COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report

Second Quarter • Fiscal Year 2012

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

Office of State Budget Director
Capitol Building, 700 Capitol Avenue
Frankfort, Kentucky 40601

Steven L. Beshear
Governor

(502) 564-2611 or (502) 564-7300
FAX: (502) 564-7022 or (502) 564-6684
Internet: osbd.ky.gov

Mary E. Lassiter
State Budget Director

Governor's Office for Policy and Management
Governor's Office for Economic Analysis
Governor's Office for Policy Research

January 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 second quarter of Fiscal Year 2012 (FY12). It also includes an interim economic and revenue forecast for the last two quarters of FY12 and the first quarter of FY13.

General Fund receipts for the second quarter of FY12 totaled $2,329.9 million, an increase of 1.4 percent or $31.6 million compared to the same period in FY11. Road Fund revenues totaled $347.1 million, an increase of 10.4 percent or $32.8 million over the second quarter of FY11.

The interim General Fund forecast for the final two quarters of FY12 calls for an increase of 2.6 percent compared to the same period one year ago, resulting in an unofficial interim outlook for the entire FY12 of $9,007.7 million. Corporate income tax and coal severance tax are the largest sources of growth for FY12.

The interim estimates in this report are based on a "control scenario" forecast for the national and Kentucky economies as adopted by the Consensus Forecasting Group (CFG) in December 2011. The revised official revenue estimate for the General Fund for FY12 is $9,007.7 million representing 2.8 percent growth, and is also the interim estimate used in this Quarterly Report.

The interim forecast for the Road Fund for the final two quarters of FY12 is $711.0 million and calls for an increase of 3.7 percent over FY11. The interim estimate for the entire FY12 is $1,412.5 million and is consistent with the revised official revenue estimate rendered by the CFG in December 2011.

Having completed two quarters in this fiscal year, we are pleased that revenues are on track to meet the revised estimates. 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 second quarter of FY12. As required by law, 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.

This second edition of the Quarterly Report reports the official estimate for the current year as well as a first look at the opening quarter of the upcoming fiscal year. The Consensus Forecasting Group (CFG) met last month and rendered official General Fund and Road Fund estimates, which are presented in Tables 5 and 6 of this report.

To fulfill the requirement to provide an update on current economic conditions, two sections of narrative information are included in this report. The first section profiles the most recent history of the US and Kentucky economies. Later, in the outlook section of the report, a three-quarter outlook is provided using the control forecast from Global Insight as well as the MAK model for Kentucky which is developed, maintained, and operated by the OSBD.

Some of the highlights of this report are summarized here. For greater detail, please refer to the relevant portions of the report.

Second quarter General Fund receipts increased $31.6 million, or 1.4 percent, over the same quarter in FY11. Corporate and individual income tax receipts provided most of the growth and offset significant reductions in the property and the limited liability entity taxes (LLET).

Road Fund tax collections increased $32.8 million, or 10.4 percent, in the first six months of FY12 compared to receipts in the same time frame last year. Motor fuels, motor vehicle usage and license taxes provided the majority of the growth.

The national economy, as measured by real gross domestic product (real GDP), rose only 1.6 percent in the second quarter of FY12. The fact that in the 10 quarters following the trough of the 2007 recession, real GDP is only $98.9 billion above the previous peak speaks to both the depth of the recession as well as the lack of a robust recovery.

Kentucky personal income rose 4.1 percent in the second quarter of FY12, the eighth consecutive quarterly increase. Personal income growth remains strong despite weak growth in employment.

Growth in General Fund receipts are estimated to slow slightly over the final six months of the fiscal year before turning negative in the first quarter of FY13. A sharp decline in sales and use taxes is the impetus for the FY13 quarter one decline.

Growth in Road Fund revenues is expected to slow significantly over the second half of FY12. However, nominal collections are anticipated to increase $9.5 million compared to the first two quarters of the fiscal year.

Revenue Receipts

GENERAL FUND

Revenue collections grew 1.4 percent, or $31.6 million, in the second quarter of FY12 following a 4.9 percent increase in the first quarter of the year. Through the first two quarters of the fiscal year, receipts have increased 3.1 percent. Revenues have now grown in seven consecutive quarters which followed five consecutive declines.

Second quarter gains were driven primarily by improvements in corporation income, individual income and sales and use tax receipts. Those revenue sources accounted for an increase of $62.2 million in the second quarter. Receipts in the second quarter totaled $2,329.9 million compared to $2,298.4 million received in the second quarter of FY11. 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.

Total sales and use tax receipts for the quarter were $742.6 million, compared to $732.9 million in the second quarter of FY11. The 1.3 percent increase is a slight improvement compared to the 6.1 percent increase in the second quarter of last year. Year-to-date sales tax receipts have increased 4.2 percent.

Table 1
Summary General Fund Receipts
Second Quarter, FY12, $ millions

	FY12	FY11	Diff ($)	Diff (%)
Individual Income	843.0	829.1	13.9	1.7
Sales and Use	742.6	732.9	9.7	1.3
Property	279.0	299.2	-20.2	-6.7
Corporate Income	94.5	56.0	38.5	68.7
Coal Severance	79.7	72.2	7.5	10.4
Cigarette Taxes	60.3	66.9	-6.6	-9.9
LLET	38.2	53.5	-15.3	-28.6
Lottery	55.5	50.0	5.5	11.0
Other	137.1	138.5	-1.4	-1.0
Total	**2,329.9**	**2,298.4**	**31.6**	**1.4**

Individual income tax posted receipts of $843.0 million compared to last year's second quarter receipts of $829.1 million. The resulting growth rate was 1.7 percent and compares to a growth rate of 5.2 percent in the second quarter of last year. Withholding and declarations receipts, two components of the individual income tax, grew compared to the same time frame last year. Fiduciary and net return payments decreased due to timing differences.

