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The Effects on Perceived Restaurant Expensiveness of Tipping and Its Alternatives

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Abstract
Research on behavioral pricing has found that presenting the price of a product or service in separate parts rather than a consolidated whole can reduce consumers' perceptions of the total cost. That principle suggests that restaurants which charge separate fees for their food and service whether by voluntary tipping or an automatic service charge may be perceived as less expensive than those that include service charges in the form of an all-inclusive price. An internet-based simulation testing that idea found that participants rated restaurants with tipping or automatic gratuity policies as less expensive than restaurants that built the costs of service into menu prices. Furthermore, participants ordered more expensive meals when automatic gratuities were added to the bill than when the costs of service were built into menu prices. While the study was a simulation only (and no money was at stake), the industry's longstanding practice of setting menu prices with service charges extra is supported by these findings.

Keywords
restaurants, behavioral pricing, tipping policy, expensiveness, service-inclusive pricing

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by Shuo Wang and Michael Lynn, Ph.D.

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Research on behavioral pricing has found that presenting the price of a product or service in separate parts rather than a consolidated whole can reduce consumers’ perceptions of the total cost. That principle suggests that restaurants which charge separate fees for their food and service whether by voluntary tipping or an automatic service charge may be perceived as less expensive than those that include service charges in the form of an all-inclusive price. An internet-based simulation testing that idea found that participants rated restaurants with tipping or automatic gratuity policies as less expensive than restaurants that built the costs of service into menu prices. Furthermore, participants ordered more expensive meals when automatic gratuities were added to the bill than when the costs of service were built into menu prices. While the study was a simulation only (and no money was at stake), the industry’s longstanding practice of setting menu prices with service charges extra is supported by these findings.
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Although leaving tips at table-service restaurants is a well-entrenched social norm in the United States, various problems with this practice have prompted some restaurant operators to implement service charges or service-inclusive pricing in place of tipping. Whether a restaurant should use tipping or its alternatives to cover the expense of service has long been a controversial and complex issue.¹ Most recently, the media coverage of the decision by New York City restaurant Per Se to replace voluntary tipping with compulsory gratuities of 20 percent has spurred a new round of debate over tipping and alternative policies among industry practitioners.²

One of the many considerations in choosing an appropriate tipping or service-charge policy is the policy’s effect on guests’ perceptions of how expensive a restaurant is. Research on behavioral pricing has suggested that partitioning prices, that is, presenting the price of a product or service in separate parts rather than a consolidated whole, can reduce consumers’ perceptions of the total cost and, hence, increase demand. For example, Morwitz, Greenleaf, and Johnson found that auction bidders agreed to pay more in total cost when a 5-percent auction fee was charged separately than when it was bundled into the bid price. This and other related findings suggest that restaurants which charge separate fees for their food and service via tipping or automatic service charges may be perceived as less expensive than those using all-inclusive pricing. This is a potentially important effect, especially among price-sensitive clientele.

The purposes of this report are to explain why and under what conditions tipping or service-charge policies may reduce perceptions of expensiveness (compared to a service-inclusive pricing policy), and to provide empirical evidence of those effects through a controlled experiment. In the next sections, we speculate about how consumers interpret menu prices under different tipping and service-charge policies. We then describe an experiment that tests our ideas and present the statistical analyses of our data. Finally, we discuss the implications of our findings for restaurant managers.

How Consumers Perceive Partitioned Prices

When facing partitioned prices, consumers must integrate separate price information to determine the true cost of an offer. Consumers may process the price information in different ways and, hence, they may form different perceptions. Morwitz et al. proposed three major processing strategies, claiming that consumers would choose a particular strategy if the strategy’s perceived benefit (in terms of expected accuracy in recognizing total price) outweighed the perceived cost (in terms of the time and cognitive effort required to process the price information). Specifically, consumers are thought to adopt one of the three following processing strategies when interpreting partitioned prices.

6 Morwitz et al., op.cit.
(1) Calculate the sum of the base price and the surcharge.
This strategy requires the highest cognitive effort but leads to the most accurate total price recognition. With this processing strategy, the presence or absence of price partitioning should have no effect on consumers’ perceptions of expensiveness. In general, consumers use this strategy when the surcharges are presented as a simple dollar amount so that calculating the total prices involves only summation.

(2) Resort to simplifying heuristics rather than a precise calculation.
If the consumer does not think it worthwhile to calculate the total price precisely, he or she may use heuristic shortcuts to estimate the total by integrating the two separated pieces of price information. The most commonly used heuristics in dealing with multiple pieces of information are anchoring and adjustment. When processing partitioned prices, customers may anchor on the base price (the primary information that is salient and important) and subjectively adjust that anchor upward to account for the surcharge (the secondary information with less availability and importance). Typically, such heuristics result in a combined price that is lower than the actual total price, given that research indicates that such adjustments are often too small.

