

COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report

First Quarter • Fiscal Year 2012 • First Edition

**Governor's Office for Economic Analysis
Office of State Budget Director**



Kentucky
UNBRIDLED SPIRIT



Office of State Budget Director

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Steven L. Beshear
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October 31, 2011

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 2012 (FY12). It also includes an interim economic and revenue forecast for the last three quarters of FY12.

General Fund receipts for the first quarter of FY12 totaled \$2,156.5 million, an increase of 4.9 percent compared to the same period in FY11. Road Fund revenues totaled \$354.4 million, an increase of 4.6 percent from the first quarter of FY11.

The interim General Fund forecast for the final three quarters of FY12 calls for an increase of 2.8 percent compared to the same period one year ago, resulting in an unofficial interim outlook for the entire FY12 of \$9,046.6 million, or \$175.4 million higher than the official enacted revenue estimates. A portion of the severance receipts is statutorily dedicated to the counties and therefore, the net difference is projected to be \$142.7 million. Corporate income tax and the limited liability entity tax are the largest sources for the difference in the current estimates over the enacted estimates.

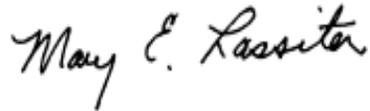
The interim estimates in this report are based on a "control scenario" forecast for the national and Kentucky economies, consistent with historical practice of the OSBD. As you know, earlier this month, the Consensus Forecasting Group (CFG) met and produced a preliminary estimate for the General Fund of \$9,008.9 million for FY12. That estimate resulted from a blend of the "control" and "pessimistic" scenarios discussed by the CFG.

Governor Beshear
October 31, 2011
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The interim forecast for the Road Fund for the final three quarters of FY12 is \$1,058.7 million and calls for an increase of 5.9 percent over FY11. The interim estimate for the entire FY12 is \$1,413.1 million and is consistent with the preliminary estimate rendered by the CFG earlier this month. Motor fuels, the largest Road Fund account, is expected to account for the majority of the increase in revenue.

Having completed one quarter in this fiscal year, we are pleased that we appear to be on track to meet budgeted revenues. However, we continue to be cautious as the economic recovery has not stabilized. We will continue to monitor the economic and fiscal conditions of the Commonwealth and will keep you apprised of developments.

Sincerely,

A handwritten signature in cursive script that reads "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 FY12. 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.

The national economy, specifically as measured by real gross domestic product (real GDP), is expected to have extremely low growth near zero percent during the current three-quarter outlook. While national forecasts place a high probability (40 percent according to Global Insight) that the economy will slip into a recession over the forecast horizon, the estimates in this report utilize the higher probability scenario that growth will occur, but will be greatly muted compared to the last two quarters.

The Kentucky economy is similar to the US economy by many measures. Both the Commonwealth and the nation are experiencing low but positive growth in employment. However, Kentucky and the nation are quite different when it comes to personal income. The 2007 recession greatly depressed the US personal income, while Kentucky personal income only declined by a small amount. In a continuation of that fortune, Kentucky personal income is expected to outpace US personal income over

the next three quarters. Wages and salary, proprietors and transfer incomes are responsible for this growth in incomes in Kentucky.

First quarter FY12 receipts grew by 4.9 percent over the same quarter in FY11. There was good growth in most of the major receipts categories, including 7.1 percent growth in sales and use taxes and 23.3 percent growth in the combined corporate and limited liability entity tax (LLET) taxes.

Estimated receipts for the next three quarters are expected to be \$6,890.1 million compared to \$6,704.4 million for the same three quarters in FY11, an increase of 2.8 percent. The largest contributors to that growth were from the combined corporate income and LLET taxes and the coal severance tax, which are estimated to grow by 10.3 and 6.8 percent respectively. Low growth is expected in the two largest receipts categories sales and use and individual income taxes with 1.1 and 2.5 percent growth respectively.

The October Quarterly Economic and Revenue Report for the first quarter of FY12 utilizes a “control scenario” forecast for national and Kentucky estimates as well as for all of the revenue projections. The October FY12 General Fund estimate is \$9,046.6 million. That is 3.3 percent above receipts for FY11. The highest annual growth is expected to come from corporate, LLET, and coal

severance taxes. The official FY12 budget estimate established in December 2009 and modified by actions of the General Assembly is \$8,871.2 million. The October estimate is \$175.4 million above the official budget estimate. However, \$32.7 million of severance tax receipts are statutorily dedicated to local governments, leaving approximately \$142.7 million estimated excess revenues. Also in October, the Consensus Forecasting Group (CFG) met and generated a preliminary estimate for the General Fund of \$9,008.9 million for FY12. The CFG will meet again

before the 15th legislative day of the 2012 Regular Session to produce the revenue budget estimates for FY12, FY13, and FY14.

The interim forecast for the Road Fund for the final three quarters of FY12 is \$1,058.7 million and calls for an increase of 5.9 percent over FY11. The interim estimate for the full year FY12 is \$1,413.1 million. Motor fuels, the largest Road Fund account, is expected to account for the majority of the increase in revenue. Also, in October, the CFG met and produced a preliminary estimate for the Road Fund of \$1,413.1 million.

Revenue Receipts

GENERAL FUND First Quarter, FY12

General Fund receipts in the first quarter of FY12 totaled \$2,156.5 million compared to \$2,055.1 million in the first quarter of FY11, for an increase of 4.9 percent or \$101.4 million. 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. Receipts in the first quarter of FY12 reflect strong growth in revenue, especially in the corporation, coal, sales and use and LLET taxes.

The sales and use tax grew 7.1 percent in the first quarter of FY12. First quarter receipts of \$768.4 million compare to the \$717.2 million collected in the first quarter of FY11. Sales and use tax collections have increased year over year for the last six

consecutive quarters as consumer spending has increased.

