IRET Congressional Advisory

November 2, 1999   No. 92

MINIMUM WAGE HIKE AND SMALL BUSINESS TAX RELIEF: THE BAD, THE GOOD, AND THE UGLY

H.R. 3081 would boost the minimum wage by $1, from $5.15 to $6.15, or by nearly 20%, over three years. To help some of the small businesses that would be adversely affected by the higher minimum wage, modest small business tax relief (generally, a truncated version of some of the tax provisions in the recently vetoed tax bill) would be enacted.

The hike in the minimum wage would cost tens of thousands of low skilled workers their jobs. The burden would fall heaviest on black male teenagers, whose unemployment rate has averaged over 30% in 1999.

The higher labor costs would fall disproportionately on small businesses that employ many of the lowest wage workers. The tax relief being offered small business in compensation for the higher labor costs is welcome and worthwhile, but it is not as valuable as the small business relief in the vetoed tax bill, and it would not restore all the unskilled jobs lost to the minimum wage hike. Many of the affected workers will still be hurt, as would many small businesses. The tax relief would dampen the job impact only a bit. Small businesses would be able to increase investment, and there would be some productivity gains among even the unskilled that might save some of them from being fired. Nonetheless, businesses would still want to substitute higher skilled workers or machinery for many of the soon to be more costly unskilled labor.

<u>Small business tax relief provisions.</u> H.R. 3081's five largest tax reductions are:

- trimming the top estate tax rate and changing the credit to a true exemption (with a true exemption, the estate tax would begin at a marginal rate of 18%, instead of the current 37%);
- retirement pension reforms;
- accelerating by two years when the self-employed may claim full deductions for their health insurance purchases;
- allowing small businesses to expense (i.e., deduct immediately) up to $30,000 of depreciable asset purchases, starting in 2000 (under current law, small businesses could expense up to $25,000 by 2003); and
- increasing the business meals deduction, excluding entertainment, to 60% for small businesses (80% for persons subject to hours of service limitations).

Additional expensing is a good idea, but it would still be a piddling sum and would still be phased out for large firms. In an ideal tax system, all investment would be expensed, not just these small amounts.

The best help to small business in the bill is the estate tax relief (available to all estates, not just small businesses). As of 1999, a unified credit exempts from tax the first $650,000 of lifetime transfers (estates and gifts), effectively eliminating the estate tax brackets below 37% (see table). Under current law, the exempt amount will rise to $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter; it will not be adjusted for inflation. A surtax phases out the graduated rates and results in a flat 55% tax rate on large estates.

Under the proposal, the unified credit would be replaced with an exemption that would ultimately rise to $1 million. The marginal rates would be lowered, and the phase-out of the graduated rates in

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

Table 1: Marginal Tax Rate Schedule Of Estate And Gift Tax					
Current law*			Proposal in minimum wage bill (when fully phased in)**		
If the taxable estate is:		The marginal tax rate* (%) is:	If the total estate (including the $1 million exemption) is:		The marginal tax rate (%) is:
Over	But not over		Over	But not over	
			$0	$1,000,000	0
$0	$10,000	18*	1,000,000	1,010,000	16
10,000	20,000	20*	1,010,000	1,020,000	18
20,000	40,000	22*	1,020,000	1,040,000	20
40,000	60,000	24*	1,040,000	1,060,000	22
60,000	80,000	26*	1,060,000	1,080,000	24
80,000	100,000	28*	1,080,000	1,100,000	26
100,000	150,000	30*	1,100,000	1,150,000	28
150,000	250,000	32*	1,150,000	1,250,000	30
250,000	500,000	34*	1,250,000	1,500,000	32
500,000	750,000	37*	1,500,000	1,750,000	35
750,000	1,000,000	39*	1,750,000	2,000,000	37
1,000,000	1,250,000	41	2,000,000	2,250,000	39
1,250,000	1,500,000	43	2,250,000	2,500,000	41
1,500,000	2,000,000	45	2,500,000	3,000,000	43
2,000,000	2,500,000	49	3,000,000	3,500,000	47
2,500,000	3,000,000	53	Over 3,500,000		48
3,000,000	10,000,000	55			
10,000,000	17,184,000	60			
Over 17,184,000		55			

* The current law credit offsets the tax on the first $650,000 of the lifetime transfer in 1999 (effectively rendering the tax rates zero through a portion of the 37% tax rate bracket). Under current law, the credit is scheduled to rise in stages to cover the first $1 million of the lifetime transfer in 2006 (rendering rates through the 39% bracket effectively zero). Current law includes a 5% surtax (a 60% bracket) to phase-out the graduated rates.
** Under the proposed bill, the credit would be replaced by an exemption ($675,000 in 2001, rising to $1 million in 2006), the top tax rate would be lowered to 53% in 2001 and to 50% in 2002; thereafter, all rates would be lowered by 1 percentage point in 2003 and 2 percentage points by 2004, resulting in a new top rate of 48%. The proposal ends the surtax and the phase-out of the graduated rates.

current law would be eliminated. The lowest tax rates, now preempted by the credit, would be restored for amounts above $1 million. Thus, instead of beginning to be taxed at 37% (or 41% in 2006) with a top rate of 55%, and with the graduated rates phased out with a surtax, taxable estates and gifts would begin to be taxed at 16% (in 2004), with a top rate of 48%, and with no phase-out.

The estate tax proposal is clearly better than current law. However, the vetoed tax bill would have repealed the tax entirely as of 2009. Every penny of saving in an estate has either been taxed before, often more than once, or, in the case of tax deferred saving plans such as IRAs or 401(k)s, it will be subjected to the heir's income tax. Consequently, the estate tax is an added layer of tax on saving that should be completely repealed. It would be unfortunate if this partial relief gave Congress an excuse not to eliminate the tax completely.

Conclusion. The minimum wage hike is a bad idea and should be rejected. The small business tax relief should be expanded and passed separately. If the Congress and the President insist on passing a minimum wage hike, then including the tax relief is better than not including it. Nonetheless, costing some unskilled workers their jobs and hurting some small businesses while helping others is an ugly trade.

Stephen J. Entin
Executive Director
& Chief Economist

Michael A. Schuyler
Senior Economist

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.