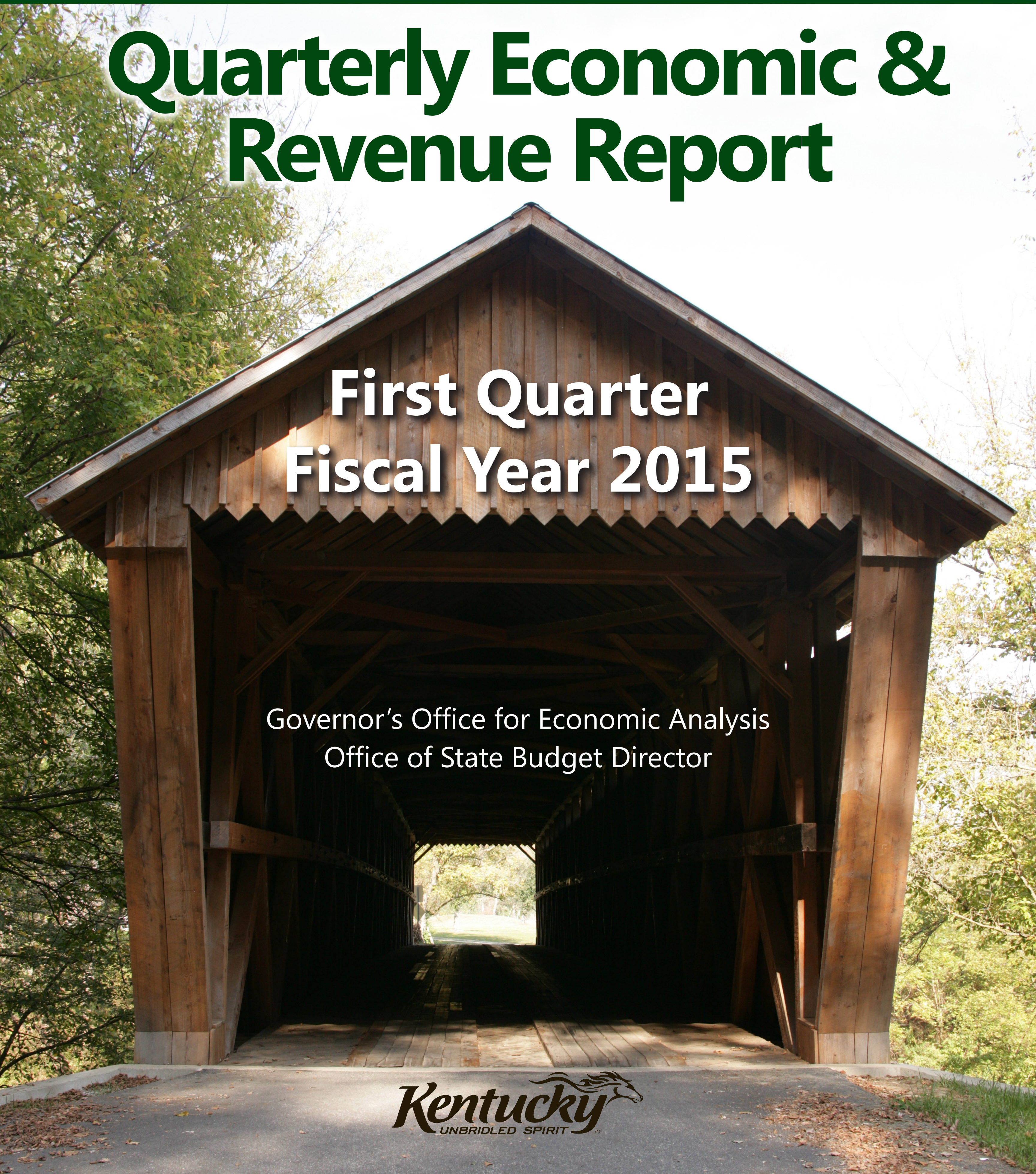
COMMONWEALTH OF KENTUCKY

Quarterly Economic & Revenue Report



First 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

November 10, 2014

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

General Fund receipts for the first quarter of FY15 totaled $2,298.4 million, an increase of 1.1 percent compared to the same period in FY14. Road Fund revenues totaled $404.8 million, an increase of 1.8 percent from the first quarter of FY14.

The interim General Fund forecast for the final three quarters of FY15 calls for an increase of 2.5 percent compared to the same period one year ago, resulting in receipts of $7,366.6 million for FY15, $135.2 million less than the enacted estimate of $9,801.2 million.

The Road Fund interim forecast for the final three quarters of FY15 is $1,118.1 million and calls for a decrease of 23.8 percent over FY14. The interim estimate for the entire FY15 is $1,522.9 million, $23.8 million less than the enacted estimate. Motor fuels tax receipts are forecasted to fall 4.9 percent in the final three quarters of FY15. This decrease is due primarily to a decline in the forecasted average wholesale price of gasoline. Motor vehicle usage tax collections are expected to fall 3.5 percent in the final nine months of FY15.

Kentucky's economic growth is projected to continue through FY15 roughly in line with the national economy. We will continue to monitor the economic and fiscal conditions of the Commonwealth and will keep you apprised of any developments.

Sincerely,

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 first 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.

Due to weak first-quarter General Fund growth of 1.2 percent, the $90.9 shortfall carried over from FY14, and an undercurrent of economic volatility, the General Fund interim estimates call for a $135.2 million shortfall in FY15.

This report is based on the September 2014 Global Insight national outlook as well as the output from the Kentucky Macroeconomic Model (MAK) using the September national inputs.

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

- The General Fund posted growth of 1.1 percent in the first quarter of FY15. Aggregate revenues fell in the midst of strong growth in the individual income tax (5.4 percent) and the sales tax (3.4 percent).

- Most of the remaining taxes in the General Fund declined, thus demonstrating that there is very little elasticity beyond the individual income tax.

- The Road Fund generated a 1.8 percent increase in the first quarter of FY15, but falling wholesale fuel prices will lower the variable excise tax in future periods. The expansion of the trade-in credit will also put downward pressure on Road Fund receipts. Over 90 percent of the Road Fund is expected to produce flat or falling tax receipts over the forecast horizon.

