

# The Social Norm of Tipping, Its Correlation with Inequality, and Differences in Tax Treatment Across Countries

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*In a previous article I argued that tipping facilitates tax evasion, hurts employees' financial security in the long run, and is a form of negative externality imposed by wealthy people on the rest of society. In this Article I try to understand the reasons for the greater popularity of the norm in the U.S. compared to other countries, suggesting it may be related to the U.S. cultural preference for linking redistribution with work requirements, relatively high income inequality and consumerism. To that end, I further develop the negative externality argument suggested in the previous article by looking at trends in income inequality in the U.S. and by interpreting the global distribution of the norm through the prism of my inequality/negative externality argument. I then look at the tax treatment of tips in various countries in search of a pattern that supports the differences in social norms.*

## INTRODUCTION

There are at least thirty three service occupations that are customarily tipped.<sup>1</sup> My focus in this Article will be on tips paid to waiters in restaurants

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<sup>1</sup> Michael Lynn, George Zinkhan & Judy Harris, *Consumer Tipping: A Cross-Country Study*, 20 J. CONSUMER RES. 478, 482 (1993).

because they are the most significant in terms of percentage of total remuneration and salience.<sup>2</sup>

A tip is conventionally defined as a sum paid by a customer as a *voluntary* act in recognition of some service performed for her. It is to be distinguished from payment of a charge, if any, made for the service. A service charge is a compulsory payment for service, such as 10 percent of the amount of the bill, imposed on a customer by an employer's establishment. It is often explicitly stated in the bill as a separate item added to the price of the food and drinks.<sup>3</sup>

The voluntary nature of the tip poses a puzzle for traditional economics, because individuals are generally presumed to act in their own self-interest and it is unclear what they receive in return for the tip. The leading conventional explanation, namely that people tip as an investment in future good service, does not make much sense because studies show that people tip as well in out-of-town restaurants as they do at local ones.<sup>4</sup> Hence traditional economic analysis cannot explain the phenomenon of tipping and must be augmented by incorporating the notion of social norms, which are "social attitudes of approval and disapproval, specifying what ought to be done and what ought not to be done."<sup>5</sup>

The social norm of tipping is not globally shared. In general, there seems to be no such social norm in Asia, the Pacific, the Middle East (with the exception of Israel) and Africa. In Asia and the Pacific, offering a tip may even be taken as insulting, implying a notion of a master-servant relationship.<sup>6</sup> In Europe, as well as in Central and South America, many hotels

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2 As mentioned in the Abstract, this Article builds on a previous article I wrote on the social norm of tipping. See Yoram Margalioth, *The Case Against Tipping*, 9 U. PA. J. LAB. & EMP. L. 117 (2006). Although much of the background to the arguments made in the current Article is shared with my previous article, it is more fully developed here.

3 See, for example, the definition of a tip in the U.S. Department of Labor regulations. 29 C.F.R. § 531.52 (2005).

4 See Daniel Kahneman, Jack Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728 (1986) (featuring answers indicating that people do not think that frequent patrons tip more, suggesting that ensuring the quality of future service is not an important reason for tipping).

5 Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 914 (1996); see also Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1127 (2000) (discussing the definition of social norms).

6 It can be found, however, in upscale restaurants in some of those countries, for example, Australia. See Magellan's, *Worldwide Tipping Guide*, <http://www>.

and restaurants add a service charge to the bill and people are not expected to add a tip on top of it.<sup>7</sup> Where no service charge is added to the bill, countries differ between those in which 10 percent is expected to be paid as a tip for restaurant service<sup>8</sup> and those where the price of the meal is thought to include the payment for service and no tip is expected.<sup>9</sup> A slight variation on the latter is the expectation in some countries that the amount being paid will be adjusted upward to the nearest round number, which means a small tip that varies arbitrarily.<sup>10</sup> The expected tip in restaurants in the U.S. is currently slightly above nineteen percent and it is fifteen percent in Canada.

This brief survey tells us that the social norm of tipping is mostly prevalent in North America. It has to do with unique aspects of U.S. culture, as it is not a part of the Anglo-Saxon culture. In England a service charge is the norm; in Australia tipping is practiced only in upscale restaurants; and in New Zealand tipping was not practiced at all in past decades and is a relatively recent phenomenon. This aspect of U.S. culture affects neighboring Canada and countries that are culturally influenced by the U.S., such as Israel.<sup>11</sup>

So, what is it in U.S. culture that makes tipping so popular? Tipping originated in sixteenth-century England and had become the norm all over Europe by the seventeenth century. It was met with fierce opposition when it was first introduced to the U.S. in the late 1800s by affluent Americans who traveled (and tipped) in Europe. It was seen as fostering a master-servant relationship ill-suited to a nation whose people were meant to be social equals.<sup>12</sup> Popular opposition to tipping was so strong in the U.S. that, between 1909 and 1918, seven states passed anti-tipping laws.<sup>13</sup> All these laws, however, were repealed by 1926, when the concept slowly took

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magellans.com/store/article/367 (last visited Dec. 8, 2009). This is also the social norm in South Korea. Conversation with Hwa-Jin Kim, Law Professor, Seoul Nat'l Univ. (Nov. 2009).

7 Magellan's, *supra* note 6.

8 Such as Belgium and England.

9 Such as Denmark and Japan.

10 As is the norm in Germany.

11 The average tip rate in restaurants in Israel is twelve percent.

12 See WILLIAM R. SCOTT, *THE ITCHING PALM: A STUDY OF THE HABIT OF TIPPING IN AMERICA* 38 (1916) ("Every tip given in the United States is a blow at our experiment in democracy."); Z. Withers, *The Moral Tone of Tipping*, *CHI. DEFENDER*, June 12, 1915, at 5 ("The law of master and servant presupposes a condition of serfdom, and the tip is the personification of that evil."). The author would like to thank Marjorie Kornhauser for sending him the latter document.

13 Ian Ayres, Fredrick E. Vars & Nasser Zakariya, *To Insure Prejudice: Racial Disparities in Taxicab Tipping*, 114 *YALE L.J.* 1613, 1660 (2005).

off.<sup>14</sup> Business owners began to lower the wages of employees until tips were needed to supplement their income, and people became accustomed to the practice as a way to ensure the livelihood of workers in the service industry.<sup>15</sup> As will be detailed in Part I, the average tip as a percentage of the price of the meal has been consistently and significantly rising in the U.S. over the past thirty years.

At the same time Europe, where the practice originated, gradually abandoned this social norm and started considering the service component of the meal as no different from its other components, either implicitly or by including a mandatory service charge. It may be tempting to suggest that class-based Europe became more egalitarian whereas the U.S. became less so, and the current social norm of tipping in the U.S. represents the sharp distinction between its economic classes. I think this explanation is inaccurate. I do not think that diners perceive themselves as having a master-servant relationship with the waiters of the type that existed in seventeenth-century Europe.

I do believe, however, that the increasing significance of tipping in the U.S. over the past thirty years has to do with the growing income and wealth inequality during this period. I think that increasing inequality has had two separate effects, both of them resulting in increased tipping. The first effect has to do with the way Americans tend to justify welfare, and the second has to do with the way Americans tend to acquire social status.<sup>16</sup>

The U.S. welfare system is relatively modest compared to that of Western and especially Northern Europe. Studies comparing American — and European-style welfare systems suggest that one of the major reasons why Americans redistribute less than Europeans is that Americans believe that they live in an open and fair society and that if someone is poor, it is her own fault.<sup>17</sup> As numerous surveys have shown, much of what is widely believed about Americans' attitude towards welfare is wrong. Year after year, surveys show

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14 Herman Steutzer, Jr., Note, *Workmen's Compensation: Basis for Computation — Tips as Earnings or Wages*, 17 CORNELL L.Q. 183, 188 n.41 (1931).

