TWELFTH EDITION

COMPENSATION

JERRY M. NEWMAN

BARRY GERHART

GEORGE T. MILKOVICH

Mc Graw Hill Education

Compensation

Twelfth Edition

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Preface

A few books can change your life. Our book may not be one of them. However, if you read it, you will better understand that *pay matters*. After all, you can't pick up a newspaper, power up a computer, or read a blog today without someone talking about compensation. The Great Recession had major ramifications for pay. Some folks had their hours cut and/or their pay frozen or reduced. Why? Because it's a way to cut compensation costs (though not necessarily the benefits portion of compensation costs) without laying off workers. Others, of course, were laid off and lost their jobs, income, and benefits. The recession also focused attention on executive compensation. As the government bailed out the financial industry, newspapers were reporting large bonuses going to the very employees who helped cause the financial disaster. With the end of the recession, we saw employers put less emphasis on cutting labor costs and more emphasis on hiring (sometimes even in the United States). However, job growth was initially quite modest. Why? Employers have become increasingly careful about adding new workers because they want to keep costs under control and they don't want to have to reduce the workforce if they guess wrong about increasing product demand (and the need for more workers). But competition for some types of workers has increased and wages, salaries, and benefits have likewise increased for such workers, meaning that employers must continually evaluate and benchmark their pay to be competitive.

Pay also matters around the globe. For example, if you are a Russian cosmonaut, you can earn a bonus of $1,000 for every space walk you take (technically known as "extravehicular activity," or EVA), up to three per space trip. A contract listing specific tasks to be done on a space mission permits you to earn up to $30,000 above the $20,000 you earn while you are on the ground. (In contrast to the Russian cosmonauts, wealthy Americans are lining up to pay $15 million [plus an additional $20 million airfare] to the Russian Space Agency for their own personal EVA.) Conclusion: *Pay matters.*

If you read this book, you will also better understand that *what you pay for matters.* Many years ago, when Green Giant discovered too many insect parts in the pea packs from one of its plants, it designed a bonus plan that paid people for finding insect parts. Green Giant got what it paid for: insect parts. Innovative Green Giant employees brought insect parts from home to add to the peas just before they removed them and collected the bonus.

The Houston public school district also got what it paid for when it promised teachers bonuses of up to $6,000 if their students' test scores exceeded targets. Unfortunately, several teachers were later fired when it was discovered that they had leaked answers to their students and adjusted test scores.

Such problems are global. A British telephone company paid a cash bonus to operators based on how quickly they completed requests for information. Some operators discovered that the fastest way to complete a request was to give out a wrong number or—even faster—just hang up on the caller. "We're actually looking at a new bonus scheme," says an insightful company spokesperson. Conclusion: *What you pay for matters.*

If you read this book, you will also learn that *how you pay matters.* Motorola trashed its old-fashioned pay system that employees said guaranteed a raise every six months if you were still breathing. The new system paid for learning new skills and working in teams. Sound good? It wasn't. Employees resented those team members who went off for six weeks of training at full pay while remaining team members picked up their work. Motorola was forced to get rid of its new-fashioned system, too.

Microsoft employees were also grumbling. More were leaving; top recruits were going elsewhere. The lackluster performance of Microsoft stock was depressing the value of the eye-popping stock options the company routinely doled out. What to do? Rather than stock options, Microsoft changed its pay system to give employees actual shares of stock with a value that was immediately known. This move increased the value of employees' pay and eliminated the risk they faced from the stock performance. What did Microsoft get? Happier, more expensive people. No word yet on product innovation, customer satisfaction, or even quality of new hires. Conclusion: *How you pay matters.*

We live in interesting times. Anywhere you look on the globe today, economic and social pressures are forcing managers to rethink how people get paid and what difference it makes. Traditional approaches to compensation are being questioned. But what is being achieved by all this experimentation and change? We have lots of fads and fashions, but how much of it is folderol?

