

Decency Means More than “Always Low Prices”: A Comparison of Costco to Wal-Mart’s Sam’s Club

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Executive Overview

Wal-Mart’s emphasis on “Always low prices. *Always*” has made it the largest retail operation in history. However, this unrelenting mission has also created a way of doing business that draws substantial criticism regarding the company’s employment practices, relationships with suppliers, and the company’s impact on local economies. This paper focuses on a company that delivers low prices to consumers, but in a fundamentally different way than its competitor, Wal-Mart. That company is warehouse-retailer Costco. In the following sections we will begin by providing some background on the company, including its history, its business model, its ethical principles, core beliefs, and values. Then we will consider some typical Wall Street analysts’ assessments of this approach, followed by a systematic comparison of the financial performance of Costco with that of Sam’s Club, a warehouse retailer that is part of Wal-Mart.

To be sure, Wal-Mart wields its awesome power for just one purpose: to bring the lowest possible prices to its customers. Sam Walton, affectionately known as “Mr. Sam” by Wal-Mart associates, embodied a number of admirable values that he instilled in the company he founded: hard work, discipline, modesty, unpretentiousness, and frugality. By all accounts he also wanted his employees to be motivated, inspired, and happy to work for Wal-Mart. At the same time, however, he was driven, tireless, and determined to drive a hard bargain (Walton, 1992). His brilliance lay in his ability to execute a singularly powerful idea: Sell stuff that people need every day, just a little cheaper than everyone else, sell it at that low price all the time, and customers will flock to you. Wal-Mart’s mission is found as a slogan printed on every Wal-Mart bag: “Always low prices. *Always*.” Wal-Mart’s obsessive focus on that single core value created what has become the largest and most powerful company in history.

The company espouses those same core values today, but ironically, their application is quite different from that in the 1960s, the 1970s, even the 1980s. Today, the very characteristics that allowed Wal-Mart to prosper and grow are the

source of unrelenting criticism. As Fishman (2006) notes, the company’s core values seem to have become inverted, for they now sometimes drive behavior that is not only exploitive, but in some cases, illegal as well. Consider the pressure on store managers to control labor costs. As noted in its 2005 annual report (pp. 45, 46), Wal-Mart is a defendant in numerous class-action lawsuits involving employment-related issues as varied as failure to pay required overtime to hourly employees, challenges to exempt (from overtime) status by assistant store managers, and allegations of gender-based discrimination in pay, promotions, job transfers, training, job assignments, and health-care coverage.

There is another aspect of the Wal-Mart effect that is more troubling, and it concerns how Wal-Mart gets those low prices: low wages for its employees, unrelenting pressure on suppliers, products cheap in quality as well as price, offshoring jobs (Fishman this issue). “Wal-Mart has the power to squeeze profit-killing concessions from suppliers, many of whom are willing to do almost anything to keep the retailer happy, in part because Wal-Mart now dominates consumer markets so thoroughly that they have no

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choice. . . Wal-Mart's price pressure can leave so little profit that there is little left for innovation . . . [As a result] decisions made in Bentonville routinely close factories as well as open them" (Fishman 2006, p. 89).

This paper focuses on a company that is already more than "always low prices." That company is warehouse-retailer Costco—one that may provide an alternative to the Wal-Mart model by delivering low prices to consumers, but not at the cost of employees' wages or quality of life. In the following sections we will begin by providing some background on the company, including its history, its business model, its ethical principles, core beliefs, and values. Then we will consider some typical Wall Street analysts' assessments of this approach, followed by a systematic comparison of the financial performance of Costco with that of Sam's Club, a warehouse retailer that is part of Wal-Mart.

Costco, A Brief History

The company's co-founder and chief executive officer, Jim Sinegal, is the son of a coal miner and steelworker. In 1954, as an 18-year-old student at San Diego Community College, a friend asked him to help unload mattresses for a month-old discounter called Fed-Mart. What he thought would be a one-day job turned into a career. He rose to executive vice-president for merchandising, and became a protégé of Fed-Mart's chairman, Sol Price. Mr. Price is credited with inventing the idea of high-volume warehouse stores that sell a limited number of products.

Sol Price sold Fed-Mart to a German retailer in 1975, and was fired soon after. Mr. Sinegal then left and helped Mr. Price start a new warehouse company, Price Club. Its huge success led others to enter the business: Wal-Mart started Sam's Club, Zayre's started BJ's Wholesale Club, and in 1983 a Seattle entrepreneur, Jeffrey Brotman, helped Mr. Sinegal to found Costco Wholesale Corporation (Greenhouse 2005). The company began with a single store in Issaquah, Washington, outside of Seattle. At the end of fiscal 2005, as the fourth largest retailer in the United States and the ninth largest in the world, it had a total of

460 warehouses in 37 U.S. states, Puerto Rico, and several additional countries: Canada, Mexico, United Kingdom, Taiwan, South Korea, and Japan (Costco Wholesale Corp. annual report 2005). Costco and Price Club merged in 1993.