15 See Leo P. Crespi, *The Implications of Tipping in America*, 11 PUB. OPINION Q. 424, 426 (1947).

16 I use the term "tend" to convey the message that it is all relative to other countries. I do not make any absolute arguments.

17 Alberto Alesina, Edward Glaeser & Bruce Sacerdote, *Why Doesn't the United States Have a European-Style Welfare State?*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 187 (2001); Alberto Alesina & George-Marios Angeletos, *Fairness and Redistribution: US Versus Europe*, 95 AM. ECON. REV. 913 (2005).

that most Americans see welfare as a desirable function of the government.<sup>18</sup> According to the data, the focus of considerable public resentment is not the principle of government support for the needy in and of itself, but rather, the perception that most people currently receiving welfare are *undeserving*. These trends are reflected in the U.S. welfare reform of 1996 and the shift from Aid to Families with Dependent Children (AFDC) to Temporary Assistance for Needy Families (TANF), with its emphasis on the work requirement, as well as the significant increase in recent years of the Earned Income Tax Credit (EITC) program that conditions welfare on labor market participation. Similarly, the Food Stamp Program (FSP) has been transformed from a hated welfare program into a politically popular program largely because a greater percentage of its benefits flow to low-income wage earners.<sup>19</sup>

I think that waiters, doing a job that requires low human capital, are perceived by diners as being relatively low-paid. They also seem to be *deserving* of support. They are hardworking individuals, and the U.S. social norm is that one should be encouraged and handsomely rewarded for working hard. The social norm of tipping reinforces itself because, as mentioned above, business owners lower the wages of employees in anticipation of tips to supplement their income, and people have become accustomed to the practice of tipping as a way to ensure the livelihood of workers in the service industry, whom they see as the deserving poor.<sup>20</sup>

The second explanation I would like to suggest for the prevailing social norm of tipping in the U.S., which is constantly increasing in importance, is the country's consumer culture and the centrality of positional goods as a means of gaining status in the U.S. Positional goods denote goods whose value depends relatively strongly on position in relation to others.<sup>21</sup>

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18 For a comprehensive analysis of surveys conducted in the U.S., see MARTIN GILENS, *WHY AMERICANS HATE WELFARE* (1999).

19 See, e.g., David Super, *The Quiet "Welfare" Revolution: Resurrecting the Food Stamp Program in the Wake of the 1996 Welfare Law*, 79 N.Y.U. L. REV. 1271 (2004).

20 Not all hardworking poor receive tips, but only those who perform services of a kind that traditionally involves tipping. Usually these are personal, intimate services. In such contexts, the customer feels a personal responsibility to help the lower-income individual who served her.

21 For the earliest classic criticism of consumption and the introduction of the term *conspicuous consumption*, namely, the lavish spending on goods and services acquired mainly for the purpose of displaying income or wealth, see THORSTEIN VEBLEN, *THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY IN THE EVOLUTION OF INSTITUTIONS* (New York, Macmillan 1899). For a definition of the term *positional goods* see Robert H. Frank, *Positional Externalities Cause Large and Preventable Welfare Losses*, 95 AM. ECON. REV. 137 (2005).

The classic examples are housing and special events such as weddings and birthday parties. People tend to spend on these items more than what they can comfortably afford, to mark or improve their social position.

I think that tipping belongs in the same category. As inequality grew in the U.S., affluent people increased the amount they tip in order to improve their relative positioning or their social status as viewed by anyone present at the restaurant table and especially their peers dining with them. This spending affects the group of people with slightly lower income, setting off an "expenditure cascade" to the detriment of all. Evidence supports the view that expenditure cascades in housing and other areas involving positional goods are, at least in part, a consequence of increased income inequality.<sup>22</sup> Tipping is likely to be part of that trend. I would call it a *positional practice*, namely, a practice whose value depends relatively strongly on position in relation to others.

In light of the above, I find the social norm of tipping to be welfare-reducing. Distributive justice would be more efficiently promoted through a harmonized, well-structured tax and transfer system than through haphazard giving to one type of workers (say, waiters) in one type of interaction (say, dining, particularly if paid for in cash). This is especially true because in equilibrium the wages paid to waiters account for the expected tips, thereby offsetting the redistributive effects.

Moreover, due to its being a positional practice, tipping creates a negative externality. Generous tippers improve their (short-term) social status, but make all others seem relatively stingy. Over time a new standard is formed under which everyone tips more than they would like to, and this then leads to a further increase in the average (and normatively expected) percentage of the tip.<sup>23</sup>

Countries use their tax systems to correct for such market failures. A progressive consumption tax is probably the best policy tool to address the negative externality created by positional goods.<sup>24</sup> As for tipping, the subject of this Article, the income tax could serve an important role, by taxing tip income more heavily than ordinary income. In reality, most countries tax tips relatively lightly, due to exemption or to tax evasion. This Article is an attempt to outline a broad picture of the social norm of tipping across countries and its

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<sup>22</sup> See Frank, *supra* note 21, at 139.

<sup>23</sup> See Part II below for a description of how tip rates in the U.S. have increased over time.

<sup>24</sup> A first best solution would be to set a different tax rate for every good in accordance with the strength of the positional externalities it generates, but such a solution would require information that is currently unavailable.

correlation with inequality, and to see how the different tax systems address the issue.

In Part I I explain why tipping is a social norm. In Part II I examine the possible correlation between tipping rates and inequality in the U.S. In Part III I examine the existence of the norm across countries, and in Part IV I examine how tips are taxed and try to figure out the correlation between the tax and the existence of a social norm. Finally I conclude.

## I. IS TIPPING A SOCIAL NORM?

There is no legal sanction against diners who do not leave a tip, even if it has been explicitly stated in the check that service is not included. The waiter, or the restaurant, cannot sue them in court. In addition, people tip as well in out-of-town restaurants as they do at local ones. It is therefore clear that people do not tip in return for any material consideration, such as a higher probability of getting good service in the future. The reason people tip is because a social norm prompts them to do so.

Social norms are customary rules of behavior that coordinate our interactions with others.<sup>25</sup> The term includes both simple rules that are self-enforcing at a primary level, such as which hand to extend in greeting, and more complex rules such as standing in a queue. The latter are generally enforced by non-legal sanctions.<sup>26</sup> It is yet unclear why third parties bother to punish people who violate the social norm, but the evidence suggests that they sometimes do so even at considerable personal cost.<sup>27</sup> Complex rules may also be self-enforced through the internalization of the social norm.<sup>28</sup> For example, people are likely to refrain from littering even when they believe no one is watching them.

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25 H. Peyton Young, *Social Norms*, in NEW PALGRAVE DICTIONARY OF ECONOMICS ONLINE (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008), [http://www.dictionaryofeconomics.com/article?id=pde2008\\_S000466&q=social%20norms&topicid=&result\\_number=1](http://www.dictionaryofeconomics.com/article?id=pde2008_S000466&q=social%20norms&topicid=&result_number=1).

26 Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 549 (1998) ("a norm is a rule supported by a pattern of informal sanctions").

27 Ernst Fehr, Urs Fischbacher & Simon Gächter, *Strong Reciprocity, Human Cooperation, and the Enforcement of Social Norms*, 13 HUM. NATURE 1 (2002).

