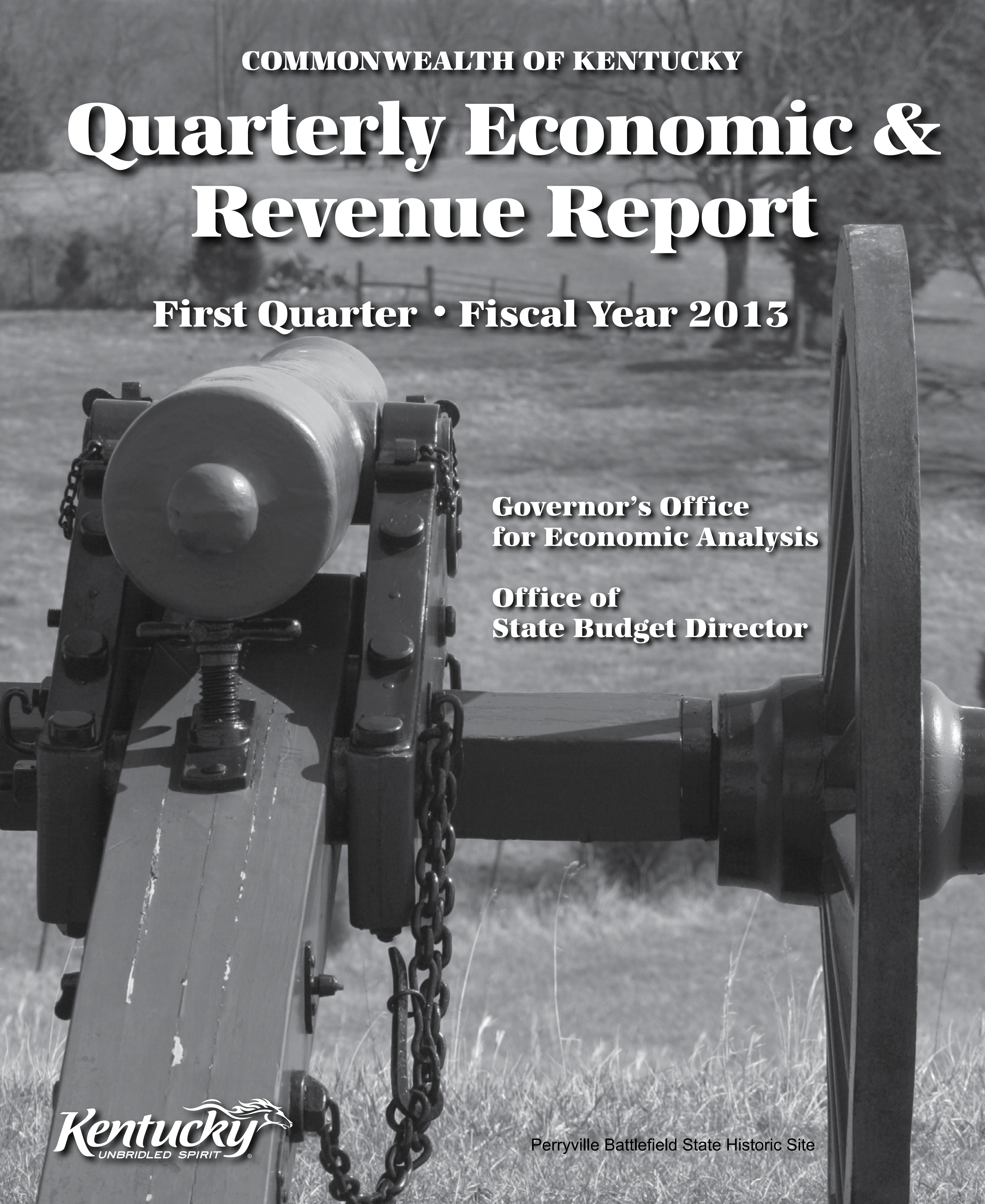
COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report

First Quarter • Fiscal Year 2013

Governor's Office
for Economic Analysis

Office of
State Budget Director



Perryville Battlefield State Historic Site

Kentucky
UNBRIDLED SPIRIT

October 8, 1862 - 150th Anniversary of the Battle of Perryville

Perryville was the largest battle fought in the State of Kentucky.

Perryville is considered the “High Water Mark” for the confederacy in the West.

At its time, Perryville was the second bloodiest battle of the Western Theater.

A severe drought in the region drew the two armies to the Perryville region.

Despite greatly outnumbering their Confederate opponent, only one of the three Union corps at Perryville was significantly engaged in the battle.

Famous confederate diarist Sam Watkins declared Perryville the “hardest fighting” that he experienced.

Small quantities of Henry repeating rifles were used at Perryville, probably the first time one was used in combat.

Two officers who fought at Perryville were fathers of significant World War Two generals.

The Perryville Battlefield has one of the first monuments, erected by the U.S. Government dedicated to the fallen Confederate soldiers.

The Perryville State Battlefield Site was established on October 8, 1954, ninety years after the battle.

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Governor's Office for Policy and Management
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October 31, 2012

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

Dear Governor Beshear:

The attached Quarterly Economic and Revenue Report summarizes the revenue and economic statistics for the first quarter of Fiscal Year 2013 (FY13). It also includes an interim economic and revenue forecast for the next three quarters of FY13.

General Fund receipts for the first quarter of FY13 totaled $2,201.0 million, an increase of 2.1 percent compared to the same period in FY12. Road Fund revenues totaled $358.7 million, an increase of 1.2 percent from the first quarter of FY12.

The interim General Fund forecast for the final three quarters of FY13 calls for an increase of 2.5 percent compared to the same period one year ago, resulting in an unofficial interim outlook for the entire FY13 of $9,306.3 million, a sum nearly identical to the enacted estimate of $9,307.8 million. While overall revenues are on track to meet budgeted levels, coal severance receipts, a revenue source that is shared with local governments, fell short of the official estimate in FY12 and will continue to decline in FY13. The projection presented here is $254.7 million in FY13 compared to an official estimate of $337.0 million.

With regard to the Road Fund, the interim forecast for the final three quarters of FY13 is $1,104.4 million and calls for an increase of 1.4 percent over FY12. The interim estimate for the entire FY13 is $1,463.1 million, $36.5 million less than the enacted estimate of $1,499.6 million. The largest deviation from the official forecast, comprising $25.3 million of the $36.5 million projected difference, is predicted in motor fuels which is also a tax shared between state and local revenue funds.

Overall, the economy continues to follow a slow but measured path of recovery. We will continue to monitor the economic and fiscal conditions of the Commonwealth and will keep you apprised of developments.

