COMMONWEALTH OF KENTUCKY

QUARTERLY ECONOMIC & REVENUE REPORT

SECOND QUARTER FISCAL YEAR 2014

GOVERNOR'S OFFICE FOR ECONOMIC ANALYSIS

OFFICE OF STATE BUDGET DIRECTOR

Kentucky UNBRIDLED SPIRIT

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January 31, 2014

The Honorable Steven L. Beshear
Governor
Commonwealth of Kentucky
State Capitol Building
Frankfort, KY 40601

Dear Governor Beshear:

This Quarterly Economic and Revenue Report summarizes the revenue and economic statistics for the second quarter of Fiscal Year 2014 (FY14) as well as an unofficial interim outlook for the next three fiscal quarters.

General Fund receipts for the second quarter of FY14 totaled $2,438.1 million, a decrease of 0.7 percent or $17.4 million compared to the same period in FY13. The interim General Fund forecast for the final two quarters of FY14 calls for an increase of 3.1 percent compared to the second half of FY13 resulting in an unofficial interim outlook for the entire FY14 of $9,548.1 million. Prior to the December 19, 2013 meeting of the Consensus Forecasting Group (CFG), the official enacted estimate for FY14 was $9,523.9 million – a difference of $24.2 million. The difference between the previous official forecast and the new official forecast is 0.25 percent, a very small difference.

Total Road Fund receipts grew 3.2 percent during the second quarter of FY14 due to large increase in motor fuels taxes. Total receipts of $378.3 million and compare to $366.5 million from the second quarter of last year. The interim forecast for the Road Fund growth in revenues is forecasted to slow over the final six months of the fiscal year, increasing 5.2 percent compared to growth of 7.0 percent in the first two quarters of FY14. The full FY14 Road Fund estimate is therefore $1,582.6 million. Growth in revenues is expected to turn negative in the first quarter of FY15, declining 3.3 percent.

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

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 FY14. As required by law, this report includes a current synopsis of the economic and fiscal conditions of the Commonwealth, as well as an outlook for the next three fiscal quarters.

This second edition of the Quarterly Report reports the official estimate for the current year as well as a first look at the opening quarter of the upcoming fiscal year. The Consensus Forecasting Group (CFG) met last month and rendered official General Fund and Road Fund estimates, which are presented in Tables 5 and 6 of this report.

To fulfill the requirement to provide an update on current economic conditions, two sections of narrative information are included in this report. The first section profiles the most recent history of the US and Kentucky economies. Later, in the outlook section of the report, a three-quarter outlook is provided using the control forecast from Global Insight as well as the Kentucky Macroeconomic Model (MAK) which is developed, maintained, and operated by the Office of State Budget Director (OSBD).

Some of the highlights of this report are summarized here. For greater detail, please refer to the relevant portions of the report.

- Second quarter General Fund receipts decreased $17.4 million, or 0.7 percent, over the same quarter in FY13. Sales and use, individual income, and lottery tax receipts provided growth but were unable to offset significant losses in the property and limited liability entity taxes (LLET).

- Road Fund tax collections increased $11.8 million, or 3.2 percent, in the first six months of FY14 compared to receipts in the same time frame last year. Motor fuels tax provided the majority of the growth.

- The national economy, as measured by real gross domestic product (real GDP), rose only 2.1 percent in the second quarter of FY14. Growth above two percent is a positive development, but still continues the trend of low growth seen since the 2007 recession. The seasonally adjusted unemployment rate measured 7.2 percent, down from 7.8 percent in the same quarter of FY13.

- Kentucky personal income rose 2.2 percent in the second quarter of FY14, continuing its positive trend. Wage and salary growth measured 2.6 percent despite relatively weak growth in employment.

Growth in General Fund receipts is estimated to increase over the final six months of the fiscal year and remain positive in the first quarter of FY15. A strong increase in property tax receipts is expected to lead the growth for the second half of FY14.

Growth in Road Fund revenues is expected to slow over the second half of FY14 due primarily to a reduction in the motor fuels tax rate. Nominal collections are anticipated to decrease in the first quarter of FY15.

Revenue Receipts

GENERAL FUND

After positive revenue growth for the last 14 quarters, second quarter collections of FY14 turned negative. In the second quarter of FY14, revenue collections fell a modest 0.7 percent, or $17.4 million. Second quarter collections were dragged down primarily by weak property, corporation, coal severance, cigarette, LLET, and "Other" taxes. This General Fund decline is the first decline since the third quarter of FY10.

Receipts in the second quarter totaled $2,438.1 million compared to $2,455.5 million received in the second quarter of FY13. 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 the timing of payments into revenue accounts. While timing differences were less prevalent in the past, property tax receipts continue to be impacted because of a significant timing issue this year.

Table 1
Summary General Fund Receipts
Second Quarter, FY14, $ millions

	FY14	FY13	Diff ($)	Diff (%)
Individual Income	925.3	911.2	14.1	1.6
Sales and Use	779.0	751.2	27.9	3.7
Property	306.2	331.4	-25.2	-7.6
Corporation Income	79.9	81.9	-2.0	-2.4
Coal Severance	52.8	56.6	-3.9	-6.8
Cigarette Taxes	57.8	60.9	-3.1	-5.1
LLET	45.4	60.9	-15.5	-25.5
Lottery	54.6	53.3	1.4	2.6
Other	137.0	148.1	-11.1	-7.5
Total	**2,438.1**	**2,455.5**	-17.4	-0.7

Individual income tax posted receipts of $925.3 million, compared to last year's second quarter receipts of $911.2 million. The resulting growth rate was 1.6 percent, and compares to a growth rate of 8.1 percent for the second quarter of last year. Declarations payments, one of the four individual income tax components, declined compared to the same time frame last year.

The sales and use tax grew 3.7 percent in the second quarter of FY14. Receipts of $779.0 million were received in the second quarter, compared to $751.2 million in the second quarter of FY13. The first two quarters of FY14 show signs of an economic rebound.

Combined corporation income and LLET receipts were down in the second quarter of the fiscal year. Revenues of $125.3 million were 12.2 percent lower than previous year receipts of $142.8 million.

