The Effects of Universal Basic Income on Small and Medium-Sized Enterprises

Group Report

SOS10.1.3 Universal Basic Income

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Abstract

Basic Income has been debated by scholars coming from a broad spectrum of disciplines in social sciences in the course of past several decades. It is safe to say that the controversy around Basic Income concept and its varieties is saturated with relatively straightforward - as well as some which are less so - arguments in support and against the proposal. Nowadays we can define potential benefits and flipsides, as well as predict long-term consequences of putting Basic Income policy in place - yet, apart from general theory, gray areas regarding outcomes of Basic Income implementation remain to be explored. What has been largely left on the outskirts of the discussion is the question of Basic Income effects on small and medium-sized enterprises (SMEs). In our report we review existing literature on the subject and demonstrate that it is incomplete, limited in content and detalization and clearly requires further expansions to be made. We outline intuitions surrounding the subject from sociological, political science and economic perspectives, connect it to the general debate and the Finnish Basic Income Experiment, and identify relevant directions for future research.

Keywords: basic income, small and medium-sized enterprises, Finnish Basic Income Experiment, innovation, economics of basic income, politics of basic income, sociology of basic income
Contents

Introduction

Basic Income and Employment

   Background discussion: Effects of Basic Income on Labour Market

Small and Medium-Sized Businesses

   Basic Income as an Incentive for SMEs

   Basic Income as a Disincentive for SMEs

Economics of BI and SMEs

Startups

Constituency

Conclusion

Literature

Digital sources

Course evaluation
Introduction

In this report, we study the effects universal basic income (in short BI) might have on small and medium-sized enterprises (in short SMEs). First, we will take a look at the discussion of employment effects a BI grant of an undefined size might have and then move to handling of SMEs. We will base our argument on the proposition for the partial basic income currently being a subject of an experiment here in Finland. Our primary assumption for the labour market is that it is heavily regulated, and wages are mostly set according to collective agreements and employment law. Understanding the key points of employment will guide the reader as we discuss SMEs. In the end of the report we'll study the problems SMEs might face if BI is implemented.

Increasing employment is one of the main targets of the Finnish basic income experiment (Pulkka 2016), which makes the subject we intend to cover here important and current. Encouraging people to start their own business will have its effect on employment as well. Granting (young) people a modest income during the early stages of entrepreneurship will help entrepreneurs assure a small but stable income.

Basic Income and Employment

Even though social security and the welfare state are seen as great concepts, suspicion for both of them has risen. There are calls for reform, and they have to be answered with a novel proposal preserving the best of the old system and ridding it of the worst. BI appears to be just the solution everybody has been looking for, but it might be more complex and controversial than it appears at the first glance. BI warrants an in-depth economic analysis followed by large-scale and long-term empirical testing. While some studies have already addressed this target, effects of BI on specific policy areas have not been properly considered - especially its impact
on the subject matter of this report, small and medium-sized enterprises. Employment is a big part of this particular discussion that we explore in this report.

**Background discussion: Effects of Basic Income on Labour Market**

Most of the economic models and simulation studies on BI or BI-like policies have attended to the question of what would happen to labour market if this policy was to be introduced. This point is worth considering before turning to SMEs, as it informs the discussion of this segment of private sector under a BI policy.

The evidence derived from Bowles (1992) model of universal and unconditional cash transfers is purely intuitive. The core finding is that feasibility of basic income grant for all depends, other things equal, on the tax rate and has serious limitations. The feasibility of unconditional and universal social transfer in the paper is assessed in terms of positive effects on labour supply, defined as the “one which does not lower the after-tax profit share of output, or does not lower the ratio of labour effort to the wage”. Bowles considered a model where “all income-replacing payments [are eliminated] and the expenditures [are redistributed] in the form of an unconditional universal grant to all members of the society”. As the grant is increased to its optimal amount (i.e. satisfying feasibility criterion described above), the labour “effort to wage ratio rises, and with it the profit share of the firm”. Such amount can only be very small (around USD 250 annually, estimated with 1989 US data on employment and income) for this conclusion to hold. The tax introduced to procure funding for the universal grant in the model is levied on the workers by subtracting a fraction of their hourly wages. If the amount of BI is allowed to rise higher than the minimum feasible estimate, the labour supply is expected to be negatively affected - as is the after-tax wage of the tax-paying employees. That is, “the advantages of employment over non-employment (that is not being in the labor force) would be greatly reduced”. The increase in gains from non-employment will be proportional to the drop in utility of being employed and equal to maximum feasible tax rate. In other words, individual labour effort is concave and increasing function of wage
affected by the increase in BI grant amount. The following figure is a graphical representation this conclusion (Bowles 1992), indicating weaker propensity to work under maximum BI grant amount:

![Diagram showing the relationship between e, w, and the maximal grant with endogenous decrease in unemployment duration.](image)

Fig. 6. The maximal grant with endogenous decrease in unemployment duration.

