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## The Law and Economics of Tipping: The Laborer's Perspective

Samuel Estreicher\*

Jonathan R. Nash†

\*New York University School of Law

†Tulane Law School

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## The Law and Economics of Tipping: The Laborer's Perspective

Samuel Estreicher<sup>†</sup>

Jonathan Remy Nash<sup>‡</sup>

The phenomenon of tipping service providers is seen to present a conundrum for standard economic theory. Economists presume that individuals act in their economic self-interest. Thus, individuals engage in transactions with one another when it is in both their economic self-interests to do so. But it is hard to see how tipping is in the tipper's self-interest.<sup>1</sup> Tipping is a mere custom; it is not ordinarily required by any contractual obligation, express or otherwise. Moreover, one generally tips only after the services for which the tip is offered have been fully delivered.

One might think that repeat customers of the same service provider tip in order to ensure proper service the next time—i.e., they actually tip in advance for services to be rendered in the future. But studies show that individuals tip service providers even if it is a virtual certainty that they will never seek service from that service provider ever again.<sup>2</sup>

Some commentators have suggested that tipping allows customers to monitor directly service providers.<sup>3</sup> This achieves two goals. First, it creates an incentive for service providers to provide quality service.<sup>4</sup> Second, it allows for monitoring of service

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<sup>†</sup> Charles L. Denison Professor of Law and Director of the Center for Labor and Employment Law, New York University School of Law.

<sup>‡</sup> Associate Professor of Law, Tulane Law School, and Research Fellow, New York University Center for Labor and Employment Law.

<sup>1</sup> Ofer H. Azar, *The Implications of Tipping for Economics and Management*, 30 INT'L J. SOC. ECON. 1084, 1087 (2003) ("Tipping is a challenge to standard economic modeling. Why do consumers leave money to strangers when they are not legally obligated to do so and do not derive a material benefit from it?").

<sup>2</sup> Saul Levmore explains:

Rational choice adherents are somewhat puzzled by the tipping custom, as they are by many other norms, especially when practiced by non-repeat players. A one-time customer would seem to gain very little by making a gratuitous payment. The mystery is why the practice persists or why it has not moved up chronologically to precede the provision of service.

Saul Levmore, *Norms as Supplements*, 86 VA. L. REV. 1989, 1991 (2000) [hereinafter Levmore, *Norms as Supplements*] (footnote omitted); see Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051, 1128 (2000) (echoing this concern).

<sup>3</sup> See generally Ofer H. Azar, *Optimal Monitoring with External Incentives: The Case of Tipping*, 70 S. ECON. J. (forthcoming 2004) (exploring the interplay between tipping and monitoring).

<sup>4</sup> Levmore argues that a tipping norm is most likely to be useful to encourage—and is therefore most likely to arise in the setting of—customized personal service. See Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards*, 36 J.L. & ECON. 503, 533 n.55 (1993) [hereinafter Levmore, *Commissions and Conflicts*] (noting that, with respect to the question of where tipping customs evolve, "[o]ne fairly successful theory is that tipping is correlated with customized rather than with uniform service"). "Thus," explains Levmore, "waiters (who fill water

providers (and the accompanying incentive to provide good service) at lower cost than it would if employers had to monitor directly their service-providing employees.<sup>5</sup>

But there are problems with this explanation for tipping as well. First, because tipping is not required as any sort of contractual obligation and the tip is not provided until service has been rendered, it is unclear why service providers should rely on tips being provided. And, as elucidated above, it is even more unclear where the customers are not repeat customers.<sup>6</sup> Second, empirical studies have shown that, while service quality is one factor that determines tip size, in reality many other factors—most of them unrelated to service quality—affect tip size.<sup>7</sup> Thus, the extent to which tipping in general creates an incentive for service providers to provide marginally better service is unclear.<sup>8</sup> At the other extreme, if tipping does incentivize service providers to provide better

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glasses and provide other customized services), porters, cab drivers (who exercise great control over routes and speed), and hair cutters are often tipped while bus drivers, fast-food cashiers, and flight attendants, who provide less customized services, are not customarily tipped.” *Id.* One might consider how the recent proliferation of “tip cans” for workers at cafeteria-style eateries like Starbucks and Subway fits into this model.

In more recent work, Levmore seems to afford the “customized service” argument less weight, explaining: “While tipping surely has something to do with individualized service, it may be more useful to emphasize the presence of tipping where there is no danger of destructive competition among those who are served.” Levmore, *Norms as Supplements*, *supra* note [check], at 1995. Moreover, Levmore observes that, even where customized services may be provided, tipping will generally not inhere where the owner himself or herself provides those services, *see* Levmore, *Commissions and Conflicts*, *supra* note [check], at 533 n.55; *supra* [check], or “where the customer already pays the provider by the hour,” Levmore, *Norms as Supplements*, *supra* note [check], at 1996 (although Levmore suggests that the last variable “may simply camouflage the question of whether the customer is especially well situated to help determine the provider’s compensation,” *id.*).

<sup>5</sup> Michael Conlin, Michael Lynn, and Ted O’Donoghue characterize the norm as a proxy for what would be a costly explicit service contract between consumers and service provider. *See* Michael Conlin, Michael Lynn & Ted O’Donoghue, *The Norm of Restaurant Tipping*, 52 J. ECON. BEHAVIOR ORG. 297, 304-05 (2003). Saul Levmore argues that the tipping norm is a socially valuable supplement to the employment contract between service providers and their employers. *See* Levmore, *Norms as Supplements*, *supra* note 2, at 1991-92.

<sup>6</sup> Levmore concedes this shortcoming in the explanation. *See* Levmore, *Norms as Supplements*, *supra* note 2, at 1992-93. But, he argues, “these flaws must be compared to those which accompany a compensation scheme controlled by the employer alone, and it is certainly plausible that tipping improves upon the contract that the employer and [service provider] (or the regulatory authorities and these private parties) an arrange on their own.” *Id.* at 1992.

<sup>7</sup> *See* Michael Lynn, *Restaurant Tipping and Service Quality: A Tenuous Relationship*, 42 CORNELL HOTEL & RESTAURANT ADMIN. Q. 14 (2001) [hereinafter Lynn, *Restaurant Tipping*]; Michael Lynn, *Tip Levels and Service: An Update, Extension, and Reconciliation*, 44 CORNELL HOTEL & RESTAURANT ADMIN. Q. 139 (2003) [hereinafter Lynn, *Tip Levels and Service*]. For specific examples, *see* Conlin et al., *supra* note 4, at 303 (finding statistically significant empirical evidence that “percent tip decreases with bill size at a decreasing rate; percent tip increases with group size and consumption of alcohol; percent tip decreases with the age of the tipper; and percent tip is larger for individuals who frequent full-service restaurants more often” (footnote omitted)); Rick B. van Baaren, Rob W. Holland, Bregje Steenaert & Ad van Knippenberg, *Mimicry for Money: Behavioral Consequences of Imitation*, 39 J. EXPERIMENTAL SOC. PSYCH. 393 (2003) (describing study findings that restaurant customers will tend to tip more when servers verbally mimic their customers by repeating back customers’ orders after the customers have stated their orders).

<sup>8</sup> *See* Lynn, *Tip Levels and Service*, *supra* note 3, at 148 (“Research on tipping makes it clear that . . . managers should not rely on tips to motivate good service.”).

service, there is the risk of so-called destructive competitive tipping—i.e., that tipping will encourage service providers to provide service to higher tippers to the exclusion of lower tippers.<sup>9</sup> If that is true, then the efficiency gains that the manager might enjoy by virtue of reduced monitoring costs might be lost to destructive competitive tipping.<sup>10</sup>

Other commentators, including behavioral law and economics scholars, have suggested that tipping can best be explained as a norm. On this account, people tip either because they seek the social approval of others,<sup>11</sup> because they have internalized societal

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<sup>9</sup> A commercial of current vintage for an insurance company presents an example of destructive competitive tipping. The commercial presents a short vignette of a waitress, Cheryl, serving customers in a restaurant. The customers, eager for service, engage in a bidding war for Cheryl's services by offering to increase the amount they will tip Cheryl. The winning table of customers offers the highest bid and also offers to bus the table. The commercial, for Progressive Insurance Company, concludes by identifying Cheryl as Progressive's "kind of customer", presumably because she takes the time to seek out the best deal available.

