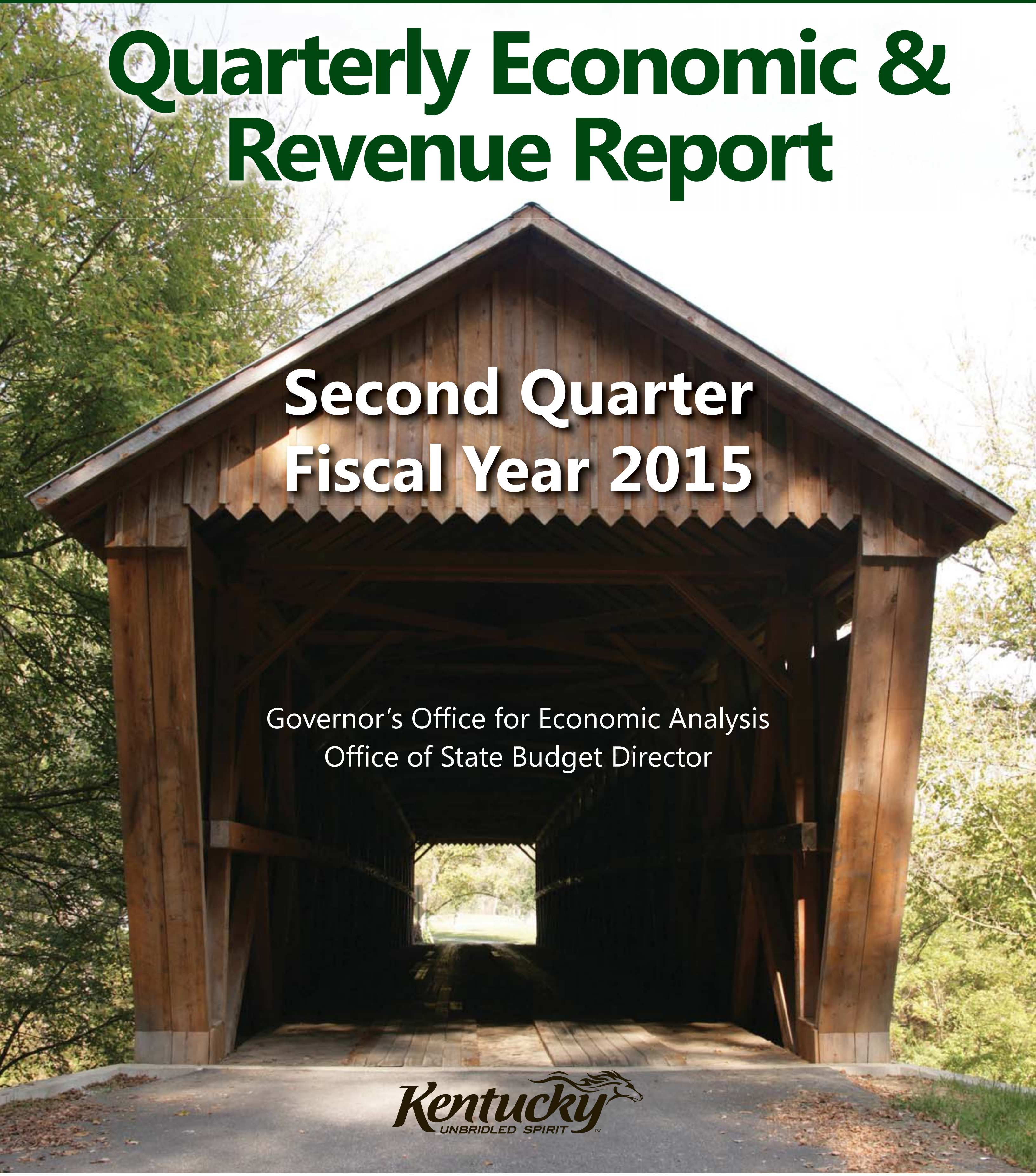
COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report



Second Quarter Fiscal Year 2015

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

Kentucky
UNBRIDLED SPIRIT™

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Steven L. Beshear
Governor

Jane C. Driskell
State Budget Director

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

January 30, 2015

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 2015 (FY15). It also includes an interim economic and revenue forecast for the next three fiscal quarters.

General Fund receipts are now projected to surpass the enacted estimates by $8.0 million in FY15, while Road Fund receipts are now projected to fall short of the enacted estimates by $43.7 million in FY15.

The fiscal situation has solidified considerably since the first quarterly report was published. General Fund revenue grew 5.8 percent in the second quarter, with nominal revenues $140.8 million greater than the second quarter of FY14. The second quarter boasted the highest rate of growth during a single quarter since the third quarter of FY12. Year-to-date growth went from 1.1 percent after the first quarter to the current pace of 3.5 percent. In order to hit the enacted estimate of 3.6 percent growth, or $9,801.2 million, General Fund growth needs to grow 3.7 percent.

Road Fund revenues are forecasted to decline significantly over the final six months of the fiscal year and then fall even more precipitously in the first quarter of FY16. The first two quarters of FY15 have seen Road Fund revenues increase 1.1 percent. The second half of the year is estimated to decline by 8.5 percent while collections in the first quarter of FY16 decline by 16.5 percent.

The upcoming fiscal quarters will prove very telling as to the relative strength of economic factors and their ability to generate an elastic response in state tax revenues. These trends will be closely monitored as the next two quarters progress.

Sincerely,

Jane C. Driskell

Jane C. Driskell
State Budget Director

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Executive Summary

In accordance with KRS 48.400(2), the Office of State Budget Director (OSBD) has prepared a *Quarterly Economic and Revenue Report* for the second quarter of Fiscal Year 2015 (FY15). This report includes a current synopsis of the economic and fiscal conditions of the Commonwealth, as well as an outlook for the next three fiscal quarters.

This report is based on the January 2015 Global Insight national outlook as well as the output from the Kentucky Macroeconomic Model (MAK) using the January national inputs. Looking back to the past report, the discussion was very hypothetical – the economy was well-positioned for economic growth yet state revenue growth remained anemic. General Fund managed a meager 1.1 percent rate of growth in the first quarter of FY15 and the General Fund interim estimate called for a $135.2 million shortfall in FY15.

The fiscal situation has solidified considerably since that report was issued. General Fund revenue grew 5.8 percent in the second quarter, with nominal revenues over $140 million greater than the second quarter of FY14. The second quarter boasted the highest rate of growth during a single quarter since the third quarter of FY12. Year-to-date growth went from 1.1 percent in the first quarter to 3.5 percent through the second quarter of FY15. General Fund growth needs to reach 3.7 percent for the rest of the fiscal year in order to meet the enacted estimate of $9,801.2 million. In the previous fiscal year, third and fourth quarter growth rates were 2.1 and 0.5 percent, respectively. This forecast predicts higher rates of growth due to the strength in the state and national economies. Table 6 highlights the General Fund forecast for the remainder of FY15 and the first quarter of FY16. Growth in the second half of FY15 is expected to be 3.7 percent, which is slightly above the level needed to meet the revenue target.