Variations in the quarterly receipts are often affected by differences in the timing of payments into revenue accounts. While timing differences were not as prevalent as in the past, property tax receipts continue to record fluctuations because of these differences. The due-date for timely paid real property tax payments is December 31st of each year. The late due date creates timing differences as payments are transferred from the county sheriffs' offices to the state account.

Second-quarter property tax receipts posted revenues that were $20.2 million less than the second quarter of FY11. The difference is due mainly to timing issues in the real property sub-category. Second-quarter receipts of FY12 of $279.0 million compare with $299.2 million from the second quarter of FY11.

Combined corporation income and LLET receipts were up in the second quarter of the fiscal year. Revenues of $132.7 million were 21.2 percent more than year-earlier figures of $109.5 million.

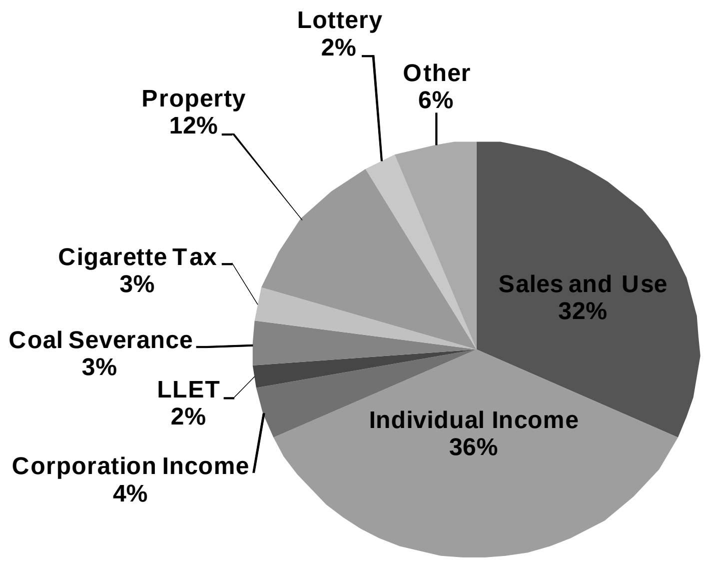
Coal severance tax revenue increased in the second quarter, with receipts up 10.4 percent. Collections of $79.7 million compare to the FY11 second quarter total of $72.2 million.

Cigarette tax receipts of $60.3 million in the second quarter of FY12 declined slightly compared to last year's total of $66.9 million. Year-to-date, cigarette tax receipts have fallen 6.7 percent due to lower sales.

Lottery receipts were $55.5 million, which were 11.0 percent above last year's second-quarter total of $50.0 million.

The "Other" category, which represents the remaining accounts of the General Fund, decreased 1.0 percent in the second quarter. Second quarter receipts for FY12 were $137.1 million compared to $138.5 million in FY11.

Figure 1
General Fund Receipts Composition
Second Quarter, FY12



ROAD FUND

The Road Fund reported growth of 10.4 percent in the second quarter of FY12. Receipts totaled $347.1 million and compare to $314.3 million from the second quarter of last year. Summary data are contained in Table 2 and detailed data are shown in the Appendix.

Motor fuels tax receipts were $199.6 million for the quarter and compare to $183.7 million collected during the second quarter of last year. The 8.6 percent growth is due primarily to the increase in the formula-driven tax rate.

Motor vehicle usage tax has increased 10.7 percent in the second quarter. Receipts during the second quarter of FY12 totaled $93.3 million and compare to $84.2 million collected during the same period last year. The strong growth in this account is the result of an increase in motor vehicle sales.

Motor vehicle license tax receipts increased 33.9 percent in the second quarter of FY12 to $22.5 million.

Motor vehicle operators license tax receipts were $3.9 million in the second quarter of FY12.

Weight distance tax receipts of $19.0 million represent a 1.6 percent increase compared to receipts of $18.7 million during the second quarter of FY11. The weight distance tax is typically considered a good leading indicator of manufacturing output, so growth in this account is a small, but encouraging sign that factory activity is improving.

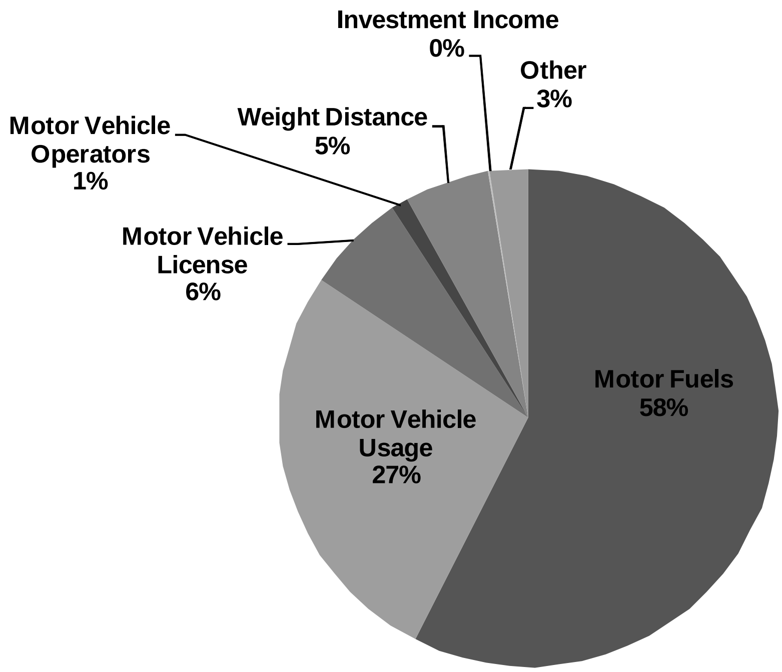
Investment receipts of $0.2 million were down 51.1 percent over the total collected in the second quarter of FY11.

