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RESULTS OF THE 2014 WAGE DYNAMICS NETWORK FOR MALTA

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Table of Contents

Executive Summary	3
1. Introduction	5
2. Structural characteristics of the Maltese economy	6
3. Data and survey design	8
4. Shocks and adjustments	11
4.1. The economic environment after the crisis	11
4.2. Changes in the cost structure	14
4.3. Methods of adjustment.....	18
4.4. Hiring and wage-setting	26
4.4.1. Main obstacles for hiring	26
4.4.2. Labour costs of newly hired employees	27
4.4.3. Collective bargaining and wage setting	30
5. Price setting and price changes	32
6. Conclusion	36
References	38
Appendix A: The macroeconomic environment in Malta.....	39
Appendix B: Definition of covariates.....	40

Executive Summary

This report documents the response of Maltese firms after the economic and financial crisis of 2009. The results are based on a survey of 178 firms undertaken as part of the Wage Dynamics Network (WDN) mainly for the reference period 2010-2013.

The survey focuses on a wide array of factors such as key firm characteristics, the economic environment after the crisis, the nature and size of the shocks hitting the economy, the adjustments made by firms and aspects related to wage and price setting behaviour. The survey follows a similar one conducted in 2010, whose primary focus was on the adjustment during the crisis and, in particular, the relevance of various cost-cutting strategies. The collection of data from these surveys provide valuable evidence directly from firms, with a detailed breakdown by sector and size classes, that is typically not available from existing statistics.

The main findings are the following:

- Most sectors experienced a positive demand shock between 2010 and 2013, with the exceptions being manufacturing and construction. The sector that needed to adjust its workforce the most during this period – manufacturing – did so mainly by freezing or reducing new hires and reducing working hours. This sector was hit not only by an adverse demand shock but also by higher uncertainty associated with demand.
- Credit constraints were not considered to be the most pressing problem but around 40% of firms reported an increase in financing costs. The latter occurred at a time of unprecedented monetary easing by the European Central Bank. With domestic small and medium enterprises (SMEs) being predominantly reliant on bank financing, a more diversified mix of funding options than those currently available would represent a more sustainable financing environment for Maltese SMEs.
- All sectors reported an increase in total costs, driven mainly by labour and the cost of supplies. In terms of labour costs, this was due to an increase in base wages and, to a lesser extent, in employment. The increase in costs, however, did not lead to a deterioration in price competitiveness as they were matched or even exceeded by gains in productivity.
- Wage bargaining in Malta takes place at the firm level and changes in wages generally occur on an annual basis due to the Cost-of-Living Adjustment (COLA) mechanism. In terms of trade union coverage, the survey points to a reduction in the percentage of employees covered by a collective agreement compared to the previous wave.

- When setting wages, the most relevant factors for firms are profitability, productivity, the market wage rate and difficulties in attracting employees. For hiring purposes, the availability of skilled labour, the wage rate and uncertainty about economic conditions are the most important considerations.
- Price-setting behaviour in Malta varies on whether the main market served by the firm is domestic or international. In the domestic market, the most common strategy is to set prices as a mark-up over costs. In international markets, negotiating the price with individual customers is the most common approach, while a significant proportion of firms are not autonomous in setting their prices, mostly because they are set either by the parent company or by the main customers.
- Slightly less than 20% of firms have increased the frequency of price changes in recent years, with this share being especially pronounced in manufacturing and financial services. Stronger competition and more frequent price changes by competitors or in other input costs were the most common justifications. On the contrary, more frequent changes in labour costs were rarely mentioned, suggesting a rather weak link between the timing of wage and price changes in Malta.
- According to the survey, 70% of firms consider skill shortages as a relevant obstacle in hiring new employees. Regression analysis also shows that higher wages for new employees compared to incumbents are more likely to be awarded in firms facing skill shortages and high workforce turnover. These findings support policies that raise the workforce's skill base, not only through investment in education to improve the quality of human capital but also to strengthen active labour market policies, such as lifelong learning and adequate incentives for both employers and employees to promote the development of job-specific skills. It also calls for targeted measures, such as enhanced collaboration between academia and the business community, to ensure that the diversification of the economy's production structure does not lead to shortages in specific segments of the labour market.

1. Introduction

This paper documents the response of Maltese firms in the aftermath of the economic and financial crisis of 2009. For this purpose, the Central Bank of Malta carried out a survey in 2014 as part of the Wage Dynamics Network (WDN) project.² The results are based on a survey of 178 firms for the reference period 2010-2013.

The survey focuses on a wide array of factors such as key firm characteristics, the economic environment after the crisis, the nature and size of the shocks hitting the economy and the adjustments made by firms, including obstacles to such adjustments. In addition, the survey also covers aspects of wage and price setting behaviour and the degree of competition facing firms, making a distinction between domestic and foreign markets. The survey follows a similar one conducted in 2010, whose primary focus was on the adjustment during the crisis and, in particular, the relevance of various cost-cutting strategies (Central Bank of Malta, 2010). The collection of data from these surveys provide direct evidence from firms, with a detailed breakdown by sector and size classes, that is typically not available from existing statistics.

The main findings are summarized as follows. Most sectors of the economy experienced a favourable economic environment after the crisis although firms in manufacturing faced a more difficult environment, as they were hit not only by adverse demand conditions but also by higher uncertainty associated with demand and hence, needed to adjust their workforce. Manufacturing firms that adjusted their labour input did so mainly by freezing or reducing new hires and reducing working hours. Credit conditions were not considered to be the most pressing problem but a significant number of firms reported an increase in financing costs. Most sectors reported an increase in costs which were, however, matched or even exceeded by gains in labour productivity and hence, not detrimental to price competitiveness. As expected, given the institutional framework, almost all firms stated that wage changes occurred annually due to COLA but the survey points to a decline in the share of employees covered by a collective pay agreement compared to the previous wave. Price-setting behaviour in Malta varies depending on whether the main market served by the firm is domestic or international. Slightly less than 20% of firms have increased the frequency of price changes in recent years, with stronger competition and more frequent price changes by competitors or in other input costs being the most common justifications. On the contrary, changes in labour

² See Druant et al (2009), Babecky et al (2009), Bertola et al (2010) and Dhyne and Druant (2010) for some of the main findings of the WDN project.

costs were rarely mentioned, which points to a fairly weak link between the timing of wage and price changes in Malta. Finally, 70% of firms consider skill shortages as a relevant obstacle in hiring new employees, with higher wages for new employees compared to incumbents being more likely to be awarded in firms facing skill shortages and high workforce turnover.

The rest of the paper is organised as follows. Section 2 gives an overview of the structural characteristics of the Maltese economy. Section 3 describes the design of the survey. Section 4 focuses on the changes in the economic environment after the crisis, changes in the cost structure, the methods of adjustment used, the factors affecting hiring decisions and the wage-setting process. Section 5 documents the price-setting process in Malta and Section 6 concludes.

2. Structural characteristics of the Maltese economy

The Maltese economy has weathered the economic and financial crisis relatively well (see Appendix A). After contracting in 2009, economic activity recovered strongly such that, by mid-2010, real GDP had already surpassed the pre-crisis peak. After the crisis, Malta has registered one of the highest rates of GDP growth among the euro area countries, with real GDP standing at around 15% higher at the end of 2014 compared to 2008Q1. This performance was due to a number of factors, including the diversification of the economy to sectors which proved resilient to the recession and the absence of major shocks to the financial system. According to the European Commission, Malta is one of only two countries in the EU, the other being Germany, in which potential GDP in 2014 had already exceeded the pre-crisis growth rate.

Improvements were also registered in external competitiveness, with the current account, which has been in deficit since the 1990s, turning to a surplus of around 5% of GDP over the period 2012-2014. Contrary to stressed economies, Malta's reversal of its current account position was mainly driven by an increase in exports, mostly of services, rather than by the deterioration in domestic demand. The robust economic performance did not lead to excessive price pressures, with inflation in Malta averaging slightly less than 2% over the period 2010-2014, reflecting lower oil prices, a reduction in electricity tariffs and low inflation in the euro area.

Similarly, the domestic labour market performed relatively well after the crisis, at a time when labour market performance in a number of euro area countries deteriorated drastically. Employment growth had already returned to its pre-crisis growth trend in 2010, with job creation in the services sector continuing unabated even during the crisis. There are, however, wide differences across sectors, which are even more pronounced when seen from a longer-term perspective. Even before the crisis, pronounced structural changes in the Maltese economy have led to a diversification of the economic base and a shift from traditional industries towards higher-value added activities, mostly in the services sector. For instance, the share of non-traditional market services has increased from 15.8% of total employment in 1995 to 26.2% in 2014.³ The increase in the share of services has coincided with the relative decline in the share of manufacturing, with its employment share declining by 12.6 percentage points between 1995 and 2014, from 24.5% to 11.9%.

The modest increase in unemployment in 2009 started to be reversed by early 2010 and since then, the unemployment rate has declined close to its historical lows, being among the lowest in the euro area, despite increasing labour participation rates. Estimates of Malta's structural unemployment rate have remained broadly unchanged between 2008 and 2013 (Micallef, 2014). The relatively low unemployment rate in Malta, however, masks important differences in the profile of the unemployed, with the relatively high share of long-term unemployed being the result of a mismatch between the skills offered by the unemployed and those required by today's industries.

Labour market reforms in Malta were generally targeted at attracting and retaining more people in the labour force, especially females and older workers. In both these categories, Malta has the lowest participation rates across all EU countries. These reforms have started to bear fruit: the participation rate of females increased by 11.7 percentage points between 2008 and 2014, by far the highest increase among EU countries, to stand at 52.1% in 2014. The increased participation rate of females is attributable to a number of initiatives, including back-to-work fiscal incentives, new income tax rules and an increase in maternity and adoption leave. Measures were also aimed at making childcare facilities more available and affordable, while, at the same time, extending after-school care services in a number of schools to bridge the gap between school days and regular working hours of parent in employment. The participation rate of older workers, aged between 55 and 64, increased by 8.7 percentage points during this period, although the gap with the EU in this area is only narrowly closing down. The pension reform, in conjunction with targeted fiscal measures, should however encourage older workers to remain active over the coming years.

³ Non-traditional market services consist of NACE categories J-N and R-U (i.e. services excluding wholesale & retail trade, tourism, public administration, health, education and social work activities).