28 Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 340 (1997) ("informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of fear of external non-legal sanctions, or both").

Tipping is a complex rule that is enforced by non-legal sanctions, which take the form of disapproval by the people surrounding the diner in case she violates the social norm of tipping. People seek the social approval of others dining with them, as well as that of the waiter. People tip because they are embarrassed not to, in countries where tipping is the social norm.

In addition, people may tip because they have internalized the social norm. The norm is complex in the sense that people may tip due to the social norm against stealing, which is legally binding, but has also been self-internalized by most people. People know that although the service component of the meal may not have been included in the bill, it was not meant to be free, unless the service was truly bad. People tip even when dining in foreign places where no one knows them and to which they do not expect to return, due to their fear of disapproval by the waiter and due to their internalization of the social norm.<sup>29</sup> Other plausible explanations could be altruism or empathy for the waiter, who is often perceived to be hardworking and poorly paid by his employer.

## II. TIPPING RATES AND INEQUALITY

Tipping has significantly increased in the U.S. over the past thirty years. The data presented in Graph 1 below reveals a substantial and constant increase of 4.6 percent of the cost of the meal in the average tip rate in the past twenty-six years,<sup>30</sup> the rate having risen from 14.4 percent in 1982 to 19 percent in 2008. According to these data, the average rate of tips rose by nearly 32 percent over the entire period. This increase is in addition to the increase in the absolute amount paid as a tip, which has risen in direct proportion to the rise in the cost of meals in restaurants due to inflation and other factors.

Inequality has also increased sharply in the U.S. during the same period. Between the 1920s and the 1950s, a process named "the great compression" took place in the U.S., narrowing income gaps and transforming the U.S. into a middle-class society in the '50s.<sup>31</sup> Income tax rates on the rich rose sharply, lowering the after-tax income of the richest one percent of Americans

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<sup>29</sup> Departures from a norm can trigger emotions of guilt even when third-party enforcement is absent. See Young, *supra* note 25; JAMES COLEMAN, FOUNDATIONS OF SOCIAL THEORY (2000).

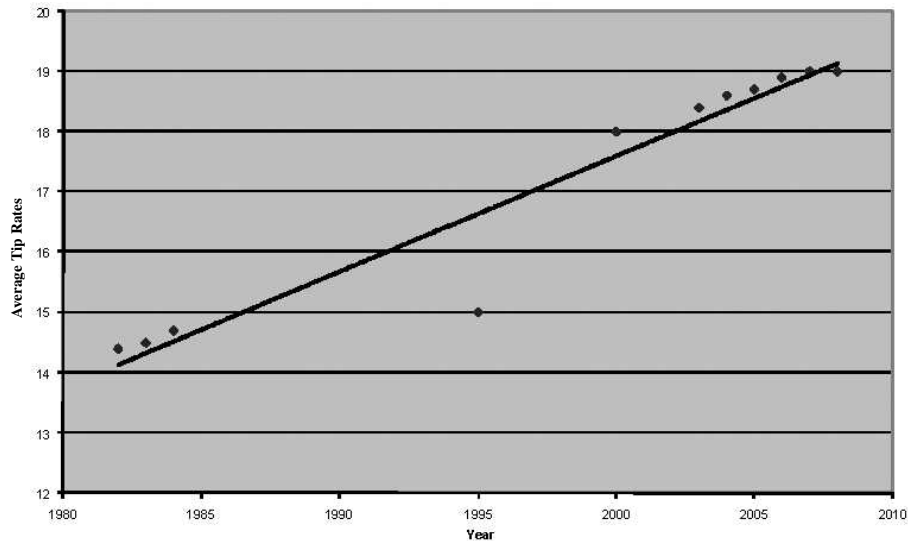
<sup>30</sup> The source of the data are NPD and Zagat surveys discussed in Appendix A *infra*.

<sup>31</sup> See PAUL KRUGMAN, THE CONSCIENCE OF A LIBERAL 38 (2007); Thomas Piketty & Emmanuel Saez, *How Progressive Is the U.S. Federal Tax System? A Historical and International Perspective*, 21 J. ECON. PERSP. 3 (2007).



by 20 to 30 percent, and that of the top tenth of one percent by more than half of what they'd had in the '20s.<sup>32</sup> At the same time, the real income of the median family had doubled since 1929. The period between the mid-'40s and the mid-'70s was especially good for blue-collar workers. The U.S. was a leading producer and the workers were protected by unions. The post-World War II economic boom was equally shared by all Americans.

**Graph 1: Average Tip Rates in the U.S.**



Earnings inequality in the U.S. has a U-shape: inequality decreased sharply up to 1953, and has increased steadily and continuously afterwards, but the sharpest increases in inequality started with the crisis of 1973. The U.S. economy picked up in the '80s and again in the mid-'90s, but the huge gains from then on have not been equally shared.<sup>33</sup> Inflation-adjusted earnings of men working fulltime in 2005 were lower than they had been in

<sup>32</sup> See KRUGMAN, *supra* note 31, at 41.

<sup>33</sup> When mobility is accounted for, it does not change the overall picture. A closer look at the data reveals that inequality and mobility among male workers have worsened along almost any dimension since the 1950s and were offset by the large earnings gains achieved by women since the 1950s, due to increases in labor force participation and pay. See Wojciech Kopczuk, Emmanuel Saez & Jae Song, Earnings Inequality and Mobility in the United States: Evidence from Social Security Data Since 1937 (Mar. 18, 2009) (unpublished manuscript), available at [http://www.columbia.edu/~wk2110/bin/mobility\\_final.pdf](http://www.columbia.edu/~wk2110/bin/mobility_final.pdf).

1973. Inequality grew significantly, especially due to the increases in income of those at the very top.

The main reasons for the acceleration in the growth of inequality in the past thirty years is the rising demand for skills due to technological change and to the increased competition brought by globalization, the decline of worker unions, and the increases in executive pay.<sup>34</sup> It is yet too soon to tell what effects the 2008/09 economic crisis and Obama's administration will have on these trends.

**Table 1: Average Tip Rates by NPD and Zagat<sup>35</sup> and Gini Ratios for Families by U.S. Census Bureau<sup>36</sup>**

Year	Average tip rate	Gini Coefficient
1982	14.4	0.380
1983	14.5	0.382
1984	14.7	0.383
1995	15	0.421
2000	18	0.433
2003	18.4	0.436
2004	18.6	0.438
2005	18.7	0.440
2006	18.9	0.444
2007	19	0.432
2008	19	Not yet available

Table 2 below does not provide any proof of correlation between tip percentage and inequality, because tipping and inequality could be correlated through a third factor, though I have no idea what it might be. A positive correlation between inequality and tipping seems plausible to me for two reasons. First, I believe that in times of great inequality Americans tend to be more generous towards those that are perceived to be the working poor. Waiters are likely to fall into that category. This is a futile exercise, because the existence of the norm results in equilibrium, with employers paying lower wages and relying on tips to augment the pay.

<sup>34</sup> See KRUGMAN, *supra* note 31, at 131-52.

<sup>35</sup> See Appendix A *infra*.

<sup>36</sup> U.S. Census Bureau, Historical Income Tables — Families, available at <http://www.census.gov/hhes/www/income/histinc/f04.html> (last visited Dec. 8, 2009).

Second, I believe that tipping is a positional practice. People tip generously to signal their high earning ability or wealth. It starts from the top and cascades downwards, hence, increases in inequality are likely to increase tip rates. This intuition is supported by the fact that tips are higher (as a percentage of the meal) in upscale restaurants. Some additional support can be found in the international comparison in Part III below.