The remainder of the accounts in the Road Fund combined for an increase of 33.2 percent from a year earlier. In the “Other” category, revenues of $8.7 million compare to $6.5 million in the second quarter of FY11.

Table 2
Summary Road Fund Receipts
Second Quarter, FY12, $ millions

	FY12	FY11	Diff ($)	Diff (%)
Motor Fuels	199.6	183.7	15.9	8.6
Motor Vehicle Usage	93.3	84.2	9.1	10.7
Motor Vehicle License	22.5	16.8	5.7	33.9
Motor Vehicle Operators	3.9	3.9	-0.1	-2.4
Weight Distance	19.0	18.7	0.3	1.6
Investment Income	0.2	0.4	-0.2	-51.1
Other	8.7	6.5	2.2	33.2
Total	**347.1**	**314.3**	**32.8**	**10.4**

Figure 2
Road Fund Receipts Composition
Second Quarter, FY12



The Economy
Second Quarter FY12

NATIONAL ECONOMY

Real gross domestic product (real GDP) is the broadest measure of economic activity for a nation. It is defined as the sum of all goods and services sold within a country's physical boundaries in a given year. Real GDP can be broken down into five major components: consumption, investment, government expenditures, exports and imports. Real GDP for the United States is estimated to have risen to $13,424.9 billion in the second quarter of FY12.

Real GDP rose by a modest 1.6 percent in the second quarter of FY12. In the second quarter of FY12, 10 quarters following the trough of the 2007 recession, real GDP is only $98.9 billion above the previous peak. It took nine quarters from the trough to finally surpass the previous peak. This length is a statement about both the depth of the 2007 recession and the lack of a robust recovery. The five GDP components behaved very differently during the 2007 recession. The trough in real GDP occurred in the fourth quarter of FY09. Since then, real GDP has increased by a net $783.6 billion, or 6.2 percent.

The five GDP components also behaved quite differently during the current expansion. Consumption was the largest absolute net contributor during the expansion, contributing $507.6 billion to GDP growth. Investment was the largest percentage net contributor during the expansion, contributing $419.1 billion, or 30.0 percent to GDP growth. Government expenditures are a countercyclical component of GDP, which means that during contractions, government expenditures rise and during expansions, government expenditures fall. Exports contributed $351.1 billion, or 24.2 percent, to GDP growth during the expansion. Imports, which are subtracted from total GDP, rose by $408.4 billion during the expansion. Imports rose by more than exports, therefore, net exports detracted from GDP growth during the expansion. It is a complete coincidence that the trough for consumption, investment, exports and imports each coincided with the trough for real GDP in the fourth quarter of FY09.

Real consumption has been the largest absolute contributor to real GDP growth over the last five quarters, contributing an additional $177.8 billion to real GDP over the second quarter of FY11. (see Table 3) Real investment and exports have been the two fastest growing components over the last five quarters with 4.7 and 4.9 percent growth respectively. During the last five quarters, export growth has outpaced import growth, causing the trade deficit to shrink slightly. The trade deficit shrank by $69.6 billion to $389.1 billion during the second quarter of FY12.

In the nine quarters since the trough in US personal income, there have been only two quarters which have performed at or above the expansion-period average growth rate of 1.5 percent. The last four adjacent-quarter growth rates are 2.1, 0.8, 0.2, and 0.7 percent. US personal income has increased by a net 3.9 percent since the second quarter of FY11. Wages and salaries, which makes up approximately 51 percent of personal income, has risen at about the same pace as total personal income since the recession trough. Wages and salaries grew 3.5 percent over the second quarter of FY11.

Inflation has tapered slightly in the second quarter compared to the first quarter, falling from 3.1 percent annual rate to 1.0 percent annual rate. The last five quarters were precipitously high, 2.6, 5.2, 4.1, 3.1 and 1.0 respectively. The figures depicted in Table 3 show the change in the CPI as compared to the same quarter the previous year. So on net, prices have grown by 3.3 percent from the second quarter of FY11 to the second quarter of FY12. Growth rates above two percent compared to the previous quarter are considered 'high'. These measures of inflation are for "all goods" and therefore they include energy commodities, which can greatly influence the overall inflation measure.

US employment is growing much slower than in previous expansion periods. During the last two years of the 1990s, US employment grew a net 6.0 percent. During the 2004 to 2006 period, employment grew a net 4.7 percent. During the last eight quarters, following the trough of the 2007 recession, US employment has grown only 1.8 percent. Quarter to quarter growth is low and stable around 0.2 and 0.3 percent. Net growth over the second quarter of FY11 is 1.2 percent, which is well below historical averages for an expansion period. US manufacturing employment is doing slightly better than total employment with 1.9 percent growth over the second quarter of FY11.

Table 3
Summary of US Economic Series
Second Quarter of FY12 & FY11

	Second Quarter			
	FY12	**FY11**	**Chg**	**% Chg**
Real GDP	13,424.9	13,216.1	208.8	1.6
Real Consumption	9,506.1	9,328.4	177.8	1.9
Real Investment	1,816.3	1,734.5	81.8	4.7
Real Govt. Expenditures	2,485.4	2,552.1	-66.7	-2.6
Real Exports	1,800.5	1,716.8	83.7	4.9
Real Imports	2,189.6	2,131.0	58.6	2.8
Personal Income ($ billions)	13,069.2	12,577.6	491.6	3.9
Wages and Salaries ($ billions)	6,706.7	6,477.0	229.7	3.5
Inflation (% chg of CPI)	3.3	1.2	NA	NA
Industrial Production Index	94.7	91.7	3.0	3.2
Civilian Labor Force (millions)	154.3	153.9	0.5	0.3
Total Non-farm Employment (millions)	131.7	130.1	1.5	1.2
Manufacturing Employment (millions)	11.8	11.6	0.2	1.9
Unemployment Rate (percent)	9.0	9.6	NA	NA