Coal severance tax revenue continued to decline in the second quarter, with receipts down 6.8 percent. Collections of $52.8 million compare to the FY13 second quarter total of $56.6 million. Tax receipts have declined on an annual basis for the last seven quarters.

Cigarette tax receipts of $57.9 million in the second quarter of FY14 compare to $60.9 million in the second quarter of FY13. Receipts have declined for the last four quarters due to a fall in the number of packs sold.

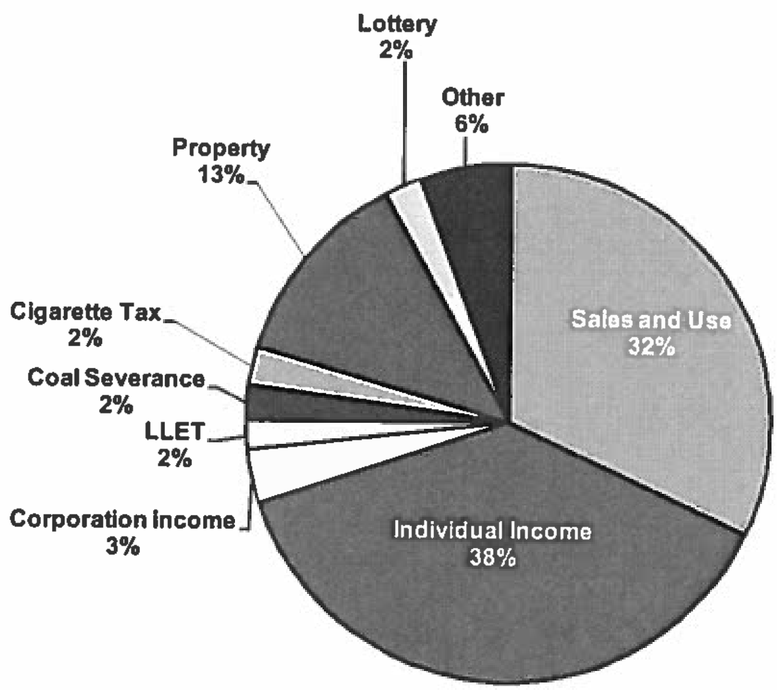
Total property taxes decreased 7.6 percent during the second quarter of the fiscal year as distributions to local government affected net collections. Receipts totaled $306.2 million and compare to $331.4 million collected in the second quarter of FY13.

Lottery receipts were $54.6 million, which were 2.6 percent above last year's second quarter total of $53.3 million.

The "Other" category, which represents the remaining accounts of the General Fund, declined 7.5 percent in the second quarter. Second quarter receipts for FY14 were $137.0 million and compare to $148.1 million for the same quarter in FY13.

Figure 1 details the composition of General Fund revenues by tax type for the second quarter of FY14. Seventy percent of General Fund revenues were in the areas of the individual income tax and the sales tax. The next largest sources of revenue were property tax accounted for 13 percent of the total General Fund receipts followed by the "Other" category at six percent. The largest components in the "Other" category include insurance pre-

Figure 1
General Fund Receipts Composition
Second Quarter, FY14



mium, bank franchise, telecommunications, and beer wholesale taxes. Corporation income taxes accounted for three percent. Lottery, cigarette, coal severance and LLET receipts each made up roughly two percent of the General Fund.

ROAD FUND

Total Road Fund receipts grew 3.2 percent during the second quarter of FY14 due to large increase in motor fuels taxes. Total receipts of $378.3 million and compare to $366.5 million from the second quarter of last year. Summary data are contained in Table 2 and detailed data are shown in the Appendix.

Motor fuels tax receipts grew at a rate of 5.6 percent during the second quarter due to the formula-driven increase in the tax rate tied to the price of gasoline. Receipts were $227.7 million and compare to $215.6 million collected during the second quarter of last year.

Motor vehicle usage tax receipts of $101.3 million represent an increase of 1.3 percent compared to the $100.0 million collected in the second quarter of FY13.

Table 2
Summary Road Fund Receipts
Second Quarter, FY14, $ millions

	FY14	FY13	Diff ($)	Diff (%)
Motor Fuels	227.7	215.6	12.1	5.6
Motor Vehicle Usage	101.3	100.0	1.3	1.3
Motor Vehicle License	18.1	17.7	0.4	2.3
Motor Vehicle Operators	3.9	3.9	0.0	0.0
Weight Distance	19.5	18.9	0.6	3.2
Income on Investments	0.1	0.8	-0.7	-87.5
Other	7.7	9.6	-1.9	-19.8
Total	378.3	366.5	11.8	3.2

Motor vehicle license tax receipts increased 2.3 percent in the second quarter of FY14 to $18.1 million.

Motor vehicle operators license tax receipts were $3.9 million in the second quarter of FY14.

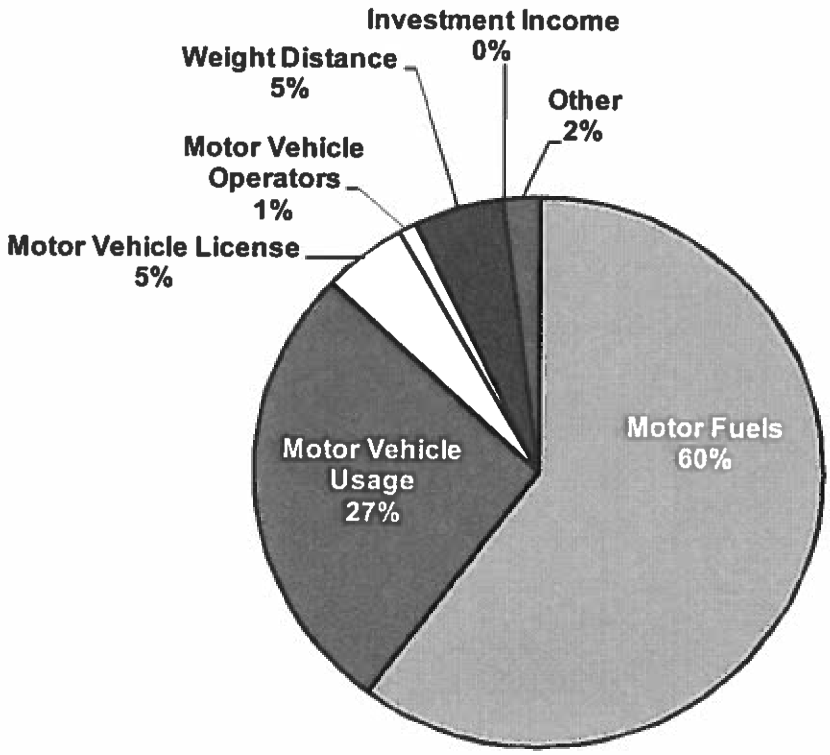
Weight distance tax receipts of $19.5 million represent a 3.2 percent increase compared to receipts of $18.9 million received during the second quarter of FY13.

