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Commentary

Title:

"Why McDonald's Is Wrong About the Minimum Wage"

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In a surprising about-face, McDonald's has reversed its opposition to drastically raising the Federal minimum wage. In 2019 McDonald's dropped its participation in the lobbying effort of the National Restaurant Association opposing the proposed increase to $15 per hour. In January of this year McDonald's CEO Chris Kempczinski told investors that "…McDonald's will do just fine through that."[1] While some companies such as Domino's Pizza have endorsed McDonald's position, others, such as The Cheesecake Factory, have opposed the proposed new minimum.

How should we think of the minimum wage, and is it good for the country as a whole? Is it even good for workers in the affected labor markets? In order to answer these questions we need to analyze how wages are set in a competitive market. The first thing to recognize is that a wage is just another name for a price, the price of hiring one hour's worth of labor. Labor markets can be analyzed using the same tools and techniques used by economists to analyze price in any market, labor or otherwise.

The most famous, and probably the most misunderstood, tool of market analysis used by economists is the model of Supply and Demand. This model attempts to capture the interactions between all the participants in a particular market, and then determine what the equilibrium, or balance, between the parties will be. In particular, for a labor market, we will analyze what the level of wages will be and how many workers firms will choose to hire.

Do Firms Exploit Workers without the Minimum Wage?

It is commonly assumed that the resulting "balance" between workers and employers will be strongly in favor of the employer and to the detriment of the worker, leaving the worker underpaid or exploited. Under this assumption, the minimum wage is seen as a mechanism to redress the imbalance of power between low-wage workers and their employers, and restoring the wage to its "rightful" level. Under this view, the higher legal minimum wage will have no long-term negative consequences since the minimum wage just returns things to the level that should exist if employers were not taking advantage of their workers.

Is this commonly held belief true? There are strong theoretical and empirical reasons to think not. But, how could it *not* be true? How can a worker with limited skills and education go up against a billion dollar corporation and get a fair deal? While the argument positing worker exploitation has merit in a monopsony situation, the reason why it is generally not true, and specifically untenable in low-skilled worker markets, is due to the mediating effect of competitive markets.[2]

To see how competitive markets change the bargaining dynamic consider the following thought experiment. You are a district manager for Chevron, the major oil corporation, with sales of over $94 billion in 2020. You are deciding on the price to charge for gasoline at a new station located in Kennesaw, Georgia. The current market price of gasoline being charged by your competitors in the surrounding area is $2.89 for regular gas. In making your pricing decision you have the "power" of one of the world's largest corporations backing you up. In addition to this corporate power, you are selling to individual consumers, most of whom have an income less than $100,000 compared to Chevron's billions. What price will *you* choose to impose on these "helpless" victim/consumers? How about $5 per gallon? After all, gas is a necessity to get to work and school, they will have to pay it!

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[1] https://www.newsweek.com/mcdonalds-other-ceos-tell-investors-15-minimum-wage-wont-hurt-business-1580978

[2] Monopsony is a situation in which there is only one buyer of a good or service, loosely the mirror image of monopoly. In a labor market (where workers are the sellers and firms are the buyers), a monopsony situation would arise if there was only one firm hiring a particular pool of workers.

No doubt, you have already spotted the flaw in this pricing strategy by Chevron. As long as there are other powerful corporations selling gas, Chevron would not be able to impose their preferred $5 price. Once consumers saw that BP, Shell, and other gas stations were charging $2.89, they would skip the Chevron station and frequent the others. Once Chevron saw their sales drop towards zero, you as the pricing manager, would be "forced" to lower your price to the market price. From this simple thought experiment, we can see that corporations actually have very little power when operating in competitive markets since each company's power is offset by the power of other companies.

Labor markets are even more competitive than gasoline markets, and especially so for low skilled workers. There are far more firms trying to hire workers than there are oil companies trying to sell gasoline. To continue with our though experiment, place yourself in the position of Wendy's hiring manager. Wendy's generated $1.7 billion in sales in 2020, so you have the backing of a major corporation. You are only legally required to pay $7.25 per hour under the current Federal minimum wage law. If you could hire the workers you needed at this wage you could make a huge fortune, so you offer this wage in your job ads. How many workers can you hire, and what worker quality will you get? In my neighborhood, Wendy's is actually offering over $10 to start and will pay more for experience. Why does Wendy's (and other fast food outlets) pay so much over the legally required minimum? Is it their benevolence due to great religious conviction, or something more mundane? Economists would simply point to the fact that other firms are also paying above the Federal minimum since there is a shortage of qualified help at that wage.

It turns out that a major corporation, generating billions in revenue, cannot force a worker with only a limited education to accept a wage offer below the competitive equilibrium price, even though it is perfectly legal to do so.[3] This is due to the same forces that prevent Chevron from overcharging for gasoline. Competitive markets consist of multiple firms, so no individual firm has much power to determine the market price or wage on its own.