Not Seasonally Adjusted. Real series are in billions of chained 2000 dollars.
GDP components may not sum due to rounding at lower levels of detail.
Data for FY12 Q2 are December 2011 estimates.
Source: IHS Global Insight Inc., December 2, 2011 data release

KENTUCKY ECONOMY

Kentucky personal income rose by 4.1 percent in the second quarter to $148,246.2 million. This is the eighth consecutive improvement in personal income and the sixth robust consecutive improvement. Personal income has grown by 2.9, 2.8, 4.9, 4.8, 3.7, and 4.1 percent respectively over the last six quarters. Despite weak employment growth, Kentucky personal income has grown heartily since the trough in the first quarter of FY10. Wages and salaries, which make up 51.1 percent of personal income in Kentucky, has grown in roughly the same measures as overall personal income. Stated another way, the non-wages and salaries components of income are just as responsible for the good personal income growth as wages and salaries.

Kentucky personal income surpassed its previous peak rather quickly following the 2007 recession. The previous peak in Kentucky personal income occurred in the fourth quarter of FY08. Personal income contracted sharply for three consecutive quarters and reached a trough in the third quarter of FY09. Personal income surpassed its previous peak by the first quarter of FY11, one quarter sooner than US personal income surpassed its previous peak.

The 2007 recession was particularly harsh on Kentucky employment. Kentucky non-farm employment declined in eight of the 10 quarters between the fourth quarter of FY08 and the first quarter of FY11. Non-farm employment declined 98,700 jobs, a net 5.3 percent during this time. Since the first quarter of FY11, non-farm employment has risen a net 1.5 percent, recovering less than a third of the recession losses. Adjacent-quarter growth has been weak, rising between 0.2 and 0.5 percent in each of the last five quarters.

Employment declined in three sectors (construction, financial services and government employment), contributing to the weak total employment figures. Employment in the largest supersector, trade, transportation and utilities, was positive but very weak, growing a net 0.7 percent over the last five quarters. Employment in leisure and hospitality services, mining, and business services grew vigorously over that time, rising 6.4, 5.7 and 5.0 percent respectively. When comparing the second quarter to the second quarter of FY11 (see Table 4), the same three supersectors are outstanding. Overall, employment is still weak, having grown just 1.0 percent over the previous year. Non-farm employment is still 71,200 seasonally adjusted jobs below the previous peak, which occurred in the third quarter of FY08.

Table 4
Summary of Kentucky Economic Series
Second Quarter of FY12 & FY11

	Second Quarter			
	FY12	FY11	$ Chg	% Chg
Personal Income ($ millions)	148,246.2	142,387.0	5,859.2	4.1
Wages and Salary Income ($ millions)	75,697.2	72,559.0	3,138.2	4.3
Non-farm Employment (thousands)	1,797.9	1,779.5	18.4	1.0
Goods Producing (thousands)	303.3	300.7	2.6	0.9
Construction	64.9	66.5	-1.6	-2.4
Mining	23.8	22.7	1.1	5.0
Manufacturing	214.6	211.5	3.1	1.5
Service Providing (thousands)	1,167.8	1,148.1	19.7	1.7
Trade, Transportation & Utilities	362.1	359.1	3.0	0.8
Information	26.1	26.0	0.1	0.2
Finance	84.8	86.1	-1.4	-1.6
Business Services	189.2	182.9	6.3	3.5
Educational Services	255.7	251.4	4.2	1.7
Leisure and Hospitality Services	177.2	170.7	6.5	3.8
Other Services	72.8	71.9	0.9	1.3
Government (thousands)	326.7	330.7	-4.0	-1.2

Not Seasonally Adjusted. Data for FY12 Q2 are December 2011 estimates.
Source: IHS Global Insight Inc. and Governor's Office for Economic Analysis MAK model

Interim Outlook

GENERAL FUND

The revenue forecasts presented in Table 5 and Table 6 were estimated using the December 2011 "control scenario" economic forecast from both IHS Global Insight and the Kentucky MAK model. The FY12 estimates presented here are the same as those ratified by the CFG and represent the revised official revenue estimates.

The official General Fund estimate for FY12 is $9,007.7 million, an increase of 2.8 percent over FY11 collections. Projected General Fund revenues for the next three quarters are shown in Table 5. As the table indicates, General Fund growth is projected to slow but remain positive over the final two quarters of the fiscal year before turning negative in the first quarter of FY13. It should be noted that even though the rate of growth will slow in the second half of the current fiscal year, nominal collections will be $34.9 million greater than in the first six months of FY12.

Individual income tax receipts, which are composed of four components (withholding, declarations, fiduciary and net returns), are expected to increase by less than 1.0 percent over the next two quarters before showing more robust growth in the first quarter of FY13. 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 0.7 percent for the remainder of FY12 and 2.1 percent in the first quarter of FY13.