- Kentucky non-farm employment rose by 0.6 percent in the first quarter. Post-recession employment growth continues to be sluggish, similar to the employment growth pattern from the 2001 recession. The distribution of the sluggish growth in employment was equally distributed between the goods-producing and the service-providing firms. In the goods world, employment growth was -0.1 percent with 0.7 percent in the service providing sectors. Further details on job growth by sector can be found in Table 5.

- Kentucky personal income rose by 4.0 percent in the first quarter of FY15, but failed to hit the US average of 4.2 percent and well below a rate of growth expected at this stage of an economic recovery.

- The national economic outlook remains filled with more questions than answers. In periods of great uncertainty, consumers and businesses exercise restraint and additional caution before making decisions that will affect current and future expectations. Until the fog of uncertainty is lifted, growth rates will remain muted.

Revenue Receipts

GENERAL FUND
First Quarter, FY15

General Fund receipts grew 1.1 percent in the first quarter of FY15 as nominal receipts totaled $2,298.4 million compared to $2,274.4 million last year. Collections in the major revenue categories are shown in summary form in Table 1. Detailed information on these major accounts is available in the Appendix.

The official General Fund revenue estimate for FY15 calls for revenue to grow 3.6 percent compared to FY14 actual receipts. Based on receipts through September, General Fund revenues must now increase 4.4 percent for the remainder of the fiscal year to meet the official estimate.

Growth in the General Fund was low in the first quarter, raising the bar for the remainder of this fiscal year. The two largest sources of revenue grew more strongly in line with broader economic indicators: the individual income tax which grew by 5.4 percent and the sales tax which grew by 3.4 percent. However, the remaining General Fund accounts fell by a combined 9.3 percent during the first quarter, mitigating the momentum of the two largest sources of revenue. Weakness in the corporate income tax is still a concern. Estimated quarterly payments were down 33.3 percent in September compared to last year.

Individual income tax receipts increased 5.4 percent in the first quarter of FY15. Receipts of $981.3 million were $50.1 million more than was collected in the first quarter of the previous fiscal year. Withholding receipts and declaration payments were up 5.7 percent and 0.6 percent respectively for the quarter.

Table 1
Summary General Fund Receipts
First Quarter, FY15, $ millions

	FY15	FY14	Diff ($)	Diff (%)
Individual Income	981.3	931.3	50.1	5.4
Sales and Use	804.5	778.1	26.4	3.4
Property	44.6	55.8	-11.2	-20.0
Corporation Income	112.0	150.7	-38.7	-25.7
Coal Severance	48.8	51.3	-2.6	-5.0
Cigarette Taxes	57.3	59.3	-2.1	-3.5
LLET	44.5	48.6	-4.1	-8.4
Lottery	52.0	48.5	3.5	7.2
Other	153.4	150.7	2.6	1.8
Total	**2,298.4**	**2,274.4**	**24.1**	**1.1**

Sales and use tax receipts rose 3.4 percent in the first quarter of FY15. Receipts of $804.5 million compare to the $778.1 million collected in the first quarter of FY14. Sales tax receipts had lagged wage and salary growth for many quarters since the recession officially ended. However, that source of revenue has begun to gather some momentum and is currently growly at roughly the pace of the underlying economy.

Property taxes were down 20.0 percent in the first quarter of FY15 due to timing of collections in the tangible and public service company accounts. Collections of $44.6 million compare unfavorably to $55.8 million received in the first quarter of the prior fiscal year. In general, property taxes have been very slow in recovering losses incurred during the 2007 recession where the valuations on all types of property plummeted.

Corporation income tax posted a decrease of 25.7 percent, or $38.7 million, during the first quarter of FY15. Receipts totaled $112.0 million compared to the $150.7 million received a year earlier. During the last four completed fiscal years, corporation income tax has grown 26.4, 24.5, 7.0 and 18.6 percent respectively. A portion of the volatility in corporation taxes is due to prior year acceleration of receipts from the 2010 expedited protest resolution program and the 2012 Tax Amnesty.

The limited liability entity tax (LLET) registered a $4.1 million decrease in tax collections in the first quarter of FY15 when compared to FY14. Total collections in the current fiscal year totaled $44.5 million and compare to revenues of $48.6 million in the same period a year earlier.

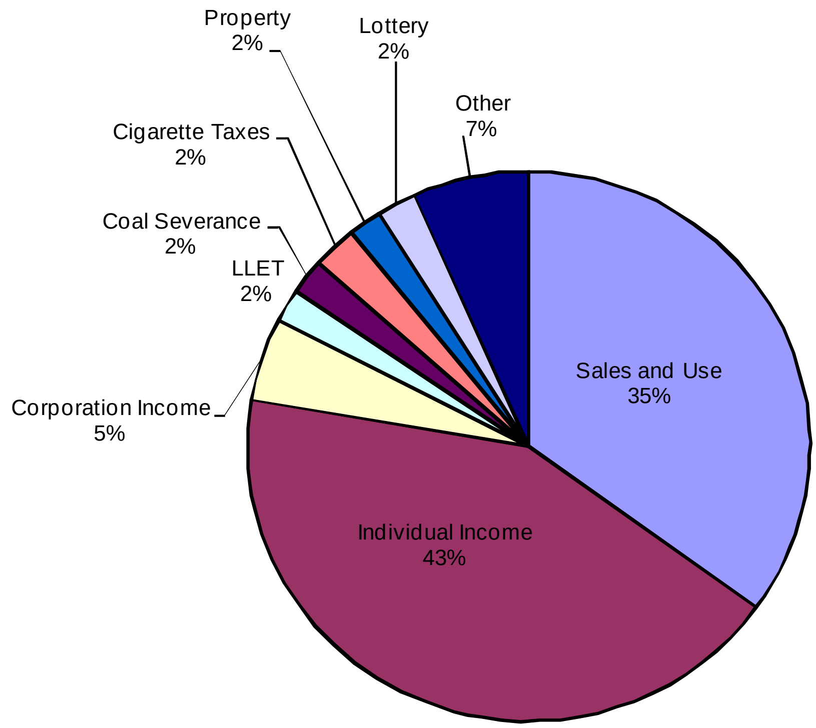
The coal severance tax receipts continued to decrease in the first quarter as receipts fell 5.0 percent. Receipts of $48.8 million compare to $51.3 million collected in the first quarter of FY14. Severed tons fell 20.5 percent in FY13 and by 7.6 percent in FY14. Severed tons have risen slightly over the last two quarters, gaining 2.2 and 1.2 percent respectively. Kentucky severed tons have likely settled around 20 million tons per quarter, having fallen from their peak of 34 million tons in FY10.

