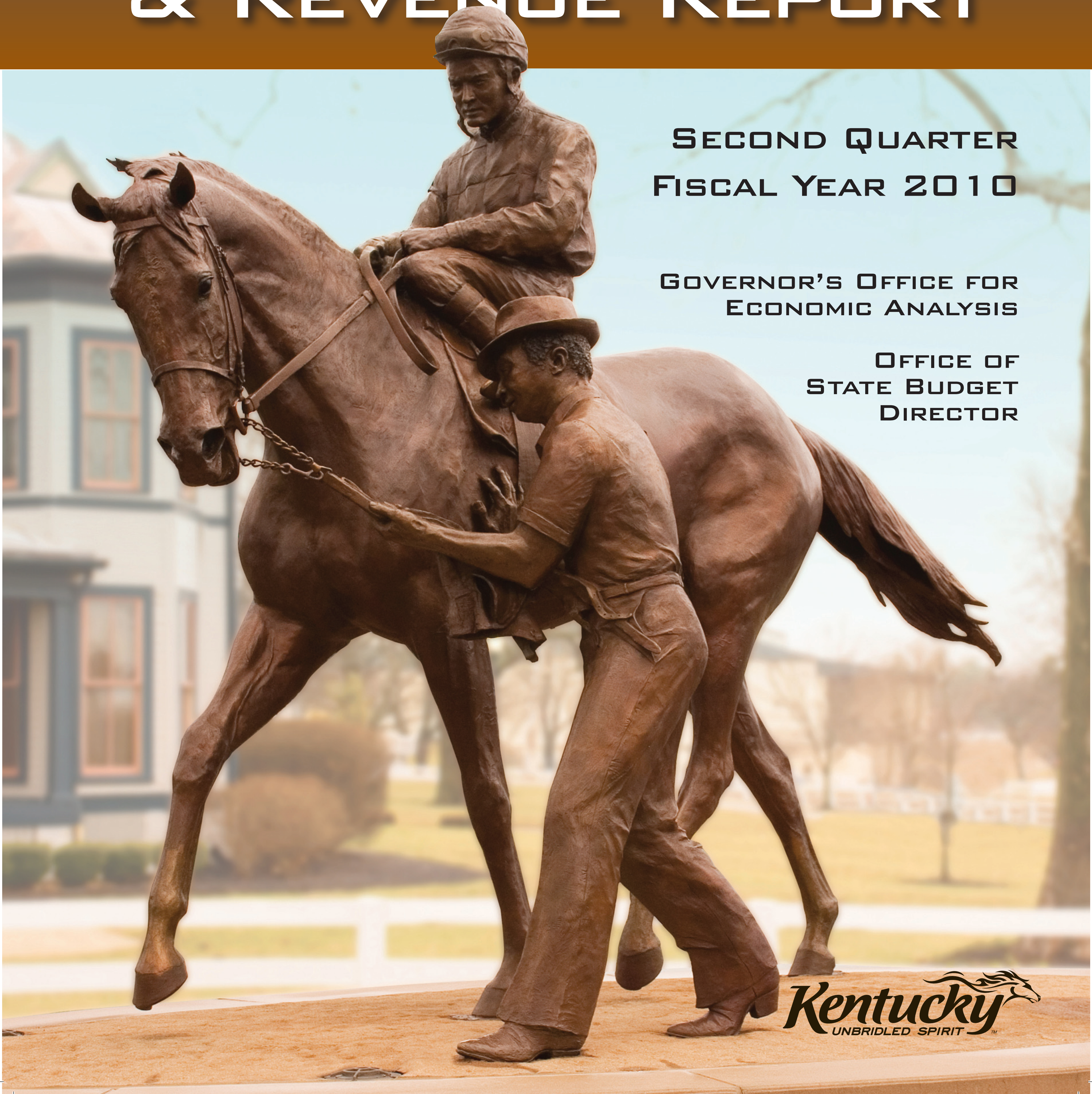
COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report



Second Quarter Fiscal Year 2010

Governor's Office for Economic Analysis

Office of State Budget Director

Kentucky
UNBRIDLED SPIRIT

Office of State Budget Director
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Frankfort, Kentucky 40601

Steven L. Beshear
Governor

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State Budget Director

Governor's Office for Policy and Management
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January 29, 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 second quarter of Fiscal Year 2010 (FY10). It also includes an interim economic and revenue forecast for the last two quarters of FY10 and the first quarter of FY11.

General Fund receipts for the second quarter of FY10 totaled $2,162.4 million, a decrease of 3.6 percent compared to the same period in FY09. Road Fund revenues totaled $279.1 million, a decrease of 0.3 percent from the second quarter of FY09.

The interim General Fund forecast for the final two quarters of FY10 calls for a decrease of 1.5 percent compared to the same period one year ago, resulting in a projected decline of 3.1 percent for the entire fiscal year. The interim forecast for the Road Fund for the final two quarters of FY10 calls for an increase of 1.8 percent, resulting in a projected increase of 0.1 percent for the entire fiscal year.

Compared to the current official revenue estimates, the interim General Fund forecast for FY10 falls $27.5 million short. For the Road Fund, the interim forecast is $6.5 million less than the current official forecast.

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

Attachment

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Executive Summary

In accordance with KRS 48.400(2), the Office of State Budget Director has prepared a Quarterly Economic and Revenue Report for the second quarter of FY10. 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 which represent the final two quarters of FY10 and the first look at FY11.

General Fund receipts fell 3.6 percent in the second quarter of FY10, marking the fourth consecutive quarterly decline in the General Fund. For the year, the General Fund has declined 4.6 percent. Road Fund receipts were down marginally by 0.3 percent, a seventh consecutive quarterly decline. For the year, the Road Fund has declined 1.7 percent vis-à-vis the first half of FY09.

The major sources of weakness in the General Fund for the first half of FY10 were the income and sales taxes, which together comprise approximately three-quarters of the General Fund revenues. Individual income tax receipts plummeted 7.7 percent while the sales tax suffered a 5.6 percent setback. Due to timing, most of the income tax payments received in the first half of FY10 were payroll taxes collected through withholding. The large rate of decline is directly attributable to fewer employed persons and anemic wage growth for those continuing their work service. The story is largely the same for the Kentucky sales tax. The cumulative loss of employment in Kentucky since the recession began has taken an exacting toll on sales tax collections. Counterbalancing occurred as tobacco taxes grew on the strength of the rate increase which took effect in April, but the magnitude was not enough to preserve positive growth in the second quarter.