Business Model

Costco's business model is based on that of Sol Price: sell a limited number of items, keep costs down, rely on high volume, pay workers well, have customers buy memberships, and aim for upscale shoppers, especially small-business owners. In addition, don't advertise—that saves two percent a year in costs.

Consider one key feature of the business model: sell a limited number of items. A typical Costco store stocks 4,000 types of items, including perhaps just four brands of toothpaste. A Wal-Mart, in contrast, typically stocks more than 100,000 types of items, and may carry 60 sizes and brands of toothpastes. Narrowing the number of options increases the sales volumes of each, allowing Costco to squeeze deeper and deeper bulk discounts from suppliers. Among warehouse retailers, Costco is number one in market share, accounting for about half of the sales in the industry. Sam's Club is number two, with 642 stores, and about 40 percent of the market. Sam's Club, however, is not a typical runner-up: it is part of the Wal-Mart empire, which, with \$315.6 billion in 2005 sales, dwarfs Costco's sales of \$52.9 billion in the same year (*Fortune* 500 2006).

In terms of memberships and target customers, at the end of fiscal 2005 Costco had 45.3 million loyal members, each paying \$45 per year to join, with an 86 percent renewal rate. Executive memberships are available both to business and individual members, for an annual fee of \$100, and there were 4.2 million of those at the end of fiscal 2005. The Executive Membership program offers members additional savings and benefits on various business and consumer services offered by Costco (Costco Wholesale Corp. Annual Report 2005). The average annual income of Costco's customers is \$74,000, with 31 percent earning over \$100,000 (Greenhouse 2005).

Ethical Principles, Core Beliefs, and Values

In their most recent letter to shareholders, co-founders Jeff Brotman and Jim Sinegal wrote: “We remain committed to running our company and living conscientiously by our Code of Ethics every day: to obey the law; take care of our members; take care of our employees; respect our suppliers; and reward you, our shareholders” (Costco Wholesale Corp. Annual Report 2005, p. 5). Note the modern-day heresy in Costco’s numbered code of ethics: taking care of customers and employees takes precedence over rewarding shareholders. As we will see below, this has not escaped the critical appraisal of Wall Street analysts.

In contrast to Wal-Mart, which believes, as many other companies do, that shareholders are best served if employers do all they can to hold down costs, including the costs of labor, Costco’s approach is decidedly different. In terms of how it treats its workers, Mr. Sinegal says, “It absolutely makes good business sense. Most people agree that we’re the lowest-cost provider. Yet we pay the highest wages. So it must mean we get better productivity. It’s axiomatic in our business—you get what you pay for” (Shapiro 2004, p. 5).

Wages at Costco start at \$10 an hour, rising to \$18.32, excluding *twice-a-year* bonuses of between \$2,000 and \$3,000 for those at the top wage for more than a year. Its average hourly wage is \$17 an hour. Wal-Mart does not share its wage scale, and does not break out separately the pay of its Sam’s Club workers, but the average pay of a full-time worker at Wal-Mart is \$10.11 an hour (Coleman-Lochner 2006). The pay scale of unionized grocery clerks in the Puget Sound area, very good jobs as far as retail goes, provides a further comparison. Those jobs start at \$7.73 an hour and top out at \$18 (Shapiro 2004).

Labor costs at Costco are expensive, accounting for about 70 percent of the company’s total cost of operations, and they are more than 40 percent higher than those at Wal-Mart. So how can the company compete based on cost leadership and still pay such high wages? According to co-founder Sinegal: “It’s just good business. I mean obviously anyone who is a business person thinks about the importance of people to their

operation. You’ve got to want to get the very best people that you can, and you want to be able to keep them and provide some job security for them. That’s not just altruism, it’s good business” (Frey 2004, p. 3).

Turning Over Inventory Faster Than People

Costco’s wages help keep turnover unusually low, 17 percent overall and just 6 percent after the first year. In contrast, turnover at Wal-Mart is 44 percent per year, close to the retail-industry average (Frontline 2004). “We’re trying to turn our inventory faster than our people,” says Mr. Sinegal. “Obviously it’s not just wages that motivate people. How much they are respected, and whether they feel they can have a career at a company, are also important” (Shapiro 2004, p. 5).

