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Tipping and Its Alternatives: A Comparison of Tipping, Service Charges, and Service-inclusive Pricing

by Michael Lynn, Ph.D.





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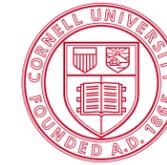
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Tipping and Its Alternatives:

A Comparison of Tipping, Service Charges, and Service-Inclusive Pricing

By Michael Lynn

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Hospitality executives and managers can compensate employees through voluntary tipping, service charges, or service-inclusive pricing. Rather than take a default position or simply follow local practices, managers should carefully weigh the pros and cons of each policy and should knowingly choose the approach that best suits their circumstances. This Center for Hospitality Research Report is design to facilitate such thoughtful decisions about how to compensate employees. It outlines the business issues surrounding tipping and its alternatives, summarizes what we know about those issues, and identifies questions in need of further research.

The principal benefits to hospitality firms of voluntary tipping are that it lowers nominal prices, increases profits through price discrimination, motivates up-selling and service, and lowers FICA tax payments. However, tipping also motivates discrimination in service delivery, gives servers surplus income that could go the firms' bottom line, increases the risk of income-tax audits, and opens firms up

to adverse-impact lawsuits. The alternatives to tipping (i.e., service charges and service-inclusive pricing) have their own sets of costs and benefits. Ultimately, no one policy is always necessarily the best. Therefore, the report presents the pros and cons of each policy with respect to nine different considerations.

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Tipping is a widespread practice in many service industries, with decisions about whom and how to tip largely determined by social custom. However, hospitality executives and managers need not accept the dictates of custom in deciding how to compensate service employees.

Instead of tipping, some hospitality operators have instituted service charges or service-inclusive pricing as a method of remunerating their servers. Furthermore, some of those firms prohibit employees from accepting further tips. Operations that have instituted service charges include cruise lines,¹ resorts,² and private clubs,³ as well as some hotels⁴ and restaurants.⁵ In 2005, for example, chef-owner Thomas Keller replaced tipping with an automatic 20-percent service charge at Per Se, his highly regarded French restaurant in New York City.⁶ In 2004, Holland America Line abandoned its decades-old tipping policy in favor of daily service charges.⁷

The issue of tipping versus service charges raises questions about how tipping-policy decisions should be made. What are the business functions of tipping? When should tipping be allowed? If tipping is abandoned, should it be replaced with service charges or with service-inclusive prices? While I cannot specifically answer those questions for each operation, this Center for Hospitality Research Report seeks to provide information and guidance so that you can analyze your operation's tipping policies. The report outlines the business issues surrounding tipping and its alternatives, summarizes what we know about those issues, and identifies questions in need of further research. It is structured around the following nine issues that should be carefully considered when deciding upon a tipping policy:

- consumer preferences,
- nominal prices,
- price discrimination,
- payment bundling,
- server incentives,
- pay levels,
- employee recruitment and retention,
- income tax evasion, and
- discriminatory practices.

After discussing these points I'll offer a summary of the issues involved so that you can determine whether a tipping policy best fits your operation, or whether service charges or service-inclusive pricing would be more appropriate.

Consumer Preferences

Tipping has remained a feature of hospitality operations despite continual criticism. Surveys about consumers' attitudes toward tipping and its alternatives that have been conducted in the United States over the past 30 years indicate that a majority of consumers prefer guaranteed server wages (implying service-inclusive pricing) over voluntary tipping, but they far prefer voluntary tipping over service charges (see Exhibit 1). Although direct research is needed to assess whether those stated preferences influence consumers' patronage, I see two reasons for expecting any effect to be small. First, psychologists have found that general attitudes, like those concerning tipping and its alternatives, typically have only weak effects on behavior, because

EXHIBIT 1

Attitudes toward tipping and its alternatives in the United States

2004 Internet Survey by Michael Lynn¹

I would prefer to have waiters and waitresses paid higher wages instead of tips.

- 44% Agree
- 34% Neutral
- 22% Disagree

I dislike having to tip waiters and waitresses.

- 11% Agree
- 20% Neutral
- 69% Disagree

2002 Telephone Survey by International Communications Research

How do you feel about the practice of tipping – that is a fair way to compensate people who perform various services, or that it is unfair to customers to expect them to pay extra for services they've already paid for.

- 73% Fair
- 24% Unfair
- 3% Don't Know

2001 Telephone Survey by TNS Intersearch³

Under normal circumstances, how do you feel when a tip is automatically added to your bill?

Are you...