Individual income tax receipts increased 4.8 percent in the first quarter of FY12. Receipts of \$886.0 million were \$40.3 million more than was collected in the first quarter of the previous fiscal year. The withholding component of the individual income tax continues to post growth for a sixth quarter despite a lack of significant improvement in the underlying employment data.

Corporation income tax posted an increase of 31.8 percent, or \$22.2 million, during the first quarter of FY12. Corporate receipts totaled \$92.1 million compared to the \$69.9 million received a year earlier. September is a declaration payment month for calendar year filers. Both declarations and net returns posted significant growth due to lower refund inventories and stronger corporate profitability.

The LLET saw an increase in tax collections in the first quarter of FY12 when compared to FY11. Total collections in the current fiscal year totaled \$48.6 million and compare to revenues of \$44.3 million in the same period a year earlier.

The coal severance tax increased 10.1 percent as coal prices have increased. Receipts of \$80.2 million compare to \$72.8 million collected in the first quarter of FY11.

Cigarette taxes fell in the first quarter with receipts of \$66.5 million which were 3.7 per-

Table 1
Summary General Fund Receipts
First Quarter, FY12, \$ millions

	FY12	FY11	Diff (\$)	Diff (%)
Sales and Use	768.4	717.2	51.2	7.1
Individual Income	886.0	845.7	40.3	4.8
Corp Inc. & LLET	140.8	114.2	26.6	23.3
Cigarette Taxes	66.5	69.0	-2.5	-3.7
Coal Severance	80.2	72.8	7.4	10.1
Property	38.1	51.6	-13.6	-26.3
Lottery	46.0	45.0	1.0	2.2
Other	130.5	139.5	-9.0	-6.4
Total	2,156.5	2,055.1	101.4	4.9

cent less than collected one year earlier, a reflection of falling state and national consumption of cigarettes.

Property taxes were down 26.3 percent in the first quarter of FY12 due to timing of collections in the tangible and public service property accounts. Collections of \$38.1 million compare to \$51.6 million received in the first quarter of the prior fiscal year.

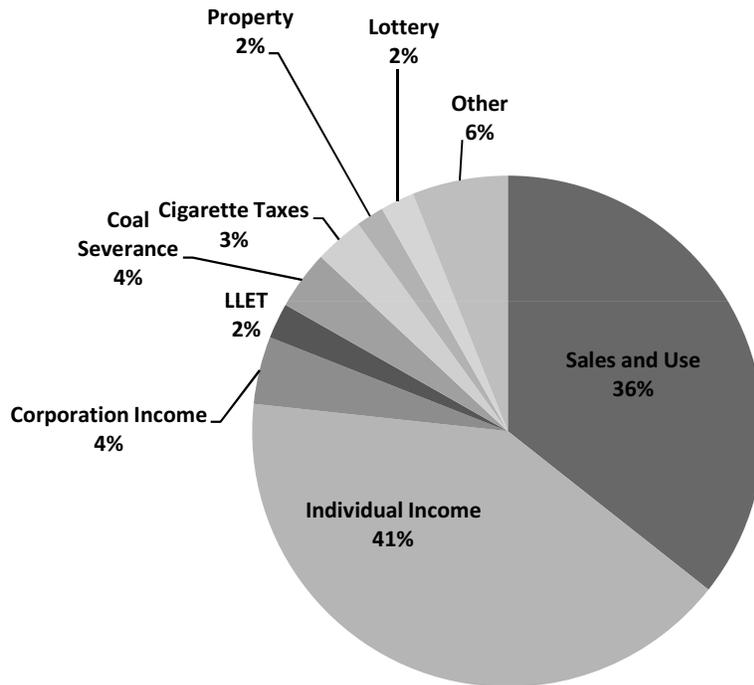
Lottery receipts increased 2.2 percent in the first quarter of FY12 with revenues of \$46.0 million.

The “Other” category represents the remaining accounts in the General Fund, and collec-

tions in this account decreased 6.4 percent with receipts of \$130.5 million.

Figure 1 details the composition of first-quarter General Fund receipts by tax type. Seventy-seven 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 percent. The major components in this category include insurance premium taxes, inheritance taxes, and the beer wholesale sales tax. Coal severance and corporation income taxes each accounted for 4 percent of the revenues. Cigarette taxes accounted for 3 percent of total revenues. Finally LLET, lottery and property taxes each accounted for 2 percent of the General Fund.

**Figure 1
General Fund Receipts Composition
First Quarter, FY12**



ROAD FUND

First Quarter, FY12

Road Fund revenue increased 4.6 percent in the first quarter of FY12. Receipts totaled \$354.4 million compared to the \$338.7 million received in the first quarter last fiscal year. Summary data are contained in Table 2 and detailed data are shown in the Appendix.

	FY12	FY11	Diff (\$)	Diff (%)
Motor Fuels	201.7	193.0	8.7	4.5
Motor Vehicle Usage	103.2	95.1	8.1	8.5
Motor Vehicle License	19.5	17.9	1.6	9.0
Motor Vehicle Operators	4.0	4.2	-0.1	-3.0
Weight Distance	18.9	18.8	0.2	0.9
Investment Income	0.0	0.5	-0.4	-90.9
Other	7.0	9.3	-2.3	-24.6
Total	354.4	338.7	15.7	4.6

Motor fuels tax receipts increased 4.5 percent during the first quarter of FY12. Receipts were \$201.7 million and compare to \$193.0 million collected during the first quarter of last year.

Motor vehicle usage tax receipts increased 8.5 percent, or \$8.1 million, during the first quarter. Receipts were \$103.2 million compared to \$95.1 million collected during the same period last year.