Toward that end, Costco also has some rules about discipline and promotion. An employee with more than two years of service cannot be fired without the approval of a senior company officer. (It used to be that only one of the co-founders, Sinegal or Brotman, could issue this approval.) The company also requires itself to promote internally for 86 percent of its openings in top positions. “In truth, it turns out to be 98 percent” according to Mr. Sinegal (Shapiro 2004, p. 5). By comparison, and this is also very high, 76 percent of all store managers at Wal-Mart started their careers in hourly positions (Wal-Mart 2005 annual report).

Costco’s chief financial officer, Richard Galanti, speaks the same language. “One of the things Wall Street chided us on is that we’re too good to our employees. . . We don’t think that’s possible.” In his office, he keeps a memo from Sol Price, dated August 8, 1967, posted on his bulletin board. It reads: “Although we are all interested in margin, it must never be done at the expense of our philosophy.” To Galanti, there is an object lesson in that approach with respect to employee relations: “Costco is not going to make money at the expense of what’s right” (Shapiro 2004, p. 6).

Costco’s senior vice president for human resources, John Matthews, echoes the same sentiment. “When Jim [Sinegal] talks to us about setting wages and benefits, he doesn’t want us to be

better than everyone else. He wants us to be demonstrably better" (Greenhouse 2005, p. 2).

The View from Wall Street Analysts

How is Costco's treatment of employees received on Wall Street? Not everyone is happy with this business strategy. Some Wall Street analysts argue that Mr. Sinegal is overly generous, not only to Costco's customers, but to its employees as well. They worry that the company's operating expenses could get out of hand. In the opinion of Deutsche Bank Securities, Inc. analyst Bill Dreher, "At Costco, it's better to be an employee or a customer than a shareholder" (Holmes & Zellner 2004, p. 76). Sanford C. Bernstein & Co. analyst Ian Gordon argued similarly: "Whatever goes to employees comes out of the pockets of shareholders" (Shapiro 2004, p. 1).

Another Sanford C. Bernstein & Co. analyst, Emme Kozloff, faulted Mr. Sinegal for being too generous to his employees. She noted that when analysts complained that Costco's workers were paying just 4 percent toward their health-care costs, he raised that percentage only to 8 percent, when the retail average is 25 percent. "He has been too benevolent," she said. "He's right that a happy employee is a productive, long-term employee, but he could force employees to pick up a little more of the burden" (Greenhouse 2005, p. 2). She added, "Their benefits are amazing, but shareholders get frustrated from a stock perspective" (Zimmerman 2004, p. 3).

Like other companies, public and private, small and large, surging health-care costs forced Costco to move aggressively to control expenses. The increase in Costco employees' contribution to 8 percent was the company's first increase in employee health premiums in eight years. According to CEO Jim Sinegal, the company held off from boosting premiums for as long as it could, and it did not give in until it had lowered its earnings forecast twice (Zimmerman 2004).

Analyst Bill Dreher agrees with Emme Kozloff. "From the perspective of investors, Costco's benefits are overly generous. Public companies need to care for shareholders first. Costco runs its business like it is a private company" (Zimmerman 2004, p. 1). According to Mr. Dreher, Costco's

unusually high wages and benefits contribute to investor concerns that profit margins at Costco aren't as high as they should be.

Analyst Ian Gordon also noted another Costco sin: it treats its customers too well. Its bargain-basement prices are legendary, and, as a result, customers flock to its stores. At about the same time that these analysts were commenting on Costco, the company was planning to add staff at checkouts in order to shorten lines. While business schools often teach that caring for customers is a cardinal rule for business success, Wall Street tended to put a different spin on the company's customer-care initiative, as analyst Gordon noted: "It was spending what could have been shareholders' profit on making a better experience for customers" (Shapiro 2004, p. 1).

What is Costco's response to this criticism? According to CEO Sinegal: "On Wall Street they're in the business of making money between now and next Thursday. I don't say that with any bitterness, but we can't take that view. We want to build a company that will still be here 50 and 60 years from now" (Greenhouse 2005, p. 2).

If shareholders mind Mr. Sinegal's philosophy, it is not obvious. Figure 1 shows a 5-year comparison of the performance of Costco's and Wal-Mart's common stock, as of May 1, 2006. Based on an index value of 100 on May 1, 2001, Costco's stock has risen 55 percent during that time period, while Wal-Mart's has fallen 10 percent. According to Forbes.com, on May 20, 2006, Costco shares traded at 24.8 times expected earnings. At Wal-Mart the multiple was 17.4. According to analyst Dreher, Costco's share price is so high because so many people love the company. "It's a cult stock" (Greenhouse 2005, p. 2).