After almost two entire years of weakness, the Road Fund performance was encouraging despite falling 1.7 percent the first half of FY10. Through December, the Road Fund has collected $581.7 million in revenues, of which 84 percent is derived from the two largest revenue sources: the motor fuels and motor vehicle usage accounts. While neither tax is posting considerable growth, the months of double-digit declines have subsided. Motor fuels are up 1.6 percent year-to-date and better growth is projected for the second half of the fiscal year. Motor vehicle usage is down 4.5 percent year-to-date but the second quarter showed considerable improvement over the first quarter's 6.3 percent rate of decline.

The remainder of this executive summary will concentrate on the highlights of the outlook portion of this report. Projected General Fund revenues for the next three quarters are shown in Table 5. The revenue outlook presented in this report is slightly lower than the official estimates rendered by the Consensus Forecasting Group (hereafter CFG) on December 21, 2009 for the present current fiscal year. The standing *official* estimate for the General Fund for FY10 is $8,196.0 million, which would produce a rate of decline of 2.7 percent compared to FY09 revenues. The unofficial interim estimates prepared for this report call for FY10 General Fund revenues to total $8,168.5 million, an estimate $27.5 million below the *official* CFG estimate for FY10.

A similar interim estimate was also prepared for the Kentucky Road Fund. Using the latest available information, Road Fund revenues are expected to reach an unofficial interim estimate of $1,192.6 million. The standing *official* estimate for the Road Fund in FY10 is $1,199.1 million. Comparing the two estimates, the latest interim estimate is $6.5 million below the *official* estimate.

Despite the lack of momentum on the revenue side of the ledger, Kentucky should begin to feel some improvement in the national economy over the short term, with a possible lag or delay. Kentucky entered the 2007 recession later than most other states due in part to export demand and a strong coal economy which held up well into FY09. Similarly, we expect a slight delay in the recovery stage, although the export-led recovery should boost Kentucky's significant manufacturing sector.

Kentucky personal income is projected to grow 5.5 percent in the next two quarters followed by 6.3 percent growth in the first quarter of FY11. Both figures compare favorably to their U.S. counterparts. The corresponding growth rates in the national economy are 3.3 percent and 4.3 percent respectively. Kentucky wages and salary income, a bell-weather indicator for many state tax variables, is expected to show much weaker growth, with expected growth of 1.8 percent growth in the final two quarters of FY10, followed by 2.7 percent growth in the first quarter of FY11.

By the first quarter of FY11, employment declines are projected to turn into employment increases at the national level and a formation of the bottom in the Kentucky employment market. Therefore, the lag of the employment recovery phase of the Kentucky economy appears to be limited to a one-quarter delay behind U.S. employment. If these trends continue, then the economic growth projected by the CFG in December 2009 should come to pass.

In comparison to the November outlook, which was the basis for the official FY10 consensus revenue estimates, both the employment and personal income projections have improved marginally. Caution is still the order of the day, however, when making projections during a turning point.

GENERAL FUND

Revenue collections fell 3.6 percent, or $81.0 million, in the second quarter of FY10 which is an improvement over the 5.6 percent decline in the first quarter of the year. Through the first two quarters of the fiscal year, receipts have fallen 4.6 percent. The revenue declines are attributable to weak economic conditions that have prevailed since the start of the current recession in December 2007.

Second quarter losses were driven primarily by declines in sales and use, individual and corporation income, and coal severance tax receipts. Those revenue sources accounted for a decline of $134.1 million in the second quarter. Offsetting those losses were significant gains in property and cigarette tax collections. Receipts in the second quarter totaled $2,162.4 million compared to $2,243.4 million received in the second quarter of FY09. The resulting growth rate was -3.6 percent, and compares to a growth rate of 3.1 percent for the same quarter last year. 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.

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.

Table 1
Summary General Fund Receipts
Second Quarter, FY10
(mil $)

	FY10	FY09	Diff ($)	Diff (%)
Sales and Use	690.9	716.3	-25.4	-3.5
Individual Income	788.4	859.6	-71.2	-8.3
Corp Income	55.4	82.3	-26.9	-32.7
LLET	36.1	30.2	5.9	19.6
Coal Severance	65.0	75.5	-10.6	-14.0
Cigarette Taxes	67.3	39.6	27.7	70.0
Property	275.8	255.5	20.4	8.0
Lottery	49.0	48.5	0.5	1.0
Other	134.4	136.0	-1.6	-1.1
TOTAL	**2,162.4**	**2,243.4**	**-81.0**	**-3.6**

Total sales and use tax receipts for the quarter were $690.9 million, compared to $716.3 million in the second quarter of FY09. The 3.5 percent decline is weaker than the 0.2 percent fall in the second quarter of last year. Year-to-date, sales tax receipts have fallen 5.6 percent.

Individual income tax posted receipts of $788.4 million, compared to last year's second-quarter receipts of $859.6 million. The resulting growth rate was -8.3 percent, and compares to a growth rate of 7.7 percent for the second quarter of last year. All four components of this tax declined compared to the same time frame last year. Particularly weak were the withholding receipts and declaration payments.

Combined corporation income and limited liability entity tax (LLET) receipts were down in the second quarter of the fiscal year. Revenues of $91.5 million were 18.7 percent lower than year-earlier figures of $112.5 million.

Coal severance tax revenue continued to decline in the second quarter, with receipts down 14.0 percent. Collections of $65.0 million compare to the FY09 second quarter total of $75.5 million. Tax receipts in the second quarter of FY09 rose by 31.5 percent. Through the first six months of FY10, receipts are off 11.1 percent.

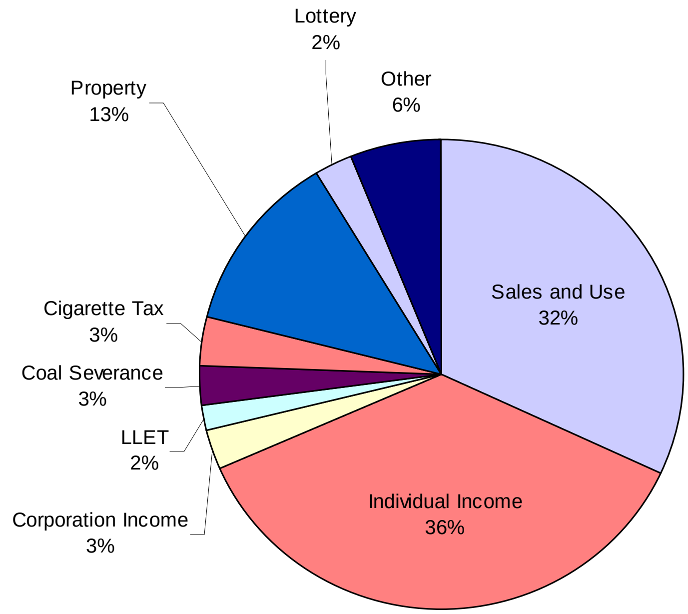
Cigarette tax receipts of $67.3 million in the second quarter of FY10 rose significantly over last year's total of $39.6 million due to a doubling of the tax rate from 30 cents per pack to 60 cents per pack. The $27.7 million increase amounted to a 70.0 percent growth rate.

