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The High Cost of Low Wages

by Wayne F. Cascio

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Wal-Mart's legendary obsession with cost containment shows up in countless ways, including aggressive control of employee benefits and wages. Managing labor costs isn't a crazy idea, of course. But stingy pay and benefits don't necessarily translate into lower costs in the long run.

Consider Costco and Wal-Mart's Sam's Club, which compete fiercely on low-price merchandise. Among warehouse retailers, Costco—with 338 stores and 67,600 full-time employees in the United States—is number one, accounting for about 50% of the market. Sam's Club—with 551 stores and 110,200 employees in the United States—is number two, with about 40% of the market.

Though the businesses are direct competitors and quite similar overall, a remarkable disparity shows up in their wage and benefits structures. The average wage at Costco is $17 an hour. Wal-Mart does not break out the pay of its Sam's Club workers, but a full-time worker at Wal-Mart makes $10.11 an hour on average, and a variety of sources suggest that Sam's Club's pay scale is similar to Wal-Mart's. A 2005 *New York Times* article by Steven Greenhouse reported that at $17 an hour, Costco's average pay is 72% higher than Sam's Club's ($9.86 an hour). Interviews that a colleague and I conducted with a dozen Sam's Club employees in San Francisco and Denver put the average hourly wage at about $10. And a 2004 *BusinessWeek* article by Stanley Holmes and Wendy Zellner estimated Sam's Club's average hourly wage at $11.52.

On the benefits side, 82% of Costco employees have health-insurance coverage, compared with less than half at Wal-Mart. And Costco workers pay just 8% of their health premiums, whereas Wal-Mart workers pay 33% of theirs. Ninety-one percent of Costco's employees are covered by retirement plans, with the company contributing an annual average of $1,330 per employee, while 64 percent of employees at Sam's Club are covered, with the company contributing an annual average of $747 per employee.

Costco's practices are clearly more expensive, but they have an offsetting cost-containment effect: Turnover is unusually low, at 17% overall and just 6% after one year's employment. In contrast, turnover at Wal-Mart is 44% a year, close to the industry average. In skilled and semi-skilled jobs, the fully loaded cost of replacing a worker who leaves (excluding lost productivity) is typically 1.5 to 2.5 times the worker's annual salary. To be conservative, let's assume that the total cost of replacing an hourly employee at Costco or Sam's Club is only 60% of his or her annual salary. If a Costco employee quits, the cost of replacing him or her is therefore $21,216. If a Sam's Club employee leaves, the cost is $12,617. At first glance, it may seem that the low-wage approach at Sam's Club would result in lower turnover costs. But if its turnover rate is the same as Wal-Mart's, Sam's Club loses more than twice as many people as Costco does: 44% versus 17%. By this calculation, the total annual cost to Costco of employee churn is $244 million, whereas the total annual cost to Sam's Club is $612 million. That's $5,274 per Sam's Club employee, versus $3,628 per Costco employee.

In return for its generous wages and benefits, Costco gets one of the most loyal and productive workforces in all of retailing, and, probably not coincidentally, the lowest shrinkage (employee theft) figures in the industry. While Sam's Club and Costco generated $37 billion and $43 billion, respectively, in U.S. sales last year, Costco did it with 38% fewer employees—admittedly, in part by selling to higher-income shoppers and offering more high-end goods. As a result, Costco generated $21,805 in U.S. operating profit per hourly employee, compared with $11,615 at Sam's Club. Costco's stable, productive workforce more than offsets its higher costs.

These figures challenge the common assumption that labor rates equal labor costs. Costco's approach shows that when it comes to wages and benefits, a cost-leadership strategy need not be a race to the bottom.

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Cash Daugherty 2 years ago

Questions. Does the management team of Sam's Club know that it could save more money by increasing pay and benefits to employees? Surely they do, right? Is there more to the puzzle of why Walmart and SC employees get so little compensation in light of Costco's performance?

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