A good case could be made that the first quarter was more of an outlier since the fiscal economy has caught up to the prosperity of the real economy. Gasoline prices are projected to remain low in the near term, providing an increase in the real disposable income of consumers. The Cleveland Federal Reserve Bank reported that Kentucky's housing prices increased at a rate faster than the national average in the second quarter. Increasing home values coupled with more disposable income leads to higher consumer demand and greater consumer sentiment — the opposite set of conditions that led to the so-called "Great Recession" of 2007. Gasoline prices spiked and housing prices fell sharply. Moving ahead to 2015, these positive developments will likely result in increased consumer spending, which is critical to the Commonwealth's budget since sales and use taxes plus individual income tax withholding make up roughly 70 percent of the General Fund.

Major points that will be discussed in this report include the following:

- The General Fund posted growth of 5.8 percent in the second quarter of FY15, based largely on the strength of withheld income tax and sales tax. For a summary of all General Fund receipts, see Table 1.

- General Fund collections are expected to total $9,809.2 million — $8.0 million higher than the enacted estimate.

- The growth taxes in the General Fund continue to be the individual income tax and the sales tax.

- Road Fund revenues are forecasted to decline significantly over the final six months of the fiscal year and then fall even more precipitously in the first quarter of FY16. The first two quarters of FY15 have seen Road Fund revenues increase 1.1 percent. The second half of the year is expected to decline by 8.5 percent while collections in the first quarter of FY16 are projected to decline by 16.5 percent.

- The largest source of Road Fund revenue, the motor fuels tax, is forecasted to fall 13.2 percent over the final six months of FY15. Declines in the average wholesale price of gasoline have lowered the variable portion of the motor fuels tax rate, which has depressed tax receipts. Road Fund receipts are now projected to fall short of the enacted estimates by $43.7 million in FY15 with an even larger shortfall expected in FY16 due to plunging fuel prices.

Revenue Receipts

GENERAL FUND
Second Quarter, FY15

Revenue collections grew 5.8 percent, or $140.8 million, in the second quarter of FY15 following a 1.1 percent increase in the first quarter of the year. Year-to-date receipts have increased a net 3.5 percent. Revenues have now grown in four consecutive quarters. With the solid growth through the first six months in receipts, revenues would need to grow 3.7 percent for the last six months of the fiscal year to meet the enacted estimate.

Second quarter gains were primarily driven by individual income, and sales and use tax collections. Total receipts in the second quarter totaled $2,578.9 million compared to $2,438.1 million received in the second quarter of FY14. 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
$ millions

	FY15 Q2	FY14 Q2	Diff $	Diff %
Individual Income	994.5	925.3	69.2	7.5
Sales and Use	822.4	779.0	43.3	5.6
Property	325.8	306.2	19.6	6.4
Corporation Income	96.8	79.9	16.9	21.2
Coal Severance	48.8	52.8	-4.0	-7.6
Cigarette Taxes	55.1	57.9	-2.8	-4.8
LLET	38.5	45.4	-6.8	-15.0
Lottery	57.5	54.6	2.9	5.2
Other	139.5	137.0	2.5	1.8
Total	**2,578.9**	**2,438.1**	**140.8**	**5.8**

Individual income tax posted receipts of $994.5 million, compared to last year's second-quarter receipts of $925.3 million. The resulting growth rate was 7.5 percent, and compares to a growth rate of 1.6 percent for the second quarter of last year. Declarations and withholding payments of this tax improved considerably compared to the same time frame last year.

The sales and use tax grew 5.6 percent in the second quarter of FY15. Receipts of $822.4 million, compared to $779.0 million in the second quarter of FY14. Year-to-date sales tax receipts have increased 4.5 percent compared to last year.

Combined corporation income and limited liability entity tax (LLET) receipts were up in the second quarter of the fiscal year. Revenues of $135.4 million were 8.1 percent more than year-earlier figures of $125.3 million.

Coal severance tax revenue continued to decline in the second quarter, with receipts down 7.6 percent. Collections of $48.8 million compare to the FY14 second quarter total of $52.8 million.

Cigarette tax receipts of $55.1 million in the second quarter of FY15 compare to $57.9 million in the second quarter of FY14. Receipts declined for the last eight quarters due to declining packs sold.

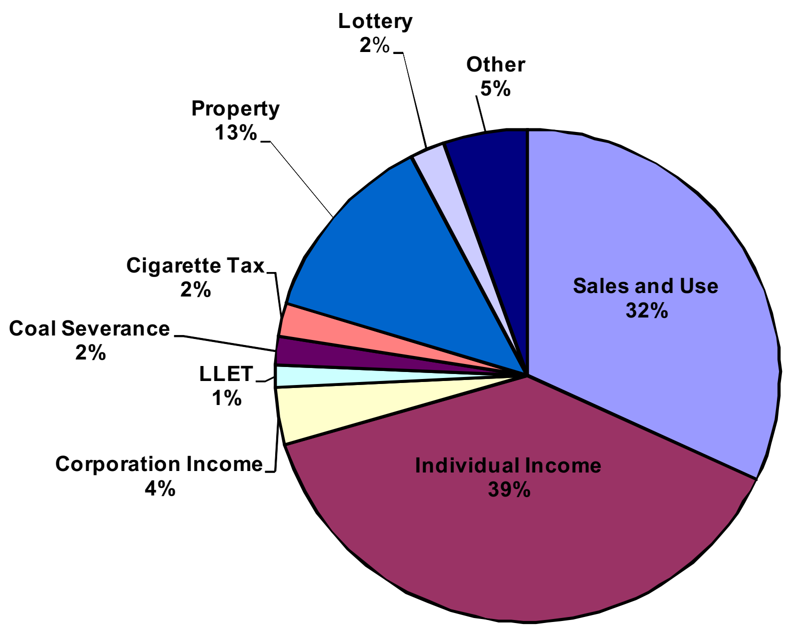
Second quarter property tax receipts posted revenues that were $19.6 million more than the second quarter of FY14. Fiscal year 2015 second quarter receipts of $325.8 million compare with $306.2 million from the second quarter of FY14.

Lottery receipts were $57.5 million, which were 5.2 percent above last year's second-quarter total of $54.6 million.

The Other category, which represents the remaining accounts of the General Fund, increased 1.8 percent in the second quarter. Second quarter receipts for FY15 were $139.5 million and compare to $137.0 million in FY14.

Figure 1 details the composition of General Fund revenues by tax type for the second quarter of FY15. Seventy-one 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 property tax which accounted for 13.0 percent of the total General Fund receipts followed by the Other category at 5.0 percent. Annually, the largest components in the Other category include insurance premium tax, bank franchise tax, telecommunications tax, beer wholesale tax and the public service tax. Corporation income taxes accounted for 4.0 percent. Lottery, cigarette and coal severance receipts each accounted for 2.0 percent each. Finally, LLET accounted for 1.0 percent.