There were no major changes in Malta's labour market institutions after the crisis. The wage setting practice in Malta is mainly based on collective bargaining at firm level. In addition, a Cost-of-Living Adjustment (COLA) mechanism has been in place since 1990, in which base wages are partially adjusted to the previous year's increase in inflation.⁴ As a result, changes in wages generally occur on an annual basis. Despite the strong economic performance, nominal wage growth in Malta has been moderate after the crisis, averaging less than 2%, and broadly in line with the euro area average. This was facilitated by the increase in the labour supply, as well as an increase in the share of foreign workers in the workforce, which has eased labour shortages in selected sectors and helped to keep wage pressures contained.⁵

3. Data and survey design

The survey was designed in close correspondence to similar surveys conducted by national central banks within the European System of Central Banks (ESCB). A total of 271 companies were chosen to take part in the survey. Of these, 60% had participated in the previous wave of the survey. Companies were selected from the Business Register of the National Statistics Office (NSO), while ensuring a stratified representation of each sector in the following employment brackets: 10-49, 50-199 and over 200 employees. As in the 2010 wave, companies with less than ten employees, public corporations and those operating in the agriculture and fisheries sectors were excluded. Firms falling within the top decile of each sector by employment were included on the basis that these reflect the main developments in the labour market. The fieldwork lasted from May till July 2014 and was carried out using face-to-face interviews by staff of the Central Bank of Malta.

From the sampled companies, 178 agreed to participate, implying an overall response rate of 66%. A response rate of 73% was registered among firms that had already participated in the 2010 exercise while the companies that had not participated in the previous wave had a response rate of 55%. Around one-third of employees of the target population were em-

⁴ More specifically, COLA is calculated as the 12-month moving average inflation rate measured from the Retail Price Index (RPI) as at September multiplied by the base wage. The base wage represents a wage level determined in 1990, which has been updated annually by the COLA increases awarded. Annual COLA increases are calculated as a fixed amount that is granted irrespective of the wage level. The base wage – the level upon which COLA is based – is a relatively low wage, standing at around 61% of the average gross weekly salary in 2011.

⁵ The share of foreigners in Malta's workforce increased from 5.1% in 2010 to 10.8% in 2014. While the influx of foreign workers is spread across the board, it is unevenly distributed towards certain sectors, such as the remote gaming industry, where the share of foreigners is around a third of the workforce. The share of foreigners exceeds 10% of the workforce also in administrative & support service activities, accommodation and food services, and professional, scientific and technical activities.

ployed with firms that participated in the survey, with coverage being strongest in the financial sector and industry (see Table 1).⁶ The effective sample for construction is relatively low, consisting of just 9 firms, and hence, results for this sector should be treated with caution.

Table 1: Sample response rate and employment coverage

	Firm				Employment		
	Population	Gross Sample	Effective Sample	Response Rate (%)	Population	Effective Sample	Coverage (%)
Industry	266	51	32	62.7	17,324	7,395	42.7
Construction	130	20	9	45.0	5,154	1,505	29.2
Trade	507	40	26	65.0	14,540	1,893	13.0
Financial services	91	30	24	80.0	7,762	5,880	75.8
Other market services	877	130	87	66.9	46,783	13,719	29.3
Total	1,871	271	178	65.7	91,563	30,392	33.2

Source: Central Bank of Malta and National Statistics Office

Weights were assigned to each company to gross up the survey micro-data to the population aggregates. Unless stated otherwise, the results presented in this paper were grossed up using weights based on firm population.⁷

Table 2 provides additional information on the characteristics of the firms. It describes the structure of the firms (i.e. whether single or multi-establishments), their ownership (i.e. whether mainly domestic or foreign owned) and their autonomy in making decisions, such as setting the prices of their products or services.

As expected, the occupational distribution varies across the different sectors.⁸ Non-manual workers represent around 60% or more of workers in the services sector while more than 70% of employees in industry and construction have manual jobs. In the financial sector and other market services, a significant proportion of workers have higher skilled non-manual jobs whereas in construction and industry, most workers have a higher skilled manual job.

⁶ In our sample, industry is made up solely of manufacturing firms. Hence, we use 'industry' and 'manufacturing' interchangeably throughout the text.

⁷ The results may thus differ from Micallef and Caruana (2015) since the latter study was based on employment weights.

⁸ Each sector's occupational grouping is classified in four different categories following ISCO-08 classification. **Higher skilled non-manual** refers to ISCO-08 categories 1, 2 and 3 (Managers; Professionals; Technicians and associate professionals); **Lower skilled non-manual** refers to ISCO-08 categories 4 and 5 (Clerical support workers; Service and sales workers); **Higher skilled manual** refers to ISCO-08 categories 7 and 8 (Craft and related trades workers; Plant and machine operators, and assemblers); **Lower skilled manual** refers to ISCO-08 category 9 (Elementary occupations).

Table 2: Firm characteristics
(percent)

	Industry	Construction	Trade	Financial services	Other market services
Structure ^(a)					
Single establishment	68.0	93.1	66.9	58.2	78.1
Multi establishment	32.0	6.9	33.1	41.8	21.9
Ownership ^(a)					
Mainly domestic	50.0	100.0	100.0	78.0	90.4
Mainly foreign	50.0	0.0	0.0	22.0	9.6
Autonomy ^(a)					
Parent company	7.5	33.1	20.9	44.0	16.3
Subsidiary/affiliate	38.6	16.2	35.3	35.2	21.7
Neither a parent company nor a subsidiary	53.9	50.8	43.8	20.9	62.0
Occupational distribution ^(b)					
Higher skilled non-manual	15.6	13.6	17.5	45.9	35.1
Lower skilled non-manual	8.8	13.5	42.4	42.2	26.1
Higher skilled manual	62.4	59.3	17.1	5.8	13.0
Lower skilled manual	13.3	13.6	23.1	6.0	25.9
Share of revenue generated in: ^(b)					
Domestic market	29.5	97.1	97.4	65.0	51.8
Foreign market	70.5	2.9	2.5	35.0	48.2
Labour cost share ^(b)	26.9	38.6	39.9	51.5	52.4
Flexible wage component ^(b)	2.5	1.0	2.9	5.3	4.3

Note: (a) and (b) denote aggregation using firm and employment weights, respectively.
Source: Central Bank of Malta

There is also a high degree of heterogeneity across sectors in the share of revenue generated in domestic and foreign markets. The percentage of domestic market sales amounted to almost 100% in construction and trade, with a relatively high share of domestic sales also recorded in the financial sector. In other market services, sales are broadly split between the domestic and the foreign market while in industry around 70% of sales are generated in foreign markets. Labour costs in relation to total costs are the highest in the services sector and the lowest in industry. The proportion of performance bonuses to the total wage bill, which allows an element of flexibility in wage setting, is the highest in financial services and other market services and the lowest in construction. Overall, however, less than 5% of the wage bill is subject to performance bonuses.

4. Shocks and adjustments

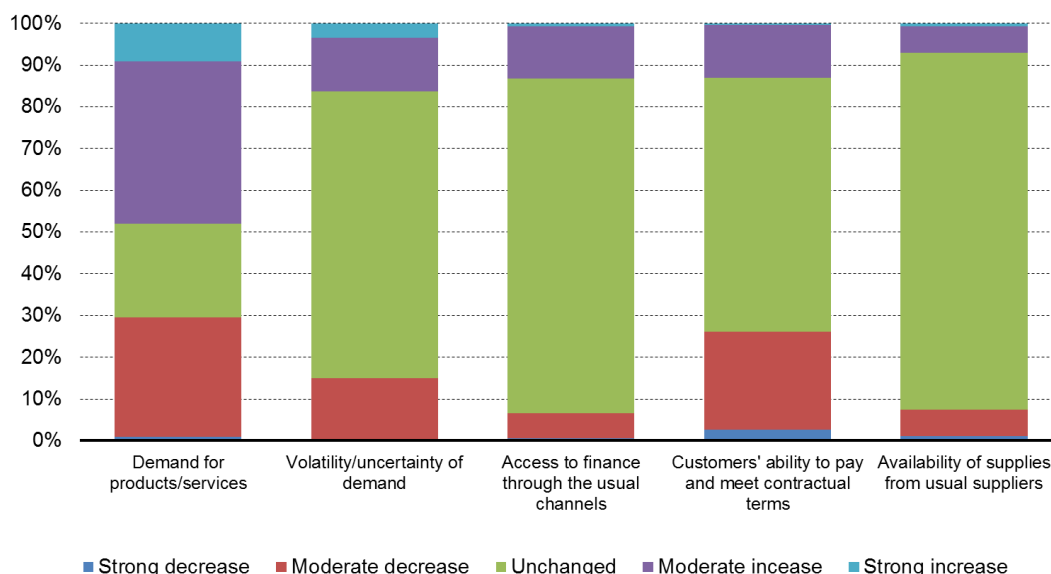
This section describes the economic environment faced by domestic firms after the crisis (2010-2013), changes in their costs structure and the methods of adjustment used. The last part looks at the hiring and wage setting process, including the relevance of various factors considered by firms when setting wages, the labour costs of newly hired employees compared to incumbents and trends in collective bargaining.

4.1. The economic environment after the crisis

The adjustment of firms to shocks is likely to depend on the nature and size of the shocks hitting the economy. Firms were asked to assess the relevance of the following five types of shocks: (i) demand for their products or services (*demand shock*), (ii) volatility/uncertainty of demand for their products or services (*uncertainty shock*), (iii) access to external finance through the usual channels (*credit constraint shock*), (iv) customers' ability to pay and meet contractual terms (*cash flow shock*) and (v) availability of supplies from usual suppliers (*supply shock*).

Firms consider demand shocks to be the most relevant during this period: slightly less than 50% of the firms stated that they have experienced an increase in demand for their products and services, compared to less than 30% which reported a fall in demand. Around 25% of firms reported a decline in customers' ability to pay or meet contractual terms. In the other three shocks listed in Chart 1 - uncertainty, credit constraints and supply - between 70% and 85% of firms reported broadly unchanged developments during the reference period.