Sincerely,

Mary E. Lassiter

Mary E. Lassiter
State Budget Director

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Executive Summary

In accordance with KRS 48.400(2), the Office of State Budget Director (OSBD) has prepared a Quarterly Economic and Revenue Report for the first quarter of FY13. In accordance with the statutes, this report includes a current synopsis of the economic and fiscal conditions of the Commonwealth, as well as an outlook for the next three fiscal quarters.

At the end of FY12, it was clear that no segment of the state or national economy was emerging as a bulwark against the threats facing the continued, modest recovery. Overall, the economy continues to follow a slow and moderate path of recovery. It seems that every quarter we are hoping that a different component of GDP will be the source for new GDP growth. Instead, every quarter that hope is dashed. In keeping with that theme, the current view is for the Federal Reserve to continue a vigilant campaign of low interest rate policy, which should be helpful to the investment portion of GDP as well as the sectors related to housing.

The Federal Reserve is pursuing a policy of low interest rates, which should help spur investment growth. Unfortunately, this policy has been at best mildly successful. In general, firms are holding off on investments and waiting for a definitive improvement in demand and a better economic climate before making any long-term commitments of capital.

The previous quarterly report also noted weak performance in the labor market, and unfortunately that performance has continued in the intervening months. During the last three months, payroll employment growth has averaged less than 125,000 per month. Employment growth this weak can barely keep up with population growth. The unemployment rate has improved slightly but that was due to a decrease in the workforce, not because of rising employment. The Global Insight forecast assumes that monthly employment increases continue in the range of 135,000 per month for the next three quarters.

Kentucky's non-farm employment is expected to grow during the final three quarters of FY13 by 1.6 percent. A significant portion of the job growth is anticipated to come from the goods producing sector which includes mining, construction and manufacturing. The combined growth in these sectors is estimated at 5.1 percent representing over 15,000 new jobs.

First quarter General Fund FY13 receipts grew by 2.1 percent over the same quarter in FY12. Estimated receipts for the next three quarters are expected to be $7,105.3 million for an increase of 2.5 percent. The largest contributors to growth are expected to come from the corporate income and LLET taxes, which are estimated to grow by 16.0 and 2.5

percent respectively. Modest growth is expected in the two largest receipts categories, the sales and use tax and the individual income tax. Growth in the sales and use tax is expected to be 2.9 percent for the remainder of FY13 and 2.1 percent in the individual income tax. While these growth rates are modest by historical standards, they are squarely within the expectations set forth in the official enacted revenue estimates. Finally, the coal severance tax is expected to continue its recent and pronounced negative trend. Coal receipts fell 19.0 percent in the final quarter of FY12 followed by a 19.1 percent dip in the first quarter of FY13. The interim projections predict a similar pattern of decine for the near term. The projection presented here is $254.7 million in FY13 compared to an official estimate of $337.0 million.

The interim forecast for the Road Fund for the final three quarters of FY13 is $1,104.4 million, an increase of 1.4 percent over FY12. The interim estimate for the full year FY13 is $1,463.1 million, $36.5 million less than the official revenue estimate of $1,499.6 million. Motor fuels, the largest Road Fund account, is expected to account for the majority of the increase in revenue, yet is the largest contributor to the projected shortfall in estimated revenues representing $25.3 million of the $36.5 million difference.

Motor fuels tax receipts increased 2.7 percent during the first quarter of FY13. Receipts were $207.1 million and compare to $201.7 million collected during the first quarter of last year. The first quarter of FY13 was affected by the automatic adjustment to the fuels tax rate prescribed in KRS 138.210 (10) and KRS 138.220 (1), which created a 2.1 cent-per-gallon increase in the variable rate on motor fuels. For gasoline, the total tax rate increased by 7.6 percent. With motor fuels collections rising only 2.7 percent, the slower growth implies a modest decrease in gallons sold. Consumption is expected to pick up slightly during the remainder of FY13 to produce 5.0 percent growth in motor fuels tax receipts.

Revenue Receipts

GENERAL FUND
First Quarter, FY13

General Fund receipts in the first quarter of FY13 totaled $2,201.0 million compared to $2,156.5 million in the first quarter of FY12, for an increase of 2.1 percent or $44.5 million. Collections in the major revenue categories are shown in summary form in Table 1. Detailed information for all accounts is available in the Appendix. Receipts in the first quarter of FY13 reflect very modest growth in General Fund and Road Fund revenues. Property taxes, the corporation income tax, and "Other" taxes all exhibited strong growth in the first quarter of FY13.

Individual income tax receipts increased 1.8 percent in the first quarter of FY13. Receipts of $901.9 million were $15.9 million more than was collected in the first quarter of the previous fiscal year. The muted growth in the individual income tax mirrors the slow employment growth.

The sales and use tax collections were down 1.0 percent in the first quarter of FY13. Receipts of $760.7 million compare to the $768.4 million collected in the first quarter of FY12. The decline in sales and use tax collections is the first quarterly decline since the recovery period began, thus breaking a string of nine consecutive quarterly increases. The culprit again appears to be the underlying economy, where consumption patterns have softened somewhat from the stronger signals just one year ago.

Property taxes grew 72.7 percent in the first quarter of FY13 due to timing of collections in the tangible and public service company accounts. Collections of $65.7 million compare to $38.1 million received in the first quarter of the prior fiscal year, but the nominal increase in receipts represents an acceleration of net collections rather than an unexpected increase in valuations or receipts.

Corporation income tax posted an increase of 22.6 percent, or $20.8 million, during the first quarter of FY13. Receipts totaled $112.9 million compared to the $92.1 million received a year earlier. September is a declaration payment month for calendar year filers. Both declarations and net returns posted significant growth during the quarter presumably due to continued expectations of sustained corporate profitability.

Table 1
Summary General Fund Receipts
First Quarter, FY13, $ millions

	FY13	FY12	Diff ($)	Diff (%)
Individual Income	901.9	886.0	15.9	1.8
Sales and Use	760.7	768.4	-7.7	-1.0
Property	65.7	38.1	27.7	72.7
Corporation Income	112.9	92.1	20.8	22.6
Coal Severance	64.9	80.2	-15.3	-19.1
Cigarette Taxes	60.6	66.5	-5.9	-8.9
LLET	47.3	48.6	-1.4	-2.9
Lottery	48.5	46.0	2.5	5.4
Other	138.4	130.5	7.9	6.1
Total	**2,201.0**	**2,156.5**	**44.5**	**2.1**

The coal severance tax decreased 19.1 percent, a continuation of the trend discussed in the previous quarterly report. Receipts of $64.9 million compare to $80.2 million collected in the first quarter of FY12. Coal prices and severed tons both continued to show signs of weakness due to inventory accumulations, input substitution, and supply side disruptions.

Cigarette taxes fell 8.9 percent in the first quarter with receipts of $60.6 million. Falling state and national consumption of cigarettes will remain the prevailing market force, with the wildcard being changes to surrounding state rates of taxation which will potentially affect border sales in some areas of the state.