Table 5
General Fund Interim Forecast
$ millions

	FY12 Q1 & Q2		FY12 Q3 & Q4		FY12 Full Year		FY12 Official CFG		FY13 Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	% Chg
Individual Income	1,728.9	3.2	1,755.3	0.7	3,484.2	1.9	3,484.2	1.9	905.0	2.1
Sales and Use	1,511.0	4.2	1,496.4	3.5	3,007.4	3.8	3,007.4	3.8	724.7	-5.7
Property	317.1	-9.6	201.7	23.0	518.8	0.8	518.8	0.8	40.1	5.4
Corporate Income	186.7	48.2	146.8	-16.0	333.5	10.9	333.5	10.9	93.2	1.1
Coal Severance	159.9	10.3	166.8	10.6	326.7	10.4	326.7	10.4	84.0	4.7
Cigarette Taxes	126.8	-6.7	126.8	0.4	253.6	-3.3	253.6	-3.3	68.7	3.2
LLET	86.8	-11.2	131.5	11.4	218.3	1.2	218.3	1.2	47.7	-1.9
Lottery	101.5	6.8	109.5	3.8	211.0	5.2	211.0	5.2	45.6	-0.8
Other	267.6	-3.8	386.6	2.4	654.2	-0.2	654.2	-0.2	142.2	8.9
Total General Fund	**4,486.4**	**3.1**	**4,521.3**	**2.6**	**9,007.7**	**2.8**	**9,007.7**	**2.8**	**2,151.1**	**-0.2**

Growth in sales and use tax collections is expected to remain steady for the remainder of the fiscal year before declining early in FY13. Sales and use receipts are closely tied to personal income and disposable income. Sales and use receipts are forecasted to rise 3.5 percent in the next six months after growing 4.2 percent in the first half of the fiscal year. Receipts are expected to decline 5.7 percent in the first six months of FY13.

Growth in property tax revenues is expected to increase significantly over the final two quarters of FY12 after declining 9.6 percent in the first six months. The disparity in growth rates is due to the volatile nature of the tax. Nearly two-thirds of total property tax receipts are collected during a three month period (November through January). With such a compressed collection schedule, small changes in the timing of collections can produce large fluctuations in growth rates. The full year of collections for FY12 are expected to rise a modest 0.8 percent over FY11. Receipts are expected to increase 5.4 percent in the first quarter of FY13.

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. Over the first six months of the fiscal year, corporation income tax collections grew 48.2 percent while LLET receipts declined 11.2 percent. For the remainder of FY12, corporate tax collections are expected to fall 16.0 percent and LLET receipts should increase 11.4 percent.

Coal severance receipts year-to-date in FY12 have grown 10.3 percent over FY11 levels. Severed tons continue on their long-run decline; however, higher contract prices have kept receipts at all-time highs. The outlook for coal severance receipts is for growth of 10.6 percent in the second half of FY12 and 4.7 percent in the first quarter of FY13.

Both nationally and in Kentucky smoking has declined, as measured by the number of packs sold. Cigarette receipts declined 6.7 percent in the first six months of FY12 but the downward trend is expected to stabilize over the forecast horizon. The outlook for cigarette tax receipts is for an increase of 0.4 percent for the remainder of FY12 and 3.2 percent in the first quarter of FY13.

Lottery receipts are determined by the Lottery Corporation's dividend schedule. Lottery receipts are projected to end FY12 at $211.0 million, an increase of 5.2 percent over FY11 levels. Expected receipts of $45.6 million for the first quarter of FY13 represent a decline of 0.8 percent.

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 2.4 percent in the next two quarters before rising 8.9 percent in the first quarter of FY13.

ROAD FUND

Road Fund revenues are forecasted to grow 3.7 percent over the final two quarters of FY12 and 4.7 percent in the first three months of FY13 as shown in Table 6. The FY12 full-year forecast for this report is the same as the official revenue forecast as revised by the CFG on December 21, 2011.

Motor fuels tax collections are forecasted to grow 6.2 percent over the final six months of FY12. This is due principally to a rise in the forecasted average wholesale gasoline prices and the 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. Growth is projected to continue in the first quarter of FY13, rising 6.2 percent.

Growth in motor vehicle usage tax collections is projected to slow down over the final six months of the fiscal year. Receipts are forecasted to be $9.7 million more than the first half of the fiscal year. Collections are projected to rise 1.9 percent over the remainder of the fiscal year and expected to grow 2.2 percent in the first three months of FY13.

The Governor's Office for Economic Analysis together with officials from the Kentucky Transportation Cabinet assessed recent growth patterns, administrative issues and statutory factors to estimate the growth rates of the remaining components of the Road Fund. Motor vehicle license taxes are forecasted to decrease 6.8 percent in the final two quarters of FY12 and decrease 0.5 percent in the first quarter of FY13. Motor vehicle operators' licenses are projected to rise 3.7 percent in the remainder of the fiscal year and expected to grow 1.8 percent in the first quarter of FY13. Weight distance tax revenue should rise 13.5 percent for the remainder of the fiscal year and 5.2 percent over the first three months of FY13. Investment income is forecasted to fall 76.2 percent over the remainder of the fiscal year and increase to approximately $500,000 in the first quarter of FY13. The "Other" revenue category will fall 4.1 percent during the last six months of FY12 and then rise 4.4 percent in the first quarter of FY13.

Table 6
Road Fund Interim Forecast
$ millions

	FY12 Q1 & Q2		FY12 Q3 & Q4		FY12 Full Year		FY12 Official CFG		FY13 Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff	Estimate	% Chg
Motor Fuels	401.3	6.5	378.2	6.2	779.5	6.4	779.5	6.4	214.3	6.2
Motor Vehicle Usage	196.5	9.5	206.2	1.9	402.7	5.5	402.7	5.5	105.4	2.2
Motor Vehicle License	42.0	21.0	58.8	-6.8	100.8	3.1	100.8	3.1	19.4	-0.5
Motor Vehicle Operators	7.9	-2.7	7.9	3.7	15.8	0.4	15.8	0.4	4.1	1.8
Weight Distance	37.9	1.2	41.5	13.5	79.4	7.3	79.4	7.3	19.9	5.2
Investment	0.2	-73.3	0.3	-76.2	0.5	-74.9	0.5	-74.9	0.5	1,062.8
Other	15.7	-0.7	18.1	-4.1	33.8	-2.6	33.8	-2.6	7.3	4.4
Total Road Fund	**701.5**	**7.4**	**711.0**	**3.7**	**1,412.5**	**5.5**	**1,412.5**	**5.5**	**370.9**	**4.7**

NATIONAL ECONOMY

The previous two quarterly reports released by the OSBD described an economy that was in a state of flux. Corporate profits remained strong, but employment was stagnant due to caution in the forecast of future demand. Monetary and fiscal policy had basically run their course. Further permissive policy options, like a third round of quantitative easing, were hamstrung by growing concerns about the national debt.