Cigarette taxes fell 3.5 percent in the first quarter with receipts of $57.3 million compared to $59.3 million in the first quarter of FY14. Lottery receipts increased 7.2 percent, or $3.5 million, in the first quarter of FY15 with revenues of $52.0 million.

The “Other” category represents the remaining accounts in the General Fund, and collections in this account increased 1.8 percent with receipts of $153.4 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 and sales taxes. The next largest source of revenue was the “Other” at seven percent. The major components in the "Other" category in the first quarter are the insurance premium tax, the beer wholesale tax, the telecommunications tax and the inheritance tax. The corporation income accounts made up five percent. Finally lottery receipts, property, cigarette, coal severance taxes and LLET each accounted for two percent each.

Figure 1
General Fund Receipts Composition
First Quarter, FY15



ROAD FUND
First Quarter, FY15

Road Fund revenue increased only 1.8 percent in the first quarter of FY15 as motor fuels and motor vehicle usage tax collections remain weak. Growth in the fuels tax was limited by institutional and economic conditions. Motor vehicle usage collections, on the other hand, were negatively impacted by recently enacted legislation. Total Road Fund receipts were $404.8 million compared to the $397.7 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.

Table 2
Summary Road Fund Receipts
First Quarter, FY15, $ millions

	FY15	FY14	Diff ($)	Diff (%)
Motor Fuels	234.0	230.4	3.6	1.6
Motor Vehicle Usage	115.0	115.6	-0.6	-0.5
Motor Vehicle License	22.4	18.5	3.9	21.2
Motor Vehicle Operators	4.1	4.2	-0.1	-2.7
Weight Distance	20.0	19.2	0.8	4.0
Income on Investments	0.6	0.8	-0.2	-22.6
Other	8.6	9.0	-0.4	-4.2
Total	**404.8**	**397.7**	**7.0**	**1.8**

Motor fuels tax receipts increased 1.6 percent during the first quarter of FY15. Growth in this account was limited for two reasons. First, the tax rate, which is adjusted quarterly based on the average wholesale price of gasoline increased only two-tenths of a cent over the rate in effect one year ago. Secondly, taxable gallons of gasoline have declined an average of 1.3

percent over the past 10 years and that trend has likely continued into FY15. Receipts were $234.0 million and compare to $230.4 million collected during the first quarter of FY14.

Motor vehicle usage tax receipts fell 0.5 percent, or $0.6 million, during the first quarter due to the effects of HB 440 which was enacted in 2013. The bill allows for a trade-in credit on new car purchases and reduced tax collections by $11.1 million during the quarter. Receipts were $115.0 million compared to $115.6 million collected during the same period last year.

Motor vehicle license tax receipts increased 21.2 percent during the first quarter of FY15. Receipts of $22.4 million compare to $18.5 million received during the first quarter of FY14.

Motor vehicle operators' license fees totaled $4.1 million, a 2.7 percent decrease compared to the level observed a year ago.

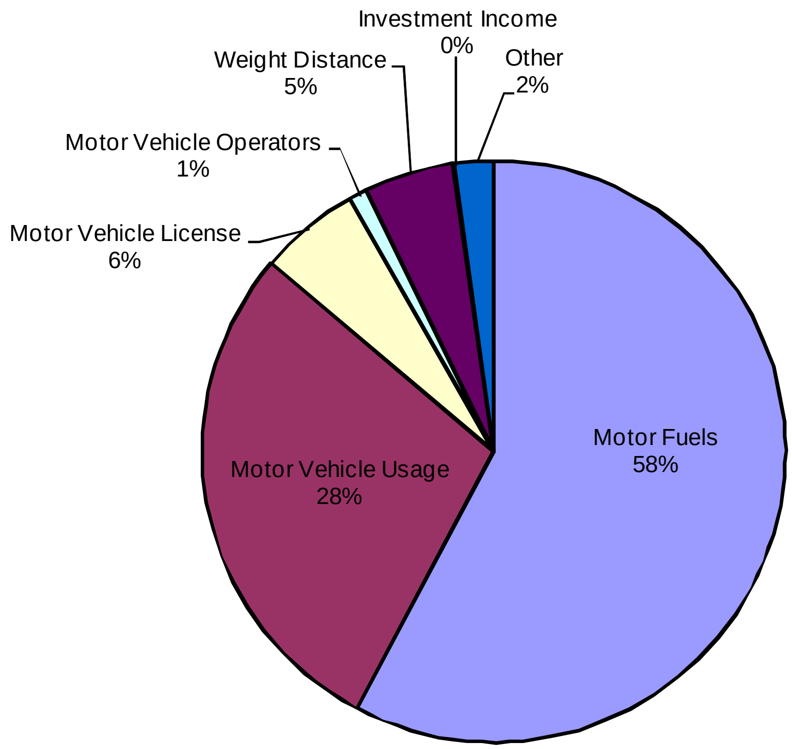
Weight distance tax receipts totaled $20.0 million, an increase of 4.0 percent from the first quarter of last year. The weight distance tax has some significance as a leading indicator of economic activity, as it is a rough proxy for goods in transit over Kentucky highways.

Investment income receipts of $0.6 million compared to $0.8 million in the first quarter of FY14.

The remainder of the accounts in the Road Fund combined for a decrease of 4.2 percent. Receipts for the "Other" category totaled $8.6 million during the first quarter, compared to $9.0 million in the first quarter of FY14.

Figure 2 details the composition of Road Fund revenues by tax type in the first quarter of FY15. Motor fuels taxes and the motor vehicle usage tax accounted for 86 percent of Road Fund revenues in the first quarter. The next-largest sources of revenue were motor vehicle license with six percent followed by weight distance taxes with five percent. The "Other" category accounted for two percent and motor vehicle operators accounted for one percent. Income on investment accounted for a negligible amount of the total Road Fund receipts.