If anything, Costco's approach shows that when it comes to wages and benefits, a cost-leadership strategy need not be a race to the bottom. In the words of CEO Sinegal, "We pay much better than Wal-Mart. That's not altruism, that's good business" (Shields 2005). The contrast is stark and the stakes are high. Which model of competition will predominate in the United States? As we shall see below, Costco's magic lies in its ability to lift productivity, to compete on employee smarts, management savvy, and con-

stant innovation, rather than to skimp on pay and benefits.

Although it is heresy to today's Wall Street analysts, Abraham Lincoln said in his First Annual Message to Congress, December 3, 1861, "Labor is prior to, and independent of, capital. Capital is the fruit of labor and could not exist if labor had not first existed. Labor is the superior of capital and deserves much the higher consideration" (Abraham Lincoln Research Site 2006).

Unfortunately, most companies that compete based on cost-leadership take the low road on wages and benefits, yet Costco shows that treating employees justly and humanely turns out to be very good business indeed. Will Costco's model

work in all situations? Probably not. Wharton professor (and *AMP* editor) Peter Cappelli argued this point recently, when he said, "It's absolutely not true that all those companies that are not being nice to their employees are simply stupid. Nor is it just about good guys and bad guys. There are systematic reasons people adopt the practices they do. . . Companies that compete on price don't necessarily need the same level of skills in their workers as do their higher-end counterparts" (Shapiro 2004, pp. 2, 3).

Fair enough. Even among companies that adopt a low-price strategy, like Sam's Club and Costco, there are important differences in the kinds of customers they serve, the merchandise

Figure 1

Five-year comparison of the performance of Costco and Wal-Mart common stock, May 1, 2001 through May 1, 2006. At May 1, 2001, the index value for each stock was 100.



they sell, and, by extension, in the skill sets of employees they hire. Costco is the largest purveyor of fine wines in the world. It also sells state-of-the-art electronics and Tiffany-style jewelry. Last year it sold 90,000 karats of diamonds, some for more than \$250,000 (Goldberg & Ritter 2005; Shapiro 2004). Make no mistake: there is a socio-economic element to Costco's success.

In contrast, Sam's Club stocks few upper-end items. There are no coats over \$100, no jewelry over \$3,000. Gourmet cheeses and other staples of *la dolce vita* are hard to find (Shapiro 2004). Yet Sam's Club and Costco compete fiercely on lower-cost merchandise. In our next section, therefore, we will consider a fundamental question—namely, why do customers shop at Costco?

Costco's Merchandise and Pricing Strategy

It starts with the buyers. Companies that do business with Sam's Club and Costco, like Mag Instrument, Inc., the manufacturer of Maglite brand flashlights, notice that the warehouse clubs' buyers have far different approaches to selecting merchandise. Sam's Club buyers tend to think about value—meaning price—while Costco's buyers tend to think about value—meaning quality. John Wyatt, Vice-president of sales at Mag Instrument says, "There's just a different mentality, a safer mentality at Sam's, less cutting-edge. Costco's buyers have full authority to do what they want. They're given freedom to make mistakes" (Coleman-Lochner 2006, p. 8C).

Costco CFO Richard Galanti linked the company's employees to the company's popularity with customers. "We certainly believe that the quality of our employees is one very important reason—realizing they're ambassadors to the customer—for our success" (Coleman-Lochner 2006, p. 8C). The fact that Costco rewards workers for treating customers well, through its bonus program, is something you don't see on the shelves, yet it contributes to the stores' popularity. So also does its pricing policy.

To appreciate the pricing policy, consider a single item, men's all-cotton button-down shirts that bear Costco's signature brand name, Kirkland. They sell for \$12.99 each. A few years ago they sold for \$17.99, a bargain even then. Costco

had committed to the manufacturer that it would buy at least 100,000 a year. Two years ago, however, it was selling a million per year. So it negotiated a better price with the manufacturer. As a result, Costco dropped the price it charges customers by \$5 a shirt (Shapiro 2004).

Acknowledging the temptation to charge a little more, CEO Sinegal asks, "Who the hell's going to notice if you charge \$14.99 instead of \$12? Well, we're going to know. It's an attitudinal thing—you always give the customer the best deal" (Shapiro 2004, p. 9). That is the essence of Costco's pricing strategy: wow consumers with unbelievably low prices so they keep coming in.

In fact, Costco sets a strict cap on its profit margin per item: 14 percent for all goods except Kirkland-brand items, which have a 15 percent cap. Department stores typically mark up items by 30 percent or more. That cap on markup stays the same no matter how great the demand or how limited the supply. As with Kirkland-brand shirts, the more people want an item, the cheaper it becomes. Costco gets away with this because of volume (Shapiro 2004).