Chart 1
TYPE AND SIZE OF SHOCKS
(percent of responding firms weighted by firm size)



The survey points to substantial differences across sectors and firm sizes (see Table 3). For instance, with the exception of industry and construction, between 50% and 60% of firms in the services sectors experienced a positive demand shock since 2010. On the contrary, more than 80% of companies in construction and 60% in industry reported a moderate decline in demand during the same period. In industry, those firms that were strongly affected considered the drop in demand to be permanent, rather than temporary. The share of firms reporting an increase in volatility or uncertainty of demand was highest in industry and financial services, with the latter being driven by changes in the regulatory environment after the financial crisis. Few firms identified substantial difficulties with access to finance, with this finding being broadly applicable to all sectors. Cash flow and supply difficulties were mainly concentrated in the construction sector, with 55% and 40% of firms in this sector reporting a drop in customers' ability to pay and meet contractual terms and in the availability of supplies from usual suppliers, respectively. These difficulties were most likely associated with the slowdown in the construction sector following the decline in house prices during most of the reference period.

The availability of credit to finance working capital, new investment or rolling over debt was not considered a relevant issue for most firms, with the exception of the construction sector (see Table 4). In the latter sector, 39% of companies experienced problems in obtaining external financing for working capital and to roll-over debt, although the difficulties were less severe for credit for investment purposes.

Table 3: Type and size of shock (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Demand for product/services									
Strong decrease	3	0	0	0	1	0	6	2	1
Moderate decrease	59	83	18	0	20	33	10	17	29
Unchanged	9	1	34	44	21	24	16	15	22
Moderate increase	27	8	46	36	43	36	52	48	39
Strong increase	1	8	2	20	15	7	16	18	9
Volatility/uncertainty									
Strong decrease	1	0	0	0	0	0	1	2	0
Moderate decrease	33	12	14	0	12	15	12	17	15
Unchanged	30	86	78	75	72	70	64	59	69
Moderate increase	32	2	8	25	10	12	18	16	13
Strong increase	3	0	0	0	6	3	4	6	3
Access to finance									
Strong decrease	2	0	0	0	1	0	1	0	1
Moderate decrease	2	0	10	0	7	7	4	3	6
Unchanged	95	82	76	82	78	82	68	87	78
Moderate increase	2	11	15	18	14	11	22	10	12
Strong increase	0	8	0	0	1	0	5	0	1
Customers ability to pay									
Strong decrease	5	9	1	0	2	2	3	4	3
Moderate decrease	8	46	18	14	29	25	16	28	24
Unchanged	71	14	72	85	56	61	62	58	61
Moderate increase	16	32	9	1	12	12	17	8	13
Strong increase	0	0	0	0	1	0	1	3	0
Availability of supplies									
Strong decrease	0	0	2	0	1	1	0	0	1
Moderate decrease	5	40	10	0	0	7	3	0	6
Unchanged	95	52	70	88	96	84	91	95	84
Moderate increase	0	9	16	12	2	7	4	4	6
Strong increase	0	0	2	0	1	1	2	1	1

Note: Weights based on firm population

Some companies, however, felt that while credit was available, the conditions, such as interest rates and other contractual terms were too onerous. This problem was mainly concentrated in the trade sector and industry.⁹ In addition, the higher cost of external finance seems to affect small firms slightly more than it does to larger ones. With Maltese SMEs being heavily reliant on bank financing, onerous contractual terms could hinder their ability to grow. This is in line with studies that show that SMEs usually have a harder time obtaining credit from banks than larger firms, mainly owing to their inability to provide high quality collateral

⁹ This finding is consistent with other surveys that show that bank credit to domestic firms is available but interest rates charged, especially for businesses, are high compared with those in other euro area economies. See the European Commission's Survey on Access to Finance for Enterprises (SAFE). Similarly, the relatively high interest rate on loans to businesses in Malta was emphasised by Bonnici (2013).

and to the lack of relevant information on their creditworthiness.¹⁰ Of course, these difficulties could be more pronounced for micro companies, which are not covered by this survey.

Table 4: Access and cost of external finance (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Credit was not available to finance working capital									
Not relevant	85	61	90	93	83	81	98	89	84
Of little relevance	1	0	7	0	11	8	1	9	7
Relevant or very relevant	14	39	3	7	6	11	0	2	9
Credit was not available to finance new investment									
Not relevant	99	93	96	93	84	90	94	90	91
Of little relevance	1	7	4	0	11	7	5	9	7
Relevant or very relevant	0	0	0	7	5	3	0	0	3
Credit was not available to roll-over debt									
Not relevant	98	54	97	99	84	87	95	93	88
Of little relevance	2	7	3	1	11	7	5	7	7
Relevant or very relevant	0	39	0	0	4	6	0	0	5
Credit was available to finance working capital but conditions were too onerous									
Not relevant	83	59	72	93	85	78	86	85	80
Of little relevance	3	41	14	5	9	12	7	15	11
Relevant or very relevant	14	0	14	1	6	10	8	0	8
Credit was available to finance new investment but conditions were too onerous									
Not relevant	83	59	73	93	86	78	88	91	80
Of little relevance	3	41	15	5	8	13	4	7	11
Relevant or very relevant	14	0	12	1	7	9	8	1	9
Credit was available to roll-over debt but conditions were too onerous									
Not relevant	97	59	75	99	87	81	96	93	84
Of little relevance	3	41	14	1	8	13	4	7	11
Relevant or very relevant	0	0	10	0	5	6	0	0	5

Note: Weights based on firm population

4.2. Changes in the cost structure

All sectors reported an increase in total costs, with 77% of firms reporting a “moderate increase” and another 11% a “strong increase” (see Table 5). Looking in more detail at cost components, the rise in total costs was mainly driven by labour and cost of supplies. The increase in labour costs was broad based across sectors and firm sizes. The rise in cost of supplies was also spread across sectors, though perhaps slightly more pronounced in industry and trade, whereas around 40% of firms in construction reported a moderate drop in supply costs. In terms of size classes, the increase in the cost of supplies was more marked in larger firms compared to small and medium sized ones.

¹⁰ See, for instance, Ayadi and Gadi (2013).

Table 5: Evolution of cost components (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Total costs									
Strong decrease	1	0	0	0	4	2	1	0	2
Moderate decrease	8	0	7	0	1	2	9	5	3
Unchanged	1	1	8	10	9	8	4	1	7
Moderate increase	63	89	75	77	81	78	74	71	77
Strong increase	26	10	10	13	7	10	12	23	11
Labour costs									
Strong decrease	2	0	0	0	4	2	2	0	2
Moderate decrease	7	0	11	1	1	4	6	5	4
Unchanged	0	0	18	0	5	9	2	0	7
Moderate increase	88	90	41	49	75	67	68	73	67
Strong increase	3	10	30	49	16	19	21	22	19
Financing costs									
Strong decrease	0	0	0	0	1	1	0	0	1
Moderate decrease	15	0	7	10	12	8	18	19	10
Unchanged	61	59	39	68	48	49	49	58	49
Moderate increase	22	41	42	14	37	38	30	19	35
Strong increase	2	0	12	8	1	5	3	5	4
Cost of supplies									
Strong decrease	0	0	0	0	0	0	0	0	0
Moderate decrease	8	40	3	2	8	9	7	7	9
Unchanged	14	7	27	42	32	27	30	14	27
Moderate increase	68	45	61	54	58	59	59	63	59
Strong increase	10	8	9	1	2	5	4	16	6
Other costs									
Strong decrease	0	0	0	0	0	0	0	4	0
Moderate decrease	2	0	0	0	2	1	1	0	1
Unchanged	73	100	96	79	82	88	80	68	86
Moderate increase	23	0	4	11	13	11	12	15	11
Strong increase	2	0	0	10	3	0	7	13	2

Note: Weights based on firm population

Developments in financing costs were more balanced, with around 50% of firms reporting these unchanged. However, 40% of firms stated that financing costs had increased, whereas only 11% reported a decline. The increase in financing costs was especially pronounced in construction, trade and other market services, whereas between 10% and 15% of firms in the financial sector and industry benefitted from lower costs. Financing costs also differed according to the size of the firm, with a larger percentage of small firms reporting an increase in financing costs compared to medium and large ones. Overall, this result supports the findings of Micallef and Gauci (2014) that had pointed towards an impaired transmission mechanism of policy rates to domestic bank lending rates, especially for non-financial corporations.

Turning more specifically to labour costs, the large majority of companies reported a rise in base wages (see Table 6). This is in line with our expectations given the institutional features

of the domestic labour market, where wages are partly adjusted to past inflation through the COLA mechanism. Around 36% of firms also awarded increases in flexible wage components, such as bonuses or fringe benefits, with this form of compensation being especially prevalent in the financial sector.

The increase in labour costs also reflects the growth in employment. Around 43% of firms stated that higher labour costs were due to a rise in the number of permanent employees, while 23% reported additional temporary or fixed-term employees. On balance, all sectors reported an increase in permanent employment with the exception of industry, where close to 40% of firms reported a decline in the number of permanent workers. The decline in employment in industry is a long-term phenomenon that started before the onset of the financial crisis. On the contrary, all sectors reported on balance an increase in the number of temporary or fixed-term employees. In general, these results provide further evidence of the robust performance of the domestic labour market after the crisis, with average employment growth exceeding pre-crisis growth rates.

Hours worked per employee remained broadly unchanged during the reference period, although around 17% of firms reported a modest rise in hours. On balance, all sectors reported a net increase in hours worked with the exception of trade and industry.

Slightly more than 50% of firms reported an increase in other non-labour costs compared to labour costs (see Table 7). Companies in industry and trade were the most affected, with more than 70% experiencing a relative increase in non-labour costs, while those in other market services were the least affected by these costs. These costs are related, for instance, to utility tariffs, administrative costs, regulatory fees and consultancy services.¹¹ The breakdown by size classes suggests that larger firms were more affected by the relative increase in non-labour costs compared to smaller and medium sized firms.

¹¹ Electricity tariffs were reduced by 25% for residential customers in 2014 while for businesses the same reduction took place in 2015 (i.e. after the survey was conducted).

