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TAX INCENTIVES FOR BUSINESSES IN RESPONSE TO A MINIMUM WAGE INCREASE

HEARING

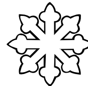
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

JANUARY 10, 2007



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TAX INCENTIVES FOR BUSINESSES IN RESPONSE TO A MINIMUM WAGE INCREASE

WEDNESDAY, JANUARY 10, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Chuck Grassley (chairman of the committee) presiding.

Present: Senators Hatch, Lott, Snowe, Kyl, Thomas, Bunning, Roberts, Baucus, Rockefeller, Lincoln, Wyden, Stabenow, Cantwell, and Salazar.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

Chairman GRASSLEY. The hearing will please come to order.

This hearing touches on two topics. The first one is the proposed increase in the Federal minimum wage. The second topic is tax incentives to assist workers and businesses burdened by the increased Federal minimum wage.

Popular support for raising the minimum wage is based on a number of widely held beliefs: first, no one can support a family on $5.15 an hour; second, minimum wage earners will not get a pay raise unless Congress gives authority and makes it happen; and third, raising the minimum wage helps millions of poor workers and hurts no one.

Unfortunately, these popular beliefs are either misleading or wrong. First, most minimum wage earners are not trying to support a family. Those who are can receive substantial government benefits to supplement their income, thus no one has to rely solely on the minimum wage to support a family.

Second, minimum wage jobs are generally entry-level jobs. Most workers who start at the minimum wage quickly earn more. Few workers remain stuck at the minimum wage for a long time. Unfortunately, those who do are most at risk of losing their job from a minimum wage increase.

Third, most minimum wage earners are not poor. Only 15 percent of the proposed minimum wage increase goes to those living below the poverty level. Increasing the minimum wage would result in higher prices for consumers of minimum wage products, higher unemployment among the least-skilled minimum wage earners, increased poverty among minimum wage families, or some combination thereof.

Much of the popular support for the minimum wage is based on the fallacy that the government can help the poor without hurting anyone. But if the government can increase wages with no ill effects, why stop at $7.25 an hour? Why not $10 or $20 an hour?

Popular support for increasing the minimum wage is tempered by the fact that virtually everyone agrees that there is some level at which the minimum wage would produce obvious negative effects.

In the past, policy makers have attempted to mitigate any negative effect by limiting the size of the minimum wage increase, providing tax credits to employers who hire at-risk workers, and providing tax or regulatory relief to business.

However, additional research in recent years has cast some doubt on the effectiveness of these previous efforts. First, this research suggests raising the minimum wage does not reduce poverty among minimum wage earners. Instead, it most likely increases poverty. Second, legislative action by various States to adopt their own higher minimum wage has led to significant differences among States. Finally, research shows that the Earned Income Credit could provide a cost-effective way to help the poorest workers. I am pleased that over the last few years we have enhanced the Earned Income Credit for many families by making the Child Tax Credit refundable.

Despite the serious policy concerns, public support for increasing the minimum wage remains very strong. It is one of the most popular things out there. It was one of the most important issues in the last election.

The purpose of today's hearing then is to review the pros and cons of raising the minimum wage and determine what steps Congress should take to mitigate the negative impact of raising the minimum wage.

I ask unanimous consent to insert into the record some additional background material on the impact of the minimum wage.

[The information appears in the appendix on p 63.]

Chairman GRASSLEY. Let us move to the second topic. Tax incentives targeted to small businesses or other businesses impacted by a minimum wage increase have been linked to the minimum wage legislation by Republicans for over a decade.

Democrats have, at times, joined Republicans in support of this language. Senator Baucus and I have worked very closely on this issue over the period of our working together as the leaders of the Republicans and Democrats on this committee.

I would like to quote from two former Chairmen of this committee in their opening remarks on the conference agreement on the last piece of legislation that raised the minimum wage.

Senator Roth, then chairman, described taxes as "the sand that grinds the gears of small business," so he saw merit to small business tax relief. Senator Roth said, "[We will] proceed to the legislation on the minimum wage and small business taxes. We're anxious to move ahead on the small business tax legislation."

Senator Moynihan said, "My distinguished chairman, as always, has so stated the facts. But there is a small semantic issue here. Some call this the small business relief act; others on this side call

it the minimum wage bill. But we will not resolve that tonight, nor need we."

Senators Roth and Moynihan were right then. If they were still living today, I would tell them that they are right on, right now.

To different groups of Senators, these topics carry their own benefit or burden. Many on my side do not like the idea of second-guessing the labor market. I pointed out some of the related issues that should give us all pause when considering such legislation.

Those on the Democratic side want a straight minimum wage hike and refuse to consider the burden that that policy puts on employers. Those members do not want any linkage between minimum wage and small business relief. Senator Moynihan, however, made clear we do not have to agree now whether the upcoming legislation will be a minimum wage bill or a small business tax relief bill.

Some, mostly Democrats, will call it a minimum wage bill. Some, mostly Republicans, will call it a small business tax relief bill. Still other members will call it both minimum wage and small business tax relief.

President Bush, like President Clinton did years ago, will recognize both parts of the package. So I ask unanimous consent to insert in the record President Clinton's signing statement on the last minimum wage/small business tax relief bill.

[The signing statement appears in the appendix on p. 69.]

Chairman GRASSLEY. I also ask unanimous consent to insert in the record the closing remarks of Senators Roth and Moynihan on that same piece of legislation.

[The remarks appear in the appendix on p. 71.]

Chairman GRASSLEY. The bottom line is, there is a well-known set of small business tax relief measures. We will examine them in this hearing. I look forward to moving these proposals to the floor.

Once again, to emphasize, Senator Baucus and I have always worked closely on this issue. There was an article this morning in the *Washington Post* in the Business section that I feel was very unfair to Senator Baucus, considering the fact that this is a very bipartisan issue of trying to bring forth a solution of small business tax relief, in conjunction with helping people who are earning the minimum wage, to move a bill forward to benefit people who need help and to offset some of the negative impact.

So I hope that we can understand, or I hope the *Washington Post* understands, that this is not something Senator Baucus has been working on and should be condemned for, because obviously I do not think he should be condemned for it. It is something that he and I are working together on. If they want to condemn people, condemn people of all stripes, where it is so strongly bipartisan that we ought to move forward.

Now, I have one last thing to do as chairman of this committee, and I am still chairman because we have not officially organized. But whenever we organize, as of this very minute, I want to welcome Senator Baucus back to his chairmanship that he has held for a short period of time before.

During our last hearing in December, I went for 5 minutes on very nice things about the close working relationship we have had and how it has been very productive for this committee.

There is no issue that has come out of here in a bipartisan way that the bill has not been signed by the President of the United States, and most of the things coming out of this committee are somewhat controversial. I think that is quite a record for he and I to have in the last 4 years, and it has been because of his cooperation.

He has told me privately and publicly that he intends to continue that cooperation with his being chairman, and I want to thank him for doing that and welcome him to leadership. It is not going to be an easy 2 years, as the last 4 years have not necessarily been easy. So, congratulations, and the gavel is yours.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. Thank you very much. Thank you for those very kind comments, too. Thank you for your graciousness in asking me to chair this hearing.

As you noted, Mr. Chairman, until the Senate passes its resolution naming the new committee chairman, you are the chairman.

The Senate is a continuing body and the Finance Committee is a continuing entity, continuing actually since 1816. Since the Senate formed the committee, 343 Senators have served on it, but just 39 have chaired it.

It is a distinguished group. Among those 39 were Daniel Webster, Henry Clay, John Calhoun. Among those 39 were five Treasury Secretaries and a Majority Leader. But among those 39 there has only been one Senator from Iowa, the Hawkeye State.

Chairman GRASSLEY. I did not know that. [Laughter.]

Senator BAUCUS. And even more importantly, there is only one Chuck Grassley. I am very grateful to have been associated with you, Mr. Chairman. You have been wonderful to work with.

Frankly, I want to say that I know of no finer man. You are a tremendous human being, and I just thank you very much for giving us the privilege of serving under you as chairman of this committee, and also for our friendship. It has been really wonderful to be with you. It has been a genuine partnership, and it is going to continue.

Today, Chairman Grassley has graciously handed me the chairman's gavel. I am happy to chair this meeting. But I want to take a moment to recognize the service of Chuck Grassley as chairman by presenting him with this gavel as a permanent memento of his service as chairman, because I think that is the least we can do.

Chairman GRASSLEY. Well, thank you. Thank you very much. [Applause.] Thank you very much. Thank you. Well, I appreciate it very much. It probably cost more than it should, and more than I would have spent on somebody else. [Laughter.]

Senator BAUCUS. No, no. It is your old gavel. [Laughter.]

Chairman GRASSLEY. Oh, it is? All right. [Laughter.] All right. So it is worn out.

Senator BAUCUS. You wore it out.

Chairman GRASSLEY. Thank you very much.

Senator BAUCUS. You bet. You bet.

I might say, too, that only 28 Senators have served on the committee for more than 20 years. Senator Rockefeller joins me, lit-

erally and figuratively, and Senator Grassley. I might say, we are now the three who are now in our third decade on this committee.

I would like also to welcome new members. First, the Senator from Michigan. Senator Stabenow is the tenth Senator from Michigan to serve on the Finance Committee. The Wolverine State is among the States that has most frequently been represented on this committee. Not many States are more frequently represented than the State of Michigan. Many of my colleagues will remember Senator Regal, who ably represented the State of Michigan, and a fine member of this committee. I welcome Senator Stabenow.

Senator STABENOW. Thank you.

Senator BAUCUS. In addition, I would like to welcome Senator Salazar, the ninth Senator from Colorado to serve on the Finance Committee. Now, many of us remember Senator Armstrong, who served with us, a great man. He liked cutting taxes, Senator Armstrong.

The Centennial State's members have also included a chairman of the committee, and that was Senator Eugene Milligan, who chaired the committee during the 80th and the 83rd Congresses, and served as ranking minority member during the 81st, 82nd, and 84th Congresses. So you can see, this is not the first time the chairmanship has gone back and forth. It did back then in that era as well.

Senator Cantwell is not here. I hope I can welcome her a little later when she does appear. But I would like now to welcome the distinguished Senator from Kansas.

Senator Roberts is the fifth Senator from the Sunflower State to serve on this committee. And, of course, most of us remember the former Senator from Kansas, Senator Dole, who served as chairman of the committee and went on to serve as Republican Leader, and also Majority Leader. So, expectations are very high for you, Senator Roberts, with your service in this committee.

America's founders held it to be self-evident that all men are created equal. It is that same belief and equality in the dignity of every person that led the Congress, in 1938, to enact the Fair Labor Standards Act. That Act put into effect President Roosevelt's call, in his words, "to put some floor below which the wage ought not to fall."

My colleagues know that our constituents hold it to be self-evident that we should raise the minimum wage. One hardworking Montanan wrote to me, "I used a third of my income tax just to pay for energy costs this year. The day-to-day life expenses such as rent, heating, and transportation leave me with nothing in case of an emergency."

Continuing, he wrote, "Why has our minimum wage stayed the same within the past 10 years, yet inflation, including rent, has risen dramatically in the same amount of time?"

Continuing, "I really hope that you take the time to thank your grocery bagger the next time you shop in the grocery store, and I hope you keep in the back of your mind that they make under poverty level and are not at home with their families."

I might say, Montanans recognize that the minimum wage must be increased. I am proud to state that in November of last year, Montanans voted to raise the State's minimum wage from $5.15 to

$6.15 an hour. Some worry, however, that an increase in the wage will burden small businesses.

Small businesses, of course, are a vital source of job creation, economic opportunity, and technological innovation. There are about 23 million small businesses in America. Businesses with fewer than 500 employees represent more than 99.9 percent of all American businesses.

They pay nearly half of total American private payroll, generating 60 to 80 percent of new jobs annually over the last decade, and they employ 41 percent of high-tech workers.

Small business is particularly important in rural States like mine. Rural communities generally do not have large employers. Rural families rely on small businesses for jobs.

This committee has the opportunity to help small businesses through tax incentives that stimulate their rates of formation and growth. Today we will hear about some of those incentives.

We will hear about helping business owners to afford new equipment and property for their businesses. We will hear about allowing lease holders and restaurants to quickly recover the cost of improvements to their establishments.

We will hear about simplifying the way that small businesses keep records for tax purposes. We will hear how small businesses provide jobs for workers who have experienced barriers to entering the workforce.

These are all important ways to help small businesses succeed. They all enjoy strong support. I look forward to hearing our witnesses testify about their experiences with these provisions.

I am also committed to introducing a responsible tax package that is fully offset. I am committed to a package that will ensure the continued growth and success of small businesses.

It is my preference that the committee report such a package next week. I want us to move it, with or without the minimum wage increases, although I think it will be with the minimum wage increases.

The small business tax provisions have traveled with minimum wage increases before, and I believe the Senate will probably vote to include these provisions in this year's minimum wage increases as well.

I think that the Finance Committee ought to conduct a hearing on this subject, as we are today, and a mark-up of such legislation before we go to the floor. I think that is the proper process. It is the process that I hope to continue, intend to continue, in this Congress. That is, to have hearings on significant issues and legislation, have mark-up on those provisions before they are offered as amendments to legislation on the floor.

So let us raise the minimum wage. Let us help small businesses cope. Let us do as much as possible through the committee process. That way we can honor the hardworking Americans who earn minimum wage, we can honor the small businesses that create American jobs, and we can honor the institution in which we serve.

Senator LOTT. Mr. Chairman?

Senator BAUCUS. Senator Lott?

OPENING STATEMENT OF HON. TRENT LOTT, A U.S. SENATOR FROM MISSISSIPPI

Senator LOTT. Thank you for recognizing me. I ask my more senior colleagues to bear with me just a moment, since I do have another meeting I have to go to. But I want to congratulate you on your ascending to the chairmanship soon.

And while sometimes I suspect it makes both Democrats and Republicans a little nervous about how closely the two of you work, you and Senator Grassley, I think it is highly commendable.

Senator BAUCUS. I know I have heard that from you.

Senator LOTT. Yes. Well, I have expressed that, jointly and severally, to the two of you.

Senator BAUCUS. Yes.

Senator LOTT. But if we had more of that approach, I think the whole atmosphere in this institution would be different and would be better.

Senator BAUCUS. Thank you.

Senator LOTT. So I congratulate you both. The fact of the matter is, the proof is in the pudding. Sometimes how we have gotten there has been very long and difficult, working with our colleagues in the other body. But the fact of the matter is, most of the time we have produced a pretty good product, and I think you deserve credit for that.

I want to thank Senator Grassley for his service as our chairman. I am sure that we are going to see continued cooperation between the two of you, and I hope between all of us, and we can produce good packages.

I want to welcome the new members. I am looking forward to working with them. Senator Roberts, the new kid down here on this end. I am looking forward to proper respect from the more junior member down there. [Laughter.]

By the way, I think it should be noted, while you are recognizing history, that the chairman of this committee when we first passed the minimum wage increase and Social Security was Pat Harrison of Mississippi, who went on to lose, by the way, to be Majority Leader by one vote because his colleague, Bilbo, voted against him. So there is an interesting history there.

One other bit of history. The last time we passed the minimum wage I was in a position to have to deal with it. It was a very difficult issue in 1996. The Senate was completely balled up over it.

But we worked together. I worked with Senator Daschle. We worked with the then-chairman and ranking member. We produced a minimum wage increase and we had attached to it small business incentives which had the desired effect.

I talked to some of the small business men and women, and they said that, actually, the small business incentives did allow them to provide the minimum wage increase, to not have to go out of business, to not have to lay people off.

The second step up was a little more problematic, but that is the way we did it, and it worked, I think, quite well. So I think, obviously, the minimum wage is overwhelmingly supported by the American people and by members of the Senate, and it is going to pass.

I also think these small business tax incentives would be constructed on their own. In my State, where we are still struggling to recover from Katrina, these tax incentives we are talking about here, the accelerated depreciation for small business, expensing, and cost accounting, will make a huge difference at a relatively small cost to the people who create over half the jobs in America.

So, I want to thank you for having this hearing. You are going about it in the right way. Let us have a hearing. Let us hear what experts have to say. Let us hear what small business men and women have to say. Let us put together a sensible package. Let us report it out, and let us go forward.

If we do it that way, I predict we will produce a good product, and working Americans at the entry level and small business men and women who carry the load of jobs creation in America will benefit. I thank you for allowing me to start off with those comments today.

Thank you very much.

Senator BAUCUS. Thank you, Senator, very much. Thanks for the comments.

I would like to begin with the panel now. The first witness is Dr. Jared Bernstein, who is the director of the Living Standards Program at the Economic Policy Institute; next, Dr. Joseph Sabia, assistant professor of housing and consumer economics at the College of Family and Consumer Sciences at the University of Georgia; Mr. Matthew Kadish, vice president of legislation, Small Business Council of America; then Mr. David Ratner, owner of Dave's Soda & Pet City; and, last, Mr. Bruce Obenour, who is president of Akwen, Limited.

Thank you all for coming. By the way, if you have longer statements than the 5 minutes allotted, we of course will put those in the record, and I urge you now to proceed.

First, Dr. Bernstein. Let us hear what you have to say.

STATEMENT OF DR. JARED BERNSTEIN, DIRECTOR, LIVING STANDARDS PROGRAM, ECONOMIC POLICY INSTITUTE, WASHINGTON, DC

Dr. BERNSTEIN. Chairman Baucus, Ranking Member Grassley, members of the Finance Committee, I thank you for this opportunity to testify on the proposed legislation to raise the Federal minimum wage.

This is a critically important issue to millions of low-wage working Americans, many of whom have seen their economic fortunes dwindle in recent years, even as the Nation's economy has prospered.

I urge you to speed congressional passage of the proposed increase, and to do so without potentially expensive and poorly targeted tax provisions. Such provisions are unwarranted given the extensive tax cuts to businesses, both small and large, over the past decade, the relative small magnitude of the current minimum wage proposal, the difficulty targeting effective firms, and the lack of a clear incentive to offset the potential costs of this wage proposal.

Our economy, in many ways, is the envy of the world, currently characterized by strong productivity growth and low unemploy-

ment. Profits to the Nation's businesses have soared throughout this recovery and, as a share of national income, profits stand at a 56-year high.

Yet, amidst all this prosperity, too many families have been left behind. The income of the typical working age family is down 5 percent, or $3,000, since 2000, and at the low end of the income scale where the minimum wage makes a real difference, poverty is up significantly, from 11.3 percent of the population in 2000, to 12.6 percent in 2005.

One factor that has undoubtedly played a role in the long-term decline is the real value of the minimum wage. Congress legislated a two-step increase in the minimum wage in 1996, and the wage floor has not been raised since September of 1997, making this the longest period on record in which Congress has failed to raise the minimum wage.

My written testimony stresses the following points. In terms of its buying power, the Federal minimum wage now stands at a 52-year low. Since the last increase in the minimum wage, inflation has eroded one-fifth of its value. For someone working full-time, full year at the Federal minimum, this represents a loss of over $2,500 per year.

While opponents of the increase stress job loss effects, recent research on the employment impacts of minimum wage increases show such effects to be negligible, with estimates that hover about zero. High-quality research tapping the geographical variation in State minimum wage has been particularly enlightening in this regard.

The last increase in the minimum wage at the Federal level did not result in any of the negative predictions made by opponents. Instead, it was followed by the strongest job and wage growth in the low-wage labor market in decades.

Economists and policy makers are recognizing the importance of this new research and these actual outcomes. In 2006, over 650 economists, including five Nobel Prize winners and six past presidents of the American Economics Association, signed a statement that said, "We believe that a modest increase in the minimum wage would improve the well-being of low-wage workers and would not have the adverse effects that critics have claimed."

The proposal under consideration is very modest. We have forecasted it would directly lift the earnings of about 4 percent of the workforce, about half the share affected by the 1996–1997 raise. Given this moderate result, Congress should pass a clean minimum wage bill without tax cuts.

Only one Federal increase in the minimum wage, the last one, was accompanied by such cuts. Since then, businesses, small and large, have benefitted from $300 billion of tax cuts. Any further cuts should be debated on their own merits outside of this minimum wage debate.

I am going to devote my remaining minute or two to amplifying these two points. First of all, opponents of the increase often argue that, instead of raising the minimum wage, we should increase the Earned Income Tax Credit.

I urge policy makers not to view these two policies as mutually exclusive. They are not substitutes, they are compliments. First, low-wage workers need both policies to lift their living standards.

As shown in a recent analysis by the Center on Budget and Policy Priorities, a family of four with one full-time minimum wage worker today remains below the poverty line, even when we account for the EITC and the market value of food stamps. But once we increase the minimum wage to $7.25, that family's income goes above the poverty threshold.

Now, since it is conditioned on income, EITC benefits will be more concentrated among low-income workers than the gains from the minimum wage increase. But the incidence of the minimum wage is far more progressive than its opponents maintain.

Over half of the benefits flow to families in the bottom 30 percent, families that receive 14 percent of total income and whose average income is $25,000. True, that is above the poverty line, but every member of this committee knows that working families at this income level face a tight squeeze trying to make ends meet.

We also must not lose sight of the fact that the minimum wage was not designed solely as an anti-poverty program. It is a minimum labor standard wherein Congress states that we will not let market forces push wages down to privation levels, regardless of the income of the person earning that wage.

Finally, while the EITC is a highly successful policy tool, Congress cannot place the full social cost of working poverty reduction on the U.S. taxpayer. Both of these policies, as well as others, are needed to accomplish this goal.

Now, some members of Congress, as well as President Bush, have argued that the increase in the minimum wage should be accompanied by tax cuts. Now, these cuts may or may not have merit, but there are good reasons to separate the two ideas in the policy process and pass a clean minimum wage bill.

Unless they are strictly temporary, any tax cuts are likely to cost more and last longer than the minimum wage increase. That is, the offset will deprive the Federal budget of more revenues than the policy it is supposed to be offsetting.

Since the proposed increase is a Federal mandate, except for those States with minimum wages above $7.25, every firm faces the same minimum. The fact that no firm is at a competitive disadvantage also militates against the need for offsets.

Since many businesses with low-wage workers are already paying wages above $7.25, or will be by 2009, or are in States with higher minimum wages, it will be very difficult to target any offset to firms actually facing higher labor costs due to this proposed increase.

Even if Congress could target these cuts, it is not clear what the cuts are supposed to offset. Since the employment effects are negligible at best, these cuts will not lead businesses to retain workers they would otherwise have let off.

This, along with the targeting challenges, raises the possibility that these cuts could end up being a windfall for businesses that have already received billions in tax cuts in recent years.

Senator BAUCUS. I would ask you if you could kind of wind up, please.

Dr. BERNSTEIN. All right. I have two more sentences.

The Democratic majority is committed to a pay-as-you-go budget rule, meaning that the cost of these taxes will have to be made up with either more revenue or less spending in some other part of the budget. Any offsets that are used for this bill will, thus, not be available for other, more pressing priorities such as providing health coverage for all eligible children through SCHIP and reversing the loss of subsidized child care payments.

More tax cuts for business may or may not be warranted, but I urge Congress to save that debate for a different day. Today there should be little debate. Low-wage workers have waited long enough for this much-needed increase in the Federal minimum wage.

Thank you.

Senator BAUCUS. Thank you very much.

[The prepared statement of Dr. Bernstein appears in the appendix.]

Senator BAUCUS. Dr. Sabia?

STATEMENT OF DR. JOSEPH SABIA, ASSISTANT PROFESSOR OF HOUSING AND CONSUMER ECONOMICS, COLLEGE OF FAMILY AND CONSUMER SCIENCES, UNIVERSITY OF GEORGIA, ATHENS, GA

Dr. SABIA. Thank you. Thank you for the opportunity to talk to you today about the likely effects of a minimum wage increase on the working poor.

Nobel Laureate Milton Friedman once said, “One of the great mistakes is to judge policies and programs by their intentions rather than their results. Programs that are labeled as being ‘for the poor,’ ‘for the needy’ almost always have effects exactly the opposite of those which their well-intentioned sponsors intend them to have.”

The minimum wage is an example of this type of ill-conceived policy. Minimum wage advocates argue passionately that no one who works hard and plays by the rules should be poor. I agree, as do most Americans. But I also agree with Milton Friedman that good intentions are not enough to make good policy.

The real test of this legislation is how its passage will impact the working poor. Here, the evidence is clear. Past minimum wage increases have not alleviated poverty, and this legislation will not do so either.

A forthcoming peer-reviewed publication, co-authored with my colleague Richard Burkhauser of Cornell University, examines census data from 1989 to 2004 and finds that minimum wage increases had no effect on overall poverty rates, on poverty rates among workers, or, importantly, on poverty rates of working single mothers.

There are two reasons for this somewhat surprising result. First, workers who lose their jobs or have their hours substantially reduced because of a minimum wage hike are clearly worse off. While some low-skilled workers who remain employed after a minimum wage are moved out of poverty, other low-skilled workers are moved into poverty as a result of these adverse employment effects.

Recent evidence shows that the net effect of past minimum wage increases leaves low-skilled workers worse off. David Neumark and

William Wascher recently published a paper for the National Bureau of Economic Research in which they critically reviewed nearly 90 empirical articles that have been published since the early 1990s on the effects of the minimum wage.

They conclude that the evidence is "overwhelming" that the least-skilled workers experienced the strongest disemployment effects from minimum wage increases; you always hurt the one you love. Those workers most harmed are disproportionately young African Americans, workers without a high school diploma, and single mothers.

In fact, among single mothers, minimum wage increases have the unintended consequence of increasing welfare use due to job loss. Moreover, it is primarily sectors of the economy that employed low-skilled laborers, particularly retail and small businesses, that experienced these adverse employment effects.

However, adverse employment effects are not the only reason, or even the central reason, why minimum wage increases fail to reduce poverty. A second reason is that, in contrast to 1938 when the minimum wage was first mandated, today the vast majority of workers who benefit from a minimum wage increase do not live in poor, or even near-poor, households. Most are second or third earners in households with incomes that are more than 2, or even 3 times, the poverty line. Less than 5 percent of minimum wage workers are poor, single mothers.

In our new paper, Burkhauser and I simulate the effects of this proposed Federal minimum wage hike from $5.15 to $7.25 an hour to see exactly who would benefit. In fact, to give the minimum wage increase its best chance to do what its proponents say it will do and reduce poverty, we put on rose-colored glasses and assumed there would be no adverse employment effects at all. We are giving it its best chance to do what folks say it is going to do.

Even in this best-case scenario, we found that just 13 percent of the benefits would go to workers in poor households, two-thirds of the benefits would go to those living in households with incomes at least 2 times the poverty line, and 40 percent of the benefits would go to workers in households with incomes over 3 times the poverty line. For a household of four in 2006, that corresponds to a household income level of $60,000.

Poor African Americans would receive only 3.7 percent of the benefits, and poor single mothers, only 3.8 percent. The evidence clearly shows that minimum wage increases are a poor way to help the working poor.

A far more effective anti-poverty tool is the Earned Income Tax Credit. Most poor workers, especially single mother and African American households, would benefit from the EITC, while only a small minority would gain from a minimum wage hike.

Because EITC costs are not borne by employers, there would be no reduction in the demand for low-skilled workers, as is the case with a minimum wage increase. My most recent work shows that a 10-percent increase in the maximum EIT refundable credit reduces poverty rates by 7 percent among full-time working single mothers.

Let us all agree that no American who works hard and plays by the rules should be poor, but good intentions cannot justify bad pol-

icy. Minimum wage increases should be abandoned and placed in the museum of antiquated anti-poverty policies.

Thank you.

Senator BAUCUS. Thank you, Dr. Sabia, very much.

[The prepared statement of Dr. Sabia appears in the appendix.]

Senator BAUCUS. Mr. Kadish?

STATEMENT OF MATTHEW KADISH, VICE PRESIDENT OF LEGISLATION, SMALL BUSINESS COUNCIL OF AMERICA, CLEVELAND, OH

Mr. KADISH. Mr. Chairman, members of the committee, my name is Matthew Kadish. I am vice president of legislation of the Small Business Council of America, and I am also a practicing attorney whose practice focuses on representing small businesses in tax and estate planning matters in Cleveland, OH. Thank you for the chance to present our ideas on behalf of small business.

As discussed, small businesses are critical to our economy. It is essential that tax incentives be given so that they can grow and thrive.

We have identified, after study, seven tax legislative priorities which we believe would best help promote small businesses. We believe that several of them would be a good fit for the legislation being considered today, and we would urge that the others be given consideration as soon as possible in the appropriate context.

Our first tax legislative priority involves the estate tax. The current situation in the estate tax is uncertainty. People cannot plan their estates. The system has become hopelessly complex, with repeal slated for 2010 and a re-start of the estate tax at a $1 million exemption in 2011, in somewhat of a Cinderella-at-midnight scenario.

When clients come in to talk to me about this, they shake their heads. It is bizarre. They are losing faith in the system. That train-wreck-waiting-to-happen is only 3 to 4 years away, and we urge Congress to act on this now and not to put it off until the last minute.

One prominent attorney in the estate planning area is recommending three estate plans for each client, one for 2007 to 2009, one for the repeal year of 2010, and another one to cover 2011 when the estate tax comes back in at a $1 million exemption. Is that the kind of system we should have?

We believe Congress should increase the exemption now to $3.5 to $5 million. Do not wait until 2009. Retain the basis step up. Reunify estate and gift taxes. Exempt retirement plan assets for an additional million as an incentive to save, and exempt real small businesses from estate tax, or reduce the rate on them if that is not feasible.

Second, there is a code section that is affectionately known as section 409A. In 2004, 409A was enacted in the Enron/Worldcom aftermath. Shareholders throughout the country had just watched in helpless horror as key executives drained their non-qualified deferred compensation plans right before their companies went into bankruptcy; 409A imposes fearsome tax, interest, and penalty results on employees who are involved in a deferred compensation arrangement which does not meet the requirements of 409A. The de-

tails of those requirements and consequences are contained in my written materials.

Importantly, the IRS and Treasury are broadly interpreting what constitutes a deferred compensation arrangement, leaving employers and business owners scrambling to review many standard business arrangements, including partnership agreements, buy-sell arrangements, and a lot of other things that Congress likely did not intend when they passed this statute.

Unlike public companies where shareholders normally have little direct voice or supervision over the executives, shareholders and management are tightly aligned in a closely held business. Therefore, the shareholders of a closely held business do not need Enron-type protection from 409A.

Pre-2004 law is adequate to address deferred compensation arrangements outside of the publicly traded area, and the complexity is causing too much time and money to be wasted, and too much uncertainty. We urge Congress to scale 409A back to apply only to public companies.

Third, we urge Congress to enact SIMPLE cafeteria plans. Under current law, small businesses are effectively precluded from having cafeteria plans because their owners cannot participate due to the application of the non-discrimination rules.

Under the SIMPLE cafeteria plan proposal patterned after the successful SIMPLE defined benefit plan and supported by Senators Snowe, Bingaman and Bond, small businesses would be able to have the same kind of cafeteria plans as big businesses and government, and the owners would be able to participate, provided they made certain minimum contributions to the health plans for their employees.

Fourth, Alternative Minimum Tax. We applaud the work that the chair and the incoming chair are doing on this issue. We realize that, given the revenue implications, this is a titanic task. However, it is growing exponentially. We believe this is a serious issue, and it is a serious issue for small businesses, and we would like to lend our support to their efforts.

Fifth, on expensing, we would like to make the increased limits currently set to expire in 2010 as extended permanent, and increase the amounts, if possible. That would be very helpful.

Sixth, on the cash method of accounting, we would like to increase the true safe harbor for the use of the cash method from $1 million to somewhere in the $5 to $10 million range. That would be very helpful to allow small businesses not to have to use the complicated and burdensome accrual method.

For taxpayers who switch over to the accrual method from the cash method, we would like to give them a 4-year spread on the section 481 adjustment, regardless of whether or not the change is made voluntarily, because the IRS can currently come in, change them, and cause a catastrophic change to their cash flow which they may not have budgeted for.

Finally, and in conclusion, our last item is on personal service corporations. Cleveland in particular, but probably the rest of the country, has shifted very much to a service-based economy, and the tax code contains a surprising number of disincentives to service

professionals, taxing them at unfair rates and in unfair ways, and it is greatly complicated.

Our written materials set forth a series of proposals to even the field for these professionals, including not just lawyers, doctors, actuaries and accountants, but also consultants who are currently subject to surprisingly unfair rules.

Thank you once again for the opportunity to be here today.

Senator BAUCUS. Thank you, Mr. Kadish. That is an interesting list, and we deeply appreciate that.

[The prepared statement of Mr. Kadish appears in the appendix.]

Senator BAUCUS. Mr. Ratner?

STATEMENT OF DAVE RATNER, OWNER, DAVE'S SODA & PET CITY, AGAWAM, MA

Mr. RATNER. Chairman Baucus, Senator Grassley, members of the committee, my name is Dave Ratner. I am the owner of Dave's Soda & Pet City, a mini-chain of four stores in Agawam, Springfield, Amhurst, and Northampton, MA.

I am appearing today on behalf of the National Retail Federation and thousands of other small businesses like me. I am also a member of the board of directors of the Retail Association of Massachusetts.

I am really more than pleased to have the opportunity to testify today on tax incentives for businesses in response to a minimum wage increase, especially tax incentives that would help small businesses like mine.

In particular, I am testifying in support of legislation that would level the playing field for retailers like myself who own the buildings in which our stores are located. I want to thank Senator Snowe for introduction of this in the last Congress.

By way of background, I founded Dave's Soda & Pet City in 1975. I started with one store and one employee in Hadley, MA. Today I have four stores, 86 employees, and way less hair. [Laughter.]

I am proud to say that the reason my business has grown, and even thrives, is that we have the best and the nicest folks in the world working at Dave's. Dave's has always been an integral part of the community. We sponsor a gazillion teams, plays, community events, library functions, charity events; you name it, we sponsor it.

Chairman Baucus, I commend you for holding this hearing. I am not here today to voice any opposition to the Federal minimum wage increase. I am in Massachusetts. I am already living it. As a representative of the National Retail Federation, I am here representing thousands of small retailers like me from all over the United States.

Retailers, who employ 1 in 5 American workers, are among the industries hardest hit by a minimum wage increase. For many, the current proposals would represent a whopping 41-percent increase in entry-level wages. For small business, these government-mandated increases in overall payroll take a wicked-heavy toll as we strive to compete with the big guys.

As a result of the January 1st Massachusetts minimum wage increase, my stores have implemented a hiring freeze, and we will

adjust our workers' schedules to avoid overtime, steps that I am sure will be replicated by small businesses all over the country.

In the longer term, we will need to find other cost reductions to make up for the wage hike because we simply cannot raise prices or you will go to our competition. We will certainly not be able to do some of the innovations we were hoping to do to help us better compete against the big guys.

Within the context of this hearing, I advocate eliminating the tax code that discriminates against retailers that own their own businesses. Under the current law, retailers that own their stores must write off improvements to those stores over 39 years, while the retailers that lease their stores can write those improvements off in 15 years.

For me and thousands of small retailers across the country, eliminating this discriminatory treatment would greatly reduce the cost of improving our stores and free up capital as wages go up and we strive to compete with the large national chains that benefit from economies of scale.

S. 3806 would eliminate this unfair treatment. I urge you to include this legislation as part of the minimum wage tax package.

For me, both the major national chains that I compete with lease most of their stores in shopping centers. When they renovate their stores, they write off these costs over 15 years. With respect to the stores that I own, I have to write them off in 39 years. Frankly, I do not get it.

Retailers generally make more of an investment in the community when we own our own stores. When a neighborhood deteriorates, the retailer who leases his store can break the lease or wait for it to expire and move to a new location.

Retailers that own their own stores have a way bigger investment in the community. They have a stronger bond and an incentive to work towards revitalizing the community. But we still need to keep our stores fresh.

For some of my independent retailer buddies and colleagues, the store may have been passed down from previous generations and the store, the building, is the principal asset of the family-owned business. We should not have to pay a higher price for our renovations because we own the store rather than lease it.

If you are thinking, well, then, why do you not lease your stores to get the 15 years? We cannot get into the good malls. The developers will not lease to us because we are not credit-worthy.

If you think about it in your States, all the great strip centers, the real high-flying places, they have no independents in there. We cannot get in there, so we have to buy our own buildings, usually not in the A locations.

So, Mr. Chairman, thank you again for holding this timely hearing. I would be happy to answer any questions after.

Senator BAUCUS. Thank you, Mr. Ratner.

[The prepared statement of Mr. Ratner appears in the appendix.]

Senator BAUCUS. Mr. Obenour?

STATEMENT OF BRUCE OBENOUR, PRESIDENT, AKWEN, LTD, DUBLIN, OH

Mr. OBENOUR. I am Bruce Obenour, owner of Akwen, Ltd., a Wendy's franchisee in Northeast Ohio. Thank you for the invitation today to testify about the Work Opportunity Tax Credit and the impact of the minimum wage increase.

Ten years ago, my family and I took a risk and started a business. Today, we own 21 restaurants and provide jobs for about 100 full-time and 650 part-time workers. Our hourly crew rate for those part-time workers last month was $6.44 an hour.

Mandated increases in the starting wage may or may not result in quality of life improvements for low-skilled and entry-level workers. There is certainly a broad spectrum of opinion. As an employer in the industry with a majority of these workers, I assure you there are consequences to our business and our employees.

I have lived in Ohio all my life. My stores are in Northeast Ohio in the Rust Belt. Many are in older buildings and older neighborhoods. On January 1, the minimum wage in the State of Ohio increased to $6.85. That may not sound like much, but the cost of 41 cents more an hour equates to $370,000 annually to my business.

An increase in the minimum wage comes with an increase in Social Security, employment, and workers' compensation taxes. In fact, we just closed a store in Cuyahoga Falls, OH.

The decision was a difficult one because we have long been a part of that community, but with the looming minimum wage increase in the State of Ohio, that store was no longer economical. The wage increase was not the only factor in the closing, but it was certainly a significant one.

More than any other private industry sector, restaurants provide the most on-site job training for entry-level, especially teens, in the workforce. It is more than putting the pickles on first.

Our employees are required to be rigorously trained through a specialized and highly structured format, and at considerable cost. The training we provide prepares them for future work opportunities and self-sufficiency later in life.

We give our crew opportunities to gain specialized training in not only food preparation and equipment use, but we also provide technology training for point-of-sale systems, inventory control, security systems, and the like.

Our trainees learn compliance with basic workplace laws like OSHA, ADA, wage, hour, civil rights, sexual harassment, discrimination, and other employment laws.

When we hire someone, we teach the fundamental expectations all employers have for on-time arrival to work, scheduling, proper procedures for absences, being prepared for work—meaning uniforms, appearance, and attitude—and learning what is acceptable behavior in the workplace.

Often, we are the first to teach these young people basic workplace values, teamwork, and personal responsibility. Consequently, hiring teens and low-skilled workers is more expensive than you might think, especially when our cost of labor goes up.

Current minimum wage proposals call for a 41-percent increase. As a labor-intensive business with a low-skilled workforce, we are disproportionately challenged to manage the resulting margin pres-

sure. The quick-service restaurant segment is different from other industries.

We will not manage our labor costs by shipping our jobs overseas. Our option is to run our stores with less labor. In 2001, I had roughly 900 employees. At the end of last year, I had 750, even though the total number of my restaurants remained static.

We cannot eliminate large numbers of jobs at the store level. Instead, we are forced to work relentlessly to take labor out of the restaurants one hour at a time, and we do it by installing high-tech equipment.

We need WOTC. It is well-intentioned and can be effective. However, it should be strengthened and expanded. To do that, I recommend the following: the credit should be made permanent or have a longer extension; the targeted groups under WOTC should be expanded to include teens in the quick-service restaurant segment. Our segment is burdened most by the increase because of the nature of our workforce and our business model.

In December, the unemployment rate was 4.5 percent; in my part of the country it was significantly higher. Significantly higher still is the national unemployment rate for teens, at 15.2 percent, and for African Americans, at 26.2 percent.

In light of these high rates and the costs associated with training teen workers, it makes sense to enact a narrow incentive intended to help us hire those who need these job opportunities the most.

For small businesses like mine and many other franchisees, we run our businesses through pass-through entities. Adjustments to the Alternative Minimum Tax are necessary for us to make the most use of the WOTC and other tax incentives.

Because of the AMT, which often kicks in due to deductions for State and local taxes, and in our case depreciation adjustments, we cannot take advantage of the WOTC credits, thereby eliminating the program's effectiveness. The law should be amended to permit WOTC to offset AMT liability.

These recommendations will contribute to the reinvestment in the workforce and our businesses in the near term to benefit the economy.

I thank the committee for its work and sincerely appreciate your focus on these important policy issues.

[The prepared statement of Mr. Obenour appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Obenour, very much. Thanks for the suggested refinements, for example, to the AMT. I appreciate that very, very much.

I would like to just generally ask your reactions to a tentative package we are thinking about here to help small business. There is going to be an increase in minimum wage, which means I cannot get into too much of a debate between Dr. Bernstein and Dr. Sabia. I think it is going to happen.

But I very much agree that the EITC certainly helps poorer people much more directly. You made some very, very good points. I am a big fan, frankly, of the Earned Income Tax Credit. It has helped a lot of people in a lot of ways.

What I would like to do is just get the panel's reaction generally to the package we are thinking about. Maybe you can suggest some

changes. Maybe you can suggest some better ideas on how to deal with the small business portion. We will just see what you have to say.

We are dealing with, maybe, roughly, $8 to $10 billion total, so the sky is not the limit here. We have to make choices. But the general thought is to continue the section 179 expensing provision—it is $100,000, indexed a little bit—at least for a year. My guess is, like some of the taxing standards, those just tend to continue over time, hopefully indexed, and maybe make some changes.

Second, the leasehold improvement change includes some modifications that you have suggested, Mr. Ratner, namely, that it apply not just to those who lease, but to owners, too. He made some very good points, and I think they are very valid. That is extended for one year.

The WOTC is made permanent, the Work Opportunity Tax Credit, with some additions. We can look at the additions you suggested, Mr. Obenour, but at this point we are thinking of helping veterans, disabled veterans and families of disabled veterans, and so forth. It is an expansion to the definition that was included in the Work Opportunity Tax Credit.

Let me see what I have forgotten. Cash accounting. We would raise that to $10 million businesses and make that permanent. So any business that grosses under $10 million can use the cash basis. That would be a permanent provision in the law.

So, I guess, your reactions? Let me go backwards this time. I will start with Mr. Obenour. Actually, I will make this kind of freewheeling. Just, anybody jump in. If somebody says something that needs a response, pipe up, all right?

Mr. Obenour?

Mr. OBENOUR. I would suggest to you that, when we look at WOTC, it is a well-intended program. The benefits are minuscule in reality. We have roughly 550 of our 650 hourly folks that are under the age of 20. Forty-five percent of our folks are under the age of 20.

It's my opinion that these folks need to be included in the WOTC program, and WOTC needs to be adjusted such that we can derive the benefit from it, because these are the large numbers of folks that we are employing.

Senator BAUCUS. All right.

Mr. Ratner, your thoughts?

Mr. RATNER. I agree with him completely. We employ lots of teens as well. These are the kids that we are trying to make into our future citizens. We are their teachers, for crying out loud. So that is a big deal. It should be happening.

As far as my main point with the leaseholds, the only way that guys like me—and all of you have lots of small businesses in your communities—can compete with the big guys, because we cannot do it on price—they buy better than us, they get leases better than us, they do everything better than us—is to own our location and to provide better service. If our service is not good, there is no reason to go to an independent.

We all go to independents because we expect better service. For us, owning our own business means that the landlord cannot sell it and throw us out and put a Wal-Mart in. It means that, in my

case—and I called five of my friends who all own our own buildings—every one of us needs to redo our buildings.

I am in the pet business. The new PETCOs and PetSmarts are just God-awful gorgeous. Our stores have to be like that. We cannot afford to do it and write it off in 39 years. Plus, the fact that a floor does not last for 39 years. It is our retirement. These buildings are our retirement.

Senator BAUCUS. All right. Good.

To you, Mr. Kadish, generally.

Mr. KADISH. On the cash method, I applaud the idea of bringing it up to $10 million. I would suggest, though, that there are a number of different cash method thresholds. There is a $5 million threshold in the statute. There is a $1 million and a $10 million administrative one.

There is more stuff in my materials, and I can go into it if you would like. But the test that is set forth in Rev. Proc. 2002–28, which provides that small businesses currently below $1 million do not need to maintain inventories or use the accrual method, would be the one to bump the limit up on. If we adopted that, that would be of the most help.

Senator BAUCUS. My time has, frankly, expired. Just very quickly, Dr. Sabia and Dr. Bernstein, your thoughts on what works best here, your perspective.

Dr. BERNSTEIN. Two quick thoughts. First of all, I appreciate the fact that you are talking about something like $8 to $9 billion of tax cuts. Incoming Chairman Baucus mentioned that these will be offset.

Senator BAUCUS. Right. That is completely offset.

Dr. BERNSTEIN. And so I think we need to know what those offsets will be.

Senator BAUCUS. You will find out. [Laughter.]

Dr. BERNSTEIN. We are all engaged in tooth-and-nail arguments and fights over $1, $2 billion.

Senator BAUCUS. Sure.

Dr. BERNSTEIN. Do we expand child care?

Senator BAUCUS. But you make a good point. We have to have offsets for future provisions later this year, and we are keeping that well in mind.

Dr. BERNSTEIN. So we are fighting tooth and nail for $1 to $2 billion for child care slots to complement welfare reform, and if the community is able to come up with $8 to $9 billion in these tax cuts, then I would hope we can turn there as well.

On WOTC, the Work Opportunity Tax Credit, there are two views. One is the view that Mr. Obenour expressed, and I take that view very seriously because he is at the ground level.

The research on this has found that it tends to be more of a windfall for employers who are essentially taking the credit for workers they would have hired anyway. I think both are probably true. I take the comments we heard earlier seriously in terms of streamlining the process.

Senator BAUCUS. We haven't got time here, but I see Mr. Obenour shaking his head. He does not really agree with all that. But I appreciate that very much. I might say, my time has expired,

too. I am sorry, Dr. Sabia. Maybe we can get to you a little bit later, but my time has expired.

Senator Grassley?

Chairman GRASSLEY. Dr. Bernstein, I would like to refer to 1996 when a *New York Times* reporter asked you whether any argument could be made that would change your mind about supporting minimum wage. You were quoted as saying, "If someone could show me you were hurting the people you were trying to help, that would change my mind, but I don't think anybody can do that."

Now, since that time that you gave that interview in 1996, there have been a number of studies, some of them referred to by Dr. Sabia, that show an increase in the minimum wage will increase the number of families living in poverty.

Considering those studies, would you agree that raising the minimum wage hurts people that you were trying to help?

Dr. BERNSTEIN. I think the benefits of raising the minimum wage, including the proposal that is on the table today, far outweigh any potential job losses. I absolutely agree that you can find good-quality research that shows employment losses. But we have to be careful not to say, somebody lost the job, therefore the policy is not worthy.

Even research that Dr. Sabia cited, research cited in this exhaustive review by Neumark and Wascher, has shown that the typical job loss effects, among the studies that find such effects, are 1 to 2 percent for a 10-percent increase in the minimum wage, meaning that, again, the vast majority of affected workers are beneficiaries.

And by the way, you can talk about the studies that find negative effects. We can talk about studies on the other side of the ledger that find zero effects. Some of those are very high-quality studies that compare two places that are very much the same in terms of their economic conditions, yet one had the increase and one did not. It is a pseudo-experiment that is so rare in empirical economics and it has changed economists' views in the sense that I said back in 1996, and maintain today.

Chairman GRASSLEY. All right.

Dr. Sabia, would you please comment? I presume you have a different view.

Dr. SABIA. Sure. I think Dr. Bernstein is probably referring most dramatically to the Cardin-Kreuger studies of the early 1990s, which found no evidence of significant employment effects.

Since that time there have been dozens and dozens of studies—nearly 100 empirical studies, as I said, reviewed in the Neumark and Wascher study—findings of consistent evidence of these adverse employment effects.

Now, it is no doubt true that, after a minimum wage increase, some low-wage workers who keep their jobs may—and this is what is found—move out of poverty as a result of the wage increase because they have kept their jobs, but other low-wage workers, in fact, will fall into poverty as a result of the adverse employment effects, and also the reduction in hours.

Employers can respond to minimum wage hikes not just by laying people off, but also by cutting back the number of hours they can work. On net, what has been found is that those who move into poverty outweigh those who are lifted out of poverty. So on that,

the minimum wage increases are not doing what its proponents say it ought to do, which is to reduce poverty.

If I could make a quick comment on this Work Opportunity Tax Credit and minimum wage sort of combination of policy. It is not clear that the Work Opportunity Tax Credit is going to be any better targeted than the minimum wage if the goal is to reduce poverty. As we heard, most workers who are going to receive that credit are going to be teenagers in middle-class families.

This idea of sort of combining work opportunity tax credits and minimum wage increases has this feel of Ronald Reagan's old line about government: if it moves, tax it; if it stops, subsidize it. It seems to me it is not the right approach if the goal is to reduce poverty. We know what we can do to achieve that goal.

Chairman GRASSLEY. I would like to go to Mr. Kadish and ask him about the extent to which he believes 179 expensing encourages growth in small business. You might have specific examples since you advise, as an attorney, people on the use of that.

Mr. KADISH. Yes, sir. We think that 179 expensing is terribly helpful to small businesses. They have equipment to put in place. They need to make decisions on when and whether to make expenditures.

As a practical matter, if they can deduct more, they spend more, they invest more in their businesses, and we think that is good for their businesses. It just helps them do their jobs.

Chairman GRASSLEY. All right. I am going to put a couple of questions in in writing.

Senator BAUCUS. All right.

[The questions appear in the appendix.]

Senator BAUCUS. Next, as all Senators know, the rule, just to remind us all, is that Senators, but for Senator Grassley and myself, who arrive before the committee begins will be recognized in order of seniority, but alternating back and forth on each side of the aisle. Senators who arrive after the committee hearing begins will be recognized in order of appearance, irrespective of political party.

So combining all that together, the next Senator to be recognized is Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

First, let me say that it is a real honor and pleasure to serve with you and with Senator Grassley on this committee. I want to thank both of you.

As a person, in the past, interested in many issues before the committee but not serving on the committee, I have appreciated your graciousness, and the graciousness of your staffs, in working on many issues that affect Michigan. I am proud to be the tenth member here from Michigan.

There is no question that even in a State like mine that is a large industrial, large business State, that small business is our economic engine in terms of growth, entrepreneurship, not only in the service industry, but in suppliers, entrepreneurs, high-tech across the board. We have tremendous strength and growth in small business. So, I am very interested in what we can do on an ongoing basis as it relates to small business.

I also know that the picture in my State is different than what has been described today in terms of who is on the minimum wage,

and I would be remiss if I did not say that we have a lot of folks in their 50s who have lost a job with a factory in other places who have now gone back to not only one minimum wage job, but possibly two, in some cases two and a half or three.

It is not surprising to see an older person standing at the window of a fast-food restaurant rather than a younger person. So, I come to this with a different experience than has been related in many cases today.

But, nonetheless, we are in a situation where we are balancing on this committee the need to value work and the need to value those who create the work: the owners, the entrepreneurs, the business people. And when we look at the last minimum wage increase on September 1, 1997, since that time the GDP has increased over 32 percent.

Corporate profits have increased 46 percent. S&P 500, adjusted for inflation, has increased 58 percent, but the purchasing power of our minimum wage earners has deteriorated by 20 percent. So, that is what we are grappling with, valuing those who are working and trying to make sure they can have what they need to take care of their families.

Dr. Bernstein, on October 1, 2006, first, Michigan became one of 28 States to increase our minimum wage. I personally believe we are better off, from a national standpoint, rather than having States competing among wage differentials to actually have a national minimum wage. I think that is better for small businesses in America.

Although it is too early to tell exactly the impact on this current increase in Michigan, I am very hopeful, based on a Fiscal Policy Institute study that occurred in the past—and I recall that in 2004 you testified before a House committee regarding the minimum wage and its effect on small businesses, and in that testimony you cited a Fiscal Policy Institute study that compared the impact of higher minimum wages on small businesses in States with minimum wages above the Federal level and those at the Federal level.

That study actually discounted the theory that higher minimum wages hurt small businesses. Instead, the study showed employment actually grew more quickly, by 1.5 percent, in high minimum wage States.

I am interested in knowing your view today as it relates to that study since 2004 and whether you have found areas of the country that counter that study. Have there been areas that have faced a decrease in small businesses due to an increase in the minimum wage?

Dr. BERNSTEIN. I know of no studies that have found that last point. In fact, one study that I also cited in that earlier testimony shows that there is no correlation across States between increases or changes in the minimum wage and small business start-ups or failures.

That makes a lot of sense, because if you think about just the past 9 years, at least at the Federal level, when the minimum wage has eroded, we have not seen a dramatic increase, or for that matter a decrease, in business start-ups.

Basically, when you get right down to it—and this is what the Fiscal Policy Institute study found—what really drives business

creation tends to be the macro economy, tends to be the demand for the goods and services that businesses are producing and selling. The quality of that job has a lot to do with the minimum wage, as well as a set of other policies that we have talked about today.

I will only add that I think the study you mentioned is important in the following regard. Once again, we have the opportunity to look at different States' experiences, States like your own, and what that study that you mentioned did was, it looked at job growth and payroll among small businesses in States with higher minimum wages and States without and found that there were relatively small differences between them, and if anything the differences seemed to favor small business, both in terms of employment and payroll growth, in States with higher minimum wages.

Senator STABENOW. Thank you, Mr. Chairman. My time is up. Thank you.

Senator BAUCUS. Thank you, Senator.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus. It is good to be here and to be a part of this committee. Let me just, first of all, say to you and to Senator Grassley, and to all the members of the committee, that I think you set a very high standard for how people in the U.S. Senate should function.

For me, a part of being in this committee is very much looking forward to working with you in the bipartisan fashion in which you have dealt with some very, very difficult and complex issues.

So I will say, as my first statement on this committee, that it is truly a day of honor for me to be able to sit here with all of you as we deal with this particular issue.

Let me also say that I know that that extends to the staff of this committee. All of us, I know, serve on other committees, but I think the reputation of this committee is that the staff works for all of us and is very helpful, and I certainly have found that in my first few weeks. So, thank you very much.

Second, in terms of just my own interest on this issue and some background, I look at this from a lot of different points of view, including the workers who are minimum wage workers, as well as small business.

My life history has taken me through a wife who ran a Dairy Queen franchise in Westminster, Colorado for a number of years, so she understands the same kinds of issues that Mr. Obenour was talking about, and as a farmer and rancher in southern Colorado, dealing with many of the small business issues that you have all addressed today.

I want to make just two quick points. The first is that I think that it is important that we in the U.S. Congress act on increasing the minimum wage, and that we ought to do it this year, we ought to do it quickly, we ought to do it soon.

In Colorado this last year, we had a ballot initiative that increased the minimum wage from $5.15 to $6.85, and to many of my friends in the business community who would come and talk to me about that particular campaign, I said the reason Colorado was acting on its own is, frankly, because the Congress has failed to act.

So my hope is that this committee does move forward with legislation and that we would move forward with legislation that does

increase the minimum wage. It seems to me that it makes much more sense to do it on a national basis as opposed to doing it through the kind of patchwork that we otherwise will see across the Nation. So, I am supportive.

Second, I also think that the suggestions that have been made by Chairman Baucus and other members of this committee that we create some incentives for small businesses are a very important way for us to go.

At the end of the day, small businesses contribute hugely to the economic well-being of our country to create jobs for about 80 percent of the people whom we employ here in the United States of America.

As you struggle to make ends meet at the end of the day, the kinds of incentives that we have been talking about here today and the package, I think, are important.

I think the two witnesses at the end are sort of ideological in terms of their point of view, one opposed, one for this minimum wage. I want to ask the other three witnesses, Messrs. Kadish, Ratner, and Obenour, a very simple question.

That is, if we look at three of the kinds of tax credits for small businesses—one, a depreciation schedule for leasehold improvements from 29 years to 15 years; second, the WOTC, Work Opportunity Tax Credit; and three, the increased expensing for small businesses, those three—how would you rate those three in terms of their importance, if you could quickly respond to that question?

Mr. KADISH. I will go first, I guess. In terms of the types of clients that I work with and the membership of our organization, I would rank them: expensing, one, depreciation, two, and WOTC, three, but I think you will find that that varies from industry to industry and sector to sector.

Senator SALAZAR. Mr. Ratner?

Mr. RATNER. I would do the depreciation first, the expensing second, and the WOTC third.

Senator SALAZAR. Mr. Obenour?

Mr. OBENOUR. I would do the depreciation first, the expensing second, and WOTC third.

Senator SALAZAR. All right. Thank you. Thank you very much.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator Salazar.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman, and congratulations 1 day early, or 2 days early.

Senator BAUCUS. Whatever. [Laughter.]

Senator BUNNING. Mr. Kadish, one of the proposals under consideration, and it was not mentioned by prior committee members, is to change the ability of small businesses to use the cash method of accounting for tax purposes.

Can you explain why small businesses generally prefer the cash method over the accrual method of accounting, and why is more flexibility in this area appropriate?

Mr. KADISH. Yes, sir. Under the cash method of accounting, a business takes items into income as they are received and deducts expenditures as they are paid. The advantage of the cash method

is simplicity. It makes sense and it works the way that a small business person and an average lay person thinks.

They do not need to hire an accountant in order to understand that when they get a check in the mail, they need to consider that to be something that they have gotten. When they make an expenditure, they need to treat it as an item paid.

The accrual method, by contrast, is more complex. It is perhaps a more refined accounting concept. The IRS generally prefers it because they feel that it more correctly reflects the proper incidence of taxation. The problem is, your average taxpayer does not understand it and they generally need to get an accountant involved in order to properly implement it.

Senator BUNNING. So it would be the simplification.

Mr. KADISH. It is simplification. And the cost which comes with complexity. Yes, sir.

Senator BUNNING. All right.

Dr. Sabia, do you have a different opinion on the Fiscal Policy Institute's employment study than Dr. Bernstein?

Dr. SABIA. Yes. In fact, you should have a study of mine in your packet——

Senator BUNNING. I do, right here.

Dr. SABIA [continuing]. Which looks at the effects of minimum wage increases on small business and retail employment. In fact, the Fiscal Policy Institute's study, while interesting descriptively, was not particularly—how do I say this? Statistically rigorous. Econometrically rigorous.

That is to say, it did not approximate close enough the conditions of an experiment. It did not control for anything else, any other changes in the economies of the respective States that were being compared.

The study that you have before you that looks at the effects of minimum wage increases on small businesses' attempts to control for lots of other things, like changing demographic characteristics of the States, changes in the macro economy, changes in State economy, and so on, comes to a very different conclusion: the fact that a 10-percent increase in the minimum wage would reduce small business employment by between 1 and 1.5 percent.

Senator BUNNING. Completely different than prior.

Dr. SABIA. That is right.

Senator BUNNING. Last, but not least, the two small business men, Mr. Ratner and Mr. Obenour. Tell the committee about the increase of expensing 179, your personal experience with that, because you are the only two here who have small businesses.

I was a very strong supporter of this provision when it was first passed in 2003. I would like to hear from the small business owners about whether they have taken advantage of it.

Mr. OBENOUR. Senator, my experience is that I generally have been unable to take advantage of it because my business is very capital-intensive in short-term assets that I have to replace on a regular basis, and my capital spending generally overruns the number, so I have not been able to take advantage of it.

Senator BUNNING. You cannot take it up to $100,000?

Mr. OBENOUR. My understanding is that my capital spending is in excess. I can take the first 100 but I cannot go beyond that.

Senator BUNNING. Well, then it does help to that degree.

Mr. OBENOUR. It does help, but it needs to be expanded.

Senator BUNNING. All right.

What about you?

Mr. RATNER. You bet. Every one of my stores has electric pallet jacks. We have forklifts. We all got new telephone systems.

Senator BUNNING. Because of that fact.

Mr. RATNER. Absolutely. It never would have happened if we did not have that law.

Senator BUNNING. All right. Thank you, Mr. Chairman.

Senator BAUCUS. You bet. Thank you, Senator.

Senator Roberts?

Senator ROBERTS. Thank you, Mr. Chairman.

It is a privilege to be the 343rd member of this committee. I am not sure I can fill the shoes of Bob Dole. Lord knows, I have toted enough buckets for him, so perhaps he can give me some advice. [Laughter.]

I have to apologize to Senator Grassley, who has left. I usually have the obligation to provide him a glass of ethanol every morning and it warms him up. [Laughter.] I tried that with Senator Rockefeller, but it did not work, on the Intelligence Committee.

Chairman Baucus, I do want to congratulate you, sir. I look forward to working with you. I am sorry. I got your windows cleaned up yesterday; I will have your shoes shined like you intended as of tomorrow. [Laughter.] We are working on that.

I want to refer to Senator Grassley's comments about the Washington paper—I think it is called the *Post*—and complaining, or at least having some concern, about the Business section.

I would like to have everybody in the audience, all the witnesses, and all the remaining members, all four of us, to read the first-page story about Atchison, KS, America and a fellow named Jack Bauer. Now, this is not the Jack Bauer who is going to be on Sunday and Monday. He can take matters in his own hands.

This is Jack Bauer who is a small business person who cannot take matters in his own hands. It is about what he is going to face, life at $7.25 an hour, which is going to happen. The chairman is right, we are going to pass this.

But the key is, what we pass basically works with this increase to be of benefit to small business. So it is an interesting story. It is a micro-story. Dr. Bernstein, you are a macro guy. I am a micro guy. I have to tell you, I get letters all the time from Kansas, from small business people, and we are talking about 60,000, at least.

They are not writing me saying I want more regulations, or I want this bill passed or that bill passed. They say, what on earth are you doing back there, passing bills with more regulations, burdensome paperwork, putting me out of business, and so on and so forth? They do not look at it as tax cuts, they look at it as tax relief. There is a big difference.

I know everybody says tax cuts, and then the favorite line around here is "for the rich." Well, or to spend it somewhere else. These folks cannot afford that. They are looking for tax relief because they are on the margin.

Now, Jack Bauer has a choice. He has four employees. He operates a store that is called Wow-Only One Buck! That is the name

of his store. David, that is even smaller than your stores, or Wendy's. So everything in there is $1.00 and he has four employees. So he says he wonders whose hours he will have to cut if he has to give his employees a raise. And he is for it, as are all his employees.

Now, let me go down these employees. It is not that he is against raising the minimum wage. I do not think $5.15 is adequate. That is what he pays. He says, adding the $7.25 seems fair, but his profit margin is very thin. His wages are his biggest controllable expense, so if his wages go up, he said, hours will have to come down. The question will become, whose?

Who will it be? Neil Simpson, 66, works 6 hours a day as a stockman, 5 more hours somewhere else, and he is cleaning floors. He takes care of a wife who is blind and has arthritis.

Will it be Susan Irons, who is 57, who was infected with hepatitis C from a blood transfusion and is on a waiting list for a liver transplant and needs more hours rather than fewer?

Will it be Christina Lucks, who is 22 and 13 weeks pregnant?

Will it be Robert Eylas? There is a big story about Robert. He takes care of his dad, who is very ill, and his mom, who is also taking care of his dad. He lives in a trailer. The story goes on from there.

So I guess my question to you is a very generic question. I just do not see how we can pass a minimum wage without some package that, as has been proposed by the chairman and the distinguished ranking member-to-be, without giving some help to these people.

That is the real story that we are dealing with here, time after time after time in many small communities in Kansas and many rural States. Ken Salazar also represents a State like that.

Would anybody like to comment? I love your studies. I love the macro studies. I love all the percentages. I am talking about people. I am talking about people that I visit with every time I go back home.

Any comments? Yes, sir?

Dr. SABIA. Again, I believe that the best way to help those types of workers is through expansions in the Earned Income Tax Credit. Those are the ways that you are going to be able to transfer income to these people. These tax benefits to small business might have some indirect effect in which some of these workers may be able to work more hours because firms will keep them on because they have this tax break. But the most direct way to help these workers is through expansions in the Earned Income Tax Credit.

This discussion of, well, let us join together this minimum wage increase and the Earned Income Tax Credit and have both sort of happen at the same time, in combination they can reduce poverty, well, there is strong evidence that the EITC reduces poverty. There is no evidence that the minimum wage increase will decrease poverty. So will a combination of the two together decrease poverty? Well, I mean, maybe.

But that is like saying the Aaron brothers, Hank and Tommy, in combination hold the baseball home run record. Well, I mean, if you want to achieve the goal of winning the game, who do you want at the plate, Hank's 755 or Tommy's 13? You want to go with

the Earned Income Tax Credit, just like you would go with Hank, to get the job done. The minimum wage is not going to help these workers, it is probably going to hurt them.

Senator ROBERTS. My time is up, Mr. Chairman. Thank you very much. I urge everybody to read the story. Thank you.

Senator BAUCUS. Thank you.

Before we wrap up here, is there anyone who would like to say something because somebody said something outrageous? Oh, Senator Rockefeller. I forgot you. [Laughter.] My good friend, Senator Rockefeller. You have clean-up now.

Senator ROCKEFELLER. All right. Thank you, Mr. Chairman.

A couple of things. I would just, again, say to you, Dr. Sabia, that you sort of take the minimum wage all by itself. I do not think we, in the Senate or on this committee, think of it that way. We think of it as being a part of a series of efforts to try to raise the condition of the poor.

We have spent a lot of time on the Earned Income Tax Credit over the last number of years. Now, that is a very expensive thing, and it is at a pretty high level right now. The food stamps is another aspect. I think in the farm bill this year there is a very good chance that there will be an increase in that.

Then, also, the refundable Child Tax Credit is very much—children are very much—on the minds of the entire Congress if we are going to do anything about health care. So I would just say, I think you sort of take it by itself, the direct effect of it as opposed to some of the indirect aspects that come from other public policies.

I will not ask you to respond to that unless you want to. Senator Stabenow was describing Michigan. West Virginia has always been among the three or four most challenged States in terms of job opportunities.

We figure that there will be about 59,000 people who will be directly benefitted from the exact minimum wage aspect—in other words, what you were talking about, the exact amount of increase—but that there will be close to 133,000 who will get more than that and who will be helped in a variety of other ways.

To Dr. Bernstein, something that is really difficult for me to understand, actually, which I would like to have you try to interpret for me. Usually when you have a panel of this sort you get a very negative aspect about minimum wage or other matters, how the government is doing. I understand that.

But there was a Gallup poll last year specifically on this subject which said that 86 percent of small business owners do not think that the minimum wage affects their businesses.

Would you try to put that in perspective in terms of what the general talk is about minimum wage, and then what this particular poll seemed to say and what your own thoughts might be?

Dr. BERNSTEIN. Absolutely. Let me just begin by reflecting on the article that Senator Roberts mentioned. He noted a number of people who are affected by this increase whose ages were 66, 57, and 22 and whose families clearly depended on their increase.

So, I very much disagree with the notion that Dr. Sabia and others have put forth that this just does not help people who need the raise. I mean, I think that is demonstrably untrue.

Regarding small business, I mean, we are talking about a minimum wage that is at a 52-year low. The reason why so many small businesses answered that poll question in the way you correctly cited is because many of them are already paying wage levels that are at or close to the proposal to go up to $7.25, at least in 2009.

So the fact has been mentioned today, this is a 40-percent increase, from $5.15 to $7.25. That is irrelevant. What matters is the share of workers that is affected by the increase. The last increase was a 20-percent increase, from $4.25 to $5.15. It affected 9 percent of the workforce. This increase is going to affect about 4 percent of the workforce directly.

The reason is, because we have waited such a long time to fix the wage floor, lots of workers have passed through that threshold and it is not a very binding increase.

You are always going to find people and business persons who will reasonably tell you, we do not want our labor costs to go up. Totally understandable. But the magnitude of this increase, in historical terms, is really very small.

Senator ROCKEFELLER. Thank you.

Thank you, Mr. Chairman. Mr. Chairman, can I put my opening statement in the record?

Senator BAUCUS. Certainly.

[The prepared statement of Senator Rockefeller appears in the appendix.]

Senator BAUCUS. I would now like to turn to a Senator who has mastered the art of timely arrival. [Laughter.] Senator Lincoln?

Senator LINCOLN. Well, thank you, Mr. Chairman. I just passed Senator Grassley in the hallway. We were switching places over there in the Agriculture Committee, I suppose.

But I want to thank you today for bringing up the ability to discuss two very important, yet separate, issues: minimum wage and small business tax relief. They do have some bearing on one another, but I think they are so important in regard to quality of life, as well as the ability to grow our economy.

In places like Arkansas where we find our small businesses to be our largest employer, they are both very important. Of course, in a State like Arkansas where we do have a large percentage of minimum wage workers, they are both very important. So, increasing the minimum wage certainly is long overdue.

Our workers' wages have remained stagnant, while they have at the same time seen nothing but increases in their costs of living; multiple, multiple different increases in their costs of living.

I think we all agree, as we raise our families, that any American who works 40 hours a week should not have to raise their family in poverty. My children are going through tennis shoes like water right now, and I know when other families and other mothers see that happen, dealing with that on the basis of the minimum wage salary or minimum wage is very, very difficult.

So I do appreciate the chairman bringing this up, and I think you have dealt with it in a very balanced way. I appreciate the fact that you have brought these issues together and allowed us to have this discussion, and hopefully to move forward on issues that I think are very important.

As I mentioned, Mr. Chairman, in my State of Arkansas, as in so many of our rural States, most of our businesses are small businesses. They are family-owned businesses. They provide the bulk of our jobs and they are the backbone of our rural communities. They are the ones that sponsor the Little League team. They are the ones that sponsor the high school band in their trip or in their uniforms.

They are truly the backbone of rural America and our small communities. Just like our workers who face obstacles as a result of stagnant wages, our small businesses also face their fair share of obstacles, whether it is the skyrocketing costs of health care, the globalization of the marketplace, or the increased competition from their larger competitors.

As a result, I am so pleased that we have this opportunity, just as the Congress and President Clinton did in 1996 when the last minimum wage increase was passed, again, to look at the ways that we might be able to provide some relief to our small businesses that are so important to our small rural communities.

Just a couple of questions I hope I can slide in, Mr. Chairman.

Dr. Bernstein, I would like to hear your thoughts regarding the value that indexation of the minimum wage could bring. I bring this up because I have been extremely frustrated with the impact that wage stagnation has on, in particular, one very important tax policy to me which you all hear me repeatedly talk about, and that is the Child Tax Credit.

Because we index the income threshold to qualify for the refundable Child Tax Credit, every year we have more and more of our working families that are living on minimum wage and are not even getting to the threshold to qualify for that tax credit.

So, I guess, maybe your thoughts on the benefits of indexation of the minimum wage or the bigger picture, and also the interaction between the minimum wage and our tax policies that are designed to really benefit low-wage working families, such as I mentioned with the Child Tax Credit.

Dr. BERNSTEIN. Thank you. Senator, we have been talking about tax policy before you arrived.

Senator LINCOLN. I am sorry. I hope you are not repeating.

Dr. BERNSTEIN. No, no. I want to highlight a point that is very relevant to your question which has not come up yet. The point is that the policies that we have been talking about, policies that every member on this panel, except for myself, in some cases, has been advocating are all indexed for inflation.

If they were not indexed for inflation, there would be tremendous concern among folks at this table and members of this panel. The Earned Income Tax Credit is a good example. We talked about how the section 179 is now indexed for inflation and how important that is to other folks who are testifying today, and maintaining that indexation.

