COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report

First Quarter
Fiscal Year 2011
First Edition

Governor's Office for Economic Analysis

Office of State Budget Director

Kentucky UNBRIDLED SPIRIT™

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State Budget Director

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November 1, 2010

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 2011 (FY11). It also includes an interim economic and revenue forecast for the last three quarters of FY11.

General Fund receipts for the first quarter of FY11 totaled $2,055.1 million, an increase of 4.4 percent compared to the same period in FY10. Road Fund revenues totaled $338.7 million, an increase of 11.9 percent from the first quarter of FY10.

The interim General Fund forecast for the final three quarters of FY11 calls for an increase of 5.1 percent compared to the same period one year ago, resulting in an unofficial interim outlook for the entire FY11 of $8,629.3 million, or $58.4 million higher than the enacted revenue estimates. Note, however, that a significant share of the projected increase is from coal severance taxes, and therefore would be shared with local governments if it materialized.

The interim forecast for the Road Fund for the final three quarters of FY11 is $983.6 million and calls for an increase of 8.8 percent. The interim estimate for the full year FY11 is $1,322.3 million. If the interim forecast holds true, the Road Fund estimate will exceed the official budgeted estimate by $56.4 million.

With just one quarter complete 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,

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 FY11. 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.

The first quarter edition of the *Quarterly Report* takes on additional importance since it contains the first unofficial outlook for the current complete fiscal year. It is customary to juxtapose the latest unofficial estimates with the official enacted estimates that were included in the budget process. Both the General Fund and Road Fund estimates are included. Unless otherwise noted, the enacted estimates include the fiscal impact of all recently enacted laws that would affect revenues. These impacts, which total $80.1 million in FY11, have been incorporated into estimates for the major tax categories.

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. The second section "Interim Outlook" provides a three-quarter outlook of the economy using a control forecast from Global Insight and the Kentucky Macroeconomic Model (MAK), which is created and operated by the Office of State Budget Director.

Some of the highlights of this report are included below. For a more detailed explanation, please refer to the relevant portion of the report for the full details.

- General Fund receipts rose for the second consecutive fiscal quarter following five consecutive declines.
- Through the first quarter, General Fund receipts grew 4.4 percent. Road Fund receipts grew 11.9 percent.
- Road Fund receipts posted a third consecutive quarterly increase following a recession that led to seven consecutive quarters of declining revenues. The Road Fund is in full recovery mode due to current and projected strength in the motor fuels and motor vehicle usage taxes.
- The recovery for the General Fund is a little more fragile. The two largest revenue sources, the income and sales taxes, are now posting positive growth over prior year quarters, but any disruptions or shocks to the economy could easily derail the recovery.

- Despite the fragile nature of the economic recovery, two revenue sources have established a growth pattern in excess of projections. The corporation income tax is clearly benefiting from the national growth in corporate profits. All of the corporate variables are well poised for growth in excess of the official estimates. Coal severance tax receipts are also coming in ahead of the pace set by the official estimates. The combination of corporate and coal is approximately $150 million ahead of projections for FY11.
- Offsetting these well-performing taxes, the remainder of the General Fund is slightly below the growth incorporated into the official estimates.
- The unofficial General Fund estimate calls for growth of 4.9 percent in FY11 for a final sum of $8,629.3 million. If realized, the estimate would exceed the enacted estimate of $8,570.9 million by $58.4 million.
- Interim estimates for the Road Fund also reveal a projected excess of revenues over the official estimates. Due to growth in the fuels taxes, the current unofficial estimate calls for $1,322.2 million in FY11, an amount $56.4 million higher than the official estimate.
- Regarding the economy, real GDP rose by 2.9 percent in the first quarter; this growth was largely based on the high growth in real private investment.
- Kentucky personal income rose by a welcomed 4.0 percent in the first quarter, despite zero growth in Kentucky employment.
- The three-quarter outlook calls for no significant changes to the National forecast, especially the economic forecast that prevailed when the official estimates were approved. There was a period earlier in calendar year 2010 when Global Insight had raised the forecast for many key variables. Since then, the economy has softened somewhat but still compares favorably to the last approved Consensus Forecasting Group (CFG) forecast of the economy.
- Recent regional projections have shown Kentucky in a favorable light vis-à-vis the recovery path of other states.

The recovery is viewed by national experts as very fragile, such that minor disruptions have a greater possibility than usual of escalating into full-blown setbacks. The optimistic scenario presented to OSBD from Global Insight did not contain any potential source of huge upside risk; rather, it merely implied that the control or baseline recovery may occur more quickly with slightly higher growth. Contrastingly, the pessimistic scenario listed several potential macro economic issues that could completely derail the train of recovery. Any one of the risks could potentially trigger another period of unforeseen contraction. Simply put, most economists would agree that the downside risks to the economy greatly outweigh the upside risks.

Given the presence of significant downside risks, both the General Fund and Road Fund estimates prepared in this report should be interpreted to be “right on course” rather than "significantly ahead of schedule". Both amounts in excess of the official estimates are within the normal error range of economic models. The next quarterly report in January 2011 should give a better indicator of final FY11 revenues as actual receipts for several important taxes that are heavily weighted with fall collections will be known.

Finally, it is often useful to know what the experts are saying about the Kentucky economy. While this is difficult to do on a unique and objective scale, the intangible remarks from the experts seem to be saying that Kentucky should recover from the recession more quickly since Kentucky peak-to-trough losses were less severe than national average. By most accounts, Kentucky was somewhat insulated from the national recession that ended in June 2009. There are three primary factors at play. First, the loss of household wealth from home equity was not as severe in Kentucky since there was a smaller run-up in prices and less speculative buying. Second, all mineral extraction states had hard assets to fall back to when other sectors failed. Finally, Kentucky has a broad mix of manufacturing. A broad economic base provides a certain degree of insulation against wild swings in the state economy. The diversity and stability of our tax code also limits the downside risks during recessions by sustaining government services and interjecting resources into the private economy.

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GENERAL FUND
First Quarter, FY11

General Fund receipts in the first quarter of FY11 totaled $2,055.1 million compared to $1,968.5 million in the first quarter of FY10, for an increase of 4.4 percent or $86.6 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. Growth in sales and use, individual income and corporate taxes made up the majority of the growth in the General Fund over the first quarter of FY11. However, employment and wage growth will be the key elements going forward, as progress in these broad economic aggregates will likely have a profound impact on the two major sources of state revenues, namely the individual income and sales taxes.