Figure 2
Road Fund Receipts Composition
First Quarter, FY15



The Economy
First Quarter FY15

NATIONAL ECONOMY

Real Gross Domestic Product (real GDP) rose by 2.3 percent in the first quarter. 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 or sold by US citizens in other countries. Real GDP growth has largely stabilized since the end of the 2007 recession. There have been two negative quarters since the 2007 recession ended, one in third quarter of FY11 and the second in the third quarter of FY14. Both of the single-quarter declines were small, -0.4 and -0.5 percent respectively and full amount of losses were regained in the following quarter. Average adjacent-quarter growth since the end of the recession is 0.6 percent, which makes the current 0.9 percent adjacent-quarter growth slightly above average.

Real GDP is composed of five components: consumption, investment, government expenditures, exports and imports. Imports, which by definition are not produced nor sold within the US boundaries, are deducted from total real GDP. Real consumption grew 2.3 percent in the

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

	First Quarter			
	FY15	FY14	Chg	% Chg
Real GDP	16,141.3	15,779.9	361.4	2.3
Real Consumption	10,960.0	10,713.3	246.7	2.3
Real Investment	2,757.4	2,610.3	147.1	5.6
Real Govt. Expenditures	2,887.4	2,902.4	-15.0	-0.5
Real Exports	2,084.3	2,027.7	56.6	2.8
Real Imports	2,521.6	2,452.3	69.3	2.8
Inflation (% chg CPI)	1.9	1.5	NA	NA
Industrial Production Index (% chg)	4.5	2.7	NA	NA
Civilian Labor Force (millions)	156.1	155.5	0.6	0.4
Total Non-farm Employment (millions)	139.2	136.6	2.6	1.9
Manufacturing Employment (millions)	12.2	12.0	0.2	1.6
Unemployment Rate (%)	6.1	7.2	NA	-15.2

Not Seasonally Adjusted. Real series are annual rate, billions of chained 2000 dollars.
Components do not sum to GDP because they are annualized independently.
Data for FY15 Q1 are September 2014 estimates.
Source: IHS Global Insight Inc., September 15, 2014 data release

first quarter of FY15. It was also the largest net contributor to real GDP growth contributing an additional $246.7 billion to real GDP. Real consumption is the largest component of real GDP, making up 67.9 percent of real GDP.

Real investment grew by 5.6 percent in the first quarter of FY15, making it the fastest growing component of real GDP. In 2010 and 2012 real investment grew in double digits for several consecutive quarters. Since then, real investment growth has slowed down. Average adjacent-quarter growth since the end of the recession has been 2.0 percent. Real investment is the third largest of the five components and makes up 17.1 percent of real GDP.

Real government expenditures declined by 0.5 percent in the first quarter. However, on an adjacent-quarter basis, first quarter FY15 real government expenditures increased by 0.3 percent. It is normal for government expenditures to decline during an expansion. As the economy improves, transfer payments like food stamps and unemployment insurance payments decline. As transfer payments decline, total government expenditures recede. Between the end of the 2007 recession and the third quarter of FY14 real government expenditures declined by a net $227.5 billion, a 7.3 percent reduction. However, in the last two quarters, real government expenditures have risen by $18.9 billion. It is not clear whether the period of reduction has ended. Government expenditures make up 17.9 percent of real GPD.

First quarter real exports increased by 2.8 percent over last year. Real exports increased by 0.4 percent over the fourth quarter of FY14. Real exports make up 12.9 percent of real GDP. Meanwhile, first quarter real imports also increased by 2.8 percent over last year. Real imports fell 0.7 percent over the fourth quarter of FY14. As a result, the trade deficit (net exports) improved slightly to $437.3 billion. By comparison, the trade deficit stood at $819.7 billion in the first quarter of FY07, which was shortly before the 2007 recession began.

Personal income is made up of seven components, six of which contribute to personal income and one (social insurance) that is subtracted from it. US personal income increased by 4.2 percent in the first quarter compared to last year. See Table 4. Wages and salaries makes up the largest share of personal income and it contributed the largest nominal and percentage amounts towards personal income growth in the first quarter. Transfer receipts were also a large contributor to US personal income growth in the first quarter, growing 4.3 percent over the same quarter of last year. Transfer receipts made up 17.1 percent of total personal income in the first quarter. US personal income adjacent-quarter growth has been modest and stable for the last three quarters, growing 1.2, 1.5 and 1.0 percent respectively.

US non-farm employment grew by 1.9 percent in the first quarter. The civilian labor force grew by only 0.4 percent in the first quarter compared to the same quarter last year. The civilian labor force has struggled to remain flat over the last couple years. The labor force shrunk three times over the last five quarters. Since the end of the recession, the civilian labor force grew by a net 1.4 million persons, an increase of 0.9 percent. Meanwhile, non-farm employment grew by 7.9 million net jobs, a net increase of 6.0 percent. By comparison, 21 quarters following the end of the 1981 recession, employment grew by a net 15.3 million jobs, an increase of 17.3 percent. Meanwhile, 21 quarters following the end of the 1990 recession employment grew by 10.7 million jobs, a net increase of 9.8 percent. So by comparison, the 2007 recovery has been 26.2 percent slower than in the 1990 recovery and 48.4 percent slower than the 1981 recovery.

Table 4
Personal Income
$ millions, SAAR

	Q1			
	2015	**2014**	**$ Diff**	**% Diff**
United States				
Personal Income	14,844	14,247	597	4.2
Social Insurance	1,173	1,108	66	5.9
Residence Adjustments	-26	-44	19	-42.3
Dividends, Interest and Rents	2,796	2,711	85	3.1
Transfer Receipts	2,532	2,427	105	4.3
Wages & Salaries	7,515	7,145	370	5.2
Supplements to W&S	1,812	1,771	42	2.4
Proprietor's Income	1,387	1,346	41	3.1
Kentucky				
Personal Income	166,329	159,912	6,417	4.0
Social Insurance	13,689	13,086	603	4.6
Residence Adjustments	-2,180	-2,043	-138	6.7
Dividends, Interest and Rents	25,792	25,050	742	3.0
Transfer Receipts	39,379	37,566	1,813	4.8
Wages & Salaries	82,007	78,532	3,474	4.4
Supplements to W&S	22,278	21,545	733	3.4
Proprietor's Income	12,742	12,347	396	3.2

US Personal Income and components are in billions of dollars annual rate.
KY personal income and components are in millions of dollars annual rate.
Source: Sept. 2014 IHS Global Insight Inc. and Kentucky MAK model estimates

KENTUCKY ECONOMY

Kentucky personal income increased by 4.0 percent in the first quarter. This growth is largely due to above average quarterly growth in the third and fourth quarters of FY14, where adjacent-quarter growth was 1.3 and 1.6 percent respectively. Adjacent-quarter growth has slowed to 0.8 percent in the first quarter. Similar to the US personal income analysis, KY personal income growth came largely from transfer receipts and wages and salaries growth, which grew by 4.8 and 4.4 percent over last year respectively.