In this book, we strive to cull beliefs from facts, wishful thinking from demonstrable results, and opinions from research. Yet when all is said and done, managing compensation is part science, but also part art.

ABOUT THIS BOOK

This book focuses on the strategic choices in managing compensation. We introduce these choices, real-world issues that managers confront from New York to New Zealand and all points between, in the total compensation model in Chapter 1. This model provides an integrating framework that is used throughout the book. Major compensation issues are discussed in the context of current theory, research, and practice. The practices illustrate new developments as well as established approaches to compensation decisions.

Each chapter contains at least one *e-Compensation box* to point you to some of the vast compensation information on the Internet. Real-life *Your Turn* cases ask you to apply the concepts and techniques discussed in each chapter. For example, the Your Turn in Chapter 9 draws on Professor Newman's experience when he worked undercover for 14 months in seven fast-food restaurants. The case takes you into the gritty details of the employees' behaviors (including Professor Newman's) during rush hour, as they desperately work to satisfy the customers' orders and meet their own performance targets set by their manager. You get to recommend which rewards will improve employees' performance (including Professor Newman's) and customers' satisfaction. We tackle major compensation issues from three sides: theory, research, and practice—no problem can survive that onslaught!

The authors also publish *Cases in Compensation,* an integrated casebook designed to provide additional practical skills that apply the material in this book. The casebook is available directly from the authors (e-mail: cases.in.compensation@gmail.com). Completing the integrated case will help you develop skills readily transferable to future jobs and assignments. Instructors are invited to e-mail for more information on how *Cases in Compensation* can help translate compensation research and theory into practice and build competencies for on-the-job decisions.

But *caveat emptor!* "Congress raises the executive minimum wage to $565.15 an hour," reads the headline in the satirical newspaper *The Onion* (www.onion.com, "America's Finest News Source"). The article says that the increase will help executives meet the federal standard-of-easy-living. "Our lifestyles are expensive to maintain," complains one manager. Although the story in *The Onion* may clearly be fiction, sometimes it is more difficult to tell. One manager told us that when she searched for this textbook in her local bookstore, store personnel found the listing in their information system—under fiction!

WHAT'S NEW

All chapters have been revised, in recognition of ongoing changes at organizations and in their competitive environments around the world. Many examples are provided of the current pay strategies or practices used in specific, named companies. Some of these are well established and successful (Apple, IBM, Microsoft, Merrill Lynch, Nucor, Toyota), some face real problems (American Airlines, Best Buy, General Motors), and others are using unique practices (Google, Whole Foods). Whenever possible, we observe how the challenges faced by these companies have evolved over time. This edition continues to emphasize the importance of total compensation and its relevance for achieving sustainable competitive advantage. It reinforces our conviction that beyond *how much* people are paid, *how* they are paid really matters. Managing pay means ensuring that the right people get the right pay for achieving objectives in the right way. Greater emphasis is given to theoretical advances and evidence from research. Throughout the book we translate this evidence into guidance for improving the management of pay.

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Part **One**

Introducing the Pay Model and Pay Strategy

Why do we work? If we are fortunate, our work brings meaning to our lives, challenges us in new and exciting ways, brings us recognition, and gives us the opportunity to interact with interesting people and create friendships. Oh yes—we also get a paycheck. Here in Part One of your book, we begin by talking about what we mean by "pay" and how paying people in different ways can influence them and, in turn, influence organization success. Wages and salaries, of course, are part of compensation, but so too, for some employees, are bonuses, health care benefits, stock options, and/or work/life balance programs.

