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October 30, 2008

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 2009 (FY09). It also includes an interim economic and revenue forecast for the last three quarters of FY09.

General Fund receipts for the first quarter of FY09 totaled \$2,085 million, an increase of 0.9 percent compared to the same period in FY08. Road Fund revenues totaled \$312.0 million, a decrease of 4.5 percent from the first quarter of FY08.

The interim General Fund forecast for the final three quarters of FY09 calls for a decrease of 1.4 percent compared to the same period one year ago, resulting in a projected decline of 0.8 percent for the entire fiscal year. The interim forecast for the Road Fund for the final three quarters of FY09 is for growth of 0.6 percent, resulting in a projected decline of 0.7 percent for the entire fiscal year.

The resulting interim forecast calls for General Fund receipts to fall \$293.6 million short of the official enacted budgeted revenues. For the Road Fund, the interim forecast predicts a revenue deficit of \$70.6 million when compared to the official enacted budgeted revenues.

We will continue to monitor the economic and fiscal conditions of the Commonwealth and will keep you apprised of developments.

Sincerely,

A handwritten signature in cursive script that reads "Mary E. Lassiter".

Mary E. Lassiter  
State Budget Director

Attachment

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# Executive Summary . . .



General Fund receipts totaled \$2,085 million in the first quarter of Fiscal Year 2009 (FY09), increasing 0.9 percent from the same quarter in FY08. The 0.9 percent growth corresponds to \$17.8 million in revenue growth compared to FY08. Total Road Fund receipts for the quarter were \$312.0 million in FY09 versus \$326.7 million in FY08. The computed growth rate for the quarter was -4.5 percent, which computes to a shortfall of \$14.7 on a quarter-over-quarter basis.

Both the Kentucky General Fund and Road Fund were adversely impacted by a markedly slower state and national economy. The quarter began in July with record-high nominal fuel prices, triggering a demand-side slowdown and a reduction of disposable income for consumers. As the quarter progressed, the economy was rocked by worries of a severe meltdown in the nation's credit markets. The ripple effect from the systemic weakness in the financial sector and corresponding market collapse was a further reduction in aggregate demand and significant reductions in credit available for businesses and consumers. As the quarter ended, markets remained volatile and the underlying economic conditions continued to weaken.

Despite a recent decline in the price of oil and gasoline at the pump, employment growth continues to decline, claims for unemployment insurance have risen and consumer sentiment wanes.

Even with the weakness in the national economy, Kentucky was able to post positive revenue growth in the first quarter. The sales and use tax increased 3.2 percent, the indi-

vidual income tax grew at a rate of 6.6 percent, and the coal severance tax ballooned to 36.0 percent growth on the strength of historically high coal prices. The coal severance tax grew \$19.2 million for the quarter, an amount greater than the \$17.8 million in the aggregate General Fund growth. Property taxes also had a strong quarter with 8.4 percent growth. These favorable accounts were tempered significantly by a large reduction in the corporation income tax, which fell \$81.6 million for the quarter – a 49.8 percent rate of decline. In comparison, Tennessee's business excise and franchise taxes fell 23.6 percent and Indiana's corporation income tax fell over 26 percent over the same period.

States with a concentration in energy extraction or mining have seen their revenues hold up much better than states without a significant presence in these industries. However, states with a major manufacturing presence, especially automobile manufacturing, have had relatively poor revenue collections. Kentucky falls into both categories with a major presence in coal mining and in automobile manufacturing. This economic diversity, coupled with a relatively broad tax base, has manifested in positive revenue growth in the first quarter of FY09 while other states have posted negative growth.

Road Fund receipts depend heavily upon the motor fuels taxes and the motor vehicle usage tax (the 6.0 percent transactions tax on the sale of new and used vehicles). Motor fuels tax receipts decreased 1.4 percent during the first quarter of FY09. Receipts were \$158.0 million as compared to \$160.2 million collected during the first quarter of last year.

Motor fuels tax revenues were affected by a decline in motor fuels consumption, more than offsetting the statutory increase in the tax rate. The tax rate on gasoline increased 7.1 percent from 21.0 cents per gallon to 22.5 cents per gallon in July 2009, pursuant to a statutory recalculation of the weighted wholesale price of gasoline. Declining fuels revenue in the first quarter implies that fuel consumption fell more than the 7.1 increase in the gasoline tax rate.

Motor vehicle usage tax receipts also fell in the first quarter of FY09 at a rate of 9.2 percent. This account has been heavily impacted by the poor economy. High fuel prices have driven businesses and consumers away from larger, expensive and less fuel efficient vehicles in favor of smaller, less expensive and more efficient ones. A weakening labor market, along with tighter lending policies due to the credit crunch, have depressed motor vehicle usage tax collections and will continue to be a drag on collections through the forecasting horizon.

The interim forecast for the General Fund expects revenues to decline 1.4 percent over the remaining three quarters of FY09. Total revenues for the current fiscal year are expected to be \$8,592.4 million, which computes to a growth rate of -0.8 percent. The interim General Fund forecast for FY09 calls for \$293.6 million less revenue than the official budgeted estimate that was based on the modified Consensus Forecasting Group estimate of January 2008.

