The Development of Tip Elimination and Its Effects on the Industry

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The Development of Tip Elimination and Its Effects on the Industry

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Overview of Topics

• Brief history
• Current Status of Tipping
• Forces against the elimination of tip credit
• Forces for the elimination of tip credit
• Future Implications
History of Tipping in the US

- Origin is debated
- To Insure Promptness
- Dutch? Latin?
- Civil War? Roman times?
- Near the time of prohibition (1920-1933)
- Restaurant sales were down
- Employees were encouraged to except tip from customers
- Increased over time and formalized in 1960’s
Tipping and the IRS

• 1965: employers must withhold FICA tax on tips from employees’ pay
• 1982: employees must report at least 8% of gross sales as tips
• 1993: FICA tip credit enacted - employers allowed a tax credit
• 1993: introduction of Tip Rate Determination/Education Program (TRDEP)
  • encourages employees to report the correct amount of tip income to their employer.
• 2002: Supreme Court rules the IRS can determine the amount of tips it thinks employees should have reported based on restaurant data and can assess the employer share of FICA tax on suspected unreported tips
• 2013: IRS clarifies distinction between tips, service charges and treatment of each
Tips v. Service Charges

• Tips
  • Voluntarily given from customer
  • Go directly to service worker
  • Directly from Customer
  • From Tip Pools, Splitting...

• Service Charges
  • Involuntarily given from customer
  • Considered business revenue
  • Examples
    • Hotel Service Charge
    • Banquet Event Fees
Current Status of Tipping

• Federal Tip allocated wage has been $2.13 since 1991.
• Federal minimum wage is 7.25
• Federal Tip credit is $5.12
• Average reported tipped wage ~11-12/hr

• Business Model of 80+ years
• Tips constitute the bulk of pay

• There are forces for and against subminimum wage.
Forces for the Elimination of Tipping

• State laws
• Popular Restauranteurs
• Raise Wage Act
• Poverty Thresholds
• Special Interest Groups
• Research
The Elimination of Tip credit by State

7 states have no tip credit
26 2.13>5.12 tip credit
17 have full tip credit
Research: Tips Discriminate

• Tipping Creates an Environment where:
  • Better Service
    • White males
  • Less Service
    • Young, old, people of color, women, religions, foreigners

Tippers are typically male and 70% servers are female.

Non-White Servers make less $ than white servers.

Bottom line........

Tips cause discrimination among both customers and employees
Danny Meyer and the Media

• High profile operators
  • Thomas Keller
  • Danny Meyers
  • Joe’s Crabshack*
  • 20+ others in NYC

Case Study Example
• NY minimum wage rising
• Tip Credit eroding
• Shortage of kitchen workers
  • Needs to pay more to attract them. $11.25 to $15.25
• Money for this increase has to come from somewhere.
  • Prices could be increased
  • Lower profit margins accepted
  • Equilibrium achieved
• Scenario doesn’t apply to most
Raise Wage Act

• S.1150 — 114th Congress (2015-2016) Murray
• Wants to raise to Fed. Min. Wage from $7.25 to $12.00/hour by 2020
## Poverty Thresholds in the US

United States Department of Health and Human Services (HHS) figures for Federal Poverty Level in 2015

<table>
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<th>Persons in Family Unit</th>
<th>48 Contiguous States and D.C.</th>
<th>Alaska</th>
<th>Hawaii</th>
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<td>$14,720</td>
<td>$13,550</td>
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<tr>
<td>2</td>
<td>$15,930</td>
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<td>$18,330</td>
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<td>$47,010</td>
</tr>
</tbody>
</table>

Each additional person adds: $4,160 (48 states), $5,200 (Alaska), $4,780 (Hawaii)

Note: if a single individual works 40 hours @ $7.25 = $15,080
Special Interest Groups

• Began after 9/11 to help Windows of the World employees

• Erika Medeiros of ROC

• “tips aren’t guaranteed”

• Many are below the poverty line.

• $7.25
Research Findings: Tips v. Service Quality

• *Tip amount has little to do with service quality.*

• **Theory**
  • gratuity is motivation to do their best

• **Reality**
  • Size of a tip has less to do with the quality of service provided
  • Mostly attributed to the size of the bill.
  • Customers
    • reluctant to leave anything less than the normal 20% gratuity
    • fear of social disapproval
    • gratuity unlikely to fluctuate is unlikely to motivate.