Compensation is one of the most powerful tools organizations have to influence their employees. Managed well, it can play a major role in organizations successfully executing their strategies through their employees. We will see how companies like Whole Foods, Nucor, the SAS Institute, Microsoft, Google, and others use compensation to attract, motivate, and retain the right employees to execute their strategies. We will also see how companies like Apple sell premium products at attractive price points, to an important degree by using suppliers that have low labor costs. Managed less well, as bankruptcies at General Motors, Chrysler, Lehman Brothers, and American Airlines (which stated that it needed to reduce labor costs by $1.25 billion per year to be competitive), for example, might indicate, compensation decisions can also come back to haunt you. In Part One, we describe the compensation policies and techniques that organizations use and the multiple objectives they hope to achieve by effectively managing these compensation decisions.

Although compensation has its guiding principles, we will see that "the devil is in the details" and how any compensation program is specifically designed and implemented will help determine its success. We want you to bring a healthy skepticism when you encounter simplistic or sweeping claims about whether a particular way of managing compensation does or does not work. For example, organizations, in general, benefit from pay for performance, but there are many types of pay for performance programs and it is not always easy to design and implement a program that has the intended consequences (and avoids *unintended* consequences). So, general principles are helpful, but only to a point.

Thus, in Part One, our aim is to also help you understand how compensation strategy decisions interact with the specific context of an organization (e.g., its business and human resource strategies) to influence organization success. We emphasize that good theory and research are fundamental to not only understanding compensation's likely effects, but also to developing that healthy skepticism we want you to have toward simplistic claims about what works and what does not.

Chapter **One**

The Pay Model

Chapter Outline

COMPENSATION: DOES IT MATTER? (OR, "SO WHAT?")

Why should you care about compensation? Do you find that life goes more smoothly when there is at least as much money coming in as going out? (Refer, for example, to the lyrics for the Beatles' song "Money.")[1] They say something like: it's true money doesn't buy everything, but if money can't buy it, I can't use it. OK, maybe something of an exaggeration, but . . . . Yes? Well, of course, it is the same for companies. It really does help to have as much money coming in (actually, more is better) as going out. Until recently, workers at Chrysler got total compensation (i.e., wages plus benefits) of about $76 per hour, whereas U.S. workers at Toyota received $48 per hour and the average total compensation per hour in U.S. manufacturing was $25 (and $16 in Korea, $3 in Mexico). It is one thing to pay more than your competitors if you get something more (e.g., higher productivity and/or quality) in return. But, Chrysler was not. So, the "strategy" was not sustainable. It ended up going through bankruptcy, being bought out by Fiat, and then reducing worker compensation costs as part of its strategy for return to competitiveness. Specifically, Chrysler took steps (as part of its bankruptcy plan) to bring its hourly labor costs down to about $49 more recently.[2]

General Motors (GM), like Chrysler, has, for decades, paid its workers well—too well perhaps for what it received in return. So what? Well, in 1970, GM had 150 U.S. plants and 395,000 hourly workers. In sharp contrast, GM now has 40 U.S. manufacturing plants and 51,000 U.S. hourly workers.[3] In June 2009, GM, like Chrysler, had to file for bankruptcy (avoiding it for a while thanks to loans from the U.S. government—i.e., you, the taxpayer). Not all of GM's problems were compensation related. Of course, building too many vehicles that consumers did not want was also a problem. But, having labor costs higher than the competition, without corresponding advantages in efficiency, quality, and customer service, does not seem to have served GM or its stakeholders well. Its stock price peaked at $93.62/share in April 2000. Its market value was about $60 billion in 2000. That shareholder wealth was wiped out in bankruptcy. Think of the billions of dollars the U.S. taxpayer had to put into GM. Think of all the jobs that have been lost over the years and the effects on communities that have lost those jobs.

On the other hand, Nucor Steel pays its workers very well relative to what other companies inside and outside of the steel industry pay. But Nucor also has much higher productivity than is typical in the steel industry. The result: Both the company and its workers do well. Apple Computer is able to keep prices for its iPad and iPhone lower than otherwise by outsourcing manufacturing to China in facilities owned by the Hon Hai Precision Industry Co., Ltd (Foxconn), a Taiwanese company. (See Chapter 7.) As we will see later, doing so generates billions (yes, billions with a "b") of dollars in cost savings per year. Google and Facebook are companies that are known for paying very well. So far, that seems to have worked in that their high pay allows them to be very selective in who they hire and who they keep and they would say that their talent rich strategy has helped them to foster growth and innovation.