Investment receipts of $0.1 million were down 87.5 percent over the total collected in the second quarter of FY13.

The remainder of the accounts in the Road Fund combined for a decrease of 19.8 percent from a year earlier. In the "Other" category, revenues of $7.7 million compare to $9.6 million in the second quarter of FY13.

Figure 2 details the composition of Road Fund revenues by tax type in the second quarter of FY14. Motor fuels taxes and the motor vehicle usage tax accounted for 87 percent of Road Fund revenues in the second quarter. The next largest sources of revenue were the weight distance tax and motor vehicle license tax with approximately five percent each. The "Other" category accounted for two percent, while motor vehicle operators comprised one percent. Investment income accounted for a negligible amount of total Road Fund receipts.

Figure 2
Road Fund Receipts Composition
Second Quarter, FY14



The Economy
Second Quarter FY14

NATIONAL ECONOMY

The most common metric used to measure the US economy is real gross domestic product (real GDP). Real GDP is the sum of all final goods and services sold within a country's physical boundaries in a given period and explicitly excludes those goods and services which are produced by US citizens in other countries. Second quarter growth compared to the second quarter of FY13 was 2.1 percent. The economy grew slower in the second quarter of FY14 than the previous two quarters. Real growth in the last three quarters was 0.6, 0.7 and 0.4 percent, respectively on an adjacent-quarter basis. Real GDP growth during this point in the recovery (18 quarters out from the trough) is still relatively weak. Growth at this point following the 2001 recession was 1.2 percent on an adjacent-quarter basis, which is three times the growth we are experiencing now. Gross domestic product is made up of five mutually exclusive components: consumption, investment, government expenditures, imports and exports.

Table 3
Summary of US Economic Series
Second Quarter FY14 & FY13

	Second Quarter			
	FY14	FY13	Chg	% Chg
Real GDP	15,858.5	15,539.6	318.9	2.1
Real Consumption	10,792.6	10,584.8	207.8	2.0
Real Investment	2,619.5	2,441.8	177.7	7.3
Real Govt. Expenditures	2,892.6	2,938.8	-46.2	-1.6
Real Exports	2,037.4	1,967.0	70.4	3.6
Real Imports	2,463.6	2,379.1	84.5	3.6
Personal Income ($ billions)	14,343.0	14,073.1	269.9	1.9
Wages and Salaries ($ billions)	7,219.7	7,086.6	133.1	1.9
Inflation (% chg CPI)	1.1	1.9	NA	NA
Industrial Production Index (% chg)	2.8	2.8	NA	NA
Civilian Labor Force (millions)	155.0	155.5	-0.5	-0.3
Total Non-farm Employment (millions)	136.7	134.5	2.2	1.7
Manufacturing Employment (millions)	12.0	11.9	0.1	0.5
Unemployment Rate (%)	7.2	7.8	NA	-8.1

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 FY14 Q2 are November 2013 estimates.
Source: IHS Global Insight Inc., November 18, 2013 data release

Real consumption grew by 2.0 percent in the second quarter compared to the previous year. Real consumption growth has been very stable for the last five quarters. Real consumption growth (annual rate) reached a peak in FY11 with 3.1 percent growth.

Real consumption, the largest component of real GDP, makes up 68.1 percent of real GDP. In 2000, real consumption made up 65.2 percent of real GDP. These shares are heavily influenced by the long term effects of recessions and the acceleration and braking of government expenditures through business cycles.

Real investment makes up 16.5 percent of real GDP. The 2007 recession had a profound effect on investment. From peak to trough, real investment fell by $969.1 billion, or 34.9 percent. Seventeen quarters after the trough, real investment is still below its previous peak. Average quarterly growth has been just 2.2 percent since the previous trough. Real investment growth in the second quarter was just 1.4 percent over the first quarter. Despite extremely low interest rates for a prolonged period of time, investment growth has been weak. If investment growth continues at its current pace, it will finally return to its previous peak in the third quarter of FY15.

Real government expenditures make up 18.2 percent of real GDP. Real government expenditures have been declining since the 2007 recession ended. This is common for expenditures to decline following recessions and is linked heavily to transfer payments. On average, real government expenditures have declined by 0.4 percent every quarter since the recession ended. Real government expenditures have declined a net 1.6 percent since a year ago. Real government expenditures have increased three times in the last seven quarters which could indicate that the contraction is coming to an end.

US personal income rose by 1.9 percent in the second quarter. Average year-over-year growth is 3.3 percent since the end of the recession. The recent slowdown is largely due to the 1.0 percent decline which occurred in the third quarter of FY13. US wages and salaries make up 50.3 percent of total personal income. Therefore, it is not surprising that US wages and salaries are similar to total personal income, as it was this quarter. US wages and salaries grew (on a year-over-year basis) by 1.9 percent down from 6.4 percent a year ago.

US total non-farm employment grew by 1.7 percent over last year. The 2007 recession affected US total non-farm employment in a very different way than the 2001 recession affected it. The duration of employment declines was very similar across the two recessions, nine quarters of declines compared to eight quarters of declines respectively. In 2001, total non-farm employment declined by 2.7 million jobs, a 2.0 percent net decrease. In 2007, total non-farm employment declined by 8.6 million jobs, a 6.2 percent net decrease. During the 2001 recession recovery, it took seven quarters to return to previous peak. During the 2007 recession recovery, it has been 15 quarters and the US is still not back to the previous peak. If the current growth trend continues it will take three more quarters for non-farm employment to reach its previous peak. Growth rates during the respective recoveries have been very similar. In both cases, the average growth rate for the 12 quarters following the trough was 0.4 percent. So the longer duration of the current recovery is more a statement about the absolute magnitude of employment losses, and less a statement about current quarterly growth.

