S.C.'s actual income tax rates much lower than portrayed

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Gov. Nikki Haley is demanding that legislators cut personal income taxes to make South Carolina more competitive with neighboring states. But South Carolinians already pay less in income taxes than their counterparts in North Carolina and Georgia, as well as most other states that collect the tax.

"Our state's 7 percent income tax rate stands out and puts us at a disadvantage. In order to keep the ball rolling in our economy, we must bring down our income tax," Haley said in her State of the State address.

Lawmakers who agree with Haley point to that 7 percent top rate as the highest in the Southeast. However, South Carolina's effective rate – what people actually pay – averages just under 3 percent, ranking 10th lowest nationwide among the 41 states that tax wages, according to the state's Revenue and Fiscal Affairs Office.

That's largely due to South Carolina, unlike most states, basing tax collections on "federal taxable income," meaning the state taxes only what's left after home mortgage interest, property taxes and various other deductions and personal exemptions are subtracted. Add to that South Carolina's generous tax breaks, which rank among the highest nationwide.

Using an example of a married couple with two children filing jointly, South Carolina's high standard deductions and a zero-percent bottom tax bracket exempt about $31,000 of their income from state taxes.

"It's a myth that we don't compare favorably with other states," said Sen. Vincent Sheheen, D-Kershaw.

Sen. Tom Davis, R-Beaufort, agrees. He plans to work with Sheheen on a bill that would better align South Carolina's advertised to actual tax rates.

Since his time as Gov. Mark Sanford's chief of staff, Davis has argued the 7 percent rate deters investment and entrepreneurial activity in the state. He recently realized, he said Thursday, that

South Carolina's top rate would be 4.5 percent if the state taxed "adjusted gross income" as most states do, including neighboring North Carolina and Georgia.

"There are lots of things that benefit South Carolinians that aren't readily apparent, unless you look under the hood," he said. "It's a huge issue. One of our competitive advantages is masked, and we really ought to be about getting that fixed."

Such a fix will be difficult, as any adjustment would create tax winners and losers. Davis wants to study who those would be.

South Carolina is not alone in having its tax code's "sticker prices" being "out of whack with what people pay," said Scott Drenkard, an economist with the nonpartisan Tax Foundation.

However, while the effective rate is what matters to taxpayers' pocketbook, the statutory rates matter in decision-making and can distort behavior, Drenkard said.

That's partly because studies that compare states' business climates look at top tax brackets, said Norton Francis, a senior research associate at the Urban Institute.

The Tax Foundation, for example, ranks South Carolina's income tax rates as 41st out of 50 nationwide, causing its overall tax system to rank 37th. That's despite the same group ranking South Carolina's overall tax burden, combining all state and local taxes, as eighth-lowest nationwide.

Haley spokeswoman Chaney Adams said Friday that while the Republican governor is fighting for a competitive position among states, that's not the only reason she's pushing for income tax cuts.

"We are fighting for it because revenues have grown, and we don't want state spending to just keep growing with it," Adams said. "As she has every year, Gov. Haley has proposed a plan that would put money back in the pockets of taxpayers where it belongs."

Haley has tied tax cuts to road funding, saying she'll allow a 10-cent hike in the gas tax only if the Legislature also cuts income taxes by 2 percentage points over 10 years, bringing down the top rate to 5 percent. That would reduce revenue to the state by $1.8 billion annually when fully implemented, according to the economic board.

Legislators of both parties have balked at her insistence that only economic growth would be impacted.

In an effort to either avoid Haley's veto or gather enough support to override it, Senate Republicans earlier this month proposed meeting her about halfway. Their plan would cut income taxes by $700 million annually when fully implemented in five years, reducing the top rate to 6 percent.

But it's unclear whether the Senate will even get a chance to vote on it before the regular session ends Thursday.

PERCEPTION VERSUS REALITY

South Carolina's effective income tax rates are much lower than what the tax code suggests. The state's top marginal rate is 7 percent, compared to Georgia's 6 percent and North Carolina's 5.8 percent. But here's a closer look at how South Carolina's tax breaks affect how much people actually pay.

Using the example of a married couple with two children, filing jointly, here's what they paid for 2014 in state income taxes, applying only standard deductions and personal exemptions to different income levels:*

- **On $50,000,** they paid $483 in South Carolina, $1,756 in Georgia and $2,030 in North Carolina.
- **On $75,000,** they paid $2,233 in South Carolina, $3,256 in Georgia and $3,480 in North Carolina.
- **On $100,000,** they paid $3,983 in South Carolina, $4,756 in Georgia and $4,930 in North Carolina.
- **On $150,000,** they paid $7,483 in South Carolina, $7,756 in Georgia and $7,830 in North Carolina.

* Tax credits could further reduce taxes. Taxpayers who itemize could pay less in all three states, though North Carolina's 2013 tax reform law limited itemizations on charitable donations, mortgage interest and property taxes.

SOURCE: Senate Finance Committee staff

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