	487.1	5.4	1.1%
Lottery	186.6	182.6	4.0	2.2%
Other	<u>636.3</u>	<u>600.1</u>	<u>36.2</u>	<u>6.0%</u>
TOTAL	8,573.8	8,610.0	-36.2	-0.4%

General Fund revenue growth

Evolution of the FY07 GF revenue estimate

	CFG Dec-05	CFG Post- session	OSBD Oct-06	CFG Jan-07	Actual
Sales and Use	2.4	2.6	3.0	3.0	2.5
Individual Income	5.4	8.1	10.0	7.0	4.2
Corp. Inc. & License	-8.3	-18.2	-7.4	-6.0	-4.3
Coal Severance	1.3	1.3	-1.6	0.4	-1.1
Tobacco Taxes	-5.7	-2.5	-8.1	-3.5	-3.7
Property	-4.1	-4.1	-4.2	-3.1	-2.0
Lottery	-2.6	-12.9	-6.5	-3.9	-1.8
Other	<u>1.1</u>	<u>8.3</u>	<u>6.8</u>	<u>6.9</u>	<u>13.3</u>
TOTAL	1.5	1.7	3.4	2.8	2.4

(projected growth rates, percent)

General Fund revenue growth

What conditions strengthened FY07 GF rev?

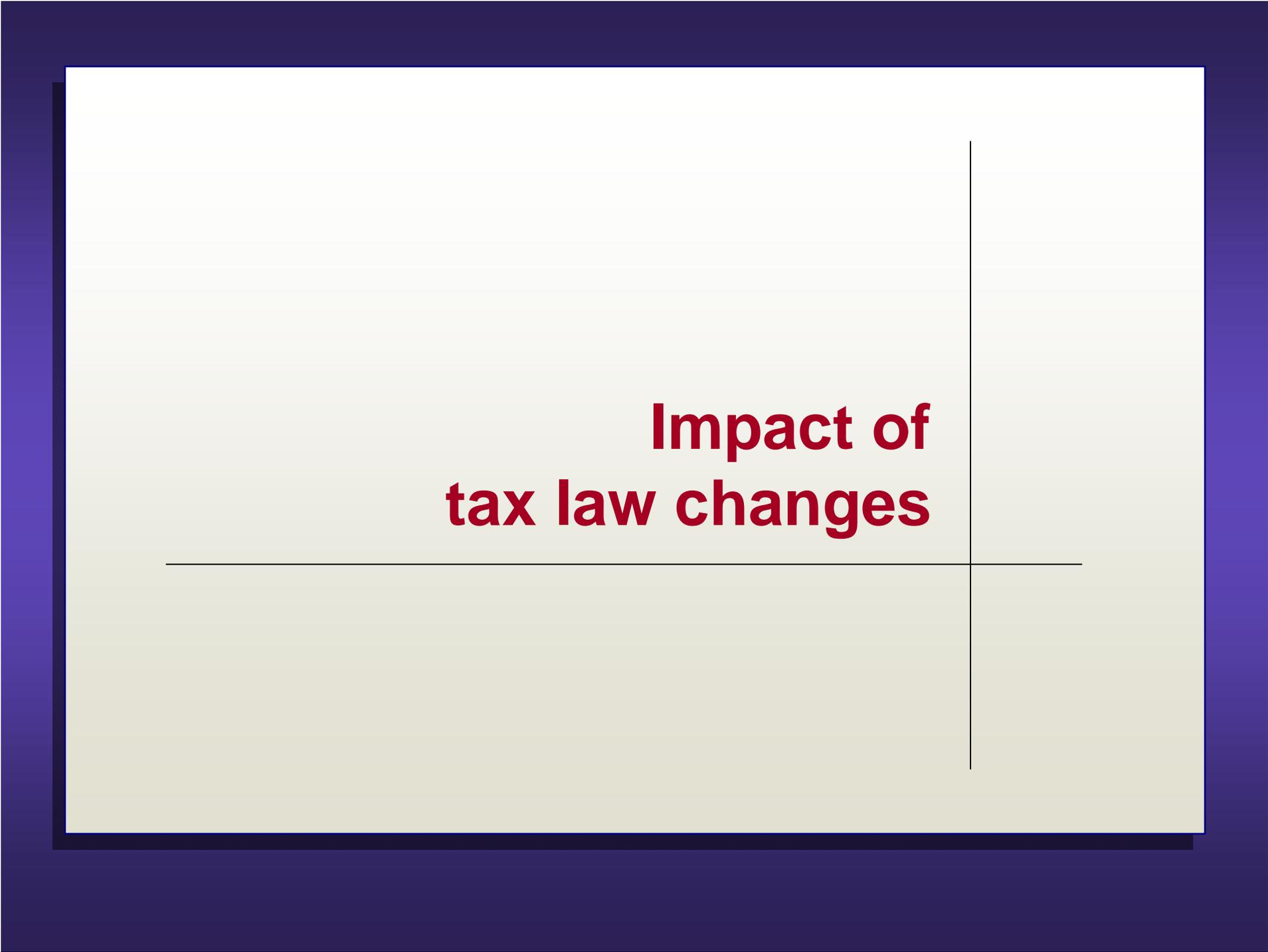
- ✓ Telecommunications tax fully implemented
- ✓ Dept of Revenue strengthened collection efforts
- ✓ Business confidence, investment and profits were high in Kentucky throughout FY07
- ✓ Legislation affecting abandoned property led to one-time gain
- ✓ Improved performance on state investments due to higher interest rates and higher balances

General Fund revenue growth

What conditions reduced FY07 GF revenue?