The make up of personal income in Kentucky is different than that of the US. Transfer receipts make up a much larger share of personal income in Kentucky than they do in the US. Transfer receipts made up 22.6 percent of Kentucky personal income in the first quarter. Supplements to wages and salaries (aka fringe benefits) make a larger share of Kentucky personal income than they do in US personal income. Supplements make up 13.0 percent of Kentucky personal income compared to 12.2 percent of US personal income. Kentucky personal income has notably smaller shares of dividends, interest and rents (15.1 percent vs. 18.8 percent); wages and salaries (47.2 percent vs. 50.6 percent); and proprietor's income (7.4 percent vs. 9.3 percent) than in US personal income.

Kentucky non-farm employment grew 0.6 percent in the first quarter. Adjacent-quarter growth was 0.1 percent. The weak employment growth has been a hallmark of this recovery. Adjacent-quarter growth for the last four quarters was -0.02, -0.5, 0.9 and 0.1 respectively. The 0.9 percent growth in the fourth quarter of FY14 was the highest growth recorded since the 2007 recession started. The largest gains in employment occurred in the leisure and hospitality services sector, where 3,300 jobs were gained for 1.8 percent growth over the first quarter of last year. The leisure and hospitality sector contains a large share of part-time employment and low wage jobs. Three sectors (manufacturing, information services, and finance services) lost jobs during the first quarter. Kentucky non-farm employment growth has been low and essentially stable since the end of the 2007 recession. The average quarterly growth for the last five years was 0.1, 0.2, 0.5, 0.2 and 0.2 percent respectively.

The current labor market is not a robust labor market. The expansion period that began in April 1991 was arguably one of the best labor market environments since World War II. This was true for both the national labor market as well as for Kentucky. During the 109 month expansion period of the 1990s, 356,300 jobs were gained in Kentucky, for a net increase of 24.2 percent growth. On a per month basis, that would average over 3,260 new jobs per month. By contrast, during the current expansion period, which so far has a duration of 54 months, 117,300 new jobs were gained, for a net increase of 6.2 percent growth. On a per month basis, that would average just over 2,200 new jobs per month. So job growth is 33 percent lower now than during a strong expansion period. During the expansion following the 2001 recession, approximately 2,000 new jobs per month were gained. So the job growth which has occurred following the 2007 recession is closer to that of the recovery period following the 2001 recession, which is widely believed to be one of the worst recoveries in terms of job growth.

Table 5
Summary of Kentucky Economic Series
First Quarter FY15 & FY14

	First Quarter			
	FY15	**FY14**	**Chg**	**% Chg**
Non-farm Employment (thousands)	1,851.0	1,840.7	10.3	0.6
Goods-producing	315.1	315.4	-0.3	-0.1
Construction	68.3	68.2	0.1	0.1
Mining	17.6	17.5	0.1	0.6
Manufacturing	229.2	229.7	-0.5	-0.2
Service-providing	1,196.4	1,187.9	8.5	0.7
Trade, Transportation & Utilities	371.9	370.2	1.7	0.5
Information	26.2	26.3	-0.1	-0.4
Finance	86.6	88.8	-2.2	-2.5
Business Services	202.2	200.3	1.9	0.9
Educational Services	261.2	258.1	3.1	1.2
Leisure and Hospitality Services	182.6	179.3	3.3	1.8
Other Services	65.7	64.9	0.8	1.2
Government	339.6	337.5	2.1	0.6

Not Seasonally Adjusted. Data for FY15 Q1 are September 2014 estimates.
Source: IHS Global Insight Inc., September 15, 2014 data release

Interim Outlook

GENERAL FUND

The revenue forecasts presented in Table 6 and Table 7 were estimated using the September 2014 "control scenario" economic forecast from both IHS Global Insight (hereafter Global Insight) and the Kentucky MAK model. The first Quarterly Report of any fiscal year is unique because it represents the first internal, unofficial update on expected revenues for the current fiscal year.

Underlying economic conditions — provided by Global Insight have stabilized somewhat for the near-term forecast, as partially alluded to in the Economic Outlook section of this report.

Projected General Fund revenues for the next three quarters are shown in Table 6. As the table indicates, General Fund growth is projected to be 2.1 percent compared to the final three quarters of FY14.

Individual income tax receipts are expected to increase by 3.6 percent during the final three quarters of FY15. With growth of 5.4 percent in the first quarter of FY15, the amount needed to hit the official estimate is $2,996.0 (or 6.3 percent). A large share of the FY14 General Fund shortfall, $63.0 million of the $90.9 million, was attributed to individual income tax.

Table 6
General Fund Interim Forecast
$ millions

	FY15						FY15	
	Q1		Q2, Q3, & Q4		Full Year		Official CFG	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff
Individual Income	981.3	5.4	2,920.1	3.6	3,901.4	4.1	3,977.3	-75.9
Sales & Use	804.5	3.4	2,398.7	1.9	3,203.3	2.3	3,154.0	49.2
Property	44.6	-20.0	516.0	1.8	560.6	-0.3	581.2	-20.6
Corporation Income	112.0	-25.7	338.0	4.2	450.0	-5.3	462.4	-12.4
Coal Severance	48.8	-5.0	140.8	-3.7	189.6	-4.0	204.6	-15.0
Cigarettes	57.3	-3.5	162.3	-3.8	219.6	-3.7	223.5	-3.9
LLET	44.5	-8.4	140.5	-6.8	185.0	-7.2	233.7	-48.7
Lottery	52.0	7.2	186.0	8.2	238.0	8.0	238.0	0.0
Other	153.4	1.8	565.2	3.0	718.6	2.7	726.5	-7.9
General Fund	**2,298.4**	**1.1**	**7,366.6**	**2.5**	**9,666.0**	**2.1**	**9,801.2**	**-135.2**

The largest component of individual income tax receipts is withholding, which makes up approximately 95 percent of total individual income tax receipts. Withholding is closely tied to wages and salaries and employment in the state. Employment has been lackluster for the last two fiscal years, with growth of 1.1 and 0.6 percent respectively. The increased rate of growth in the individual income tax for the forecast period is once again predicated upon improvement in the underlying economy.