Saul Levmore provides the following illustration, in the context of apartment building residents and a doorman:

A resident or tenant in a high-rise building might tip a doorman or other employee "because" the tenant observes the level of service better than the manager who pays the doorman's base salary. Tipping might generate greater effort on the doorman's part. But there is a danger that in order to maximize gratuities, the doorman will withhold service from some tenants and shift effort to others. Tipping might simply cause the provider to allocate efforts and good cheer across residents, rather than to increase total effort. If tipping generates competition among residents more than it does greater effort from the employee, then tenants might be better off with a no-tipping norm. This conclusion requires that we downplay the possibility that competitive tipping . . . is efficient simply if it works to allocate services to those who value it most highly. The rough idea is that such a market would be imperfect because the doorman, or comparable provider, is able to manipulate relatively ill-informed buyers.

Levmore, *Norms as Supplements*, *supra* note 2, at 1994 (footnote omitted). Levmore also suggests that owners and employers, too, might suffer by virtue of competition among customers for service. *See id.* at 1994 n.7.

<sup>10</sup> Given the possible problem of competitive tipping, Levmore suggests that a tipping norm is more likely to establish itself in situations "where there is no danger of destructive competition among those who are served. . . . In short, the collective action problem among those who are served by a single provider reduces the efficiency of the tipping supplement and makes a positive theory more difficult." *Id.* at 1995 (footnote omitted). Levmore notes that the argument against tipping in the context of a single service provider is "the cousin" of an argument he elsewhere makes that "multiple principals served by a single agent (as in the case of most homeowners who employ a single real estate agent to sell their houses) will prefer fixed commissions that reduce the agent's incentive to prefer one seller over another." *Id.* at 1995 n.8 (citing Levmore, *Commissions and Conflicts*, *supra* note 3, at 507).

Conlin, Lynn, and O'Donoghue also acknowledge the potential for destructive competitive tipping, but give it less weight than does Levmore, at least in the context of restaurant service:

While some customers certainly behave in this fashion, we suspect this issue is not a major concern for our analysis because customers rarely discuss potential tips with waitpeople prior to meals. Of course, whether such competition is likely to occur may help to explain why tipping arises in some arenas (and countries) but not others.

Conlin et al., *supra* note 4, at 306.

<sup>11</sup> *See, e.g.*, Leo P. Crespi, *The Implications of Tipping in America*, 11 PUB. OPINION Q. 424, 429 (1947) ("[C]ustom, meaning primarily fear of social disapproval, is today the principal reason why people tip. If the arguments are accepted, a large proportion of the tipper public, and certainly the largest proportion of tippees, are quite wrong in their belief that the main reason for tipping is still the original motive of incentive and reward for good service."). Russell Korobkin and Thomas Ulen elucidate:

norms and believe it would be “wrong” not to tip,<sup>12</sup> or some combination of the two.<sup>13</sup> But the norm justification fails to explain how such a specific norm as topping would evolve and persist.

In this paper, we advance an explanation for tipping that has received scant attention from commentators, especially economic commentators: Tipping developed, and continues to exist, at least in part as result of efforts to reduce costs in certain industry by funneling money to service providers tax-free. Our explanation offers what other economic commentators’ explanations have not: an economic explanation for an economic phenomenon.

Our approach also differs from that of other commentators in another important way. We focus on tipping from the laborer’s perspective. Tipping also presents an economic conundrum, at first blush, from the point of view of laborers. As a general matter, people prefer jobs that offer steady wages as compared to jobs that offer variable wages—especially, as is generally the case with jobs that feature tipping as an income

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On one account, people value not only the inherent qualities of actions that they might take but also the esteem, or social approval of others. Compliance with social norms earns the actor esteem, whereas violation of social norms costs her esteem. In economic terms, social norms can be thought of as providing a subsidy (in the form of positive esteem) for some behaviors while imposing a tax (in the form of negative esteem) for others.

Korobkin & Ulen, *supra* note 2, at 1129-30 (footnotes omitted). Along these lines, “when we see a diner leave a tip in a restaurant to which [she] will never return, we might interpret her behavior as evidence that she fears the loss of esteem she would suffer should her friends and neighbors learn that she failed to tip her server.” *Id.* at 1130. *Accord* Azar, *supra* note 1, at 1088 (“[T]he reason[] for tipping is that tipping is a social norm and that disobeying the norm is associated with a disutility caused by feelings of unfairness and embarrassment.”).

<sup>12</sup> Korobkin and Ulen explain:

A competing view posits that people obey social norms that are contrary to their direct interests because actors internalize the norms of their communities. According to this view, the cost of violating social norms is not loss of esteem in the eyes of peers but guilt or shame for doing something the actor experiences as “wrong” (the benefit to be gained from compliance with social norms can be referred to as “pride”). The costs of violating social norms are imposed not by society but by the violator himself.

Korobkin & Ulen, *supra* note 2, at 1130 (footnotes omitted). Under this approach, “if a diner tips her server in a restaurant in a community in which she knows no one and which is many miles away from her hometown, we might suspect that internalization is the better behavioral explanation.” *Id.*

<sup>13</sup> Korobkin and Ulen explain: “In many cases, a social norm might derive its power from both the desire for social approval and from internalization. That is, . . . a diner might leave the server a tip because [she] would fear the imposition of social sanctions and feelings of guilt should [she] act otherwise.” *Id.* at 1131 (footnote omitted).

Ofer Azar propounds an explanation for tipping that echoes this rationale in that it describes the tipper’s utility as increasing by virtue both of the tipper herself and of societal approval: “[T]ipping may result in a positive utility from feeling generous and because consumers often feel empathy for the worker who serves them, and want to show their gratitude by leaving him a tip . . .” *Id.*; *cf.* Levmore, *Norms as Supplements*, *supra* note 2, at 1996 (“There is . . . something awkward about—which is to say there is a mysterious norm against—tipping across or up the socioeconomic ladder, and perhaps a positive theory should limit itself to the presence or absence of discretionary transfers to relatively low-earning providers.” (footnote omitted)); *id.* at 1996 n.9 (“Something of this sort may be at stake in the (old-fashioned) norm of refraining from tipping when the service provider owns the establishment. The cultural interpretation of this practice is that the entrepreneur is more of an equal and that it might be insulting to suggest that an immediate ex-post evaluation is necessary to encourage effort.”).

source, where the job itself is of relatively low salary. Why, then, should laborers agree to accept some of their income—indeed, as statistics on tipping suggest, a large portion of their income—in the form of tips, which in theory they have no right to receive?

Here, again, our explanation offers an answer to this question that other theories do not. Laborers prefer jobs that include tip-based compensation because that compensation, historically at least, was tax-free.

Continuing our interest in the laborer's perspective on tipping, we proceed to discuss the economic incentives that tipping creates for laborers and their employers. In particular, we discuss how employees and (to the extent they are authorized to mandate it) employers choose whether or not to invoke tip-pooling—i.e., sharing of tips among employees. We also discuss how tip-pooling arrangements may affect cooperation among laborers.

In Part I of this Article, we provide a broad overview of tipping. Part II summarizes the labor and tax laws governing tips and tipping. In Part III, we examine tipping from the laborers' perspective. Focusing on restaurant workers, we look first at employees' and employers' general response to tipping, and then turn to the specific question of tip pooling, both as initiated voluntarily by waitstaff and as mandated by employers.

## I. Overview of Tipping

For purposes of this paper, we consider tipping to include situations where individuals give money to providers of service, purportedly in relation to particular provisions of service.<sup>14</sup> Tipping is a custom. It is required neither by law nor by private contract. It varies across geographic areas and social and occupational settings.

Tipping extends to various areas where services are offered, including restaurant service, taxicab use, valet parking, and hotel services.<sup>15</sup> And the tips are significant in terms of the national economy. Tips for the nation's two million waitresses and waiters are estimated to total well in excess of \$20 billion annually.<sup>16</sup> Indeed, "millions of

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<sup>14</sup> It is possible to conceive of far more inclusive definitions of tipping. For example, one might argue that a lawyer's Christmas present to her assistant is a form of a tip. We restrict our discussion here to tips that fall within the definition in the text.