Yet, the minimum wage is not indexed. Its value, as you correctly pointed out, erodes every week and every month as prices increase. There is just no good rationale why this wage floor should be allowed to collapse as it has.

What you are essentially doing is putting the fates of low-wage workers in the hands of a political body that may or may not pay

attention to the issue and, in fact, is on record now for the longest period of ignoring that very point.

In terms of the interaction of the minimum wage with other programs, in some cases, because of the marginal tax rates of the Earned Income Tax Credit, the Child Tax Credit, certainly food stamps, families can actually end up gaining from the minimum wage and losing on the credit side.

Senator LINCOLN. Right.

Dr. BERNSTEIN. I think that is clearly an inappropriate outcome, given that these policies are targeted to raise the income of families who very much need both the minimum wage lifting their market earnings, but some of these credits to help fill out the gap between what they earn and what they need. So, I urge the committee to keep those kinds of "cliff effects," as they are called, in mind as they negotiate these issues.

Senator LINCOLN. Well, it really does have such an incredible impact, not just on the economics of our families, but also the sentiment of our children.

There was a very incredible piece that I got during the holidays in solicitations from nonprofits and it was for food banks, and it had a picture of a child with a backpack who said, "The other kids know that I am poor. They do not have to know that I'm hungry."

But when you look at working American families across this country, and my husband and I both produce an income in our household, yet looking at saving for college or trying to make sure that our kids get to join the chess club, and participate in Odyssey of the Mind, and the Cub Scouts, and all the different activities that kids want to do and be a part of, they take resources.

No matter how hard those low-income families work to pinch and save and shift those dollars, it is so critically important to at least give them the benefit of the doubt in these instances.

So I am extremely hopeful that we will address this issue one way or another in the coming year to ensure that we really live up to our promise to make the tax code for all working families fair and equitable and helpful.

So, Mr. Chairman, I appreciate your patience in allowing me to slip in and ask at least one question, and I look forward to working with all the gentlemen on the panel in the future. But we have lots to do.

Mr. Chairman, can I just make one quick comment? I have not heard much testimony today regarding the small business subchapter S corporation reform. Small businesses are often organized as S corporations.

In fact, we have more than 3 million of them in our country today. So I know the chairman and the ranking member, in the past, have supported a number of our S corporation updates, and I appreciate your past help.

I also appreciate the support of so many of our colleagues, Senators Hatch, Smith, and Snowe, and just want to urge the committee to work with us to include some of the much-needed updates on those S corporation rules for our small businesses.

Senator BAUCUS. You bet.

Senator LINCOLN. Thank you.

Senator BAUCUS. You bet. Those are very good suggestions. Thank you very much, Senator.

Now it is my honor to welcome a new member of the committee, Senator Cantwell, from the Evergreen State, the State of Washington.

Senator Cantwell is now the second Senator from the State of Washington to serve on the Finance Committee. One little interesting historical note here. Senator Cantwell can very quickly become the longest-serving member from the State of Washington by just completing this Congress, because there was an earlier Senator, Senator Wesley Jones, in the 72nd Congress who just served that one Congress.

Senator CANTWELL. Mr. Chairman, I am not sure exactly what that says about Washington State. [Laughter.]

Senator BAUCUS. We are very honored to have you, Senator, on the committee.

Senator CANTWELL. I, too, am very honored to be here and honored to work with you as chairman of the committee. I apologize. I was at another committee on China trade-related policy, and I know that is something that you care about.

But I, too, will be brief this morning and wanted to come and, if I could, just offer a perspective and ask Dr. Sabia a question.

In your testimony, you assert that raising the minimum wage is an ineffective anti-poverty tool, which is, I think, how you described it, because it does not target the poor population who need the help most and because it diminishes work opportunities for low-skilled workers.

Washington State has had a different experience. Back in 1998, by initiative of the people, I think with 60 percent of the vote, we passed a minimum wage law indexed to the rate of inflation. In fact, we just increased that index recently, so we are at $7.93. I think that puts us at the highest in the Nation.

At the same time, according to the 2005 Small Business Survival Index, which I think is done by the Small Business Entrepreneur Council, so it is a private organization, Washington is ranked fourth nationwide as the friendliest policy environment for entrepreneurship.

So Florida is another State where the minimum wage is also higher than the Federal minimum wage and is ranked sixth on that same list. So you have a couple of States—in fact, 5 of the 10 States—in the Retail Trade Group that have had higher than a Federal minimum wage. So, here is this Small Business Council Economic Index saying that these States have this great environment.

So, clearly Washington and Florida are examples of higher minimum wages that have maintained competitiveness for small business and work opportunities, obviously, for low-skilled workers. So how do you reconcile what is going on in Washington State and Florida with your testimony?

Dr. SABIA. Sure. Those are interesting sort of correlations, but what they may reflect is, in fact, that States with better environments for small businesses may be the types of States that have legislatures that are more likely to either pass minimum wage hikes or have the people support higher minimum wage hikes.

That does not necessarily mean that the higher minimum wage hike has caused this more favorable business environment.

Senator CANTWELL. Well, I would think the statistics would show it certainly has not hurt.

Dr. SABIA. Well, no. The more precise sort of question, if you want to do sort of an experimental analysis, is to see what would small business growth be in the absence of a minimum wage. What you may see is, in fact, a reduction in the rate of growth in jobs as a result of the minimum wage.

That is an explanation for why you might see States with more sort of pro-business attitudes that might have legislatures or populations that vote for a higher minimum wage increase. That does not suggest there is a causal relationship between the two.

In fact, more detailed econometric studies that have attempted to control for lots of other factors that are correlated with both the sentiments that lead to higher minimum wage hikes and to different business environments have concluded that minimum wage hikes reduce employment of small business. So you have a reduction in the rate of growth, for instance, in small business employment.

Senator CANTWELL. Washington State can have a cyclical economy, primarily because of the Boeing industry and aerospace, and now it has diversified in the last couple of years to software, so we have lessened that impact.

But I would say that Washington State has had some very robust job creation activity over the last several decades. Taking out those periods of—as I said, we have a very cyclical nature to our economy. And, of course, we have a different tax structure than most of the Nation, too. But I think it is a very positive sign. I do not know, Dr. Bernstein, if you would like to comment on that.

Dr. BERNSTEIN. I think your points are very well taken. I think you can always say, boy, things look like they have worked out pretty well here, and have somebody like Dr. Sabia say, well, yes, but they would be even better without the minimum wage increase. That is the unknowable counter-factual. I do not find it a convincing argument at all.

The question is, the way you framed it, has the increase in the minimum wage precluded positive economic outcomes? We know that it has very much helped positive microeconomic outcomes regarding the living standards of affected workers, and we also know that it has not precluded some positive macroeconomic outcomes as he has articulated.

And by the way, this is precisely the argument we had in 1996 when we went from $4.25 to $5.15. Doomsayers predicted that the economy, and particularly the low-wage labor market and particularly the opportunities of our least-advantaged workers, would be slammed by this increase. Precisely the opposite occurred. 1996 to 2000 was the best low-wage labor market we had achieved in 30 years.

Now, I am by no means, just as in answering your question, saying that the reason that occurred was because we raised the minimum wage. By no means. The minimum wage did help to improve the job quality of workers at the low end, but we saw steep reductions in single mom poverty.

We saw black poverty rates fall to their lowest level on record over this period, driven largely by a full employment macro economy that was running on full bore, and some good fiscal policy, too.

The point is that the higher minimum wage does what it is supposed to do, it helps raise the living standards of the workers who need the raise without significant adverse effects.

Dr. SABIA. I should just say, in 1996 I was just coming out of high school, so I cannot be deemed as one of those doomsayers. And I am not predicting even doomsday as a result of this Federal minimum wage increase. What I am suggesting is that its effect will be to cause job loss and not improve poverty.

Senator CANTWELL. Well, I would just say, Mr. Chairman, because I know my time has expired and I know you want to end this hearing, that I, too, heard all the doomsday when I was in the State legislature in the mid-1980s. I also saw Washington State citizens take over by initiative and pass this.

I would hope that Congress could act to increase the minimum wage, but I would encourage people to look at the Washington State experience at $7.93 in a very robust economy and what it has done for individual families. I thank the Chair.

Senator BAUCUS. Thank you very much, Senator.

Any Senators who have additional questions that they want to ask of the witnesses, we would like to have them in by close of business tomorrow. Tentatively, we plan to mark up this legislation on Wednesday of next week and then bring it to the floor as quickly as possible.

Thank you very, very much for taking the time, all of you. I know it is a bit of an expense for all of you, and we appreciate all the comments you have made. It has been very, very helpful, very interesting. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:52 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Tax Incentives for Businesses in Response to a Minimum Wage Increase

Hearing before the Senate Committee on Finance
January 10, 2007

Testimony by Jared Bernstein, Ph.D.
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Introduction

Chairman Baucus, Ranking Member Grassley, members of the Finance Committee, I thank you for this opportunity to testify on the proposed legislation to raise the Federal minimum wage. This is a critically important issue to millions of low-wage working Americans, many of whom have seen their economic fortunes dwindle in recent years, even as our nation's economy has prospered.

I urge you to speed Congressional passage of the proposed minimum wage increase and to do so without potentially expensive and poorly targeted tax provisions. Such provisions are unwarranted given the extensive tax cuts to business both small and large over the past decade, the relatively small magnitude of the current minimum wage proposal, difficulty targeting affected firms, and the lack of a clear incentive to offset the potential costs of the wage proposal.

The United States economy is in many ways the envy of the world. Productivity growth, a key measure of economic efficiency, has been stellar over this business cycle, rising 3.1% per year.[1] Our unemployment rate has been below 5% for the past year, and though real wage gains arrived on the scene only recently in this recovery, the last few months have been impressive in this regard as well. Profits to the nation's businesses have soared throughout the recovery, and as a share of national income, profits stand at a 56 year high.[2]

Yet, amidst all this prosperity, too many working families have been left behind. The income of the typical, working-age family is down five percent, or $3,000 dollars since 2000, and at the low end of the income scale, where the minimum wage makes a real difference, poverty is up significantly, from 11.3% of the population in 2000 to 12.6% in 2005.[3]

There are many reasons for the disconnection between growth and broadly shared prosperity, but one factor that has undoubtedly played a role is long-term decline in the real value of the minimum wage. Congress legislated a two-step increase in the minimum wage in 1996, and the wage floor has not been raised since September of 1997. As shown in Figure 1, we recently entered the longest period on record in which Congress has failed to raise the federal minimum wage.

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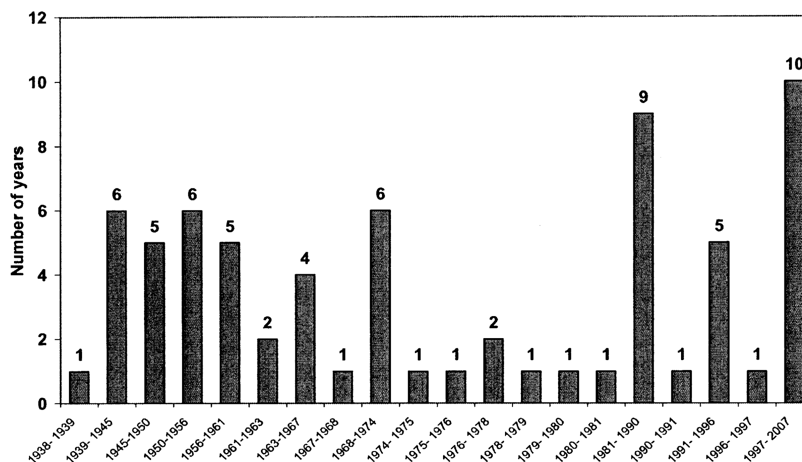
[1] Source: Bureau of Labor Statistics, Nonfarm Business Productivity, 2001q1-2006q3.

[2] Source: Bureau of Economic Analysis. As a share of gross domestic income, profits were 14.1% in 2006q3, the highest share since 1950q4.

[3] Source: Census Bureau's data on real median household income of families headed by a person under 65 and poverty for all persons.

Number of years between federal minimum wage increase



As Congress considers legislation to raise the minimum wage to $7.25 by 2009, my testimony stresses these points:

- In terms of its buying power, the federal minimum wage stands at a 52 year low. Compared to the average wage, the current minimum wage stands at 30.8%, the lowest level on record.[4]
- Since the last increase in the minimum wage, inflation has eroded one-fifth of its value. For someone working full-time, full-year at the federal minimum, this represents a loss of over $2,500 per year.
- While opponents of the increase stress job loss effects, recent research on the employment impacts of minimum wage increases show such effects to be negligible, with estimates that hover about zero; high-quality research tapping pseudo-experimental methods has been particularly enlightening in this regard.
- The last increase in the federal minimum wage did not result in any of the negative predictions made by opponents. Instead, it was followed the strongest job and wage growth in the low-wage labor market in decades.
- Economists and policy makers are recognizing the importance of the new research and these actual outcomes. In 2006, over 650 economists, including five Nobel Prize winners and six past presidents of the American Economics Association signed a statement that stated: "[w]e believe that a modest increase in the minimum wage would improve the well-being of low-wage workers and would not have the adverse effects that critics have claimed."

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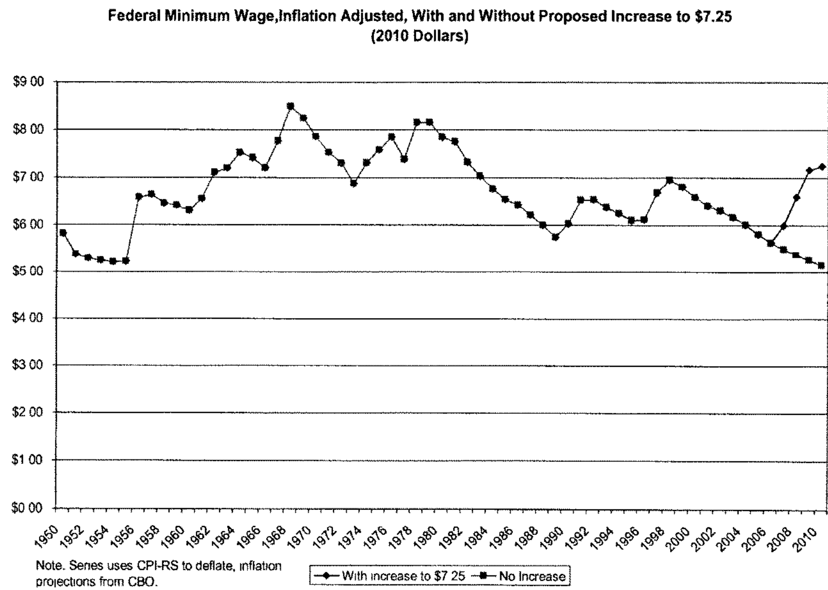
[4] See http://www.epinet.org/issuebriefs/227/ib227.pdf.

- The proposal under consideration is very modest. We forecast that it will directly lift the earnings of four percent of the workforce, about half the share reached by the 1996/97 raise.
- Given this moderate result, the Congress should pass a "clean" minimum wage bill, without tax cuts. Only one federal increase—the last one—was accompanied by such cuts, and since then businesses small and large have benefited from $300 billion in tax cuts. Any further cuts should be debated on their own merits, outside of this minimum wage debate.

The Decline in the Buying Power of the Minimum wage

Figure 2 shows the long-term trend in the minimum wage, adjusted for inflation, including a projection of H.R. 2429, a proposal to raise the minimum wage in three steps from $5.15 to $7.25 by 2009.

The series in Figure 2 shows how inflation erodes the buying power of the minimum wage, and reveals the two longest periods in which Congress failed to increase the wage: the current period, and the 1980s. Using CBO inflation projections to put these wage values in 2010 dollars, the figure shows the alternative paths of allowing inflation to further erode the current minimum wage versus raising the wage floor to $7.25. The increase would return the buying power of the federal minimum back to its level in the early 1980s.



Note. Series uses CPI-RS to deflate, inflation projections from CBO.

Bernstein and Shapiro (2006) show a similar long-term trend in the minimum wage relative to the average wage of non-managerial workers. As we noted in that report, "The federal minimum wage has often been set with the level of other workers in mind. This approach reflects the principle that minimum-wage workers should share in economic gains and should not fall too far behind other workers."5

During the 1950s and the 1960s, the minimum wage averaged 50%—or half—the average wage of workers in nonsupervisory positions. The minimum wage has now fallen to 30.8%—or less than one-third—of the average hourly wage for nonsupervisory workers of $16.73 in 2006. This is the lowest share in the history of this data series, which begins in 1947. Research has shown that the fall in the relative value of the minimum wage has contributed to the persistent increase in wage inequality since the latter 1970s.[6]

Who Would Benefit From an Increase in the Minimum wage to $7.25?

Research by Liana Fox at the Economic Policy Institute (Appendix Table 1) reveals that about 4% of the workforce, about 5.6 million, would be directly affected (another 7.4 million might indirectly benefit through so-called spillover effects). Most directly affected workers are adults (71%) and women (61%); 43% work full-time, and another 36% work 20-34 hours per week. Comparing the two columns reveals that those disproportionately affected by the increase include African-Americans and Hispanics, and workers in retail, hospitality, sales and low-end services.

Analysis shown in Table 1 suggests that while affected workers are disproportionately in smaller firms, size is by no means a primary determinant indicator of minimum wage receipt. About 11% more affected workers are in small (less than 100 employees) relative to all firms, and only 7.5% fewer are in large firms (more than 1000).

Table 1: Workers by Firm Size, All and Those Between 5.15-7.25.

Firm Size*	All	5.15-7.25	Difference (Those in min wg sweep-all)
Less than 100	43.0%	53.8%	10.9%
100-1000	18.5%	15.1%	-3.4%
More than 1000	38.5%	31.1%	-7.5%
Total	100.0%	100.0%	0.0%

* Source: Author's analysis of 2006 March CPS data. Note that firm size includes all workers at the firm, even though an establishment may be a subset.

[5] See: http://www.epi.org/content.cfm/ib227.

[6] See, for example, David Lee, "Inequality in the United States during the 1980s: Rising dispersion or falling minimum wage?" *Quarterly Journal of Economics*, 1999, 114(3), 977-1023.

While data suggest that most of the prospective beneficiaries of the proposal are adults working in low-wage sectors, some critics have claimed that the minimum wage is poorly targeted. That is, since receipt of the minimum is not income-tested, some who benefit from the increase live in families with incomes above the poverty line.

Research on workers' wage levels by income class reveals, however, that the policy is actually highly progressive in the sense that most of its benefits flow to working families in the lower reaches of the income scale, families that arguably need the raise. Over half of the benefits flow to families in the bottom 30%, families that receive only 14% of total income, and whose average income is around $25,000.[7] On the other end of the income scale, less than 5% of the benefits from an increase in the minimum wage are likely to flow to families in the top ten percent of the income scale.

Furthermore, new research by Furman and Parrot (2007) on the current minimum wage proposal finds the just under half (48%) of those likely to benefit from the higher wage are their family's primary breadwinner while a similar share (47%) live in families below twice the poverty line.[8]

Of course, since minimum wage receipt is not conditioned on family income, it lacks the target efficiency of the Earned Income Tax Credit, a wage subsidy for low-wage workers in low income families. However, it is worth recalling Congress' initial motivation for enacting the policy back in 1938. In addition to raising the living standards of low-income families, the policy is also a statement that we will not let the market drive wages down to unacceptably low levels. This is equally as true for a middle-class youth working to raise money for college as it is for a single mother supporting a family. Raising the income of the working poor is not the sole purpose of the minimum wage. It is also about the value and dignity of work, and the opportunities that work provides, regardless of family income.

It's also the case that while most minimum wage workers will soon earn above the minimum as they gain skills and experience, a minority remain at or near the minimum wage for years. Carrington and Fallick (2001) use longitudinal data to show that a non-trivial share of workers continue to earn wages near the minimum wage for extended periods of time.[9] For example, they find that ten years into their career, about ten percent of the population held a job paying near the minimum wage, with higher shares for women and minorities.

Returning for a moment to the question of the Earned Income Tax Credit, because it is more precisely targeted, opponents often argue that it is preferable to the minimum wage for helping low-income workers. Yet Furman and Parrott (2007) show the complementary nature of the EITC and the minimum wage. Figure 3 shows that a family of four with one full-time, minimum-wage worker remains below the poverty line, even when we account for EITC and the market value of food stamps. With the increase to

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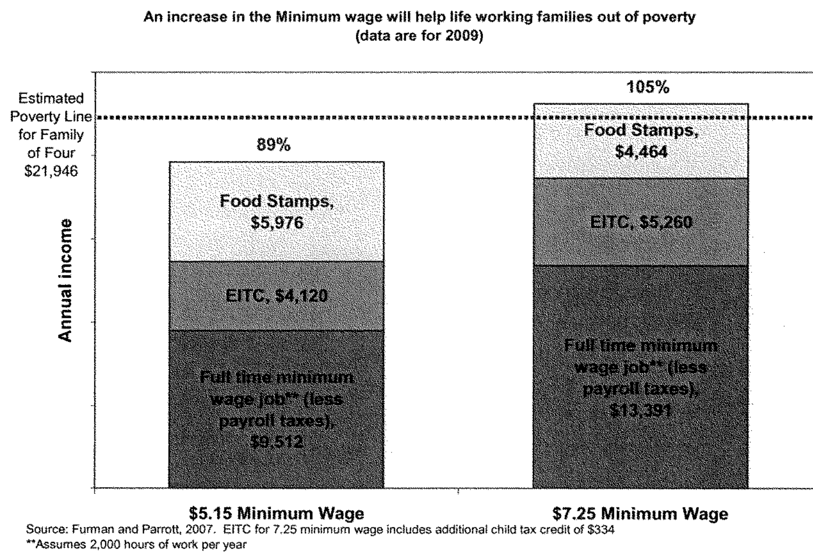
[7] See Figure 6, http://www.epi.org/content.cfm/webfeatures_viewpoints_raising_minimum_wage_2004.
[8] http://www.cbpp.org/1-5-07mw.htm.
[9] http://www.bls.gov/opub/mlr/2001/05/art2full.pdf.

$7.25, however, the family's income goes above the poverty threshold. For a family with two minimum-wage workers—one full and the other half time—income relative to poverty comes to 108% under the current minimum and 126% under a $7.25 wage. In other words, the increase in tandem with available tax credits helps move families from poor to near-poor.

This complementarity is too often ignored by minimum wage opponents who advocate for sole reliance on the EITC to help low-wage workers. Since the policy under discussion is a minimum wage *increase*, it is not suitable to simply cite the *existence* of the EITC as a counterargument. Minimum wage opponents taking this tack must advocate for an expansion of the tax credit. This clearly has a fiscal cost which must be considered, one which many, myself included, might well deem worthy. Yet taxpayers may reasonably view a higher minimum wage as another valid source of support for low-wage workers. Congress can of course offset the costs of expanding the EITC by phasing the credit out more quickly, but this higher marginal tax rate creates a work disincentive that lawmakers may want to avoid.

An increase in the Minimum wage will help life working families out of poverty (data are for 2009)



Source: Furman and Parrott, 2007. EITC for 7.25 minimum wage includes additional child tax credit of $334
**Assumes 2,000 hours of work per year

Will the Increase Price Low-Wage Workers out of the Labor Market?

Like any legislated policy change, Congress needs to consider any unintended consequences generated by the policy. The most scrutinized question in this regard is whether increases in the minimum wage lead employers to lay off workers affected by the increase. The question flows from the simplest version of economic theory which

predicts that workers whose wages rise by mandate instead of by market forces will be priced out of the labor market.

Like all theoretical contentions in economics, this question can only be answered by looking at the evidence. In this regard, there are some important insights for Congress to recognize:

- The fact that so many states and cities have introduced their own minimum wage, above the federal level, has allowed research to tap this rich variation in the context of pseudo-experimental designs. Much of this research has found no measurable disemployment (Card and Krueger, 1995), challenging the simplistic theory of the labor market.[10]
- In cases where the new research does find job loss effects, these effects tend to be small, in that the number of beneficiaries from an increase far surpass the number of job losers.
- This work has moved many economists' views. As Nobel laureate Robert Solow stated: "The main thing about this research is that the evidence of job loss is weak. And the fact that the evidence is weak suggests that the impact on jobs is small."[11]

Echoing these sentiments, Alan Blinder, a leading economic thinker and a former vice chairman of the Federal Reserve, recently summarized the research this way: "What's changed in the last 10 to 15 years is an accumulation of pretty convincing evidence that the employment problem is not very significant."[12]

In fact, note the difference in the way Blinder discusses the policy in two editions of his influential economics textbook.

> *From the first edition* (1979, p. 519): "... the minimum wage effectively bans the employment of workers whose marginal product is less than [the minimum wage]. The primary consequence of the minimum wage law is not an increase in the incomes of the least skilled workers but a restriction of their employment opportunities."
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> *From the tenth edition* (2006, p. 493): "Elementary economic reasoning... suggests that setting a minimum wage...above the free-market wage...must cause unemployment... Indeed, earlier editions of this book, for example, confidently told students that a higher minimum wage must lead to higher unemployment. But

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[10] Card, David and Alan B. Krueger. 1995. *Myth and Measurement: The New Economics of the Minimum Wage.* Princeton, New Jersey: Princeton University Press.

[11] Quoted in Uchitelle, Louis. 1995. "A Pay Raise's Impact." New York Times (January 12), p. D1.

[12] http://www.nytimes.com/2006/10/25/business/25leonhardt.html?ex=1168232400&en=d749a9ae053c9174&ei=5070

> some surprising economic research published in the 1990s cast serious doubt on this conventional wisdom."

As much of this new research was being conducted, another very important phenomenon occurred: the federal minimum wage increase of 1996/97 was followed by the best low-wage labor market outcomes in decades. When that proposed increase was under discussion, opponents predicted massive job losses among those affected by the increase from $4.25 to the current level of $5.15. Instead, the employment rates of the least advantaged workers soared to unprecedented levels, poverty rates fell to historic lows, particularly for minority populations, the least skilled workers, and single mothers. Low wages rose in step with productivity growth for the first time in almost thirty years.

Note that I do not claim that the federal minimum wage increase was solely responsible for these outcomes. It helped boost wages at the very bottom of the wage scale, but the full employment macroeconomic conditions that prevailed over these years were of much greater importance. But Congress should take note: the 1996/97 increase complemented these conditions; it did not preclude them.

I stress the gains of the least advantaged workers in this context for an important reason: these are the same populations that opponents of the current increase argue will be hurt the most by the increase under consideration. They were wrong the last time we had this debate, and they are wrong today.

An objective reading of the minimum wage research on this question of job loss leads to this conclusion: moderate increases have their intended effect. They raise the incomes of the vast majority of their intended beneficiaries without hurting their employment prospects.

Before closing this section, lawmakers will reasonably wonder: if minimum wage increases do not lead to significant job loss effects, how are the increases absorbed. The mechanisms appear to be profits, prices, and productivity. Researchers have not suitably quantified the relative roles of these absorption mechanisms, it part because they interact and are very difficult to parse out.

There is some evidence of price effects, but they are relatively small, suggesting pass-though of a small fraction of the wage increase (Lee et al, 1999; Aaronson, 2006).[13] There is less evidence of redistribution from profits to wages, though this is due to data limitations and the difficulty teasing out this impact from the myriad forces effecting

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[13] Chinkook Lee and O'Roark, Brian. The Impact of Minimum Wage Increases of Food and Kindred Product Prices: An Analysis of Price Pass-Through, *Technical Bulletin No. (TB1877)*, August 1999, USDA Economic Research Service. Daniel Aaronson and Eric French. Product Market Evidence on the Employment Effects of the Minimum Wage, *Journal of Labor Economics*, volume 25, 2007.

profit margins. However, it is likely that this is an important mechanism. Certainly, the investment in lobbying activities by affected firms to stop such increases is indirect evidence of this effect.

Finally, numerous researchers have suggested that higher minimum wages partially pay for themselves by reducing firm-level inefficiencies such as protracted vacancies and excessive turnover, both of which are notable problems in low-wage industries. Higher wages, it is argued, reduce these costs, and thus while wage costs may rise following a minimum wage increase, neither unit labor nor unit profit costs (wages or profits relative to productivity) are likely to follow suit.

Note that both the productivity and price mechanisms imply that the net cost to businesses of a minimum wage increase are lower than the gross costs. This insight has implications for the final section of this testimony.

Should the Increase by Accompanied by Tax Cuts?

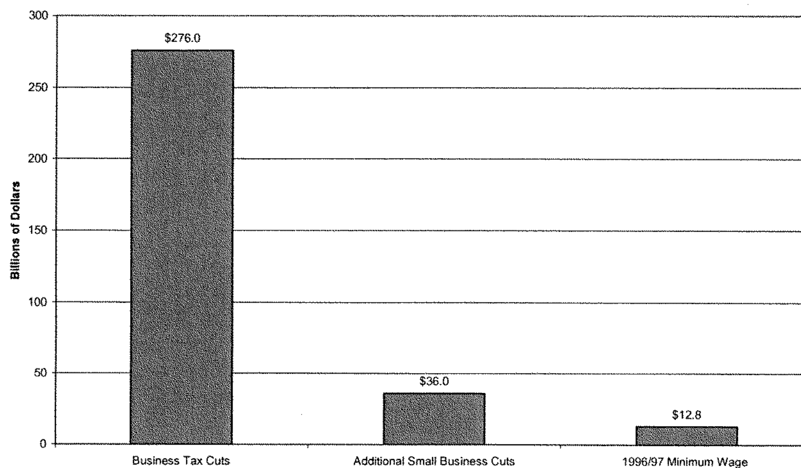
Some members of Congress, as well as President Bush, have argued that the increase in the minimum wage should be accompanied by tax cuts to affected businesses to offset the increase in labor costs. While such tax cuts may or may not have merit, there are many good reasons to separate these two ideas in the policy process, and pass a clean minimum wage bill (i.e., a bill that solely raises the minimum wage).

- Unless they are strictly temporary, any tax cuts are likely to cost more and last longer than the minimum wage increase, i.e., the offset will deprive the federal budget of more revenues than the policy it is supposed to be offsetting.
- Since the proposed increase is a federal mandate, except for those states with minimum wages above $7.25, every firm faces the same minimum. The fact that no firm is at a competitive disadvantage also militates against the need for offsets.
- Since many businesses with low-wage workers are already paying wages above $7.25 (or will be by 2009), or are in states with higher minimum wages, it will be very difficult to target any offsets to firms actually facing higher labor costs due to the proposed increase.
- Even if Congress could target the cuts, it is not clear what costs these tax cuts are supposed to offset. Since employment effects are negligible at best, these cuts will not lead businesses to retain workers they would have otherwise laid off. This, along with the targeting challenge, raises the possibility that the cuts could end up being a windfall for businesses that have already received billions in tax cuts.
- The Democratic majority has committed to a pay-as-you-go budget rule, meaning the cost of these tax cuts will have to be made up with either more revenue or less spending in some other part of the budget. Any offsets that are used for this bill will thus not be available for other, more pressing priorities, such as providing health coverage for all eligible children through SCHIP and reversing the loss of subsidized child care placements.

The budgetary cost of the tax cuts can easily swamp the costs engendered by the minimum wage, i.e., the supposed offsets are ultimately likely to cost much more than the policy they are offsetting. Since the minimum wage is not indexed for inflation, it fades over time as a cost to business. For example, the value of the last federal minimum wage increase has been fully eroded by inflation and no longer constitutes an increased business cost.[14] Yet the tax cuts that were passed in 1996 allegedly to offset the cost of this eroded increase remain in place. In fact, several have been expanded (e.g., expensing caps under section 179 have been raised significantly since 1996).

My estimate of the increase in labor costs through 2005 attributable to the 1996/97 federal minimum wage hike is about $13 billion (see Figure 4 and data appendix). Joint Taxation Committee data, analyzed by the Citizens for Tax Justice, reveal $276 billion worth of tax cuts targeted at businesses over the past decade, with an additional $36 billion in cuts targeted directly to small businesses. Of course, only a small share of the budgetary costs of these cuts date back to the 1996 minimum wage legislation, but the point stands: businesses, both small and large, have been much more than compensated for any labor cost increases associated with a minimum wage increase, past and future.

Costs of Business Tax Cuts Since 1996 and the 1996/97 the Minimum Wage



Source: Citizens for Tax Justice analysis of Joint Tax Committee data, and authors' analysis (minimum wage--see data appendix).

In this context, it is also worth considering the relatively small share of workers affected by the proposed increase. Along with state minimum wage increases, nominal wages have grown considerably since the last increase, and the 10th percentile wage was about

[14] Before the first step of the last increase in October 1996, the federal minimum wage was $4.25. In Nov 2006 dollars, that amounts to $5.41 (using CPI-RS), above today's federal minimum wage of $5.15.

$7.50 in 2006. Aging this value by CBO inflation projections yields a 10th percentile wage of $7.90 in 2009, already well above the proposed minimum scheduled to phase in that year. CBO projects that in the FY2010, the first year when the proposed bill is fully phased in, the cost will by $5.7 billion, less the 0.1% of total wage and salary costs.[15] The current proposal is thus unlikely to represent a significant cost increase to businesses, and will very likely cost less than any tax cuts under consideration.

These values imply that any tax cuts associated with this bill has a potentially serious targeting problem, in that it will be impossible for Congress to reliably reach firms whose labor costs are raised by the wage increase. Many businesses in states with higher minimum wages are already paying higher wages to their low-wage employees (California, Connecticut, Massachusetts, Oregon, and Washington State either already have or are scheduled to have their own minimum wage higher than the Federal). As the above wage numbers reveal, market forces have also led many low-wage employers to already pay more than the new minimum. Thus, some employers will essentially receive a windfall: a tax cut to compensate them for a federal minimum wage increase that did not affect them at all.

Even if Congress could effectively target the tax cuts to businesses that whose labor costs were truly affected by the increase, it is worth asking whether this is a wise reason to sacrifice revenue. These employers have kept wages very low relative to employers in states with higher minimum wages, or those providing better jobs in states still tied to the federal minimum. Why should these employers be compensated for raising wages, after years of benefiting from Congressional inaction on the minimum wage?

Possibly for these reasons, minimum wage bills have historically not included tax cuts. Only one federal minimum wage bill, the 1996 legislation, included such cuts. Relative to much of Congress' work, raising the minimum wage is a simple, highly transparent piece of legislation, requiring little more than statements of the wage level and phase-in dates. Tax cuts, however, complicate the legislation considerably, both because of their complexity and their budgetary implications.

Congress should be particularly wary of any ideas to weaken existing labor standards. For example, one source suggested that as part of this bill, businesses with gross annual sales of less than $1 million should be exempted from minimum wage laws (the current cap is $500,000), or that workers should not get overtime in one week, if they work reduced hours the next week (so called "flex time").[16] Analysis by Ross Eisenbrey of the Economic Policy Institute finds that the proposal to raise the FLSA coverage threshold to $1 million will remove more employees from minimum wage and overtime coverage than the number directly affected by the proposed wage increase. These ideas go way beyond monetary offsets, striking at the heart of long-standing protections that insulate workers with little bargaining power from unfair treatment and privation-level wages.

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[15] CBO, Letter to Honorable William Thomas, December 29, 2006. CBO also projects that wage and salary income will be 7.43 trillion in 2010.

[16] Congressional Quarterly Today, Jan 2, 07.

None of these points are intended to cast aspersions on any particular tax cut to businesses. Members of this committee are surely aware, for example, that the limit for small business expensing will revert back to $25,000, not indexed for inflation, by 2010 (2003 tax legislation set the level to $100,000, indexed). There is ample time before that sunset, however, to address this reversion.

This strategy of discussing each tax cut on its merits is particularly important as not every proposed cut can reasonably be viewed as a legitimate offset to a minimum wage increase. Legislation by the House of Representatives in the previous Congress attached a partial estate tax repeal to a minimum wage increase. Offsets to a minimum wage bill in 2000, never enacted, included increased write-offs for business meals and for business investments, tax breaks for timber companies and for tax-exempt bonds, a higher self-employment health deduction, and expanded enterprise zones. While some of these may have merit, they should not be considered offsets to higher labor costs.

Even assuming Congress could target the tax cuts to businesses affected by this proposed minimum wage increase, it seems reasonable to ask the committee precisely what cost these tax cuts are supposed to offset. Recalling the discussion in the last section, since employment effects are negligible at best, these cuts will not lead businesses to retain workers they would have otherwise laid off. To the extent that efficiency gains, such as less vacancies and lower turnover rates absorb the wage increase, the tax cuts are also an unnecessary offset. More likely, the tax cuts will simply feed into higher after-tax profits, a windfall unrelated to the minimum wage hike.

Finally, the Democratic majority has committed to a pay-as-you-go budget rule, meaning the cost of these tax cuts will have to be made up with either more revenue or less spending in some other part of the budget. In an era of worrisome budget deficits, this is a highly worthy endeavor, but the discussion of these fiscal options and their relative tradeoffs should occur independently of a minimum wage increase, a policy that has virtually no fiscal implications. And any offsets that are used for this bill, unnecessarily so in my view, will not be available for other, more pressing priorities.

Conclusion

The American economy is the envy of the world. Our living standards, on average, are well above those in many other advanced economies. Yet, as is well known, there is tremendous variation around that average. Even as the economy prospers, and well-placed workers receive outlandish bonuses on top of impressive salaries, too many in our workforce fail to benefit much at all from their efforts.

This reality violates a basic social value: whether it's a home health aid dressing the wounds of homebound senior, a cashier on her feet all day in retail, or a CEO atop a global corporation, all the bakers should get their fair slice of the pie. They shouldn't all get the same slice: some are demonstrably more productive than others. But it is a basic premise of economics, as well as a basic democratic value, that those who contribute to

the economy's productive capacity should receive compensation commensurate with their contribution.

This premise has been violated in recent years, and one reason is that Congress has failed to raise the value of the minimum wage for 10 years, the longest period since the wage floor was introduced in 1938. In that regard, the fact that Congress is considering correcting this oversight is indeed welcome news.

As I have argued, minimum wage policy is a simple, direct way to help lift the earnings of those whose limited ability to bargain for a fair wage has precluded them from sharing in the prosperity they themselves help to generate. High-quality research and the uniquely positive experiences of low-wage workers following the last federal increase has revealed that the policy leads to few of the distortions cited by opponents. And while targeting concerns have also been raised, the evidence shows that most of the benefits from the increase flow to workers who need the raise.

Finally, there is little rationale for adding any tax cuts to this bill. Businesses both large and small have enjoyed hundreds of billions of such cuts over the past decade, as the value of the last federal minimum wage increase has evaporated. The wage increase under consideration is a small one in historical terms, and it is very likely that any tax cuts intended to offset its costs to businesses will swamp it in magnitude. And while the wage increase has no fiscal costs, the same cannot be said for tax cuts. They must either add to the federal budget deficit or, under the new PAYGO rules, be paid for by revenue additions and spending cuts elsewhere.

More tax cuts for businesses may or may not be warranted, but I urge Congress to have save that debate for a different day. Today, there should be little debate: low-wage workers have waited long enough for this much-needed increase in the federal minimum wage.

I thank Jin Dai, Aviva Aron-Dine, Ross Eisenbrey, Michael Ettlinger, Liana Fox, Jason Furman, Rob Gray, Mark Greenberg, Sharon Parrot, and Jesse Rothstein for helpful comments and assistance. Any mistakes are my own.

Appendix Table 1
Characteristics of workers directly affected by the minimum wage increase to $7.25*

	Direct affected**	Total workforce***
Number of worker (in millions)	5.6	130.3
Percent of workforce	4%	100%
Gender		
Male	39%	52%
Female	61%	48%
Race / ethnicity		
White	61%	69%
Black	17%	11%
Hispanic	18%	14%
Asian	2%	4%
Family status		
Parent	25%	36%
Married Parent	15%	29%
Single Parent	9%	7%
Age		
16-19	30%	5%
20 and older	71%	95%
Work hours		
1-19 hours	22%	5%
20-34 hours	36%	13%
Full time (35 + hrs)	43%	82%
Industry		
Retail trade	24%	12%
Leisure and hospitality	29%	9%
Other	47%	79%
Occupation		
Sales	21%	11%
Service	41%	17%
Other	38%	72%

* Assuming a phase-in with the final step in 2009
** These are the workers earning between the state minimium wage and $7.25
*** Includes workers not covered by minimum wage.
Source: EPI analysis of 2005 Current Population Survey data by Liana Fox.

Data appendix: estimating the costs of the 1996/97 minimum wage increase (Figure 4).

The 1995 outgoing rotation group files of the Current Population Survey were used for this simulation (since later year data sets reflected the actual higher minimum, I would not be able to simulate costs from them). In order to derive a counterfactual against which to measure employers' costs, I took the difference between the higher minimum wage phased in over 1996-97 and actual wages in the affected range. To simulate wage growth on the 1995 file, I aged wages by actual nominal wage growth at the 20th percentile in each successive year until 2002, when the $5.15 minimum wage no longer was binding (i.e., low-wage growth in the economy applied to $4.25 in 1996 surpassed $5.15 in 2002).

The extra hourly wage costs was then multiplied by weekly hours worked and by 52 (for weeks worked) and finally by the ORG person weight. This variable was aged by the rate of total employment growth, and the values were summed over the data set. The employers share of social security tax (7.65%) was added to this sum.

Jared Bernstein, Senior Economist, Economic Policy Institute
Responses to Questions From the Senate Finance Committee
Regarding Testimony Given January 10, 2007

From Senator Baucus:

If the minimum wage is increased, what changes, if any, should be made to the Earned Income Tax Credit?

I view these programs as complements, not substitutes. As I noted in my spoken testimony:

> First, opponents of the increase often argue that instead of raising the minimum wage, we should increase the Earned Income Tax Credit, I urge policy makers not to view these two policies as mutually exclusive. They are not substitutes; they are complements.
>
> Low-wage workers need both policies to lift their living standards. As shown in recent analysis by the Center on Budget and Policy Priorities, a family of four with one full-time, minimum-wage worker today remains below the poverty line, even when we account for EITC and the market value of food stamps. With the increase to $7.25, however, the family's income goes above the poverty threshold.
>
> Yes, since it's conditioned on income, EITC benefits will be more concentrated among low-income workers than the gains from the minimum wage increase. But the incidence of the minimum wage is far more progressive than opponents maintain. Over half of the benefits flow to families in the bottom 30%, families that receive only 14% of total income, and whose average income is around $25,000.[1] True, that's above the poverty line, but every member of this committee knows that working families at this income level face a tight squeeze trying to make ends meet.
>
> We must not lose sight of the fact that the minimum wage was not designed solely as an anti-poverty program: it is a minimum labor standard wherein Congress states that we will not let market forces push wages down to privation levels, regardless of the income of the person earning that wage.
>
> Finally, while the EITC is a highly successful policy tool, Congress cannot place the full social cost of working poverty reduction on the US taxpayer. We'll need both these and other policies to accomplish this goal.

---

[1] See Figure 6, http://www.epi.org/content.cfm/webfeatures_viewpoints_raising_minimum_wage_2004.

I also recently wrote a piece, jointly with Urban Institute policy analyst Elaine Maag, exploring some of these complementarities in greater detail. I attach that here. From the perspective of Senator Baucus' and the Finance Committee, I believe the most relevant part of the analysis is that which shows the very significant changes in the EITC parameters, where policy makers attempt to replace this minimum wage increase with an EITC increase.

Tax Credits or Minimum Wages? We Need Both
Jared Bernstein and Elaine Maag

Which helps low-income people the most--the minimum wage or the Earned Income Tax Credit? Granted, it's a contest that won't be viewed on *American Idol*, but this question came up, as it always does, during the recent debate to raise the federal minimum wage.

The federal minimum wage has been ignored by Congress for 10 years, and inflation has eroded its value to a 52 year low. Now the new Congress is poised to raise the wage floor to $7.25. But opponents of the increase have claimed all along that expanding the Earned Income Tax Credit (or EITC, a substantial wage subsidy for low-income workers) would better serve the working poor.

It's a false choice. Together, these two programs balance the social cost of low-wage work between taxpayers and low-wage employers. They are complements, not substitutes. To place the full burden of raising low-wage on the EITC would create significant costs and undesirable incentives that neither taxpayers nor their representatives would be willing to support.

Two camps are pushing the tax credit over the wage hike. Many business owners and their lobbyists prefer the EITC because they'd rather not have a higher minimum wage crimp their operating costs and profit margins. Their message to Congress: If you want to help low-wage workers, use the tax code and leave us out of it.

Policy analysts like the tax credit's more precise targeting of beneficiaries and lack of market interference. The EITC is based on family income, not wage levels, so low-wage workers in higher-income families don't qualify for it. This is a legitimate preference, but it's no reason to discount the importance of setting a national wage floor.

The minimum wage is more than an anti-poverty program. It's Congress' declaration that market forces won't be allowed to drive wages down to a pittance, no matter what the low-wage earner's income. To judge a minimum wage solely by how effectively it targets recipients is to overlook a key reason for the policy. And, for the record, most of the gains from the wage increase do, in fact, go to working families in the bottom 40 percent of the income scale.

> Today, the EITC increases earnings by up to 40 percent. To pack the same punch as the proposed $7.25 increase in the minimum wage after taxes for a full-time worker, the EITC would need to more than double. So would the maximum credit, currently $4,500 for a family with two or more children.
>
> Increasing the credit would leave Congress with two choices: either phase out the credit at over 40 percent to hold down its overall cost or apply today's phase-out rate to a larger income range. The first choice discourages work. The second, as economist Max Sawicky points out, would end up subsidizing wage levels of $30 per hour, adding tens of billions to the program's annual cost.
>
> There is no reason to choose between setting a wage floor or boosting the tax credit. Together, these programs can help reconnect some of our least advantaged workers to a growing economy—one that has largely passed them by.
>
> *Jared Bernstein is a senior economist at the Economic Policy Institute and author of All Together Now: Common Sense for a Fair Economy. Elaine Maag is a Research Associate at the Urban Institute and Tax Policy Center.*

Finally, I would encourage the Senator and the Committee to consider an expansion of the EITC, particularly the component for persons without children, and for those with more than two children (i.e., there is a need for a "third tier" with higher benefits for those with three or more children). The increase in the minimum wage to $7.25, in tandem with the EITC (and other credits, such at the Child Tax Credit), absolutely help to close the gap between what many low-income workers earn and what they need to meet their family budgets. But even with this wage increase, that gap, though diminished, still exists.

The federal minimum wage is not indexed for inflation. Please discuss the annual adjustment of the minimum wage based on the Consumer Price Index by states.

I believe that indexing the minimum wage would be a sensible policy for Congress to consider. As noted in this document (http://www.epi.org/content.cfm/bp177), numerous states (Washington, Oregon, Vermont, and Florida) have already done so, and there appear to advantages to this approach to sustaining a viable wage floor.

First, increases are predictable, both to workers and businesses. Second, indexing would help push back against the growing problem of wage inequality. When the minimum wage is allowed to erode relative to inflation, it also tends to fall behind average wages, leaving low-wage workers increasingly isolated and less prone to benefit from overall economic growth.

From Senator Cantwell:

Question: At what point then, do you estimate, would raising the minimum wage adversely impact employment job prospects?

Historical evidence on this point comes for my own research and that of others. This work suggests that when ten percent or less of the workforce is covered "in the sweep"—earning between the old and new minimum wage—any employment impacts will be marginal at worst. The 1996/97 increase covered about nine percent (about nine percent of the workforce got a direct boost from the increase) and, as I noted in my testimony, low-wage workers did very well as a group in the latter 1990s. Our own research found no significant job-loss effects from the increase (Bernstein and Schmitt, 1998).

The current proposal, to lift the minimum wage to $7.25 by 2009, will reach about four percent of the workforce, well below the ten-percent threshold just noted. Thus, we can confidently assert that the increase will have its intended effect of lifting the earnings of our lowest paid workers.

From Senator Grassley:

Your testimony highlights the fact that the current minimum wage, adjusted for inflation, is well below the level that prevailed during the 1960s and 1970s. However, many low-wage jobs in agriculture, restaurants, and retail were excluded until 1966 and were covered at a lower rate until 1978. Can you provide the Committee with historical data on the percentage of low-wage jobs covered by the minimum wage?

I do not have a yearly time series on this variable, though the Wage and Hour Division of the Department of Labor should have this. It is the case that most workers are now covered, and that a smaller share were covered in the past.

Your testimony cites several studies that suggest increasing the minimum wage does not result in higher unemployment. However, these studies do not address the question of whether a higher minimum wage results in higher skilled workers displacing lower skilled workers, resulting in shift in the composition of the workforce, rather than a change in the total size of the workforce. Have you considered this possibility?

I have not seen convincing evidence of such displacements, although I know some researchers claim that they occur. I would note that after the last Federal minimum wage increase (1996/97) the employment rates of the least skilled workers, increased sharply, contradicting this displacement scenario. For example, employment rates (the share of the population employed) for African-American high-school drop-outs grew by a whopping

ten percentage points, 1995-2000, a period when overall employment rates rose by 1.5 points.[2] Of course, I am not claiming that the wage increase led to these gains, though it surely helped pull some disadvantaged workers into the job market. But neither did the wage increase preclude these gains.

Your testimony states, "except for states with minimum wages above $7.25, every state faces the same mandate... that no state is at a competitive disadvantage..." However, the cost of the new higher minimum wage depends on prevailing wage for each industry within each state. According to Census data, 23 percent of hourly workers in Louisiana and Alabama earn between $5.00 and $7.25. Can you provide the Committee with an explanation of why these states are not disadvantaged relative to other states?

To the contrary, the federal wage floor, like any other federal regulation, is a "leveler." Barring for the moment states with their own minimums higher than the federal, it puts each state on equal footing—since each state faces the same wage floor, no state has a comparative advantage or disadvantage.

Now, it is absolutely the case that the increase will "bite" more in areas with more low-wage workers, but that just means the increase does away with a comparative advantage these firms had prior to the implementation of the higher wage. Also, note that some of the best research has used precisely this type of variation to examine the impact of minimum wage increases and found results consistent with my testimony (see, for example, Card 1992).

Your testimony suggests there would be significant "spillover effects" from a minimum wage increase. Can you provide the Committee with a list of any peer-reviewed empirical studies that quantify this effect?

See this paper by Jeanette Wicks-Lim (http://www.peri.umass.edu/fileadmin/pdf/WP116.pdf) and note the citations therein as well.

Also: Card, David and Alan B. Krueger. 1995a. Myth and Measurement: The New Economics of the Minimum Wage. Princeton, New Jersey: Princeton University Press, page 160.

Your testimony states "...it is a basic premise of economics, as well as a basic democratic value, that those who contribute to the economy's productive capacity should receive compensation commensurate with their contribution." Could you provide the Committee with an explanation of how you would calculate a person's compensation "ccmmensurate with their contribution?"

---

[2] From EPI analysis of Current Population Survey data. Persons in school are excluded.

Out of context, I am not sure how to answer this, so I include the context from my testimony:

> The American economy is the envy of the world. Our living standards, on average, are well above those in many other advanced economies. Yet, as is well known, there is tremendous variation around that average. Even as the economy prospers, and well-placed workers receive outlandish bonuses on top of impressive salaries, too many in our workforce fail to benefit much at all from their efforts.
>
> This reality violates a basic social value: whether it's a home health aid dressing the wounds of homebound senior, a cashier on her feet all day in retail, or a CEO atop a global corporation, all the bakers should get their fair slice of the pie. They shouldn't all get the same slice: some are demonstrably more productive than others. But it is a basic premise of economics, as well as a basic democratic value, that those who contribute to the economy's productive capacity should receive compensation commensurate with their contribution.

The point is clearly that real wages should not be stagnant or falling for significant swaths of workers in a period of strong expansion marked by historically high productivity growth. Yet, Bureau of Labor Statistics data show that between 2000 and 2006, a period when productivity grew roughly 20%, the real weekly earnings of 10th percentile workers fell 3%. Unless the Senator would like to argue that these workers contributed less than nothing to the growth of our economy, my point stands.

From Senator Hatch:

Of all minimum wage workers in Utah, 82.3 percent are part-time employees. One of my constituents, Tim Robison, owner of two Papa Murphy's pizza franchises in the Salt Lake area, argues that an increase in the minimum wage will cripple his business. He currently employs 20 part-time workers ranging in age from 16 to 18. He gives these teenagers the ability to earn extra cash and an opportunity to learn valuable employment skills. Mr. Robison states that if he is forced to pay the $7.25 minimum wage, he will cut back on hiring younger, less-experienced workers and simply hire older, more experienced workers. Don't you think this will have some serious negative effects on the ability of teenagers to enter the workforce?

I am certainly concerned about negative effects of the type you raise, Senator. They are both plausible and logical. However, as an economic researcher, I recognize that such concerns cannot be allowed to drive policy debates, especially when there is high-quality empirical research to shed light on the issue. I refer the Senator to the citations throughout this note and in my testimony, especially Card and Krueger's path-breaking work, collected in this text:

Card, David and Alan B. Krueger. 1995a. Myth and Measurement: The New Economics of the Minimum Wage. Princeton, New Jersey: Princeton University Press.

Also, regarding the potential displacement effect you raise, please see my answer to Senator Grassley's second question above.

Dr. Bernstein, the "surprising economic research" published in the 1990s that you cite (or more correctly, that you quote Professor Blinder as writing) that purports to show that the minimum wage did not impact employment was more controversial than your testimony suggests. The research, presumably the work of Blinder's former students David Card and Alan Krueger, was contradicted by David Neumark, who found many flaws in their empirical work on this subject. Is it really correct to say that there is a consensus among economists is that an increase in the minimum wage won't affect employment?

I cannot find this statement in either my written or spoken testimony. If I am mistaken, please point out where I make this claim.

I do have the following, related language in the testimony, but it does not claim a consensus:

> The last increase in the federal minimum wage did not result in any of the negative predictions made by opponents. Instead, it was followed the strongest job and wage growth in the low-wage labor market in decades.
>
> Economists and policy makers are recognizing the importance of the new research and these actual outcomes. In 2006, over 650 economists, including five Nobel Prize winners and six past presidents of the American Economics Association signed a statement that stated: "[w]e believe that a modest increase in the minimum wage would improve the well-being of low-wage workers and would not have the adverse effects that critics have claimed."

If increasing the minimum wage will be effective in raising the income of the working poor with little or no cost to the economy, why stop at the proposed $7.25 per hour? Why not go to $15 or $20 per hour minimum wage?

Policies that set standards and regulate markets (or behavior) are always a balancing act. We worry about the impact of speeding vehicles on the safety of those on the road, but we don't want to set speed limits in such a way that would unnecessarily retard commerce. If so, to paraphrase your question, why set them at 55 miles per hour; why not set them at 10 mph?

It is hard to take this question seriously, and without meaning to be disrespectful, I believe that such questions reveal a lack of basic understanding of the rationale for standards and regulatory actions taken by governments throughout history.

In my home state of Utah, about 17,000 people earn the minimum wage of $5.15 per hour. Most of these people are in the food-service industry. In a restaurant, like most businesses, there are many expenses – for food, for labor, and so on. If these costs go up, either the restaurant owner will have to let people go or raise prices. That's just economic reality. The problem is that in many cases, prices cannot be raised because of competition. Unless we offer some kind of tax relief, how to do you expect all small businesses to survive the expenses of a wage hike?

This is a reasonable, if asymmetrical (see below) question, and one I cover in some detail in my testimony under the heading: ***Should the Increase by Accompanied by Tax Cuts?*** starting on page 10. Here, I summarize the relevant points. I consider the fourth bullet (italics and bolded) to be most relevant.

- Unless they are strictly temporary, any tax cuts are likely to cost more and last longer than the minimum wage increase, i.e., the offset will deprive the federal budget of more revenues than the policy it is supposed to be offsetting.
- Since the proposed increase is a federal mandate, except for those states with minimum wages above $7.25, every firm faces the same minimum. The fact that no firm is at a competitive disadvantage also militates against the need for offsets.
- Since many businesses with low-wage workers are already paying wages above $7.25 (or will be by 2009), or are in states with higher minimum wages, it will be very difficult to target any offsets to firms actually facing higher labor costs due to the proposed increase.
- ***Even if Congress could target the cuts, it is not clear what costs these tax cuts are supposed to offset. Since employment effects are negligible at best, these cuts will not lead businesses to retain workers they would have otherwise laid off. This, along with the targeting challenge, raises the possibility that the cuts could end up being a windfall for businesses that have already received billions in tax cuts in recent years.***
- The Democratic majority has committed to a pay-as-you-go budget rule, meaning that the cost of these tax cuts will have to be made up with either more revenue or less spending in some other part of the budget. Any offsets that are used for this bill will thus not be available for other, more pressing priorities, such as providing health coverage for all eligible children through SCHIP and reversing the loss of subsidized child care placements.
- My estimate of the increase in labor costs through 2005 attributable to the 1996/97 federal minimum wage hike is about $13 billion. A recent estimate by Merrill-Lynch of the aggregate cost of the current minimum wage proposal is in this same range.[3] Joint Taxation Committee data, analyzed by the Citizens for Tax Justice, reveal $276 billion worth of tax cuts targeted at businesses over the past decade, with an additional $36 billion in cuts targeted directly to small businesses. Of course, only a small share of the budgetary costs of these cuts date back to the 1996 minimum wage legislation, but the point stands: businesses, both

[3] See "Labor's Love Not Lost: The Pendulum is Shifting," Merrill Lynch publication, Jan 31, 2007: http://rsch1.ml.com/9093/24013/ds/9_83_395.PDF.

> small and large, have been much more than compensated for any labor cost increases associated with a minimum wage increase, past and future.

Also consider that the current increase is only replacing the value of the minimum wage eroded by inflation over the years—recall that the wage floor is at a fifty-two year low. In this context, I am struck by the lack of symmetry suggested by your question. Did these businesses ask for a tax increase as this wage value was eroding? To the contrary, as pointed out above, they've received billions in tax cuts over the past decade.

Citations

Bernstein, Jared and John Schmitt. 1998. "Making Work Pay: The Impact of the 1996-1997 Minimum Wage Increase." Washington, D.C.: Economic Policy Institute.

Card, David. 1992. "Using Regional Variation in Wages to Measure the Effects of the Federal Minimum Wage." *Industrial and Labor Relations Review*. Vol. 46, No. 1. (October), pp. 22-37.

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
Tax Incentives for Business in Response to a Minimum Wage Increase
10 January 2007

Thank you, Mr. Chairman.

I welcome our guests to the Committee today and thank them for taking the time to share their experiences and expertise with us.

The issue of whether to raise the federal minimum wage has been discussed quite a bit in the last few months. As we all know, the House passed a bill increasing the minimum wage last summer but we fell a few votes short of overcoming a filibuster against that bill here in the Senate.

In the next couple weeks, I understand that we will likely be voting on another bill on the Senate floor to raise the minimum wage. I feel that it is extremely important that any such bill recognize the impact that such a wage hike will have on the small businesses in this country that rely on low-skilled workers. I thank Senators Baucus and Grassley for recognizing the importance of adding to a minimum wage bill the types of small business tax incentives that we will be examining today.

I think this is an important hearing and I look forward to hearing from our witnesses.

Thank you.

[BACKGOUND MATERIAL FOLLOWS]

Issue #1 – No One Can Support a Family on $5.15

Most minimum wage workers are not trying to support a family. Only 15 percent of those who would be affected by an increase in the minimum wage to $7.25 are sole earners in families with children.[1]

A person working full-time, year round at the current minimum wage would earn $10,712 on a pre-tax basis.[2] This amount falls short of the poverty level for every family size larger than one.

Poverty Level for Selected Families

Family Type	HHS Poverty Guidelines (2006)	U.S. Census Bureau Poverty Thresholds (2005)
Single Adult under age 65	$9,800	$10,160
Single Parent with One Child	$13,200	$13,461
Single Parent with Two Children	$16,600	$15,735
Married Couple with Two Children	$20,000	$19,806

However, minimum wage workers are entitled to receive various government benefits designed to supplement their income. For example, they could all receive the Earned Income Credit, and those with children could also receive Food Stamps. By including the value of these benefits, many minimum wage workers would exceed the poverty level for their given family size.

Selected Government Benefits Available to Minimum Wage Workers in 2006

Family Type	Federal Minimum Wage	Earned Income Credit	Food Stamps	TOTAL
Single Adult under age 65	$10,712	$108	$0	**$10,820**
Single Parent with One Child		$2,747	$1,236	**$14,695**
Single Parent with Two Children		$4,285	$2,688	**$17,685**
Married Couple with Two Children		$4,285	$3,972	**$18,969**

[1] http://www.epionline.org/mw_statistics_state.cfm

[2] $5.15 per hour x 8 hours a day x 5 days a week x 52 weeks a year

Families with children may also be eligible to receive childcare, energy, housing, medical, and other forms of government assistance.[3]

Because government benefits for low-wage workers are income-related, benefits are reduced as income rises above certain thresholds. Thus, increasing the minimum wage from $5.15 to $7.25 would cause a reduction in EIC and Food Stamps for many poor families. For example, a minimum wage worker who is a single parent with one child would receive only $1.64 per hour, rather than the full $2.10 per hour increase.

Wages, Taxes, and Benefits for a Single Parent with One Child in 2006

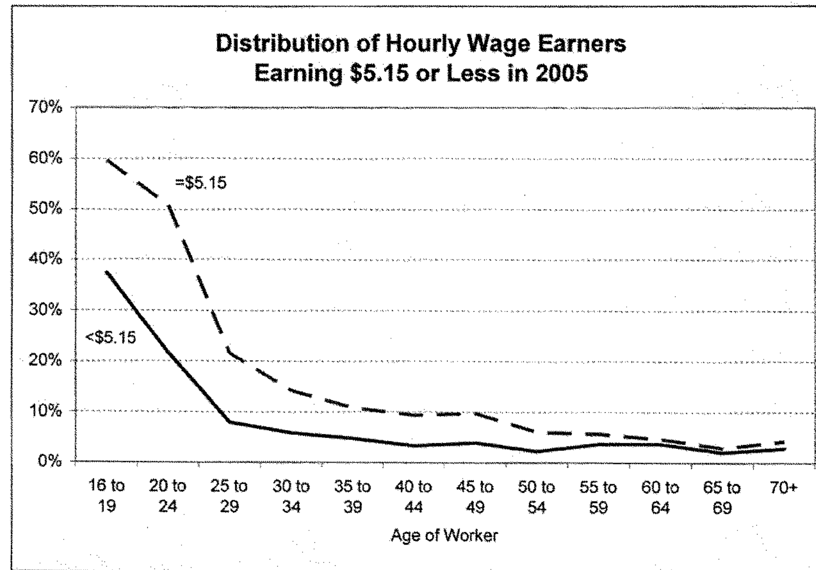
	Current Law	**Proposal**	**Net Change**
Minimum Wage	$5.15	$7.25	+$2.10
Annual Wage	$10,712	$15,080	+$4,368
(-) Payroll Tax	*$819*	*$1,154*	*+$334*
(-) Income Tax	*$0*	*$93*	*+$93*
(+) Child Credit	*$0*	*$567*	*+$567*
(+) EIC	*$2,747*	*$2,704*	*-$43*
(+) Food Stamps	*$1,236*	*$192*	*-$1,044*
Annual Income	$13,876	$17,296	+$3,421
Per Hour	$6.67	$8.32	+$1.64

Advocates of raising the minimum wage often argue that workers should not have to rely on government programs to escape poverty. They insist employers should be forced to pay their workers a "living wage." But, how much is that? The amount needed to exceed poverty depends on family size. Moreover, paying workers according to their family size would create an untenable policy of "unequal pay for equal work."

[3] More than 80 programs provide assistance to persons with low income – http://www.congress.gov/erp/rl/html/RL33340.html. See also, HHS list of programs that utilize poverty guidelines – http://aspe.hhs.gov/poverty/faq.shtml#programs

Issue #2 – Minimum Wage Workers Won't Get a Raise Unless Congress Acts

The majority of minimum wage workers are under the age of 25. Those who start their career at the minimum wage, generally see their wages rise quickly as they complete their education and acquire workplace skills and on-the-job training.



http://www.bls.gov/cps/minwage2005tbls.htm#7

The distribution of hourly wage earners shows a dramatic decline in minimum wage workers by age. Longitudinal studies (that follow the same workers overtime) also show significant declines, averaging more than 20 percent each year.

Share of Initial Minimum Wage Earners Remaining at Minimum Wage

	Year 1	Year 2	Year 3	Year 4	Year 5
Share of Workers	30.5	23.4	16.7	10.5	9.2
% Change	n/a	-23%	-29%	-19%	-22%

http://www.bls.gov/opub/mlr/2001/05/art2full.pdf

Since this study focuses on workers who began their initial minimum wage job after leaving school, it does not reflect the more favorable outcomes for workers that obtain their initial minimum wage job before leaving school.

Issue #3 – Raising the Minimum Wage Helps the Poor and Harms No One

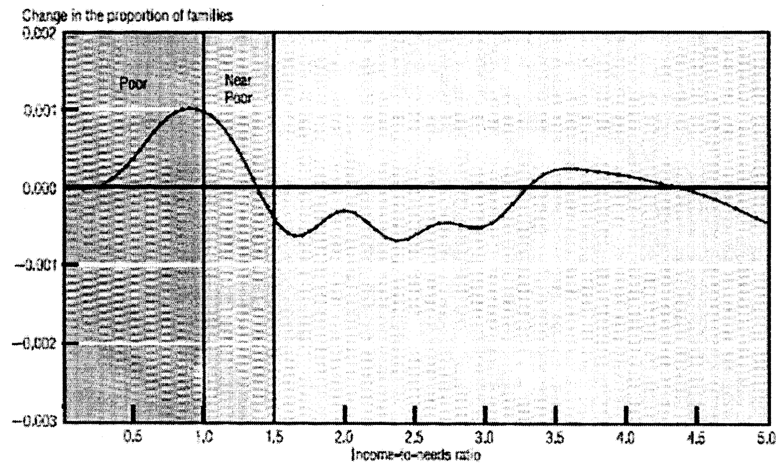
Most minimum wage earners are not poor because they live with other family members who are employed, or they have other sources of income. Only 15 percent of the additional income resulting from the proposed minimum wage increase will go to those living below the poverty level.

Proponents claim raising the minimum wage will create millions of "winners" who keep their job at the new higher wage and they deny there will be any "losers" who lose their job because of the new higher wage. These claims are based on studies that purport to show that minimum wage increases have no effect on employment. But, even if total employment remains the same, the composition of the workforce may change. Some workers may obtain the new higher paying minimum wage jobs at the expense of others.

The evidence suggests the winners more often reside in high-income families while the losers more often reside in low-income families. Thus, the net result of raising the minimum wage is more poverty, not less.

A study of the 1996-1997 minimum wage increase shows a 4.5 percent increase the number of families living below poverty, and a 4.1 percent increase in the number of families living within 150% of poverty.

FIGURE 2 SUMMARY EFFECTS ON INCOME-TO-NEEDS RATIO



http://www.clevelandfed.org/research/com99/0201.pdf

Issue #4 – Minimum Wage Workers Vary Dramatically By State and Industry[4]

The percentage of hourly wage earners who would be affected by the proposed increase in the minimum wage would vary from 2 percent in Alaska to 23 percent in Louisiana.

Percentage of Hourly Workers Paid between $5.00 and $7.24 in 2005

Top 5 States		Bottom 5 States	
Louisiana	23%	Alaska	2%
Alabama	23%	Washington	2%
Idaho	19%	Oregon	3%
New Mexico	19%	New Hampshire	5%
Arkansas	19%	Rhode Island	6%

Likewise, the percentage of affected workers would vary from 32 percent in the Leisure and Hospitality industry to 2 percent in the Transportation industry.

Percentage of Hourly Workers Paid between $5.00 and $7.24 in 2005

Top 5 Industries		Bottom 5 Industries	
Leisure and Hospitality	32%	Transportation	2%
Agriculture, Forestry, Fishing, and Hunting	29%	Public Administration	3%
Other Services	18%	Mining	3%
Wholesale and Retail Trade	18%	Construction	4%
Information	12%	Manufacturing	7%

Thus, the impact of raising the minimum wage will vary dramatically based on industry and geography.

It should also be noted, that while small businesses employ more minimum wage earners as a percentage of their workforce (19%), there are more minimum wage earners employed by larger businesses (38%).

Distribution of Hourly Wage Earners ($5.00 to $7.24) By Size of Employer

Employer Size	Under 10	10-24	25-99	100-999	500-999	1,000 or more	Total
	Employees						
% by Size	19%	19%	15%	11%	7%	12%	n/a
% of Total	17%	15%	16%	12%	4%	38%	100%

[4] Data provided by the Congressional Research Service

Issue #5 – Raising the Minimum Wage: Costs, Benefits, and Alternatives

Assuming no loss of jobs, or reduction in hours worked, raising the minimum wage from $5.15 to $7.25 in 2004 would have cost employers nearly $11 billion. Of that amount, less than $2 billion would have gone to minimum wage earners living below the poverty level. In other words, for every $1 it cost businesses to raise the minimum wage, only 15 cents would have gone to those living in poverty.

Distributional Effects of Minimum Wage Increase ($5.15 to $7.25) in 2004

Income-to-Poverty Ratio	Increased Earnings	Percent
Under 1.0	$1.6 billion	15
1.0 to 1.49	$1.6 billion	14
1.5 to 1.99	$1.6 billion	14
2.0 to 2.99	$2.2 billion	20
3.0 or more	$4.0 billion	36
Total	$10.9 billion	100

http://www.cbo.gov/ftpdocs/77xx/doc7721/01-09-MinimumWageEITC.pdf

After taxes and offsets to government benefits, like the EIC and Foods Stamps, it is likely those living below poverty would receive less than 15 cents of every dollar.

By comparison, modest changes in the EIC could deliver the same amount of money to the poor for about one-fourth the cost of a minimum wage increase. That's a rate of nearly 60 cents on the dollar.

Distributional Effects of EIC Change in 2004

Income-to-Poverty Ratio	Increased EIC	Percent
Under 1.0	$1.4 billion	58
1.0 to 1.49	$0.6 billion	25
1.5 to 1.99	$0.2 billion	8
2.0 to 2.99	$0.1 billion	4
3.0 or more	$0.1 billion	4
Total	$2.4 billion	100

http://www.cbo.gov/ftpdocs/77xx/doc7721/01-09-MinimumWageEITC.pdf

The American Presidency Project

americanpresidency.org

• William J. Clinton

Statement on Signing the Small Business Job Protection Act of 1996

August 20th, 1996

Today I have signed into law H.R. 3448, the "Small Business Job Protection Act of 1996."

This is important and long overdue legislation that provides a badly needed pay raise for millions of Americans and their families who struggle to make ends meet while working at the minimum wage. The Act boosts the minimum wage in two steps—a 50 cent increase from $4.25 to $4.75 an hour that takes effect October 1, followed by an additional 40 cent rise to $5.15 an hour on September 1, 1997. This increase will help some 10 million of our hardest pressed working families build a better future. It is true to the basic American bargain that if you work hard you ought to have food on your table and a living wage in your pocket. It is the right thing to do.

I should note that I disagree with certain provisions added to the minimum wage title of the Act, such as the provision creating a new subminimum wage for young people and the one denying increased cash wages to most employees who rely on tips for part of their income. Still, those defects do not obscure the central accomplishment of this Act—securing the first minimum wage increase since 1991.

Beyond raising the minimum wage, this Act represents real progress on a number of other fronts.

First, I am particularly gratified by the important provisions in this Act concerning adoption. The Act provides a nonrefundable tax credit of up to $5,000 per child for adoption expenses; $6,000 for children with special needs. It will help thousands of children waiting for a family who wants them. It will help thousands of middle class parents realize their dream of adopting a child. It will build stronger families and stronger communities.