Wall Street financial services firms and banks used **incentive** plans that rewarded people for developing "innovative" new financial investment vehicles and for taking risks to earn themselves and their firms a lot of money.[4] That is what happened—until several years ago. Then, the markets discovered that many such risks had gone bad. Blue Chip firms such as Lehman Brothers slid quickly into bankruptcy, whereas others like Bear Stearns and Merrill Lynch survived to varying degrees by finding other firms (J.P. Morgan and Bank of America, respectively) to buy them. The issue has not gone away. Recently, U.S. Federal Reserve officials have "made it clear that they believe bad behavior at banks goes deeper than a few bad apples and are advising firms to track warning signs of excessive risk taking and other cultural breakdowns." In the words of one Fed official, "Risk takers are drawn to finance like they are to Formula One racing." An important driver of risk taking among traders and others is the incentive system that encourages them to be "confident and aggressive" and that often results in those who thrive under this incentive rising to top leadership positions at the banks.[5]

Does greater expertise in the design and execution of compensation plans play a role in controlling excessive risk taking and other problematic behaviors and encouraging a more positive culture? Congress and the president seemed to think so, because in hopes of avoiding a similar financial crisis in the future they put into place legislation, the Troubled Asset Relief Program (TARP), which included restrictions on executive pay designed to discourage executives from taking "unnecessary and excessive risks." Another commentator agreed. In an opinion piece in *The Wall Street Journal,* entitled "How Business Schools Have Failed Business," the former director of corporate finance policy at the United States Treasury argued that misaligned incentives were a major cause of the global financial crisis (see above) and he wondered how many of the business schools that educated top executives and directors included a course on how to design compensation systems. His answer: not many. Our book, we hope, can play a role in helping to better educate you, the reader, about the design of compensation systems, both for managers and for workers.

How people are paid affects their behaviors at work, which affect an organization's success.[7] For most employers, compensation is a major part of total cost, and often it is the single largest part of operating cost. These two facts together mean that well-designed compensation systems can help an organization achieve and sustain competitive advantage. On the other hand, as we have recently seen, poorly designed compensation systems can likewise play a major role in undermining organization success.

COMPENSATION: DEFINITION, PLEASE

How people view compensation affects how they behave. It does not mean the same thing to everyone. Your view probably differs, depending on whether you look at compensation from the perspective of a member of society, a stockholder, a manager, or an employee. Thus, we begin by recognizing different perspectives.

Society

Some people see pay as a measure of justice. For example, a comparison of earnings between men and women highlights what many consider inequities in pay decisions. In 2013, among full-time workers in the United States, U.S. Bureau of Labor Statistics data indicate that women earned 82 percent of what men earned, up from 62 percent in 1979.[8] If women had the same education, experience, and union coverage as men and also worked in the same industries and occupations, the ratio would increase, but most evidence suggests that no more than one-half of the gap would disappear. Thus, under even a best case scenario, such adjustments would increase the women/men earnings ratio to as high as about 90 percent, still leaving a sizable gap.[9] Society has taken an interest in such earnings differentials. One indicator of this interest is the introduction of laws and regulation aimed at eliminating the role of discrimination in causing them.[10] (See Chapter 17.)