Among the major accounts, the outlook for the last three quarters of FY09 is for sales and use taxes to increase by 0.5 percent. The individual income tax and corporation income tax are both projected to decline as the economy continues to weaken. For the year,

sales tax growth is expected to be 1.2 percent, individual income taxes are forecasted to decline by 2.1 percent, and the corporation income tax and LLET portion of the General Fund are projected to decrease by 21.0 percent. Compared to budgeted levels, the sales and use tax is \$65.6 million lower, individual income tax is down \$61.3 million, and corporate taxes will plummet \$200.7 million in the current fiscal year.

One bright spot is the expected strong growth in coal severance tax. Though energy prices are receding, most of the sale of coal is contract-based and these contracts were locked in before the price decline. Coal severance taxes are expected to be up 20.0 percent for the last three quarters of FY09 for an annual increase of 23.6 percent.

Property tax revenue is expected to be 4.9 percent higher for the next three quarters and the lottery revenues will be up by 6.5 percent. The full year growth rate for property taxes and the lottery are estimated to be 5.3 percent and 5.9 percent, respectively. The relatively strong growth in the lottery dividend is from the legislative mandate that requires an additional \$7.0 million in return from the Kentucky Lottery Corporation.

The interim outlook for the Road Fund anticipates an increase in revenue of 0.6 percent for the next three quarters. This represents a FY09 decrease of \$70.6 million from budgeted revenues. Fuel taxes are expected to increase by 7.1 percent from October to June as lower fuel prices spur greater consumption. Tightened credit and a weak economy are expected to cause a decline of 7.3 percent in the motor vehicle usage tax. The decline for the full year is expected to average 7.9 percent. Investment income should fall by 49.2 percent due to lower fund

balances. All other revenues should combine for a growth of 3.7 percent during the last nine months of FY09.

The outlook for the national and state economies is recessionary. Real GDP is expected to decline in two of the next three quarters bringing the average growth in GDP to just

0.1 percent. U.S. personal income is expected to increase by 3.1 percent and nonfarm employment is forecasted to contract by 1.0 percent. In Kentucky, the prognosis is only marginally better. Personal income is expected to rise by 3.4 percent, with nonfarm employment declining by 15,900 jobs or 0.8 percent.

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# Revenue Receipts . . .



## GENERAL FUND

General Fund receipts in the first quarter of FY09 totaled \$2,085 million compared to \$2,067 million in the first quarter of FY08, for a net gain of \$17.8 million and growth of 0.9 percent. Collections in the major revenue categories are shown in summary form in Table 1. Detailed information on these and other accounts is available in the Appendix.

Receipts in the first quarter of FY09 reflected the poor economic conditions in the U.S. and Kentucky. Weak employment data, higher gasoline prices, and lower aggregate demand have all negatively impacted state revenues.

**Individual income tax** receipts grew 6.6 percent in the first quarter of FY09. Receipts of \$876.7 million were \$53.9 million more than was collected in the first quarter of the previous fiscal year due to strength in declaration payments and withholding collections.

**Corporation income tax** collections posted a decrease of 49.8 percent, or \$81.6 million, during the first quarter of FY09. Receipts totaled \$82.4 million compared to the \$164.0 million received a year earlier. Factors contributing to this decline include the effects of recent law changes, the presence of loss-carryforwards, and the expectations of lower future profits.

The **limited liability entity tax (LLET)** saw a decrease in tax collections in the first quarter of FY09 when compared to FY08. Total collections in the current fiscal year totaled \$11.9 million and compare to revenues of \$18.6 million in the same period a year earlier.

The **coal severance tax** continued its recent trend of very strong growth in the first quarter, increasing 36.0 percent. Coal prices have remained strong in recent months, thereby increasing the value of coal being severed in Kentucky. Receipts of \$72.7 million compare to \$53.4 million collected in the first quarter of FY08.

	FY09	FY08	Diff (\$)	Diff (%)
Sales and Use	751.4	728.2	23.2	3.2
Individual Income	876.7	822.7	53.9	6.6
Corp Inc. & LLET	94.3	182.6	-88.3	-48.4
Coal Severance	72.7	53.4	19.2	36.0
Tobacco Taxes	43.7	46.1	-2.4	-5.2
Property	63.8	58.8	4.9	8.4
Lottery	43.0	41.5	1.5	3.6
Other	139.4	133.8	5.7	4.2
<b>TOTAL</b>	<b>2,084.9</b>	<b>2,067.1</b>	<b>17.8</b>	<b>0.9</b>

The **sales and use tax** had moderate growth of 3.2 percent in the first quarter of FY09. Receipts of \$751.4 million compare to the \$728.2 million collected in the first quarter of FY08.

**Tobacco taxes** fell in the first quarter with receipts of \$43.7 million which were 5.2 percent less than collected one year earlier. Cigarette taxes included in the General Fund in-

clude the cigarette excise tax, the 26-cent per pack surtax, and taxes on other tobacco products (e.g., cigars, pipe tobacco, chewing tobacco, and snuff) as well as cigarette rolling papers.

