

Capital tax, minimum wage, and labor market outcomes

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Abstract

Often an increase in the minimum wage is accompanied by a reduction in the capital tax. This paper analyzes the effects of interactions between the minimum wage and the capital tax in the general equilibrium framework. The analysis is conducted in an inter-temporal search model in which firms post wages. A (binding) minimum wage provides a lower support for the distribution of wages. The paper finds that the interaction of these two policy instruments significantly modify labor market outcomes and welfare cost. In the presence of a binding minimum wage, a decrease in the capital tax leads to an increase in wage dispersion. In contrast, when it is not binding, a lower capital tax may reduce the dispersion in wages. A binding minimum wage magnifies the positive effects of a lower capital tax on labor supply, employment, and output. It also enhances the welfare cost of capital tax. A policy change which involves an increase in the minimum wage and a fall in the capital tax such that employment level remains constant increases welfare and output.

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1. Introduction

Legal minimum wage is one of the most important labor market institutions. It is widely used as a tool of redistribution in the industrialized countries. The *direct* impact of the minimum wage on dispersion of wages and employment has been extensively studied (Freeman, 1996; OECD, 1998; Brown, 1999; Dolado et al., 2000).¹ In this paper, I study the implications of the interaction between the minimum wage and the capital tax for the labor market outcomes and welfare.

The study is motivated by the fact that these two policy instruments are often used in conjunction. In particular, many times an increase in the minimum wage is accompanied by a decrease in the capital tax. For instance, the 1996–1997 minimum wage increase in the US from \$4.75 per hour in 1996 to \$5.15 per hour was a part of the “Small Business Job Protection Act of 1996” which included tax relief for small businesses. To quote the preamble of the act

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¹ Empirical evidence suggests that changes in minimum wage have substantial effect on the dispersion of wages, but its effect on employment is controversial (Machine and Manning, 1994; DiNardo et al., 1996; Freeman, 1996; OECD, 1998; Katz and Autor, 1999; Lee, 1999; Teuling, 2003; Card and Kruger, 1994). Pries and Rogerson (2005) find that minimum wage is an important factor in explaining the observed difference in the workers’ turnover between the US and the Western Europe.

(it is) “An act to provide tax relief for small businesses, to protect jobs, . . . and to amend the Fair Labor Standard Act of 1938 to increase the minimum wage rate and to prevent job loss by providing flexibility to employers . . .” (Public Law 104–188, August 20, 1996).²

In the UK the budget of 1998 included significant corporate tax cuts for “*promoting enterprise through a range of tax incentives to boost investment, small firms and research and development*” (Pocket Budget, HM Treasury).³ In the same year, the National Minimum Wage Act 1998 was passed which introduced a national minimum wage of 3.60 pound per hour for the first time in the UK for “*encouraging work and making work pay*.”

In Canada where minimum wage is set by provinces, an increase in the minimum wage is frequently accompanied by a decrease in the capital tax. In British Columbia minimum wage was raised from \$6.75 per hour to \$8 per hour effective November 1, 2001. At the same time, the budgets of 2001 and 2002 significantly reduced corporate tax rates. Similarly, in Ontario the minimum wage was raised in 2003 to \$7.15 per hour (effective February 1, 2004) from \$6.85 per hour. The budget of 2003 substantially reduced small business tax rate as well general corporate tax rate.

In this paper, I study the implications of the concurrent use of these two policy instruments. In particular, I examine the following questions:

- (i) Whether the interactions between these two policy instruments are significant for the labor market outcomes and welfare?
- (ii) Whether a reduction in the capital tax mitigates the unemployment effect of an increase in the minimum wage?
- (iii) Whether such a policy change increases or decreases the dispersion of wages?
- (iv) Does such a policy change increase welfare?

I analyze these questions in a general equilibrium inter-temporal search framework. Search models are widely used to analyze labor market issues.⁴ The model developed has a Walrasian goods market and a non-Walrasian labor market characterized by search frictions. In the model, households optimally make decisions regarding savings, labor supply, and search strategies. Firms optimally choose investment, vacancies, and the associated wage offers. In the model, unemployment and wage dispersion arise endogenously.

The wage-setting process is modeled using a variant of Burdett and Mortensen (1998) wage posting model. As in the Burdett and Mortensen model, firms post wages and both employed and unemployed workers search among the posted wages. Firms posting higher wages attract larger pool of workers and experience less turnover of workers. Consequently, firms face a trade-off between profit per worker and the size of the work-force. This allows firms to be indifferent among different wages, and non-degenerate distributions of wage offers and earnings are equilibrium outcomes even with *ex ante identical* firms and workers.⁵

Manning (2003) and Mortensen (2003) provide evidence that wage posting is an appropriate characterization of the wage setting process faced by non-unionized workers in the industrialized countries. The variants of Burdett and Mortensen model are widely used to explain wage dispersion (e.g. Bontemps et al., 2000; van den Berg and Ridder, 1998; Vuuren et al., 2000). In addition, the basic mechanism underlying Burdett and Mortensen model has been exploited by many other wage-posting models in order to explain wage dispersion (e.g., Coles, 2001; Postel-Vinay and Robin, 2002).

Turning to the results, I find that the effects of capital tax on the labor market outcomes and welfare crucially depend on the mandated minimum wage. The binding minimum wage amplifies the welfare cost of capital tax. In addition, it magnifies the positive effects of a reduction in the capital tax on labor supply, employment, and output.

² At the time of writing, the Fair Labor Standard Act was in the process of being revised. On January 10th, 2007, the House of Representatives passed the bill to raise the minimum wage from \$5.15 per hour to \$7.25 per hour over two years. On January 17th, 2007, the Senate Finance Committee voted to add \$8.30 billion worth of tax breaks for small business to the bill raising the minimum wage.

³ Available at www.hm-treasury.gov.uk/budget/budget_1998/bud98_pocket_bud.cfm. The budget reduced corporate tax by 1 percent to 30 percent for big companies and to 20 percent for small companies.

⁴ Search frictions arise due to imperfect information, mobility costs, heterogeneity etc. These frictions make trading costly and lead to coexistence of unemployed workers and vacancies and have important implications for economic performance and public policy (see Mortensen and Pissarides, 1999 for a review).

⁵ Empirical evidence suggests that residual wage dispersion (dispersion of wages among similar workers in similar jobs) accounts for 40–60 percent of total dispersion of wages in industrialized countries (Katz and Autor, 1999).

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