Table 6: Evolution of labour costs (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Base wages or piece work rates									
Decreased	0	0	0	0	0	0	0	1	0
Unchanged	11	32	11	4	22	19	9	11	17
Increased	89	68	89	96	78	81	91	88	83
Flexible wage components									
Decreased	2	0	0	0	0	0	1	0	0
Unchanged	76	53	70	21	62	64	60	61	64
Increased	22	47	30	79	38	36	39	39	36
Number of permanent employees									
Decreased	38	2	5	1	22	16	20	24	17
Unchanged	45	40	39	35	39	45	22	16	40
Increased	17	58	56	64	39	39	58	60	43
Number of temporary/fixed-term employees									
Decreased	3	2	10	0	15	11	4	10	10
Unchanged	87	89	66	71	57	69	64	41	67
Increased	10	9	24	29	28	20	31	49	23
Number of agency workers									
Decreased	2	0	0	0	4	2	1	5	2
Unchanged	97	89	97	96	76	88	87	60	87
Increased	1	11	3	4	20	10	12	35	11
Working hours per employee									
Decreased	11	1	10	0	0	4	5	4	4
Unchanged	78	58	82	84	78	79	72	78	78
Increased	11	42	8	16	22	17	23	18	18
Other components of labour costs									
Decreased	0	0	0	0	0	0	0	0	0
Unchanged	94	100	100	89	96	97	93	94	97
Increased	6	0	0	11	4	3	7	6	3

Note: Weights based on firm population

Increases in costs, however, were matched or even exceeded by gains in labour productivity. Around 25% of firms reported that growth in productivity per employee exceeded labour costs, with the improvement in productivity being especially pronounced in industry, the financial sector and, to a lesser extent, other market services. Medium and large firms benefited slightly more from the increase in productivity compared to smaller companies. More generally, this result is at odds with official statistics that point to a sharp deterioration in labour productivity after the crisis. This could be, to a certain extent, the result of the difficulty of accurately measuring output in an increasingly service-oriented economy. However, it could also be affected by the fact that, by construction, micro enterprises, which generally exhibit lower productivity levels compared to larger firms, are excluded from the survey.

Around 35% of companies have also registered a moderate increase in their profit margins due to a rise in the prices for their products compared to total costs. There were, however,

significant differences across sectors, with the largest increases being concentrated in the trade sector. On the contrary, around 55% of firms in industry and 45% in the financial sector registered a moderate decline in prices compared to total costs since 2010.

Table 7: Prices, costs and productivity (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Average productivity per employee (compared to labour costs per employee)									
Decreased	6	8	9	4	5	6	9	8	7
Unchanged	34	85	77	54	71	71	54	58	67
Increased	60	8	13	42	24	23	37	34	26
Prices compared to total costs									
Decreased	56	18	11	45	11	19	22	21	20
Unchanged	17	79	28	36	57	46	36	36	44
Increased	27	2	61	19	31	34	42	43	36
Other non-labour costs compared to labour costs									
Decreased	3	0	6	12	7	4	15	1	6
Unchanged	23	41	21	38	57	43	36	22	41
Increased	74	59	73	50	36	53	49	77	53

Note: Weights based on firm population

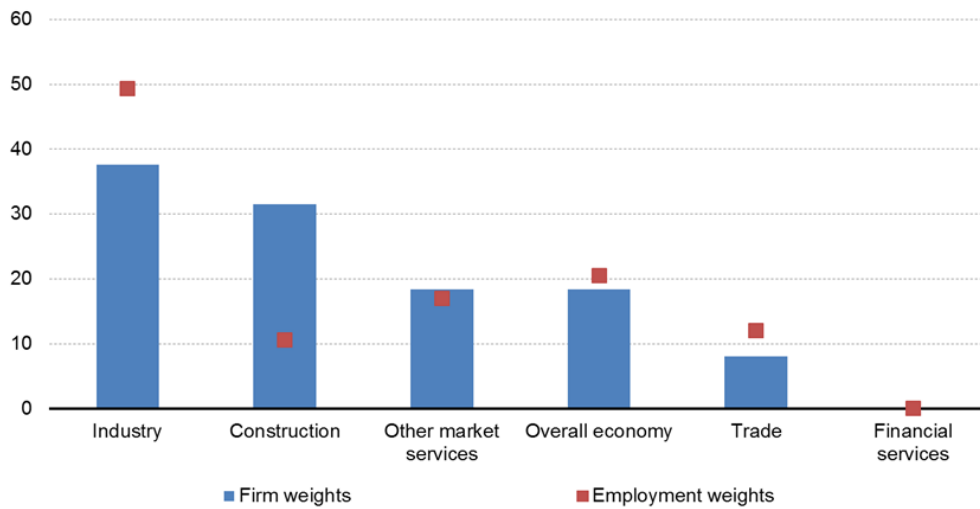
4.3. Methods of adjustment

Slightly less than 20% of firms stated that they needed to significantly reduce their labour input or alter its composition after the crisis (see Chart 2). This figure, however, masks significant differences across sectors, with companies in industry and construction being the most adversely affected. On the contrary, firms in the financial services sector did not need to change their labour force during this period.

Differences also depend on whether the aggregation is done using firm or employment weights. For instance, the 38% of firms that needed to adjust their workforce in industry employ slightly less than 50% of the workers in the sector, whereas in construction, the adjusting firms employed only 11% of workers, suggesting that the adjustment in this sector was mainly borne by small firms. Using employment weights, therefore, the need for adjustment was mainly concentrated in industry.

Chart 2
NEED TO SIGNIFICANTLY ADJUST LABOUR INPUT OR
ALTER ITS COMPOSITION

(percent)



In addition to these descriptive statistics, we investigate the structural factors behind firms' decisions to adjust the workforce in an empirical multivariate framework. We estimate a probit regression in which the model predicts the probability that a firm will adjust its workforce – the dependent variable being a 0-1 dummy with 1 representing those firms that had adjusted their labour force – conditional on a set of covariates that control for the firm's characteristics (e.g. sector and size), the composition of its workforce, its production technology, institutional features governing its wage setting process and the degree of competition faced in domestic and foreign markets. In a separate model, we also account, in addition to the above covariates, to the nature of shocks faced by the firms. The exact definition of the covariates is found in Appendix B. The results are presented in Table 8.

Firm size is found to influence the adjustment of the workforce, with medium and large firms less likely to adjust or significantly alter their labour input compared with smaller ones (the reference category in the regression is that of firms employing between 10 and 49 workers).

In terms of cross-sectoral differences, we find that firms in the manufacturing sector were more likely to adjust their workforce compared to other market services, which is the reference category. On the contrary, we do not find statistically significant differences between construction, trade and other market services.

Turning to the role played by the economic environment and market forces, the results suggest that firms facing competitive pressures are more likely to adjust. However, only those

firms facing strong competition in foreign markets have a statistically significant impact, while the effects are not significant for those facing domestic competitive pressures.

The institutional environment and the composition of the labour force are also found to play an important role. The presence of collective pay agreements makes it more likely for a firm to adjust its workforce, a result that could be influenced by the predominance of trade union membership in the manufacturing sector. Similarly, firms with a higher share of low skilled workers are more likely to adjust. On the contrary, firms facing skill shortages are less likely to adjust their workforce. This could be due, for instance, to the fact that the sectors in which skill shortages are more prevalent were expanding during this period or, even if not, these firms could choose to retain labour in response to shocks, especially if deemed temporary, to avoid recruitment and training costs when conditions return to normality. Firms' cost structure and the flexibility of its cost structure, proxied by the share of labour in total costs and the share of bonuses in the total wage bill, respectively, do not have a statistically significant effect on labour force adjustment.

The second column in Table 8 accounts for the nature of the shocks hitting the firms. Firms that are hit by adverse demand shocks and by a higher volatility or uncertainty associated with demand are more likely to adjust their workforce. On the contrary, the three other shocks considered – access to finance, customers' ability to pay and availability of supplies from the usual suppliers – do not have a statistically significant effect.

Interestingly, once we control for the nature of shocks, all the covariates that were significant in Model 1 retain their significance with one exception: manufacturing. Instead of cross-sectoral differences in the adjustment process, therefore, it is more likely that manufacturing firms were hit not only by adverse demand shocks during this period but also by higher uncertainty associated with demand. Heightened uncertainty could have been driven by the European sovereign debt crisis and volatility in international commodity and asset prices, such as energy prices and the exchange rate, to which the manufacturing sector is more exposed compared to other sectors.

Table 8: Need to adjust labour input*Average Marginal Effects from Probit Regressions*

	(1)	(2)
Firm size		
10-49		
50-199	-0.154 **	-0.118 *
200+	-0.164 **	-0.139 *
Sector of economic activity		
Manufacturing	0.139 **	0.026
Construction	0.035	-0.061
Trade	-0.038	-0.045
Other market services		
Competition		
Domestic competition	0.079	0.074
Foreign competition	0.156 ***	0.140 **
Production technology, pay structure & workforce characteristics		
Labour share	-0.082	-0.074
Collective bargaining	0.143 **	0.148 **
Flexible wage component	-0.567	-0.681
Skill shortages	-0.138 ***	-0.132 **
Share of low skilled manual workers	0.173 **	0.164 *
Nature of shocks		
Demand		0.181 ***
Volatility/uncertainty of demand		0.129 **
Access to external finance		0.119
Customers' ability to pay		0.043
Availability of supplies		0.006

*Note: ***, ** & * denote statistical significance at 1%, 5% and 10%, respectively*

The dependent variable is a 0-1 dummy that takes the value of 1 if the firm needed to significantly reduce its labour input or alter its composition during 2010-2013.

Firms may adopt various measures to adjust their workforce (see Table 9). Freezing or decreasing new hires and reduction of working hours, mostly non-subsidised, were the two most commonly used measures by industrial firms.¹² Only 5% of firms in industry adjusted

¹² The small number of observations limits the possibility of estimating separate probit models for alternative labour adjustment strategies.

their workforce through collective layoffs, whereas another 6% reduced their use of agency workers. The latter strategy was mainly pursued by large firms. Construction firms resorted mainly to freezing or reducing new hires whereas trade companies opted for a reduction in working hours and individual layoffs. Given the heterogeneity of firms in the sector, companies in other market services used a variety of measures to adjust, the most common being the non-renewal of temporary contracts at expiration, freezing or reduction of new hires, reduction in working hours and layoffs. Only very few companies, mostly large firms in manufacturing and trade, opted for early retirement schemes.

Firm size also matters for the choice of adjustment strategy. For instance, individual layoffs were more used by small firms whereas medium and larger firms availed themselves more of collective layoffs. Non-renewal of temporary contracts, reduction of agency workers and early retirement schemes were also predominantly used by large firms. On the contrary, small firms used mainly freezing or reduction of new hires, reduction of working hours and non-renewal of temporary contracts at expiration. In general, the options used by small firms point to some degree of labour hoarding, which, despite its costs, becomes an attractive human resource strategy in the context of sizeable search and training costs for experienced and skilled workers.