Table 1
Summary General Fund Receipts
($ millions)

	FY11 Q1	FY10 Q1	Diff ($)	Diff (%)
Sales and Use	717.2	693.9	23.3	3.4
Individual Income	845.7	814.4	31.3	3.8
Corp Income	69.9	49.0	20.9	42.5
LLET	44.3	30.5	13.7	45.0
Coal Severance	72.8	66.8	6.0	9.0
Cigarette Taxes	69.0	74.2	-5.2	-7.0
Property	51.6	60.1	-8.5	-14.1
Lottery	45.0	44.0	1.0	2.3
Other	139.5	135.4	4.1	3.1
TOTAL	**2,055.1**	**1,968.5**	**86.6**	**4.4**

The sales and use tax grew 3.4 percent in the first quarter of FY11 as consumers continued to retrench and limit their purchases of taxable goods. Receipts of $717.2 million compare to the $693.9 million collected in the first quarter of FY10. After six quarters of decreased sales tax activity, the last two quarters have shown signs of an economic rebound.

Individual income tax receipts increased 3.8 percent in the first quarter of FY11. Receipts of $845.7 million were $31.3 million more than was collected in the first quarter of the previous fiscal year. The withholding component of the individual income tax has posted growth twice despite the lack of improvement in the underlying employment data.

Corporation income tax posted an increase of 42.5 percent, or $20.9 million, during the first quarter of FY11. Receipts totaled $69.9 million compared to the $49.0 million received a year earlier. September is a declaration payment month for calendar-year filers. Both declarations and net returns posted significant improvements due to lower refund inventories and stronger corporate profitability.

The limited liability entity tax (LLET) saw an increase in tax collections in the first quarter of FY11 when compared to FY10. Total collections in the current fiscal year totaled $44.3 million and compare to revenues of $30.5 million in the same period a year earlier.

The coal severance tax increased 9.0 percent as coal prices have increased. Receipts of $72.8 million compare to $66.8 million collected in the first quarter of FY10.

Cigarette taxes fell in the first quarter with receipts of $69.0 million which were 7.0 percent less than collected one year earlier, a reflection of falling state and national consumption of cigarettes.

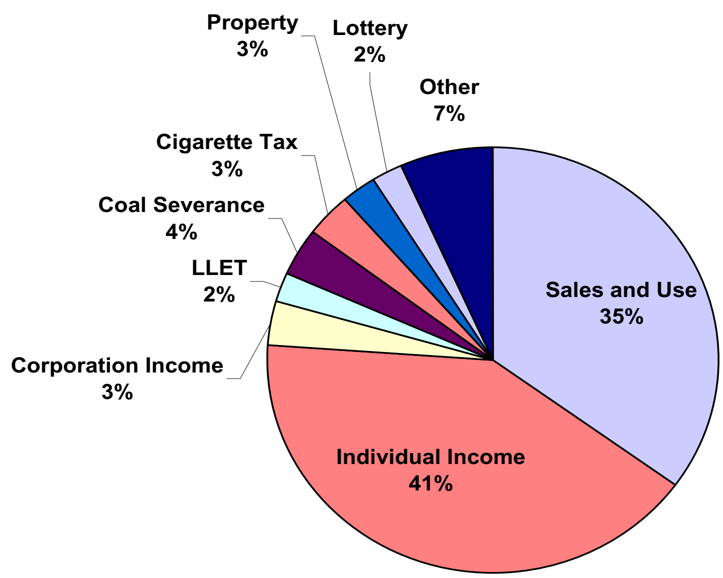
Property taxes were down 14.1 percent in the first quarter of FY11 due to timing of collections in the tangible and public service property accounts. Collections of $51.6 million compare to $60.1 million received in the first quarter of the prior fiscal year.

Lottery receipts increased 2.3 percent in the first quarter of FY11 with revenues of $45.0 million.

The "Other" category represents the remaining accounts in the General Fund, and collections in this account increased 3.1 percent with receipts of $139.5 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 7.0 percent. The major components in this category include inheritance taxes, insurance premium taxes, beer wholesale sales tax, telecommunications taxes, and the natural gas severance tax. Coal severance taxes accounted for 4.0 percent of the revenues while cigarette, corporation income and property taxes each accounted for 3.0 percent of the total. Finally, lottery receipts and LLET each accounted for 2.0 percent of the General Fund.

Figure 1
First Quarter, FY11
General Fund Receipts



ROAD FUND
First Quarter, FY11

Road Fund revenue increased 11.9 percent in the first quarter of FY11. Receipts totaled $338.7 million compared to the $302.6 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 19.0 percent during the first quarter of FY11. Re-

Table 2
Summary Road Fund Receipts
($ millions)

	FY11 Q1	FY10 Q1	Diff ($)	Diff (%)
Motor Fuels	193.0	162.2	30.8	19.0
Motor Vehicle Usage	95.1	93.7	1.4	1.5
Motor Vehicle License	17.9	17.0	0.9	5.2
Motor Vehicle Operators	4.2	4.2	-0.1	-2.1
Weight Distance	18.8	17.4	1.4	7.9
Investment Income	0.5	1.3	-0.8	-63.3
Other	9.3	6.8	2.5	36.6
TOTAL	**338.7**	**302.6**	**36.1**	**11.9**

ceipts were $193.0 million and compare to $162.2 million collected during the first quarter of last year. Motor fuels taxes were affected by a statutory tax rate increase tied to the wholesale price of gasoline. The variable rate of 19.5 cents per gallon in the first quarter of FY11 was considerably higher than the 16.1 cent tax rate that prevailed in the same period in FY10. In FY10, there was no increase in the July-September period as the recession kept wholesale gasoline prices at lower levels. However, as the year progressed, wholesale prices increased and the variable fuels rate climbed to 17.7 cents per gallon for the second half of the fiscal year.

Motor vehicle usage tax receipts increased 1.5 percent, or $1.4 million, during the first quarter. Receipts were $95.1 million compared to $93.7 million collected during the same period last year. The legislatively enacted trade-in credit expired on August 16, 2010. Receipts in the quarter were both positively and negatively affected by the legislatively enacted trade-in credit. The $25 million cap was reached on August 16, 2010 meaning collections were still affected by the tax credit in the first half of the quarter, but receipts returned to a more customary pattern after the credit was exhausted.