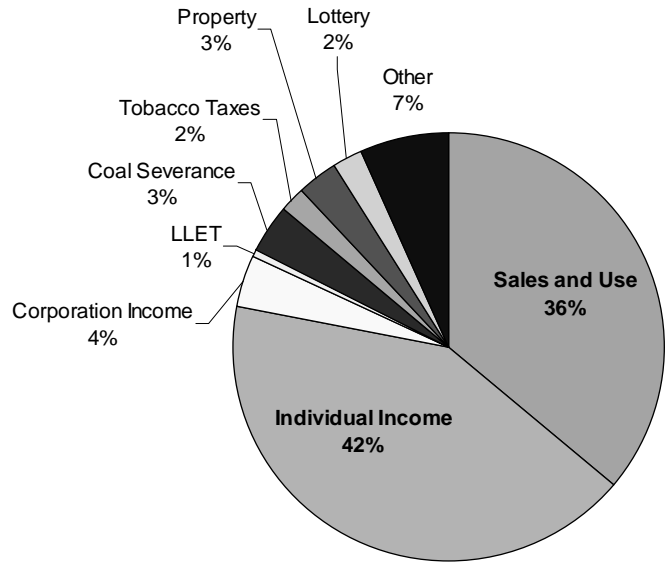
**Property taxes** were up by 8.4 percent in the first quarter of FY09 due to strength in the tangible property account. Collections of \$63.8 million compare to \$58.8 million received in the first quarter of the prior fiscal year.

**Lottery receipts** increased by 3.6 percent in the first quarter of FY09 with revenues of \$43.0 million.

The **“Other” category** represents the remaining accounts in the General Fund, and collections in this account increased 4.2 percent with receipts of \$139.4 million.

Figure 1 details the composition of first-quarter General Fund receipts by tax type. Seventy-eight percent of General Fund revenues were collected in the areas of the individual income tax and the sales tax. The next largest source of revenue was the “Other” account at seven percent. The major components in this category include inheritance taxes, insurance premium taxes, beer wholesale taxes, telecommunications taxes, and the natural gas severance tax. Coal severance and property taxes each accounted for three percent of the total while tobacco taxes and lottery receipts each accounted for two percent of the revenues. Finally, the LLET accounted for one percent of the General Fund.

**Figure 1**  
**First Quarter, FY09**  
**General Fund Receipts**



**ROAD FUND**

The Road Fund fell by 4.5 percent in the first quarter of FY09. Receipts totaled \$312.0 million compared to the \$326.7 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 and motor fuels use tax** receipts decreased 1.4 percent during the first quarter of FY09. Receipts were \$158.0 million and compare to \$160.2 million collected during the first quarter of last year. Motor fuels tax revenues were affected by a



decline in motor fuels consumption which failed to offset the increase in the tax rate from that in effect in the previous fiscal year.

**Motor vehicle usage tax** receipts fell by 9.2 percent during the first quarter reflecting fewer vehicle sales resulting from uncertainty in the labor market and tighter credit conditions. Receipts were \$100.0 million compared to \$110.2 million collected during the same period last year.

**Motor vehicle license tax** receipts fell by 4.8 percent during the first quarter of FY09. Receipts of \$17.6 million compare to \$18.5 million received during the first quarter of FY08.

Table 2 Summary Road Fund Receipts First Quarter, FY09 (mil \$)				
	FY09	FY08	Diff (\$)	Diff (%)
Motor Fuels	158.0	160.2	-2.2	-1.4
Motor Vehicle Usage	100.0	110.2	-10.2	-9.2
Motor Vehicle License	17.6	18.5	-0.9	-4.8
Motor Vehicle Operators	4.3	4.0	0.2	6.2
Weight Distance	20.7	22.1	-1.3	-6.1
Investment Income	2.7	3.4	-0.7	-19.8
Other	8.7	8.3	0.4	4.7
<b>TOTAL</b>	<b>312.0</b>	<b>326.7</b>	<b>-14.7</b>	<b>-4.5</b>

**Motor vehicle operators' license fees** totaled \$4.3 million, a 6.2 percent increase compared to the level observed a year ago.

**Weight distance tax** receipts of \$20.7 million fell by 6.1 percent compared to receipts of \$22.1 million during the first quarter of last year.

**Investment income** fell by 19.8 percent in the first quarter due to lower investment balances. Receipts of \$2.7 million for FY09 are

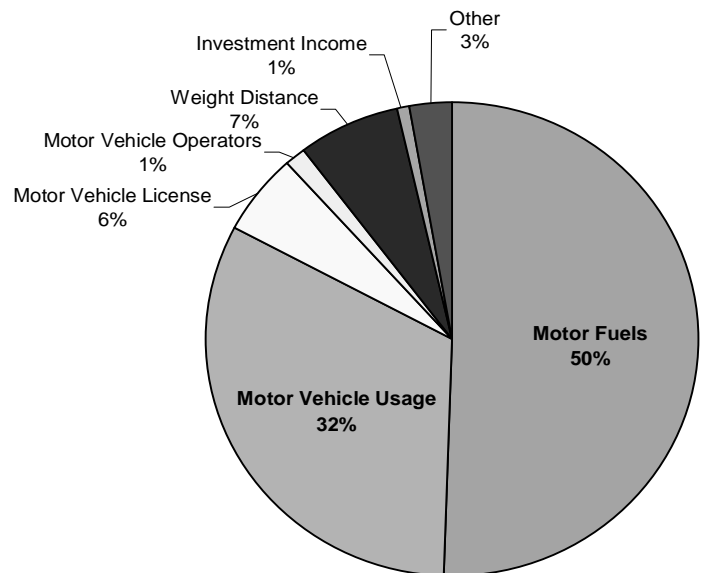
much lower compared to \$3.4 million in the first quarter of FY08.

The remainder of the accounts in the Road Fund combined for an increase of 4.7 percent.