Firms were also asked whether labour market reforms enacted in Malta over the last few years facilitated or made more difficult the adjustment in their labour force compared to the situation in 2010 (see Table 10). Contrary to other stressed euro area economies, labour market reforms in Malta focused more on measures to attract and retain people in the labour force, with the aim of increasing the participation rate of females and older workers. Hence, more than 90% of firms reported that difficulties associated with dismissing workers, both for economic or disciplinary reasons have remained broadly unchanged.

On balance, firms consider that adjusting their workforce has become more difficult compared to the situation in 2010, possibly reflecting the buoyancy of the labour market and problems associated with skill shortages, especially in some sectors. For instance, recruiting employees is considered by 46% of firms to have become more difficult, with this problem being particularly pronounced in the financial services sector. Lowering the wages of new hires is considered to have become more difficult by 23% of firms, mostly in trade and financial services. In industry, however, 20% of firms consider that it is much less difficult to lower the wages at which they hire new workers.

Table 9: Methods used for adjusting the labour force (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Collective layoffs									
Not at all	87	100	100	100	78	89	69	69	86
Marginally	8	0	0	0	12	6	21	19	8
Moderately	0	0	0	0	10	6	0	0	5
Strongly	5	0	0	0	0	0	10	13	2
Individual layoffs									
Not at all	95	100	73	100	51	70	88	80	72
Marginally	5	0	0	0	48	26	12	7	24
Moderately	0	0	27	0	1	4	0	13	4
Strongly	0	0	0	0	0	0	0	0	0
Subsidised reduction of working hours									
Not at all	91	100	73	100	71	80	79	100	81
Marginally	0	0	0	0	29	16	0	0	14
Moderately	5	0	27	0	0	4	12	0	5
Strongly	4	0	0	0	0	0	10	0	1
Non-subsidised reduction of working hours									
Not at all	44	100	59	100	62	60	66	69	61
Marginally	1	0	0	0	38	21	0	19	18
Moderately	3	0	0	0	0	0	5	13	1
Strongly	52	0	41	0	0	19	29	0	19
Non-renewal of temporary contracts at expiration									
Not at all	93	100	100	100	51	76	85	20	75
Marginally	4	0	0	0	41	22	0	53	20
Moderately	0	0	0	0	6	2	10	0	3
Strongly	3	0	0	0	2	0	5	27	2
Early retirement schemes									
Not at all	95	100	100	100	96	98	100	63	97
Marginally	3	0	0	0	0	0	0	19	1
Moderately	2	0	0	0	4	2	0	13	2
Strongly	0	0	0	0	1	0	0	6	0
Freeze or reduction of new hires									
Not at all	5	0	100	100	69	47	44	27	45
Marginally	43	100	0	0	22	39	10	27	35
Moderately	16	0	0	0	5	5	17	33	7
Strongly	36	0	0	0	4	10	29	13	12
Reduction of agency workers									
Not at all	94	100	100	100	90	94	95	63	93
Marginally	0	0	0	0	10	6	0	0	5
Moderately	3	0	0	0	1	0	5	19	1
Strongly	3	0	0	0	0	0	0	19	1

The question was only answered by firms that have replied YES to the following question: "During 2010-2013 did you need to significantly reduce your labour input or to alter its composition?"

Note: Weights based on firm population

Other measures that are deemed to have become more difficult are the adjustment of working hours and the wages of incumbent employees, faced by 17% and 16% of firms, respectively. Difficulties in adjusting working hours were primarily faced by small and medium sized firms in the services sector whereas, on the contrary, 13% of firms in industry claim that it is 'much less difficult' to adjust hours. Slightly less than 25% of firms in industry claim that it is

less difficult to move employees to other locations or across different job positions, pointing to enhanced flexibility in this sector to adjust its workforce, reflecting on-going restructuring efforts to become more competitive.

Companies could also restructure their production through out-sourcing or off-shoring. Out-sourcing is a cost saving strategy in which firms transfer part of their operations to outside suppliers rather than completing them internally (abroad in case of off-shoring). During 2010-2013, only 2% of firms have off-shored part of their operations while another 9% have considered this option. Firms that off-shored part of their operations were mostly in financial services and construction although in the case of financial firms, they only employed 2% of workers in the sector. On the contrary, around 22% of firms have out-sourced part of their operations during the reference period, with this strategy being especially used in the construction sector (55%). In the financial sector, around 18% of firms have out-sourced part of their operations representing 40% of workers.

Table 10: Difficulties in adopting these measures compared to 2010 (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
To lay off employees for economic reasons (collectively)									
Much less difficult	0	0	0	0	0	0	0	0	0
Less difficult	2	0	0	0	0	0	3	0	0
Unchanged	82	98	92	99	97	95	90	78	94
More difficult	16	2	6	1	2	5	4	19	5
Much more difficult	0	0	2	0	0	0	3	4	1
To lay off employees for economic reasons (individually)									
Much less difficult	0	0	0	0	0	0	0	0	0
Less difficult	0	0	2	0	0	1	1	1	1
Unchanged	84	98	90	99	97	95	92	77	93
More difficult	16	2	6	1	2	5	4	22	5
Much more difficult	0	0	2	0	0	0	3	0	0
To dismiss employees for disciplinary reasons									
Much less difficult	0	0	0	0	0	0	0	0	0
Less difficult	2	0	0	0	0	0	2	1	0
Unchanged	79	100	88	97	94	94	77	80	91
More difficult	18	0	10	3	5	5	18	19	8
Much more difficult	0	0	2	0	1	1	3	0	1
To hire employees									
Much less difficult	0	0	0	0	0	0	0	0	0
Less difficult	0	4	2	1	3	2	5	7	2
Unchanged	50	54	53	19	55	53	47	43	52
More difficult	50	39	45	70	37	43	44	34	43
Much more difficult	0	3	0	10	5	2	4	16	3
To adjust working hours									
Much less difficult	13	0	0	0	0	2	0	0	2
Less difficult	3	0	15	0	9	8	10	6	8
Unchanged	72	93	59	71	76	72	69	86	72
More difficult	11	7	19	27	15	15	18	7	15
Much more difficult	1	0	7	1	0	2	3	1	2
To move employees to positions in other locations									
Much less difficult	20	0	0	0	0	4	0	1	3
Less difficult	3	0	3	0	2	1	7	6	2
Unchanged	73	100	83	100	90	89	78	83	87
More difficult	4	0	14	0	6	6	14	7	7
Much more difficult	0	0	0	0	2	1	0	2	1
To move employees across different job positions									
Much less difficult	20	0	0	0	0	4	0	1	3
Less difficult	3	0	3	0	5	2	11	6	4
Unchanged	57	98	74	100	93	85	76	77	84
More difficult	19	2	23	0	2	9	13	13	10
Much more difficult	0	0	0	0	0	0	0	2	0
To adjust wages of incumbent employees									
Much less difficult	0	0	0	0	0	0	0	0	0
Less difficult	0	0	0	0	4	2	0	2	2
Unchanged	83	100	71	93	85	82	83	90	82
More difficult	17	0	25	7	11	15	14	5	15
Much more difficult	0	0	4	0	0	1	3	2	1
To lower wages at which you hire new employees									
Much less difficult	20	0	0	0	3	5	0	1	4
Less difficult	1	0	0	0	7	4	2	1	3
Unchanged	72	92	55	71	74	69	72	73	69
More difficult	5	2	26	27	14	15	21	17	16
Much more difficult	2	7	19	1	3	8	5	7	7

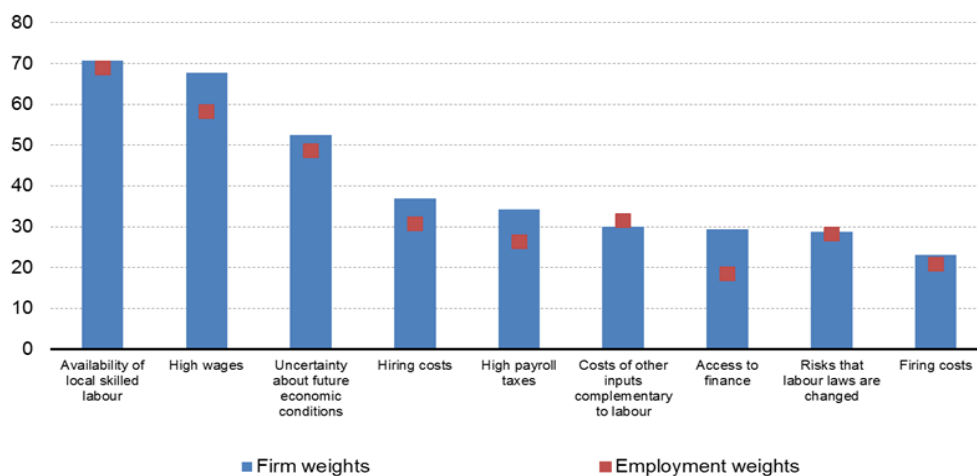
Note: Weights based on firm population

4.4. Hiring and wage-setting

4.4.1. Main obstacles for hiring

Firms were asked to determine the main obstacles they faced when hiring workers on a permanent, open-ended contract (see Chart 3 and Table 11). The availability of skilled labour was the most relevant factor, with around 70% of firms considering labour shortages as “relevant” or “very relevant”. This finding is in line with conclusions in the National Employment Policy published in 2014, which identified the mismatch between demand and supply of skills as one of the main challenges facing the Maltese labour market.¹³ Shortages of skilled labour are especially prevalent in the services sector but also in industry, especially as firms in this sector move to higher value-added activities. Other important factors that employers consider when hiring staff are wages and future economic uncertainty, with 68% and 53% of firms, respectively, regarding these two factors as “relevant” or “very relevant”. In contrast, most firms do not consider access to finance as a relevant factor in hiring workers, with a further 23% claiming that it is only of little relevance. There are, however, indications that small firms face more difficulties in accessing finance compared with larger companies: 33% of small firms claim that access to finance is a ‘relevant’ or ‘very relevant’ obstacle for them to hire workers compared to 18% for medium sized firms and 8% of large firms.

