No. 86
February 7, 1996

The Flat Tax Cuts Individual Income Taxes in Every State

William W. Beach
Visiting Fellow in
Tax Analaysis

Daniel J. Mitchell
McKenna Senior Fellow in
Political Economy

With support from many presidential candidates and a ringing endorsement from the National Commission on Economic Growth and Tax Reform, the idea of a flat tax has captured the imagination of long-suffering taxpayers. This support should come as no surprise. The current system, which penalizes work, saving, investment, and entrepreneurship, imposes nearly $200 billion of compliance costs on the economy and corrupts the political process. By contrast, a flat tax would spur growth while treating taxpayers equally. Moreover, a properly designed flat tax also would provide much-needed tax relief. As Table 1 indicates, the benefits of the flat tax to individual taxpayers would be considerable.

The table compares how individual income taxpayers will fare if the current system is replaced by a 17 percent flat tax.[1] Such a reform proposal would tax individual wage and salary income at a 17 percent rate and would apply the same rate, at the business level, to all interest earnings,

Table 1

States that Benefit Most from a 17% Flat Tax

Average Per Household Dollar Savings		Federal Tax Savings for All Taxpayers (In Billions)		% Reduction in Average Household Tax Bill	
Connecticut	$1,856	New York	$9.81	South Dakota	38.28%
New Jersey	1,521	Texas	8.03	North Dakota	32.63%
Illinois	1,511	Illinois	8.00	Indiana	30.78%
North Dakota	1,506	Florida	7.98	Florida	30.16%
Virginia	1,463	Ohio	6.58	Rhode Island	30.02%
Indiana	1,415	Pennsylvania	6.08	Missouri	29.45%
Rhode Island	1,406	Michigan	5.77	Ohio	28.92%
Washington	1,385	New Jersey	5.63	Iowa	28.86%
Michigan	1,372	California	5.30	Maine	28.85%
Florida	1,335	Virginia	4.09	Illinois	28.81%

Note: Tax payments are for tax year ending December 31, 1994.
Source: IRS, Heritage calculations.

---

[1] In creating these estimates, Heritage used the fully implemented flat tax proposal of Representative Richard Armey (R-TX) and Senator Richard Shelby (R-AL), H.R. 2060 and S. 1050, respectively.

dividends, capital gains, and other non-labor income.[2]

Besides the rates and deductions, the biggest difference between the flat tax and today's code is the way the flat tax treats income from savings, equities, appreciated capital assets, and estates. Flat tax proposals based on the Hall-Rabushka model, such as the Armey-Shelby bill, do not double-tax savings or estate income, since the principal used to create such income streams already has been taxed and, in the case of interest income, reflects in part the level of taxes paid by financial institutions. Dividends and capital gains also are not taxed at the individual level, because taxes are paid at the business level on the income that creates dividends and produces appreciation in the value of capital assets.

Table 1 shows, for example, that Connecticut's per household tax liability drops by $1,856 under a flat tax of 17 percent. The 17 percent flat tax saves New Yorkers filing individual income tax returns almost $10 billion, and the average individual tax bill in South Dakota falls by 38 percent. Appendices 1 and 2 present average and total tax savings for all 50 states and the District of Columbia. It is important to note that these tables reveal only that average tax liabilities and the total tax bill will be reduced under a flat tax of 17 percent, not that all taxpayers will see their taxes reduced.

Some critics of the flat tax have complained that it is not possible to reduce everyone's taxes and still have a tax system that produces about the same amount of federal revenue as the current one does. They are right, of course. Generally, lower taxes on individuals are made possible by two factors. The many proposals based on the Hall-Rabushka model,[3] for example, would cause a shift in the tax burden to corporations. These higher taxes, needless to say, ultimately are borne by individual workers, consumers, and shareholders, but the actual payment of the tax takes place at the corporate level.[4] The second reason individuals will enjoy dramatically lower tax payments is that sponsors of the legislation want to reduce the amount of money the government takes out of the private sector. Cutting federal spending over a seven-year period, for example, would enable Congress to reduce tax rates. The flat tax, in other words, is designed both to cut taxes and to reform the system to make it fair. To avoid higher deficits, the lower level of revenue collections would be offset by spending savings and the additional revenues generated by stronger economic growth.

WHAT IS THE FLAT TAX?[5]

The flat tax would repeal the current income tax code and replace it with a system based on the following principles:

❶ Tax all income with no deductions except a generous allowance based on family size. Today's complex system could be replaced by two simple, postcard-sized forms, one for business and one for individuals.