Motor vehicle license tax receipts increased 5.2 percent during the first quarter of FY11. Receipts of $17.9 million compare to $17.0 million received during the first quarter of FY10.

Motor vehicle operators' license fees totaled $4.2 million, a 2.1 percent decrease compared to the level observed a year ago.

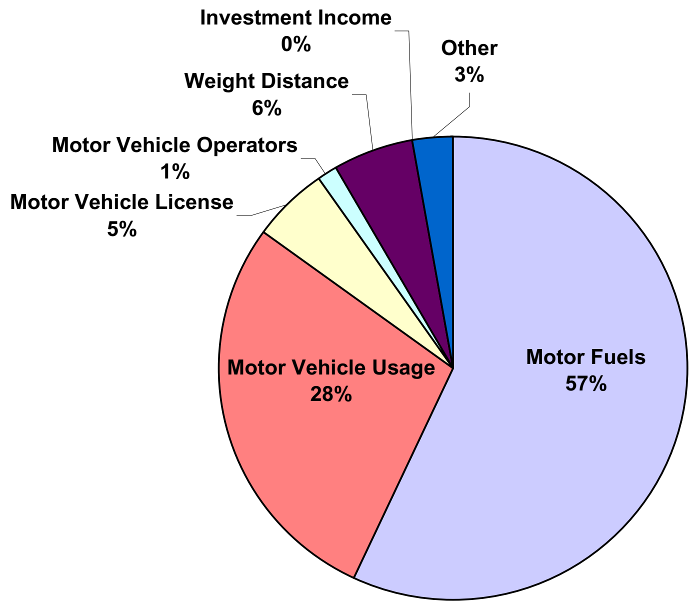
Weight distance tax receipts of $18.8 million increased 7.9 percent compared to receipts of $17.4 million collected during the first quarter of last year. The weight distance tax has some significance as a leading indicator of economic activity, as it is a rough proxy for goods in transit over Kentucky highways.

Investment income fell 63.3 percent in the first quarter due to lower investible balances. Receipts of $0.5 million compare to $1.3 in the first quarter of FY10.

The remainder of the accounts in the Road Fund combined for an increase of 36.6 percent. Receipts for the "Other" category totaled $9.3 million during the first quarter, compared to $6.8 million in the first quarter of FY10.

Figure 2 details the composition of Road Fund revenues by tax type in the first quarter of FY11. Motor fuels taxes and the motor vehicle usage tax accounted for 85.0 percent of Road Fund revenues in the first quarter. The next-largest sources of revenue were the weight distance tax with 6.0 percent followed by motor vehicle license with 5.0 percent. The "other" category accounted for 3.0 percent, while motor vehicle operators' license fees comprised one percent. Investment income accounted for zero percent of total Road Fund receipts.

Figure 2
First Quarter, FY11
Road Fund Receipts



The Economy First Quarter FY11

NATIONAL ECONOMY

The output of the national economy is typically measured by real Gross Domestic Product (GDP). GDP is the sum of all final goods and services sold in a year. Real GDP can be broken down into five components: consumption, investment, government expenditures, imports and exports. Real GDP rose by 2.9 percent in the first quarter of FY11 to $13,234.5 billion.

The previous peak for real GDP occurred in the second quarter of FY08 with $13,363.5 billion. The trough for real GDP occurred in the fourth quarter of FY09 with $12,810.0 billion, a loss of $553.5 billion, or a net 4.1 percent decline. Historically, this was a deep and moderately-long recession; the second deepest in absolute and percentage terms. The 2007 recession officially started in December 2007 and ended in June 2009 according to the National Bureau of Economic Research. The most severe recession in the last 110 years is still the Great Depression, which lasted for 43 months from 1929 to 1933. Using annual figures, real GDP fell by 26.7 percent during the Great Depression. Behind the 2007 recession, the next worst recession in terms of real GDP losses was the 1973 recession, where real GDP fell by a net $157.8 billion, a 3.2 percent decline.

All four of the components, which add to real GDP, improved in the first quarter of FY11. Real consumption had the slowest growth rate, but contributed a solid $153.3 billion to real GDP. Real consumption has grown steadily at 1.7 percent for two consecutive quarters.

Real investment grew the fastest among the five components of real GDP, gaining $304.2 billion or 20.4 percent over the first quarter of FY10. This is the third consecutive quarter that real investment has grown at double digit growth, gaining 10.5, 23.0 and 20.4 percent respectively. Unfortunately, real investment is still far below its pre-recession level, due to 13 consecutive quarter-over-same-quarter-last-year declines. Real investment is still down $466.0 billion below its pre-recession peak.

Government expenditures grew insignificantly in the first quarter, gaining $11.2 billion over the first quarter of FY10. It is worth noting that government expenditures growth has slowed substantially in the last five quarters compared to the previous nine years. In the last five quarters, quarter-over-same-quarter-last-year growth averaged 0.9 percent, while in the previous eight years, growth averaged 2.2 percent. The share of real government expenditures to real GDP has fallen slightly over the last five quarters. In the first quarter, the share fell to 19.4 percent, compared to a year ago when it was 19.9 percent, a seven-year high.

Both US imports and US exports rose substantially in the first quarter, gaining 13.9 and 12.9 percent respectively. This is the third consecutive quarter in which both exports and imports have increased. Exports have made up nearly all of the losses from the 2007 recession and are only $15.1 billion under its pre-recession peak. Imports are growing a little bit faster than exports, which has increased the trade deficit to $460.7 billion in the first quarter. The trade deficit creates a substantial drag on the real GDP figures.

US personal income grew by 3.3 percent in the first quarter. This is the highest growth for personal income since the first quarter of FY09. US personal income increased on a year-over-year basis for the last three quarters and has brought it above its pre-recession levels to $12,562.1 billion.

The civilian labor force contracted slightly during the recession. The previous labor force peak was 154.8 million in the fourth quarter of FY09. The labor force then fell in four of the next five quarters. The labor force fell by an additional 400,000 persons in the first quarter of FY11 over the fourth quarter of FY10. It is currently 153.9 million. Consistent with economic theory, the labor force response occurred afer the contraction in output.