Chart 3
RELEVANCE OF FACTORS TO HIRE WORKERS WITH A PERMANENT OPEN-ENDED CONTRACT
(percent of firms responding 'Relevant' and 'Very relevant')



¹³ Further details on the National Employment Policy can be found at: <http://education.gov.mt/employment/Documents/EMPLOYMENT%20POLICY%20DOC%20sml.pdf>

Table 11: Obstacles to hire workers with a permanent open-ended contract (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Uncertainty about economic conditions									
Not relevant	33	42	23	47	39	35	29	41	34
Of little relevance	9	0	18	38	11	12	18	21	13
Relevant	52	19	57	14	42	46	40	29	45
Very relevant	6	38	2	0	8	7	12	9	8
Availability of local skilled labour									
Not relevant	32	40	15	11	10	16	18	16	16
Of little relevance	3	32	9	7	16	13	12	11	13
Relevant	35	11	59	42	33	38	43	48	39
Very relevant	30	18	17	41	41	33	27	26	31
Access to finance									
Not relevant	61	52	37	60	47	46	51	66	47
Of little relevance	24	10	24	15	26	21	31	25	23
Relevant	13	32	38	14	26	31	15	8	27
Very relevant	1	7	1	10	1	2	3	0	2
Firing costs									
Not relevant	70	50	42	60	52	52	49	67	52
Of little relevance	21	1	33	26	24	24	31	18	25
Relevant	1	18	21	14	19	18	14	13	17
Very relevant	8	32	3	0	4	6	6	1	6
Hiring costs									
Not relevant	39	47	42	32	44	42	42	54	43
Of little relevance	37	3	20	12	19	19	24	21	20
Relevant	20	50	36	48	24	30	29	25	30
Very relevant	3	0	1	8	13	8	5	0	7
High payroll taxes									
Not relevant	70	12	31	49	44	39	50	70	42
Of little relevance	12	39	17	32	28	23	29	17	24
Relevant	13	42	51	19	24	34	20	13	31
Very relevant	5	7	1	0	4	4	1	0	3
High wages									
Not relevant	44	3	14	22	14	15	27	27	18
Of little relevance	23	2	3	15	20	14	17	21	14
Relevant	28	88	81	45	43	57	43	49	55
Very relevant	6	7	3	18	22	14	12	2	13
Risks that labour laws are changed									
Not relevant	41	45	25	54	34	32	38	64	34
Of little relevance	23	32	33	38	44	38	36	20	37
Relevant	25	22	38	8	18	26	19	11	24
Very relevant	11	2	3	0	4	4	7	5	5
Costs of other inputs complementary to labour									
Not relevant	52	42	30	46	38	37	44	51	38
Of little relevance	15	35	31	40	36	33	27	24	32
Relevant	29	22	36	14	23	28	27	17	27
Very relevant	3	0	3	0	3	3	2	7	3

Note: Weights based on firm population

4.4.2. Labour costs of newly hired employees

In a separate question, employers were asked to compare the labour costs of a newly hired worker with that of similar workers at the firm in terms of both experience and task assignments (see Table 12). In addition, firms were requested to compare the situation during

2010-2013 with that prevailing before 2010. Before 2010, 73% of firms reported that the labour costs of newly hired workers were similar to those of incumbents, while another 22% gave newly hired workers a lower salary. Only 5% of firms reported higher costs for newly hired workers. The latter share, however, increased to 12% during 2010-2013, reflecting tight labour market conditions after the crisis, especially in specific sectors. The increase in labour costs to newly hired workers was mainly concentrated in the services sector, possibly a reflection of skill shortages in some industries and hence, the need to offer more attractive salary packages to attract talent.

Table 12: Labour costs of newly hired workers compared to incumbents (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Before 2010									
Much lower	0	2	0	0	1	0	0	5	1
Lower	10	7	43	25	14	22	15	13	21
Similar	89	91	55	61	77	72	79	75	73
Higher	2	0	2	2	8	4	3	7	4
Much higher	0	0	0	11	1	1	2	0	1
During 2010-2013									
Much lower	0	2	0	0	0	0	0	5	0
Lower	12	7	29	11	10	14	18	18	15
Similar	85	89	59	65	74	74	68	59	72
Higher	3	2	12	13	14	11	11	18	11
Much higher	0	0	0	11	2	1	2	0	1

Note: Weights based on firm population

Given its policy relevance, we investigate in more-detail the factors behind the decision to award higher wages to new employees in a multivariate framework. As in the econometric exercise in Section 4.3., the analysis is conducted using a probit model in which the dependent variable consist of a 0-1 dummy taking the value of 1 if the wages for new employees are 'higher' or 'much higher' compared to incumbents. As in Galuscak et al (2010), we use three broad groups of covariates that represent factors related to the firm (e.g. size and sector), the characteristics of the workforce (e.g. tenure, skill composition, workforce turnover, percentage of temporary employees, extent of variable pay and collective bargaining) and the structure of the product market in which the firm operates (e.g. competitive pressures and exposure to foreign markets). The results are presented in Table 13.

Table 13: Higher wages for newly hired employees*Average Marginal Effects from Probit Regression*

Firm size	
10-49 (Reference group)	
50 - 199	-0.046
200+	0.029
Sector of economic activity	
Manufacturing (Reference group)	
Construction	0.119
Trade	0.225 *
Other services	0.179 *
Structure of product market	
Domestic competition	0.075
Share of foreign sales	0.057
Pay structure	
Collective bargaining	0.012
Flexible wage component	1.055 ***
Workforce characteristics	
Skill shortage	0.191 ***
Workforce turnover	0.532 ***
Share of high skilled non-manual workers	0.007
Share of low skilled manual workers	-0.078
Share of temporary contracts	0.191
Tenure: Less than 1 year	-0.148
Observations	178
Pseudo R2	0.2374

*Notes: (***) , (**) and (*) denotes significance at 1%, 5% and 10%, respectively.*

The dependent variable is a 0-1 dummy that takes the value of 1 if wages for new employees between 2010-2013 are 'higher' or 'much higher' compared to incumbents

The results confirm that firms in the services sector are more likely to offer higher wages to new employees compared to those in manufacturing (the reference group). On the contrary, differences owing to size classes are not statistically significant.

Regression analysis shows that higher wages for new employees are more likely to be awarded in firms facing skill shortages and high workforce turnover, defined as strong worker flows due to exits. The pay structure also matters, as firms with more flexible wage com-

ponents, are more likely to offer higher wages in order to attract talent. The effects of the other covariates, such as those pertaining to the structure of the product market, the presence of collective bargaining and the characteristics of the workforce, do not play a statistically significant role.

4.4.3. Collective bargaining and wage setting

As already stated in the introduction, wage bargaining in Malta takes place at firm level and almost all firms stated that changes occurred annually. This is not surprising given the obligation to implement the statutory COLA mechanism. COLA also imply that all firms adapt, at least partially, changes in base wages to inflation and that, during the reference period, wages were neither frozen nor cut. As expected, therefore, the partial indexation mechanism leads to a high degree of downward wage rigidity in Malta, even by European standards.

In terms of collective bargaining, the survey results suggest that around 23% of employees were covered by a collective pay agreement in 2013.¹⁴ This represents a significant decline from the previous WDN survey, which had reported coverage at around 29% in 2008. This is in line with the decline in trade union membership in recent decades. For instance, Baldacchino and Gatt (2009) finds that the proportion of private sector employees covered by collective agreements declined from almost 33% in 1995 to 27% in 2008. At a sectoral level, the employees covered by a collective agreement are mainly concentrated in manufacturing and financial services.

Firms were asked to assess the relevance of a number of factors which they consider when setting wages (see Table 14). More than 80% of respondents identified workers' productivity, the market wage and the firm's profitability as a "relevant" or "very relevant" consideration in the wage-setting process. Difficulties to attract employees are also high on employers' agenda, being mentioned by more than 70% of companies. Other considerations, such as changes in prices, the state of the domestic economy, the cost-of-living and the workforce turnover rate were deemed to be less relevant. While most of these factors are broad-based across sectors, some sectoral patterns are identifiable. For instance, changes in prices of products or services are relatively more important for firms in construction and industry, whereas difficulties to attract employees are relatively more relevant to companies in the services sector, especially other market services, which include high-value added industries such as remote gaming and ICT, and the financial sector. Wage setting decisions in the financial sector are also not very much affected by the general state of the economy and

¹⁴ Using employment weights.

changes in the prices of products or services, whereas the firm's profitability, productivity and the market wage rate assume a more prominent role. Considerations about job turnover are relatively more relevant for companies in other market services.

Table 14: Relevance for wage setting decisions (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Profitability									
Not relevant	3	8	9	17	6	5	13	6	7
Of little relevance	3	1	18	13	13	13	9	11	12
Relevant	51	87	51	30	50	54	47	41	52
Very relevant	43	5	22	40	30	28	30	42	29
Workers' productivity									
Not relevant	2	0	2	26	10	5	14	10	7
Of little relevance	2	0	16	8	3	7	3	13	6
Relevant	67	49	57	39	58	60	46	49	57
Very relevant	29	51	25	28	30	28	37	28	30
Workforce turnover rate									
Not relevant	20	42	27	47	23	28	17	29	26
Of little relevance	38	39	33	22	22	29	25	21	28
Relevant	41	18	40	31	45	38	51	50	41
Very relevant	2	0	0	0	10	5	6	0	5
Cost of living									
Not relevant	22	42	11	35	20	19	25	33	20
Of little relevance	48	33	15	33	31	29	32	16	29
Relevant	28	25	71	32	37	44	40	46	44
Very relevant	3	0	3	0	12	8	3	5	7
Market wage rate									
Not relevant	18	0	3	2	6	5	12	7	6
Of little relevance	5	0	25	20	8	13	7	4	12
Relevant	70	86	54	68	60	64	49	63	62
Very relevant	7	14	19	10	26	17	31	27	20
General state of the economy									
Not relevant	11	8	3	24	15	9	20	25	11
Of little relevance	28	41	28	39	38	35	30	36	34
Relevant	53	52	66	34	41	53	40	30	50
Very relevant	8	0	3	3	5	3	10	10	5
Changes in the price of product/services									
Not relevant	22	11	23	52	19	19	34	33	22
Of little relevance	4	0	23	26	30	22	27	21	22
Relevant	59	89	49	19	46	55	31	39	50
Very relevant	15	0	4	3	4	5	8	7	6
Difficulty to attract employees									
Not relevant	42	41	9	13	4	14	18	6	14
Of little relevance	17	33	18	18	9	15	13	12	15
Relevant	32	12	56	33	54	47	48	65	48
Very relevant	8	14	18	36	32	25	22	16	24

Note: Weights based on firm population

5. Price setting and price changes

Price-setting behaviour in Malta varies on whether the main market served by the firm is domestic or international (see Chart 4). Overall, around 60% of sales were oriented to the domestic market, with the remaining 40% taking place abroad. There are, of course, wide differences across sectors. For instance, firms in construction, trade and, to a lesser extent, finance, are predominantly domestically-oriented. In other market services, sales are broadly split between the domestic and the foreign market while around 70% of sales in industry are generated abroad.