Moreover, the Act bars placement agencies that receive Federal funds from denying or delaying adoptions based on race, color, or national origin. As I have consistently said, it is time to end the historical bias against interracial adoptions. That bias has too often meant interminable delay for children waiting to be matched with parents of the same race. It is time to put the creation of strong and loving families first.

Second, the Act creates a simplified, 401(k) retirement plan for small businesses, making it far easier for such companies to offer pensions to their employees. This new plan includes many of the pension reforms my Administration proposed more than a year ago. For example, it increases the portability of pensions, allowing more new workers to start saving for retirement from their first day on the job. It cuts the vesting period for workers in multiemployer plans from 10 years to 5, immediately vesting over 1 million workers in their benefits. It repeals the so-called "family aggregation rule," which limited the retirement benefits of family members working together in the same business. It allows nonprofit organizations and Indian tribes to maintain 401(k) plans for their workers; assures veterans they will have continued pension coverage if they return to a civilian job after military service; and makes pension benefits safer and more secure for millions of employees of State and local governments. The pension provisions in the Act are not perfect—they provide a smaller share of benefits to lower and middle wage workers than I proposed. But they are a significant step in the right direction.

Third, the Act gives a boost to small business by increasing the amount of capital that small businesses can write off as an expense. I proposed a $15,000 increase in 1993 in order to encourage the kind of investment that creates new growth and jobs. The Congress passed half of what we advocated then and this legislation gives us the other half. Although the measure in this Act is phased in more slowly than I proposed, it will still give small businesses a good incentive for capital investment.

Fourth, the Act extends the research tax credit, an important measure for a high-tech economy that will retain its competitive edge in the 21st century only if we remain committed to innovation and the research that underlies it. I wanted the Congress to go further by reinstating the research credit retroactively to July 1, 1995, when it last expired, and making it permanent. But this extension, through May of next year, is an important step forward.

Fifth, the Act extends a tax incentive for businesses that train and educate their employees. That incentive excludes from an employee's taxable income as much as $5,250 of educational assistance provided by an employer. Such assistance is another key element in maintaining U.S. competitiveness because a better trained, better educated work force is vital to achieving higher productivity. I regret that the Congress failed to make this incentive permanent and that it has eliminated the incentive for post-graduate education. But in extending the incentive for undergraduate education through May 1997, the Act takes a useful step.

Sixth, by replacing the expiring Targeted Jobs Tax Credit (TJTC) with a new Work Opportunity Tax Credit, the Act provides a significant incentive for employers to hire people from certain targeted groups most in need of jobs, such as high-risk youth. I am pleased to see improvements that address many of the concerns raised about implementation of the TJTC. For example, the minimum employment period required before an employer becomes eligible for the credit will promote longer, more meaningful work experiences for those hired.

As strong a piece of legislation as this is overall, however, I am concerned about three provisions, two of which I objected to when they were included in legislation I vetoed last year.

The first provision repeals the tax credit related to corporate investments in Puerto Rico and other insular areas. I urged the Congress to reform the credit and use the resulting revenue for Puerto Rico's social and job training needs. My proposal would have, over time, prevented companies from obtaining tax benefits by merely attributing income to the islands, but it would have continued to give companies a tax credit for wages and local taxes paid and capital investments made there, as well as for earnings reinvested in Puerto Rico and qualified Caribbean Basin Initiative countries. This legislation ignores the real needs of our citizens in Puerto Rico, ending the incentive for new investment now and phasing out the incentive for existing investments. I remain committed to my proposal for an effective incentive based on real economy activity that preserves and creates jobs in underdeveloped islands, and I hope that the Congress will act to ensure that the incentive for economic activity remains in effect.

A second provision repeals a 1993 initiative of this Administration that reduces tax incentives for U.S. companies to move jobs and operations abroad. Repeal of this provision will allow businesses to avoid taxes by accumulating foreign earnings without limit.

Finally, I have reservations about a provision in the Act which makes civil damages based on nonphysical injury or illness taxable. Such damages are paid to compensate for injury, whether physical or not, and are designed to make victims whole, not to enrich them. These damages should not be considered a source of taxable income.

Notwithstanding these objections, this is important, forward-looking legislation. It gives millions of hard-pressed workers a well-deserved raise, will make adoption a reality for thousands of grateful families and children, takes a good first step toward providing adequate retirement benefits and security for employees of small businesses, and creates useful tax incentives for the benefit of small businesses and their employees. Where there are improvements yet to be made, we will continue to work with the Congress to make them.

William J. Clinton
The White House,
August 20, 1996.

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majority. This has overwhelming support in the House of Representatives. As the Senator mentioned, the President would like this bill.

I am anxious for the Senator to propound his unanimous consent to see why we cannot move forward with this very vital piece of legislation for our national security.

Mr. COATS. Mr. President, I will now do that. I am sure the minority leader would like to comment on it. But I ask unanimous consent that we proceed immediately to the conference report to accompany H.R. 3230, the National Defense Authorization Act for fiscal year 1997.

The PRESIDING OFFICER. Is there objection?

Mr. DASCHLE. Mr. President, I object.

The PRESIDING OFFICER. Objection is heard.

Mr. DASCHLE. Mr. President, I appreciate very much the comments made by the distinguished Senator from Indiana and my other colleagues.

This is the bill. It is over 1,000 pages. I will not ask the distinguished Senator from Indiana whether he has read every page or not. But I daresay that I suppose that, if anybody has, he has, as thoughtful and as studious as he is. But there are very few people in this body who have read this report. It is 1,000 pages long. We got it yesterday. Two Democrats on the conference refused to sign this report because they had very serious concerns about it that they would like the opportunity to discuss.

This is the most expensive legislation that we will pass this year in one bill. I intend to vote for it, I think. I want to read it over the next couple of weeks myself. I think I will be supporting it. But I must say it wouldn't be a bad idea if we just took a little time, had a little chance to read it, and discuss whether or not it is the bill we want to vote for. That is all we are asking.

I have heard a lot of comments about how this would only take 20 minutes or 15 minutes. I must say when you have a bill like this of 1,000 pages, I can recall many times we have been on the floor—whether it was health reform or many other bills—when someone has risen, and said with indignation, "We can't pass this because we do not know what is in it." I heard that speech from my colleagues on the Republican side probably a half-dozen times in the last Congress.

So I do not think it is too much to ask, Mr. President, that we have the opportunity to look at it, read it, hopefully talk about it, have a good discussion, and analyze it. After all, it is the defense of the United States that we are talking about here. We should not minimize it. We certainly should not demean it. And I am not implying that anyone is. But this is a very critical decision. This is something we ought to be careful about.

So we just are not prepared tonight, now that everybody is gone and were told that there would be no more votes, to bring this up under any circumstances, especially under a unanimous consent agreement without any debate or any thoughtful deliberation, and without having read this. I can't do that. Not many of my colleagues can do that.

So let us just take another breath, take another look, and we will be ready to go when we come back in September.

I yield the floor.

Mr. COATS addressed the Chair.

The PRESIDING OFFICER. The Senator from Indiana.

Mr. COATS. Mr. President, first of all, I appreciate the fact that the minority leader is willing to read the bill over the August recess. I just want to let him know, as a member of the committee who has helped negotiate the bill and is familiar with all aspects of the bill, that I will leave him my phone number in case he has questions. He can track me down, and I will be happy to answer those.

But I would state to the minority leader that, as he well knows, we frequently bring a bill that comprises a great number of pages to the floor and pass them with less tribulation than would be accorded this particular bill. We do so because they have been subject to weeks, if not months, of negotiations between members of the committee, between leadership, between all of those involved, and all of those who have questions about the various issues.

So when the bill finally arrives at the floor, when it finally comes here for final passage, we are all very familiar with it, and we know what the differences are between us. In this particular instance, probably the most knowledgeable Member of the U.S. Senate as to the national defense issues facing this country is not a Republican but a Democrat—Senator SAM NUNN, chairman of the committee for many, many years, now ranking member of the committee. It was Senator NUNN that just an hour ago stood on the floor and said we have resolved all the differences here; there is no reason why this should take very long. And that was propounded not by a Republican. That was propounded by the Democrat ranking member of the committee. The distinguished chairman of the committee, Senator THURMOND, agreed. Those of us who serve on the committee, both Republicans and Democrats, indicated that we have looked at it. We have been meeting in rooms for weeks attempting to iron out the small details and the differences on this.

There really are no outstanding issues. We could talk about issues, but they have already been discussed and they are already familiar to everybody here. I would also point out to the minority leader that just today the minimum wage conference report came to us, the safe drinking water conference report came to us, the health bill came to us yesterday, defense came on Wednesday.

Now, of those four—minimum wage, safe drinking water, health, defense—defense is the one that got here first. Those other three were passed today without extended debate, with very limited debate. Why? Because all of the details had been worked out, because we have been debating the bill for months and various committees have been meeting and all of us had the opportunity to look and determine what is in the bill, to raise questions about any details we had concerns about, and to resolve the differences. All of that has been done.

So anybody who has been watching this proceeding knows that we have just passed three major pieces of legislation that have been in negotiation for months, and yet they were brought to the floor with less time to debate than the defense bill. As important as those bills are—health, safe drinking water, and minimum wage conference reports—I do not believe they stand higher priority than the national defense of the United States.

I regret that the minority leader felt constrained to object to this bill. I regret that we have to delay moving forward to the important provisions in this legislation that affect all Americans.

Mr. President, with that I yield the floor.

Mr. ROTH addressed the Chair.

The PRESIDING OFFICER. The Senator from Delaware is recognized.

SMALL BUSINESS JOB PROTECTION ACT

Mr. ROTH. Mr. President, parliamentary inquiry. Under the unanimous consent agreement, following the vote, we were supposed to complete the debate on the health legislation and then proceed to the legislation on the minimum wage and small business taxes. We are anxious to move ahead on the small business tax legislation.

What is necessary to get us on that?

The PRESIDING OFFICER. The Senator is correct. By a previous consent agreement, debate on the conference report to the Small Business Job Protection Act, H.R. 3448, is the pending business. The Senator from Delaware has 60 minutes under his control, the Senator from New York has 60 minutes under his control, and the Senator from Massachusetts, Mr. KENNEDY, has 30 minutes under his control.

Who yields time?

Mr. ROTH. I yield myself such time as I may take, and I will be very brief.

It is my understanding that there are no requests for time on the minority side. Is that correct?

Mr. MOYNIHAN addressed the Chair.

The PRESIDING OFFICER. The Senator from New York is recognized.

Mr. MOYNIHAN. That is correct. My distinguished chairman, as always, has so stated the facts. But there is a small semantic issue here. Some call this the small business relief act; others on this side call it the minimum wage bill. But

we will not resolve that tonight, nor need we.

Mr. ROTH. Could I ask the distinguished ranking member whether or not his side is willing to yield all time?

Mr. MOYNIHAN. If I may speak directly to the Senator—I ask unanimous consent to do—exactly.

Mr. ROTH. So I think both sides are willing to yield back——

Mr. MOYNIHAN. I cannot speak for the Senator from Massachusetts, who is not present.

That is the case.

Mr. ROTH. Could I ask, would it be possible to check that with the staff?

Mr. MOYNIHAN. I have just so done and am informed that is the case.

I see the Senator from Kansas is present, however.

Mrs. KASSEBAUM. Mr. President, I was going to speak, after the chairman and ranking member finish speaking, on a component I believe was important to consider along with the minimum wage and the welfare reform legislation.

Mr. ROTH. Mr. President, this has certainly been a busy month. I appreciate not only the perseverance of my colleagues, but also the willingness of the many valiant staff members who have been working around the clock—both here and on the House side.

This Congress began with great promise, and I'm pleased to say that we are drawing near conclusion with great accomplishment. With the passage of this small business legislation Americans everywhere will have tools necessary for increased opportunity, greater achievement, and more certain security. This is important. It's important for our future, for the well-being of American families, and for the strength of our communities.

And what a departure this is from the past—from the old philosophies that ran this city. It was then that Washington seemed to have only three criteria when it came to American businesses: if they moved, tax them; if they kept moving, regulate them; if they stopped moving, subsidize them.

I believe this legislation demonstrates that those days are over. This legislation demonstrates that this Congress understands that opportunity for Americans, security for our families, is directly tied to the strength of small business.

There are 22 million small business owners who provide paychecks for 6 out of 10 Americans. These risk takers provide more than half of our economy's output, and what we're demonstrating with this legislation is that this Congress is ready and willing to help create an environment where there can be greater growth, opportunity, and jobs—and environment where these small businessmen and women can hire, expand, and modernize.

Among the many important provisions offered in this legislation, first and foremost is an increase in the amount of equipment eligible for expensing. We raise the current law level of $17,500 per year to $25,000 per year, beginning in 1997 and fully phased in by the year 2003.

Next, we include a package of subchapter S corporation reforms that will permit more shareholders in S corporations, the use of S corporations for estate planning purposes, and increased flexibility for subchapter S corporation business use.

We also include a package of pension simplification provisions. An important element of this package is a new pension plan directed to small business, known as SIMPLE. The SIMPLE plan developed by Senator Dole will enable small business owners to set up pensions with less record keeping and guaranteed benefits to their employees. Additionally, tax exempt organizations, as well as State and local governments, will be able to offer section 401k pension plans.

One provision in this legislation that I'm particularly proud of is the new spousal IRA. This will permit homemakers to contribute up to $2,000 per year to an IRA, the same amount as their spouse. This represents an increase of $1,750 over current law, and will go a long way toward creating self-reliance and retirement security for American families.

Among other important changes offered by this legislation is a 6-month delay in the effective date for electronic filing of taxes for small business. In other words, small businesses will be provided more time to become familiar with, and prepare for, the electronic filing program that was part of NAFTA.

These, Mr. President, are some of the major provisions of the Small Business Job Protection Act of 1996. In addition to these important changes, we offer a package of extensions of expiring tax provisions.

These include an extension of the tax-free treatment of employer provided education expenses. Other important extensions cover the research and development tax credit, the orphan drug tax credit, and a new work opportunity tax credit. Along with these were extend tax deductible contributions of appreciated stock to certain charities, the section 29 tax credit for alternative fuels produced from biomass and coal facilities, and a moratorium on the collection of diesel tax paid by recreational boaters at marinas.

Another very important provision in this legislation—one that is not so much associated with strong businesses as it is with strong families and a strong America—is the new credit for adoption expenses. This tax credit will provide $6,000 for special needs adoptions and $5,000 for other adoptions. This, Mr. President, will go a long way to helping loving parents provide homes for children who will now be raised in families.

Mr. President, these are only a few of the many components of this important legislation. One final change, I would like to mention is that extension of the generalized system of preferences trade program, otherwise known as GSP. This extension will run through May 31, 1997, and will help our exporters better compete in the global economy.

It's important to note that this conference agreement is a bipartisan effort—a bipartisan effort that is fully paid for. It contains incentives that will go a long way toward creating an environment for growth, job creation, economic security, and real opportunity for Americans. With the changes we propose in this legislation, small business men and women will have greater incentives and resources to move our economy forward.

As I've said many times, taxation and regulation have profound influences on the ability of nations to create jobs. What we do with this legislation is take some of the burden off the backs of American small business men and women. My hope is that this is only a beginning.

Mr. President, as we complete action on the H.R. 3448, the Small Business Job Protection Act of 1996, I would like to take this opportunity to thank the many staff members who worked long and hard on this bill.

Senate Finance Committee majority staff—Lindy Paull, Frank Polk, Mark Prater, Dough Fisher, Brig Gulya, Sam Olchyk, Tom Roesser, Rosemary Becchi, Lori Peterson, Erik Autor, and Jeremy Preiss.

Senate Finance Committee minority staff—Mark Patterson, Jon Talisman, Patti McClanahan, Maury Passman, and Debbie Lamb.

Senator LOTT's staff—Annette Guarisco and Susan Connell.

Senator DASCHLE's staff—Larry Stein, Alexandra Deane Thornton, and Leslie Kramerich.

House of Representatives Ways and Means majority staff—Phil Moseley, Chris Smith, Jim Clark, Donna Steele Flynn, Paul Auster, Tim Hanford, John Harrington, Norah Moseley, Mac McKenney, Thelma Askey, and Meredith Broadbent.

House of Representatives Ways and Means minority staff—Janice Mays, John Buckley, Mildeen Worrell, Kathleen O'Connell, Beth Vance, Bruce Wilson, and Maryjane Wignot.

Joint Committee on Taxation staff—Ken Kies, Mary Schmitt, Carolyn Smith, Joe Mikrut, Cecily Rock, Ben Hartley, Mel Thomas, Harold Hirsch, Barry Wold, Steve Arkin, Tom Barthold, Tom Bowne, Barbara Angus, Brian Graff, Leon Klud, Judy Owens, Laurie Mathews, Alysa McDaniel, Joe Nega, Angela Yu, and a special thanks to Bernie Schmitt and his excellent estimating staff who worked long into the night on several occasions.

Mr. MOYNIHAN. An increase in the minimum wage is long overdue, and this legislation should be sent to the President before the August recess. The value of the minimum wage has eroded due to inflation since it was last increased in 1989.

It is true that an increase in the minimum wage will reduce demand for labor somewhat, although not significantly in my view. But if you are looking for a painless time to increase the minimum wage, it is now. The current economic expansion is in its 66th month. Unemployment is down to 5.4 percent. The Washington Post recently reported that labor shortages have developed around the country, so much so that some fast-food franchises are paying substantial signing bonuses to new employees.

In response to concerns of some on the other side that the minimum wage increase will cause hardship to small businesses, the Finance Committee took up the small business tax package last month. We worked on a bipartisan basis to craft a small business relief bill all Senators could support. It was approved unanimously by the Finance Committee on June 12, 1996. The bill passed the Senate with broad bipartisan support by a vote of 74 to 24 on July 9, 1996.

Unfortunately, many of the provisions that lent bipartisan support to the small business tax title of the bill in the Senate were dropped in conference. I will briefly mention two matters of particular importance: the tax exemption for employer-provided educational assistance, and the phase-out of the long-standing tax incentives for Puerto Rico codified in section 936 of the Internal Revenue Code.

The conference agreement inexplicably limits prospective extension of the exclusion for employer-provided educational assistance to undergraduate education. Only undergraduate education is covered prospectively here, whereas both undergraduate and graduate education were extended through 1997 in the Senate bill.

This provision is one of the most successful education programs the Federal Government sponsors. It encourages employees to upgrade their skills and thereby maintain and improve their productivity throughout their careers.

Roughly a million persons a year are assisted by their employers with higher education expenses on a tax-free basis, a quarter of them at the graduate level. Both employers and employees benefit. Many of our most successful companies know the benefits of sending valuable employees to school to learn a new field, or a field that has developed since that person had his or her education. Employers understand the opportunities for bringing a promising young person, or middle management person, to higher levels of productivity, and pay them more in the process. This is an elegant piece of unobtrusive social policy.

Second, addressing the special tax rules for Puerto Rico is a difficult subject, but the Senate approach was acceptable to the elected officials in Puerto Rico, and should have been adopted by the conference. The conference agreement fails to provide a continuing economic incentive for investment in Puerto Rico after 10 years. Puerto Rico still has significant economic problems, such as high unemployment rates and low median incomes. The island's unemployment rate is almost 14 percent. While this rate is the lowest in 20 years, we are still talking about an economy in which unemployment has routinely approached, and exceeded, 20 percent in the last two decades. It is also an economy in which the median income of the American citizens who live there is about $6,200, or half that of Mississippi, our poorest State.

Section 936 of the Tax Code has been in existence for 60 years, and nearly all have come to recognize that it is time to move to the next stage. However, we have a profound responsibility to that possession, which we obtained just short of 100 years ago in the aftermath of the Spanish-American War.

Under the Senate provision, adopted at the urging of this Senator, a permanent, although reduced, wage-based credit for jobs located in Puerto Rico would have remained for existing employers. This would have preserved a limited measure of Federal support for Puerto Rico after the remainder of the section 936 incentives are gone after 10 years. It was the least that should be done, given that the people of Puerto Rico—citizens of the United States—are being asked to pay for half or more of these tax cuts for small business, none of which will benefit Puerto Rico.

Understanding the responsibility we have to this island and its people, I hope that at a later time, as early in the next Congress as possible, we will return to this issue and adequately address our obligations to Puerto Rico. We must work together to provide effective economic incentives for new investment in Puerto Rico to provide new jobs and job security for Puerto Rican workers. The people of Puerto Rico—who are not represented in Congress—have the right to be respected and to have their interests advanced.

Thus, while I am disappointed by the resolution of the conference on the small business tax package, I will vote for the conference report because of the importance of the increase in the minimum wage. I will continue to pursue the issues that were not resolved to my satisfaction in the conference report.

Mr. ROTH. I will yield such time as the distinguished Senator from Kansas desires.

The PRESIDING OFFICER. The Senator from Kansas is recognized.

Mrs. KASSEBAUM. Mr. President, I certainly thank the chairman of the Finance Committee, Senator ROTH. I appreciate his help and leadership on health insurance reform, and certainly as he worked with small business tax relief as a part of the minimum wage package.

I supported the conference report, Mr. President, on small business tax relief which includes, of course, an increase in the minimum wage. However, I have strong reservations about raising the minimum wage because I have believed that in many instances with small businesses, particularly the mom and pop operations, it will mean some loss of jobs or, indeed, reduced hours. But we will have to see.

I supported the conference report overall because I believe the detrimental effects of the minimum wage increase will be offset by many of the small business tax relief provisions. However, as this minimum wage increase moves closer to becoming law, along with health care and welfare reform, I believe it is important to point out that there is still a gaping hole in our efforts to assist workers and improve their economic security. Congress has yet to act on the legislation to reform our job training system, which is, I would suggest, in drastic need of repair.

I listened with great interest to the debate that took place yesterday on welfare reform where Senator after Senator pointed out the importance of training to bring welfare recipients into the work force. As we debated the minimum wage bill through its passage and briefly the conference report, we heard the argument that this increase is needed to raise the living standards of those who are at the bottom of the economic ladder. Yet we all know that the only way to improve the long-term prospects of those at the bottom of the pay scale is to equip them with the skills and education that will allow them to compete and move upward in today's changing workplace. It is ever more competitive, ever more demanding of new skills and, unfortunately, the training infrastructure that we have now in place is woefully inadequate. In fact, it is nothing less, I would suggest, than a national disgrace.

I will not take up the time of the Senate at this point to discuss the scores of reports documenting with overwhelming evidence why the current system is broken and must be fixed. I would just like to mention one of the latest GAO reports outlining the failure of current Federal programs.

The General Accounting Office compared control groups with participants in JTPA titles II-A and II-C, both programs for the economically disadvantaged, the very people we are trying to help with the minimum wage. Amazingly, the report found that there were no statistically significant differences over time between the earnings of both groups. This was one in which they were assisting the economically disadvantaged and others where there had been no program offered.

In other words, the Federal training these disadvantaged participants received did nothing to improve their income. It had no effect. This is nothing short of a fraud on the American taxpayer and, more importantly, a cruel hoax on the disadvantaged who think they are getting help but end up no better off. I remain astounded that we should want to continue funding these ineffective programs.

I am particularly disappointed with the Secretary of Labor, who supports this increase in the minimum wage but is also responsible for these job training programs which he knows are in a state of disarray. He has done little to advance legislation to reform job training even though bills passed both Houses with wide bipartisan margins. For 3½ years now, the Secretary has stressed the critical importance of training for the closing of the wage gap for those at the bottom. We have talked often about this. He has been supportive of early efforts. Yet he has done nothing to really try to improve our Federal job training system.

Even before the ink was dry, the Secretary recommended that the President veto the job training conference report. Secretary Reich's main concern with the job training reform bill seems to be lack of accountability. But, according to the National Journal article:

> When pressed, (Secretary) Reich acknowledged that his real problem with accountability concerns the legislation's failure to require participation of mayors in local boards and federal approval of state workforce development plans.

In other words, his concerns are largely political. He wants to preserve the Federal Government's control, the status quo, and business as usual. This is not going to solve the problem.

We have such an opportunity to really try to be more innovative and try to bring to the fore something that will reinforce what we are seeking to do with welfare reform and the minimum wage legislation. When it comes to job training, I suggest the status quo is unacceptable. We must move forward this year with comprehensive job training reform. After months and months of negotiations, and compromises made on all sides, we now have a conference agreement that will bring real reform to a broken system, consolidating duplicative programs over some 80 programs. They will be combined and much duplication removed, giving the States the flexibility needed to design the programs that fit their States, whether it be Kansas, Iowa, New Hampshire, New York or California, and focus the resources there where there is the greatest need—whether it would be in vocational education or a job services initiative.

The job training conference report will encourage real partnership between educators, job trainers and the business community. And it will focus accountability on real results. If we are truly concerned about raising living standards, raising the minimum wage is only half the answer. Proponents of the minimum wage have argued that you cannot support a family on $4.25 an hour, and that is certainly correct. You cannot support a family on $5.15 an hour either. Education and training are also needed to improve one's living standards, and right now we are wasting billions of dollars on dozens of ineffective programs that are just not delivering to those who need help the most. I personally cannot believe there is anything more important we could do to really enhance those who, we have argued for months, most need assistance, than by being willing to address this issue.

I want to put my colleagues on notice that I will do everything I can to ensure the job training conference report comes to a vote this year and goes to the President.

The Senator from Nebraska, Senator KERREY, and I have asked Senator LOTT and Senator DASCHLE to bring this conference report up the week that we return from recess. I tend to believe most of us are now asking the majority leader to consider legislation the week we return. But I am hopeful our request will be met. I will continue to push this conference report because I believe it is too important—and the status quo is unacceptable—not only to the American taxpayer but, more important, to those who desperately need and want training education as well.

I yield the floor.

Mr. GRASSLEY addressed the Chair.

The PRESIDING OFFICER. The Senator from Iowa is recognized.

Mr. GRASSLEY. Mr. President, I am happy that the Senate is finally taking up the conference report on the Small Business Job Protection Act. The House has already overwhelmingly passed this measure in a vote of 354 to 72. Finally, we are making laws instead of rhetoric about tax relief.

Finally, American families and entrepreneurs can get a break from the tax man.

As a member of the Finance Committee, I am proud of my part in moving this legislation through the Finance Committee and through the bill's conference committee.

This bill is good, sound bi-partisan work. In my belief, great credit also goes to Finance Chairman ROTH for his leadership of the committee. To ensure that his efforts will not go unnoticed, I want to remind all Senators that Chairman ROTH completed work on three separate conference reports this week. This is no small accomplishment, and I extend my gratitude to my friend from Delaware.

For my State of Iowa, this conference report on the small business tax bill makes some vital improvements. Particularly, I want to point out the provisions enabling new loans for first time farmers. I hope that this legislation will save the future of agriculture.

LOANS FOR FIRST TIME FARMERS

I introduced this Aggie Bond legislation with Senators PRESSLER, BAUCUS, and MOSELEY-BRAUN. It improves the program that allows tax-exempt bonds to finance discount rate loans for beginning farmers.

Loans for beginning farmers are important because of the changing scene in agriculture and the inability of young farmers to get started in farming. Of particular importance are the statistics of the average age of farmers. In Iowa, our farmers average in their late fifties. In 5 to 6 years, we will have 25 percent of our farmers retiring.

The U.S. Department of Agriculture has announced that my State of Iowa has 2,000 less farms today than it did only a year ago. Four other States also lost 2,000 farms each. The largest decreases were in the States of Ohio, Alabama, Georgia, and Indiana. Clearly, farming States are still feeling the effects of the agricultural recession of the 1980's.

Young people are discouraged about becoming farmers because they cannot afford to get started. Many want to continue the family farm when their parents retire and cannot.

This Aggie Bond legislation helps by lifting the present restriction that disallows the bonds from being used to finance family to family transactions. In other words, under present law, a young person cannot get a good loan to continue the family farm. This legislation fixes that problem. I am very proud to be an agent of this important change.

CONTRIBUTIONS IN AID OF CONSTRUCTION

Mr. President, this Conference Report also includes another unrelated important change for families trying to buy a home.

The provision is called Contributions in Aid of Construction. It repeals an indirect tax that has been imposed on families building homes since the 1986 Tax Act.

It will save families up to $2,000 off the price of a new home. Current law requires that water utilities pass a "gross up" tax onto a family that wants to buy a home. The "gross up" tax can increase the cost of extending water services to a new home by 70 percent. This conference report repeals this unfair "gross up" tax. It will foster home ownership where it is currently out of reach.

Repealing the "gross up" tax is an outstanding addition to this Small Business Job Protection Act. I am pleased to have introduced the original bill.

PENSION SIMPLIFICATION

Mr. President, I want to point out that the pension simplification provisions in this bill represent a major step forward. Not much has been said about these provisions in the commentary about what we are accomplishing here this week.

But I think you can argue that these pension simplification provisions could represent one of the major accomplishments of this week of many substantial legislative accomplishments.

Their enactment should ultimately result in more pension plans being created, particularly by smaller businesses. Since it is that segment of the business community that has the greatest difficulty in offering pensions to their employees, enactment of these provisions could result in a major increase in pension coverage.

Ultimately, that means more savings and more income for retirees.

Statement of Senator Orrin Hatch
Before the
Senate Finance Committee
Tax Incentives for Businesses in Response to a Minimum Wage Increase
January 10, 2007

Thank you very much for calling this hearing, Mr. Chairman. I think the minimum wage has been a topic on the minds of many Americans as well as every member of this committee and it is important that we examine this issue closely before we begin debate on the Senate floor.

No one is more concerned than I about the plight of the working poor in our country, but I am afraid that merely increasing the minimum wage is not a cure for this disease. If we are to increase the minimum wage it is important that we include additional provisions to help alleviate the extra costs the increase will impose on those businesses. This is especially true for small businesses, which have generated 60 to 80 percent of the net new jobs annually over the past decade. One way to mitigate the loss in employment that will invariably accompany an increase in the minimum wage is to lower the tax bill that these small businesses face.

I agree with the proponents of increasing the minimum wage that the current minimum is not enough to support a family, but that obscures the fact that the majority of those people who receive the minimum wage are not supporting a family. Many of these are high school students who are just entering the labor market for the first time and learning about the world of work.

The minimum wage is a blunt instrument with which to help the poor. Some are undoubtedly helped by an increase in the minimum wage but others are hurt. We have at our disposal another way to help the working poor, and that is the Earned Income Tax Credit. The EITC provides a subsidy for low-wage workers that encourages participation in the labor market and is hailed by economists of all stripes for its effectiveness. I am not sure that our current unemployment rate necessitates further intervention by the federal government to further increase employment but if it is indeed necessary then the EITC seems like a much better tool to use.

It is easy for people who are from the high-wage states on the coasts to say that the practical costs of such a minimum wage increase are slight. That is probably true for their states, but for those of us from lower-wage states the reality is different.

In my home state of Utah there are approximately 169,000 workers who earn less than the proposed minimum wage of $7.25 an hour, and roughly 16,000 receive the Federal minimum wage of $5.15. I am not about to say that all of these workers will lose their jobs, but we know that whenever government imposes a minimum price of anything, less will be bought. If the minimum wage forces businesses to pay more for workers, at least some of them will hire fewer workers, or have them work fewer hours, or reduce their benefits in some way. Some businesses will move their operations elsewhere as a result of the increase, some will invariably close down, and some will produce less. I think that is indisputable.

The proponents of a minimum wage increase can argue that the number of jobs lost will not be that great, or that the benefits to those who keep their jobs will outweigh the costs to those who lose their jobs, but to simply state that an increase in the minimum wage will not materially affect employment simply strains credulity.

Ultimately, the best way to combat poverty is to increase the growth of productivity, that is, the amount of goods and services each worker can produce. We do that by increasing the amount of investment in technology, and the amount of education and training that workers receive. A growing, prosperous economy creates benefits for everyone.

In the current political environment, an increase in the minimum wage seems inevitable. The real question before this committee is what provisions should accompany the increase to mitigate the damages. There are many good ideas for cutting the tax burden on small businesses, and I am looking forward to hearing the comments of our witnesses today.

Congressional Testimony

Tax Incentives for Businesses in Response to a Minimum Wage Increase

Testimony Before
United States Senate Committee on Finance

Testimony of Matthew F. Kadish. Esq.
Vice President of Legislation, Small Business Council of America

January 10, 2007

The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is proud and fortunate to have the leading small business advisors in the country on its Advisory Boards.

The SBCA has identified the following seven legislative priorities, which would be of immediate help to small businesses. Each is discussed more fully below:

- Estate tax – need immediate certainty and reform;
- Deferred compensation – limit §409A to public companies;
- §179 expensing – make permanent at higher levels, and increase amount;
- Create SIMPLE cafeteria plans;
- Repeal the AMT;
- Expand the allowable use of the cash method of accounting by small businesses; and
- Eliminate unfair tax treatment of professional service organizations.

Need For Certainty and Reform in the Estate Tax Area

Small businesses, their owners, and many other taxpayers need certainty in the estate tax area as soon as possible. The law yearns for certainty, and in that regard, estate planning has operated under a cloud since 2001. Since then, the law in this area has failed one of its basic functions – to provide taxpayers with the opportunity to predict, with reasonable certainty, the likely outcome of their choices.

In order to immediately exempt small businesses from the federal estate tax, the estate tax exemption should be increased to the $3.5 million dollar level this year – not in 2009. The SBCA is in favor of reforming the existing estate tax system and is not in favor of the repeal of the estate tax law in 2010 and beyond, because repeal would hurt many small business owners.

Furthermore, the SBCA believes that the time for certainty in this area is now – the estate tax and various related provisions are currently set for repeal in 2010 – less than three years away, only to reappear at a $1 million exemption amount in 2011. This "Cinderella-at-midnight scenario" is making it increasingly difficult for small business owners and many others to do estate planning with any level of confidence.

Accordingly, the SBCA urges Congress to do the following as soon as possible:

- Increase the exemption amount immediately to $3.5 million and then increase it gradually over a number of years until it reaches at least $5 million and thereafter have it increase by COLA

- Preserve the step-up in basis at death for simplicity and fairness
- Rejoin the estate and gift tax systems immediately for simplicity
- Exempt retirement plan assets from the estate tax in an amount up to an additional $1 million as an additional incentive for people to save for their retirement
- Create a true small business exemption - *any* ownership interest owned by the decedent in a "real" small business or family business if left to a family member would be exempt from estate tax or if this is not feasible, reduce the estate tax rates to 15%, on any small business or family owned business that is part of the estate

By implementing these steps, small business owners who have worked a lifetime to build their company will be helped immensely. Additionally, by implementing these proposals, many small business owners will find themselves in a better tax position than they would if the proposed repeal were to take place as scheduled in 2010. This is because total repeal would be accompanied with a loss of the step-up in basis and the continued decoupling of the gift tax from bequests made at death. We saw what happened when the basis step up was dropped from the law in 1976. The enormous difficulties faced by taxpayers caused Congress to re-establish it in 1980. Further, enactment of our proposal exempting a certain portion of retirement plan assets from the estate tax would promote retirement plan savings at a time when it is essential for Congress to incentivize such savings in order to assist our country in dealing with the future health care and retirement income burdens which will be imposed on the country by the baby boomer generation.

Under our proposal, the only estates that will be left paying any tax will be those which are comprised of huge amounts of wealth not due to an active family or closely held business. Most Americans, if they truly understood this issue, would probably feel that it is not a prudent thing for the country to allow a very few people to amass great wealth and to be able to establish dynasties of this great wealth by passing it down tax free from generation to generation. From the viewpoint of keeping our democracy strong, it makes sense for our country to tax at least some portion of this huge build up of wealth. In fact, the estate tax historically was imposed only on the very, very rich of this country as a way to avoid the problems that occur when a very small elite of the country is able to amass great wealth and pass this wealth down to the next generation; it was never intended to reduce the estates of working Americans who had built up a family business or a small business based on their own hard work.

Unfortunately, many small businesses will actually end up paying more taxes under the repeal in 2010 and beyond than they would with the increased exemption proposed to be in effect in 2009. This is because a majority of small businesses actually do better under our current system of estate tax with the increased exemption ($3.5 million or more) than they would under repeal because of the loss of the step up in basis.

To understand our pro-small business proposal and why it is preferable to repeal, there are a few basic concepts to our estate tax system that need to be explained.

First, today any assets that a person receives from another person's estate receive a "step-up" in basis - this means that the person receiving them gets them at fair market value as of date of death. Thus, when the person decides to sell the property, he would be taxed on the difference between the sales price and the date of death fair market value (this would generally be subject to capital gains tax).

A step-up in basis is contrasted to a "carry-over" in basis where the heirs receive the assets with the same basis that the deceased owner had. For example, assume a father bought a house for $20,000 and did not improve it in any way and that 35 years later at his death, the house is valued at $750,000. If the son received the house with a "carry-over" basis, his basis in the house would be $20,000. If the son then sold the house for $750,000, he would have $730,000 of gain which would be subject to capital gains taxes. If instead the son received the house with a stepped- up basis, his basis in the house would be $750,000 and there would be no gain subject to tax when he sold the house for $750,000.

Second, any assets that a person owns up to the exemption level - $2 million this year, can be given away at death, free of estate taxes. This is referred to as the exemption or exclusion amount and it is scheduled to increase to $3.5 million in the year 2009. This means with basic estate planning in the year 2009, a couple could leave $7 million to their heirs without the imposition of estate tax and with a step-up in basis on the entire $7 million of assets.

Third, assuming a couple has assets in excess of $7 million in 2009, the excess would be subject to the maximum rate of 45%. (This assumes that the couple has already sheltered $3.5 million at the earlier death of the first spouse).

After the full repeal of the estate tax in 2010, the current rule providing for a fair market value basis in property acquired from a decedent (i.e., the step-up in basis) is repealed. In lieu of this rule, the recipient of property acquired from a decedent will have basis in such property equal to the lesser of the decedent's adjusted basis in the property or the property's fair market value at the time of the decedent's death. However, recipients of property from a decedent will be entitled to an aggregate basis increase of $1.3 million (adjusted for inflation after 2010). In addition, the decedent's surviving spouse will be entitled to an additional aggregate basis increase of $3 million (adjusted for inflation after 2010). Accordingly, if a decedent is survived by the decedent's spouse and the value of the decedent's estate is $4.3 million, the full amount of the estate will pass to the spouse free of any estate tax and the surviving spouse will have a stepped-up basis for the entire estate. If there is no surviving spouse, then only $1.3 million of assets will receive the step-up in basis.

Assume there is a small business owner who has $3.5 million of assets and no surviving spouse. He (or rather his heirs) are better off under the 2009 law rather than total repeal because of the loss in the step up in basis. This is how this works:

Under total repeal: $1.3 million of the assets receive a step-up in basis to the fair market value of those assets at date of death. The remaining $2.2 million have the basis that the decedent had in those assets. (As an aside, imagine if the decedent were an 85 year old man who acquired many of these assets more than 40 years ago... how anyone is even going to be able to figure out the carry over basis of those assets is beyond us. The step-up in basis was repealed back in 1976 and was then reinstated in 1980, though the carry-over rules never became applicable during that period, because Congress learned from attorneys and accountants who handled the probate process that it was almost impossible to determine the carry-over basis for many assets.)

Now when the heirs of this decedent sell this $2.2 million of assets, they will be subject to capital gains tax on the difference between the then market value of the assets and the decedent's basis in those assets. For example, let's assume that the carry-over basis in the assets is $1 million - then the heirs will be taxed on $1.2 million of capital gain (assuming the fair market value of the assets was still $2.2 million).

Under the $3.5 million exemption - 2009 law: All $3.5 million of assets receive a step-up in basis to the $3.5 million level (this is the fair market value of his assets as of his passing). Now when the heirs sell any of these assets - there is no capital gains and no estate tax.

Basically, a single person with assets greater than $1.3 million up to $3.5 million is better off without total repeal of the estate tax and is in a better tax situation under the estate law as it stands in 2009. Similarly, a decedent who is married with assets greater than $4.3 million up to $7 million does better under the law as it would stand in 2009 than he would under total repeal. This covers a significant amount of taxpayers based on the data that illustrates how many taxpayers drop off of the estate tax rolls as the exemption amount increases. Based on data set forth in a March 16, 2005, issue paper from the Center on Budget and Policy Priorities[1] on this topic, if the estate tax exemption were $1 million in 2011, then 53,800 estates would be subject to the estate tax (this represents about 2% of the 2.6 million people expected to die in that year). Of the 53,800 estates that would be taxable, nearly half (46%) would have assets of less than $2 million and nearly three fourths would be valued at less than $3.5 million. If the exemption level in 2011 were $2 million instead of $1 million, then the number of taxable estates would shrink to 21,000. This is a reduction of 61% in the number of estates that would face the estate tax. If the exemption amount in 2011 were $3.5 million instead of $2 million, then the number of taxable

[1] This paper is entitled, "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options with Low Tax Rates Raise Very Little Revenue" by Joel Friedman and Ruth Carlitz

estates would drop to 8,500 (84% of the estates would be exempt compared to the number that would have been subject to estate tax if the exemption amount were to be $1 million in 2011). This amount represents about 0.3% of all the people who are expected to die in 2011. These numbers clearly show how many small business owners would be worse off under total repeal than if the law were frozen at 2009 (with the $3.5 million exemption and the step-up in basis).

The SBCA believes that the reason why most small businesses owners (particularly where they have assets which under repeal will have a carry over basis versus a stepped up basis if the $3.5 million exemption were in effect) do not understand that they are worse off under repeal, is because they do not understand the impact of the carry over basis and the ultimate imposition of capital gains tax on those assets.

If Congress wants to protect small business owners then it could do so by not only increasing the exemption amount immediately up to $3.5 million, retaining the step-up in basis, rejoining the gift and estate tax system, but also by putting into place a real exemption for small business owners. Such an exemption would not bear any resemblance to the Qualified Family Owned Business Interest (QFOBI) exemption that came into law a few years back. This rule was not only complicated, but suffered from the most severe planning defect - a business owner would not be able to know if he qualified for the exemption until death occurred. The exemption that the SBCA would endorse would be a very simple exemption - *any* business interests owned by a decedent in an active family or small business that was passed on to a family member would be exempt from the estate tax (again for simplicity, the interests should be passed on to the heirs with a step-up in basis).

The SBCA also believes that giving an exemption for up to $1 million in retirement plan assets that are left to a surviving spouse and up to $500,000 for retirement plan assets that are left to others would go a long way towards promoting retirement plan savings by small business owners and others. Right now the incentives towards locking up money in a retirement plan are being diminished by the lower tax rates on capital gains and dividends that do not apply to funds coming out of a retirement plan.

In conclusion, the 2001 Tax Act has created a legal landscape that makes it impossible for small business owners and other taxpayers to plan their estates with any predictability. This uncertainty is preventing taxpayers from making transfers and undertaking necessary planning. Uncertainty also undermines taxpayer confidence in the tax system. The SBCA urges Congress to act as soon as possible to provide estate tax certainty by way of an increase in the exemption amount, retaining the step-up in basis, reunifying the estate and gift tax, and taking the other steps outlined above.

Provide Certainty, Simplification and Fairness
Limit Application of Nonqualified Deferred Compensation – Code §409A

In 2004, Congress acted in response to perceived abuses committed by corporate executives at companies like Enron and WorldCom by enacting new Section 409A of the Internal Revenue Code. For publicly traded companies, the goals of §409A were, and still are,

valid and important. However, its application to small businesses is unnecessary and unduly burdensome. In addition, the burden of failing §409A is borne by employees. Small businesses are often uninformed, and §409A has become a trap for the unwary. **Section 409A should be revised so as to exempt businesses that are not publicly traded from its application.**

Section 409A serves no purpose for nonpublic companies and costs small businesses money in unnecessary legal and accounting expense. In addition, section 409A prevents common sense economic arrangements that are sensible for the employees and businesses and pose no opportunity for abuse. Unlike public companies and the well known problems of excessive executive and sometimes director deferred compensation at the expense of the shareholders, there is no abuse in private businesses by executives at the expense of shareholders due to the close identity of the owners and the executives in private businesses, which is totally different than public companies, when those controlling the business (executives and directors) are often owners of a small percentage of the outstanding stock.

Background

In general, whether compensation is taxed currently or on a deferred basis is determined under several long-standing statutory provisions and judicial doctrines. These include Code Section 83 (relating to property received for the performance of services), the doctrine of constructive receipt, the economic benefit doctrine, and others. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, and the payments are subject to a risk of forfeiture (meaning that creditors of the employer have priority over the potential recipient of the nonqualified deferred compensation), the compensation is includable in income when it is actually or constructively received. Correspondingly, the employer gets a deduction only when nonqualified deferred compensation is actually paid, not earlier when the commitment to pay it is made. If the arrangement is funded, then income is taxed to the recipient for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture, whether or not it is paid later.[2]

Overlaying those rules, Section 409A requires that all amounts deferred under a nonqualified deferred compensation plan (including arrangements set up by the employer unilaterally with no employee involvement or choice) after December 31, 2004 comply with very complex new rules. If these rules are violated, the amounts are currently included in the employee's income and also are subject to an additional 20% income tax. In addition, the employee is required to pay interest at the IRS underpayment rate plus 1% on the underpayment that would have occurred if the amounts had been included in income when first deferred or, if later, when they were not subject to a substantial risk of forfeiture.[3]

Section 409A defines a "nonqualified deferred compensation plan" as any plan that

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2 See House Committee Report, H.R. Rep. No. 108-548, pt. 1.

3 Explanation from comments of American Bar Association: "The Application of Section 409A to Transactions Involving Partnerships," submitted to Mark W. Everson, Commissioner of the Internal Revenue Service on May 20, 2005.

provides for the deferral of compensation (other than certain enumerated exceptions). It includes plans where the employee has no election to defer. A plan generally provides for the deferral of compensation if it gives a service provider a legally binding right during a taxable year to compensation that (i) has not been "actually or constructively received and included in gross income" and (ii) pursuant to the terms of the plan (a) is payable to (or on behalf of) the service provider in a later year and (b) is not required to be "actually or constructively received" by the employee within 2½ months after the end of the tax year of the employee in which it is no longer subject to a substantial risk of forfeiture (or if later, 2½ months after the end of the tax year of the service-recipient in which it is no longer subject to a substantial risk of forfeiture.) Prop. Regs. §409A-1(b)(1), (4)(i).

Section 409A imposes three restrictions on (i) distributions; (ii) acceleration of payments; and (iii) the employee's election of payment. The provisions must be satisfied both in form and operation. **The scope of 409A spans much farther than many originally expected or is warranted. It not only encompasses traditional nonqualified deferred compensation arrangements (such as so-called rabbi trusts and secular trusts), but as interpreted by the IRS and Treasury, extends to any agreement which has the effect of deferring compensation. Thus, owners of closely-held business continue to scramble to review, among other things, their employment agreements, buy-sell or other purchase agreements (to the extent purchase obligations are measured by productivity or contain severance pay), stock options, restricted stock arrangements, partnership agreements, limited liability company operating agreements, and numerous other standard business arrangements, to determine whether they contain any potential exposure to premature taxation (before receipt of the funds) and the severe penalties imposed by §409A for nonconforming deferrals of compensation. What a waste of time and effort for small business!**

The enactment of Section 409A, due to its complexity and wide reach, has spawned an industry, both on the government side and in private practice, as clients and their advisors (and the IRS, for that matter) struggle to understand and define the scope and relevant operating rules. The IRS and Treasury have issued several rounds of guidance, and are continuing to receive comments and requests for further guidance in this far-reaching and difficult area. However, Treasury has not provided any exceptions for private businesses (where no abuses like those in public companies can occur). Despite this guidance, many tax experts continue to struggle in providing clear answers on the scope and applicability of §409A to many real-world situations.

The justification for the enactment of §409A was to protect investors (including employees' ownership of stock in the employer's retirement plans) in publicly traded companies as a response to the abuses seen in the Enron, WorldCom and similar scenarios. In those and similar cases, corporate executives had, or created, large nonqualified deferred compensation accounts, and withdrew their balances shortly before the corporation declared bankruptcy, depleting company funds to the detriment of shareholders and creditors. As large public companies, the corporations' shareholdings were very broad, and the shareholders had no direct input or control over corporate activities, learning too late of the draining of the nonqualified deferred compensation accounts and the collapse of the corporation's financial position.

It appears that IRS believes that §409A was enacted to provide uniform and specific rules on when income deferral should be allowed in nonqualified compensation arrangements, but the rules were already well defined for tax purposes. Funded arrangements, as discussed above, were taxed to employees when they vested, even if they had not received any payments. Unfunded arrangements were taxed when payments were received, and only then could the employer take a deduction. Thus, the rules made sense and there were no abuses of the tax system because the rules made that impossible.

Small (not publicly traded) businesses and their advisors are experiencing significant uncertainty and burdens as a result of the new provisions, and the burdens far outweigh any possible public benefit. In fact, we see no public benefit and know of no abuses where private companies are concerned because the owners, not the executives (if they are also not owners) are in control.

For one thing, unlike in tax-qualified retirement plans, no real income deferral results from nonqualified deferred compensation arrangements. The employer (or its owners, in the case of a flow-through entity) pays taxes on the income as earned. It receives no deduction for deferred compensation paid unless and until the amounts are includible in income by the employee (or independent contractor). Accordingly, the perceived need for specific tests when nonqualified deferred compensation arrangements in fact defer income is misleading – the issue is essentially when the incidence of taxation shifts from the employer to the employee. For the reasons noted earlier in this paragraph, it is expected that there would be little or no revenue impact from restricting the application of §409A to publicly traded companies. **Overall, we submit that in the small business context, the level of complexity and risks imposed by §409A are harmful, burdensome, and completely inappropriate.**

In addition, unlike in Enron and other public companies, in a small closely-held business, the interests (and often identity) of the shareholders and executives are closely aligned. Even where the shareholders are not in fact themselves the executives, they generally exercise direct supervision over their activities and compensation arrangements. Accordingly, there are inherent safeguards present in the small business model that were not present to protect the shareholders in Enron and similar cases.

For example, assume Small Corp. has two shareholders and 30 employees. The shareholders are 59 and 62, and have invested in their company over the years. The company is now valued at about $2.5 to $3 million. However, the company is very entrepreneurial, dependent on the vision and leadership of its two shareholder-employees, and no outside buyers appear interested in buying it if the shareholders do not continue to be directly involved in guiding the company's future. The shareholders want to convert their business capital into retirement cash for the owners. A proposal is made to offer two current key management employees an option to buy the company at a relatively low price, provided it meets certain income goals at the end of five years, and subject to ongoing payment of extra income to the two shareholder-employees, which will be taxed to them as ordinary income, taxed at a much higher rate (35%) than would the same payments if treated as a part of the sale of their stock (15%) while they phase out of the business. The company's tax advisor tells the shareholders that the

proposed arrangement is a nonqualified deferred compensation arrangement under §409A. The shareholders cannot understand why there is anything wrong with this arrangement.

Employers frequently prefer to pay deferred bonuses or allow employees to defer payment, but the employer wants cash flow protection, providing that payment is deferred if the company fails to meet an objective financial criteria (such as minimum sales, EBITDA, or gross profit), but these standards are not permitted as exceptions under §409A.

Section 409A also inhibits negotiation of severance pay agreements where it is in the business interest of the employer to accelerate payments in exchange for a reduction in the amount due. There can sometimes be a substantial savings in interest costs and a reduction in amount payable, particularly where the employee perceives a credit risk in collecting the full amount. There may also be valid business reasons for an employer to pay off a deferred compensation obligation earlier, such as when it has excess cash, or to reduce a later obligation for credit purposes. This is usually done by paying bonuses during employment. This would currently violate both the rule against acceleration and the rule that precludes payments except on termination of employment or change of control. It is also a problem that the current severance pay exception is only for involuntary terminations, where in the real world most involuntary terminations are characterized as resignations. (The irony here is that in this instance, the Government would actually receive taxes earlier but for this code section that the IRS has been interpreting in the broadest possible way.)

Small employers often prefer to issue stock options at low values as an added incentive to employees. Unlike public companies (where values can be established based on the stock's traded value), the valuation of any given closely-held company is often open to debate, even among valuation experts. If the exercise price of the stock option is below fair market value as of grant, §409A applies. Unfortunately, the uncertain value of closely-held business interests presents a huge risk to a closely-held business considering issuing stock options, as the IRS can challenge the value (even if supported by an independent appraisal), thus exposing the transaction to penalties, interest and additional taxes under §409A.

The misplaced application of §409A is particularly evident in the personal service organization arena (accountants, architects, dentists, lawyers, nurses, physicians, psychologists, social workers, etc.), where essentially all of the practice's income is derived from personal services. In such a case, any non-immediate payments to shareholders as compensation or severance pay are subject to scrutiny and immediate tax and 20% penalty if §409A is violated. Such violations are often inadvertent and cause no harm.

For example, suppose Medical Practice has several family practice doctors, and one, Dr. Senior, wants to be able to slow down but not fully retire. Medical Practice values Dr. Senior, who is a valuable resource for the community, and would like him to stay on, but economically needs to limit his pay based on productivity. By contrast, Dr. Senior would like to supplement that income. As an incentive to encourage Dr. Senior, Medical Practice would like to propose to allow him to begin receiving his severance pay, which was to be funded by the collection of his accounts receivable after he retired, when his billings drop below a certain level, but while he

was still employed. Medical Practice is advised by its tax advisor that the proposed arrangement would violate §409A, as it is not permissible without the imposition of current tax and a 20% penalty to Dr. Senior on money that he would be paid later (but taxed earlier when he was paid unlike the original arrangement, when he would be taxed when paid after retirement). Clearly, section 409A makes no sense in this situation, as Dr. Senior would be taxed when he received the money.

Section 409A complicates planning for partnerships and other entities (such as limited liability companies treated as partnerships for tax purposes), as the IRS has not yet determined how to address partnership deferrals, due to the conflict between Code sections 409A and 736.

There is also a high degree of complexity in determining whether a plan is grandfathered out of the application of §409A, or even if so, which part is grandfathered where, for example: (a) there is uncertainty about whether amounts were legally binding; (b) not all amounts are vested; and (c) one of the participants was a controlling owner.

In summary, it would be a tremendous help to small businesses to limit the application of §409A to publicly traded companies. As noted above, existing statutory and judicial provisions provide sufficient rules to cover nonqualified deferred compensation plans for private business, where Enron-type abuses do not occur. Small businesses would be better served if could they could take the money they currently have to spend on tax advisors to cope with §409A, and could instead invest more money in making their businesses profitable

Section 179 (Expensing) – Make it Permanent and Increase the Dollar Limitations

Section 179 of the Internal Revenue Code allows businesses to expense (fully deduct from taxable income) a limited amount of the cost of new business equipment acquired that year. This tax benefit is limited by a provision of the law which stipulates that the expensing amount is phased out dollar for dollar for any amount of investment above a certain limit in a given year. Under current law, businesses can expense up to $100,000 and the phase-out threshold level begins at $400,000 for equipment in service in taxable years 2004 through 2007, but those limits revert back to $25,000 and $200,000, respectively, in 2010, if the current provision is not made permanent.

In 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The measure included a temporary increase that raised the direct expensing allowance for business from $25,000 to $100,000 for 2003, 2004, and 2005. The provision's phase-out threshold was increased from $200,000 to $400,000 over the same time period. In 2004, the American Jobs Creation Act of 2004 extended for two years, through 2007, the increases in the direct expensing allowances and the phase out threshold. The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) extended the changes in the allowance made by JGTRRA through 2009.

In his fiscal year 2007 budget, President Bush proposed an increase in the allowance to $200,000 and an increase in the asset cap to $800,000. Last year, Senator Olympia Snowe introduced the Small Business Expensing Permanency Act of 2006, which would codify the President's proposal and make this benefit permanent.

These past efforts to increase both the expensing limit and the phase-out threshold have had the dual effect of simplifying the tax code for small businesses and freeing up more capital so small businesses can invest in themselves and create new jobs. **The SBCA believes that increasing the amount a small business can expense, as well as the amount of money that can be invested before the expense is phased out, will allow companies to invest more freely without fear of being hit by higher taxes. Furthermore, making these benefits permanent will eliminate uncertainty and allow these companies to better make long-term plans and invest with confidence.**

Allow Small Businesses to Have Cafeteria Plans – Give Small Business a Level Playing Field!

The SBCA strongly endorses the concept of a SIMPLE cafeteria plan which would allow small businesses to sponsor cafeteria plans. We strongly endorses the SIMPLE Cafeteria Plan Act of 2005[4], introduced by Senator Olympia Snowe, and co-sponsored by Senators Kit Bond and Jeff Bingaman. We applaud the efforts of these Senators to bring health insurance to small business employees through this vehicle which is valued by employees. We agree with Senator Snowe's comment with respect to this essential legislation, "Establishing a SIMPLE Cafeteria Plan for small businesses will help them offer the same health insurance and savings options currently available to employees of large companies and government agencies."

Even though it seems beyond belief, as the law stands today, sole proprietors, partners and S-corporation stockholders who own more than 2% of the stock as well as other small business owners are not eligible to participate in a cafeteria plan. It is essential that the tax code be amended so that owners of small businesses who are set up in any business form other than a C corporation would be allowed to participate in a cafeteria plan. There is simply no rationale for this type of discrimination against small business owners.

It is important for small businesses to have a SIMPLE cafeteria plan which would be easy for small businesses to sponsor and administer. This would enable them and their employees to be able to purchase employer-provided health insurance with pretax dollars.

Modeled after the effective Savings Incentive Match Plan for Employees (SIMPLE) pension plan enacted in 1996, the new SIMPLE cafeteria plan would allow most small businesses who are not currently able to satisfy the existing anti-discrimination cafeteria plan rules due to their size, to sponsor these plans that are highly valued by their employees, in exchange for making a contribution to the plan for their employees' employee benefits, particularly health insurance.

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4 S.723 (2005).

It is important that cafeteria plans be allowed to offer long term care insurance as an optional benefit for the employees to select.

The "use it or lose it" rule which causes employees to actually have their own salary revert back to their employer if they do not spend as much money on medical care as they had anticipated, is long overdue to be thrown out. In effect, instead of being rewarded for being healthy (as is true with the HSAs), this rule, created by the IRS, stands common sense on its head and causes employees to forfeit their own dollars to their employers because they did not need to spend those dollars on health care.

Legislation that would make it easier for small business employees to be covered by a cafeteria plan will allow the small business employees to be able to select the benefits that can be offered by a cafeteria plan that they need most, the same way that employees for mid and large businesses are currently able to do so. Even more important, by giving the small business owners an incentive to sponsor cafeteria plans, this legislation will go a long way in helping small business employees to afford health insurance.

- **Employees of big businesses, mid-size businesses and the Federal government appreciate the valuable benefits provided by cafeteria plans. Cafeteria plans allow workers to obtain and choose employee benefits that are tailored to their needs in a tax advantaged manner.** Cafeteria plans can allow employees to pay their portion of health insurance on a pre-tax basis. They can allow employees to have deductions taken from their paychecks to pay for braces, eyeglasses, and other health care items that insurance will not pay for, dependent care, disability insurance and life insurance. Workers are able to select the benefits that they need most and are able to save for these expenses by having funds removed from their paychecks. It is clear that this is the easiest way for workers to save for these necessary expenditures - the dramatic success of employees saving for their retirement in 401(k) plans but not in IRAs attests to the importance of payroll deduction for effective savings. **It is clear that cafeteria plans offer a successful approach to encourage employee participation in healthcare costs.**

- **Employees of small businesses are seldom offered this valuable benefit because small business owners are effectively precluded from participating in a cafeteria plan. As mentioned above, small business owners who operate in any entity other than a C Corp (or those that own less than 2% in a Sub-S corp) are basically not allowed to be covered by a cafeteria plan.** When small business owners cannot take advantage of the benefits offered by a cafeteria plan, they seldom have any interest in sponsoring such a plan. Even if the owners are allowed to participate (e.g., a less than 2% stockholder in an S Corp or an owner in a C Corp), the existing non-discrimination rules effectively preclude the owners from being able to use the plan except for de minimus amounts. Again, if the owners of a small business cannot benefit from the plan to a meaningful degree, it is not likely to be offered.

- **Small businesses are at a double disadvantage when it comes to offering health care and other employee benefits to their employees. Health care insurance premiums are higher because small businesses lack the bargaining power of larger businesses. Because most small businesses do not offer cafeteria plans, small business employees are not able to pay for their health care and other benefit expenditures on a pre-tax basis. The health care playing field needs to be leveled for small businesses and its employees.**

- **Small business needs a safe-harbor cafeteria plan that would be modeled after the SIMPLE retirement plan that has been very successful with small businesses.** For example, in a SIMPLE cafeteria plan, if the small business contributes a safe harbor contribution of 2% or matches employee contributions up to 3% of the employee's compensation, then in exchange for this required contribution, none of the discrimination tests applicable to cafeteria plans and dependent care plans would apply. **Providing a SIMPLE cafeteria plan would provide small business employees access to this important cost savings employee benefit vehicle.** Small businesses have demonstrated that they are willing to absorb some additional cost for employees in the way of mandated contributions in exchange for relief from complex administration and discrimination tests with the widespread acceptance of the SIMPLE plan in the retirement plan area. It is anticipated that the safe-harbor cafeteria plan patterned on the SIMPLE retirement plan would also be accepted and adopted by small business. **If this is correct, then literally millions of small business employees would be likely to have health care insurance with some portion of the premium paid for by the employer and the remainder being paid for by the employee. Small business employees would also be able to select from other benefits those that are most needed.**

Congress has already decided that the SIMPLE plan provides sufficient benefits for the non-owner employees to justify the contributions for the owners – this SIMPLE cafeteria plan is patterned on the SIMPLE model and if it works it will bring access to valuable employee benefits, most importantly health insurance to small business employees.

- **Cafeteria plans should be able to provide employees with long term care insurance.** Presently this valuable employee benefit is not allowed to be offered by a cafeteria plan. By allowing employees to purchase this valuable benefit on a pre-tax basis and by payroll deduction, it is far more likely that employees will elect to be covered by long term care. It is also more likely that they will select long term care when the policy has been "pre-selected" by the employer for them. **This change would encourage more employees to finance their own long term care. It is desirable to shift as much of the burden of providing for the long term care needs of the baby boomer generation over to them rather than having to be taken care of by the government. The more we can incentivize individuals to purchase long term care insurance on their own the better.**

- **It is time for the unpopular and unfair "use it or lose it" policy now applicable to flexible health care accounts to be eliminated.** This policy basically means that if an employee has over estimated the amount of health care expenditures that he or she will have to pay during the year (over and above those paid by health insurance) then the excess amount is forfeited to the employer. Employers are prohibited from bonusing this amount back to the employee who forfeited his or her own money. Some employers apply these forfeited amounts to benefits for all the employees in the following year, but there is no requirement that they do so. Theoretically, the policy behind this unpopular rule created by the IRS was to make the flexible health care account be more like an insurance policy. Though the absurdity of this argument is easy to see – it's hard to imagine any insurance policy being purchased where the risk is limited

to the amount of "premiums" paid and the "insureds" forfeit their own money if they can't come up with enough expenses. Thus, comparing the "use-it-or-lose-it" rule of a medical reimbursement account under a flexible spending arrangement to health insurance (or any other kind of insurance) is ridiculous. Regardless of where this idea came from it is a bad idea and it is time for the flexible health care account to be treated like its sister benefit - the dependent care flexible account. The use it or lose it concept is unfair to employees and runs counter to public policy inasmuch as employees generally will not save as much as they are able to pay for health care expenditures because they are fearful of forfeiting their own money (their savings for health care expenditures) to their employer.

The nature of the health care flexible spending account should be changed to that of a reimbursement account so that it is the same as the dependent care account. By capping the amount of the health cared flexible spending account similar to the way dependent care account is capped, there is no need to fear that the account could be subject to abuse.

These changes would encourage employees to select the appropriate amount required for health care expenditures rather than possibly choosing to estimate low so that they don't forfeit their own money to their employer. This would assist employees in dealing with rising health care costs and provide a vehicle for them to save for these expenditures in a tax free manner.

- **The legislation would revise the discrimination tests applicable to the dependent care flexible spending account so that it is easier for all employees to use the benefit. The dollar amount would be increased to take into account today's cost of providing care for dependents.**

Some have argued that this legislation is too expensive to pass – however because good health care for our citizens is so vital, it is essential to incentivize individuals to undertake as much of the burden of providing for this health care as possible. Passing legislation similar to S. 723 will allow small business employees to join their counterparts in mid and large businesses and to save for health care and other employee benefits in a tax advantaged manner. Furthermore, it makes sense for all employees regardless of the size of the entity they work for to be able to have access to the same benefits under the tax code. Small business employees are in need of access to health care in a cost effective manner.

Repeal AMT

AMT is basically a second tax system that sits on top of our regular system and in effect the taxpayer has to end up paying the higher tax generated by each of the systems. Viewing this from a bare bones approach, it means that many of the deductions allowed by the regular tax system are rendered meaningless by the AMT. This particularly harms small business owners. This is another tax that was never designed to hit the working American but instead was designed to apply to a very few, very rich taxpayers who one way or another seemed to be able to dodge their tax bill every year under the regular tax code - they did it legitimately, but it did

not sit right with Congress that the very richest taxpayers often paid the smallest amount of tax. Today, the AMT affects more and more Americans and it is time that it be rolled back entirely. A repeal of AMT will simplify our tax system and will make it more fair for the American worker and small business owner.

We are aware that AMT reform or repeal has major revenue implications. However, as has been increasingly well-publicized, the reach of the AMT appears to be growing exponentially, and along with it the cost of fighting back this out-of-control tax. We applaud the Senate leadership for bringing this matter to the legislative forefront now, and believe that it is a legitimate priority for small business owners, as well as all taxpayers.

Expand the Safe Use of the Cash Method by Small Businesses

Taxpayers generally are allowed to use the same accounting method for tax purposes that they use for book accounting purposes. Code §446(a). However, §448 prohibits certain entities from using the cash method (C corporations, partnerships with C corporation partners, and tax shelters). Certain limited exceptions apply, including small business exceptions. Code §448(b)(3) exempts taxpayers with average annual gross receipts of not over $5 million. Also, via Rev. Proc. 2001-10, 2001-2 IRB 272, the IRS has administratively exempted businesses with not more than $1 million of gross receipts from accounting for inventories and using the accrual method. The IRS supplemented Rev. Proc. 2001-10 with Rev. Proc. 2002-28, 2002-18 IRB 815, allowing relief for some taxpayers with average annual gross receipts of up to $10 million. However, Rev. Proc. 2002-28 relief is not available for taxpayers otherwise barred by §448 from using the cash method. In addition, entire industry segments are barred from Rev. Proc. 2002-28 relief, based on the codes assigned to them under the North American Industry Classification System (NAICS).

While the SBCA agrees with the approach in Rev. Proc. 2001-10, we urge Congress to expand that safe harbor to businesses with average gross receipts of up to $5-10 million (regardless of whether §448 applies, and regardless of NAICS codes). SBCA believes that raising the threshold more realistically reflects an appropriate small business cut-off point for this purpose, as shown in part by the existing §448(b)(3).

As noted above, taxpayers are generally allowed to use the same accounting method for tax purposes that they use for book accounting purposes. However, Code §446(b) gives the IRS the discretion to force taxpayers to change that method if it does not clearly reflect income, and the IRS generally prefers the accrual method. Small business taxpayers often prefer the cash method, which they can understand, and which is much less costly to comply with. In many cases, there is considerable room for debate (and which sometime consumes significant amounts of taxpayer and Government time and money) over what method(s) clearly reflect income.

When a taxpayer switches from cash to accrual method, an adjustment generally needs to be made to the taxpayer's income under §481(a) to reflect mismatched timing due to the old method. Depending on the case and amount of time involved, §481(a) adjustments can be very

large. Although some rules provide for limited mitigation, a huge §481(a) adjustment can pose an immediate, and potentially fatal, threat to the continuing economic viability of a small business. Small businesses often do not have sufficient cash reserves or borrowing power to withstand large unanticipated liabilities.

The IRS treats taxpayer conversions from cash method to accrual in one of two ways. If the taxpayer voluntarily changes, it is given a four year period over which to spread the impact of the §481(a) adjustment. (See Rev. Proc. 97-27.) If the IRS discovers and forces the change, it does not give the spread-out period. (See Rev. Proc. 2002-13). By this "carrot and stick" approach, the IRS attempts to force taxpayers to switch to the accrual method, to avoid a sudden §481(a) adjustment from occurring at a time beyond the taxpayer's control.

The SBCA believes that small business taxpayers should be allowed to use the cash method without the fear of a sudden and disastrous audit and §481(a) adjustment. The area is too unclear for many taxpayers to understand, and the use of the accrual method is too complex and burdensome for taxpayers to simply capitulate and use. Accordingly, we ask that Congress change §481 to provide that the type of 4-year spread-out of a §481(a) adjustment be allowed for any conversion from cash to accrual method, whether or not voluntary.

Eliminating Unnecessary Complexity & Burdens For Personal Service Corporations

The Internal Revenue Code is riddled with provisions affecting various types of service corporations. The special and intricate rules that apply to personal service corporations (professional corporations) are burdensome, unfair, and unnecessary. They create a significant amount of tax complexity, which could be eliminated by the removal of several Code sections. Service corporations should be able to have graduated income tax rates, the choice of fiscal year, and other options available to other corporations.

The following tax rules must be considered by all personal service corporations. The Internal Revenue Code's definition of a personal service corporation is inconsistent and not uniform among the various Internal Revenue Code sections dealing with personal service corporations. In addition, many of the provisions serve no worthwhile purpose.

There are different types and definitions of service corporations that are the subject of restrictions or penalties under the Internal Revenue Code. Only three serve any meaningful purpose. Code §§ 269A and 414(m)), and 414(m)(2)(A). They should be modified, as described below, to prevent an inadvertent application of the rules to situations for which it was not intended. Another sensible rule that need not be changed is section 448, which in part provides that the cash method may be used by a qualified personal service corporation, an organization with a two-part definition. First, such a corporation provides services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. Second, substantially all of the stock must be held by, among others, (1) employees performing these services, (2) retired employees who had performed these services, or (3) the estate of a deceased employee or a retired employee who had performed these services. These

organizations thus pay tax when money is received, which is a correct method of taxation because personal services (and not inventory or depreciable capital equipment) are the major basis for their gross income.

Internal Revenue Code § 269A

Section 269A permits the Internal Revenue Service to reallocate income and tax benefits between personal service corporations and their employee-owners to prevent evasion or avoidance of Federal income taxes or to reflect clearly the income of the personal service corporation or any of its employee-owners. This Code section performs a useful purpose. While Code section 482, which does much the same thing, is probably sufficient, the SBCA does not oppose Code § 269A.

Internal Revenue Code § 469(a)(2)(C); §469(j)(2)

The second type of "personal service corporation" is contained in § 469 dealing with the passive loss rules. This definition is broader than the 269A definition because employee-owner applies to an employee that owns any stock in the corporation. In addition, the attribution of ownership of a corporation under § 318 will apply regardless of the level of ownership of the attributing corporation. The general passive loss rules are sufficient. There is no need for special passive loss rules for personal service organizations. Section 469(a)(2)(B) applies the rules to any closely held C corporation. For example, although a C corporation generally is not subject to the at-risk rules or the passive loss rules, a closely held corporation is. For purposes of these rules, a closely held corporation is a corporation in which five or fewer individuals own at least 50 percent of the corporation's stock. Thus, there is no need for Code § 469(a)(2)(C) and §469(j)(2), which separately applies to any personal service corporation. The rules for closely held corporations are sufficient.