Receipts for the **“Other”** category totaled \$8.7 million during the first quarter, compared to \$8.3 million in the first quarter of FY08.

Figure 2 details the composition of Road Fund revenues by tax type in the first quarter of FY09. Motor fuels taxes and motor vehicle usage taxes comprised 82 percent of Road Fund revenues in the first quarter. The next-largest source of revenue was the weight distance tax with seven percent, followed by motor vehicle license with six percent. The “Other” category accounted for three percent, while motor vehicle operators' license fees and investment income comprised one percent each.

**Figure 2**  
**First Quarter, FY09**  
**Road Fund Receipts**



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# The Economy . . .



## First Quarter, FY09

*The current slowdown has not been officially labeled a recession. That's principally because the official arbitration body, the National Bureau of Economic Research, doesn't announce a recession until a year after it has begun. Both employment and output have contracted as the economy adjusts to the new paradigm of tight credit and low aggregate demand. Kentucky had avoided the strong winds of change until September when employment contracted and the unemployment rate climbed to 7.1 percent.*

## NATIONAL ECONOMY

The broadest measure of economic performance is real gross domestic product (GDP), an inflation-adjusted measure of the total output of goods and services produced in the United States. Real GDP growth is typically reported as a seasonally adjusted annual rate that compares consecutive quarters. On that basis real output has shrunk by 0.2 percent (comparing April-June to July-September 2008) in contrast to a robust increase of 4.8 percent a year ago. In analyzing revenue growth it is more appropriate to compare data to the same quarter a year ago. On that basis when the first quarter output for FY09 is compared to the same quarter a year ago the situation is different: real GDP increased by 0.8 percent compared to 2.8 percent in FY08.

There are four broad components of the economy that drive overall growth: consumption, investment, government spending, and net exports. Consumption is by far the largest component accounting for about 70 percent of the total. Consumer concern about the economy and the future can be seen in the sharp drop in aggregate demand. When adjusted for inflation consumption grew by just 0.1 percent in the first quarter compared to 2.9 percent a year ago. The worsening credit crisis squelched the purchase of durable goods resulting in a contraction of 5.6 percent in the first quarter of FY09 compared to an increase of 5.1 percent a year ago. The purchase of motor vehicles and parts decreased by 15.8 percent as banks tightened their loan standards. The consumption of nondurable goods decreased by 0.3 percent compared to an increase of 2.4 percent a year ago.

Total investment comprises close to 15.0 percent of real GDP and is usually sensitive to both interest rates and future expansion opportunities. The investment component of GDP declined for the eighth straight quarter—down 8.2 percent in the first quarter compared to a fall of 4.1 percent a year ago. Given the problems arising from subprime lending and the overbuilt housing market it is not surprising that residential fixed investment component was down for the thirteenth straight quarter.

Government spending constitutes 17 percent of GDP and was up 2.2 percent, led by a surge in defense outlays (up 4.1 percent). State and local government revenues haven't fared well and were up just 1.3 percent in the first quarter compared to a gain of 2.3 percent a year ago.

The final component of GDP is net exports: the difference between exports and imports. As a result of the financial crisis the dollar regained its primacy as a safe currency and gained 15.6 percent against the currency of our major trading partners. This automatically made imports cheaper and increased the cost of U.S. goods to foreign buyers. However, the sudden onset of the crisis meant that the market had little time to adjust to the renewed strength of the dollar, and in the short-run trade continued as if the dollar was still weak. Given this anomaly imports declined by 3.0 percent and exports grew 8.4 percent.

Industrial production was down 2.3 percent, after rising by 1.8 percent in the same quarter a year ago. Output in coal mining was flat in contrast to a 0.2 percent decline a year ago.

The University of Michigan Consumer Sentiment Index has been going down for the last

seven quarters. It has slid from a high of 85.7 in FY07:1 to 64.8 in FY08:1. The deterioration in consumer confidence is related to the increase in crude oil prices during the first two months of the quarter followed by the financial crisis in the last month of the quarter and the subsequent volatility in the markets.

Personal income, a measure of spending power, was \$12,254.1 billion in the first quarter, an increase of 4.5 percent over the previous year. That growth rate is very lackluster given that inflation for the same period is estimated to have been 7.0 percent.

The unemployment rate in the first quarter averaged 6.0 percent compared to 4.7 percent a year ago. Total nonfarm employment dropped by 0.2 percent to 137.4 million jobs. Manufacturing employment continued its steep rate of decline with a drop of 3.0 percent during the first quarter.

**Table 3**  
**Summary US Economic Indicators**  
**First Quarter FY09**

	<b>FY08:1</b>	<b>FY09:1</b>	<b>% Chg</b>
Real GDP (billion 2000 \$)	11,625.7	11,722.8	0.8
Personal Income (billion \$)	11,730.4	12,254.1	4.5
Consumer Price Index (percent change)	2.8	7.0	-
Industrial Production (percent change)	3.6	-6.6	-
Civilian Labor Force (millions)	153.2	154.7	1.0
Total Nonfarm Employment (millions)	137.8	137.4	-0.2
Manufacturing Employment (millions)	13.9	13.4	-3.0
Unemployment Rate (percent)	4.7	6.0	-

Sources: Global Insight, Inc., and U.S. Department of Commerce, BEA.  
Data for FY09:1 are October 2008 estimates.