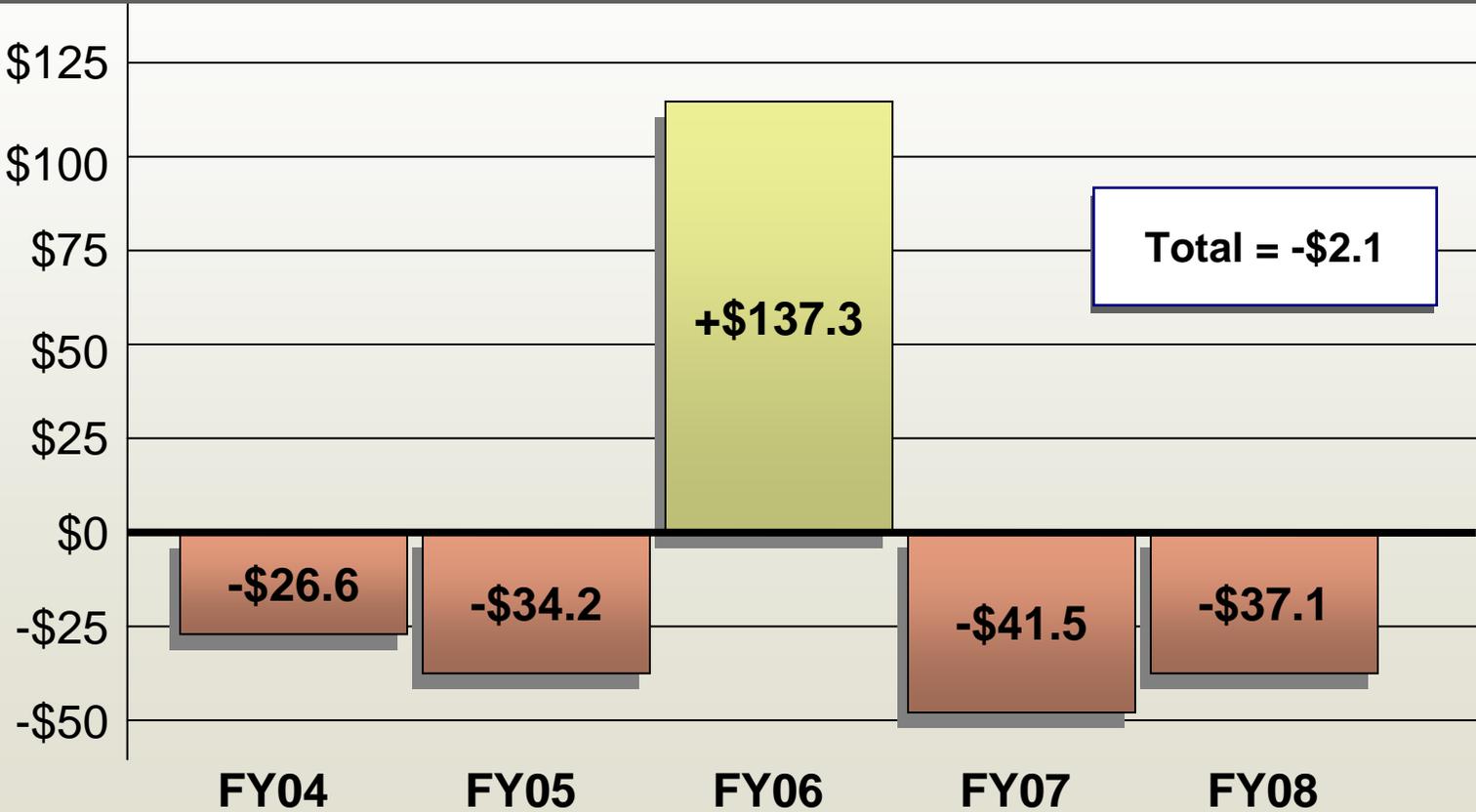
- ✓ Small business tax cuts in HB 1 (2006 special session)
- ✓ Tax modernization legislation phased in several cuts that were fully realized in FY07
 - ✓ Abolition of corporation license tax
 - ✓ Abolition of intangible property tax
 - ✓ Removal of telecom from PSC property tax
 - ✓ Additional corporation income tax rate cut
- ✓ Housing slump affected sales tax
- ✓ Manufacturing employment woes affected withholding
- ✓ Cigarette floor stocks tax boosted FY06, but not FY07

Impact of tax law changes



Impact of tax law changes

FY07 included tax modernization cuts



LRC score of HB 272, March 2005, in millions, including revenue dedicated to restricted funds

Impact of tax law changes

Impact of tax law changes

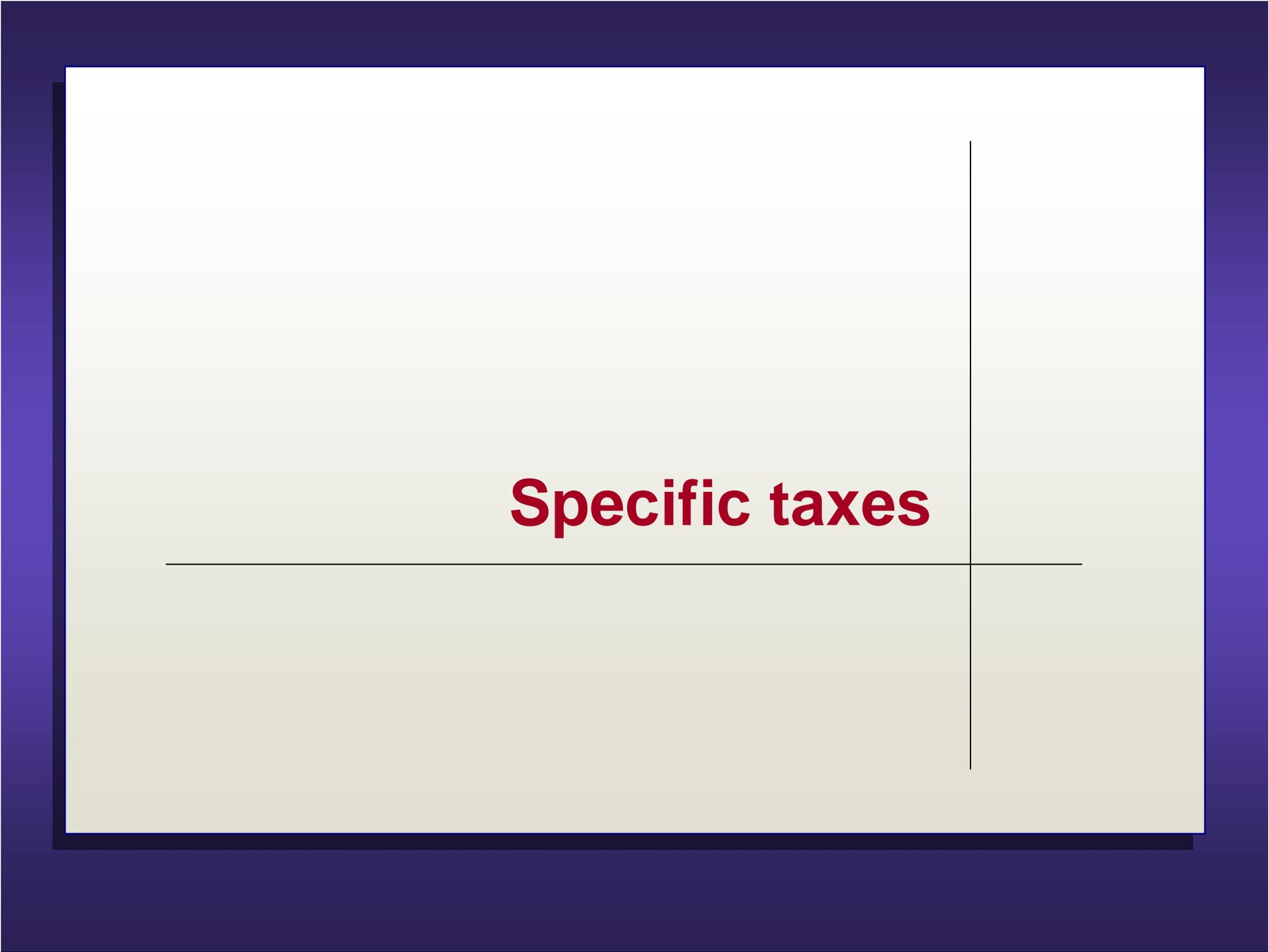
<u>Year</u>	<u>Legislation</u>	<u>FY06</u>	<u>FY07</u>
2005	Tax Modernization	138.1	-42.7
2005	2005 Budget Bill	48.1	11.1
2005	County fair sales tax exempt., pari-mutuel tax exemption	-0.5	0.0
2006	2006 Budget Bill (GOEA Est.)	-0.5	45.2
2006	HB 1 2006 Special Session, AMC relief	21.1	-13.3
2007	Federal conformity (HB 258)		0.3
	TOTAL	206.3	0.6