US nonagricultural employment peaked in the third quarter of FY08 with 137.9 million employed. Employment reached the bottom by the second quarter of FY10, losing a net 8.3 million jobs. This is a net 6.0 percent decline during the 2007 recession. Since the trough, the economy has only regained a net 700,000 jobs; an improvement of only 0.5 percent. It is not uncommon for employment to lag other output variables like GDP following a recession. Labor is a derived demand; this means that firms only rehire workers once they see demand for their product improve for a prolonged period. It is also a well-established pattern that the deeper the output losses, the longer it takes for employment to improve. This occurs for a variety of reasons including: decreases to productive human capital, outsourcing shared costs and expanded hours for the labor force that was retained during the cuts.

Table 3
Summary of US Economic Series
First Quarter FY11/FY10

	First Quarter			
	FY11	**FY10**	**Chg**	**% Chg**
Real GDP	13,234.5	12,860.8	373.7	2.9
Real Consumption	9,314.9	9,161.6	153.3	1.7
Real Investment	1,798.7	1,494.5	304.2	20.4
Real Govt. Expenditures	2,570.5	2,559.3	11.2	0.4
Real Exports	1,681.5	1,490.0	191.5	12.9
Real Imports	2,142.2	1,880.8	261.4	13.9
Personal Income ($ billions)	12,562.1	12,164.0	398.1	3.3
Inflation (% chg CPI)	1.3	-1.6	NA	NA
Industrial Production Index (percent change)	6.5	-8.6	NA	NA
Civilian Labor Force (millions)	153.9	154.2	-0.3	-0.2
Total Nonfarm Employment (millions)	130.3	130.1	0.3	0.2
Manufacturing Employment (millions)	11.7	11.7	0.0	0.0
Unemployment Rate (percent)	9.6	9.6	NA	-0.3

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Data for FY11 Q1 are October 2010 estimates.
Source: IHS Global Insight Inc., September 8, 2010 data release

KENTUCKY ECONOMY

Kentucky personal income increased by $5,535.3 million or 4.0 percent over the first quarter of FY10. Kentucky personal income outperformed US personal income during the first quarter of FY11 and also managed to weather the recession with smaller losses. From peak to trough, the US lost a net 3.0 percent in personal income, while Kentucky lost only 1.5 percent net. Kentucky has experienced six consecutive adjacent-quarter increases in personal income since the recession, while the US has had only four such increases. This is not typical, as Kentucky typically lags the US (for most variables) coming out of recessions.

Kentucky wages and salaries, which make up 50.7 percent of personal income, increased by 2.9 percent in the first quarter of FY11. This is the sixth consecutive quarter of adjacent-quarter growth for wages and salaries. Growth has tamed in the first quarter of FY11 compared to the second half of FY10, where growth was 1.2 and 1.4 percent respectively. The first quarter of FY11 grew by 0.1 percent over the fourth quarter of FY10. The recession really began when Kentucky personal income plummeted in the third quarter of FY09. Wages and salaries fell by an astounding 3.0 percent in that one quarter. Wages and salaries finally surpassed its previous peak in the fourth quarter of FY10, five quarters after the devastating loss.

Kentucky nonagricultural employment increased by a modest 0.5 percent over the first quarter of FY10. The changes among the supersectors were also small. The biggest winner in both absolute and percentage terms was business services employment which rose 7.8 million jobs, or 4.6 percent, since the first quarter of FY10. The biggest loser in both absolute and percentage terms was construction employment which lost 4.7 million jobs, or 6.6 percent.

Despite the positive position relative to the US, the recession still had a profound effect on Kentucky nonagricultural employment. From peak to trough, Kentucky lost 113,700 seasonally adjusted jobs during the recession. That is a 6.1 percent net loss in jobs. In the last two quarters, nonagricultural employment has increased by a net 12,400 seasonally adjusted jobs. This is particularly descriptive of the condition of Kentucky employment. Kentucky nonagricultural employment reached 1,831,800 in October 2000; this was the peak preceding the 2001 recession. The most recent peak, preceding the 2007 recession, occurred in January 2008 with 1,871,200 employed. So from peak to peak, Kentucky only gained a net of 39,400 jobs, or 2.2 percent additional jobs above the 2000 peak level. The 2007 recession has been so devastating to Kentucky employment, that even after two quarters of job growth, Kentucky is still 12,600 jobs below the trough from eight years ago.

Manufacturing employment, which makes up 11.9 percent of nonagricultural employment in Kentucky, has grown slightly in the last two quarters. During the 2001 recession, Kentucky manufacturing employment shed 47,500 jobs [May 2000 to April 2003]. Following the 2001 recession, there was no identifiable recovery for manufacturing jobs in Kentucky. Other than a few irregular fluctuations, manufacturing employment was flat or slightly declining from 2003 to 2008. From 2008 until February of 2010, Kentucky shed just over 45,000 additional manufacturing jobs due to the 2007 recession. It is therefore encouraging that first quarter FY11 manufacturing employment is 211,100. That is a net increase of 3,600 jobs since the trough in the third quarter of FY10. This is the first identifiable improvement in manufacturing employment since early 2000.

The various supersectors of employment in Kentucky shared pretty evenly in the losses from the 2007 recession. The largest supersector, trade, transportation and utilities fell by a net 27,300 seasonally adjusted jobs, 7.1 percent, from peak to trough. The second largest loser in absolute terms was the construction sector, which lost 20,600 jobs from peak to trough. Construction was also the largest percentage loser, losing 23.9 percent from peak to trough. Education and health services employment was the least affected sector falling only three times in the last three years. Each time it fell it was only by a small measure. Manufacturing employment was affected the most, in terms of most declines. Manufacturing employment declined for 11 consecutive quarters during the recession. It declined by 15 quarters with only one intervening quarterly improvement.

It is informative that Kentucky manufacturing started declining a year and a half before the official start date of the 2007 recession.

