

## LABOR

# Tipped Workers and the Minimum Wage

*California's broad minimum-wage increases appear tailored to manage political forces.*

✦ BY RICHARD B. MCKENZIE

**A**t the start of this year, California's mandated minimum wage for workers in firms with 26 or more employees rose from \$11 to \$12 an hour, after rising in 50¢ increments the previous two years. The state's minimum wage for those employers will continue to rise by a dollar a year until it reaches \$15 at the start of 2022, an increase of 50% over six years. Smaller employers will have to match that level the following year.

Proponents of minimum-wage increases have argued that the hikes are needed to provide low-income, low-skill workers in, say, fast-food restaurants a "living wage," meaning enough income to provide an acceptable living standard. Interestingly, though, the coming California wage increases will have an unheralded (and, some might say, perverse) effect: they will raise the paychecks of some well-off California restaurant servers who work in higher-end restaurants and whose total earnings, including hefty tips, are now well above the "living wage." Thus, minimum-wage policy is not particularly well targeted to the low-wage workers that it's ostensibly intended to help.

Minimum-wage coverage of already-well-off servers may be nothing more than an unintended consequence of the legislation, a simple policy mistake made by busy legislators. However, another explanation is that this policy is intended to dampen opposition from some affected industry sectors, as well as manage political forces.

## SERVERS' HOURLY TIP INCOME

Because California law, unlike federal law, does not allow a sub-minimum wage for tipped workers, restaurants must pay those workers the state's minimum wage regardless of how much they

receive in tips. Tips are considered by law to be servers' "sole property" and many servers make significantly more income from tips than from their wages.

In the fall of 2015, the Restaurant Opportunities Centers United and other labor groups pressed for a ban on restaurant tipping on the grounds that it leads to unequal server incomes (because of, say, customers' racial and gender biases). Further, these groups argue, tipping forces servers to grovel for income and "tolerate inappropriate and degrading behavior from customers, co-workers and managers in order to make a living," to quote a labor activist writing in the *New York Times*. Tipping-ban advocates proposed to replace tips with a minimum hourly wage of \$15.

As I previously described in these pages ("Should Restaurant Tipping Be Abolished?" Summer 2016), I interviewed 40 servers in eight Orange County, CA "casual" table-service restaurants, which I defined as serving alcoholic beverages and cheeseburger-and-fries meals for less than \$12 (e.g., Chili's). All interviewed servers scoffed, without hesitation, at the idea of giving up their tips for a "mere" \$15 minimum wage. I then asked what minimum wage they would accept in exchange for giving up tips plus the then-\$10 minimum wage. Their responses ranged from \$18 to \$50 an hour, with \$30 being the median. (Several servers responded after consulting their smartphones, where they recorded their tips.) That median translates to slightly more than \$33 an hour today, after adjusting for inflation on tip income and adding the \$2 increase in the state's minimum wage since 2015.

Understandably, many servers said that if tips were banned and replaced with a \$15-minimum wage, they'd leave their restaurant jobs for work that pays better. Most servers volunteered that their relatively high income inclusive of tips was the key inducement for serving. Several added that they were quietly pleased that customers think they make far less than they do, believing that results in better tips.

RICHARD B. MCKENZIE is the Gerken Professor of Economics and Society (emeritus) in the Merage School of Business at the University of California, Irvine. His latest book is *A Brain-Focused Foundation for Economic Science* (Palgrave, 2018).

### SERVER INCOMES

To assess the absolute and relative income of the interviewed servers, let's suppose a server works 40 hours a week for 50 weeks a year, earning an average of \$33 an hour. The server's annual income would be \$66,000, which is 6% above the June 2018 national household median.

Assuming the "median server" reports for tax purposes two-thirds of his total income, he would save \$5,903 in taxes by not reporting his full tip income, making his "effective pre-tax annual income" \$71,903. That income would put the server in the top 42% of American households, roughly speaking. If two median servers live together, they would have an effective pre-tax household income of \$141,890 and be in the top 15% of all households.

With the scheduled \$3 increase in the California minimum wage by 2022, the effective annual income of an individual server will be \$79,061 (assuming tips do not rise, which they could with minimum-wage-induced increases in menu prices). The median server, alone, will be in the top 38% of households. Two such servers, living together, will reach the top 12% of households. If those two servers make the upper limit of my responses, \$50 an hour, they would be in the top 5% of all households in 2022.