Second-quarter property tax receipts posted revenues that were $20.4 million more than the second quarter of FY09. The difference is due mainly to timing issues. FY10 second-quarter receipts of $275.8 million compare with $255.5 million from the second quarter of FY09.

Lottery receipts were $49.0 million, which were 1.0 percent above last year's second-quarter total of $48.5 million.

The "all other" category, which represents the remaining accounts of the General Fund, declined 1.1 percent in the second quarter. Second quarter receipts for FY10 were $134.4 million and compare to $136.0 million in FY09.

Figure 1
Second Quarter, FY10
General Fund Receipts



ROAD FUND

The Road Fund reported a decline of 0.3 percent in the second quarter of FY10. Receipts totaled $279.1 million and compare to $280.1 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 grew at a rate of 0.6 percent during the second quarter due to the formula-driven increase in the tax rate tied to the price of gasoline. Most of those gains were offset due to a decrease in demand for motor fuels. Receipts were $158.6 million and compare to $157.7 million collected during the second quarter of last year.

Motor vehicle usage tax showed signs of stabilizing in the second quarter, with receipts falling only 2.0 percent. Receipts during the second quarter of FY10 totaled $72.3 million and compare to $73.8 million collected during the same period last year.

Motor vehicle license tax receipts increased 5.4 percent in the second quarter of FY10 to $16.2 million.

Motor vehicle operators license tax receipts were $3.8 million in the second quarter of FY10, an increase of 2.5 percent.

Weight distance tax receipts of $17.9 million represent a 10.4 percent decrease compared to receipts of $20.0 million during the second quarter of FY09.

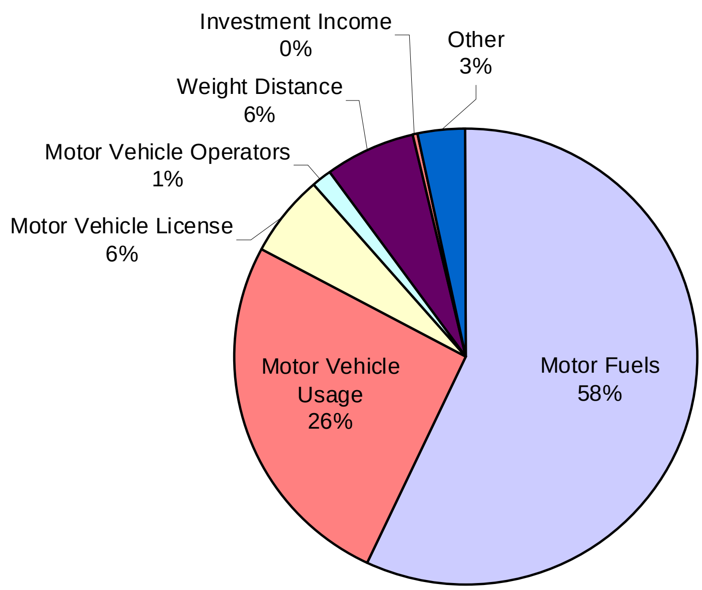
Investment receipts of $1.0 million were down 54.7 percent over the total collected in the second quarter of FY09.

The remainder of the accounts in the Road Fund combined for an increase of 28.4 percent from a year earlier. In the "other" category, revenues of $9.2 million compare to $7.2 million in the second quarter of FY09.

Table 2
Summary Road Fund Receipts
Second Quarter, FY10
(mil $)

	FY10	FY09	Diff ($)	Diff (%)
Motor Fuels	158.6	157.7	0.9	0.6
Motor Vehicle Usage	72.3	73.8	-1.5	-2.0
Motor Vehicle License	16.2	15.4	0.8	5.4
Motor Vehicle Operators	3.8	3.7	0.1	2.5
Weight Distance	17.9	20.0	-2.1	-10.4
Investment Income	1.0	2.3	-1.2	-54.7
Other	9.2	7.2	2.0	28.4
TOTAL	**279.1**	**280.1**	**-1.0**	**-0.3**

Figure 2
Second Quarter, FY10
Road Fund Receipts



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NATIONAL ECONOMY

Despite some improvement in several key national indicators, the National Bureau of Economic Research, the entity which identifies the official turning points in the national economy has not officially dated the end of the recession. The recession officially started in December of 2007 and as of January 19, 2010 the turning point signaling expansion has not yet been determined. Real Gross Domestic Product (GDP) declined in all four quarters of FY09. Real GDP rose by 0.6 percent in the first quarter of FY10 over the fourth quarter of FY09. It is estimated that the second quarter of FY10 will grow by 1.3 percent over the first quarter of FY10. The adjacent quarter growth rates provided above are meaningful and appropriate given that real GDP data are seasonally adjusted. However, adjacent quarter growth rates do miss two things: non-seasonal cyclical patterns and attention to historical perspective. It is for these reasons that growth rates compared to the same quarter of the previous year are often published in newspaper outlets and on the Bureau of Economic Analysis' website. The growth rates for the last five quarters compared to the previous year were: -1.9, -3.3, -3.8, -2.6, and -0.04 respectively.

Real GDP data in the national accounts are provided in three estimates. As more data is collected the first estimate (or preliminary estimate) is replaced by the second estimate (or revised estimate). And finally, the second estimate is replaced by the third estimate (or final estimate). The three first quarter real GDP figures of 3.5 percent, 2.8 percent and 2.3 percent respectively were revised down sharply on both occasions. The third estimate was revised down based in large part to downward revisions to non-residential fixed investment.

Gross Domestic Product is composed of five components: consumption, investment, government expenditures, exports and imports. While growth in real GDP was essentially flat in the second quarter, the components still contained considerable variation. Real consumption increased by $96.6 billion, or 1.1 percent in the second quarter of FY10. The largest mover in absolute and percentage terms was real investment, which declined by $260.3 billion, or 14.0 percent. Real government expenditures increased by $41.0 billion, or 1.6 percent. And finally, imports declined by $149.8 billion, or 7.3 percent.

Government expenditures as a share of real GDP fell in the second quarter to 19.7 percent of national income. Preceding this decline were 10 consecutive quarterly increases in the share of government expenditures to national income. It is not uncommon for government expenditures to surge during and following recessions, as transfer payments (unemployment insurance claims, food stamps, etc.) increase. The same 'peak' of government expenditure share, 19.9 percent, which occurred in this first quarter of FY10 also occurred in the second and fourth quarters of FY03 on the heels of the 2001 recession.

The trade deficit shrank slightly in the second quarter over the first quarter, as exports rose at a slightly faster rate than imports. The trade deficit, once $756.4 billion in the first quarter of FY07, is now about half that at $349.4 billion. Large declines in U.S. imports, as result of the recession's impact on incomes, was the primary reason for this difference.