The limited liability entity tax (LLET) saw a decrease in tax collections in the first quarter of FY13 when compared to FY12. Total collections in the current fiscal year totaled $47.3 million and compare to revenues of $48.6 million in the same period a year earlier.

Lottery dividends increased 5.4 percent in the first quarter of FY13 with revenues of $48.5 million.

The "Other" category represents the remaining accounts in the General Fund, and collections in this account increased 6.1 percent with receipts of $138.4 million.

Figure 1 details the composition of first-quarter General Fund receipts by tax type. Seventy-six percent of General Fund revenues were collected in the areas of the individual income and sales taxes. The next largest source of revenue was the "Other" account at 6.0 percent. The major components in this category include the insurance premium tax, the bank franchise tax, telecommunications tax, beer wholesale, and the inheritance tax, $133.1 million, $94.2 million, $64.9 million, $54.1 million and $41.3 million respectively Corporation income taxes accounted for 5.0 percent of the revenues. Cigarette, coal severance and property taxes each accounted for 3.0 percent. Finally LLET and lottery taxes each accounted for 2.0 percent of the General Fund.

ROAD FUND
First Quarter, FY13

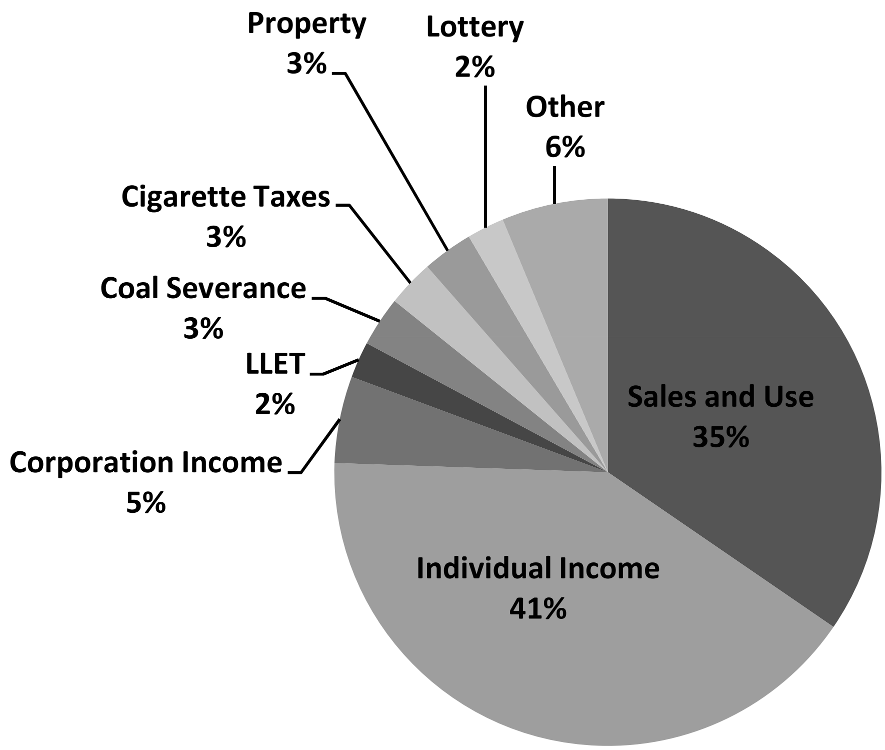
Road Fund revenue increased 1.2 percent in the first quarter of FY13. Receipts totaled $358.7 million compared to the $354.4 million received in the first quarter of the last fiscal year. Summary data are contained in Table 2 and detailed data are shown in the Appendix.

Motor fuels tax receipts increased 2.7 percent during the first quarter of FY13. Receipts were $207.1 million and compare to $201.7 million collected during the first quarter of last year. The first quarter of FY13 was affected by the automatic adjustment to the fuels tax rate prescribed in KRS 138.210 (10) and KRS 138.220 (1), which created a 2.1 cent-per-gallon increase in the variable rate on motor fuels. For gasoline, the total tax

Table 2
Summary Road Fund Receipts
First Quarter, FY13, $ millions

	FY13	FY12	Diff ($)	Diff (%)
Motor Fuels	207.1	201.7	5.4	2.7
Motor Vehicle Usage	101.7	103.2	-1.5	-1.5
Motor Vehicle License	17.5	19.5	-2.0	-10.2
Motor Vehicle Operators	4.3	4.0	0.3	6.9
Weight Distance	19.0	18.9	0.0	0.2
Investment Income	1.3	0.0	1.3	2,947.9
Other	7.8	7.0	0.8	11.5
Total	**358.7**	**354.4**	**4.3**	**1.2**

Figure 1
General Fund Receipts Composition
First Quarter, FY13



rate increased by 7.6 percent. With motor fuels collections rising only 2.7 percent, the slower growth implies a modest decrease in gallons sold.

Motor vehicle usage tax receipts decreased 1.5 percent, or $1.5 million, during the first quarter. Receipts were $101.7 million compared to $103.2 million collected during the same period last year. Weak car sales is the Road Fund parallel to the General Fund weakness in the sales and use tax. Households and businesses appear to be postponing vehicle purchases until economic conditions improve.

Motor vehicle license tax receipts decreased 10.2 percent during the first quarter of FY13. Receipts of $17.5 million compare to $19.5 million received during the first quarter of FY12.

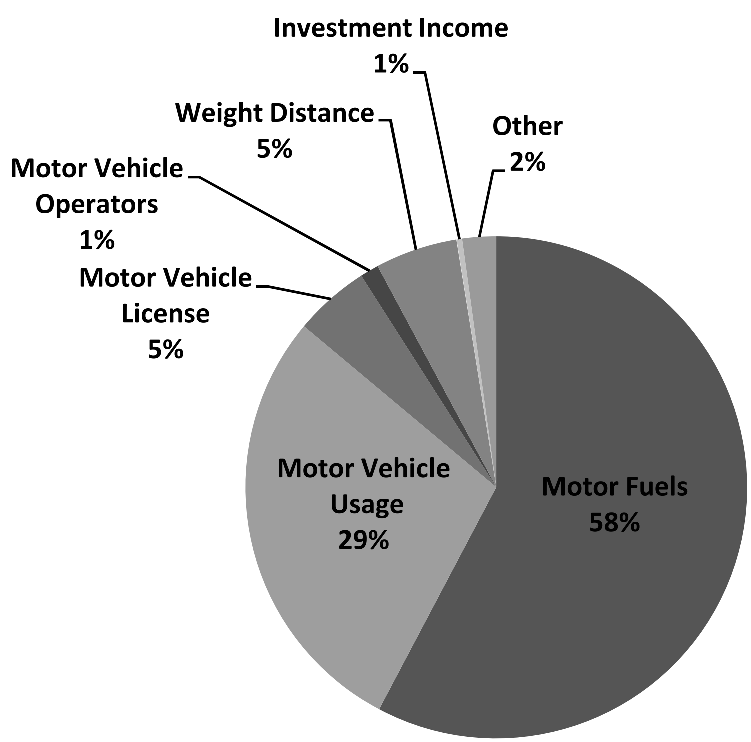
Motor vehicle operators' license fees totaled $4.3 million, a 6.9 percent increase compared to the level observed a year ago.