Internal Revenue Code § 441(i)(2)

This definition is the broadest of the personal service corporation definitions. As we know, the federal income tax system is based on an annual theory of taxation. Taxable income must be computed and taxed on an annual basis through the filing of annual returns. The return must show the net result from all of a taxpayer's transactions during the year. A taxpayer is not generally permitted to take deductions during the current tax year to adjust for deductions that the taxpayer failed to take in a previous year, and income improperly excluded in an earlier year is not properly included in a later year return. Section 441 limits personal service corporations to the use of calendar year fiscal years, or other years ending in the last quarter of the calendar year, but only if additional rules of sections 280H and 444 are followed. There is no reason to single out PSCs for this limitation on choice of a fiscal year. In addition, by forcing PSCs to a calendar year, this rule imposes an additional hardship on accountants and their PSC clients by forcing the PSC to use a year ending in most accountants' busiest time of the year. The use of a fiscal year does not result in a greater opportunity for deferral of income by professionals than any other businesses.

Qualified Personal Service Corporation - § 448(d)(2)

This definition is still different than the previous three personal service corporation definitions above. A "qualified" personal service corporation is not a subset or a type of any of the personal service corporations described above. It is a distinct definition that requires "substantially all" of the activities of the corporation involved in the performance of service in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

In addition to the type of activity requirement, there is the ownership requirement that "substantially all" of the stock of the corporation that is held directly or indirectly by employees performing services for the corporation- in connection with the activities involving a field referred to above. This ownership requirement may also be satisfied by retired employees who have performed such services, the estates of the retired or current employees, and any successor in interest to their stock for a two-year period beginning with the date of death of such person. Treasury regulations identify ninety-five percent (95%) or more as "substantially all." This ninety-five percent (95%) is based upon time spent by employees rather than measuring by compensation or payroll. The regulations attempt to explain the particular fields of service but the term "directly or indirectly" remains somewhat mysterious. The definitions above for the first three personal service corporation definitions use the attribution rules of § 318 for "indirect" ownership. There is no such use of the attribution rules for a qualified personal service corporation.

Certain Service Corporations – Code § 535(c)(2)

A "certain service corporation" has a minimum accumulated earnings credit of $150,000 rather than the $250,000 enjoyed by all other corporations. A "certain service corporation" is one where the "principal function" is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. While the definition is similar to the "qualified personal service corporation," there is no ownership aspect to the definition. Again, we are at a loss to distinguish a corporation whose "principal function" is in one of these fields versus a "principal activity" in the personal service' corporation definitions. One can only conclude that it is part of the strategy of the bias against service corporations by the IRS that they are able to be armed with seemingly similar but nonidentical terms.

Service Organizations § 414(m)(2)

A "service organization" is a corporation, partnership, or other organization the "principal business" of which is the performance of services. The proposed regulations provide that the "principal business" of an organization is services if they are engaged in certain activities (the qualified personal service corporation activities described above plus insurance) or if capital is not a material income-producing factor. Meeting this definition may result in the corporation not being able to have a qualified plan under § 401(a) because of the minimum participation and nondiscrimination rules under § 401(a)(26).

A Professional Service Corporation under Prop. Regs. § 1.414(m)-1(c) is a corporation organized for the principal purpose of providing professional (i.e., accountants, actuaries, architects, attorneys, chiropodists, chiropractors, medical doctors, dentists, engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians) services and has at least one shareholder who is legally authorized to perform such service. Only professional service corporations may be considered "First Service Organizations" under IRC § 414(m).

The SBCA does not oppose this affiliated service group rule but submits that section 414(m)(2)(A) should be modified to require 50% or more common ownership for 414(m)(2)(A) to limit the rule to the situations for which it was intended in the Kiddie and Garland cases. For example, under the current 414(m)(2)(A), if an individual owns two percent of the value of a professional corporation, which in turn owns a 1/10th of one percent interest in an LLC (such as an ambulatory surgery center), the entities must be aggregated in accordance with section 414(m) and treated as one for retirement plan tax purposes, even though they are clearly two separate entities.

Nongraduated Corporate Tax Taxes - § 11(b)(2)

If a PSC is engaged in activities involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, it is denied the benefits of the graduated corporate tax rates. The taxable income of such a PSC is taxed at a flat rate of 35 percent by Code § 11(b)(2). For most taxpayers, the tax result after using the 35 percent flat rate exceeds the tax result when using the maximum (graduated) individual tax rate of 35 percent for 2006. However, the 35 percent rate does not apply to most individual taxpayers for 2006 until adjusted gross income exceeds $336,550. **The denial of graduated income tax rates for corporations with less than $100,000 of taxable income if they are professional corporations is not appropriate, as these organizations, like any other small corporation, must buy significant computer hardware and software as well as other items, and the graduated rates are necessary for PSCs, like other small corporations, to grow and prosper.**

At Risk Rules - §465(c)(7)(B)(iii)

This definition is identical to the definition in §269A except only five percent ownership is required to be an "employee-owner" rather than the 10 percent in §269A(b). The "at risk" rules do not apply to a qualified active business activity in a "qualified C corporation." However, a PSC is not eligible to be a "qualified C corporation." This provision should be repealed, as it serves no meaningful purposes.

Currently, a small business (or in reality, its tax advisor) is required to distinguish a principal activity (§§ 269A, 469, 441), substantially all of the activities (§448), principal function (§ 535), principal business (§ 414(m)), and principal purpose (Prop. Regs. § 1.414(m)-1(a)) just to ascertain the proper degree of the corporation's involvement. There then remains the analysis of type of activity and ownership. These rules, other than the two noted above, serve no

significant purpose. The SBCA believes that there is no good policy reason for service corporations to be treated differently than other corporations.

Matthew F. Kadish is the current Vice President of Legislation and a member of the Board of Directors of the Small Business Council of America, Inc., the only national non-profit organization which has represented the interests of privately owned businesses exclusively in the Federal tax, retirement, health care and employee benefits areas for more than twenty-five years. Mr. Kadish is a shareholder in the Cleveland, Ohio law firm of Kadish, Hinkel & Weibel. His practice includes a wide range of tax, business and estate planning matters, including choice of entity, business succession, exempt organizations, and representation of clients before the Internal Revenue Service and U.S. Tax Court. He formerly was an attorney-advisor to Judge Herbert L. Chabot of the U.S. Tax Court. He holds an LL.M. degree in taxation from the New York University School of Law, a J.D. from Case Western Reserve University School of Law, and a B.A. from Williams College. Prior to returning home to Cleveland, he practiced in Honolulu, Hawaii, and Washington, D.C. For further information, please see http://www.khwlaw.com/mkadish.htm.

United States Senate – Finance Committee

Responses to Questions for the Record

Tax Incentives for Businesses in Response to a Minimum Wage Increase

Hearing date: January 10, 2007

Response date: January 30, 2007

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From Senator Baucus:

1. **How does the increased section 179 small business expensing help small business?**

   Most small businesses need to make regular and substantial capital investments in order to continue to be competitive. If those investments are required to be depreciated over time, it effectively increases the economic burden of those investments (as there will be income tax on the money earned for the investment, since it is not fully depreciable), and acts as a disincentive to needed capital investments. Conversely, the increased small business expensing limit encourages more capital investment.

   Therefore, the section 179 expensing limit of $100,000 per year is economically very beneficial for small businesses, especially when available annually. Additionally, allowing taxpayers to expense capital investments helps reduce the administrative and accounting fees involved in setting up depreciation schedules and updating them each year.

[CONTINUED NEXT PAGE]

2. **Please provide an example of how section 179 expensing helped a small business.**

   One case study (of many) is that of Electrovations. Electrovations is an Ohio-based manufacturing company founded in the 1970s, and based on successful research and development. It has grown since its inception into a $10 million company, which directly and indirectly creates jobs keeping 100 people working. Electrovations embodies inventiveness. None of its products, or the means of producing them, existed before Electrovations innovated them.

   Almost all of the products Electrovations originally made are either obsolete or their manufacture has moved to China or elsewhere outside the U.S. Out of need, Electrovations must continually reinvent its product line, resulting in continuous retooling of its manufacturing operations.

   Section 179 expensing is crucial to enabling Electrovations to remain competitive in the fast-changing international business environment. §179 expensing also more accurately reflects the shortened useful life caused by the rapidly evolving marketplace. Although equipment might otherwise seem useful for a longer time period, once the window for its profitable manufacturing in the U.S. has expired, Electrovations moves on to innovate new products, in order to remain relevant and profitable.

   Electrovations uses the maximum §179 deduction each year, and urges Congress to continue and expand the amount of the §179 deduction on an ongoing basis.

From Senator Cantwell:

1. **How have your members utilized tax incentives to enhance human capacity, production and/or infrastructure? What are the biggest obstacles small business face with utilizing tax incentives?**

   Many small businesses have used the incentive of offsetting administrative costs for adopting a retirement plan. Their retirement plans then help them attract and retain employees and thus enhance their human capacity. Beginning in 2002, small businesses with 100 employees or less are eligible for an annual tax credit of 50 percent on up to $1,000 of administrative costs for the first three years of a new plan. The credit is available if at least one non-highly compensated employee is participating.

   The ability to expense up to $100,000 of capital expenditures a year helps small businesses enhance production facilities and infrastructure because every dollar of taxable income spent on such items is not taxed.

Tax incentives provide small businesses with more net disposable funds to enhance human capacity, production and/or infrastructure. A relatively small amount of incentive can make a huge difference to the flexibility a small business has to take the steps needed to maximize competitiveness and profitability.

Small businesses face several huge obstacles in utilizing tax incentives, many of which Congress could help eliminate or reduce:

(a) Lack of predictability. Taxpayers need to be able to predict the tax consequences of their planned actions. If the tax incentives involve undue risk or uncertainty, taxpayers often opt to forego the incentives and forego engaging in the type of transaction Congress intended to encourage.

Recent tax laws have contained a wide range of different effective dates and sunset provisions. While this may effectively allow Congress the "leverage" under revenue constraints to enact more tax incentives, it also makes it difficult for taxpayers to plan. For example, Congress recently made permanent the retirement savings provisions of EGTRRA 2001. One of those provisions involved Roth 401(k) plans. Employers were reluctant to under take the cost and inconvenience of sponsoring those plans, which Congress wanted to encourage, because of the prospect of the provision no longer being in effect a few years later. We anticipate an increase in employer adoption of Roth 401(k) plans now that employers can expect them to remain in force on an ongoing basis.

Another important example, as highlighted in my written and oral testimony, is the estate tax. Taxpayers are unable effectively to plan their affairs with any certainty. The lack of consistency and predictability is eroding taxpayer confidence in the tax system, which invariably hurts compliance and accordingly increases the tax gap.

(c) Impediments to getting good tax advice. Congress (and to a greater extent the IRS and Treasury Department) has placed increasing barriers to taxpayers seeking good tax advice on which to plan and properly report their tax liability.

A major example are the rules currently applicable under Circular 230. Circular 230 is a set of regulations which apply to lawyers, accountants, and any other tax professionals (e.g., return preparers, enrolled agents, etc.) who practice before the IRS. Under §10.35 of Circular 230, tax professionals are effectively prevented from giving written tax advice to clients unless it meets the requirements of a formal legal opinion. The costs of such an opinion can double (or often much more) the cost of the tax advice.

We understand the motivation behind the covered opinion rules in Circular

230 was to protect the investors in tax-motivated tax transactions. However, the provision unfortunately extends beyond promoter transactions, and is impeding the ability of taxpayers to get reasonably priced quality tax advice. Where the viability of a transaction depends on the tax result, it can tend to discourage taxpayers from entering into the types of transactions Congress intends to encourage with tax incentives.

2. **Can providing wages higher than the federal minimum increase or decrease worker retention at your company? Can you quantify how much a company may have saved (or would have spent) in terms of employee training costs?**

   My company is a small law firm, and our workers are making more than the minimum wage. Accordingly, we do not expect changes in the minimum wage to affect our worker retention. Because the members of the Small Business Council of America are largely successful small businesses that often provide health insurance and retirement plan benefits to their employees, unlike many small businesses, most of the SBCA membership employs workers above minimum wage, so the same answer would result. As a result, we have not conducted any related studies, and lack any verifiable data.

From Senator Grassley:

1. **In September of last year, this Congress had proposed a $5 million dollar unified credit per person, which would have been phased in by 2015. If small business knew the permanent estate tax credit would be $5 million instead of reverting back to $1 million in 2011, do you think the savings to small business owners would have a direct effect to their bottom line and their ability to pay an increased minimum wage?**

   It is clear that a better bottom line would increase a business' ability to pay increased wages. If instead of borrowing against family business assets to pay estate taxes, the business was not burdened by this cost, it could pay higher wages. Labor costs are one of many factors in determining the viability of a business. We strongly encourage Congress to provide estate tax certainty as soon as possible. Estate tax certainty would benefit the bottom line of small business owners in several ways.

   (a) Cash flow burden on survivors. The estate tax is a tax on death-time transfers. Many small businesses are family businesses, and often a large portion of the owner's estate is the business interest. When the next generation inherits the business , the heirs have their share reduced by the estate tax. If they are fortunate, the parent planned for the needed liquidity to handle the estate tax (via life insurance, investments or otherwise). If not, they may need to avail themselves of statutory assistance (e.g.,

§6166), if they meet the legal requirements, or more likely, they will need to borrow money or sell assets of the business. Under either alternative (§6166 or borrowing to pay estate tax), the operation of the business is subject to an added cash flow burden.

To give an example of the impact of the current law on a small business owner, imagine an owner who is single with a total estate of $3.5 million. If this owner were to die today, his/her estate would be subject to tax on roughly $1.5 million of assets at a tax rate of 37%, or approximately $555,800. If the owner instead died in 2009 with an estate of the same size, there would be no estate tax due, as the $3.5 million estate tax exemption in effect in 2009 would fully cover the size of the estate. In 2010, the amount of tax due would be determined on whether the heirs sold the business or other assets and what the basis was in those assets. In all likelihood, there would be significant income tax due when the assets were sold (capital gains or ordinary income depending upon the asset sold), in part because as a practical matter the heirs are unlikely to be able to prove what basis the decedent had in the asset. In 2011, if the owner were to die, there would only be an estate tax exemption of $1 million, leaving $2.5 million taxed at a rate of 49%, for an approximate tax of $1,225,000. These dollars would to a large extent need to come from the business, so that there is a significant likelihood that the business would have to be gutted or heavily leveraged to pay the taxes. This is why it is so critical for Congress to act on this issue this year.

(b) Net inheritance. As discussed further in my written testimony, studies have indicated that increasing the estate tax exemption to $3.5 million per spouse would effectively exempt 84% of the estates that would be subject to estate tax at a $1 million level, meaning that only about 0.3% of people expected to die in 2011 would owe estate tax. A $5 million per spouse exemption would eliminate some additional small businesses from estate tax. With either $3.5 million or $5 million, most family farms and other small businesses could pass to the next generation without the need to sell them or borrow to pay estate taxes. Setting a permanent level (indexed for inflation) of $5 million per spouse will eliminate the estate tax for almost all Americans. We believe, however, that phasing the exemption up to $5 million over the next nine years is probably too long a time period and in fact, we believe that the exemption should be immediately increased to $3.5 million in 2007.

(c) Compliance. Small business owners are currently forced to review and revisit their estate plans on a frequent basis, as the law has been changing frequently. This involves not only legal fees, but lost productivity time while assembling and reviewing the necessary information. Estate plans for small business owners would also become less complex (and easier to understand), and therefore less costly.

Finally, we believe that increasing the exemption amount would better translate to the bottom line of a small business than would reducing the estate tax rate. As noted above, increasing the estate tax exemption would effectively exempt almost all small businesses from estate tax.

2. **How would your organization feel if we could make estate tax reform permanent immediately – like contemporaneous with the rest of this tax package? Do you think those same savings would benefit small business owners?**

   Yes. Immediate and permanent estate tax certainty would make a large and positive impact on the small business community, and the Small Business Council of America strongly endorses it. A recent membership survey indicates that immediate estate tax certainty is one of the top three tax legislative priorities (along with limiting §409A to public companies and the SIMPLE cafeteria plan) for small businesses. As noted above, the tax savings from exempting more estates from the estate tax would directly benefit small business owners. In addition, permanent rules would allow everyone to plan. With the estate tax slated for temporary total repeal in 2010 and then re-emerging in 2011 at a $1 million exemption, it makes planning very difficult and very expensive.

From Senator Hatch:

1. **Mr. Ratner and Mr. Kadish, among the biggest obstacles to small business formation and expansion is the high cost of health insurance. In recent years, Congress has provided new health care options for small firms through tax preferred health savings accounts and high deductible health plans. In your opinion have these programs helped to address some small business health care needs? Would you recommend any changes to, or expansions of, these accounts that would make them more attractive for businesses like yours and the ones you advise?**

   Both HSAs and high deductible health plans have been useful in incentivizing individuals to monitor, take personal responsibility for, and prioritize their own health care spending. High deductible plans accomplish that by making individuals have to spend more of their own money. The HSA does that for the same reason. To further help, Congress could pass the SIMPLE cafeteria plan bill discussed in my testimony, which would give small business owners the opportunity to adopt a cafeteria plan and benefit from it (most cannot under current cafeteria plan rules due to the 25% concentration test and the fact that most are not "employees" in the sense required by the current cafeteria plan rules, as described in my testimony), which would help defray the costs of both insurance and uninsured medical expenses for both working owners and other employees.

2. **It seems obvious that you are very experienced in advising small businesses on their tax matters. As you may know, I have long been a proponent of easing the tax burden on small businesses and in particular, I have long supported a series of bills that would give tax relief to S corporations. What kinds of tax relief do you think that S corporations specifically stand in need of now?**

We would suggest the following tax relief (each of which has been previously proposed) to help S corporations and their owners:

- **Permission to Issue Preferred Stock.** Allow S corporations to issue "qualified preferred stock" as defined in §1504(a)(4). Permit distributions made with respect to the stock to be deductible to the corporation and treated as ordinary income to the stockholder.

- **Treatment of Sales of QSub Interest.** Deem the sale of QSub shares to be a sale of the pro-rata share of the QSub's assets followed by a §351 transfer into a newly formed corporation.

- **Reduced recognition period for Built-in Gains.** Shorten the 10-year built-in gain period to 7 years. Eliminate current built-in gains in the 8th, 9th or 10th year.

- **Passive Investment Income.**

  - Eliminate the termination of S status as a result of excess passive investment income.
  - Amend §1375 to increase the amount of passive income an S corporation could have before being subject to the "sting tax" from 25% to 60% of gross receipts.
  - Reduce the §1375 tax rate on excess net passive income to 15%.
  - Eliminate gains from the sale of stock or securities as an item of passive investment income.

- **Back to Back Loans.** Allow shareholders to receive increased basis on their pro rata share of loans made to the S corporation, which currently partners in partnerships can do, but S shareholders cannot.

- **Stock Basis Adjustment for Certain Appreciated Charitable Contributions.** Allow shareholders to increase stock basis by the pro-rata share of the appreciation of property contributed to charity by the S corporation. This would create parity on contributions by S corps and partnerships, and would encourage additional charitable contributions.

3. **Mr. Kadish, you mentioned several tax provisions that are important to small businesses and might be effective in helping to alleviate the extra burden placed on them by an increase in the minimum wage. Which tax changes you mentioned should receive the highest priority by this committee? Which of them do you believe will be the most effective in combating the effect of an increase in the minimum wage for the largest number of businesses?**

We appreciate your and the Committee's interest in tax incentives for small businesses. Among our proposals, we would rank our priorities as follows:

(1) Estate tax certainty (increase the estate tax exemption to $3.5 million, to gradually increase to $5 million with subsequent COLA adjustments; retain stepped-up basis; reunify estate and gift tax; provide exemptions for retirement assets and an improved exemption for small businesses, as detailed further in our written testimony). This would allow people to plan, which they cannot do with certainty now. It would eliminate the estate tax for 99.7% of Americans. Many, if not most, Americans who currently favor estate tax repeal do not understand that the increased estate tax exemption would mean the same thing to them as repeal – no estate tax.

(2) §409A -- limit application of §409A to publicly traded companies . As discussed in my written testimony, it is difficult to overstate the mayhem this provision is causing to small businesses and their planners. In addition, eliminating 409A for small business should not have any revenue impact. It is an administrative burden that forces existing agreements to be, in many cases, rewritten for no meaningful purpose. Small businesses are run and/or managed by their owners and do not need to worry about the CEO adopting generous nonqualified deferred compensation for him/herself at the expense of the owners.

One possible and clear-cut approach would be to exempt the entities exempt from the Code Section 280G, which addresses golden parachute payments (another case where Congress chose to protect shareholders from overpayment of executives). Section 280G exempts small business companies (incorporated or not) with 100 or less owners, and larger non-public companies where sufficient shareholder approval is obtained for the payment or plan.

(3) SIMPLE Cafeteria Plans

(4) Expand and/or extend §179 expensing

(5) Cash method of accounting - increase availability to small businesses. The most useful framework is that provided in Rev. Proc. 2002-28 (allowing the use of cash method regardless of a business' NAICS code).

(6) AMT repeal – The reality is that this is a critical issue for small business but we are aware that the cost of repeal is very significant.

(7) Repeal of complex and unfair burdens on personal service corporations.

It is difficult to say what burdens would land on small businesses from an increase in the minimum wage, and similarly, it is difficult to say the extent to which these incentives would match up with those. No doubt a minimum wage increase would negatively impact small businesses paying new employees at the minimum wage, as it would increase the cost of doing business. It may conversely increase retention and lower those costs, and if those persons are primarily students, retirees, those with other income, then the minimum wage may not need to be increased, but we do not have that data. However, based on a survey of our membership, we believe that the tax legislative changes shown above would be the most help to small businesses.

Statement of Bruce G. Obenour
President/Owner
Akwen, LTD. (Wendy's Franchise), Akron, Ohio
U.S. Senate – Committee on Finance
Wednesday, January 10, 2007

Opening Statement

Mr. Chairman and Members of the Committee, I'm Bruce Obenour, owner of Akwen, Ltd., a Wendy's franchise in Northeast Ohio. Thank you for the invitation to testify about the Work Opportunity Tax Credit (WOTC) and the impact of a minimum wage increase.

Company Profile

Ten years ago my family and I took a risk and started a business. Today, we own 21 restaurants. We provide jobs for about 100 full time and 650 part time workers. Our hourly crew employees averaged $6.44 an hour in December.

Mandated increases in the starting wage may or may not result in quality of life improvements for low-skilled and entry level workers. There is certainly a broad spectrum of opinions. As an employer in the industry with the majority of these workers, I assure you there are consequences to our business and employees.

I've lived in Ohio all my life. My stores in Northeast Ohio are in the "Rust Belt." Many are in older buildings and neighborhoods. On January 1st, the Ohio minimum wage increased to $6.85. That may not sound like much, but the cost at 41 cents more an hour is at least $370,000 annually. An increase in the minimum wage comes with an increase in social security, employment and workers compensation taxes. In fact, we just closed a store in Cuyahoga Falls. Our decision to close was difficult, but with the wage increase looming we knew we could no longer make the store economics work. The wage increase was not the only factor in our decision, but it was a major factor.

Employer Provided "Work Opportunity"

More than any other private sector industry, restaurants provide the most on-site job training for the entry-level (especially teen) workforce. It's more than "putting pickles on first!" Our employees are required to be rigorously trained through a specialized and highly structured format – and at considerable cost. The training we provide prepares them for future work opportunities and self-sufficiency later in life.

Training is extensive and includes proper food handling, equipment safety, preventing slips and falls, material handling, burn and cut prevention, use of fire suppression systems, personal hygiene, personal and workplace security practices, teamwork and customer relations.

We give our crew opportunities to gain specialized skill not only in food preparation and equipment use, but we also provide technology training for Point-of-Sale systems, inventory control, security systems and time clocks. Our trainees learn compliance with basic workplace laws like OSHA, Americans with Disabilities Act, wage, hour, civil rights, sexual harassment, discrimination and other employment laws.

When we hire someone, we teach the fundamental expectations all employers have for on-time arrival to work, scheduling, proper procedures for absences, being prepared for work (meaning uniforms, appearance, attitude) and learning what is acceptable behavior in the workplace.

Often we're the first to teach young people basic workplace values, teamwork and personal responsibility.

Consequently, hiring teens and low-skilled workers is more expensive than you might think especially when the cost of labor goes up.

Mitigating the Negative Impact of Minimum Wage Increases by Targeting the Right Employers

Current minimum wage proposals call for a 41% increase. As a labor intensive business with a low-skilled workforce we're disproportionately challenged to manage the resulting margin pressure. The Quick Service Restaurant segment is different from other industries. We won't be managing labor costs by exporting jobs overseas. Our option is to run our stores with less labor. In 2001 I had 908 employees but in 2006 just 750 even though the total number of stores remained static. We can't eliminate large numbers of jobs at the store level; instead we work relentlessly to take labor out of the restaurant one hour at a time by installing more efficient dish washing equipment, high-tech grills and the like.

Proposals

We need the WOTC, it is well intentioned and effective. However it should be strengthened and expanded. To do that, we recommend the following:

Extend WOTC

The credit should be made permanent or have a longer extension.

Expand WOTC

The targeted groups under WOTC should be expanded to include teens in the Quick Service Restaurant segment. Our segment is burdened most by an increase because of the nature of our workforce and our business model.

In December the unemployment rate was 4.5%. But in my part of the country, it's higher. Significantly higher still is the national unemployment rate for teens at 15.2% and for African American teens it's 26.2%. In light of these high rates and the costs associated with training teen workers, it makes sense to enact a narrow incentive intended to help us hire those who need these job opportunities the most.

AMT Relief

For small business like mine and many other franchises which run our businesses through pass through entities, adjustments to the Alternative Minimum Tax ("AMT") are necessary for us to make the most of WOTC and other incentives. Because of the AMT which often kicks in due to the deduction for state and local taxes and depreciation adjustments, we cannot take advantage of the WOTC thereby limiting the programs effectiveness. The law should be amended to permit the WOTC to offset AMT liability.

Summary

These recommendations would contribute to reinvestment in the workforce and businesses in the near term to the benefit of the economy. I commend the committee for its work and sincerely appreciate your focus on these important policy issues.

January 19, 2007

Honorable Max Baucus
U.S. Senate
Committee on Senate
2I9 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Baucus:

Thank you for the opportunity to testify before the Senate Committee on Finance. I have received questions from Committee staff and provide the answers below. Your effort to include small business tax relief as part of the minimum wage legislation is very important to the employer community and in particular those of us in labor intensive industries with a heavy concentration of entry-level and low-skilled workers. I urge you to hold fast to your position that such a large hike in the minimum wage include targeted tax relief.

Questions from Senator Baucus:

1. What, if any, problems have you had administratively with taking the Work Opportunity Tax Credit (WOTC)? Please discuss the State Employment Security Agency certification process.

Response to Question #1:

Generally we have few problems with the direct administration of WOTC because we use a third party vendor; they may have a different experience. We incur a fee payable to the vendor for each certification. The fee must be paid whether we get the credit or not and regardless of whether we can actually use the credit (AMT problem) so we can reinvest quickly in our businesses and by extension, our communities.

2. Please describe how you find qualified employees for WOTC. Do you use an agency?

Response to Question #2:

Our hiring generally takes place from applicants who live in the area surrounding each restaurant and the hiring practices used vary depending on the local economy and demographics. In certain instances we do make use of state and local employment resources to identify potential employees. In particular we use these and other paid resources to attract urban applicants to work in suburban stores. This generally requires us to fund employee transportation to and from work because these workers are unable to find a job close to home and must rely on public transportation.

3. WOTC was allowed to expire last year until it was reinstated and extended in December in the Tax Relief and Health Care Act of 2006. Please describe your experience as a WOTC employer after the credit expired.

Response to Question #3:

We continue to send data on eligible employees through the existing certification process with the assumption that the program will be renewed without significant change. In doing so, we incur the cost of processing and take a risk that the program is renewed. We will not recover fees already paid to the vendor for WOTC certifications if WOTC is not renewed.

Question from Senator Cantwell:

1. I have heard that some employers have missed opportunities to take the Work Opportunity Tax Credit because people they hire have not told them they are welfare recipients. Question: Have you experienced this problem? What are areas you would recommend for improving program effectiveness?

Response to Question

We are not aware that this is a major problem for our company. If a new hire doesn't declare their status to our WOTC vendor we can't know whether or not we missed a credit. We rely on applicants to honestly report their status. There are employers who complete the certification process on their own where there certainly exists the potential for missed opportunity and no return on their effort to participate in the program.

With respect to improving the program I offer two suggestions. First, either make the program permanent or find another way to get this group of people employed. One cannot successfully run a small business and make hiring and investment decisions if government incentive programs are so unpredictable and inconsistent.

Second, the WOTC is well intentioned and can promote employment for targeted categories of people. However, as I stated in my testimony, AMT very often renders the credit unusable thereby defeating the purpose. I will likely use the credits someday, but that will be after I have sold my business and am no longer an employer in the same context. The value of the credit should be able to be realized by small business in the time frame in which it is earned, today!

Allowing the credit to offset the AMT liability of a small business owner would help the government achieve the goals of the program.

Questions from Senator Hatch:

1. Mr. Obenour, about what proportion of your applicants qualify for WOTC at present? What kinds of problems have you experienced by this credit not being permanent and being allowed to expire and having it reinstated again and again?

Response to Question #1:

The chart below shows the percentage of our applicants who qualified for WOTC over the past six years. Obviously the number is increasing due in part to the economy in which I operate my business – the "Rust Belt." Further, the numbers emphasize the need to make the credit more useful today as noted above in my response to Senator Cantwell.

2001	15.7%
2002	12.5%
2003	15.2%
2004	20.5%
2005	23.8%
2006	22.6%

With respect to the challenges of the on again off again nature of WOTC please refer to my answer to Senator Baucus's question #3.

2. You mentioned that when the minimum wage is increased, it affects more than just those employees earning below the new minimum. Why is it that higher paid workers also get an increase in pay when the minimum wage is raised?

Response to Question #2:

As an employer, I must maintain equity among my employees with respect to wages. By that I mean employees in the same job are paid within a wage range. The range contains a minimum and a maximum. Typically, people who demonstrate better skills and have more experience are paid closer to the maximum. Thus, a minimum wage increase means an increase in the minimum of the range and subsequently it becomes necessary to move the maximum of the range as well.

Prior to the minimum wage hike the maximum for a position may have been $7.50, however if the minimum increases to $7.25 that $7.50 maximum no longer applies. You have to move it up as well. If you don't increase the maximum you take away the ability for employees to earn a merit increase, therefore taking away employees' incentive and motivation to strive for outstanding performance. This is a big issue in states that have indexed minimum wages to CPI. Generally speaking, employees will get an annual raise of 2-3% thereby minimizing the personal motivation of merit increases and fostering the destructive attitude of entitlement.

Increasing the minimum wage may (or will in our case) affect the next job level in the organization. This is best illustrated in the following example. If you have a non-management (crew) person making $7.25 an hour, it no longer makes sense to have a manager (shift supervisor) making $8.00 an hour. The internal equity I addressed earlier between these two individuals is now gone. The manager has much more responsibility, and rightly expects a significant difference in pay. Therefore you're faced with increasing their position range as well. It is a domino effect in my business and a challenge in an economy where compensation is determined based on skill and performance.

3. How many applicants do you have for a typical job opening in one of your restaurants? Were you having trouble attracting qualified workers before the increase in the minimum wage?

Response to Question #3:

Applicants for a typical job vary by restaurant. Some stores may have 20, some may have 1 or 2, and others may have none. Economics of the community in which the stores are located, contribute to those numbers. However, it is important to point out that prior to Ohio's minimum wage increase none of my 600 +/- employees (crew members — the entry level unskilled workers) ***none*** were actually making minimum wage. This is because the market of supply and demand worked as it should and created its own natural minimum wage, one higher then what the government set. As the dynamics of and demand for workers change, the pay rate changes respectively with the market creating a naturally equity between employees.

Please contact me if you or the Committee has additional questions.

Respectfully,

Bruce G. Obenour
President
Akwen, Ltd.
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Suite A
Uniontown, Ohio 44685

Statement
Of
Dave Ratner
Dave's Soda and Pet City
Agawam, Massachusetts

On behalf of
The National Retail Federation

Tax Incentives for Business in Response to a Minimum Wage Increase
Before the
Senate Committee on Finance
Wednesday, January 10, 2007

Contact:

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Mr. Chairman and Members of the Committee, my name is Dave Ratner. I am the owner of Dave's Soda and Pet City, a mini chain of 4 pet stores in Springfield, Amherst and Northampton, Massachusetts. I am appearing today on behalf of the National Retail Federation (NRF). I am also a member of the Board of Directors of the Retail Association of Massachusetts. I am pleased to have the opportunity to testify today on Tax Incentives for Business in Response to a Minimum Wage Increase.

By way of background, The NRF is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees - about one in five American workers and 2005 sales of $4.4 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations, including the Retail Association of Massachusetts.

I founded Dave's Pet City in 1975. I started with one store and one employee in Hadley, Massachusetts, and today I have four stores and 86 employees. I am proud to say that the reason my business has grown, and even thrives, is that we have the best and nicest folks in the world working at Dave's. Dave's has always been an integral part of the community. We sponsor many teams, plays, community events, library functions, charity events, etc. We set the standard for small businesses in our area with such programs as Dave's Student of the Month, summer reading programs and educational programs. Dave's has been chosen as Small Business of the Year by the Greater Springfield Chamber of Commerce and is a perennial winner of the people's choice awards for best pet shop in Western Massachusetts. I am frequently invited to speak on how to start and grow a business.

I commend Chairman Baucus for holding a hearing on tax measures that might help small businesses, especially in light of a minimum wage increase. In Massachusetts, the minimum wage was increased from $6.75 to $7.50 an hour, effective January 1 of this year. Because my policy is to pay my workers more than minimum wage, when there is a minimum wage increase, it causes me to increase wages throughout my labor force. I just increased the wages of my entry level workers to $7.75 an hour, as a result of the Massachusetts minimum wage hike. I plan to increase the wages of my more experienced employees in a corresponding manner. For a small business, these government mandated increases in overall payroll take a particularly heavy toll as we strive to compete with the national chains.

I am not here today to voice opposition to a federal minimum wage increase. Obviously, the Massachusetts legislature has already acted on this issue, so the minimum wage increase that Congress is considering today will not affect small businesses in my state. Of course, the cost of living in Massachusetts is higher than in many states, so it is appropriate that wage structures vary in different parts of the country. As a representative of the National Retail Federation, I am here representing small retailers from all over the United States. Retailers, who employ one in five American workers, are among the industries hardest hit by a minimum wage increase. For many, the current proposals would represent a 41% increase in entry-level wages. For most retailers, an increase in entry-level wages necessitates an increase in all wages in order to treat our more experienced workers fairly and maintain the vitality of our work force.

It is increasingly difficult for small, independent retailers to compete with the large chains. Because wholesalers price their goods based on volume purchased, we pay more for our inventories than do the large chains. Other costs of doing business also tend to be higher because the level of our purchases of goods or services is so much smaller than the big chains. A national chain may even have the ability to negotiate multiple leases with national operators of shopping malls. Most significantly, we do not have the benefit of the "branding" that a national chain has.

Small retailers must compete in other ways. I believe the best way to compete is with more service – more people on the selling floor to assist customers. A forced increase in payroll structure limits my ability to maintain or increase payroll. As a result of the January 1 Massachusetts minimum wage increase, we have implemented a hiring freeze and will adjust our workers' schedules to avoid overtime. Over the longer term, we will need to find other cost reductions to make up for the wage hike, because we cannot raise prices and still compete. We certainly will not be able to do some of the innovations we were hoping would help us better compete against the major chains.

Within the context of this hearing, I am here today to suggest the elimination of a tax code provision that discriminates against retailers. Under current law, retailers that own their stores must write off improvements to those stores over 39 years while retailers that lease their stores can write those improvements off over 15 years. For me and thousands of small retailers across the country, eliminating this discriminatory treatment would greatly reduce the cost of improving our stores and free up capital as wages go up and we strive to compete with large national chains that benefit from economies of scale. Legislation to eliminate this discriminatory treatment, S. 3806, was introduced in the last Congress by Finance Committee Members, Senator Olympia Snowe, by my Senator, John Kerry, as well as Senator Blanche Lincoln. I urge you to consider including this legislation as part of a minimum wage tax package.

Depreciation of Improvements to Retail Stores

The existing 39-year recovery period for real estate grossly overstates the useful life of structures and, even more so, the improvements made to structures, increasing the cost of capital and distorting business decisions. Studies conducted by the Treasury Department[1], Congressional Research Service[2] and private economists[3] have all found that the depreciation life for buildings is too long and that the depreciation life for building improvements is even worse. In fact, tax depreciation rules for investment in nonresidential structures may be the only type of investment where tax rules provide for decelerated cost recovery. As a result, current depreciation allowances generate high tax costs for these investments and reduce investment in these projects.

In the retail trade sector of the economy, structures and especially their improvements rarely last 39 years. Retailers generally remodel their stores every five to seven years to reflect changes in customer taste and needs. Remodeling is needed to maintain the retailer's customer base and compete with newer stores. Moreover, many improvements, such as interior partitions, ceiling tiles, restroom accessories, paint, etc., may only last a few years before requiring replacement.

A provision to temporarily reduce the depreciable life of *leasehold* improvements from 39 to 15 years was enacted as part of the American Jobs Creation Act of 2004 (AJCA). AJCA also temporarily reduced the depreciable life of improvements to restaurants, regardless of whether the restaurant was leased or owned. These provisions were recently extended by the Tax Relief and Health Care Act of 2006. Under these provisions, improvements made to buildings that are leased would be depreciated over 15 years, but improvements made to buildings that are owned would still have to be depreciated over 39 years, except for improvements to restaurants, which were given a 15 year life regardless of whether the restaurant is leased or owned. The leasehold/restaurant improvement provision will expire for property placed in service after December 31, 2007.

Approximately, half of retail stores are leased and about half are owned by the retailer. For retailers that lease their property, the leasehold improvement provision greatly reduces the cost of improvements to their stores. However, the leasehold improvement provision puts

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[1] *Report to the Congress on Depreciation Recovery Periods and Methods,* Washington, D. C.: U.S. Department of the Treasury, July 2000.
[2] Jane G. Gravelle, *Depreciation and the Taxation of Real Estate,* Congressional Research Service, The Library of Congress, Washington, D.C.: May 5, 1999.
[3] See, for example, Deloitte and Touche, LLP., *Analysis of the Economic and Tax Depreciation of Structures.* Washington, D. C., June 2000.

retailers that own their stores at a competitive disadvantage because they must continue to write-off store improvements over a 39-year period.

In my business, I am currently squeezed by the high cost of making improvements to my stores. I currently operate four stores, two of which I lease and two of which I own. I will be moving my fourth store in the near future, to a larger building I recently purchased that was an Ames Department store and stood empty for several years. I need to renovate the store before I can open it. The renovation costs are huge to get this older building up to Code, and the renovations must be written off over 39 years. Once I am able to open this store, I anticipate that I will be hiring an additional 15 employees to work there, because will be a much larger store than the one I am replacing.

Both of the major national chains with which I compete lease most of their stores in shopping centers. When they renovate their stores, they can write off the costs over 15 years. Of course, with respect to the two stores that I lease, I can write off my improvements over 15 years, as well. With respect to my other two stores, I must write off improvements over 39 years. This discrepancy makes no sense.

Retailers generally make more of an investment in the community when we own our stores. When a neighborhood deteriorates, the retailer who leases his store can break the lease or wait for it to expire and move to a new location. Retailers that own their stores have a bigger investment and a stronger incentive to work towards revitalizing the community. For some of my independent retailer colleagues, the store may have been passed down from previous generations and is the principal asset of a family-owned business. We should not have to pay a higher price for our renovations because we own a store, rather than lease.

The Joint Tax Committee in its 2005 report to this Committee on expiring tax provisions questioned whether the leasehold improvement provision's bias toward leasehold retail property improvements over non-leasehold retail property improvements is appropriate[4]. We agree that the tax code should not provide an incentive to lease rather than own similar property. A 39 year life for building improvements is too long, regardless of whether the property is leased or owned. The current Tax Code bias can easily be remedied by extending the terms of the provision to apply to improvements to retail space, regardless of whether leased or owned.

Conclusion

The economic data is clear that the depreciable life for improvements to buildings is far too long. The shortened depreciation life for leasehold improvements needs to be expanded to

[4]Joint Committee on Taxation, *Description and Analysis of Certain Federal Tax Provisions Expiring in 2005 and 2006* (JCX-12-05), March 11, 2005, at p. 50.

include improvements made to non-leasehold retail property. Shortening the depreciable life for improvements to stores owned by retailers will eliminate discriminatory treatment suffered by those of us who own our stores, whether we are large or small businesses. For small businesses, like mine, this provision will allow us to more easily afford the store updates we need to make to compete with large chains in shopping malls, especially in light of rising payroll costs.

Retailers grow their businesses by expanding their locations and opening new sites. When we expand, we hire more people to work in these locations. Lowering the tax cost of these expansions allows us to grow our businesses and increase employment.

Responses to Questions for the Record From Dave Ratner
Finance Committee Hearing of January 10, 2007

From Senator Baucus

1. Please detail what tax incentives help you as a small business owner to compete with larger corporations?

I own 2 of my buildings and lease 2 of my stores. I have a Petco opening across the street from a store I lease, so the 15-year depreciation will in fact allow me to refurb and update my store. One of the other stores I own is in need of "refreshing," which would consist of grooming rooms for dogs, play areas for pets, and other services which the big guys are offering in their new stores. The plumbing alone is thousands.

Building rooms to new codes, etc., will be a fortune. I simply can't do the changes I want unless we can write off the expenses faster than 39 years.

The section 179 is hugely important as well. We have in the last couple of years bought new electric pallet jacks, forklifts, computers and other office equipment, new shelving, and a delivery van. Just today I ordered 4 dog tag machines at $3,000 each because I can expense them.

Please understand much of these purchases were real upgrades not just replacement machines.

2. How has section 179 expensing and 15-year straight-line cost recovery for leasehold improvements helped you start or grow your business?

I have not yet used the 15-year depreciation. I will this year, as I mentioned above. My store that we will "refresh" (the one we lease) will be as sparkly as the new Petco across the street. Customers love us, but still want to shop in a nice, fresh store.

From Senator Cantwell

Do you use the WOTC program? What is working—or not—with the WOTC program? Do you have any suggestions for ways we can encourage employers to participate in the WOTC program?

We do use the program. I think the program is a great secret waiting to be leaked. There should be a way to partner with the National Retail Federation or state retail federations to

spread the word. I think the fellow from Wendy's had a great idea that would help businesses and frankly, more importantly, would get thousands of teens into the work force, which would ultimately help businesses. Extending the credits to some of the teen population would be a real win-win situation.

From Senator Hatch

1. New health care options.

I was very excited to learn about these programs until my insurance agent showed me the cost. At this point they are not an option for businesses like mine. The carriers and options are not there yet. I would be happy to share the facts and figures with you.

2. Besides the depreciation, what are the most important tax changes to help small businesses?

Keeping the 179 helps *every* small business owner. I can't imagine there isn't a small business owner in the USA that hasn't bought something for the business as a direct result of the 179. We all have to keep up with technology, replace equipment, add machinery to grow the business, etc. Section 179 is a beautiful thing; please keep it.

3. What do you think about the debate between the two economists?

I have to take the side that increasing the minimum wage has to be a good thing for workers who are at that level. I don't think it will have any effect on the poverty level; I don't really think this is about the poverty level. This is about the folks who are working for not enough money, and it has to help them.

From a very personal point of view, I am way more upset watching my electric and gas bills skyrocket than I am giving my crew another 75 cents an hour. The fact is, I pay the utility bills and still manage to stay in business. I will figure out how to deal with a higher payroll.

STATEMENT OF SENATOR ROCKEFELLER
SENATE FINANCE COMMITTEE
JANUARY 10, 2007

Mr. Chairman and Senator Baucus, thank you for holding this hearing. I believe that an increase in the minimum wage is long overdue, and I am pleased that Congress will be acting on that issue soon. I appreciate that it is the responsibility of the Finance Committee to consider whether or not tax cuts are appropriate to mitigate any potential negative effects of a minimum wage increase. I am grateful that the Committee is taking a thoughtful approach to the question.

Throughout my career, I have fought hard to create and protect jobs in my home state of West Virginia. So I take very seriously any suggestion that an increase in the minimum wage could cost workers their jobs. I am very interested to hear from today's witnesses about what steps, if any, Congress ought to take to protect jobs. I do not necessarily buy into arguments that claim that any increase in the minimum wage would be bad for the economy and/or increase unemployment. And indeed, right now the minimum wage is historically low. But I am willing to take a careful look at reasonable tax policies that can soften the impact for businesses of having to pay higher wages.

I am particularly interested on efforts to make the welfare to work tax credits permanent. Evidence suggests that these tax incentives have been extremely effective at helping some of our most vulnerable citizens participate in the workforce. And I have long supported making these incentives permanent. I believe that we may have a good opportunity to do so now.

Thank you again, Mr. Chairman.

Tax Incentives for Business in Response to a Minimum Wage Increase
Testimony Prepared for:
U.S. Senate Finance Committee
Dirksen Senate Office Building, Room 215
Washington, DC

January 10, 2007

Professor Joseph J. Sabia
Department of Housing & Consumer Economics
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Nobel laureate Milton Friedman once said:

> "One of the great mistakes is to judge policies and programs by their intentions rather than their results...[P]rograms that are labeled as being for the poor, for the needy, almost always have effects exactly the opposite of those which their well-intentioned sponsors intend them to have."[1]

The minimum wage is an example of this type of ill-conceived policy.

Minimum wage advocates argue passionately that no one who works hard and plays by the rules should be poor. I agree, as do most Americans. But, I also agree with Milton Friedman that good intentions are not enough to make good policy. The real test of this legislation is how its passage will impact the working poor. Here the evidence is clear – past minimum wage increases have not alleviated poverty and this legislation will not do so either.

A forthcoming peer-reviewed publication coauthored with my colleague, Richard Burkhauser, examines Census data from 1989 to 2004 and finds that minimum wage increases had no effect on overall poverty rates, on poverty rates among workers, or on poverty rates of working single mothers.[2] These findings, consistent with several previous studies[3,4], provide compelling evidence that minimum wage hikes are a poor antipoverty tool.

There are two reasons for this surprising result. First, individuals cannot be lifted out of poverty by a minimum wage increase if such a hike causes them to lose their jobs or have their hours significantly reduced. While some low-skilled workers who remain employed after a minimum wage hike are moved out of poverty, other low-skilled workers are moved into poverty as a result of adverse employment effects. Research by David Neumark shows that the net effect simply redistributes income among low-income families.[3] The net effect of past minimum wage hikes generally leaves low-skilled workers worse off.[3]

Recently, economists David Neumark and William Wascher published a paper for the National Bureau of Economic Research in which they critically review nearly 90 empirical articles that have been published since the early 1990s on the effects of the minimum wage.[5] They conclude that the evidence is "overwhelming" that the least-skilled workers experience the strongest disemployment effects from minimum wage increases.[6] Those workers most harmed are disproportionately workers without a high school diploma[7], young African-Americans[7], and single mothers.[8]

The estimated adverse employment effects are not trivial in magnitude. Burkhauser et al.[7] find that a 10 percent increase in the minimum wage results in an 8.5 percent decline in employment of African-Americans aged 16-24, a 5.7 percent reduction in teenage employment, and an 8.5 percent decline in non-high school graduate employment among those aged 20-24. Sabia[8] finds that a 10 percent hike in the minimum wage results in a 2.4 to 3.8 percent reduction in single mothers' employment, and even larger disemployment effects for single mothers without a high school diploma, with elasticities ranging from -0.68 to -1.4.

Among single mothers, there is growing evidence that minimum wage increases have the unintended consequence of increasing welfare use.[8,9] A study published last year in a peer-reviewed public policy journal found that a 10 percent increase in the minimum wage is associated with a 1 to 2 percent increase in welfare caseloads.[9] Sabia[8] finds that these welfare effects are even larger for less educated single mothers. Taken together, this body of literature suggests that while a growing economy, pro-work welfare reforms, and expansions in the Earned Income Tax Credit increased labor force participation and decreased poverty of single mothers during the 1990s and early 2000s, minimum wage increases actually undermined these gains.

Moreover, it is primarily sectors of the economy that employ low-skilled laborers—particularly retail and small businesses—that experience adverse employment effects. Sabia[10] finds that a 10 percent increase in the minimum wage is associated with a 1 percent reduction in retail and small business employment.

Reducing employment is not the only means by which employers respond to minimum wage increases. In fact, focusing one's attention only on employment effects will actually understate the total adverse effects of a minimum wage increase. Employers can also respond to a minimum wage increase by reducing employees' work hours. Couch and Wittenberg[11] find that a 10 percent increase in the minimum wage reduces average hours worked by teenagers by 5 to 6 percent. Sabia[16] finds that a 10 percent increase in the minimum wage results in a 6 to 8 percent reduction in hours worked by single mothers without a high school diploma.

However, adverse employment effects are not the only reason—or even the central reason— why minimum wage increases fail to reduce poverty. A second reason is that in contrast to 1938 when the minimum wage was first mandated, today, the vast majority of workers who benefit from a minimum wage increase do not live in poor or even near poor households. In 1938, many low-wage employees headed poor households. So, it

was much more likely that a raise in the minimum wage would transfer dollars to poor families. But since then, the relationship between earning a low wage and living in poverty has become weaker and weaker. By 2003, only 9 percent of low-wage workers were heads of poor households. The vast majority are second or even third earners in households with incomes that are more than two or even three times greater than the poverty line. Less than 5 percent are poor single mothers.[12]

Only 13 percent of workers who earn between $5.00 per hour and $7.25 per hour live in poor families, while 64 percent live in families with earnings more than twice the poverty line. Moreover, almost two-thirds of workers who live in poor families already earn wage rates greater than $7.25 per hour and will not be directly helped by a federal minimum wage increase.

In our new paper, Burkhauser and I simulate the effects of a federal minimum wage hike from $5.15 per hour to $7.25 per hour to see who would benefit.[13] To give the minimum wage its best chance to reduce poverty, we put on rose-colored glasses and assumed that there would be no adverse employment effects associated with the minimum wage increase. Even in this best case scenario, we found that just 13 percent of the benefits would go to workers in poor households; two-thirds of the benefits would go to those living in households with incomes at least two times the poverty line, and over 40 percent of the benefits would go to workers in households with incomes over three times the poverty line. For a household of four in 2006, that corresponds to household income greater than $60,000. Poor African-Americans would receive only 3.7 percent of the benefits and poor single mothers only 3.8 percent. And again, these are the best case estimates, assuming that no one loses her job or has her hours reduced as a result of a minimum wage increase. Hence, the paltry benefits we report accruing to the working poor may, in fact, be overstated.

In summary, raising the minimum wage is an ineffective antipoverty tool because it does not target the population of poor workers we would most like to help, and because it diminishes work opportunities for many low-skilled workers.

Excluding the costs of any adverse employment effects, we estimate that the cost of this minimum wage hike will be over $18 billion dollars, which will, in part, be passed on to consumers in the form of higher prices for products.[14] Given the high costs of this minimum wage increase, and the small share of the benefits that will actually accrue to poor families, it is difficult to justify a minimum wage hike on antipoverty grounds.

The evidence clearly shows that minimum wage increases are a poor way to help the working poor. A far more effective antipoverty tool is the Earned Income Tax Credit (EITC). The federal EITC program provides tax credits to poor working families. A minimum wage worker from a low-income family with two or more children stands to gain a credit of 40 cents for every dollar in wages earned. Such employees have an effective wage of $7.21 per hour. In states that provide EITC supplements, they can earn even more.

Importantly, in contrast to the minimum wage, the EITC is based on family income, not on a wage rate. Hence, a worker earning more than $7.25 per hour but who lived in a low-income family is eligible for the credit. Such a worker would gain nothing from a minimum wage increase to $7.25 per hour. Furthermore, the vast majority of minimum wage workers who do not live in low income families do not received EITC benefits. Thus the EITC is much more target efficient than the minimum wage.[15]

Most poor households—especially single mothers and African-Americans—would benefit from the EITC, while only a minority would gain from a minimum wage hike. And because EITC costs are not borne by employers, there will be no reduction in demand for low-skilled workers, as is the case with a minimum wage increase. My research shows that a 10 percent increase in the maximum EITC refundable credit reduces poverty rates by 7 percent among full-time employed single moms.[16]

Let us all agree that no American who works hard and plays by the rules should be poor. But good intentions cannot justify bad policy. Minimum wage increases are useless at best and downright harmful at worst. They should be abandoned and placed in the museum of antiquated antipoverty policies.

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The Effect of Minimum Wage Increases on Single Mothers' Labor Supply, Wage Income, and Poverty*

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The Effect of Minimum Wage Increases on Single Mothers' Labor Supply, Wage Income, and Poverty

Abstract

Using pooled cross-section data from the 1990-2005 March Current Population Survey (CPS), this study provides estimates of the effect of minimum wage increases on employment, hours worked, wage income, welfare receipt, and poverty status of single mothers. The results show that while a growing economy, pro-work welfare reforms, and expansions in the Earned Income Tax Credit (EITC) increased the labor supply of unmarried mothers, minimum wage increases had adverse effects on employment. A 10 percent increase in the minimum wage is associated with a 2.4 to 3.8 percent reduction in single mothers' employment. Among single mothers who have not completed high school, the effects are even larger, with elasticities ranging from -0.68 to -1.4. Moreover, minimum wage increases decrease annual hours worked and decrease annual wage income, potentially leading to increased welfare dependency. Comparing the relative effectiveness of the minimum wage and the EITC as antipoverty tools, the evidence shows that a 10 percent increase in the maximum EITC benefit is associated with a 7 to 8 percent reduction in poverty among full-time employed single mothers while minimum wage increases have no significant effect on poverty. In fact, the estimated coefficient is positive in some specifications. Taken together, the evidence in this study suggests that minimum wage increases undermined the pro-work policy goals of welfare reform and EITC expansions.

(JEL: J21, J38, J23)

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Introduction

> "[T]he jobs available to women leaving welfare are often minimum wage jobs, and it is difficult, if not impossible, for them to meet the needs of their families and raise their children. Daily life is often harsh for low-income working mothers in all parts of the country, whether or not they have been on welfare. For them, survival is the daily goal. If they work hard enough and their working hours are long enough, they can make ends meet – but only barely....We must stop asking these families to do it all alone. They are working too many hours for too little pay, without access to the support they need to make ends meet and improve the quality of their lives. One of the most important steps we can take is to guarantee a fair minimum wage." - *Senator Edward M. Kennedy (D-MA), May 2005*

While single mothers comprise less than 15 percent of all workers earning between $5.15 and $7.25 per hour (Burkhauser and Sabia, 2005), policymakers advocating a federal minimum wage increase to $7.25 per hour often refer to single mothers as their target population for minimum wage protection. Several studies have demonstrated that most minimum wage workers are not poor, that most workers in poor families earn wage rates higher than the federal minimum, and that even in the absence of adverse employment effects, the minimum wage is a poor policy tool to alleviate poverty because it is not target efficient, relative to the Earned Income Tax Credit (EITC) program (Burkhauser et al., 1996a; Burkhauser and Finegan, 1989; Burkhauser and Harrison; 1999; Burkhauser and Sabia, 2004; 2005).[1] Moreover, recent dynamic analyses that have examined the effect of minimum wage hikes on household-specific flows into and out of poverty have found that minimum wage hikes cause some low-skilled workers to fall into poverty due to adverse employment effects (Neumark and Wascher, 2001,

[1] Using data from the Outgoing Rotation Group of the 2003 Current Population Survey, Burkhauser and Sabia (2005) find that 13 percent of workers earning between $5.15 and $7.24 per hour live in households with income to needs ratios (INR) less than 1.0, while 45 percent live in households with incomes over three times the family-size adjusted federal poverty line. Moreover, 64 percent of workers living in poor families earn wages greater than $7.25 per hour.

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2002; Neumark et al., 2005).[2] Despite this empirical evidence, the political rhetoric surrounding minimum wage hikes continues to center on the policy goal of helping single mothers to escape poverty, particularly since the passage of the Personal Responsibility and Work Opportunity Act (PRWORA) of 1996, which provided strong incentives for single mothers to increase labor supply and leave (or remain off of) the welfare rolls.

Much of the literature examining the employment effects of minimum wage hikes have focused on populations of low-skilled workers, usually teenagers and high school dropouts, because these are the populations most likely to be affected by minimum wage increases (Card and Krueger, 1995; Card et al., 1994; Burkhauser, Couch, and Wittenburg, 2000a; Deere, Murphy, and Welch, 1995; Neumark, 2001; Neumark and Wascher, 1992, 2002; Neumark et al., 2004; Partridge and Partridge, 1999; Currie and Fallick, 1996; Williams, 1993; Couch and Wittenburg, 2001; Campolieti et al., 2006; Campolieti et al., 2005). While Card and Krueger (1992), Card et al. (1994) and Card and Krueger (1995) found no evidence that minimum wage increases had adverse effects on teenage employment, these studies have proven to be largely iconoclastic.[3] Much of the recent minimum wage literature has returned a consensus among labor economists that minimum wage increases have modest, adverse effects on employment and hours worked among low-skilled workers and in low-skilled sectors (Campolieti et al., 2006; Campolieti et al., 2005; Burkhauser, Couch, and Wittenburg, 2000a; Deere, Murphy, and Welch, 1995; Neumark, 2001; Neumark and Wascher, 1992, 2002; Neumark et al., 2004;

[2] These studies have found that, on net, minimum wage hikes have little effect or even a positive effect on overall poverty rates, a result consistent with findings by Card and Krueger (1995) and Burkhauser and Sabia (2006).

[3] One line of criticism of the Card and Krueger (1994) fast food study concerns choice of research design (Hamermesh, 1995) and phone survey methodology (Welch, 1995). Criticism of Card and Krueger's CPS-based panel study have focused on the author's interpretation of year effects as well as the availability of sufficient within-state state variation in the minimum wage to estimate policy impacts with sufficient precision (see, for example. Burkhauser et al., 2000a).

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Partridge and Partridge, 1999; Currie and Fallick, 1996; Williams, 1993; Couch and Wittenburg, 2001; Sabia, 2006).[4] However, few studies in the minimum wage literature have specifically examined the effects of minimum wage increases on the outcomes of unmarried single mothers.

Several recent studies have examined the effect of such hikes on welfare receipt. Brandon (1995) and Turner (1999) use data from the Survey of Income and Program Participation (SIPP) to estimate the effect of minimum wage increases on the probability of exit from AFDC and reach opposite conclusions. However, as Page et al. (2005) note, these studies focus on only a few years of data and minimum wage effects may be imprecisely estimated in short panels (Baker et al., 1999).[5]

More recently, Page et al. (2005) estimate the effect of state minimum wage increases on welfare caseloads. Using a panel of states and years from 1983 to 1996, the authors find robust evidence that a 10 percent increase in the minimum wage was associated with a 1 to 2 percent increase in welfare caseloads. One explanation for this finding is that minimum wage increases have adverse employment effects for single mothers, thus increasing welfare dependency.

There are two limitations of the above welfare caseload study. First, Page et al. (2005) do not estimate structural models to determine the causal pathways through which

[4] While monopsony power by firms employing low-skilled workers offers one theoretical explanation for the empirical findings of the "new economics of the minimum wage" literature, a 1996 poll found that the median labor economist believes that a 10 percent increase in the minimum wage causes a 1 percent reduction in teenage employment, a finding consistent with Brown, Curtis and Kohen (1982) (Fuchs, Krueger and Poterba, 1998).

[5] While not specifically exploring the effects of minimum wage increases on welfare caseloads, Grogger (2002, 2003) and the Council of Economic Advisors (CEA) use the minimum wage as a control variable in estimating the effects of other policies on welfare caseloads. Grogger finds a statistically insignificant positive effect and CEA finds a significant negative effect. Page et al. (2005) convincingly show that the treatment of state-specific time trends and the time period chosen for analysis can explain differences in their findings from that of the CEA.

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minimum wage hikes increase welfare take-up among single mothers. While the most likely pathway is through adverse employment effects, Page et al. (2005) do not provide any empirical evidence on this interpretation of their results. Second, the authors do not examine the effect of minimum wage increases on single mothers in the post-PRWORA period in order to avoid the difficult task of disentangling the effects of welfare reform, economic growth, and minimum wage increases. While this task is empirically challenging, it is arguably the more relevant question in the current policy environment. That is, in the context of pro-work welfare reforms, a growing economy, and expansions in the EITC, do minimum wage increases improve the economic well-being of unmarried mothers?

Three studies by Grogger (2002; 2003; 2004) do not focus on the effect of minimum wage increases on single mothers' employment, but does include the minimum wage as a control variable in estimating the effects of time limits and the EITC on unmarried mothers' labor supply and welfare use from 1979-1999. In welfare use regressions, Grogger finds that higher minimum wages are associated with greater welfare use among those with younger children. The sign on the minimum wage coefficient in employment equations is negative, but is insignificant in most specifications.[6]

This study contributes to the existing minimum wage literature in three important ways. First, no paper in this literature has focused on producing credible estimates of the effect of minimum wage increases on the labor supply, wage income, and poverty status

[6] However, in the minimum wage-employment results reported by Grogger (2003), there are no controls for state-specific time trends. Grogger (2003) does estimate models with state-specific linear and quadratic time trends, but does not report the full results of this estimation. He concludes that the exclusion of state-specific trends does not affect the time limit results, which are the primary focus of his paper.

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of unmarried mothers aged 15-55, a vulnerable population targeted by current state and federal policymakers for minimum wage protection. It is also the first to examine the effect of minimum wage increases not only in the immediate post-PRWORA era, which saw a large increase in employment rates among single mothers, but also in the early 2000s, which saw an economic recession and a large increase in the frequency and magnitude of minimum wage increases.[7] Moreover, in addition to examining a nationally representative sample of unmarried single mothers, this study is the first in the literature to focuses on the population of single mothers aged 15-55 who have not received a high school diploma. This low-educated subset of a low-skilled population is even more likely to be affected by changes in minimum wage law.

Second, in contrast to many previous minimum wage analyses, this study follows Couch and Wittenburg (2001) and Sabia (2006) by examining the effect of minimum wage increases on annual hours worked and wage income among working single mothers. These outcomes are important to measure in order to obtain a more complete picture of the effect of minimum wage hikes on the economic well-being of the family (income) as well as other dimensions of the employment contract (work hours). For example, among those who continue working after a minimum wage hike, a minimum wage increase could increase wages and hence annual wage income. However, annual wage income may fall if employers respond to minimum wage increases by cutting back employees' hours.

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[7] Since the last federal minimum wage increase (1997), not only are a greater number of states implementing minimum wages higher than the federal minimum (10 states in 1995 vs. 14 states in 2005), but the states that are implementing higher minimum wages are choosing minimum wage levels that are increasingly higher than the federal minimum. The mean state minimum wage among states with minimum wages higher than the federal minimum was 13 percent higher that the federal minimum in 1995 and 28 percent higher than the federal minimum in 2005.

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Finally, building on the simulations of Burkhauser et al. (1996a), Burkhauser and Finegan (1989), Burkhauser and Harrison (1999), and Burkhauser and Sabia (2004; 2005; Neumark and Wascher, 2001), this study estimates the effect of minimum wage increases on poverty rates of employed single mothers and compares the effects of minimum wage increases to expansions in the Earned Income Tax Credit (EITC). Given that some policymakers have presented minimum wage hikes as an important antipoverty measure for single mother-headed households, testing the effectiveness of the minimum wage hike in ameliorating poverty relative to the EITC is important.

The study's main results are summarized as follows. Using data on a pooled cross-section of unmarried mothers from the March 1990 to March 2005 Current Population Survey (CPS), fixed effects estimates reveal robust evidence that a growing economy, pro-work welfare reforms, and expansions in the EITC increased the labor supply of unmarried mothers. However, the results also suggest that minimum wage hikes may have undermined the goals of welfare reform and EITC expansions. A 10 percent increase in the minimum wage is associated with a 2.4 to 3.8 percent reduction in single mothers' employment rates. For single mothers without a high school diploma, the effects are even larger, with elasticities ranging from -0.68 to -1.4. Among single mothers who are employed, a 10 percent increase in the minimum wage is associated with a 2.4 to 3.2 percent reduction in annual work hours and a 3 to 4 percent reduction in real income. Consistent with Page et al. (2005), the evidence shows that minimum wage increases are associated with an increase in the proportion of single mothers receiving public assistance, though this effect is imprecisely estimated. And while a 10 percent increase in the maximum EITC grant is associated with a 7 to 8 percent reduction in

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poverty rates among full-time employed single mothers, minimum wage increases have no significant effect on poverty rates, with a positive sign on the estimated minimum wage parameter in several specifications. Taken together, the evidence in this study suggests that minimum wage increases undermined the pro-work policy objectives of welfare reform and EITC expansions.

Econometric Model and Data

Following much of the existing minimum wage literature, and building on the model estimated by Page et al. (2005), the econometric model used to estimate the effect of minimum wage increases on single mothers' employment is given as:

$$E_{ist} = \beta MW_{st} + X_{st}\delta + Z_{i}\gamma + \sum_{s=1}^{S}\alpha_{s} + \sum_{t=1}^{T}\tau_{t} + \sum_{s=1}^{S}\omega_{s}t + \sum_{s=1}^{S}\omega_{s}t^{2} + \varepsilon_{ist} \qquad (1)$$

where E_{ist} is a measure of the employment of person i in state s at time t, MW_{st} is the natural log of the higher of the state or federal minimum wage in time period t, X_{st} is a set of state and year-specific economic controls, Z_{i} are a set of individual characteristics, α_s are time-invariant state effects, τ_t are state-invariant year effects, $\omega_s t$ is a state-specific linear time trend, and $\omega_s t^2$ is a state-specific squared time trend. All models are estimated via weighted least squares with robust standard errors clustered at the state level. Card et al. (1994), and Krueger (1995) have shown that weighting may have an important impact on employment probabilities and is appropriate if one wishes to estimate the extent to which minimum wage increases will affect overall U.S. employment probabilities (Page et al., 2005).[8]

[8] This model is used to estimate the effect of minimum wage increases on several other outcomes: annual hours worked, wage income, welfare receipt, and poverty.

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As in Page et al. (2005), identification of minimum wage effects come from variation in minimum wages around a state-specific trend. While the specification in (1) controls for several forms of unmeasured heterogeneity, this comes at a cost of reduced precision. For example, year effects eliminate a potentially important identification source: federal variation in the minimum wage. Moreover, state-specific time trends require estimated employment effects to come off of deviation from trend, which may eliminate some of the state-specific variation in minimum wages. As noted in Page et al. (2005), since the real value of the minimum wage tends to trend downward over time and increase abruptly with the passage of a minimum wage hike, this identification source appears to be appropriate. Moreover, there is a credible theoretical reason to imagine that states adopting higher minimum wages may be trending differently than states that do not adopt higher wages. Minimum wage hikes are likely to be more politically palatable, and are likely to face fewer objections from state legislators, when employment trends are more favorable. When the labor market is tight and a recession is on the horizon, states may be less willing to enact policies such as minimum wage hikes that could exacerbate unemployment. Thus, for both empirical and theoretical reasons, the inclusion of state-specific trends is appropriate.

Equation (1) is estimated using pooled cross-sections from the 1990 to 2005 March CPS. Because questions about poverty, annual work hours, and welfare receipt are asked about the previous year, these data correspond to the years 1989-2004. While the unit of observation is the individual, the estimate of β can be interpreted as the estimated effect of a state minimum wage increase on predicted employment rates. The chief advantage of using individual-level data is the ability to control for individual-

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specific characteristics that affect employment decisions, as well as the ability to examine sub-populations, such as less educated single mothers who may be affected by minimum wage increases. An important limitation of these data is that the use of pooled cross-sections may introduce measurement error, as discussed by Page et al. (2005). If there are insufficient state and year-specific observations on single mothers and measurement, particularly from smaller states, and the measurement error is random, then the estimate of β will be unbiased, but inefficient. This is because states with smaller numbers of single mothers sampled are likely to have greater within-state variation in employment rates over time. Moreover, while not expected, if measurement error is systematically correlated with state changes in minimum wage law and with single mothers' employment, then the estimate of β will be biased, though the direction of the bias is a prior uncertain. To address this concern, separate models are estimated on a sub-sample restricted to "large" states. While the results from these alternative models may not be generalizable nationally, they will provide some insight on the consequences of measurement error.

The weighted means and standard deviations of the key dependent and independent variables are found in Table 1. To be included in full sample, an individual must be a single female head of household aged 15-55 with children under 18 living in the family.

Employment Measures. Employment is defined using information about the number of weeks worked last year and the typical number of hours per week. 78 percent of single mothers reported at least one hour of work in the previous year. A single mother is defined as being *steadily employed* if she reports working at least 1,040 hours

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last year, which corresponds to an average of 20 hours per week throughout the year. 64 percent of all single mothers in the sample reported working steadily; only 38 percent of unmarried mothers without a high school diploma were employed steadily.[9] *Full-time* employment is defined as working at least 1,820 hours last year, which corresponds to an average of 35 hours per week throughout the year. 50 percent of all single mothers and 26 percent of single mothers with less than a high school education reported working full-time last year.

Figures 1A and 1B show employment trends for the period 1989-2004. Trends for any work (positive work hours last year), steady work, and full-time work show that employment rates for single mothers were steady or slightly declining from 1989-1993, then grew dramatically from 1993 to 2000, and then began falling slightly from 2001-2004. Figure 1B shows that employment rates for less educated single mothers are much lower than for all mothers; the trends over time, however, are quite similar. Employment trends are consistent with (i) a growing economy attracting single mothers into the labor force, (ii) pro-work welfare reforms of the 1996 Personal Responsibility and Work Opportunity Act (PRWORA), and (iii) expansions in the EITC (1990, 1993, 1996) making market work more attractive.

Welfare Receipt and Poverty. A single mother is defined as receiving welfare if she reports receiving some income from public assistance in the previous year. 22 percent of all single mothers and 41 percent of single mothers with less than a high school education reported receiving public assistance benefits during the 1989-2004

[9] As discussed in the results section below, the empirical findings are not sensitive to the parameters of the "steady employment" definition.

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period. Figure 2 shows the dramatic decline in welfare receipt over time, with the decline beginning prior to PRWORA, but accelerating following its passage.

36 percent of all single mothers and 64 percent of single mothers with less than a high school education reported living in poverty, where poverty is defined as a household's income-to-needs ratio (INR) falling below 1.[10] Figure 3 presents trends in poverty rates during the 1989-2004 period. The overall poverty rate declined by nearly 35 percent between 1993 and 2000, but leveled off or rose slightly following the recession of 2001. Descriptively, this decline in poverty appears to be largely explained by the large increase in labor force participation during this period. Among single mothers who worked steadily or full-time, poverty rates declined much more modestly during the economic boom of the late 1990s.

State Economic and Policy Variables. State economic and policy variables are expected to influence single mothers' employment outcomes. The minimum wage is measured as the natural log of the larger of the state or federal minimum wage.[11] As in Burkhauser et al. (2000a), Card and Krueger (1995), and Deere et al., (1995), several state and year-specific measures of economic health are included as controls. These measures include the natural log of the average wage rate for workers aged 25-54. Higher market wages are expected to attract workers into the labor force. The unemployment rate for prime age males aged 25-54 is included to capture the availability of jobs. And finally, the natural log of the state Gross Domestic Product (GDP) is included to capture state-specific economic growth.