<sup>15</sup> See Michael Lynn, *Tipping in Restaurants and Around the Globe: An Interdisciplinary Review*, in *Foundations and Extensions of Behavioral Economics: A Handbook 2* (Morris Altman ed., forthcoming 2004) ("[T]ipping is not confined to restaurant servers . . . . In the U.S., consumers also tip barbers, bartenders, beauticians, bellhops, casino croupiers, chambermaids, concierges, delivery persons, doormen, golf caddies, limousine drivers, maitre-d's, masseuses, parking attendants, pool attendants, porters, restaurant musicians, washroom attendants, shoeshine boys, taxicab drivers, and tour guides among others . . . .")

<sup>16</sup> See Lynn, *Tip Levels and Service*, *supra* note [check], at 139 (estimate of \$21 billion); Azar, *supra* note 1, at 1084 (estimate of \$26 billion). The broad restaurant industry constitutes a substantial portion of the United States economy. See, e.g., Sherri Day, *Restaurant Hiring May Lead the Way to Wider Job Gains*, N.Y. TIMES, Dec. 10, 2003, at [check] ("Since the beginning of August, the restaurant business, which

[American] workers . . . derive a significant portion of their income, often most of it, from tips.”<sup>17</sup> Further, while local customs often vary, the notion of tipping is by no means restricted to the United States.<sup>18</sup>

A substantial academic literature has developed on the psychology and sociology of tipping. Economic interest in the subject is more recent and, by comparison, little has been written on the economics of tipping.<sup>19</sup> More generally, the academic literature—including the economic literature—tends to focus on tipping from the consumer perspective and to ignore the perspective of laborers.<sup>20</sup> We seek to fill that gap with this Article.

## II. Overview of the Legal Treatment of Tips

### a. Labor Law

#### i. Minimum Wage

Through the Fair Labor Standards Act (“FLSA”),<sup>21</sup> Congress has established a national minimum wage.<sup>22</sup> The statute sets out a slightly modified standard for so-called “tipped employees”—that is, employees “engaged in an occupation in which [they] customarily and regularly receive[] more than \$30 a month in tips.”<sup>23</sup> While tipped employees must receive at least the minimum wage, they may receive a portion of their compensation in the form of tips rather than direct cash wages. Prior to 1996, the FLSA allowed up to 50 percent of tipped employees’ wages to be in the form of tips.<sup>24</sup> In

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includes everything from McDonald’s to corner bars to four-star restaurants, has accounted for 18 percent of the 300,000 jobs created in the nation.”)

<sup>17</sup> Azar, *supra* note 1, at 1084 (“[S]ervers in full course restaurants earn 58 percent of their income from tips; those in counters earn 61 percent of their earnings in tips (in fact, the true percentages are likely to be much higher, because tips are often unreported.”).

<sup>18</sup> See Lynn, *supra* note 2, at 2 (“Although not as common as in the U.S., tipping is also practiced in most countries around the world.”).

<sup>19</sup> See Azar, *supra* note 1, at 1085 (“While tipping was the subject of many studies in psychology, economists for some mysterious reason hardly explored the economic implications of tipping.”); see also Lynn, *supra* note 14, at 16 (“The empirical literature on tipping . . . is dominated by psychologists. Only recently have economists begun to collect and analyze data on this phenomenon.”).

<sup>20</sup> See Lynn, *supra* note 14, at 16 (“Most [economic] models, theories and speculations [of tipping] address one of two questions – (1) Why do rational individuals leave tips? and (2) How has the custom of tipping evolved?”).

<sup>21</sup> 29 U.S.C. §§ 201-219.

<sup>22</sup> See *id.* § 206(a)(1). Since 1997, the minimum wage has been set at \$5.15 per hour. See *id.*

<sup>23</sup> 29 U.S.C. § 203(t).

<sup>24</sup> Prior to its 1996 amendment, the FLSA provided:

In determining the wage of a tipped employee, the amount paid such employee by his employer shall be deemed to be increased on account of tips by an amount determined by the employer, but not by an amount in excess of . . . 50 percent of the applicable minimum wage rate after March 31, 1991, except that the amount of the increase on account of tips determined by the employer may not exceed the value of tips actually received by the employee.

1996, Congress amended the FLSA to “allow employers to take greater tip credits as the minimum wage increased.”<sup>25</sup> Current law sets the minimum compensation cash compensation due tipped employees at “the cash wage required to be paid such an employee on August 20, 1996”,<sup>26</sup> i.e., \$2.13.<sup>27</sup> Thus, current law allows more than 58.6 percent of the current \$5.15 hourly minimum wage to come in the form of tips.<sup>28</sup> The amount of compensation that an employer may provide to a tipped employee in the form of tips and credit toward the employee’s minimum wage is called the “tip credit.”<sup>29</sup>

The FLSA imposes two requirements that an employer must meet in order to take advantage of the tip credit with respect to an employee: first, the employer must advise the employee of its intent to “treat tips as satisfying part of the employer’s minimum wage obligation,”<sup>30</sup> and, second, it must allow the employee to retain “all tips received by such employee.”<sup>31</sup>

The FLSA sets only a federal minimum wage floor; it explicitly authorizes state and local governments free to impose higher minimum wage requirements.<sup>32</sup> And, indeed, some jurisdictions have imposed higher minimum wages than federal law requires.<sup>33</sup>

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29 U.S.C. § 203(m) (1994). The minimum wage in effect from 1991 through October 1, 1996 was \$4.25 per hour. *See id.* § 206(a)(1); *Kilgore v. Outback Steakhouse of Fla., Inc.*, 160 F.3d 294, 297 (6th Cir. 1998). Thus, employers had to provide \$2.13 in minimum cash compensation to tipped employees. *See Myers v. Copper Cellar Corp.*, 192 F.3d 546, 548 & n.3 (6th Cir. 1999).

<sup>25</sup> *Kilgore*, 160 F.3d at 298 n.3.

<sup>26</sup> 29 U.S.C. § 203(m).

<sup>27</sup> *See infra* note [check].

<sup>28</sup> Prior to 1996, the FLSA mandated that up to 50% of tipped employees’ minimum wages could be in the form of tips:

In determining the wage of a tipped employee, the amount paid such employee by his employer shall be deemed to be increased on account of tips by an amount determined by the employer, but not by an amount in excess of . . . 50 percent of the applicable minimum wage rate after March 31, 1991, except that the amount of the increase on account of tips determined by the employer may not exceed the value of tips actually received by the employee.

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<sup>29</sup> *See Kilgore*, 160 F.3d at 298; 29 C.F.R. § 531.51.

<sup>30</sup> *Kilgore*, 160 F.3d at 298. Section 203(m) of the Act itself requires employers to inform the tipped employee “of the provisions of this subsection.” 29 U.S.C. § 203(m). The court in *Kilgore* interpreted this to require “an employer [to] inform the employee that it intends to treat tips as satisfying part of the employer’s minimum wage obligation. . . . In other words, an employer must inform its employees of its intent to take a tip credit toward the employer’s minimum wage obligation.” *Kilgore*, 160 F.3d at 298.

<sup>31</sup> 29 U.S.C. § 203(m).

<sup>32</sup> *Id.* § 218(a) (“No provision of this chapter or of any order thereunder shall excuse noncompliance with any Federal or State law or municipal ordinance establishing a minimum wage higher than the minimum wage established under this chapter . . .”).

<sup>33</sup> *See, e.g., Wessels, supra* note [check], at 347 tbl. 1 (1986 data).



## ii. Splitting and Pooling of Tips

Tipped employees do not always retain the tips that they receive for themselves. First, the employees may engage in “tip splitting” with other restaurant employees; for example, waiters may opt to split tips—or, as it also described, to “tip out”—other employees, such as members of the bus staff.<sup>34</sup> Second, tipped employees may engage in “tip pooling” with other employees—i.e., to share tips on a regular basis with other employees.

Two issues arise in connection with tip pooling. First, is the tip credit available where tip pooling occurs? Second, may employers require tip pooling, or must tipped employees agree to such an arrangement?

With regard to the availability of the tip credit, one at first blush might read the statutory “tip credit” requirement—that the employer must allow the employee to retain “all tips received by such employee”<sup>35</sup>—as foreclosing the possibility of tip pooling where a tip credit is sought. But the statute goes on explicitly to reject this reading, directing that it “shall not be construed to prohibit the pooling of tips among employees who customarily and regularly receive tips.”<sup>36</sup> A Department of Labor regulation explicitly endorses tip pooling even where a tip credit is sought.<sup>37</sup>

Courts and the Department of Labor have interpreted the Fair Labor Standards Act to allow tip pooling both as a voluntary matter, and as mandated by employers.<sup>38</sup>

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In fact, state minimum wage laws predate federal minimum wage legislation. See William P. Quigley, ‘A Fair Day’s Pay for a Fair Day’s Work’: Time to Raise and Index the Minimum Wage, 27 ST. MARY’S L.J. 513, 516-20 (1996) (presenting the history of early state minimum wage laws); see generally Willis J. Norlund, A Brief History of the Fair Labor Standards Act, 39 LAB. L.J. 715 (1988) [check].