Following three consecutive quarterly declines, U.S. personal income is finally starting to improve. In the second quarter of FY10, U.S. personal income increased by 0.9 percent over the first quarter, but is still down 0.3 percent over last year at this time. Part of this rise is due to the recent increases in inflation, which is measured as the change in the Consumer Price Index (CPI). In the second quarter of FY09, the CPI fell by 2.2 percent, the sharpest single quarter drop in over a decade. It was a low hurdle, but the CPI rose by 0.8 percent in the second quarter of FY10.

The civilian labor force declined by 0.5 percent or by 800,000 workers in the second quarter compared to the second quarter of FY09. Some of this decline is the result of discouraged workers; those workers who have been unemployed for a long period of time, cannot find acceptable employment and have decided to stop looking for work entirely. Nonfarm employment has declined for the eighth consecutive quarter, with a decline of 0.2 percent, which is now 3.5 percent below a year ago. The losses were small to moderate and widespread across nearly every employment sector.

KENTUCKY ECONOMY

Kentucky personal income fell during most of FY09. But a recent surge is bringing it back above its fourth quarter of FY08 peak. Kentucky personal income rose by 3.2 percent over the first quarter of FY10. It is now 1.1 percent above its second quarter FY09 level.

Wages and salary income, which makes up approximately 53 percent of Kentucky personal income, fell sharply in the second half of FY09. It has only recently turned around. Wages and salary growth was positive but shallow for the last three quarters. It remains 2.4 percent below its second quarter FY09 level.

Kentucky non-farm employment fell for the eighth consecutive quarter, with a 0.3 percent loss in the most recent quarter. Peak to trough losses are now at 107,900 jobs, which represents a 5.8 percent drop in total employment. It is not yet clear whether the bottom has been reached in total employment, although the losses have become progressively smaller for the last three quarters.

Most Kentucky employment sectors lost jobs in the second quarter. The largest absolute loser of jobs was in the manufacturing sector, which lost 27,800 seasonally adjusted jobs, or 11.8 percent compared to the previous year. The largest percentage loser was the construction sector, which lost 15,600 seasonally adjusted jobs, or 19.0 percent compared to the previous year. The service sectors netted a 2.4 percent decline with the trade transportation and utilites sector losing the most jobs. Educational services and other services showed small increases in employment.

The recent peak to trough losses in the Kentucky employment sectors varied considerably in both absolute and percentage terms. The Kentucky manufacturing sector lost 54,600 seasonally adjusted jobs since the second quarter of FY06, which is the largest absolute number of jobs lost in any one sector. That is a 20.8 percent net decline. Kentucky construction employment lost the most jobs as a percent with 19,900 seasonally adjusted jobs lost since second quarter of FY08, a 23.1 percent net decline. Kentucky employment in the trade, transportation and utilities sector also experienced substantial declines losing 25,500 seasonally adjusted jobs, or 6.6 percent, since the fourth quarter of FY07. Education and health services employment has experienced moderate increases throughout the 2007 recession period. Other services employment contains a long-term downward trend. During FY09, other services employment fell marketedly due to the recession. It has now grown for three consecutive quarters and regained all the losses from its brief downturn.

Kentucky government employment peaked in the first quarter of FY08 with 325,000 seasonally adjusted jobs. Government employment has trended down for the last 10 quarters, falling to 319,200 jobs in the second quarter of FY10. The second quarter rose slightly over the first quarter, but is still down 0.1 percent over the previous year.

Table 3
Summary of US Economic Series
Second Quarters of FY09 & FY10

	Second Quarter			
	FY10	**FY09**	**Chg**	**% Chg**
Real GDP	13,136.5	13,141.9	-5.4	0.0
Real Consumption	9,291.9	9,195.3	96.6	1.1
Real Investment	1,597.4	1,857.7	-260.3	-14.0
Real Govt. Expenditures	2,585.0	2,544.0	41.0	1.6
Real Exports	1,539.7	1,568.0	-28.3	-1.8
Real Imports	1,889.1	2,038.9	-149.8	-7.3
Personal Income ($ billions)	12,196.0	12,233.5	-37.5	-0.3
Inflation (% chg of CPI)	0.8	-2.2	NA	NA
Industrial Production Index (% chg)	99.4	104.4	-5.0	-4.8
Civilian Labor Force (millions)	153.9	154.6	-0.8	-0.5
Total Nonfarm Employment (millions)	131.0	135.7	-4.7	-3.5
Manufacturing Employment (millions)	11.7	13.1	-1.4	-10.8
Unemployment Rate (percent)	10.1	6.9	NA	NA

Real series are in billions of chained 2000 dollars.
GDP components may not sum due to rounding at lower levels of detail.
Data for FY10 Q2 are December 2009 estimates.
Source: IHS Global Insight Inc., December 31, 2009 data release

Table 4
Summary of Kentucky Economic Series
Second Quarters of FY09 & FY10

	Second Quarter			
	FY10	FY09	Chg	% Chg
Personal Income ($ millions)	138,626.4	137,109.0	1,517.4	1.1
Wages and Salary Income ($ millions)	70,923.2	72,676.0	-1,752.8	-2.4
Non-farm Employment (thousands)	1,763.3	1,835.6	-72.3	-3.9
Goods Producing (thousands)	300.0	343.2	-43.2	-12.6
Construction	66.4	82.0	-15.6	-19.0
Mining	25.2	25.1	0.1	0.4
Manufacturing	208.3	236.1	-27.8	-11.8
Service Providing (thousands)	1,144.1	1,172.9	-28.7	-2.4
Trade, Transportation & Utilities	360.9	378.6	-17.7	-4.7
Information	28.9	29.7	-0.8	-2.7
Finance	87.8	92.1	-4.3	-4.6
Business Services	173.1	179.7	-6.6	-3.7
Educational Services	247.3	245.8	1.5	0.6
Leisure and Hospitality Services	171.4	173.2	-1.9	-1.1
Other Services	74.7	73.7	1.0	1.3
Government (thousands)	319.2	319.5	-0.3	-0.1

Data for FY10 Q2 are December 2009 estimates.
Source: IHS Global Insight Inc. and Governor's Office for Economic Analysis MAK model

Projected General Fund revenues for the next three quarters are shown in Table 5. The revenue outlook presented in this report is slightly lower than the December 21, 2009, official estimates rendered by the Consensus Forecasting Group for FY10. When the official estimates were projected, staff did not have access to the actual collections for December 2009. Moreover, the economic forecast used in December was from the November 2009 Global Insight report, so this report has the benefit of using the latest economic outlook available. The estimates in this report were prepared with the January forecast from both Global Insight and the Kentucky Macro Model, which is operated by the Governor's Office for Economic Analysis.