During FY14, the sales and use tax receipts posted the largest nominal increase over FY13 levels, 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 six previous years. Unlike the individual income tax (where the forecasting error from the prior year made for a greater challenge), the sales tax can achieve the official estimate with much slower growth. This interim report calls for 1.9 percent growth for the final nine months of FY15. If the current unofficial estimate is attained, then the sales tax will generate $49.2 million more in receipts than the official estimate for sales tax.

Property tax revenues are expected to increase by 1.8 percent over the forecasting horizon. The state rate on real property will remain at 12.2 cents per $100 in valuation for property assessed as of January 1, 2016. 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 six 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 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 rise and vice versa. The FY14 receipts exemplified this theoretical relation 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. The corporation income tax is expected to increase by 4.2 percent for the final three quarters of FY15. Meanwhile, the LLET is expected to decrease by 6.8 percent for the final three quarters of FY15. So the counterbalancing mechanism appears to be operational over the forecast horizon. However, due to the sharp drop in first quarter corporation income tax receipts, the growth rates for both taxes will be negative for the full year of FY15.

The forecast for FY15 calls for declines in both of the taxes. The corporate income tax is expected to fall 5.3 percent from FY14 levels and the LLET to fall 7.2 percent.

Coal severance receipts fell slightly short of the official estimate in FY14 and are expected to decline further in FY15. Energy markets and coal markets in particular, have become quite volatile. The interim estimate is for a 4.0 percent decline in FY15 following a 14.3 percent decline in FY14. Increased EPA regulations and a gridlock in the issuances of new mining permits, a return to the levels near the FY12 peak ($298.3 million) is implausible in the short to intermediate forecasting horizons.

Cigarette tax receipts declined 4.4 percent in FY14 but the accelerated downward trend is expected to stabilize somewhat over the forecast horizon. The outlook for cigarette tax receipts is for a nominal 3.7 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 1.9 percent in FY14 but fell $4.5 million short of the enacted estimates. The official estimate for FY15 remains at $238.0 million. This is another case where missing the estimate in one year does not imply shortfalls in subsequent years.

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 2.1 percent during the forecasting horizon, a lackluster increase coming off FY14 where revenues declined 2.0 percent. Each account was re-examined after FY14 and the proper adjustments were made to calibrate the models. The "Other" accounts totaled $699.7 million in FY14. "Other" collections are estimated to be $726.5 million for the forecasting horizon.

ROAD FUND

Road Fund revenues are forecasted to decline 3.8 percent over the remaining three quarters of FY15 as shown on Table 7 below. The motor fuels and motor vehicle usage taxes, which are the largest Road Fund accounts, are expected to account for the majority of the decrease. Motor vehicle license receipts and income on investments are also expected to post declines. The remaining accounts are estimated to increase. However, the increases are expected to be small and will not offset the declines in the larger accounts.

Motor fuels tax receipts are forecasted to fall 4.9 percent in the final three quarters of FY15 after increasing 1.6 percent in the first quarter. This decrease is due primarily to a decline in the forecasted average wholesale price of gasoline. Motor fuels taxes have three components; two fixed and one variable part. The variable portion is adjusted quarterly and is calculated as nine percent of the average wholesale price of gasoline in Kentucky. Our forecast calls for a significant reduction in the variable portion of the tax rate in the third quarter but rates more in line with FY14 levels in the second and fourth quarters. Therefore, most of the expected decline in this account will occur in the middle of the forecast horizon.

The tax rate has already been established for the second quarter of the fiscal year (October – December) and it is 0.4 cents per gallon lower than the rate in effect last year. A significant revenue decline will occur in the third quarter of the fiscal year (January – March) when the tax rate is forecasted in be 3.2 cents per gallon lower than last year's rate. For the fourth quarter, the tax rate is expected to increase slightly over FY14, leaving revenues roughly on par with the FY14 total.

Motor vehicle usage tax collections are expected to fall 3.5 percent in the final nine months of FY15, continuing the trend exhibited in the first quarter of the year. Collections in this account fell 0.5 percent during the first quarter due to the effects of HB 440 which was enacted in 2013. The bill allows for a trade-in credit on new car purchases and reduced tax collections by $11.1 million during the quarter. The trade-in credit will have an impact on receipts for the remainder of the fiscal year. It is estimated the credit will reduce collections by $34 million in FY15.

Motor vehicle license taxes are forecasted to decrease 3.0 percent in the final three quarters of FY15. Motor vehicle operators' licenses are projected to rise 2.2 percent in the remainder of the fiscal year. Weight distance tax revenue should grow 2.5 percent for the remainder of the fiscal year. Investment income should decrease $700,000. All other revenues should combine for growth of 2.4 percent during the last nine months of FY15.

Table 7
Road Fund Interim Forecast
$ millions

	FY15						FY15	
	Q1		Q2, Q3, & Q4		Full Year		Official CFG	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff
Motor Fuels	234.0	1.6	623.7	-4.9	857.7	-3.2	883.2	-25.5
Motor Vehicle Usage	115.0	-0.5	315.9	-3.5	430.9	-2.7	425.5	5.4
Motor Vehicle License	22.4	21.2	80.9	-3.0	103.3	1.4	101.9	1.4
Motor Vehicle Operators	4.1	-2.7	12.2	2.2	16.3	0.9	16.7	0.9
Weight Distance	20.0	4.0	59.1	2.5	79.1	2.9	79.9	-0.8
Income on Investments	0.6	-22.6	2.5	-22.1	3.1	-22.4	3.1	0.0
Other	8.6	-4.2	23.9	2.4	32.5	0.6	36.4	-3.9
Road Fund	**404.8**	**1.8**	**1,118.1**	**-3.8**	**1,522.9**	**-2.4**	**1,546.7**	**-23.8**

NATIONAL ECONOMY

At the conclusion of the first quarter of FY15, the balance between the relative improvement of the economy's fundamentals with the continuing policy uncertainty from the Federal Reserve is one of the primary observations of the US economy.