<sup>34</sup> See 6 West Ltd. Corp. v. NLRB, 237 F.3d 767, 772 n.8 (7th Cir. 2001) (“It is a common practice for servers to ‘tip-out’ other employees, such as bartenders, busboys, and hostesses, after their shift.”); but cf. Wessels, *supra* note [check], at 336 (“[T]he current use of tip outs is small.”).

<sup>35</sup> *Supra* note [check].

<sup>36</sup> 29 U.S.C. § 203(m).

<sup>37</sup> The regulation, captioned “Tip pooling”, elucidates:

Where employees practice tip splitting, as where waiters give a portion of their tips to the busboys, both the amounts retained by the waiters and those given the busboys are considered tips of the individuals who retain them . . . . Similarly, where an accounting is made to an employer for his information only or in furtherance of a pooling arrangement whereby the employer redistributes the tips to the employees upon some basis to which they have mutually agreed among themselves, the amounts received and retained by each individual as his own are counted as his tips for purposes of the Act.

29 C.F.R. § 531.54.

<sup>38</sup> See, e.g., *Kilgore*, 160 F.3d at 303-04 (concluding that the FLSA “expressly permits the ‘pooling of tips’ and does not bar employers from requiring tip pooling”); cf. 5 EMPLOY. COORDINATOR ¶ C-14,116 (“Do not be misled by [29 C.F.R. § 531.54] of the Wage and Hour Division’s regulations, which suggests that all tip-pooling arrangements must be mutually agreed on by the employees. This regulation no longer reflects the policy of the division.”).

Mandatory tipping pools may extend only to employees “who customarily and regularly receive tips.”<sup>39</sup> Tipped employees enjoy more latitude in crafting voluntary tip pooling arrangements than employers have in mandating them.<sup>40</sup> States remain free to impose bars against employer-mandated tip pooling.<sup>41</sup>

### b. Tax Law

Section 61 of the Internal Revenue Code requires individuals to include in gross income “all income from whatever source derived, including . . . compensation for services.”<sup>42</sup> Tips, therefore, are subject to the income tax.<sup>43</sup>

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The Wage and Hour Division of the Department of Labor has taken the position that an employer cannot require employees “to contribute a greater percentage of their tips than is customary and reasonable”; the Division has elucidated that a mandatory tipping pool is “customary and reasonable” if employees retain at least 15% of their tips. 1 LES A. SCHNEIDER & J. LARRY STINE, *WAGE AND HOUR LAW: COMPLIANCE AND PRACTICE* § 7:9. But the court of appeals in *Kilgore* recently rejected the Division’s interpretation as supported neither by the language of the statute or regulations, and as unentitled to deference under *Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984). See *Kilgore*, 160 F.3d at 302-03 (finding that the only valid restriction on mandatory tipping pools is that tipped employees’ wages remain at or above the applicable minimum wage).

<sup>39</sup> 29 U.S.C. § 203(m). Compare *Kilgore*, 160 F.3d at 301-02 ((holding that restaurant hosts at Outback Steakhouses “work in an occupation that customarily and regularly receives tips,” and in doing so contrasting hosts with “restaurant employees like dishwashers, cooks, or off-hour employees like an overnight janitor who do not directly relate with customers at all”).), with *Myers v. Copper Cellar Corp.*, 192 F.3d 546, 550-51 (6th Cir. 1999) (“Because [Copper Cellar “salad makers”] abstained from any direct intercourse with diners, worked entirely outside the view of restaurant patrons, and solely performed duties traditionally classified as food preparation or kitchen support work, they could not validly be categorized as “tipped employees” under section 203(m),” and therefore were not improperly included in a mandatory tipping pool.).

<sup>40</sup> See *Schneider & Stine, supra* note [check], § 7:9 (“Despite these requirements [that tip pools not extend to employees who do not customarily and regularly receive tips and that (to the extent it remains valid, see *supra* note [check]) tipped employees retain 15% of their tips] for involuntary pooling arrangements imposed by [an] employer, employees may enter pooling arrangements with terms which do not conform to these rules if the contributing employees mutually agree to such terms.” (footnote omitted)).

<sup>41</sup> See *Jameson v. Five Fleet Restaurant, Inc.*, 131 Cal. Rptr. 2d 771, 776 (Ct. App. 4th Dist. 2003) (“Because [California law] imposes prohibitions on tip pooling not contained in the FLSA, . . . federal authorities . . . are inapplicable.”); *id.* (“Under [California law], tip pooling is only permitted among employees who are neither employers nor agents”). Some states have statutes that expressly prohibit employer-mandated tip pooling. See *Wessels, supra* note [check], at 336; see, e.g., MINN. STAT. § 177.24(3) (“No employer may require an employee to contribute or share a gratuity received by the employee with the employer or other employees or to contribute any or all of the gratuity to a fund or pool operated for the benefit of the employer or employees. This section does not prevent an employee from voluntarily and individually sharing gratuities with other employees. The agreement to share gratuities must be made by the employees free of any employer participation.”). But that position is hardly uniform. Compare *Matter of Wage & Hour Violations of Holly, Inn Inc.*, 386 N.W.2d 385, 310 (Minn. Ct. App. 1986) (Minnesota “statutes indicate that mandatory tip sharing is not allowed.”), with *Leighton v. Old Heidelberg, Ltd.*, 268 Cal. Rptr. 647, 649-53 (Ct. App. 2d Dist. 1990) (California law does preclude employer-mandated tip pooling); *Alford v. Harolds Club*, 669 P.2d 721, 723-24 (Nev. 1983) (same result under Nevada law); *Fraser v. Pears Co.*, 16 Mass. L. Rptr. 255 (Mass. Super. Ct. 2003) (same result under Massachusetts law).

<sup>42</sup> I.R.C. § 61(a)(1); William A. Raabe, G. E. Whittenburg & Devona D. Newport, *Power Swings to IRS on Assessment of Employer FICA Tax on Tipped Employees*, 6 J. TAX’N EMPLOYEE BENEFITS 260, 260 (1999) (“Money received in the form of tips is Section 61 gross income.”).

Tips are also subject to Federal Insurance Contribution Act (“FICA”) taxes on wages that go toward the social security fund.<sup>44</sup> FICA establishes independent taxes on employees<sup>45</sup> and employers.<sup>46</sup> Employees must pay a percentage of their “wages” earned,<sup>47</sup> with “wages” defined generally as “all remuneration for employment.”<sup>48</sup> Employers must pay a FICA tax equal to a percentage of “the wages . . . paid . . . with respect to employment.”<sup>49</sup> Section 3121 of the Internal Revenue Code provides, subject to a de minimis exception,<sup>50</sup> that “tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer . . .).”<sup>51</sup>

Tips were historically not subject to FICA taxation. As the Federal Circuit recently explained:

Tips were not always subject to FICA tax liability. In 1965, Congress amended the law to require employers to withhold FICA taxes based on tip income and to allow employees’ Social Security wage earnings accounts to be credited for tip income earned. . . . Tips, however, were not considered remuneration for employment for purposes of the employer’s share of the FICA tax.

The Social Security Amendments of 1977 established the duty of an employer to pay FICA taxes on some of the tips received by its employees. . . . Employers were required to pay FICA tax on tips received by employees up to the amount of the federal minimum wage. . . . As a result, employees were subject to FICA taxes on all tips, but employers were exempt from FICA taxes for the amount of employee tip income in excess of the federal minimum wage. In 1987, Congress established an employer duty to pay FICA taxes on all tips that fall within the definition of “wages.”<sup>52</sup>

In addition to income and FICA taxes, tips are also subject to federal unemployment tax act (“FUTA”) liability. The FUTA tax is levied on employers, and is

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<sup>43</sup> TREAS. REG. § 1.61-2(a)(1) (“[T]ips . . . are income to the recipients unless excluded by law.”); *see, e.g.*, *Cracchiola v. Comm’r*, 643 F.2d 1383, 1384 (9th Cir. 1981) (rejecting as “totally without merit” the argument that waiters’ and waitresses’ tips are not gross income within the purview of the Internal Revenue Code).