CEO Sinegal is famous for his ferocious attention to detail, price, and focus on the customer. As he has said, "We're very good merchants and we offer value. The traditional retailer will say, 'I'm selling this for \$10. I wonder whether I can get \$10.50 or \$11.' We say, 'We're selling it for \$9. How do we get it down to \$8?' We understand that our customers don't come and shop with us because of the Santa Claus or the piano player. They come and shop with us because we offer great values" (Greenhouse, 2005 p. 2).

Relations with Suppliers

Fishman (2006 this issue), and others (Welch & Welch 2006) have described Wal-Mart's legendary squeeze plays on its suppliers. Costco takes a slightly different, but no less tough, approach toward its suppliers. It simply warns suppliers not to offer other retailers lower prices than Costco gets.

When a frozen-food supplier mistakenly sent Costco an invoice meant for Wal-Mart, Mr. Sinegal discovered that Wal-Mart was getting a better price. Costco has not brought that supplier back. Costco

has to be flinty, because the competition is so fierce. Says Mr. Sinegal, “We have to be competitive against the biggest competitor in the world. We cannot afford to be timid” (Greenhouse 2005, p. 3).

Nor can Costco allow personal relationships to get in the way. As an example, consider what happened when Starbucks did not pass on savings from a drop in coffee-bean prices. Although Mr. Sinegal is a friend of Starbucks Chairman Howard Schultz, Mr. Sinegal warned that he would remove Starbucks coffee from his stores unless it cut its prices. Starbucks relented. According to Tim Rose, Costco’s Senior Vice-President for food merchandizing, “Howard said, ‘Who do you think you are, the price police?’” Mr. Sinegal replied emphatically that he was (Greenhouse 2005, p. 4).

To sum up the previous two sections, a reasonable conclusion is that Costco offers high-quality merchandise at low prices, and it does not hesitate to lean on its suppliers—all of its suppliers—to ensure that it is getting as good a deal as any other retailer. What it sacrifices in margin it makes up in volume. Such frugality extends to the chief executive officer’s pay, but when it comes to Costco employees, generous benefits and accommodation to labor unions set Costco apart from almost any other retailer.

CEO Pay and Employee Benefits at Costco

For the last three years, CEO Sinegal has received a salary of \$350,000, excluding stock options. That is very low for a CEO of a \$52 billion-per-year business. By comparison, the typical CEO of a large American company makes more than 430 times the pay of the average worker (*NBC Nightly News* 2006). In a 2005 interview with *ABC News* Mr. Sinegal said, “I figured that if I was making something like 12 times more than the typical person working on the floor, that was a fair salary.” Of course, as a co-founder of the company, Sinegal owns a lot of Costco stock—more than \$150 million worth. He’s rich, but only on paper (Goldberg & Ritter 2005).

In terms of employee benefits, Costco contributes generously to its workers’ 401(k) plans, starting with 3 percent of salary the second year, and rising to 9 percent after 25 years. Its insurance

programs absorb most dental expenses. Costco workers pay 8 percent of their health premiums. Full-time workers are eligible for health insurance after three months, and part-timers after six months. The retail-industry average is 23 percent (Coleman-Lochner 2006). Eighty-five percent of Costco employees have health-insurance coverage, compared to less than half at Wal-Mart and Target (Greenhouse 2005).

Perhaps Chief Financial Officer Richard Galanti best sums up Costco’s philosophy of employee relations. “From day one, we’ve run the company with the philosophy that if we pay better than average, provide a salary people can live on, have a positive environment and good benefits, we’ll be able to hire better people, they’ll stay longer, and be more efficient” (Zimmerman 2004, pp. 2–3).

In return for all of its largesse, Costco does enjoy low employee turnover, as we mentioned earlier, but it also reaps a less obvious benefit: low inventory shrinkage. Shrinkage is a combination of employee theft, shoplifting, vendor fraud, and administrative error. Of these four components, employee theft is by far the largest contributor. How much does shrinkage cost? A 2002 study by Ernst & Young of 55 of the largest and most successful American retailers operating an average of 1,076 stores with mean revenues of approximately \$8.8 billion, revealed that the average loss was 1.7 percent of sales, or roughly \$19 million annually (Ernst & Young, 2003). At a national level that amounts to more than \$31 billion, costing the average family of four more than \$440 a year in higher prices (“Retail theft,” 2002). Costco’s inventory shrinkage is the lowest in the industry, well below 0.20 percent of sales for fiscal 2005 (Costco Wholesale Corp. annual report 2005). That also keeps prices low for consumers.