Weight distance tax receipts of $19.0 million increased 0.2 percent compared to receipts of $18.9 million collected during the first quarter of last year. The weight distance tax has some significance as a leading indicator of economic activity, as it is a rough proxy for goods in transit over Kentucky highways.

The remainder of the accounts in the Road Fund combined for an increase of 11.5 percent. Receipts for the "Other" category totaled $7.8 million during the first quarter, compared to $7.0 million in the first quarter of FY12.

Figure 2 details the composition of Road Fund revenues by tax type in the first quarter of FY13. Motor fuels taxes and the motor vehicle usage tax accounted for 87.0 percent of Road Fund revenues in the first quarter. The next-largest sources of revenue were motor vehicle license and weight distance taxes, each with 5.0 percent. The "Other" category accounted for 2.0 percent, while motor vehicle operators' license fees comprised one percent.

Figure 2
Road Fund Receipts Composition
First Quarter, FY13



The Economy
First Quarter FY13

NATIONAL ECONOMY

Real gross domestic product (real GDP) rose by 2.3 percent in first quarter of FY13 compared to the first quarter of FY12. Table 3 presents the growth as it was released September 10, 2012. As of October 4, 2012, the Bureau of Economic Analysis revised fourth quarter FY12 real GDP growth down to 1.3 percent. This is the third and final estimate for real GDP. The second estimate for real GDP growth for fourth quarter FY12 was 1.7 percent and was published on August 29, 2012. The estimates published in this report are based on that second estimate. The third estimate for real GDP is final until rebenchmarking occurs next February. Global Insight's estimates for first quarter FY13 real GDP are based on the second estimate. For purposes of this report, we will analyze real GDP as it appears as of September 10, 2012.

Real consumption, which makes up 70.7 percent of real GDP, rose by 2.0 percent in the first quarter of FY13. Real GDP grew by $309.2 billion in the first quarter while real consumption grew by $191.4 billion. Real

Table 3
Summary of US Economic Series
First Quarter FY13 & FY12

	First Quarter			
	FY13	FY12	Chg	% Chg
Real GDP	13,616.1	13,306.9	309.2	2.3
Real Consumption	9,633.2	9,441.9	191.4	2.0
Real Investment	1,918.2	1,735.8	182.4	10.5
Real Govt. Expenditures	2,477.9	2,516.6	-38.7	-1.5
Real Exports	1,853.8	1,792.9	60.9	3.4
Real Imports	2,261.0	2,190.8	70.2	3.2
Personal Income ($ billions)	13,490.2	12,976.3	513.9	4.0
Wages and Salaries ($ billions)	6,937.3	6,678.1	259.2	3.9
Inflation (% chg CPI)	1.8	3.8	NA	NA
Industrial Production Index (% chg)	3.7	3.3	NA	NA
Civilian Labor Force (millions)	155.2	153.7	1.5	1.0
Total Non-farm Employment (millions)	133.4	131.5	1.8	1.4
Manufacturing Employment (millions)	12.0	11.8	0.2	2.0
Unemployment Rate (%)	8.3	9.1	NA	NA

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Components do not sum to GDP because they are annualized independently.
Data for FY13 Q1 are September 2012 estimates.
Source: IHS Global Insight Inc., September 10, 2012 data release

consumption makes up a large share of real GDP and so it is not surprising that they are correlated in this way on a regular basis. Real consumption growth has been very low since the trough 13 quarters ago. Since the trough, real consumption has grown a net 7.0 percent. Across the corresponding 13 quarters following the previous four recessions, real consumption grew by a net 17.6, 17.2 11.5 and 9.8 percent respectively.

Real investment, which makes up 14.1 percent of real GDP, rose by 10.5 percent in the first quarter of FY13. In percentage terms, investment grew by the largest amount among the components. In the 12 quarters since real investment reached a trough, real investment has grown by a net 37.5 percent. This growth occurred in two periods. In the period immediately following the trough, real investment grew rapidly for four quarters. Then real investment declined for two straight quarters. Real investment picked up again and grew solidly for the next six quarters. Adjacent-quarter growth in the first quarter of FY13 was weak at 0.5 percent. The majority of the growth in the last four quarters occurred in the second quarter of FY12, where real investment grew by 7.6 percent compared to the previous quarter.

Real government expenditures, which make up 18.2 percent of real GDP, fell by 1.5 percent in the first quarter of FY13. Real government expenditures have declined in 10 of the last 11 quarters on an adjacent-quarter basis. Real government expenditures are typically countercyclical and therefore it is not surprising that expenditures have declined for the last few quarters. Since the last peak, real government expenditures have declined by a net 5.5 percent.

Real government expenditures declined in the first quarter compared to a year ago, but the major expenditure categories varied widely in their changes since last year. The largest expenditure category, Social Security, increased by $49.9 billion, an increase of 7.0 percent since a year ago. National defense, the second largest expenditure category, decreased by $21.8 billion, a loss of 3.0 percent compared to last year. Medicare, the third largest expenditure category, increased by $15.7 billion, an increase of 2.9 percent. Non-defense goods and services expenditures increased by $14.7 billion, an increase of 4.3 percent. Interest payments, the fifth largest category of government expenditures declined by $7.3 billion, a 2.3 percent decline since last year. Medicaid expenditures increased by $12.5 billion, a 5.2 percent increase compared to last year. So the decline in government expenditures occurred as a result of declines in national defense, interest payments and several other smaller expenditure accounts.

Real exports increased by 3.4 percent in the first quarter, while real imports increased by 3.2 percent. Real imports are larger in magnitude than real exports and therefore the growth in real exports needs to be significant for it to have an effect on the trade deficit. The trade deficit expanded slightly in the first quarter to $407.2 billion. The current trade deficit expansion follows trade deficit contractions in both of the previous two quarters.