- 57% Annoyed
- 41% Not Annoyed
- 1% Don't Know

1996 Reader Survey by USA Today (w/ Penn State)⁴

Which do you prefer – having an automatic service charge added to your bill to cover the tip or determining for yourself what the tip should be?

- 5% Prefer service charge
- 95% Prefer tipping

In general, which of the following best describes how you feel about tipping?

- 86% Favor
- 12% Oppose

1989 Telephone Survey by Yankelovich Clancy Shulman⁵

Would you favor a system under which restaurants would add a mandatory service charge of 15 to 18 percent to your bill?

- 19% Yes
- 77% No

1987 Telephone Survey by Gallup⁶

Waiter or waitress should receive a guaranteed wage instead of tips.

- 58% Agree
- 13% Neutral
- 23% Disagree
- 5% Don't Know

I would like it better if I was not expected to tip at restaurants.

- 33% Agree
- 19% Neutral
- 45% Disagree
- 3% Don't Know

A service charge of 15 to 18 percent is reasonable.

- 45% Agree
- 16% Neutral
- 34% Disagree
- 5% Don't Know

Sources

¹ Unpublished survey of 419 members of a commercial consumer panel; contact Mike Lynn for more information.

² Survey of 1,001 adults; see "Snapshots—Here's a Tip," *Public Perspective*, November–December 2002, pp. 52.

³ Survey of 1,024 adults; see Pamela Paul, "The Tricky Topic of Tipping," *American Demographics*, May 2001, pp. 10-11.

⁴ Survey of 5,774 adults; see Vivienne Wildes, Stuart Mann and Fred DeMicco, "The Penn State/USA Today Restaurant Service Survey or (un)Forkedible Frequencies," *Journal of International Hospitality, Leisure and Tourism Management*, Vol. 1 (1998), pp. 103-115.

⁵ See Wendy Cole, "Leaving Tips," *Time*, (Feb 27, 1989), p. 54.

⁶ Survey of 1,007 adults; see Susan Mills and Hudson Riehle, "Tips vs. Service Charges," *Restaurants USA*, October 1987, pp. 20-22.

EXHIBIT 2

Restaurateurs' experiences with service charges as reported in the trade press.

Restaurateur	Restaurant	Location	Reported experience
Barry Wine ¹	The Quilted Giraffe The Casual Quilted Giraffe	New York, New York	"Customer reaction has been very positive. I have found less than 1 percent of our customers have commented on it negatively (p. 5)."
Sigi Krauss ¹	Briar Hurst Manor Inn	Manitou Springs, Colorado	"Krauss will waive the charge if patrons feel it is not deserved, a policy twice enforced. ... Krauss has not seen his business decline ... (p. 6)."
Len Allison ¹	Hubert's	New York, New York	"Allison's patrons have been accepting of the service charge (p. 6)."
Richard Perry ¹	Richard Perry Restaurant	St Louis, Missouri	"Most patrons do not even comment on the policy. Of those who voluntarily remark, Perry estimates that positive comments outweigh the negatives by about five to one. Business has not been adversely affected by the policy (p. 7)."
Fred Abood ²	Green Derby	Jacksonville, Florida	"Abood feels the results have been excellent and thinks his approach to imposing a service charge has a great deal to do with its customer and employee acceptance. Abood reports only two customer complaints in the two years since the service charge has been in effect. 'The reason for its acceptance,' says Abood, 'is that my customers are aware from the moment they walk in that a service charge will be added tot heir check total' (p. 116)."
Jim Stephanis ²	Wharf	Lauderdale-By-The-Sea, Florida	"Stephanis, for the most part, has experienced no difficulties. In fact, he is extremely pleased with the results (p. 116)."
Dick Siple ³	Siple's Garden Seat	Clearwater, Florida	"Siple is pretty confident that the majority of his patrons don't object to the mandatory 15 percent. ... In the initial four months of using the service charge, Siple can recall only two instances of customer complaints. In both cases the customer's service charge was refunded (p. 31)."
Jimmy Schmidt ⁴	Rattlesnake Club		"During the first couple of weeks, Schmidt noted a few complaints. But overall, he says, he was amazed at how well it worked. 'Once the customers understand, they're very accepting of it (p. 116)."
		Detroit, Michigan	"Sales at the Rattlesnake Club in Detroit have doubled since the high-profile restaurant abandoned a controversial program of service charges and returned to the traditional system of voluntary tipping."
		Denver, Colorado	"'We ran Rattlesnake in Denver for two years without a service charge,' Schmidt said, 'from December 1985 to December 1987. Then in the first month we put it in, we had a 27-percent drop in sales.'"

¹ Source: Waitstaff Compensation: Tips vs. Service Charges

² Source: "The tipping/service charge dilemma: No easy answers," *Restaurant Business*, 6/1/80, pp. 114-116.