Impact of tax law changes

FY07 'economic growth' exceeded rev growth

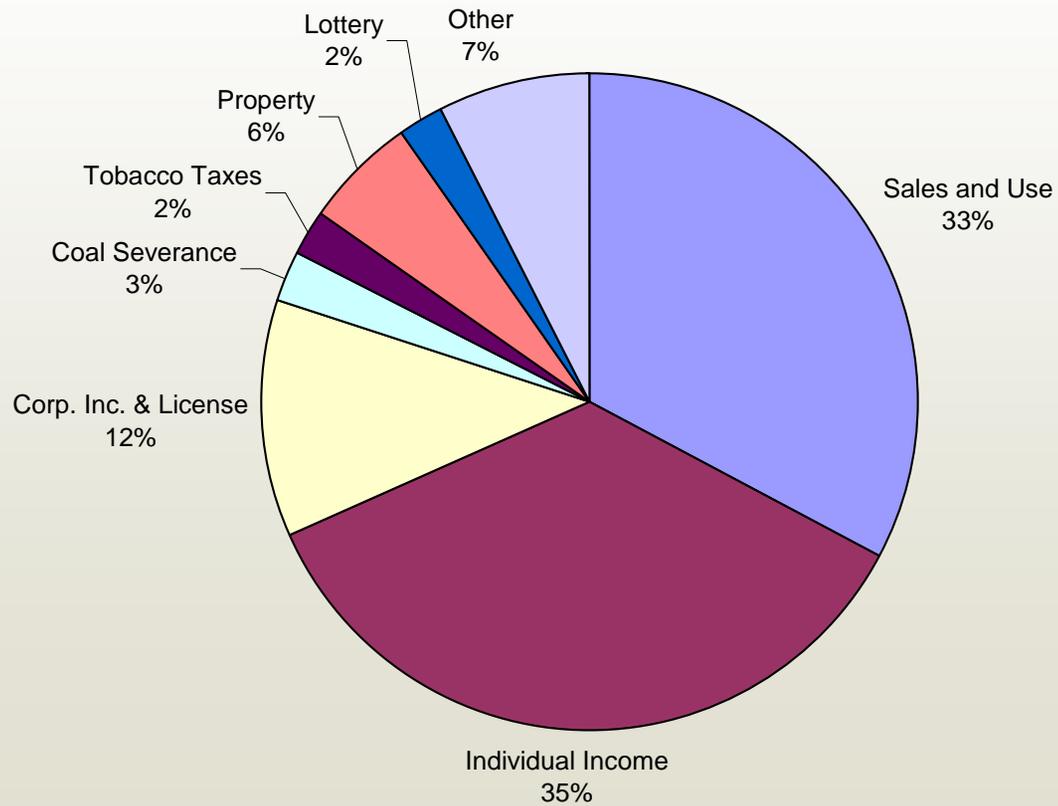
	FY05	FY06	FY07
General Fund Revenues	7,645.0	8,376.1	8,573.8
% Growth	9.6%	9.6%	2.4%
Adjustments to Forecast			
Tax Modernization	13.2	138.1	-42.7
2005 Budget Bill	18.4	48.1	11.1
HB 350 & HB 497 (2005)	-0.1	-0.5	0.0
2006 Budget Bill (GOEA Est.)	0.0	21.1	45.2
HB 1 2006 Special Session			-13.3
HB 258 2007 Session (conformity)			0.3
"ECONOMIC" REVENUE	7,613.5	8,169.3	8,573.2
% Growth	9.1%	7.3%	4.9%