Benefits given as part of a total compensation package may also be seen as a reflection of equity or justice in society. Employers spend about 44 cents for benefits on top of every dollar paid for **wages** and **salaries**.[11] Individuals and businesses in the United States spend $2.9 trillion per year, or 17.4 percent of its economic output (gross domestic product) on health care.[12] Nevertheless, roughly 41 million people in the United States (14 percent of the population) have no health insurance.[13] (The Affordable Care Act of

2010 is aimed at increasing coverage and one projection is the number of uninsured will decrease to 23 million by 2023.)[14] A major reason is that the great majority of people (who are under the age of 65 and not below the poverty line) obtain health insurance through their employers, but small employers, which account for a substantial share of employment, are much less likely than larger employers to offer health insurance to their employees. As a result, 8 in 10 of the uninsured in the United States are from working families.[15] Given that those who do have insurance typically have it through an employer, it also follows then that as the unemployment rate increases, health care coverage declines further. Some users of online dating services provide information on their employer-provided health care insurance. Dating service “shoppers” say they view health insurance coverage as a sign of how well a prospect is doing in a career.

Job losses (or gains) in a country over time are partly a function of relative labor costs (and productivity) across countries. People in the United States worry about losing manufacturing jobs to Mexico, China, and other nations. (Increasingly, white collar work in areas like finance, computer programming, and legal services is also being sent overseas.) Exhibit 1.1 reveals that the hourly compensation (wages plus benefits) for Mexican manufacturing work ($6.82) are about 19 percent of those paid in the United States ($36.34). China’s estimated $3.38 per hour is about 9 percent of the U.S. rate. However, the value of what is produced also needs to be considered. Productivity in China is about 22 percent of that of U.S. workers, whereas Mexican worker productivity is 30 percent of the U.S. level.[16] Finally, if low wages are the goal, there always seems to be somewhere that is lower. Some companies (e.g., Coach) are now moving work from China because its hourly wage, especially after recent increases, is not as low as in countries like Vietnam, India, and the Philippines. However, for other companies such as Foxconn, which builds iPhones and iPads for Apple, even with rapid increases in wages in China, labor costs remain very low in China compared to those in the United States and other advanced economies and Foxconn appears to be poised to continue having a larger presence in China.[17] (We return to the topic of international comparisons in Chapter 7 and Chapter 16.)

EXHIBIT 1.1 Hourly Compensation Costs for Production Workers in Manufacturing and Economy-wide Productivity (Gross Domestic Product, GDP, per Employed Person), in U.S. Dollars

	Hourly Compensation Cost	Productivity (GDP per employee)
China	3.38	15,250
Mexico	6.82	20,275
Czech Republic	12.17	26,781
United States	36.34	68,374
Germany	49.98	42,343

Source: Hourly Compensation Cost: The Conference Board. International Comparisons of Hourly Compensation Costs in Manufacturing, 2013. December 2014. Productivity: The World Bank. http://data.worldbank.org/indicator/SL.GDP.PCAP.EM.KD. Extracted February 3, 2015.

Notes: Compensation includes wages and benefits. The most recent Conference Board compensation cost was $3.07 (in 2012) for China. The estimate for China was obtained by inflating the Conference Board estimates based on data from the National Bureau of Statistics of China. Productivity is gross domestic product (GDP), in constant 1990 PPP $, divided by total employment in the economy. Purchasing power parity (PPP) GDP is GDP converted to 1990 constant international dollars using PPP rates. An international dollar has the same purchasing power over GDP that a U.S. dollar has in the United States.

Some consumers know that pay increases often lead to price increases. They do not believe that higher labor costs benefit them. But other consumers lobby for higher wages. While partying revelers were collecting plastic beads at New Orleans' Mardi Gras, filmmakers were showing video clips of the Chinese factory that makes the beads. In the video, the plant manager describes the punishment (5 percent reduction in already low pay) that he metes out to the young workers for workplace infractions. After viewing the video, one reveler complained, "It kinda takes the fun out of it."[18]

Stockholders

Stockholders are also interested in how employees are paid. Some believe that using stock to pay employees creates a sense of ownership that will improve performance, which will, in turn, increase stockholder wealth. But others argue that granting employees too much ownership dilutes stockholder wealth. Google's stock plan cost the company $600 million in its first year of operation. So people who buy Google stock are betting that this $600 million will motivate employees to generate more than $600 million in extra revenue.

