

Tipping: The Economics of a Social Norm

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Abstract

Tipping illustrates the importance of social norms in motivating economic behavior. People tip because this is the social norm and disobeying norms results in social disapproval that creates emotional disutility. Tipping is also economically important: in the United States alone, millions of workers derive most of their income from tips, and annual tips amount to dozens of billions of dollars. I claim that tipping is not a single phenomenon; the economics of some tipping occasions is very different from that of others. I divide tipping to six different categories: reward-tipping, price-tipping, tipping-in advance, bribery-tipping, holiday-tipping and gift-tipping, and discuss the economics of each category. The analysis suggests that in many cases the social norm of tipping has economic justification, because it solves some inefficiency and increases welfare. In particular, tipping can promote good service where other mechanisms fail to do so. This suggests that the relationship between economics and social norms is indeed complex; not only social norms motivate economic behavior, but also economic reasons may promote the establishment of certain social norms, as Arrow (1971) argued.

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I. Introduction

Tipping is a phenomenon that illustrates the importance of social norms as motivating economic behavior. People tip because this is the social norm, and disobeying the norm creates emotional disutility because of social disapproval and related feelings such as embarrassment, guilt and unfairness. They voluntarily give money without receiving any future benefit from it, clearly in contradiction with the common assumption of a selfish economic agent.¹

While a single tip usually does not exceed a few dozens of dollars, the prevalence of tipping makes the magnitude of tips in the aggregate a significant economic phenomenon. Hundreds of millions of consumers around the globe tip on a regular basis. The total amount of annual tips in US restaurants alone is estimated at about \$26 billion.² Clearly, adding tips in other occasions and countries results in a much higher number.

Moreover, millions of workers in the United States alone derive a significant portion of their income, often most of it, from tips. For example, servers in full course restaurants earn 58% of their income from tips (in fact, the true percentages are likely to be much higher, because tips are often unreported). In the United States, for over two million workers the primary occupation is being servers; the estimate for the number of servers including those who are servers as a secondary occupation is over three million (Wessels 1997). Tipping is also a major source of income for taxi drivers and for many others.

Lynn, Zinkhan and Harris (1993), for example, considered 33 service professions that are tipped.

Tipping is a unique form of an economic transaction. While a service is provided and is paid for as in numerous other transactions, the payment is voluntary and its magnitude is determined by social norms and by the consumer's discretion rather than by a contract. How can we think about this transaction from an economic perspective? This is the main question this paper addresses. I claim, however, that tipping is not a single phenomenon. The economics of some tipping occasions is very different from that of some others. In the next sections I categorize tipping in six different categories: reward-tipping, price-tipping, tipping-in advance, bribery-tipping, holiday-tipping and gift-tipping, and discuss the economics of each of these categories.

II. Tipping as a Unique Economic Transaction

Most economic transactions involve the exchange of goods, services, and money, between two or more parties. It is usually clear to all parties what they are entitled to receive in the transaction, and what they are obligated to give. Tipping, while still being an exchange of services for money, is less clear about the obligations of the parties. There is no explicit contract between the consumer, the worker, and the employer about the tip to be given.

Tipping has several different forms, each having a different economic characterization. The common feature of all forms of tipping is the voluntary and discretionary nature of the tip: the consumer is free to choose how much to tip, if at all.

This definition excludes service charges that are sometimes added to the bill (for example in many European countries), imposed gratuities (US restaurants often impose a 15–18 percent gratuity for large parties – usually six diners or more), and imposed tips (for example some tour packages include a certain amount that the consumer has to pay for tips). Indeed, these cases have little in common with voluntary tipping. I categorize the different forms of voluntary tipping to six main groups:

1. Tips that are given after the service is rendered to induce good service, for example tipping waiters; I call it “reward-tipping.”

2. Tips that are given after the service is rendered as the price of the service, for example tipping skycaps. I refer to it as “price-tipping.”

3. Tips that are given before the service is rendered to induce good service, for example tipping the hotel concierge in advance, which I denote as “tipping-in-advance.”

4. Tips that are given before the service is rendered as bribery, for example when tipping a maitre d’ to get a table when customers with reservations are waiting in line. This form of tipping is referred to as “bribery-tipping.”

5. Holiday-tipping: these are tips that are given once a year to workers who serve the consumer during the year, such as the newspaper boy or the building doorman.

6. Gift-tipping: tips that are non-monetary, for example giving chocolates to nurses who took good care of a patient.

In the next sections, I discuss in more detail the economics of each of these forms of tipping.