Motor vehicle license tax receipts increased 9.0 percent during the first quarter of FY12. Receipts of \$19.5 million compare to \$17.9 million received during the first quarter of FY11.

Motor vehicle operators' license fees totaled \$4.0 million, a 3.0 percent decrease compared to the level observed a year ago.

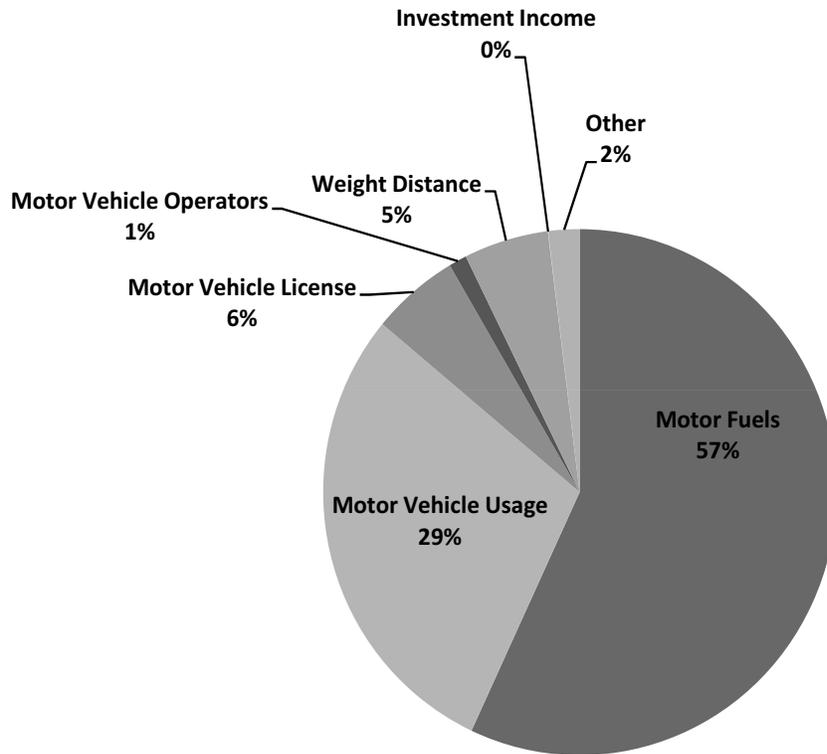
Weight distance tax receipts of \$18.9 million increased 0.9 percent compared to receipts of \$18.8 million collected during the first quarter of last year. The weight distance tax has some significance as a leading indicator of economic activity, as it is a rough proxy for goods in transit over Kentucky highways.

Investment income fell 90.9 percent in the first quarter due to lower investible balances. Receipts of just under \$50,000 compare to \$0.5 million in the first quarter of FY11.

The remainder of the accounts in the Road Fund combined for a decrease of 24.6 percent. Receipts for the "Other" category totaled \$7.0 million during the first quarter, compared to \$9.3 million in the first quarter of FY11.

Figure 2 details the composition of Road Fund revenues by tax type in the first quarter of FY12. Motor fuels taxes and the motor vehicle usage tax accounted for 86 percent of Road Fund revenues in the first quarter. The next-largest sources of revenue were motor vehicle license with six percent followed by weight distance tax with five percent. The "Other" category accounted for two percent, while motor vehicle operators' license fees comprised one percent. Investment income accounted for less than one percent of total Road Fund receipts.

Figure 2
Road Fund Receipts Composition
First Quarter, FY12



The Economy

First Quarter FY12

NATIONAL ECONOMY

Real GDP rose by 1.3 percent (annual rate) in the fiscal quarter ending June 2011 over the previous quarter.¹ The Bureau of Economic Analysis third estimate was revised up slightly from 1.0 percent which was reported in the second estimate. The small upward revision was based on a small adjustment to personal consumption expenditures. The first estimate, published in July 2011, was also 1.3 percent. Real GDP grew by 1.2 percent (annual rate) in the first quarter of FY12 over the fourth quarter of FY11 (IHS Global Insight estimates). See Table 3.

The last three quarters of growth are considerably muted compared to the moderate to good growth that occurred from the first quarter of FY10 to second quarter of FY11. Those six quarters of solid growth alone regained 76.2 percent of the losses from the 2007 recession. First quarter FY12 real GDP is still \$26.8 billion below its previous peak. During the 2007 recession, real GDP declined by \$684.7 billion, or 5.1 percent from peak to trough, a six-quarter period of contraction. From the fourth quarter of FY09 to the fourth quarter of FY11, real GDP grew a net 4.9 percent during that eight-quarter period.

Real consumption, which makes up 70.9 percent of real GDP, rose by 1.9 percent

over the first quarter of FY11. In absolute terms, real consumption was the largest contributor to real GDP growth in the first quarter, adding \$179.4 billion.

Real investment, which makes up 13.5 percent of real GDP, rose by 1.8 percent over the first quarter of FY11. Growth has tapered considerably over the last five quarters. The last five quarters of year over year growth were 25.5, 14.0, 7.4, 2.9 and 1.8 percent respectively. Real investment was the largest loser in both absolute and percentage terms in the 2007 recession. From peak to trough, real investment declined by \$869.1 billion, a 38.3 percent net decline. Despite several quarters of strong growth, real investment has only made up 55.2 percent of its 2007 recession losses to date.