Health-Care Insurance at Wal-Mart and Target

As of February, 2006, Wal-Mart’s own count indicates that 46 percent of its employees are enrolled in company health plans. With an average income of \$20,000 a year, they spend 8 percent of their income on health care insurance,

nearly twice the national average (Gogoi & Berner 2006). They also pay 33 percent of their health-care insurance premiums (Coleman-Lochner 2006). To make matters worse, a CBS *News* report of an internal Wal-Mart memo from the fall of 2005 indicated that 46 percent of the children of Wal-Mart workers were uninsured or on public health care ("Unions protest" 2006).

In response, Wal-Mart has announced improvements to its health-care insurance offerings, effective May 13, 2006. While full-time employees wait 180 days to be eligible for health-insurance coverage, part timers (those who work fewer than 34 hours a week) will be eligible after one year of working at the company, down from two years previously. (The average wait in the retail industry is less than 90 days, Coleman-Lochner 2006.) Part-timers also will be able to add their children to their coverage for the first time. In addition, the company cut co-pays on some generic medicines from \$10 to \$3 and offers 20 percent discounts on prescription drugs otherwise not covered. These changes will affect more than 150,000 part-time workers (Gogoi & Berner 2006).

In April 2006, Target Corporation changed its health-care plan so that its 300,000 employees are responsible for more of the costs, and it is considering eliminating its traditional health insurance entirely. Under its new plans, Target will make annual contributions of \$400 for individual workers and \$800 for families. Monthly premiums will drop to as little as \$20 for individuals, but deductibles will be as high as \$5,000. The other alternative is an employer-funded health-reimbursement account that is not portable. Premiums paid by workers are higher, but deductibles are lower (Zimmerman 2006).

These moves are an attempt to reign in rising health-care costs. According to the Kaiser Family Foundation, health-care premiums paid by workers and their employers jumped 73 percent between 2000 and 2005 (Zimmerman 2006). Comparisons to Wal-Mart and Target, two of Costco's major competitors, bring the generosity of Costco's health-care benefits into even starker relief.

Relations with Unions

When 70,000 employees of the nation's three largest grocery chains, Kroger, Safeway, and Albertson's, went on strike in Southern California in 2004, Costco avoided the fray, quietly renegotiating a separate contract with its union employees there. The three-year deal, which was ratified by more than 90 percent of the workers, included higher wages and increased company contributions to employee pension plans.

In contrast, the strike at the supermarket chains lasted four months before a settlement was reached on February 29, 2004. It resulted in cuts in wages and benefits for new workers, thereby creating a two-tier system in which new workers coming in do not have the same wages and benefits as older workers (Frontline 2004).

About 13 percent of Costco's employees belong to unions (in California, Maryland, New Jersey, New York, and Virginia), and they work at warehouses that were previously Price Club locations (Frey, 2004). The relative labor peace is symbolic of the company's relations with its employees. According to Rome Aloise, an international union representative for the Teamsters, Costco is one of the better companies he deals with. "They gave us the best agreement of any retailer in the country." The contract guarantees employees at least 25 hours of work a week, and requires that at least half of a store's employees be full time (Greenhouse 2005).

Wal-Mart takes a different tack. Its official stance, as stated on its Website, Walmart-facts.com, is as follows:

Our Wal-Mart union stance is simple. There has never been a need for a Wal-Mart union due to the familiar, special relationship between Wal-Mart associates and their managers. Wal-Mart has encouraging and advantageous relationships with both our loyal and happy associates on the floor of each Wal-Mart facility and our wonderful managerial staff. There has yet to be a standard in Wal-Mart union history for a union to be needed.

According to the *Los Angeles Times*, at the first sign of union activity, Wal-Mart managers are supposed to call a hotline, prompting a visit from a special team from Wal-Mart headquarters. Wal-Mart spokesperson Mona Williams told the *Times*

that such teams do exist, but that their purpose is merely to help managers respond effectively and legally to union organizing activity. Judges have ruled in cases across the country that Wal-Mart has illegally influenced employees seeking to organize (Frontline 2004).

A few Wal-Mart employees have succeeded in organizing. A Wal-Mart store in Jonquière, Canada was certified as a union shop, represented by the United Food & Commercial Workers (UFCW), in August, 2004. Two months later, just as the UFCW and Wal-Mart representatives were preparing to begin mandatory contract negotiations, Wal-Mart Canada issued an ominous press release from its headquarters near Toronto. "The Jonquière store is not meeting its business plan, and the company is concerned about the economic viability of the store." In February, 2005, before a collective-bargaining agreement was reached, Wal-Mart closed the store (Bianco 2006).

In 2000, 10 butchers at a Wal-Mart Supercenter in Jacksonville, Texas, voted to join a union. Less than a month later, Wal-Mart switched to pre-packaged meats, eliminating jobs for butchers from its stores nationwide (Frontline 2004).