Of course, servers in low-level restaurants don't do nearly as well as my interviewed servers. But servers in higher-end restaurants (e.g., Morton's) often do much better than my surveyed workers and still must be paid the state's mandated minimum wage.

I recognize that my interviewed servers would rank lower on the Orange County income scale (which has a median income 42% above the national median), but that doesn't affect their real incomes. Their relatively higher living cost—mainly from housing—does. However, the servers can also take advantage of the driving forces behind the higher housing costs, mainly the mild year-round climate, proximity to stunning coastlines, pockets of superior public schools, and the surrounding high-tech/entrepreneurial economy (with an unemployment rate at 2.8% in November 2018, a full percentage point below the national rate). I don't suggest that servers' hourly income is not undercut by living costs, only that there are good reasons the interviewed servers continue to work and live in the area.

### THE MINIMUM WAGE AND RESTAURANT TECHNOLOGY

Econometric studies of the employment effects of minimum-wage hikes over the last 70 years have mainly focused on young, low-

RAWPIXEL LTD. / GETTY IMAGES PLUS



## LABOR

wage, low-skill workers. For those labor groups, empirical studies have found minor reductions in employment—generally no more than 3% and, at times, between 0 and 1%—given wage increases of 10%. No one (to my knowledge) has considered the employment effects of minimum-wage increases on groups of skilled and well-off workers receiving the minimum wage, namely servers and other workers with significant (even substantial) tip incomes.

My interviewed servers do well enough that, as several volunteered, they consider their wage to be an income supplement that mainly covers their withheld income taxes, while the tips provide the lion's share of their take-home pay. Restaurant managers, on the other hand, clearly see mandated wages as a significant cost that needs to be managed to remain competitive on menu prices—especially now that the California minimum wage will rise another 25% by 2022.

California's minimum-wage increases will give an added competitive edge to restaurants that conserve paid labor by shifting work to customers. Of the eight restaurants I surveyed, Chili's and Red Robin are the only ones to date to have placed small consoles with touchscreens on tables. They both did that in mid-2017, after the scheduled minimum-wage increases became law earlier that year. Customers use the consoles to order and pay for their meals, resulting in less work for servers.

The devices offer the prospect of mutual gains for management and some—but not all—servers. Because the consoles enable individual servers to cover more customers, managers can reduce their wait-staffs and wage payments, as well as moderate menu-price increases. For servers who keep their jobs, the consoles can cause their total tips to increase because they're working more customers. But the consoles can also cause servers' tips to decrease because the servers have less interaction with their customers (and a number of my interviewed servers were confident they could affect their tips with customer interaction).

I pressed four Chili's and Red Robin bartenders on the effects of the devices. All agreed that the consoles had been a boon to their ability to cover more customers. One Chili's bartender observed, "Had we not had the consoles at lunch today, I could not have handled the demands without delays." When asked if server hours had been cut as a result of the devices, he admitted, "Instead of having three servers in the bar at lunch before the consoles were installed, we now have just me, but then I have an additional 'runner' to move completed orders from the kitchen to customers." Red Robin took a different tack. It took out all bussers and shifted table-clearing duties to the bartenders, and it plans to streamline the kitchen and use fewer cooks.

The Chili's bartender assured me that the consoles had increased his average daily tip income by 20% "at least!" The Red Robin bartender, who confessed to not tracking his tips carefully, could only say that his percentage tips had risen, primarily because people who use the consoles click on "20% tip," which is at the top of the list of tip options.

If the bartenders had their tip increases right, we should expect

the consoles to pop up in other casual restaurants. The looming minimum-wage increases will raise the rate of return on ordering technologies that shift some of the food service work to unpaid customers. Some restaurants will make the substitution for an old-fashioned economic reason: to cut costs. Others will adopt them later for another old-fashioned reason: to fend off the cost and pricing gains by competitors that have already implemented the technologies. Similar labor-saving consoles and kiosks are now spreading rapidly at many airport restaurants, as well as fast-food restaurants.