(3) Simply ignore the surcharge.
In some cases, consumers may ignore the surcharge completely, either by failing to notice the surcharge information or by noticing the surcharge but not incorporating it in the total price. The latter case may happen when the surcharge is relatively standard. In this case, incorporating information about additional charges does not lead to a better decision. This strategy uses the least amount of cognitive effort and results in the lowest perceived accuracy of total prices among the three strategies.

Employee Compensation Policies and Partitioned Pricing

Service-inclusive pricing presents consumers with a single price, while tipping and service charges present them with partitioned prices—one for the food and another for the service. When consumers evaluate the expensiveness of restaurants that have policies either of voluntary tipping or service charges, the guests must choose one of the three aforementioned strategies to process the partitioned prices. We believe that consumers are unlikely to choose the calculation strategy because calculating the dollar value of percentage tips or service charges and then adding that amount to the menu prices can be difficult, or, in many cases, guests are not inclined to fiddle with such calculations when they’re trying to enjoy themselves. We also believe that it is unlikely that guests will ignore the tip or service charge, because at 5 to 20 percent of the bill, the typical tip or service charge is too large to ignore completely. These considerations mean that customers are most likely to make a near estimate of cost using the heuristic strategy.

Accordingly, we believe that consumers are likely to anchor their evaluations of restaurant expensiveness on menu prices and to subjectively adjust those evaluations either upward under tipping and service-charge policies or downward under a service-inclusive-pricing policy. In either case, the adjustment is likely to be insufficient, so that equivalent total costs will be perceived as lower under tipping and service charges than under service-inclusive pricing.

This possibility means that restaurants with voluntary tipping or 15-percent service charges may be perceived as less expensive than restaurants with comparable levels of employee compensation built into menu prices. It also means that restaurants with 18-percent service charges may be perceived as no more expensive than restaurants with 15-percent-higher service-inclusive menu prices, despite higher

8 Ibid.
actual total costs at the restaurants with the 18-percent surcharge.

Consumers’ demand usually increases when the perceived price for a product or service decreases. Thus, if tipping and service charges do lower perceptions of restaurant expensiveness, then they should also increase demand. One aspect of consumer demand is willingness to order the more expensive items from the menu, so any tipping or service-charge effects on perceived expensiveness may be reflected in restaurant patrons’ check averages. This reasoning suggests that, after adjusting for differences in menu prices, restaurants that use tipping and automatic 15-percent gratuities should enjoy higher average check totals than would restaurants with comparable service costs built into menu prices. Furthermore, restaurants with automatic 18-percent gratuities may enjoy average adjusted check totals comparable to those of restaurants that have 15-percent-higher service-inclusive menu prices, despite greater total costs at the restaurants with the 18-percent service charge.

To this point, we have assumed that consumers base their evaluations of a restaurant’s expensiveness on its menu prices (with insufficient adjustments for expected tips and service charges). That assumption is reasonable when menu prices and service charges (if any) are the only information available to consumers for their decisions. However, once a customer has paid the bill, he or she could evaluate the restaurant’s expensiveness according to the actual payment rather than on some estimate based on menu prices. In that case, restaurants with tipping or service charges may be perceived as no less expensive than those with service-inclusive pricing, because the check has already arithmetically combined the separate food and service prices. This possibility means that a restaurant with voluntary tipping, one with a 15-percent service charge, and an establishment with service-inclusive menu prices may be perceived as equally expensive, once the customer has received bills specifying the total costs of eating at each of those restaurants.

We believe that equivalent total menu costs will be perceived as lower under tipping and service charges than under service-inclusive pricing.

Method

We conducted an interactive web-based experiment to test our expectations about the effects of tipping, service charges, and service-inclusive pricing on perceived expensiveness and demand (as shown in Exhibit 1 and successive exhibits). Participants in this study were given information about four hypothetical restaurants, were asked to place a food and beverage order at each restaurant, and then requested to rate the expensiveness of each one. Each restaurant had a different tipping policy (i.e., voluntary tipping, a 15-percent automatic gratuity, an 18-percent automatic gratuity, or no tipping with a 15-percent surcharge built into the menu prices). Participants viewed and rated each restaurant one at a time. They viewed photographs of the exterior and interior of the restaurant and read a menu from the restaurant. In addition to listing the restaurant’s food and beverage offerings, the menu contained information about its tipping policy.

Participants were next asked to order one appetizer, one entrée, and one drink from the menu. Based on this order, they received a bill. In half of the cases, the bill was presented and then the participant was asked to rate the expensiveness of the restaurant. The other half rated the expensiveness before they saw the check. After doing this for all four restaurants, participants were given a chance to reconsider their expensiveness ratings for the restaurants, and were asked to provide information about their demographic characteristics, tipping habits, and other traits.