KENTUCKY ECONOMY

Kentucky personal income grew by 2.2 percent in the second quarter. Kentucky personal income was up 0.9 percent over the first quarter. Kentucky personal income growth has tapered each year for the last three years. Proprietor's income has grown the fastest (among the personal income components) since the recession ended. Kentucky personal income has grown an average of 0.8 percent since the recession ended, while proprietor's income has grown 1.8 percent on average during that time. The other five components of personal income all grew by an average of under one percent during that time. Kentucky wages and salary income increased 2.6 percent in the second quarter over FY13. Wages and salaries increased only 0.8 percent compared to the first quarter of FY14.

Kentucky total non-farm employment grew by 0.8 percent in the second quarter. Growth has tapered somewhat since FY12 when annual growth was 1.9 percent in the fourth quarter. The recoveries of the last two recessions have had different effects on Kentucky employment as it has

Table 4
Summary of Kentucky Economic Series
Second Quarter FY14 & FY13

	Second Quarter			
	FY14	FY13	Chg	% Chg
Personal Income ($ millions)	161,488.0	158,050.0	3,438.0	2.2
Wages and Salary ($ millions)	79,724.1	77,713.0	2,011.1	2.6
Non-farm Employment (thousands)	1,848.0	1,834.1	13.9	0.8
Goods-producing	312.8	311.5	1.3	0.4
Construction	65.6	66.8	-1.1	-1.7
Mining	18.1	19.0	-0.9	-4.5
Manufacturing	229.0	225.8	3.3	1.4
Service-providing	1,198.0	1,187.4	10.6	0.9
Trade, Transportation & Utilities	380.5	375.8	4.7	1.3
Information	25.4	25.7	-0.2	-1.0
Finance	88.0	88.5	-0.5	-0.6
Business Services	197.1	193.7	3.5	1.8
Educational Services	258.7	258.6	0.1	0.1
Leisure and Hospitality Services	182.1	176.3	5.8	3.3
Other Services	66.1	68.9	-2.8	-4.1
Government	337.2	335.2	2.0	0.6

Not Seasonally Adjusted. Data for FY14 Q2 are November 2013 estimates.
Source: IHS Global Insight Inc., November 18, 2013 data release

for US employment. During the 2001 recession, Kentucky non-farm employment lost 56,000 jobs, a 3.1 percent net decline. This period of declines occurred over a 13 quarter period. During the 2007 recession, Kentucky non-farm employment lost 120,000 jobs, a 6.4 percent net decline. This took place over a period of just nine quarters. It took 10 quarters for employment to reach its previous peak during the 2001 recovery. Meanwhile, it has been 15 quarters since the 2007 recession trough and non-farm employment is still not back to its previous peak. If Kentucky non-farm employment growth continues at its current rate it will take four more quarters for employment to reach its previous peak.

There has been very little total employment growth over last year, so it is not surprising that there is very little growth within the 11 employment supersectors. The biggest upward mover was leisure and hospitality services employment, which grew by a net 3.3 percent and added 5,800 jobs. The biggest downward mover was mining employment which fell by 4.5 percent, a net loss of 900 jobs. Effects were very mixed, as five components decreased and six components increased.

Kentucky government employment grew by 0.6 percent in the second quarter over last year. It remained constant with 337,200 jobs compared to the first quarter of FY14. Kentucky government employment, which includes federal, state and local government jobs, has fallen in four of the last seven quarters, but is still up by 11,100 jobs from where it was at the end of the recession.

Interim Outlook

GENERAL FUND

The interim General Fund forecast for the final two quarters of FY14 calls for an increase of 3.1 percent compared to the same period one year ago, resulting in an unofficial interim outlook for the entire FY14 of $9,548.1 million. The projected General Fund and Road Fund outlooks in this report are identical to the official consensus estimates prepared on December 19, 2013.

Prior to the December 19, 2013 meeting of the CFG, the official enacted estimate for FY14 was $9,523.9 million – a difference of $24.2 million. The difference between the previous official forecast and the new official forecast is 0.25 percent, a very small difference.

The revenue forecasts presented in Table 5 and Table 6 were estimated using the November 2013 "control scenario" economic forecast from both IHS Global Insight and the Kentucky MAK model. Since then, OSBD has received December and January updates from IHS Global Insight. As discussed with the CFG, the differences were minor enough to remain confident about the general direction of the state and national economies.

Projected General Fund revenues for the next three quarters are shown in Table 5. As the table indicates, General Fund growth is projected to accelerate over the final half of FY14 from growth of 1.2 percent during the July-December period to 3.1 percent growth for the second half of FY14. Growth for the first quarter of

Table 5
General Fund Interim Forecast
$ millions

	FY14						FY14		FY15	
	Q1 & Q2		Q3 & Q4		Full Year		Official CFG		Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff	Estimate	% Chg
Individual Income	1,856.6	2.4	1,955.7	2.4	3,812.3	2.4	3,812.3	0.0	945.9	1.6
Sales & Use	1,557.1	3.0	1,542.2	2.1	3,099.3	2.6	3,099.3	0.0	803.8	3.3
Property	362.0	-8.8	206.9	28.3	568.9	1.9	568.9	0.0	57.1	2.3
Corporate Income	230.6	18.4	229.9	11.6	460.5	14.9	460.5	0.0	151.4	0.5
Coal Severance	104.1	-14.4	96.5	-11.4	200.6	-13.0	200.6	0.0	52.8	2.8
Cigarette Tax	117.2	-3.6	114.0	-2.7	231.2	-3.1	231.2	0.0	60.3	1.6
LLET	93.9	-13.2	137.8	-0.1	231.7	-5.9	231.7	0.0	49.4	1.9
Lottery	106.0	4.1	118.0	4.0	224.0	4.1	224.0	0.0	51.5	0.3
Other	287.7	0.4	431.9	1.1	719.6	0.8	719.6	0.0	154.9	2.8
General Fund	**4,712.5**	**1.2**	**4,835.6**	**3.1**	**9,548.1**	**2.1**	**9,548.1**	**0.0**	**2,327.1**	**2.3**

FY15 is expected to taper to 2.3 percent. While 3.1 percent growth for the remainder of FY14 may seem ambitious given year-to-date growth of 1.2 percent, it is noteworthy that FY13 ended with quarterly growth rates of 0.2 percent and 3.4 percent during the third and fourth quarters.