❷ Tax all income at one rate, applying the law equally to all taxpayers. A taxpayer with ten times the taxable income of his neighbor would pay ten times as much in taxes.

---

2   The Armey-Shelby proposal begins with a 20 percent tax rate for individuals and businesses, which drops to a 17 percent rate after two years. Each taxpayer in a household receives a standard deduction of $10,700, and each dependent receives a $5,000 deduction. The standard deduction for heads of households is set at $14,000.

3   See Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, California: Hoover Institution Press, 1995).

4   The next Heritage Foundation paper in this series on tax reform will analyze the incidence of tax change by income group stemming from replacement of the current multi-rate tax system with the Armey-Shelby flat tax proposal.

5   The Heritage Foundation has published a number of papers on tax reform and on the flat tax specifically. See, for example, Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs A Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995, and Daniel J. Mitchell, "Which Tax Reform Plan is Best for America?," Heritage Foundation *Backgrounder* No. 1055, September 26, 1995.

❸ Tax all income just once, ending the bias against savings and investment. Capital income would be taxed on the business form to ensure compliance, and labor income would be taxed on the individual form.

With so much interest in replacing today's unfair tax code with a system that rewards productive behavior, ends special-interest lobbying, and forces everyone to play by the same rules, policymakers and other interested parties have been clamoring for more details about the impact of this proposed reform. The state-by-state figures demonstrate the amount of tax relief individual taxpayers will realize if the 17 percent flat tax proposed in the Armey-Shelby bill for the 1994 tax year is enacted into law.

A Note on Technical Matters

The "current" tax liabilities in Appendix 1 include all of the kinds of taxable income that individuals now report on their annual 1040 tax form. Individuals currently report their labor income (for example, wages and salaries) as well as business income from self-employment, trusts, partnerships, farming operations, and other business activities. However, the more prominent flat tax proposals make an important change in the way small business income is reported. Proposals similar to the Armey-Shelby bill separate labor income from business income and allow businesses to deduct from their gross income the costs of operations, the value of land and capital structures purchased during the year, and the wages and salaries paid to their employees.

This separation of labor from business income makes comparing the current tax system to a flat tax system difficult. In order to compare current taxes fairly with those collected under a flat tax, we added together the flat taxes individuals would pay on their labor income and on their small business income. This combination is reported in the flat tax columns of Appendices 1 and 2. Thus, both sets of numbers include taxes paid on labor and business income.

The data shown in Table 1 and Appendices 1 and 2 are based on income tax records contained on the I.R.S. Public Use File for 1991, a statistically accurate sample of all individual income tax returns for that year. The file contains 155,000 taxpaying households and 178 tax variables per household. When a variable is multiplied by its weight, the value of the variable equals its national total. Thus, the value of wage and salary income for a family earning $35,000 equals the national total for families in that income class when it is multiplied by its national weight. These are the same data the IRS's own Statistics of Income Division uses when preparing its annual analysis of taxpayers. They are the most accurate and complete tax data available for public use, and the data for tax year 1991 are the most current data available.

Heritage adjusted the state-by-state estimates of current and flat tax liabilities drawn from the I.R.S. Public Use File for 1991 by multiplying these estimates by the total change in the CPI-U between December 1991 and December 1994. Adjusting our 1991 estimates by the CPI-U produced 1994 estimates that were within 0.6 percent of actual collections. We chose December 1994 rather than December 1995 as our terminal point because estimates for annual federal revenue collected through the income tax are not particularly sound until June of the next year. It also is worth noting that the Public Use File for 1994 is not yet available.

Comparison of Average Household Tax Payments by State under Current Tax Law and a Flat Tax of 17% and 20%