Having examined business models, pricing strategies, and employment policies at Costco and some of its competitors, it is appropriate to look at their relative financial and operating performance in the marketplace. To do that, we will compare some relevant operating and financial-performance statistics of warehouse retailer Sam's Club, a business unit of Wal-Mart, to those of Costco.

Costco versus Sam's Club: A Test of High- and Low-Wage Strategies

All data in this section come from the 2005 annual reports of Costco and Wal-Mart, unless otherwise noted. In 2005 Costco employed approximately 67,600 workers at its 338 warehouses in the United States, while Sam's Club employed approximately 110,200 at its 551 U. S. warehouses.¹ In terms of wages alone, a Costco employee earned, on average, \$35,360

(\$17 per hour). The average Sam's Club employee earned \$21,028 (\$10.11 per hour).² Labor rates at Costco are therefore more than 40 percent higher than those at Sam's Club. One important effect of high-versus-low wages is on employee turnover, and the financial effects of such turnover. These effects are quite different at Costco and Sam's Club.

The fully loaded cost of replacing a worker who leaves (separation, replacement, and training costs), depending on the level of the job, typically varies from 1.5 to 2.5 times the annual salary paid for that job, excluding lost productivity (Cascio 2000). To be extremely conservative, let us assume that the fully loaded cost to replace an hourly employee at Costco or Sam's Club costs only 60 percent of his or her annual salary.

If a Costco employee quits voluntarily, the fully loaded cost to replace him or her is therefore \$21,216. If a Sam's Club employee leaves, the cost is \$12,617. At first glance it may look like the low-wage strategy at Sam's Club yields greater savings in turnover. But wait. Employee turnover at Costco is 17 percent per year (11,492 employees), excluding seasonal workers (Coleman-Lochner 2006). At Sam's Club it is more than 2.5 times higher, 44 percent a year (48,488 employees) (Frontline 2004). The total annual cost to Costco is therefore $\$21,216 \times 11,492 = \243.81 million, while the total annual cost to Sam's Club is $\$12,617 \times 48,488 = \611.77 million.

Of course the overall costs and numbers of employees who leave at Sam's Club is higher, because it employs more people. If Costco had an annual employee-turnover rate equivalent to that of Sam's Club (44 percent), that is, 29,744 employees who leave, its annual cost would be \$631.05 million. Costco's opportunity savings (costs not incurred) therefore are \$387.24 million

Costco had 338 warehouses in the United States. In 2005 Sam's Club had 551 U. S. warehouses.

² The average wage rate for Costco employees was reported in Coleman-Lochner (2006). The average wage rate for Sam's Club employees is based on the average wage rate for Wal-Mart's hourly workers. The company does not identify the pay rate of Sam's Club employees separately. Annual wages are computed by multiplying 2,080 (40 hours per week x 52 weeks) times the average employee's hourly wage in each company.

¹ These figures were derived under the assumption that each warehouse at Sam's Club and Costco employs an average of 200 workers. In 2005

per year.³ Averaged over the total number of employees at each firm, however, the per-employee cost at Sam's Club is still higher, \$5,274.41 versus \$3,628.11 at Costco. High employee-turnover rates are expensive any way you look at it.

Wages are not the only distinguishing characteristic between the two retailers. At Costco, 85 percent of employees are covered by the company's health-care insurance plan, with the company paying an average of \$5,735 per worker. Sam's Club covers 47 percent of its workers, at an average annual outlay of \$3,500 (Greenhouse 2005; Holmes & Zellner). Fully 91 percent of Costco's employees are covered by retirement plans, with the company contributing an average of \$1,330 per employee, versus 64 percent of employees at Sam's Club, with the company contributing an average of \$747 per employee (Holmes & Zellner 2004).

In return for all of its generosity, Costco gets one of the most loyal and productive workforces in all of retailing. While Sam's Club's 110,200 employees generated some \$37.1 billion in U. S. sales in 2005, Costco did \$43.05 billion in U. S. sales with 38 percent fewer employees. As a result, Costco generated \$21,805 in U. S. operating profit per hourly employee, compared to \$11,615 at Sam's Club.⁴

Costco's productive workforce more than offsets its higher costs. Labor and overhead costs at Costco (selling, general, and administrative expenses, or SG&A) were 9.73 percent of sales in 2005. Wal-Mart does not break out SG&A at Sam's Club, but it is likely higher than at Costco, but lower than Wal-Mart's 17 percent of sales. By comparison, it was 24 percent at Target Stores (Holmes & Zellner 2004). Costco's motivated employees also sell more: \$886 of sales per square

foot, versus only \$525 of sales per square foot at Sam's Club, and \$461 at BJ's Wholesale Club, its other primary club rival.⁵

