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Mr. Richard A. Stoff
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Dear Mr. Stoff:

At your request, we have conducted an analysis of the statewide revenue and business tax competitiveness impacts under a proposal introduced by Governor Kasich that provides significant individual income tax relief to Ohioans.

The Governor's proposal includes a proportionate, 8.5% reduction in individual income tax rates by tax year 2016 with a top marginal tax rate of 4.88%. The cost of the individual income tax reduction is paid for by an increase in the commercial activities tax (CAT) rate (from 0.26% to 0.3%), increases in cigarette taxes and a new severance tax on horizontal wells. The package requires expenditure reductions of approximately $130 million a year to be balanced.

EY's analysis, which follows this letter of transmittal, provides estimates of the impact of the proposal on the effective tax rates paid by representative business taxpayers in selected industries. The Ohio effective business tax rates, under both current law and the proposal, are compared to effective tax rates in seven competitive states.

Table 1 presents revenue impacts of the proposal for fiscal years 2015, 2016 and 2017.

Table 2 presents estimates of the business effective tax rates for three types of manufacturers and four service industries representative of firms in Ohio's overall economy. In this table, the effective tax rates include state business taxes that are imposed at the entity level on the representative taxpayers. Although the proposal would increase business entity taxes, the increases are not large enough to change Ohio's ranking relative to the comparison states.

Table 3 provides a second set of effective tax rate estimates that add the impact of the 8.5% individual income tax rate reduction to the business entity tax changes, assuming that corporate profits are paid out in dividends to shareholders. The effective tax rates fall, compared to current law, for all industry examples when the impact of the proposed individual income tax cut is included.

Based on the effective tax rates presented in Table 3, our analysis concludes that the combination of business and individual tax changes, including the increase in the CAT tax rate, in the Governor's proposal will result in improved business tax competitiveness in Ohio.

The analysis also looks at the impact of recent and proposed reductions in Ohio's statutory individual income tax rates on the effective state and local income tax rates paid by taxpayers in Ohio since 2012. In addition, the analysis compares Ohio's effective income tax rates to those in Michigan and Indiana, two neighboring competitive states with flat-rate individual income taxes.

The effective tax rate analysis estimates the reduction in individual income tax rates due to Ohio's 10% across-the-board statutory tax rate reductions enacted in 2013. It also evaluates the impact of Governor Kasich's proposal to reduce statutory individual income tax rates by an additional 8.5% by 2016. The analysis does not include any changes in the tax base enacted in 2013 or being proposed by the Governor.

The impacts are reported in Figure 1 as changes in effective tax rates (ETRs), measured as the ratio of individual income taxes to income, by income group. The first four groups each include 20% of the population ("quintiles") ranked by income; the fifth group represents the top 1% of households with the highest incomes.

The analysis shows that the 10% tax rate reductions enacted in 2013, combined with the proposed additional rate reductions, reduce Ohio's relatively high tax rates on middle income taxpayers to a level comparable to Michigan's ETRs and significantly below Indiana's rates. It also shows that Ohio's ETRs are still substantially above the rates in Michigan and Indiana for the top income group.

Very Truly Yours,

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Analysis of Ohio Tax Policy Changes

I. Ohio Tax Policy Option

Description of Proposal

- Individual income tax: across-the-board, tax rate cuts, relative to current law, of 3.5% (5.203% top rate) in TY14, 7.0% (4.960% top rate) in TY15, and 8.5% (top rate of 4.88%) beginning in TY16
- Additional individual income reductions: an expanded personal exemption for taxpayers with Ohio AGI up to $80,000, and a 15% earned income tax credit
- CAT tax: increase rate from 0.26% to 0.3% (+15.4%)
- Cigarette tax rate increase to $1.85 per pack (+ 48% from $1.25 per pack current rate) in two steps of $0.30 per year; other tobacco products wholesale tax rate increases from 17% to 41% in FY15 and 49% in FY16; revenue increase includes collections from a floor tax
- Severance tax: new severance tax on horizontal wells of 2.75% of gross receipts.
- 20% of gross severance tax is distributed to local governments and a portion of the new tax is dedicated to the DNR for regulatory costs.
- The tax proposal reduces annual state revenue between $23 and $91 million annually. It also earmarks a portion of the new severance tax revenue for additional expenditures. As a result, total spending will have to be reduced by $125 to $132 million annually over the three fiscal years for the package to be balanced.