## STATE ECONOMY

Kentucky's personal income is estimated to be \$137.2 billion for the first quarter of FY09, an increase of 4.9 percent from a year ago. U.S. personal income grew by 4.5 percent during the same period. Wages and salaries constitute a little over half of personal income. Income derived from wages and salaries is estimated to have grown by just 4.1 percent in FY09:1, slightly higher than the national average of 3.8 percent.

Employment data is commonly used to gauge the strength of the state's economy, primarily because of its timely availability and its impact on consumer spending and confidence. Nonfarm employment in Kentucky is estimated to have increased by 8,900 jobs in the

first quarter of FY09 compared to one year earlier, resulting in growth of 0.5 percent. At first glance the slight increase in employment seems to indicate that Kentucky has avoided the job loss that has plagued the national economy. Upon further analysis, state employment growth has slipped for every month of the first quarter and was negative in September. Employment growth in Kentucky had resisted falling into negative territory because of the weak dollar and the subsequent boost to manufacturing exports. However, the strength of the dollar in the current quarter and the deepening of the financial crisis have recently had a dampening effect on Kentucky nonfarm employment. Therefore, the factors that insulated the Kentucky labor force from the downward national trend are beginning to dissipate.

**Table 4**  
**Selected Kentucky Economic Indicators**  
**First Quarter, FY09**

	<u>FY08:1</u>	<u>FY09:1</u>	<u>Chg</u>	<u>% Chg</u>
Total Personal Income (\$ billions)	130.9	137.2	6.4	4.9
Wage & Salary Income (\$ billions)	70.9	73.7	2.9	4.1
Total Nonfarm Employment (thousands)	1,871.0	1,879.9	8.9	0.5
Contract Construction	85.6	86.2	0.6	0.7
Mining	22.0	22.4	0.3	1.5
Manufacturing	254.7	248.6	-6.1	-2.4
Trade, Transportation & Utilities	387.0	392.5	5.5	1.4
Information	30.3	29.6	-0.7	-2.3
Finance	93.7	93.2	-0.5	-0.5
Business Services	181.7	180.8	-0.9	-0.5
Educational Services	241.4	242.2	0.8	0.3
Leisure and Hospitality Services	172.9	175.2	2.3	1.3
Other Services	76.2	75.8	-0.5	-0.6
Government	325.4	333.4	8.0	2.5

Note: Numbers may not add up due to rounding  
Sources: U.S. Department of Commerce, BEA,  
GOEA's Macromodel of Kentucky Forecast, October 2008

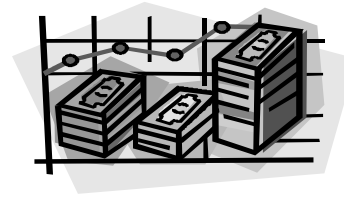
The largest gain in employment was in the Government sector with a gain of 8,000 jobs. Almost all the gains were in the area of local government. In the private sector, the biggest gains were in Trade, Transportation and Utilities sector (up 1.4 percent with an increase of 5,500 jobs) and Leisure and Hospitality Services (up 1.3 percent with the addition of 2,300 jobs). Most of the gains in the latter were in the area of accommodation and food services.

The Contract Construction sector (up 0.7 percent with an increase of 600 jobs) has bucked the national trend by growing in spite of the problems associated with valuations of commercial properties and residential housing. The spurt of growth was, however, only

in the first month of the quarter with declines in the next two months.

Historically the focus of Kentucky's economy has been on the manufacturing sector. It is the third largest sector in the Kentucky economy after Government and the Trade, Transportation, and Utilities sectors. Manufacturing employment accounts for about 13 percent of all nonfarm employment in Kentucky compared to 10 percent nationally. Over the last four years manufacturing employment declined sharply due to both the relocation of production facilities abroad and increased domestic productivity. During the first quarter manufacturing employment was down sharply by 2.4 percent with a loss of 6,100 jobs.

# Interim Outlook . . .



## GENERAL FUND

Projected General Fund revenues for the next three quarters of FY09 are shown in Table 5. General Fund revenues were \$2,085 million in the first quarter of FY09, a growth rate of 0.9 percent from the same period a year ago. Revenues grew slowly reflecting a softening economy. Individual income tax growth was strong as both employment and income in Kentucky were initially immune to the national economic woes.

Anticipated revenues for the last three quarters of FY09 are \$6,508 million, corresponding to a decline of 1.4 percent from the previous fiscal year. Total General Fund revenue for FY09 is estimated at \$8,592 million.

The official revised revenue estimate determined by the Consensus Forecasting Group in January 2008 and then modified by legis-

lative action anticipated General Fund revenues of \$8,886 million for FY09. The interim forecast revenues are \$293.6 million less than the budgeted level. A weakened economic outlook precipitated by a national crisis in the financial markets has led to expectations of lower revenues for FY09 in Kentucky.

Total sales and use tax receipts for the first quarter of FY09 were \$751.4 million, representing an increase of 3.2 percent from the same period a year ago. The projected rate of growth for the remaining three quarters of FY09 is a tepid 0.5 percent. Total sales and use tax receipts for FY09 are estimated to be \$2,912 million.