The CFG met on December 21, 2011, to discuss the current economic conditions and expectations for the upcoming biennium. The CFG previously met in August and October for the preliminary and planning estimation processes; therefore, much of the discussion centered on changes to economic variables compared to conditions that prevailed during the earlier meetings. Economic trends during the August and October meetings caused the CFG to use a blend of the economic scenarios. During the December meeting, more concrete signs of a recovery in the national and state economies began to emerge. Thus, official revenue estimates for both the General Fund and Road Fund were based on the control forecasts for the national and Kentucky economies.

The chances of a "double-dip" recession have become less likely as the economy draws further away from the official end of the recession. The Christmas retail purchasing season was a pivotal period for the US economy. Only pent-up demand gave economists high hopes for holiday sales, even as unemployment is stubbornly high and hiring is weak. The forecast used in this quarterly report calls for the best holiday season since 2005.

Consumers have been deleveraging in the aftermath of the housing crash. At the height of the housing market, household wealth from homeowner equity was about $13.0 trillion. Current estimates place homeowner equity at around $7.9 trillion. Losses in wealth are noteworthy because they affect consumer sentiment and the ability to purchase goods and services beyond what could be spent from current wages and salaries. While nominal interest rates are at historic lows, consumers will remain cautious until household wealth and employment gain momentum. Periods of deleveraging (saving) are typically followed by pent-up demand, which appears to be evident in the holiday sales data. If domestic consumption continues to build momentum it could become a source of growth as employment and consumer sentiment improve.

Domestic corporations remain a critical link in the recovery period. It has been widely reported that many corporations have favorable cash positions, despite all of the other lackluster macroeconomic data. This prime cash position is a function of streamlining production, reducing fixed costs, and exercising extreme caution with workforce levels. There is evidence that some corporate investment is taking place, but the emphasis is on replacing machinery including updating computers and software. While all investments are potentially stimulative, investments in workforce and productive capacity typically have a higher impact on the overall economy. Through this period of corporate streamlining, domestic companies have positioned themselves well in the area of global competiveness and profitability. The next step in increasing corporate profits must come from increasing revenues, rather than reducing costs. Higher demand and stronger sales will be required before the US can finally emerge from the current stagnation in the employment market.

Foreign trade is another vital segment of the national economy. With a fragile consumer recovery and a frugal investment profile for the near-term, net exports play a pivotal role in shaping the US economy. The control forecast assumes that the Eurozone remains intact and that the European recession is mild. Looking further eastward, baseline assumptions assume China avoids a "hard landing" from their economic slowdown.

A temporary extension of the payroll tax cuts has allayed some fears that a collapse in domestic spending was forthcoming. A third round of quantitative easing is also being discussed. The stock market behaves favorably to Fed actions which insert money into the economy. Inflation has not been an issue as banks have been reluctant to increase lending, preferring to increase their reserves and take advantage of near-zero short-term borrowing from the Fed directly. One quarter ago policy errors were a real concern to Global Insight. These fears, for the time being, have been allayed.

Unfortunately, a recovery in employment lags the recovery in the rest of the economy. This has several consequences that add considerable uncertainty to the current economic forecast. Wages and salaries are highly correlated with household consumption, which is in turn a driver for many other elements of the economy. Uncertainty about employment has a dampening effect on two of the largest consumer super-sectors – housing and vehicles. This uncertainty is compounded by the aftermath of the financial crisis, as lending has tightened. The discussion above would suggest that until the employment picture becomes clearer, housing and automobile sales as well as business planned investment will likely remain weak.

There are both upside and downside risks to the control forecast. The single largest downside concern is that the economy will not grow as quickly without further stimulative policy. Fiscal stimulus spending, homebuyer tax credits, the inventory cycle, and other transitory boosts to the economy are countercyclical agents, but they are not necessarily sources of sustainable aggregate demand. Until demand improves, the pessimistic scenario exhibits a w-shaped recession stemming from increasingly fragile financial and equity markets with ripple effects that could reach all of the typical broader economic aggregates.

The optimistic forecast calls for the private sector to recover more quickly than expected. Financial markets will respond by easing credit to consumers ready to start buying again after a long period of deleveraging.

KENTUCKY ECONOMY

The 2007 recession impacted Kentucky to a lesser degree than it affected the US economy. The loss of household wealth was muted in Kentucky since the Commonwealth never really experienced a pronounced run-up in home values. Second, Kentucky's abundance of coal provided stable employment and income in the mining sector. Finally, Kentucky has a broad mix of manufacturing employment rather than an over reliance on a single industry.

Just like in the US expansion, Kentucky exhibits muted employment growth. An examination of Table 7 bears out this point. During the second half of FY12, US employment is projected to increase by 1.1

percent. Meanwhile Kentucky employment growth is slated for 0.8 percent growth, a comparison close to par for Kentucky. On a more promising note, Kentucky wage and salary income is expected to climb 3.2 percent over the same period, which compares favorably to anticipated national growth of 2.8 percent. Table 8 shows the outlook for the first quarter of FY13. The results show slightly higher growth with very similar comparisons between US and Kentucky economic aggregates.