### III. THE SOCIAL NORM OF TIPPING: A COMPARATIVE VIEW

Table 2 below is taken from only one website, but seems to be reasonably accurate when compared with data on some specific countries available from other sources.<sup>37</sup>

**Table 2: International Tip Rates**

Country	Restaurants	Porters	Taxis
Argentina	10%	\$1	Round taxi fare upward or small tip
Armenia	10%	50 cents-\$1 per bag	None
Australia	10% in fine restaurants only	\$2 per bag	Round upward
Austria	5% above service charge	\$1-\$2 per bag	Round upward
Azerbaijan	10%	50 cents-\$1 per bag	None
Bahamas	10%	\$1 per bag	10%
Bahrain	10%	\$1-\$2 per bag	10%

<sup>37</sup> Magellan's, *supra* note 6. The website also contains information regarding tips to porters and taxi drivers, which are not the topic of this Article. I have left this information in place because it is relevant to an examination of the social norm of tipping, even though the Article focuses on tipping in restaurants. Another excellent source of information on tipping practices is Tripadvisor.com that has a Tipping and Etiquette category with respect to many individual countries. See Tripadvisor, <http://www.tripadvisor.com/> (search: "Tipping and Etiquette"; then follow hyperlink for the relevant country) (last visited Dec. 8, 2009).

<b>Country</b>	<b>Restaurants</b>	<b>Porters</b>	<b>Taxis</b>
Belgium	10% if no service charge	\$1 per bag	Round upward
Bolivia	10%	75 cents per bag	10%
Brazil	10-15%	\$1 per bag	10%
Brunei	None	None	None
Bulgaria	10%	\$1 per bag	Round upward
Canada	15%	\$1-\$2 per bag	10%
Cayman Isles	15% if no service charge	\$1 per bag	10%
Chile	10% in addition to service charge	\$1 per bag	None
China	3% in major cities	\$1-\$2 total	None
Colombia	10%	75 cents per bag	None
Costa Rica	None	\$1 per bag	10%
Cuba	\$1 for special service	\$1 for special service	\$1 for special service
Czech Rep	5-10%	\$1 per bag	Round upward
Denmark	None	\$1 per bag	Round upward
Ecuador	10% if no service charge	75 cents per bag	None
Egypt	5-10% + service charge	\$1 per bag	Round upward
England	10% if no service charge	\$1 per bag	15%
Fiji	None	None	Round upward
Finland	10% if no service charge	\$1 per bag	Round upward
France	5-10%	\$1 per bag	Round upward
Germany	5-10%	\$1 per bag	Round upward

<b>Country</b>	<b>Restaurants</b>	<b>Porters</b>	<b>Taxis</b>
Greece	5-10% in addition to service charge	\$1 per bag	Round upward
Guatemala	10% in addition to service charge	\$1 per bag	10%
Holland	5-10%	\$1 per bag	Round upward
Hong Kong	10% in addition to service charge	\$1 per bag	Round upward
Hungary	10% if no service charge	None	Round upward
Iceland	10% if no service charge	\$1 per bag	Round upward
India	10% if no service charge	\$1 per bag	Round upward
Indonesia	10%	50 cents total	Round upward
Ireland	10-15%	\$1 per bag	Round upward
Israel	12-15% if no service charge	\$1 per bag	12-15%
Italy	10% in addition to service charge	\$1 per bag	Round upward
Japan	Tipping is perceived as insulting	None	None
Kenya	5% if no service charge	50 cents per bag	None
Luxembourg	5-10%	\$1 per bag	Round upward
Macao	10% in addition to service charge	\$1 per bag	Round upward
Madagascar	10%	50 cents per bag	Round upward
Malaysia	None	None	None
Mexico	10-15%	\$1	50 cents

<b>Country</b>	<b>Restaurants</b>	<b>Porters</b>	<b>Taxis</b>
Morocco	Leave loose change	50 cents per bag	Round upward
New Zealand	None	None	None
Nicaragua	10% for special service	\$1 per bag	10%
Norway	10% if no service charge	\$1 per bag	Round upward
Oman	None	None	None
Paraguay	10%	75 cents per bag	10%
Peru	Up to 10% for special service	75 cents per bag	None
Philippines	10%	50 cents-\$1 per bag	Round upward
Poland	10%	\$1 per bag	Round upward
Portugal	10-15% if no service charge	\$1 per bag	Round upward
Romania	Round upward	\$1 per bag	Round upward
Russia	10-15%	\$1 per bag	Round upward
Samoa	None	None	None
Saudi Arabia	10-15%	\$1-\$2 per bag	10%
Scotland	10-15% if no service charge	\$1 per bag	Round upward
Singapore	None	None	None
South Africa	10% if no service charge	50 cents total	10%
South Korea	None	None	None
Spain	7-10% in addition to service charge	\$1 per bag	10%
Sweden	10% if no service charge	\$1 per bag	Round upward
Switzerland	Round upward	\$1 per bag	Round upward

Country	Restaurants	Porters	Taxis
Taiwan	10% if no service charge	\$1 per bag	None
Tanzania	10%	None	None
Thailand	None	None	None
Turkey	Round upward	\$1 per bag	Round upward
Ukraine	10%	\$1 per bag	Round upward
United Arab Emirates	None	None	None
United States	15-20%	\$1-\$2 per bag	10-15%
Venezuela	10%	75 cents per bag	10%
Vietnam	None	None	None
Wales	10% if no service charge	\$1 per bag	10%

Europe, which historically was much less egalitarian than the U.S., developed its welfare state after World War II, whereas the U.S. has gone through a process, especially since the 1970s, of becoming less egalitarian. According to my hypothesis, these trends in inequality had opposite effects on the social norm of tipping. Whereas in Europe it was mostly abandoned, in the U.S. it sharply increased.

In countries where tips are not the norm, such as Denmark, people believe that waiters are well paid and that the service component is as integral a part of the dining experience as the food, and is therefore taken into account in the price of the meal.<sup>38</sup> Hence tipping would be superfluous, akin to going to the kitchen at the end of the meal and paying the chef for her efforts. The belief that waiters are well paid and do not need to rely on customers' generosity is more likely to be the norm in cultures in which income equality significantly exists. Tipping is sometimes practiced in such countries' upscale restaurants, a fact that seems to support my argument as well.

In Spain, which has a somewhat less developed welfare system than

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<sup>38</sup> Conversation with Frank Pedersen, Tax Law Professor, Den. (Mar. 2009); *see also* Tripadvisor, Denmark Tipping & Etiquette, <http://www.tripadvisor.com/Travel-g189512-s606/Denmark:Tipping.And.Etiquette.html> (last visited Dec. 8, 2009).

Denmark, there is no significant social norm of tipping, that is, people do not feel required in any sense to leave a tip, but they are expected to round the payment upward. Leaving a tip of up to 10 percent when there is no service charge is not uncommon.<sup>39</sup> The same is true for Germany, where there is no social norm of tipping, but the practice is nevertheless common in mid-to upscale restaurants.<sup>40</sup>

Tipping is insignificant in most poor countries where the vast majority of the population works in low human-capital jobs.<sup>41</sup> Waiters are not perceived as deserving of an extra monetary transfer from the customer, as their work is no different in any relevant sense from that of others. They do not belong to a low-income class as their human capital is no lower than that of most others.