	Current Average Tax Payments	Flat Tax at 17% Average Tax Payments	Dollar Difference	Percent Change	Flat Tax at 20% Average Tax Payments	Dollar Difference	Percent Change
Alabama	$3,858	$2,861	-$997	-25.83%	$3,366	-$492	-12.74%
Alaska	5,306	4,242	-1,064	-20.05%	4,990	-315	-5.94%
Arizona	4,398	3,491	-907	-20.63%	4,107	-291	-6.62%
Arkansas	3,563	2,660	-904	-25.36%	3,129	-434	-12.19%
California	4,901	4,520	-381	-7.77%	5,318	+417	+8.51%
Colorado	5,106	3,829	-1,277	-25.00%	4,505	-601	-11.77%
Connecticut	6,666	4,810	-1,856	-27.84%	5,659	-1,007	-15.11%
Delaware	5,259	3,969	-1,290	-24.53%	4,669	-590	-11.21%
DC	5,967	4,116	-1,852	-31.03%	4,842	-1,125	-18.86%
Florida	4,427	3,092	-1,335	-30.16%	3,638	-790	-17.84%
Georgia	4,435	3,453	-982	-22.14%	4,063	-373	-8.40%
Hawaii	4,899	3,786	-1,113	-22.72%	4,454	-445	-9.08%
Idaho	3,511	2,617	-893	-25.44%	3,079	-431	-12.29%
Illinois	5,246	3,735	-1,511	-28.81%	4,394	-852	-16.24%
Indiana	4,597	3,182	-1,415	-30.78%	3,744	-853	-18.56%
Iowa	3,856	2,743	-1,113	-28.86%	3,227	-629	-16.30%
Kansas	4,726	3,396	-1,331	-28.15%	3,995	-731	-15.47%
Kentucky	3,752	2,674	-1,078	-28.73%	3,146	-606	-16.15%
Louisiana	4,107	3,140	-966	-23.53%	3,695	-412	-10.04%
Maine	3,453	2,457	-996	-28.85%	2,890	-563	-16.29%
Maryland	5,867	4,605	-1,263	-21.53%	5,417	-450	-7.68%
Massachusetts	5,626	4,365	-1,261	-22.42%	5,135	-491	-8.73%
Michigan	4,996	3,623	-1,372	-27.47%	4,263	-733	-14.67%
Minnesota	4,725	3,673	-1,052	-22.26%	4,321	-404	-8.54%
Mississippi	3,210	2,484	-726	-22.61%	2,923	-288	-8.96%
Missouri	4,231	2,985	-1,246	-29.45%	3,512	-720	-17.00%
Montana	3,180	2,711	-469	-14.75%	3,190	+9	+0.29%
Nebraska	4,345	3,214	-1,131	-26.03%	3,781	-564	-12.98%
Nevada	4,927	3,693	-1,234	-25.04%	4,345	-582	-11.81%
New Hampshire	4,983	3,929	-1,054	-21.15%	4,623	-360	-7.23%
New Jersey	6,215	4,694	-1,521	-24.47%	5,523	-692	-11.14%
New Mexico	3,437	2,694	-743	-21.61%	3,170	-267	-7.78%
New York	5,576	4,279	-1,298	-23.27%	5,034	-543	-9.73%
North Carolina	3,901	2,961	-941	-24.11%	3,483	-418	-10.72%
North Dakota	4,614	3,109	-1,506	-32.63%	3,657	-957	-20.74%
Ohio	4,529	3,219	-1,310	-28.92%	3,787	-742	-16.38%
Oklahoma	3,923	3,324	-599	-15.26%	3,911	-12	-0.30%
Oregon	4,343	3,385	-959	-22.07%	3,982	-361	-8.32%
Pennsylvania	4,625	3,517	-1,108	-23.97%	4,137	-488	-10.55%
Rhode Island	4,684	3,278	-1,406	-30.02%	3,856	-828	-17.67%
South Carolina	3,532	2,720	-813	-23.00%	3,200	-333	-9.42%
South Dakota	3,422	2,112	-1,310	-38.28%	2,485	-937	-27.39%
Tennessee	4,049	2,997	-1,052	-25.99%	3,526	-524	-12.93%
Texas	4,585	3,514	-1,071	-23.36%	4,134	-451	-9.84%
Utah	4,270	3,178	-1,092	-25.58%	3,739	-531	-12.45%
Vermont	4,762	3,971	-791	-16.61%	4,672	-90	-1.90%
Virginia	5,559	4,096	-1,463	-26.32%	4,819	-740	-13.31%
Washington	5,618	4,233	-1,385	-24.65%	4,980	-638	-11.36%
West Virginia	3,680	2,684	-997	-27.08%	3,157	-523	-14.21%
Wisconsin	4,308	3,181	-1,127	-26.16%	3,742	-566	-13.13%
Wyoming	3,711	3,070	-642	-17.29%	3,611	-100	-2.70%
Total	$4,539	$3,417	-$1,122	-24.71%	$4,020	-$519	-11.43%

Note: Totals may not add up due to rounding.
Source: Internal Revenue Service Public Use File for 1991. All values adjusted to 1994 levels.