With regard to pricing in the domestic market, the most common strategy, pursued by around 40% of firms, is to set prices according to costs and a self-determined profit margin. This strategy is especially common in construction and trade, with more than half the firms using this pricing approach. Another 23% set prices following their main competitors while 22% negotiate their prices with individual customers.¹⁵

Compared to the domestic market, the share of firms that set prices as a mark-up over costs drops to 22% in the foreign market. In addition, another 22% of firms are not autonomous in setting their prices abroad, mostly because prices are set either by the parent company or by the main customers. This practice is especially common in industry. Negotiating the price with individual customers is the most common pricing approach in foreign markets, adopted by 36% of firms. This pricing strategy is more preferred by small firms (40%) compared to medium (28%) and larger ones (26%). The remaining 17% of firms set prices in response to those of competitors.

As in the previous survey, most companies stated that they faced strong or severe competition, whereas very few declared that they faced no competition at all (see Table 15a). In addition, most companies considered that the degree of competitive price pressures had increased in the relevant market compared with the situation prevailing before 2010 (see Table 15b). This finding is in line with results of the Survey on Access to Finance (SAFE), which ranks competition as the most pressing problem facing Maltese firms in 2014.

¹⁵ A direct comparison with the 2010 edition of the survey is not straightforward since the current survey makes a distinction between pricing for domestic and foreign markets. In the previous wave, setting prices as a mark-up over costs was the most commonly used pricing strategy, adopted by around 42% of firms, with following the main competitors, at 30%, being the second option.

Chart 4
PRICE SETTING BEHAVIOUR IN DOMESTIC AND FOREIGN
MARKETS

(percent)

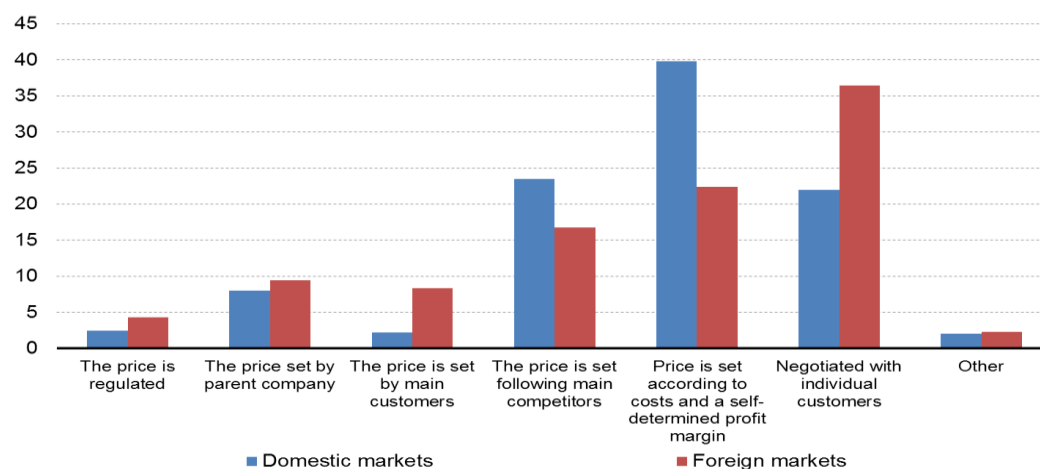


Table 15a: Degree of competition in domestic and foreign markets (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Domestic markets									
Weak	2	0	0	1	8	4	6	2	4
Moderate	25	72	41	42	27	37	22	22	34
Severe	12	5	33	20	29	23	31	37	25
Very severe	17	24	25	21	25	24	24	20	24
Not applicable	45	0	0	16	12	12	17	19	13
Foreign markets									
Weak	14	0	0	0	2	3	5	9	3
Moderate	0	3	4	33	20	12	11	25	12
Severe	37	0	8	14	34	25	19	21	24
Very severe	25	0	0	2	12	7	21	11	9
Not applicable	24	97	87	50	32	54	44	35	51

Note: Weights based on firm population

Table 15b: Change in the degree of competition compared to before 2010 (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Domestic markets									
Strong decrease	0	0	0	0	2	1	0	0	1
Moderate decrease	0	0	0	0	0	0	0	0	0
Unchanged	8	1	31	34	30	25	25	24	25
Moderate increase	25	81	38	48	14	28	30	28	28
Strong increase	22	19	31	16	38	32	27	30	31
Not applicable	45	0	0	2	17	14	18	17	15
Foreign markets									
Strong decrease	0	0	0	0	0	0	0	2	0
Moderate decrease	0	0	0	13	3	2	0	9	2
Unchanged	28	3	0	17	15	13	9	16	12
Moderate increase	28	0	1	20	23	13	28	31	16
Strong increase	20	0	9	1	30	19	23	11	19
Not applicable	24	97	89	49	30	53	41	31	50

Note: Weights based on firm population

As expected, respondents reported a high degree of heterogeneity regarding the frequency of price setting, with sector-specific characteristics likely to play an important role (see Table 16). Overall, around 21% of firms change their prices on a regular pattern every year, while another 30% change their prices less frequently than once a year. Only slightly less than 20% change their prices more frequently than once every year, with the remaining 30% having no predefined pattern. The latter share is particularly large in industry and financial services. In the case of industry, this could be due to the prevalence of prices being set by the parent company at irregular intervals. The category other market services masks additional sectoral patterns. For instance, a significant proportion of firms in the tourism sector change prices at a high frequency, reflecting the prevalence of internet bookings for hoteliers. In terms of size categories, an interesting finding is that small firms change prices less frequently compared to medium and larger firms with a relatively larger share having no predefined pattern.

Table 16: Frequency of price changes on a regular pattern (%)

	Sector breakdown					Size class			Total
	Industry	Construction	Trade	Financial services	Market services	10-49	50-199	200+	
Monthly or more frequently	1	0	7	10	5	3	12	20	5
Quarterly or half-yearly	8	0	15	14	18	14	14	15	14
Once a year	37	4	19	24	20	16	43	32	21
Between one and two years	5	39	14	7	8	12	7	10	11
Less frequently than once every two years	5	39	20	1	22	24	1	6	19
No predefined pattern	44	18	25	44	27	31	21	17	29

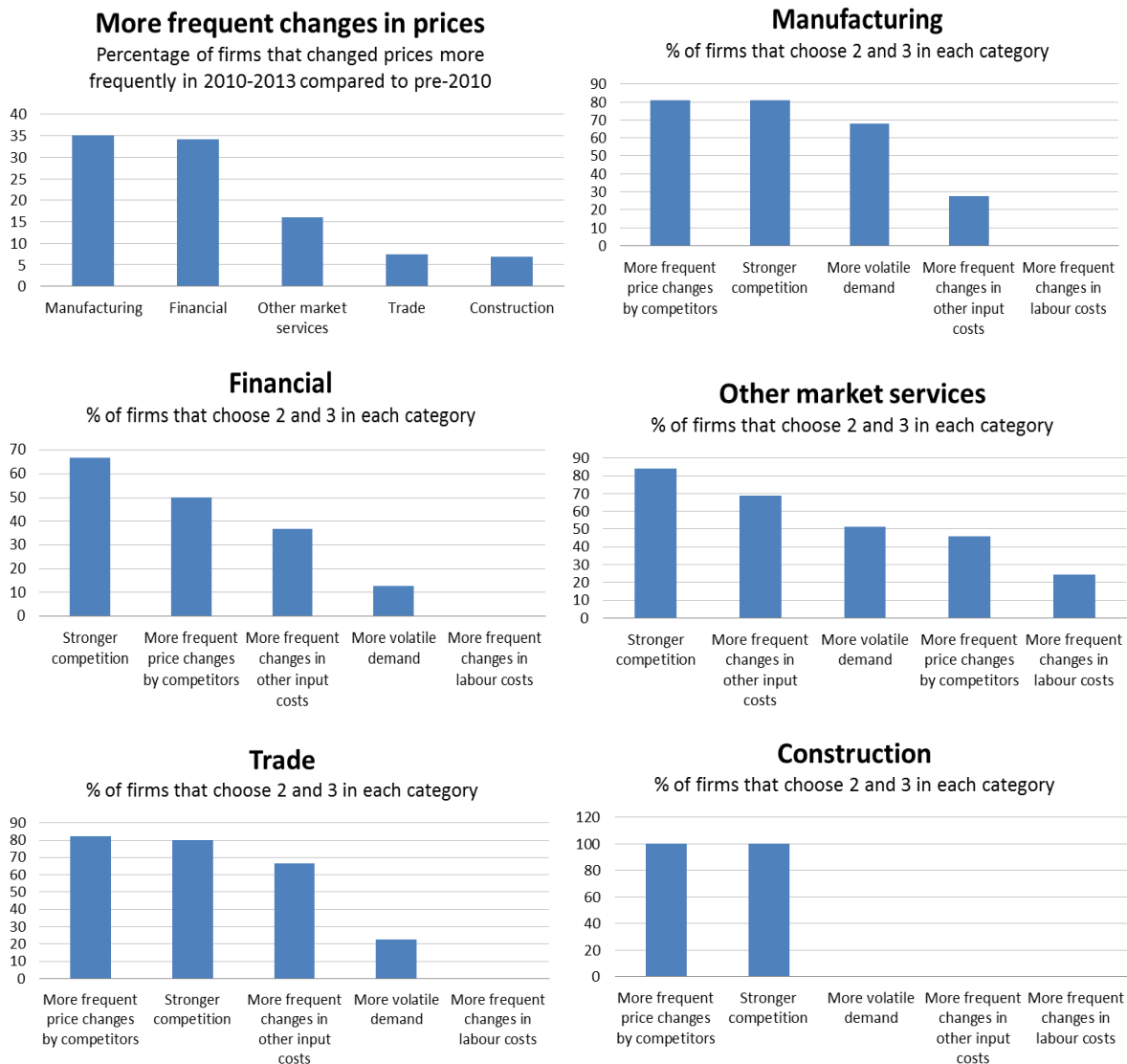
Note: Weights based on firm population

The survey also asked firms whether, over the period 2010-2013, they have changed the frequency of price changes with respect to the pre-2010 period (see chart 5). Slightly less than 20% of firms have increase the frequency of price changes in recent years. Around 35% of firms in manufacturing and in the financial sector reported they have increased the frequency of price changes, with another 16% in other market services and 7% in construction and trade, respectively, also increasing the frequency. Very few firms reported a reduction in the frequency of price changes.