According to my understanding of the social norm of tipping, I would expect tipping to be significant only in countries where the average diner is clearly wealthier than the typical waiter and the data seem to support this expectation. Waiters in Africa, for example, are probably not any poorer than the average (or median) worker. Being a waiter in China or India does not put you in a lower income class than the diners you serve. Eating out in many of these countries is daily practiced at all levels of society. Even though tipping is not the norm in nearly all poor countries of the world, you do find it in upscale restaurants in such countries, a fact that further supports my claim. In China, where there are great differences in wealth between urban and rural areas, there is a norm of leaving a low tip, of 3 percent, but only in the major cities.

Among the wealthier countries, I would assume that tipping is significant in countries with high inequality, if solidarity is part of their culture. In most European countries and Japan, inequality is already addressed by the government through regulation and the tax and transfer system. Diners in Denmark know that waiters earn decent wages, because otherwise they would be living on welfare. In most Western and Northern European countries, reducing inequality is perceived to be the government's role, and waiters are not expected to rely on voluntary payments. Their pay is

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39 Conversation with Pedro Manuel Herrera, Tax Law Professor, Universidad Complutense de Madrid, Spain (Mar. 2009); *see also* Tripadvisor, Spain Tipping and Etiquette, <http://www.tripadvisor.com/Travel-g187427-s606/Spain:Tipping.And.Etiquette.html> (last visited Dec. 8, 2009).

40 Conversation with Alexander Rust, Tax Law Professor, F.R.G. Acting Assistant Professor of Tax Law, N.Y. Univ. Sch. of Law (Mar. 2009); *see also* Tripadvisor, Germany Tipping and Etiquette, <http://www.tripadvisor.com/Travel-g187275-s606/Germany:Tipping.And.Etiquette.html> (last visited Dec. 8, 2009).

41 *See* Magellan's, *supra* note 6; Tripadvisor, *supra* note 37.



either taken into account in the price of the meal or stated in the bill as a (mandatory) service charge. That eliminates any need for further payment by the customer.

The average tip rate in Canada is 15 percent and has held steady over the past years.<sup>42</sup> This may support my thesis, as after-tax inequality has not increased in Canada in the same way it has in the U.S. Therefore, the tip rates, which were the same in both countries in the '70s, have increased in the U.S., but not in Canada.

The social norm in countries in South and Central America is difficult to predict because they have high inequality coupled with a class-based culture, namely, a low aversion to inequality.<sup>43</sup> This creates a tradeoff, leading to inconsistent tipping norms that are affected by the state of the economy, and that apply only to mid- and upscale restaurants.<sup>44</sup>

As discussed in Part II above, the U.S. social norm of tipping could be explained by the U.S.'s relatively high income inequality together with a culture-based generosity towards low-income working people, and the relatively greater importance of material wellbeing to social status in the U.S. American social norms tend to affect the rest of the world due to the U.S.'s leadership position. In popular U.S. travelling destinations, such as St. Thomas, U.S. Virgin Islands, the Bahamas, and the Caribbean in general, tourists are expected to tip according to the U.S. norm, and in some places locals have adopted the norm and tip accordingly when acting as customers.<sup>45</sup> Foreigners who spend long periods of time in the U.S. internalize the social norm of tipping and may carry it back to their home countries, at least for a while. Hollywood movies and American TV shows are also likely to have some effect on consumers of this form of culture all over the world.<sup>46</sup>

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42 Conversation with David Duff, Tax Law Professor, Univ. of British Columbia, Canada (Apr. 2009).

43 Richard M. Bird, *Taxation in Latin America: Reflections on Sustainability and the Balance Between Equity and Efficiency* 44 (Joseph L. Rotman Sch. of Mgmt., Univ. of Toronto, International Tax Program Paper No. 0306, 2003), available at <http://www.rotman.utoronto.ca/iib/ITP0306.pdf> (finding inequality to be "the central social and economic problem in many Latin American countries").

44 Conversation with Eduardo Baistrocchi, Tax Law Professor, Arg., Currently at London Sch. of Econ. (Mar. 2009). From Baistrocchi I learnt that the data in Table 2 regarding the tipping norm in Argentina is likely to be outdated. Tipping used to be significant in previous times, but today it is practiced mostly in mid- and upscale restaurants, and signals wealth.

45 See Tripadvisor, St. Thomas Tipping and Etiquette, <http://www.tripadvisor.com/Travel-g147404-s606/St-Thomas:Caribbean:Tipping.And.Etiquette.html> (last visited Dec. 8, 2009).

46 U.S. literature is unlikely to have such an effect for two reasons. First, tipping

### A. Anecdotal Evidence

The link between inequality and capitalism and the development of a social norm of tipping seems to find empirical support when the cases of Russia and New Zealand are examined.

New Zealand serves as an example of a society that is developing a social norm of tipping, with no clear legal or political reason except for a significant growth in inequality. The Russian case serves as an example of such a change in tipping practices, caused to some extent by the political shift from a communist to a market economy. Both countries experienced significant increases in inequality during the relevant time period.

In his study of tipping in New Zealand, Brigid Casey found that, whereas local travel guides of the past few decades had implied that the practice did not exist in New Zealand, it is in fact rapidly developing and expanding in New Zealand.<sup>47</sup> From his qualitative study, in which 64 managers and workers were interviewed, Casey concludes that "[i]n New Zealand tipping is not an institution, yet. It is not generally considered part of the culture, but there is evidence that it is becoming more widespread and acceptable."<sup>48</sup>

B.W.A. Dewald and John Self have written a paper on tipping in Russia entitled "Tipping Is Becoming Russia's Cup of Tea."<sup>49</sup> Up until the beginning of the '90s, when Russia had a planned economy in which prices were determined by the central government, tipping was prohibited. Since the eradication of communism, the practice of tipping has been introduced into Russia. In their research, Dewald and Self collected data from a group of university students in the city of Petrozavodsk regarding how much they actually tipped when they went out. They found that tipping is common among Russian students, even though their income is relatively low. Most students did not tip (64 percent), but a large portion of students did tip at an average rate of 8.78 percent. Dewald and Self concluded: "The practice of tipping is creeping into the social fabric of Russia with only the level of tipping different from Western countries."<sup>50</sup>

The findings from New Zealand and Russia may support my thesis

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practices do not tend to be mentioned in books. Second, U.S. literature is much less popular in the world than U.S. movies and TV shows.

47 Brigid Casey, *Tipping in New Zealand Restaurants*, 20 HOSPITALITY MGMT. 219 (2001).

48 *Id.* at 223.

49 B.W.A. Dewald & John Self, *Tipping Is Becoming Russia's Cup of Tea*, 18 ANATOLIA: INT'L. J. TOURISM & HOSPITALITY RES. 343 (2007).

50 *Id.* at 347.

that there is a link between inequality and the social norm of tipping. Within-country inequality has been growing over the past two decades nearly all over the world, due mostly to the increased importance of skills<sup>51</sup> and in the same period tipping seems to become a more widespread social norm. Although tipping is not a universal norm, there are quite a few countries that have adopted the norm, and there is no evidence of any country having abandoned it, this despite the general dissatisfaction with the norm expressed by customers in numerous surveys. This, it seems to me, is the result of the growing income inequality and the switch to U.S.-style consumerism where people gain status by signaling high earnings through spending and high tipping.

Outside North America, the norm is most prevalent in Eastern Europe and South America, which again supports my hypothesis that tipping is correlated with and maybe even caused by inequality, as inequality in those regions is relatively high. Moreover, the norm is practiced in high-end restaurants in most countries of the world.