The interim forecast for the individual income tax calls for a decline of 4.7 percent for the remainder of FY09, amounting to collections of \$2,535 million in the final nine

**Table 5  
General Fund Interim Estimate  
(million dollars)**

	FY09 Quarter 1		FY09 Quarters 2, 3, & 4		FY09 Full Year		Official Budget Estimate	Dif
	Actual	%Chg	Estimate	%Chg	Estimate	%Chg		
Sales & Use	751.4	3.2	2,160.8	0.5	2,912.2	1.2	2,977.8	-65.6
Individual Income	876.7	6.6	2,534.9	-4.7	3,411.5	-2.1	3,472.8	-61.3
Corporation Inc& LLET	94.3	-48.4	327.3	-6.7	421.6	-21.0	622.3	-200.7
Coal Severance	72.7	36.0	215.4	20.0	288.1	23.6	223.7	64.4
Tobacco Taxes	43.7	-5.3	129.4	-2.2	173.1	-3.0	178.5	-5.4
Property	63.8	8.4	463.4	4.9	527.2	5.3	518.9	8.3
Lottery	43.0	3.6	155.5	6.5	198.5	5.9	198.5	0.0
Other	139.4	4.2	520.8	-2.9	660.2	-1.5	693.5	-33.3
<b>Total General Fund</b>	<b>2,084.9</b>	<b>0.9</b>	<b>6,507.5</b>	<b>-1.4</b>	<b>8,592.4</b>	<b>-0.8</b>	<b>8,886.0</b>	<b>-293.6</b>

months. The individual income tax grew by 6.6 percent in the first quarter of FY09, and is expected to decline by 4.7 percent during the remainder of the fiscal year. Further weakness in employment, wages and salaries, and weak aggregate demand all contribute to the lower forecasts. For the entire fiscal year, individual income tax revenues are projected to decline by 2.1 percent.

Corporation income tax revenues in FY09 are expected to decline sharply. Factors contributing to this decline include the effects of recent law changes, the presence of loss-carryforwards, and the expectations of lower future profits. The outlook for the combined corporation income and limited liability entity tax projects a decrease of 6.7 percent in the final three quarters of FY09, representing collections of \$327.3 million. This brings the FY09 total to \$421.6 million, a decrease of 21.0 percent from FY08.

The coal severance tax surged in the first quarter with receipts gaining 36.0 percent from a year ago. The forecast is that coal prices will drift downward slightly over the remainder of the fiscal year. As a result, revenue from this source is projected to be up by 20.0 percent for the remaining three quarters. Overall for the fiscal year, coal severance tax receipts are expected to increase by 23.6 percent.

Tobacco taxes were down by 5.3 percent when compared to a year earlier most likely due the rise in the price of gasoline and other commodities. The outlook for the remaining nine months of the fiscal year is for \$129.4 million in revenue, which corresponds to a decline of 2.2 percent for the year. For the entire fiscal year, receipts are forecasted to drop by 3.0 percent and yield \$173.1 million in revenue.

Property tax revenues totaled \$63.8 million in the first quarter of FY09, representing a growth rate of 8.4 percent from a year earlier. Receipts in property tax are sensitive to timing of payments, and in the first quarter payments of the tangible portion of telecommunications taxes grew sharply in relation to the previous year. It is expected that the remaining three quarters of FY09 will yield total property tax revenues of \$463.4 million, for an increase of 4.9 percent from the previous year. For the entire fiscal year property taxes should rise by 5.3 percent.

Lottery revenues grew by 3.6 percent in the first quarter of FY09. In the next three quarters, lottery revenues are expected to rise by 6.5 percent as the Kentucky Lottery Corporation increases its return to the General Fund in accordance with legislative mandate.

The “Other” category contains estimates for several of the smaller revenue sources not otherwise classified. The final three quarters of FY09 are expected to decline by 2.9 percent. The anticipated decrease is due to several factors: abandoned property receipts will not be as large as in the previous year, and investment income will also be lower than in the year before.

## **ROAD FUND**

Road Fund revenues are forecasted to grow by 0.6 percent over the remaining three quarters of FY09 as shown on Table 6 below. This represents a decrease of \$70.6 million from budgeted levels. The two largest Road Fund accounts, motor fuels and motor vehicle usage, are responsible for the majority of the downward revision in the estimate.



Motor fuels tax receipts are forecasted to grow by 7.1 percent in the last three quarters of FY09. This is principally due to a change in forecasted gasoline prices and their effect on the statutory rate of the motor fuels tax. Lower gasoline prices will spur demand and stem the decline in consumption of motor fuels. While tax receipts are expected to grow relative to the final three quarters of FY08, the estimate is \$23.0 million lower than the official revenue estimate.

Motor vehicle usage tax collections are expected to fall by 7.3 percent in the final nine months of FY09. Receipts in the first quarter declined by 9.2 percent and will remain weak due to tight credit conditions and uncertainty over expected future earnings attributable to the weak labor markets.

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 increase by 4.9 percent in the final three quarters of FY09. Motor vehicle operators' licenses are projected to rise by 5.7 percent in the remainder of the fiscal year. Weight distance tax revenue should fall by 2.3 percent for the remainder of the fiscal year. Investment income should fall by 49.2 percent due to lower fund balances. All other revenues should combine for a growth of 3.7 percent during the last nine months of FY09.