The additional conclusion is that gradually the reduction of labour force participation will result in the shortage of aggregate income base utilised as a source of funding for the UBI policy, to the point of forcing decision-makers to legislate for reduction in the amount of grant entitlement. **The demand for labour will either be stable or will increase, which, coupled with a drop in labour supply and hike in tax rate, will cause a decrease in the cost of job loss and raise the reservation wage (i.e. the minimum amount deemed acceptable to the worker to enter an employment contract), making participation in the market less profitable for firms.** The true magnitudes of changes described here could only be estimated empirically, yet the basic logic of the model should remain pertinent to the UBI implementation and its consequences.

There have been a lot of empirical studies of social policies in developing countries dealing with cash transfers with weak conditionality and microsimulation testing of basic income policy effects on labour market. One of the latest is Mederos & O’Donoghue (2015) paper analysing Ecuadorian data on a UBI-like social benefit
with non-enforced household conditionality. It bears a high degree of importance, as the authors contend that negative effects on labour force participation for adults with larger than minimal consumption/income can be expected to increase with the growth in the amount of BI grant allocated. Specifically, they state that:

“Social transfers may negatively affect labour supply in the case of individuals with income/consumption higher than minimum level of consumption/income, [i.e. below which leisure ceases to display characteristics of a normal good with positive income elasticity of demand, or the demand for leisure is non-existent], while producing positive or zero effects in the case of persons with income/ consumption below it”.

Scutella (2004) points out that there might be many serious problems with funding, implementation and effects on labour market if a BI policy supplied with revenues from a flat tax scheme is introduced. The application of the Melbourne Institute Tax Transfer Simulator (MITTS), a behavioural microsimulation model of the Australian tax-transfer system, helped establish the prospective costs of the system, found to be as high as 50 per cent if the aim is to maintain at least the same level of tax revenues as the one required for sustainable provision of existing social benefits. BI is expected to reduce labour supply, echoing findings in Bowles (1992).

Small and Medium-Sized Businesses

Small and medium-sized enterprises are businesses with less than 250 workers, and they are the most common form of enterprises in Finland (Tilastokeskus, 2014). Basic income can be seen as both an incentive and a disincentive for entrepreneurs to work in Finland. In this chapter, both incentives and disincentives are studied. On one hand, BI offers a stepping stone for entrepreneurs (Nootbeboom, 2013) but on the other hand, the problems of constituency and unfavorable economic consequences have to be taken into account.
Basic Income as an Incentive for SMEs

One of the main targets of social policy is raising the standard of living while creating equal income distribution. Partial basic income can increase the standard of living of entrepreneurs by providing a safety net especially for the early years of entrepreneurship. Roughly half of the enterprises go down during the first three years (Ministry of Employment and the Economy 2012, 17). BI is also a social security benefit paid regularly and without means-testing, so one does not have to prove to be qualified or fail with one’s enterprise to get BI. Therefore BI is a social security benefit without shame (Nootboom 2013, 212-213).

BI would also cover some of the threshold costs of an SME, for example the wages of the staff. Since the expenses are relatively higher for SMEs, BI serves as a compensator for the entrepreneur (Nootboom 2013, 211-212). The complicated net of subsidies, regulations compensations are also seen as a problem and Nootboom sees that BI could replace at least some of the subsidies entrepreneurs get (ibid. 213-214). Yet basic income should not only be seen as a means to take down the other forms of subsidies, but view it as a layer on which the other subsidies and compensations are piled on. That way BI would serve as a universal social security benefit while other forms of benefits would compensate it.

Basic Income as a Disincentive for SMEs

On the other hand Edmund Phelps (2013) focuses on three major drawbacks basic income could produce. Employment is also used as an angle here, but Phelps gives it a different perspective, looking at the issue from a social point of view. In Phelps view, the implementation of basic income could have the following ramifications.

Work, career, and achievement are already threatened by a whole array of competitors – crime, unemployment, and the underground economy. This is no time to launch a new scheme that would create further disincentives to work in the legitimate business economy. Marginalization must be reduced, not increased. In
this day’s societies, with the legitimacy issues such as democratic deficit and the increasing social exclusion from the public space and decision-making, we cannot allow marginalization of the already disengaged to go any further.