US personal income increased by a solid 4.0 percent in the first quarter of FY13. That growth was based primarily upon similar growth in wages and salary growth. The civilian labor force expanded by 1.5 million persons in the first quarter. Total non-farm

Table 4
Summary of Kentucky Economic Series
First Quarter FY13 & FY12

	First Quarter			
	FY13	FY12	Chg	% Chg
Personal Income ($ millions)	153,726.5	147,664.0	6,062.5	4.1
Wages and Salaries ($ millions)	78,837.5	75,542.0	3,295.5	4.4
Non-farm Employment (thousands)	1,831.5	1,792.5	39.0	2.2
Goods-producing	320.7	303.8	16.9	5.6
Construction	67.4	67.9	-0.6	-0.8
Mining	23.3	22.8	0.5	2.2
Manufacturing	230.0	213.0	17.0	8.0
Service-providing	1,185.1	1,159.5	25.6	2.2
Trade, Transportation & Utilities	370.5	363.4	7.1	2.0
Information	26.6	26.6	0.1	0.2
Finance	84.3	84.2	0.1	0.2
Business Services	199.0	190.0	9.0	4.8
Educational Services	260.6	255.7	4.9	1.9
Leisure and Hospitality Services	173.9	169.2	4.6	2.7
Other Services	70.1	70.4	-0.3	-0.4
Government	325.7	329.2	-3.5	-1.1

Not Seasonally Adjusted. Data for FY13 Q1 are September 2012 estimates.
Source: IHS Global Insight Inc., September 10, 2012 data release

employment increased by 1.8 million workers during the same period. Unemployment, which is a function of the labor force and employment, fell from 9.1 to 8.3 percent in the first quarter.

KENTUCKY ECONOMY

Kentucky personal income rose by 4.1 percent in the first quarter compared to a year ago. This is similar to the growth of US personal income. Also similar to the US, wages and salary income made up the largest share of growth in Kentucky personal income. Kentucky personal income growth has been solid and steady for the last seven quarters.

Kentucky non-farm employment has been weak since the 2007 recession ended. Non-farm employment rose by 2.2 percent in the first quarter. The first quarter of FY13 is the best year over year growth for non-farm employment since the recession ended.

Manufacturing employment improved significantly in the first quarter, adding 17,000 jobs, an 8.0 percent increase. Manufacturing employment is the largest of the goods-producing employment sectors. Historically, Kentucky has a larger share of manufacturing employment than the US as a whole. Manufacturing employment growth was the largest in absolute and percentage terms among all the employment supersectors in the first quarter. Kentucky construction employment has bounced around during the last year with quarterly growth as high as 4.1 percent to losses as high as 4.4 percent.

The largest supersector, trade, transportation and utilities, rose by only 2.0 percent over the first quarter of FY12. Trade, transportation and utilities employment growth has been very weak since the recession ended. The best adjacent-quarter growth for trade, transportation and utilities employment since the recession ended was 0.9 percent, which it duplicated again this quarter. The first quarter of FY13 was a stubborn one for all services employment sectors. All services sectors combined declined by a net 0.4 percent compared to the fourth quarter of FY12. Among the services sectors, trade, transportation and utilities performed the best, growing 0.9 percent over the fourth quarter of FY12. over the past year, business services employment has performed the best growing a net 4.8 percent over the first quarter of FY12

Employment growth has been weak following both the 2001 recession and the 2007 recession. Average annual growth following these two recessions was 1.2 percent. Average annual growth following the 1990 recession was 2.4 percent. Employment growth in the current expansion can be characterized as weak historically speaking. Meanwhile, Kentucky personal income growth is lower than in the past two expansion periods, but can not be characterized as weak. It would be more appropriate to say that personal income growth is low but still within the normal range. Average annual personal income growth following the 1990 recession was 2.4 percent. Average annual personal income growth following the 2001 recession was 4.6 percent. Average annual personal income growth following the 2007 recession has been 3.9 percent. One should exercise caution when comparing nominal personal incomes over time. Inflation and deviation from the mean will reveal changes in growth rates over long periods of time, which do not reflect meaningful economic events.

Interim Outlook

GENERAL FUND

The revenue forecasts presented in Table 5 and Table 6 were estimated using the September 2012 "control scenario" economic forecast from both IHS Global Insight and the Kentucky MAK model. Underlying economic conditions have softened somewhat for the near-term forecast, as illustrated in the Economic Outlook section of this report. However, the cloud of uncertainty has not changed appreciably since the economic forecast was officially adopted by the Consensus Forecasting Group (CFG) in December 2011. This, coupled with a slight revenue surplus in FY12, creates confidence that we remain on a revenue path consistent with the enacted revenue estimates.

The official revenue estimate for the General Fund in FY13 is $9,307.8 million which includes the December 2011 estimate of $9,220.6 million in addition to the $87.2 million modification due to legislative actions taken during the 2012 legislative sessions.

Projected General Fund revenues for the next three quarters are shown in Table 5. As the table indicates, General Fund growth is projected to be 2.5 percent for the forecast horizon. The interim estimate calls for nominal collections of $9,306.3 million, a sum nearly identical to the enacted estimate of $9,307.8 million. While the current unofficial estimate presented in this report is very similar to the official enacted estimate, there

Table 5
General Fund Interim Forecast
$ millions

	FY13						FY13	
	Q1		Q2, Q3, & Q4		Full Year		Official CFG	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff
Individual Income	901.9	1.8	2,703.2	2.9	3,605.1	2.6	3,587.7	17.3
Sales & Use	760.7	-1.0	2,331.8	2.1	3,092.6	1.3	3,089.2	3.4
Property	65.7	72.7	487.3	-0.9	553.0	4.4	538.4	14.6
Corporation Income	112.9	22.6	327.4	16.0	440.3	17.6	370.3	70.0
Coal Severance	64.9	-19.1	189.8	-13.0	254.7	-14.6	337.0	-82.3
Cigarettes	60.6	-8.9	180.9	-3.9	241.5	-5.2	252.3	-10.8
LLET	47.3	-2.9	158.9	4.5	206.2	2.7	222.9	-16.7
Lottery	48.5	5.4	165.5	0.4	214.0	1.5	214.0	0.0
Other	138.4	6.1	560.6	6.3	699.0	6.2	696.0	3.0
Total	**2,201.0**	**2.1**	**7,105.3**	**2.5**	**9,306.3**	**2.4**	**9,307.8**	**-1.5**

are still some notable differences among the specific accounts which are significantly different than in the official enacted estimate. Specifically, the coal severance tax has been revised down sharply as detailed below.

Individual income tax receipts are expected to increase by 2.9 percent during the final three quarters of FY13 following first quarter growth of 1.8 percent. The largest component of individual income tax receipts is withholding, which makes up over 98 percent of total individual income tax receipts. Withholding, in turn, is closely tied to wages and salaries and employment in the state. Employment growth has been somewhat weak despite a decline in the unemployment rate.

Growth in sales and use tax collections is expected to resume at a very moderate pace after falling for the first quarter since the recession. Despite a small increase in September, the first quarter of FY13 fell at a rate of 1.0 percent. Our previous reports hypothesized that we may have experienced a slight bubble in the sales tax in FY12 — since the rate of growth in the sales tax exceeded growth in incomes; our models detected some one-time spending trends that usually follow recessionary periods from pent-up demand. Growth tends to mitigate in the following years without the continued support of one-time demand factors, and our models indicate that adjustment process may be playing out in the onset to FY13.