The official CFG General Fund estimate for FY10 is $8,196.0 million. The interim estimates included in this report project General Fund revenues in FY10 of $8,168.5 million, an amount $27.5 million below the current official estimate. For the Road Fund, the official CFG estimate from December is $1,199.1 million. December receipts and the new economic forecast led to very slight modifications in this interim report, as the Road Fund estimate profiled in this report totals $1,192.6 million – a reduction of $6.5 million.

General Fund receipts through the first half of FY10 totaled $4,130.8 million, a reduction of 4.6 percent from the amount collected in the first half of FY09. The projections in-

Table 5
General Fund: Interim Control Forecast
($ millions)

	FY10 Q 1 & Q2		FY10 Q 3 & Q4		FY10 Full Year		Difference From Dec CFG	FY11 Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	$ millions	Estimate	% Chg
Sales and Use	1,384.8	-5.6	1,406.5	1.2	2,791.3	-2.3	-1.3	723.0	4.2
Individual Income	1,602.8	-7.7	1,526.2	-3.4	3,129.0	-5.6	-19.8	765.4	-6.0
Corporation Inc & LLET	171.1	-17.2	186.3	1.9	357.4	-8.3	-18.8	72.2	-9.3
Coal Severance	131.8	-11.1	124.3	-13.9	256.1	-12.5	11.4	59.5	-11.0
Cigarette Tax	141.7	74.9	138.3	13.3	280.0	37.9	-0.2	71.3	-4.1
Property	336.0	5.2	184.8	-4.7	520.8	1.5	2.1	63.7	5.9
Lottery	93.0	1.6	107.0	4.9	200.0	3.4	0.0	46.0	4.5
Other	269.6	-2.9	364.3	-5.1	633.9	-4.2	-0.9	137.7	1.8
General Fund	**4,130.8**	**-4.6**	**4,037.7**	**-1.5**	**8,168.5**	**-3.1**	**-27.5**	**1,938.7**	**-1.5**

cluded in this report call for a 1.5 percent reduction for the remainder of FY10, resulting in an overall loss of 3.1 percent for FY10. By comparison, General Fund revenues fell 2.7 percent in FY09. If the projected decline in FY10 manifests, it will be the first time in the modern era that the General Fund has declined in consecutive years.

The sales and use tax estimate is virtually unchanged from the December 21 CFG estimate. Sales and use tax receipts are expected to grow 1.2 percent over the second half of FY10 despite falling 5.6 percent thus far in FY10. The sales tax has been particularly vulnerable to the underlying weaknesses in employment and income, both of which are expected to improve slightly in the forecast horizon. During the current five-quarter streak of consecutive declines in the sales tax, the rates of decline grew as the recession progressed. However, the five consecutive quarterly declines have created a lower base of comparison while computing the rates of growth for the remainder of FY10, so the projected increase is more indicative of a low base rather than an overwhelming endorsement of the health of the sales tax.

The interim forecast for the individual income tax calls for receipts to fall by 5.6 percent in FY10. Individual income tax receipts fell 7.7 percent in the first half of FY10 but the rate of decline is expected to mitigate to 3.4 percent for the second half of the year. While the weakness in this revenue source is widespread, payroll withholding taxes have been notably weak in recent quarters, a result once again of the underlying weakness in the Kentucky and national labor markets. The improved plight of the individual income tax will be directly correlated with forecasted improvements in the Kentucky employment picture. Also, like the sales tax, the lower months of comparison in FY09 will make growth much more obtainable in the second half of FY10.

Combined corporation income and limited liability entity tax (LLET) receipts fell 17.2 percent in the first half of FY10 but are expected to grow 1.9 percent over the remainder of FY10. The FY10 total estimate is $357.4 million, a 8.3 percent reduction compared to FY09. The combined LLET and corporate income tax account masks a tale of two different taxes, one increasing and the other falling. On the positive side, the limited liability entity tax has grown 58.4 percent through the first six months of FY10 with collections of $66.7 million. Counteracting this growth has been a 36.6 percent free fall in the corporation income tax on actual collections of $104.4 million. A portion of the LLET tax increase in collections is attributable to compliance efforts by the Department of Revenue and prior year tax liabilities being paid in the current year. However, the base of the LLET is Kentucky gross receipts or gross profits, both of which exhibit more stability than net income.

Unprecedented revenue growth in coal severance tax revenue came to an abrupt halt in the first half of FY10, as that revenue source fell 11.1 percent compared to the extremely high bar set in the first half of FY09. The FY10 estimate for the coal severance tax is $256.1 million, a decline of 12.5 percent. Compared to the official estimate from December 2009, the coal severance estimate has improved $11.4 million. The primary reason for the upward revision is an increase in the outlook for coal prices, and energy prices in general.

Cigarette taxes totaled $141.7 million in the first two quarters of FY10, an improvement of

74.9 percent over the first half of FY09. The new interim estimate for FY10 projects $280.0 million in cigarette tax collections, for an annual growth rate of 37.9 percent. While it is too early to compute elasticities from the tax increase, it does appear that there were very modest consumption declines in line with the projections. The rate of growth for the remainder of FY10 diminishes off the torrid pace set in the first half, but such a slowdown is expected in recognition that the higher tax rates took effect in April 2009, and also in recognition of nearly $16.3 million in floor stock taxes collected in FY09 that will not be collected in FY10. Other tobacco taxes are expected to show similar growth to the anticipated increases in the cigarette tax.

Property taxes are expected to rise marginally in FY10. The rate of increase in property tax revenues was 5.2 percent in the first half of FY10, but the second quarter is typically overcollected since the largest source of property tax revenue is the real property tax. Real property taxes have exceeded expectations so far in the first half of FY10 with growth of 14.8 percent. Given the underlying data on the appreciation of real property, the bulge in receipts year-to-date appears to be an acceleration of the timing in payments. Nonetheless, this interim report has raised the estimate for real property since the collections thus far comprise the overwhelming majority of the annual estimate with several collection months remaining. The remaining property tax accounts are producing collections in line with expectations.