Specific taxes



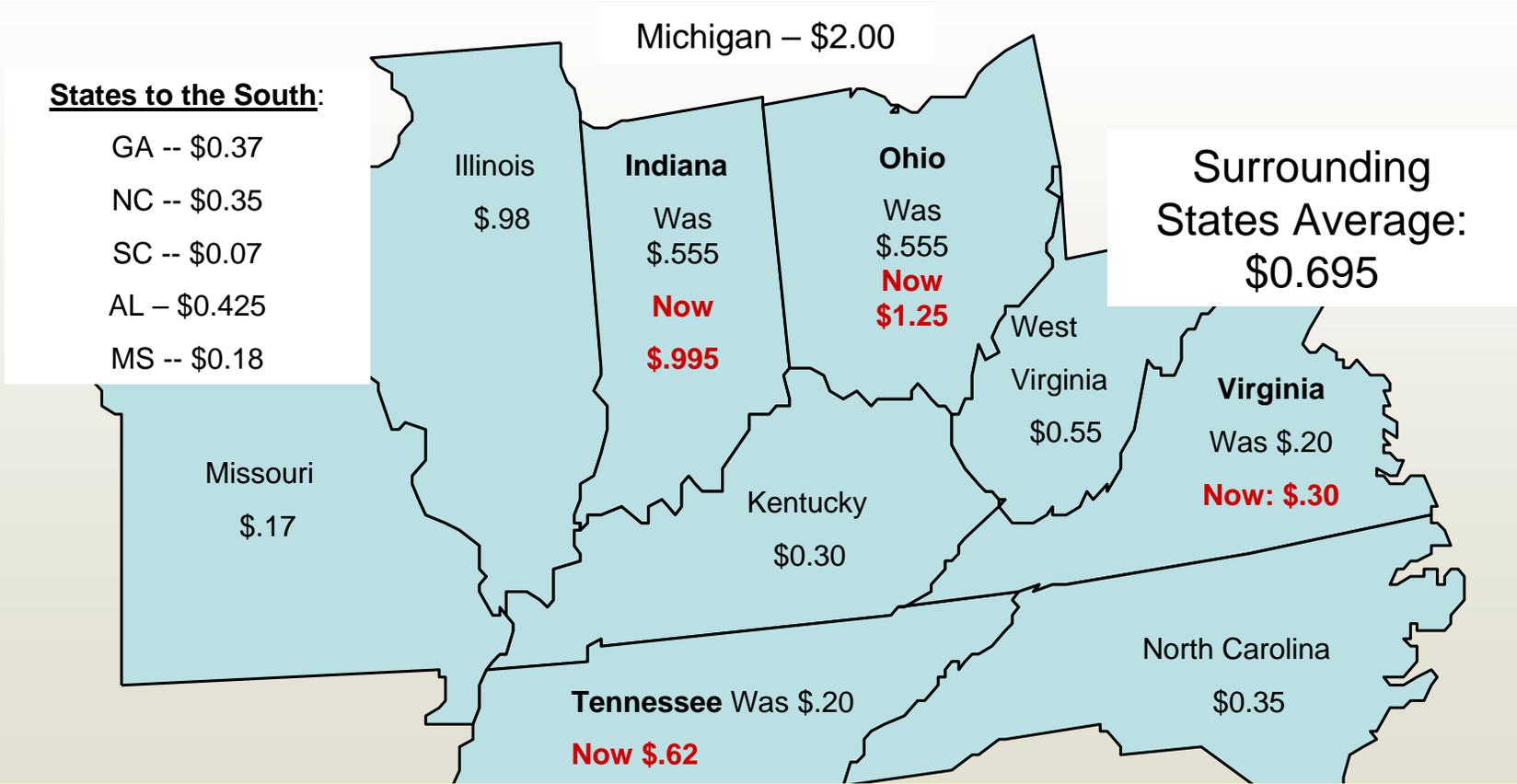
Specific taxes

Where did FY07 GF revenue come from?



Specific taxes

4 of 7 contiguous states have responded



National Average -- Was \$0.953 per pack Now \$1.07

Specific taxes

FY07 MSA revenues exceed budget

Enacted Estimate	\$ 88.8
FY07 General Fund Receipts	<u>107.9</u>
FY07 Revenue Surplus	19.1

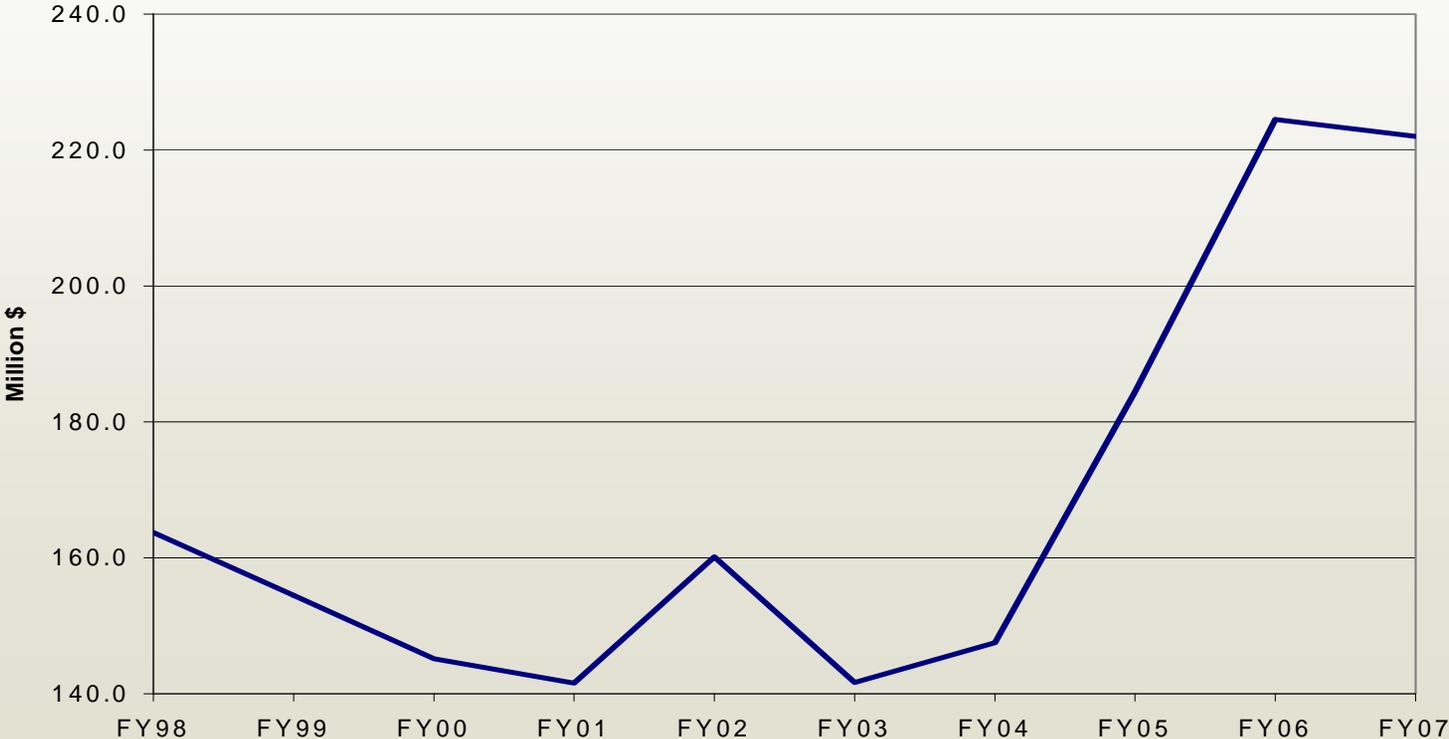
✓ Additional revenues distributed per statutes