The coming minimum-wage increases can also be expected to favor "fast-casual" (counter-service) restaurants over "casual" (table-service) restaurants. This is because the fast-casual model reduces paid server hours by shifting work to customers and permits restaurants to tap lower-skilled workers who don't have the experience and language skills that servers need. In lieu of tips, fast-casual restaurants can raise menu prices to cover added minimum-wage costs, effectively claiming a portion of what would have been server tips and, at the same time, leaving customers with lower total bills than they would receive otherwise, with an implicit payment for their added work.

One manager noted that his burger-based restaurant chain was already feeling market pressure from the growing number of fast-casual, burger-based restaurants (e.g., Five Guys, The Habit, The Stand) that have higher-quality burgers and prices than traditional fast-food (and some casual) restaurants but with prices lower than his own casual chain. Interestingly, in late 2018, fast-casual sales were estimated to be expanding by 7.5% for the year, while casual and fine-dining sales were expected to grow by only 2.7% and 1.8%, respectively.

Such a shift in the relative growth rates of restaurant segments can mean increased employment for low-skill workers, partially offsetting the overall job losses among menial workers in fast-food restaurants (and elsewhere) that can result from higher menu prices.

#### ARE WAGE INCREASES FOR SOME WELL-OFF SERVERS UNINTENDED?

Minimum-wage increases for some well-off tipped workers could be an unintended effect of policy advocates and policymakers failing to think through the consequences of their proposed market controls. But the effect could also be intended, grounded in the underlying economic and political forces that press for the expansion of wage controls beyond their narrowly intended targets—say, fast-food workers who seldom make tips.

If restaurant segments above fast food were exempt from paying the scheduled higher minimum wages because of servers' tip incomes, then fast-food restaurants would suffer a growing cost disadvantage relative to other industry segments. Their menu prices would have to rise relative to near-competitors' prices. Understandably, fast-food chains might vehemently oppose minimum-wage increases in principle but, at the same time, when wage hikes are assured, they could strongly favor industry-wide

coverage. From this perspective, tipped servers are the beneficiaries of policy efforts to disturb as little as possible the competitive balance across restaurant segments.

In addition, full industry coverage of minimum-wage hikes makes it easier for all restaurants to pass along their higher wage costs to customers in the form of higher menu prices. Doing this converts the wage increases into a disguised excise tax with the intent of redistributing income from customers to workers (with some collateral income destruction overall). Broad minimum-wage coverage might even moderate resulting job losses by not concentrating the effects of the wage hikes on a given market segment—fast food, for example—that could be most vulnerable to replacement of workers with technology and reduction in sales because of the segment’s relatively price-sensitive customers.

In short, labor (or any other) market controls can beget extension of their coverage, not so much because of fairness considerations, but because of the economic and political forces set in motion by controls. Friedrich Hayek warned of this in *The Road to Serfdom* and other works.

#### CONCLUDING COMMENTS

California’s scheduled minimum-wage increases will likely have conventional and unconventional labor-market effects. They can decrease the growth, albeit marginally, in the state’s total

employment opportunities for low-wage workers, as menu price increases reduce growth in restaurant meals eaten and as readily available technology replaces some workers.

The increases can also be seen, ironically, as an indirect and partial means of curbing servers’ opportunities to work for tips, perhaps causing some servers to move to different jobs, such as teaching, that pay less than what they once earned in their restaurant jobs. At the same time, relatively well-off tipped servers may have been included in the state’s minimum-wage increases not because they “deserve” or “need” more money, but because including them reduces the political opposition from different types of employers. R

#### READINGS

- “Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research,” by David Neumark and William Wascher. National Bureau of Economic Research working paper #12663, January 2006.
- “Should Tipping Be Abolished?” by Richard B. McKenzie. *Policy Report* #382, National Center for Policy Analysis, March 2016.
- “The 2018 Restaurant Technology Trends to Look Out For,” by Caitlin Stanley. *Revel Systems*, January 6, 2018.
- “The Effect of the Minimum Wage on Employment and Unemployment,” by Charles Brown, Curtis Gilroy, and Andrew Kohen. *Journal of Economic Literature* 20(2): 487–528 (June 1982).
- “Why Are There So Few Job Losses from Minimum-Wage Hikes?” by Richard B. McKenzie. *Policy Report* #354, National Center for Policy Analysis, April 9, 2014.

**LIBERTY IN ACTION**

*Real Activism  
Real Results*

**JOIN TODAY IJ.ORG/ACTION**

INSTITUTE FOR JUSTICE