<sup>44</sup> *See Bubble Room v. United States*, 159 F.3d 553, 555-57 (Fed. Cir. 1998). This was not always the case: *Id.* at 557 (citations omitted).

<sup>45</sup> *See* I.R.C. § 3101.

<sup>46</sup> *See id.* § 3111.

<sup>47</sup> *See id.* § 3101.

<sup>48</sup> *Id.* § 3121(a).

<sup>49</sup> *Id.* § 3111.

<sup>50</sup> Section 3121(a)(12)(B) provides that wages “shall not include . . . cash tips received by an employee in any calendar month in the course of his employment by an employer unless the amount of such cash tips is \$20 or more.” *Id.* § 3121(a)(12)(B).

<sup>51</sup> *Id.* § 3121(q). This is subject to the general exception that remuneration received by an employee does not include amounts in excess of the applicable “contribution and benefit base” under the Social Security Act. *Id.* § 3121(a)(1).

<sup>52</sup> *Bubble Room v. United States*, 159 F.3d 553, 557 (Fed. Cir. 1998) (citations omitted).

based upon the “total wages” paid to those in each employer’s employ.<sup>53</sup> Code section 3306(s) provides that “the term ‘wages’ includes tips” for FUTA purposes.<sup>54</sup>

Like FICA tax liability, FUTA tax liability based upon tips is a comparatively recent development. Section 3306(s) was enacted in 1984 and became effective in 1986.<sup>55</sup>

With this overview of the applicable tax law in place, we turn to the question of how the Internal Revenue Service (the “Service”) enforces the various tax liabilities for tip income. For years, the Service has had to deal with tip-compensated employees who do not have adequate documentation of their tip-based income. In response, the Service has developed methods to approximate tip income based upon factors such as charged tip data and restaurant income.<sup>56</sup> The Service has applied similar methods to estimate employer tax liability arising from employee tip liability. The courts have been receptive to these methods; recently the Supreme Court endorsed the use of such a method in the employer tax liability context.<sup>57</sup>

To aid in tax enforcement, Code section 6053 requires all employees who receive tips as wages to furnish their employers with monthly statements of tips received.<sup>58</sup> The Code imposes more onerous reporting requirements on so-called “large food or beverage establishments”.<sup>59</sup> Among these requirements<sup>60</sup> is the obligation to allocate tip income among employees.<sup>61</sup> That allocation must be reported both to the Service and to each affected employee.<sup>62</sup> The Code provision further directs employers at large food or beverage establishment to

<sup>53</sup> See I.R.C. § 3301.

<sup>54</sup> More precisely, the Code section provides that, for FUTA purposes, the term “wages” includes tips which are—

- (1) received while performing services which constitute employment, and
- (2) included in a written statement furnished to the employer pursuant to section 6053(a).

I.R.C. § 3306(s).

<sup>55</sup> 47B C.J.S. Internal Revenue § 584 (2004).

<sup>56</sup> This approach was first approved by the Tax Court in *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122 (1973), *action on dec.* (May 21, 1974) (acq.). The Service, courts and commentators generally refer to similar formula-based estimates to be conducted under a “McQuatters formula”. See, e.g., Bryan E. Gates, 2 I.R.M. ABR. & ANN. § 4.23.7.13 (2003).

<sup>57</sup> See *United States v. Fior D’Italia, Inc.*, 122 S. Ct. 2117 (2002) (holding that the Internal Revenue Service is justified in basing a restaurant’s FICA tax liability on an estimate of the amount that all customers tip all restaurant employees).

<sup>58</sup> See I.R.C. § 6053(a).

<sup>59</sup> A “large food or beverage establishment” is defined as any trade or business (or portion thereof)—

- (A) which provides food or beverages,
- (B) with respect to which the tipping of employees serving food or beverages by customers is customary, and
- (C) which normally employed more than 10 employees on a typical business day during the preceding calendar year.

*Id.* § 6053(c)(4).

<sup>60</sup> See generally *id.* § 6053(c).

<sup>61</sup> See *id.* § 6053(c)(1)(D), (E).

<sup>62</sup> See *id.* § 6053(c)(1)(E), (2)(C).

allocate (as tips for [reporting] purposes . . . ) among employees performing services during any payroll period who customarily receive tip income an amount equal to the excess of—

- (i) 8 percent of the gross receipts (other than nonallocable receipts) of such establishment for the payroll period, over
- (ii) the aggregate amount reported by such employees to the employer under subsection (a) [which requires employees to report tip income to employers] for such period.<sup>63</sup>

The allocation is to be conducted either “on the basis of a good faith agreement by the employer and the employees”<sup>64</sup> or pursuant to applicable regulations.<sup>65</sup>

### III. Tipping from the Laborer’s Perspective

#### a. Acceptance of Tip-Based Compensation

An initial question is why employees would be willing to accept tip-based compensation. Most individuals are risk-averse when it comes to compensation—especially those who, like many who receive tip-based income, are low-salary earners. Tip-based compensation is inherently riskier than standard wage compensation. Why, then, should tipping be as widespread as it is in service industries?

Tax incentives provide an answer to this question. As noted above, the taxation of tip-based income is of relatively recent vintage for FICA and FUTA tax purposes.<sup>66</sup> Moreover, even to the extent that tip-based income is subject to taxation, the government faces enforcement difficulties that are larger than in most other forms of compensation. Indeed, an Internal Revenue Service study of tipping practices in the foodservice industry in 1984 reported that “only one-third of tip income is reported.”<sup>67</sup> Michael Lynn explains that “[t]ipping allows servers to pay lower income taxes because under-reporting of tip income is more difficult for the government to catch than is under-reporting of standard wages.”<sup>68</sup>

<sup>63</sup> *Id.* § 6053(c)(3)(A). Under subsection (c)(3)(C), “[u]pon the petition of the employer or the majority of employees of such employer, the Secretary may reduce (but not below 2 percent) the percentage of gross receipts required to be allocated under subparagraph (A) where he determines that the percentage of gross receipts constituting tips is less than 8 percent.” *Id.* § 6053(c)(3)(C).

<sup>64</sup> *Id.* § 6053(c)(3)(B)(i).

<sup>65</sup> *Id.* § 6053(c)(3)(B)(ii).

<sup>66</sup> *See supra* Part II.b.

<sup>67</sup> IRS, TIP INCOME STUDY: A STUDY OF TIPPING PRACTICES IN THE FOOD SERVICE INDUSTRY FOR 1984 i (1990).

<sup>68</sup> Lynn, *supra* note [check], at 24. *Cf.* Azar, *supra* note 4, at 1089 (describing how an Israeli court decision mandating that tipped employees receive minimum cash wages in addition to tips resulted in many restaurants simply imposing fixed service charges and, while increasing nominally waitstaff’s salary, reducing waitstaff’s overall pay); *but cf.* Walter John Wessels, *Minimum Wages and Tipped Servers*, 35 ECON. INQUIRY 334 (1997) (arguing that an increase in the minimum cash wage will result in an increase in minimum wage-level restaurant worker employment). Still, the import of the minimum wage on restaurant workers is tempered by the fact that many restaurant laborers earn in excess of the minimum wage. *See,*

Service providers' lower tax burden inures as well to the benefit of employers and customers. Lynn elucidates: "[T]ipping allows customers to pay lower sales taxes because (by lowering restaurants' labor costs) it reduces the prices restaurants charge for meals. Together, these tax evasion opportunities benefit customers, servers, and restaurateurs by reducing the costs of supplying services."<sup>69</sup>

Still, commentators have questioned whether tax evasion offers a full explanation for tipping. First, Lynn notes that the

finding that tipping is more prevalent in countries with lower tax burdens casts doubt on the idea that tipping exists as a means of evading taxes. The motivation to evade taxes should be greater the higher those taxes, so if tipping customs are actively supported because they are a means of evading taxes, then tipping should be more (not less) prevalent the greater a nation's tax burden.<sup>70</sup>

Lynn cites unpublished findings indicated that in fact a greater national tax burden correlates with less tipping, not more.<sup>71</sup>

Second, Örn Bodvarsson and William Gibson observe that, "[w]hile it is not clear when tipping began, it certainly predates income taxes."<sup>72</sup> They also assert (without citation) that "[a]ttempts at more rigorous collection of tip income by Canadian and American authorities have not had discernible impacts on restaurant tipping."<sup>73</sup>

Third, Zvi Schwartz and Eli Cohen have conducted an empirical cross-country study of the relation between the national tax burden and the number of tipped-service occupations.<sup>74</sup> Their study revealed a negative correlation between the two statistics.<sup>75</sup> Schwartz and Cohen argue that their findings tend to rebut the "tax evasion" explanation for tipping,<sup>76</sup> arguing that the negative correlation instead supports the "disposable income effect"—that is, that a higher tax burden leaves less income to be spent on, and therefore reduces demand for, superior goods, such as services that warrant tipping.<sup>77</sup>

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*e.g.*, Day, *supra* note 8 ("While wages are relatively low for restaurant workers, not all the jobs are at the bottom of the wage scale . . . . Even burger restaurants pay new hires well above the federal minimum wage . . . ."). Many of these jobs, however, may not reap much in the way of tips.