Figure 1
General Fund Receipts Composition
Second Quarter, FY15



ROAD FUND

Total Road Fund receipts grew only 0.5 percent during the second quarter of FY15 as motor fuels and motor vehicle usage tax collections remained weak. Total receipts of $380.1 million compare to $378.3 million from the second quarter of last year. Summary data are contained in Table 2 and detailed data are shown in the Appendix.

Table 2
Summary Road Fund Receipts
$ millions

	FY15 Q2	FY14 Q2	Diff $	Diff %
Motor Fuels	228.5	227.7	0.7	0.3
Motor Vehicle Usage	100.4	101.3	-0.9	-0.8
Motor Vehicle License	18.2	18.1	0.1	0.5
Motor Vehicle Operators	4.0	3.9	0.1	3.4
Weight Distance	20.5	19.5	1.1	5.5
Income on Investments	0.6	0.1	0.6	671.1
Other	7.8	7.7	0.1	1.3
Total	**380.1**	**378.3**	**1.8**	**0.5**

Motor fuels tax receipts grew at a rate of 0.3 percent during the second quarter. Receipts were $228.5 million and compare to $227.7 million collected during the second quarter of last year. The slim increase is due to a decline in taxable gallons of motor fuels sold and tax rates. The tax rate for the quarter was only 25.5 cents per gallon comparing to 25.9 cents per gallon for the same period in FY14.

Motor vehicle usage tax receipts of $100.4 million represent a decrease of 0.8 percent compared to the $101.3 million collected in the second quarter of FY14. The trade-in credit on new car purchases accounted for $11.4 million for the quarter, which was higher than anticipated.

Motor vehicle license tax receipts increased 0.5 percent in the second quarter of FY15 to $18.2 million.

Motor vehicle operator's license tax receipts were $4.0 million in the second quarter of FY15, an increase of 3.4 percent.

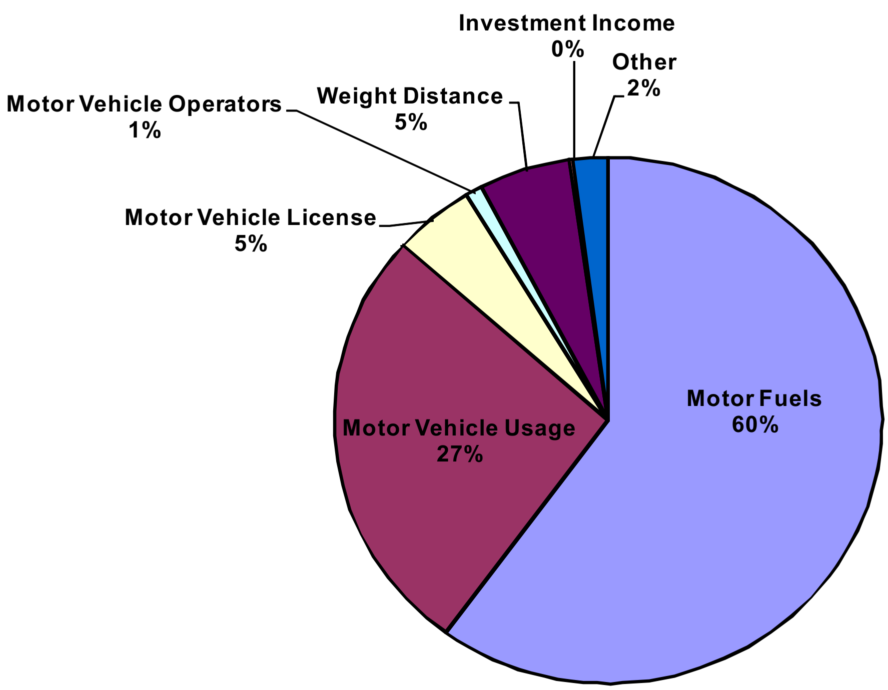
Weight distance tax receipts of $20.5 million represented a 5.5 percent increase compared to receipts of $19.5 million during the second quarter of FY14.

Investment receipts of $0.6 million compared to $0.1 million in the second quarter of FY14.

The remainder of the accounts in the Road Fund combined for an increase of 1.3 percent from a year earlier. In the Other category, revenues of $7.8 million compare to $7.7 million in the second quarter of FY14.

Figure 2 details the composition of Road Fund revenues by tax type in the second quarter of FY15. Motor fuels taxes and the motor vehicle usage tax accounted for 87.0 percent of Road Fund revenues in the second quarter. The next-largest sources of revenue were the motor vehicle license and weight distance taxes with 5.0 percent each. The Other category accounted for 2.0 percent, while motor vehicle operators comprised 1.0 percent. Investment income accounted for a negligible amount of total Road Fund receipts.

Figure 2
Road Fund Receipts Composition
Second Quarter, FY15



The Economy
Second Quarter FY15

NATIONAL ECONOMY

Real gross domestic product (real GDP) increased by 2.5 percent in the second quarter of FY15. Real GDP is the sum of all final goods and services sold within a country's physical boundaries in a given year and explicitly excludes those goods and services which are produced by US citizens in other countries. This is the third consecutive quarter where real GDP growth is above two percent. Growth during this recovery, however, is still below that of the 2001 recovery. Growth during the 2001 recovery period averaged just over 2.5 percent, while current average growth is 2.2 percent. Historically, these are both low average growth rates for the recovery period immediately following a recession.

Real consumption grew by 2.8 percent in the second quarter of FY15. Growth in consumption appears to be accelerating slightly. Growth has accelerated over the last three quarters. The last four growth rates were 2.2, 2.4, 2.7 and 2.8 percent, respectively. On an adjacent-quarter basis, real consumption grew by 1.0 percent in the second quarter. This is the fastest growth for consumption since the recession ended.

Table 3
Summary of US Economic Series
Second Quarter FY15 & FY14

	Second Quarter			
	FY15	FY14	Chg	% Chg
Real GDP	16,308.2	15,916.2	392.0	2.5
Real Consumption	11,111.6	10,811.4	300.1	2.8
Real Investment	2,789.9	2,634.7	155.2	5.9
Real Govt. Expenditures	2,889.5	2,874.5	15.0	0.5
Real Exports	2,125.7	2,076.5	49.2	2.4
Real Imports	2,581.4	2,460.5	120.9	4.9
Personal Income ($ billions)	14,924.0	14,311.7	612.3	4.3
Wages and Salaries ($ billions)	7,546.9	7,208.5	338.4	4.7
Inflation (% chg CPI)	1.2	1.2	NA	NA
Industrial Production Index (% chg)	4.9	3.3	NA	NA
Civilian Labor Force (millions)	156.4	154.9	1.4	0.9
Total Non-farm Employment (millions)	140.0	137.2	2.8	2.0
Manufacturing Employment (millions)	12.2	12.0	0.2	1.4
Unemployment Rate (%)	5.8	7.0	NA	NA

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Components do not sum to GDP because they are annualized independently.
Data for FY15 Q2 are January 2015 estimates.
Source: IHS Global Insight Inc., January 5, 2015 data release

Real investment rose by 5.9 percent in the second quarter of FY15. Investment growth during this recovery has been better than the previous recovery in many ways. Average growth of real investment during the current recovery is 6.8 percent per quarter. Growth has slowed recently. In the first 11 quarters of the recovery, real investment growth averaged 8.1 percent. Over the last nine quarters, growth has averaged 5.1 percent. Real investment has had strong growth in 2010 and 2012, but otherwise it has been modest at best.