Individual income tax receipts are composed of four components: withholding, declarations, fiduciary and net returns. Individual income tax receipts are expected to increase by 2.4 percent over the next two quarters before tapering slightly to 1.6 percent in the first quarter of FY15. The largest component of individual income tax receipts is withholding, which makes up approximately 98 percent of total individual income tax receipts. Withholding is closely tied to wages and salaries and employment in the state. As growth in these two latter series increases, so too does withholding.

Sales and use tax collections rebounded nicely from a lull in FY13 to post 3.0 percent growth in the first half of FY14. Sales and use tax receipts are expected to grow by 2.1 percent in the second half of the FY14. This represents a slight tapering in the rate of growth from the first half of FY14, but growth is encouraging given that nominal sales tax collections have fallen in three of the last six fiscal years. Sales and use receipts are closely tied to disposable income. As disposable income rises, expenditures on applicable sales taxed goods increase. Receipts are expected to rise 3.3 percent in the first quarter of FY15 over FY14.

Growth in property tax revenues is expected to increase by 28.3 percent in the second half of FY13. Property tax collections are generally stable on an annual basis, typically growing anywhere from two percent to five percent per year. However, revenues can exhibit large fluctuations across months and even quarters. This can occur because the bulk of annual property tax receipts are received in a short window of time. In FY13 for example, over two-thirds of the total receipts were collected during the period October-January. With such large collections in a concentrated period, small changes in the timing of receipts can create seemingly large swings when viewing receipts on a quarterly or monthly basis. Additionally, for some accounts, the Department of Revenue collects both state and local portions of the tax liabilities and the timing of the distributions out of the General Fund to the localities can cause similar problems.

Corporate income tax receipts are expected to increase by 11.6 percent in the second half of FY14 relative to the second half of FY13. Growth for the full fiscal year is therefore expected to be 14.9 percent over FY13. Growth is expected to slow to 0.5 percent in the first quarter of FY15. The LLET receipts have fallen sharply relative to first half of FY13, but the rate of decline is expected to moderate in the second half of FY14 to produce an overall decline of 5.9 percent in FY14. The first quarter of FY15 is expected to grow a modest 1.9 percent with total collections of $49.4 million for the quarter.

Coal severance receipts have fallen by 14.4 percent year-to-date in FY14. Both severed tons and prices have fallen during that time. The general decline in demand for coal is due to increased regulations from the EPA on power plants and coal mines and due to the lower price of natural gas. Spot market prices for eastern Kentucky coal fell from $67.15 in the first part of July 2013 to $63.58 in the last part of December 2013. Meanwhile, spot market prices for western Kentucky coal inched up from $45.40 in the first part of July 2013 to $46.15 in the last part of December 2013. Contracts that are ending now were set one to five years ago at higher prices than today. New contracts will be negotiated at lower prices than old contracts regardless of the small recent increase in western Kentucky coal prices. Coal receipts are expected to fall by 11.4 percent in the second half of FY14 compared to the second half of FY13. This is more of a statement about FY13 than FY14, as quarterly receipts now seem to be settling in the $48 to $52 million range.

Cigarette smoking has declined both in Kentucky and nationally, as measured by the number of packs sold. This underlying trend continues to influence cigarette receipts in Kentucky. Cigarette receipts declined 3.6 percent in the first six months of FY14 and are expected to continue falling for the next six months. Receipts in the second half of FY13 are expected to decline 2.7 percent. The first quarter of FY15 receipts are expected to decline by 1.6 percent compared to the already depressed first quarter FY14.

Lottery receipts are determined by the Lottery Corporation's dividend schedule. Lottery receipts are projected to end FY14 at $224.0 million, an increase of 4.1 percent over FY13 levels. First quarter FY15 receipts are expected to be $51.5 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 a net 1.1 percent in the latter half of FY14. Receipts in the first quarter of FY15 are expected to grow 2.8 percent relative to the same quarter a year earlier.

ROAD FUND

Growth in Road Fund revenues is forecasted to slow over the final six months of the fiscal year, increasing 5.2 percent compared to growth of 7.0 percent in the first two quarters of FY14. Growth in revenues is expected to turn negative in the first quarter of FY15, declining 3.3 percent.

Motor fuels tax collections are forecasted to grow only 6.5 percent over the final six months of FY14. The slowing of the growth in revenue from 8.4 percent in the first half of the fiscal year is due primarily to a reduction in the motor fuels tax rate, effective for the final two quarters of the fiscal year. Taxable gallons have declined an average of just over one percent annually for the past eight years. During this time, declining consumption has been offset by an increasing tax rate, keeping revenue growth at a moderate level. In FY14, however, taxable gallons have been flat to slightly positive, helping to pump up fuels receipts. Growth in this revenue source will decline 4.4 percent in the first quarter of FY15 as the motor fuels tax rate fails to increase to the maximum amount allowed by law.

Motor vehicle usage tax collections will slow over the final six months of the fiscal year as well before declining in the first quarter of FY15. Collections will increase 2.8 percent over the remainder of the fiscal year but decrease 3.6 percent in the first three months of FY15. The FY15 decline is the result of a tax law change which extends a trade-in credit for new car purchases. The estimated impact of this legislation is $34 million annually.