[10] The income-to-needs ratio is defined as the ratio of household income to the household-size adjusted federal poverty line.
[11] The table in the appendix shows nominal state and federal minimum wages from 1989-2004. For years in which the federal minimum wage changed during the middle of a year, a weighted average of the federal minimum wage level during that year is coded.

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During the period from 1989-2004, many state-specific welfare reforms were adopted, as states applied to the federal government for waivers from federal welfare regulations. Between January 1987 and August 1996, 46 states — including the District of Columbia — received approval to implement at least one demonstration project to amend their Aid to Families with Dependent Children (AFDC) and Job Opportunities and Basic Skills (JOBS) programs.[12] Of the states that received approval, 39 actually implemented the waivers before PRWORA was passed in August 1996.[13] This act instituted, at the federal level, many of the welfare waivers with which states had been experimenting and it also facilitated states adopting different types of provisions. The inclusion of year effects in equation (1) will capture federal implementation of welfare reform; thus, welfare reform effects will be identified from variation in state-specific implementation of welfare waivers around a trend. These welfare waivers may affect labor supply decisions of single mothers, particularly poor single mothers who had been, are, or anticipate joining the welfare rolls.

Data on welfare waivers are obtained from the Council of Economic Advisors (1999) and Horvath-Rose and Peters (2001), the latter who interviewed officials from many states in order to collect accurate data about the statewide scope of implementation. As in Horvath-Rose and Peters (2000), this analysis also includes welfare waivers that were not adopted statewide, with the relevant welfare waivers coded to the share of the population covered. Moreover, if a reform was only adopted for some fraction of the year, that fraction is coded in the relevant state and year.

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[12] States that either did not apply for approval or did not receive approval on their application were: Alaska, Kentucky, Nevada, New Mexico and Rhode Island.

[13] States that did not implement the waivers prior to August, 1996 were: D.C., Idaho, Kansas, Louisiana, Maine, South Carolina, and Tennessee. These states then either implemented them under the new Temporary Assistance to Needy Families (TANF) laws or rewrote them.

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Four welfare reform policies are included in the analysis: work requirements, time limits for welfare benefits, family caps, and sanctions for non-compliance with child support arrangements. Among the four policies, work requirements provide an unambiguous incentive to increase labor supply. Time limits also reduce long-run welfare benefits and may induce single mothers on welfare to increase labor supply. The family cap and child support enforcement policies are expected to affect labor supply indirectly. Family caps reduce or eliminate the incremental AFDC/TANF benefits if a single mother on welfare has an additional child while on the welfare rolls. This policy provides a disincentive for additional out of wedlock childbearing and a potential incentive to increase labor supply in the presence of additional new children since additional benefits will not be forthcoming. Sanctions for non-compliance with child support arrangements provide incentives for welfare mothers to establish paternity and to induce fathers to pay child support. The effect of this policy on labor supply is ambiguous — if it encourages mothers to obtain child support, it may decrease incentives for work; however if mothers do not want contact with the father, failing to assist the state in establishing paternity would result in a welfare benefit cut, creating incentives to increase labor supply.

In addition to welfare waivers, the natural log of the state and year-specific maximum AFDC-food stamp benefit for a family of three is included as a control variable. This benefit level captures the attractiveness of unemployment. Declines in a state's real AFDC-food stamp benefit are expected to increase labor supply (Moffitt, 1992).

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Finally, a measure of the maximum state and family-size specific EITC credit allowable is included. Many studies in the literature have found that expansions in the EITC are associated with an increase in labor supply, though this effect is concentrated along the extensive margin (see, for example, Hotz and Scholz, 2003; Eissa and Hoynes, 2005; Meyer, 2002; Meyer and Rosenbaum, 2001; Ellwood, 2000; Grogger, 2003; Meyer and Jenn, 2000; Hotz et al., 2001; Eissa and Liebman, 1996). That is, work participation decisions are affected by the EITC, but work hours are not especially sensitive to changes in the EITC. While there were large expansions in the EITC subsidy rate and maximum credit in 1990, 1993, and 1996, these policy changes will be largely captured by year effects in equation (1). However, during the period 1989-2004, 11 states enacted or changed their refundable EITC credit, thus increasing the maximum credit available to workers. New York, Minnesota, and Vermont each offered refundable credits of at least 30 percent of the federal EITC, which would increase the maximum credit by nearly $1,200 for a family with two or more children.[14] Because the EITC may have an important affect on labor supply decisions for single mothers, a variable measuring the natural log of the higher of the state or federal maximum EITC benefit is included.

Individual Level Characteristics. Included in Z are the standard set of demographic characteristics that are expected to affect labor supply. These include age, age squared, race, education (measured by whether the woman has less then a high school degree, a high school degree, some college, a college degree, or some post college training), whether the mother has a disability that limits work, young children under 6 in

[14] The maximum federal EITC credit in 2004 was 4,300. In Wisconsin, a refundable credit of 43% of the federal EITC is available for a family with three or more children, which would result in a possible maximum credit of $6,149.

the household, the number of children in the house, and whether the mother lives in a metropolitan statistical area (MSA).

There are 76,034 single mothers in the sample with non-missing observations and 16,370 single mothers who have not completed high school. All variables that measure dollar amounts (minimum wages, EITC benefits, AFDC-FS benefits, annual income, state GDP, and state mean wage) are adjusted for inflation and are measured in 2004 dollars.

Results

Employment Effects. Table 2 presents estimates of the effect of minimum wage increases on the employment of single mothers during the period 1989-2004. Given the functional form of the specification, elasticities are calculated via the product of the coefficient on the log minimum wage variable and the mean of the dependent variable (reported in Table 1). Each model includes state effects, year effects, and state-specific time trends. Identification comes from variation in the minimum wage around these state-specific trends.

The dependent variable in models (1)-(3) is whether the single mother was steadily employed for, and the dependent variable in models (4)-(6) is whether she was employed full-time.[15] Model (1) regresses steady employment on the minimum wage and individual characteristics; model (2) includes state-specific indicators of economic

[15] The results presented are not sensitive to the definition of steady employment. For example, a more liberal definition defining steady work as working at least 15 hours per week for at least 35 weeks produces similar results. Later, we consider an indicator for whether a single mother worked *any hours* in the previous year, though small numbers of hours worked in a year could introduce additional measurement error as it is likely to be correlated with informal labor market work not directly affected by minimum wage, welfare, or EITC policies.

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health; and model (3) includes the set of state-specific welfare reform policies, state EITC expansions, and state welfare benefits packages. Estimates from each of these models show that an increase in the minimum wage is associated with lower steady employment among single mothers. A 10 percent increase in the minimum wage is associated with a 2.4 to 2.8 percent reduction in single mothers' estimated employment rate.

The findings in Model (3) suggest that while the implementation of pro-work welfare reforms, a growing economy, and expansions in the EITC were increasing the labor supply of single mothers, minimum wage increases reduced steady employment opportunities for them. This result suggests that rather than attract single mothers into the labor market with higher wages, demand-side effects of minimum wage hikes dominated, with increases in the minimum wage undermining the pro-work goals of welfare reform and the EITC.

Individual-level characteristics were the most important determinants of labor supply, as expected. Less educated single mothers, those with disabilities that limited work, those with younger children, those with greater numbers of children, younger single mothers, and Blacks (relative to whites) were each less likely to be steadily employed than their respective counterparts. Year effects and state-specific time trends were highly significant, likely reflecting that economic growth and PRWORA were among the most important factors influencing labor supply outcomes for single mothers during this period.

Models (4)-(6) reflect that the results for steady employment held for full-time employment as well, with minimum wage elasticities that were slightly higher. A 10 percent increase in the minimum wage is associated with a 3.0 to 3.7 percent lower full-

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time employment rate for single mothers. This may reflect that minimum wage increases affect labor supply on the intensive margin as well, a possibility explored in a later table. This result is robust to the inclusion or exclusion of state-specific observable macroeconomic controls, state welfare reform policies, and state EITC expansions. Note that in contrast to the findings for steady employment, EITC effects and welfare reform effects are no longer significant, which may reflect that their influence dominates in the work participation decision, which is captured more cleanly in the steady employment regressions. Taken together, the results in Table 2 suggest consistent evidence that minimum wage hikes have not attracted single mothers into the labor force, but rather have diminished employment opportunities.

While the full sample of single mothers represents a vulnerable population that policymakers have sought to target for minimum wage protection, the heterogeneity in skill-level among these workers suggests that the estimated effects in Table 2 could be lower bound estimates of the effects of minimum wage hikes on the least skilled single mothers.

In Table 3, a subset of the least skilled single mothers is examined: single mothers who have attained less than a high school education. As in Table (2), the first three models present results for steady employment and the final three models present results for full-time employment. The results suggest consistent evidence that minimum wage increases adversely affect employment opportunities for single mothers with less than a high school education. Estimated elasticities are larger for less educated mothers than was the case in the full sample. A 10 percent increase in the minimum wage is associated with a 6.8 to 8.1 percent decline in steady employment rates and a 12 to 14 percent

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decline in full-time employment rates. These estimated elasticities are similar in magnitude to what Burkhauser et al. (1996) found for less educated young African Americans. The results again suggest that minimum wage policy has its strongest adverse employment effects on the least skilled, most vulnerable workers.

The results in Tables 2 and 3 have utilized the full sample of single mothers. However, as Page et al. (2005) note, there may be important measurement error introduced by smaller states due to large within-state variation in employment rates. While this measurement error is not expected to be systematically correlated with minimum wage increases, if the unmeasured error is positively correlated with minimum wage increases and negatively correlated with employment, then this measurement error could be driving the previous results. More probable, however, is that the measurement error is simply creating random noise in the dependent variable, which is resulting in unbiased, but inefficient estimates of the effect of minimum wage hikes.

In Table 4, the sample of all single mothers is restricted to (i) the 30 states that have at least 50 single mothers sampled in each state and in each year[16], and (ii) the 11 states that have at least 150 single mothers sampled in each state and in each year.[17] Across specifications for both the sample of all single mothers and for less educated single mothers, there remains consistent evidence that minimum wage increases are associated with significantly lower employment rates. In fact, for the sample of all single mothers, almost all are now significant at the 1 percent level, suggesting that these estimates may be more precise. The elasticities for steady employment range from -0.35 for all single mothers to -0.81 for less educated single mothers; for full-time employment,

[16] These states include AK, AL, AR, CA, DC, DE, FL, GA, IL, KS, KY, LA, MA, MI, MO, MS, NC, NJ, NM, NY, OH, OK, PA, RI, SC, SD, TN, TX, WI, and WV.
[17] These states include CA, FL, IL, MA, MI, NC, NJ, NY, OH, PA, and TX.

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elasticities range from -0.45 for all single mothers to -1.2 for less educated single mothers. These results reflect that the significant adverse effects of minimum wage increases are not driven by systematic measurement error.

Additional robustness checks on the estimates in Tables 2 and 3 are presented in Table 5. The previous models have assumed a linear-log relationship between the minimum wage and employment. In models (1)-(4) of Table 5, we explore whether the significant effects are driven by this nonlinearity assumption. In these models, the effect of real minimum wage *levels* on employment is estimated. Estimated elasticities are calculated as the product of the estimated parameter and the ratio of the mean of the minimum wage and the employment rate. The findings in the level models are consistent with those in Tables 2-4. A 10 percent increase in the minimum wage is associated with a 2.3 to 2.5 percent reduction in employment of all single mothers and a 10 percent reduction in employment of less educated mothers.

Next, models (5)-(8) examine whether the results are sensitive to the definition of steady employment. Models (5) and (6) define steady employment as working 15 hours per week for at least 35 weeks last year. The results are similar for both all single mothers and less educated single mothers. With this definition, a 10 percent increase in the minimum wage is associated with a 2.7 percent reduction in employment for all single mothers and an 8.5 percent reduction in employment for less educated single mothers. When employment is defined as any positive work hours last year (models 7 and 8), the results become smaller in magnitude and are insignificant for the full sample, but remain significant for the less educated sample. One explanation for this result is that

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a worker working a very small number of annual work hours may be engaged in informal employment that is not covered by minimum wage policy.

Finally, as Neumark et al. (2004), Burkhauser et al. (2000a), and Page et al. (2005) suggest, there may be important lagged minimum wage effects. Hence, the specification in model (9) includes both contemporaneous and lagged minimum wages. The signs on each of the coefficients is negative, but neither is individually significant; however, the implied long-run elasticity is consistent with previous estimates (-0.28). In model (9), it is interesting to note that the magnitude of the estimated parameter on the lagged minimum wage is larger than the coefficient on the contemporaneous minimum wage variable. Thus in model (10), only the lagged minimum wage is included. Again, the implied elasticity is -0.27, which is consistent with previous findings.

To this point, this study has focused exclusively on employment effects, as is the case in much of the minimum wage literature. However, this is not the only outcome that may be affected by minimum wage increases. Minimum wage hikes may impact other dimensions of the employment contract (hours worked), may affect reliance on public assistance programs (welfare), and may impact household-specific economic well-being (poverty). These outcomes are explored in the remaining tables.

Hours, Income, and Welfare Receipt. Findings by Couch and Wittenburg (2001), and Sabia (2006) suggest that minimum wage increases may not just affect employment rates, but may also affect hours worked. Employers may respond to minimum wage increases not only by laying off workers, but also by reducing hours worked among their employees. In models (1) and (2) of Table 6, the effect of minimum wage increases on annual hours worked among single mothers reporting positive hours of employment is

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estimated. There is some evidence that minimum wage increases are associated with fewer hours worked, with estimated hours elasticities between -0.24 and -0.32. The coefficient is only significant when the sample is restricted to "larger" states reflecting that measurement error may result in imprecisely estimated hours elasticities in the full sample. The result in model (2) is consistent with empirical findings on teenagers (Couch and Wittenberg, 2001; Sabia, 2006), and suggests that minimum wage increases may affect other dimensions of the employment contract than simply employment. In this sense, adverse employment effects may be lower bound estimates of the effects of minimum wage increases.[18]

Models (3)-(5) examine whether minimum wage increases have a significant effect on the annual wage income of employed single mothers. Models (3) and (4), which restrict the sample to those working positive work hours, suggest little evidence that minimum wage effects increase wage income, and, in fact, some evidence that increases in the minimum wage may decrease household income. A 10 percent increase in the minimum wage is associated with a 3 to 4 percent decrease in annual income. However, this result is not robust when restricting the sample to those working steadily (model 5). In this sample, minimum wage increases have no significant effect on single mothers' wage income. This result suggests that among workers, the demand-side reduction in work hours by employers neutralizes, or perhaps dominates, any positive wage gains. In sharp contrast to the negative minimum wage effects, note that pro-work

[18] Estimates of the effect of minimum wage increases on hours worked among working single mothers with less than a high school education reflect a negative relationship between minimum wage increases and hours worked. However, these estimates are not presented due to imprecision caused by small state and year-specific sample sizes.

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welfare requirements, and expansions in state EITC programs consistently have positive effects on labor supply and annual wage income.

The results in Tables 2-5 and the first five columns of Table 6 provide empirical support for a labor supply-related interpretation of the minimum wage-welfare study by Page et al. (2005). Because minimum wage increases have negative effects on employment and hours worked, and do not have a significant positive effect on wage income, they may have the unintended consequence of increasing welfare caseloads. This hypothesis is tested directly in these data. In models (6)-(8) of Table 6, the effects of minimum wage increases on welfare receipt is estimated. In the full sample of single mothers (model 6), the coefficient on the minimum wage variable is positive, but is not statistically significant. This is consistent with the finding reported in footnote 9 of Page et al. (2005). Those authors interpreted the absence of statistical significance as evidence that measurement error in the dependent variable—predicted welfare receipt probabilities—led to inflated standard errors. In models (7) and (8), the sample is restricted to the largest states to test this hypothesis. Here, there is some evidence that an increase in the minimum wage is associated with a significant increase in welfare receipt. A 10 percent increase in the minimum wage is associated with an approximately 8 percent increase in welfare receipt. However, one should exercise care in generalizing these estimated elasticities nationally given the restrictions placed on the sample.

Poverty. A number of studies (Neumark et al. (2004, Neumark and Wascher, 2001; Burkhauser et al., 1996a; Burkhauser and Finegan, 1989; Burkhauser and Harrison; 1999; Burkhauser and Sabia, 2004; 2005) have examined the effectiveness of minimum wage policy as an antipoverty tool among the working poor. Neumark et al. (2002; 2004)

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have examined household-specific flows into and out of poverty and how these flows are related to minimum wage policy. Their results reflect that minimum wage increases may increase poverty among some low-wage workers. Burkhauser and colleagues have focused attention on the target inefficiency of minimum wage increases, because most minimum wage workers are not poor and workers from poor families earn wage rates greater than federal minimum wage levels. In simulations that assume no adverse employment effects Burkhauser et al. 1996 have found that the EITC is a more target efficient antipoverty policy. To this point, however, no studies have compared the effects of minimum wage increases on the poverty rates of working single mothers to the effects of EITC expansions on poverty rates. In Table 7, this issue is explored.

All models include the full set of control variables as in the previous tables.[19] In these models, the sample is restricted to working single mothers, which gives the minimum wage is given its best chance to improve economic conditions of families. If the minimum wage increases poverty by causing employed single moms to lose their jobs, then the estimates in Table 7 can be interpreted as lower bound estimates. The three measures of poverty examined are *severe poverty* (whether household income falls below 75 percent of the household-size adjusted federal poverty line), *poverty* (below 100 percent of the poverty line), and *near-poverty* (below 125 percent of the poverty line). Separate models are estimated for the full sample and for the large state sample.[20]

Across samples and definitions of poverty, there is no evidence that minimum wage increases reduce poverty. In fact, in most specifications, the coefficient is positive

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[19] Estimated coefficients on the remaining independent variables are available upon request.

[20] While one would like to estimate models of the effect of minimum wage increases on poverty of working single mothers with less than a high school education, these results are not presented because the sample size is too small to credible identify minimum wage effects, even if the sample were restricted to "large" states.

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and insignificant. In contrast, the maximum EITC credit is associated with a significant reduction in the likelihood that a single mother headed household lives in poverty. The estimated coefficient on the EITC variable is larger among full-time workers than among merely steady employed workers, suggesting that those who work more hours receive a higher credit. A 10 percent increase in the minimum wage is associated with a 3 to 4 percent reduction in poverty rates among steadily employed workers and a 7 to 8 percent reduction in poverty rates among those working full time. At 125 percent of the poverty line, the effects of the EITC on poverty are insignificant. The results in Table 7 suggest that, relative to the EITC, raising the minimum wage is an ineffective antipoverty tool for working single female headed households. This result can be explained by two important facts. First, the EITC program targets poor families while the minimum wage may not. Second, steady employment is the most effective antipoverty tool, and while employment is encouraged by the EITC, low-skilled labor demand is reduced by increases in the minimum wage.

Taken together, the results in Tables 2-7 suggest that policymakers' claims that minimum wage increases are an important economic aid to single mothers, the evidence suggests that such increases decrease the likelihood of steady employment, reduce hours worked, and have no effect on poverty rates. In contrast, state expansions in the EITC during the 1990s and 2000s appear to have enhanced the economic well-being of single female-headed households.

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Conclusions

The 1990s and early 2000s were a period that saw important economic change for single mothers. Employment rates rose, welfare receipt fell, and poverty rates fell. The evidence presented here suggests that while pro-work welfare reforms, a growing economy, and expansions in the Earned Income Tax Credit program each played a role in these positive economic trends, increases in the minimum wage did not. Rather, the evidence in this study finds that minimum wage increases reduced single mothers' labor force participation and hours worked, and may have enhanced welfare dependency while failing to alleviate poverty. A 10 percent increase in the minimum wage is associated with a 2.4 to 3.8 percent reduction in single mothers' employment. Among less educated single mothers, the effects are even larger, with elasticities around unity in some specifications. Among single mothers who are employed, a 10 percent increase in the minimum wage is associated with a 2.4 to 3.2 percent reduction in annual hours worked and a 3 to 4 percent reduction in real income. Minimum wage increases have no significant effect on poverty with the sign on the relevant being positive in several specifications.

The results of this study should serve as a caution to policymakers who view minimum wage increases as an effective policy tool to help single mothers to avoid poverty, the welfare rolls, and unemployment. Rather, the evidence presented here reflects that minimum wage hikes actually undermined the goals of pro-work welfare reforms and pro-work EITC expansions, as well as the rising tide of a growing economy. While the results presented here do not preclude possible minimum wage gains for some single female headed households, on net, employment is depressed and poverty is not alleviated. Because an increase in labor supply appears to be the chief reason for the

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improved economic well-being of single mother families, it is not surprising that minimum wage increases have created an unintended glass ceiling for this vulnerable population.

Finally, it is important to note that the adverse employment effects reported in this study may well be lower bound estimates of the overall adverse effects of minimum wage increases. The labor contract is, in principle, multifaceted, and minimum wage increases could have important effects on job flexibility, on-the-job training, fringe benefits, turnover, and the part-time and full-time composition of the labor force. These and other dimensions of the employment contract could be adversely affected by minimum wage hikes in both the short and long-run. These issues remain largely unexplored in the literature, often because of the lack of credible data. However, these important areas should be investigated in future work on single mothers.

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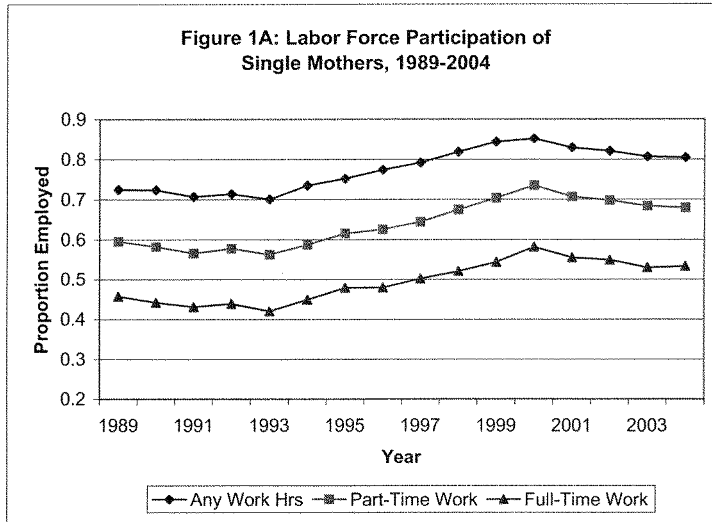

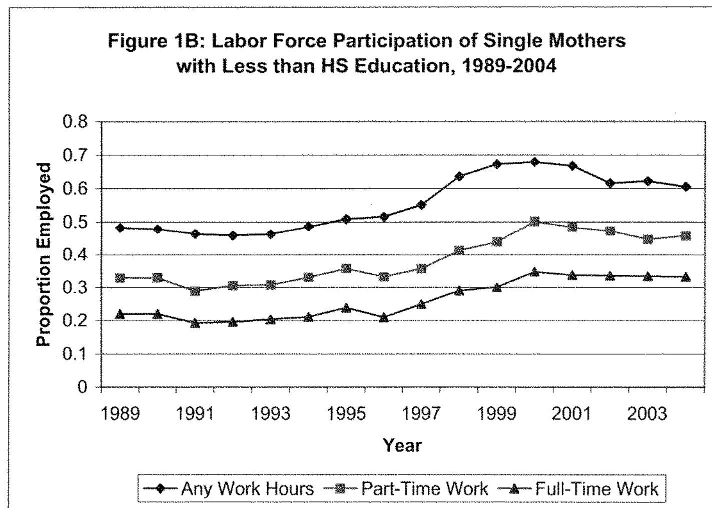

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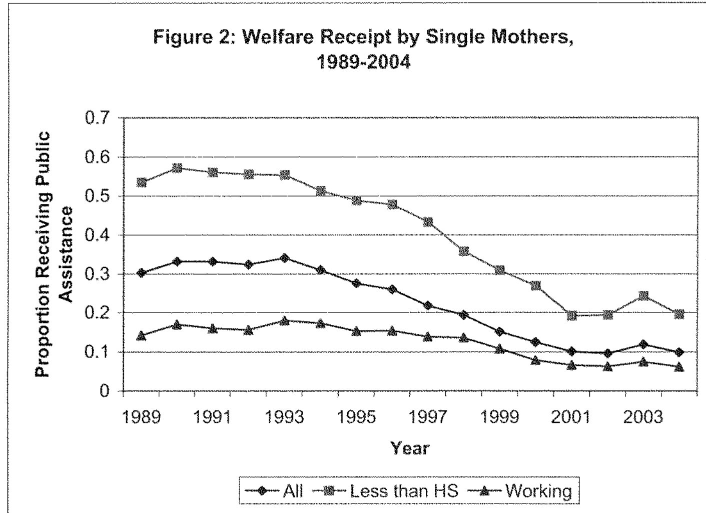

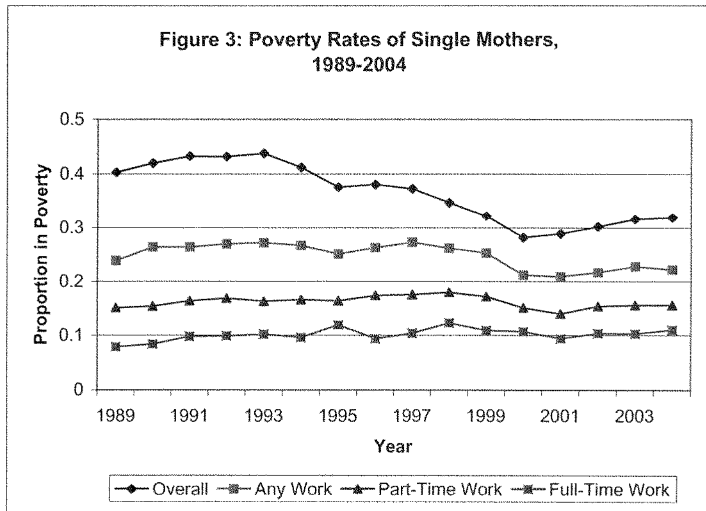

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Table 1: Weighted Means and Standard Deviations of Variables

	Full Sample		Large (30) State Sample[1]		Steady Work Sample	Full-Time Work Sample
	All	< HS	All	< HS	All	All
	(1)	(2)	(3)	(4)	(5)	(6)
Steady Employment (≥ 1,040 Hours)	0.642 (0.480)	0.380 (0.486)	0.630 (0.483)	0.373 (0.484)	---	---
Full-Time Employment (≥ 1,820 Hours)	0.496 (0.500)	0.260 (0.439)	0.487 (0.500)	0.255 (0.436)	0.774 (0.418)	---
Any Work Hours	0.777 (0.416)	0.552 (0.497)	0.764 (0.424)	0.542 (0.498)	---	---
Ln (Work Hours)	---	---	---	---	7.57 (0.232)	7.67 (0.127)
Ln (Annual Income)	---	---	---	---	9.64 (0.769)	9.380 (0.627)
< 75% Poverty Line	0.276 (0.477)	0.517 (0.500)	0.291 (0.454)	0.529 (0.499)	0.087 (0.282)	0.047 (0.211)
< 100% Poverty Line	0.363 (0.481)	0.637 (0.481)	0.380 (0.485)	0.648 (0.478)	0.162 (0.368)	0.103 (0.303)
< 125% Poverty Line	0.443 (0.497)	0.728 (0.445)	0.461 (0.498)	0.738 (0.440)	0.246 (0.431)	0.177 (0.382)
Welfare Receipt	0.220 (0.414)	0.412 (0.492)	0.225 (0.417)	0.415 (0.493)	0.061 (0.238)	0.030 (0.172)
Ln (Minimum Wage)	1.37 (0.261)	1.34 (0.268)	1.36 (0.259)	1.34 (0.265)	1.39 (0.259)	1.39 (0.258)
Ln (Max EITC Benefit)	7.57 (0.604)	7.54 (0.643)	7.57 (0.605)	7.55 (0.643)	7.60 (0.588)	7.60 (0.584)
Work Requirement	0.588 (0.477)	0.542 (0.483)	0.588 (0.476)	0.549 (0.482)	0.625 (0.470)	0.630 (0.468)
Time Limit	0.538 (0.495)	0.485 (0.497)	0.531 (0.495)	0.479 (0.496)	0.578 (0.490)	0.584 (0.489)
Family Cap	0.317 (0.460)	0.303 (0.454)	0.321 (0.462)	0.304 (0.454)	0.338 (0.468)	0.345 (0.470)
Paternity Enforcement	0.533 (0.496)	0.482 (0.497)	0.529 (0.496)	0.478 (0.497)	0.572 (0.492)	0.579 (0.491)
Ln (Max AFDC-FS3 Benefit)	6.32 (0.253)	6.31 (0.267)	6.31 (0.264)	6.30 (0.276)	6.32 (0.251)	6.32 (0.250)
Less than HS Educ	0.214 (0.410)	---	0.227 (0.419)	---	0.127 (0.333)	0.112 (0.316)
Some College	0.302 (0.459)	---	0.294 (0.456)	---	0.246 (0.431)	0.350 (0.477)

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	Full Sample		Large State Sample		Steady Work Sample	Full-Time Work Sample
	All (1)	< HS (2)	All (3)	< HS (4)	All (5)	All (6)
College	0.084 (0.277)	---	0.080 (0.272)	---	0.111 (0.314)	0.120 (0.325)
Post-College	0.033 (0.180)	---	0.032 (0.175)	---	0.046 (0.210)	0.050 (0.217)
Disability	0.087 (0.282)	0.142 (0.349)	0.089 (0.285)	0.144 (0.351)	0.025 (0.156)	0.275 (0.446)
Child < 6 years	0.373 (0.484)	0.436 (0.496)	0.374 (0.484)	0.432 (0.495)	0.302 (0.459)	0.275 (0.466)
Number of Children	1.84 (1.04)	2.21 (1.29)	1.86 (1.06)	2.23 (1.30)	1.69 (0.898)	1.66 (0.878)
Age	35.3 (8.73)	33.9 (9.81)	35.3 (8.75)	34.2 (9.79)	36.4 (8.17)	37.0 (7.92)
Black	0.335 (0.472)	0.366 (0.482)	0.366 (0.482)	0.383 (0.486)	0.308 (0.462)	0.308 (0.462)
Non-MSA	0.177 (0.382)	0.176 (0.381)	0.163 (0.370)	0.165 (0.371)	0.173 (0.379)	0.168 (0.374)
State Unemployment Rate (Males Aged 25-54)	0.087 (0.025)	0.089 (0.025)	0.093 (0.024)	0.093 (0.023)	0.087 (0.025)	0.087 (0.025)
Ln (State Mean Wage) (All Aged 25-54)	3.06 (0.343)	3.03 (0.343)	3.06 (0.337)	3.02 (0.339)	3.09 (0.342)	3.09 (0 342)
Ln (State GDP)	12.23 (0.999)	12.33 (1.00)	12.43 (0.953)	12.48 (0.964)	12.23 (0.997)	12.24 (0.995)
N	76,034	16,370	57,692	13,629	48,808	37,690

[1]These states are AK, AL, AR, CA, DC, DE, FL, GA, IL, KS, KY, LA, MA, MI, MO, MS, NC, NJ, NM, NY, OH, OK, PA, RI, SC, SD, TN, TX, WI, and WV

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Table 2: Estimates of Relationship Between Log Minimum Wage and Employment of Single Mothers, 1989-2004

	Steady Employment (≥ 1,040 Hours)			Full-Time Employment (≥ 1,820 Hours)		
	(1)	(2)	(3)	(4)	(5)	(6)
Ln (Minimum Wage)	-0.156**	-0.173***	-0.179**	-0.147**	-0.169**	-0.184***
	(0.067)	(0.066)	(0.070)	(0.071)	(0.067)	(0.068)
Min Wage Elasticity	*-0.243*	*-0.269*	*-0.279*	*-0.296*	*-0.341*	*-0.371*
Ln (Max EITC Benefit)	---	---	0.070***	---	---	0.014
			(0.012)			(0.014)
Work Requirement	---	---	0.060***	---	---	0.039
			(0.016)			(0.026)
Time Limit	---	---	-0.012	---	---	-0.024
			(0.019)			(0.025)
Family Cap	---	---	0.020	---	---	0.034**
			(0.015)			(0.015)
Paternity Enforcement	---	---	0.017	---	---	0.045**
			(0.025)			(0.021)
Ln (Max AFDC-FS3 Benefit)	---	---	-0.173	---	---	-0.165
			(0.166)			(0.146)
Less than HS Educ	-0.185***	-0.185***	-0.184***	-0.159***	-0.159***	-0.159***
	(0.007)	(0.007)	(0.007)	(0.005)	(0.005)	(0.005)
Some College	0.047***	0.047***	0.047***	0.044***	0.043***	0.043***
	(0.005)	(0.005)	(0.005)	(0.005)	(0.005)	(0.005)
College	0.103***	0.103***	0.104***	0.114***	0.114***	0.114***
	(0.008)	(0.008)	(0.008)	(0.010)	(0.010)	(0.010)
Post-College	0.125***	0.125***	0.125***	0.119***	0.119***	0.118***
	(0.012)	(0.012)	(0.012)	(0.014)	(0.014)	(0.014)
Disability	-0.488***	-0.489***	-0.489***	-0.429***	-0.429***	-0.429***
	(0.009)	(0.009)	(0.009)	(0.009)	(0.009)	(0.009)
Child < 6 years	-0.089***	-0.089***	-0.089***	-0.089***	-0.089***	-0.089***
	(0.006)	(0.006)	(0.006)	(0.005)	(0.005)	(0.005)
Number of Children	-0.059***	-0.059***	-0.068***	-0.055***	-0.055***	-0.057***
	(0.002)	(0.002)	(0.003)	(0.002)	(0.002)	(0.002)
Age	0.051***	0.051***	0.050***	0.055***	0.055***	0.055***
	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)
Age Squared	-0.001***	-0.001***	-0.001***	-0.001***	-0.001***	-0.001***
	(0.00002)	(0.00002)	(0.00002)	(0.00002)	(0.00002)	(0.00002)
Black	-0.036***	-0.036***	-0.036***	-0.023***	-0.023***	-0.023***
	(0.008)	(0.008)	(0.008)	(0.008)	(0.008)	(0.008)
Non-MSA	-0.024***	-0.024***	-0.024***	-0.035***	-0.035***	-0.035***
	(0.009)	(0.009)	(0.009)	(0.007)	(0.007)	(0.007)
State Unemployment Rate	---	-0.402**	-0.469**	---	-0.357*	-0.418**
		(0.186)	(0.182)		(0.208)	(0.203)
Ln (State Mean Wage)	---	0.040*	0.042**	---	0.060***	0.065***
		(0.022)	(0.020)		(0.020)	(0.018)
Ln (State GDP)	---	-0.067	-0.002	---	-0.080	-0.011
		(0.106)	(0.107)		(0.094)	(0.094)
State Effects?	Y	Y	Y	Y	Y	Y
Year Effects?	Y	Y	Y	Y	Y	Y
State -Specific Linear and Quadratic Time Trends?	Y	Y	Y	Y	Y	Y
N	76,034	76,034	76,034	76,034	76,034	76,034

*** Significant at 1% level, ** Significant at 5% level; * Significant at 10% level
Robust standard errors are in parentheses. All regressions are estimated via weighted least squares.
[1]Omitted category is high school completion
[2]Omitted category is Caucasian; Asian, American Indian and Other race categories are also included in all models.
[3]Sample includes single mothers betwene ages 15 and 55.

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Table 3: Estimates of Relationship Between Log Minimum Wage and Employment of Single Mothers with Less than High School Education, 1989-2004

	Steady Employment (≥ 1,040 Hours)			Full-Time Employment (≥ 1,820 Hours)		
	(1)	(2)	(3)	(4)	(5)	(6)
Ln (Minimum Wage)	-0.257**	-0.280**	-0.307**	-0.301***	-0.322***	-0.364***
	(0.126)	(0.134)	(0.148)	(0.106)	(0.109)	(0.111)
Min Wage Elasticity	*-0.676*	*-0.737*	*-0.808*	*-1.158*	*-1.238*	*-1.400*
Ln (Max EITC Benefit)	---	---	0.049*	---	---	-0.006
			(0.027)			(0.026)
Work Requirement	---	---	-0.015	---	---	-0.019
			(0.048)			(0.043)
Time Limit	---	---	-0.080	---	---	-0.051
			(0.047)			(0.052)
Family Cap	---	---	0.051	---	---	0.063**
			(0.031)			(0.024)
Paternity Enforcement	---	---	0.027	---	---	0.062
			(0.057)			(0.044)
Ln (Max AFDC-FS3 Benefit)	---	---	0.156	---	---	-0.045
			(0.244)			(0.237)
Disability	-0.412***	-0.412***	-0.411***	-0.312***	-0.312***	-0.311***
	(0.013)	(0.013)	(0.013)	(0.007)	(0.007)	(0.007)
Child < 6 years	-0.103***	-0.102***	-0.102***	-0.093***	-0.093***	-0.092***
	(0.014)	(0.014)	(0.014)	(0.012)	(0.012)	(0.012)
Number of Children	-0.048***	-0.048***	-0.052***	-0.037***	-0.037***	-0.037***
	(0.003)	(0.003)	(0.005)	(0.003)	(0.003)	(0.003)
Age	0.053***	0.053***	0.053***	0.044***	0.044***	0.044***
	(0.005)	(0.005)	(0.005)	(0.003)	(0.003)	(0.003)
Age Squared	-0.001***	-0.001***	-0.001***	-0.001***	-0.001***	-0.001***
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
Black	-0.044***	-0.044***	-0.043***	-0.028**	-0.028**	-0.028**
	(0.016)	(0.016)	(0.016)	(0.013)	(0.013)	(0.013)
Non-MSA	-0.036**	-0.036**	-0.036**	-0.023**	-0.023**	-0.023**
	(0.016)	(0.016)	(0.016)	(0.011)	(0.011)	(0.011)
State Unemployment Rate	---	-0.029	-0.042	---	-0.029	-0.090
		(0.346)	(0.338)		(0.346)	(0.393)
Ln (State Mean Wage)	---	0.051	0.060	---	0.051	0.061
		(0.042)	(0.045)		(0.042)	(0.037)
Ln (State GDP)	---	0.298	0.373*	---	0.298	0.301*
		(0.191)	(0.202)		(0.191)	(0.160)
State Effects?	Y	Y	Y	Y	Y	Y
Year Effects?	Y	Y	Y	Y	Y	Y
State -Specific Linear and Quadratic Time Trends?	Y	Y	Y	Y	Y	Y
N	16,370	16,370	16,370	16,370	16,370	16,370

*** Significant at 1% level; ** Significant at 5% level; * Significant at 10% level

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Table 4: Estimates of Relationship Between Log Minimum Wage and Employment of Single Mothers in "Large" States, 1989-2004

	Steady Employment (≥ 1,040 Hours)				Full-Time Employment (≥ 1,820 Hours)			
	30 States		11 States[1]		30 States		11 States[1]	
	All	< HS	All	< HS	All	< HS	All	< HS
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Ln (Minimum Wage)	-0.239***	-0.255	-0.217***	-0 300*	-0.218***	-0.346***	-0 186**	-0.299**
	(0 071)	(0.163)	(0.065)	(0.154)	(0.060)	(0.117)	(0.064)	(0.144)
Min Wage Elasticity	*-0.379*	*-0.684*	*-0.349*	*-0 806*	*-0.448*	*-1 357*	*-0.388*	*-1.163*
Ln (Max EITC Benefit)	0.067***	0 025	0.071***	0.038	0.014	-0.027	0.016	-0.022
	(0.014)	(0.029)	(0.016)	(0 035)	(0.016)	(0.028)	(0.019)	(0.034)
Work Requirement	0.060***	-0 009	0.066***	0.021	0.033	-0.026	0.015	-0.005
	(0.019)	(0 055)	(0.019)	(0.053)	(0.028)	(0.028)	(0 015)	(0.040)
Time Limit	0.008	-0 026	0.026	-0.031	-0.003	-0.019	0.013	0.034
	(0.023)	(0.047)	(0.023)	(0.044)	(0.020)	(0.044)	(0.019)	(0.051)
Family Cap	0.019	0.062*	0.002	0 070	0.031*	0.080***	0.020	0.066*
	(0.017)	(0.034)	(0.023)	(0.043)	(0.016)	(0.026)	(0.017)	(0 032)
Paternity Enforcement	0.037	0.021	0 036	0.022	0.050**	0 046	0.041	0.046
	(0 023)	(0.054)	(0.031)	(0.054)	(0 019)	(0.049)	(0.026)	(0.057)
Ln (Max AFDC-FS3 Benefit)	-0.211	0.096	-0.048	0.151	-0.144	0.132	0.037	0 081
	(0.190)	(0.248)	(0.226)	(0.237)	(0.178)	(0.215)	(0.201)	(0.196)
Less than HS Educ	-0.184***	---	-0.182***	---	-0 159***	---	-0.157***	---
	(0.008)		(0.009)		(0.005)		(0.006)	
Some College	0.056***	---	0.056***	---	0.053***	---	0.047***	---
	(0.004)		(0.006)		(0.005)		(0.005)	
College	0.116***	---	0.115***	---	0.133***	---	0.129***	---
	(0.007)		(0.009)		(0.010)		(0.011)	
Post-College	0.137***	---	0.143***	---	0.134***	---	0.132***	---
	(0.015)		(0.019)		(0.016)		(0.020)	
Disability	-0 496***	-0 408***	-0.487***	-0.395***	-0.430***	-0 310***	-0.421***	-0 303***
	(0.010)	(0.014)	(0.013)	(0 018)	(0.009)	(0.008)	(0.013)	(0 009)
Child < 6 years	-0.090***	-0.107***	-0.092***	-0.103***	-0.089***	-0.091***	-0.092***	-0.092***
	(0.007)	(0.014)	(0 010)	(0.016)	(0.006)	(0.013)	(0.008)	(0.015)
Number of Children	-0.067***	-0 049	-0.069***	-0.051***	-0.056***	-0.034***	-0.057***	-0.035***
	(0.003)	(0 005)	(0.003)	(0.006)	(0.004)	(0.004)	(0 004)	(0.005)
Age	0.048***	0.049***	0 048***	0.046***	0.053***	0.041***	0.050***	0 039***
	(0.002)	(0.005)	(0.002)	(0.007)	(0.002)	(0 003)	(0.002)	(0.004)
Age Squared	-0.001***	-0.001***	-0.001***	-0.001***	-0.001***	-0 001***	-0.001***	-0 0004***
	(0.00002)	(0.0001)	(0.00002)	(0.0001)	(0 00003)	(0 0001)	(0 00003)	(0.0001)
Black	-0.036***	-0.040**	-0.034**	-0 024	-0.023**	-0 028*	-0 016	-0.013
	(0 008)	(0.016)	(0.012)	(0.019)	(0.009)	(0.014)	(0.012)	(0.017)
Non-MSA	-0 024**	-0.038*	-0.016	-0 017	-0 031***	-0 018	-0.030**	-0 005
	(0.010)	(0.019)	(0.016)	(0.024)	(0.008)	(0.014)	(0.012)	(0 016)
State Unemployment Rate	-0.333*	0.101	-0.850***	-0.312	-0 340	-0 213	-0.516	0.244
	(0.200)	(0.364)	(0 261)	(0 540)	(0.220)	(0.409)	(0 319)	(0.575)
Ln (State Mean Wage)	0 048	0.079	-0 001	0 086*	0 086***	0.109***	0.050***	0.076**
	(0.0239)	(0.049)	(0.017)	(0 047)	(0 025)	(0.037)	(0.012)	(0.031)
Ln (State GDP)	-0 002	0.476**	-0.028	0.509*	-0.064	0.368**	-0.170	0 424**
	(0.130)	(0.190)	(0.226)	(0.284)	(0 105)	(0 155)	(0.207)	(0.182)
State Effects?	Y	Y	Y	Y	Y	Y	Y	Y
Year Effects?	Y	Y	Y	Y	Y	Y	Y	Y
State -Specific Linear and Quadratic Time Trends?	Y	Y	Y	Y	Y	Y	Y	Y
N	57,692	13,629	37,532	9,623	57,692	13,629	37,532	9,623

*** Significant at 1% level; ** Significant at 5% level; * Significant at 10% level

[1]These states include CA, FL, IL, MA, MI, NC, NJ, NY, OH, PA, and TX.

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Table 5: Robustness of Estimates of Relationship Between Log Minimum Wage and Employment of Single Mothers, 1989-2004

	Minimum Wage Levels				Alternate Steady Definition		Positive Work Hours Last Year		Lagged Effects	
	Steady		Full-Time						Steady	
	All	< HS	All	< HS	All	< HS	All	< HS	All	All
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Ln (Minimum Wage)	-0.036**	-0.091**	-0.031	-0 111***	-0.171**	-0.308**	-0.064	-0.322**	-0.063	---
	(0.017)	(0 039)	(0 019)	(0.027)	(0.075)	(0 133)	(0 093)	(0.124)	(0.257)	
Lag [Ln(Minwage)]	---	---	---	---	---	---	---	---	-0 116	-0.173**
									(0 250)	(0.070)
Min Wage Elasticity	*-0 228*	*-0.948*	*-0.254*	*-1 691*	*-0 273*	*-0 846*	*-0.082*	*-0 583*	*-0.279*	*-0.269*
Ln (Max EITC Benefit)	0.070***	0.048*	0.014	-0.006	0.070***	0.036	0.110***	0.085***	0.022	0.070***
	(0.012)	(0.027)	(0.014)	(0.026)	(0.013)	(0.028)	(0.015)	(0.029)	(0.020)	(0.012)
Work Requirement	0.062***	-0.011	0.041	-0.014	0.046**	-0.005	0.011	-0.034	0.014	0 060***
	(0.016)	(0.048)	(0.026)	(0.043)	(0 021)	(0.045)	(0.019)	(0.031)	(0.012)	(0.016)
Time Limit	-0.012	-0.080	-0.025	-0.050	-0.014	-0.088	0.005	-0.054	0.030**	-0.012
	(0.019)	(0 046)	(0 024)	(0.051)	(0.018)	(0.056)	(0 017)	(0.043)	(0.012)	(0.019)
Family Cap	0.018	0.047	0.031*	0.058**	0.027	0.052	0.015	0.072**	0.014	0.020
	(0.015)	(0 031)	(0 016)	(0.023)	(0.017)	(0.032)	(0.015)	(0.030)	(0.018)	(0.015)
Paternity Enforcement	0.018	0 028	0.046**	0.062	0.030	0.033	0.011	0.049	0.021	0.017
	(0.025)	(0.057)	(0.020)	(0.044)	(0.023)	(0.059)	(0.021)	(0.073)	(0.021)	(0.025)
Ln (Max AFDC-FS3 Benefit)	-0.144	0 232	-0.140	0 046	-0.132	-0.004	-0.111	0.206	-0.098	-0.173
	(0.175)	(0.252)	(0.149)	(0.243)	(0.179)	(0.239)	(0.155)	(0.311)	(0 176)	(0.167)
Less than HS Educ[1]	-0.184***	---	-0.159***	---	-0.184***	---	-0.169***	---	-0.184***	-0.184***
	(0.007)		(0.005)		(0.006)		(0.009)		(0.007)	(0.007)
Some College[1]	0.047***	---	0 043***	---	0.048***	---	0.042***	---	0.047***	0.047***
	(0.005)		(0 005)		(0.006)		(0.005)		(0.005)	(0 005)
College[1]	0 104***	---	0.114***	---	0.101***	---	0 083***	---	0.104***	0.104***
	(0.008)		(0.010)		(0.008)		(0.008)		(0.008)	(0.008)
Post-College[1]	0 125***	---	0 119***	---	0.130***	---	0.099***	---	0.125***	0 125***
	(0 013)		(0.014)		(0.011)		(0.011)		(0 013)	(0 013)
Disability	-0 489***	-0 411***	-0.430***	-0.311***	-0.493***	-0.399***	-0.444***	-0.426***	-0.489***	-0.489***
	(0 009)	(0.013)	(0.009)	(0.007)	(0.008)	(0.012)	(0.007)	(0.017)	(0 009)	(0.009)
Child < 6 years	-0 089***	-0.103***	-0.089***	-0 092***	-0.093***	-0.106***	-0.068***	-0.099*	-0.089***	-0.089***
	(0.006)	(0.013)	(0.005)	(0.012)	(0.007)	(0.013)	(0.007)	(0.015)	(0.006)	(0.006)
Number of Children	-0.068***	-0 052***	-0.057***	-0 037***	-0 067***	-0.051***	-0.062***	-0.058***	-0.068***	-0.068***
	(0.003)	(0.005)	(0 003)	(0.004)	(0 003)	(0 005)	(0.003)	(0.005)	(0.003)	(0.003)
Age[3]	0 050***	0 053***	0 055***	0.044***	0.051***	0.049***	0 024***	0.034***	0.050***	0.050***
	(0.002)	(0 005)	(0 002)	(0.003)	(0.001)	(0 004)	(0.002)	(0.003)	(0.002)	(0.002)
Age Squared	-0.001***	-0.001***	-0.001***	-0.001***	-0.001***	-0 001***	-0.003***	-0.0004***	-0.001***	-0.001***
	(0.00002)	(0 0001)	(0.00002)	(0.0001)	(0 00002)	(0 0001)	(0.00002)	(0.00004)	(0.00002)	(0.00002)
Black	-0.036***	-0.044***	-0.023***	-0.028**	-0.042***	-0.042***	-0 034***	-0.028*	-0.036***	-0.036***
	(0 008)	(0.016)	(0.008)	(0.013)	(0 008)	(0.015)	(0.009)	(0.016)	(0.008)	(0 008)
Non-MSA	-0 024***	-0.036**	-0.035***	-0.023**	-0.029***	-0.029*	-0.004	-0.032	-0 024***	-0.024***
	(0.009)	(0.016)	(0.007)	(0.036)	(0 009)	(0.017)	(0.009)	(0.020)	(0.009)	(0.009)
State Unemployment Rate	-0.470**	-0.056	-0.418**	-0.108	-0 483***	-0.379	-0.288	0.077	-0 469**	-0.468**
	(0.182)	(0 338)	(0 204)	(0.393)	(0.201)	(0 359)	(0 202)	(0.421)	(0.182)	(0.182)
Ln (State Mean Wage)	0.041**	0.062	0 064***	0.063*	0 057***	0.089*	0.034**	-0.001	0.042**	0.042**
	(0.021)	(0 045)	(0 018)	(0.038)	(0.020)	(0 047)	(0.016)	(0.038)	(0 020)	(0.020)
Ln (State GDP)	-0.004	0.377*	-0 013	0.306*	-0.050	0.368*	0.108	0 361*	-0.002	-0.002
	(0.106)	(0 201)	(0 093)	(0 157)	(0 107)	(0.202)	(0.120)	(0 214)	(0.107)	(0 107)
State Effects?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Year Effects?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
State -Specific Linear and Quadratic Time Trends?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
N	76,034	16,370	76,034	16,370	76,034	16,370	76,034	16,370	76,034	76,034

*** Significant at 1% level, ** Significant at 5% level; * Significant at 10% level

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Table 6: Estimates of Relationship Between Log Minimum Wage and Hours Worked, Income, and Welfare Receipt of Single Mothers, 1989-2004

	Ln (Annual Work Hours) Among Working		Ln (Annual Income) Among Working			Welfare Receipt		
	All	30 States	All	30 States	All Steady	All	30 States	11 States
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Ln (Minimum Wage)	-0 236	-0.319**	-0.369**	-0.316**	-0.100	0 044	0.188***	0.208**
	(0.153)	(0.151)	(0.144)	(0 133)	(0.111)	(0.072)	(0 051)	(0.074)
Min Wage Elasticity	*-0.236*	*-0.319*	*-0.369*	*-0.316*	*-0.100*	*0.200*	*0.836*	*0.870*
Ln (Max EITC Benefit)	0.048**	0 058**	0.072***	0.070**	0.020	-0.098***	-0.095***	-0 101***
	(0.023)	(0.027)	(0 026)	(0.029)	(0.017)	(0.012)	(0.013)	(0.014)
Work Requirement	0 141***	0.144***	0.160***	0.151***	-0 020	-0 040***	-0.038**	-0.029*
	(0.030)	(0.032)	(0.032)	(0.037)	(0.031)	(0.014)	(0.015)	(0.016)
Time Limit	-0.100*	-0.069	-0.107**	-0.059	-0.057	0.010	0 017	0.002
	(0 053)	(0.059)	(0.053)	(0.072)	(0.045)	(0.016)	(0.016)	(0.019)
Family Cap	0.020	0.006	0.068**	0 060	0.050*	-0.012	-0.007	0.004
	(0.027)	(0.031)	(0.034)	(0.039)	(0 028)	(0.013)	(0.016)	(0.015)
Paternity Enforcement	0.040	0 008	0 050	0.038	0 014	-0.046*	-0.081***	-0.081***
	(0.047)	(0.052)	(0.050)	(0.077)	(0 046)	(0.026)	(0.017)	(0.016)
Ln (Max AFDC-FS3 Benefit)	-0.168	-0.210	-0.374	-0 314	-0.203	0.173	0.153	0.139
	(0.242)	(0.284)	(0.279)	(0 302)	(0.250)	(0.131)	(0.120)	(0.171)
Less than HS Educ	-0 210***	-0.215***	-0.465***	-0 466***	-0.332***	0.132***	0.134***	0.135***
	(0.014)	(0.017)	(0.013)	(0 014)	(0.016)	(0.011)	(0.013)	(0.018)
Some College	0.037***	0.035***	0 206***	0.229***	0.176***	-0.040***	-0.045***	-0.049***
	(0.009)	(0.011)	(0.017)	(0.016)	(0.010)	(0.005)	(0.005)	(0.007)
College	0.090***	0.084***	0.575***	0.601***	0.506***	-0.087***	-0.091***	-0.098***
	(0.012)	(0.015)	(0.017)	(0.017)	(0.015)	(0 008)	(0 009)	(0.012)
Post-College	0.106***	0.108***	0.807***	0.831***	0.743***	-0.094***	-0 099***	-0.108***
	(0.015)	(0.018)	(0 026)	(0.034)	(0.020)	(0.009)	(0.010)	(0.012)
Disability	-0.703***	-0.715***	-0.924***	-0.976***	-0.339***	0.193***	0.186***	0.187***
	(0.033)	(0 042)	(0 038)	(0.040)	(0.022)	(0 009)	(0.010)	(0.010)
Child < 6 years	-0.098***	-0.100***	-0.112***	-0.110***	-0.019**	0.087***	0.087***	0.089***
	(0.011)	(0 013)	(0 019)	(0.021)	(0.009)	(0 008)	(0.010)	(0.014)
Number of Children	-0.081***	-0.080***	-0 132***	-0.131***	-0.059***	0.069***	0.069***	0.074***
	(0.009)	(0.010)	(0 008)	(0.009)	(0.004)	(0 004)	(0.004)	(0.003)
Age	0.095***	0.092***	0.161***	0 157***	0.094***	-0 023***	-0.021***	-0.020***
	(0 004)	(0.004)	(0 005)	(0.005)	(0.003)	(0.002)	(0.003)	(0.003)
Age Squared	-0.001***	-0 001***	-0 002***	-0.002***	-0.001***	0.0002***	0.0002***	0.0002***
	(0.0001)	(0.0001)	(0 0001)	(0.0001)	(0.00004)	(0.00003)	(0 00004)	(0.0001)
Black	-0.039***	-0.034***	-0 103***	-0.093***	-0.068***	0.077***	0 077***	0.079***
	(0.009)	(0.011)	(0.015)	(0 016)	(0.014)	(0.009)	(0.009)	(0.013)
Non-MSA	-0 054***	-0.055***	-0.216***	-0.205***	-0 167***	0 004	0 007	0 022
	(0.014)	(0.018)	(0.026)	(0.027)	(0.018)	(0.009)	(0.015)	(0 015)
State Unemployment Rate	-0.340	-0.395	-0.329	-0 352	0.092	0.213	0.190	0 214
	(0.255)	(0.327)	(0.399)	(0.532)	(0.309)	(0.157)	(0.177)	(0 313)
Ln (State Mean Wage)	0 006	0 023	0.110***	0.142***	0.110***	-0.018	-0.022	-0.014
	(0.038)	(0.033)	(0.038)	(0.047)	(0.027)	(0.019)	(0 022)	(0.030)
Ln (State GDP)	-0.231	-0.350*	-0.344*	-0.519**	-0.110	-0 130	-0.135	-0.062
	(0.158)	(0.200)	(0 201)	(0 214)	(0 190)	(0.089)	(0 101)	(0.198)
State Effects?	Y	Y	Y	Y	Y	Y	Y	Y
Year Effects?	Y	Y	Y	Y	Y	Y	Y	Y
State -Specific Linear and Quadratic Time Trends?	Y	Y	Y	Y	Y	Y	Y	Y
N	58,972	42,403	57,160	42,403	47,391	76,034	57,692	37,532

*** Significant at 1% level; ** Significant at 5% level; * Significant at 10% level

Table 7: Effectiveness of Minimum Wage vs. EITC at Reducing Poverty Among Working Single Mothers, 1989-2004[1]

	< 75% Poverty Line				< 100% Poverty Line				< 125% Poverty Line			
	Steady		Full-Time		Steady		Full-Time		Steady		Full-Time	
	All	30 States	All	30 States	All	30 States	All	30 States	All	30 States	All	30 States
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Ln (Minimum Wage)	0.001	0.068	-0.027	-0.015	0.016	0.064	-0.034	-0.042	0.040	0.127	0.001	0.010
	(0.058)	(0.068)	(0.037)	(0.048)	(0.049)	(0.060)	(0.041)	(0.051)	(0.075)	(0.094)	(0.061)	(0.093)
Ln (Max EITC Benefit)	-0.038***	-0.035**	-0.060***	-0.059***	-0.034***	-0.033**	-0.074***	-0.077***	0.013	0.027	-0.018	-0.001
	(0.012)	(0.014)	(0.020)	(0.014)	(0.012)	(0.013)	(0.010)	(0.013)	(0.013)	(0.015)	(0.016)	(0.017)
State Effects?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Year Effects?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
State -Specific Linear and Quadratic Time Trends?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
N	48,808	36,091	37,690	27,922	48,808	36,091	37,690	27,922	48,808	36,091	37,690	27,922

*** Significant at 1% level; ** Significant at 5% level; * Significant at 10% level

[1]All models include the full set of individual-level and state-level independent variables described in the previous tables.

Appendix: State Minimum Wages from 1989 to 2004 that were Higher than the Federal Minimum on January 1

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Federal minimum	3.35	3.80	4.25	4.25	4.25	4.25	4.25	4.75	5.15	5.15	5.15	5.15	5.15	5.15	5.15	5.15
Northeast																
New England																
Maine	3.75	3.85	---	---	---	---	---	---	---	---	---	---	---	5.75	6.25	6.25
New Hampshire	3.65	3.75	3.85	---	---	---	---	---	---	---	---	---	---	---	---	---
Vermont	3.65	3.75	3.85	---	---	---	4.75	4.75	5.00	---	---	5.75	6.25	6.25	6.25	6.75
Massachusetts	3.75	3.75	---	---	---	---	---	---	5.25	---	---	6.00	6.75	6.75	6.75	6.75
Rhose Island	4.00	4.25	4.25	4.45	4.45	4.45	4.45	4.45	5.15	---	---	5.65	6.15	6.15	6.15	6.15
Connecticut	4.25	4.25	4.25	4.27	4.27	4.27	4.27	4.27	4.77	---	5.65	6.15	6.40	6.70	6.90	7.10
Middle Atlantic																
New Jersey	---	---	---	5.05	5.05	5.05	5.05	5.05	5.05	---	---	---	---	---	---	---
New York	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
Pennsylvania	3.70	3.80	---	---	---	---	---	---	---	---	---	---	---	---	---	---
Midwest																
East North Central																
Illinois	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	5.50
West North Central																
Minnesota	3.85	3.95	4.25	---	---	---	---	---	---	---	---	---	---	---	---	---
Iowa	---	3.85	4.25	4.65	4.65	4.65	4.65	4.65	---	---	---	---	---	---	---	---
South																
South Atlantic																
Delaware	---	---	---	---	---	---	---	4.65	5.00	---	---	5.65	6.15	6.15	6.15	6.15
District of Columbia	4.33	4.33	4.33	4.33	4.33	5.25	5.25	5.25	5.75	5.75	6.15	6.15	6.15	6.15	6.15	6.15
East South Central																
None	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
West South																
None	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
West																
Mountain																
None	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
Pacific																
Washington	3.85	4.25	4.25	---	---	4.90	4.90	4.90	4.90	---	5.70	6.50	6.72	6.90	7.01	7.16
Oregon	---	4.25	4.75	4.75	4.75	4.75	4.75	4.75	5.50	6.00	6.50	6.50	6.50	6.50	6.90	7.05
California	4.25	4.25	4.25	---	---	---	---	---	---	5.00	5.75	5.75	6.25	6.75	6.75	6.75
Pacific (noncontiguous)																
Alaska	3.85	3.85	4.30	4.75	4.75	4.75	4.75	4.75	5.25	5.65	5.65	5.65	5.65	5.65	7.15	7.15
Hawaii	3.85	3.85	---	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.75	6.25	6.25

Source Updated from Burkhauser et al. (2000), Fiscal Policies Institute (2004), and the U.S. Department of Labor

In 1990 and 1991, the federal minimum wage was not implemented until April 1. Thus, some states listed in the table have a higher state minimum wage than the federal minimum wage from January to March in those years. In 1996 and 1997, the federal minimum wage was not implemented until October 1. Thus, some states listed in the the table have a higher state minimum wage than the federal minimum wage from January to September in those years.

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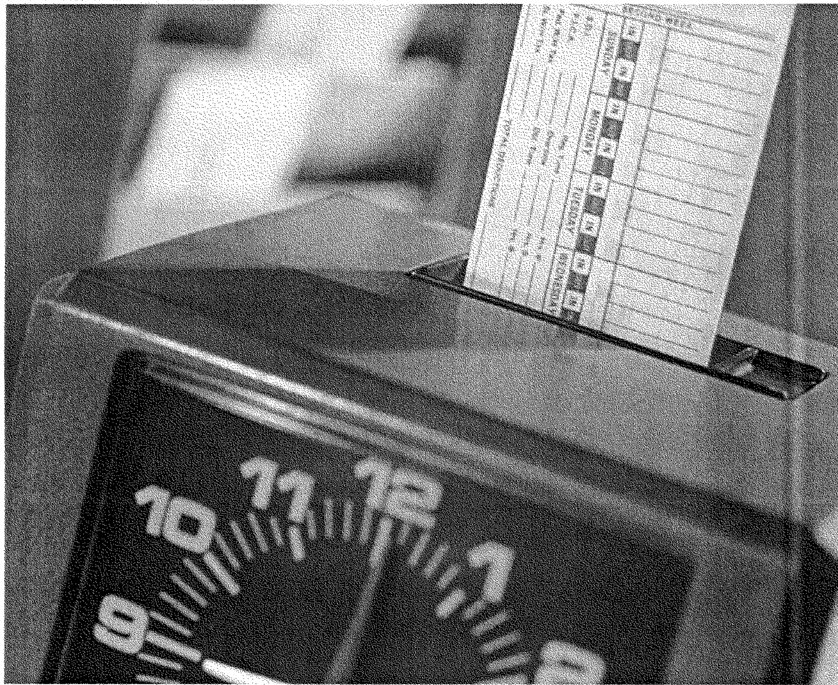

The Effect of Minimum Wage Increases on Retail and Small Business Employment

by Joseph J. Sabia, University of Georgia
May 2006

The Employment Policies Institute (EPI) is a nonprofit research organization dedicated to studying public policy issues surrounding employment growth. In particular, EPI research focuses on issues that affect entry-level employment. Among other issues, EPI research has quantified the impact of new labor costs on job creation, explored the connection between entry-level employment and welfare reform, and analyzed the demographic distribution of mandated benefits. EPI sponsors nonpartisan research that is conducted by independent economists at major universities around the country.

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The Effect of Minimum Wage Increases on Retail and Small Business Employment

Executive Summary

Overview

A recent study by the Fiscal Policy Institute (FPI) claims that increases in the minimum wage at the state level have had no adverse employment effects. Specifically, the FPI report concludes that states that raised their wage floor above the federal level did not experience declines in small business employment, and, in fact, actually experienced an increase in retail employment.

While the FPI study has been frequently cited by supporters of increases in the minimum wage, the study is based on faulty statistical methods, and its results provide an inaccurate picture of the effect of state-level minimum wage increases. This paper, by Dr. Joseph Sabia of the University of Georgia, presents a more careful and methodologically rigorous analysis of state-level minimum wage increases. His results confirm the consensus economic opinion that increases in the minimum wage decrease employment, particularly for low-skilled and entry-level employees.

Employment Results

Using government data from January 1979 to December 2004, the effect of minimum wage increases on retail and small business employment is estimated. Specifically, a 10 percent increase in the minimum wage is associated with a 0.9 to 1.1 percent decline in retail employment and a 0.8 to 1.2 percent reduction in small business employment.

These employment effects grow even larger for the low-skilled employees most affected by minimum wage increases. A 10 percent increase in the minimum wage is associated with a 2.7 to 4.3 percent decline in teen employment in the retail sector, a 5 percent decline in average retail hours worked by all teenagers, and a 2.8 percent decline in retail hours worked by teenagers who remain employed in retail jobs.

These results increase in magnitude when focusing on the effect on small businesses. A 10 percent increase in the minimum wage is associated with a 4.6 to 9.0 percent decline in teenage employment in small businesses and a 4.8 to 8.8 percent reduction in hours worked by teens in the retail sector.

Methodological Concerns in the Fiscal Policy Institute Report

The results in this report are all statistically significant. In both the small business and retail industry analyses conducted by FPI, however, no explicit tests for statistically significant differences in employment were presented. This is only one of the important differences between this study and the FPI report. Another is that while the FPI report chiefly examines employment changes over only two time periods (1998 and 2001), this study examines the effect of state minimum wage increases on employment across a significantly longer time period (1979-2004).

Even more troubling, the FPI analysis does not control for any changes in state-level socioeconomic or demographic characteristics that could affect both minimum wage hikes and changes in employment. For example, states may choose to raise their minimum wages when they anticipate strong economic growth in sectors that employ a large share of minimum-wage workers. If this is true, then estimates of the impact of the minimum wage on employment will be biased toward zero. Put another way, the FPI study does not hold "all else equal" in estimating the effect of the minimum wage.

By controlling for economic and demographic changes that may be associated with both the implementation of minimum wage increases and changes in teenage employment, this study is able to more credibly isolate the effect of minimum wage increases.

Conclusion

These findings provide consistent evidence that minimum wage increases result in a significant decline in retail and small business employment. This finding is robust across several model specifications. Furthermore, these findings refute many of the claims raised in the FPI study so often cited in favor of minimum wage increases at the state and federal levels. The differences between these studies are likely a result of the more careful and appropriate methodological methods utilized in this study.

Taken together with other recent work, the results of this study suggest that low-skilled employees will find themselves unable to escape adverse labor market consequences resulting from minimum wage increases. Instead of passing these politically popular but destructive mandates, policymakers should consider other programs to help the working poor such as the Earned Income Tax Credit. The EITC is a far more effective policy tool to reduce poverty among poor families. Moreover, the EITC has the advantage of avoiding the adverse employment effects described in this study.

The Effect of Minimum Wage Increases on Retail and Small Business Employment

Introduction

A recent study by the Fiscal Policy Institute (FPI) (2004) suggests that minimum wage increases do not have adverse employment effects. The authors of the FPI report conclude that states that increased their minimum wages above the federal minimum did not experience declines in small business employment, and, in fact, actually experienced an increase in retail employment. Along with the influential studies of Card et al. (1994) and Card and Krueger (1995), the findings of the FPI study challenge the widely shared view among labor economists that minimum wage hikes cause unemployment of low-skilled workers (Fuchs et al., 1998).

The results of the FPI study have been publicized in the mainstream media (see, for example, New York *Newsday*, 2006) and have been cited by numerous advocates of minimum wage increases at both the federal and state levels. In 2004, Dr. Jared Bernstein, a senior economist at the Economic Policy Institute, testified before the U.S. House Subcommittee on Workforce, Empowerment, and Government Programs. He claimed that a federal minimum wage hike would not have disemployment effects, citing the FPI study's results on retail and small business employment as evidence for his position. Bernstein stated that "between 1998 and 2001, the number of small business establishments grew twice as quickly in states with higher minimum wages (3.1% vs. 1.6%)" (Bernstein, 2004).

In May 2005, United States Senator Ted Kennedy (D-MA) re-introduced legislation to raise the federal minimum wage from $5.15 to $7.25, and argued that minimum wage increases had no adverse employment effects in the retail industry:

> "History clearly shows that raising the minimum wage has not had any negative impact on jobs, employment, or inflation. In the four years after the last minimum wage increase passed, the economy experienced its strongest growth in over three decades. More than 11 million new jobs were added, at a pace of 232,000 per month. There were ten million new service industry jobs, including more than one and a half million retail jobs, of which nearly 600,000 were restaurant jobs." (Kennedy, 2005)

Several advocates of state minimum wage hikes have also cited the conclusions of the FPI study. In a legislative analysis of California Senate Bill 1162—which would raise the state minimum wage from $7.25 to $7.75—the Committee on Industrial and Labor Relations bolstered its support for a minimum wage hike by referring to "a recent Fiscal Policy Institute (FPI) study of state minimum wages [that] found no evidence of negative employment effects on small businesses" (CSCILR, 2004).

In February 2005, Steve Hill of the Maryland Budget and Tax Policy Institute testified before the Maryland Senate Finance Committee in support of a proposed minimum wage hike and cited the FPI study, stating, "Between 1998 and 2001, the number of small business establishments grew twice as quickly in states with higher minimum wages [and] retail employment grew 1.5 times more quickly in higher minimum wage states" (Hill, 2005).

In September 2005, economist Stephen Herzberg testified before the Pennsylvania Senate Labor and Industry Committee and cited the

"recent Fiscal Policy Institute study of state minimum wages [that] found no evidence of negative employment effects" to support his claim that the state minimum wage should be raised. Judith Conti, director of the D.C. Employment Justice Center, testified in support of a minimum wage in the District of Columbia by telling the D.C. Committee on Public Services:

> "There are many credible and well-documented studies that prove that modest raises in the minimum wage have a negligible impact on employment levels or the rate of businesses closing. Indeed, a raise in the minimum wage usually accomplishes the exact opposite. Workers who make more money have more money to invest in consumer goods. The whole community wins. An April 2004 Fiscal Policy Institute study showed that in states with a minimum wage above $5.15, rather than having to lay workers off, small businesses experienced higher employment than their counterparts in states with lower minimum wages." (Conti, 2005)

Thus, along with the studies of Card et al. (1994) and Card and Krueger (1995), the results of the FPI study have become an important talking point among advocates of state and federal minimum wage hikes. However, there are important theoretical and methodological problems with the FPI report that cast doubt on the conclusion that minimum wage hikes have no adverse effects on retail and small business employment.

This study presents a more careful analysis of the effect of minimum wage hikes during the 1980s, 1990s, and 2000s and finds that there are important adverse employment effects among low-skilled workers in the retail sector and in small businesses. Using Current Population Survey (CPS) data from January 1979 to December 2004, the effect of minimum wage increases on retail and small business employment is estimated. Teenagers are examined as a population of interest because they represent a group of low-skilled workers that are most likely to be directly affected by minimum wage hikes. This study examines the effect of minimum wage increases on the following employment outcomes:

- the share of individuals aged 16-64 employed in the retail industry;
- the share of individuals aged 16-64 employed in small businesses;
- the share of teenagers (age 16-19) employed;
- average hours worked by all teenagers;
- average hours worked by employed teenagers;
- the share of teenagers employed in the retail industry;
- average hours worked by teenagers in the retail industry;
- the share of teenagers employed in small businesses; and
- average hours worked by teenagers in small businesses.