Table 4
Summary of Kentucky Economic Series
First Quarter FY11/FY10

	First Quarter			
	FY11	**FY10**	**Chg**	**% Chg**
Personal Income ($ millions)	143,533.3	137,998.0	5,535.3	4.0
Wages and Salary ($ millions)	72,820.8	70,794.0	2,026.8	2.9
Nonagricultural Employment (thousands)	1,767.9	1,759.5	8.4	0.5
Goods-producing	301.7	304.9	-3.2	-1.0
Construction	67.0	71.8	-4.7	-6.6
Mining	23.6	22.9	0.7	3.0
Manufacturing	211.1	210.2	0.9	0.4
Service-providing	1,142.1	1,130.4	11.8	1.0
Trade, Transportation & Utilities	364.7	361.3	3.3	0.9
Information	26.6	26.7	-0.1	-0.4
Finance	86.7	87.7	-1.1	-1.2
Business Services	177.6	169.8	7.8	4.6
Educational Services	250.4	247.6	2.8	1.1
Leisure and Hospitality Services	168.3	167.1	1.2	0.7
Other Services	67.8	70.1	-2.2	-3.2
Government	324.1	324.2	-0.2	-0.1

Not Seasonally Adjusted. Data for FY11 Q1 are September 2010 estimates.
Source: IHS Global Insight Inc., September 8, 2010 data release

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Interim Outlook

The revenue estimates in this report were prepared using the September 2010 control economic forecast from both Global Insight and the MAK, which is operated by the Office of State Budget Director. Projections have stabilized during the interim period between official estimates due to two primary factors; actual FY10 revenues were very close to the base projected by the CFG during the budget forecast; and second, Global Insight has made few changes to their outlook, aside from some slight differences in timing.

The enacted General Fund estimate for FY11 is $8,570.9 million, a tally which includes $80.1 million in legislatively enacted policy changes during the 2010 Special Session of the General Assembly. October's unofficial interim outlook calls for General Fund revenues of $8,629.3 million, or $58.4 million higher than the enacted estimates.

Projected General Fund revenues for the next three quarters are shown in Table 5. As the table suggests, the outlook demonstrates the volatility in certain taxes, both in terms of normal volatility and additonal uncertainty given our current position in the business cycle. The largest two revenue sources, the individual income tax and the sales tax, are projected to come in slightly lower than the official estimates. The amount of the projected reduction is roughly attributable to the difference between the underlying economic assumptions. Our current interim

Table 5
General Fund Interim Forecast
($ millions)

	FY11						Official	
	Q1		Q2, Q3, & Q4		Full Year		Budget	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff
Sales & Use	717.2	3.4	2,165.5	3.1	2,882.7	3.2	2,929.3	-46.6
Individual Income	845.7	3.8	2,444.6	4.5	3,290.3	4.3	3,322.2	-31.9
Corporation Inc & LLET	114.2	43.5	386.6	27.0	500.8	30.5	403.9	96.9
Coal Severance	72.8	9.0	217.3	5.9	290.1	6.7	230.4	59.7
Cigarette Taxes	69.0	-7.1	202.6	-0.7	271.6	-2.5	280.9	-9.3
Property	51.6	-14.1	485.2	6.4	536.8	4.0	540.2	-3.4
Lottery	45.0	2.3	161.0	3.2	206.0	3.0	205.4	0.6
Other	139.6	3.1	511.5	4.2	651.1	4.0	658.7	-7.6
Total General Fund	**2,055.1**	**4.4**	**6,574.2**	**5.1**	**8,629.3**	**4.9**	**8,570.9**	**58.4**

estimates were derived from the control forecast whereby the enacted estimates were a 70:30 blend of the control and optimistic economic scenarios. Significant growth is still expected in the income and sales taxes, but the magnitude of the growth has been slightly lowered.

The sales tax grew 3.4 percent in the first quarter with growth expected to slow to 3.1 percent in the remaining three quarters of the fiscal year. Part of the slowing of growth in the sales tax is attributable to the fact that the sales tax improved over the second half of FY10, which will set a higher bar for growth in FY11. The Global Insight forecast for US retail sales continues to be strong, but several forces are at work which will delay a full rebound in the sales tax. Many consumers continue to pay down debts and have limited availability to credit. Also, until the employment picture comes into better focus, consumers will be cautious in spending in the event that they are faced with a disruption from their current employment.

The individual income tax is expected to grow 4.5 percent over the remaining nine months of FY11 despite growing only 3.8 percent in the first quarter. Relative to the enacted estimate, the individual income interim forecast is $31.9 million lower. Higher growth for the remainder of the fiscal year is partially attributable to an increase in Kentucky employment and wages. The withholding component comprises approximately 90 percent of the total individual income tax.

Despite small downward revisions to the sales and income taxes, three major revenue sources continue to outperform estimates. The corporation income tax, the LLET, and the coal severance tax have been strong performers in the first quarter, and the momentum is expected to continue through the forecasting horizon. By any measure, corporate profits are running very high right now. Apportioned profits are the basis of the corporate income tax, and the first two declaration periods for tax year 2010 calendar filers have both posted sizable growth. Moreover, refund balances are at historic lows as the Department of Revenue has put a higher priority on the timely handling of refund requests in an effort to minimize interest payments.

The other significant source of business taxation, the LLET, has also outperformed expectations. Substantial compliance efforts were undertaken to ensure proper taxpayer understanding of the LLET. While a component of these compliance efforts led to one-time catch-up payments, it appears as if compliance efforts are also paying dividends in terms of proper payment of the tax at the estimated payments end of the cycle. The interim estimate for the combination of the corporation income tax and the LLET is $500.8 million, which is $96.9 million greater than the official estimate.

The unprecedented revenue growth in coal severance tax revenue for FY09 was only partially reversed in FY10. Despite very slow going in the first three quarters, the fourth quarter of FY10 posted growth of 3.6 percent over the record levels set in FY09. Coal severance finished FY10 at $271.9 million in collections, $27.2 million higher than projected. With the higher base heading into FY11, it is reasonable to assume that the projections going forward would be slightly higher than the official estimates. That was indeed the case in the first quarter, and the next three quarters are expected to sustain this momentum. The current estimate of $290.1 million is nearly $60 million higher than the enacted estimate.