✓ Reasons for increased revenue:

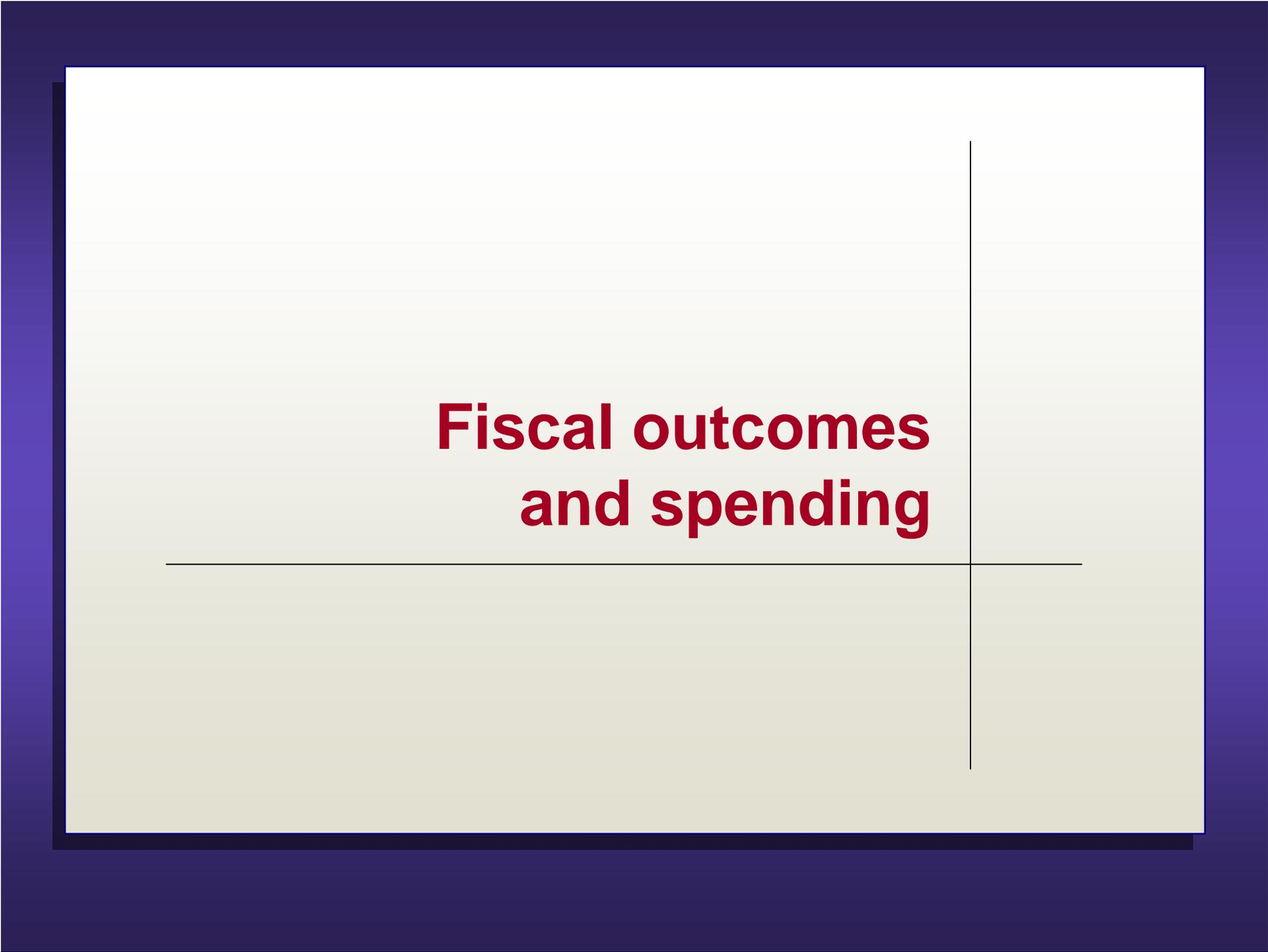
- Payments Not Withheld (+\$7 million)
- Cigarette Consumption Estimates (+\$10 million)
- Lawsuit Settlements (+\$1 million)
- Recalculations and Additional Payments (+\$1 million)

Specific taxes

Coal receipts leveled off after meteoric rise



Fiscal outcomes and spending



Fiscal outcomes and spending

How do we expect to end the year?

Preliminary Estimate—Not Final

✓ Revenues higher than estimated	\$ 182.7
✓ Fund transfers lower than estimated	(\$ 18.7)
✓ Higher appropriations from dedicated revenues	(\$ 10.4)
✓ 2006 Spec/2007 Regular appropriations	(\$ 1.5)
✓ Unbudgeted expenses	(\$ 46.1)
✓ Adjustment to Fund Balance	(\$ 4.0)
✓ Expenditures less than budgeted – early est.	<u>\$ 36.0</u>
General Fund surplus estimate	\$ 138.0

in millions

Fiscal outcomes and spending

Anticipated lapses

Enacted Budgeted required \$57 million in lapses

Other budget lapses \$36.0

✓ Debt Service \$21.4

✓ SEEK \$10.6

✓ K-12 Health and Life Ins. \$ 4.0

in millions

Fiscal outcomes and spending

Appropriations from GF surplus account

- ✓ Guardian Ad Litem payments-\$7.6
- ✓ Military Affairs-\$8.1
- ✓ Forest Fire Suppression-\$2.7
- ✓ Survivor Benefits-\$1.3
- ✓ Judgments-\$3.6
- ✓ State Inmates in Local Jails -\$10.4
- ✓ Prior Year Claims-\$7.2
- ✓ Ky State Police Extraordinary Duty-\$3.3

Fiscal outcomes and spending

Wolf Creek Dam

- ✓ April 13, 2007: Governor Fletcher signed executive order
- ✓ Authorized up to \$25 million from GF surplus for disaster and emergency responses
- ✓ Targeted to drinking water and infrastructure alterations required by the lowering of Lake Cumberland water level
- ✓ 5 drinking water projects approved: Albany, Somerset, Monticello, Jamestown, Bronston (total: \$11.9 m; none paid yet)
- ✓ These projects are capital in nature and bond financing would be appropriate