Stockholders have a particular interest in executive pay.[19] (Executive pay will be discussed further in Chapter 14.)[20] To the degree that the interests of executives are aligned with those of shareholders (e.g., by paying executives on the basis of company performance measures such as shareholder return), the hope is that company performance will be higher. There is debate, however, about whether executive pay and company performance are strongly linked in the typical U.S. company.[21] In the absence of such a linkage, concerns arise that executives can somehow use their influence to obtain high pay without necessarily performing well. Exhibit 1.2 provides descriptive data on chief executive officer (CEO) compensation. Note the large numbers (total annual compensation of about $10 million to $11 million, depending on whether one uses the median or mean) and also that the bulk of compensation (stock-related) is connected to shareholder return or other performance measures (bonus). As such, one would expect changes in CEO wealth and shareholder wealth to be, generally speaking, aligned. To be sure, there are overpaid executives who earn a lot and produce little

EXHIBIT 1.2
Annual Compensation of Chief Executive Officers, 200 Largest (by revenues) U.S. Public Companies

Compensation Component	**Median**	**Mean**
Salary	$ 1,100,000	$ 1,161,343
Bonus	$ 2,139,014	$ 2,866,328
Other	$ 184,674	$ 284,929
Stock granted + (estimated) value of stock options granted	$ 6,198,613	$ 6,754,191
Total Annual Compensation	$10,130,520	$11,066,790

Source: Original data from S&P Capital IQ; USA TODAY research, as reported in Barbara Hansen and Mark Hannan. Millions by millions, CEO pay goes up. USA TODAY, April 4, 2014 http://www.usatoday.com/story/money/business/2014/04/03/2013-ceo-pay/7200481/.

Notes: Based on 200 Standard & Poor's 500 companies that filed proxies with the Securities and Exchange Commission between January 1 and March 27, 2014. Mean (but not median) compensation components sum to equal total annual compensation.

in return for shareholders (or other stakeholders such as employees). However, the assessment of whether an executive is being paid appropriately for performance is not as simple as it may seem:

> Consider the example of Richard Fairbank, the CEO of Capital One, as reported in the annual Wall Street Journal/Mercer CEO Compensation Survey (April 13, 2006). In 2005, Capital One shareholders earned a one-year return of 2.7 percent, and over five years, had earned a return of 5.8 percent. The survey reported that Fairbank received $249.3 million in total direct compensation from Capital One in 2005. This large lump sum, compared with a relatively small shareholder return number, implies a lack of alignment between shareholder return and CEO compensation that was widely reported in the popular press. However, most of the $249.3 million received by Fairbank arose from the exercise of stock options granted to him in 1995 (and that expired in 2005, forcing him to exercise them or lose them). Over that longer time period (1995–2005), shareholder wealth at Capital One increased by $23 billion, for a cumulative shareholder return of 802 percent.[22]

As the example indicates, the answer to how strongly CEO pay and shareholder return are related depends to some degree on how carefully the timing and measurement of performance are addressed. One study, which sought to address this issue found a strong relationship ($\Delta R^2 = .35$, $\Delta R = .59$) over time between total shareholder return and a new, corresponding concept, CEO return (i.e., change in CEO wealth). Exhibit 1.3 shows how CEO wealth changes in response to changes in shareholder wealth.