Lottery revenues for FY10 were lowered from $202.0 million in May to $200 million at the December meeting of the CFG. Lottery receipts in the current year have fallen prey to a poor economy which has led to weak scratch-off sales and weaker on-line game revenue. Both of these factors contributed to the decline in the official estimate. Revenues in the “other” category fell 2.9 percent in the first half of FY10 with an additional 5.1 percent slide predicted for the next two fiscal quarters. Expected modest growth in the wholesale alcohol taxes, the bank franchise tax, and insurance premium taxes will be counterbalanced by weaknesses in mineral taxes,

Table 6
Road Fund: Interim Control Forecast
($ millions)

	FY10 Q 1 & Q2		FY10 Q 3 & Q4		FY10 Full Year		Difference From Dec CFG	FY11 Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	$ millions	Estimate	% Chg
Motor Fuels	320.8	1.6	330.9	7.9	651.7	4.7	-3.9	174.5	7.6
Motor Vehicle Usage	166.0	-4.5	158.0	-2.8	324.0	-3.7	-4.6	95.2	1.6
Motor Vehicle License	33.2	0.6	60.4	-7.4	93.6	-4.7	0.1	18.4	8.1
Motor Vehicle Operators	8.1	1.0	7.1	-5.3	15.2	-2.1	-0.1	3.9	-8.1
Weight Distance	35.3	-13.3	36.3	4.5	71.6	-5.1	1.2	19.2	10.4
Investment	2.3	-52.8	1.6	-72.6	3.9	-63.4	0.0	0.4	-69.5
Other	16.0	0.8	16.6	-5.2	32.6	-2.4	0.8	7.3	7.5
Road Fund	**581.7**	**-1.7**	**610.9**	**1.8**	**1,192.6**	**0.1**	**-6.5**	**318.9**	**5.4**

pari-mutuel taxes and other miscellaneous revenues.

ROAD FUND

Road Fund revenues are forecasted to grow 1.8 percent over the final two quarters of FY10 and 5.4 percent in the first three months of FY11 as shown in Table 6. The FY10 full-year forecast is $6.5 million less than the official revenue forecast as approved by the Consensus Forecasting Group on December 21, 2009.

Motor fuels tax collections are forecasted to grow by 7.9 percent over the final six months of FY10. The increase in tax receipts is due principally to a change 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. Growth is projected to continue in the first quarter of FY11, rising 7.6 percent.

Motor vehicle usage tax collections are projected to continue their skid as receipts are estimated to fall 2.8 percent over the remainder of the fiscal year before reversing trend and growing 1.6 percent in the first three months of FY11. A strengthening economy with job growth and pent up demand will contribute to the increase in usage tax receipts.

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 together assessed recent growth patterns as well as administrative and statutory factors. Motor vehicle license taxes are forecasted to decrease 7.4 percent in the final two quarters of FY10 and increase 8.1 percent in the first quarter of FY11. Motor vehicle operators' licenses are projected to fall 5.3 percent in the remainder of the fiscal year and decline 8.1 percent in the first quarter of FY11. Weight distance tax revenue should rise 4.5 percent for the remainder of the fiscal year and 10.4 percent over the first three months of FY11. Investment income will fall 72.6 percent over the remainder of the fiscal year and by 69.5 percent in Q1 of FY11 due to lower fund balances and interest rates. All other revenues are expected to fall 5.2 percent during the last six months of FY10 and then rise 7.5 percent in the first quarter of FY11.

NATIONAL ECONOMY

When our January 2009 *Quarterly Report* was issued, the outlook for the national economy was very bleak. We expected profound declines in output, employment, and personal income. The extended outlook looked somewhat more bright for 2010, but first the economy had to get through 2009, which was predicted to witness the first decline in world real GDP in the postwar era. All of these predictions, unfortunately, became manifested in reality for 2009. Can the economy now look forward to better times in 2010? The latest evidence suggests it can, at least on the national front.

The U.S. economy appears to have ended 2009 on a high note. Global Insight now projects a 5.1percent growth rate for GDP in the fourth quarter of calendar year 2009. This hot quarter will likely prove unsustainable, largely because a majority of the increase comes from a dramatic slowing in the rate of inventory adjustments. Both the inventory adjustment and the federal stimulus spending are temporary aids to aggregate demand, so the truly telling sign will be the falloff in demand when these two factors have played out.

A more encouraging and sustainable sign of good news is a solid increase in export demand. Most of the rest of the world has emerged at least somewhat from their respective recessions, as evidence in the strong performance of exports. The export sector is a primary reason for optimism in the short-run, and will likely be an engine of growth leading us out of the Great Recession. Businesses are looking for solid signs that aggregate demand has rebounded for the foreseeable future. With U.S. consumption still mired in the early stages of a credit-restrained recovery, it is likely that exports will be the primary boost to aggregate demand. With the depletion portion of the inventory adjustment behind us, improvements in aggregate demand will trigger improved domestic labor markets which should provide a second-round stimulus from domestic consumption.

The pivotal question for employment is just how far companies can stretch their remaining workers before they decide to make hiring decisions. Recent employment reports suggest that job losses might come to an end nationally in the second half of FY10. Unit labor costs have fallen sharply, productivity is high, and businesses' profitability is growing. Therefore, the January forecast has built in an expectation that firms will need to rehire sooner after this recession than after the 2001 recession. However, the forecast calls for little change in the unemployment rate over the next 12 months, since we will likely see large swings in the labor force as displaced workers outside the workforce continue to evaluate their employment options.

While our interim outlook is based on the control forecast, history indicates that increased volatility can occur during times of transition in the business cycle. Volatility can occur on both the positive and negative side. The financial markets remain weakened and subject to fluctuations. Moreover, the Federal Reserve System will be watching for signs of inflation very closely, and will likely react swiftly and sharply when inflation signs emerge. A reasonable sector to expect future inflation may be the energy sector. While the demand for oil and other commodities has been lackluster, this has not prevented prices from rising. In such an environment, even a minor supply disruption could push prices much higher, adding to the major headwinds facing U.S. consumers and businesses. It is worth noting that the 2007 recession coincided with quick inflation in oil prices, and as world demand improves, a price spike in oil remains a risk to the recovery.

However, there are an equal number of upside risks to the control forecast. At the December 4, 2009 meeting of the Consensus Forecasting Group, staff noted that the optimistic scenario was a V-shaped recovery. In other parts of the world, especially Asia, V-shaped recoveries have already occurred. As these economies chug along, export demand could exceed forecasts, which would serve to accelerate the U.S. recovery in employment, income, and consumption.

Finally, pent-up demand has been a powerful force in the early stages of recoveries. In the current cycle, there is plenty of evidence that such pent-up demand exists: companies are hoarding cash, housing sales and starts are well below the rate of household formation, and car sales are well below normal replacement rates. The majority of consumers and businesses are holding back, mostly because of fears regarding the strength and sustainability of the recovery. It is entirely possible, given recent good news on the economy, that consumers and companies will shake off months of restraint and begin spending in patterns more closely aligned with historical norms.

KENTUCKY ECONOMY

Kentucky is well poised to benefit from the improvement in the national economy over the short term, with a possible lag or delay. As noted in previous reports, Kentucky's economy was one of the later states to enter into the 2007 national recession, due in part to export demand and strong demand for coal. Similarly, we expect a slight delay in the recovery stage, although the export-led recovery should boost Kentucky's significant manufacturing sector.