Comparison of Total Tax Payments by State under Current Tax Law and under a Flat Tax of 17% and 20%, in Billions of Dollars

	Current Total Tax Payments	Flat Tax at 17% Total Tax Payments	Total Tax Savings with Flat Tax at 17%	Flat Tax at 20% Total Tax Payments	Total Tax Savings with Flat Tax at 20%
Alabama	$6.84	$5.08	$1.77	$5.97	$0.87
Alaska	$1.49	$1.19	$0.30	$1.41	$0.09
Arizona	$6.97	$5.53	$1.44	$6.51	$0.46
Arkansas	$3.37	$2.52	$0.86	$2.96	$0.41
California	$68.20	$62.90	$5.30	$74.00	-$5.80
Colorado	$8.54	$6.40	$2.13	$7.53	$1.00
Connecticut	$10.88	$7.85	$3.03	$9.23	$1.64
Delaware	$1.73	$1.31	$0.43	$1.54	$0.19
DC	$2.03	$1.40	$0.63	$1.65	$0.38
Florida	$26.44	$18.47	$7.98	$21.72	$4.72
Georgia	$12.73	$9.91	$2.82	$11.66	$1.07
Hawaii	$2.79	$2.15	$0.63	$2.53	$0.25
Idaho	$1.49	$1.11	$0.38	$1.31	$0.18
Illinois	$27.76	$19.76	$8.00	$23.25	$4.51
Indiana	$11.51	$7.97	$3.54	$9.37	$2.14
Iowa	$5.73	$4.07	$1.65	$4.79	$0.93
Kansas	$5.05	$3.63	$1.42	$4.27	$0.78
Kentucky	$6.14	$4.37	$1.76	$5.15	$0.99
Louisiana	$6.89	$5.27	$1.62	$6.20	$0.69
Maine	$1.96	$1.39	$0.56	$1.64	$0.32
Maryland	$14.38	$11.29	$3.10	$13.28	$1.10
Massachusetts	$15.10	$11.71	$3.39	$13.78	$1.32
Michigan	$21.00	$15.23	$5.77	$17.92	$3.08
Minnesota	$10.03	$7.80	$2.23	$9.18	$0.86
Mississippi	$2.94	$2.28	$0.67	$2.68	$0.26
Missouri	$9.74	$6.87	$2.87	$8.09	$1.66
Montana	$1.06	$0.91	$0.16	$1.07	-$0.01
Nebraska	$2.97	$2.20	$0.77	$2.58	$0.39
Nevada	$3.02	$2.26	$0.76	$2.66	$0.36
New Hampshire	$2.83	$2.23	$0.60	$2.62	$0.20
New Jersey	$23.00	$17.37	$5.63	$20.44	$2.56
New Mexico	$2.47	$1.93	$0.53	$2.27	$0.19
New York	$42.16	$32.35	$9.81	$38.06	$4.10
North Carolina	$11.97	$9.09	$2.89	$10.69	$1.28
North Dakota	$1.24	$0.83	$0.40	$0.98	$0.26
Ohio	$22.75	$16.17	$6.58	$19.02	$3.73
Oklahoma	$4.91	$4.16	$0.75	$4.90	$0.01
Oregon	$5.77	$4.50	$1.27	$5.29	$0.48
Pennsylvania	$25.35	$19.28	$6.08	$22.68	$2.67
Rhode Island	$2.14	$1.50	$0.64	$1.76	$0.38
South Carolina	$5.78	$4.45	$1.33	$5.23	$0.54
South Dakota	$1.17	$0.72	$0.45	$0.85	$0.32
Tennessee	$9.10	$6.73	$2.37	$7.92	$1.18
Texas	$34.39	$26.35	$8.03	$31.00	$3.38
Utah	$2.79	$2.08	$0.71	$2.44	$0.35
Vermont	$1.28	$1.07	$0.21	$1.26	$0.02
Virginia	$15.55	$11.46	$4.09	$13.48	$2.07
Washington	$12.98	$9.78	$3.20	$11.50	$1.47
West Virginia	$2.56	$1.86	$0.69	$2.19	$0.36
Wisconsin	$9.96	$7.35	$2.60	$8.65	$1.31
Wyoming	$0.91	$0.75	$0.16	$0.89	$0.02
Total	$539.84	$414.86	$124.98	$488.07	$51.77

Note: Totals may not add up due to rounding. Negative "Tax Savings" means an increase in tax payments.
Source: Internal Revenue Service Public Use File for 1991. All values adjusted to 1994 levels.