### **B. Is the Social Norm of Tipping Desirable?**

Some social norms enhance efficiency by "providing commodities to which the price system is inapplicable."<sup>52</sup> Tipping may be an efficient way to monitor service quality. Customers know better than the restaurant owner how well they were treated by the waiter, and the tipping mechanism saves on litigation costs. The customer is not required to prove to a restaurant manager that the service was bad and demand a reduction in the service charge. If the service was bad, the customer can simply leave a small tip or no tip at all.

The argument that tipping is efficient is based on the assumption that customers tip according to service quality, whereas in reality there is only a weak correlation between service quality and tip size.<sup>53</sup> By far the most important factor in determining tip size is the size of the bill, and there is no

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51 See INT'L MONETARY FUND, *WORLD ECONOMIC OUTLOOK: GLOBALIZATION AND INEQUALITY* 31-65 (2007), available at <http://www.imf.org/external/pubs/ft/weo/2007/02/>.

52 Kenneth Arrow, *Political and Economic Evaluation of Social Effects and Externalities*, in *FRONTIERS OF QUANTITATIVE ECONOMICS* 3 (Michael Intriligator ed., 1971).

53 See, e.g., Michael Lynn & Andrea Grassman, *Restaurant Tipping: An Examination of Three "Rational" Explanations*, 11 *J. ECON. PSYCHOL.* 169 (1990) (finding that tipping is related to a number of factors, including the size of the bill, number of courses, and alcohol consumption).

reason to think that the size of the bill is correlated with service quality. The size of the bill is related to the price of the items on the menu and to the number of items ordered. The latter is correlated with service, but not with the quality of the service. Tipping may therefore be correlated with quantity of service, but such a correlation does not save on monitoring costs, because a fixed percentage service charge would compensate the waiters for their extra effort in bringing many dishes to the table, as the number of orders affects the size of the bill. Researchers have found that the average relationship between tip size and service evaluations by customers is quite small, accounting for less than two percent of the variability in tip percentages.<sup>54</sup> Such small variability is unlikely to affect the service provider's behavior.<sup>55</sup> Others have found tipping to have no effect on service quality at all.<sup>56</sup>

To sum up, the social norm of tipping is unlikely to be desirable on efficiency grounds. It is, in fact, welfare-reducing for the following reasons:

First, tipping may facilitate prejudice. As shown by Ayres et al., customers

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54 See Michael Lynn & Michael McCall, *Gratitude and Gratuity: A Meta-Analysis of Research on the Service-Tipping Relationship*, 29 J. SOC.-ECON. 203, 211 (2000) (suggesting that there is a poor correlation between service quality and tip size).

55 See Michael Lynn, *Restaurant Tipping and Service Quality: A Tenuous Relationship*, 42 CORNELL HOTEL & RESTAURANT ADMIN. Q. 14 (2001) (explaining the effect of variability in tipping rates); Michael Lynn, *Tip Levels and Service: An Update, Extension and Reconciliation*, 44 CORNELL HOTEL & RESTAURANT ADMIN. Q. 139, 148 (2003) (referring to research that shows that managers ought not to use tips to encourage good service among servers). Empirical studies have found that repeated customers do tend to leave higher tips than non-regular customers, but the difference was very small, only one or two percent. See Orn B. Bodvarsson & William A. Gibson, *Economics and Restaurant Gratuities: Determining Tip Rates*, 56 AM. J. ECON. & SOC. 187, 190 (1997) (showing that even repeat customers do not tip to ensure good service in the future); Michael Conlin, Michael Lynn & Ted O'Donoghue, *The Norm of Restaurant Tipping*, 52 J. ECON. BEHAV. & ORG. 297 (2003) (showing that tips of frequent patrons are not more sensitive to service quality than tips of non-frequent patrons); Lynn & Grassman, *supra* note 53, at 171 (describing incentives in tipping).

56 See, e.g., Daniel Kahneman, Jack Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728 (1986); NINA ZAGAT & TIM ZAGAT, ZAGAT: AMERICA'S TOP RESTAURANTS 2008, at 6 (2009) ("Service Checkup: Given that 70% of our surveyors nationwide say service trumps all other irritants when dining out, it's clear that front-of-the-house hospitality remains the industry's weakest link. Nevertheless, tipping has edged upwards over the years, from a national average of around 18% in 2002 to 19% today (just one percentage point shy of the 'Golden 20%' that staffs hope for). Go Figure.").

tend to discriminate against minority cabdrivers.<sup>57</sup> Moreover, minority passengers tend to leave lower tips, thereby giving cabdrivers a revenue-based incentive to refuse to pick them up.<sup>58</sup> This phenomenon extends to other minority service providers, such as waiters. Research in restaurants suggests that this variance in tipping behavior is influenced not only by perceived differences in service levels, but also by such factors as the ethnicity of the tipper or the server.<sup>59</sup> Waiters are likely to exert less effort when providing services to minority customers, assuming that, because minority customers are less likely to tip, they will not pay the wait- staff for their efforts. It is also possible that customers leave lower tips or no tip for minority waiters more often than for white waiters, for the same reason that they do so to minority cabdrivers.

Second, tipping, when paid in cash, facilitates tax evasion. By artificially separating the service component from the bill, the restaurant avoids any sales tax on the service component of the meal. In addition, if the waiters rather than the restaurant are held responsible for reporting the tip income to the tax authorities, as is usually the case in most countries, tip income is usually underreported.

Third, when tip income is underreported to the tax authorities it is usually not taken into account in computing the waiters' income for purposes of social security benefits and various other social benefits that vary by country.

Fourth, accumulation of wealth and conspicuous consumption may create a negative externality as well, because people care about their relative position and spend on items such as housing, cars and clothes, vying to be at least as visibly impressive as others who spend lots of money on the same things. Economic models that incorporate positional concerns predict that sharply increased spending by top earners will exert indirect upward pressure

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57 Ayres et al., *supra* note 13, at 1627 (stating that passengers systematically tipped white drivers substantially more than nonwhite drivers).

58 *Id.* at 1628-29.

59 *Id.* at 1641 (explaining that "the statistical discrimination based on perceived racial tipping differences may not be limited to the taxi industry"); Michael Lynn, *Ethnic Differences in Tipping: A Matter of Familiarity with Tipping Norms*, 45 CORNELL HOTEL & RESTAURANT ADMIN. Q. 12 (2004) (arguing that "many waiters and waitresses believe that African-Americans tip less than Caucasians . . . . As a result of that belief, many table servers dislike waiting on black customers, deliver inferior service to black guests on whom they must wait, and refuse to work in restaurants with a predominantly black clientele"); *see also* Michael Lynn, *Black-White Differences in Tipping Various Service Providers*, 34 J. APPLIED SOC. PSYCHOL. 2261 (2004) (revealing racial tipping patterns in the restaurant industry).

on spending by the median earner.<sup>60</sup> This results in over-consumption, less leisure time, and an overall decrease in welfare.

Similarly, people who tip may be perceived as imposing a negative externality on others who tip less generously or do not tip at all. I suggest that as inequality grew in the U.S., affluent people increased the amount they tipped in order to improve their relative positioning; that is, their status. This put pressure on the somewhat less affluent to increase the amount of the tips that they left, beginning a cascade effect to the detriment of all.

A social norm is a form of behavior. Taxes are often used to change the way people behave to correct for positive or negative externalities. The fourth argument mentioned above is a classic case for intervention through the tax system. A standard policy reaction to a negative externality such as pollution is to impose a Pigouvian tax on the polluting activity.