Estimation results suggest consistent evidence of a significant negative relationship between minimum wage increases and retail and small business employment. A 10 percent increase in the minimum wage is associated with a 0.9 to 1.1 percent decline in the share of individuals aged 16-64 who are employed in the retail industry, and a 0.8 to 1.2 percent reduction in the share of individuals aged 16-64 employed in small businesses.

As expected, the effects of minimum wage hikes are larger in magnitude for low-skilled

workers. A 10 percent increase in the minimum wage is associated with a 2.7 to 4.3 percent decline in the ratio of teenagers employed in the retail sector, a 5 percent decline in average retail hours worked by all teenagers, and a 2.8 percent decline in retail hours worked by teenagers who remain employed in retail jobs. For small businesses, the disemployment effects are even larger. A 10 percent increase in the minimum wage is associated with a 4.6 to 9.0 percent decline in the ratio of teenagers employed in businesses with 100 or fewer employers, a 4.8 to 8.8 percent decline in average small business hours worked by all teenagers, and a 5.6 to 7.3 percent decline in average small business hours worked by teenagers who remain employed in small businesses.

The results of this study cast doubt on the Fiscal Policy Institute's claim that raising the minimum wage will have no adverse effects on low-skilled employment in retail or small businesses. These findings suggest that state minimum wage increases have adverse effects on employment in retail and small businesses. Moreover, the results suggest that teenagers —a group of low-skilled workers most likely to be adversely affected by minimum wage hikes—experience important declines in employment and hours worked due to minimum wage increases. Taken together with other research by labor economists (Abowd, Kramarz, Lemieux, and Margolis, 2004; Burkhauser, Couch, and Wittenburg, 2000a; Burkhauser, Couch, and Wittenburg, 2000b; Deere, Murphy, and Welch, 1995; Neumark and Wascher, 1994; Neumark et al., 2001; Neumark et al., 2004, 2005; Burkhauser, Couch, and Glenn, 1996; Burkhauser and Sabia, 2004), this finding suggests that raising the minimum wage is a poor policy tool to aid low-skilled workers.

Empirical Literature

The "new economics of the minimum wage" literature was forged by Card et al. (1994) and Card and Krueger (1995). Using Current Population Survey (CPS) data from 1979 to 1992, these authors found that state minimum wage increases did not have adverse employment effects. Following these highly publicized series of papers, many researchers have used the CPS to estimate the impacts of minimum wage increases on the employment of low-skilled workers (Abowd, Kramarz, Lemieux, and Margolis, 2004; Burkhauser, Couch, and Wittenburg, 2000; Deere, Murphy, and Welch, 1995; Neumark and Wascher, 1994; Neumark et al., 2002; Neumark et al., 2004, 2005). Most of these studies have found that raising the minimum wage is associated with a reduction in the employment of low-skilled workers, including teenagers, restoring a general consensus among labor economists that minimum wage hikes have adverse employment effects (Fuchs et al., 1998).[1]

A recent FPI study (2004), however, finds its inspiration in earlier studies by Card and Krueger (1995), with the twist of focusing on the relationship between minimum wage increases and employment in retail and small businesses. The authors focus on retail and small businesses because, they argue, such sectors have large concentrations of low-skilled laborers that are expected to be most adversely affected by minimum wage hikes. Using data from the U.S. Commerce Department's County Business Patterns in 1998 and 2001, the authors compare the change in small business employment in states that raised the minimum wage with the change in small business employment in states that did not raise the minimum wage, and find no difference in small business employment. Moreover, when the authors compare the change in retail employment, they concluded that "retail

employment grew by 6.1 percent in minimum wage states versus 1.9 percent in other states." However, in both the small business and retail industry analyses, no explicit tests for statistically significant differences in employment were presented.

There are several important shortcomings with the FPI study, which are addressed in the current study. First, while the FPI report chiefly examines employment changes over two time periods (1998 and 2001), this study examines the effect of state minimum wage increases on employment across a longer time period: 1979-2004. Both the greater sample size and the greater within-state variation in minimum wages enhance the statistical power of this study.

Second, the FPI analysis does not control for any changes in state-level socioeconomic or demographic characteristics that could affect both minimum wage hikes and changes in employment. For example, states may choose to raise their minimum wages when they anticipate strong economic growth in sectors that employ a large share of minimum wage workers. If this is true, then estimates of the impact of the minimum wage on employment will be biased toward zero. Put another way, the FPI study does not hold "all else equal" in estimating the effect of the minimum wage. The current study includes several state-specific and national control variables designed to better hold all else equal in estimating the effect of minimum wage increases. By controlling for economic and demographic changes that may be associated with both the implementation of minimum wage increases and changes in teenage employment, this study is able to more credibly isolate the effect of minimum wage increases. These control variables include the state-specific prime male age unemployment rate, the average wage rate of adults, the share of the state population that are teenagers, whether the national economy is in a recession, seasonal employment trends, unobserved national trends, state-specific unobserved linear trends, and time-invariant unobserved state-specific characteristics.[2]

Third, the FPI study uses the overall retail or small business employment rate as the dependent variable. While it is true that the concentration of low-skilled workers in both retail and small businesses warrants special attention to these sectors, the presence of skilled workers in these sectors creates an important problem. Minimum wage increases are not expected to directly impact the employment rates of non-minimum wage workers. Moderately- or highly-skilled workers, for example, will not be directly affected by state minimum wage hikes. Thus, the FPI report may find no difference in overall employment rates between states that raised their minimum wage and states that did not, because adverse employment effects may simply be "masked" by the inclusion of skilled workers in the employment measure. This problem is amplified by the limited statistical power of the report's evaluation design. Rather than examine the overall employment rate in these sectors, it may be more appropriate to examine the employment of workers most likely to be affected by the minimum wage—low-skilled workers. The current study examines the effect of minimum wage increases on the labor market outcomes of a group of low-skilled workers that is likely to be affected by such policy changes: teenagers. Examining the outcomes of teenagers will allow an examination of whether the FPI results "masked" adverse employment effects experienced by low-skilled workers in retail and small businesses. This study uses state-specific minimum wage rates rather than grouping all states with minimum wages higher than the federal minimum together and treating them identically.

Fourth, the FPI study assumes that every state with a minimum wage higher than the federal minimum wage will have the same effect

on all workers. But since each of these states has a different minimum wage, it is inappropriate to group such states together. More precisely estimated policy impacts that take into account each state's minimum wage rate are desirable, and this is done in the current study.

Fifth, the FPI study examines only the effects of minimum wage increases on employment rates. But minimum wage increases may affect not only employment decisions by employers, but hours worked among current employees. Neumark, Schweitzer, and Wascher (2004, 2005) have emphasized the need for more complete analyses of the impacts of minimum wage increases, focusing not only on employment, but also on wages, hours worked, and earnings. For example, in their 2004 paper, these authors conclude that while "workers who initially earn near the minimum wage experience wage gains[,] their hours and employment decline, and the combined effect of these changes on earned income suggests adverse consequences, on net, for low-wage workers." Unlike the FPI study, this study examines hours worked to provide a more complete picture of the effect of minimum wage increases on labor market outcomes. This is important because firms may respond to minimum wage increases not only by reducing their number of employees but also hours offered existing employees. And finally, this study explicitly allows for the possibility that the lagged minimum wage may affect current year employment. Taken together, these methodological and theoretical improvements will permit more credible estimates of the effect of minimum wage increases on the employment outcomes of low-skilled workers in small or retail businesses.

Finally, the methodology used in the FPI report does not explicitly allow for lagged minimum wage effects. Neumark et al. (1994) note that firms may respond to minimum wage hikes following their implementation. It may be that the prevailing minimum wage in the previous period may impact employment decisions in the current period. That is, there may be important lagged effects that should be incorporated into analyses of the effects of minimum wage increases. This is done in the current study.

Econometric Model

Following Card and Krueger (1995) and Burkhauser et al. (2000), a fixed effects model of the following form is used to estimate the employment models:

1

$$E_{ijt} = \alpha + s_i\delta_i + m_j\lambda_j + \tau_t\theta_t + MW_{ijt}\gamma + X_{ijt}\beta + \varepsilon_{ijt}$$

where E_{ijt} is the ratio of employment to population in state *i* in month *j* in year *t*, s_i is a time-invariant state effect, m_j is a seasonal (month) effect, τ_t is a year effect, MW_{ijt} is the natural logarithm of the larger of the state or federal minimum wage, and X_{ijt} is a set of state-specific time-varying observables.[3] Each of the control variables is included because each is expected to have an impact on employment, and the variable's omission may result in a biased estimate of the impact of minimum wage increases.

The dependent variable is a measure of employment to population, as is common in the minimum wage literature. This measure is preferred to employment levels because employment levels may change simply because of state-specific changes in the working-age population over time. Five specific employed to population measures are used:

- the share of individuals aged 16-64 employed in the retail industry;
- the share of individuals aged 16-64 employed in small businesses;

- the share of 16-19 year-olds employed;
- the share of 16-19 year-olds employed in retail businesses; and
- the share of 16-19 year-olds employed in small businesses.

In the model described in equation (1), the state effect (δ) is included to capture any state-specific, time-invariant unobserved characteristics associated with employment rates. For instance, if there is a stronger work ethic among teens in Georgia than in New York, the state effect will capture this, as long as this unmeasured work ethic does not change over time in Georgia or New York. A time-varying state-level measure of the prime age unemployment rate and year effects are included so as to capture changes in macroeconomic conditions that may be correlated with the adoption of state-level minimum wage changes and with changes in employment. Month effects are included to capture seasonal trends in employment. The key parameter of interest is. The estimate of can be interpreted as the effect of state minimum wage hikes above the federal minimum wage on teenage employment.[4]

The empirical framework described in equation (1) can be extended to permit delayed employment effects through the inclusion of a lagged minimum wage variable, and nonlinear impacts of minimum wage increases by using dummy variables for each state and federal minimum wage rather than the continuous measure described in equation (1). These alternate specifications are estimated to show that estimation results are not sensitive to modest changes in the model specification.

In addition to estimating employment effects, this study also examines the effects of minimum wage increases on average hours worked by teenagers:

2

$$H_{ijt} = \alpha + s_i\delta_i + m_j\lambda_j + \tau_t\theta_t + MW_{ijt}\gamma + X_{ijt}\beta + \varepsilon_{ijt}$$

where H_{ijt} is the natural log of the average hours worked by individuals. Six measures of average hours worked are used:

- average hours worked by all 16-19-year-olds(including nonworkers);
- average hours worked by employed 16-19-year-olds;
- average retail hours worked by all 16-19year-olds (including nonworkers);
- average retail hours worked by 16-19 year-olds employed in retail jobs;
- average small business hours worked by all 16-19-year-olds (including nonworkers);
- average retail hours worked by 16-19-year-olds employed in small business jobs;

Because employers may respond to minimum wage increases not only by reducing employment but also by reducing hours worked, estimating models such as equation (2) will provide a more complete picture of the effect of minimum wage increases on labor market outcomes.

Data

The data for the overall and retail employment analyses come from the CPS Merged Outgoing Rotation Group (MORG) from January 1979 to December 2004. From these individual-level data, a panel of states and months is created. There are approximately 22,000 to 23,000 individuals aged 16-64 in each month, and these individual observations, along with their respective weights, are used to create nationally representative state-month observations. While several previous studies have used panels of states and years using CPS data (Card and Krueger, 1995; Neumark and Wascher, 1994; Deere et al., 1995), Burkhauser et al. (2000) argue in favor of state-month observations due to (i) the statistical power gained from the increase in the overall sample size and (ii) the

gain in month-specific variation in the state or federal minimum wage. The total sample size for the overall and retail employment analysis is 11,861.[5]

For the analysis of small business employment, monthly data on employer size are not available, and annual information is only available beginning in the late 1980s. A panel of states and years is constructed using the March CPS outgoing rotation group data from March 1989 to March 2005. There are 867 observations used in the small business employment analysis, so the power of the evaluation design is weakened.

Table 1 presents the names, definitions, and weighted means of the dependent and independent variables used in the econometric analysis. The key dependent variables are listed first. They include the ratio of individuals aged 16-64 who are employed in retail jobs (ORETAIL) and in small businesses (OSMALL). A retail sector job is defined using the two-digit Standard Industrial Classification (SIC)-based Detailed Industry Classification Code and the North American Industry Classification System (NAICS).[6] An individual is defined to have been employed in the retail industry if he or she reports working positive hours last week in a retail job. The mean ratio of retail employment to population in the sample is 0.11.

Data on employer size are available in the CPS from March 1989 to March 2005. In annual surveys, workers were asked, "Counting all locations where [your primary] employer operates, what is the total number of persons who work for [the] employer?" This measure of employer size may be measured with error since employees may not know the number of locations of their employer and may be ignorant of the total number of employees. Indeed, comparing CPS reports on employer size to the Census' Statistics on U.S. Businesses, the Small Business Administration (1997) concludes that while the CPS may understate true employer size, the CPS is still, the CPS is still valuable in its matching of individual characteristics to characteristics of their employers. In this study, an individual is defined as employed in a small business if he or she reports working for an employer with 100 or fewer employees at all locations.[7]

It is important to note that individuals in the March CPS are asked about employer size for their *previous year's* employment, rather than current employment, as is the case for retail employment. Hence, for the small business analysis, labor market participation information must be used from the previous year. Moreover, minimum wage information must be used from the year prior to the administering of the survey. For the small business sample, an individual is defined as employed if he or she reported working positive hours in the previous *year*. The mean ratio of small business employment to population in the sample is 0.34.

For low-skilled workers—teenagers—the key dependent variables include the natural logarithm of the average teenage wage rate (TEENWAGE), the ratio of teenagers employed to the teenage population (TEMPLOY), the natural log of the average number of hours worked by all teenagers (THOURS), and the natural log of the average number of hours worked by employed teens (THOURSW). The variables also include measures of teenage employment and hours worked in the retail industry (TRETAIL, TRHOURS, TSHOURSW) and in small businesses (TSMALL, TSHOURS, TSHOURSW).

Over the period 1979-2004, the mean ratio of teenage employment in the retail sector to teenage population was 0.22, representing more than 50 percent of all teenage employment. The mean number of hours per week worked by employed teens in the retail sector was 21.6 hours (natural log equal to 3.07).

From March 1989 to March 2005, the ratio of teenagers employed in franchises with 100

or fewer employees to teenage population was 0.27. A measure of annual hours worked is constructed using reports of weeks worked last year and usual hours worked per week. Among all teens, the average annual hours worked in small businesses is 195 hours (natural log of 5.27); among teens employed in small businesses, the average annual hours worked is 731 hours (natural log of 6.59).

Also included in Table 1 are the weighted means and standard deviations of the control variables, identical to those used in Card and Krueger (1995) and by Burkhauser et al. (2000). The central independent variable of interest is the natural log of the greater of the state or federal minimum wage. Economic and demographic variables believed to influence retail or small business employment include the mean wage rate of prime-age working adults, the share of teenagers in the overall population, and the overall unemployment rate of prime-age males. Other control variables include seasonal adjustments (month effects), which are especially important for teenagers who are more likely to work over the summer months and over holiday breaks than at other times of the year. Recession dummies are included as an alternative macroeconomic control to year effects in some models.[8] Several different models are estimated to show whether the results are sensitive to choice of macroeconomic control variables, the inclusion of lagged minimum wages, and nonlinear effects of minimum wages. All models presented are weighted by the overall state population, and include state effects to control for time-invariant state-level unobserved heterogeneity.

Appendix A shows state minimum wages that were higher than the federal minimum wage on January 1 of each year from 1979 to 2005. In 2005, 14 states had minimum wages that were higher than the federal minimum wage level of $5.15 per hour. Since the last federal minimum wage increase, there have been many increases in state minimum wages. Not only are a greater number of states implementing minimum wages higher than the federal minimum (i.e., 10 states in 1995 vs. 14 states in 2005), but the states that are implementing higher minimum wages are choosing minimum wage levels that are increasingly higher than the federal minimum.[9]

Empirical Findings

Overall Retail and Small Business Employment.

Table 2 presents estimates of the effect of state minimum wage increases on the share of individuals aged 16-64 who are employed in retail jobs (columns 1-4) or in small businesses (columns 5-8). Estimates on retail employment are obtained using the full state-month panel of 15,861 observations from January 1979 to December 2004. Estimates on small business employment are obtained using state-year observations from March 1989 to March 2005.

The findings in columns (1)-(4) suggest consistent evidence that increases in state minimum wages are associated with declines in retail employment. Model (1) presents fixed effects estimates, model (2) corrects for heteroskedastic and autocorrelated errors[10], model (3) controls for state-specific changes in the overall prime-age adult male (age 25-54) unemployment rate, and model (4) controls for state-specific linear time trends to capture linear trends in unobserved state-specific characteristics. Across each specification, the evidence is consistent: a 10 percent increase in state minimum wages decreases the share of 16-64-year-olds employed in the retail industry by 1 to 3 percent. This finding is consistent with neoclassical economic theory, which predicts that price floors cause unemployment among low-skilled workers, and contradicts the FPI report's finding that a minimum wage hike *increased* retail employment.

In columns (5)-(8) of Table 2, estimates of the effect of state minimum wage increases on the share of individuals aged 16-64 employed in small businesses are presented. Employment in small businesses is defined as those working at a business with fewer than 100 employees employed at any location. As discussed above, information on employer size is only available annually in the March CPS beginning in the late 1980s. A panel of 51 states[11] and 16 years between 1989 and 2005 is used to estimate the effect of minimum wage increases on teen employment in small businesses. The use of annual data over this limited time interval reduces the power of the evaluation design due to (i) the reduction in sample size from more than 16,000 to 867 and (ii) elimination of state-specific monthly variation in minimum wage policies. Despite this reduction in statistical power, across each of these specifications, there is consistent evidence that a 10 percent increase in the minimum wage is associated with a 1 percent decline in small business employment. Again, this finding is in contrast to the FPI report, which found no adverse effects of minimum wage hikes on small business employment.

Taken together, the findings in Table 2 suggest that despite the FPI report's claim, there is no such thing as a free lunch. More careful statistical models with more complete data suggest that minimum wage hikes come at a price: unemployment of workers in retail and small businesses. There are three key reasons why the current study's findings are more credible than those presented in the FPI report. First, the econometric model used in this study is more appropriate than the simple "difference-in-difference" framework used by the authors of the FPI study.[12] While the FPI study did not control for any changes in the economic environment that could be correlated with both states' decisions to implement the minimum wage and with employment outcomes, this study controls for several state-specific changes in economic conditions, as well as national macroeconomic trends. Second, this study has greater statistical power than the FPI study because of a significantly larger number of observations over a longer period of time (more than 16,000 state-month observations) and greater within-state variation in minimum wages. The greater statistical power allows a greater ability to detect significant effects of minimum wage increases on employment.

In addition to the limited statistical power of the evaluation design, the FPI study grouped skilled and unskilled workers together to examine the effect of the minimum wage on overall retail and small business employment. Thus, an important limitation of the FPI report is that it does not specifically focus on the effects of minimum wage hikes on the employment of low-skilled workers. One would not expect that employment of skilled workers in retail or small businesses would be directly affected by minimum wage hikes. Taken together with the limited power of the study's design, it is not surprising that the researchers failed to detect significant adverse effects of minimum wage hikes on overall employment. The evidence presented here, however, suggests that minimum wage hikes do have important disemployment effects in both retail and small businesses.

In fact, the estimates presented in Table 2 may actually understate the adverse effects of minimum wage increases on low-skilled workers to the extent that overall employment rates include skilled laborers. This study next turns to a group of low-skilled workers who have often been examined in the minimum wage literature —teenagers. Minimum wage increases are expected to have their strongest adverse effects on low-skilled workers employed in retail and small businesses.

Before examining the effect of minimum wage increases on teenage employment and

hours worked in the retail and small business sectors, the effects of minimum wage hikes on teenage wage rates and on overall teen employment are examined. If minimum wage increases are expected to influence teenage retail and small business employment, it is important to examine first whether minimum wage increases affect overall teenage employment.

Teenage Wage Effects. Columns (1)-(3) of Table 3 present evidence on the effect of minimum wage increases on the mean hourly wage rates of employed teenagers. Effects on wages must be observed if we are to expect employment effects. These models estimate the relationship between the natural log of the minimum wage and the natural log of the mean hourly teen wage rate. In the specification in column (1), the results show that minimum wage increases are associated with a significant increase in teenage wage rates. This result persists in model (2) when recession dummies are included to control for economic trends in the national economy. Finally, in model (3), year effects are included to control for year-specific unobserved characteristics. The magnitude of the minimum wage effect falls by more than 50 percent but remains statistically significant. These findings confirm results in the existing empirical literature (see, for example, Burkhauser et al., 2000). Minimum wage increases positively affect the average hourly wage rates of teenagers who remain employed, with wage elasticities ranging from 0.159 to 0.498.

Overall Teenage Employment Effects.

In columns (4)-(6) of Table 3, estimates of the effect of minimum wage increases on the ratio of teenage employment to teenage population are presented. Across all model specifications, there is consistent evidence that minimum wage increases are associated with a decline in the teenage employment ratio. Controlling for the average adult wage rate, the share of teens in the state, the prime-age adult male unemployment rate, seasonal employment trends, unobserved time-invariant state characteristics, and year effects, an increase in the minimum wage is consistently associated with a decline in teen employment. A 10 percent increase in the minimum wage is associated with a 2.2 to 3.0 percent decline in the ratio of teenagers who are employed. This finding is generally consistent with the results obtained by Abowd et al. (2004), Burkhauser et al. (2000), Deere et al., (1995), and Neumark and Wascher (1994).

In Table 4, we examine whether these results persist if there are autocorrelated errors, lagged minimum wage effects, and nonlinear effects of minimum wage increases.[13] Across all models, there is consistent evidence that minimum wage increases reduce the employment of teenagers. Models (1)-(3) continue to assume a contemporaneous relationship between the minimum wage and teenage employment. Whether macroeconomic trends are controlled for via a recession dummy (model 2) or year effects (model 3), minimum wage hikes have adverse employment effects for teens. A 10 percent increase in the minimum wage is associated with a 1.8 to 3.0 percent decline in the ratio of teens who are employed.

In models (4)-(6), lagged minimum wage effects are permitted. Included in each model is a measure of the state minimum wage one year prior to the contemporaneous employment rate. The elasticities[14] presented in these models are long-run elasticities. The lagged minimum wage effect is included because firms might not instantaneously respond to increases in the price of low-skilled labor. When these lagged effects are permitted, the estimated long-run elasticity is slightly higher than the short-run elasticity estimated in the previous models. A 10 percent increase in the minimum wage is associated with a 2.5 to 3.3 percent decrease in the ratio of employed teenagers.

In models (7)-(8), dummy variables for each state and federal minimum wage are included to allow the minimum wage to have a nonlinear effect on teenage employment, as in Deere et al. (1995). Dummy variables are created for each of the 55 federal and state minimum wages from January 1979 to December 2004, and include all but a dummy variable for $3.35, the federal minimum wage from 1981 to 1989. The coefficients and elasticities for the federal minimum wage rates of $4.25 and $5.15 are reported in the table[15]. As in the previous models, an increase in the minimum wage is found to significantly decrease the employment of teenagers.

The results in Table 4 provide consistent evidence that minimum wage increases are associated with significant declines in the ratio of teenage employment to teenage population. These findings are consistent with much of post-Card and Krueger minimum wage literature (see, for example, Deere et al., 1995; Burkhauser et al., 2000).[16]

Effect on Teenage Hours Worked.

Table 5 presents estimation results on the effect of minimum wage hikes on average weekly hours worked. This is an important outcome of interest since employers can respond to minimum wage hikes not only by reducing the employment of new teenagers and laying off existing workers but also by reducing the hours of existing employees. In columns (1)-(5), the effect of minimum wage increases on average hours worked by all teenagers is presented. Estimates of the effect of minimum wage increases on average hours worked by all teenagers include the total effect of minimum wage hikes on both employment and hours worked by employed teens. Teenagers who do not work contribute zero work hours in the calculation of the state-month specific measure of average hours worked.

Model (1) includes a recession effect rather than year effects to control for macroeconomic conditions, model (2) uses year effects, models (3) and (4) permit lagged minimum wage effects, and model (5) permits a nonlinear relationship between the minimum wage and average hours worked. Across each of these specifications, there is consistent evidence that minimum wage increases reduce average weekly hours worked by teenagers. A 10 percent increase in the minimum wage is associated with a 3.7 to 4.5 percent reduction in average weekly hours worked by teens. This finding reflects, in part, that minimum wage hikes reduce teen employment (resulting in more teens with zero hours worked). However, as models (6)-(10) show, this finding also suggests that minimum wage increases may reduce hours worked among those who are employed.

The dependent variable used in models (6)-(10) is the natural log of average hours worked by *employed* teenagers.[17] There is fairly consistent evidence that minimum wage increases reduce hours worked by teenagers who are employed. This finding is especially strong in models that use a recession effect to control for macroeconomic trends (models 6, 8, and 10).[18] The estimates obtained in models (6) and (8) reflect that a 10 percent increase in the minimum wage is associated with a 2.9 percent decline in average hours worked by employed teenagers.

Taken together, the results in Tables 3-5 suggest strong evidence that minimum wage hikes continue to have adverse effects on teenage employment and hours worked. Contrary to recent claims by some minimum wage advocates, minimum wage increases are associated with a reduction in employment and hours worked among low-skilled workers. In the remaining tables, we once again turn specifically to the claim made in the FPI study—that raising the minimum wage has no adverse employment effects on low-skilled workers in retail or small businesses.

Teenage Retail Sector Employment.

Given that teenagers often select jobs in the retail sector, such low-skilled workers are likely to be hardest hit by minimum wage hikes. As noted above, the majority (51 percent) of employed teenagers worked in the retail sector.

Table 6 presents the effect of minimum wage hikes on the ratio of teenagers employed in the retail sector, on average retail hours worked by all teenagers (including nonworkers), and on average retail hours worked by teenagers employed in retail jobs. Each of the models is corrected for heteroskedastic and autocorrelated residuals. Columns (1)-(4) present employment effects. There is consistent evidence that minimum wage increases reduce the proportion of teenagers employed in the retail industry. A 10 percent increase in the minimum wage is associated with a 2.7 to 4.3 percent decline in the employment of teenagers in the retail sector. This finding is robust across all model specifications. This effect is larger than the effect of minimum wage increases on the overall retail employment, reflecting that low-skilled workers are, as expected, most adversely affected.

Models (5)-(7) in Table 6 show the effect of minimum wage increases on average retail hours worked by all teenagers. These estimates capture the total effect of minimum wage increases on both retail employment and on hours worked by teenagers employed in retail businesses.[19] These models show that a 10 percent increase in the minimum wage is associated with a 5 percent decline in average hours worked in the retail sector. The results in columns (8)-(10) suggest that while the reduction in retail hours can be partially explained by disemployment effects, minimum wage increases may also decrease mean hours worked by teenagers working in the retail sector. In models that use a recession dummy to control for macroeconomic trends (columns 8 and 10), there is evidence of a significant negative relationship between minimum wage increases and retail hours worked among teens *employed* in the retail sector. A 10 percent increase in the minimum wage is associated with a 2.8 percent decline in retail hours worked among teens employed in retail businesses. However, the model including year effects (column 9) finds a negative, but insignificant, relationship between minimum wage increases and hours worked among employed teens.

In summary, the results in Table 6—along with the findings in columns (1)-(4) of Table 2—provide strong evidence that minimum wage increases have adverse effects on employment and hours worked of low-skilled retail workers.

Teenage Small Business Employment.

The effect of minimum wage increases on teenage small business employment is examined in Table 7. Due to the limited power of the evaluation design, the choice of macroeconomic controls (year effects vs. recession effects) is likely to have a greater influence over these estimates. This is because the year effects will capture all changes in the federal minimum wage. Moreover, given that the data are less precisely measured (annual data vs. monthly data) than those data used for the previous models, lagged minimum wage effects may be more important in these specifications.

Columns (1)-(4) present estimates of the relationship between minimum wage increases and the ratio of teenagers employed in small businesses. Across all model specifications, there is consistent evidence that an increase in the minimum wage is associated with a significant reduction in teenage small business employment. A 10 percent increase in the minimum wage is associated with a 4.6 to 9.0 percent reduction in the ratio of teenagers employed in small businesses.

In columns (5)-(7), estimates of the effect of minimum wage increases on average teenage hours worked in small businesses are presented. Across each of these models, an increase in the minimum wage is associated with a decline in average small business hours worked by all teenagers. A 10 percent increase in the minimum wage is associated with a 4.8 to 8.8 percent reduction in average hours worked. The findings in columns (8)-(10) suggest that among teenagers who work in small businesses, average hours worked may be adversely affected by minimum wage increases. However, the adverse effects do not appear to occur contemporaneously, but rather are lagged effects. In model (8), the estimate reflects that a 10 percent increase in the minimum wage is associated with a 5.6 percent reduction in average hours worked among teens who are *employed* in small businesses. However, the negative effects appear to be strongest in the period following the implementation of the minimum wage.[20] That is, the previous year's minimum wage has an important adverse effect on hours worked during the current year. A likely explanation for this finding is that the use of annual data reduces the precision of the evaluation design; that is, analyzing mid-year changes in state or federal minimum wages may not have their full effects until the following year.

Along with the findings in columns (5)-(8) of Table 2, the results in Table 7 paint a picture quite different from that of the FPI report, which concluded that there were no adverse employment effects of minimum wage hikes on small businesses. When more appropriate statistical methods are used, and the dependent variable is more carefully defined, important adverse employment effects are detected. As expected, the magnitude of the disemployment effect is larger for teenage small business employment than for overall small business employment.

Conclusions

This study has examined the impact of minimum wage increases on retail and small business employment, with special attention to employment by a group of low-skilled workers—teenagers—employed in retail and small businesses. These findings provide consistent evidence that minimum wage increases result in a significant decline in retail and small business employment. This finding is robust across several model specifications. A 10 percent increase in state minimum wages is consistently associated with a 1 percent reduction in retail employment and a 1 percent reduction in small business employment.

Minimum wage hikes are associated with an even larger reduction in teenage employment in the retail sector, with elasticities ranging from -0.267 to -0.429. Moreover, a 10 percent increase in the minimum wage reduces average retail hours worked by 5 percent, and, among teens who remain employed in the retail sector, reduces average hours worked by 2 to 3 percent. Finally, teen employment in small businesses is negatively affected by minimum wage hikes. A 10 percent increase in the minimum wage is associated with a 4.6 to 9.0 percent decline in teenage employment in small businesses and a 4.8 to 8.8 percent reduction in hours worked by teens in the retail sector.

Taken together with other recent work (Abowd, Kramarz, Lemieux, and Margolis, 2004; Burkhauser, Couch, and Wittenburg, 2000a; Burkhauser, Couch, and Wittenburg, 2000b; Deere, Murphy, and Welch, 1995; Neumark and Wascher, 1994), the findings of this study suggest that low-skilled workers will not escape adverse labor market consequences resulting from minimum wage increases. Moreover, the results of this study suggest that the findings from the Fiscal Policy Institute report

(2004) are misleading. Raising the minimum wage has negative effects on the employment and hours worked of low-skilled workers, particularly in the retail sector and in small businesses. This finding is consistent with standard neoclassical economic theory, which suggests that if the price of low-skilled labor rises, employers will reduce the numbers of low-skilled employees, reduce the hours offered to currently employed low-skilled employees, or both.

In addition to the adverse employment effects of the minimum wage, there are other important reasons why raising the minimum wage is a poor policy strategy. Modern-day minimum wage hikes are no longer an effective means of reducing poverty among the working poor (Burkhauser, Couch, and Wittenburg, 1996; Burkhauser and Finegan, 1989; Burkhauser and Harrison, 1999; Burkhauser and Sabia, 2004). This is true for two reasons. First, most minimum wage workers now live in nonpoor households because they are second or third earners in a family, such as teenage dependents. Second, most workers from poor households earn wage rates higher than the minimum wage. Hence, raising the minimum wage is not target efficient at reducing poverty among the working poor. As Burkhauser et al. (1996) show, the Earned Income Tax Credit (EITC) is a far more effective policy tool to reduce poverty among poor families. Moreover, the EITC has the advantage of avoiding the adverse employment effects described in this study. In fact, Neumark et al. (2002) show that a minimum wage hike may actually increase the poverty rate because the increase's adverse effect on hours worked will push nonpoor families into poverty.

The findings of this study should serve as a caution to legislators considering an increase in the minimum wage. While the findings of the FPI study may be seductive to some policymakers, the evidence presented here should serve as a reminder that there is no such thing as a free lunch. Raising the minimum wage will hurt rather than help low-skilled workers in retail and small businesses.

Endnotes

1. Burkhauser, Couch, and Wittenburg (2000a) find that the anomalous Card and Krueger (1995) results using the CPS can be explained by the authors' choice of macroeconomic controls. Card and Krueger's use of year effects to control for macroeconomic trends captures all of the federal variation in minimum wages; thus, given the small amount of identifying variation left in state-specific minimum wages, it is not surprising that they find insignificant effects of minimum wage increases. When Burkhauser et al. (2000) use alternate macroeconomic controls that do not capture all of the variation in federal minimum wage increases, they find significant negative effects of minimum wage increases on teenage employment.

2. This final control is accomplished through the use of state fixed effects.

3. Most of the models presented are corrected for panel-level heteroskedasticity and first-order autocorrelation, i.e. $\varepsilon \sim (0, \sigma_j^2)$ $\varepsilon_{jt} = \rho\varepsilon_{jt-1} + \upsilon$, via Prais-Winsten feasible generalized least squares estimation with panel-corrected standard errors.

4. One alternate specification, suggested by Burkhauser et al. (2000), uses a recession dummy variable to capture national macroeconomic trends rather than year effects. A specification of this form will allow identifying variation to come from changes in the federal minimum wage as well as state minimum wages, rather than just changes in state-specific minimum wages. If this alternate specification is adopted, then the estimate of can be interpreted as the effect of the higher of the state or federal minimum wage. This permits identifying variation from changes in the federal minimum wage as well as state minimum wages. Another specification permits state-specific linear time trends to capture linear trends in unobserved state-specific characteristics.

5. Data from November 2004 are not available.

6. Comparable measures of retail employment were created during the period when the CPS switched from the Standard Industrial Classification (SIC) system to the North American Industry Classification System (NAICS). Thanks to Jean Roth at NBER for assistance with creating comparable measures of retail employment.

7. Given available data in the CPS, I could not replicate the 50 employee threshold used in the FPI study (2004).

8. In these models, variation in the federal minimum wage (in addition to variation in state minimum wages) is permitted to affect employment.

9. The mean state minimum wage among states with minimum wages higher than the federal minimum was 13 percent higher that the federal minimum in 1995 and 28 percent higher than the federal minimum in 2005.

10. Failing to correct for autocorrelation when it is, in fact, present could result in depressed standard errors. This would

11. This includes the District of Columbia.

12. More precisely, the identification strategy is more credible.

13. Each model is estimated via feasible generalized least squares (FGLS) models using the Prais-Winsten method of autocorrelation correction and with state-specific, panel corrected standard errors.

14. This is the sum of the contemporaneous and one-year lagged effect.

15. Estimates for other coefficients are available upon request of the author.

16. Burkhauser et al. (2000) could not identify significant effects of minimum wage hikes when including year dummies in their models because these dummies captured much of the identifying variation in minimum wages, specifically that from changes in the federal minimum wage. The results presented here reflect that because of significant variation in state minimum wage policies from 1997-2005, significant effects of state minimum wage policies can be estimated.

17. Teenagers who contribute to mean hours worked by employed teens (HOURSW) have positive number of hours worked last week. The denominator includes only those who are employed. This is in contrast to the previous measure of average hour worked (HOURS), which include work hours of all teenagers in the calculation; the denominator in the HOURS measure includes all teenagers.

18. One explanation for why the finding is not as strong in models that use year effects is that these year effects capture much of the identifying variation in the minimum wage needed to find significant effects on hours worked by employed teens.

19. As before, teenagers who report no employment in a retail job are coded as working for zero hours.

20. While contemporaneous minimum wage is actually positive and significant, indicating a short-run positive effect of minimum wage hike, the long-run effect, which includes both the contemporaneous and lagged minimum wage effect, is negative and large.Thus, a specification that did not consider the importance of large negative lagged minimum wage effects would erroneously conclude that minimum wage increases actually increased employment.

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Table 1: Means and Standard Deviations of Variables (January 1979 - December 2004)

Variable Name	Definition	Mean (StD)
Dependent Variables		
ORETAI	Ratio of overall (ages 16-64) retail employment (last week) to population aged 16-64	0 11 (0 02)
OSMALL[2]	Ratio of overall (ages 16-64) small business employment (last year) to population aged 16-64	0.34 (0.04)
TEMPLOY	Ratio of teenage (ages 16-19) employment (last week) to teenage population	0.42 (0 12)
TEENWAGE	Natural log of wage of employed teenagers	1.63 (0.27)
THOURS	Natural log of average weekly hours worked by all teenagers	2 26 (0.40)
THOURSW	Natural log of average weekly hours worked by employed teenagers (ages 16-19)	3.15 (0.21)
TRETAIL[1]	Ratio of teenage (ages 16-19) employment in retail sector to teenage population	0.22 (0 08)
TRHOURS[1]	Natural log of average weekly retail hours worked by all teenagers	1.48 (0.47)
TRHOURSW[1]	Natural log of average weekly hours worked by teenagers employed in retail sector	3 07 (0 25)
TSMALL[2]	Ratio of teenage (ages 16-19) employment at any time during last year in small-size firm (<100 employees) to teenage population	0 28 (0 08)
TSHOURS[2]	Natural log of average annual small business hours worked by all teenagers	5.27 (0.33)
TSHOURSW[2]	Natural log of average annual hours worked by teenagers employed in small businesses	6.59 (0.16)
Independent Variables		
MINWAGE	Natural log of higher of state or federal minimum wage	1.42 (0 21)
ADULTWAGE	Natural log of the wage rate of workers aged 25-54	2 46 (0.30)
SHARETEEN	Proportion of population aged 16-64 who are teenagers (aged 16-19)	0 09 (0 02)
AUNEM	Unemployment rate of males aged 25-54	0.05 (0.03)
RECESSION	Dummy variable equal to one in the month in which the economy was officially in a recession	0.12 (0 32)
State Effects	Dummy variable equal to one for each state	—
Seasonal Effects	Dummy variable equal to one for each month in the year	—
Year	Dummy variable equal to one for each year	—
Number of states[3]		51
N		15,861

SOURCE: Computed by the author with monthly CPS data from the outgoing rotation group.

[1]Consistent data on retail employment for teenagers available for 15,859 observations.

[2]Data on firm size are available annually in the March CPS beginning in 1989; N = 867.

[3]Includes the District of Columbia

Table 2: Effect of Minimum Wage on Ratio of Employment in Retail and Small Businesses to Population (Age 16-64)

	ORETAIL				OSMALL			
	1	2	3	4	5	6	7	8
MINWAGE	-0.011***	-0.009**	-0.010***	-0.032***	-0.028***	-0.038***	-0.040***	-0.028***
	(0.003)	(0.004)	(0.004)	(0.002)	(0.008)	(0.006)	(0.006)	(0.008)
ADULTWAGE	-0.039***	-0.041***	-0 041***	-0.049***	0.009	0.004	-0.005	-0.003
	(0.002)	(0.003)	(0.002)	(0.002)	(0.009)	(0.010)	(0.010)	(0.008)
SHARETEEN	0.083***	0.088***	0.087***	0.090***	-0.024	-0.002	0.015	0.203***
	(0.009)	(0.010)	(0.010)	(0.009)	(0.070)	(0.066)	(0.065)	(0.061)
AUNEM	—	—	-0.039***	-0.012***	—	—	-0.168***	-0.082***
			(0.007)	(0.006)			(0.031)	(0.030)
Seasonal Effects	Yes	Yes	Yes	Yes	—	—	—	—
State Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	No	Yes	Yes	Yes	No
State Linear Time Trend	No	No	No	Yes	No	No	No	Yes
Prais-Winsten	No	Yes	Yes	Yes	No	Yes	Yes	Yes
N	15,861	15,867	15,867	15,867	867	867	867	867
Elasticity	-0.101	-0.085	-0.092	-0.290	-0.081	-0.113	-0.116	-0.081

SOURCE: Computed by the author.

Dependent variable in models (1)-(4) is the ratio of 16-64 year-olds employed in retail industry.
Dependent variable in models (5)-(8) is ratio of of 16-64 year-olds employed in small businesses.
**** Significant at 1% level ** Significant at 5% level * Significant at 10% level*

Table 3: **Effect of Minimum Wage on Average Teenage (Ages 16-19) Wage Rates and Ratio of Teenage Employment to Teenage Population, January 1979 - December 2004**

	TEENWAGE			TEMPLOY		
	1	2	3	4	5	6
MINWAGE	0.498***	0.496***	0.159***	-0.094***	-0.092***	-0.126***
	(0.015)	(0.015)	(0.026)	(0.010)	(0.010)	(0.019)
ADULTWAGE	-0.039***	-0.041***	-0.041***	-0.049***	0.009	
	(0.002)	(0.003)	(0.002)	(0.002)	(0.009)	
SHARETEEN	0.134*	0.119	-0.003	-0.027	-0.017	0.007
	(0.081)	(0.081)	(0.085)	(0.054)	(0.054)	(0.054)
AUNEM	-0.445***	-0.453***	-0.166***	-0.853***	-0.847***	-0.548***
	(0.052)	(0.051)	(0.052)	(0.032)	(0.032)	(0.035)
RECESSION	—	0.009**	—	—	-0.006**	—
		(0.003)			(0.002)	
Seasonal Effects	Yes	Yes	Yes	Yes	Yes	Yes
State Effects	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	No	No	Yes	No	No	Yes
R^2	0.788	0.788	0.802	0.463	0.463	0.487
N	15,861	15,861	15,861	15,861	15,861	15,861
Elasticity	-0.498	0.496	0.159	-0.222	-0.217	-0.298

SOURCE: Computed by the author.

Dependent variable in models (1)-(3) is natural log of the average teenage wage rate.
Dependent variable in models (4)-(6) is ratio of employed teenagers to teenage population.
**** Significant at 1% level ** Significant at 5% level * Significant at 10% level*

Table 4: **Prais-Winsten FGLS Estimates of Impact of Minimum Wage on Ratio of Teenage (Ages 16-19) Employment to Teenage Population (January 1979 - December 2004)**

	1	2	3	4	5	6	7	8
MINWAGE $4.25[1]	—	—	—	—	—	—	-0.011***	-0.011***
							(0.004)	(0.004)
MINWAGE $5.15[1]	—	—	—	—	—	—	-0.015	-0.012
							(0.006)	(0.006)
MINWAGE	0.080***	-0.078***	-0.127***	-0.007	0.002	-0.094***	—	—
	(0.009)	(0.010)	(0.010)	(0.009)	(0.070)	(0.066)	(0.065)	(0.061)
LAG MINWAGE (1 YR)	—	—	—	-0.101***	-0.108***	-0.044	—	—
				(0.027)	(0.027)	(0.031)		
ADULTWAGE	-0.007	-0.010	-0.001	0.019	0.016	0.002	-0.019*	-0.025**
	(0.009)	(0.009)	(0.014)	(0.011)	(0.011)	(0.014)	(0.011)	(0.011)
SHARETEEN	-0.007	0.005	0.037	-0.020	-0.008	0.031	-0.002	0.009)
	(0.051)	(0.051)	(0.051)	(0.053)	(0.053)	(0.053)	(0.051)	(0.051)
AUNEM	-0.711***	-0.704***	-0.454***	-0.685***	-0.682***	-0.462***	-0.663***	-0.658***
	(0.037)	(0.037)	(0.038)	(0.038)	(0.038)	(0.038)	(0.037)	(0.037)
RECESSION	—	-0.008**	—	—	-0.008**	—	—	-0.010***
		(0.004)			(0.004)			(0.004)
Seasonal Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
State Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	No	No	Yes	No	No	Yes	No	No
N	15,861	15,861	15,861	15,249	15,249	15,249	15,861	15,861
Elasticity	-0.189	-0.184	-0.300	-0.255	-0.250	-0.326	—	--

SOURCE: Computed by the author.

[1]Relative to $3.35 federal minimum wage level.

Dependent variable in each model is the ratio of teenage employment to teenage population

**** Significant at 1% level ** Significant at 5% level*

Table 5: **Prais-Winsten FGLS Estimates of Effect of Minimum Wage on Average Hours Worked by Teenagers, January 1979 - December 2004**

	THOURS					THOURSW				
	1	2	3	4	5	6	7	8	9	10
Min Wage $4.25[1]	—	—	—	—	-0.079***	—	—	—	—	-0.067***
					(0.015)					(0.009)
Min Wage $5.15[1]	—	—	—	—	-0.130***	—	—	—	—	-0.110***
					(0.023)					(0.013)
MINWAGE	0.454***	-0.371***	-0.141	-0.377***	—	-0.287***	-0.039	-0.146***	-0.111**	—
	(0.045)	(0.070)	(0.093)	(0.103)		(0.286)	(0.038)	(0.054)	(0 057)	
LAG MINWAGE (1 YR)	—	—	-0.373***	0.011	—	—	—	-0.142***	0.099	—
			(0.095)	(0.110)				(0.056)	(0.061)	
ADULTWAGE	-0.101***	-0.050	-0.055	-0.048	-0.173***	-0.087***	-0.045	-0.097***	-0.049*	-0.123**
	(0.032)	(0.047)	(0.037)	(0.049)	(0.038)	(0.019)	(0.027)	(0.022)	(0.028)	(0.022)
SHARETEEN	0.892***	1.00***	0.931***	1.03***	0.935***	0.587***	0.620***	0.638***	0.638***	0.586***
	(0.173)	(0 174)	(0.179)	(0 180)	(0.174)	(0 102)	(0.102)	(0.106)	(0.106)	(0.102)
AUNEM	-2.01***	-1.43***	-2.01***	-1.46***	-1.93***	0.259***	-0.293***	-0.296***	-0.298***	-0.296***
	(0.128)	(0.128)	(0.131)	(0.131)	(0.126)	(0 075)	(0.073)	(0.077)	(0.075)	(0.074)
RECESSION	-0.001	—	-0.007	—	-0.018	0.018**	—	0.012	—	0.014
	(0.013)		(0.013)		(0.013)	(0.008)		(0.008)		(0.008
Seasonal Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
State Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	No	Yes	No	Yes	No	No	Yes	No	Yes	No
N	15,861	15,861	15,249	15,249	15,861	15,861	15,861	15,249	15,249	15,861

SOURCE: Computed by the author.

Dependent variable in each model is the natural log of the average hours worked.
[1]Relative to $3.35 federal minimum wage level. All other minimum wage levels were included in models (5) and (10) and are available upon request of the author.

*** Significant at 1% level ** Significant at 5% level * Significant at 10% level*

Table 6: **Prais-Winsten FGLS Estimates of Impact of Minimum Wage on Ratio of Teen age (Ages 16-19) Retail Employment to Teenage Population and on Average Hours Worked, January 1979 - December 2004**

	TRETAIL				TRHOURS			TRHOURSW		
	1	2	3	4	5	6	7	8	9	10
Min Wage $4.25[1]	—	—	—	0.001 (0.003)	—	—	-0.074*** (0.019)	—	—	-0.067*** (0.010)
Min Wage $5.15[1]	—	—	—	-0.011** (0.004)	—	—	-0.171*** (0.028)	—	—	-0.106*** (0.015)
MINWAGE	-0.058*** (0.009)	-0.087*** (0.016)	-0.069*** (0.023)	—	-0.530*** (0.099)	-0.502*** (0.146)	—	-0.204*** (0.058)	-0.107 (0.069)	—
LAG MINWAGE (1 YR)	—	—	-0.024 (0.025)	—	—	-0.021 (0.155)	—	-0.075 (0.060)	0.061 (0.074)	—
ADULTWAGE	0.052*** (0.007)	0.015 (0.011)	0.014 (0.011)	0.032*** (0.008)	0.057 (0.068)	0.056 (0.070)	0.078 (0.049)	-0.054 (0.025)	-0.068* (0.036)	-0.084*** (0.025)
SHARETEEN	-0.251*** (0.041)	-0.155*** (0.042)	-0.158*** (0.043)	-0.199*** (0.042)	0.361 (0.259)	0.372 (0.267)	0.157 (0.256)	0.523*** (0.138)	0.586*** (0.140)	0.472*** (0.135)
AUNEM	-0.395*** (0.028)	-0.270*** (0.030)	-0.273*** (0.030)	-0.418*** (0.028)	-1.49*** (0.181)	-1.52*** (0.185)	-2.14*** (0.174)	-0.157* (0.095)	-0.186* (0.096)	-0.173* (0.091)
RECESSION	-0.006** (0.003)	—	—	-0.007*** (0.003)	—	—	-0.036** (0.016)	0.005 (0.009)	—	-0.004 (0.008)
Seasonal Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
State Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	No	Yes	Yes	No	Yes	Yes	No	No	Yes	No
N	15,859	15,859	15,249	15,859	15,859	18,249	18,589	15,249	18,249	18,859
Elasticity	-0.267	-0.401	-0.429	—	-0.530	-0.523	—	-0.279	-0.046	—

SOURCE: Computed by the author.

Dependent variable in models (1)-(4) is the ratio of teenage retail employment to teenage population. The dependent variable in the remaining models is the natural log of the average hours worked.

[1]Relative to $3.35 federal minimum wage level. All other minimum wage levels were included in models (4), (7), and (10) and are available upon request of the author.

**** Significant at 1% level ** Significant at 5% level * Significant at 10% level*

Table 7: Prais-Winsten FGLS Estimates of Impact of Minimum Wage on Ratio of Teenage (Ages 16-19) Small Business Employment to7 Teenage Population and on Average Hours Worked, March 1989 - March 2005

	TSMALL				TSHOURS			TSHOURSW		
	1	2	3	4	5	6	7	8	9	10
Min Wage $4.25[1]	—	—	—	-0.054***	—	—	-0.188***	—	—	-0.086**[2]
				(0.010)				(0.032)		(0.030)
Min Wage $5.15[1]	—	—	—	-0.087***	—	—	-0.281***	—	—	0.034[2]
				(0.032)			(0.091)			(0.041)
MINWAGE	-0.246***	-0.185***	-0.196***	—	-0.478***	-0.431***	—	0.268***		—
	(0.013)	(0.020)	(0.019)		(0.108)	(0.113)		(0.073)		
LAG MINWAGE	—	—	0.071	—	—	-0.406	—	-0.809***	-0.697***	—
(1 YR)			(0.044)			(0.280)		(0.163)	(0.153)	
ADULTWAGE	-0.000	0.001	0.001	-0.000	-0.008	-0.007	-0.011**	-0.009***	-0.009***	0.001
	(0.001)	(0.001)	(0.001)	(0.001)	(0.005)	(0.006)	(0.005)	(0.003)	(0.003)	(0.002)
SHARETEEN	0.900***	0.570***	0.594***	1.36***	0.912	0.952	3.88***	-1.53**	-0.806	-1.93***
	(0.174)	(0.201)	(0.201)	(0.167)	(0.963)	(0.995)	(1.17)	(0.612)	(0.592)	(0.597)
AUNEM	-0.134	0.320***	0.312***	-0.064	0.156	0.191	-2.31***	-0.186	-0.256	-0.132
	(0.097)	(0.101)	(0.101)	(0.079)	(0.784)	(0.789)	(0.810)	(0.448)	(0.447)	(0.397)
RECESSION	-0.027**	—	—	-0.008	—	—	—	—	—	-0.048
	(0.013)			(0.011)						(0.050)
Seasonal Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
State Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes	No
N	867	867	867	867	867	867	867	867	867	867
Elasticity	-0.885	-0.668	-0.451	—	-0.478	-0.887	—	-0.541	-0.697	—

SOURCE: Computed by the author.

Dependent variable in models (1)-(4) is the ratio of teenage small business employment to teenage population. The dependent variable in the remaining models is the natural log of the average hours worked.

[1]Relative to $3.35 federal minimum wage level. All other minimum wage levels were included in models (4), (7), and (10) and are available upon request of the author.
[2]Coefficients presented are lagged minimum wage effects.
**** Significant at 1% level ** Significant at 5% level * Significant at 10% level*

Appendix

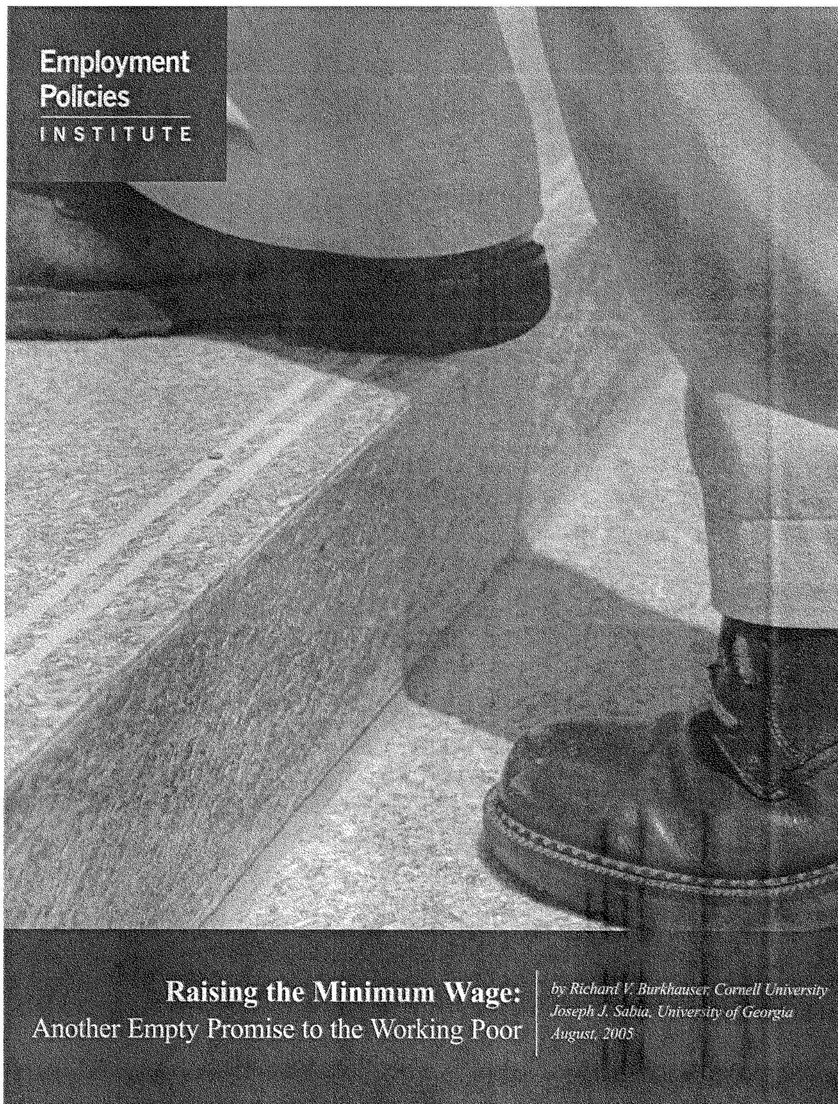
State Minimum Wages from 1979 to 2005 that were Higher than the Federal Minimum on January 1

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
FEDERAL MINIMUM[a]	3.35	3.35	3.35	3.80	4.25	4.25	4.25	4.25	4.25	4.75	5.15	5.15	5.15	5.15	5.15	5.15	5.15	5.15	5.15
NORTHEAST																			
New England																			
Maine[b]	3.65	3.65	3.75	3.85	---	---	---	---	---	---	---	---	---	---	---	5.75	6.25	6.25	6.25
New Hampshire	3.45	3.55	3.65	3.75	3.85	---	---	---	---	---	---	---	---	---	---	---	---	---	---
Vermont	3.45	3.55	3.65	3.75	3.85	---	---	---	4.75	4.75	5.00	---	---	5.75	6.25	6.25	6.25	6.75	6.75
Massachusetts	3.55	3.65	3.75	3.75	---	---	---	---	---	---	5.25	---	---	6.00	6.75	6.75	6.75	6.75	6.75
Rhose Island	3.55	3.65	4.00	4.25	4.25	4.45	4.45	4.45	4.45	4.45	5.15	---	---	5.65	6.15	6.15	6.15	6.15	6.15
Connecticut[c]	3.37	3.75	4.25	4.25	4.25	4.27	4.27	4.27	4.27	4.27	4.77	---	5.65	6.15	6.40	6.70	6.90	7.10	7.10
MIDDLE ATLANTIC																			
New Jersey	---	---	---	---	---	5.05	5.05	5.05	5.05	5.05	5.05	---	---	---	---	---	---	---	---
New York	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	6.00
Pennsylvania	---	---	3.70	3.80	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
MIDWEST																			
East North Central																			
Illinois	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	5.50	6.50
WEST NORTH CENTRAL																			
Minnesota	---	3.55	3.85	3.95	4.25	---	---	---	---	---	---	---	---	---	---	---	---	---	---
Iowa	---	---	---	3.85	4.25	4.65	4.65	4.65	4.65	4.65	---	---	---	---	---	---	---	---	---
SOUTH																			
South Atlantic																			
Delaware	---	---	---	---	---	---	---	---	---	4.65	5.00	---	---	5.65	6.15	6.15	6.15	6.15	6.15
District of Columbia[d]	4.16	4.33	4.33	4.33	4.33	4.33	4.33	5.25	5.25	5.25	5.75	5.75	6.15	6.15	6.15	6.15	6.15	6.15	6.15
East South Central																			
None	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
West South																			
None	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
WEST																			
Mountain																			
None	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
Pacific																			
Washington	---	---	3.85	4.25	4.25	---	---	4.90	4.90	4.90	4.90	---	5.70	6.50	6.72	6.90	7.01	7.16	7.35
Oregon	---	---	---	4.25	4.75	4.75	4.75	4.75	4.75	4.75	5.50	6.00	6.50	6.50	6.50	6.50	6.90	7.05	7.25
California	---	---	4.25	4.25	4.25	---	---	---	---	---	---	5.00	5.75	5.75	6.25	6.75	6.75	6.75	6.75
Pacific (noncontiguous)																			
Alaska[e]	3.85	3.85	3.85	3.85	4.30	4.75	4.75	4.75	4.75	4.75	5.25	5.65	5.65	5.65	5.65	5.65	7.15	7.15	7.15
Hawaii	---	3.85	3.85	3.85	---	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.75	6.25	6.25	6.25

Source: Updated from Burkhauser et al. (2000), Fiscal Policies Institute (2004), and the U.S. Department of Labor

In 1990 and 1991, the federal minimum wage was not implemented until April 1. Thus, some states listed in the table have a higher state minimum wage than the federal minimum wage from January to March in those years. In 1996 and 1997, the federal minimum wage was not implemented until October 1. Thus, some states listed in the table have a higher state minimum wage than the federal minimum wage from January to September in those years.

[a]The federal minimum wage was $2.90 in 1979, $3.12 in 1980, and $3.37 from 1981 to 1983.
[b]The minimum wage in Maine was $3.45 in 1985 and $3.55 in 1986.
[c]The minimum wage in Connecticut was $2.91 in 1979, $3.12 in 1980, and $3.37 from 1981 to 1986.
[d]The minimum wage in the District of Columbia was was $2.95 in 1979, $3.14 in 1980, $3.48 in 1981, $3.62 from 1983-1984, $3.82 in 184-1985, and $3.86 in 1986.
[e]The minimum wage in Alaska was $3.40 in 1979, $3.60 in 1980, and $3.85 from 1981 to 1986.


Employment
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Raising the Minimum Wage:
Another Empty Promise to the Working Poor
by Richard V. Burkhauser, Cornell University
Joseph J. Sabia, University of Georgia
August, 2005

The Employment Policies Institute (EPI) is a nonprofit research organization dedicated to studying public policy issues surrounding employment growth. In particular, EPI research focuses on issues that affect entry-level employment. Among other issues, EPI research has quantified the impact of new labor costs on job creation, explored the connection between entry-level employment and welfare reform, and analyzed the demographic distribution of mandated benefits. EPI sponsors nonpartisan research that is conducted by independent economists at major universities around the country.

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Raising the Federal Minimum Wage: Another Empty Promise to the Working Poor

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Raising the Federal Minimum Wage: Another Empty Promise to the Working Poor

Executive Summary
Craig Garthwaite—Employment Policies Institute

Overview

This paper provides a historical view of the effect of increases in the federal minimum wage on the working poor with a particular focus on the past 15 years. Since its inception in 1938, increases in the federal minimum wage have become an increasingly weak mechanism for addressing the problem of poverty in America. This continuing deterioration stems from the fact that fewer low-wage employees are supporting a family on a minimum wage income. As poverty becomes more a problem of hours worked and not an individual's wage level, anti-poverty policies that focus on wages will be less efficient than polices that focus on income, such as the Earned Income Tax Credit (EITC).

Wages vs. Income

While wages and income are certainly related, the connection between the two has always been tenuous. In 1946, Nobel prize-winning economist George Stigler commented, "the connection between hourly wages and the standard of living of a family is remote and fuzzy." As this study shows, the fuzzy connection in 1946 has become blurrier over time.

Examining Census Bureau data since 1939, the authors found that fewer low-wage employees live in poor households today than in years past. Specifically, in 1939, 85 percent of low-wage employees[1] were living in poor households. By 2003, only 17 percent of low-wage employees were living in poor households. Consequently, attempting to target poor families by manipulating wages is an inefficient means of addressing the problem.

Even more important than the number of low-wage employees living in poor households is the number of low-wage employees who are the heads of poor households. This stereotypical beneficiary of an increase in the wage floor is the one supporters of minimum wage increases claim represents the typical minimum wage employee. In reality, a small fraction of low-wage employees are the head of a poor household, and this number has decreased significantly over time. In 1939, nearly one-third (31%) of all low-wage employees were the heads of a poor household. By 2003, only 9 percent of low-wage employees were heading a poor household.

These statistics all reveal an underlying point—modern families have multiple workers whose collective earnings make up the family income. Federal anti-poverty policy should adjust accordingly. As more women and teenagers have entered the workforce as second and third earners, the ranks of low-wage employees contain fewer individuals single-handedly supporting a family.

Federal Minimum Wage Increases and Poverty

A byproduct of the aforementioned changes in the composition of family incomes is that the poor make up a small percentage of beneficiaries from a wage hike. Contrary to popular perception, the average minimum wage employee is not in poverty or raising a family on a mini-

mum wage income. Analyzing Census data, the authors found that a beneficiary from a proposed federal minimum wage hike to $7.25 an hour is far more likely to be in a family earning more than three times the poverty line than in a poor family. In total, only 12.7 percent of the benefits from a federal minimum wage increase to $7.25 an hour would go to poor families. In contrast, 63 percent of benefits would go to families earning more than twice the poverty line and 42 percent would go to families earning more than three times the poverty line. The average benefit per household is approximately the same, with poor families receiving a benefit of $1,110 and families earning three times the poverty line earning $1,090—nearly the same benefit, despite a vast difference in family incomes.

While there is strong empirical evidence to suggest that increasing the minimum wage will have adverse employment effects—particularly among young African Americans, young non-high school graduates, and teenagers—the authors assume no disemployment effects associated with the minimum wage hike so as to allow the policy its best chance to achieve the poverty-reducing goals promised by its proponents. While the minimum wage is often promoted as a policy designed to help the poor, minorities, and single mothers, this analysis reveals that only 3.7 percent of the benefits from a $7.25 an hour federal minimum wage would go to poor African-American families. Only 3.8 percent would go to poor single-mother households. Even more troubling, the majority of "working poor" families—families who are working but remain in poverty—receive no benefit from an increase to $7.25 an hour. These families don't benefit because they already earn more than the new federal minimum wage and remain in poverty either because of a low number of hours worked or a large family size. Many of these individuals would benefit far more from an increase in the generosity of federal and state EITC programs.

Work Effort and Poverty

Examining the hours worked by poor employees reveals that increases in work effort could have a significant effect on income. The authors found that the median wage of the highest earner in a poor household was much higher than the proposed federal minimum wage—$9.25 for poor households and $9.60 for poor and near-poor households (up to 150 percent of the poverty line). While this wage should be sufficient to put a family of four out of poverty (even without a second or even third earner), the data reveal that the majority of these individuals are not working full-time.

The median hours worked for the highest earner in a poor family in 2003 was 1,720—significantly less than full time (2,080 hours a year). While including near-poor families in the calculation brings this number up to 1,872 hours, the majority of these individuals are still working less than full time at their current wage. These individuals would receive significantly more benefit from programs that promote increased work effort than they ever would from a minimum wage increase.

Single Mothers and the Minimum Wage

Advocates of increasing the federal minimum wage often insinuate that primary beneficiaries will be single mothers raising a family on a minimum wage income. As was mentioned above, only 3.8 percent of the benefits from an increase to $7.25 an hour accrue to poor single mothers. One of the factors causing this low percentage of benefits is the fact that the majority of poor single mothers (58%) have hourly wages above this level. In addition, only 18.5 percent of the benefits going to single mothers will go to those in poverty. The majority of benefits going to single mothers will go to those earning more than twice the poverty line.

Senator Edward Kennedy (D-MA), the primary sponsor of a federal minimum wage increase to $7.25 an hour, recently stated in support of an increase that "the jobs available to women leaving welfare are often minimum wage jobs." Census data, however, shows this is not the case. From 1995–2000, the time period following welfare reform, the employment rate of single mothers increased by 10.8 percentage points. Many of these single mothers were undoubtedly leaving the welfare rolls and joining the workforce. If Sen. Kennedy's claim is correct, one would expect a significant increase in the number of single mothers holding low-wage or federal minimum wage jobs. In reality, 77 percent of the increase in employment was accounted for by single mothers holding jobs paying more than low wages (50 percent of the average private sector hourly wage rate).

Examining the period over the 1990's business cycle produces similar results. The employment rate of single mothers increased by 14 percentage points, with 64 percent of this increase accounted for by single mothers earning more than low wages. Only 24 percent of the increase can be accounted for by those who held jobs at the prevailing federal minimum wage rate.

Conclusion

The authors calculate that, absent any employment loss, the cost to employers of the proposed increase in the federal minimum wage to $7.25 an hour will be $18.26 billion. Only 12.7 percent ($2.3 billion) of this cost will actually go to poor families, with only 3.7 percent going to poor African-American families. The ability of the minimum wage to target poor families is weaker and decreasing over time. Contrary to the statements of its advocates, fewer and fewer low-wage employees are supporting a family on the minimum wage, with only 9 percent of low-wage employees actually supporting a poor family.

Therefore, effective anti-poverty programs must concentrate on family income and not wages. While most working poor families will not receive any benefit from an increase in the federal minimum wage to $7.25 an hour, the vast majority would receive a benefit from increases in the generosity of federal and state EITC programs. These programs provide targeted assistance to the low-income working families so often cited in support of minimum wage increases—the same families that receive a minority of the benefits from a wage increase.

[1]For the purposes of this study, a low-wage employee is anyone earning less than 50 percent of the average private sector wage.

Raising the Minimum Wage: Another Empty Promise to the Working Poor

I. Overview

"It's time to honor and reward people who work hard and play by the rules. ... No one who works full time and has children should be poor any more."

—Bill Clinton and Al Gore, 1992

Minimum wage increases are supported by those who want to ensure that no one who works hard and plays by the rules lives in poverty. But who really gains from a minimum wage increase? How many of the working poor are actually helped? And are there more effective means of achieving this social goal?

This paper provides a historical view of the effectiveness of Federal minimum wage increases in raising the wages of the working poor, focusing specifically on the 1990s. Despite the recent increase in the employment of single mothers, which reversed the long-term decline in the share of low-wage workers who were heads of households, a Federal minimum wage increase (from $5.15 to $7.25 per hour) along the lines proposed by Senator Edward Kennedy (D-MA) will once again promise much more than it will deliver to the working poor. This mandated wage increase will be an even less target-efficient mechanism for improving the economic well-being of the working poor than was the last federal minimum wage increase (from $4.25 per hour to $5.15 per hour), which was signed into law by President Clinton in 1996. Relative to the 1996 increase, the current proposal, if enacted, will result in an even greater share of its mandated wage gains going to workers who live in higher income households while once again failing to help the vast majority of workers who are poor.

We focus on the growing population of working single mothers (defined as single-female heads of households who work at least 14 hours a week and at least 15 weeks per year and have children under age 18) because it is argued that the growth in their number among the working poor or near-poor has made it even more important to increase the Federal minimum wage. By examining the population of working single mothers before and after the passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA), we show that despite political rhetoric to the contrary, the majority of the jobs held by single mothers who live in poor or near-poor households pay an hourly wage that already exceeds $7.25 per hour and hence will not be helped by the proposed increase in the Federal minimum wage. We also show that the vast majority of workers who will gain do not live in poverty.

The welfare reforms of 1996, together with other pro-work policies of the 1990s, shifted federal social welfare policy away from programs that discouraged single mothers from working to those that encouraged work. Chief among these was a substantial increase in the Earned Income Tax Credit (EITC), enacted in 1993 but only fully implemented in 1996.[1] Because the EITC targets workers—especially single working mothers—who live in low-income households, rather than low-wage workers regardless of their household's income, the EITC is far more effective in helping the working poor in general and single working mothers in particular than are minimum wage increases. The EITC has not only increased the after-tax wage earnings of workers in low-income households but is a major reason for the dramatic increase in the employ-

ment of former welfare mothers. A further increase in the EITC is a far more effective mechanism for increasing both the employment and income of single mothers than is a further increase in the federal minimum wage. (See: Hotz and Scholz, 2003 for a review of the EITC literature; Burkhauser, Couch and Glenn, 1996 and Neumark and Wascher, 2001 for measures of its target effectiveness relative to minimum wage increases.)

II. Minimum Wage Law and the Working Poor

The federal minimum wage was enacted as part of the Fair Labor Standards Act of 1938 (FLSA). President Roosevelt rallied Congressional support for this legislation with the promise that it would help the one-third of Americans who were "ill-housed, ill-clad, and ill-nourished" (Roosevelt, 1937). This ringing call for social action still echoes in the words of modern-day minimum wage supporters. In his 1995 State of the Union address, President Clinton declared:

> *"I've studied the arguments and the evidence for and against a minimum wage increase. I believe that the weight of the evidence is that a modest increase does not cost jobs, and may even lure people into the job market. But the most important thing is, you can't make a living on $4.25 an hour."*
>
> —Clinton, 1995

Making a similar argument nine years later, Senator Kennedy stated:

> *"[T]he jobs available to women leaving welfare are often minimum wage jobs, and it is difficult, if not impossible, for them to meet the needs of their families and raise their children. Daily life is often harsh for low-income working mothers in all parts of the country, whether or not they have been on welfare. For them, survival is the daily goal. If they work hard enough and their working hours are long enough, they can make ends meet—but only barely. ... We must stop asking these families to do it all alone. They are working too many hours for too little pay, without access to the support they need to make ends meet and improve the quality of their lives. One of the most important steps we can take is to guarantee a fair minimum wage."*
>
> —Kennedy, 2004

While the social justice concerns raised by modern supporters of the minimum wage continue to appeal to the vast majority of Americans—who believe that those who work hard and play by the rules should not live in poverty—over the years minimum wage increases have in fact become a weaker and weaker mechanism for achieving this goal.