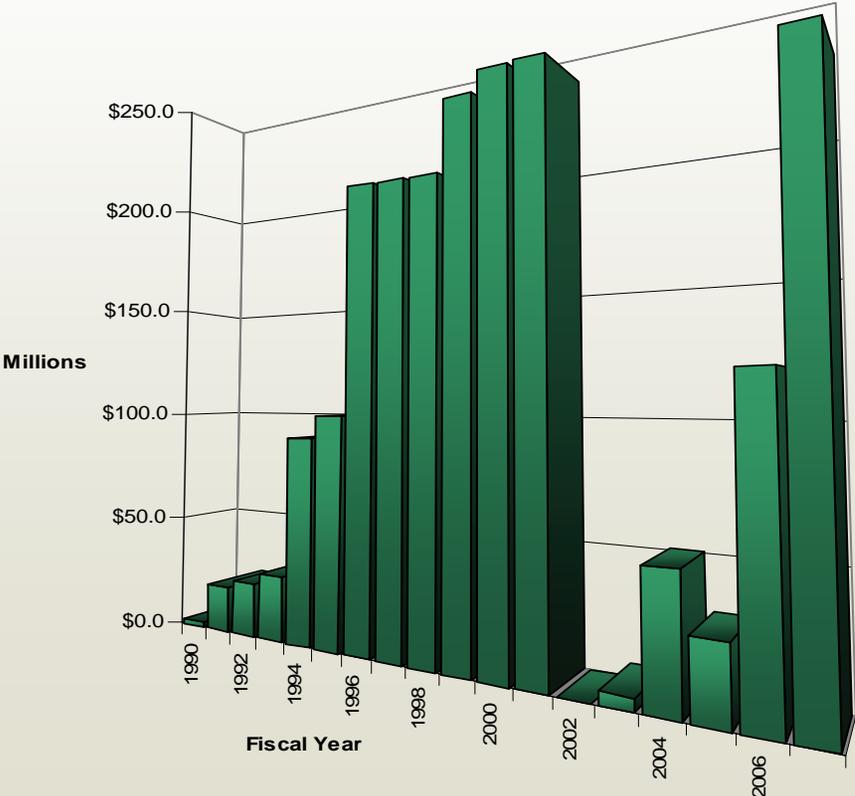
Fiscal outcomes and spending

What's the balance of the rainy day fund?

- ✓ Current balance is \$231.5 million
- ✓ No deposits in FY 2007 from the sale of escrows from MSA Non-participating manufacturers

Fiscal outcomes and spending

Balance of rainy day fund?



*Current balance after FY 06 Surplus Plan deposit

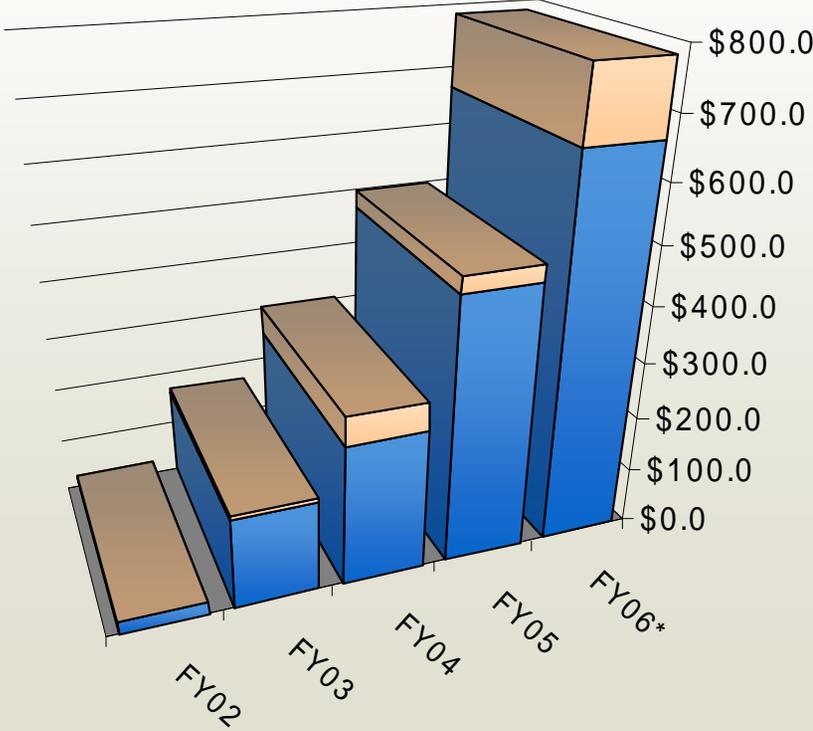
Fiscal outcomes and spending

Estimated General Fund cash balance

Budget Reserve Trust Fund	\$231.5
Budgeted carryforward	\$434.2
Estimated Surplus	<u>\$138.0</u>
Total Estimated Carryforward	\$803.7

