Like a fish needs a bicycle—Does a minimum wage increase require new business tax cuts?

By Max B. Sawicky | January 31, 2007

The House of Representatives has passed an increase in the minimum wage, but the proposal faces obstacles in the Senate ostensibly founded on a desire to compensate small business owners for the burden such an increase might impose. But this alleged need to compensate businesses is dubious at best and clearly more inspired by politics rather than credible equity considerations or sound economic reasoning.

Finding the gored ox

A minimum wage increase to $7.25 an hour could directly benefit 5.6 million workers (Bernstein 2007; Fox 2007), lifting the incomes of many families currently under or not far above the poverty line. Critics claim the raise would create problems, but even if some businesses, consumers, or low-wage workers are negatively affected, the tax cuts that have been proposed are not logical remedies.

In spinning out scenarios, business lobbyists tend to depict a whole that is greater than the sum of its parts, multiplying the alleged harms. The oft-cited costs of a minimum wage increase include layoffs for workers, higher prices for consumers, or higher business costs for owners. Insofar as the wage increase causes business firms to spend more on wages, it means the workers still have their jobs and are getting paid. If the workers are dismissed, then business costs do not rise. If a new business cost estimated at $13 billion (Bernstein 2007) results in higher product prices, it cannot directly affect the business owners or their workers. As Fed Chairman Benjamin Bernanke wrote last summer (2006), in the end, the price impact of an increase would be small in a $12 trillion economy.

To create tax cuts that actually target the businesses that employ workers affected by a minimum wage increase would be impossibly convoluted and cumbersome. For one, businesses have different numbers of employees at various points between the hourly wages of $5.15 (the current minimum), and the proposed level of $7.25. To keep a firm's operations undisturbed, genuine relief would have to take the form of a subsidy for paying wages above the market levels prevailing prior to the increase. From this standpoint, the employer should get variable tax credits to accurately compensate the employer for not releasing the workers in question. To complicate matters further, 29 states have minimum wages above the national minimum, so the impact of a higher national minimum varies by state, as well as by firm and by worker.

Of course, there is no way in the world for the tax authorities to know what those credits should be for 140 million workers, some of them employed in small business, others in huge corporations, and others still in non-profit organizations. It is interesting to note that public-sector programs are often criticized for a "one-size-fits-all" approach to delivering services when the tax subsidies being foisted onto the current minimum wage proposal are guilty of the same sin. From an efficiency standpoint, a "one-size-fits-all" tax subsidy would be wasteful and ineffective, inducing insufficient retention of employees in some places and too much retention in others.

The Senate reacts

The Small Business and Work Opportunity Act of 2007 (SBWOA) has been put forward in the Senate purportedly to provide relief to business owners from the supposed burden of an increased minimum wage.

These proposed tax breaks don't make sense for a variety of reasons. Although the estimated cost of the tax cuts in the bill is $8.3 billion over 10 years (JCT 2007), as in recent tax legislation, some of the provisions are phased out well before the 10 years are up, thus understating the true tax revenue that is lost. Second, the bill contains 27 different provisions, at a time when tax complexity is lamented on all sides. Third, although the bill includes tax increases to comply with the new pay-as-you-go (PAYGO) regime in Congress, only one of these increases is phased out before the 10 year period (and then by only one year), so the phase-in/phase-out features are jimmied to reduce the sticker shock of the bill.

How does the bill support its purpose of compensating business owners whose profits are diminished by a higher minimum wage? There are three principal types of tax cuts in question here: liberalized depreciation rules, treatment of "S-corporations," and an expansion of the Work Opportunity Tax Credit (WOTC).

The proposed SBWOA tax cuts pertaining to depreciation and S-corps share an utter lack of targeting to any business owner affected by a minimum wage increase. They could just as easily benefit owners not affected, owners helped by the increase, and people who own no business at all but elect to invest in an old business or begin a new one in the future. The tax cuts could benefit a firm with no minimum wage employees, or a firm with no employees at all. They are completely unrelated to a business firm's labor costs, past, present, or future.

From the standpoint of tax fairness, a business owner might be very wealthy, or he might be barely hanging on in business. Some critics of Social Security cast doubt upon the merits of providing any retirement benefits to well-off retirees. By contrast, any conceivable compensation from a business tax break has no relation whatsoever to the economic circumstances of the taxpayer in question. Businesses don't pay taxes, people do. No tax break pertaining to a business entity can be premised in any way on the household income of the business owner who would benefit. Depreciation. About half of the tax cuts' cost stems from more generous depreciation rules. This means that under certain circumstances a business firm gets larger deductions for the purchase of capital equipment or the improvement of its facilities. In effect, the returns to somenew investment would be more lightly taxed. New investment in a small or large business can be undertaken by anyone. An S-corp can sell shares, and a proprietor can get a bank loan or form a partnership with his cousin. But the increased returns from any new investment have nothing to do with how the minimum wage increase may have affected anyone's preexisting holdings.

Take this concrete example. Suppose a restaurant employs four workers earning less than $7.25 an hour. The workers perform tasks essential for the functioning of the establishment, like washing dishes or busing tables. The better-paid staff could not do these tasks without neglecting other essential duties. A mandate comes down to raise the pay of the four, and the owner does so. The owner also chooses not to raise prices and potentially induce customers to eat at home more often or to eat at restaurants less affected by the new law. As a result, the burden of the minimum wage mandate is on the owner's capital investment in the establishment. For the sake of argument, we assume there is no way for him to shift his investment into a better line of business.