<sup>69</sup> *Id.* at 24-25; *see also* Örn B. Bodvarsson & William A. Gibson, *Economics and Restaurant Gratuities*, 56 AM. J. ECON. & SOC. 187, 188 (1997) ("Gratuities increase the scope for income tax evasion that could lower the cost of service to customers and restaurateurs alike.").

<sup>70</sup> Lynn, *supra* note [check], at 25.

<sup>71</sup> *Id.* at 15, 25.

<sup>72</sup> Bodvarsson & Gibson, *supra* note [check], at 201 n.4.

<sup>73</sup> *Id.*

<sup>74</sup> *See* Zvi Schwartz & Eli Cohen, *Tipping and the Nation's Tax Burden: A Cross-Country Study*, 10 ANATOLIA: INT'L J. TOURISM & HOSPITALITY RES. 135 (1999).

<sup>75</sup> *See id.* at 141-45.

<sup>76</sup> *See id.* at 137, 145.

<sup>77</sup> *See id.* at 137-38, 145.

While Schwartz and Cohen's findings are informative, they do not establish that the tax evasion explanation of tipping is devoid of validity. First, they rely upon the total taxes imposed by a nation; a more focused approach would look in particular to taxes that are likely to have an impact, if they are collected, on workers' wages. Second, they use as the relevant statistic the number of tipped professions, but not the number of tipped professionals or the total amount of tips in fact paid.

In addition, our focus in this Article is on the perspective of the laborer. And, to return to our assertion above, it is logical—and Schwartz and Cohen's findings do not contradict—that laborers, who ordinarily would prefer the security of a fixed wage, might agree to accept some remuneration in the form of tips because of the wage enhancement that results from the opportunity for tax reduction.

Moreover, another aspect of Schwartz and Cohen's study provides indirect support for the notion that tax evasion may underlie tipping. Schwartz and Cohen also sought to evaluate the "crowding out" effect as applied to tipping. The "crowding out" effect generally posits that government and charity compete for available dollars; thus, the more the government affirmatively engages in wealth redistribution, the less the citizenry will be inclined to donate to charity.<sup>78</sup> Thus, if it is in fact true that tipping results from people's generosity, then "crowding out" effect should apply to tipping: "Higher levels of imposed wealth redistribution reduce charity in general and consumers' tendency to tip in particular."<sup>79</sup>

In order to evaluate the "crowding out" hypothesis, Schwartz and Cohen considered the relationship between the number of tipped professions and the differing portion of tax monies that various countries transferred to the poor through social security and welfare programs.<sup>80</sup> But their findings did not indicate that the two statistics were related in a statistically significant way.<sup>81</sup> They thus reject the "crowding out" hypothesis,<sup>82</sup> and speculate that perhaps "tipping has less to do with generosity than previously thought."<sup>83</sup> That, in turn, suggests that tipping has some economic motive underlying it, which takes us back to our earlier point.

Note, moreover, that there is at least anecdotal evidence that the acceptable tipping rate in the United States has gone in recent years from 10-15% to 15-20%. (There may also have been, however, an increase in the tendency to charge tips on credit cards, which reduces the opportunity not to report tip income to the tax authorities.)

### **b. General Waiter/Waitress Behavior**

The traditional—and to some degree, although not altogether, accurate—view that tipping is proportionate to quality of service should incentivize tipped employees to

<sup>78</sup> See *id.* at 138.

<sup>79</sup> *Id.*

<sup>80</sup> See *id.* at 139-40.

<sup>81</sup> *Id.* at 145.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

provide quality individualized service to each customer. To the extent that, as studies have shown, other factors influence tip size, one would expect knowledgeable (or intuitive) employees to modify their behavior so as to take advantage of these factors as well. Thus, waiters and waitresses may write “Thank you” on the bill, or try to engage their customers in friendly conversation.

Management also generally has an incentive to help tipped employees maximize their tips, insofar as higher tips both (i) can help to provide a “tip credit” for minimum-wage employees, and (ii) more importantly effectively increases employees’ wages, with the result that management can expect to hire better qualified employees which should translate into more repeat business and higher profits. Thus, we can expect management to provide training to employees as to how to increase tip income—provided that the cost of this training is outweighed by the benefit to the owner of the training.<sup>84</sup>

### c. Tip Pooling

We consider tip pooling under two circumstances. First, we consider the setting where waitstaff themselves decide whether or not to engage in tip pooling. Then we consider the scenario in which management decides to impose tip pooling.

#### i. Voluntary Tip Pooling

If management does not mandate tip pooling, then waitstaff enjoy the prerogative to decide whether, and if so with whom and to what extent, to pool tips.<sup>85</sup> In accordance with standard economic assumptions, we assume generally that in making these decisions each waiter or waitress seeks to maximize his or her own profits.<sup>86</sup> Under these conditions, we can view waiters and waitresses as a restaurant as private businesspeople independently providing services to restaurant customers. To be sure, the waiters and waitresses do not compete for individual customers as do, for example, competing restaurants.<sup>87</sup> Rather, the waitstaff service the customers that choose to patronize the restaurant at which the waitstaff work. Still, we may view each waitress or waiter as purchasing food from the restaurant kitchen, which she or he then resells to the customers seated at her or his tables. The waitresses and waiters enjoy the profits (in the form of

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<sup>84</sup> See Lynn, *Tip Levels and Service*, *supra* note [check], at 148 (“Research on tipping makes it clear that . . . managers should train servers to take one or more of 14 tip-enhancing actions.”).

This phenomenon helps to explain the recent proliferation of “standard” waitering observable at eateries such as Friday’s and Houlihan’s, where waiters and waitresses will introduce themselves by first name and sit down at the table (or kneel down next to it) when taking orders. One might ask whether such training may render the service that these waiters and waitresses provide less “customized” to individual customers, and therefore on at least some theories less of a proper basis for tipping. See *supra* [check]. On the other hand, the recent increase in requests for tips in fast-food-like establishments like Starbucks, see *supra* [check], suggests that the tipping norm may be shifting in this regard.

<sup>85</sup> Even if management mandates tip pooling, waitstaff presumably remains free to implement tip pooling that extends beyond management’s mandate.

<sup>86</sup> But see Cass R. Sunstein, *Human Behavior and the Law of Work*, 87 VA. L. REV. 205, 207 (2001) (“[W]orkers are like most people. They behave like *homo sapiens*, not like *homo economicus*.” (footnote omitted)).

<sup>87</sup> We address the possibility of [using maitre d’] below. [check]



tips),<sup>88</sup> and they must decide how to structure restaurant service so as to maximize those profits.<sup>89</sup>

### 1. Degrees of Cooperation

To begin, the waitstaff must decide how much they will cooperate. Saul Levmore has offered theories as to why firms might, and might not, cooperate with each other under competitive conditions.<sup>90</sup> First, Levmore identifies different degrees of cooperation: explicit cooperation, and varying degrees of implicit cooperation and of non-cooperation; he delineates them in the context of two competing firms that purchase like goods on an ongoing basis.<sup>91</sup> Under the model of explicit cooperation, the two competitors might engage in joint venture-like behavior and agree to own and operate a factory from which they both will purchase output.<sup>92</sup> Implicit cooperation arises if the two firms purchase supplies from the same factory, with neither of the competitors having an ownership or operational interest in the factory.<sup>93</sup> Stronger implicit cooperation exists if the factory supplies goods to both competitors but is owned by one of the competitors.<sup>94</sup> Under strict non-cooperation, firms “may refuse to deal with suppliers who deal at all with competitor firms.”<sup>95</sup> A less strict form of non-cooperation envisions firms that “refuse to deal with suppliers who sell identical components to competitor firms.”<sup>96</sup>

Levmore’s taxonomy of cooperation can be adapted to the setting of restaurants and waitstaff. There is a minimal level of cooperation at a restaurant, insofar as the waiters and waitresses have at a minimum agreed to work at the same restaurant and (viewing each waitress and waiter as an independent operator) to offer the same food prepared by the same chefs. To this extent, then, the waitstaff have agreed to cooperate implicitly. Beyond that, the waitstaff remain free to choose a level of cooperation.

