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Bigger Pie, Bigger Pieces
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WASHINGTON -- The president's plan to end the double taxation of corporate income would have far-reaching effects on the American economy. The most obvious benefits will accrue to those who will no longer be taxed on their dividend income, as long as taxes were paid on this income at the corporate level. Opponents of the plan contend that it unfairly favors these recipients, but in reality, the plan lowers the effective tax burden on all Americans, even those who have yet to receive a penny of dividend income.

Understanding why ending double taxation of corporate income will help all Americans starts with a simple fact: You can still bear the burden of a tax even if you do not write the check to the IRS. Consider the Social Security tax: Up to an earnings limit, workers and employers both pay 6.2% of their income to the Social Security trust fund for a total of 12.4%. On paper, half of the burden of the tax is borne by the worker. In reality, all of it is. The 6.2% of wages that firms pay to the government has to come from somewhere, and economists agree that it comes from workers in the form of lower wages.

The shifting of the capital-tax burden onto workers also involves lower wages, but the chain of reasoning is more subtle. Consider an economy in which workers own no capital and spend all of what they get each month. Savers do not work and live off the capital income from their past investments. These investments finance the machines, computers, factories, and office buildings used by workers.

The decisions of the capitalists/savers will have a large impact on workers' standards of living. If capitalists save less, for example, then investment falls. Worn-out machines are not replaced, and the capital stock shrinks. As workers are left with fewer machines, they become less productive. Their wages and standards of living decline.

It may not seem fair that workers' standards of living fall because of the decisions of the savers. But the opposite is also true: Workers benefit when savers decide to consume less now and save more instead. One way to get the savers to save more is to raise the reward for doing so, and this is where ending the double taxation of corporate income comes in.

Having two layers of tax on corporate income, rather than just one, raises the effective tax rate on capital income. The high capital tax reduces the after-tax return to saving below the before-tax return, which is simply the productivity of capital in the marketplace. Reducing the capital tax raises the after-tax return to saving, encouraging capitalists to plow back more of their income into the economy by saving and investing more.

As the capital stock increases, the productivity of workers rises, and so do their wages. The higher level of capital in the economy reduces the productivity of each additional unit of capital, because the larger capital stock means that each unit of capital has fewer workers to work with. Putting the pieces together suggests that the after-tax rate of return on capital rises after the cut in the capital tax, then falls back as the capital stock grows. The process concludes when the after-tax return has fallen all the way back to its original level, which is determined by the underlying patience levels of the savers.

Moreover, the relationship linking investment, capital, and wages implies that workers are better off if capital is not taxed at all, even though this means that workers must pay taxes on their labor income to fund the government. To see why, think of the economy as one big pie that is split between workers, savers, and the government. Think of the slice corresponding to the government as fixed in size. The

savers' slice will equal the after-tax return on each unit of capital times the size of the capital stock. By definition, the part of the pie that is left over goes to workers as after-tax wages.

Critics charge that the president's proposals are intended to increase the share of the pie that goes to capitalists. The opposite is true. The proposals are designed to increase the absolute size of the workers' slice by making the entire pie bigger.

To see how this works, think of what happens when capital taxes are cut. The capital stock grows, which increases economic output -- the size of the pie. The increase in the size of the economic pie is proportional to the productivity of capital in the marketplace. The higher the productivity of capital, the bigger is the increase in the pie that occurs when an extra unit of capital is added.

Now think about each slice of the pie individually. Capital accumulation will increase the absolute size of the savers' slice, because this slice is proportional to the size of the (now larger) capital stock. But note that as we add more capital, this slice gets bigger with respect to the after-tax return on capital. The after-tax return on capital will be smaller than the before-tax return on capital as long as the capital tax is above zero.

The absolute size of the government slice does not increase when taxes change, because it does not vary with movements in capital and labor taxes. The workers' slice is what is left over.

Now put the pieces together. The increase in the whole pie is proportional to the before-tax return on capital. But the increase in the savers' slice is proportional to the after-tax return, which is smaller than the before-tax return if the capital tax is positive. If the whole pie is rising at a faster rate than both the savers' slice and the (fixed) government slice, then the left-over slice for workers must be getting bigger in absolute terms. Workers are left with a higher standard of living by cutting capital taxes, even if they own no capital themselves.

Critics miss this dynamic when they focus on the president's proposals as allocating the slices of a fixed pie. The reason that everyone wins with lower capital taxation is that lower capital taxes leads to a larger capital stock and thus to an increase in the size of the economic pie. Because workers' wages are held back by high capital taxes, they bear part of the burden of those taxes, just as they bear the burden of the employer's share of the Social Security tax.

In many ways, the arguments for lower capital taxes are like arguments for free trade. The arguments do not fit on a bumper sticker, but careful reasoning shows that both free trade and low capital taxes are good for workers because both policies expand the size of the pie. The president's package will increase investment and help create jobs today, while the higher capital stock that results will raise the standard of living of workers tomorrow, including workers who never receive a dividend check.

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