Real government expenditures, which makes up 18.7 percent of real GDP, declined by 3.5 percent over the first quarter of FY11. Government expenditures are countercyclical. That is, they rise during a contraction and fall during an expansion. In the case of real government expenditures, the real GDP relationship is also slightly lagged. During a contraction, demand falls, employers cut hours, then employers layoff workers, and then transfers like unemployment insurance, food stamps and housing subsidies rise. The lag occurs because employers do not lay off workers immediately. And also it takes time for some of the transfers to be paid out. Also, the longer

¹ Third estimate released by Bureau of Economic Analysis on September 29, 2011 data release. All other data in this report reflect data and forecasts from IHS Global Insight's September 8, 2011 estimates.

the contraction, the more pronounced the increase in government expenditures. Real government expenditures have fallen (on an adjacent quarter basis) for the last four quarters and are now at the same level as they were in the fourth quarter of FY08. The previous peak for real GDP occurred in the second quarter of FY08.

Real exports, which makes up 13.4 percent of real GDP, rose by 5.6 percent over the first quarter of FY11. Real imports, a subtraction to real GDP, rose by 2.2 percent over the first quarter of FY11. Net exports rose slightly in the fourth quarter of FY11 from -\$421.2 billion to -\$411.3 billion, in the first quarter of FY12. The second consecutive quarter of improvement. For point of reference, net exports in the first quarter of FY08 (the quarter before the recession started) were -\$638.0 billion.

US personal income grew 0.6 percent in the first quarter of FY12 over the previous quarter. This was the eighth consecutive quarter of growth since reaching the trough in the first quarter of FY10. The 2007 recession had a significant impact on US personal income. Personal incomes declined for five consecutive quarters and lost a net 5.5 percent (\$697.6 billion) over that time. With solid growth immediately following the official end of the recession, US personal income surpassed its previous peak in the second quarter of FY11. While growth has tapered some in the first quarter, US personal income is 5.0 percent above its FY11 first quarter level.

Inflation has risen for the last four consecutive quarters. Inflation in the first quarter of FY12 was 3.8 percent, while inflation in the first quarter of FY11 was 1.2 percent. The

Table 3
Summary of US Economic Series
First Quarter, FY12 & FY11

	First Quarter			
	FY12	FY11	Chg	% Chg
Real GDP	13,299.2	13,139.6	159.6	1.2
Real Consumption	9,426.5	9,247.1	179.4	1.9
Real Investment	1,798.1	1,766.8	31.3	1.8
Real Govt. Expenditures	2,480.3	2,570.3	-90.0	-3.5
Real Exports	1,779.8	1,684.8	95.0	5.6
Real Imports	2,191.1	2,143.5	47.6	2.2
Personal Income (\$ billions)	13,078.5	12,453.2	625.3	5.0
Wages and Salaries (\$ billions)	6,688.3	6,454.5	233.8	3.6
Inflation (% chg CPI)	3.8	1.2	NA	NA
Industrial Production Index (percent change)	3.1	6.9	NA	NA
Civilian Labor Force (millions)	153.5	154.0	-0.5	-0.3
Total Non-farm Employment (millions)	131.1	129.9	1.3	1.0
Manufacturing Employment (millions)	11.8	11.6	0.2	1.8
Unemployment Rate (percent)	9.1	9.6	NA	NA

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.

Data for FY12 Q1 are September 2011 estimates.

Source: IHS Global Insight Inc., September 8, 2011 data release

money supply rose sharply in the first quarter 4.8 percent and that may have contributed to the increase in inflation.

US non-farm employment rose slightly in the first quarter to 131.1 million employed. This is only the fifth increase in employment since reaching a trough in the first quarter of FY11. US employment is still significantly below its pre-recession peak of 137.9 million employed.

KENTUCKY ECONOMY

Kentucky personal income grew by 2.7 percent in the first quarter over the previous quarter. This is 6.4 percent above the first quarter of FY11. While the first quarter growth is better than US personal income growth, it is still not a robust or even an average recovery. The previous peak in

Kentucky personal income occurred in the fourth quarter of FY08. The trough occurred in the third quarter of FY09, three quarters later. Growth in the nine quarters following the trough were 0.7, -0.1, 0.5, -0.1, 1.3, 1.2, 0.4, 1.9, and 1.2 percent respectively. Over the last two expansionary periods, average Kentucky personal income growth was 1.3 percent. So Kentucky personal income has been well below the historical average for most of this expansion period.

Kentucky wages and salaries rose by 0.5 percent in the first quarter over the fourth quarter of FY11. Wages and salary growth has slowed over the last three quarters. In the third and fourth quarters of FY11, wages and salaries grew by 1.5 and 1.4 percent respectively on an adjacent-quarter basis. The two fastest growing segments of Kentucky personal income in the first quarter

Table 4
Summary of Kentucky Economic Series
First Quarter, FY12 & FY11

	First Quarter			
	FY12	FY11	Chg	% Chg
Personal Income (\$ millions)	150,920.4	141,866.0	9,054.4	6.4
Wages and Salary (\$ millions)	75,037.0	73,170.0	1,867.0	2.6
Non-farm Employment (thousands)	1,793.7	1,770.5	23.2	1.3
Goods-producing	308.5	299.2	9.3	3.1
Construction	67.3	67.0	0.3	0.4
Mining	25.0	22.5	2.5	11.1
Manufacturing	216.2	209.7	6.5	3.1
Service-providing	1,159.5	1,138.8	20.7	1.8
Trade, Transportation & Utilities	362.8	359.8	3.0	0.8
Information	26.2	25.9	0.4	1.4
Finance	86.1	85.6	0.5	0.6
Business Services	186.0	180.1	5.9	3.3
Educational Services	254.0	249.6	4.5	1.8
Leisure and Hospitality Services	172.0	166.5	5.4	3.3
Other Services	72.4	71.3	1.1	1.5
Government	325.7	332.5	-6.8	-2.1

Not Seasonally Adjusted. Data for FY12 Q1 are September 2011 estimates.

Source: IHS Global Insight Inc., September 8, 2011 data release

were transfer income and dividends, interest and rents income, which grew at 0.9 and 1.0 percent respectively.