III. Reward-Tipping

This is the most common form of tipping and the most significant in terms of the monetary amounts involved. In this form of tipping, the worker provides the service and then the consumer determines how much to tip him. Tipping of waiters, taxi drivers and barbers, in addition to many others, belongs to this group. The economic justification for reward-tipping is that it improves service quality. It can do so as long as the tips are positively correlated with service quality. Sources about tipping etiquette support such positive correlation, suggesting that tips should be reduced or not given at all when service quality is low (Post 1997; Schein, Jablonski and Wohlfahrt 1984). Moreover, empirical studies of tipping found that tips are indeed positively correlated with service quality, although the difference between tips given for good and mediocre service is small (Bodvarsson and Gibson 1997; Lynn and McCall 2000). In addition, when people are asked hypothetically how much they would tip for different quality levels, they report tipping significantly more for good service compared to bad service (Bodvarsson and Gibson 1999).³

Sisk and Gallick (1985) claim that tipping (reward-tipping according to the categories mentioned above) is an arrangement that protects buyers from an unscrupulous seller. Their interpretation and justification for tipping (with some complementary ideas of my own) is as follows. Often, what ensures the buyer that the good purchased would be satisfactory is the ability to return it to the seller if it is of inferior quality. It is usually impossible to return services, however. For services, one mechanism that ensures quality is the reputation of the firm. The firm does not provide low service quality because

consumers will avoid purchasing again and may also inform other potential buyers about the low quality. If the worker who provides the service does not have enough incentives not to harm the firm's reputation, however, the worker is not likely to exert enough effort to provide good service. The firm can sometimes monitor the worker to ascertain that service quality is good; this may be too costly, however, meaning that the cost of monitoring exceeds the benefits from increased quality. In particular, if the firm deals mainly with non-repeated customers who do not communicate with future potential buyers (a restaurant that caters to tourists, for example), the benefits from increased service quality are reduced.

Whenever the firm does not monitor the worker and the worker does not have incentives to provide good service, the buyer may be hurt by expecting and paying for good service and receiving bad service. When the cost of the service is high, the buyer may find it optimal to use litigation in order to be compensated. When service quality is unobservable to a third party, or when service cost is low, the buyer usually finds it optimal to pay despite the unsatisfactory service. This gives unscrupulous sellers the ability to maximize profits by providing low service quality at low cost rather than good service quality. Of course, in equilibrium the buyer may expect bad service quality and the market for good service quality may collapse, as in Akerlof's (1970) seminal article about the market for lemons.

To overcome this potential problem, tipping makes part of the equilibrium price discretionary and contingent on service quality. The consumer no longer has to prove that service quality was bad; he can reduce his tip according to service quality without having

to go to litigation. The worker has an incentive to provide good service because otherwise he may earn lower tips. In a way, tipping may protect both the buyer and the seller from costly negotiation. For example, if service in a restaurant was bad, the buyer may not want to pay the full price of the meal, yet there is no natural agreement with the owner what the discount for the bad service should be. Tipping provides a focal point for the negotiation: in most cases, the consumer pays the menu price but does not tip, or at least reduces the tip. While the buyer can in principle abuse his position as the last mover and not tip even when service is satisfactory, such behavior is rare.

Conlin, Lynn, and O'Donoghue (2002) analyze the case of restaurant tipping (their analysis is applicable also to other forms of reward-tipping, however) and suggest that if efficiency requires the server to exert some effort, the server must have an incentive to exert this effort. While a service contract can provide this incentive, writing such contract between the customer and the server involves prohibitive transaction costs. Therefore, tipping serves as a substitute that economizes these transaction costs.

I agree with their view, and think that in fact tipping can also save enforcement costs, the magnitude of which might be even more important than eliminating the cost of writing the contract. It is true that writing a contract between any possible combination of consumers and workers is prohibitively costly. One can imagine, however, that the firm could write a standard contract that applies to each of its workers and consumers; such contract has reasonable costs. The bigger problem, in my opinion, will be the enforcement of such contract: who will monitor the service quality? Will the consumer have to prove that service quality was not satisfactory, or the worker to prove that service

quality was good? How can one prove what the service quality was when service is personal and depends to a large extent on the friendliness of the worker? I claim that society, by creating the social norm of tipping and making people who stiff (who do not tip appropriately) feel embarrassed and unfair, provides an efficient enforcement mechanism. People then tip without the need for third party involvement in the evaluation of service quality, because their emotional disutility if they stiff after receiving good service exceeds the monetary gains.