Cigarette taxes totaled $278.2 million in FY10, an improvement of 37.1 percent over FY09. Compared to the official projections for FY10, the cigarette taxes missed the mark by six-tenths of one percent – quite respectable given that the state tax rate doubled in April 2009 and the federal government raised taxes at the same time by over $1.00 per pack. The CFG estimated that Kentucky would lose approximately 105 million annual packs due to the combined price impacts from the state and federal taxes. Twelve month equivalent data suggests that the pack loss was approximately 112 million packs. Going forward, the interim forecasts calls for softer cigarette tax receipts for the remainder of FY11. Several factors are simultaneously at play. In the last decade, the trend has been falling demand for cigarettes. Smoking bans and the presence of substitute goods have further depressed pack sales. All of these factors serve to reduce revenues, so the interim estimates call for a reduction in the outlook for the cigarette tax.

The property tax forecast is virtually unchanged in this interim forecast. Expected receipts of $536.8 million are $3.4 million lower than the enacted estimate for property taxes. Receipts to date, and a reduction to the property tax estimate on watercraft, were the primary factors resulting in the minor adjustment.

Lottery revenues for FY10 were lowered from $202.0 million to $200 million at the December 2009 meeting of the CFG. The FY10 dividend payments from the Kentucky Lottery Corporation were exactly $200.0 million, right on estimate. The annualized estimate for FY11 is $206.0 million, or 3.0 percent higher than FY10. No changes were made for the interim forecast. While demand for scratch-off products continues to be weak, online sales of mega-jackpot tickets as well as the daily online draws have served to more than counterbalance poor instant ticket sales.

Revenues in the “Other” category fell 5.3 percent in FY10. The numerous accounts within this category are a mixed bag of large versus small and stable versus erratic revenue sources, many of which also have timing idiosyncrasies that dominate any underlying autoregressive patterns. Collectively, the interim forecast calls for a $7.6 million reduction as compared to the official estimate of $658.7 million. Each account is examined during an interim forecast. Slight downward revisions were done based on year-to-date performance. The largest reductions were made to the oil production tax and the natural gas severance tax.

The official General Fund estimate for FY11 is comprised of the $8,490.8 million projected in December 2009, plus $80.1 million estimated from legislatives actions in 2010. Of the $80.1 million expected in FY11, very little was received during the first quarter. Many of the revenue enhancements added through the budget bill or other tax-related measures will not be uniformly collected throughout the fiscal year. The Office of State Budget Director is projecting a back-loading of legislatively added revenues such that the final quarter of FY11 will see the largest quarterly infusion of the additional revenues.

ROAD FUND

Road Fund revenues are forecasted to increase 8.8 percent over the remaining three quarters of FY11 as shown in Table 6 below. The two largest Road Fund accounts, motor fuels and motor vehicle usage, are expected to account for the majority of the increase in revenue.

Motor fuels tax receipts are forecasted to grow 9.0 percent in the last three quarters of FY11. This is due principally to a rise in 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.

Motor vehicle usage tax collections are expected to rise 12.4 percent in the final nine months of FY11. Receipts increased 1.5 percent in the first quarter but will rebound strongly through the end of the fiscal year due to the expiration of legislation which depressed collections in FY10. House Bill 3, passed during the 2009 Special Session of the General Assembly, exempted from tax the value of trade-ins on new vehicle purchases, depressing tax collections. The fiscal impact for the final three quarters of FY10 was $18.4 million. Restoring the tax exemption plus an increase in motor vehicles sales will boost tax collections through the end of FY11.

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 0.7 percent in the final three quarters of FY11. Motor vehicle operators' licenses are projected to rise 5.1 percent in the remainder of the fiscal year. Weight distance tax revenue should grow 7.0 percent for the remainder of the fiscal year. Investment income should fall 55.4 percent due to lower interest rates. All other revenues should combine for growth of 7.4 percent during the last nine months of FY11.

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

	FY11 Quarter 1		FY11 Quarters 2, 3 & 4		FY11 Full Year	
	Actual	% Chg Year Ago	Interim Estimate	% Chg Year Ago	Interim Estimate	% Chg Year Ago
Motor Fuels & MF Use/Surtax	193.0	19.0	538.2	9.0	731.2	11.5
Motor Vehicle Usage & Rental	95.1	1.5	268.8	12.4	363.9	9.3
Motor Vehicle License	17.9	5.2	80.3	0.7	98.2	1.4
Motor Vehicle Operators	4.2	-2.1	12.2	5.1	16.4	3.1
Weight Distance Tax/Surtax	18.8	7.9	56.8	7.0	75.6	7.2
Investment	0.5	-63.4	1.0	-55.4	1.5	-58.3
Other	9.3	36.7	26.2	7.4	35.5	13.8
Road Fund	**338.7**	**11.9**	**983.6**	**8.8**	**1,322.3**	**9.6**

NATIONAL ECONOMY

When the July 2010 Quarterly Report was issued, the outlook for the national economy was beginning to cool somewhat from the pace set earlier in 2010. GDP, personal income, industrial production, exports, and retail sales – the major national economic aggregates that feed into the Kentucky economy – were all moderating from the strong performance in the first calendar quarter of 2010. Corporate profits were the lone bright spot, but it was unclear whether high corporate profits would eventually lead to an increase in productive capacity and higher employment. Employment growth was anemic, wages and salaries dormant, and the unemployment rate persistently high. Talks of a double-dip recession were becoming increasingly mainstream. The national economy was facing a weak and fragile recovery period.

The outlook one quarter later is virtually unchanged. Easy gains, like the inventory correction, federal fiscal policy, and quantitative easing, are in the rear view mirror. A holding pattern has formed pending the resolution of three very critical issues: the path of the consumer; the path of corporations; and foreign demand for US exports.

Consumers have been deleveraging in the aftermath of the housing crash. In the height of the housing market, household wealth from homeowner equity was about $13.0 trillion. Current estimates place homeowner equity at around $6.5 to $7.0 million. This represents a deeper loss of household wealth than was experienced in the stock market plunge in 2001. 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 inflation and nominal interest rates hover around historic lows, consumers will remain cautious until household wealth and employment gain a more firm foothold. On the positive side, periods of deleveraging (saving) are typically followed by some pent-up demand. Therefore, while domestic consumption does not appear to be taking a leadership role in the recovery, there is certainly room for increased demand if employment and consumer sentiment find firmer footing.