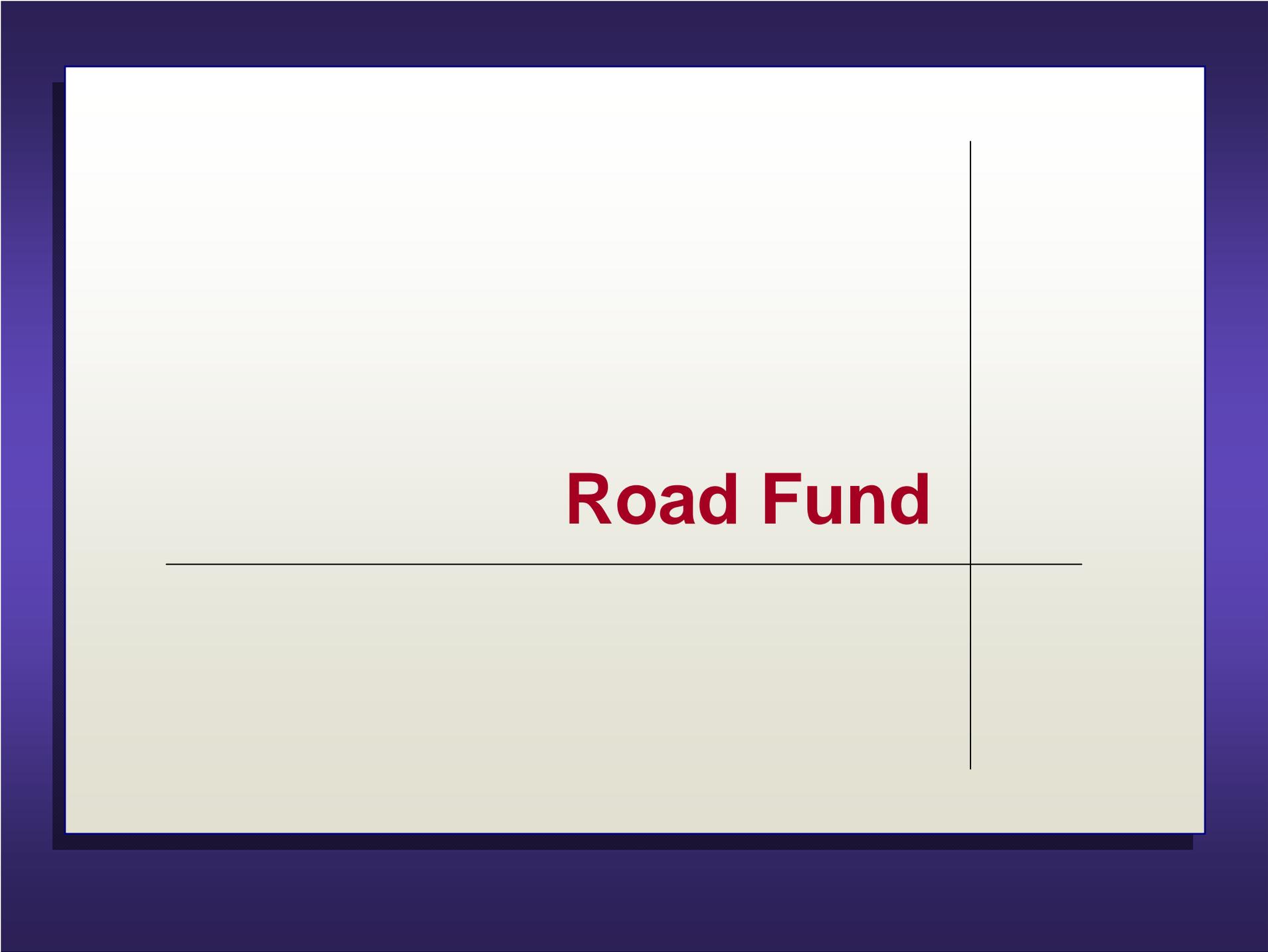
Fiscal outcomes and spending

Unprecedented cash balance



in millions

Road Fund



Road Fund

FY07 Road Fund revenue highlights

- ✓ Strong revenue growth of 5.2%
- ✓ \$12.7million less than the enacted budget (which will be covered with appropriation lapses)
- ✓ \$10.8 million more than the January 2007 CFG estimate
- ✓ Promising 4% growth in motor vehicle usage taxes
- ✓ Motor fuels taxes up by 7.3%
- ✓ Remaining tolls on Ky parkways removed November 2006

Road Fund

FY07 Road Fund revenue over FY06

	FY07	FY06	Difference	
			(mil. \$)	(%)
Motor Fuels	563.4	528.3	35.1	6.6
Motor Vehicle Usage	411.3	395.6	15.7	4.0
Motor Vehicle License	101.7	93.9	7.8	8.3
Motor Vehicle Operators	15.8	14.6	1.2	8.6
Weight Distance	85.4	85.3	0.1	0.1
Investment Income	16.1	6.4	9.7	152.6
<u>Other</u>	<u>32.2</u>	<u>41.3</u>	<u>-9.1</u>	<u>-22.0</u>
TOTAL	1,225.9	1,165.4	60.5	5.2

Road Fund

RF revenues were below budgeted estimates

Enacted Estimate	\$1,238.7
FY07 Road Fund Receipts	<u>1,226.0</u>
FY07 Revenue Shortfall	(12.7)