There are two reasons for the slow recovery in real investment. First, the 2007 recession hit real investment particularly hard, losing a net 34.9 percent of its value. Second, the strong growth which persisted for many quarters during other recoveries has been absent during this recovery. Real investment in the second quarter of FY15 finally surpassed its pre-recession peak. It took 22 quarters to attain that landmark. By comparison, it took only 10 quarters for real investment to make up its recession losses following the 2001 recession.

Government expenditures increased by 0.5 percent in the second quarter of FY15. On an adjacent-quarter basis, real government expenditures have declined in 15 of the 21 quarters since expenditures reached their last peak. This is normal during an expansion period as transfer payments recede. Since the first quarter of FY10, government expenditures have declined a net 7.2 percent, or $223.5 billion. In 2011, the declines averaged 3.0 percent per quarter. Since then, the contraction of real government expenditures has slowed considerably. In 2014, the average per quarter decline was only 0.2 percent. While the trend has been for decreasing government expenditures, the current expenditures are up slightly.

While government expenditures increased by a small amount in the second quarter, there were still large changes in many of the components. Major accounts where government expenditures increased significantly include: federal transfers to private residents, which increased by 3.2 percent over the second quarter of FY14; federal grants to state & local governments (+15.4%); federal transfers to the rest of the world (+27.7%); interest payments on federal debt (+10.6%); Medicaid expenditures (+23.1%); and Social Security & Disability (+4.1%). The notable increase in federal transfers probably indicates that the government expenditure contraction, which normally occurs after a recession, is over or nearly over.

US imports increased by 4.9 percent in the second quarter of FY15, while US exports increased by 2.4 percent. While the level of imports and exports determines the trade deficit, the growth rates indicate that that trade deficit will continue to get worse. The trade deficit in the second quarter was $455.6 billion. This is up significantly from the recession-end level of $366.3 billion.

US personal income rose by 4.3 percent in the second quarter. This is the fourth consecutive quarter of solid growth for personal income. Both transfer receipts and proprietor's income were the two components with the largest growth rates in the second quarter, each growing 4.9 percent.[1] See Table 4. Wages and salaries, which makes up 50.6 percent of personal income grew by 4.7 percent in the second quarter. This is the fourth consecutive quarter of wages and salary growth of 3.9 percent or higher.

Non-farm employment grew by 2.0 percent in the second quarter of FY15. Non-farm employment has grown steadily for the last nine quarters, increasing by 500,000 to 800,000 jobs each quarter. This is the best sustained growth for US employment since the end of the recession. In the fourth quarter of FY14 US non-farm employment finally surpassed its pre-recession peak - 17 quarters later. While the recovery employment growth has been slow, it has been steady. Business services and trade, transportation and utilities employment were large contributors to the growth in the second quarter of FY15, growing by 700,000 and 500,000 jobs respectively.

KENTUCKY ECONOMY

Kentucky personal income grew by 5.2 percent in the second quarter of FY15. Kentucky personal income growth has been improving over the last five quarters, growing 0.2, 2.8, 3.9, 4.1 and 5.2 percent, respectively. The largest component and contributor to Kentucky personal income in the second quarter was wages and salaries. Wages and salaries make up 49.5 percent of total personal income in Kentucky. This is slightly below the national average which is 50.6 percent. Wages and salaries increased by 5.6 percent in the second quarter. This is a net increase of $4,447 million and makes up over half of the total gains in personal income.

The second largest contributor to personal income in the second quarter was transfer receipts. Transfer receipts grew by 6.7 percent in the second quarter and make up 23.5 percent of total personal income in Kentucky. This is significantly higher than the national average where transfer payments make up 17.1 percent of personal income. In the last 14 years, Kentucky has shifted a large share of its income from other sources to transfer income. For comparison, in 1998, transfer income made up 16.7 percent of personal income.

Supplements to wages and salaries (also known as “fringe benefits”) make up a larger share of Kentucky personal income than the national share. In Kentucky supplements make up 12.8 percent of income, while nationally, they make up only 8.3 percent of total income. In the second quarter, supplements income increased by 3.9 percent over the previous year. Supplements to wages and salaries experienced some considerable volatility in the last three years. For the six quarters from fourth quarter of FY12 to the second quarter of FY14, supplements income decreased in each quarter losing a net 4.1 percent in value. Supplements income has just begun to recover during the last three quarters, growing 0.9, 1.9 and 3.9 percent, respectively. In the last four quarters, supplements income regained $809.7 million of the prior six quarterly losses.

[1] Social insurance had the highest growth rate in the second quarter, but this is a deduction from personal income, not a ‘contributor’ to income.

Non-farm employment increased by 1.4 percent in the second quarter of FY15. Growth since the end of the recession has been weak. Historically, quarterly employment growth during an expansion period is between two and four percent. During this expansion period the highest growth was 1.9 percent and it occurred in the fourth quarter of FY12. Growth during the expansion period between the 2001 and 2007 recessions was also weak. The highest employment growth during that expansion was just 1.7 percent. Kentucky still has not surpassed its pre-recession peak of 1,868,800 jobs, which was recorded in the fourth quarter of FY07.

However, employment improved in the majority of the employment sectors in the second quarter of FY15. Only two sectors lost jobs during the second quarter: construction and finance services, which lost 2.7 and 1.6 percent, respectively. The best performing sector was leisure and hospitality services employment, which increased 5.0 percent, or an increase of 8,800 jobs. In absolute terms, the best performer was the trade, transportation and utilities sector, which increased by 10,300 seasonally-adjusted jobs in the second quarter.

Table 4
Personal Income
Second Quarter FY15 & FY14

	Q2			
	FY15	**FY14**	**$ Diff**	**% Diff**
United States ($ billions, AR)				
Personal Income	14,924	14,312	612	4.3
Social Insurance	1,175	1,118	58	5.2
Employer-paid Social Insurance Taxes	555	532	24	4.5
Dividends, Interest and Rents	2,799	2,708	91	3.4
Transfer Receipts	2,550	2,432	118	4.9
Wages & Salaries	7,547	7,209	338	4.7
Supplements to W&S	1,239	1,207	32	2.7
Proprietor's Income	1,409	1,343	66	4.9
Kentucky ($ millions, AR)				
Personal Income	168,218	159,952	8,266	5.2
Social Insurance	13,717	12,995	722	5.6
Residence Adjustments	-2,041	-1,778	-262	NA
Dividends, Interest and Rents	26,439	25,549	889	3.5
Transfer Receipts	39,506	37,025	2,481	6.7
Wages & Salaries	83,193	78,746	4,447	5.6
Supplements to W&S	21,466	20,656	810	3.9
Proprietor's Income	13,371	12,748	623	4.9