³ Source: "Restaurateur adds service charge, finds initial resistance fades," *Foodservice Marketing*, February 1982, pp. 30-31.

⁴ Sources: Paul Frumkin (1988); Rick Telberg, "Tips KO service charges at rattlesnake; sales leap," *Nation's Restaurant News*, July 24, 1989.

Although consumers say they do not like service charges, there is little evidence that guests will stay away because of them.

too many other factors influence behavior for attitudes to strongly predict it.⁸ Second, consumers' preferences about tipping policies do not appear to be all that strong. For example, 77 percent of U.S. respondents to a 1989 telephone survey did not favor service charges, but only 34 percent of U.S. respondents to a 1987 telephone survey thought a 15- to 18-percent service charge was unreasonable (again, see Exhibit 1). Similarly, 44 percent of U.S. respondents to a 2004 internet survey would prefer to have waiters and waitresses paid higher wages instead of tips, but only 11 percent of those same respondents disliked tipping (Exhibit 1 also). I conclude, in other words, that while consumers may prefer service-inclusive pricing over tipping and tipping over service charges, they typically will accept any of those policies.

Anecdotal evidence consistent with the idea that consumers find service charges acceptable (even though not desirable) can be found in the experiences of restaurateurs who have implemented service charges. An informal search through the hospitality trade press uncovered information about customers' reactions to the decisions of eight restaurateurs who had implemented service charges at ten restaurants. At eight of the ten restaurants, customers appear to have accepted the service charges with no reported loss of business (see Exhibit 2). The only contrary cases were those of Jimmy Schmidt's Rattlesnake Club in Denver, where sales dropped by 27 percent after the restaurant implemented a service charge in December 1987, and the Rattlesnake Club in Detroit, where sales doubled after it restored tipping in 1989. These contrary cases are dramatic, but they probably have more to do with the increased checks associated with service charges than with customers' dislike of service charges, as I will discuss more in the section on price discrimination. Despite the drop in sales, Schmidt said,

⁸ Better prediction can be made from attitudes toward the behavior. In other words, consumers' attitudes toward eating at restaurants with tipping, service charges or service-inclusive pricing would better predict their patronage of restaurants with these policies than would their attitudes toward the policies themselves. Unfortunately, information about those attitudes is not available. See: David G. Myers, "Module 9: Behavior and Belief," *Exploring Social Psychology* (New York: McGraw Hill, 1994), pp. 82-92.

"Once the customers understand [the service charge], they're very accepting of it."⁹ Thus, the available cases suggest that consumers will accept even their least-preferred policy, that is, service charges. From this discussion I conclude that consumers' preferences need not dictate tipping policies.

Nominal Prices

When talking about tipping, service charges, and service-inclusive pricing it is helpful to make a distinction between nominal prices and real prices. Nominal prices constitute only a part of the final bill, which also comprises unstated charges, such as taxes, service charges, or tips. The prices on most restaurant menus, for instance, are nominal prices, as is the case with most hotel room rates and cruise fares. In contrast, real prices are the total costs to consumers of goods and services including all unstated charges. Nominal prices are generally lower with tipping and service charges than with service-inclusive pricing, because tips and service charges cover some labor costs that would otherwise add to nominal prices. By lowering nominal prices, hospitality firms can reduce distribution costs and increase demand, as I discuss next.

Reduced Distribution Costs

Commissions paid to travel agents, tour operators, or on-line distributors (such as Expedia) are based on a percentage of the sales they generate. With tipping and service charges, lower nominal prices reduce sales figures, so commission payments are not as high as they might otherwise be. The benefits are difficult to see because they are accompanied by those reduced sales figures, but they are real. The following hypothetical calculation shows why.

Say that an organization which uses service-inclusive pricing generates \$100 in sales with transactions that involve labor costs of \$30 and other production costs of \$40. Further assume that the organization must pay a 5-percent commission to distributors. Under the service-inclusive pricing

⁹ Paul Frumkin, "The Great Tipping Debate," *Restaurant Business*, July 20, 1988, p. 116.

system, the firm clears \$25 on \$100 in sales.¹⁰ Now assume that \$20 of labor costs are covered by tips or service charges and that nominal prices are reduced accordingly. Sales and labor costs fall, while everything else (including the actual number of sales transactions) remains the same. In this case, sales drop to \$80, labor costs fall to \$10, other production costs remain at \$40, and the commission is \$4.00 (still 5 percent). Thus, the firm is making a profit of \$26.00 on \$80 in sales (which are equivalent in this instance to \$100 of sales with service-inclusive pricing).¹¹ In this hypothetical case, shifting some employee expense to tipping or service charges increased profits by 4 percent on an equivalent amount of business. (Stated sales declined in nominal terms, not in terms of lower volume).