An initial decision is whether the waitstaff will agree to engage in what we refer to as “explicit cooperation”—pooling of tips among all waiters and waitresses. In the economic language of firm structure, this is the decision of whether or not to integrate horizontally. If the waitstaff agree to cooperate explicitly, then a subsidiary decision arises—whether or not further to pool tips with other restaurant workers such as the busstaff. Table 1 reflects these choices.

<sup>88</sup> Cf. Wessels, *supra* note [check], at 334-35 (“likening tipping to profit sharing”).

<sup>89</sup> We discuss below the question of how waitstaff might choose whether, and the extent to which, to pool tips, *see infra* [check].

<sup>90</sup> See Saul Levmore, *Competition and Cooperation*, 97 MICH. L. REV. 216 (1998) [hereinafter Levmore, *Competition and Cooperation*].

<sup>91</sup> See *id.* at 217-18.

<sup>92</sup> *Id.* at 218.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* Levmore describes this option as lying between the first two insofar as “[t]he trading between competitors is now explicit although the investment in the factory was implicitly cooperative.” *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

TABLE 1 – OPTIONS UNDER EXPLICIT COOPERATION

Tip Pooling Restricted to Waitstaff; Other Services Effectively Purchased from Restaurant
Tip Pooling Extended to Other Staff

If the waiters and waitresses decide not to pool tips among one another, then in effect they will be in competition. At this point, they must decide the degree to which they will implicitly cooperate with one another.<sup>97</sup> First, they might decide simply to share (without delineation) the support staff provided by the restaurant. Under this scenario, the waiters and waitresses would not pool tips with other restaurant staff, and would simply use their services as needed; in Levmore’s terms the waitresses and waiters would be cooperating implicitly by using services offered by a single provider—the restaurant.

A second option that reflects less cooperation is to have individual waiters and waitresses entice restaurant support staff to provide more (or faster) service to them by tipping the support staff as they provide services or at the end of each shift. By this, we do not envision a formal tip-pooling arrangement between waitstaff and support staff; rather, waitresses and waiters provide tips on an individual basis as they see fit. This notion may be of greater applicability with respect to certain support staff services than others. For example, the notion of a waitress tipping a busboy for prompt service on an individual basis might be difficult in practice, but waitresses at some restaurants do indeed tip the individuals manning the beverage or dessert bars for faster service.<sup>98</sup> Under this scenario, the waitstaff are still using services provided by the restaurant, but they are openly competing with one another for priority with respect to those services.

A third option that reflects even less cooperation among the waitstaff is for the waitstaff to join with particular support staff and form “service teams” that share tips. In the economic language of firms, this scenario is a form of vertical integration. For example, each waiter might choose his or her own busperson; each team of waiter and busperson would then service only their own customers, and would pool tips obtained from those customers. Under this scenario—minimal cooperation—the waiters and waitresses cooperate with one another only with respect to the provision of foods prepared by the restaurant.

<sup>97</sup> As noted above, there is a minimal level of implicit cooperation, so that non-cooperation is not an option.

<sup>98</sup> Interview with Orin Tempkin [check].



voluntarily. Under our model, individual waiters and waitresses are akin to competitive entrepreneurs. While it is possible that a particular waitstaff might agree to a particular form of governance (majority rule, for example), it still seems unlikely that such an arrangement could be reached in the absence of initial unanimous agreement to the governance model. In short, an independent actor need not agree to something unless she wants to, and probably will not agree to something unless she somehow sees it to be in her interest.

That said, the reality may be that unanimity does not translate into a strict system in which there is voting and each voter has a veto. Instead, given the fact that the waiters and waitresses are not absolutely independent operators—they do, after all, work together—some effort might be had to achieve a consensus. In this sense, the governance model may bear some of the characteristics of a “voluntary assent” voting rule.<sup>100</sup>

Still, given the need to satisfy a consensus of waitstaff, it seems to us that voluntary movement toward greater cooperation will prove more difficult than movement toward less cooperation or retaining the status quo. For similar reasons, an initial choice is more likely to involve less cooperation than more; indeed, the default rule is no tip pooling.

We thus arrive at two general background presumptions: one in favor of continuing the status quo, and another against greater degrees of cooperation. But this does not mean that cooperation can never be achieved, or that change is not possible.

First, the possibility that management might intervene to establish tip pooling might make voluntary tip pooling more likely. To the extent that management is empowered to mandate tip pooling, the shadow of management compulsion may convince waitstaff simply to come up with an agreement on their own, which they may prefer to whatever arrangement management might require.<sup>101</sup>

Second, it may be in the economic self-interest of waiters and waitresses to engage in tip pooling. For example, waitstaff might believe that tip pooling would lead to uniformly better service, which would in turn lead to increased patronage and increased tipping, such that all (or virtually all) members of the waitstaff would receive higher pay under a tip pooling regime.<sup>102</sup>

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<sup>100</sup> See Jonathan Baert Wiener, *Global Environmental Regulation: Instrument Choice in Legal Context*, 108 YALE L.J. 677, 737-38 (1999) (noting that “voluntary assent” is the voting rule for international environmental treaty law, in part because of the custom of seeking a consensus). The voting rule for restaurant waitstaff is not likely to be a pure version of voluntary assent insofar as “[v]oluntary [a]ssent cannot impose regulation on the unwilling.” *Id.* at 738. While voluntary assent is in practice quite close to unanimity, the two remain “slightly different” in that voluntary assent “does not require, as [u]nanimity does, the consent of every last voter to become binding on those who do consent.” *Id.*

<sup>101</sup> Even if the arrangement to which they agree is the same arrangement (or even is a worse arrangement than the arrangement) that management in fact would mandate, there may be psychological reasons that waitstaff would prefer to reach the tip pooling arrangement somewhat of their own accord. [check].

<sup>102</sup> Cf. Kaldor-Hicks [check].

Third, considerations of behavioral law and economics may render tip pooling more likely. Robert Frank and Cass Sunstein have argued that workers evaluate their satisfaction with their salaries based more upon how their salaries match up with other workers' salaries, than on their salaries' absolute magnitude.<sup>103</sup> They explain that “[s]urveys of employers and employees suggest that salaries depend a great deal on what employees think other people are receiving, and that perceptions of relative position have large effects on morale.”<sup>104</sup> From this general consideration, one can reason—empirical studies tend to confirm—that workers who receive lower compensation than their co-workers will see the salary differential as a negative and will want some degree of compensation for it. In other words, “compensating wage differentials must be paid and are paid, not only for higher risks and less vacation time, but also for lower relative positions within firms.”<sup>105</sup> And, because higher-ranked and better-compensated employees benefit from the mere fact that they are earning more than their co-workers, it follows that “[e]veryone can do better if the top-ranked workers induce their lesser-ranked colleagues to remain by sharing some of their pay with them.”<sup>106</sup>

Frank and Sunstein predict that “the difference between productivity and pay will increase with the extensiveness of interaction between coworkers”<sup>107</sup>—i.e., that the more closely people work together, the more likely they are to be willing to compensate lower-ranked workers more highly. Frank and Sunstein verify their prediction with respect to three occupations with varying degrees of worker interaction: real estate salesperson, and automobile salesperson, and research chemist.

