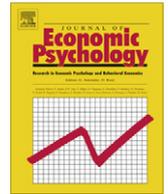




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Business strategy and the social norm of tipping

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ABSTRACT

Tipping is an important economic phenomenon, involving about \$47 billion a year in the US food industry alone, and trillions of dollars across different occupations and countries over the years. Moreover, tipping is a major source of income for millions of workers. This article discusses the implications of tipping for business strategy in the relevant industries. For example, firms can choose to impose a compulsory service charge in lieu of tipping – what are the advantages and disadvantages of doing so? How does tipping change the profit-maximizing level of investing in screening job applicants, training workers, monitoring them, and providing performance-based incentives by the firm? Can industries such as the music industry use tips (i.e., prices being voluntary and determined by the customers) as an alternative business model?

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1. Introduction

Social norms sometimes demonstrate how psychological motivations may affect economic behavior. One of the best examples is the social norm of tipping. Tipping has been examined by researchers in many studies, but the economic and managerial aspects of it have received relatively little attention, and are important issues that call for additional research. The purpose of this article is to review the economic and practical implications of tipping for management and business strategy, with the hope of encouraging others to contribute to this growing research area. Reviews of the tipping literature that discuss additional issues that are beyond the focus of this article include Lynn and McCall (2000a, 2000b), Lynn (2006a, chap. 31, 2006b), and Azar (2007b).

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1.1. The economic magnitude of tipping

One reason for the importance of tipping in general and as a research topic in particular is its large economic magnitude. The extent of tipping should be estimated, because tips are often unreported to the tax authorities; Hemenway (1993), for example, mentions that the only income with a lower compliance rate than tipping is illegal income. Fortunately, we can estimate the extent of tipping reasonably well at least in the US restaurant industry. The 2010 Statistical Abstract of the United States suggests that in 2009 (based on a projection) sales of food and alcoholic beverages to consumers amounted to \$564 billion. However, tipping is not a strong social norm in all eating places. Therefore, to be conservative, let us consider only part of this amount, as follows. Sales in full-service restaurants were \$182.9 billion; in snack and nonalcoholic beverage bars – \$19.9 billion; in bars and taverns – \$17.1 billion; and in lodging places – \$28.0 billion (US Census Bureau, 2010, Table 1247). The sum of these numbers is \$247.9 billion. Now the question is what is the average tip in percentage of the bill. Research on US tipping in restaurants reports an average tip of 23.2% (Parrett, 2003, Table 14). However, it may be the case that larger bills are tipped on average a smaller percentage, so to be conservative let us consider instead the average tip amount in that study, which was \$6.52, and the average bill size, which was \$34.67. The ratio between the two numbers, which is 0.188 (or 18.8%), is the weighted average tip (weighted by the bill size), as opposed to the simple average tip of 23.2% mentioned above. The product of 18.8% and \$247.9 billion gives us an estimate for annual tipping in the US food industry, \$46.6 billion.

Moreover, tipping is common in other industries as well. Lynn, Zinkhan, and Harris (1993), for example, examine 33 tipped service professions. Tipping is also common in many countries in addition to the US, to the extent that there are even books about tipping practices in different countries (e.g., Star, 1988) and travel guide books often mention the tipping practices in the destination country. Finally, tipping is not a very new phenomenon. Azar (2004b) reports that tipping in Europe started hundreds of years ago, and significant tipping exists in the US for over a century. He mentions for example that “Towards the end of the 1890s, tipping was established in the United States, involving many workers and large amounts of money. During the early 1910s it was estimated that five million workers in the United States, more than 10% of the labor force, had tip-taking occupations. Tips were estimated to total \$200–\$500 million each year.” Adjusting for CPI the amount of \$200–\$500 million gives a result of \$4.4–\$11.1 billion in today’s prices.¹ To correctly interpret this number, remember that the US population in 1910 is estimated to be about 92 million, whereas in 2009 it is estimated at about 308 million.² The above suggests that over the years (in today’s prices) and across different occupations and countries tips totaled to trillions of dollars.

In addition, tipping has a large impact on many people. Millions of US workers, for example, derive most of their income from tips. Wessels (1997) reports that in the US, the primary occupation of more than two million workers is being servers (in addition to many others who are servers in their secondary occupation). He adds that servers in full-course restaurants earn 58% of their income from tips and those in counters earn 61% of their earnings in tips, and these figures are underestimations because tip income is often underreported.

Many others, such as taxi drivers, also obtain much of their income from tips. Post (1997, p. 538), for example, suggests that “In general, a tip to a taxi driver is about 20 percent of the fare.” If the price of a ride is P (before the tip) and the costs of the driver (fuel, depreciation, payment to the taxi company, etc.) are equal to C , then a 20% tip represents $0.2P/(1.2P - C)$ of the net income of the driver before tax, which is a number between 16.7% and 100% for $0 \leq C \leq P$. If the driver does not report tip income for tax purposes, then with respect to his net income after tax, the tip income will constitute even more than $0.2P/(1.2P - C)$ of the total net income.

1.2. Implications of tipping for other behaviors

Tipping is also interesting because it is puzzling from the perspective of traditional economic models. The usual assumption in economics is that people are selfish and they maximize utility subject to a budget constraint by consuming the goods and services that give them the highest utility. This assumption implies that consumers should not give up money unless they receive goods or services in return. When people tip, however, the service has already been provided and therefore the tip can no longer affect service quality. The consumer may still tip if he believes that this can improve the service he will receive in the future. Many people, however, tip also when they travel and do not intend to return to the same establishment again, and therefore future service considerations cannot be the reason for their tipping. It follows that tipping is a voluntary payment that is not motivated solely by future service considerations, so why do people tip? This is the question that several articles in the tipping literature try to answer (e.g., Azar, 2010; Lynn & Grassman, 1990). Azar (2010) suggests that the two main reasons for tipping in restaurants in the US and Israel are that tipping is a social norm and that customers can use tipping to show their gratitude for the service they received. Additional important motivations for tipping that Azar mentions are that people know that waiters receive low wages and depend on tips, and that people report feeling guilty and embarrassed if they do not tip. Thus, tipping is motivated by several psychological and social considerations.

Research on tipping may allow us to better understand the role of such psychological and social motivations not only in tipping behavior but also in other contexts. For example, giving donations and gift giving result at least partially from psy-

¹ Information on the CPI in the US is available at <ftp://ftp.bls.gov/pub/special.requests/cpi/cpiat.txt>. The earliest CPI information reported there is for 1913. For January 1913 the CPI reported is 9.8, and for June 2010 it is 217.965.

² See http://www.npg.org/facts/us_historical_pops.htm and <http://www.factfinder.census.gov/servlet/SAFFPopulation?sse=on>.

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