**Table 6**  
**Road Fund Interim Estimate**  
**(million dollars)**

	FY09 Quarter 1		FY09 Quarters 2, 3, & 4		FY09 Full Year		Official Budget Estimate	Dif
	Actual	%Chg	Estimate	%Chg	Estimate	%Chg		
Motor Fuels & MF Use/Surtax	158.0	-1.4	480.4	7.1	638.4	4.9	661.4	-23.0
Motor Vehicle Usage & Rental	100.0	-9.2	273.9	-7.3	373.9	-7.9	411.9	-38.0
Motor Vehicle License	17.6	-4.8	78.7	4.9	96.3	3.0	109.5	-13.2
Motor Vehicle Operators	4.3	6.2	12.0	5.7	16.3	5.8	15.5	0.8
Weight Distance Tax/Surtax	20.7	-6.1	60.9	-2.3	81.6	-3.3	85.9	-4.3
Investment	2.7	-19.8	8.2	-49.2	10.9	-44.1	5.8	5.1
Other	<u>8.7</u>	<u>4.7</u>	<u>28.1</u>	<u>3.7</u>	<u>36.8</u>	<u>4.0</u>	<u>34.8</u>	<u>2.0</u>
<b>Road Fund</b>	<b>312.0</b>	<b>-4.5</b>	<b>942.2</b>	<b>0.6</b>	<b>1,254.2</b>	<b>-0.7</b>	<b>1,324.8</b>	<b>-70.6</b>

## NATIONAL ECONOMY

The economic forecast for the next three quarters includes two negative quarters. Though it is too early to call it a recession the downturn does fit the rule-of-thumb convention: at least two consecutive quarters of contraction in real output. The downward shift is a result of the collapse of the housing and credit markets. Overall real GDP is expected to show a gain of just 0.1 percent from a year ago during the October-to-June period of FY09. This is substantially lower than the 2.3 percent growth experienced in the same period in FY08.

Consumption has always been a major driver of the national economy. Consumer expenditures constitute 70 percent of real GDP. Over the last three years consumption has played a greater role in real GDP as the other components—investment, net exports, and government spending—have been hit by overcapacity and state government budget woes. During the next three quarters of FY09 con-

sumption is expected to decrease by 0.4 percent compared to an increase of 1.6 percent a year ago. Consumption of durable goods is expected to plummet from an increase of 1.2 percent a year ago to a decline of 6.2 percent. The dampening is related to a renewed slowdown in the purchase of motor vehicles and parts (down 12.1 percent) as tight credit further dampens demand.

The federal funds rate is expected to drop to 1.0 percent during the next three quarters, but the near recessionary state of the economy and the drop in aggregate demand is expected to discourage investment thus creating a liquidity trap. Total real investment is forecasted to decline sharply by 9.6 percent, and the residential investment market is expected to free fall by 19.6 percent during the last three quarters of FY09.

The continuing fall in commodity prices is expected to keep inflation under control at 2.5 percent during the forecast period. This is lower than the personal income forecast of

**Table 7**  
**U.S. Economic Outlook for FY09**  
**Quarters 2, 3, & 4**

	<b>FY08</b>	<b>FY09</b>	<b>Percent Change</b>
Real GDP (billion 2000 \$)	11,664.7	11,677.4	0.1
Personal Income (billion \$)	12,007.2	12,375.8	3.1
Consumer Price Index (1992-94=100)	212.9	218.2	2.5
Industrial Production (2002=100)	112.0	109.2	-2.4
Civilian Labor Force (millions)	153.9	155.1	0.8
Total Nonfarm Employment (millions)	137.9	136.5	-1.0
Manufacturing Employment (millions)	13.7	13.1	-4.1
Unemployment Rate (percent)	5.0	6.8	-

Sources: Global Insight and U.S. Department of Commerce, BEA.  
Data for FY08 are September 2007 estimates.

3.1 percent. In the current outlook nonfarm employment is expected to decline by 1.0 percent and the unemployment rate is expected to reach 6.8 percent. Crude oil prices are forecasted to average \$91.10 per barrel as OPEC countries cut production in the face of a drop in global consumption.

## STATE ECONOMY

Kentucky is not immune to the downturn in the national economy. In the last three quarters of FY09 personal income is expected to grow by 3.4 percent and average \$138.8 billion. Wage and salary income constitutes about 53 percent of personal income and is expected to increase by 2.4 percent.

Kentucky's nonfarm employment is expected to decline by 0.8 percent during the final

three quarters of FY09 resulting in a loss of 15,900 jobs. The goods producing sectors account for one-fifth of all employment and are expected to decline by 2.7 percent. Manufacturing employment is projected to drop by 3.4 percent and construction by 3.0 percent. Mining is the only industry in the goods-producing category expected to show a gain in employment.

The service-providing industries account for about 65 percent of employment and are forecasted to contract by 0.6 percent with the loss of 7,500 jobs. The only area of growth in this sector is in educational services (up 1.4 percent). With the slowdown in the economy employment in business services is expected to decline by 2.6 percent. Employment in government—including federal, state, and local—is anticipated to rise by 0.4 percent.