Current popular support for the minimum wage is based on legal and political precedents set during the first part of the 20th Century (Burkhauser, Couch, and Glenn, 1996). During the 19th and early 20th Centuries, the right to contract was guaranteed under the 14th Amendment to the Constitution, and legislatures could only intervene in the labor market under narrow circumstances (*Lochner v. New York*, 198 U.S. 45 (1905)). However, by 1937, the Supreme Court upheld a state minimum wage law (for women), stating that "the legislature was entitled to adopt measures to reduce the evils of the 'sweating system,' the exploiting of workers at wages so low as to be insufficient to meet the bare cost of living ..." (*West Coast Hotel Co. v. Parish*, 300 U.S. 379

(1937)). This decision paved the way for state intervention in the marketplace to correct social inequities.

While the right of States or the Federal Government to use minimum wage increases to help the working poor is now fully established, the effectiveness of minimum wage laws in achieving this goal is not. Stigler (1946), in his seminal article on this topic, formalized two critiques of the minimum wage. First, the impact of raising the minimum wage on the working poor was uncertain. While those workers who kept their jobs and worked the same number hours would see their labor earnings rise, those workers who lost their jobs or had their hours reduced would be harmed. In our analysis, we assume that there are no employment effects associated with an increase in the minimum wage. Hence, our simulations estimate the impact of a minimum wage increase assuming no change in hours worked. (We will discuss this in more detail in Section III.)

Second, Stigler pointed out:

> *"The connection between hourly wages and the standard of living of a family is remote and fuzzy. Unless the minimum wage varies with the amount of employment, number of earners, non-wage income, family size, and many other factors, it will be an inept device for combating poverty even for those who succeed in retaining employment."*
>
> —Stigler, 1946, p. 363

Stigler's second insight is the motivation for our work. Household income depends on factors beyond an individual worker's wage rate. It depends on the number of hours the person works, the number of workers in the household, their wages and hours worked as well as on income from other sources. As Burkhauser, Couch, and Glenn (1996, p. 67) note, "poverty is gauged by looking at household circumstances, not the earnings of each individual in isolation."

III. The Minimum Wage and Employment

Until the 1990s, a consensus existed among economists that raising the minimum wage caused net employment losses. Wessels (1980); Brown, Gilroy, and Kohen (1982); and Brown (1988) provide reviews of the pre-1992 literature on the minimum wage. Brown (1988) summarizes this literature by concluding that a 10 percent increase in the minimum wage was associated with a 1 to 3 percent reduction in teenage employment (a common indicator of entry-level employment). But in the 1990s, four influential articles argued that minimum wage increases had an insignificant and negative effect or even a significant and positive effect on employment (Katz and Krueger, 1992; Card, 1992a; Card, 1992b; and Card and Krueger, 1994). These studies, together with Card and Krueger (1995), fundamentally challenged the previous consensus, and provided the intellectual underpinnings of President Clinton's 1995 statement that "a modest increase [in the minimum wage] does not cut jobs, and may even lure people into the job market" (Clinton, 1995).

An additional decade of research has discounted the notion that minimum wage increases have positive employment effects and a near consensus has returned to the view that minimum wage increases have significant but relative modest negative effects on the employment of teenagers and other low-skill groups. (See: Abowd, Kramarz, Lemieux and Margolis, 2004; Burkhauser, Couch, and Wittenburg, 2000; Deere, Murphy, and Welch, 1995; Neumark and Wascher, 1994, 2000, 2002, 2004.) Public opinion surveys conducted in 1996 reveal that the median labor economist reported that a 10-percent increase in the minimum wage would

result in a 1-percent decline in the employment of teenagers, consistent with the findings in Brown, Curtis, and Kohen (1983) (Fuchs, Krueger, and Poterba, 1998).

Based on this more recent research, our assumption of no change in the employment or hours of work will, if anything, overstate the gains to low-wage workers from a minimum wage increase.

IV. Low Wages and Poverty

Between 1939 and 2003, the federal minimum wage has fluctuated between 34 and 56 percent of the average private sector wage, defined as the gross average hourly earnings of all production and non-supervisory workers in the private nonfarm sector, based on payroll data reported by employers to the Bureau of Labor Statistics (Burkhauser, Couch, and Glenn, 1996). In 2003, the federal minimum wage was at a historic low (33.6 percent) as a percentage of the average private sector wage.[2,3] Advocates of the minimum wage have generally proposed increases in the minimum wage to around 50 percent of this average.[4] It is this group of low-wage workers (those who earn wages of 50 percent or below the average) on whom we focus in this section.

Early in the 20th Century, the relationship between low wages and low household income was strong, since most households had only one worker and such households could count on few social programs to supplement their wages. However, at the start of the 21st Century, the relationship between being a low-wage worker and living in a poor or near-poor household is even fuzzier than in Stigler's day.

Table 1 builds on the work of Burkhauser, Couch, and Glenn (1996), and Burkhauser and Finegan (1989). It shows how the distribution of low-wage workers over the income distribution has changed since 1939. As in Burkhauser, Couch, and Glenn (1996), we define a low-wage worker as one whose wages fall below 50 percent of the average private sector wage.[5]

The income-to-needs ratio is our measure of economic well-being for these workers. For the years 1949 to 2003, this is defined as the ratio of total household income to the official U.S. Census-determined poverty line, adjusted for household size.[6] So, for example, in 2003, the poverty line for a household of four was $18,810. Therefore, a worker living in a household with four members whose total household income was $37,620 would have an income-to-needs ratio of 2.0. Importantly, we use household income because a worker is not an independent entity with respect to his or her economic well-being. A worker lives in a household and it is the total income of that household, not the worker's wage rate or labor earnings, that affects his or her economic well-being.[7]

Table 1 shows a relatively close relationship between being a low-wage worker and living in poverty in 1939. One reason is that a large share (34 percent) of low-wage workers are household heads (defined here as the head of a household with more than one person) and most (94 percent) headed poor households, so that 31 percent of low-wage workers are poor household heads. Another reason is that households with low-wage workers had fewer other sources of income. So even when low-wage workers are not household heads, they are still likely (85 percent) to live in a poor household. Hence, in 1939, just after the passage of the FLSA, when no other mechanisms for helping the working poor existed, a minimum wage (assuming no negative employment effects) was a relatively target-efficient mechanism for helping the working poor since a large share of low-wage workers lived in poor households.

This relationship between being a low wage worker, especially if one were a household head, and living in a poor household declined steadily over the next 40 years. Hence by 1979

Table 1 The Distribution of Low-wage Workers Across the Income Distribution: 1939–2003 (percentages)

	1939[a]		1949[b]		1959		1969		1979	
Income-to-Needs Ratio	Heads of Household	All Workers	Heads of Household	All Workers	Heads of Household	All Workers	Heads of Household	All Workers	Heads of Household	All Workers
Less than 1.00 (poor)	94	85	77	NA	61	42	45	23	37	20
1.00 to 1.24	3	5	8	NA	11	10	13	9	13	7
1.25 to 1.49	2	3	5	NA	7	10	9	7	9	7
1.50 to 1.99	1	4	6	NA	8	12	11	14	13	12
2.00 to 2.99	0	2	3	NA	9	16	13	20	16	20
3.00 or above	0	0	1	NA	4	10	10	27	12	34
Total	100	100	100	NA	100	100	100	100	100	100
Percent of all low-wage workers who were heads of:										
households	34	–	31	–	29	–	25	–	21	–
poor households	31	–	24	–	18	–	11	–	8	–
	1989		1995		2000		2003			
Less than 1.00 (poor)	37	22	33	14	33	16	31	17		
1.00 to 1.24	13	9	11	7	9	6	10	7		
1.25 to 1.49	10	8	8	8	7	7	8	8		
1.50 to 1.99	12	12	15	14	10	12	13	13		
2.00 to 2.99	15	19	16	22	18	22	17	22		
3.00 or above	13	30	18	35	21	37	21	34		
Total	100	100	100	100	100	100	100	100		
Percent of all low-wage workers who were heads of:										
households	22	–	25	–	27	–	29	–		
poor households	7	–	8	–	8	–	9	–		

Notes:

[a] Income-to-needs ratio in 1939 excludes income from sources other than wages and salaries.

[b] Data for 1949 are not entirely comparable due to different sampling procedures. Data for all workers and other household members are not available.

[c] Working head-of-households is defined as heads under age 65 in households of size greater than one. Low-wage workers earned less than half of the average private sector wage. Poverty levels for 1939, 1949 and 1959 were formed by extrapolation using the Consumer Price Index. Details may not sum to 100 due to rounding.

[d] Tabulations include all workers aged 17 to 64, whether living alone or in households. The former are classified by the ratio of total personal income to the poverty level for one-person households; workers in households are classified by the ratio of total household income to the size-adjusted poverty level for their household. Comparable data were not gathered in the 1950 census.

Source: Update and compilation of tables from Burkhauser and Finegan (1989) and Burkhauser, Couch, and Glenn (1996).

only 21 percent of low wage workers were household heads and only 8 percent of all low wage workers were poor household heads.All other low-wage workers were either not household heads or did not live in poor households. These numbers remained about the same over the next 10 years.

Hence, between 1939 and 1989 the relationship between earning a low wage and living in poverty became weaker and weaker as low-wage workers increasingly became second or even third workers in non-poor households. Even when they headed households, the labor earnings of other household members, as well as the income from other household sources, usually pushed their household's income above the poverty line. Hence, minimum wage increases that once could be expected to primarily benefit the working poor became less and less likely to do so.

The long term decline in the share of low-wage workers who were heads of households ended in the 1990s. In 1989, 22 percent of low-wage workers were household heads. By 1995 this share had grown to 25 percent. By 2003, it was up to 29 percent, a share not seen since 1959. But importantly, while the share of low-wage workers who are household heads returned to 1959 levels, the share of low-wage workers who are poor household heads did not. In 1959, 18 percent of low-wage workers were poor household heads. In 2003, only 9 percent of low-wage workers were poor household heads. The reason is that in 1959 61 percent of low-wage household heads lived in poor households. In 2003, 31 percent did so.[8]

V. Low-wage Workers and Single Mothers

Table 2 separates the overall increase of 6.8 percentage points (29.1 minus 22.3) in the share of household heads in the low-wage population between 1989 and 2003 into two parts—the percentage point increase caused by the increase in the share of low-wage earning single mothers and the increase in the share of low-wage earners among other types of household heads. The growth is almost equally divided between the two (3.1 and 3.7 percentage points, respectively). The share of low-wage earners who were single mothers rose from 4.9 percent in 1989 to 8.0 percent in 2003. More troubling, Table 3 shows that almost the entire increase in the share of poor low-wage workers who are household heads (1.6 out of 1.8 percentage points) came from the growth in the share of low-wage workers who are single mothers. Their share increased from 2.9 percent in 1989 to 4.5 percent in 2003.

While this increase in the share of poor working household heads who are single mothers is a cause for concern, it must be put into perspective. Table 4 shows that the increase is not caused by an increase in the poverty rate of low-wage single mothers. That rate fell slightly over the period, from 59.5 percent in 1989 to 57.2 percent in 2003. It continues to be the case that a single mother who does not work is far more likely to be in poverty than a single mother who works at a low-wage job (71.9 percent versus 57.2 percent in 2003). Work clearly reduces poverty. The overall poverty rate of all single mothers who work (19.9 percent in 2003), while higher than that of other working heads of households (3.3 percent), is far lower than the poverty rate of single mothers who do not work.

As we will see, it is the dramatic increase in the employment rate of single mothers in the 1990s that is driving their increasing shares in both the low-wage and the higher-wage working populations. Furthermore, as is shown in Table 1, it is still the case that the vast majority of low-wage workers are not household heads (only 29 percent of low-wage workers were household heads in 2003), and an even larger majority are not poor household heads (only

Table 2 Composition of Low-wage Worker Population by Household Type: 1989-2003 (percentages)

Household Type	1989	1995	2000	2003	Change 1989-2003
All Heads	22.3	24.9	26.8	29.1	6.8
Single Mothers	4.9	6.1	6.9	8.0	3.1
Not Single Mothers	17.4	18.8	19.9	21.1	3.7
Not Household Heads	77.7	75.1	73.2	70.9	-6.8
Total	100.0	100.0	100.0	100.0	-

Source: March Current Population Survey, 1990, 1996, 2001, and 2004.

Table 3 Composition of Low-wage Workers Who Are and Are Not Poor Heads of Household: 1989-2003 (percentages)

Household Type	1989	1995	2000	2003	Change 1989-2003
All Poor Heads	7.1	7.6	7.9	8.9	1.8
Single Mothers	2.9	3.2	4.1	4.5	1.6
Not Single Mothers	4.2	4.4	3.8	4.4	0.2
Not Poor Household Heads	92.9	92.3	82.1	91.1	-1.8
Total	100.0	100.0	100.0	100.0	-

Source: March Current Population Survey, 1990, 1996, 2001, and 2004.

Table 4 | Poverty Rates of Low-wage Household Heads: 1989–2003 (percentages)

	1989	1995	2000	2003
All Single Mothers	41.4	38.2	32.1	32.1
Single Mothers Working	19.8	19.6	21.6	19.9
Single Mothers Earning Low Wages	59.5	53.7	60.0	57.2
Single Mothers Not Working	82.7	75.6	72.5	71.9
All Other Household Heads	6.6	7.3	6.4	6.7
Other Household Heads Working	3.5	3.6	3.2	3.3
Other Household Heads Earning Low Wages	24.8	23.5	19.4	21.1
Other Household Heads Not Working	26.4	23.0	19.5	19.5
All Household Heads	10.5	11.2	9.3	10.2
All Household Heads Working	5.0	5.3	5.4	5.5
All Household Heads Earning Low Wages	32.5	30.8	29.9	31.0
All Household Heads Not Working	41.6	35.0	26.5	27.5

Source: March Current Population Survey, 1990, 1996, 2001, and 2004.

8.9 percent of low-wage workers were poor household heads in 2003). Thus, despite the increase in the share of single mothers in the low-wage population in the 1990s, the overwhelming majority of low-wage workers continue to be neither household heads nor poor.

Even though single mothers continue to make up a small percentage of the low-wage worker population, it is nonetheless important to understand why their share in this population has grown since 1989. If it were the case, for instance, that "the jobs available to women leaving welfare are often minimum wage jobs," as Senator Kennedy argues, then perhaps the dramatic increase in the employment rate of single mothers will make minimum wage increases more target-efficient today than was the case when Burkhauser *et al.* (1996) did their evaluation of the 1990 minimum wage increase to $4.35 per hour. But do working single mothers hold predominately minimum wage or even low-wage jobs?

Single mothers play a small but important role in the low-wage labor market, and the low-wage labor market plays a small but important role in the entire United States labor market. To more fully understand what happened to both low-wage single mothers in particular and low-wage workers in general over the 1990s, it is useful to observe what happened to all households over this period.

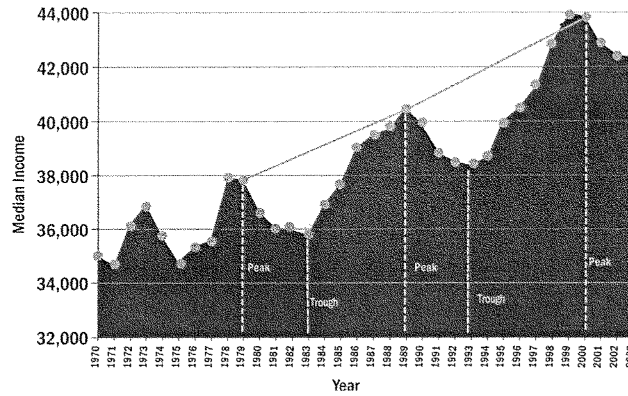
Figure 1 shows how median household income, adjusted for inflation, has changed in the United States since 1970. While there was substantial growth in median household income between 1970 and 2003, median household income fluctuated widely within business cycles over that period. One can roughly divide the last two business cycles of the 20th Century (as defined by peaks in median household income) as 1979–1989 and 1989–2000.

Figure 2 shows how the official U.S. Census poverty rate varied over these same years. Yearly poverty rates closely track the business cycle, rising and falling with median and real income. Figure 2 shows that not only did real median income increase between 1989 and 2000, but poverty rates also fell between these two business cycle peaks.

Burkhauser, Couch, Houtenville, and Rovba (2005) show—using these years as approximations of the 1980s and 1990s business cycles—that economic growth over the 1990s business cycle was more equally shared across the income distribution than was the case over the 1980s business cycle. They found that the income of vulnerable populations that had not shared in the economic growth of the 1980s, including single mothers and those households receiving federal welfare benefits, substantially increased in the 1990s. How does this increase in the economic well-being of single mothers square with the increase in their share of all low-wage workers?

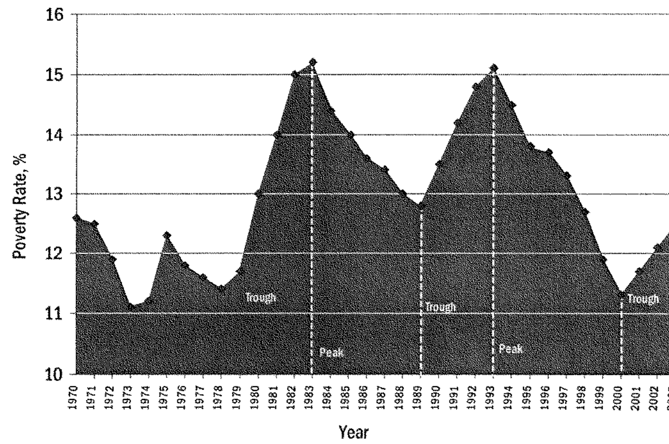
As we saw in Table 2, the share of low-wage workers who were single mothers increased from 4.9 percent to 6.9 percent over the business cycle of the 1990s and continued to increase thereafter, reaching 8.0 percent in 2003. Row 1 of Table 5 reports these values. Row 2 shows that a major part of the reason for the rise in the share of single mothers in this population is that the share of single mothers in the labor force increased dramatically over this period. In 1989 it was 9.4 percent. By 2000 it was 11.8 percent. In 2003, despite three years of slow economic growth, it increased to 12.9 percent. This was not primarily because the share of single mothers in the population increased (row 3) but rather because of the explosion in the employment rate of single mothers over this period, especially after welfare reform in 1996. Row 4 shows that the employment rate of single mothers was 65.9 percent in 1989. It grew to 69.1 percent in 1995 before leaping to 79.9 percent in 2000 and then falling slightly to 76.8 percent in 2003.[9]

Figure 1. Real Median Household Income in the United States: Total Population, 1970–2003 (in 2002 dollars)



Source: U.S. Bureau of the Census based on yearly values from March Current Population Surveys.

Figure 2. Poverty Rate in the United States: Total Population, 1970 to 2003



Source: U.S. Bureau of the Census based on yearly values from March Current Population Surveys.

Table 5 | Composition and Employment of Single Mothers and Low-wage Workers: 1989–2004 (percentages)

Low-wage Worker Groups	1989	1995	2000	2003
Single Mothers in Low-wage Population	4.9	6.1	6.9	8.0
Working Household Heads Who Are Single Mothers	9.4	11.0	11.8	12.9
Single Mothers in the Population	4.1	4.5	4.1	4.8
Employment of Single Mothers	65.9	69.1	79.9	76.8
Working Single Mothers Who Earn Low Wages	23.9	26.3	25.9	24.0
All Workers Who Earn Low Wages	18.3	18.6	16.6	16.7

Source: March Current Population Survey, 1990, 1996, 2001, and 2004.

Importantly, it is the increase in the employment rate of single mothers rather than a dramatic downward shift in their wage earnings that is driving the increase in the share of single mothers in the low-wage population observed in row 1. As can be seen in row 5, while the percentage of single mothers who earned low wages increased between 1989 and 1995, it actually declined slightly thereafter, so that the increase in the share of single mothers holding low-wage jobs only grew from 23.9 percent to 25.9 percent over the 1990s business cycle and was 24.0 percent in 2003. Pro-work welfare reform policies, along with a strong economy, dramatically increased the employment of single mothers and hence their shares in both the low-and non-low-wage population of workers. (See Blank, 2002 for a review of the literature on the impact of 1996 welfare reforms on employment of single mothers.) Finally, as can be seen in row 6, the strong economic growth of the 1990s also reduced the percentage of all workers who earned low-wages over this period (from 18.3 in 1989 to 16.6 percent in 2000), which further increased the importance of single mothers as a share of the remaining workers in low-wage jobs.

In Table 6, we more carefully look at the distribution, of single mothers across the wage distribution and thus more carefully consider the argument that single mothers "often move into minimum wage jobs." In so doing, we once again choose the years 1989, 1995, 2000, and 2003. These are particularly useful years to compare with respect to the expected consequences of a federal minimum wage increase on single mothers. The year 1989 preceded the federal minimum wage increases in 1990, and the year 1995 preceded the federal minimum wage increase of 1996. The years 1989 and 2000 are the peak years of the 1990s business cycle, and 2003 is the most recent year of our data and reflects the decline in the economy since 2000.

Table 6, row 1 shows the dramatic decline in the percentage of single mothers not working over the period but especially following welfare reform in 1996. In 1989, 34.1 percent of single mothers did not work. This fell to 30.9 percent by 1995, a decrease of 3.2 percentage points. Between 1995 and 2000, the non-working single mother population fell by 10.8 percentage points. While some of that gain in jobs was lost as the United States moved into recession, in 2003 the non-working percentage of 23.2 was still far below the 1995 level.

How did the number of single mothers change across the wage distribution over this period? First, the vast majority of single mothers did not and do not hold minimum wage jobs or even low-wage jobs. This was true in 1989, just before the minimum wage increase of 1990, when only 6.2 percent of single mothers held minimum wage jobs of $3.45 per hour and another 9.0 percent held low-wage jobs. The majority, 50.9 percent, held jobs that paid more than 50 percent of the average private sector wage rate. It remained true over all the other years reported in Table 6. But how did the share of all single mothers in each of our wage rate groups change over the period? Between 1989 and 1995 most of the gain in employment of single mothers can be accounted for by an increase in the minimum wage and low-wage categories. But this is not the case between 1995 and 2000. In 1995, just prior to the federal minimum wage increase from $4.25 to $5.15 per hour, 8.1 percent of single mothers held minimum wage jobs of $4.25. In 2000, 9.5 percent of the single mothers held minimum wage jobs of $5.15 per hour. This was an increase of 1.4 percentage points (row 2, column 5). As row 3, column 5 shows, there was another 1.1 percentage point increase in single mothers who held low-wage jobs above $5.15 per hour. But the greatest increase between 1995 and 2000 (row 4, column 5) was in single mothers who held jobs above 50 percent of the average private sector wage rate—8.3 percentage points. So of the 10.8 percentage point gain in employment of single mothers between 1995

Table 6 Percentage of Single Mothers in Various Hourly Wage Rate Categories

Hourly Wage Rate Categories	1989	1995	1989–1995	2000	1995–2000	2003	2000–2003
Not working[a]	34.1	30.9	3.2	20.1	10.8	23.2	+4.1
Earning the federal minimum wage[b]	6.2	8.1	1.9	9.5	1.4	9.0	-0.5
Earning a low wage greater than federal minimum[c]	9.0	9.5	0.5	10.6	1.1	15.0	+4.4
Earning more than a low wage[d]	50.9	51.5	0.6	59.8	8.3	52.8	-7.0

Notes:

a Not working at least 14 weeks last year at an average of 15 hours/week.

b Earning $3.35 or less in 1989, $4.25 or less in 1995, and $5.15 or less in 2000 and 2003.

c The percentages of those "earning the Federal minimum wage" are calculated under the assumption that those earning less than the Federal minimum wage are minimum wage earners. That is, it assumes that all employment is covered under the Federal law. Therefore, the percentage can be interpreted as an upper-bound estimate. A low wage is defined as one-half of the average private sector wage rate.

d Greater than one-half the average private section wage.

Source: March Current Population Survey, 1990, 1996, 2000, and 2004.

and 2000, 8.3 percentage points (77 percent) was accounted for by an increase in single mothers holding jobs paying more than 50 percent of the average private sector hourly wage rate. These gains were caused by rapid economic growth over the period, and welfare reforms that encouraged welfare mothers to work. It is unlikely that increases in the minimum wage in 1996 played any role in helping the vast majority of single mothers, since they already held jobs that paid in excess of the new federal minimum wage. These above minimum wage jobs were earned in the marketplace without government intervention. Between 2000 and 2003, 3.1 percent more single mothers did not work, but the vast majority of jobs gained since 1995 remain those that pay more than the federal minimum.

The employment rate of single mothers increased by 14.0 percentage points over the business cycle of the 1990s. Fully 64 percent (8.9 percentage points) of the increase in the share of single women who work can be accounted for by the increase in jobs that paid more than 50 percent of average wages. Another 12 percent (1.6 percentage points) can be accounted for by the increase in jobs that paid more than the prevailing federal minimum wage but less than 50 percent of the average wage. Only 24 percent (3.3 percentage points) can be accounted for by those who held jobs at the prevailing minimum wage, despite the fact that the minimum wage was increased twice over the period—from $3.35 to $4.25, and to $5.15 per hour.[10]

VI. Who Gains from Minimum Wage Increases?

We examine who gained from the 1996 increase in the federal minimum wage to $5.15 per hour and who will gain from the proposed minimum wage increase to $7.25 per hour by using a sample of workers aged 17 to 64 taken from the March 1996 and the March 2004 CPS. Wage data is used from the outgoing rotation groups, which include information on workers' usual gross weekly earnings in their primary job and the number of hours per week they usually work in that job.[11]

Table 7 compares poor and near-poor households prior to the actual minimum wage increases in 1989, 1995, and 2003.[12] As can be seen from the first two rows, the share of poor or near-poor households that have at least one worker fell slightly between 1989 and 1995, but in 2003 this share was greater than in 1989. Hence, other things being equal, a greater share of poor families could be helped by work-based programs like the minimum wage or the EITC.

As can be seen in the next three rows of Table 7, however, the vast majority of workers who live in or near poverty levels earned wages above the proposed minimum in the year before enactment and hence were not helped by the subsequent minimum wage increases in 1990 and 1996. The story is the same for the latest proposal to raise the federal minimum. While the share of working poor households that could be helped increased substantially between 1989 and 2003 (from 16.9 percent of working poor households in 1989 to 26.2 percent in 1995, and to 29.3 percent in 2003), a minimum wage increase to $7.25 per hour will still provide no help for the vast majority of the working poor. The same is true if we look at those who are either in or near poverty.

As the final three rows of Table 7 show, the median wage of the highest earner in a poor or near-poor household was well above the proposed minimum, hence putting the highest earner in these households out of the reach of the minimum wage increase. As the next row shows, the median hours of work of these highest earners is well below full-time employment (2,000 hours per year). Increases in their hours of work, rather than a minimum wage hike, would have most effectively increased the

Table 7 Characteristics of Low-income Households: 1989, 1995, and 2003 (percentages)

	1989 Income-to-Needs Ratios		1995 Income-to-Needs Ratios		2003 Income-to-Needs Ratios	
Household Types	Less than 1 (poverty)	0 to 1.49 (in or near poverty)	Less than 1 (poverty)	0 to 1.49 (in or near poverty)	Less than 1 (poverty)	0 to 1.49 (in or near poverty)
All Households						
No workers	25.7	17.4	26.1	19.7	22.9	17.8
One or more workers	74.3	82.6	73.9	80.3	77.1	82.2
All Working Households						
No minimum wage worker[a]	83.1	84.3	73.8	71.7	70.7	71.6
One minimum wage worker	16.3	14.9	21.7	24.6	27.8	26.9
Two or more minimum wage workers	0.6	0.8	4.5	3.7	1.5	1.5
All Non-Minimum Wage Working Households						
Median wages	$5.50	$6.00	$7.00	$7.11	$9.25	$9.60
Median annual[b]	1,520	1,820	1,680	1,800	1,720	1,872
Median household size	2	2	3	3	4	3

Notes:

[a] A minimum wage worker is defined as making between $3.00 and $4.25 in 1989, $4.00 and $5.14 in 1995, and between $5.00 and $7.24 in 2003.

[b] Highest paid workers in household.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 1996 and March 2004. Estimates for 1989 from Burkhauser, Couch, and Glenn (1996).

wage earnings of the majority of the working poor. The median number of hours worked per year has increased over the three calendar years shown in Table 7, but so has the average household size of the working poor.

Table 8 presents the same information as Table 7, but focuses solely on poor or near-poor single-mother households.[11] Between 1995 and 2003, the share of poor single-mother households containing a worker increased dramatically from 71.7 percent to 78.3 percent. But even among this subgroup of the working poor, the majority was not helped by the 1996 federal minimum wage increase and will not be helped by the proposed federal minimum wage increase to $7.25 per hour. Only 24.2 percent of poor working single-mother households were helped by the 1996 federal minimum wage increase, and while a greater share of poor working single-mother households will be helped by a federal minimum wage hike to $7.25 per hour (39.6 percent), the majority will not be helped. In contrast, an increase in the EITC would help virtually all of these households. The same is the case if we expand our population to those in or near poverty.

Table 9 provides a closer examination of the relationship between workers' wage rates and the income-to-needs ratio of their households prior to a simulated increase in the federal minimum wage from $4.25 per hour to $5.15 per hour in 1995. Each row shows the wage distribution of workers living in a household with a given income-to-needs ratio.

The last row of Table 9 shows the percentage of all workers in each wage category. An increase in the minimum wage to $5.15 that did not change hours worked would increase the wages of the 8.2 percent of all workers in 1995 who earned between $4.25 and $5.15 per hour. We also assume the 0.4 percent of workers who earned between $4.00 and $4.24 are covered by the federal minimum wage and would be helped. We assume those reporting wage rates below $4.00 per hour are not in federal minimum wage covered employment and would not be helped. Thus, we estimate that the federal minimum wage increase to $5.15 per hour in 1996 only affected 8.6 percent of all workers.

As Table 9 shows, a greater share of workers living in lower income households was helped by this minimum wage increase. That is, there is certainly a connection between low wages and low income—a greater share of those workers who live in poor households held jobs that paid between $4.00 and $5.15 per hour than did workers living in higher income-to-needs households. However, there is substantial variance in the wage earnings of workers within each of our income-to-need categories because most households have more than one worker and many have other sources of income. Hence, even in poor working households (those whose income-to-needs ratio is less than 1), only 27.3 percent of workers (1.4 percent earning between $4.00 and $4.24 and 25.9 percent earning between $4.25 and $5.14) were helped by the minimum wage increase to $5.15 per hour in 1996.

Moreover, as the next to last column shows, the share of all workers who actually live in poor (4.6 percent) or between poor and near-poor households (5.8 percent) is small relative to workers in households that live at three times the poverty line, or $46,707 for a family of four in 1995 (64.1 percent). As can be seen in the last column, we estimate that only a small minority of those helped by the last federal minimum wage increase in 1996 lived in poverty (14.7 percent) or near poverty (15.5 percent). The majority of minimum wage workers (69.8 percent) lived in households well above the poverty line and 40.2 percent lived in households whose income was three times the poverty line or greater.

Table 10 repeats the same exercise done in Table 9 but focuses on working single mothers. As can be seen in the last row of Table 10, the

Table 8 Characteristics of Low-income Single Mothers in 1995 and 2003

	1995 Income-to-Needs Ratios		2003 Income-to-Needs Ratios	
	Less than 1 (poverty)	0 to 1.49 (in or near poverty)	Less than 1 (poverty)	0 to 1.49 (in or near poverty)
All Households				
No workers	28.3	22.7	21.7	16.5
One or more workers	71.7	77.3	78.3	83.5
All Working Households				
No minimum wage worker[a]	75.8	78.2	62.5	63.1
One minimum wage worker	21.3	19.4	37.4	34.7
Two or more minimum wage workers	2.9	2.4	0.2	2.2

Notes:

[a] A minimum wage worker is defined as making between $3.00 and $4.25 in 1989, $4.00 and $5.14 in 1995, and $5.00 and $7.24 in 2003.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 1996 and March 2004.

Table 9 Wage Distribution of All Workers by Income-to-Needs Ratio of Their Household in 1995

	Hourly Wage Categories[a]								
Income-to-Needs Ratio	$0.01 to $3.99	$4.00 to $4.24	$4.24 to $5.14	$5.15 to $7.99	$8.00 to $3.99	$0.01 to $14.99	Total	Percent of All Workers	Percent of Workers Earning More Than $3.99 and Less Than $5.15
Less than 1.00	3.7	1.4	25.9	44.2	21.1	3.7	100.0	4.6	14.7
1.00 to 1.24	5.0	0.8	26.9	36.9	26.6	3.9	100.0	2.5	8.1
1.25 to 1.49	4.1	1.3	17.9	43.7	29.4	3.7	100.0	3.3	7.4
1.50 to 1.99	3.0	0.2	11.4	41.3	37.0	7.1	100.0	7.4	10.1
2.00 to 2.99	2.6	0.3	9.0	29.4	47.0	11.9	100.0	18.1	19.5
3.00 or above	1.1	0.3	5.1	15.1	39.4	39.0	100.0	64.1	40.2
Whole Category Share[b]	1.8	0.4	8.2	22.5	39.1	28.1	100.0	100.0	100.0

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour on their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 1996 dollars.

[b] Share of all workers with wage earnings in each category.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 1996.

Table 10 Wage Distribution of Working Single Mothers by Income-to-Needs Ratio of Their Household in 1995

	Hourly Wage Categories[a]								
Income-to-Needs Ratio	$0.01 to $3.99	$4.00 to $4.24	$4.24 to $5.14	$5.15 to $7.99	$8.00 to $14.99	$15.00 and Over	Total	Percent of All Workers	Percent of Workers Earning More Than $3.99 and Less Than $5.15
Less than 1.00	4.5	1.3	21.1	51.8	16.9	4.4	100.0	23.7	55.6
1.00 to 1.24	0.0	0.0	6.3	51.9	33.2	8.6	100.0	7.6	5.0
1.25 to 1.49	0.0	0.0	15.7	55.3	26.7	2.3	100.0	10.4	17.2
1.50 to 1.99	0.0	0.0	4.0	33.5	49.4	9.0	100.0	15.3	6.5
2.00 to 2.99	3.4	0.0	5.6	15.7	64.3	11.0	100.0	20.5	12.1
3.00 or above	0.2	0.0	1.5	9.4	46.5	42.4	100.0	22.5	3.6
Whole Category Share[b]	2.4	0.3	9.2	32.4	40.5	15.1	100.0	100.0	100.0

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour on their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 1996 dollars.

[b] Share of all workers with wage earnings in each category.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 1996.

share of working single mothers helped by a minimum wage increase to $5.15 per hour (9.5 percent) is only slightly higher than that of the entire population (8.6 percent). The share of poor single mothers who earn wages between $4.00 and $5.15 is also somewhat greater at all income-to-needs levels. Nonetheless, while the percentage of working single mothers continues to be much higher at lower income-to-needs levels, only 22.4 percent of working single mothers were helped by the last minimum wage increase. However, a much greater share of those single mothers who were helped lived in poor (55.6 percent) and between poor or near-poor households (22.2 percent) (last column) because a greater percentage of all working single mothers live in poor (23.7 percent) and between poor and near-poor households (18.0 percent) (next to last column).

In Table 11, we estimate the yearly cost of increased wages to producers because of a minimum wage increase to $5.15 per hour and how the gains to workers were distributed. But to the extent that markets are perfectly competitive, the costs of higher minimum wages will eventually result in higher prices to consumers for the goods and services they purchase.[14]

Assuming no employment losses or reductions in hours worked, the total cost of the minimum wage hike was $4.79 billion (column 1). While the average benefit per household was approximately the same (column 2) across the income distribution, the share going to the groups was not. As can be seen in column 3, the vast majority of the benefits went to workers in households with income-to-needs ratios greater than 2 (60.6 percent), with 40.1 percent of benefits going to those from households whose incomes were three times the poverty line or greater. Only 14.2 percent of benefits went to workers from poor families. Likewise, the overall gains to vulnerable populations were small—while 4.3 percent of the gains of the 1996 minimum wage hike went to single mother households, only 2.2 percent went to poor single mother households. African-Americans received 15.5 percent of the gains but only 2.9 percent of the benefits accrued to poor African-American workers.[15]

These estimates assume that hours worked and employment status did not change after the 1996 minimum wage hike. But minimum wage increases will cause some workers to lose their jobs. Burkhauser, Couch, and Wittenburg (2000) find that young African-Americans, young non-high school graduates, and teenagers are most likely to lose their jobs as a result of a minimum wage hike. They estimated that a 10 percent minimum wage hike results in an 8.5 percent decline in the employment rate of African-Americans aged 16 to 24, a 5.7 percent reduction in teenage employment (aged 16 to 19), and an 8.5 percent decline in non-high school graduate employment (aged 20 to 24). Moreover, work by Neumark, Schweitzer, and Wascher (2004, 2005) shows that minimum wage increases hurt low-wage workers by reducing their employment and their hours worked, and by increasing the proportion of families that are poor or near-poor. The minimum wage hike was therefore probably even less target-efficient than we estimate.

Our estimates of the benefits of the 1996 minimum wage hike are thus likely upper-bound estimates because we assume that workers' employment status and hours worked remained constant following the policy change. Even using these optimistic assumptions, we conclude that the 1996 minimum wage hike did little to improve the economic well-being of poor households. Most workers from poor households were not helped by the 1996 minimum wage increase because they already earned more than $5.15 per hour. Furthermore, we find that the vast majority of workers who were helped lived in higher income households, so the minimum wage increase was also not target-efficient. These findings are consistent with studies (Burkhauser and Finegan, 1989; Burkhauser, Couch and Glenn, 1996;

Table 11 Distribution of Benefits Across Income-to-Needs Categories from a Federal Minimum Wage Increase from $4.25 to $5.15, Based on the 1995 Wage Distribution

			Distribution of Benefits (percentage)			
Income-to-Needs Ratio	Total Benefits (billions of dollars)	Mean Benefit per Household (dollars)	Total	African-Americans	Non-African Americans	Single-Female Headed Households
Less than 1.00	0.68	$527	14.2	2.9	11.3	2.2
1.00 to 1.24	0.39	630	8.2	0.8	7.4	0.4
1.25 to 1.49	0.33	485	6.8	1.1	5.7	0.6
1.50 to 1.99	0.49	532	10.2	3.0	7.2	0.2
2.00 to 2.99	0.98	600	20.5	3.3	17.2	0.7
3.00 or above	1.92	566	40.1	4.4	35.7	0.2
All Households	4.79	538	100.0	15.5	84.5	4.3

Note:

[a] Simulation assumes hours worked in 1995 remained the same under the new minimum wage and those earning below $4.00 per hour were employed in a job not covered by minimum wage rules.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 1996.

Burkhauser, Couch, and Wittenburg, 1996; and Burkhauser and Harrison, 1999) of previous minimum wage hikes that suggest that even under the assumption of no adverse employment effects the minimum wage is a poor mechanism for helping the working poor.

As Tables 12, 13 and 14 will show, the proposed Kennedy minimum wage increase from $5.15 to $7.25 will be even less effective in targeting the working poor. While it will do slightly better with respect to the percentage of the working poor whose wages will be increased relative to the last minimum wage increase in 1996, once again the vast majority of the working poor will still not be helped by this increase.

Table 12 uses 2003 wage rates and income distributions to estimate the type of workers who would be helped by increasing the federal minimum wage to $7.25 per hour. The percentage of all workers helped (those earning between $5.00 and $7.24) is 9.7 percent. Once again, a greater share of workers in low income-to-needs households earned this amount. But among poor workers only 31.1 percent did so. So only 31.1 percent of all low-wage workers would be helped by a minimum wage increase to $7.25 per hour. This is somewhat higher than the 27.3 percent who were helped by the last minimum wage increase. However, because an even smaller percentage of all workers lived in poor or near-poor households in 2003 than in 1995 (next to last column) a greater percentage of the workers who are helped by the minimum wage do not live in or near poverty. Only 25.2 percent of those helped by the minimum wage lived in poor or near-poor households in 2003 relative to 30.2 percent in 1995. In contrast, 44.8 percent live in households with incomes three or more times the poverty line ($56,430 for a family of four in 2003). Hence, the target-efficiency of this minimum wage increase is even worse than in 1996.

The dramatic increase in the employment of single mothers has also changed the distribution of wages for that population, but, as Table 13 shows, a great majority of single mothers continue to earn wages well above the proposed minimum wage of $7.25 per hour. Only 13.3 percent of single mothers would be helped by such an increase. While this is larger than the 9.5 percent of single mothers who gained from the last minimum wage increase, it is still a very small share of working single mothers. It is also the case that the share of single mothers earning between $5.00 and $7.25 per hour in lower income-to-needs households is larger than richer single working class mothers. Among poor working mothers, the share who will be helped by a $7.25 per hour minimum wage is 37.8 percent. This is considerably larger than the 22.4 percent of poor working mothers who were helped by the last minimum wage increase, but it is still a minority of all working poor mothers. Furthermore, the dramatic increase in the income of working mothers has reduced the share of all working mothers who live in or near poverty. Thus, the share of working mothers helped by this minimum wage increase who live in poor (18.5 percent) and between poor and near-poor households (13.2 percent) is even smaller than in 1995. As a result, the share of single mothers helped by this minimum wage increase who live in poverty (53.4 percent) or near poverty (27.2 percent) is not much different from the 1996 increase.

Table 14 shows that the total cost of the proposed minimum wage increase will be $18.36 billion. But only 12.7 percent will go to the working poor, an even smaller share than the 14.2 percent from the last round of minimum wage increases. The dramatic increases in the employment of African-Americans and single mothers between 1995 and 2002 will mean that these populations will receive higher shares of the gains, 21.1 percent for African-Americans versus 15.5 percent last time and 8.4 percent for single mothers compared to 4.3 percent last time. But poor African-Americans will only receive 3.7 percent and poor single mothers 3.8 percent of the benefits.

Table 12 Wage Distribution of All Workers by Income-to-Needs Ratio of Their Household in 2003

	Hourly Wage Categories[a]								
Income-to-Needs Ratio	$0.01 to $4.99	$5.00 to $5.14	$5.15 to $7.24	$7.25 to $8.99	$9.00 to $14.99	$15.00 and Over	Total	Percent of All Workers	Percent of Workers Earning More Than $4.99 and Less Than $7.25
Less than 1.00	4.5	1.2	29.9	24.7	29.0	10.7	100.0	4.2	13.4
1.00 to 1.24	2.7	1.5	22.5	23.2	35.7	14.5	100.0	2.1	5.3
1.25 to 1.49	1.8	1.0	23.8	20.4	38.9	14.1	100.0	2.6	6.5
1.50 to 1.99	2.6	0.6	15.3	21.1	44.5	15.9	100.0	6.4	10.5
2.00 to 2.99	1.7	0.4	11.6	14.3	47.3	24.8	100.0	15.7	19.4
3.00 or above	1.3	0.3	6.0	6.6	28.0	57.8	100.0	69.1	44.8
Whole Category Share[b]	1.6	0.4	9.3	10.2	32.6	45.9	100.0	100.0	100.0

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour at their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 2003 dollars.

[b] Share of all workers with wage earnings in each category.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 2003.

Table 13 Wage Distribution of Working Single Mothers by Income-to-Needs Ratio of Their Household in 2003

	Hourly Wage Categories[a]								
Income-to-Needs Ratio	$0.01 to $4.99	$5.00 to $5.14	$5.15 to $7.24	$7.25 to $8.99	$9.00 to $14.99	$15.00 and Over	Total	Percent of All Workers	Percent of Workers Earning More Than $4.99 and Less Than $7.25
Less than 1.00	4.4	1.3	36.5	29.0	23.3	5.5	100.0	18.5	53.4
1.00 to 1.24	0.5	1.9	26.9	28.7	36.6	5.5	100.0	6.8	15.0
1.25 to 1.49	2.9	0.0	24.8	22.1	39.4	10.9	100.0	6.5	12.2
1.50 to 1.99	3.6	0.0	3.2	17.4	64.1	11.8	100.0	14.3	3.4
2.00 to 2.99	1.8	0.0	6.2	6.9	59.2	25.8	100.0	22.9	10.9
3.00 or above	0.9	0.0	2.1	6.0	25.9	67.6	100.0	31.0	5.1
Whole Category Share[b]	2.2	0.4	12.8	14.7	40.1	29.9	100.0	100.0	100.0

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour at their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 2003 dollars.

[b] Share of all workers with wage earnings in each category.

Source Estimated from the outgoing rotation group of the Current Population Survey, March 2003.

Table 14 Distribution of Benefits Across Income-to-Needs Categories from a Federal Minimum Wage Increase from $5.15 to $7.25, Based on the 2003 Wage Distribution

			Distribution of Benefits (percentage)			
Income-to-Needs Ratio	Total Benefits (billions of dollars)	Mean Benefit per Household (dollars)	Total	African-Americans	Non-African Americans	Single-Female Headed Households
Less than 1.00	2.33	$1,110	12.7	3.7	9.0	3.8
1.00 to 1.24	1.16	1,392	6.3	1.7	4.6	1.3
1.25 to 1.49	1.34	1,298	7.3	2.3	5.0	1.1
1.50 to 1.99	1.91	1,151	10.4	2.6	7.8	1.0
2.00 to 2.99	3.95	1,289	21.5	3.8	17.7	0.8
3.00 or above	7.67	1,090	41.8	7.0	34.8	0.4
All Households	18.36	1,167	100.0	21.1	78.9	8.4

Note:

[a] Simulation assumes hours worked in 2003 remained the same under the new minimum wage and those earning below $5.00 per hour were employed in a job not covered by minimum wage rules.

Source: Estimated from the outgoing rotation group of the Current Population Survey, March 2003.

VII. Conclusions

Minimum wage increases have become a weaker and weaker policy tool for increasing the household income of the working poor. While a somewhat higher percentage of the working poor will be helped by the proposed Federal minimum wage increase to $7.25 per hour than were helped by the last Federal minimum wage increase in 1996, the percentage helped is still small—31.1 vs. 27.3 percent. Furthermore, the target-efficiency of this increase is worse, as an even larger percentage of those who are helped do not live in or even near poverty—74.8 vs. 69.8 percent. This is true despite the increase in the share of low-wage workers who were household heads between 1989 and 2003. While the post-1996 rise in the labor force participation rates of single mothers increased the share of the gains they will receive from a minimum wage hike, even among this more vulnerable population, the majority of working poor mothers will not gain from the proposed $7.25 minimum wage increase. So even the growth in the share of single mothers in the low-wage population has not changed the downward spiral in the target-efficiency of minimum wage increases. Neither will the vast majority of the working poor be helped by this latest proposed increase.

Even the small gains that we find among the working poor probably overestimate the actual gains of the proposed legislation to the working poor since, for purposes of this paper, we assume that minimum wage increases will have no negative employment effects. In fact, the preponderance of evidence suggests that teenagers, young African-Americans and young high school dropouts will experience reductions in their employment rates when minimum wages are increased.

An effective policy alternative to the minimum wage is the Earned Income Tax Credit (EITC). The federal EITC program provides a tax credit of 40 cents for every dollar in wages earned by a worker in a low-income family with two or more children, and a credit of 34 cents per dollar earned for a worker in a poor family with one child. Thus, workers living in poor, one-child families and earning the current federal minimum of $5.15 per hour have an effective minimum wage of $6.90 per hour, and workers living in poor families with two or more children have an effective minimum wage of $7.21 per hour. In some states federal EITC programs are supplemented by state programs and provide even greater benefits to the working poor. (See Burkhauser and Sabia, 2004 for a discussion of the New York EITC supplement in the context of minimum wage policy.)

In contrast to the minimum wage, which is based solely on a worker's wage rate, the EITC is based on family income. Thus, a worker earning $7.25 or more per hour and living in a poor family would not benefit from the proposed minimum wage hike, but would be eligible for EITC benefits. Most poor or near-poor households—especially single mothers—would benefit from the EITC, while only a minority would gain from a minimum wage hike. Moreover, because EITC costs are not borne by employers, there will be no reduction in employers' demand for low-skill workers, as is the case with a minimum wage increase.

The minimum wage makes little sense in 21st Century labor markets, where multiple workers living in a single household is the rule rather than the exception and being a low-wage worker is only fuzzily connected to living in poverty. Policymakers should focus on expansions in the EITC rather than increases in the minimum wage to ensure that those who work hard and play by the rules do not live in poverty. The fact that welfare reforms have increased the share of single mothers in the low-wage population has not changed this reality.

Appendix Table 1A | Wage Distribution of All Workers by the Income-to-Needs Ratio of Their Household, 2003[a]

	Hourly Wage Categories[a]								
Income-to-Needs Ratio	$0.01 to $4.99	$5.00 to $5.14	$5.15 to $6.24	$6.25 to $8.99	$9.00 to $14.99	$15.00 and Over	Total	Percent of All Workers	Percent of Workers Earning More Than $4.99 and Less Than $6.25
Less than 1.00	4.4	1.1	11.8	42.2	29.6	11.0	100.0	4.4	14.2
1.00 to 1.24	2.7	1.7	9.8	36.8	36.5	12.6	100.0	2.3	6.6
1.25 to 1.49	1.8	1.1	8.2	33.6	39.6	15.8	100.0	2.5	5.9
1.50 to 1.99	2.9	0.5	6.0	29.3	45.2	16.1	100.0	6.8	11.1
2.00 to 2.99	1.6	0.4	4.5	20.6	47.3	25.6	100.0	16.1	19.8
3.00 or above	1.3	0.3	2.2	10.3	27.8	58.2	100.0	67.9	42.4
Whole Category Share[b]	1.7	0.4	3.6	15.8	32.7	45.9	100.0	100.0	100.0

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour at their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 2003 dollars.

[b] Share of all workers with wage earnings in each category.

Source: Estimated from outside rotation group of the March 2004 Current Population Survey.

Appendix Table 2A | Wage Distribution of Single Mother Households by the Income-to-Needs Ratio of Their Household, 2003[a]

	Hourly Wage Categories[a]								
Income-to-Needs Ratio	$0.01 to $4.99	$5.00 to $5.14	$5.15 to $6.24	$6.25 to $8.99	$9.00 to $14.99	$15.00 and Over	Total	Percent of All Workers	Percent of Workers Earning More Than $4.99 and Less Than $6.25
Less than 1.00	4.2	1.2	16.7	48.7	23.7	5.4	100.0	19.1	65.2
1.00 to 1.24	2.2	1.7	8.5	42.4	39.6	5.6	100.0	7.5	14.6
1.25 to 1.49	3.2	0.0	7.9	36.6	41.3	10.9	100.0	6.1	9.1
1.50 to 1.99	4.1	0.0	0.7	19.0	61.9	14.3	100.0	14.8	1.9
2.00 to 2.99	1.9	0.0	2.1	11.2	59.3	25.6	100.0	22.5	9.1
3.00 or above	0.6	0.0	0.0	8.0	24.4	67.1	100.0	30.1	0.0
Whole Category Share[b]	2.4	0.4	4.9	22.4	39.8	30.1	100.0	100.0	100.0

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour at their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 2003 dollars.

[b] Share of all workers with wage earnings in each category.

Source: Estimated from outside rotation group of the March 2004 Current Population Survey.

Appendix Table 3A Distribution of Benefits Across Income-to-Needs Categories from a Federal Minimum Wage Increase from $5.15 to $6.25, Based on the 2003 Wage Distribution

			Distribution of Benefits (percentage)			
Income-to-Needs Ratio	Total Benefits (billions of dollars)	Mean Benefit per Household (dollars)	Total	African-Americans	Non-African Americans	Single-Female Headed Households
Less than 1.00	$0.61	$661	13.0	3.9	9.1	3.2
1.00 to 1.24	0.35	818	7.5	2.8	4.7	1.5
1.25 to 1.49	0.29	777	6.3	1.9	4.4	0.8
1.50 to 1.99	0.53	742	11.4	3.2	8.2	0.1
2.00 to 2.99	1.02	803	21.9	3.6	18.3	0.8
3.00 or above	1.86	698	39.8	8.5	31.3	0.0
All Households	4.67	722	100.0	23.9	76.1	6.4

Notes:

[a] Hourly wage rates are based on a direct question concerning earnings per hour at their current primary job. All income data used to calculate income-to-needs ratios come from retrospective information from the previous year because that is the period for which it is reported. Wages are in 2003 dollars.

[b] Share of all workers with wage earnings in each category.

Source: Estimated from outside rotation group of the March 2004 Current Population Survey.

Appendix Table 4A | Proportion of All Low-Wage Household Heads, by Household Size, 1989-2003

Household Size	Year			
	1989	1995	2000	2003
1	7.2	7.3	8.3	7.7
2	24.1	24.0	23.3	22.3
3	23.8	23.4	22.4	23.0
4	23.7	23.2	22.7	23.9
5+	21.3	22.0	23.4	23.1

Source: Estimated from the outgoing rotation group of the March 2004 Current Population Survey.

Appendix Table 4B | Proportion of Low-Wage Household Heads Living in Poverty, by Household Size, 1989-2003

Household Size	Year			
	1989	1995	2000	2003
1	16.8	14.7	15.6	14.4
2	19.3	19.5	19.7	20.1
3	18.4	19.5	20.4	20.2
4	20.4	18.9	19.9	22.8
5+	21.1	27.4	24.4	23.6

Source: Estimated from the outgoing rotation group of the March 2004 Current Population Survey.

Endnotes

1. The EITC was enacted in 1975 as a means of offsetting Social Security payroll taxes paid by workers in poor households. However, in 1975, the EITC offered a relatively small maximum benefit of $400 with a 10 percent credit rate. Important changes in the EITC in 1993 raised the 1994 credit rate to 26.3 percent for a working family with one child, with a maximum benefit level of $2,030 and established a series of further increases through 1996. In 2003, these parameters were 34 percent and $2,547, respectively.

2. In 2003, 12 states had minimum wage levels higher than the Federal minimum wage of $5.15 per hour. These higher state minimum wages are imbedded in our analysis on the impact of increasing the Federal minimum wage, since workers' wage rates will already reflect their state's minimum wage. That is, we are estimating the impact of an increase in the current Federal minimum wage, given the current structure of state minimum wages.

3. While it is true that the Federal minimum wage is now at an historic low relative to the average private sector wage, the total "income floor" provided by both the minimum wage and the Earned Income Tax Credit (EITC) remains relatively generous. That is, Federal policy not necessarily become more "stingy," but rather has shifted away from minimum wage hikes and toward expansions in the EITC as a mechanism for increasing the earnings of low-skill laborers.

4. The AFL-CIO has consistently argued that "[f]airness to the working poor demands that the federal minimum wage should not be less than 50 percent of average annual earnings of non-supervisory workers and production workers in the non-farm private economy" (see, for example, AFL-CIO Reviews the Issues, "Restore the Floor ... It's Time to Raise the Minimum Wage," Report No. 86: October 1995).

5. For data presented from 1939 through 1979, the Decennial Census is used to calculate wage data. Thereafter, wages are calculated using retrospective data from the Current Population Survey (CPS). A fuller discussion of the use of the Census and CPS data appears in Burkhauser, Couch, and Glenn (1996).

6. For 1939, the income-to-needs ratio is given by the ratio of the household's wage or salary earnings to its poverty level because data were not available on non-wage or non-salary income.

7. Furthermore, work by Neumark, Schweitzer, and Wascher (2004) finds that low-wage workers are harmed by minimum wage increases.

8. In our income calculations, we are using CPS-based pre-tax, post-transfer increase. This is consistent with how official U.S. Census poverty measures are calculated. But this measure ignores the income that working household heads receive from EITC benefits. Including EITC benefits would lower the share of poor working heads, especially of working single mothers in poverty.

9. Individuals are defined as working if they worked at least 14 hours per week and at least 15 weeks per year in the previous year.

10. Note that we use cross-sectional data to measure gross changes in the distribution of all single mothers who held no jobs or held jobs at various wage rates across these years. We are not directly measuring the wage distribution of those who left the welfare rolls over time. To do so, one would need longitudinal data that would show the actual hourly wage rates of single mothers who worked after leaving the welfare rolls. But our analysis does show that increases in the share of higher wage jobs account for the majority of the gross increases in the share of single mothers who hold jobs across these years.

11. Workers paid by the hour directly report their hourly wage rate. As argued in Burkhauser, Couch, and Glenn (1996) and Burkhauser and Harrison (1999), these data are better suited for simulating the effects of a rise in the minimum wage because they do not require workers to recall earnings and hours from the previous year.

12. Wages calculated in Tables 7–14 come from estimates using the outgoing rotation group of the CPS.

13. Data on median annual hours worked and median wage rates for working single mothers in poverty that earn more than the proposed minimum wage ($5.15 in 1995 and $7.25 in 2003) are not presented due to small sample sizes.

14. In this analysis we do not attempt to measure the general equilibrium effects of minimum wage

increases on the poor. Macurdy and McIntyre (2001) argue that because poor families are likely to have a smaller share of their income come from employment and are more likely to purchase goods and services that are produced by low skilled labor, a disproportionate amount of the cost of minimum wage increases will be borne by the poor.

15. The share of benefits from a minimum wage hike that accrue to workers in poor (non-poor) households is not necessarily equivalent to the share of minimum wage workers in poor (non-poor) households. For example, in 1995, 14.7 percent of minimum wage workers lived in poor households (see the first row of the final column in Table 9). However, as the first row of the third column in Table 11 shows, workers in poor families gained only 14.2 percent of the benefits from the minimum wage hike. The difference in these percentages arises because benefits are calculated based upon hours worked per year, weeks worked per year, and the difference between the proposed minimum wage and the worker's current wage. Thus, if workers in poor households work fewer hours, fewer weeks, or have wage rates closer to the proposed minimum wage than workers in non-poor households, we would expect the share of benefits they receive to be less than the percentage of workers they represent.

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Tax Incentives for Business in Response to a Minimum Wage Increase
Responses to Questions for the Record Prepared for:
U.S. Senate Finance Committee
Dirksen Senate Office Building, Room 215
Washington, DC

January 30, 2007

Professor Joseph J. Sabia
Department of Housing & Consumer Economics
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Question #1 From Senator Cantwell:

[Back in 1998, voters across Washington chose to raise our minimum wage to the highest in the nation and our economy continues to thrive. Today, Washington state still holds the highest minimum wage at $7.93 – and it's indexed to inflation. At the same time, according to the 2005 Small Business Index, Washington is ranked fourth nationwide as the "friendliest policy environment for entrepreneurship." Florida's minimum wage is also higher than the federal minimum and is ranked sixth...] Clearly, Washington and Florida are examples of states with higher minimum wages that have maintained competitiveness for small firms—and presumably maintain work opportunities for low-skilled workers. How do you reconcile what is going on in Washington or Florida with your testimony today (that an increase has resulted in job loss and opportunities)? What makes my state different?

Answer to Question #1:

Neither Washington nor Florida is immune from the laws of supply and demand. When the minimum wage is raised, there is little incentive for profit-seeking firms to hire workers whose hourly production is valued at less than the new minimum. For example, the current minimum wage in Washington is $7.93 per hour. A low-skilled Washingtonian who produces goods and services that are valued at less than $7.93 per hour would not be hired by a state employer who wishes to make a profit on that worker's labor.

It is certainly true that in robust economies with tight labor markets there is increasing demand for all types of workers, including those with the least skills. It would be wonderful if that described all parts of the U.S. at all times, but that is not reality. Rather,

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economic booms are followed by economic downturns, and the state of Washington is no exception.

Minimum wage increases do not affect the employment of the vast majority of workers, either in Washington or nationwide because most workers earn well above the proposed minimum wage. According to 2004 Census data, over 90 percent of U.S. workers earned wage rates higher than $7.25 per hour. Hence in good times, overall economic growth rates can be positive even in states like Washington (or Florida) that modestly increase their minimum wages. But correlation is not causation. Minimum wage increases did not cause this economic growth. It is much more likely that strong economic growth offset the negative impact of the increase in the minimum wage on low-skilled workers, and that their employment would have been even greater had the minimum wage increase not been implemented. When economic growth slows, and with it the demand for workers, the employment bite caused by automatic cost of living increases in Washington's minimum wage is likely to lower the employment of low-skilled workers even more.

It is quite unlikely that the 2005 Small Business Survival Index ranked Washington as the fourth "friendliest policy environment for entrepreneurship" because of the state's high minimum wage. Rather, the presence of the state's strong economic growth can more likely be attributed to the growing skill-level in the state population and to the absence of state personal income taxes and corporate income taxes.

Labor economists who have studied the effects of minimum wage increases have not argued that minimum wage hikes cause a collapse in state or national economies. Rather, we have argued that the least-skilled workers—teenagers, high school dropouts, less-educated single mothers, and young racial minorities—will experience the strongest adverse employment effects from minimum wage hikes. Thus, it is important to look not simply at the aggregate economic growth rate as an indicator of the impact of minimum wage hikes, but to dig more deeply and examine the economic outcomes of the most vulnerable workers.

When we examine the effects of minimum wage increases on these low-skilled populations, the evidence is clear. Economists David Neumark and William Wascher recently reviewed over 90 empirical studies in the economics literature and concluded that the evidence is "overwhelming" that less-skilled workers are most adversely affected by minimum wage increases.[1] My own recent work finds that a 10 percent increase in the minimum wage reduces employment among single mothers without a high school diploma by 6.0 percent and reduces annual hours worked by 9.9 percent.[2]

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But even if one wishes to ignore all of the empirical evidence that shows significant adverse employment effects from minimum wage hikes, the minimum wage is still a very poor antipoverty tool both in Washington and nationally. Economist David Macpherson found that less than 15 percent of beneficiaries of Washington's 1999-2000 minimum wage increase were single household heads or sole earners in married families with children. Less than 20 percent were poor. Most beneficiaries were teenagers or young adults in household with incomes well over the poverty line.

In a forthcoming peer-reviewed publication, my colleague, Richard Burkhauser of Cornell University, and I simulate the effects of a federal minimum wage hike from $5.15 per hour to $7.25 per hour to see who would benefit.[3] We gave the minimum wage its best chance to help the poor by assuming that the hike would have no effect on employment. Even in this "best case scenario," we found that just 13 percent of the benefits would go to workers in poor households; two-thirds of the benefits would go to those living in households with incomes at least two times the poverty line, and over 40 percent of the benefits would go to workers in households with incomes over three times the poverty line. For a household of four in 2006, that corresponds to household income greater than $60,000. Poor African Americans would receive only 3.7 percent of the benefits and poor single mothers only 3.8 percent. And again, these are the best-case estimates, assuming that no one loses her job or has her hours reduced as a result of a minimum wage increase. Hence, the paltry benefits we report accruing to the working poor may, in fact, be overstated.

Follow-Up Question From Senator Cantwell:

Where in the discussion are we talking about the difference between states or between workforces? To say that one state's economy is fairing well with a higher-than-federal minimum wage, but yet another state's economy isn't, seems to ignore other economic and demographic issues. How do you account for other factors that play into the health of a state's economy such as a general level of educational attainment?

Answer to Follow-up Question:

This is an excellent question. Ideally, researchers would prefer to have a true experiment in which individuals and firms are randomly assigned to economies with different mandated minimum wage levels. If this were possible, one could be confident that any differences in employment levels among low-skilled workers in these economies could be attributed to differences in minimum wage policy. Unfortunately, a randomized control experiment has not yet been conducted. Hence, labor economists have sought to exploit state-level "natural experiments" in minimum wage policy, and to control for as many factors as we can to isolate the effect of the minimum wage on employment.

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Economists have generally compared employment trends within states that have adopted minimum wage policies to employment trends in states that have not adopted minimum wage policies, while controlling for state-specific changes in demographic characteristics, average wages, economic growth, prime-age male unemployment, and other policies. Controlling for these other state-specific factors has become standard in the peer-reviewed economics literature on the minimum wage. Failure to control for these factors can lead to misleading conclusions. For example, an unpublished study by the Fiscal Policies Institute suggests that higher minimum wages may actually increase retail and small business employment. But this study does not control for the many other factors that could affect both minimum wage levels and employment outcomes. In a more careful analysis that controlled for the health of state economy, demographic characteristics, and average wage rates, I found that a 10 percent increase in the minimum wage was associated with a 1 percent reduction in retail and small business employment.[4]

But I would agree that investment in the education of our citizens is the best long-run solution to low wages. The vast majority of Americans earn wages well above the minimum wage not because government orders employers to pay such wages or even because union power dictates such wages, as most workers do not belong to unions. The reason U.S. workers' wages are high is because our jobs skills and training command such wage premiums.

Question #1 From Senator Hatch:

Do you agree with Dr. Bernstein that the evidence from research published in the 1990s showed that the effects of a minimum wage are slight? Do you believe there is a consensus among economists that an increase in the minimum wage will not affect employment?

Answer to Question #1:

I disagree with Dr. Bernstein's assertion. An increase in the minimum wage has substantial adverse employment effects for low-skilled workers. Public opinion surveys conducted in 1996 reveal that the median labor economist reported that a 10 percent increase in the minimum wage would result in a 1 percent decline in the employment of teenagers.[5]

Recently, economists David Neumark and William Wascher published a paper for the National Bureau of Economic Research in which they critically review nearly 90 empirical articles that have been published since the early 1990s on the effects of the

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minimum wage.[1] They conclude that the evidence is "overwhelming" that the least-skilled workers experience the strongest disemployment effects from minimum wage increases.[6] Those workers most harmed are disproportionately young African Americans[7], workers without a high school diploma, and single mothers.[2]

The estimated adverse employment effects are not trivial in magnitude. For example, using Census data from 1989 to 2004, my research finds that single mothers without a high school degree experience significant adverse economic consequences from minimum wage increases. For these low-skilled single mothers, a 10 percent increase in the minimum wage is associated with a 6.0 percent decline in employment, a 7.9 percent reduction in usual weekly hours worked, an 8.3 percent reduction in annual weeks worked, and a 9.9 percent reduction in annual hours worked. While minimum wage hikes do increase wages for employed less-educated single mothers, the adverse employment and hours effects of minimum wage increases dominate, resulting in a -0.88 wage income elasticity. This means that a 10 percent increase in the minimum wage reduces these single mothers' wage income by 8.8 percent. Burkhauser et al. (1996) find that a 10 percent increase in the minimum wage results in an 8.5 percent decline in employment of African Americans aged 16-24, a 5.7 percent reduction in teenage employment, and an 8.5 percent decline in non-high school graduate employment among those aged 20-24.[7] Neumark (2007) finds adverse employment effects of similar magnitudes for less educated male racial minorities.[8]

Question #2 From Senator Hatch:

Can you tell us what you think about the consensus of the economics profession concerning the effect of an effective minimum wage on the jobs created in this country? Who are the winners and losers in such a policy?

Answer to Question #2:

The effect of the minimum wage on overall employment is likely fairly slight because the vast majority (over 90 percent) of U.S. workers earn wages higher than the proposed federal minimum. The minimum wage has its biggest bite among low-skilled workers: teenagers, high school dropouts, less-educated single mothers, and young adults entering the labor market for the first time. Among these low-skilled populations, minimum wage increases are likely to have the most significant adverse employment effects.

Contrary to popular belief, the working poor are not "winners" of increases in the minimum wage. Eighty-seven (87) percent of beneficiaries from a federal minimum wage increase are not poor. Nearly two-thirds are workers in households with incomes

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over two times greater than the poverty line, and over 40 percent are workers in households with incomes over three times greater than the poverty line. Less than 5 percent are poor single mothers.

Thus, most low-skilled workers do not gain from minimum wage increases, and many lose. Neumark and Wascher (2002) find that many low-skilled workers are moved into poverty as a result of adverse employment and hours effects from minimum wage hikes.[9] I find that a 10 percent increase in the minimum wage reduces wage income among less-educated single mothers by 8.8 percent. Moreover, much of the employment loss occurs in sectors of the economy in which there is a high concentration of low-skilled workers: the retail sector and small businesses.

The winners from minimum wage increases are low-skilled workers who keep their jobs and do not have their hours substantially reduced. These workers are generally teenagers or young adults, mostly second or third earners in households with incomes two or three times the poverty line.

Taken together, raising the minimum wage is an ineffective, and often counterproductive antipoverty policy that hurts precisely the people proponents claim to want to help.

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[1] Neumark, David and William Wascher. 2006. "Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research," National Bureau of Economic Research Paper No. 12663.

[2] Sabia, Joseph J. 2007. "The Effect of Minimum Wage Increases on Single Mothers' Employment, Hours, and Wage Income" Working Paper, University of Georgia.

[3] Burkhauser, Richard V. and Joseph J. Sabia (2007). "The Effectiveness of Minimum Wages in Reducing Poverty: Past, Present, and Future," *Contemporary Economic Policy* (Forthcoming).

[4] Sabia, Joseph J. (2006). "The Effect of Minimum Wage Increases on Retail and Small Businesses," Employment Policies Institute.

[5] Fuchs, Victor R., Alan B. Krueger, and James M. Poterba. 1998. "Economists' Views about Parameters, Values, and Policies: Survey Results in Labor and Public Economics," *Journal of Economic Literature*, 36: 1387-1425.

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[6] See, for example, Campolieti et al., 2006; Campolieti et al., 2005; Burkhauser, Couch, and Wittenburg, 2000; Deere, Murphy, and Welch, 1995; Neumark, 2001; Neumark and Wascher, 1992, 2002; Neumark et al., 2004; Partridge and Partridge, 1999; Currie and Fallick, 1996; Williams, 1993; Couch and Wittenburg, 2001; Sabia, 2006.

[7] Burkhauser, Richard V., Kenneth A. Couch, and David C. Wittenburg. 2000. "Who Minimum Wage Increases Bite: An Analysis Using Monthly Data from the SIPP and CPS," *Southern Economic Journal* 67 (1): 16-40.

[8] Neumark, David (2007). "Minimum Wage Increases in the Post-Welfare Reform Era," Employment Policies Institute.

[9] Neumark, David and William Wascher. 2002. "Do Minimum Wages Fight Poverty?," *Economic Inquiry* 40(3): 315-333.

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SENATOR KEN SALAZAR
FINANCE COMMITTEE HEARING
JANUARY 10, 2007
"TAX INCENTIVES FOR BUSINESS IN RESPONSE TO A MINIMUM WAGE INCREASE"
OPENING STATEMENT

Thank you, Mr. Chairman. I would first like to offer my sincere gratitude to Chairman Baucus and Senator Grassley for their fine leadership of this Committee, and for the kindness and good will they and their staffs have shown me as new member of this prestigious panel.

It is a true honor for me to be welcomed as a member of the Senate Finance Committee in just my third year as U.S. Senator from Colorado. I am grateful to Majority Leader Reid and Chairman Baucus for providing me with this incredible opportunity, and I am eager to begin what will surely be a busy year as we work to address the many vital issues that fall within this Committee's jurisdiction.

I look forward to working with my esteemed colleagues—both Republican and Democrat—in the spirit of bipartisanship and comity that the Finance Committee is known for. I also look forward to working to meet the needs of our nation's working families, businesses, students, patients, seniors, and so many others.

I would also like to thank both the Chairman and Ranking Member for calling this important hearing today. We have a lot of work ahead of us in the 110th Congress, and there is no better place to start than with the small business owners and their employees that serve as the engine of our nation's economy.

An examination of an increase in the minimum wage and how it will impact our small businesses is particularly timely for me and my constituents in Colorado. On November 7, Coloradans voted to amend our state's Constitution to provide for an increase in the minimum wage from $5.15 to $6.85 per hour. That increase took effect on January 1.

