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Minimum wages and appropriation of quasi-rents

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Abstract

This note argues that the appropriation of the quasi-rents from firms to labor is a more persuasive interpretation of the effects of minimum wages than is generally recognized.

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Since Card and Krueger (1994), the near-universal consensus among economists that minimum wages have disemployment effects has been lost. Additional empirical research has come to support the position that such policies have no disemployment effects (e.g., Dube *et al.* 2010, and Basker and Khan 2016, c.f. Neumark and Wascher 2008). Those opposing the policy largely appeal to supply and demand (e.g., Mankiw 2014), while theoretically squaring the empirical result requires quite sophisticated rationales (e.g., Flinn 2006). Lee (2004) has, to the contrary, argued that the correct interpretation of such a result is that it still hurts workers by reducing fringe benefits or by providing worse working conditions.

However, another interpretation of the result has not been widely discussed. Inframarginal firms receive rents (producer surplus) from the sale of their goods and services. All firms receive quasi-rents as well. Quasi-rents are cash flows which serve as payments to fixed factors of production. Firms do not need to receive rents for their production to persist in the long run. Quasi-rents are unnecessary in the short run, but the firm will shut down in the long run in their absence. Klein *et al.* (1978) noted that labor, when organized, is capable of bargaining for not just the rent the business owner would earn under competitive conditions, but for the quasi-rents which would normally provide the market rate of return to the capital. In other words, unions are capable of pushing the firm to just above the shutdown condition and appropriate not only the full producer surplus, but the cost of capital as well. Despite this, in the short run, there are no disemployment effects. Organized labor thereby theoretically can disincentivize investment under the threat of quasi-rent appropriation.

Card *et al.* (2014), summarizing and extending the empirical evidence on quasi-rents and the more general rent-sharing, argue that unions are not this myopic. The authors find that, at least in the case of the Veneto region of Italy, workers bargain for rents, but only after the cost of capital has been deducted. Either bargaining or not bargaining for quasi-rents may be rational depending on discount rates. For a rational union with a long time horizon, hoping to secure long run fruitful employment for its members, this makes sense, though perhaps it lacks this incentive in a one period model.

How this relates to the minimum wage follows. Labor unions are theoretically capable of appropriating quasi-rents, but it appears that in at least some cases they are wise enough not to do so. Under such circumstances, there are no disincentives to investment. A labor union which bargains perfectly forces rent-sharing without having other deleterious effects on the firm. However, a minimum wage may also transfer the quasi-rent from the firm to labor. The hope of minimum wage proponents is to transfer the rent from the firm to labor, but this policy instrument does not discriminate between rents and quasi-rents. When this occurs, each of the stylized facts of the aforementioned empirical studies holds: unchanged employment, higher wages, and lower profits. There may yet be a small disemployment effect due solely to the marginal firms, though this effect is plausibly within the error term of most such empirical studies. For most firms, there are no disemployment effects in the short run. On the other hand, this verbal model is highly stylized, with firms locked into specific production techniques, an assumption that will not hold for all firms.

But the on-impact negative effects of minimum wages may be hidden. In the longer run, after the quasi-rent is dissipated, the owner would have the incentive to eventually switch from more labor-intensive methods to ones that are less globally efficient (this being the conventional "demand slopes down" result). More perniciously, the threat of future increases in the minimum

wage may create regime uncertainty undermining a willingness to invest in the types of technology and capital complementary to low skilled labor, thereby reducing employment for low skilled workers. That is to say, the risk of the appropriation of quasi-rents can shift investment towards capital unlikely to be appropriated via the minimum wage. Repeated and arbitrary increases in the minimum wage worsen this risk. This is consistent with the recent shift towards long run effects of increases in the minimum wage, for instance Meer and West (2016).

Because quasi-rents are typically thought of narrowly (often as already grown agricultural products that will rot if a farm cannot hire labor to collect them; more generally it includes firm-specific capital machinery as well), here is a narrative to motivate the possibility of it being very relevant economically. A firm in the fast food industry must choose between a low labor intensity production technique and a high labor intensity production technique and purchase the relevant capital. The high labor intensity production technique is a set of traditional point of sale terminals each requiring an employee. The low labor intensity production technique is a set of self-serve terminals, requiring only a single employee supervising them simultaneously. Suppose that, at the market wage rate, the high labor intensity production technique is profit-maximizing and economically efficient. The firm invests in the high labor intensity capital not expecting a spike in the minimum wage. Should one occur, the firm has a choice to make among three options. The firm can recognize that sunk costs are sunk and continue operating, approximately as before. The point of sale terminals, organizational capital, location, and other fixed or quasi-fixed attributes of the business are analogous to the potentially rotting fruits in the field of a farm. The second is that it can shift the production technique and liquidate its capital. Or it can shut down. In the first instance, disemployment effects are modest, in the second they are large but perhaps on a lag, and in the third they are large and immediate.

It should also be noted that if the increases in minimum wage are anticipated, the firm would invest with that expectation and choose the low labor intensity production technique at the outset of investment, and this too would not appear in the contemporaneous data (or at least minimally in comparison to its actual effect on employment). Should such expectational effects be important empirically, considerable challenges to identification are present but unrecognized.

This discussion ultimately rests on a rather elementary recognition of the complexities of the short run, the long run, and the characteristics of shut down conditions. The point is that they are not really being discussed in the context of the debate. These considerations could explain the data as well as monopsony, matching, or bargaining theories. This results directly from the bluntness of a general minimum wage as a policy tool, whether it is enacted at the national, state, or local level. In countries where minimum wages are more carefully negotiated, or set with a very long time horizon, these effects may be less important. However, this explanation is simpler and more straightforward than many models making the same empirical predictions, although it comes to the opposite policy conclusions.

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