Kentucky personal income is projected to grow 5.5 percent in the next two quarters followed by 6.3 percent growth in the first quarter of FY11. Both figures compare favorably to their U.S. counterparts. The corresponding growth rates in the national economy are 3.3 percent and 4.3 percent respectively. However, the most recent personal income data suggest an unfavorable mix in the components of personal income. Transfer payments are up sharply with four consecutive quarters of double-digit growth. Wages and salary income, a bell-weather indicator for many state tax variables, is expected to show much weaker growth than total personal income in general, with expected growth of 1.8 percent growth in the final two quarters of FY10, followed by 2.7 percent growth in the first quarter of FY11. Both of these growth rates are under their national counterparts, which underscores the unfavorable mix of personal income growth in Kentucky.

The three-quarter employment outlook by sector reveals widespread weakness, with the goods-producing industries suffering the brunt of the job losses in percentage terms. Both the U.S. and Kentucky economies will continue to shed jobs in the final two quarters of FY10, but the rates of decline are shrinking. By the first quarter of FY11, employment declines will turn into employment increases at the national level and a formation of the bottom in the Kentucky employment market. Therefore, the lag on the recovery phase of the Kentucky economy appears to be limited to a one-quarter delay. If these trends continue, then the economic growth projected by the CFG in December 2009, should come to pass.

In comparison to the November Global Insight Economic outlook, which was the basis for the official FY10 consensus revenue estimates, both the employment and personal income projections have improved marginally. Caution is still the order of the day, however, when making projections during a turning point. The Office of State Budget Director will closely monitor state personal income and employment data during the next quarter to get further clues as to whether the recovery from the Great Recession will have a delayed appearance in Kentucky.

Table 7
US and KY Economic Outlook
Second Half of FY09 & FY10

	Q3 & Q4		
	FY10	**FY09**	**% Chg**
United States			
Real GDP	13,249.8	12,913.5	2.6
Real Consumption	9,365.3	9,199.1	1.8
Real Investment	1,645.2	1,507.6	9.1
Real Government Expenditures	2,611.5	2,547.9	2.5
Real Exports	1,587.0	1,427.0	11.2
Real Imports	1,968.5	1,785.4	10.3
Personal Income ($ billions)	12,402.4	12,000.8	3.3
Wage & Salary ($ billions)	6,445.2	6,310.5	2.1
Consumer Price Index (1992-99=100)	2.17	2.13	2.1
Industrial Production Index (% chg)	100.9	97.7	NA
Civilian Labor Force (millions)	154.1	154.5	-0.2
Nonfarm Employment (millions)	131.2	132.9	-1.3
Manufacturing Employment (millions)	11.6	12.2	-5.2
Unemployment Rate (percent)	10.1	8.7	NA
Kentucky			
Personal Income ($ millions)	140,783.4	133,425.0	5.5
Wage & Salary ($ millions)	71,705.7	70,442.0	1.8
Non-farm Employment (thousands)	1,764.7	1,792.4	-1.5
Goods Producing (thousands)	297.3	310.7	-4.3
Service Providing (thousands)	1,146.3	1,161.3	-1.3

Table 8
US and KY Economic Outlook
First Quarter of FY10 & FY11

	Q1		
	FY11	**FY10**	**% Chg**
United States			
Real GDP ($ billions)	13,360.5	12,973.0	3.0
Real Consumption	9,465.2	9,252.6	2.3
Real Investment	1,670.9	1,474.4	13.3
Real Government Expenditures	2,620.0	2,585.5	1.3
Real Exports	1,614.0	1,478.8	9.1
Real Imports	2,017.7	1,836.2	9.9
Personal Income ($ billions)	12,609.4	12,083.9	4.3
Wage & Salary ($ billions)	6,535.9	6,333.2	3.2
Consumer Price Index (1992-99=100)	2.19	2.15	1.6
Industrial Production Index (% chg)	102.2	97.8	NA
Civilian Labor Force (millions)	154.5	154.4	0.1
Non-farm Employment (millions)	131.4	131.3	0.1
Manufacturing Employment (millions)	11.6	11.8	-1.9
Unemployment Rate (percent)	10.1	9.6	NA
Kentucky			
Personal Income ($ millions)	142,695.3	134,279.0	6.3
Wage & Salary ($ millions)	72,547.6	70,660.0	2.7
Non-farm Employment (thousands)	1,764.6	1,768.8	-0.2
Goods Producing (thousands)	294.9	303.0	-2.7
Service Providing (thousands)	1,150.4	1,147.3	0.3

Table 9
Summary of US Economy Series Quarterly Growth Rates
FY10 Q1, Q2, Q3, Q4 & FY11 Q1

	FY10				FY11
	Q1 Actual	Q2 Estimate	Q3 Estimate	Q4 Estimate	Q1 Estimate
Real GDP	0.6	1.3	0.6	0.5	0.6
Real Consumption	0.7	0.4	0.5	0.5	0.8
Real Investment	1.2	8.3	2.4	1.1	1.0
Real Government Expenditures	0.7	0.0	0.7	0.6	0.0
Real Exports	4.2	4.1	2.3	1.5	0.9
Real Imports	4.9	2.9	3.2	2.0	1.5
Personal Income ($ billions)	0.3	0.9	1.1	1.2	1.1
Consumer Price Index (1992-99=100)	0.9	0.8	0.1	0.2	0.4
Industrial Production Index	1.5	1.6	1.0	1.0	0.8