Key Assumptions

- The severance tax raises $163 million per 1% by FY17.
- The CAT tax raises $278 million in FY17.
- The cigarette tax rate increase raises $231 million by FY17. The increase in the wholesale tax on other tobacco products raises an additional $79 million. Among neighboring states, at $1.85 per pack, the increase would put Ohio second highest after Michigan (at $2.00 per pack).

Table 1: Static Revenue Estimates for Ohio Tax Reform Proposal ($millions)

	Proposal (millions)		
Tax Components	**FY15**	**FY16**	**FY17**
Individual income tax			
reduce rates 3.5%, 7.0% and 8.5% over 3 yrs.; top tax rate of 4.88%	($461)	($816)	($909)
earned income tax credit (15%)	($40)	($40)	($40)
personal exemption increase	($111)	($111)	($111)
Total individual income tax change	($612)	($967)	($1,060)
CAT			
rate increase to .003 (+15.4%)	$196	$269	$278
Cigarette tax increase			
2-yr. ($0.30/yr.) increase to $1.85/pack; wholesale tobacco products tax rate of 49%	$204	$334	$310
New gross severance tax (gross receipts base)			
rate of 2.75%	$121	$304	$449
Net revenue change	**($91)**	**($60)**	**($23)**
Spending changes			
earmarked severance taxes: 20% to local governments + DNR	($37)	($72)	($102)
expenditure reduction needed to balance package	$128	$132	$125
Net impact	**$0**	**$0**	**$0**

Note: Tax changes assumed to be effective on July 1, 2014. Revenue impacts are based on Ohio Office of Budget and Management estimates.

Table 2: Estimated Effective State Tax Rate Impacts of Proposal, Entity Taxes Only

Consumer products		**Advanced manufacturing**		**Motor vehicle parts manufacturing**		**Market research**		**Computer systems design**		**Headquarters**		**Drug wholesale**	
State	ETR	State	ETR	State	ETR	State	ETR	State	ETR	State	ETR	State	ETR
TN	4.4	TN	5.9	TN	6.5	TN	12.6	TN	11.4	TN	7.7	TN	6.7
KY	3.3	KY	4.4	KY	5.3	IN	10.4	KY	8.8	KY	5.0	KY	5.4
GA	1.1	SC	2.3	SC	3.8	KY	10.0	IN	8.1	PA	4.3	PA	5.2
SC	1.1	GA	2.2	GA	3.2	PA	9.7	PA	7.6	IN	3.7	IN	4.2
PA	1.1	**OH Prop.**	**2.0**	**OH Prop.**	**3.1**	SC	8.6	**OH Prop.**	**7.1**	SC	2.7	MI	3.7
IN	1.0	**OH CL**	**2.0**	**OH CL**	**3.0**	MI	8.4	**OH CL**	**7.0**	MI	2.7	SC	3.6
MI	1.0	MI	1.9	MI	2.8	**OH Prop.**	**8.3**	SC	6.9	GA	2.4	**OH Prop**	**3.5**
OH Prop.	**1.0**	PA	1.6	PA	2.5	**OH CL**	**8.2**	MI	6.7	**OH Prop.**	**2.0**	**OH CL**	**3.4**
OH CL	**0.9**	IN	1.4	IN	2.5	GA	6.9	GA	5.8	**OH CL**	**2.0**	GA	2.8

Notes:
Calculations are for C corporations. State business taxes include sales taxes on business inputs, CAT and corporate income taxes. CAT tax calculations assume that in-state sales are between 5% and 20% of total sales, depending upon the industry.

The effective tax rates measure the reduction in before-tax income due to state taxes. The taxes are calculated from tax base estimates derived from income and balance sheet financial information for each representative taxpayer. The tax liabilities are estimated over a 30-year period. Because the same financial profiles are used in calculating each state's tax liabilities for the representative taxpayers, the differences in effective tax rates measure only the difference in each state's tax system, including the definition of tax bases and statutory tax rates.