M. Lynn, Cornell
Research Findings: Tips Diminish Teamwork to TEA

- Provides no incentive for working as part of a team.
- Focused on their customers and theirs alone
  - “That’s not my section”
  - “I’ll get your server”
- Pooling tips among servers can help alleviate this circumstance
  - most servers dislike
  - fear of sharing with team members that work less
Theory: Tips Make it Difficult to Manage

• Danny Meyer
  • Direct transaction between
    • the customer and service provider
    • leaves no place for the manager.
  • Eliminating tips
    • puts the manager between these two parties
    • allows them to manage service through pay increases, bonuses and promotions.
  • Meyer is confident that his managers will be better at this than his customers.
Tipping is North American (Europe)

• The rest of the world as a case study
  • What can we learn from them?
• Initial Points
  • They have never had it.
  • Cultural Differences.
  • Different service expectations.
  • More government intervention.
  • Serving is a respectful career choice.
Forces Against the Elimination of Tipping

• Elimination of tipping is not working
  • Customers perceptions
    • Felt they lost control
    • Didn’t like mandated tip
  • Service Providers
    • Delivered less service
    • Earned less money
  • Managers
    • Dealt with lower CSS
Research: Customer Opinions

• Changing the familiar business model
• Consumer attitudes have been extensively researched
• Customers
  • unwilling to tip less than the norm or not at all
  • feel a sense of transactional power where tipping is involved
  • feel powerless without tipping
  • Resent being mandated to pay
Raising Menu Prices

• Example: Meyer has stated that he will be raising the prices on his menu by more than 20%.
• sticker shock for many customers.
• acceptable in NYC
• What if none of your competitors do the same?
  • Will customers understand what you are doing?
• The French Laundry
  • a service charge is acceptable.
  • unwelcomed most everywhere else.
Comparison of Tipped/Hourly @ 40 hours

- **Scenario 1 – Erika**
  - Coffee Shop
  - $2.13/hour $9.87 tips
  - 40 hours
  - 15% taxes = $72
  - $13.20 paycheck
  - Poor Sally
  - Dependent on tips

- **Scenario 2 – Ron**
  - Home Depot
  - $12/hour
  - 40 hours
  - 15% taxes = $72
  - $408 paycheck
  - Rich Ron
  - HD pays him well!
What they don’t mention...

• Scenario 1 – Erika
  • Coffee Shop
  • $2.13/hour
  • $9.87/hour in tips which is the national “reported” average

• Take-home is the same.
• If it falls below $246.50 the café will compensate. (still above poverty level)
• She would have received an additional $88 (~$14.20/hr) for enough taxes to be deducted for a $0 paycheck.

• Scenario 2 – Ron
  • Home Depot
  • $12/hour

• Take home is the same
• Guaranteed pay, but no opportunity for an extra $88/week.
Who benefits from a higher minimum wage?

**WHAT PEOPLE THINK**

- Teenager
- Works part time after school
- Lives with parents
- Earning extra spending money

**THE REALITY**

- Average age: 36 years old
- 89% are not teens, they’re 20 or older
- 37% are 40 or older
- 56% are women
- 28% have children
- 57% work full time
- On average, they earn more than half of their family’s total income

Statistics describe civilian workers, ages 16+, that would be affected by an increase in the federal minimum wage to $12.00 by 2020. The median age of affected workers is 32 years old.

ECONOMIC POLICY INSTITUTE

go.epi.org/raisethewage
Research: Service Worker Perspectives

- Survey of tipped service workers

- Servers are motivated by money
  - Serving and bartending are difficult jobs.
    - physically demanding
    - hours are long
    - workweek is unconventional
    - public can be difficult
    - primary motivation for doing these jobs is $$$$ (yes, passion too)

- Servers are risk takers
  - Preferred uncertainty of tips over a steady wage
    - Many mentioned the actual amount of money they can make on a busy Friday.
    - When asked about a dead Tuesday, they again mentioned “Making Bank” on Friday.
Research: Service Worker Perspective

• **Servers are entrepreneurial**
  • Indicated that they worked hard to
    • provide great service
    • upsell for their financial benefit
  • Preferred working alone
  • Expected to benefit from their effort.
  • Didn’t expect the house or their co-workers to take what they had earned.

• **Servers are Transitory**
  • servers consider themselves as something else.
  • students paying their way through school
  • out of work accountants, teachers looking to supplement
  • make money and move on
  • less interested in promotion, 401K’s
Entities to Consider

- Special Interest Groups
  - Will aggressively
  - Will people believe bad statistics?

- Industry Change Agents
  - Will they continue?
  - Tipping Point? (Malcolm Gladwell)

- National Restaurant Association
  - Continues to aggressively lobby against

- Workers
  - don’t like it
  - but can they adjust?

- Owners
  - are mostly against it
  - but they are a highly adaptable group

- Customers
  - don’t like the change
  - but do they matter?
  - norms have changed throughout history
Future Predictions

What might happen?

- Congress/States will continue to erode tip credit
- Labor Shortages will continue
- Labor costs will increase
- Tipping will continue to erode
- Initial Dip in level of service
- All will adjust
- A new normal will appear

Insert picture of back to the future
Questions/Comments?

Thank you for attending
I appreciate that you are here.