The components of personal income have shifted over the last decade. Wages and salaries income made up 49.7 percent of Kentucky personal income in the first quarter of FY12. This share has gone down only slightly over the last decade, falling from 53.9 percent in the first quarter of 2001. Transfer payments, on the other hand, have risen sharply in the last decade, rising from 17.4 percent share of Kentucky personal income in the first quarter of FY01 to 24.6 percent share in the first quarter of FY12.

It is expected that transfer payments increase during recessions, as individuals apply for unemployment insurance, food stamps and Medicare, as other sources of income are reduced. It is surprising, however, that the share of transfer income does not go down during the last two expansion periods, as employment improves and incomes rise.

The shares of only two categories of personal income grew over the last decade, transfer income and supplement income. The share of supplement income grew from 11.8 percent of personal income in the first quarter of FY01 to 14.0 percent share in the first quar-

ter of FY12. The other categories of personal income each fell by small amounts over the last decade.

Kentucky non-farm employment rose by 1.3 percent from the first quarter of FY11 to the first quarter of FY12. Growth has been small or declining since employment reached its trough in the third quarter of FY10. No particular supersector of employment showed good growth in the first quarter. The fastest growing supersector on a percentage basis was mining employment which grew by 11.1 percent compared to a year ago. Manufacturing employment grew by the largest absolute amount, contributing an additional 6,500 jobs, or 3.1 percent, to non-farm employment gains. Only one supersector contracted from the first quarter of FY11 to the first quarter of FY12 and that was government employment. Government employment includes state, county and local government employment and declined by 6,800 jobs, a 2.1 percent decrease over that period. Construction employment grew by 4.2 percent in the first quarter over the fourth quarter of FY11. This increase in jobs follows 12 consecutive quarters of losses in construction employment in the state. The previous peak in construction employment was 86,200 jobs, which occurred in the second quarter of FY08. Current construction employment is 67,300 jobs.

Interim Outlook

GENERAL FUND

The revenue estimates in this report were prepared using the September 2011 control economic forecast from both IHS Global Insight and the Kentucky MAK model, which is operated by the Governor's Office for Economic Analysis within the Office of State Budget Director. The outlook for the national economy, as measured by real GDP, is for growth very near zero. The Global Insight weight for the pessimistic forecast (which is characterized as a full-blown recession is 40 percent, equal to the highest probability ever assigned to a pessimistic scenario).

The official enacted General Fund estimate for FY12 is \$8,871.2 million. The unofficial interim outlook, generated using the control forecast, calls for FY12 General Fund

revenues of \$9,046.6 million, or \$175.4 million over the official enacted estimates. A portion of the severance receipts is dedicated to go back to the counties and therefore, the actual difference from the official estimate is \$142.7 million.

Projected General Fund revenues for the next three quarters are shown in Table 5. As the table indicates, corporate income tax and LLET are the largest sources for the difference in the current estimate over the enacted estimates.

It is not surprising that sales and use tax estimates for the next three quarters are low. Sales and use receipts are closely tied to personal income and disposable income. The forecasts for these two series is greatly dampened and therefore sales and use tax

Table 5
General Fund Interim Forecast
(\$ millions)

	FY12						FY12 Off.	
	Q1		Q2, Q3, & Q4		Full Year		Budget Estimate	\$ Diff
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg		
Sales & Use	768.4	7.1	2,202.6	1.1	2,971.0	2.6	3,032.9	-61.9
Individual Income	886.0	4.8	2,637.0	2.5	3,523.0	3.1	3,486.6	36.4
Corporation Inc & LLET	140.8	23.3	443.9	10.3	584.7	13.2	369.0	215.7
Coal Severance	80.2	10.1	238.2	6.8	318.4	7.6	230.8	87.6
Cigarette Taxes	66.5	-3.7	187.1	-3.2	253.6	-3.4	278.8	-25.2
Property	38.1	-26.3	494.8	6.8	532.9	3.5	556.9	-24.0
Lottery	46.0	2.2	164.0	5.5	210.0	4.7	212.0	-2.0
Other	130.5	-6.4	522.5	1.3	653.0	-0.4	663.0	-10.0
Total General Fund	2,156.5	4.9	6,890.1	2.8	9,046.6	3.3	8,871.2	175.4

estimates are also low. So despite some improvement over the last three quarters and strong growth in the first quarter of FY12, sales and use receipts are expected to rise by only 1.1 percent in the next three quarters compared the same three quarters of FY11.

Individual income tax receipts, which are composed of four major components (withholding, declarations, fiduciary and net returns), are expected to increase only modestly over the next three quarters. The largest component of individual income tax receipts is withholding, which makes up 98 percent of total individual income tax receipts. Withholding in turn is closely tied to wages and salaries and employment in the state. As growth in these two series declines, so too does the growth in withholding. Individual income tax receipts are expected to rise by 2.5 percent in the next three quarters compared to the same three quarters in FY11.

Corporate income tax and LLET both posted strong growth in the last five quarters. In FY11, they posted 26.4 and 47.8 percent respectively over FY10. In the first quarter they posted 23.3 percent combined growth. Given that US corporate profits are increasing and expected to continue rising, it is not surprising that the Kentucky corporate income tax is also expected to improve over the forecast horizon. The outlook for corporate income tax and LLET receipts combined is an increase of 10.3 percent for the next three quarters over the same three-quarter period in FY11.

Coal receipts in FY11 grew by a robust 8.8 percent over FY10 levels. Severed tons continue to shrink. Kentucky severed 28.6 million tons of coal in the first quarter of FY12. This is fast approaching the 12-year

low of 27.5 million tons, which was severed in the third quarter of FY07. While severed tons have declined nearly every quarter for the last two years, the rise in prices has offset those declines and both gross value of coal and tax receipts have continued to rise. The outlook for coal severance receipts is good as prices are expected to remain high; growth of 13.0 percent in the next three quarters is expected compared to the same three quarters in FY11.