During the run-up to Election Day, Coloradans fiercely debated many of the questions we will discuss today – how to meet the needs of the working poor, how to uphold the value and dignity of work, and how to ensure the continued prosperity of our businesses. Colorado voters made up their minds, and we have now joined several other states as a laboratory for a higher minimum wage and its impact on both workers and businesses.

As Coloradans begin to undertake this change, I am happy to be part of the discussion in the Finance Committee about whether we need to provide my state's businesses and others across the nation with additional tax incentives in response to an increase in the

federal minimum wage. And I am eager to hear the testimony of today's witnesses, including business owners who live in states with higher minimum wages.

It is worth pointing out that I have some personal experience with the challenges small businesses face. My wife, Hope, owned and operated a Dairy Queen, which she sold in 2006. While Hope is a shrewd businesswoman who made good decisions, her experience demonstrated to me why many businesses struggle to turn a profit while working to retain good employees. I am interested to hear more from our panel about these struggles and what we can do to help businesses address them.

Thank you again, Chairman Baucus and Senator Grassley, for holding today's hearing, and for the opportunity to be part of this distinguished Committee.

COMMUNICATIONS

STATEMENT
of
The American Health Care Association

Before
the
Senate Finance Committee:
"Tax Incentives for Business in Response to a Minimum Wage Increase"
January 10, 2007
215 Dirksen Building

The American Health Care Association (AHCA) appreciates the opportunity to submit testimony to the Senate Finance Committee regarding the impact of a minimum wage increase on our profession, our talented and dedicated workforce, and, ultimately, our efforts to continue providing quality care to more than 2.5 million of America's most vulnerable frail, elderly and people with disabilities.

AHCA is a non-profit federation of affiliated state health care organizations, together representing nearly 11,000 non-profit and for-profit, nursing facilities, assisted living residences, sub-acute centers, and homes for persons with developmental disabilities. At the core of AHCA's commitment to the continued, ongoing provision of quality care is our dedicated workforce. While most of our workforce is compensated at levels above the proposed minimum wage, long term care providers do employ workers at or very close to the proposed minimum wage level.

According to 2005 data from the Bureau of Labor Statistics, the national median hourly wage for direct-care workers in skilled nursing facilities was well over the current minimum wage and over the proposed minimum wage. Specifically, the national median hourly wage for nurse aides was $10.07; $9.25 for home health aides; and $9.07 for personal care aides in 2005.

The cost impact on nursing facilities from a minimum wage increase, we believe, will vary significantly by state and by urban and rural differentiation. Facilities located in urban areas and in states with state minimum wage rates substantially above the federal minimum wage rate will be least affected, while facilities located in rural areas and in states with no or low state minimum wage rates will be affected more substantially and more adversely.

Despite the documented success on the quality improvement front through our participation in the collaborative Advancing Excellence in America's Nursing Home Campaign, the federal Nursing Home Quality Initiative (NHQI), and our profession's own Quality First program, our immediate concern is the need to sustain our progress in the face of a growing demand for care among the leading edge of baby-boom retirees. As *Congressional Quarterly* recently found nearly 70 percent of those turning 65 this year will eventually require long term care during their lifetime, promoting and passing sound fiscal policies designed to strengthen our workforce and promote the continued improvement in seniors' care quality deserves to be a top national priority.

The high demand for long term care workers is already documented by the federal government as well as by AHCA/NCAL. A recent study by the Department of Health and Human Services (HHS) and U.S. Department of Labor (DoL) estimates the U.S. will need between 5.7 million to 6.5 million nurses, nurse aides, and home health and personal care workers by 2050 to care for the 27 million Americans who will require long term care – up over 100 percent from the 13 million requiring long term care in 2000.

In addition, a recent AHCA study examining staff vacancy rates in our nation's nursing homes found approximately 52,000 Certified Nursing Assistants (CNAs) are needed immediately – just to meet existing demand for care. As CNAs perform almost 80 percent of direct patient care tasks, they are a vital part of assuring quality objectives within any given facility are achieved.

Prior to a discussion of possible tax code changes or recalibrating Medicare and Medicaid reimbursement formulas, a closer look at our profession's reimbursement structure - which provides a baseline understanding of how sensitive long term care is to slight variations and changes in our costs - is in order.

AHCA members operate their facilities within an environment in which the nation's oldest, highest acuity patients are often discharged from the hospital needing extensive care and rehabilitation. We often provide critical care services for stroke patients, ventilator-dependant patients, cancer patients and others needing intensive around-the-clock care.

Our patients and residents require assistance help with the most basic daily aspects of life, including bathing, dressing and eating. Caring for these patients and residents is complicated by the fact that most are dependent upon government payment for their care. Nearly 70 percent of nursing home patients rely on Medicaid while another 10 percent rely upon Medicare. Thus, 80 percent of our resident population rely on federal or state payments for their care needs.

Many of the remaining 20 percent will ultimately deplete their financial resources and move onto the Medicaid rolls. Only a small portion of our residents rely on private payment for their entire course of care. It is easy to see, therefore, that our profession faces a unique and challenging business environment. We are obligated to continue providing quality care for our patients, yet we cannot increase prices in response to an increase in our labor costs – as is the case in almost every other economic sector.

For the record, Mr. Chairman, AHCA supports an increase in the minimum wage. However, we also support corollary efforts to ensure any increase in labor costs does not result in compromising the rising care quality standards occurring in long term care facilities nationwide.

Such efforts, we believe, could be achieved through tax relief initiatives, through Medicare and Medicaid reimbursement adjustments, or both.

Because the primary focus of this hearing is tax relief proposals that would offset increased labor costs from a minimum wage increase, we will first outline recommended changes to federal fiscal policy, and then examine issues pertaining to reimbursement.

Tax Relief and the Minimum Wage

The Committee's efforts to identify and enact tax relief in conjunction with a minimum wage increase are much appreciated. It recognizes the long term care profession is dealing with real world labor cost increases with implications to both patients and the ongoing stability of our sector – which, again, is vital to the continued success of our quality improvement programs. We encourage Congress to provide targeted tax relief that will have the positive effect of mitigating the labor cost increases.

Specifically, the Committee should consider establishing a statutory 10-year recovery period for qualified long term facilities' improvement property placed in service after date of enactment. Long term care facilities would be defined as nursing facilities, assisted living facilities, residential care facilities, intermediate care facilities for the mentally retarded, and similar facilities.

Qualified long term care facilities' improvement property is any improvement or expansion to a building that is residential commercial real property designed to provide housing and healthcare for our nation's elderly and disabled. The improvement must be placed in service more than three years after the date the building was first placed in service.

This provision would be analogous to the provisions in current law shortening the recovery period for restaurant property and lease-hold build outs. Under present law a taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization.

The cost of residential commercial real property is recovered using the straight-line method of depreciation and a recovery period of 27 years.

If an improvement constitutes an addition or improvement to residential commercial real property already placed in service, the improvement is depreciated using the straight-line method over a 27-year recovery period, beginning in the month the addition or improvement was placed in service (§§168(b)(3), (c),(d)(2), and (i)(6)).

The existing 27-year life is an unfortunate element of the tax code that deters investment in improvements to nursing and long term care facilities, because improvements and renovations are needed more often than every 27 years. The current tax law therefore penalizes improvements and renovations that would provide those under our care safer, more modern and more efficient facilities. Greater capital investment increases worker productivity and improves service to the patients and residents who are our consumers. The tax savings derived from a shorter depreciable life will improve cash flow, promote renovation and improvements of aging physical plants, and assist in absorbing the cost of an increase in the minimum wage.

Congress can significantly improve the tax treatment for investing in better, safer, and more modern nursing and long-term care facilities by shortening the recovery period to 10 years - a recovery period that is better aligned with the true economic life of renovations and improvements to structures.

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Recalibrating Medicare and Medicaid Reimbursements

Although Medicare reimbursement rates do have a component that accounts for wage increases in our profession, there is a significant time lag between rising labor rates and increases in reimbursement rates.

Historically, when an event such as the minimum wage increase causes a ripple of wage increases, that data is not reflected in reimbursement rates for as long as two years. Through the Centers for Medicare and Medicaid Services (CMS), AHCA believes expediting the update of wage rates would help alleviate this problem.

Further, skilled nursing facilities and other long term care facilities do not have their own wage index through Medicare. Rather, they share a wage index with hospitals. This grouping of dissimilar care settings into a single index causes staff recruiting difficulties for our profession.

CMS, to our disappointment, has not yet developed a separate skilled nursing and long-term care index, and an increase in the minimum wage would exacerbate the substantial challenges already faced by our profession in regard to staffing and retention because shifting wage rates impact hospitals and our profession in an entirely different manner. Again, this has the potential to create problems with our ongoing efforts to improve patient care quality, and is a prime reason why nursing facilities and long-term care facilities require their own index.

Through Medicaid, conversely, an increase in the federal minimum wage is not coordinated with state Medicaid reimbursements. States are not obligated to adjust their reimbursement under Medicaid while the federal government is mandating higher wage costs through an increase in the minimum wage.

Obviously, this has the potential to create a still greater cost squeeze on facilities than is already the case, and places increased pressure on already strained state Medicaid programs and budgets.

An obvious and disturbing case in point regarding to our profession's cost squeeze is an analysis of the nation's Medicaid financing system from the national accounting firm, BDO Seidman. The study projected states would cumulatively under fund the actual cost of providing quality long term care by $4.5 billion for 2006. The study further showed the average shortfall in Medicaid nursing home reimbursement will be $13.10 in 2006 - a 4 percent increase from 2004, and a 45 percent increase from 1999.

Still another ongoing problem in the context of federal reimbursement policy was on display just yesterday, when the Medicare Payment Advisory Commission (MedPAC) recommended against providing an inflation adjustment in Medicare funding for skilled nursing facility (SNF) care in the year ahead. An adjustment is critical to the health of our sector and well being of our patients for a variety of reasons.

Beyond the fact Medicare is increasingly called upon to subsidize Medicaid under funding, rising labor costs, out of control litigation-related costs and escalating drug prices all serve to drive up the cost of delivering quality care. The failure of MedPAC to account for these cost increases is inadvisable and

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illogical – especially as we are here today discussing how an increase in the minimum wage will, in many cases, could negatively impact our ability to provide quality patient care.

With so much upward cost pressure already on long term care, we urge Congress in the strongest possible way to include provisions in the minimum wage bill to account for the increased labor costs mandated by the federal minimum wage increase.

In conclusion, AHCA commends the Committee for studying tax relief measures that will help solve the dilemma created by a minimum wage increase, and AHCA is committed to working with this Committee, and with the Congress, in a collegial and constructive manner to ensure we have the capacity to continue providing quality long term care today and in the decades to come.

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Below is proposed legislative text for accelerated depreciation of long term care facilities. This tax relief would be an appropriate means of mitigating the impact of increased labor costs imposed on the industry by a minimum wage increase. In the 109th Congress, this provision was included in Long Term Care Quality and Modernization Act of 2006 (Sec. 301 of H.R. 6199 and Sec. 301 of S. 2815.) AHCA expects similar legislation to be introduced in the 110th Congress.

10-YEAR RECOVERY PERIOD FOR QUALIFIED LONG-TERM CARE IMPROVEMENT PROPERTY.

(a) In General- Subparagraph (D) of section 168(e)(3) of the Internal Revenue Code of 1986 (relating to 10-year property) is amended by striking `and' at the end of clause (i), by striking the period at the end of clause (ii) and inserting `, and', and by adding at the end the following new clause:

`(iii) any qualified long-term care improvement property.'.

(b) Qualified Long-Term Care Improvement Property- Section 168(e) of the Internal Revenue Code of 1986 (relating to classification of property) is amended by adding at the end the following new paragraph:

`(8) QUALIFIED LONG-TERM CARE IMPROVEMENT PROPERTY- The term `qualified long-term care improvement property' means any section 1250 property which is an improvement to a building if--

`(A) such improvement is placed in service more than 3 years after the date such building was first placed in service, and

`(B) such building is, or is a part of, a nursing facility, assisted living facility, residential care facility, intermediate care facility for the mentally retarded, or similar facility designed to provide housing and healthcare for the elderly and disabled.'.

(c) Alternative System- The table contained in section 168(g)(3)(B) of the Internal Revenue Code of 1986 (relating to special rule for certain property assigned to classes) is amended by inserting after the item relating to subparagraph (D)(ii) the following:

`(D)(iii) 10'.

(d) Effective Date- The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act.

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Comments Submitted to the Senate Finance Committee

Hearing on Tax Incentives for Businesses in Response to a Minimum Wage Increase

January 10, 2007

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Finance Committee's January 10, 2007, hearing titled "Tax Incentives for Businesses in Response to a Minimum Wage Increase." In particular, ASPPA supports the Savings Incentive Match Plan for Employees of Small Employers Cafeteria Plan Act of 2005 (SIMPLE Cafeteria Plan),[1] introduced in the 109th Congress, which would enable small businesses to purchase employer-provided health insurance and other benefits with pre-tax dollars.

ASPPA is a national organization of approximately 6,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA unusual insight into current practical applications of ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-sponsored retirement plan system.

Background

There are 46 million uninsured Americans, and over 60 percent of these Americans work for (or are family members of) small businesses. Only 42 percent of businesses with less than 50 employees offer health insurance to their employees, and these workers are three times as likely to be without health insurance as workers in large firms.

Of the 25 million Americans who own a small business, 10 million are primarily self-employed (*i.e.*, have no common-law employees). Small business owners in recent years have typically seen a 20 percent increase in their health insurance costs. According to a

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[1] On April 6, 2006, Senators Olympia Snowe (R-ME), Kit Bond (R-MO) and Jeff Bingaman (D-NM) introduced the "SIMPLE Cafeteria Plan Act of 2005" (S. 723) that would, among other things, allow small employers to set up SIMPLE cafeteria plans for their employees.

survey by the National Federation of Independent Business, the most critical issue for small businesses is their cost and availability of health insurance.

Opening Cafeteria Plans to Small Business Owners

Currently, employer-sponsored IRC Section 125 plans (cafeteria plans) allow participants to pay for health insurance coverage, dependent care costs (IRC Section 129) and out-of-pocket medical expenses (IRC Section 105) on a pre-tax basis. Cafeteria plans allow employees to obtain and pay for, on a pre-tax basis, employee benefits, such as deductibles, co-pays, drugs, braces, eyeglasses and other health care expenses, as well as dependent care, adoption expenses, and group term life insurance. These important tax breaks currently allow many Americans, who would not otherwise have the opportunity, to obtain health coverage. The tax savings can be as much as 30 percent. An example of saving on a pre-tax basis is the dramatic success of employees saving for their retirement through 401(k) plans.

While employees of big businesses, mid-size employers, non-profits, schools, universities and the federal government appreciate the valuable benefits provided by cafeteria plans, small business owners are presently precluded from participating in cafeteria plans. Under current law, cafeteria plans can be utilized by common-law employees but not by:

- Sole proprietors.
- Partners in a partnership.
- S-corporation 2% or more shareholders (and by attribution, their family members).
- Limited liability corporation and partnership members.

Their inability to participate is due to language in IRC Section 125 that limits participation to "employees" without further language allowing self-employed individuals to participate. As a result, without the small business owner able to participate in cafeteria plans, employees of small businesses are seldom offered this valuable benefit.

SIMPLE Cafeteria Plans

ASPPA encourages the Senate to incorporate the SIMPLE Cafeteria Plan into the minimum wage legislation, the Small Business and Work Opportunity Tax Act of 2007 (S. 2).[2] The SIMPLE Cafeteria Plan would enable small business owners and their employees to purchase employer-provided health insurance and other benefits with pre-tax dollars.

The SIMPLE Cafeteria Plan amends the tax code so that owners of small businesses, including partners and S-corporation stockholders who own more than 2 percent of the stock, could participate in a cafeteria plan if they worked for the business. As stated previously, such persons are excluded under current tax law because they are not

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[2] S. 2 was passed by the Senate Finance Committee on January 17, 2007, and contains an increase to the minimum wage and various small business tax provisions.

"employees" (even if working full-time) but rather are self-employed individuals and thus ineligible by definition.

The SIMPLE Cafeteria Plan, modeled after the effective 1996 SIMPLE Pension Plan, would benefit small businesses that are currently unable to satisfy the existing nondiscrimination cafeteria plan rules due to their size. The SIMPLE Cafeteria Plan would provide a safe harbor for satisfying the nondiscrimination rules, in exchange for making a required annual contribution of 2 percent or a matching contribution of 3 percent to their employees' accounts, for health insurance and other employee benefits. These plans are highly valued by employees for their pre-tax allowance.

The measure would also permit the carryover of unused flexible spending accounts funds, as well as simplifying the administration of, and increasing the amounts contributed to, dependent care accounts for employers of all sizes. It would also allow cafeteria plans to provide for long-term care insurance as an optional employee benefit. It also eliminates the despised "use it or lose it" rule, which causes employees' salaries to revert back to their employer if they do not spend as much money on medical care as they had anticipated. In effect, instead of being rewarded for being healthy (as is true with the Health Savings Accounts), the current rule causes employees to forfeit their dollars to their employers because they did not need to spend their cafeteria plan dollars on health care. This discourages full participation by many employees, despite the tax benefits.

The SIMPLE Cafeteria Plan is important for all employees, but in particular for small business employees. It will make it easier for small business employees to be covered by a cafeteria plan the same way that employees for mid- and large-size businesses are currently covered. The result is that small business employees will be able to select and budget for the benefits that they need most. Even more important, by giving *all* small business owners an incentive to sponsor cafeteria plans, the legislation will now be helping small business employees afford health insurance. Furthermore, *all* employers should be provided with equal access to benefits under the tax code.

We have attached S. 723 to these comments for your consideration.

Recommendation

ASPPA recommends that the Senate incorporate the SIMPLE Cafeteria Plan (S. 723 from the 109th Congress) in the Small Business and Work Opportunity Tax Act of 2007 (S. 2). The SIMPLE Cafeteria Plan would enable small business owners and their employees to purchase employer-provided health insurance and other benefits with pre-tax dollars.

Small business employees need greater access to cost-effective health care. Congress understands how vital health care is for Americans and has incentivized individuals to undertake as much of the burden of providing for their health care as possible. The SIMPLE Cafeteria Plan does this—small business employees would now be able to join their counterparts in mid-size and large businesses and save for health care and other employee benefits in a tax-advantaged manner.

II

109TH CONGRESS
1ST SESSION

S. 723

To amend the Internal Revenue Code of 1986 to allow small businesses to set up simple cafeteria plans to provide nontaxable employee benefits to their employees, to make changes in the requirements for cafeteria plans, flexible spending accounts, and benefits provided under such plans or accounts, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 6, 2005

Ms. SNOWE (for herself, Mr. BOND, and Mr. BINGAMAN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1986 to allow small businesses to set up simple cafeteria plans to provide nontaxable employee benefits to their employees, to make changes in the requirements for cafeteria plans, flexible spending accounts, and benefits provided under such plans or accounts, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 (a) SHORT TITLE.—This Act may be cited as the
5 "SIMPLE Cafeteria Plan Act of 2005".

1 (b) AMENDMENT OF 1986 CODE.—Except as other-
2 wise expressly provided, whenever in this Act an amend-
3 ment or repeal is expressed in terms of an amendment
4 to, or repeal of, a section or other provision, the reference
5 shall be considered to be made to a section or other provi-
6 sion of the Internal Revenue Code of 1986.

7 **SEC. 2. ESTABLISHMENT OF SIMPLE CAFETERIA PLANS**
8 **FOR SMALL BUSINESSES.**

9 (a) IN GENERAL.—Section 125 (relating to cafeteria
10 plans) is amended by redesignating subsections (h) and
11 (i) as subsections (i) and (j), respectively, and by inserting
12 after subsection (g) the following new subsection:

13 "(h) SIMPLE CAFETERIA PLANS FOR SMALL BUSI-
14 NESSES.—

15 "(1) IN GENERAL.—An eligible employer main-
16 taining a simple cafeteria plan with respect to which
17 the requirements of this subsection are met for any
18 year shall be treated as meeting any applicable non-
19 discrimination requirement with respect to benefits
20 provided under the plan during such year.

21 "(2) SIMPLE CAFETERIA PLAN.—For purposes
22 of this subsection, the term 'simple cafeteria plan'
23 means a cafeteria plan—

24 "(A) which is established and maintained
25 by an eligible employer, and

1 "(B) with respect to which the contribution
2 requirements of paragraph (3), and the eligi-
3 bility and participation requirements of para-
4 graph (4), are met.
5 "(3) CONTRIBUTIONS REQUIREMENTS.—
6 "(A) IN GENERAL.—The requirements of
7 this paragraph are met if, under the plan—
8 "(i) the employer makes matching
9 contributions on behalf of each employee
10 who is eligible to participate in the plan
11 and who is not a highly compensated or
12 key employee in an amount equal to the
13 elective plan contributions of the employee
14 to the plan to the extent the employee's
15 elective plan contributions do not exceed 3
16 percent of the employee's compensation, or
17 "(ii) the employer is required, without
18 regard to whether an employee makes any
19 elective plan contribution, to make a con-
20 tribution to the plan on behalf of each em-
21 ployee who is not a highly compensated or
22 key employee and who is eligible to partici-
23 pate in the plan in an amount equal to at
24 least 2 percent of the employee's com-
25 pensation.

1 "(B) MATCHING CONTRIBUTIONS ON BE-
2 HALF OF HIGHLY COMPENSATED AND KEY EM-
3 PLOYEES.—The requirements of subparagraph
4 (A)(i) shall not be treated as met if, under the
5 plan, the rate of matching contribution with re-
6 spect to any elective plan contribution of a
7 highly compensated or key employee at any rate
8 of contribution is greater than that with respect
9 to an employee who is not a highly compensated
10 or key employee.
11 "(C) SPECIAL RULES.—
12 "(i) TIME FOR MAKING CONTRIBU-
13 TIONS.—An employer shall not be treated
14 as failing to meet the requirements of this
15 paragraph with respect to any elective plan
16 contributions of any compensation, or em-
17 ployer contributions required under this
18 paragraph with respect to any compensa-
19 tion, if such contributions are made no
20 later than the 15th day of the month fol-
21 lowing the last day of the calendar quarter
22 which includes the date of payment of the
23 compensation.
24 "(ii) FORM OF CONTRIBUTIONS.—Em-
25 ployer contributions required under this

1 paragraph may be made either to the plan
2 to provide benefits offered under the plan
3 or to any person as payment for providing
4 benefits offered under the plan.

5 "(iii) ADDITIONAL CONTRIBUTIONS.—
6 Subject to subparagraph (B), nothing in
7 this paragraph shall be treated as prohib-
8 iting an employer from making contribu-
9 tions to the plan in addition to contribu-
10 tions required under subparagraph (A).

11 "(D) DEFINITIONS.—For purposes of this
12 paragraph—

13 "(i) ELECTIVE PLAN CONTRIBU-
14 TION.—The term 'elective plan contribu-
15 tion' means any amount which is contrib-
16 uted at the election of the employee and
17 which is not includible in gross income by
18 reason of this section.

19 "(ii) HIGHLY COMPENSATED EM-
20 PLOYEE.—The term 'highly compensated
21 employee' has the meaning given such term
22 by section 414(q).

23 "(iii) KEY EMPLOYEE.—The term
24 'key employee' has the meaning given such
25 term by section 416(i).

1 "(4) MINIMUM ELIGIBILITY AND PARTICIPA-
2 TION REQUIREMENTS.—
3 "(A) IN GENERAL.—The requirements of
4 this paragraph shall be treated as met with re-
5 spect to any year if, under the plan—
6 "(i) all employees who had at least
7 1,000 hours of service for the preceding
8 plan year are eligible to participate, and
9 "(ii) each employee eligible to partici-
10 pate in the plan may, subject to terms and
11 conditions applicable to all participants,
12 elect any benefit available under the plan.
13 "(B) CERTAIN EMPLOYEES MAY BE EX-
14 CLUDED.—For purposes of subparagraph
15 (A)(i), an employer may elect to exclude under
16 the plan employees—
17 "(i) who have less than 1 year of serv-
18 ice with the employer as of any day during
19 the plan year,
20 "(ii) who have not attained the age of
21 21 before the close of a plan year,
22 "(iii) who are covered under an agree-
23 ment which the Secretary of Labor finds to
24 be a collective bargaining agreement if
25 there is evidence that the benefits covered

1 under the cafeteria plan were the subject
2 of good faith bargaining between employee
3 representatives and the employer, or
4 "(iv) who are described in section
5 410(b)(3)(C) (relating to nonresident
6 aliens working outside the United States).
7 A plan may provide a shorter period of service
8 or younger age for purposes of clause (i) or (ii).
9 "(5) ELIGIBLE EMPLOYER.—For purposes of
10 this subsection—
11 "(A) IN GENERAL.—The term 'eligible em-
12 ployer' means, with respect to any year, any
13 employer if such employer employed an average
14 of 100 or fewer employees on business days
15 during either of the 2 preceding years. For pur-
16 poses of this subparagraph, a year may only be
17 taken into account if the employer was in exist-
18 ence throughout the year.
19 "(B) EMPLOYERS NOT IN EXISTENCE DUR-
20 ING PRECEDING YEAR.—If an employer was not
21 in existence throughout the preceding year, the
22 determination under subparagraph (A) shall be
23 based on the average number of employees that
24 it is reasonably expected such employer will em-
25 ploy on business days in the current year.

1 "(C) GROWING EMPLOYERS RETAIN
2 TREATMENT AS SMALL EMPLOYER.—If—
3 "(i) an employer was an eligible em-
4 ployer for any year (a 'qualified year'), and
5 "(ii) such employer establishes a sim-
6 ple cafeteria plan for its employees for
7 such year, then, notwithstanding the fact
8 the employer fails to meet the require-
9 ments of subparagraph (A) for any subse-
10 quent year, such employer shall be treated
11 as an eligible employer for such subsequent
12 year with respect to employees (whether or
13 not employees during a qualified year) of
14 any trade or business which was covered
15 by the plan during any qualified year. This
16 subparagraph shall cease to apply if the
17 employer employs an average of 200 more
18 employees on business days during any
19 year preceding any such subsequent year.
20 "(D) SPECIAL RULES.—The rules of sec-
21 tion 220(c)(4)(D) shall apply for purposes of
22 this paragraph.
23 "(6) APPLICABLE NONDISCRIMINATION RE-
24 QUIREMENT.—For purposes of this subsection, the
25 term 'applicable nondiscrimination requirement'

1 means any requirement under subsection (b) of this
2 section, section 79(d), section 105(h), or paragraph
3 (2), (3), (4), or (8) of section 129(d).

4 "(7) COMPENSATION.—The term 'compensa-
5 tion' has the meaning given such term by section
6 414(s)."

7 (b) EFFECTIVE DATE.—The amendments made by
8 this section shall apply to years beginning after December
9 31, 2004.

10 **SEC. 3. MODIFICATIONS OF RULES APPLICABLE TO CAFE-**
11 **TERIA PLANS.**

12 (a) APPLICATION TO SELF-EMPLOYED INDIVID-
13 UALS.—

14 (1) IN GENERAL.—Section 125(d) (defining caf-
15 eteria plan) is amended by adding at the end the fol-
16 lowing new paragraph:

17 "(3) EMPLOYEE TO INCLUDE SELF-EM-
18 PLOYED.—

19 "(A) IN GENERAL.—The term 'employee'
20 includes an individual who is an employee with-
21 in the meaning of section 401(c)(1) (relating to
22 self-employed individuals).

23 "(B) LIMITATION.—The amount which
24 may be excluded under subsection (a) with re-
25 spect to a participant in a cafeteria plan by rea-

1 son of being an employee under subparagraph
2 (A) shall not exceed the employee's earned in-
3 come (within the meaning of section 401(c)) de-
4 rived from the trade or business with respect to
5 which the cafeteria plan is established."
6 (2) APPLICATION TO BENEFITS WHICH MAY BE
7 PROVIDED UNDER CAFETERIA PLAN.—
8 (A) GROUP-TERM LIFE INSURANCE.—Sec-
9 tion 79 (relating to group-term life insurance
10 provided to employees) is amended by adding at
11 the end the following new subsection:
12 "(f) EMPLOYEE INCLUDES SELF-EMPLOYED.—
13 "(1) IN GENERAL.—For purposes of this sec-
14 tion, the term 'employee' includes an individual who
15 is an employee within the meaning of section
16 401(c)(1) (relating to self-employed individuals).
17 "(2) LIMITATION.—The amount which may be
18 excluded under the exceptions contained in sub-
19 section (a) or (b) with respect to an individual treat-
20 ed as an employee by reason of paragraph (1) shall
21 not exceed the employee's earned income (within the
22 meaning of section 401(c)) derived from the trade or
23 business with respect to which the individual is so
24 treated."

1 (B) ACCIDENT AND HEALTH PLANS.—Sec-
2 tion 105(g) is amended to read as follows:
3 "(g) EMPLOYEE INCLUDES SELF-EMPLOYED.—
4 "(1) IN GENERAL.—For purposes of this sec-
5 tion, the term 'employee' includes an individual who
6 is an employee within the meaning of section
7 401(c)(1) (relating to self-employed individuals).
8 "(2) LIMITATION.—The amount which may be
9 excluded under this section by reason of subsection
10 (b) or (c) with respect to an individual treated as an
11 employee by reason of paragraph (1) shall not ex-
12 ceed the employee's earned income (within the mean-
13 ing of section 401(c)) derived from the trade or
14 business with respect to which the accident or health
15 insurance was established."
16 (C) CONTRIBUTIONS BY EMPLOYERS TO
17 ACCIDENT AND HEALTH PLANS.—
18 (i) IN GENERAL.—Section 106, as
19 amended by subsection (b), is amended by
20 adding after subsection (b) the following
21 new subsection:
22 "(c) EMPLOYER TO INCLUDE SELF-EMPLOYED.—
23 "(1) IN GENERAL.—For purposes of this sec-
24 tion, the term 'employee' includes an individual who

1 is an employee within the meaning of section
2 401(c)(1) (relating to self-employed individuals).
3 "(2) LIMITATION.—The amount which may be
4 excluded under subsection (a) with respect to an in-
5 dividual treated as an employee by reason of para-
6 graph (1) shall not exceed the employee's earned in-
7 come (within the meaning of section 401(c)) derived
8 from the trade or business with respect to which the
9 accident or health insurance was established."
10 (ii) CLARIFICATION OF LIMITATIONS ON
11 OTHER COVERAGE.—The first sentence of sec-
12 tion 162(l)(2)(B) is amended to read as follows:
13 "Paragraph (1) shall not apply to any taxpayer
14 for any calendar month for which the taxpayer
15 participates in any subsidized health plan main-
16 tained by any employer (other than an employer
17 described in section 401(c)(4)) of the taxpayer
18 or the spouse of the taxpayer.
19 (b) LONG-TERM CARE INSURANCE PERMITTED TO
20 BE OFFERED UNDER CAFETERIA PLANS AND FLEXIBLE
21 SPENDING ARRANGEMENTS.—
22 (1) CAFETERIA PLANS.—The last sentence of
23 section 125(f) (defining qualified benefits) is amend-
24 ed to read as follows: "Such term shall include the
25 payment of premiums for any qualified long-term

1 care insurance contract (as defined in section
2 7702B) to the extent the amount of such payment
3 does not exceed the eligible long-term care premiums
4 (as defined in section 213(d)(10)) for such con-
5 tract''.

6 (2) FLEXIBLE SPENDING ARRANGEMENTS.—
7 Section 106 (relating to contributions by employer to
8 accident and health plans) is amended by striking
9 subsection (c).

10 (c) EFFECTIVE DATE.—The amendments made by
11 this section shall apply to taxable years beginning after
12 December 31, 2004.

13 **SEC. 4. MODIFICATION OF RULES APPLICABLE TO FLEXI-**
14 **BLE SPENDING ARRANGEMENTS.**

15 (a) IN GENERAL.—Section 125, as amended by sec-
16 tion 2, is amended by redesignating subsections (i) and
17 (j) as subsections (j) and (k), respectively, and by insert-
18 ing after subsection (h) the following new subsection:

19 ''(i) SPECIAL RULES APPLICABLE TO FLEXIBLE
20 SPENDING ARRANGEMENTS.—

21 ''(1) IN GENERAL.—For purposes of this title,
22 a plan or other arrangement shall not fail to be
23 treated as a flexible spending or similar arrangement
24 solely because under the plan or arrangement—

1 "(A) the amount of the reimbursement for
2 covered expenses at any time may not exceed
3 the balance in the participant's account for the
4 covered expenses as of such time,
5 "(B) except as provided in paragraph
6 (4)(A)(ii), a participant may elect at any time
7 specified by the plan or arrangement to make
8 or modify any election regarding the covered
9 benefits, or the level of covered benefits, of the
10 participant under the plan, and
11 "(C) a participant is permitted access to
12 any unused balance in the participant's ac-
13 counts under such plan or arrangement in the
14 manner provided under paragraph (2) or (3).
15 "(2) CARRYOVERS AND ROLLOVERS OF UNUSED
16 BENEFITS IN HEALTH AND DEPENDENT CARE AR-
17 RANGEMENTS.—
18 "(A) IN GENERAL.—A plan or arrange-
19 ment may permit a participant in a health flexi-
20 ble spending arrangement or dependent care
21 flexible spending arrangement to elect—
22 "(i) to carry forward any aggregate
23 unused balances in the participant's ac-
24 counts under such arrangement as of the
25 close of any year to the succeeding year, or

1 "(ii) to have such balance transferred
2 to a plan described in subparagraph (E).
3 Such carryforward or transfer shall be treated
4 as having occurred within 30 days of the close
5 of the year.
6 "(B) DOLLAR LIMIT ON
7 CARRYFORWARDS.—
8 "(i) IN GENERAL.—The amount which
9 a participant may elect to carry forward
10 under subparagraph (A)(i) from any year
11 shall not exceed $500. For purposes of this
12 paragraph, all plans and arrangements
13 maintained by an employer or any related
14 person shall be treated as 1 plan.
15 "(ii) COST-OF-LIVING ADJUSTMENT.—
16 In the case of any taxable year beginning
17 in a calendar year after 2005, the $500
18 amount under clause (i) shall be increased
19 by an amount equal to—
20 "(I) $500, multiplied by
21 "(II) the cost-of-living adjust-
22 ment determined under section 1(f)(3)
23 for such calendar year, determined by
24 substituting '2004' for '1992' in sub-
25 paragraph (B) thereof.

1 If any dollar amount as increased under
2 this clause is not a multiple of $100, such
3 amount shall be rounded to the next lowest
4 multiple of $100.
5 "(C) EXCLUSION FROM GROSS INCOME.—
6 No amount shall be required to be included in
7 gross income under this chapter by reason of
8 any carryforward or transfer under this para-
9 graph.
10 "(D) COORDINATION WITH LIMITS.—
11 "(i) CARRYFORWARDS.—The max-
12 imum amount which may be contributed to
13 a health flexible spending arrangement or
14 dependent care flexible spending arrange-
15 ment for any year to which an unused
16 amount is carried under this paragraph
17 shall be reduced by such amount.
18 "(ii) ROLLOVERS.—Any amount
19 transferred under subparagraph (A)(ii)
20 shall be treated as an eligible rollover
21 under section 219, 223(f)(5), 401(k),
22 403(b), or 457, whichever is applicable, ex-
23 cept that—
24 "(I) the amount of the contribu-
25 tions which a participant may make to

1 the plan under any such section for
2 the taxable year including the transfer
3 shall be reduced by the amount trans-
4 ferred, and
5 "(II) in the case of a transfer to
6 a plan described in clause (ii) or (iii)
7 of subparagraph (E), the transferred
8 amounts shall be treated as elective
9 deferrals for such taxable year.
10 "(E) PLANS.—A plan is described in this
11 subparagraph if it is—
12 "(i) an individual retirement plan,
13 "(ii) a qualified cash or deferred ar-
14 rangement described in section 401(k),
15 "(iii) a plan under which amounts are
16 contributed by an individual's employer for
17 an annuity contract described in section
18 403(b),
19 "(iv) an eligible deferred compensa-
20 tion plan described in section 457, or
21 "(v) a health savings account de-
22 scribed in section 223.
23 "(3) DISTRIBUTION UPON TERMINATION.—
24 "(A) IN GENERAL.—A plan or arrange-
25 ment may permit a participant (or any des-

1 ignated heir of the participant) to receive a
2 cash payment equal to the aggregate unused ac-
3 count balances in the plan or arrangement as of
4 the date the individual is separated (including
5 by death or disability) from employment with
6 the employer maintaining the plan or arrange-
7 ment.

8 "(B) INCLUSION IN INCOME.—Any pay-
9 ment under subparagraph (A) shall be includ-
10 ible in gross income for the taxable year in
11 which such payment is distributed to the em-
12 ployee.

13 "(4) TERMS RELATING TO FLEXIBLE SPENDING
14 ARRANGEMENTS.—

15 "(A) FLEXIBLE SPENDING ARRANGE-
16 MENTS.—

17 "(i) IN GENERAL.—For purposes of
18 this subsection, a flexible spending ar-
19 rangement is a benefit program which pro-
20 vides employees with coverage under which
21 specified incurred expenses may be reim-
22 bursed (subject to reimbursement maxi-
23 mums and other reasonable conditions).

24 "(ii) ELECTIONS REQUIRED.—A plan
25 or arrangement shall not be treated as a

1 flexible spending arrangement unless a
2 participant may at least 4 times during
3 any year make or modify any election re-
4 garding covered benefits or the level of cov-
5 ered benefits.
6 "(B) HEALTH AND DEPENDENT CARE AR-
7 RANGEMENTS.—The terms 'health flexible
8 spending arrangement' and 'dependent care
9 flexible spending arrangement' means any flexi-
10 ble spending arrangement (or portion thereof)
11 which provides payments for expenses incurred
12 for medical care (as defined in section 213(d))
13 or dependent care (within the meaning of sec-
14 tion 129), respectively."
15 (b) CONFORMING AMENDMENT.—
16 (1) The heading for section 125 is amended by
17 inserting "**AND FLEXIBLE SPENDING ARRANGE-**
18 **MENTS**" after "**PLANS**".
19 (2) The item relating to section 125 in the table
20 of sections for part III of subchapter B of chapter
21 1 is amended by inserting "and flexible spending ar-
22 rangements" after "plans".
23 (c) EFFECTIVE DATE.—The amendments made by
24 this section shall apply to years beginning after December
25 31, 2004.

1 **SEC. 5. RULES RELATING TO EMPLOYER-PROVIDED**
2 **HEALTH AND DEPENDENT CARE BENEFITS.**

3 (a) HEALTH BENEFITS.—Section 106, as amended
4 by section 3, is amended by adding at the end the fol-
5 lowing new subsection:

6 "(e) LIMITATION ON CONTRIBUTIONS TO HEALTH
7 FLEXIBLE SPENDING ARRANGEMENTS.—

8 "(1) IN GENERAL.—Gross income of an em-
9 ployee for any taxable year shall include employer-
10 provided coverage provided through 1 or more health
11 flexible spending arrangements (within the meaning
12 of section 125(i)) to the extent that the amount oth-
13 erwise excludable under subsection (a) with regard
14 to such coverage exceeds the applicable dollar limit
15 for the taxable year.

16 "(2) APPLICABLE DOLLAR LIMIT.—For pur-
17 poses of this subsection—

18 "(A) IN GENERAL.—The applicable dollar
19 limit for any taxable year is an amount equal
20 to the sum of—

21 "(i) $7,500, plus

22 "(ii) if the arrangement provides cov-
23 erage for 1 or more individuals in addition
24 to the employee, an amount equal to one-
25 third of the amount in effect under clause

1 (i) (after adjustment under subparagraph
2 (B)).
3 "(B) COST-OF-LIVING ADJUSTMENT.—In
4 the case of taxable years beginning in any cal-
5 endar year after 2005, the $7,500 amount
6 under subparagraph (A) shall be increased by
7 an amount equal to—
8 "(i) $7,500, multiplied by
9 "(ii) the cost-of-living adjustment de-
10 termined under section 1(f)(3) for the cal-
11 endar year, determined by substituting
12 '2004' for '1992' in subparagraph (B)
13 thereof.
14 If any dollar amount as increased under this
15 subparagraph is not a multiple of $100, such
16 dollar amount shall be rounded to the next low-
17 est multiple of $100."
18 (b) DEPENDENT CARE.—
19 (1) EXCLUSION LIMIT.—
20 (A) IN GENERAL.—Section 129(a)(2) (re-
21 lating to limitation on exclusion) is amended—
22 (i) by striking "$5,000" and inserting
23 "the applicable dollar limit", and
24 (ii) by striking "$2,500" and insert-
25 ing "one-half of such limit".

1 (B) APPLICABLE DOLLAR LIMIT.—Section
2 129(a) is amended by adding at the end the fol-
3 lowing new paragraph:
4 "(3) APPLICABLE DOLLAR LIMIT.—For pur-
5 poses of this subsection—
6 "(A) IN GENERAL.—The applicable dollar
7 limit is $5,000 ($10,000 if dependent care as-
8 sistance is provided under the program to 2 or
9 more qualifying individuals of the employee).
10 "(B) COST-OF-LIVING ADJUSTMENTS.—
11 "(i) $5,000 AMOUNT.—In the case of
12 taxable years beginning after 2005, the
13 $5,000 amount under subparagraph (A)
14 shall be increased by an amount equal to—
15 "(I) $5,000, multiplied by
16 "(II) the cost-of-living adjust-
17 ment determined under section 1(f)(3)
18 for the calendar year in which the tax-
19 able year begins, determined by sub-
20 stituting '2004' for '1992' in subpara-
21 graph (B) thereof.
22 If any dollar amount as increased under
23 this clause is not a multiple of $100, such
24 dollar amount shall be rounded to the next
25 lowest multiple of $100.

1 "(ii) $10,000 AMOUNT.—The $10,000
2 amount under subparagraph (A) for tax-
3 able years beginning after 2005 shall be
4 increased to an amount equal to twice the
5 amount the $5,000 amount is increased to
6 under clause (i)."
7 (2) AVERAGE BENEFITS TEST.—
8 (A) IN GENERAL.—Section 129(d)(8)(A)
9 (relating to benefits) is amended—
10 (i) by striking "55 percent" and in-
11 serting "60 percent", and
12 (ii) by striking "highly compensated
13 employees" the second place it appears and
14 inserting "employees receiving benefits".
15 (B) SALARY REDUCTION AGREEMENTS.—
16 Section 129(d)(8)(B) (relating to salary reduc-
17 tion agreements) is amended—
18 (i) by striking "$25,000" and insert-
19 ing "$30,000", and
20 (ii) by adding at the end the fol-
21 lowing: "In the case of years beginning
22 after 2005, the $30,000 amount in the
23 first sentence shall be adjusted at the same
24 time, and in the same manner, as the ap-

1 plicable dollar amount is adjusted under
2 subsection (a)(3)(B)."
3 (3) PRINCIPAL SHAREHOLDERS OR OWNERS.—
4 Section 129(d)(4) (relating to principal shareholders
5 and owners) is amended by adding at the end the
6 following: "In the case of any failure to meet the re-
7 quirements of this paragraph for any year, amounts
8 shall only be required by reason of the failure to be
9 included in gross income of the shareholders or own-
10 ers who are members of the class described in the
11 preceding sentence."
12 (c) EFFECTIVE DATE.—The amendments made by
13 this section shall apply to taxable years beginning after
14 December 31, 2004.

○

INTERNATIONAL FRANCHISE ASSOCIATION

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January 10, 2007

The Honorable Max Baucus
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Senator Baucus,

On behalf of the nation's franchised businesses, thank you for holding this important and timely hearing on tax incentives for businesses in response to a minimum wage increase. This is a critical issue and the IFA strongly opposes an increase to the minimum wage without the necessary tax relief offsets to assist small businesses.

Serving more than 1,100 franchisor, 8,000 franchisee and 400 supplier members, the International Franchise Association (IFA) is the largest and oldest franchising trade group. IFA's mission is to safeguard the business environment for franchising worldwide. The 760,000 franchised businesses in the U.S. generate jobs for more than 18 million Americans (nearly 14 percent of the nation's private-sector employment – or one in every seven jobs) and account for $1.53 trillion in economic activity (9.5 percent of the private-sector economic output). Over 75 industries utilize the franchise model for distribution of products and services: everything from the familiar restaurants and hotels to lawn care, tax preparation, personnel services and movers.

Most franchisor companies and the vast majority of franchisee businesses are small businesses. As you may know, small businesses operate on thin profit margins and are most at risk from an increase in the minimum wage. For the few small businesses that actually pay the federal minimum wage, the wage serves as a starting wage. In fact, more than 65 percent of minimum wage earners receive a median raise of 14 percent within the first year of working, often within the first month. Businesses should be allowed to determine the most competitive starting wage and subsequent raises for their employees within their industry and local economy. A drastic minimum wage increase – such as a 41 percent increase – would ripple throughout the economy.

Mandating an increase in the starting wage will force difficult staffing and pricing decisions for many small businesses. As a result of the last minimum wage increase, many small businesses were forced to close their doors permanently. The proposed minimum wage hike is just the latest burden for small employers, along with the 10 percent increase in energy prices this year and annual double-digit increases in health care premiums.

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Congress must consider tax relief for affected small businesses along with efforts to increase the minimum wage. Making permanent the work opportunity tax credit and shortening depreciation schedules for new restaurant construction, leasehold improvements, and a one year extension of Section 179 expensing, so that it would expire in 2010 with many other tax cuts would help many small businesses as they adjust to sharply higher labor costs.

Finally, I encourage you to consider health care costs in your calculations. Small businesses are at a competitive disadvantage with larger businesses when it comes to offering healthcare benefits. In some parts of the country, for example, it is nearly impossible to find health insurers that offer small group plans. If such plans are being offered, they are either unaffordable, or will be within the next few years. Increasing the minimum wage does not help small businesses provide healthcare benefits, and has the potential to sap their ability to afford such benefits in the future. That is why the IFA strongly urges the Senate to offer Small Business Health Plan legislation as an offset to a minimum wage hike to allow small businesses the opportunity to pool together to access available and affordable health benefits packages.

IFA urges the Senate Committee on Finance to pair the minimum wage legislation with a bipartisan compromise health plan bill, like Small Business Health Plans, that would address the needs of small business owners, their families, employees and local communities.

Sincerely,

David French
Vice President, Government Relations

Statement
of the
National Restaurant Association
for a hearing on

Tax Incentives for Businesses
in Response to a Minimum Wage Increase

January 10, 2007

On behalf of the restaurant industry, America's second largest private sector employer, the National Restaurant Association appreciates the Senate Finance Committee seeking input from businesses on tax incentives to offset the financial burden of a potential mandated minimum wage increase. Eating and drinking places—the primary component of the restaurant industry which accounts for roughly three-fourths of the total restaurant and foodservice workforce—added nearly 978,000 jobs, or roughly one out of every six net new jobs added to the national economy during the last 46 months.

The restaurant industry is the largest employer of minimum wage employees. The impact of the proposed minimum wage increase is expected to be significant, affecting restaurant employers, employees and the millions of customers they serve. The average restaurant, which operates on a narrow profit margin, is not equipped to absorb a mandated wage increase without it impacting jobs, benefits, and menu prices.

After the last wage hike in 1996 and 1997, according to a nationwide NRA survey of 1000 restaurants, 146,000 jobs were cut from restaurant payrolls and operators postponed plans to hire an additional 106,000 employees. In nationwide surveys conducted in October 2006, restaurant operators reported that they plan to take a number of actions if the federal minimum wage was increased from $5.15 to $7.25 over the course of 30 months:

- In general, the largest impact would be seen in the quickservice, family dining and casual dining segments, with fine dining experiencing a comparatively smaller impact.

- The most common action planned by restaurant operators would be an increase in menu prices, with nearly nine out of 10 operators saying they would increase menu prices as a result of a $2.10 minimum wage increase. Ninety-eight percent of quickservice operators said they would increase menu prices, compared to about three out of four family dining and casual dining operators.
- Roughly two out of five restaurant operators said they would cut jobs as a result of a $2.10 minimum wage increase. Forty-one percent of family dining and casual dining restaurant operators said they would cut jobs, while 36 percent of quickservice operators reported similarly.
- In addition to job losses, roughly one-half of restaurant operators said they would reduce the number of employee hours worked.
- Approximately one out of four restaurant operators said they would postpone plans for new hiring if the federal minimum wage rose to $7.25 over the course of 30 months.
- Approximately three out of 10 restaurant operators said they would cut employee benefits as a result of a minimum wage increase from $5.15 to $7.25.

When the minimum wage is raised, it is difficult to ignore the laws of economics—prices go up and job opportunities go down.

The restaurant industry is projected to employ 12.8 million individuals in 2007. In recent years, the restaurant industry has been an engine of growth for the overall economy, even when some other industries experienced job losses. While the overall economy posted job losses in both 2002 and 2003, restaurant industry employment continued to grow. In fact, restaurant industry job growth outpaced the overall economy in each of the last seven years. Clearly, the restaurant industry plays a critical role in providing jobs to the U.S. economy. By the year 2017, the industry is expected to create an additional 2 million positions. If the restaurant industry is to fulfill the expectation of job growth in the coming years, the National Restaurant Association urges Congress to include safeguards in any mandated wage hike and to target offsets to those industries disproportionately affected by the potential wage increase.

For the restaurant industry, the National Restaurant Association supports two industry specific tax issues that would mitigate the impact of a wage increase—accelerated depreciation schedules

for restaurant buildings and improvements, and a provision to ensure that employers of tipped-employees are not hit with a tax increase as the result of a wage increase.

Industry-wide, restaurants have been urging passage of permanent 15-year accelerated depreciation schedule for new restaurant buildings and building improvements. This year, the nation's 935,000 restaurant locations will serve over 70 billion meals and have an overall economic impact of more than $1 trillion. On any given day, nearly half of adults are restaurant industry patrons. Restaurants are a high-volume business, serving more customer traffic and maintaining longer hours than the average commercial business—the average restaurant being open seven days a week, roughly 18 hours a day, resulting in rapid deterioration.

Research shows that most restaurants remodel and update their buildings every six to eight years, far more often than the 39-year depreciation schedule allows. According to Association research, changing the existing depreciation schedule to 15 years would generate an additional $3.7 billion in cash flow for the industry over ten years, resulting in increased spending by the industry.

The increased spending would stimulate both short and long-term economic growth and create jobs not only in the restaurant industry, but in the trades and businesses that will indirectly benefit from the construction and renovation of restaurant buildings. According to Association research, if ten percent of the additional cash flow generated from the accelerated schedules were reinvested in new construction and renovations it would produce an additional $341 million in economic activity. A 25 percent re-investment would generate an additional $853 million.

Additionally, for employers with workers that receive a gratuity, the minimum wage increase will also create a tax increase on their FICA tax obligations. Currently, employers must pay FICA taxes on all employee income (employer-paid wages and customer-paid gratuities). Because a gratuity is not an employer-paid wage, employers are permitted to take a dollar-for-dollar FICA tax credit towards the FICA taxes paid on gratuities above the minimum wage. Known as the 45(B) tax credit, this credit is a "general business credit" that allows restaurateurs to reduce their federal income taxes by the amount of FICA taxes they pay on employee's gratuities above the minimum wage level.

If the minimum wage is increased to $7.25, an increase of $2.10, the 45(B)credit would no longer be available for the FICA contribution on that additional income used to meet the new minimum wage. The result would be a significant increase in payroll taxes. Should Congress pass a minimum wage increase, language should be included to maintain current law with regard to employers FICA tax obligation and continue to allow a tax credit for FICA contributions over the existing level of $5.15. This provision only addresses an employer's tax obligation and does not impact an employee's wages in any way. The National Restaurant Association does not believe Congress intended to impose a tax increase as part of a mandated wage increase.

Finally, the National Restaurant Association believes that certain relief should be targeted to the restaurant industry due to the disproportionate share of the burden that our industry will face. However, the Association also recognizes that other industries will be affected by a wage hike and therefore more general relief is appropriate as well such as the Work Opportunity Tax Credit, and small business expensing.

The National Restaurant Association continues to oppose a mandated wage increase on our nation's restaurants, but if one is enacted, it is critical that tax offsets targeted to the restaurant industry be included in any final package in order to mitigate the negative effect on small business employers—accelerated depreciation schedules for restaurant buildings and improvements, and a provision to ensure employers of tipped-employees are not hit with a tax increase as a result of this minimum wage increase.

United States Senate Committee on Finance
Tax Incentives for Business in Response to a Minimum Wage Increase
10 January 2007

Statement by the Professional Beauty Association

Steven T. Sleeper
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Professional Beauty Association
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On behalf of the Professional Beauty Association (PBA), representing the interests of the 82,000 salons and spas nationwide, we commend the committee for exploring tax incentives targeted at businesses that will be impacted by an increase in the minimum wage.

Salons are labor-intensive businesses, providing a large number of entry-level positions. Wages and salaries represent roughly 45 percent of sales for salons, well above that of restaurants (29 percent) construction firms (21 percent), manufacturing firms (15 percent), grocery stores (11 percent), and the overall retail sector (10 percent), according to the U.S. Census Bureau. As a result, an increase in labor costs will have a disproportionately larger impact on salon businesses, compared to the rest of the economy.

The salon industry is a thriving sector of the US economy – a 33 billion dollar industry with a workforce of roughly 800,000 professionals. The salon industry is a jobs machine for the economy, creating employment opportunities with upward mobility for individuals of all backgrounds. The vast majority of managers and salaried employees in salons started out in entry-level positions.

In addition, in six of the last seven years, job growth in the salon industry outpaced the overall economy, with 2006 marking the 14th consecutive year of salon industry job growth. Even while the overall economy was losing jobs in both 2002 and 2003, salon industry employment continued to grow. The salon industry needs the have the resources available to them to continue to make a positive contribution to this nation's economy and to continue to create jobs.

Providing tax relief to the salon industry to help meet the increased costs of a wage increase is critical. Like restaurants, salon owners are required to report and pay FICA payroll taxes on employee tip income. Policing employees with regard to their tip reporting obligations is an onerous task. Salon owners must educate employees about tip reporting laws, do their best to ensure employees are complying with the law, keep records of reported tips, and report the income to the Internal Revenue Service (IRS). Unlike restaurants, salons are not allowed to take the FICA tip credit, known as the 45(b) tax credit – a dollar-for-dollar tax credit on the employer share of FICA taxes paid on tip income above the minimum wage. The salon industry is asking the committee to adopt a provision that will allow salon owners to use this tax credit for its tipped employees.

PBA encourages the committee to consider inclusion of this provision to provide additional resources to the salon industry to help offset the increase labor costs created by an increase in the minimum wage.

We appreciate the opportunity to offer the committee our thoughts. Included with this testimony is draft legislation, which has been pending before this committee in past Congresses.

Thank you.

Attachment: "Small Business Tax Equalization and Compliance Act of 2005"
[S. 327; 109th Congress]

II

109TH CONGRESS
1ST SESSION

S. 327

To amend the Internal Revenue Code of 1986 to expand the tip credit to certain employers and to promote tax compliance.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 9, 2005

Mr. SANTORUM (for himself and Mrs. LINCOLN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1986 to expand the tip credit to certain employers and to promote tax compliance.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the "Small Business Tax
5 Equalization and Compliance Act of 2005".

1 **SEC. 2. EXPANSION OF CREDIT FOR PORTION OF SOCIAL**
2 **SECURITY TAXES PAID WITH RESPECT TO**
3 **EMPLOYEE TIPS.**

4 (a) EXPANSION OF CREDIT TO OTHER LINES OF
5 BUSINESS.—Paragraph (2) of section 45B(b) of the Inter-
6 nal Revenue Code of 1986 is amended to read as follows:

7 "(2) APPLICATION ONLY TO CERTAIN LINES OF
8 BUSINESS.—In applying paragraph (1), there shall
9 be taken into account only tips received from cus-
10 tomers or clients in connection with—

11 "(A) the providing, delivering, or serving
12 of food or beverages for consumption if the tip-
13 ping of employees delivering or serving food or
14 beverages by customers is customary, or

15 "(B) the providing of any cosmetology
16 service for customers or clients at a facility li-
17 censed to provide such service if the tipping of
18 employees providing such service is cus-
19 tomary.".

20 (b) DEFINITION OF COSMETOLOGY SERVICE.—Sec-
21 tion 45B of such Code is amended by redesignating sub-
22 sections (c) and (d) as subsections (d) and (e), respec-
23 tively, and by inserting after subsection (b) the following
24 new subsection:

25 "(c) COSMETOLOGY SERVICE.—For purposes of this
26 section, the term 'cosmetology service' means—

1 "(1) hairdressing,
2 "(2) haircutting,
3 "(3) manicures and pedicures,
4 "(4) body waxing, facials, mud packs, wraps,
5 and other similar skin treatments, and
6 "(5) any other beauty related service provided
7 at a facility at which a majority of the services pro-
8 vided (as determined on the basis of gross revenue)
9 are described in paragraphs (1) through (4).".
10 (c) EFFECTIVE DATE.—The amendments made by
11 this section shall apply to tips received for services per-
12 formed after December 31, 2004.

13 **SEC. 3. INFORMATION REPORTING AND TAXPAYER EDU-**
14 **CATION FOR PROVIDERS OF COSMETOLOGY**
15 **SERVICES.**

16 (a) IN GENERAL.—Subpart B of part III of sub-
17 chapter A of chapter 61 of the Internal Revenue Code of
18 1986 is amended by inserting after section 6050T the fol-
19 lowing new section:

20 **"SEC. 6050U. RETURNS RELATING TO COSMETOLOGY SERV-**
21 **ICES AND INFORMATION TO BE PROVIDED TO**
22 **COSMETOLOGISTS.**

23 "(a) IN GENERAL.—Every person (referred to in this
24 section as a 'reporting person') who—

1 "(1) employs 1 or more cosmetologists to pro-
2 vide any cosmetology service,
3 "(2) rents a chair to 1 or more cosmetologists
4 to provide any cosmetology service on at least 5 cal-
5 endar days during a calendar year, or
6 "(3) in connection with its trade or business or
7 rental activity, otherwise receives compensation
8 from, or pays compensation to, 1 or more cosmetolo-
9 gists for the right to provide cosmetology services to,
10 or for cosmetology services provided to, third-party
11 patrons, shall comply with the return requirements
12 of subsection (b) and the taxpayer education require-
13 ments of subsection (c).
14 "(b) RETURN REQUIREMENTS.—The return require-
15 ments of this subsection are met by a reporting person
16 if the requirements of each of the following paragraphs
17 applicable to such person are met.
18 "(1) EMPLOYEES.—In the case of a reporting
19 person who employs 1 or more cosmetologists to pro-
20 vide cosmetology services, the requirements of this
21 paragraph are met if such person meets the require-
22 ments of sections 6051 (relating to receipts for em-
23 ployees) and 6053(b) (relating to tip reporting) with
24 respect to each such employee.

1 "(2) INDEPENDENT CONTRACTORS.—In the
2 case of a reporting person who pays compensation to
3 1 or more cosmetologists (other than as employees)
4 for cosmetology services provided to third-party pa-
5 trons, the requirements of this paragraph are met if
6 such person meets the applicable requirements of
7 section 6041 (relating to returns filed by persons
8 making payments of $600 or more in the course of
9 a trade or business), section 6041A (relating to re-
10 turns to be filed by service-recipients who pay more
11 than $600 in a calendar year for services from a
12 service provider), and each other provision of this
13 subpart that may be applicable to such compensa-
14 tion.
15 "(3) CHAIR RENTERS.—
16 "(A) IN GENERAL.—In the case of a re-
17 porting person who receives rent or other fees
18 or compensation from 1 or more cosmetologists
19 for use of a chair or for rights to provide any
20 cosmetology service at a salon or other similar
21 facility for more than 5 days in a calendar year,
22 the requirements of this paragraph are met if
23 such person—
24 "(i) makes a return, according to the
25 forms or regulations prescribed by the Sec-

1 retary, setting forth the name, address,
2 and TIN of each such cosmetologist and
3 the amount received from each such cos-
4 metologist, and
5 "(ii) furnishes to each cosmetologist
6 whose name is required to be set forth on
7 such return a written statement showing—
8 "(I) the name, address, and
9 phone number of the information con-
10 tact of the reporting person,
11 "(II) the amount received from
12 such cosmetologist, and
13 "(III) a statement informing
14 such cosmetologist that (as required
15 by this section), the reporting person
16 has advised the Internal Revenue
17 Service that the cosmetologist pro-
18 vided cosmetology services during the
19 calendar year to which the statement
20 relates.
21 "(B) METHOD AND TIME FOR PROVIDING
22 STATEMENT.—The written statement required
23 by clause (ii) of subparagraph (A) shall be fur-
24 nished (either in person or by first-class mail
25 which includes adequate notice that the state-

1 ment or information is enclosed) to the person
2 on or before January 31 of the year following
3 the calendar year for which the return under
4 clause (i) of subparagraph (A) is to be made.
5 "(c) TAXPAYER EDUCATION REQUIREMENTS.—In
6 the case of a reporting person who is required to provide
7 a statement pursuant to subsection (b), the requirements
8 of this subsection are met if such person provides to each
9 such cosmetologist annually a publication, as designated
10 by the Secretary, describing—
11 "(1) in the case of an employee, the tax and tip
12 reporting obligations of employees, and
13 "(2) in the case of a cosmetologist who is not
14 an employee of the reporting person, the tax obliga-
15 tions of independent contractors or proprietorships.
16 The publications shall be furnished either in person or by
17 first-class mail which includes adequate notice that the
18 publication is enclosed.
19 "(d) DEFINITIONS.—For purposes of this section—
20 "(1) COSMETOLOGIST.—
21 "(A) IN GENERAL.—The term 'cosmetolo-
22 gist' means an individual who provides any cos-
23 metology service.
24 "(B) ANTI-AVOIDANCE RULE.—The Sec-
25 retary may by regulation or ruling expand the

1 term 'cosmetologist' to include any entity or ar-
2 rangement if the Secretary determines that en-
3 tities are being formed to circumvent the re-
4 porting requirements of this section.

5 "(2) COSMETOLOGY SERVICE.—The term 'cos-
6 metology service' has the meaning given to such
7 term by section 45B(c).

8 "(3) CHAIR.—The term 'chair' includes a chair,
9 booth, or other furniture or equipment from which
10 an individual provides a cosmetology service (deter-
11 mined without regard to whether the cosmetologist
12 is entitled to use a specific chair, booth, or other
13 similar furniture or equipment or has an exclusive
14 right to use any such chair, booth, or other similar
15 furniture or equipment).

16 "(e) EXCEPTIONS FOR CERTAIN EMPLOYEES.—Sub-
17 section (c) shall not apply to a reporting person with re-
18 spect to an employee who is employed in a capacity for
19 which tipping (or sharing tips) is not customary.".

20 (b) CONFORMING AMENDMENTS.—

21 (1) Section 6724(d)(1)(B) of such Code (relat-
22 ing to the definition of information returns) is
23 amended by redesignating clauses (xiii) through
24 (xviii) as clauses (xiv) through (xix), respectively and

1 by inserting after clause (xii) the following new
2 clause:
3 "(xiii) section 6050U(a) (relating to
4 returns by cosmetology service pro-
5 viders).".
6 (2) Section 6724(d)(2) of such Code is amend-
7 ed—
8 (A) by striking "or" at the end of subpara-
9 graph (AA),
10 (B) by striking the period at the end of
11 subparagraph (BB) and inserting ", or", and
12 (C) by inserting after subparagraph (BB)
13 the following new subparagraph:
14 "(CC) subsections (b)(3)(A)(ii) and (e) of
15 section 6050U (relating to cosmetology service
16 providers) even if the recipient is not a payee.".
17 (3) The table of sections for subpart B of part
18 III of subchapter A of chapter 61 of the Internal
19 Revenue Code of 1986 is amended by adding after
20 section 6050T the following new item:

"Sec. 6050U. Returns relating to cosmetology services and information to be provided to cosmetologists.".

21 (c) EFFECTIVE DATE.—The amendments made by
22 this section shall apply to calendar years after 2004.

○

S CORPORATION ASSOCIATION

Statement of Jim Redpath, CPA
HLB Tautges Redpath, Ltd
for the
S Corporation Association

Senate Committee on Finance
"Tax Incentives for Businesses in Response to a Minimum Wage Increase"

January 10, 2007

Chairman Baucus, Ranking Member Grassley and other members of the Committee, thank you for the opportunity to submit testimony before the Senate Committee on Finance.

My name is Jim Redpath. I am a certified public accountant and an officer at HLB Tautges Redpath, Ltd., a 90 plus person full-service accounting firm serving clients in the greater Minneapolis/St. Paul metropolitan area since 1971. We help more than 1,000 closely-held businesses make better decisions that create value and contribute to their financial well-being. I also serve as the Chairman of the Board of Advisors for the S Corporation Association and submit my testimony today on its behalf.

I want to thank you for holding this hearing to consider potential tax incentives for businesses that would be affected by any increase in the federal minimum wage. I am concerned that many of the companies that will bear the impact of this increase in labor costs are closely-held or family-owned businesses structured as Subchapter S corporations. My goal is to provide you with a first hand account of how to offset some of this new labor cost to small businesses by improving the outdated rules currently governing S corporations.

Coupling this assistance with the legislation to increase the federal minimum wage is particularly appropriate. Our country has more than 3 million S corporations today, the vast majority of which are small, closely-held businesses with less than $10 million in assets. These companies are already hampered by restrictions that put them at a disadvantage relative to other pass-through business entities. Thus, I believe S corporations should be taken into account when considering any adjustment to the federal minimum wage – just as Congress and President Clinton did for the last increase to the minimum wage in 1996 as part of the Small Business Job Protection Act.

LLCs and S Corporations

Let me first discuss just how S corporations operate at a competitive disadvantage these days. Last year, our firm was involved in creating more than 100 business entities for clients. Of those, virtually all were LLCs and only a select few were S corporations. The advent of the LLC has created, in many cases, a superior business structure.

When S corporations were created almost fifty years ago, the rules governing their operations reflected the times. S corporations had to be domestic entities; the number of shareholders was limited; the type of shareholders was restricted; and only one class of stock was allowed. Failure to comply with those rules resulted then and still results in loss of S corporation status and unexpected double taxation.

In contrast, the LLC was created in a different environment entirely. Their introduction and development between 1977 and 1997 coincided with a world-wide reduction in business regulation. Reflecting this different era, the LLC is encumbered with none of the rules governing and limiting S corporations. An LLC can have multiple classes of ownership and there is no limitation on the number and type of owners.

When an entrepreneur sits down in my office to discuss starting a business, these differences play a leading role in our conversation. Why would someone subject themselves to S corporation restrictions and the possibility of inadvertent double taxation? Therefore, most choose to be an LLC.

This begs the question, why wouldn't an S corporation convert to an LLC? Converting from an S corporation to an LLC is a taxable event, making such a conversion prohibitively expensive. In essence, you would have to liquidate the business and pay taxes on any appreciated property. In my experience, no one is willing to go through that pain to gain LLC status.

This means existing S corporation businesses have three choices. They can pay a significant tax converting to an LLC, they can accept the competitive disadvantage under which they exist, or they can work with Congress to ease these limitations and bring their business structure closer to par with the LLC. Summarized below are some of the situations and applicable changes that would help S corporations.

Managing a Family Businesses

Anyone who has operated a closely-held business understands the challenges of managing the needs and expectations of the shareholders, especially shareholders who are family members and have differing levels of participation in the business. For an LLC, overcoming this challenge is facilitated by the ability to issue different classes of ownership. Among other advantages, this flexibility allows the business ownership to be customized by distinguishing active family member owners from inactive family member owners.

S corporations do not have that flexibility. If you own fifty percent of the shares, then you must receive 50 percent of distributions and other economic benefits from ownership, regardless of your level of risk or participation as an owner. Any attempt to circumvent this rule could mean the loss of S corporation status.

One area where this limitation plays a critical role is during the transition of the business from one generation to the next. If you have a family-owned business with multiple shareholders, I find the ability to issue different classes of stock really helps keep family members involved in the future of the business. Under S corporation rules, you cannot issue preferred shares or other classes of stock that would provide different levels of compensation to different shareholders, making it more difficult to retain multi-generational family members in the business.

Allowing S corporations to have multiple classes of stock would dramatically improve their ability to transition of the business from one generation to the next.

Eliminating Obsolete Rules

In my experience, many new S corporations are former C corporations. The tax code includes a number of provisions designed to ensure that businesses converting from C to S corporation do not enjoy a tax windfall when they make that conversion. I believe in certain circumstances these provisions go too far.

For example, S corporations are subject to a corporate level tax on certain income and gains recognized within 10 years after they convert from a C corporation to S corporation. I find the built-in gains provision causes many S corporations to hold onto unproductive assets that would otherwise be replaced. Ten years is a long time. Many times I have experienced changes in the business environment or the economy during the 10 year period which prompt action that if taken, would trigger this built-in gain tax. This resulted in business owners not making the appropriate decision for the business, its employees and other stakeholders.

In addition, an S corporation election is terminated when it is converted from a C corporation and has certain thresholds of passive investment income for three years. S corporations are also subject to a special corporate level tax on such passive investment income when it exceeds 25 percent of gross receipts.

Changing the built-in gains limitation to allow for assets to be reinvested in the business or reducing the built-in gains tax period from 10 to 7 years would assist in making appropriate business decisions, as circumstances change, and preserve the rule prohibiting tax windfalls from a sale of assets soon after converting to an S corporation. Also, modifying the passive investment income limitation - which generates a corporate level tax - and eliminating the passive income termination event would remove unneeded limitations on S corporations.

Raising Capital

Raising capital is always a challenge for closely held businesses, even without the additional limitation faced by S corporations. Limiting the class of ownership and the types of owners adds another burden on the process.

The world of business has changed in the past 50 years, and the limitations imposed on those simple businesses are now restricting the ability of established S corporations to access the capital they need.

Allowing S corporations to issue additional classes of stock and allowing non-resident aliens and IRAs as shareholders will enhance the ability of S corporations to remain competitive by accessing the capital they need.

Certainty of Tax Status

The S corporation is the only business structure where you can inadvertently lose your entity tax status. An S corporation election is terminated whenever the S corporation has excessive passive income, too many shareholders, an ineligible shareholder, or an arrangement that is considered a

second class of stock. Often, these businesses are unaware they have violated the S corporation restrictions and it is discovered too late.

While Internal Revenue Code allows the IRS to absolve an S corporation and restate its S corporation status, it is entirely up to the Internal Revenue Service.

This also impacts the selling and purchasing of S corporations. In the last year, I was involved in three transactions relating to the sale or purchase of an S corporation where the remote possibility of the entity not satisfying the S corporation requirements during its entire existence stopped the transaction or resulted in a major modification of the terms of the transaction.

Changing the rules to allow an S corporation, without IRS consent, to rectify an ineffective election or a terminating event, increases tax status certainty to S corporations.

Conclusion

The S corporation structure has proven to be a huge success, but times have changed, and it is important for Congress to recognize that some of the rules governing S corporations need to change as well.

Last Congress saw numerous bills introduced that would have vastly improved the rules governing S corporations. Senators Hatch and Lincoln introduced S. 3838, the "S Corporation Reform Act", which included all of the reforms I discussed above plus numerous other items that would enhance the viability of S corporations.

In addition, Senators Lincoln and Smith introduced S. 3857, the "Bringing Opportunity to Our Small Business Taxpayers Act", which included many of the S Corporation Association's priorities, and S. 965, which would have reformed the built-in gains tax rules I discussed. These Senators have been great friends to the S corporation community and I strongly encourage the Committee to review their proposals for inclusion in this bill.

I appreciate the opportunity to submit this testimony.

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