In the context of tipping, I do not suggest imposing a tax on tippers, but a similar effect could be achieved by taxing tip income. A high enough tax would reduce the incentives for restaurants to artificially exclude the service component from the price of the meal, allowing all the above welfare-reducing effects to take place. No country in the world does so, but there are great variations between countries in the ways they tax income from tips. In the next Part I will try to examine the link between the tax treatment of tips in some specific countries and their presumed social norm of tipping.

#### IV. TAX TREATMENT OF TIPPING

A tip is not a gift, but a payment for service which is one component of a bundle of goods and services the restaurant offers its customers. The waiter is paid because she provides a service in her capacity as a restaurant employee. The payment is therefore income to the restaurant and it should be taxed accordingly. It is no different from payment for any other component of the meal. The fact that the tip is paid in cash by the customer to the waiter and that the restaurant allows the waiter to keep it does not change its character. By allowing the waiter to keep the tip, the restaurant pays the waiter a salary. It is a transfer of ownership. The customer's intent in making the payment is irrelevant. It cannot create a fiction that the waiter performs more than one service job at the same time: once as an employee

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<sup>60</sup> Robert H. Frank, *Progressive Consumption Taxation as a Remedy for the U.S. Savings Shortfall*, 2 *ECONOMISTS' VOICE* 1, 4 (2005).

providing regular service and earning wages, and another as a self-employed individual earning tip income.

For some odd reason, most countries tax cash tips as income earned by the waiter as self-employed, even though she is generally taxed as an employee of the restaurant.<sup>61</sup> If, for example, the customer pays a tip by credit card, the total amount is taxed as business income to the restaurant. When the restaurant then pays the amount of the tip to the waiter, it is taxed as wages. The waiter reports it as income from employment and the restaurant deducts it as an expense. If, on the other hand, the customer pays the tip by cash, most countries consider the waiter to have earned the income as if she were self-employed. The latter case results in massive tax evasion, as it is much more difficult to enforce the tax on individuals than on businesses. It also does not make any sense. It does not save on compliance costs, namely, the restaurant having to collect the cash tips from the waiters, because nearly all restaurants practice tip-pooling; that is, tips do not go directly to the staff who provided the service, but instead are aggregated and then distributed to all servers according to some formula.<sup>62</sup> If tips are anyway pooled, they could be taxed to the business with no additional collection costs.

Argentina: Tips are theoretically taxed like wages, but in practice are not reported and there are no enforcement attempts. Restaurants do not allow customers to pay tips by credit card. Customers who wish to leave a tip are required to pay in cash, and tips are not taxed at all.<sup>63</sup>

Canada: Tips are taxable as employment income, but there is probably substantial evasion. If reported, they are taken into account for payroll taxes.<sup>64</sup>

Denmark: As mentioned in Part II above, there is no social norm of tipping in Denmark, but tipping is sometimes practiced in upscale restaurants. In

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61 See, for example, the U.S., Israel and the U.K. See Margalioth, *supra* note 2 (describing the U.S. taxation of tip income); Yoram Margalioth & Sharon Rabin-Margalioth, *Tips*, 38 HEBREW U. L. REV. (MISHPATIM) 107 (2009) (describing the Israeli taxation of tip income); the European Court of Human Rights in 2002, *Nerva v. United Kingdom*, 8 Eur. Ct. H.R. 3 (2002) (similarly distinguishing between tips paid in cash and those paid by check or credit card, thereby pointlessly allowing the form of payment to decide the question who owns the tip).

62 Tip-pooling is required to prevent harmful competition among wait-staff for customers who are expected to be generous tippers, and to promote collective efforts, thus providing better service overall. See Michael Lynn, *Tipping*, in INTERNATIONAL ENCYCLOPEDIA OF HOSPITALITY MANAGEMENT 620 (Abraham Pizam ed., 2005).

63 See Conversation with Eduardo Baistrocchi, *supra* note 44.

64 See Conversation with David Duff, *supra* note 42.

theory it is taxable income to the employee, but in practice it is never reported and there are no attempts at enforcement.

Germany: Tips are explicitly defined as income from employment for tax purposes. However, waiters rather than restaurants are required to report the income for tax purposes and most of the waiters in restaurants did not include their tips in the income tax return. In order to decriminalize waiters, the government finally decided to exempt tips in 2002.<sup>65</sup>

Hungary: Cash tips are not considered business income. Under the Hungarian Personal Income Tax Law, taxpayers are required to add tips to their tax base, not to be taxed, but merely to push their income to a higher tax bracket. Evasion is pervasive.<sup>66</sup>

Israel: Cash tips are taxed as income from self-employment of the waiter, even though she is an employee. In practice tipping is unreported and enforcement efforts are miniscule.<sup>67</sup>

Spain: Same as in Israel.<sup>68</sup>

United States: Cash tips are taxed as income from self-employment of the waiter, even though she is an employee. Employees who receive wages in the form of tips are required to report the amount of the tips they receive to their employer, who must send copies of these reports to the IRS.<sup>69</sup> The IRS uses presumptive tax methods to overcome its disadvantage in relying on waiters to report their cash tip income.<sup>70</sup> The presumption may be rebutted if the taxpayer demonstrates that the government's calculation in the particular case has likely produced an inaccurate result.<sup>71</sup>

The *Nerva* case in the European Court of Human Rights may be interpreted as providing us with a general European view of taxation of tips, beyond that of particular European countries. The case discusses only tips paid through credit cards and checks. The British restaurant did not consider tips paid in cash as its own. The court argued that ownership of tips through checks and credit cards first passes to the employer, simply because vouchers signed

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<sup>65</sup> See Conversation with Alexander Rust, *supra* note 40.

<sup>66</sup> Conversation with Bori Kolozs, Tax Academic, Hung. (June 2009). For some general information on the social norm of tipping in Hungary see Tripadvisor, Hungary Tipping and Etiquette, <http://www.tripadvisor.com/Travel-g274881-s606/Hungary:Tipping.And.Etiquette.html> (last visited Dec. 8, 2009).

<sup>67</sup> Margalioth & Rabin, *supra* note 61.

<sup>68</sup> See Conversation with Pedro Manuel Herrera, *supra* note 39.

<sup>69</sup> 26 C.F.R. § 31.6011(a)-1(a) (2006).

<sup>70</sup> The formula was perfected in *McQuatters v. Comm'r*, 32 T.C.M. (CCH) 1122 (1973), and this method of presumptive tax calculation has been known ever since as the "McQuatters Formula."

<sup>71</sup> *United States v. Fior D'Italia, Inc.*, 536 U.S. 238, 247-48 (2002).



by customers are made out in the employer's name and are cleared through the latter's account.<sup>72</sup> The wait-staff then receives the tips as wages. The case should therefore be interpreted as confirming the British practice of not taxing tips paid in cash, which is the quintessential tip.

What can we learn from the above survey? The primary lesson seems to me to be that it is very difficult to perform a comparative tax law study. Income taxation is primary in some countries, but does not exist or is relatively insignificant in many others, especially in the developing world. Taking a broader view of the entire tax system requires information that is mostly unavailable in English. This is particularly true with regard to tips. Tips are a significant source of tax revenue in the U.S. and a few other countries where the social norm of tipping is important, but they are insignificant in most countries, hence there is no documentation in the academic literature regarding their taxation.<sup>73</sup>

The little information I have gathered yields the following picture. The most systematic method of taxation of tips is that practiced in the U.S. It is far from optimal, because taxing tips at the business level, as I've suggested, would improve compliance considerably, in addition to being more accurate analytically. Nevertheless, the combination of a personal requirement to file a tax return plus presumptive taxation is likely the most comprehensive attempt in the world at taxing income from tips.