Property tax revenues are expected to decline by 0.9 percent over the forecasting horizon. The reason for the decline is primarily due to timing issues which inflated first quarter receipts. Even though most of the FY13:1 increase was transitory, FY13 receipts are nevertheless estimated to be a net $14.6 million over the official enacted estimate. The state rate on real property that affects FY13 real property tax collections will remain at 12.2 cents per $100 in valuation. Due to the effects of the housing recession, the state rate has remained at 12.2 cents since valuation year 2008, an unprecedented event. As the housing market improves, growth in new property and existing values can be expected to resume more normal trends.

Corporation income and LLET collections are behaving as intended. The LLET is a backstop for the corporation income tax, meaning that when corporate profits and tax receipts fall, LLET collections rise and vice versa. That pattern is evident in FY12 collections as well as in the forecast. In FY12, corporation income tax collections grew 24.5 percent while LLET receipts declined 7.0 percent. For the forecasting horizon, both taxes should gravitate toward longer term trend values. The corporation income tax is expected to grow 16.0 percent, based on sustained profitability, and the LLET tax is projected to remain fairly stable, with projected growth near 4.5 percent. The interim projection for the corporation income tax is $70.0 million in excess of the official estimate but the LLET is now projected to come in $16.7 million below the estimate, making the major two business taxes right on par to hit the official estimates when viewed together.

Coal severance receipts fell short of the official estimate in FY12 and will continue to fall in FY13. Energy markets, and coal markets in particular, have become quite volatile in the wake of technological advances in natural gas extraction. Input substitution, slowing global demand, and unseasonable weather all combined in a concerted fashion to depress coal demand and coal prices. Coal receipts fell 19.0 percent in the final quarter of FY12 followed by a 19.1 percent dip in the first quarter of FY13. Our interim projections predict more of the same in the near term. Coal severance receipts are expected to reach $254.7 million for all of FY13. This is $82.3 million less than the official enacted estimate of $337.0 million.

Cigarette receipts declined 2.9 percent in FY12 but the downward trend spiraled to 8.9 percent in the first quarter of FY13. The outlook for cigarette tax receipts is for a nominal 3.9 decline percent over the final three quarters of FY13 to end the year at $241.5 million, a 5.2 percent annual decline. A downward trend in smoking rates is still expected, but the $1.00 per pack increase in the tax rate for Illinois is expected to have a small revenue impact for cigarette purchases in Kentucky. The net effect, however, is for a continuation of the downward forces to outpace the border effect from the Illinois tax law change.

Lottery receipts are determined by the Lottery Corporation's dividend schedule. The dividend expected in FY13 remains at $214.0 million, the same as the enacted estimate. Growth over the final three quarters of FY13 is expected to produce roughly the same amount as FY12, hitting the enacted estimate for the fiscal year.

The "Other" category contains dozens of smaller accounts, which make up the remainder of the General Fund. Insurance premiums tax, bank franchise and telecommunications tax are the three largest accounts in the "Other" category. The "Other" category of taxes is expected to rise 6.3 percent during the forecasting horizon, a slight increase in growth compared to FY12. In all, these accounts were estimated to be $654.2 million in FY12, with actual collections totaling $658.0 million – an error rate of less than 1.0 percent.

ROAD FUND

Road Fund revenues are forecasted to increase 1.4 percent over the remaining three quarters of FY13 as shown on Table 6. Motor fuels, the largest Road Fund account, is expected to account for the majority of the increase in revenue. Motor vehicle usage, motor vehicle license and investment are all forecasted to decline.

Motor fuels tax receipts are forecasted to grow 5.0 percent in the final three quarters of FY13. This increase is due primarily to the increase in the variable rate on motor duels that occurred in July 2012, pursuant to the statutory formula. The variable rate went up 2.1 cents per gallon in July 2012. The projected market conditions for the remainder of the fiscal year call for the wholesale fuel prices to remain above the statutory threshold level, such that the rate adjustment in July will apply for the entire FY13. Taxable gallons, on the other hand, are expected to decline from FY12 levels. Since the tax on fuels is a "per-gallon" excise tax, a reduction in total gallons sold partially offsets the revenue gains from July's statutory rate adjustment.

Motor vehicle usage tax collections are expected to fall 2.3 percent in the final nine months of FY13. Receipts fell 1.5 percent in the first quarter and are expected to remain subdued over the final three quarters of the fiscal year as demand for motor vehicles slows on the heels of very strong growth over the two previous fiscal years.

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 assessed recent growth patterns as well as administrative and statutory factors to formulate the projections. Motor vehicle license taxes are forecasted to decrease 9.2 percent in the final three quarters of FY13. Motor vehicle operators' licenses are projected to rise 6.2 percent in the remainder of the fiscal year. Weight distance tax revenue should grow 1.3 percent for the remainder of the fiscal year. Investment income should fall 29.0 percent due to lower interest rates. All other revenues should combine for growth of 0.7 percent during the last nine months of FY13.

Table 6
Road Fund Interim Forecast
$ millions

	FY13						FY13	
	Q1		Q2, Q3, & Q4		Full Year		Official CFG	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff
Motor Fuels	207.1	2.7	618.1	5.0	825.2	4.4	850.5	-25.3
Motor Vehicle Usage	101.7	-1.5	306.6	-2.3	408.2	-2.1	410.8	-2.6
Motor Vehicle License	17.5	-10.2	80.2	-9.2	97.7	-9.4	99.3	-1.6
Motor Vehicle Operators	4.3	6.9	12.4	6.2	16.7	6.4	15.9	0.8
Weight Distance	19.0	0.2	56.9	1.3	75.9	1.1	86.0	-10.1
Investment	1.3	2,947.9	2.2	-29.0	3.5	12.9	2.3	1.2
Other	7.8	11.5	28.1	0.7	35.9	2.9	34.9	1.0
Total	**358.7**	**1.2**	**1,104.4**	**1.4**	**1,463.1**	**1.3**	**1,499.6**	**-36.5**

NATIONAL ECONOMY

At the end of FY12, it was clear that no segment of the state or national economy was emerging as a bulwark against the threats facing the continued, modest recovery. Overall, the economy continues to follow a slow and moderate path of recovery. Each quarter brings a rotation of which sectors are showing renewed signs of improvement and which sectors experience abating growth.

For the first quarter of FY13, the housing market showed continued signs of further recovery with new housing starts and home prices both continuing their upward trend and the corresponding inventory of unsold homes continuing to decline. Additional positive signs were observed in consumer spending, especially in light-vehicle sales. The pent up demand for replacement of cars and light trucks in the past few years has begun to occur, or perhaps even run full course.

The latest flag bearer of the recovery's weak momentum has cycled back through to the same economic sectors that provided initial sparks of a more pronounced and rapid rebound. Exports, fixed business investment, and manufacturing sectors have all shown signs of succumbing to the headwinds imposed by continued weakness in the global economy and domestic political uncertainty.