Thus, when labor costs are built into prices, companies pay commissions on those labor costs. By taking a portion of labor costs out of nominal prices and sales figures, tipping or service charges reduce the commissions paid on labor costs and thereby increase profits.

Increased Demand

Consumers may focus on nominal prices (rather than real prices) as they compare the expense of competing services. If they do so, the lower nominal prices made possible by tipping or service charges should improve competitiveness and increase demand. However, if consumers instead focus on real prices when comparing service providers, then lower nominal prices will not improve competitiveness. The question is whether consumers compare nominal prices or real prices.

Research is needed to determine the influence of nominal and real prices on consumers' perceptions of how expensive a service is. Until such research is conducted, however, executives and managers can take guidance from general decision-making theory and research, which suggest that people do focus on nominal prices when assessing expensiveness.

Research on decision-making has found that the easier information is to acquire and use, the more likely it will actually be applied in decision making.¹² Nominal prices are generally easier to discover than real prices because nominal prices are explicitly stated while the ultimate real price typically includes add-on charges that would otherwise be un-

stated. Even when add-on charges are not hidden, they are often presented in a format (such as percentages) that makes their use more difficult for consumers. Thus, the principles of accessibility and ease of use suggest that consumers use nominal prices more than real prices when making judgments about expensiveness. In addition, researchers have found that when people subjectively adjust their initial judgment they almost always make too small an adjustment.¹³ This means that subjective comparisons of expensiveness will be influenced by nominal prices even if people make adjustments for add-on costs not factored into their initial assessments.

These general findings need to be replicated in the context of tipping and its alternatives.¹⁴ However, they do suggest that hospitality organizations using tipping or service charges to reduce nominal prices will be perceived as less expensive than organizations that instead cover their labor costs through higher nominal prices. It is difficult to quantify the effects on demand of that competitive advantage, but it should increase with consumers' price sensitivity, which can be assessed from their apparent socio-economic status or purchase behavior.

Price Discrimination

Charging different customers different prices for the same service results in higher revenues and profits when (1) consumers differ in price sensitivity, (2) the prices charged match each customer's willingness to pay, and (3) demand from price-insensitive customers is lower than the firm's production capacity. In that case, revenues and profits are maximized because firms extract more money from price-insensitive consumers without losing the business of price-sensitive consumers.¹⁵ Tipping represents a form of price discrimination, because it allows some customers to pay less than other customers for the same service. Although all customers must pay the same nominal price for that service, they can differ in the amounts that they tip.

As a form of price discrimination, tipping is unique in two respects that deserve discussion. First, the price differentials paid under tipping are voluntary. Consequently, price-insensitive customers could avoid paying a price premium by tipping as little as do price-sensitive customers. Fortunately, research findings suggest that this does not occur. Price insensitivity (or the amount consumers are willing to pay for a service) should increase with income and percep-

tions of value, both of which are associated with larger tips.¹⁶ Thus, price-insensitive customers do pay a price premium by tipping more than their price-sensitive counterparts. Second, firms do not directly receive revenues from tips, as they do from other premium prices charged to price-insensitive customers. However, as discussed below, they do receive those revenues indirectly in the form of lower labor costs.

Since price-sensitive customers can and do keep their costs down by tipping less than price-insensitive customers, and since the price premiums paid by the price-insensitive customers do go indirectly to the service firm, the price discrimination achieved through tipping means increased sales and profits as long as the price-sensitive customers are filling seats that would otherwise be empty.¹⁷ This filling of seats with price-sensitive customers may have operated in the case of the Rattlesnake Club restaurants described previously.

When demand from price-insensitive customers is strong and price-sensitive customers are not needed to fill seats, however, price discrimination through tipping simply attracts a more diverse customer base without enhancing revenues or profits. Therefore, firms enjoying strong demand and seeking a relatively exclusive, upscale clientele may want to replace tipping with service charges or service-inclusive pricing as a way to discourage price-sensitive customers.

Payment Bundling

Although many credit card users combine their tip payment with the check payment, the payment of tips is just as typically separated in time and place from the payment of the

¹⁶ Michael Lynn and Clorice Thomas-Haysbert, "Ethnic Differences in Tipping: Evidence, Explanations and Implications," *Journal of Applied Social Psychology*, Vol. 33 (2003), pp.1747-1772; Kevin McCrohan and Robert Pearl, "Tipping Practices of American Households: Consumer Based Estimates for 1979," 1983 *Program and Abstracts: Joint Statistical Meetings*, August 15-18, 1983, Toronto, Canada. Michael Lynn and Michael McCall, "Beyond Gratitude and Gratitude: A Meta-Analytic Review of the Predictors of Restaurant Tipping," (2000) Working paper, Cornell University, available online at www.people.cornell.edu/pages/wml3/working_papers.htm.