Road Fund

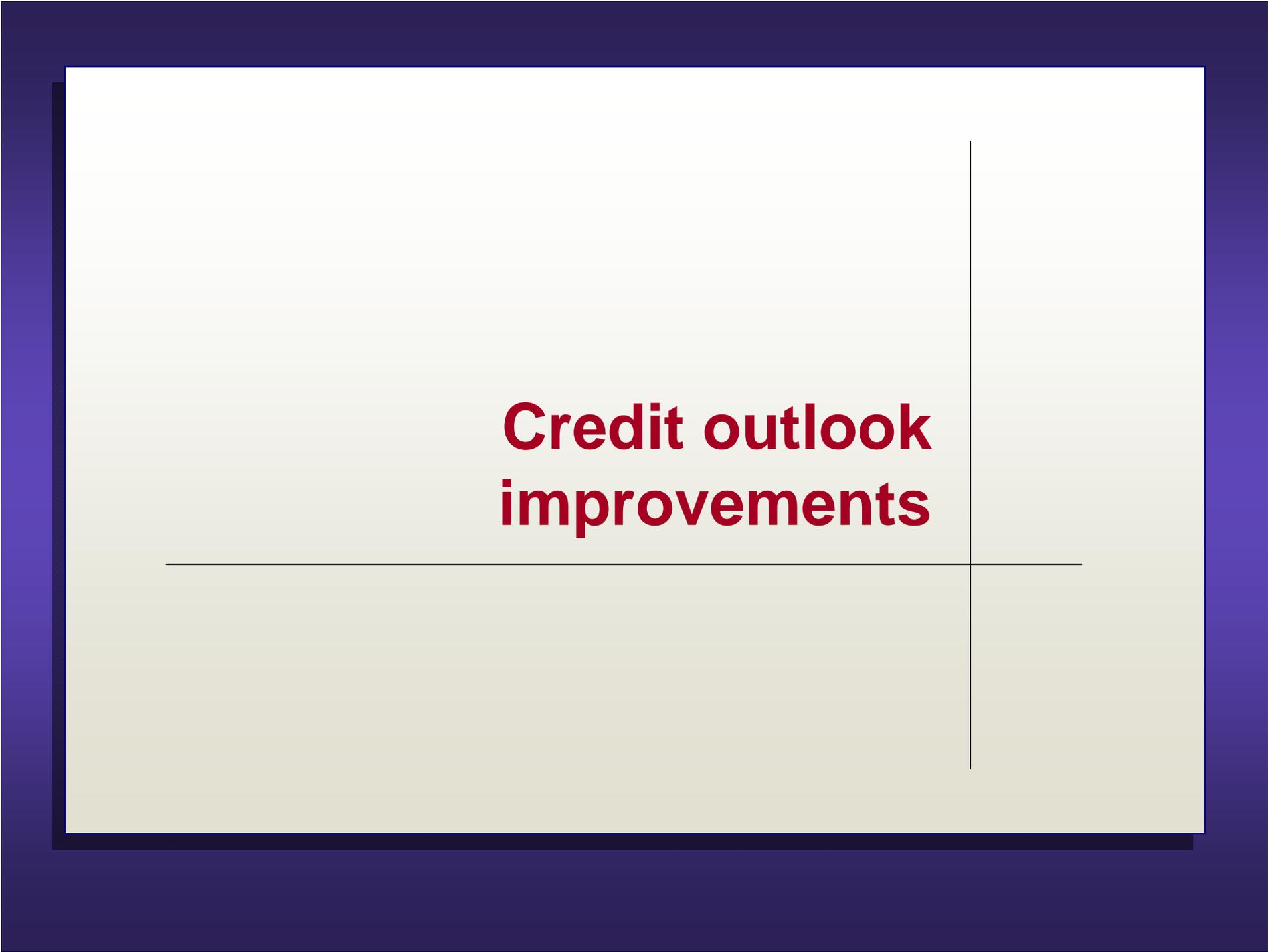
Expected Road Fund surplus

PRELIMINARY ESTIMATE

Revenues lower than estimated	(\$ 12.7)
Lower appropriations from dedicated revenues	\$ 1.2
Expenditures less than budgeted – early est.	<u>\$ 29.5</u>
ROAD FUND SURPLUS ESTIMATE	\$ 18.0

in millions

Credit outlook improvements



Credit outlook improvements

Our credit rating outlook has improved

	<u>Issuer rating</u>	<u>Outlook</u>
Standard & Poor's	AA-	Positive
Moody's Investors Service	Aa2	Stable
Fitch*	n/a	Stable

*Fitch does not publish an issuer rating for Kentucky but rates our General Fund supported lease appropriation as AA-. Fitch first assigned outlooks to its ratings in February 2007.

Credit outlook improvements

Our credit rating outlook has improved

- Improved liquidity through increasing reserved and unreserved fund balances: Rainy Day Fund, higher cash balances, and higher investment earnings
- On-time budget enacted in 2006
- Borrowing on an as-needed basis for authorized capital projects to manage debt ratios within targeted levels

Credit outlook improvements

Our credit rating outlook has improved

Standard & Poor's raised the Commonwealth's Outlook to "**Positive**" from "Stable" in January 2007, citing:

- ✓ Improving economy, though lags the U.S. in certain key areas;
- ✓ An improving GAAP financial position, due in part to budget balancing initiatives as well as positive revenue growth; and
- ✓ Manageable, but rising, debt burden balanced by infrastructure needs.

Credit outlook improvements

Our credit rating outlook has improved

Moody's raised the Commonwealth's outlook to "**Stable**" from "Negative" in February 2007, citing:

- ✓ Ongoing trend of strong financial control;
- ✓ Improved finances, including strengthened revenues that have outperformed estimates; and
- ✓ Economic strengthening, reflecting increasing non-farm payroll employment growth following prior year declines.

FY08 outlook

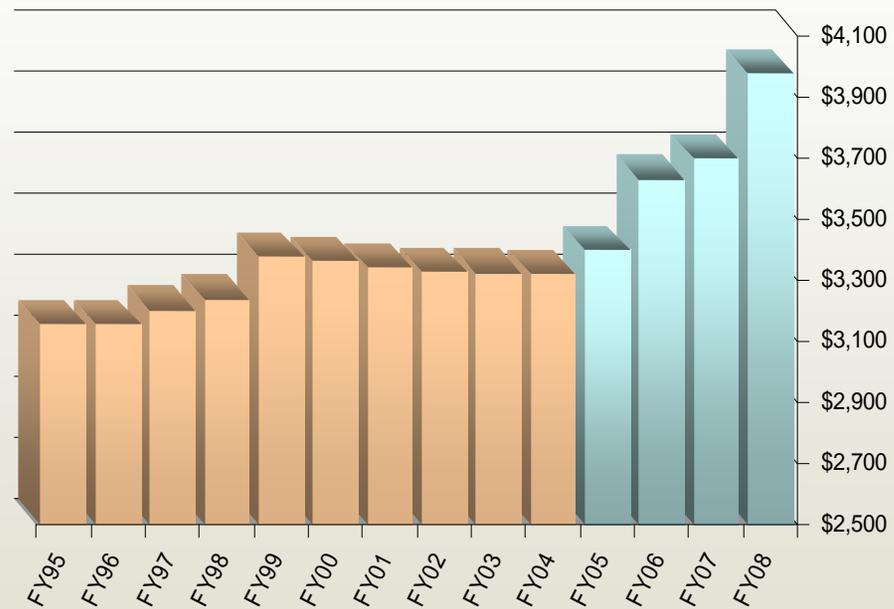
FY08: good news, with qualifications

- ✓ Jan 2007 CFG: \$169 m GF revenue surplus in FY08
- ✓ HB1 from 2006 special session: \$32 m in small business tax cuts
- ✓ Adjustments to FY08 budget are approximately \$52 m because of
 - Dedicated revenue (\$10 m)
 - 2007 regular session (\$26 m in appropriations and \$16 m in tax cuts)
- ✓ Net projected increase in balance = \$85 m
- ✓ Approximately \$138 m in unbudgeted surplus forwarded

FY08 outlook

Dramatic rise in total education spending

Aggregate General Fund Education Spending, Inflation Adjusted, in Millions	
FY05	\$ 3,153
FY06	\$ 3,156
FY07	\$ 3,201
FY08	\$ 3,236
FY99	\$ 3,373
FY00	\$ 3,359
FY01	\$ 3,340
FY02	\$ 3,325
FY03	\$ 3,321
FY04	\$ 3,319
FY05	\$ 3,398
FY06	\$ 3,628
FY07 Budget	\$ 3,698
FY08 Budget	\$ 3,976



The Governor's recommended budget for FY07 included \$26 million more than was enacted. The enacted budget for FY08 included \$116 more than the Governor's recommended budget for that year.

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