While the interpretation of tipping of Sisk and Gallick (1985) and of Conlin, Lynn, and O'Donoghue (2002) is somewhat different, both views support the conclusion that what I denoted reward-tipping is an economic mechanism that addresses certain market inefficiencies using consumer monitoring of the service.

IV. Price-Tipping

In this sort of tipping the tip is also given after the service is provided, as in reward-tipping. In some cases the borderline between the two categories is not clear, but the idea behind price tipping is that tips are in fact the price of the service, not an incentive to provide better service. Tipping hotel bellman or airline skycap for carrying the luggage, or a doorman for stopping a taxi, belong to this group. Taking the example of the bellman, often the customary amount is specified as a certain price per bag. The service is quite homogeneous, and therefore it is not likely that the reason for tipping is to ensure service quality. After all, the bellman just brings bags from point A to point B. The tip is

given to the bellman as the price of his services, not to induce him to provide higher quality of service.

Why then not have an explicit price? From efficiency point of view, tips can cut transaction costs. Tipping saves, for example, the need to issue a receipt. More importantly, however, the parties involved have several reasons to prefer tipping to explicit prices. Workers often underreport tip income to tax authorities, giving them a clear incentive to prefer tipping. The tax savings may in principle also benefit the employer and the consumer, through lower wages and prices. Moreover, the worker prefers tips because his total income is likely to be higher than if he would only receive a wage, even when his wage is reduced when he is tipped. The reason is that since wages are often bounded from below (either by zero or by a positive minimum wage), tips may bring the worker's total income above his reservation wage, while without tips the employer just pays the worker's reservation wage. In other words, the lower bound on wages introduces a market friction that is likely to lead to economic rents for the worker when tips are prevalent.

The consumer often prefers tipping because it enables him to show his gratitude to the worker. In addition, because of preference for income equality, the consumer prefers tips to prices also because tips are likely to increase the worker's income while a price is going to the business (whose owner is probably wealthier than the worker). The owner has an incentive to charge prices rather than to allow tips, in order to eliminate the economic rents that the worker may enjoy. However, owners have to take into account what is appropriate in their industry, and clearly when they accommodate the desires of

the consumer and the worker they derive from it benefits as well. A hotel owner is not likely to charge the customer when the doorman stops a taxi for him, simply because it will be considered inappropriate; doorman services are free (do not involve an explicit price) anywhere in the industry.

V. Tipping-in-Advance

Tipping in advance was the original type of tipping in commercial enterprises. There are several versions for the origin of tipping, but one of the common versions dates tipping back to England of the sixteen century. Brass urns with the inscription “To Insure Promptitude” were placed first in coffee houses and later in local pubs, and people tipped in advance by putting money in these urns.

The purpose of tipping-in-advance from the consumer’s perspective is to commit the worker to provide good service quality. This form of tipping reverses the opportunism problem: instead of the consumer being able to stiff, here the worker is able to provide bad service despite the advance tip. Tipping experts, however, suggest that workers who get advance tips try very hard to justify the trust they received: Brenner (2001) claims, “The advance tip is the most effective method for assuring results... This strategy will insure that you’ll be taken care of with the highest degree of consideration,” and Star (1988) suggests about hotel concierge “If you want to be fawned over, tip the concierge upon arrival as you introduce yourself.” Just as the consumer finds it less costly to tip than to feel unfair and embarrassed in reward-tipping, the worker prefers to exert effort than to feel unfair and untrustworthy with tipping-in-advance.

VI. Bribery-Tipping

The idea of bribery-tipping occurred to me while reading the description of tipping a maitre d' in Schein, Jablonski and Wohlfahrt (1984). Bribery-tipping is also done before the service is rendered, as in tipping-in-advance. The difference between tipping-in-advance and bribery-tipping is not always clear. Generally, I categorize tips in advance as bribery-tipping when someone else (either other consumers or the employer) is hurt as a result of what the worker does, and as tipping-in-advance otherwise.

Tipping-in-advance is paying for something that is socially desirable: better service. Bribery-tipping is paying for something that is socially undesirable: getting preferred treatment without justification at the expense of others. For example, tipping a concierge in advance is not likely to hurt anyone and therefore is categorized as tipping-in-advance. Tipping a maitre d' in order to get a table without having a reservation in an overbooked restaurant, however, implies that other customers with reservations (or those without reservations who arrived before the tipper) will have to wait longer for their tables, and can be considered a bribe offered to the maitre d'. Tipping the maitre d' for a better table is somewhat more complex to categorize, but can still be categorized as bribery-tipping. If we assume that the customer is entitled to an average table, tipping the maitre d' to get a better table hurts the other customers who get less-than-average tables.