¹⁷ Zvi Schwartz, "The Economics of Tipping: Tips, Profits, and the Market's Demand-Supply Equilibrium," *Tourism Economics*, Vol. 3, No. 3 (1997), pp. 265-279.

Decision-making theory suggests that consumers focus on nominal (posted) prices in making a purchase—prices that are lowered by the presence of tipping.

bill. Hospitality operators may want to minimize this separation of payments, because research on decision making has found that people feel more pain over two small losses than over one large loss that is comparable in size to the combined small losses.¹⁸ In other words, decision-making research tells us that people will find the separate payments for the check and the tip under a tipping system to be more distressing than the single payment of a comparable amount under a service-charge or all-inclusive pricing system. Research is needed to test this effect and to assess its impact on purchase behavior. Until that research is done, executives and managers can minimize this issue by encouraging customers to add the tip to their bill and make a single payment.

Server Incentives

One set of arguments for tipping involve its supposed incentive for servers to up-sell menu items and to deliver good service. In contrast, it is thought that service charges provide an incentive to up-sell but not to deliver good service, and that service-inclusive pricing provides no incentive for either activity. These assumptions are not entirely supported, as I explain next.

Incentives for Up-Selling

The up-selling argument seems simple enough, but research has indicated that this incentive for up-selling will motivate behavior only if servers actually expect their up-selling efforts to affect customers' orders.¹⁹ More research is needed on this issue, but managers should not assume that tipping or service charges alone will motivate their staff to up-sell. Servers must also feel that they are competent to make the sale for tipping and service charges to increase their selling efforts.

¹⁸ Richard Thaler, "Mental Accounting and Consumer Choice," *Marketing Science*, Vol. 4, No. 3 (1985), pp. 199-214.

¹⁹ Albert Bandura, *Self-Efficacy: The Exercise of Control* (New York: W.H. Freeman, 1997); and Robert McMurray, Rajesh Srivastava, and Terry Holmes, "The Impact of Self-efficacy on Expectancy, Effort, and Adaptive Selling in a Personal-selling Context," *American Marketing Association, Conference Proceedings*, Vol. 13 (Summer 2002), pp. 399-406.

The value of tipping as a system for motivating servers is lower than commonly believed.

Incentives for Good Service

The common idea that voluntary tipping policies enhance service levels is important, but no direct tests of this idea have been published. Numerous studies have tested the idea that consumers tip more for better service, but when I analyzed those studies I found only a tiny correlation between tip sizes and customers' evaluations of the service or the dining experience.²⁰ The correlation is so small that servers are unlikely to notice the effects of their service efforts on the tips their customers leave. While it is not clear how much the weak service-tipping relationship in restaurants generalizes to other service contexts, it does suggest that tipping may not provide as strong an incentive to deliver good service as many believe.²¹ Then again, if servers believe that good tips depend on good service, that belief may trump any hard evidence.

Other Incentives

When servers focus on their tips, some of them may have an incentive for undesirable actions. First, an expectation of a poor tip may lead servers to give less attention to certain patrons, including Blacks, foreigners, women, teenagers, the elderly, and anyone bearing coupons.²² Second, tipping encourages servers to focus on their own tables and to ignore the needs of other guests. Unless tips are pooled (which reduces the incentive for individual effort provided by tipping),

helping another server is irrational because it reduces a server's ability to attend to his or her own customers. Finally, tipping encourages servers to give products or services to customers free of charge. Research has found that customers receiving gifts from servers reciprocate with larger tips, so one strategy astute servers use to increase their tips is to give away goods and services their employers want them to charge for.²³ To my knowledge, there is no research quantifying the supposed negative effects of tipping described here. Nevertheless, tipping provides at least as strong an incentive for servers to engage in these negative actions as it does for servers to deliver good service.

Weighing the positive and negative incentives of tipping, I conclude that the value of tipping as a system for motivating servers is lower than commonly believed. In particular, service organizations with a large clientele of people perceived to be poor tippers might well look to other means of motivating servers to deliver good service.