Although CEO and shareholder interests appear to be significantly aligned on average, there are important exceptions and it is certainly an ongoing challenge to ensure that executives act in the best interest of shareholders. For example, during the meltdown in the financial services industry, top executives at Bear Stearns and Lehman Brothers regularly exercised stock options and sold stock during the 2000 to 2008 period prior to the meltdown. One estimate is that these stock-related gains plus bonus payments generated $1.4 billion for the top five executives at Bear Stearns and $1 billion for those at Lehman Brothers during the 2000–2008 period. "Thus, while the long-term shareholders in their firms were largely decimated, the executives' performance-based compensation kept them in positive territory." The problem here is that shareholders paid a huge penalty for what appears to have been overly aggressive risk-taking by executives, but the executives, in contrast, did quite well because of "their ability to claim large amounts of compensation based on short-term results."[23]

Shareholders can influence executive compensation decisions in a variety of ways (e.g., through shareholder proposals and election of directors in proxy votes). In addition, the Dodd–Frank Wall Street Reform and Consumer Protection Act was signed into law in 2010.

EXHIBIT 1.3
Chief Executive Officer (CEO) Return and Shareholder Return

Shareholder Return	Shareholder Return in $ (change in wealth)	CEO Return in $ (change in wealth)
25th percentile	−198 milion	−0.7 million
Median	+163 million	+9.5 million
75th percentile	+553 million	+21.6 million

Source: A. Nyberg, I. S. Fulmer, B. Gerhart, and M. A. Carpenter, "Agency Theory Revisited: CEO Returns and Shareholder Interest Alignment," *Academy of Management Journal*, 53 (2010), pp. 1029–1049.

Among its provisions is "say on pay," which requires public companies to submit their executive compensation plan to a vote by shareholders. The vote is not binding. However, companies seem to be intent on designing compensation plans that do not result in negative votes. In addition, clawback provisions (designed to allow companies to reclaim compensation from executives in some situations) are available under Dodd-Frank and have also been adopted in stronger form by some companies.[24]

Managers

For managers, compensation influences their success in two ways. First, it is a major expense that must be managed. Second, it is a major determinant of employee attitudes and behaviors (and thus, organization performance). We begin with the cost issue. Competitive pressures, both global and local, force managers to consider the affordability of their compensation decisions. Labor costs can account for more than 50 percent of total costs. In some industries, such as financial or professional services and in education and government, this figure is even higher. However, even within an industry, labor costs as a percent of total costs vary among individual firms. For example, small neighborhood grocery stores, with labor costs between 15 percent and 18 percent, have been driven out of business by supermarkets that delivered the same products at a lower cost of labor (9 percent to 12 percent). Supermarkets today are losing market share to the warehouse club stores such as Sam's Club and Costco, who enjoy an even lower cost of labor (4 percent to 6 percent), even though Costco pays above-average wages for the industry.

Exhibit 1.4 compares the hourly pay rate for retail workers at Costco to that at Walmart and Sam's Club (which is owned by Walmart). Each store tries to provide a unique shopping experience. Walmart and Sam's Club compete on low prices, with Sam's Club being a "warehouse store" with especially low prices on a narrower range of products, often times sold in bulk. Costco also competes on the basis of low prices, but with a mix that includes more high-end products aimed at a higher customer income segment. To compete in this segment, Costco appears to have chosen to pay higher wages, perhaps as a way to attract and retain a higher quality workforce.[25] Indeed, in a recent annual report, Costco states, "With respect to expenses relating to the compensation of our employees, our philosophy is not to seek to minimize the wages and benefits that they earn. Rather, we believe that achieving our longer-term objectives of reducing employee turnover and enhancing employee satisfaction requires maintaining compensation levels that are better than the industry average for much of our workforce." By comparison, Walmart simply states in a recent annual report that they "experience significant turnover in associates [i.e., employees] each year."[26] Based on Exhibit 1.4, Costco is quite successful, relative to its competitors, in terms of employee retention, customer satisfaction, and the efficiency with which it generates sales (see revenue per square foot and revenue per employee). So, although its labor costs are higher than those of Sam's Club and Walmart, it appears that this model works for Costco because it helps gain an advantage over its competitors.

Thus, rather than treating pay only as an expense to be minimized, a manager can also use it to influence employee behaviors and to improve the organization's performance. High pay, as long as it can be documented that it brings high returns through