To estimate the growth of all other components of the Road Fund, officials of the Kentucky Transportation Cabinet and staff of the Governor's Office for Economic Analysis together assessed recent growth patterns as well as administrative and statutory factors. Motor vehicle license taxes are forecasted to decrease 3.5 percent in the final two quarters of FY14 but increase 0.5 percent in the first quarter of FY15. Motor vehicle operators' licenses are projected to rise 1.4 percent in the remainder of the fiscal year as well as for the first quarter of FY15. Weight distance tax revenue should rise 0.8 percent for the remainder of the fiscal year and 4.0 percent over the first three months of FY15. Investment income will decline by $1.0 million over the remainder of the fiscal year and increase 27.2 percent in the first quarter of FY15. All other revenues will grow 27.3 percent during the last six months of FY14 and then increase 2.7 percent in the first quarter of FY15.

Table 6
Road Fund Interim Forecast
$ millions

	FY14						FY14		FY15	
	Q1 & Q2		Q3 & Q4		Full Year		Official CFG		Q1	
	Actual	% Chg	Estimate	% Chg	Estimate	% Chg	Estimate	$ Diff	Estimate	% Chg
Motor Fuels	458.2	8.4	442.5	6.5	900.7	7.4	900.7	0.0	220.3	-4.4
Motor Vehicle Usage	216.9	7.6	231.5	2.8	448.4	5.1	448.4	0.0	111.4	-3.6
Motor Vehicle License	36.6	4.0	64.7	-3.5	101.3	-0.9	101.3	0.0	18.6	0.5
Motor Vehicle Operators	8.1	-0.7	8.0	1.4	16.1	0.3	16.1	0.0	4.3	1.4
Weight Distance	38.7	2.3	37.4	0.8	76.1	1.6	76.1	0.0	20.0	4.0
Income on Investments	0.9	-58.4	1.9	-177.6	2.8	-803.5	2.8	0.0	1.0	27.2
Other	16.7	-4.6	20.5	27.3	37.2	10.7	37.2	0.0	9.2	2.7
Road Fund	**776.0**	**7.0**	**806.6**	**5.2**	**1,582.6**	**6.1**	**1,582.6**	**0.0**	**384.8**	**-3.3**

NATIONAL ECONOMY

As we enter the third quarter of FY14, the economic fundamentals are expected to continue an ongoing rebalancing toward a stronger pace of economic growth. Real GDP is expected to grow at a rate of 2.7 percent for the upcoming calendar year as compared to the 2.1 percent growth observed in calendar year 2013.

For the first quarter of FY14, there were only two weeks between the release of the second and third estimates of GDP growth from the Commerce Department. The shutdown of the Federal government caused a compression of the release schedule which only added to the surprise of the announced third quarter real GDP growth of an annual rate 4.1 percent in the quarter, up from the estimate two weeks earlier of 3.6 percent. There had been some concern that the increases in measured real GDP had been disproportionately attributable to inventory accumulation. However, the final release indicated that while the increases in inventories were quite large, there were increases to be attributable to final sales growth, as final sales increased from 1.9 percent to 2.6 percent. Final sales are a broad measure of consumer consumption and expenditures and exclude the impact of inventory accumulation. The increases in the third estimate were due to larger increases in personal consumption expenditures and non residential fixed investment.

Consumer spending is expected to remain in the 2.6 percent range in the rest FY14, following a 2.9 percent increase in the first half of FY14. Real disposable income should rise 3.3 percent on a year-over-year basis compared to the slight 0.4 percent rise in 2013. Modest inflation pressures, combined with the absence of major tax policy changes in 2014, should help to support more robust, widespread real disposable income growth.

In the year ahead, employment growth is expected to continue the pace observed in the past year with approximately 170,000 to 190,000 jobs per month, as numerous structural and policy issues continue to hamper growth in the labor market. The largest component of the decline in the unemployment rate comes from a smaller percentage of the working-age population participating in the labor market. The labor participation rate, a measure of the population working or actively seeking work, declined to 62.8 percent in December; this is the lowest labor force participation rate since early 1978.

The housing market recovery should continue in the coming year as residential investment continues to regain its historical role in real GDP growth and spending. Residential construction spending has historically been the largest category of construction spending, but during the recession that position was lost. With the recent GDP data, residential construction has regained the top spot in construction spending but is still 52 percent below the peak level of spending observed in 2006. Home prices will continue to appreciate but at a reduced pace as compared to that observed over the past year. The continued improvement in the fundamentals of the housing market will allow construction activity to continue its upward climb. Nationally, housing starts are expected to increase to 1.4 million-unit pace.

Business equipment expenditures are expected to increase from calendar 2013's modest 3.0 percent gain to around 7.0 percent in 2014. As the economy continues to recover, the focus of business' equipment expenditures are likely to be concentrated in the areas of automobiles and information and technology equipment. Business related, non-residential construction should also see increases as increased demand for distribution centers continues to grow as a response to the decline in utilized retail space. Non-residential construction has increased 33 percent from the lowest levels observed during the recession but is still 28 percent below the peak levels observed in 2008.

Net exports will continue to represent a larger role in supporting economic growth in 2014. Exports are expected to increase by 4.5 percent next year as stronger global demand, along with continued support from the domestic shale gas boom, drives the increased pace of US exports.

The coming calendar year will represent continued improvement in the nation's economic fundamentals. The ongoing risk starting in the third quarter is domestic fiscal policy and global economic uncertainty. On the domestic front, ongoing uncertainty from Washington on the finalization of the federal 2014 budget and the impending clash that could result from the need to raise the nation's borrowing limit provide increased risk of disruptions to business investment and consumer spending. Adding additional discord will be the continued debate on the extension of extended unemployment benefits. Previous extensions have been delayed by as many as eight weeks, but the political will to extend unemployment compensation seems to lacking.

KENTUCKY ECONOMY

Employment in the Commonwealth should show improvement in line with the national employment picture. Growth in non-farm employment is projected to be one percent for the remainder of the fiscal year, and the unemployment rate is expected to continue to fall from the 8.2 percent rate recorded for Kentucky in November. Table 7 shows that service sector job growth is projected to lead the way as Kentuckians' income grows. Employment in manufacturing and construction is also projected to increase in the first quarter of FY15 (Table 8) as Kentucky automobile manufacturers enjoy the rebound in the U.S. market. Employment at all levels of government is expected to increase slightly over FY14.