Participants

Although 369 members of a national consumer panel participated in our online experiment, we had to exclude the results of 51 participants who did not complete the experiment. Completing the process entered the participant in a sweepstakes promoted by a marketing research company. Of the participants, 57 percent were women and 87 percent were Caucasian. Their ages ranged from 18 to 80, with the average being 47. Two percent of the participants had some education, 20 percent were high school graduates, 41 percent
had some college, 25 percent were college graduates, and 12 percent had done post-graduate work. Twenty percent of the participants earned less than $25,000 a year, 36 percent earned between $25,001 and $50,000, 37 percent earned between $50,001 and $100,000, and 7 percent earned more than $100,000 a year. They reported dining out at full-service restaurants an average of five times per month, with a low response of no dining out and a high response of 80 times per month. Thus, in most regards our sample comprised a diverse set of restaurant patrons.

Stimuli

The four hypothetical restaurants in this study were mid-scale, full-service restaurants. Each of the three menu categories (i.e., appetizer, entrée, and beverage) had five individual items with various prices. The prices on the menus of Restaurant 1 and Restaurant 3 were roughly comparable and mid-price. The menu of Restaurant 2 was comparatively low-price, while Restaurant 4's menu was comparatively high price. We always presented the four restaurants in the same order, starting with Restaurant 1. Likewise the two pictures and the menu items for each restaurant were always the same.

Things changed at the bottom of each menu, where we tried out the four different tipping policies. The four tipping policies were rotated among the four restaurants in such a way that each policy was associated with each restaurant's menu with equal frequency. We also made sure that the order in which the
policies appeared (that is, before or after one of the other policies) also attained equal frequency, a process known as a Latin-square counterbalancing. The reason for this was to control for any effect that the order of presentation of the tipping policies might have on our outcome measures.

Each participant was asked to answer three questions either before or after he or she viewed the check from each restaurant. The first question focused on attention on the tipping policy by asking the participant to indicate which of the four tipping or service-charge policies was in effect at that restaurant. The second question was a filler question regarding the participant’s liking of the restaurant’s décor. Finally, the participant was asked to rate the expensiveness of the restaurant, on a 7-point Likert-type scale, ranging from very cheap (1) to very expensive (7). Again, some participants rated the restaurant before they saw the check and the others did so after they saw the check.

The check listed the items ordered and the price for each along with a subtotal, tax amount (which was 7 percent of the subtotal), the automatic gratuity (if any), and a grand total. For the restaurant with voluntary tipping, the check had a place for the participant to type in the tip amount, and the grand total was then automatically calculated.

After rating all four restaurants individually, participants were then asked to complete a final, end-of-experiment survey. This was the point when they could reconsider their expensiveness ratings for each restaurant, again using the seven-point scale. Then they were asked questions about their tipping habits, their attitudes toward different tipping and service-charge policies, their demographics, their familiarity with U.S. tipping customs, and the frequency with which they dine at full-service restaurants.

Immediate Ratings of Restaurant Expensiveness

The first round of ratings of restaurant expensiveness under the four tipping policies is presented in Exhibit 3. The restaurants with the policy of no tipping (a mean of 4.95 out of 7) and the policy of an 18-percent service charge (4.85) were perceived as significantly more expensive ($p < .05$) than were the restaurants with voluntary tipping (4.55) or a 15-percent service charge (4.68). Other than the significant difference of these restaurant pairs, we found no other significant differences, though the difference between the 15-percent service charge and the voluntary tipping policies was marginally significant ($p < .07$). These findings support our expectations about the effects of partitioned pricing on perceived restaurant expensiveness.

The order in which the bill and the questions on expensiveness were presented had no significant effect on the ratings. This means that the effects of tipping policies on immediate expensiveness ratings did not differ according to when the bill was presented (see Exhibit 4). This suggests
that the effects of the various tipping policies on perceived restaurant expensiveness are fairly robust, and that consumers base evaluations of restaurant expensiveness on menu prices rather than on the bills they receive.

Summary Ratings of Restaurant Expensiveness

Participants’ ratings of expensiveness did not change substantially in the second round of ratings. Once again, the restaurants with the no-tipping policy (mean 4.84) and 18-percent service charge (4.91) were perceived as significantly more expensive ($p < .05$) than were those with voluntary tipping (4.67) or a 15-percent service charge (4.67). Again, we found no other significant differences (see Exhibit 5). These findings, like those above, support our expectations concerning the effects of partitioned pricing on perceptions of expensiveness. Furthermore, since the delayed ratings all occurred after subjects had received their bills, the findings provide additional evidence that partitioned pricing reduces perceived restaurant expensiveness even when consumers are well aware of the total cost of their meal.

