Baumol's Law

... the foundation shaker of retailing.

by Brian Woolf (February 16, 2015)

We do a lot of reading in our professional lives: most is forgotten, some is remembered, and those few pieces that trigger an "Aha!" stay forever. Baumol's Law, which I came across three decades ago, evoked that response. Why? Because it explained so simply and succinctly why retailing (and many other sectors) is forced to keep changing, structurally, over time.

Baumol's Law states that...
Any service that is inherently labor-intensive will tend to rise in cost faster than the general rate of inflation.

Implications
That statement, in *Forbes*, Aug 15, 1983, of Economics Professor William Baumol, tells us that total labor costs rise faster than other costs, ie, labor costs as a percentage of sales will keep rising over time. Obviously, such is unsustainable in the long run for labor-intensive businesses if they are to survive and thrive. As there are limits to how much an employee's productivity can increase in his or her existing job, to make jumps in productivity (to reduce the growing labor costs) structural changes will inevitably occur from time to time.

Retailing Example
Food retailing's history illustrates this well. As a child, I remember going to a grocery store and giving my mother's shopping list to an employee who quickly gathered each item off the tall shelves on the walls behind the counter. However, over time, the growing labor cost of this way of doing business naturally caused higher grocery prices for customers. As the labor component continued to grow, innovative retailers saw ways to restructure their labor element to lower labor costs and retail prices and resulting in increased sales.

At different times over a period of decades, creative retailers introduced radical labor-reducing ideas including self-service stores with shopping carts (eliminating the employee behind the counter and transferring the work to the customer in exchange for lower prices); checkout scanners (eliminating employees attaching price labels to every item); and warehouse clubs with their limited assortment of high-volume merchandise displayed on pallets (rolled in from delivery trucks) and processed at streamlined checkouts from where customers wheel their own un-bagged orders to their cars. In addition, along the road of retailing, to slow the growth in labor costs, many retailers reduced and/or eliminated carryout and bagging service.

New labor-reducing approaches continue to appear. For example, one US website offers bulk diapers, mailed monthly, that are priced lower than at supermarkets, accomplished in part by side stepping most of the usual retail labor costs between vendor and consumer. With similar intent, some manufacturers have set up direct manufacturer-consumer selling of selected items.

What follows? No one is sure but Baumol's Law continues to be very much alive. I have no doubt that innovators will continue to find creative new ways to take advantage of the changing economics and times.

Current Example
It seems that Baumol's Law may be the cause of the tectonic plates currently shifting under UK's food retailers. For years, the four "majors" (Tesco, Sainsbury, Asda, and Morrisons) have slowly increased prices as they added services. The rising prices provided a great opportunity for any Baumol-minded retailer: offer comparable quality at much lower prices by significantly simplifying the business, including its largest cost, labor. As if from the wings, two new retailers appeared, introduced themselves, and then quietly went about their market-changing ways. Several years ago, a tipping point was reached: the combined market share of the four majors peaked and began to decline. And has continued to do so while the two new actors, Aldi and Lidl, enjoy double-digit sales gains probably helped by an increasing societal cost-consciousness in these less certain economic times. It will be interesting to see how the majors restructure their businesses, when marketplace equilibrium is finally reached, and what it will look like. Then, some time later, one wonders what the next round of foundation shaking will bring … and it will come, so long as retailing remains labor-intensive.

It's Not Just Retailing
Even though I talk of Baumol's Law being applied to retailing, Professor Baumol's research, according to *Forbes*, was heavily influenced by other, even more labor-intensive sectors. Baumol opens his research findings with an historical flourish. "Do you know how many daily mail deliveries there were in 19th century London?" The answer? "Twelve, even on Saturdays!" The punch line, of course, is that the number today is now one delivery. Despite computerized address reading and automatic mail sorting there is a limit to the number of mailboxes a postman can reach each day, so postal labor costs continue to increase. The US Postal Service is the poster child for this, losing billions each year as it faces a world of electronic communication. Some proactive countries are discussing mail deliveries on only 3 days a week. Radical change is inevitable.

Orchestras and the theater were two high-labor sectors that also caught Baumol's curious eye. It's hard to shrink an orchestra playing a Beethoven Symphony; and it's difficult to have actors delivering Shakespeare's lines faster and faster. Orchestra and theater tickets will keep growing; how quickly will depend, in part, on how successfully labor costs can be offset by music sales on iTunes and elsewhere and concerts and plays are enjoyed via simulcast performances and supported with donations.

Many Government services are threatened by Baumol's Law, too. For example, to hold rising police costs, speed-reading cameras already automatically trigger the mailing of "tickets" to excessive speedsters and downtown security cameras "walk the beat" on many a street.

Baumol's Law is evident everywhere. Understanding its implications is important, both as a citizen and as a retailer.

Closing Thoughts
Is there an end to the relentlessness of Baumol's Law? Actually, yes—when the industry in question moves from high-labor to low-labor intensity, ie, when ongoing labor cost increases have less impact on total costs. Another way for retailers to minimize the impact of Baumol's Law is in highly differentiating the offering so that customers are prepared to pay for the high labor content included in the price; for example, offering upscale top quality, bakery and specialty food items.

In the meantime, until labor-intensity is low we, as marketers in the retail arena, have to think not just about next week's, next quarter's, or even next year's plans, but what also might be coming from "the other side of the hill" that could affect our business in the coming years. Baumol's Law lurks there among the potential foundation shakers.

About the author...

Brian Woolf is a global leader in loyalty marketing and has written three definitive works on the subject, Measured Marketing: A Tool to Shape Food Store Strategy, Customer Specific Marketing, and Loyalty Marketing: The Second Act. He devotes his time to helping retailers develop, critique and strengthen their loyalty programs.

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www.brianwoolf.com

E: brian@brianwoolf.com
T: +1 864 458-8277

Retail Strategy Center Inc.
6 Parkins Lake Court,
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29607-3628
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