**Table 8**  
**Kentucky Economic Outlook for FY09**  
**Quarters 2, 3, & 4**

	<u>FY08</u>	<u>FY09</u>	<u>Percent Change</u>
Total Personal Income (\$ millions)	134,310	138,839	3.4
Wage & Salary Income (\$ millions)	72,479	74,232	2.4
Total Nonfarm Employment (thousands)	1,878.3	1,862.4	-0.8
Contract Construction	86.5	83.9	-3.0
Mining	22.2	23.5	6.2
Manufacturing	251.3	242.9	-3.4
Trade, Transportation & Utilities	390.1	385.9	-1.1
Information	30.2	29.4	-2.6
Finance	94.1	93.9	-0.3
Business Services	182.3	177.6	-2.6
Educational Services	240.9	244.2	1.4
Leisure and Hospitality Services	174.5	173.5	-0.6
Other Services	76.4	76.6	0.2
Government	329.7	331.1	0.4

Source: GOEA's Macromodel of Kentucky, October 2008

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# **APPENDIX**

## KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	First Quarter FY 2009	First Quarter FY 2008	% Chg
<b>TOTAL GENERAL FUND</b>	<b>2,084,910,078</b>	<b>2,067,111,590</b>	<b>0.9%</b>
Tax Receipts	2,020,580,152	1,997,393,265	1.2%
Sales and Gross Receipts	870,858,767	840,733,564	3.6%
Beer Consumption	1,754,302	1,841,929	-4.8%
Beer Wholesale	14,550,916	14,195,303	2.5%
Cigarette	41,412,129	43,773,840	-5.4%
Distilled Spirits Case Sales	27,683	25,372	9.1%
Distilled Spirits Consumption	2,895,426	2,564,003	12.9%
Distilled Spirits Wholesale	7,138,166	6,336,080	12.7%
Insurance Premium	31,198,941	24,057,543	29.7%
Pari-Mutuel	607,836	709,782	-14.4%
Race Track Admission	121,628	152,651	-20.3%
Sales and Use	751,428,090	728,207,530	3.2%
Wine Consumption	375,761	551,662	-31.9%
Wine Wholesale	2,512,852	2,660,279	-5.5%
Telecommunications Tax	14,562,276	13,325,831	9.3%
OTP	2,272,762	2,331,758	-2.5%
License and Privilege	104,553,209	87,784,495	19.1%
Alc. Bev. License Suspension	101,400	318,770	-68.2%
Coal Severance	72,674,552	53,432,118	36.0%
Corporation License	1,089,515	1,902,281	-42.7%
Corporation Organization	12,615	88,057	-85.7%
Occupational Licenses	62,480	40,595	53.9%
Oil Production	4,004,923	2,039,617	96.4%
Race Track License	172,500	186,575	-7.5%
Bank Franchise Tax	(3,376,114)	(45,848)	---
Driver License Fees	160,551	176,915	-9.2%
Minerals Severance	4,190,886	4,577,349	-8.4%
Natural Gas Severance	13,570,778	6,466,697	109.9%
Limited Liability Entity	11,889,122	18,601,369	-36.1%
Income	959,032,081	986,684,703	-2.8%
Corporation	82,372,047	163,972,164	-49.8%
Individual	876,660,034	822,712,539	6.6%
Property	\$63,763,104	\$58,819,593	8.4%
Building & Loan Association	228,467	93,832	143.5%
General - Real	270,689	576,149	-53.0%
General - Tangible	37,703,936	26,264,166	43.6%
Omitted & Delinquent	12,240,028	19,557,415	-37.4%
Public Service	12,738,260	12,164,491	4.7%
Other	581,724	163,541	255.7%
Inheritance	\$13,019,297	\$14,061,662	-7.4%
Miscellaneous	\$9,353,695	\$9,309,248	0.5%
Legal Process	6,180,588	6,553,328	-5.7%
T. V. A. In Lieu Payments	3,165,484	2,755,921	14.9%
Other	7,623	0	---
Nontax Receipts	\$64,610,930	\$67,977,075	-5.0%
Departmental Fees	6,216,916	7,352,300	-15.4%
PSC Assessment Fee	9,354,102	10,529,657	-11.2%
Fines & Forfeitures	7,372,509	7,616,003	-3.2%
Interest on Investments	1,155,631	436,629	164.7%
Lottery	43,000,000	41,500,000	3.6%
Sale of NOx Credits	0	0	---
Miscellaneous	(2,488,228)	542,485	---
Redeposit of State Funds	(\$281,005)	\$1,741,250	---

## KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	First Quarter FY 2009	First Quarter FY 2008	% Chg
<b>TOTAL ROAD FUND</b>	<b>\$311,972,993</b>	<b>\$326,655,562</b>	<b>-4.5%</b>
Tax Receipts-	\$303,190,348	\$316,854,726	-4.3%
Sales and Gross Receipts	\$257,971,666	\$270,389,961	-4.6%
Motor Fuels Taxes	157,975,206	160,215,349	-1.4%
Motor Vehicle Usage	99,996,460	110,174,612	-9.2%
License and Privilege	\$45,218,682	\$46,464,765	-2.7%
Motor Vehicles	17,644,064	18,542,154	-4.8%
Motor Vehicle Operators	4,255,424	4,006,702	6.2%
Weight Distance	20,713,520	22,058,728	-6.1%
Truck Decal Fees	43,810	36,052	21.5%
Other Special Fees	2,561,864	1,821,129	40.7%
Nontax Receipts	\$8,487,536	\$9,740,611	-12.9%
Departmental Fees	5,397,125	5,769,404	-6.5%
In Lieu of Traffic Fines	245,178	293,569	-16.5%
Investment Income	2,694,178	3,359,254	-19.8%
Miscellaneous	151,055	318,384	-52.6%
Redeposit of State Funds	\$295,108	\$60,225	390.0%