If the firms conspired to hold prices up or wages down, could they overcome this problem that competition causes them? Naturally, the answer is yes. But, it is next to impossible to maintain a labor market conspiracy among hiring firms. This is due to the fact that if they conspire to set the wage below the equilibrium price there will be a shortage of workers. Since each firm would like to hire more workers at this low price, the self-interest of each separate firm will impel them to offer slightly higher wages to lure workers away from other employers. Over time the conspiracy breaks down due to firms "cheating" and the wage rises to the market clearing, or equilibrium, price.[4]

What Is the Harm in Having a $15 Minimum Wage?

The discussion so far has revolved around the question of whether workers would be exploited, or paid less than a competitive wage, without Federal intervention in the form of a minimum wage. As we can see, there is no reason to think so. But, this still leaves us with the question of whether we, as a society, could do a good deed to low-skilled workers by granting

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[3] This statement is true for any wage above the legal minimum wage. So, for example, Wendy's is legally permitted to set their wage offers at $8 per hour (which is above the legal minimum of $7.25), even when the market equilibrium for those workers is $10.

[4] For a fuller discussion of how markets break down labor market conspiracies, see: "Competitive Markets Eliminate Discrimination: the Example of Professional Sports" by Burt Folsom & Michael Patrono, Bagwell Center Commentary (August 2020) https://coles.kennesaw.edu/econopp/commentary.php.

them a legal minimum wage above the market equilibrium level. Certainly, most of us want those who are struggling with low incomes to do better. Unfortunately, due to the Law of Unintended Consequences, we could do harm while trying to do this good deed. Certainly we would not today credit a medical doctor's good will if he or she chose to bleed his or her patients with leeches to cure them of disease. Good will is not enough; we hope to actually do good with social policy, not just feel good.[5] We should avoid harming those we are trying to help.

So where does the harm come from? When wages are forced up by law above market levels, firms that hire the affected workers will see their labor costs rise. Firms must make a competitive rate of return, or profit, if they are to stay in business. No private business owner is wealthy enough to run a business as a money-losing charity indefinitely. So, there are several things that a business can do in the face of rising wages; among other things, they can: raise output prices, automate to reduce labor, reduce worker hours, or directly let workers go.

According to the Law of Demand, when you raise price consumers reduce the quantity they purchase. We can expect that as wages rise above the competitive level we will see restaurants, car washes, retailers, and others raising their prices. Consumers will cut back on their purchases, so at the margin, some firms will not be able to survive at their current size and will have to lay off workers. Firms can also automate, as we have seen in the car wash business and the self-check-out line at the grocery store. In this way, the firm substitutes capital for now more expensive labor. We can expect this trend to accelerate after an artificial increase in the minimum wage. Furthermore, we can expect that many firms that are just making it now will not be able to stay in business after the wage increase. They will of course have to lay off their workers.

Now we can see that the harm imposed by the minimum wage increase above equilibrium comes in the form of making jobs scarcer and raising the level of "unemployment" for low-skilled workers above its normal rate.[6] We are now caught in a dilemma where some workers (the ones who keep their jobs at the higher wage rate) are helped, but others (those laid off due to the higher wage) are harmed. To make things even more difficult, the workers who are laid off or who cannot find work tend to be the least educated and least skilled. After all, if employers are now forced to pay $15 per hour, they will upgrade the skills that they demand in a worker. With lots of qualified workers looking for work, why would a firm settle for the least skilled? The unemployment effect, therefore, will fall most heavily on the youngest and least educated workers. Those helped will be those most likely to have done fine in the already existing labor market as they accumulate training and skill through work experience. The irony is that the minimum wage most helps those workers who are already poised to do well and most harms those workers who are already worst off.

Why Is McDonald's in Favor of the Minimum Wage Increase?

The CEO of McDonald's may believe sincerely that he is doing good by supporting the proposed minimum wage increase, but interestingly there could be another, less noble reason for him to support the increase. The restaurant industry is divided into the self-service model and the full-service model. The self-service model is based on attracting customers through low prices,

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[5] "Are Nonprofits Natural? or Is It Better to Feel Good Than To Do Good?" by J. Wilson Mixon, Jr. and Michael Patrono, Journal of Private Enterprise, Volume X, Number 1 Summer, 1994.

[6] As a strictly technical point, the workers who cannot find jobs may not show up in the government unemployment statistics. If workers give up looking for a job they are categorized as "not in the labor force" by the Labor Department, and are not counted as unemployed.

while the full-service model attracts customers with a more pleasant, but costly, dining experience. Since McDonald's already has fewer employees per meal than a full-service restaurant, any increase in the minimum wage will have a smaller impact on them than on the full-service restaurant. As customers reduce their consumption of restaurant meals in general, part of their cost saving strategy will be to switch to the relatively lower cost self-service restaurant and reduce their full-service dining. McDonald's could actually see an *increase* in their sales in response to the higher minimum wage by taking market share from the high cost full-service competitor! This helps to explain the different reaction of The Cheesecake Factory's CEO to the same minimum wage increase. These two firms will experience the proposed wage increase very differently.

In conclusion, raising the minimum wage has great potential to harm the least skilled among us by making low-skilled workers less desirable in the labor market. Jobs at the bottom of the wage scale will pay better, but there will be fewer of them. Advice on whether to support the increase, when it comes from firms who could benefit from it but who won't experience the harm from it, should be taken with a grain of salt.