Table 7 shows that Kentuckians' incomes are projected to grow at 3.7 percent over the next two quarters, not far below the rate of growth for the entire U.S. over the same period. Wages and salaries are forecast to grow 2.7 percent over the remainder of the fiscal year, and Table 8 projects an increased rate of growth in the first quarter of FY15. As income and wages grow, so will personal consumption. The St. Louis Federal Reserve's district office in Louisville reports improvements in Kentuckians' balance sheets and loan quality, indicating that consumption and investment should continue to experience growth in 2014.

Coal production and employment continues to be an area of concern, as illustrated by the projected decrease in coal severance tax revenue. The downward trend is expected to continue as power plants shift toward more natural gas-generated electricity production. As industrial production in the U.S. increases with economic growth, demand for electricity and coal will increase, but not dramatically enough to offset the overall decline in the coal industry, particularly in Eastern Kentucky where unemployment remains markedly elevated. In Western Kentucky, the coal production and employment picture is expected to be much more stable.

Table 7
US and KY Economic Outlook
Second Half of FY14 & FY13

	Q3 & Q4		
	FY14	FY13	% Chg
United States			
Real GDP	16,006.1	15,631.8	2.4
Real Consumption	10,900.3	10,668.0	2.2
Real Investment	2,658.8	2,497.5	6.5
Real Govt. Expenditures	2,906.4	2,906.0	0.0
Real Exports	2,068.9	1,979.5	4.5
Real Imports	2,507.2	2,402.8	4.3
Personal Income ($ billions)	14,618.7	13,995.5	4.5
Wages and Salaries ($ billions)	7,340.4	7,067.7	3.9
Inflation (% chg CPI)	1.3	1.5	NA
Industrial Production Index (% chg)	2.5	2.2	NA
Civilian Labor Force (millions)	157.2	155.5	1.1
Total Non-farm Employment (millions)	137.5	135.4	1.6
Manufacturing Employment (millions)	12.1	12.0	1.2
Unemployment Rate (%)	7.0	7.7	NA
Kentucky			
Personal Income ($ millions)	164,457.7	158,524.5	3.7
Wage & Salary ($ millions)	80,682.0	78,589.0	2.7
Non-farm Employment (thousands)	1,855.9	1,837.5	1.0
Goods Producing (thousands)	315.2	313.2	0.6
Service Providing (thousands)	1,202.8	1,186.6	1.4
Government (thousands)	337.8	337.7	0.0

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 FY14 Q3 and Q4 are November 2013 estimates.
Source: IHS Global Insight Inc., November 18, 2013 data release

Table 8
US and KY Economic Outlook
First Quarter of FY15 & FY14

	Q1		
	FY15	FY14	% Chg
United States			
Real GDP	16,164.8	15,790.1	2.4
Real Consumption	11,017.3	10,732.3	2.7
Real Investment	2,715.0	2,583.1	5.1
Real Govt. Expenditures	2,913.2	2,906.0	0.2
Real Exports	2,107.7	2,020.8	4.3
Real Imports	2,565.2	2,434.0	5.4
Personal Income ($ billions)	14,864.0	14,197.7	4.7
Wages and Salaries ($ billions)	7,472.0	7,135.5	4.7
Inflation (% chg CPI)	1.4	1.6	NA
Industrial Production Index (% chg)	2.7	2.5	NA
Civilian Labor Force (millions)	157.9	155.6	1.5
Total Non-farm Employment (millions)	138.4	136.2	1.6
Manufacturing Employment (millions)	12.3	12.0	2.8
Unemployment Rate (%)	6.9	7.3	NA
Kentucky			
Personal Income ($ millions)	166,729.1	160,114.2	4.1
Wage & Salary ($ millions)	81,685.7	79,110.1	3.3
Non-farm Employment (thousands)	1,864.8	1,842.2	1.2
Goods Producing (thousands)	318.8	311.5	2.3
Service Providing (thousands)	1,207.7	1,193.4	1.2
Government (thousands)	338.3	337.2	0.3

Not Seasonally Adjusted.
Source: IHS Global Insight, Inc. and the Kentucky Governor's Office for Economic Analysis MAK model, November 2013