Source: IHS Global Insight Inc., January 5, 2015 data release and January 2015 KY MAK Model

Table 5
Summary of US & KY Employment
Second Quarter FY15 & FY14

	Q2 US (millions)			Q2 KY (thousands)		
	FY15	FY14	% Chg	FY15	FY14	% Chg
Non-farm Employment	140.0	137.2	2.0	1,865.2	1,840.4	1.4
Goods-producing	19.2	18.8	2.4	312.9	312.3	0.2
Construction	6.1	5.9	3.9	64.9	66.8	-2.7
Mining	0.9	0.9	5.1	18.1	17.5	3.4
Manufacturing	12.2	12.0	1.4	229.9	228.1	0.8
Service-providing	98.8	96.6	2.3	1,213.2	1,190.8	1.9
Trade, Transportation & Utilities	26.6	26.1	2.0	378.5	368.2	2.8
Information	2.7	2.7	0.3	26.6	26.1	1.7
Finance	8.0	7.9	1.4	86.8	88.2	-1.6
Business Services	19.5	18.8	3.8	207.2	205.9	0.6
Educational Services	21.7	21.2	2.1	262.2	259.3	1.1
Leisure and Hospitality Services	14.8	14.4	2.7	186.7	177.9	5.0
Other Services	5.5	5.5	1.1	65.3	65.2	0.2
Government	21.9	21.9	0.4	339.2	337.2	0.6

Seasonally Adjusted. Data for FY15 Q3 are January 2015 estimates.
Source: IHS Global Insight Inc., January 5, 2015 data release

Interim Outlook

GENERAL FUND

The revenue forecasts presented in Table 6 and Table 7 were estimated using the January 2015 "control scenario" economic forecast from both IHS Global Insight (hereafter Global Insight) and the Kentucky MAK model. The first edition of the FY15 *Quarterly Report* described an economy that was well-poised for economic growth – yet growth in revenue receipts proved stubbornly elusive. The General Fund grew by a meager 1.2 percent in FY14. The final shortfall for FY14 was $90.9 million and the new anticipated shortfall for FY15 was $135.2 million. The improvements in the second quarter have changed the outlook for FY15 considerably.

The fiscal situation has solidified since that report was issued. General Fund revenue grew 5.8 percent in the second quarter, the highest rate of growth during a single quarter since the third quarter of FY12. Year-to-date growth went from 1.1 percent after the first quarter to the current pace of 3.5 percent. In order to hit the enacted estimate of 3.6 percent growth, or $9,801.2 million, General Fund growth needs at 3.7 percent. Table 6 highlights the General Fund forecast for the remainder of FY15 and the first quarter of FY16. Growth in the second half of FY15 is expected to generate revenue growth of 3.7 percent, slightly above the level needed to meet the revenue target.

Revenues have built some momentum coming off a strong second quarter. Gasoline prices are projected to remain low in the near term, providing an increase in the real disposable income of consumers. The Cleveland Federal Reserve Bank reported that Kentucky's housing prices

Table 6
General Fund Interim Forecast
$ millions

	FY15						FY15		FY16	
	Q1 & Q2		Q3 & Q4		Full Year		Official CFG		Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff	Estimate	% Chg
Individual Income	1,975.9	6.4	2,014.7	6.4	3,990.6	6.4	3,977.3	13.3	1,028.5	4.8
Sales & Use	1,626.9	4.5	1,632.7	3.7	3,259.6	4.0	3,154.0	105.6	841.5	4.6
Property	370.4	2.3	198.0	-1.2	568.4	1.1	581.2	-12.8	48.6	8.9
Corporate Income	208.9	-9.4	238.0	-2.6	446.9	-5.9	462.4	-15.5	113.8	1.6
Coal Severance	97.6	-6.3	93.8	0.4	191.4	-3.1	204.6	-13.2	43.6	-10.7
Cigarette Tax	112.3	-4.1	106.0	-4.4	218.3	-4.3	223.5	-5.2	57.6	0.6
LLET	83.0	-11.6	97.0	-8.0	180.0	-9.7	233.7	-53.7	45.2	1.6
Lottery	109.5	6.2	130.5	12.2	238.0	9.3	238.0	0.0	56.0	7.7
Other	292.9	1.8	423.2	2.7	716.1	2.3	726.5	-10.4	155.6	1.4
General Fund	**4,877.3**	**3.5**	**4,931.9**	**3.8**	**9,809.2**	**3.7**	**9,801.2**	**8.0**	**2,390.4**	**4.0**

increased at a rate faster than the national average in the second quarter. When these two factors are considered retrospectively, they are the exact opposite of conditions that led to the so-called "Great Recession" of 2007. Gasoline prices spiked and housing prices fell sharply. Moving ahead to 2015, these positive developments will likely result in increased consumer spending, which is important to the Commonwealth's revenues since sales and use taxes make up 32 percent of the General Fund.

Individual income tax receipts are expected to increase by 6.4 percent during the second half of FY15. If the projected amount materializes, collections would exceed estimates by $13.3 million. Solid growth in withholding has been the headline for the last two quarters in the individual income tax, as witnessed by the 6.9 percent quarterly growth rate in the second quarter. With higher withholding and low gasoline prices, consumer sentiment is on the rise leading to higher consumption and higher employment levels.

During FY14, the sales and use tax posted the largest nominal increase among General Fund accounts growing $109.3 million or 3.6 percent. The rate of growth in this account was welcome, given it has declined in three of the last six years. Sales and use tax receipts have increased 4.5 percent through December with continued growth of 3.7 percent expected for the second half of FY15. These projections would generate sales tax receipts that are $105.6 million above enacted estimates.

Property tax revenues are expected to decline 1.2 percent in the second half of FY15 but end the year with a net 1.1 percent annual growth. Due to the effects of the recession on the housing market, the state rate has remained at 12.2 cents since valuation year 2008, an unprecedented occurrence of seven consecutive years without a rate decline. As the housing market shores up, growth in new property and existing values can be expected to eventually return to more traditional growth patterns, but this interim forecast assumes that this reversion to "normal" will not occur during the forecasting horizon.

The corporation income tax and the LLET were designed to be complementary. The LLET is a backstop for the corporation income tax. That is, when corporate profits and tax receipts fall, LLET collections should rise and vice versa. The FY14 receipts exemplified this theoretical relationship between the two taxes. In FY14, corporation income tax collections grew 18.6 percent, while LLET receipts plummeted with a decline of 19.0 percent. That relationship broke trend in FY15 as both taxes are expected to fall over the course of the fiscal year. The corporation income tax is expected to fall an additional 2.6 percent in the second half of FY15 after declining 9.4 percent during the first two quarters of the year. Meanwhile, the LLET is expected to decrease by 8.0 percent over the second half of FY15 after a decrease of 11.6 percent year-to-date.

Coal severance receipts fell slightly short of the official estimate in FY14 and are expected to lose more ground in FY15. Energy markets and coal markets in particular, have become quite volatile. The interim estimate is for a 3.1 percent decline in FY15 following a 14.3 percent decline in FY14. Increased EPA regulations, a slowdown in federal certification of new mine permits, and shifts to natural gas electricity generation have contributed to the multi-year decline in coal sales and coal severance taxes in Kentucky. A return to the FY12 peak of $298.3 million in the severance tax is completely implausible in the short to intermediate forecasting horizon.