Now suppose a new tax break reduces the cost of enhancing the restaurant's facilities or equipment. If the owner has no better outlet for new investment, he could undertake it. But so could any new partner in the business who had been unaffected by the owner's higher wage costs. So could any new restaurant. Nor is the newly favored investment necessarily the best one for the economy. A tax preference for one sort of investment leaves less money for others.

Perhaps most importantly, the tax break has nothing to do with whether or not minimum wage workers are retained or added. It might be argued that such benefits steer capital towards industries that tend to employ lower-wage workers, but this could only be at the cost of industries that do not. The desirability of such an industrial policy—favoring industries that pay low wages—should be open to criticism. More likely, a tax advantage for capital investment implies a bias in favor of capital-intensive industries, and against labor. The tax advantage is granted regardless of how the taxpayer is affected by the minimum wage increase, and it gives incentive for a shift to less-productive investment from a market standpoint.

There is a scenario that is more favorable for the employer. The tax break could bring within reach an investment that reduced the affected employer's labor costs, by allowing him to substitute capital for labor. In this case the tax break, not a higher minimum wage, levies a cost on the worker.

It might be argued that, although the tax benefit is not targeted to businesses employing low-wage workers, at least it may benefit some such firms whose owners lost income from a minimum wage increase. The difficulty is that the decisions to undertake new investment and to retain low-wage employees could be either completely independent of each other, or actually at cross-purposes.

S-corps. If they meet certain qualifications, some business firms are permitted to obtain the benefits of incorporation without being liable for the corporate income tax. Instead, their owners file under the individual income tax. SBWOA provides new tax breaks for S-corps on the grounds that, because they are "small," they must be experiencing hardship under a minimum wage increase. Fox (2007) shows that lower-wage workers are spread over firms of all sizes, with only a limited bias towards smaller firms.

Some S-corps may be small, but that doesn't mean their net income is low, nor that their owners are poor. With respect to any business tax, the net income in question need not comprise the total income of the owner(s), as noted above.

For S-corps with receipts of $50 million or more, average net income per shareholder in 2003 was over a million dollars. By contrast, for the S-corps of the smallest class, net income per shareholder was about $15,000 (Luttrell 2006). If we were to gauge hardship according to individual circumstance, tax relief would depend on the income of the taxpayer, not the fact that someone had income from an S-corp.

S-corps need not have many workers, much less workers earning minimum wage. In 2003, S-corps devoted only 11% of their total receipts to wages and salaries.

SBWOA provides tax cuts to S-corps pertaining to arcane transactions in financial assets and trusts. These benefits have nothing to do with the firms' employment practices. As for the depreciation benefits, there is no relevance to any change in the minimum wage.

Expansion of the Work Opportunity Tax Credit

A significant portion of the costs of the SBWOA bill is expansion of the Work Opportunity Tax Credit (WOTC). In contrast to the provisions discussed above, this component of the legislation is germane to the issues raised by the minimum wage.

The WOTC was born in 1996. There is not much research on it available. It provides subsidies for employers to hire members of groups targeted as disadvantaged, including welfare recipients, veterans receiving Food Stamp benefits, ex-felons, high-risk youth, and others. Its cost in forgone tax revenue in 2006 was $210 million (OMB 2006).

Targeting is a central goal of the credit, in stark contrast to the other tax cuts in SBWOA. Even so, participation rates leave much to be desired. For instance, in 1999, a very good year for employment of low-wage workers, employers failed to claim subsidies for somewhere between 9% and 32% of their WOTC-eligible workers (Hamersma 2006).

The impact of the WOTC program on employment is open to dispute. It seems to be concentrated on firms with the capacity to do the extra paperwork necessary to claim the benefits (GAO 2001). Hamersma concludes that the Earned Income Tax Credit (EITC) is much more effective in boosting the low-wage labor market.

In accordance with the new PAYGO rules, the architects of SBWOA supposedly designed it to be revenue neutral (JCT 2007; CTJ 2007), although the cost estimates do not take any account of the costs to taxpayers from coping with a more complex tax system. From this standpoint, SBWOA should be judged by its own merits as tax reform. If it improves the tax system and enhances the employment prospects of low-wage workers, it is worth doing with or without a minimum wage increase. If it doesn't, it is not worth doing at all. Because SBWOA would help some and hurt others, it raises extraneous political controversies. Such disputes should not hinder consideration of minimum wage legislation, whose connection to SBWOA is political and not economic.

Conclusion

There is no sound rationale for the current efforts to offset the impact of an increase in the minimum wage. As a general matter, every budget decision entails a shift in resources somewhere in the economy. Obviously, most such decisions are not subjected to a compensation requirement. Moreover, any actual compensation disadvantages some third party. A tax cut to offset the impact of the minimum wage is ultimately paid for by future taxpayers. Finally, the bill contains tax increases that are uncompensated and must lay a burden on somebody, perhaps business owners who have also been negatively affected by the minimum wage increase.

That aside, the actual tax cuts proposed in SBWOA have no relevance to the impact of a minimum wage increase.

The only justifiable concern pertaining to a minimum wage increase is the elimination of some low-wage jobs. Available empirical evidence shows such an outcome is likely to be negligible (Bernstein 2007), and some research shows the surprising possibility of a positive effect on jobs. Concerns about poverty and rising income inequality in the United States support an increase in the minimum wage without the need to consider extraneous issues in tax policy.

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