Manufacturing, once seen as a story of robust revitalization and revival, has experienced a significant reduction in capacity utilization and has expanded in only one of the last four months. The strength of the domestic auto industry has kept the manufacturing sector from experiencing significant contraction, but the view going forward shows reasons for concern. Export orders are continuing to decline as the Euro zone continues to experience a deepening recession and the developing world, largely influenced by China, experiences a marked slowdown in growth.

The previous quarterly report noted weak performance in the labor market, and that performance has continued in the intervening months. The most recent three months have witnessed average payroll employment growth of less than 125,000 per month. Furthermore, the unemployment rate was falling due to individuals exiting the workforce, rather than finding employment. The Global Insight forecast assumes that monthly payroll increases continue in the range of 135,000 per month for the next three quarters.

Against this backdrop, the Federal Reserve made the case for and began further monetary accommodation in the form of "QE3", a program of quantitative easing focused on the purchase of mortgage backed securities, and continued guidance on "near-zero" interest rates through fiscal year 2015. The Federal Reserve's actions are intended to continue to lower long-term interest rates and borrowing costs. Up to this point in the economic recovery, capital equipment purchases have been a driver of GDP growth, but the rate of growth in this sector has begun to slow. By targeting low long-term borrowing rates, the Fed hopes to encourage firms to continue to make capital investments. The announcement of an open-ended commitment to purchase $40 billion in mortgage backed securities per month is forecasted to lower mortgage rates by 20-25 basis points. However, the overall effect of these rates on the housing market and consumers looking to purchase or refinance a home will be muted by the continued stringent credit requirements for mortgages.

A further deterrent to capital investing and risk-taking is the extreme uncertainty in Federal fiscal and tax policy. The Budget Control Act of 2011 resolved the debate over raising the nation's debt ceiling that was ongoing in the summer of 2011 by creating the "fiscal cliff" at the end of 2012. The "fiscal cliff" is the colloquial name for the automated reduction and sequestration of $1.2 trillion in discretionary spending and the expiration of numerous tax laws and provisions. Among the laws set to change at midnight on December 31, 2012, are the end of last year's temporary payroll tax cuts (resulting in a 2 percent tax increase for workers), the end of certain tax breaks for businesses, shifts in the alternative minimum tax, and the end of the tax cuts from 2001-2003.

Finally, if low interest rates are indeed going to provide an efficacious dose of stimulus, a credible source of aggregate demand must emerge. Otherwise, businesses will remain mired in a liquidity trap situation where interest rate policies will no longer have an effect on capital investment. Simply put, for businesses to have a credible inducement to invest in capital that is productive in a physical sense, they must first be convinced of *improved current expectations* for the sale of their products. Current expectations are a key predictor of future expectations, so as these expectations improve the internal rate of return on investment improves. The current investment lull (liquidity trap) is not a function of forbidding interest rates but rather a crisis of improving the internal rate of return on investment in physical capital.

It is currently not expected, as the Global Insight forecast assumes, that the economy will go off the "fiscal cliff". It is expected that compromise will be reached and the deadlines for the necessary actions by Congress will be extended into the first calendar quarter of 2013. Once the deadlines are extended, the new Congress and president are expected to produce an agreement on tax changes, entitlements, and overall Federal spending which will be phased in over several years. The final result of the compromise may be clouded by the outcome of the presidential election and the need to raise the debt ceiling in the first calendar quarter of 2013.

Overall, the outlook for the next three quarters is positive, but slow growth. GDP is expected to grow 1.7 percent over the next three quarters, and consumption is forecast to grow by 2.1 percent. Government expenditures at all levels, Federal, state, and local, will continue to decline. Oil and other energy prices will also continue to decline, helping to keep core inflation low. However, the year's drought has significantly reduced this year's corn and soybean harvest, and the resulting higher commodity prices will begin to be passed along to the consumer over the next few quarters.

KENTUCKY ECONOMY

As the national economy continues to slowly improve, Kentucky's economy continues to reclaim new highs in terms of personal income and wages and salaries. Kentucky personal income and wages and salaries are 9.0 percent and 8.3 percent respectively higher than their pre-recession peaks. Annual growth rates over the past two years have varied from 2.2 to 5.1 percent for each measure. The current forecast, for the remainder of fiscal year 2013, calls for 4.1 percent and 4.0 percent growth in those two categories. This represents very similar growth to the national economy as US personal income is expected to grow by 4.2 percent and US wages and salaries are expected to grow by 4.1 percent over the next three quarters.

Kentucky's non-farm employment is expected to grow consistently during the final three quarters of FY13 with a gain of 1.6 percent. A significant portion of the job growth is anticipated to come from the goods producing sector which includes mining, construction and manufacturing. The combined growth in these sectors is estimated at 5.1 percent representing over 15,000 new jobs.

Manufacturing employment in the Commonwealth has grown by 11.1 percent since the bottom of the past recession. This trend is expected to continue through the remaining three quarters of fiscal year 2013 with a 6.2 percent increase. Although the mining sector has been under extreme pressure from market and regulatory forces, the sector should experience similar gains with an increase of 7.4 percent in the remainder of fiscal 2013.

Among the major sectors in Kentucky's economy, service producing industries continue to account for approximately two-thirds of Kentucky jobs. The service sector has now surpassed the pre-recession peak in employment. The service-providing industries are forecasted to expand by 1.4 percent with the creation of 16,000 jobs. Among the service sectors, business services are expected to post the strongest gains with an increase of 1.9 percent.

Employment in government—including federal, state, and local—is expected to continue the recent trend and decline by 1.0 percent.

Table 7
US Economic Outlook
Quarters 2, 3, & 4

	Q2, Q3, & Q4			Full Year	
	FY13	FY12	% Chg	FY13	% Chg
Real GDP	13,733.4	13,504.0	1.7	13,798.1	1.7
Real Consumption	9,742.9	9,541.0	2.1	9,800.9	2.2
Real Investment	1,958.6	1,890.5	3.6	1,992.3	4.4
Real Govt. Expenditures	2,446.7	2,488.2	-1.7	2,435.0	-1.7
Real Exports	1,892.2	1,821.2	3.9	1,911.3	3.6
Real Imports	2,295.7	2,233.9	2.8	2,326.4	3.4
Personal Income ($ billions)	13,760.2	13,202.3	4.2	13,898.8	4.0
Wages and Salaries ($ billions)	7,076.7	6,800.1	4.1	7,149.8	3.9
Inflation (% chg CPI)	1.41	2.69	NA	1.42	NA
Industrial Production Index (% chg)	2.5	4.4	NA	2.1	NA
Civilian Labor Force (millions)	155.8	154.5	0.9	156.2	0.8
Total Non-farm Employment (millions)	134.3	132.6	1.3	134.8	1.4
Manufacturing Employment (millions)	12.1	11.9	1.5	12.1	1.3
Unemployment Rate (%)	8.1	8.4	NA	8.0	NA