Cigarette tax receipts declined 4.4 percent in FY14 . The outlook for cigarette tax receipts is for a 4.3 percent decline in FY15. A downward trend in smoking rates is still expected, but the $1.00 per pack increase in the tax rate for Illinois is expected to have a small positive revenue impact for cigarette purchases in Kentucky. Notwithstanding this minor border impact, the consumption of cigarettes has steadily been trending downward.

Lottery dividends grew by 2.0 percent in FY14 and fell $4.5 million short of the enacted estimates. The official estimate for FY15 remains at $238.0 million.

The Other category contains dozens of smaller accounts, which make up the remainder of the General Fund. Insurance premiums tax, bank franchise and telecommunications tax are the three largest accounts in the Other category. The Other category of taxes is expected to rise 2.7 percent for the reminder of FY15, following FY14 where revenues declined 2.0 percent. Other collections are estimated to be $716.1 million for all of FY15.

ROAD FUND

Growth in Road Fund revenues is forecasted to decline significantly over the final six months of the fiscal year and then fall even more precipitously in the first quarter of FY16. The first two quarters of FY15 have seen Road Fund revenues increase by a modest 1.1 percent. The Road Fund in the second half of the year is estimated to decline 8.5 percent while collections in the first quarter of FY16 will decline 16.5 percent.

Motor fuels tax collections are forecasted to fall 13.2 percent over the final six months of FY15. Declines in the average wholesale price of gasoline have lowered the variable portion of the motor fuels tax rate which, in turn, has depressed tax collections. Road Fund receipts are now projected to fall short of the enacted estimate by $43.7 million in FY15 as shown in Table 7. While lower gas prices can have a positive impact on gasoline consumption, that effect has been small relative to the revenue loss from the lower tax rate. Taxable gallons have declined an average of just over one percent annually for the past 10 years. During this time, declining consumption has been offset by an increasing tax rate, keeping revenue growth at a moderate level.

Taxable gallons have *increased* 0.6 percent over the first four months of FY15; helping motor fuels receipts grow 0.9 percent over FY14 levels. Growth in this revenue source is expected to decline 13.2 percent over the final six months of the fiscal year as the tax rate falls to the statutory floor in the final quarter of the year. The tax rate will increase only 0.1 percent the following quarter as motor fuels receipts are expected to decline 28.7 percent in the first quarter of FY16.

Motor vehicle usage tax collections declined 0.7 percent in the first half of FY15 and are expected to continue to fall through the first quarter of FY16. While motor vehicle sales have been strong both nationally and in Kentucky, motor vehicle usage tax collections have been affected by HB440. Enacted in 2013, this bill created a trade-in credit on new car purchases and has depressed revenues by $22.5 million through the first six months of FY15. Collections are expected to decrease 2.9 percent over the remainder of the fiscal year and fall 0.4 percent in the first three months of FY16.

Motor vehicle license taxes are forecasted to decrease 3.8 percent in the final two quarters of FY15 but increase 1.0 percent in the first quarter of FY16. Motor vehicle operators' licenses are projected to fall 0.8 percent in the remainder of the fiscal year and decline 3.3 percent in the first quarter of FY16. Weight distance tax revenue should rise 3.8 percent for the remainder of the fiscal year and 4.5 percent over the first three months of FY16. Investment income will decline by $0.4 million over the remainder of the fiscal year and decrease by 4.6 percent in the first quarter of FY16. All other revenues will grow 0.4 percent during the last six months of FY15 and then increase 1.6 percent in the first quarter of FY16.

Table 7
Road Fund Interim Forecast
$ millions

	FY15						FY15		FY16	
	Q1 & Q2		Q3 & Q4		Full Year		Official CFG		Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff	Estimate	% Chg
Motor Fuels	462.4	0.9	371.6	-13.2	834.0	-5.9	883.2	-49.2	164.2	-28.7
Motor Vehicle Usage	215.5	-0.7	219.5	-2.9	435.0	-1.8	425.5	9.5	115.1	-0.4
Motor Vehicle License	40.6	11.0	62.8	-3.8	103.4	1.5	101.9	1.5	18.7	1.0
Motor Vehicle Operators	8.1	0.2	8.0	-0.8	16.1	-0.3	16.7	-0.6	4.1	-3.3
Weight Distance	40.5	4.8	39.7	3.8	80.2	4.3	79.9	0.3	20.1	4.5
Income on Investments	1.3	44.3	0.9	-69.8	2.2	-45.0	3.1	-0.9	0.8	-4.6
Other	16.4	-1.6	15.7	0.4	32.1	-0.7	36.4	-4.3	9.1	1.6
Road Fund	**784.9**	**1.1**	**718.1**	**-8.5**	**1,503.0**	**-3.7**	**1,546.7**	**-43.7**	**332.1**	**-16.5**

NATIONAL ECONOMY

As we enter the third quarter of FY15, the economic fundamentals are expected to continue over the next two calendar years. Real GDP is expected to grow at an average annual rate of 3.1 percent for the upcoming calendar year as compared to the 2.4 percent growth observed in calendar year 2014. For calendar 2016, growth is expected to continue at an annualized rate of 2.7 percent, providing the strongest two year period of expansion since the early 2000's.

The composition of the economic growth should remain relatively broad based. The one significant area of weakness will likely be exports. Slower economic growth for some of our important trading partners and a stronger dollar will result in net exports being a detraction from real GDP. The reduction in real GDP from net exports will be dominated by a reduction in the export of goods, which currently comprise approximately two-thirds of total real US exports. Import growth will also rise with continuing improvements in the economy and the stronger US dollar.

The labor market improvements of the previous quarters should continue as employers add approximately 200,000 jobs per month and the unemployment rate will continue to decline toward the five and one-half percent range. The improvements in the labor market, the plummeting price of gasoline, and continued improvements in consumer confidence have all combined to increase the forecasted level of real consumer expenditures.

According to the Department of Energy, gasoline prices across all grades are approximately $1.40 lower than the prices observed at the beginning of FY15. These lower gasoline prices have helped real disposable income and consumer spending. As we enter the second half of FY15, real disposable income is expected to increase to a 3.3 percent growth rate, while real consumer spending is expected to increase to a 3.4 percent rate of growth.

The observed negatives to the decrease in oil and gasoline prices will be in the domestic investment sector. The drilling and mining sector accounts for approximately 15 percent of total equipment spending in the economy. Among non-residential structures, mining and petroleum account for approximately 30 percent of current spending. Based on the experiences of mid-2008 and 2009, when oil prices declined from$132 to $40 per barrel, the current declines in oil prices could be expected to result in significant reductions in structures and equipment investments in these sectors. However, the overall impact to the economy of the reduced cost of oil will be positive.