Pay Levels

According to the Bureau of Labor Statistics, tipped service workers earn hourly incomes that are roughly the same as those of non-tipped service workers.²⁴ However, tipped employees rarely report all their tip income,²⁵ so those statistics may be misleading—especially for high-end establishments where tips are based on relatively high menu prices and thus are more generous than those found in low-end places. In fact, my own experiences as a tipped employee and my conversations with other people in the hospitality industry suggest that many tipped workers earn far more in tips than they could possibly earn in wages from other types of work involving similar skill sets. This income premium helps to attract and retain good employees in tipped positions. On

²³ David Strohmets, Bruce Rind, Reed Fisher, and Michael Lynn, "Sweetening the Till: The Use of Candy to Increase Restaurant Tipping," *Journal of Applied Social Psychology*, Vol. 32, No. 2 (2002), pp. 300-309.

²⁴ Bureau of Labor Statistics, "Food and Beverage Serving and Related Workers," www.bls.gov/oco/ocos162.htm, accessed 2/2/2006.

²⁵ Internal Revenue Service, *Tip Income Study*, Department of the Treasury, Publication 1530 (8-90), Catalog Number 12482K.

the other hand, it also gives the servers income that might otherwise go to the restaurant if tipping were replaced with service charges or service-inclusive pricing—provided wages were adjusted to offset only part of the lost tip income. Perhaps the greatest problem is that tipping creates a disparity in the incomes of tipped and non-tipped employees. Such large discrepancies in the incomes of tipped and non-tipped employees can cause frictions, so hospitality managers might consider alternatives, including distributing some of the tips to the back of the house, implementing a service charge that all employees share in, or charging inclusive prices that allow more money equitable wages for all employees.

Employee Recruitment and Retention

Tipping means that employees' incomes can vary widely from week to week. With that prospect, tipping may attract less-professional workers than would be the case with the steadier pay from service charges or service-inclusive pricing. The daily cash payments from tips would be more attractive to part-time and temporary workers, while uncertainty about income could be troublesome to full-time and long-term workers.²⁶ On the other hand, some economists have argued that tipping should improve your staff because poor servers will find themselves with lower tip incomes and give up on restaurant employment.²⁷ More important, perhaps, tipping may provide a competitive advantage over employers who rely on other compensation methods in attracting talented servers, because tipping often results in higher overall pay for servers than is possible under service charges or service-inclusive pricing. None of these possibilities has been adequately tested by research. However, if tipping does, in fact, offer that competitive advantage in hiring, hospitality managers who use service charges or service-inclusive pricing could reduce any competitive advantage by making sure to offer wages competitive with tip incomes.

Income Tax Evasion

Unlike wages (including service-charge payments), tip income is easy to hide from employers and governments. In fact, the U.S. Internal Revenue Service (IRS) estimates that about half of all tip income is undeclared.²⁸ Underreporting

²⁶ Michael Parise, "Optional Tipping Has Seen Its Day," *Nation's Restaurant News*, March 9, 1987, p. F50.

²⁷ This argument echoes that advanced by Andrew Schotter. See: *Microeconomics: A Modern Approach*, third edition (New York: Addison-Wesley, 2000). Also see: J. Brauer, "Tipping Your Waiter: A Useful Formula for Employee Compensation," *Augusta Regional Business Journal*, September 1997, www.aug.edu/~sbamjb/abc017.htm, as viewed 2/2/2006.

²⁸ Internal Revenue Service, *Tip Income Study: A Study of Tipping Practices in the Food Service Industry for 1984*, Department of the Treasury, Publication 1530 (8-90), catalog Number 12482K.

of tip income effectively raises the wages of service workers (at the expense of the government rather than that of the service firms). Furthermore, undeclared tip income effectively reduces the FICA taxes firms pay, because the hospitality operator pays tax on tips that an employee actually claims. However, underreporting creates a long-term liability because employers are responsible for paying FICA taxes on all of their employees' tip income (not just declared tips). If the IRS audits a firm and finds undeclared tip income, it can assess back taxes on that income along with penalties and interest. Moreover, the Supreme Court recently upheld the use of aggregate tip estimates to calculate employer FICA tax liability, so audits are easier for the IRS and more costly for firms than in the past.²⁹

Rather than use service charges or service-inclusive pricing, hospitality operators can confidently use tipping and reduce the associated tax liabilities by participating in one of two programs that the IRS has set up for increasing tip reporting. The Tip Rate Determination Agreement (TDRA) is an arrangement in which the IRS agrees not to audit an employer for undeclared tip income if the employer gets 75 percent of his or her tipped employees to promise in writing to declare tip income equal to some percentage of sales predetermined by the IRS.³⁰ The Tip Reporting Alternative Commitment (TRAC) is a similar arrangement in which the employer is freed from audits of tip income in exchange for educating employees every quarter about their obligation to report all tip income.³¹ Although these programs increase tip reporting, they do not completely eliminate underreporting of tip income. In essence, the IRS is agreeing to let firms get away with having employees underreport some of their tip income in exchange for having more of it declared than would otherwise occur. Thus, restaurants participating in the TDRA and TRAC programs can still benefit from the increased attractiveness of jobs involving untaxed income while eliminating the tax liabilities of having employees who under-report tips.