These figures illustrate nicely the common fallacy that labor rates equal labor costs. Costco's hourly labor rates are more than 40 percent higher than those at Sam's Club (\$17 versus \$10.11), but when employee productivity is considered (sales per employee), Costco's labor costs are lower than those at Sam's Club (5.55 percent at Costco versus 6.25 percent at Sam's Club).⁶

Conclusions

As Holmes and Zellner (2004) noted, "Given Costco's performance, the question for Wall Street shouldn't be why Costco isn't more like Wal-Mart. Rather, why can't Wal-Mart deliver high shareholder returns and high living standards for its workforce?" Says Costco CEO James Sinegal: "Paying your employees well is not only the right thing to do, but it makes for good business" (p. 77).

To make its high-wage strategy pay off, however, Costco is constantly looking for ways to increase efficiency, such as by repackaging goods into bulk items to reduce labor, speeding up Costco's just-in-time inventory and distribution system, and boosting sales per square foot. Nor have rivals been able to match Costco's innovative packaging or merchandising mix. For example, Costco was the first wholesale club to offer fresh meat, pharmacies, and photo labs.

Defenders of Wal-Mart's low-wage strategy focus on the undeniable benefits its low prices bring to consumers, but the broader question is this: Which model of competition will predominate in the United States? While shareholders may do

³ \$631.05 million (costs that would be incurred with a 44 percent turnover rate) minus \$243.81 million (costs actually incurred with a 17 percent turnover rate) = \$387.24 million.

⁴ Wal-Mart measures the profit of each of its segments, of which Sam's Club is one, as "segment operating income," which is defined as income from continuing operations before net income expense, income taxes, and minority interest (Wal-Mart 2005 annual report, p. 48). Sam's Club's operating income for 2005 was \$1.28 billion. At Costco, it was \$1.474 billion. When Sam's Club's operating income is divided by the number of employees (110,200) it equals \$11,615.25. When Costco's operating income is divided by the number of employees (67,600) it equals \$21,804.73.

⁵ In its 2005 annual report, Costco reported that each of its warehouses averaged \$124 million in sales, and that each warehouse averaged 140,000 square feet. Wal-Mart's 2005 annual report showed Sam's Club's total square footage as 70.7 million, with \$37.119 billion in sales. Information for BJ's Wholesale Club for 2005 comes from the 5-year financial-information summary presented at following website: <http://www.bjinvestor.com/factsheet.cfm>.

⁶ These figures were computed as follows. Costco generates \$636,849 in annual sales per employee, and it pays each employee an average of \$35,360 in wages. That is 5.55 percent of the sales generated. Sam's Club generates \$336,660 in annual sales per employee, and it pays each employee an average of \$21,028 in wages. That is 6.25 percent of the sales generated.

just as well with either strategy over the long run, it is important to note that the cheap-labor model is costly in many ways. It can lead to poverty and related social problems, and transfer costs to other companies and taxpayers, who indirectly pay the health-care costs of all the workers not insured by their frugal employers.

Fishman (this issue) described the extent to which Wal-Mart shifts the burden of payments for health care to taxpayers in Georgia and Tennessee. Those are not the only states where this has occurred. According to a study by the Institute for Labor and Employment at the University of California, Berkeley, California, taxpayers subsidized \$20.5 million for medical care for Wal-Mart employees in that state alone (Chase 2003).

At a broader level, the Democratic Staff of the Committee on Education and the Workforce estimates that one 200-person Wal-Mart store may result in a cost to federal taxpayers of \$420,750 per year—about \$2,103 per employee (Democratic Staff 2004). Those additional public costs stem from items such as the following for qualifying Wal-Mart employees and their families: free and reduced lunches, housing assistance, federal tax credits and deductions for low-income families, additional federal health-care costs of moving into state children's health-insurance programs, and low-income energy assistance.

If a large number of employers adopted the same low-wage strategy, their policies would certainly reduce the wages of U. S. workers, along with their purchasing power and standards of living. Such a low-wage strategy would crimp consumer spending, and constrict economic growth. In that sense, Wal-Mart is a problem, but also an opportunity (Fishman, this issue). Consumer sentiment may provide some encouragement. Thus, in a recent survey (*USA Today*, 2005), 89 percent of consumers said they would be willing to spend "a little extra" for products that are produced by companies that pay workers good wages and have good working conditions. Only 10 percent of respondents answered "no" to that item, and 1 percent were unsure. Costco's strategy of combining high wages and benefits with innovative ideas and a productive workforce shows that consumers,

workers, and shareholders all can benefit from a cost-leadership strategy.

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