Lower energy prices will also help pull headline inflation lower for the remainder of FY15. Core inflation, which excludes many of the direct impacts of energy prices, should remain contained as the increase in employment has not lead to a significant growth in wages. The observed level of inflation is still below the Federal Reserve's target, and without clear signs of wage increases, the Federal Open Market Committee will continue to have a wide degree of latitude in normalizing short-term interest rates.

KENTUCKY ECONOMY

Just as employment increased steadily across the Commonwealth in calendar year 2014, the growth in employment will diminish as we reach a level closer to full employment. Table 9 projects total non-farm employment in Kentucky to grow 1.4 percent from the first quarter of FY15 through the first quarter of FY16, down from the rate of growth experienced over the previous four quarters.

While coal production in Western Kentucky increased in the second quarter for the first time in three years, the recent announcement of mine closings and layoffs in the area does not bode well for the future of coal output and employment. However, these mining losses are forecast to be more than offset by gains in goods producing and service providing industries (see Table 8).

Unemployment rates in several regions of the Bluegrass remain above the national average. The Cleveland and St. Louis branches of the Federal Reserve reported that among Kentucky's metropolitan statistical areas (MSAs) only employment growth in the Bowling Green and Lexington MSAs outpaced the national average. Employers surveyed in manufacturing and transportation complained of a shortage of qualified workers, which suggests we may soon see some wage increases in these sectors. Kentuckians' wage and salary growth is projected to grow at a faster pace of the U.S. as a whole over the next three quarters (see Table 9).

The Federal Reserve banks report from surveys that credit to non-corporate businesses remains tight in the region, dampening investment. Data indicate that households across the state are continuing to deleverage but all bankers surveyed expect loan demand to either remain the same or increase in the upcoming year, suggesting cautious optimism of investment growth going forward.

Gasoline prices will likely remain low in the near term, providing an increase in the real disposable income of consumers. The Cleveland Federal Reserve Bank reported that Kentucky's housing prices increased at a rate faster than the national average in the second quarter. These positive developments will likely result in increased consumer spending, which is important to the Commonwealth's revenue base since sales and use taxes make up 32 percent of the General Fund.

Regarding the risks to the forecast, the OSBD will pay close attention to the situations in Europe and Asia as well as the expected tightening of monetary policy by the Federal Reserve over the next year. As of October, Kentucky's exports were up 10 percent from 2013's state-record high. As European economic conditions worsen and the dollar appreciates due to capital flight from distressed regions, states with a significant manufacturing presence will suffer. The Philadelphia Federal Reserve's Leading Index for Kentucky, which forecasts near-term economic growth, fell in November to its lowest level since February, suggesting that some caution is warranted.

Table 8
US and KY Economic Outlook
Second Half of FY15 & FY14

	Q3 & Q4		
	FY15	**FY14**	**% Chg**
United States			
Real GDP	16,484.9	15,921.1	3.5
Real Consumption	11,251.1	10,878.4	3.4
Real Investment	2,834.7	2,646.0	7.1
Real Govt. Expenditures	2,900.1	2,874.6	0.9
Real Exports	2,150.1	2,053.8	4.7
Real Imports	2,623.2	2,507.6	4.6
Personal Income ($ billions)	15,198.9	14,572.6	4.3
Wages and Salaries ($ billions)	7,702.9	7,365.8	4.6
Inflation (% chg CPI)	-0.3	1.7	NA
Industrial Production Index (% chg)	4.1	3.8	NA
Civilian Labor Force (millions)	157.3	155.7	1.0
Total Non-farm Employment (millions)	141.0	138.1	2.1
Manufacturing Employment (millions)	12.2	12.1	1.2
Unemployment Rate (%)	5.6	6.4	NA
Kentucky			
Personal Income ($ millions)	171,598.8	163,841.6	4.7
Wage & Salary ($ millions)	85,051.8	80,621.3	5.5
Non-farm Employment (thousands)	1,876.5	1,839.4	2.0
Goods Producing (thousands)	314.4	310.1	1.4
Service Providing (thousands)	1,222.6	1,190.5	2.7
Government (thousands)	339.5	338.8	0.2

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Components do not sum to GDP because they are annualized independently.
Source: IHS Global Insight Inc., January 5, 2015 data release

Table 9
US and KY Economic Outlook
First Quarter of FY16 & FY15

	Q1		
	FY16	**FY15**	**% Chg**
United States			
Real GDP	16,643.1	16,205.6	2.7
Real Consumption	11,393.5	10,999.5	3.6
Real Investment	2,882.3	2,750.8	4.8
Real Govt. Expenditures	2,907.2	2,911.9	-0.2
Real Exports	2,173.8	2,104.0	3.3
Real Imports	2,686.4	2,535.3	6.0
Personal Income ($ billions)	15,425.1	14,792.1	4.3
Wages and Salaries ($ billions)	7,848.4	7,458.4	5.2
Inflation (% chg CPI)	0.1	1.8	NA
Industrial Production Index (% chg)	3.3	4.6	NA
Civilian Labor Force (millions)	158.2	155.9	1.4
Total Non-farm Employment (millions)	142.1	139.2	2.0
Manufacturing Employment (millions)	12.2	12.2	0.7
Unemployment Rate (%)	5.5	6.1	NA
Kentucky			
Personal Income ($ millions)	174,323.6	166,280.0	4.8
Wage & Salary ($ millions)	86,819.2	81,588.1	6.4
Non-farm Employment (thousands)	1,887.4	1,861.8	1.4
Goods Producing (thousands)	315.6	312.2	1.1
Service Providing (thousands)	1,232.3	1,211.4	1.7
Government (thousands)	339.5	338.2	0.4

Not Seasonally Adjusted.

Source: IHS Global Insight, Inc. and the Kentucky Governor's Office for Economic Analysis MAK model, January 2015.

APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	Second Quarter FY 2015	Second Quarter FY 2014	% Change	Year-To-Date FY 2015	Year-To-Date FY 2014	% Change
TOTAL GENERAL FUND	**$2,578,896,689**	**$2,438,080,950**	**5.8%**	**$4,877,338,778**	**$4,712,452,320**	**3.5%**
Tax Receipts	**$2,478,113,500**	**$2,340,838,345**	**5.9%**	**$4,693,479,311**	**$4,540,308,446**	**3.4%**
Sales and Gross Receipts	**$942,205,296**	**$900,219,850**	**4.7%**	**$1,893,971,565**	**$1,826,133,520**	**3.7%**
Beer Consumption	1,410,147	1,569,970	-10.2%	3,113,203	3,215,611	-3.2%
Beer Wholesale	13,451,751	14,873,627	-9.6%	29,642,833	30,503,617	-2.8%
Cigarette	55,054,332	57,852,292	-4.8%	112,315,711	117,173,478	-4.1%
Distilled Spirits Case Sales	33,557	31,764	5.6%	65,634	63,174	3.9%
Distilled Spirits Consumption	3,112,288	2,848,885	9.2%	6,166,887	5,866,406	5.1%
Distilled Spirits Wholesale	9,311,440	8,559,652	8.8%	17,825,011	16,659,286	7.0%
Insurance Premium	10,679,113	9,777,066	9.2%	44,704,759	43,326,674	3.2%
Pari-Mutuel	726,041	9,884	7245.8%	1,379,775	842,097	63.8%
Race Track Admission	71,647	11,722	511.2%	145,963	105,115	38.9%
Sales and Use	822,369,543	779,032,215	5.6%	1,626,908,119	1,557,141,336	4.5%
Wine Consumption	762,400	625,357	21.9%	1,472,455	1,403,423	4.9%
Wine Wholesale	4,298,068	3,872,764	11.0%	8,055,116	7,358,774	9.5%
Telecommunications Tax	15,748,596	15,860,431	-0.7%	31,442,383	31,843,724	-1.3%
OTP	5,175,697	5,297,528	-2.3%	10,732,714	10,633,052	0.9%
Floor Stock Tax	678	(3,307)	---	1,001	(2,246)	---
License and Privilege	**$101,201,888**	**$111,166,911**	**-9.0%**	**$206,269,750**	**$225,946,967**	**-8.7%**
Alc. Bev. License Suspension	93,350	77,073	21.1%	220,430	163,265	35.0%
Coal Severance	48,777,013	52,765,189	-7.6%	97,550,789	104,093,800	-6.3%
Corporation License	218,884	147,080	48.8%	303,930	404,718	-24.9%
Corporation Organization	32,106	12,562	155.6%	37,591	20,777	80.9%
Occupational Licenses	29,883	26,371	13.3%	72,907	70,606	3.3%
Oil Production	3,299,742	3,005,711	9.8%	6,563,078	6,458,483	1.6%
Race Track License	143,350	40,150	257.0%	238,350	135,150	76.4%
Bank Franchise Tax	306,477	1,086,653	-71.8%	(16,159)	2,266,310	---
Driver License Fees	161,256	158,917	1.5%	351,707	321,642	9.3%
Minerals Severance	4,075,213	4,255,603	-4.2%	8,575,460	8,876,584	-3.4%
Natural Gas Severance	5,518,119	4,227,670	30.5%	9,343,509	9,191,167	1.7%
Limited Liability Entity	38,546,495	45,363,932	-15.0%	83,028,158	93,944,464	-11.6%
Income	**$1,091,384,971**	**$1,005,247,371**	**8.6%**	**$2,184,739,846**	**$2,087,219,438**	**4.7%**
Corporation	96,849,356	79,937,486	21.2%	208,854,950	230,645,842	-9.4%
Individual	994,535,615	925,309,885	7.5%	1,975,884,896	1,856,573,595	6.4%
Property	**$325,790,623**	**$306,218,252**	**6.4%**	**$370,430,077**	**$362,031,669**	**2.3%**
Building & Loan Association	0	0	---	(498,150)	5,753	---
General - Real	185,129,144	180,090,664	2.8%	184,469,693	180,119,270	2.4%
General - Tangible	104,718,165	92,732,008	12.9%	131,191,308	121,606,849	7.9%
Omitted & Delinquent	1,745,375	3,672,123	-52.5%	6,033,049	11,015,249	-45.2%
Public Service	33,424,080	29,122,433	14.8%	48,380,070	44,058,575	9.8%
Other	773,859	601,023	28.8%	854,106	5,225,972	-83.7%
Inheritance	**$10,825,332**	**$10,441,893**	**3.7%**	**$25,785,961**	**$24,076,572**	**7.1%**
Miscellaneous	**$6,705,390**	**$7,544,068**	**-11.1%**	**$12,282,111**	**$14,900,280**	**-17.6%**
Legal Process	3,915,875	4,171,502	-6.1%	7,531,125	8,105,173	-7.1%
T. V. A. In Lieu Payments	2,789,515	3,372,174	-17.3%	4,747,082	6,794,715	-30.1%
Other	0	392	-100.0%	3,904	392	895.8%
Nontax Receipts	**$100,391,601**	**$96,509,590**	**4.0%**	**$182,960,060**	**$170,906,459**	**7.1%**
Departmental Fees	3,808,778	4,568,134	-16.6%	7,164,730	8,220,362	-12.8%
PSC Assessment Fee	460	449,640	-99.9%	14,671,653	14,699,356	-0.2%
Fines & Forfeitures	5,416,734	5,927,654	-8.6%	11,119,926	12,137,638	-8.4%
Income on Investments	(236,922)	(542,436)	---	(392,431)	(698,437)	---
Lottery	57,500,000	54,639,743	5.2%	109,500,000	103,139,743	6.2%
Sale of NOx Credits	12,000	9,438	27.2%	27,594	48,438	-43.0%
Miscellaneous	33,890,551	31,457,417	7.7%	40,868,589	33,359,359	22.5%
Redeposit of State Funds	**$391,588**	**$733,014**	**-46.6%**	**$899,407**	**$1,237,415**	**-27.3%**

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	Second Quarter FY 2015	Second Quarter FY 2014	% Change	Year-To-Date FY 2015	Year-To-Date FY 2014	% Change
TOTAL ROAD FUND	**$380,079,146**	**$378,263,090**	**0.5%**	**$784,862,700**	**$776,002,756**	**1.1%**
Tax Receipts-	**$374,780,408**	**$373,576,629**	**0.3%**	**$772,292,319**	**$764,977,090**	**1.0%**
Sales and Gross Receipts	**$328,895,288**	**$329,045,253**	**0.0%**	**$677,920,036**	**$675,049,261**	**0.4%**
Motor Fuels Taxes	228,452,300	227,743,702	0.3%	462,437,983	$458,153,342	0.9%
Motor Vehicle Usage	100,442,988	101,301,551	-0.8%	215,482,053	$216,895,919	-0.7%
License and Privilege	**$45,885,121**	**$44,531,377**	**3.0%**	**$94,372,283**	**$89,927,829**	**4.9%**
Motor Vehicles	18,168,060	18,074,640	0.5%	40,598,310	$36,587,472	11.0%
Motor Vehicle Operators	4,014,938	3,883,631	3.4%	8,138,558	$8,122,669	0.2%
Weight Distance	20,533,475	19,454,738	5.5%	40,546,877	$38,693,064	4.8%
Truck Decal Fees	12,073	4,909	145.9%	31,460	$22,019	42.9%
Other Special Fees	3,156,575	3,113,459	1.4%	5,057,078	$6,502,605	-22.2%
Nontax Receipts	**$5,434,036**	**$4,377,991**	**24.1%**	**$10,090,180**	**$9,251,799**	**9.1%**
Departmental Fees	4,223,661	4,052,150	4.2%	7,978,591	$7,695,325	3.7%
In Lieu of Traffic Fines	121,298	122,766	-1.2%	243,208	$265,354	-8.3%
Income on Investments	647,552	83,908	671.7%	1,255,726	$870,877	44.2%
Miscellaneous	441,525	119,168	270.5%	612,655	$420,242	45.8%
Redeposit of State Funds	**($135,298)**	**$308,469**	**---**	**$2,480,201**	**$1,773,867**	**39.8%**