The Federal Reserve's policy uncertainty is made more difficult due to the fact that the weakness in the labor market is comprised of both cyclical and structural components. The cyclical components are associated with the continued pace of the recovery, and the indicators of the continued slow pace of the labor market recovery are seen in the lack of growth in hourly earnings and high levels of part-time work. The most significant indicator, however, may be seen in the overall growth in the labor force. For calendar 2014, the overall growth in the labor force to date is on track to be fewer than 390,000 net new entrants. This is further indicated by the continued decline in the labor force participation rate, which has fallen by three percent since the end of the recession. These factors would suggest that any actions to raise interest rates should occur at a later time to allow the economic recovery to continue.

The question for policymakers centers on what component of the observed weakness in the labor market is structural rather than cyclical. Beginning with the 45-plus age brackets, labor force participation rates naturally fall, and these brackets are expanding at a faster pace as the population ages. There are numerous reasons for these naturally declining participation rates, including retirements, working sporadically, health considerations, or no longer needing second incomes. The fact that the participation rates themselves are falling within most age brackets exacerbates this problem, but with faster wage growth and better job prospects, participation rates could steady themselves.

The underlying demographic trends also affect household formation. The release of the Annual Social and Economic Supplement to the Current Population Survey indicated approximately 480,000 households were created during the time period of March of 2013 to March of 2014. As household formation slows, housing starts and sales will be reduced. National forecasts of GDP and related housing components will be reduced in upcoming quarters to reflect this new information. All of these demographic trends have economic impacts, but they would not support a delay in the actions of the Federal Reserve. Overall, the Federal Reserve will have to balance the cyclical and structural components of the national data in the execution of monetary policy over the remainder of the fiscal year.

Overall, the outlook for the remainder of the fiscal year is positive, and improved over previous years. Real GDP is expected to grow at an annualized rate 2.8 percent over the next three quarters, representing a 2.8 percent increase year over year. Consumption is forecast to grow by an annual rate of 2.4 percent over the next three quarters. Government expenditures at all levels, Federal, state, and local, will continue to show little growth. Oil and energy prices are expected to remain low, with West Texas Intermediate continuing to fall in price, helping to keep core inflation low.

KENTUCKY ECONOMY

Economic growth in Kentucky is projected to continue through FY15 roughly in line with the national economy. Table 9 shows Kentuckians' personal incomes are forecast to grow at the same pace as the U.S. overall (Table 8) over the next three quarters, with wage and salary growth projected to be a solid 5.2 percent. The St. Louis Federal Reserve's Burgundy Book reports that the vast majorities of contacts surveyed expect nominal wages to either increase or remain stable as the calendar year closes.

Kentucky's index of leading economic indicators, as reported by the Philadelphia Federal Reserve, was the highest among U.S. states in August. This suggests that growth will be positive in several areas over the next several months. Retail gasoline prices remained relatively low in the first quarter, a trend that looks to continue as the price of delivery of Brent crude on the futures market a year out remains under $100/barrel. The fall season is traditionally associated with declining gasoline prices potentially helping Kentucky consumer spending through a small increase in disposable income.

In August, for the first time on record, the unemployment rate fell in every Kentucky county. Unemployment in Kentucky is projected to continue trending downward as the U.S. economy picks up its pace of return to potential levels of output and employment. Growth in employment is not projected evenly across all sectors and regions, however. According to Table 9, growth in mining employment is still projected to lag that of other goods-producing areas. While the coal fields of Western Kentucky have seen positive growth recently, conditions remain challenging for the mines in Eastern Kentucky. Notably, employment growth in Kentucky's service-providing industries is projected to be lower than that of its goods-producing industries. Overall, total non-farm employment growth in Kentucky is projected to be below that of the U.S. as a whole.

The northern Kentucky areas near Cincinnati already see unemployment below the national average, and the Cleveland Federal Reserve forecasts "optimistic" employment growth in this area. The Cleveland Fed projects the housing market in the Lexington metro area to improve and notes that expansion in local automobile manufacturing over the coming months should further boost area employment and wages. The St. Louis Federal Reserve reports "especially brisk" employment growth in the Louisville and Bowling Green areas and further growth is anticipated as surveys reported improving business optimism.

Some potential impediments to growth warrant caution, however. Surveys of businesses conducted by multiple Federal Reserve banks indicate that companies are planning to primarily expand their part-time workforce in the coming year rather than hire more full-time workers. The Burgundy Book for the Louisville area reported businesses having a difficult time finding skilled labor to fill potential job openings. While the housing market is improving, the number of new home permits and mortgages issued is not very impressive. A harsh winter similar to that seen in FY13 could put a further damper on growth. While growth in output and employment is expected to be solid going forward, the recent history of this economic recovery has brought boom and bust cycles, thus reminding forecasters and analysts to temper our optimism with prudent caution.

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

	Q2, Q3, & Q4			Full Year	
	FY15	**FY14**	**% Chg**	**FY15**	**% Chg**
Real GDP	16,360.1	15,914.1	2.8	16,305.4	2.7
Real Consumption	11,114.8	10,855.4	2.4	11,076.1	2.4
Real Investment	2,807.1	2,639.2	6.4	2,794.7	6.2
Real Govt. Expenditures	2,894.3	2,873.9	0.7	2,892.5	0.4
Real Exports	2,143.5	2,059.9	4.1	2,128.7	3.7
Real Imports	2,572.7	2,491.4	3.3	2,559.9	3.2
Personal Income ($ billions)	15,164.7	14,499.9	4.6	15,084.5	4.5
Wages and Salaries ($ billions)	7,701.5	7,330.6	5.1	7,655.0	5.1
Inflation (% chg CPI)	1.8	1.6	NA	1.8	NA
Industrial Production Index (% chg)	4.1	3.6	NA	4.2	NA
Civilian Labor Force (millions)	157.3	155.4	1.2	157.0	1.0
Total Non-farm Employment (millions)	140.5	137.8	1.9	140.2	1.9
Manufacturing Employment (millions)	12.3	12.1	2.1	12.3	2.0
Unemployment Rate (%)	5.9	6.6	NA	5.9	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 through FY15 Q4 are September 2014 estimates.
Source: IHS Global Insight Inc., September 15, 2014 data release