Domestic corporations are becoming the focal point in the economy. It has been widely reported that corporations are "awash with cash". This prime cash position is a function of streamlining production, reducing fixed costs, and extreme caution with their workforce levels. Evidence to date indicates that some corporate investment is taking place, but the emphasis has been on replacement machinery and updating computers and software. While all investment is 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 to growing corporate profits must come from growing revenues, which typically requires new productive machinery and additional workers. The path to this stage of the recovery is unclear. It will be required, however, to advance the economy beyond the tepid growth of the current fragile recovery.

Foreign trade is the other critically watched segment of the national economy. This segment of the economy is very important in establishing the expectations of business. If the US consumer is not positioned to be the

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

	Q2, Q3, & Q4			Full Year	
	FY11	FY10	% Chg	FY11	% Chg
Real GDP	13,370.1	13,116.4	1.9	13,336.2	2.2
Real Consumption	9,412.1	9,226.2	2.0	9,387.8	1.9
Real Investment	1,791.6	1,687.6	6.2	1,793.4	9.4
Real Govt. Expenditures	2,570.0	2,552.4	0.7	2,570.1	0.6
Real Exports	1,748.9	1,614.0	8.4	1,732.0	9.4
Real Imports	2,163.8	1,985.1	9.0	2,158.4	10.2
Personal Income ($ billions)	12,750.2	12,353.5	3.2	12,703.1	3.2
Inflation (% chg CPI)	1.3	1.9	NA	1.3	NA
Industrial Production Index (% chg)	94.0	90.6	3.7	93.8	4.4
Civilian Labor Force (millions)	154.6	153.8	0.5	154.4	0.3
Total Nonfarm Employment (millions)	130.7	129.9	0.6	130.6	0.5
Manufacturing Employment (millions)	11.8	11.6	1.8	11.8	1.3
Unemployment Rate (percent)	9.7	9.8	NA	9.7	-0.6

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Data for FY11 Q2 through FY11 Q4 are September 2010 estimates.
Source: IHS Global Insight Inc., September 8, 2010 data release

source of demand for the economy, strong demand for US goods and services must come from another source. Early in the recovery, Federal fiscal spending and tax cuts led to a noticeable bump in the economy. Between tax cuts, aid to state and local governments, Census hiring, and wide-scale infrastructure improvements, federal fiscal policy injected a dose of demand into the economy. Unfortunately, in most cases, fiscal policy can only be a temporary cure as pressures will build as the national debt continues to grow.

A more sustainable source of demand is net exports. When foreign companies purchase domestically produced goods and services, demand rises. Businesses respond by increasing productive capacity and hiring additional workers. If export demand can serve as a backfill weak domestic consumer demand, then increased demand will perpetuate as the additional workers create consumption demand and eventually higher wages. The major challenge to sustainable export-led growth remains to be world banking interventions vis-à-vis currency wars. A weak dollar is essential to an export-led recovery. Foreign banks are often quick to intervene when they see a decline in their economies as US goods gain in popularity due to relative prices. The maneuvers of foreign banks frequently raise the strength of the US dollars versus other currencies hurting US exports.

Unfortunately, the inherent lagging nature of the employment rebound has several consequences that add considerable uncertainty to the current economic forecast. Employment, at least the wages and salaries from employment, is highly correlated with household consumption, which is in turn a driver for many other elements of the economy. Current consumption helps form the expectations for future consumption demand, which in turn drives business decisions like equipment purchases. Second, 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 consumer lending has tightened especially as it pertains to higher-risk loans.

Like most economic forecasts, there are both upside and downside risks to this control forecast. The primary downside risk to the forecast is a double-dipped recession. Global Insight has assigned a 25 percent weight to this occurrence. Most experts agree that the current recovery is very fragile in nature, such that even a small global disruption could lead to a magnified and negative response.

The upside scenario is not really a new complete course for the economy but rather a quicker path to the long-run growth models. This scenario predicts that historically low interest rates and pent-up consumer demand will interject a strong push from the consumer side of the economy. Once this pilot light is ignited, the strength of the consumer recovery will become self-perpetrating.

Finally, it should be noted that recoveries from financial recessions are more pernicious than others, and the period of recovery tends to be flat, or U-shaped. In a more structural recession, the economy can rebound more quickly when the structural problem that created the downturn is reconciled. Financial recessions leave deeper scars due to the loss of household wealth and the severe impact on consumer sentiment. The period of recovery is thus extended as consumers must dig out of the hole left behind by the loss of household wealth before becoming a reliable and sustained source of aggregate demand.

KENTUCKY ECONOMY

It would seem intuitive that forecasting the state economy is easier than forecasting the national economy, but this is not the case. At the national level, the diversity between and among states creates situations where some states under and over perform and the errors tend to offset one another vis-à-vis the business cycle. When forecasting for a single state, the benefit of canceling stochastic errors is lost and point estimates become crucial. These difficulties are magnified in periods of downturn and recovery since the precise timing of the recovery makes a material difference in the downstream revenue forecasts. It is during these turning points where extra reliance is placed on the relationships built into the state econometric models.

By most accounts, Kentucky was somewhat insulated from the national recession that ended in June 2009. There are three primary factors at play. First, the loss of household wealth from home equity was not as severe in Kentucky since there was a smaller run-up in prices and less speculative buying. Second, all mineral extraction states were buttressed by higher mineral prices and therefore had better severance tax receipts. Peak to trough job losses and personal income declines were much less severe in states with a vibrant mining presence. Finally, Kentucky has a broad mix of manufacturing instead of an overreliance on a single industry. The diversity and stability of our tax code also limits the downside risks during recessions by sustaining government services and interjecting resources into the private economy.

Tables 7 and 8 display the highlights of the current forecast. There are many similarities between the state and national outlooks. Most notably, personal income rebounds before employment, as seen in Table 8. Kentucky employment growth in FY11 is predicted to be 0.4 percent while personal income in Kentucky is expected to grow by 3.4 percent. Compared to the national forecast for the same period, the employment outlook is very similar but the rebound in personal income is slightly higher in Kentucky. If the dollar stays low, and global trading powers continue to be able to purchase US exports, then Kentucky should continue to slightly outperform the national averages and continue along the slow path of recovery.

In summary, the forecast calls for growth much in line with the projections used by the Consensus Forecasting Group during the December 2009 official estimates. Although the forecast has slowed in the past few months, the projections for many national economic aggregates have actually increased since the official estimates were rendered. All told, the main revenue drivers (employment, wages, and personal income) are very much congruous with our official estimates. The same risks that apply to the national economy exist for the state economy as well.