Regarding the risks to the forecast, the OSBD will pay close attention to the situation in Europe as well as the tight fiscal lending conditions. The manufacturing sectors in Kentucky rely to some extent on aggregate demand from foreign countries. If European economic conditions worsen, then US states with a significant manufacturing presence will suffer.

Table 7
US and KY Economic Outlook
Second Half of FY12 & FY11

	Q3 & Q4		
	FY12	**FY11**	**% Chg**
United States			
Real GDP	13,502.8	13,249.9	1.9
Real Consumption	9,578.3	9,384.7	2.1
Real Investment	1,873.4	1,764.7	6.2
Real Government Expenditures	2,454.7	2,511.1	-2.2
Real Exports	1,816.7	1,757.3	3.4
Real Imports	2,219.4	2,177.7	1.9
Personal Income ($ billions)	13,273.6	12,901.1	2.9
Wage & Salary ($ billions)	6,784.1	6,597.7	2.8
Inflation (% chg CPI)	1.8	2.8	NA
Industrial Production Index	95.5	92.8	NA
Civilian Labor Force (millions)	154.5	153.4	0.7
Total Non-farm Employment (millions)	132.2	130.8	1.1
Manufacturing Employment (millions)	11.8	11.7	1.4
Unemployment Rate (percent)	9.0	9.0	NA
Kentucky			
Personal Income ($ millions)	150,368.9	145,998.5	3.0
Wage & Salary ($ millions)	76,538.6	74,149.0	3.2
Non-farm Employment (thousands)	1,802.5	1,788.7	0.8
Goods Producing (thousands)	303.6	299.8	1.3
Service Providing (thousands)	1,174.1	1,158.6	1.3
Government (thousands)	324.7	330.3	-1.7

Not Seasonally Adjusted. Real series are in billions of chained 2000 dollars.
Data for FY12 Q3 & Q4 are estimates based on the IHS Global Insight Control scenario.
Source: IHS Global Insight Inc., December 2, 2011 data release

Table 8
US and KY Economic Outlook
First Quarter of FY13 & FY12

	Q1		
	FY13	**FY12**	**% Chg**
United States			
Real GDP	13,576.0	13,337.8	1.8
Real Consumption	9,662.0	9,446.5	2.3
Real Investment	1,894.0	1,774.6	6.7
Real Government Expenditures	2,428.1	2,507.6	-3.2
Real Exports	1,840.9	1,783.6	3.2
Real Imports	2,244.3	2,184.3	2.7
Personal Income ($ billions)	13,453.7	12,975.2	3.7
Wage & Salary ($ billions)	6,871.3	6,641.6	3.5
Inflation (% chg CPI)	1.1	3.8	NA
Industrial Production Index	96.4	94.1	2.4
Civilian Labor Force (millions)	154.7	153.6	0.7
Total Non-farm Employment (millions)	132.8	131.3	1.2
Manufacturing Employment (millions)	11.9	11.8	1.2
Unemployment Rate (percent)	9.0	9.1	NA
Kentucky			
Personal Income ($ millions)	152,346.4	147,146.0	3.5
Wage & Salary ($ millions)	77,532.2	74,986.5	3.4
Non-farm Employment (thousands)	1,811.1	1,795.2	0.9
Goods Producing (thousands)	305.5	303.2	0.7
Service Providing (thousands)	1,182.7	1,164.3	1.6
Government (thousands)	323.0	327.7	-1.4

Not Seasonally Adjusted. Real series are in billions of chained 2000 dollars.
Data for FY13 Q1 are estimates based on the IHS Global Insight Control scenario.
Source: IHS Global Insight Inc., December 2, 2011 data release