Real estate salespersons, who have the least intensive contact, pay the lowest amounts for high-ranked positions. At the other end of the spectrum, research chemists, who work together in close-knit groups for extended periods, pay very large sums indeed. In the sample studied, the most productive chemists accounted for over \$200,000 more in revenues each year than their least productive colleagues, yet received only slightly higher salaries. Auto salespersons do not associate nearly as intensively as chemists, but unlike real estate salespersons, they do spend their working hours together in the same location. And as predicted, the price of high-ranked positions for auto salespersons lies between those of the other two occupations.<sup>108</sup>

Like auto salespersons, waiters and waitresses “do not associate nearly as intensively as chemists”; they also “spend their working hours together in the same location.” Accordingly, one would expect higher-ranked and higher-paid (through tips) waiters and waitresses to be somewhat desirous of sharing their greater pay with lower-compensated coworkers in order to retain the benefit of receiving greater pay than their coworkers. And one would expect the lower-paid workers to accept this transfer in

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<sup>103</sup> See Robert H. Frank & Cass R. Sunstein, *Cost-Benefit Analysis and Relative Position*, 68 U. CHI. L. REV. 323 (2001).

<sup>104</sup> *Id.* at 342.

<sup>105</sup> *Id.* at 355 (footnotes omitted).

<sup>106</sup> *Id.* at 357.

<sup>107</sup> *Id.* at 359 (footnote omitted).

<sup>108</sup> *Id.* at 360 (footnotes omitted).

exchange for their lower-paid status. Tip pooling provides a method by which this transfer can be achieved.

A fourth reason that may lead to a greater incidence of voluntary tip pooling than our background presumptions might suggest is the fact that our depiction of waiters and waitresses as independent competitors is likely to be accurate in relatively few settings. Many waiters and waitresses may see themselves not as competitors but allies. To that extent, the assumption that tip pooling will occur only where waiters and waitresses see it to be in their individual self-interest is overstated.

Having sketched some likely characteristics of and predictions about waitstaff governance, we turn to the question of what factors may make it more or less likely that waitstaff will in fact engage in voluntary tip pooling. Though the decision will doubtless turn on the specifics on each particular restaurant setting, we offer the following speculations as to how particular factors might influence the choice.

First, if tips constitute a comparatively larger portion of waitstaff's take-home wages, it would seem less likely that waitstaff would cooperate explicitly and integrate horizontally.

If the size of tips is rather variable, we would expect the extent of cooperation to turn upon the reasons for that variation. If some waiters and waitresses garner predictably higher tips on a regular basis, then we would expect less cooperation; if, however, tips vary unpredictably or based upon factors outside waitstaff's control, then one's enthusiasm for relative lack of cooperation would translate into one's aversion to gambling. Because people may not be risk averse where the possible gains are large, we might expect waitstaff generally to oppose cooperation here. On the other hand, people might be more risk averse with respect to their wages, so that cooperation could be more likely.

A word is appropriate on the decision as to whether or not to include support staff in tip pooling. Our approach suggests that restaurant support staff will potentially enjoy tip-pooling under the two extreme cases—where waitstaff cooperate explicitly they may opt to pool tips with support staff,<sup>109</sup> and support staff will enjoy tip-pooling where the waitstaff choose to form competing “teams”. In other words, the potentiality for support staff to enjoy tip pooling is not correlated to cooperation among the waitstaff: Support staff will enjoy tip pooling where there is comparatively little cooperation among waitstaff, and support staff may enjoy tip-pooling where there is explicit cooperation. But the intervening degrees of waitstaff cooperation will not yield tip pooling with support staff. On this account, then, tip pooling among support staff under this scenario is a function not of cooperation between waitstaff and support staff but rather a function of non-cooperation among waitstaff.

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<sup>109</sup> If there is horizontal integration, we would expect tip pooling with support staff if it is perceived that better service will lead to higher tips overall. Cf. Kaldor-Hicks efficiency (defining an efficiency improvement in terms of overall utility, with the possibility—but not necessarily the reality—of winners compensating losers such that everyone would be better off). [check]

## ii. Mandatory Tip Pooling

As we noted above, federal law and the law of many (if not most) states authorize restaurant management to impose at least some degree of tip pooling on restaurant workers. In this Section, we explore the circumstances under which management is likely to exercise that authority.

One California intermediate appellate court has offered a spirited defense of employer-mandated tip pooling. The California court of appeal in *Leighton v. Old Heidelberg, Ltd.* asserted:

An established tip pooling policy encourages employees to give the best possible service. In turn, such service can only enhance the reputation of the restaurant and increase business. To permit a waitress to determine what if anything she should share with the busboy based upon what she deems to be the worth of his service can only lead to the surrender of the employer's prerogative to run his own business, dissension among employees, friction and quarreling, loss of good employees who cannot work in such an environment and a disruption in the kind of service the public has a right to expect. An employer must be able to exercise control over his business to ensure an equitable sharing of gratuities in order to promote peace and harmony among employees and provide good service to the public. To deprive a restaurateur of the ability to regulate and control the conduct of his own business, leaves the door open to anarchy in the restaurant industry. It is for this very reason that employer mandated tip pooling among employees has been a long-standing practice establishing a policy in the industry which permits the employer to operate a well run, well ordered restaurant business. Such a practice serves everyone well—the public, the employees and the employer.<sup>110</sup>

We disagree with the court's assertion that tip pooling is always preferable, or even that it always will be undertaken. But the court is correct to identify different factors that may influence management's decision whether to impose tip pooling (even if the court conflates the factors and draws absolute conclusions): Concerns of efficiency and management's ultimate prerogative to manage its business will influence the decision.

At the outset, we assume, as in the previous Section, that economic self-interest dominates. Accordingly, we assume that management is concerned in some way with maximizing restaurant profits.<sup>111</sup> That means that management will implement tip pooling where such an arrangement will lead to an increase in restaurant profits.

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<sup>110</sup> 269 Cal. Rptr. 647, 653 (Ct. App. 2d Dist. 1990).

<sup>111</sup> If management and ownership are identical, then the incentive is clear. If management is distinct from ownership, then presumably ownership will reward management for increases in profits, and thus profit-maximization is incentivized.

The time horizon over which profits are to be maximized and the type of restaurant will affect the decision management makes. For example, management may simply want to maximize customer turnover so as to increase short-term profits. In that case, management's choice as to tip pooling will turn on whether the resulting service structure is more or less geared to quick customer turnover.<sup>112</sup>

Management may also be concerned with the perceived quality of service, insofar as they affects repeat business, and profits over the longer term. Management may conclude that service is kinder and friendlier in a setting where servers get along well, and may determine that tip pooling fosters that goal. Certainly, in cases where destructive competitive tipping is interfering with proper service, management may find it especially appropriate to impose tip pooling.

Management also may be concerned with maximizing profits by minimizing cash salary payments to staff. Recall that tips can be used to offset the cash minimum wage that management must pay to workers. Thus, if a restaurant pays more of its workers at below the generally applicable minimum wage, it may invoke tip pooling as a means of distributing tips over a greater set of employees.

Management's business plan may also rely on retaining employees over the long term. One aspect of that strategy might be a focus on increasing the attractiveness of lower-tier positions. Thus, for example, one might expect to see management implement mandatory tip pooling where the restaurant tends to promote from within, i.e., to promote busstaff to waitstaff positions.<sup>113</sup>

As in the case of voluntary tip pooling, sometimes concerns that are not strictly economic might influence management's decision as to mandatory tip pooling. As the California court of appeal suggested, management might be inclined to invoke tip pooling where management wants—and thinks it's entitled—to flex managerial muscle.<sup>114</sup> On the other hand, management might be less inclined to implement tip pooling where waiters tend to stay around for a long while, and thus have developed a sense of autonomy; this is even more likely to be the case where mandatory tip pooling has yet to be employed, so that individual waiters and waitresses may have developed a sense of entitlement to the actual tips that they each receive.<sup>115</sup>

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<sup>112</sup> The question of whether tip pooling—and what scope of tip pooling—best serves the goal of customer turnover is an empirical one. Perhaps competition among serving staff speeds up service (indeed, management might capitalize on competition by, for example, rewarding productive waiters and waitresses with shifts covering the “best tables” in the restaurant); on the other hand, perhaps cooperation does.

<sup>113</sup> Cf. Day, *supra* note 8 (“Restaurant companies, which are competing against one another to attract and retain workers, are offering incentives like job training and the prospect of promotion to management . . .”); *supra* [check] (discussing Frank and Sunstein).

<sup>114</sup> See *supra* [check].

<sup>115</sup> Cf. endowment effect [check] [*supra* note [check]/ Sunstein]; Sunstein, *supra* note [check], at 229-30 (noting that perceptions of fairness are important to workers, and that people, including workers, sometimes think that the law is what they think it should be).



**IV. Conclusion**

[TO COME]