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

	Q2, Q3, & Q4			Full Year	
	FY11	FY10	% Chg	FY11	% Chg
Personal Income ($ millions)	145,282.8	140,755.5	3.2	144,845.4	3.4
Wages and Salary ($ millions)	73,879.7	71,769.5	2.9	73,614.9	2.9
Nonagricultural Employment (thousands)	1,773.5	1,766.4	0.4	1,772.1	0.4
Goods-producing	304.2	300.9	1.1	303.5	0.5
Construction	67.0	68.1	-1.6	67.0	-2.9
Mining	24.7	23.2	6.3	24.4	5.5
Manufacturing	212.5	209.7	1.4	212.1	1.1
Service-providing	1,146.8	1,139.4	0.6	1,145.6	0.7
Trade, Transportation & Utilities	364.8	362.1	0.8	364.8	0.8
Information	26.6	26.4	0.5	26.6	0.3
Finance	86.5	86.4	0.1	86.5	-0.3
Business Services	181.2	178.5	1.5	180.3	2.2
Educational Services	252.0	249.4	1.0	251.6	1.1
Leisure and Hospitality Services	167.7	168.3	-0.3	167.9	-0.1
Other Services	68.1	68.3	-0.4	68.0	-1.1
Government	322.6	326.1	-1.1	323.0	-0.8

Not Seasonally Adjusted.

Source: IHS Global Insight, Inc. and the Governor's Office for Economic Analysis MAK model, Sept 2010.

APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	First Quarter FY 2011	First Quarter FY 2010	% Change
TOTAL GENERAL FUND	**2,055,095,794**	**1,968,453,450**	**4.4%**
Tax Receipts	1,990,193,861	1,899,098,174	4.8%
Sales and Gross Receipts	869,652,836	848,152,069	2.5%
Beer Consumption	1,792,037	1,734,290	3.3%
Beer Wholesale	14,823,556	14,443,895	2.6%
Cigarette	69,001,313	74,188,631	-7.0%
Distilled Spirits Case Sales	(316,506)	27,201	---
Distilled Spirits Consumption	2,767,839	2,709,843	2.1%
Distilled Spirits Wholesale	6,905,018	6,804,743	1.5%
Insurance Premium	29,673,246	27,685,914	7.2%
Pari-Mutuel	1,945,337	(1,550,912)	---
Race Track Admission	86,736	92,698	-6.4%
Sales and Use	717,229,493	693,895,478	3.4%
Wine Consumption	602,545	580,280	3.8%
Wine Wholesale	3,378,775	2,887,009	17.0%
Telecommunications Tax	16,153,615	19,060,855	-15.3%
OTP	5,569,665	5,456,403	2.1%
Floor Stock Tax	40,169	135,740	-70.4%
License and Privilege	134,345,111	108,115,576	24.3%
Alc. Bev. License Suspension	99,250	68,350	45.2%
Coal Severance	72,839,852	66,843,188	9.0%
Corporation License	3,403,741	678,533	401.6%
Corporation Organization	19,412	101,730	-80.9%
Occupational Licenses	33,102	41,317	-19.9%
Oil Production	1,821,582	1,843,509	-1.2%
Race Track License	105,000	112,500	-6.7%
Bank Franchise Tax	2,489,017	(165,750)	---
Driver License Fees	165,064	156,963	5.2%
Minerals Severance	3,977,297	3,627,032	9.7%
Natural Gas Severance	5,136,472	4,277,040	20.1%
Limited Liability Entity	44,255,323	30,531,165	45.0%
Income	915,602,843	863,467,596	6.0%
Corporation	69,901,358	49,041,270	42.5%
Individual	845,701,485	814,426,326	3.8%
Property	$51,625,502	$60,134,196	-14.1%
Building & Loan Association	(53,180)	91,143	---
General - Real	(683,968)	134,803	---
General - Tangible	22,301,036	22,343,478	-0.2%
Omitted & Delinquent	15,315,505	13,355,891	14.7%
Public Service	14,509,632	23,521,697	-38.3%
Other	236,477	687,184	-65.6%
Inheritance	$11,333,007	$11,168,896	1.5%
Miscellaneous	$7,634,563	$8,059,842	-5.3%
Legal Process	5,208,501	5,779,530	-9.9%
T. V. A. In Lieu Payments	2,400,284	2,279,819	5.3%
Other	25,778	493	---
Nontax Receipts	$64,334,885	$68,434,525	-6.0%
Departmental Fees	5,838,998	7,498,852	-22.1%
PSC Assessment Fee	8,869,505	8,210,157	8.0%
Fines & Forfeitures	6,309,597	7,485,475	-15.7%
Interest on Investments	190,583	199,721	-4.6%
Lottery	45,000,000	44,000,000	2.3%
Sale of NOx Credits	22,513	460,780	-95.1%
Miscellaneous	(1,896,310)	579,540	---
Redeposit of State Funds	$567,048	$920,751	-38.4%

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	First Quarter FY 2011	First Quarter FY 2010	% Change
TOTAL ROAD FUND	**$338,682,693**	**$302,616,105**	**11.9%**
Tax Receipts-	$331,339,707	$296,144,029	11.9%
Sales and Gross Receipts	$288,121,203	$255,861,906	12.6%
Motor Fuels Taxes	193,009,964	162,170,900	19.0%
Motor Vehicle Usage	95,111,239	93,691,006	1.5%
License and Privilege	$43,218,504	$40,282,123	7.3%
Motor Vehicles	17,900,500	17,023,190	5.2%
Motor Vehicle Operators	4,151,824	4,242,956	-2.1%
Weight Distance	18,754,429	17,387,559	7.9%
Truck Decal Fees	34,267	29,437	16.4%
Other Special Fees	2,377,485	1,598,981	48.7%
Nontax Receipts	$6,054,380	$6,226,500	-2.8%
Departmental Fees	5,037,434	4,564,483	10.4%
In Lieu of Traffic Fines	192,973	225,982	-14.6%
Investment Income	481,952	1,313,006	-63.3%
Miscellaneous	342,021	123,030	178.0%
Redeposit of State Funds	$1,288,606	$245,576	424.7%