Table 3: Estimated Effective State Tax Rate Impacts of Proposal, Including Individual Income Tax Reductions

Consumer products		**Advanced manufacturing**		**Motor vehicle parts manufacturing**		**Market research**		**Computer systems design**		**Headquarters**		**Drug wholesale**	
State	ETR	State	ETR	State	ETR	State	ETR	State	ETR	State	ETR	State	ETR
TN	9.5	TN	11.0	TN	11.4	TN	17.8	TN	16.8	TN	13.7	TN	12.0
KY	8.5	KY	9.5	KY	10.2	KY	15.3	KY	14.1	KY	10.9	KY	10.7
SC	7.1	SC	8.2	SC	9.4	SC	14.6	SC	13.1	SC	9.5	SC	9.7
GA	6.3	GA	7.3	GA	8.1	IN	13.3	**OH CL**	**11.7**	GA	8.2	**OH CL**	**8.1**
OH CL	**5.5**	**OH CL**	**6.6**	**OH CL**	**7.4**	**OH CL**	**12.9**	**OH Prop.**	**11.4**	PA	7.2	GA	8.0
OH Prop.	**5.1**	**OH Prop.**	**6.2**	**OH Prop.**	**7.0**	**OH Prop.**	**12.6**	GA	11.1	**OH CL**	**7.1**	PA	7.8
MI	4.6	MI	5.5	MI	6.2	PA	12.3	IN	11.1	IN	6.9	**OH Prop.**	**7.8**
IN	3.9	IN	4.3	IN	5.2	MI	12.1	MI	10.4	MI	6.8	MI	7.4
PA	3.7	PA	4.3	PA	5.0	GA	12.1	PA	10.3	**OH Prop.**	**6.7**	IN	7.1

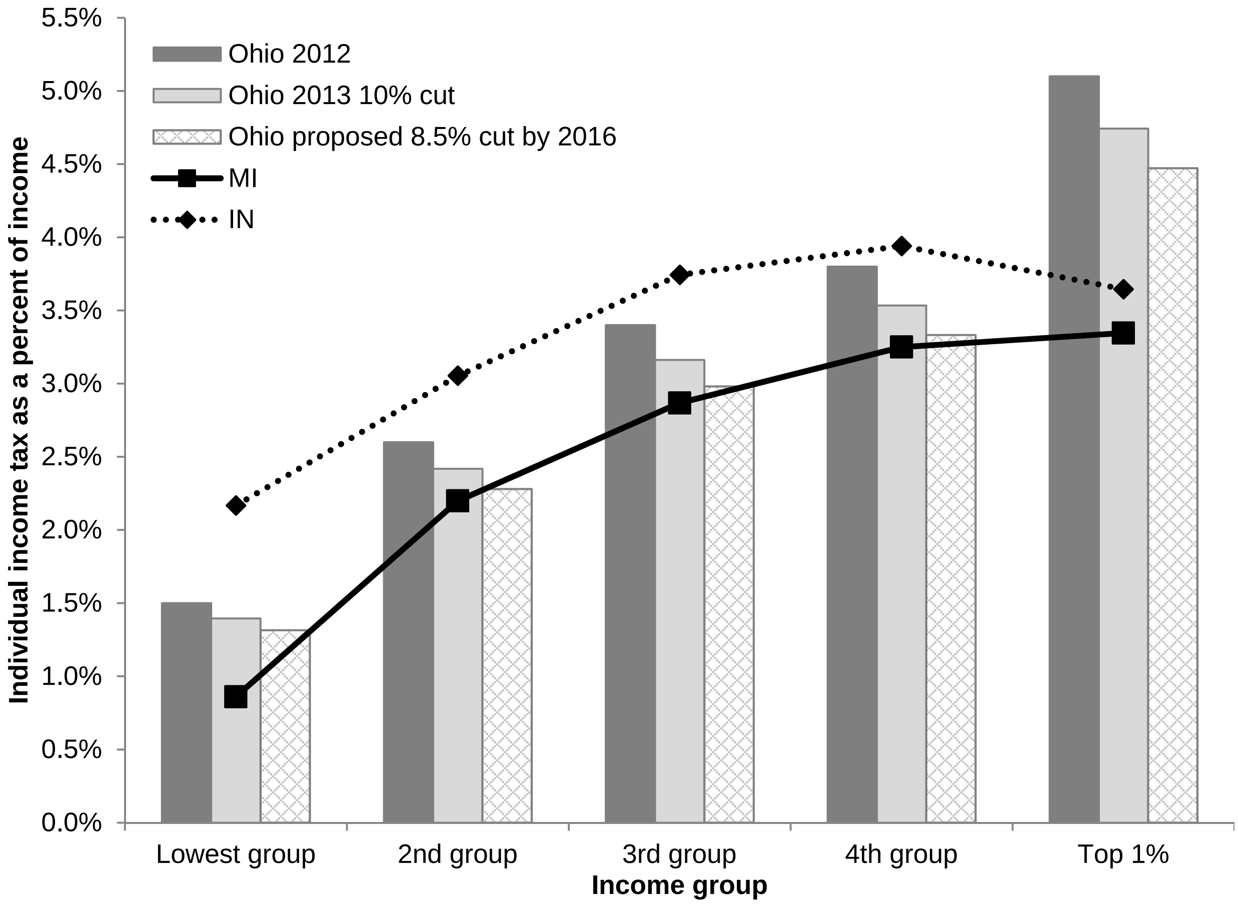
Note:
Calculations are for C corporations. The ETRs include individual income taxes on income distributed as dividends to shareholders.
CAT tax calculations assume that in-state sales are between 5% and 20% of total sales, depending upon the industry.