Size of Food Order

We found that the type of tipping policy seemed to affect the size of participants’ orders. Although participants were to order one item in each of the three categories, they could select any item in each class, items that differed in price. Thus, the differences in demand for the higher price items are reflected in the subtotals of the participants’ bills. (Note: We adjusted for the 15-percent higher menu prices in the no-tipping situation.) The order size for each tipping policy is presented in Exhibit 6. The average order size was significantly higher under the 15-percent-service-charge policy than under the no-tipping and voluntary-tipping policies (means = $20.18$ vs. $19.71$ and $20.18$ vs. $19.71$). The subtotal under the 18-percent-service-charge policy (mean = $19.89$) was not significantly different from that under any of the other policies.
These findings generally support our ideas concerning the effects of partitioned pricing on demand. Only the expectation that the average order size at restaurants with service-inclusive pricing would be smaller than those at restaurants with voluntary tipping was not supported.

Discussion

Previous research on behavioral pricing suggests that price partitioning reduces perceived expensiveness and increases demand.9 We found that restaurant tipping and service charge policies act in that way. In our study, restaurants with voluntary tipping or 15-percent service charges were, in fact, perceived as less expensive than were restaurants with 15-percent-higher menu prices that included service.10 Moreover, even though the restaurant with an 18-percent service charge had higher total costs, that restaurant was

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9 Chakravarti et al., op.cit.; Lee and Han, op.cit.; Morwitz et al., op.cit.; and Xia and Monroe, op.cit.

10 Sales taxes do create minor differences. The service-inclusive pricing is equivalent to a 23% surcharge on item prices (1.15x1.07=1.2305) assuming a 15% hidden service charge and a 7% sales tax. The 15% automatic gratuity represents a 22% surcharge on item prices (1.15+0.07=1.22) assuming a 7% sales tax. Similarly, a 25% surcharge on item prices could be derived for the 18% automatic gratuity (1.18+0.07=1.25).
perceived as being no more expensive than a restaurant with service-inclusive prices. These findings support the idea that partitioned pricing via voluntary tipping or service charges reduces perceptions of restaurant expensiveness. Moreover, these effects were evident in the summary ratings after all costs were tallied, demonstrating that the effect is robust, and reinforcing our earlier conclusion that customers base evaluations of restaurant expensiveness on menu prices.

We also found that average order sizes at restaurants with 15-percent service charges were larger than were those at restaurants with service-inclusive menu prices. Although we failed to find a significant difference in the average order size between voluntary-tipping and service-inclusive-pricing policies, the means were in the expected direction. Furthermore, an 8-percent automatic service charge did not reduce the order size compared to service-inclusive menus. Again, these findings generally sup-
port our ideas concerning the effects of partitioned pricing on demand.

Implications for Restaurant Tipping Policy

Our findings weigh against the use of service-inclusive pricing, particularly in restaurants with a price-sensitive clientele. Even so, we cannot categorically state that restaurants with service-inclusive pricing will always suffer from an unfavorable price perception. Upscale restaurants, for example, with their relatively price-insensitive clientele, should not see ef-
fects on their business from adopting service-inclusive pricing. (This is probably the situation for Per Se and restaurants like it.) Furthermore, the advantage that using an automatic gratuity confers on price cognition may disappear when service charges rise too high. In particular, if the amount of the automatic gratuity is higher than certain reference levels (e.g., the upper levels of voluntary tips left by consumers), consumers’ perception of restaurant expensiveness may be shaped by what they might consider an outrageous automatic gratuity. If a restaurant operator is determined to levy a large service charge to cover the expense of service, it might be better simply to implement service-inclusive pricing rather than shock guests with a huge automatic gratuity.

Although we endeavored to simulate consumers’ dining experience through our computer-based experiment, our study wasn’t a real-life dining situation. Our study force left out many other, related factors, such as service levels, brand, cuisine style, dining occasion, and even other customers. By isolating tipping from these other factors we may inadvertently have amplified its effect. Furthermore, our
questions about tipping policies called participants’ attention to the differences in the tipping policies at our hypothetical restaurants in a way that would not occur naturally. Therefore, participants in our study may have been more sensitive to differences in tipping policies than they would have been under normal circumstances. On the other hand, participants in this study did not actually have to pay the bills, and this may have made them less sensitive to differences in tipping policies and prices than they would be in real life.

Ideally, future research would test our hypotheses in real restaurants, but controlled experiments on tipping and service-charge policies is not feasible in the field. Realistically, restaurateurs must decide for themselves whether or not they think our findings generalize to their own circumstances. If they find our reasoning and empirical results compelling, then they can run their own case study by implementing changes in their tipping or service-charge policies to see what kind of reactions those changes bring.
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