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Components do not sum to GDP because they are annualized independently.
Data for FY13 Q2 through FY13 Q4 are September 2012 estimates.
Source: IHS Global Insight Inc., September 10, 2012 data release

Table 8
Kentucky Economic Outlook
Quarters 2, 3, & 4

	Q2, Q3, & Q4			Full Year	
	FY13	**FY12**	**% Chg**	**FY13**	**% Chg**
Personal Income ($ millions)	156,530.3	150,395.2	4.1	157,927.1	4.1
Wages and Salaries ($ millions)	80,265.1	77,192.8	4.0	80,989.1	4.1
Non-farm Employment (thousands)	1,842.2	1,813.8	1.6	1,842.6	1.4
Goods-producing	321.3	305.7	5.1	321.5	5.0
Construction	68.1	67.5	0.9	68.1	-1.9
Mining	23.7	22.0	7.4	23.7	8.0
Manufacturing	229.6	216.2	6.2	229.8	7.0
Service-providing	1,196.4	1,180.4	1.4	1,196.7	1.1
Trade, Transportation & Utilities	373.3	367.1	1.7	373.5	1.6
Information	26.6	26.6	0.1	26.6	0.9
Finance	84.7	83.5	1.4	84.7	2.0
Business Services	203.5	199.7	1.9	203.5	1.2
Educational Services	262.2	259.3	1.1	262.1	0.9
Leisure and Hospitality Services	175.7	173.8	1.1	175.7	0.4
Other Services	70.5	70.4	0.1	70.6	0.2
Government	324.5	327.8	-1.0	324.5	-1.1

Not Seasonally Adjusted.
Source: IHS Global Insight, Inc. and the Kentucky Governor's Office for Economic Analysis MAK model, September 2012.

APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	First Quarter FY 2013	First Quarter FY 2012	% Change
TOTAL GENERAL FUND	**$2,200,997,313**	**$2,156,453,495**	**2.1%**
Tax Receipts	$2,124,964,740	$2,095,978,360	1.4%
Sales and Gross Receipts	$906,547,741	$918,153,603	-1.3%
Beer Consumption	1,729,884	1,682,894	2.8%
Beer Wholesale	14,184,212	15,146,001	-6.4%
Cigarette	60,598,643	66,497,668	-8.9%
Distilled Spirits Case Sales	33,835	29,396	15.1%
Distilled Spirits Consumption	3,015,552	2,881,777	4.6%
Distilled Spirits Wholesale	7,430,202	7,202,826	3.2%
Insurance Premium	30,626,987	28,225,403	8.5%
Pari-Mutuel	1,435,748	550,119	161.0%
Race Track Admission	80,617	82,477	-2.3%
Sales and Use	760,726,690	768,399,587	-1.0%
Wine Consumption	666,152	638,976	4.3%
Wine Wholesale	3,339,811	3,231,292	3.4%
Telecommunications Tax	17,099,416	17,940,009	-4.7%
OTP	5,575,935	5,627,723	-0.9%
Floor Stock Tax	4,057	17,454	-76.8%
License and Privilege	**$119,830,971**	**$141,887,292**	**-15.5%**
Alc. Bev. License Suspension	73,367	49,875	47.1%
Coal Severance	64,922,357	80,208,638	-19.1%
Corporation License	(494,583)	510,123	---
Corporation Organization	40,248	0	---
Occupational Licenses	14,995	25,144	-40.4%
Oil Production	2,550,783	2,338,957	9.1%
Race Track License	95,000	95,000	0.0%
Bank Franchise Tax	(1,064,417)	(923,907)	---
Driver License Fees	170,198	162,721	4.6%
Minerals Severance	3,523,589	4,286,831	-17.8%
Natural Gas Severance	2,748,426	6,486,200	-57.6%
Limited Liability Entity	47,251,009	48,647,710	-2.9%
Income	**$1,014,825,371**	**$978,106,526**	**3.8%**
Corporation	112,946,738	92,147,881	22.6%
Individual	901,878,633	885,958,646	1.8%
Property	**$65,736,044**	**$38,053,283**	**72.7%**
Building & Loan Association	4,180	(2,299)	---
General - Real	(292,418)	(370,124)	---
General - Tangible	28,198,052	27,245,797	3.5%
Omitted & Delinquent	18,570,515	(2,851,363)	---
Public Service	18,989,651	13,700,361	38.6%
Other	266,063	330,911	-19.6%
Inheritance	**$9,387,227**	**$11,231,115**	**-16.4%**
Miscellaneous	**$8,637,387**	**$8,546,541**	**1.1%**
Legal Process	5,227,526	5,137,388	1.8%
T. V. A. In Lieu Payments	3,409,861	3,404,199	0.2%
Other	0	4,954	-100.0%
Nontax Receipts	**$75,514,838**	**$59,664,925**	**26.6%**
Departmental Fees	5,850,096	3,436,777	70.2%
PSC Assessment Fee	13,073,529	5,422,569	141.1%
Fines & Forfeitures	8,284,846	6,756,752	22.6%
Interest on Investments	1,175,263	247,598	374.7%
Lottery	48,500,000	46,000,000	5.4%
Sale of NOx Credits	6,500	0	---
Miscellaneous	(1,375,396)	(2,198,771)	---
Redeposit of State Funds	**$517,735**	**$810,210**	**-36.1%**

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	First Quarter FY 2013	First Quarter FY 2012	% Change
TOTAL ROAD FUND	**$358,700,978**	**$354,374,262**	**1.2%**
Tax Receipts-	$351,939,876	$349,547,826	0.7%
Sales and Gross Receipts	**$308,794,972**	**$304,893,545**	**1.3%**
Motor Fuels Taxes	207,144,135	201,716,875	2.7%
Motor Vehicle Usage	101,650,837	103,176,670	-1.5%
License and Privilege	**$43,144,904**	**$44,654,281**	**-3.4%**
Motor Vehicles	17,513,454	19,504,643	-10.2%
Motor Vehicle Operators	4,307,355	4,028,959	6.9%
Weight Distance	18,961,724	18,915,798	0.2%
Truck Decal Fees	19,890	50,802	-60.8%
Other Special Fees	2,342,481	2,154,079	8.7%
Nontax Receipts	**$5,065,306**	**$4,614,271**	**9.8%**
Departmental Fees	3,387,559	4,282,325	-20.9%
In Lieu of Traffic Fines	171,580	187,475	-8.5%
Investment Income	1,331,049	43,671	2947.9%
Miscellaneous	175,119	100,800	73.7%
Redeposit of State Funds	**$1,695,795**	**$212,165**	**699.3%**