It is important to note that what matters to people is not just their total income; it is the self-support from earning their own way. It can be criticised that no amount of UBI would substitute for the satisfaction of having earned one’s way without help from parents, friends and the state – as valued as they are. Although, compared with, say, the United States the public atmosphere is not as individual-based here in Finland and it is welfare state but highlighting bluntly that a certain amount of the population cannot hope to earn their own way in the sense of gaining access to most of the median earners’ way of life through their own earning. This could be seen as demeaning and would not promote the social status of this part of the population. Although on the other hand it can be noted that an income level provided by basic income could relieve some pressure of from especially new entrepreneurs and entrepreneurs of small scale-businesses as sort of a backup in case of health issues or other setbacks. Especially in Finland, it is tricky for families of sole entrepreneur to receive regular welfare state benefits because in the view of state and the tax officials, their income appears higher on paper than it actually is.

The value to mix and interact with others, to gain a sense of belonging in the community, shouldn’t be underestimated. The notion of a national collective project, that is business and the well-being of a people through a prosperous state is something that every citizen should have a chance to be a part of. How fiercely this should be highlighted as a duty, is of course up to every state to decide. But being a part of a collective, whether a working group or an entrepreneur contributing to a local tax revenue, is something that is important for many citizens. This inclusiveness is something that should be pursued. This idea of a collective program can be seen to be realized in the Finnish government and their discourse to the current economic state of the country. Much of the focus is on entrepreneurs, those who contribute and also are able to help others by employment. Basic income can be seen to have an opposite direction. The fear is that basic income could result in dependency in contrast to self-support, marginalization as opposed to integration and finally
disengagement, rather than personal growth. As the effects of basic income are this drastically different from the current heading of our state heads, the political support needed for basic income could be hard to defend.

Economics of BI and SMEs

Now that some relevant theoretical, empirical results and social effects have been reviewed in brief, it would be appropriate to study BI and SMESs from an economic viewpoint.

How an average small or medium-sized firm would behave when a basic income policy is considered? First, they can be expected to increase wages by the amount of tax liability of a worker. It is also likely to increase prices on its goods and services - as the purchasing power of an average household will increase by the amount of BI grant. Let’s assume that wages are regulated (by a collective agreement or national legislation), and workers’ demands are enforced. For its commercial activities to remain profitable, an SME will have to keep prices higher than median household income. Price increases might backfire, as larger competitors possessing higher degree of market power are likely to keep their prices lower and thus more attractive to customers. Even given a good economic situation and high household purchasing power, this is going to cause such losses to our firm, that laying workers off will be seen as the best solution to this situation. Some SMEs might not be able to withstand competition from larger companies and go out of business - big firms have the indispensable advantage of their market power and resources to pay high wages without resorting to staff cuts.

Investing in technology of production might help our firm to offset the costs of growing wages and keep its operations profitable - a plausible way out in this day and age. The best outcome is such that most SMEs manage to substitute their workforce with technology to the point of reaching an optimal level of their operating profit, the probability of which happening depends on the level of demand for product produced by them, on the general state of the economy and on the pace and accessibility of technological development to SMEs. SMEs will be more likely to drive
technological change (i.e. cause decrease in demand for labour) since they have less resources than large firms to maintain greater numbers of employees. Overall automatisation of production process can be expected to be a positive trend with a growing magnitude - exacerbated by the potential decrease in productivity of remaining workers, as per Bowles (1992) evidence. With less workers remaining in the labour force, taxes will have to be increased to fund BI grant, causing growing price inflation. Eventually, with large fraction of population becoming non-employed BI recipients (and some possessing high entrepreneurial ability creating successful companies), the tax burden will have to be shared by somebody other than working individuals - that is, by firms. The question of whether automatisation is less expensive for a firm than moving its operations overseas (i.e. to countries with better mix of regulatory framework, infrastructure, consumer base and costs of labour force) certainly requires further consideration. Intuitively, larger firms have more resources and political leverage to choose the latter; SMEs, on the other hand, are more likely to prefer the former option.

Startups

Basic income can help tackle the problems startup businesses face. Startup businesses have at least 10 people working in it at the beginning, but the raise in employment should be at least 20 % during the first three years (Ministry of Employment and the Economy 2012, 26). Even though they get public funding and other expert services, one has to fulfil the strict qualifications to get it. On one hand, offering startups BI as an additional stepping stone, especially during the first years of entrepreneurship new innovations and jobs might be created. Also investing in young people will help them to launch their own business and encourage them in the working life in the long run.

On the other hand, problems of economic nature may occur. For a poor household, price inflation caused by private sector’s response to the increase in wages and purchasing power will mean that a good or service might cost just a bit more than it can afford to spend. This also means that an individual wishing to start a business of their own would be struggling to do so - regardless of whether they are employed or
not. The after-tax wage of a working individual would be hurt by the redistribution to the non-employed; in a bad economic situation their earnings plus BI grant will not be seen by lenders as sufficient - making it harder to start a business. This holds even greater significance for the case of a non-employed first-time businessperson.