Both nationally and state-wide smoking has declined, as measured by packs sold. Cigarette receipts declined by 5.8 percent in FY11 compared to FY10. First quarter FY12 cigarette receipts decreased by 3.7 percent over the first quarter FY11. There are several factors occurring which cloud the tax receipts data, for what otherwise would be a simple decline in demand. First, there is the issue of border states increasing their tax rates and therefore there is a considerable flow of cigarettes being sold to out of state individuals. As border states raise their taxes, Kentucky's cigarettes gain a price advantage and this increases cigarette sales. Second, there is the issue of increased compliance by the Kentucky Department of Revenue. Vendors, who may be unaware of the law or are simply not purchasing the cigarette stamps in accordance with the law, are brought into compliance and this increases revenue both on the current stamps purchased and on all future stamp purchases. The primary source of cigarette tax receipts growth is from border sales. In the long-term and on an annual basis, cigarette tax receipts are still falling. The outlook for cigarette tax receipts is in accordance with that trend and receipts are expected to fall 10.3 percent over the next three quarters.

Lottery receipts are determined based on the Lottery Corporation's dividend schedule

which was approved during their Spring meeting. Scratch-off tickets performed poorly in the previous quarter, but are expected to improve returning to historical averages. Lottery receipts will therefore rise to \$210.0 million for FY12, which is 4.7 percent greater than in FY11.

The “Other” category contains dozens of smaller accounts, which make up the remainder of the General Fund. Insurance premiums tax, the beer wholesale tax and the inheritance tax are the three largest accounts in the “Other” category. The net of “Other” category taxes are expected to rise by 1.3 percent in the next three quarters compared to the same three quarters in FY11.

ROAD FUND

Road Fund revenues are forecasted to increase 5.9 percent over the remaining three quarters of FY12 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, weight distance and “Other” are also forecasted to show moderate growth.

Motor fuels tax receipts are forecasted to grow 8.9 percent in the last three quarters of FY12. This is due principally to a rise in the forecasted average wholesale gasoline prices

and its effect on the statutory rate of the motor fuels tax. A higher average wholesale price of gasoline will raise the variable portion of the motor fuels tax rate, generating increased tax revenues. Taxable gallons, on the other hand, are expected to remain essentially unchanged from FY11 levels.

Motor vehicle usage tax collections are expected to rise 1.9 percent in the final nine months of FY12 after growing 8.5 percent in the first quarter. Receipts will slow over the final three quarters of the fiscal year as slow growth in personal income and weak demand for motor vehicles depress collections in this account.

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 increase 0.4 percent in the final three quarters of FY12. Motor vehicle operators’ licenses are projected to fall 0.1 percent in the remainder of the fiscal year. Weight distance tax revenue is expected to grow 1.9 percent for the remainder of the fiscal year. Investment income will fall 82.1 percent due to lower interest rates. All other revenues should combine for growth of 10.6 percent during the last nine months of FY12.

Table 6
Road Fund Interim Forecast
(\$ millions)

	FY12						FY12 Off.	
	Q1		Q2, Q3, & Q4		Full Year		Budget	\$ Diff
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	
Motor Fuels	201.7	4.5	587.8	8.9	789.5	7.7	712.6	76.9
Motor Vehicle Usage	103.2	8.5	292.0	1.9	395.2	3.5	398.1	-2.9
Motor Vehicle License	19.5	9.0	80.2	0.4	99.7	1.9	94.7	5.0
Motor Vehicle Operators	4.0	-3.0	11.6	-0.1	15.6	-0.9	15.5	0.1
Weight Distance	18.9	0.9	56.3	1.9	75.2	1.6	84.8	-9.6
Investment	0.0	-91.1	2.8	82.1	2.8	40.4	1.3	1.5
Other	7.0	-24.7	28.1	10.6	35.1	1.2	33.9	1.2
Total Road Fund	354.4	4.6	1,058.7	5.9	1,413.1	5.5	1,340.9	72.2

NATIONAL ECONOMY

Since the last Quarterly Economic & Revenue Report, the outlook for the US economy has taken a decidedly pessimistic turn in the broad aggregates of real GDP, personal income and employment. The Fourth Quarter FY11 Quarterly Report anticipated growth in the first three quarters of FY12 of 2.8 percent for real GDP, 4.3 percent for personal income and 1.7 percent for total non-farm employment.

The current forecast, which covers the final three quarters of FY12 and, by extension, the full fiscal year, sees reductions in the growth rates of all three of these vital aggregates. Growth in real GDP has been revised downward to 1.7 percent for the full year. Personal income growth is expected to slow to 3.4 percent in FY12 while total non-farm employment is expected to increase by only 0.8 percent.

IHS Global Insight provides OSBD with their U.S. economic forecast and they see the U.S. economy “on thin ice”. While not forecasting a full recession, they place the

odds of a double dip at 40 percent (the pessimistic scenario) because “weak momentum leaves the economy vulnerable to shocks”. Analysis by Global Insight shows the U.S. economy expanding in FY12 but only 1.4 percent for the final three quarters.

The components of real GDP show varying rates of growth for the current fiscal year. Consumption, the largest piece of GDP, is expected to grow 2.0 percent for the FY12 which will help offset an anticipated 3.3 percent decline in government expenditures. Investment will grow 4.2 percent; however, that is a sharp revision from the 11.1 percent forecast in the fourth quarter FY11 report. Imports and exports are expected to grow 2.1 percent and 5.9 percent respectively for FY12.