Another example for bribery-tipping in which the employer is hurt rather than other customers is when a guest tips the reservation manager to get a free upgrade of a hotel room. The owner of the hotel would prefer to sell the better room for a higher price rather than giving it as a free upgrade, and is hurt by the tipping transaction. As with other cases

of bribery, both the giver and the taker (the consumer and the worker) can be blamed. Despite the negative connotations of bribery, bribery-tipping can be welfare enhancing. For example, it allocates the good tables to those who value them the most, if we assume that everyone can tip to get the better tables. If some customers are less willing “to bribe” not because of the monetary cost but because they believe that this behavior is inappropriate, however, bribery-tipping can also reduce welfare.

VII. Holiday-Tipping

Tipping workers around Christmas is customary in many occupations, such as the newspaper boy, babysitter, doorman in an apartment building and housekeeper, among others (Star 1988). Since the tip is given once a year, it provides less incentives for good service than reward-tipping, yet it might provide such incentives if it is clear to the worker that the holiday tip reflects the level of service provided during the year. This form of tipping is somewhat between a tip and a gift.

VIII. Gift-Tipping

In some occupations, tips are considered inappropriate, yet customers often want to show their gratitude by something beyond saying “thank you.” One of the common ways to do so is to give a gift, for example flowers, a box of chocolates, or a fruit basket. For instance, such gifts are often given to nurses and doctors as a symbol of gratitude. This form of tipping provides little incentives for good service by itself. That is, nurses may provide excellent service because they are rewarded by the gratitude of the patient, and

the patient may want to show his gratitude by sending a box of chocolates, but it is not likely that the box of chocolates is itself the reason nurses provide excellent service.

Gift-tipping may also take place in countries where monetary tips are not customary or even illegal, for example in China (Star 1988). Gift-tipping in these cases is again a method for the consumer to show his gratitude to the worker, although here the incentives provided by tipping may also be significant, and therefore promote better service.

IX. Conclusion

Tipping is a social norm that is economic in nature, and as such, lies in the intersection of economics and sociology. I argued that tipping is not a single phenomenon, but rather that tipping in various occasions can be very different from one another. I divided tipping customs to six categories: reward-tipping, price-tipping, tipping-in advance, bribery-tipping, holiday-tipping and gift-tipping, and discussed the economics of each of these categories. The discussion suggests that in many cases the social norm of tipping has economic justification, as it solves some inefficiency and increases welfare. In particular, it can promote good service where other mechanisms fail to do so. This suggests that the relationship between economics and social norms is indeed complex; not only social norms motivate economic behavior, but also economic reasons may promote the establishment of certain social norms.

The economic justification for tipping also confirms the view expressed by Arrow (1971, p. 22), who wrote about social norms more generally, “I want, however, to conclude by calling attention to a less visible form of social action: norms of social

behavior, including ethical and moral codes. I suggest as one possible interpretation that they are reactions of society to compensate for market failures.” Two paragraphs below Arrow adds, “There is a whole set of customs and norms which might be similarly interpreted as agreements to improve the efficiency of the economic system (in the broad sense of satisfaction of individual values) by providing commodities to which the price system is inapplicable.” Tipping seems to belong in this set of customs and norms.

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¹ This is true in the common case where the tip is given after the service has already been provided. In principle, one could argue that tipping improves the service one receives in future encounters with the worker. But the observation that people tip also when they visit places they never intend to go back to (for example when traveling) undermines this argument.

² Sales in the United States in 2001 of food and alcoholic beverages to consumers in full-service restaurants, bars and taverns, and lodging places, were \$143.3, \$12.5 and \$20.1 billion, respectively (U.S. Census Bureau 2001, Table No. 1268; the numbers for 2001 are a projection). Summing the three numbers and multiplying by an average tip of 15 percent yield annual tips of \$26.4 billion. The need for estimation arises because tips are often unreported to tax authorities: Hemenway (1993), for example, reports that the only income with a lower compliance rate in the United States is illegal income.

³ It is an interesting question for future research to explore why people report large difference in tips according to service quality when asked hypothetically while in practice the effect of service quality on tips is small.