**Constituency**

If basic income will be implemented, the question of constituency will be raised. Even though SMEs might see BI feasible, they might encounter opposition from larger companies.

The question of whether SMEs would be likely to willingly contribute large portions of their profits to fund BI programme is a matter for political science. SMEs will have to represent a significant and unified segment of private sector to successfully resist imposition of tax increases by the state. Having little competing social security benefits, though, SMES could support BI.

Large companies will still most probably be more effective in their lobbying efforts than SMEs, will likely favour flat corporation tax and will oppose subsidies to SMEs at their expense. Another argument in favour of the idea that firms are going to have enough power to refuse to finance BI transfers out of own pocket (regardless of their size) is that the number of workers, level and strength of their organisation and thus their aggregate ability to enforce wage-related demands will not be sufficient to balance influence of employers. Non-employed BI recipients with their complete dependence on taxpaying individuals and businesses, are unlikely to make any significant impact on firms’ contributions. Private sector, especially big companies, will be left as the main interest group with the unbeatable bargaining power - barring new firms from entering the market and hurting existing smaller firms.

**Conclusion**

As can be inferred from the discussion above, Basic Income provokes both hope and fear in terms of its prospective influence on small and medium-sized enterprises. As
we have demonstrated, theoretical arguments can be made in favour and against Basic Income from sociological, economic and political science perspectives. The likely conclusion is that direct answers to the problem of whether BI will make SMEs better off with respect to cost containment, lead to greater investments in innovation by SMEs, improve conditions for survival and growth of startup businesses, will have majority support in the society and will eventually reduce income inequality and promote creative human development cannot be immediate and exhaustive. One might hope that some degree of social, political and scientific consensus on BI can be reached given the availability of sufficient quantifiable evidence, empirically obtained and verified over time. Still, our report managed to raise important issues, outlined below:

- More research needs to be done to contrast BI influence on startup businesses and medium-sized firms. They might have vastly divergent concerns regarding their roles as employers and taxpayers. A startup consisting of one or two entrepreneurs can have more in common with individual employee when it comes to matters of social security for oneself and one’s own family, consumption needs and so on. Expected utility equation of a firm with a staff numbering 150 persons will, on the other hand, resemble large companies like Microsoft, caring mostly about wages, long-term investments and satisfying investors. Therefore, BI might affect SMEs differently, depending on a firm’s size.

- While we examined SMEs and BI by disregarding possible sector-specific factors, greater attention of scientific community should be streamlined into exploring the question of the ways in which BI introduction might transform IT, service sector, light and heavy industry and other particular segments of economy. Our discussion here has the capacity of serving as a starting point for studies carried out in this regard.

- We cannot be sure that the entrepreneurs themselves will support BI. We need to make sure that the BI’s constituency is composed of people from different interest groups in order for it to actually work. One potentially acceptable initiative, which can naturally satisfy all employers, the wealthy
and will (hopefully) remove obstacles to labour market entry for basic income recipients, is decisive labour market deregulation. Individuals on partial BI grant will have to derive additional income from employment, preferably part-time. If traditional full-time, permanent jobs are replaced with predominantly part-time and short-term options, the dream of full employment might finally come true. The question is, what should be sacrificed to achieve this. Perhaps, trade unions?

- What about automatisation? Crocker (2015, 92, 101) sees automatisation and technology as threats, and “[b]asic income is in fact the only solution to ultimate pervasive automation” (ibid. 101). If automatisation is a threat (for instance, since it might lead to massive expansion of structural unemployment), and BI, as we point out in this report, is likely to induce faster pace of technological change, can it be viewed indeed as a sustainable solution to the danger of ‘robots stealing our jobs’?

- The problem of freedom arises as well. If people have more money to spend, they might spend it in an unsustainable way. Considering health care provision, that might lead to individuals purchasing private health care. BI might turn into a subsidy for private health care and cause support and funding for the public health care system to erode in a long run. Is it possible that costs of privatised health care in the absence of public option will be passed on to those unable to afford anything better than bare-bones insurance plans, taking away health security and limiting incentives to create risky new businesses?

- Basic income has also the possibility to increase labor demand and further increase consumption, as Keynesian economic theory predicts. Transferring BI grants to individuals might increase their consumption power. (Crocker 2015, 92). As our analysis in the Economics of BI and SMEs section of the report indicated, these gains might be offset by price inflation. Yet if the optimal amount of BI grant can be selected, the right balance might be struck between these three arguments, empowering consumers and businesses, and improving labour market conditions for all actors.
Literature


Digital sources