How do the data on taxation correlate with the social norm of tipping and with general inequality? The tax norms seem to reflect the social norms: Taxation is important only where tipping is significant. When it is insignificant, it is usually evaded or exempted. As cash income, it is too costly to enforce. In developed countries, it is also often thought to be income earned by low-income individuals that would not have reached the threshold to be taxed, even if the tips were fully reported. This explains the tax treatment of tips in Europe. Germany is the most straightforward example, having explicitly acknowledged the widespread evasion that would otherwise take place. The U.S. is an exception, with relatively high and increasing rates of taxation on tips and the strictest tax enforcement. It seems to be in line with the U.S. social norm of helping mostly the

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<sup>72</sup> *Nerva v. United Kingdom*, 8 Eur. Ct. H.R. 3, 16 (2002).

<sup>73</sup> The few books on comparative taxation do not address this issue, and I could not find any papers in English on the subject. There is some literature on taxation of tips in the U.S. and there is the *Nerva* case that represents the European approach. As a result, the sources of the tax information presented in this Article are mostly my knowledge of the U.S and Israeli tax practices and my discussions with tax law professors from Argentina, Canada, Denmark, Germany, Hungary and Spain.

*deserving* low-income individuals, that is, those whose work efforts are verifiable. I also believe that the steady increase in tip rates over the past thirty years is the outcome of the increase in income inequality that took place during that period, due to the fact that tipping is a positional practice. This means that the U.S. taxation of tipping income is not necessarily a more advanced or accurate tax law and practice than that of other countries, but merely reflects the social norm in the U.S. and is likely to be adopted by countries in which the relevant social norm follows that of the U.S.<sup>74</sup> To the extent that people tip in order to redistribute towards waiters whom they see as "deserving" low income workers, taxing this income does not undo the effect of the social norm. It merely helps in achieving the distributive justice goal more accurately. The tax and transfer system distributes from all high income taxpayers, including waiters who happen to belong in that group, to low income individuals, including waiters.

### CONCLUSION

Tipping is a classic example of a social norm. It differs significantly across countries, with the U.S. being the world leader in terms of coverage and rates. In this Article I have suggested that this may be related to the U.S. cultural preference to link redistribution with work requirements, relatively high income inequality and consumerism. The international data seem to support these claims. Moreover, the tax treatment follows the social norms across countries.

While working on this Article, I gained two additional, somewhat unrelated, insights. The first is the sad reality that courts almost all over the world are incapable of correctly analyzing fundamental tax issues when the answer is not intuitive. The second is that performing comparative tax analysis is very difficult. It was impossible to find reliable information regarding the taxation of tipping income across countries. The only way to do so was through a personal network of contacts.

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<sup>74</sup> The system could be improved by taxing tip income more accurately as business income of the employer. See Margalioth, *supra* note 2. This would mitigate tax evasion as well as decrease the negative externality that I believe to be associated with tipping.

**Appendix A:****The Source of Information Regarding Average Tip Rates in the U.S.**

Commercial data provide clear evidence that the average tip rate in the U.S. has increased substantially over the last thirty years. These data are based on two published commercial data sources which record the tipping rates in the U.S. The first is NPD research Inc., which recorded tip rates for the years 1982-84, and is mentioned in a paper by McCrohan and Pearl.<sup>75</sup> NPD research Inc. obtained the data through analysis of the diaries left by the tippers themselves. The method of inquiry into tip rates through the tippers is regarded as more accurate than inquiry through the recipients or the employers, who have a stronger incentive to underestimate the tipping rate. The panel was comprised of 12,800 households which were geographically and demographically balanced based on U.S. Census data.

The second source of commercial data is the Zagat Survey, which is based on large-scale surveys. As an example of the large scale of the surveys which the data are based on — the data regarding tip rates for 2008, published in "2009 Zagat America's Best Restaurants," were based on 250,000 surveyors.<sup>76</sup> Although Zagat surveys include data regarding tips at least from 1995, this Article makes reference to the years for which the data are publicly accessible: 1995, 2000, 2003-2008. While the method which the NPD panel employs is to ask for information on the actual amounts the surveyor reports she tipped in the past, the Zagat survey asks a more general question, namely how much the surveyor usually tips.<sup>77</sup> The main advantage

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<sup>75</sup> Kevin McCrohan & Robert Pearl, *An Application of Commercial Panel Data for Public Policy: Estimates of Tip Earnings*, 17 J. ECON. & SOC. MEASUREMENT 217, 231 (1991).

<sup>76</sup> PR Newswire, 2009 Zagat America's Top Restaurants Survey Is Out (Oct. 23, 2008), <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=109&STORY=/www/story/10-23-2008/0004909790&EDATE=> [hereinafter Zagat 2009].

<sup>77</sup> In the few last years, the tipping rates are published in the first pages of Zagat's annual "America's Top Restaurants" Guide. Even in years for which the data weren't published in the Guide itself, they were published in the Zagat press release for the publication of a new 'America's Top Restaurants' Guide. See Caterersearch, *Zagat Puts Four Seasons on Top* (July 26, 2001), <http://www.caterersearch.com/Articles/2001/07/26/33141/zagat-survey-puts-four-seasons-on-top.html>, for the press release with the 1995 tip data; AllBusiness, *Zagat Releases New Guide to America's Top Restaurants* (Nov. 13, 2000), <http://www.allbusiness.com/marketing-advertising/price-management-price/6533126-1.html>, for the press release with the tip data for 2000; Hotel Online, *Zagat Survey 2005 — Top U.S. Hotel and Restaurant Ratings: Peninsula Chicago and Peninsula Beverly Hills Ranked #1 and #2* (Nov. 1, 2004), [http://www.hotel-online.com/News/PR2004\\_4th/](http://www.hotel-online.com/News/PR2004_4th/)

of both sources of data is that the question regarding tips is ancillary to the main objective of the panel/survey, which is to obtain general information regarding restaurants and expenses when eating out. This, together with the fact that the surveys are not carried out by personal interviews, but through the internet/phone/mail, mitigates the possible tendency of consumers to overstate the amount they tip due to prestige factors, which is especially relevant in the case of personal interviews. From the perspective of the current Article, the actual accuracy of the panel/survey and the possible biases which might affect it are not an issue of any great importance, due to the fact that they presumably affect all years equally, and the prime interest of this Article is sequential — the dynamics of tip rate averages over time.

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Nov04\_Zagat.html, for the press release with the tip data for 2003 and 2004; Hotel Online, *Zagat's 2006 America's Top Restaurants Guide Points Out a Variety of National Dining Trends and Issues* (Oct. 26, 2005), [http://www.hotel-online.com/News/PR2005\\_4th/Oct05\\_ZagatRestaurants.html](http://www.hotel-online.com/News/PR2005_4th/Oct05_ZagatRestaurants.html), for the press release with the tip data for 2005; Hotel News Resource, *Zagat 2007 Restaurants Survey* (Nov. 1, 2006), <http://www.hotelnewsresource.com/pdf/dyn/24933.pdf>, for the press release with the tip data for 2006; PR Newswire, *Zagat Releases 2008 America's Top Restaurants Survey* (Oct. 24, 2008), <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/10-24-2007/0004688599&EDATE>, for the press release with the tip data for 2007; Zagat 2009, *supra* note 76, for the press release with the tip data for 2008.