Table 9
Kentucky Economic Outlook
Quarters 2, 3, & 4

	Q2, Q3, & Q4			Full Year	
	FY15	FY14	% Chg	FY15	% Chg
Personal Income ($ millions)	169,990.7	162,571.7	4.6	169,075.3	4.4
Wages and Salary ($ millions)	84,176.7	80,014.7	5.2	83,634.3	5.0
Non-farm Employment (thousands)	1,866.8	1,840.5	1.4	1,862.9	1.2
Goods-producing	319.2	311.6	2.4	318.2	1.8
Construction	69.7	66.8	4.3	69.4	3.2
Mining	17.8	17.6	1.1	17.7	1.0
Manufacturing	231.8	227.2	2.0	231.1	1.4
Service-providing	1,207.6	1,190.6	1.4	1,204.8	1.3
Trade, Transportation & Utilities	376.3	369.2	1.9	375.2	1.6
Information	26.3	26.2	0.4	26.3	0.2
Finance	86.9	86.8	0.1	86.8	-0.6
Business Services	206.0	202.8	1.6	205.1	1.4
Educational Services	262.6	259.7	1.1	262.2	1.1
Leisure and Hospitality Services	184.6	180.5	2.3	184.1	2.2
Other Services	64.9	65.5	-0.8	65.1	-0.3
Government	339.9	338.3	0.5	339.8	0.5

Not Seasonally Adjusted.
Source: IHS Global Insight, Inc. and the Kentucky Governor's Office for Economic Analysis MAK model, September 2014.

APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	First Quarter FY 2015	First Quarter FY 2014	% Change
TOTAL GENERAL FUND	**$2,298,442,089**	**$2,274,371,371**	**1.1%**
Tax Receipts	**$2,215,365,811**	**$2,199,470,101**	**0.7%**
Sales and Gross Receipts	**$951,766,270**	**$925,913,669**	**2.8%**
Beer Consumption	1,703,057	1,645,641	3.5%
Beer Wholesale	16,191,083	15,629,990	3.6%
Cigarette	57,261,379	59,321,186	-3.5%
Distilled Spirits Case Sales	32,077	31,410	2.1%
Distilled Spirits Consumption	3,054,600	3,017,521	1.2%
Distilled Spirits Wholesale	8,513,571	8,099,634	5.1%
Insurance Premium	34,025,646	33,549,607	1.4%
Pari-Mutuel	653,734	832,213	-21.4%
Race Track Admission	74,316	93,393	-20.4%
Sales and Use	804,538,576	778,109,121	3.4%
Wine Consumption	710,056	778,066	-8.7%
Wine Wholesale	3,757,048	3,486,011	7.8%
Telecommunications Tax	15,693,787	15,983,293	-1.8%
OTP	5,557,017	5,335,523	4.2%
Floor Stock Tax	324	1,061	-69.5%
License and Privilege	**$105,067,862**	**$114,780,056**	**-8.5%**
Alc. Bev. License Suspension	127,080	86,192	47.4%
Coal Severance	48,773,776	51,328,611	-5.0%
Corporation License	85,047	257,638	-67.0%
Corporation Organization	5,486	8,215	-33.2%
Occupational Licenses	43,024	44,235	-2.7%
Oil Production	3,263,335	3,452,773	-5.5%
Race Track License	95,000	95,000	0.0%
Bank Franchise Tax	(322,636)	1,179,658	---
Driver License Fees	190,450	162,725	17.0%
Minerals Severance	4,500,247	4,620,982	-2.6%
Natural Gas Severance	3,825,390	4,963,497	-22.9%
Limited Liability Entity	44,481,663	48,580,532	-8.4%
Income	**$1,093,354,875**	**$1,081,972,066**	**1.1%**
Corporation	112,005,594	150,708,356	-25.7%
Individual	981,349,281	931,263,710	5.4%
Property	**$44,639,454**	**$55,813,418**	**-20.0%**
Building & Loan Association	(498,150)	5,753	---
General - Real	(659,451)	28,606	---
General - Tangible	26,473,143	28,874,841	-8.3%
Omitted & Delinquent	4,287,674	7,343,127	-41.6%
Public Service	14,955,989	14,936,142	0.1%
Other	80,247	4,624,949	-98.3%
Inheritance	**$14,960,629**	**$13,634,679**	**9.7%**
Miscellaneous	**$5,576,721**	**$7,356,213**	**-24.2%**
Legal Process	3,615,250	3,933,671	-8.1%
T. V. A. In Lieu Payments	1,957,567	3,422,542	-42.8%
Other	3,904	0	---
Nontax Receipts	**$82,568,460**	**$74,396,868**	**11.0%**
Departmental Fees	3,355,952	3,652,228	-8.1%
PSC Assessment Fee	14,671,193	14,249,716	3.0%
Fines & Forfeitures	5,703,192	6,209,984	-8.2%
Income on Investments	(155,509)	(156,001)	---
Lottery	52,000,000	48,500,000	7.2%
Sale of NOx Credits	15,594	39,000	-60.0%
Miscellaneous	6,978,038	1,901,942	266.9%
Redeposit of State Funds	**$507,819**	**$504,401**	**0.7%**

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	First Quarter FY 2015	First Quarter FY 2014	% Change
TOTAL ROAD FUND	**$404,783,554**	**$397,739,666**	**1.8%**
Tax Receipts-	**$397,511,911**	**$391,400,461**	**1.6%**
Sales and Gross Receipts	**$349,024,748**	**$346,004,008**	**0.9%**
Motor Fuels Taxes	233,985,683	230,409,640	1.6%
Motor Vehicle Usage	115,039,065	115,594,369	-0.5%
License and Privilege	**$48,487,163**	**$45,396,453**	**6.8%**
Motor Vehicles	22,430,251	18,512,832	21.2%
Motor Vehicle Operators	4,123,620	4,239,038	-2.7%
Weight Distance	20,013,402	19,238,326	4.0%
Truck Decal Fees	19,387	17,110	13.3%
Other Special Fees	1,900,503	3,389,146	-43.9%
Nontax Receipts	**$4,656,144**	**$4,873,807**	**-4.5%**
Departmental Fees	3,754,930	3,643,175	3.1%
In Lieu of Traffic Fines	121,910	142,589	-14.5%
Income on Investments	608,174	786,969	-22.7%
Miscellaneous	171,130	301,074	-43.2%
Redeposit of State Funds	**$2,615,499**	**$1,465,398**	**78.5%**