Discriminatory Practices

I know of no lawsuits arising from consumer discrimination in tipping, but it is possible that such claims might be made at some point. Title VII of the Civil Rights Act of 1964 prohibits employment discrimination on the basis of race, color, religion, sex, or national origin.³² Furthermore, in *Griggs*

²⁹ As described in: John Mills and Richard Mason, "Points to Consider on Tip-Reporting Agreements," *The CPA Journal*, July 2004, p. 42, www.nys-scpa.org/printversions/cpaj/2004/704/p42.htm, as viewed 2/7/06.

³⁰ *Ibid.*

³¹ More details about these two programs can be obtained at the Internal Revenue Service's website (www.irs.gov).

³² D.P. Twomey, *Labor and Employment Law*, tenth edition (Eagan, MN:

EXHIBIT 3

Summary of questions in need of additional research

1. How do consumer preferences regarding tipping and its alternatives affect their patronage behavior? (e.g., Does consumers' dislike of service charges reduce their patronage of establishments with service charges?)
2. How do consumers perceive the relative expensiveness of establishments with voluntary tipping, service charges, and service-inclusive pricing holding real prices constant?
3. Does voluntary tipping increase demand for services from price sensitive customers? How much?
4. Does the pain of making separate payments to the server and the firm decrease demand for services? How much?
5. Do voluntary tipping policies improve service levels? How much?
6. Do servers provide worse service to customers perceived to be bad tippers? How much worse?
7. Do voluntary tipping policies increase employee gifts to consumers of goods that the customers should be charged for?
8. Do tip pooling, service charges and/or service-inclusive pricing improve cooperation among servers? How much?
9. Do consumers expect service charges to go to the people who directly served them? Do they get upset if service charges are used for purposes other than compensating those who directly served them?
10. Does tipping cause poor servers to leave the industry?
11. Does tipping attract higher quality employees than other forms of compensation?
12. Do higher and more stable wages afforded by replacing tipping with service charges or service-inclusive pricing attract a more professional service staff?
13. Do consumers tip different amounts depending on the servers' sex, age, race, national origin or religion? If so, how strong and widespread is this tendency?

v. Duke Power Company, the Supreme Court ruled that the Civil Rights Act of 1964 prohibits business policies and practices that have a disparate impact on protected classes of applicants and employees even if those policies and practices appear at face value to be neutral and are not intended to discriminate.³³ Thus, one might be able to argue that tipping is an illegal means of compensating employees if consumers' tipping behavior discriminates against protected classes of servers.

Little research has examined customer discrimination in tipping, but in the few studies that have examined the effects of server sex on tipping, waitresses sometimes received larger tips on average than did waiters.³⁴ Furthermore, race

has also been shown to affect tipping. Black taxicab drivers received smaller tips on average than did white cab drivers.³⁵ This was true regardless of the race of the tipper. Both black and white tippers gave white drivers larger tips than they did black drivers. This is another issue in need of further research, because the studies examining these effects are too limited in number and in diversity of settings to support broad generalizations about customer sex and race discrimination in tipping. However, the existing studies do suggest that such discrimination occurs at least sometimes and in some places, so at least some service firms may be subject to

Reports, Vol. 83 (1998), pp. 223-226; and Lynn and McCall, *loc. cit.*

³⁵ Ian Ayres, Frederick Vars, and Nasser Zakariya, "To Insure Prejudice: Racial Disparities in Taxicab Tipping," *Yale Law Journal*, Vol. 114 (2003), pp. 1613-1674; Michael Lynn, Michael Sturman, Christie Ganley, Elizabeth Adams, Mathew Douglas, and Jessica McNeal, "Dangers in Using Customer Evaluations of Employee Job Performance: The Potential Role of Racial Bias," unpublished manuscript.

West, 1998).

³³ *Griggs v. Duke Power*, 401 U.S. 424 (1971).