APPENDIX

KENTUCKY STATE GOVERNMENT - GENERAL FUND REVENUE

	Second Quarter FY 2014	Second Quarter FY 2013	% Chg	Year-To-Date FY 2014	Year-To-Date FY 2013	% Chg
TOTAL GENERAL FUND	$2,438,080,950	$2,455,462,402	-0.7%	$4,712,452,320	$4,656,459,716	1.2%
Tax Receipts	2,340,838,345	2,355,949,216	-0.6%	$4,540,308,446	$4,480,913,957	1.3%
Sales and Gross Receipts	900,219,850	877,917,553	2.5%	$1,826,133,520	$1,784,465,294	2.3%
Beer Consumption	1,569,970	1,515,080	3.6%	3,215,611	3,244,964	-0.9%
Beer Wholesale	14,873,627	13,574,374	9.6%	30,503,617	27,758,586	9.9%
Cigarette	57,852,292	60,932,679	-5.1%	117,173,478	121,531,322	-3.6%
Distilled Spirits Case Sales	31,764	27,866	14.0%	63,174	61,701	2.4%
Distilled Spirits Consumption	2,848,885	3,056,461	-6.8%	5,866,406	6,072,013	-3.4%
Distilled Spirits Wholesale	8,559,652	8,336,866	2.7%	16,659,286	15,767,068	5.7%
Insurance Premium	9,777,066	11,183,040	-12.6%	43,326,674	41,810,028	3.6%
Pari-Mutuel	9,884	906,413	-98.9%	842,097	2,342,161	-64.0%
Race Track Admission	11,722	45,454	-74.2%	105,115	126,070	-16.6%
Sales and Use	779,032,215	751,169,454	3.7%	1,557,141,336	1,511,896,143	3.0%
Wine Consumption	625,357	764,256	-18.2%	1,403,423	1,430,408	-1.9%
Wine Wholesale	3,872,764	4,036,701	-4.1%	7,358,774	7,376,512	-0.2%
Telecommunications Tax	15,860,431	16,906,338	-6.2%	31,843,724	34,005,754	-6.4%
OTP	5,297,528	5,455,400	-2.9%	10,633,052	11,031,335	-3.6%
Floor Stock Tax	(3,307)	7,170	—	(2,246)	11,228	—
License and Privilege	$111,166,911	$131,205,495	-15.3%	$225,946,967	$251,036,466	-10.0%
Alc. Bev. License Suspension	77,073	130,567	-41.0%	163,265	203,933	-19.9%
Coal Severance	52,765,189	56,643,052	-6.8%	104,093,800	121,565,409	-14.4%
Corporation License	147,080	51,259	186.9%	404,718	(443,324)	—
Corporation Organization	12,562	7,511	67.2%	20,777	47,759	-56.5%
Occupational Licenses	26,371	21,245	24.1%	70,606	36,240	94.8%
Oil Production	3,005,711	2,673,264	12.4%	6,458,483	5,224,047	23.6%
Race Track License	40,150	101,711	-60.5%	135,150	196,711	-31.3%
Bank Franchise Tax	1,086,653	3,161,379	-65.6%	2,266,310	2,096,962	8.1%
Driver License Fees	158,917	155,742	2.0%	321,642	325,939	-1.3%
Minerals Severance	4,255,603	4,025,755	5.7%	8,876,584	7,549,343	17.6%
Natural Gas Severance	4,227,670	3,368,636	25.5%	9,191,167	6,117,062	50.3%
Limited Liability Entity	45,363,932	60,865,375	-25.5%	93,944,464	108,116,384	-13.1%
Income	$1,005,247,371	$993,100,069	1.2%	$2,087,219,438	$2,007,925,440	3.9%
Corporation	79,937,486	81,923,572	-2.4%	230,645,842	194,870,310	18.4%
Individual	925,309,885	911,176,497	1.6%	1,856,573,595	1,813,055,129	2.4%
Property	$306,218,252	$331,379,786	-7.6%	$362,031,669	$397,115,829	-8.8%
Building & Loan Association	0	(20,000)	—	5,753	(15,820)	—
General - Real	180,090,664	191,031,804	-5.7%	180,119,270	190,739,386	-5.6%
General - Tangible	92,732,008	101,379,637	-8.5%	121,606,849	129,577,690	-6.2%
Omitted & Delinquent	3,672,123	11,399,430	-67.8%	11,015,249	29,969,945	-63.2%
Public Service	29,122,433	27,074,120	7.6%	44,058,575	46,063,771	-4.4%
Other	601,023	514,794	16.8%	5,225,972	780,857	569.3%
Inheritance	$10,441,893	$11,248,426	-7.2%	$24,076,572	$20,635,653	16.7%
Miscellaneous	$7,544,068	$11,097,888	-32.0%	$14,900,280	$19,735,275	-24.5%
Legal Process	4,171,502	4,752,130	-12.2%	8,105,173	9,979,656	-18.8%
T. V. A. In Lieu Payments	3,372,174	6,345,522	-46.9%	6,794,715	9,755,383	-30.3%
Other	392	236	66.3%	392	236	66.3%
Nontax Receipts	$96,509,590	$98,796,430	-2.3%	$170,906,459	$174,311,268	-2.0%
Departmental Fees	4,568,134	4,213,148	8.4%	8,220,362	10,063,244	-18.3%
PSC Assessment Fee	449,640	2,920	15296.3%	14,699,356	13,076,450	12.4%
Fines & Forfeitures	5,927,654	6,841,086	-13.4%	12,137,638	15,125,932	-19.8%
Income on Investments	(542,436)	167,101	-424.6%	(698,437)	1,342,364	—
Lottery	54,639,743	53,266,568	2.6%	103,139,743	101,766,568	1.3%
Sale of NOx Credits	9,438	21,104	-55.3%	48,438	27,604	75.5%
Miscellaneous	31,457,417	34,284,503	-8.2%	33,359,359	32,909,106	1.4%
Redeposit of State Funds	$733,014	$716,756	2.3%	$1,237,415	$1,234,491	0.2%

KENTUCKY STATE GOVERNMENT - ROAD FUND REVENUE

	Second Quarter FY 2014	Second Quarter FY 2013	% Chg	Year-To-Date FY 2014	Year-To-Date FY 2013	% Chg
TOTAL ROAD FUND	**$378,263,090**	**$366,462,070**	**3.2%**	**$776,002,756**	**$725,163,047**	**7.0%**
Tax Receipts-	**$373,576,629**	**$360,664,478**	**3.6%**	**$764,977,090**	**$712,604,354**	**7.3%**
Sales and Gross Receipts	$329,045,253	$315,591,809	4.3%	$675,049,261	$624,386,781	8.1%
Motor Fuels Taxes	227,743,702	215,631,505	5.6%	458,153,342	$422,775,640	8.4%
Motor Vehicle Usage	101,301,551	99,960,304	1.3%	216,895,919	$201,611,140	7.6%
License and Privilege	**$44,531,377**	**$45,072,669**	**-1.2%**	**$89,927,829**	**$88,217,573**	**1.9%**
Motor Vehicles	18,074,640	17,672,585	2.3%	36,587,472	$35,186,039	4.0%
Motor Vehicle Operators	3,883,631	3,875,368	0.2%	8,122,669	$8,182,723	-0.7%
Weight Distance	19,454,738	18,871,800	3.1%	38,693,064	$37,833,525	2.3%
Truck Decal Fees	4,909	16,524	-70.3%	22,019	$36,414	-39.5%
Other Special Fees	3,113,459	4,636,392	-32.8%	6,502,605	$6,978,873	-6.8%
Nontax Receipts	**$4,377,991**	**$4,777,715**	**-8.4%**	**$9,251,799**	**$9,843,021**	**-6.0%**
Departmental Fees	4,052,150	3,756,001	7.9%	7,695,325	$7,143,560	7.7%
In Lieu of Traffic Fines	122,766	171,368	-28.4%	265,354	$342,948	-22.6%
Income on Investments	83,908	759,298	-88.9%	870,877	$2,090,347	-58.3%
Miscellaneous	119,168	91,047	30.9%	420,242	$266,166	57.9%
Redeposit of State Funds	**$308,469**	**$1,019,877**	**-69.8%**	**$1,773,867**	**$2,715,673**	**-34.7%**