The effective tax rates measure the reduction in before-tax income due to state taxes. The taxes are calculated from tax base estimates derived from income and balance sheet financial information for each representative taxpayer. The tax liabilities are estimated over a 30-year period. Because the same financial profiles are used in calculating each state's tax liabilities for the representative taxpayers, the differences in effective tax rates measure only the difference in each state's tax system, including the definition of tax bases and statutory tax rates.

II. Comparison of Ohio Individual Income Effective Tax Rates

Ohio Governor Kasich is proposing an 8.5% across-the-board cut in individual income tax rates. This cut is in addition to the 10% across-the-board rate cut enacted in 2013. The cumulative rate cuts (almost 18% compared to the 2012 tax rates) would significantly improve Ohio's individual income tax competitiveness compared to Indiana and Michigan. Figure 1 summarizes the recent and proposed changes in Ohio effective individual income tax rates (ETRs) by income level and compares ETRs for Ohio, Michigan and Indiana.[1]

Figure 1: Effective tax rate comparisons: Ohio vs. Michigan and Indiana, current law and proposed rates



Note: The first income group (quintile with 20% of population) has incomes up to $17,000; incomes in the 2nd group range from $17,000 to $31,000, incomes in the 3rd group range from $31,000 to $49,000; incomes in the 4th group range from $49,000 to $76,000. The final group is the 1% of the population with the highest incomes that begin at $324,000.

[1] The ETR calculations begin with the ETRs for each state calculated by the Institution on Taxation & Economic Policy (ITEP), *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (January 2013). The Ohio ETRs are presented for 1) the tax system in place in 2012, 2) the 10% rate reduction enacted in 2013, and 3) the Governor's proposed additional 8.5% tax rate cut. The Ohio ETRs are calculated by reducing the ITEP ETRs by the fully phased-in percentage state tax rate reductions enacted in 2013 and proposed by the Governor. The calculations apply the percentage tax reductions to the state portion of ITEP's combined state and local income tax ETRs.

Figure 1 highlights the following:

- The left-hand bar for Ohio (the 2012 ETRs before the 2013 state tax rate cuts) shows that Ohio's individual income tax rates were slightly below the Indiana tax rates for middle income groups, but above the Michigan tax rates for the similar households.[2] The middle Ohio bar shows that the across-the-board 10% tax cut in 2013 reduced Ohio's ETRs for middle income groups to be within 10% of Michigan's ETRs.

- The proposed 8.5% rate reduction (the right-hand bar) would further reduce Ohio ETRs for middle income households (2nd, 3rd and 4th income groups) to be comparable to Michigan's ETRs. For these households, Ohio's proposed tax rates would be from 15% to 25% below Indiana's ETRs.

- The ETRs in Figure 1 also show that the cumulative reductions in Ohio ETRs imposed on the top 1% of households (ranked by income) is not sufficient to reduce Ohio's ETRs to a competitive level with either state.[3] The proposed Ohio ETRs for the highest income group is still 25% to 35% above the ETRs in Indiana and Michigan.

- The ETRs in Figure 1 show the changes in ETRs due to current law and proposed changes in statutory tax rates. The calculations do not include any changes in the tax base, such as the increase in personal exemptions for low- and middle-income taxpayers and the expansion of the Ohio earned income tax credit included in the Governor's proposal. These changes will reduce the ETRs for the lowest income groups relative to the income taxes in Indiana and Michigan. The ETR calculations do not include any tax base changes enacted in 2013.

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[2] The individual income tax ETRs include both state and local income taxes and are estimated for non-elderly singles and families.

[3] The ITEP study does not present a single ETR for households in the top income quintile. The ITEP study reports ETRs for three segments of the top quintile of households: the top 15%, top 4% and top 1%. Because Ohio's effective individual income tax rates continue to increase as incomes increase in these three income groups, Figure 1 reports the ETRs for the top 1% group.