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APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	Second Quarter FY 2012	Second Quarter FY 2011	% Change	Year-To-Date FY 2012	Year-To-Date FY 2011	% Change
TOTAL GENERAL FUND	**$2,329,932,420**	**$2,298,360,130**	**1.4%**	**$4,486,385,916**	**$4,353,455,925**	**3.1%**
Tax Receipts	$2,234,206,299	$2,208,186,199	1.2%	$4,330,184,659	$4,198,380,061	3.1%
Sales and Gross Receipts	$866,023,795	$860,905,811	0.6%	$1,784,177,398	$1,730,558,647	3.1%
Beer Consumption	1,457,401	1,447,280	0.7%	3,140,296	3,239,317	-3.1%
Beer Wholesale	12,757,604	13,013,403	-2.0%	27,903,605	27,836,959	0.2%
Cigarette	60,334,763	66,934,536	-9.9%	126,832,431	135,935,849	-6.7%
Distilled Spirits Case Sales	28,835	28,641	0.7%	58,231	(287,866)	---
Distilled Spirits Consumption	2,769,400	2,792,090	-0.8%	5,651,177	5,559,929	1.6%
Distilled Spirits Wholesale	7,379,882	7,333,476	0.6%	14,582,708	14,238,493	2.4%
Insurance Premium	12,348,893	10,798,710	14.4%	40,574,297	40,471,956	0.3%
Pari-Mutuel	755,764	673,880	12.2%	1,305,884	2,619,216	-50.1%
Race Track Admission	56,521	59,915	-5.7%	138,999	146,651	-5.2%
Sales and Use	742,607,150	732,928,187	1.3%	1,511,006,738	1,450,157,680	4.2%
Wine Consumption	707,091	656,510	7.7%	1,346,067	1,259,055	6.9%
Wine Wholesale	3,775,606	3,479,412	8.5%	7,006,898	6,858,188	2.2%
Telecommunications Tax	15,634,646	15,396,765	1.5%	33,574,655	31,550,380	6.4%
OTP	5,419,930	5,340,136	1.5%	11,047,653	10,909,801	1.3%
Floor Stock Tax	(9,692)	22,871	---	7,762	63,039	-87.7%
License and Privilege	$134,571,760	$144,634,290	$0	$276,459,052	$278,979,400	-0.9%
Alc. Bev. License Suspension	84,925	94,290	-9.9%	134,800	193,540	-30.4%
Coal Severance	79,717,679	72,190,401	10.4%	159,926,317	145,030,253	10.3%
Corporation License	216,915	5,512,812	-96.1%	727,038	8,916,553	-91.8%
Corporation Organization	21,667	9,456	129.1%	21,667	28,868	-24.9%
Occupational Licenses	17,926	31,382	-42.9%	43,070	64,484	-33.2%
Oil Production	2,211,487	1,928,101	14.7%	4,550,444	3,749,683	21.4%
Race Track License	100,000	103,750	-3.6%	195,000	208,750	-6.6%
Bank Franchise Tax	2,812,181	414,863	577.9%	1,888,274	2,903,880	-35.0%
Driver License Fees	142,718	148,269	-3.7%	305,439	313,333	-2.5%
Minerals Severance	4,610,562	4,024,929	14.6%	8,897,393	8,002,226	11.2%
Natural Gas Severance	6,455,890	6,670,799	-3.2%	12,942,091	11,807,270	9.6%
Limited Liability Entity	38,179,810	53,505,238	-28.6%	86,827,520	97,760,561	-11.2%
Income	$937,495,451	$885,104,809	$0	$1,915,601,977	$1,800,707,652	6.4%
Corporation	94,534,260	56,022,973	68.7%	186,682,141	125,924,331	48.2%
Individual	842,961,191	829,081,835	1.7%	1,728,919,837	1,674,783,320	3.2%
Property	$279,047,087	$299,216,380	-6.7%	$317,100,370	$350,841,882	-9.6%
Building & Loan Association	(43,835)	0	---	(46,134)	(53,180)	---
General - Real	152,057,032	185,355,800	-18.0%	151,686,908	184,671,832	-17.9%
General - Tangible	88,419,538	93,210,570	-5.1%	115,665,335	115,511,607	0.1%
Omitted & Delinquent	14,409,844	5,118,238	181.5%	11,558,481	20,433,744	-43.4%
Public Service	23,777,037	15,023,073	58.3%	37,477,398	29,532,705	26.9%
Other	427,471	508,699	-16.0%	758,382	745,176	1.8%
Inheritance	$8,596,779	$9,493,103	-9.4%	$19,827,894	$20,826,110	-4.8%
Miscellaneous	$8,471,426	$8,831,806	-4.1%	$17,017,968	$16,466,369	3.3%
Legal Process	4,843,440	5,028,624	-3.7%	9,980,828	10,237,125	-2.5%
T. V. A. In Lieu Payments	3,627,987	3,783,341	-4.1%	7,032,186	6,183,626	13.7%
Other	0	19,841	-100.0%	4,954	45,619	-89.1%
Nontax Receipts	$95,345,052	$89,111,827	7.0%	$155,009,978	$153,446,712	1.0%
Departmental Fees	6,665,281	6,209,670	7.3%	10,102,058	12,048,668	-16.2%
PSC Assessment Fee	13,658	45,653	-70.1%	5,436,227	8,915,158	-39.0%
Fines & Forfeitures	5,913,180	6,591,148	-10.3%	12,669,932	12,900,746	-1.8%
Interest on Investments	168,534	159,573	5.6%	416,133	350,156	18.8%
Lottery	55,500,000	50,000,000	11.0%	101,500,000	95,000,000	6.8%
Sale of NOx Credits	0	0	---	0	22,513	-100.0%
Miscellaneous	27,084,399	26,105,782	3.7%	24,885,629	24,209,472	2.8%
Redeposit of State Funds	$381,069	$1,062,104	-64.1%	$1,191,279	$1,629,152	-26.9%

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	Second Quarter FY 2012	Second Quarter FY 2011	% Change	Year-To-Date FY 2012	Year-To-Date FY 2011	% Change
TOTAL ROAD FUND	**$347,134,999**	**$314,319,740**	**10.4%**	**$701,509,261**	**$653,002,433**	**7.4%**
Tax Receipts-	$341,129,455	$309,488,486	10.2%	$690,677,281	$640,828,192	7.8%
Sales and Gross Receipts	$292,900,808	$267,962,923	9.3%	$597,794,353	$556,084,126	7.5%
Motor Fuels Taxes	199,606,417	183,718,476	8.6%	401,323,292	$376,728,440	6.5%
Motor Vehicle Usage	93,294,391	84,244,448	10.7%	196,471,061	$179,355,687	9.5%
License and Privilege	$48,228,647	$41,525,562	16.1%	$92,882,928	$84,744,066	9.6%
Motor Vehicles	22,487,697	16,798,487	33.9%	41,992,340	34,698,986	21.0%
Motor Vehicle Operators	3,855,254	3,949,277	-2.4%	7,884,214	8,101,101	-2.7%
Weight Distance	18,984,385	18,681,324	1.6%	37,900,183	37,435,753	1.2%
Truck Decal Fees	26,316	32,785	-19.7%	77,118	67,052	15.0%
Other Special Fees	2,874,994	2,063,689	39.3%	5,029,073	4,441,174	13.2%
Nontax Receipts	$5,636,760	$4,385,831	28.5%	$10,251,031	$10,440,211	-1.8%
Departmental Fees	4,821,691	3,698,469	30.4%	9,104,016	8,735,903	4.2%
In Lieu of Traffic Fines	182,087	181,364	0.4%	369,561	374,337	-1.3%
Investment Income	186,518	380,995	-51.0%	230,189	862,947	-73.3%
Miscellaneous	446,465	125,003	257.2%	547,265	467,024	17.2%
Redeposit of State Funds	$368,784	$445,424	-17.2%	$580,949	$1,734,030	-66.5%