Personal income and wages and salaries are forecasted to rise 3.4 percent and 3.1 percent in FY12. Incorporated into the forecast are the assumptions that there will be no major injection of new stimulus from the President's jobs proposals but that the two percent employee payroll tax cut and emergency unemployment insurance benefits will be extended into 2012.

Global Insight sees core inflation easing in the second half of the year as commodity prices are off their peaks. Inflation is expected to end FY12 at 2.8 percent.

Total non-farm employment is forecast to be essentially flat, increasing only 0.8 percent for FY12 while the unemployment rate will tick up to 9.2 percent by the end of FY12.

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

	Q2, Q3, & Q4			Full Year	
	FY12	FY11	% Chg	FY12	% Chg
Real GDP	13,416.0	13,234.8	1.4	13,485.7	1.7
Real Consumption	9,518.1	9,364.0	1.6	9,570.4	2.0
Real Investment	1,827.7	1,754.5	4.2	1,852.8	4.2
Real Govt. Expenditures	2,446.3	2,524.8	-3.1	2,426.2	-3.3
Real Exports	1,835.4	1,743.1	5.3	1,866.8	5.9
Real Imports	2,213.5	2,163.0	2.3	2,229.6	2.1
Personal Income (\$ billions)	13,315.2	12,806.5	4.0	13,434.1	3.4
Wages and Salaries (\$ billions)	6,802.5	6,571.2	3.5	6,865.3	3.1
Inflation (% chg CPI)	2.5	2.2	NA	2.8	NA
Industrial Production Index (% chg)	2.2	5.2	NA	2.4	NA
Civilian Labor Force (millions)	153.6	153.6	0.1	153.7	0.2
Total Non-farm Employment (millions)	131.7	130.6	0.9	132.1	0.8
Manufacturing Employment (millions)	11.8	11.6	1.8	11.9	1.8
Unemployment Rate (percent)	9.3	9.2	NA	9.2	NA

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.

Data for FY12 Q2 through FY12 Q4 are September 2011 estimates.

Source: IHS Global Insight Inc., September 8, 2011 data release

KENTUCKY ECONOMY

The 2007 recession impacted Kentucky in a somewhat different way than it impacted the US economy. The US economy experienced large losses in both personal income and employment. In Kentucky, employment fell by a similar percentage to the US (-6.0 percent vs. -6.2 percent respectively), but the losses to personal income were quite different between Kentucky and the nation.

The US lost a net 5.5 percent in total personal income from peak to trough during the 2007 recession. Meanwhile, Kentucky lost a net 2.8 percent in total personal income from peak to trough. Kentucky personal income growth has been improved over the last

couple quarters. Personal income grew by 2.7 percent over the fourth quarter of FY11, which is very good for one quarter of growth. The outlook, however, is for much more muted growth for the next three quarters. Growth of just under one percent is expected for each of the next three quarters.

Kentucky employment fell by 6.0 percent from peak to trough, while US non-farm employment fell by 6.2 percent. Both of these have been improving since their respective troughs, but with very weak growth. Kentucky employment growth is expected to improve over the next three quarters rising to 0.2 percent in each of the next two quarters and rising to 0.3 percent in the fourth quarter. A growth rate of 0.3 percent during an expansion period is

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

	Q2, Q3, & Q4			Full Year	
	FY12	FY11	% Chg	FY12	% Chg
Personal Income (\$ millions)	153,266.0	144,794.7	5.9	154,445.7	5.1
Wages and Salary (\$ millions)	76,322.3	73,619.0	3.7	77,016.1	3.1
Non-farm Employment (thousands)	1,800.8	1,785.6	0.8	1,805.3	0.7
Goods-producing	309.0	300.1	3.0	309.0	2.9
Construction	65.7	65.3	0.6	65.0	0.8
Mining	24.7	22.7	8.8	24.3	6.4
Manufacturing	218.6	212.1	3.1	219.6	3.1
Service-providing	1,168.8	1,156.1	1.1	1,174.5	0.8
Trade, Transportation & Utilities	366.6	359.9	1.9	369.2	2.5
Information	26.2	26.0	1.0	26.2	0.7
Finance	86.4	85.4	1.1	86.7	2.3
Business Services	187.4	185.0	1.3	188.2	0.9
Educational Services	256.1	252.6	1.4	257.0	1.4
Leisure and Hospitality Services	173.4	175.3	-1.1	174.6	-3.9
Other Services	72.7	71.9	1.2	72.7	0.1
Government	323.0	330.5	-2.3	321.8	-2.4

Not Seasonally Adjusted.

Source: IHS Global Insight, Inc. and the Kentucky Governor's Office for Economic Analysis
MAK model, September 2011.

considered very modest growth, not particularly weak nor strong.

For the last decade, there has been a high demand for coal miners. For many reasons, there has been an insufficient supply of workers. Even before the recession, there were many quarters where mining employment declined regularly. In 2009 alone, mining employment dropped by over 3,000 workers. So despite a good jump in mining employment in the first quarter (a gain of 2,100 jobs, or +9.5 percent), the outlook for mining employment is poor. Over the next three quarters, it is expected that Kentucky will lose only 700 net seasonally adjusted jobs.

The 2007 recession had a profound impact on Kentucky manufacturing. Like the 2001 recession, it is projected that many of those jobs simply will not come back to Kentucky. There was essentially no growth at all during the expansion period following the 2001 recession. Growth since the official end of the 2007 recession has been scarce. Therefore any growth is viewed as a very good sign for manufacturing. The current quarter growth of 1.5 percent over the fourth quarter of FY11 was the best single-quarter growth of the entire decade. The outlook for the next three quarters is modest, but very promising. A net gain of 3,400 seasonally adjusted jobs is expected over the next three quarters. In percentage

terms, this is less than one percent growth but it is still excellent relative to the last decade.