³⁴ Stephen Davis, Brian Schrader, Tori Richardson, Jason Kring and Jaime Kiefer, "Restaurant Servers Influence Tipping Behavior," *Psychological*

EXHIBIT 4

Summary of the benefits offered by tipping, service charges and service-inclusive pricing

Benefit	Tipping	Service Charge	Service-Inclusive Pricing	Benefit Is Especially Strong or Important When ...
Match consumer preferences	👍	👎	👍	Rarely—preferences are weak and consumers will accept all options
Lower distribution costs (via lower nominal prices)	👍	👍	👎	Commissions paid to distributors are high
Increase demand (via lower nominal prices)	👍	👍	👎	Customers are price sensitive
Higher profits (via price discrimination)	👍	👎	👎	Customers differ in price sensitivity (e.g., when customers have diverse socio-economic backgrounds) and price sensitive customers are needed to fill seats
Decrease demand from lower socio-economic consumers	👎	👍	👍	Demand is strong and more exclusive, upscale customers are desired
Lower psychological costs to consumers (via payment bundling)	👎	👍	👍	Payments of tips and bill are separated in time or place
Motivate up-selling	👍	👍	👎	Servers are trained how to sell and feel competent to do so
Motivate good service	👍	👎	👎	Rarely—tips and tip policies are only weakly related to service
Motivate equal service for all customers	👎	👍	👍	Large portion of customer base consists of ethnic minorities, foreigners, women, teenagers and the elderly
Redistribute income from tipped staff to non-tipped staff or to the bottom line	👎	👍	👍	Tipped staff make substantially more than non-tipped workers
Attract talented workers (due to high income potential)	👍	👎	👎	Tips are high relative to wages for other jobs
Attract more professional workers (due to income certainty)	👎	👍	👍	Wages are high as well as stable
Lower FICA tax payments	👍	👎	👎	Servers fail to declare large amounts of tip income
Lower risks from tax audits	👎	👍	👍	No agreements have been reached with the IRS
Lower risks of adverse impact lawsuits	👎	👍	👍	Tips are not pooled and protected classes receive lower tips

adverse-impact employment-discrimination lawsuits stemming from their voluntary tipping policies

The idea that employers might be held liable for their customers' discrimination will come as surprise to many, so let me elaborate on it. Business necessity is a legitimate defense against disparate-impact claims, so tipping does not violate the law as long it is a business necessity. However, the burden of proof for a business-necessity defense falls on the

defendant. There are legitimate business reasons for preferring tipping over service charges or service-inclusive pricing in at least some cases, but it is unclear whether those reasons rise to the level of business necessities. In any event, trying to prove that tipping is a business necessity could be difficult and expensive. Moreover, any discriminatory effects of tipping can be offset if tips are pooled and distributed equitably among the service staff. Thus, employers who permit servers

to keep their own tips must justify that distribution system, not just tipping itself, as a business necessity to avoid violating the law.

I know the interpretation of the law described above is new and seems radical. Certainly, it has not yet been tested in the courts. However, the idea that a restaurant would lose a multi-million-dollar judgment when a customer spilled coffee on herself also came as a surprise to many.³⁶ To protect themselves against such a lawsuit, large chains should test to see whether tipping has a disparate impact on their employees. If it does, they might consider their options, either pooling tips or replacing tipping with one of its alternatives.

Weighing the Pros and Cons of Each Option

My discussion of tipping and its alternatives reveals many questions still in need of research. Exhibit 3 (on the previous page) summarizes those questions. Since the answers are not

³⁶ Linda Enghagen and Anthony Gilardi, "Putting Things in Perspective: McDonald's and the \$2.9 Million Cup of Coffee," *Cornell Hotel and Restaurant Administration Quarterly*, Vol. 43, No. 3 (June 2002), pp. 53-60.

immediately forthcoming, I summarized the relevant issues and what I know or can assume about them in Exhibit 4 (on the previous page). All the issues in that exhibit are framed in terms of the extent to which each issue is a benefit to the service firm favoring tipping, service charges, or service-inclusive pricing (shown with thumbs up or thumbs down). Furthermore, the conditions under which each benefit is especially strong or important are identified.

An examination of Exhibit 4 reveals that none of the policies is always the best. Hospitality executives and managers need to weigh the pros and cons of each policy given their own circumstances. Unfortunately, there is no way to accurately compare the different benefits using a common, objective metric, so decision makers must use their own best judgment. In particular, a decision can be made clearer when one or another issue makes a particular policy stand out from the others (whether positively or negatively). In conclusion, I suggest that the operators of hospitality firms base their tipping policies on a careful consideration of the issues raised in this report, rather than merely accede to local industry norms. ■

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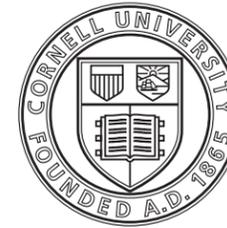
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