Source: IHS Global Insight Inc., December 31, 2009 data release

APPENDIX

KENTUCKY STATE GOVERNMENT REVENUE
GENERAL FUND REVENUE

	Second Quarter FY 2010	Second Quarter FY 2009	% Change	Year-To-Date FY 2010	Year-To-Date FY 2009	% Change
TOTAL GENERAL FUND	**2,162,364,860**	**2,243,383,334**	**-3.6%**	**$4,130,818,311**	**$4,328,293,412**	**-4.6%**
Tax Receipts	2,072,303,359	2,155,261,819	-3.8%	$3,971,401,533	$4,175,841,971	-4.9%
Sales and Gross Receipts	819,478,348	812,379,157	0.9%	$1,667,630,417	$1,683,237,924	-0.9%
Beer Consumption	2,177,939	1,615,630	34.8%	3,912,229	3,369,932	16.1%
Beer Wholesale	11,775,249	12,531,532	-6.0%	26,219,143	27,082,448	-3.2%
Cigarette	67,298,720	39,576,332	70.0%	141,487,351	80,988,461	74.7%
Distilled Spirits Case Sales	27,275	26,596	2.6%	54,476	54,279	0.4%
Distilled Spirits Consumption	2,673,852	2,445,668	9.3%	5,383,695	5,341,094	0.8%
Distilled Spirits Wholesale	6,963,744	6,705,599	3.8%	13,768,486	13,843,764	-0.5%
Insurance Premium	12,422,794	9,437,911	31.6%	40,108,708	40,636,852	-1.3%
Pari-Mutuel	474,324	1,339,656	-64.6%	(1,076,588)	1,947,492	---
Race Track Admission	45,180	72,030	-37.3%	137,878	193,657	-28.8%
Sales and Use	690,912,974	716,294,303	-3.5%	1,384,808,452	1,467,722,393	-5.6%
Wine Consumption	627,188	799,334	-21.5%	1,207,468	1,175,095	2.8%
Wine Wholesale	3,211,885	3,605,639	-10.9%	6,098,894	6,118,491	-0.3%
Telecommunications Tax	15,710,078	15,752,842	-0.3%	34,770,933	30,315,118	14.7%
OTP	5,109,179	2,176,086	134.8%	10,565,582	4,448,848	137.5%
Floor Stock Tax	47,969	0	---	183,709	0	---
License and Privilege	112,925,759	126,039,788	-10.4%	$221,041,335	$230,592,997	-4.1%
Alc. Bev. License Suspension	137,425	62,100	121.3%	205,775	163,500	25.9%
Coal Severance	64,984,087	75,549,265	-14.0%	131,827,275	148,223,817	-11.1%
Corporation License	988,596	3,066,319	-67.8%	1,667,129	4,155,833	-59.9%
Corporation Organization	21,920	21,450	2.2%	123,650	34,065	263.0%
Occupational Licenses	31,703	42,742	-25.8%	73,020	105,223	-30.6%
Oil Production	1,698,318	2,267,970	-25.1%	3,541,827	6,272,893	-43.5%
Race Track License	105,500	125,700	-16.1%	218,000	298,200	-26.9%
Bank Franchise Tax	(262,391)	(1,837,966)	---	(428,141)	(5,214,080)	---
Driver License Fees	141,897	145,014	-2.1%	298,860	305,566	-2.2%
Minerals Severance	4,267,775	4,030,191	5.9%	7,894,807	8,221,077	-4.0%
Natural Gas Severance	4,674,479	12,357,146	-62.2%	8,951,520	25,927,924	-65.5%
Limited Liability Entity	36,136,450	30,209,856	19.6%	66,667,614	42,098,978	58.4%
Income	843,799,437	941,844,905	-10.4%	$1,707,267,033	$1,900,876,986	-10.2%
Corporation	55,387,067	82,260,196	-32.7%	104,428,337	164,632,243	-36.6%
Individual	788,412,371	859,584,710	-8.3%	1,602,838,697	1,736,244,743	-7.7%
Property	$275,837,863	$255,459,522	8.0%	$335,972,059	$319,222,626	5.2%
Building & Loan Association	0	(19,101)	---	91,143	209,366	-56.5%
General - Real	173,533,717	151,008,545	14.9%	173,668,519	151,279,234	14.8%
General - Tangible	84,796,773	81,025,401	4.7%	107,140,251	118,729,337	-9.8%
Omitted & Delinquent	196,249	(1,090,007)	---	13,552,140	11,150,021	21.5%
Public Service	17,307,355	24,489,015	-29.3%	40,829,052	37,227,275	9.7%
Other	3,770	45,670	-91.7%	690,953	627,394	10.1%
Inheritance	$11,083,200	$8,999,047	23.2%	$22,252,097	$22,018,343	1.1%
Miscellaneous	$9,178,750	$10,539,400	-12.9%	$17,238,593	$19,893,095	-13.3%
Legal Process	5,524,474	5,971,628	-7.5%	11,304,004	12,152,217	-7.0%
T. V. A. In Lieu Payments	3,654,277	4,567,557	-20.0%	5,934,096	7,733,042	-23.3%
Other	0	214	---	493	7,837	---
Nontax Receipts	$89,572,328	$87,196,815	2.7%	$158,006,853	$151,807,746	4.1%
Departmental Fees	4,276,737	7,553,039	-43.4%	11,775,589	13,769,956	-14.5%
PSC Assessment Fee	45,812	2,780	1548.0%	8,255,969	9,356,882	-11.8%
Fines & Forfeitures	7,713,691	6,732,606	14.6%	15,199,166	14,105,115	7.8%
Interest on Investments	224,029	923,296	-75.7%	423,750	2,078,927	-79.6%
Lottery	49,000,000	48,500,000	1.0%	93,000,000	91,500,000	1.6%
Sale of NOx Credits	140,650	0	---	601,430	0	---
Miscellaneous	28,171,409	23,485,094	20.0%	28,750,948	20,996,866	36.9%
Redeposit of State Funds	$489,173	$924,700	-47.1%	$1,409,924	$643,695	119.0%

KENTUCKY STATE GOVERNMENT REVENUE
ROAD FUND REVENUE

	Second Quarter FY 2010	Second Quarter FY 2009	% Change	Year-To-Date FY 2010	Year-To-Date FY 2009	% Change
TOTAL ROAD FUND	**$279,091,132**	**$280,056,613**	**-0.3%**	**$581,707,237**	**$592,029,606**	**-1.7%**
Tax Receipts-	$271,598,388	$273,559,424	-0.7%	$567,742,417	$576,749,773	-1.6%
Sales and Gross Receipts	$230,894,265	$231,502,326	-0.3%	$486,756,171	$489,473,993	-0.6%
Motor Fuels Taxes	158,581,971	157,703,613	0.6%	320,752,872	$315,678,818	1.6%
Motor Vehicle Usage	72,312,293	73,798,714	-2.0%	166,003,299	$173,795,174	-4.5%
License and Privilege	$40,704,123	$42,057,098	-3.2%	$80,986,246	$87,275,780	-7.2%
Motor Vehicles	16,225,869	15,401,576	5.4%	33,249,059	$33,045,640	0.6%
Motor Vehicle Operators	3,826,839	3,733,255	2.5%	8,069,795	$7,988,679	1.0%
Weight Distance	17,929,644	20,003,828	-10.4%	35,317,203	$40,717,349	-13.3%
Truck Decal Fees	16,192	32,965	-50.9%	45,629	$76,774	-40.6%
Other Special Fees	2,705,579	2,885,474	-6.2%	4,304,560	$5,447,338	-21.0%
Nontax Receipts	$6,198,897	$6,565,565	-5.6%	$12,425,397	$15,053,101	-17.5%
Departmental Fees	4,806,742	3,896,381	23.4%	9,371,225	$9,293,506	0.8%
In Lieu of Traffic Fines	147,570	236,914	-37.7%	373,551	$482,092	-22.5%
Investment Income	1,022,506	2,257,216	-54.7%	2,335,512	$4,951,394	-52.8%
Miscellaneous	222,079	175,054	26.9%	345,109	$326,109	5.8%
Redeposit of State Funds	$1,293,847	($68,377)	---	$1,539,422	$226,732	579.0%