Leisure and hospitality services sector growth has been erratic even before the 2007 recession hit. Employment in this sector started to pull down as far back as the second quarter of FY06. A substantial loss of employment in leisure and hospitality occurred in the first quarter of FY12, losing 9,700 seasonally-adjusted jobs in just one quarter, a 5.3 percent decline. The outlook is weak but still positive for the next three quarters, with leisure and hospitality gaining a net 2,600 jobs.

The government employment sector, which includes state, county and local government employees, is expected to continue its losses in employment over the next three quarters. Government employment has declined for the last two consecutive quarters with sizeable single-quarter declines. Those sizable declines are expected to continue. It is expected that an additional 3,900 seasonally-adjusted jobs will be lost over the next three quarters. Government employment has declined in four of the last five quarters. Government employment has just now fallen back to its 2008 levels. This is not uncommon following a recession, as government-provided services begin to decline and less staff are needed to provide those services.

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APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	First Quarter FY 2012	First Quarter FY 2011	%
			Change
TOTAL GENERAL FUND	\$2,156,453,495	\$2,055,095,794	4.9%
Tax Receipts	\$2,095,978,360	\$1,990,193,861	5.3%
Sales and Gross Receipts	\$918,153,603	\$869,652,836	5.6%
Beer Consumption	1,682,894	1,792,037	-6.1%
Beer Wholesale	15,146,001	14,823,556	2.2%
Cigarette	66,497,668	69,001,313	-3.6%
Distilled Spirits Case Sales	29,396	(316,506)	---
Distilled Spirits Consumption	2,881,777	2,767,839	4.1%
Distilled Spirits Wholesale	7,202,826	6,905,018	4.3%
Insurance Premium	28,225,403	29,673,246	-4.9%
Pari-Mutuel	550,119	1,945,337	-71.7%
Race Track Admission	82,477	86,736	-4.9%
Sales and Use	768,399,587	717,229,493	7.1%
Wine Consumption	638,976	602,545	6.0%
Wine Wholesale	3,231,292	3,378,775	-4.4%
Telecommunications Tax	17,940,009	16,153,615	11.1%
OTP	5,627,723	5,569,665	1.0%
Floor Stock Tax	17,454	40,169	-56.5%
License and Privilege	\$141,887,292	\$134,345,111	5.6%
Alc. Bev. License Suspension	49,875	99,250	-49.7%
Coal Severance	80,208,638	72,839,852	10.1%
Corporation License	510,123	3,403,741	-85.0%
Corporation Organization	0	19,412	-100.0%
Occupational Licenses	25,144	33,102	-24.0%
Oil Production	2,338,957	1,821,582	28.4%
Race Track License	95,000	105,000	-9.5%
Bank Franchise Tax	(923,907)	2,489,017	---
Driver License Fees	162,721	165,064	-1.4%
Minerals Severance	4,286,831	3,977,297	7.8%
Natural Gas Severance	6,486,200	5,136,472	26.3%
Limited Liability Entity	48,647,710	44,255,323	9.9%
Income	\$978,106,526	\$915,602,843	6.8%
Corporation	92,147,881	69,901,358	31.8%
Individual	885,958,646	845,701,485	4.8%
Property	\$38,053,283	\$51,625,502	-26.3%
Building & Loan Association	(2,299)	(53,180)	---
General - Real	(370,124)	(683,968)	---
General - Tangible	27,245,797	22,301,036	22.2%
Omitted & Delinquent	(2,851,363)	15,315,505	-118.6%
Public Service	13,700,361	14,509,632	-5.6%
Other	330,911	236,477	39.9%
Inheritance	\$11,231,115	\$11,333,007	-0.9%
Miscellaneous	\$8,546,541	\$7,634,563	11.9%
Legal Process	5,137,388	5,208,501	-1.4%
T. V. A. In Lieu Payments	3,404,199	2,400,284	41.8%
Other	4,954	25,778	-80.8%
Nontax Receipts	\$59,664,925	\$64,334,885	-7.3%
Departmental Fees	3,436,777	5,838,998	-41.1%
PSC Assessment Fee	5,422,569	8,869,505	-38.9%
Fines & Forfeitures	6,756,752	6,309,597	7.1%
Interest on Investments	247,598	190,583	29.9%
Lottery	46,000,000	45,000,000	2.2%
Sale of NOx Credits	0	22,513	-100.0%
Miscellaneous	(2,198,771)	(1,896,310)	---
Redeposit of State Funds	\$810,210	\$567,048	42.9%

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	First Quarter FY 2012	First Quarter FY 2011	%
			Change
TOTAL ROAD FUND	\$354,374,262	\$338,682,693	4.6%
Tax Receipts-	\$349,547,826	\$331,339,707	5.5%
Sales and Gross Receipts	\$304,893,545	\$288,121,203	5.8%
Motor Fuels Taxes	201,716,875	193,009,964	4.5%
Motor Vehicle Usage	103,176,670	95,111,239	8.5%
License and Privilege	\$44,654,281	\$43,218,504	3.3%
Motor Vehicles	19,504,643	17,900,500	9.0%
Motor Vehicle Operators	4,028,959	4,151,824	-3.0%
Weight Distance	18,915,798	18,754,429	0.9%
Truck Decal Fees	50,802	34,267	48.3%
Other Special Fees	2,154,079	2,377,485	-9.4%
Nontax Receipts	\$4,614,271	\$6,054,380	-23.8%
Departmental Fees	4,282,325	5,037,434	-15.0%
In Lieu of Traffic Fines	187,475	192,973	-2.8%
Investment Income	43,671	481,952	-90.9%
Miscellaneous	100,800	342,021	-70.5%
Redeposit of State Funds	\$212,165	\$1,288,606	-83.5%