The survey asked firms to rank, in order of importance, the reasons behind the increase in the frequency of price changes, with 0 being the least important and 3 the most important. In manufacturing, more frequent price changes by competitors and stronger competition were the two most common responses, followed by more volatile demand. In the financial sector, the main reason was stronger competitive pressures, followed by more frequent price

changes by competitors and in other input costs. The same three responses – stronger competition, more frequent price changes by competitors and more frequent changes in other inputs costs – and to a lesser extent, more volatile demand, were the most common reasons behind more frequent changes in price setting in the other sectors. Interestingly, more frequent changes in labour costs was rarely listed as an important factor, which is not surprising given that wages in Malta are mostly changed on an annual basis. This confirms the finding of the previous wave that the link between the timing of price changes with that of wage changes is not very strong in Malta.

Chart 5: More frequent changes in prices



6. Conclusion

Labour market conditions in European countries have differed significantly over the last few years. A better knowledge of the key features and determinants of the wage-setting process, and of the labour market in general, is important for policy makers. From a central banking perspective, this knowledge is important to gauge the effectiveness of the monetary policy transmission process. The links between wages, prices and productivity are also key determinants of competitiveness, which is conducive to economic growth and job creation.

The WDN survey provides valuable information on the characteristics of Maltese firms' wage and price-setting behaviour, the main changes in the economic environment after the crisis and the adjustment measures adopted by firms. It allows for a deeper understanding of differences across sectors and firm size classes, facilitates the identification of trends in the labour market, such as the gradual decline in collective bargaining, and provides an alternative source of information to complement official statistics on selected labour market issues, such as differences in sectoral productivity developments and skill mismatches.

During this period, most sectors experienced a positive demand shock between 2010 and 2013, with the exceptions of industry and construction. The sector that needed to adjust its workforce the most during this period – manufacturing – did so mainly by freezing or reducing new hires and reducing working hours. This sector was hit not only by an adverse demand shock but also by higher uncertainty associated with demand. All sectors reported an increase in total costs, driven mainly by labour and the cost of supplies. In terms of labour costs, this was due to an increase in base wages and, to a lesser extent, in employment. However the increase in costs did not lead to a deterioration in price competitiveness as they were matched or even exceeded by gains in productivity.

Credit constraints were not considered to be the most pressing problem but around 40% of firms reported an increase in financing costs. The latter occurred despite the unprecedented monetary easing by the central banks. With domestic SMEs being predominantly reliant on bank financing, a more diversified mix of funding options than those currently available would represent a more sustainable financing environment for Maltese SMEs.

Wage bargaining in Malta takes place at the firm level and changes in wages generally occur on an annual basis due to COLA. The latter mechanism also implies that all firms adapt, at least partially, changes in base wages to inflation and that, during the reference period, wages were neither frozen nor cut. In terms of trade union coverage, the survey points to a reduction in the percentage of employees covered by a collective agreement compared to

the previous wave. When setting wages, the most relevant factors are profitability, productivity, the market wage rate and difficulties in attracting employees. For hiring purposes, the availability of skilled labour, the wage rate and uncertainty about economic conditions are the most important considerations.

Price-setting behaviour in Malta varies on whether the main market served by the firm is domestic or international. In the domestic market, the most common strategy is to set prices as a mark-up over costs. In international markets, negotiating the price with individual customers is the most common approach, while a significant proportion of firms are not autonomous in setting their prices, mostly because they are set either by the parent company or by the main customers. Slightly less than 20% of firms have increased the frequency of price changes in recent years, with this share being especially pronounced in industry and financial services. Stronger competition and more frequent price changes by competitors or in other input costs were the most common responses. On the contrary, more frequent changes in labour costs were rarely mentioned, which suggests that the timing between wage and price changes in Malta is not very strong.

Finally, a concern frequently expressed by employers is the availability of skilled workers. According to the survey, 70% of firms consider skill shortages as a relevant obstacle in hiring new employees. Regression analysis also shows that higher wages for new employees compared to incumbents are more likely to be awarded in firms facing skill shortages and high workforce turnover. These findings support policies that raise the workforce's skill base, not only through investment in education to improve the quality of human capital but also to strengthen active labour market policies, such as lifelong learning and adequate incentives for both employers and employees to promote the development of job-specific skills. It also calls for targeted measures, such as enhanced collaboration between academia and the business community, to ensure that the diversification of the economy's production structure does not lead to shortages in specific segments of the labour market.

The richness of the firm-level survey provides interesting avenues for further policy research. Going forward, a more empirical approach will be used to better understand the role of firm characteristics and the nature of the shocks hitting the firms on selected topics, such as the higher financing costs for domestic firms and the slowdown in productivity. In addition, the harmonized nature of the survey facilitates cross-country studies, for instance, on how the response of firms to shocks depends on the size, source and persistence of those shocks.

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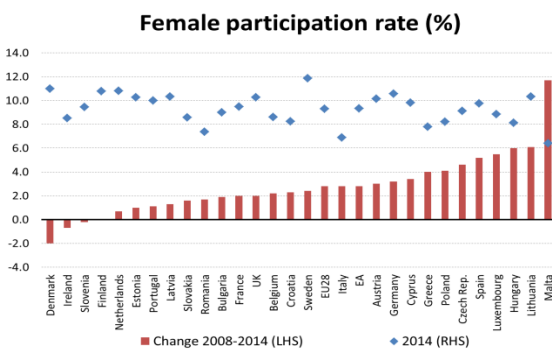
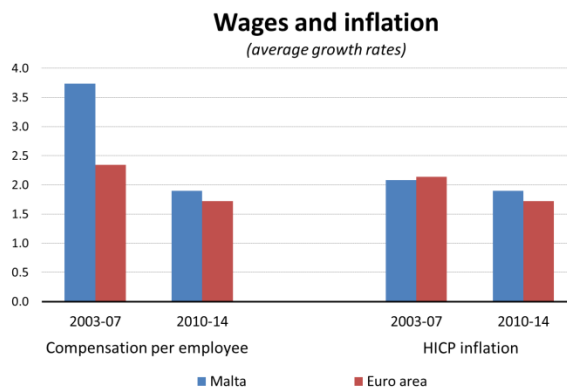
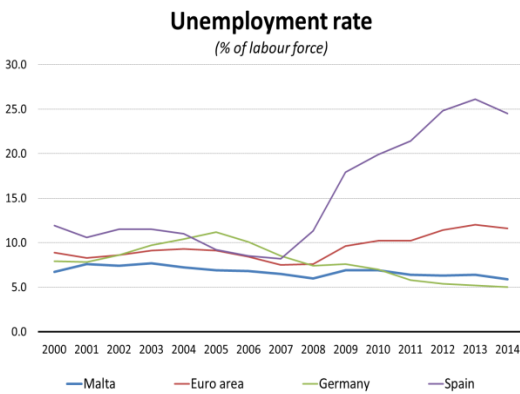
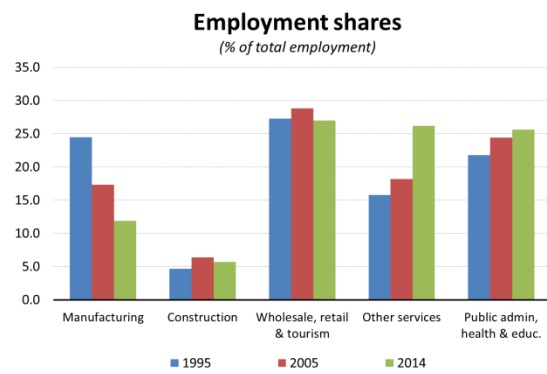
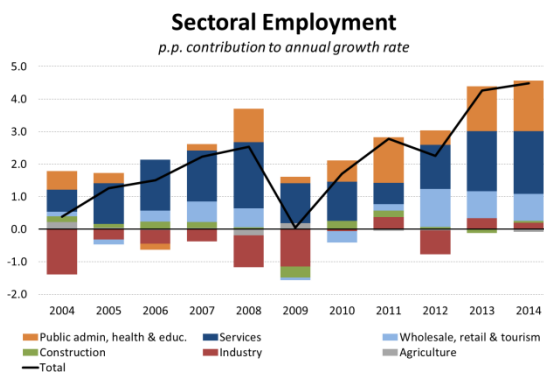
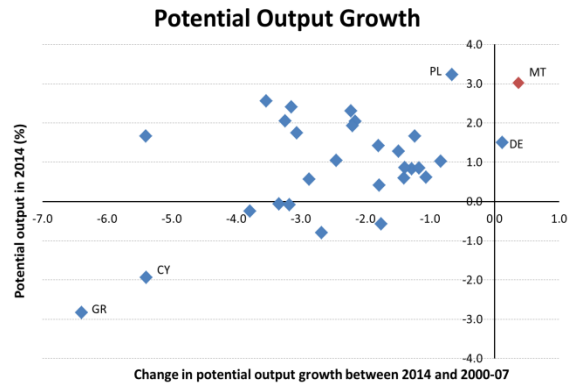
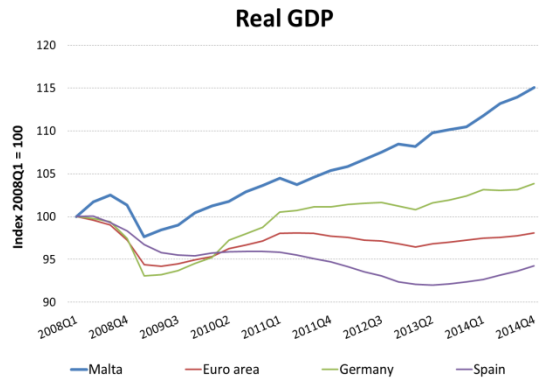
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Appendix A: The macroeconomic environment in Malta



Source: Eurostat, AMECO, Employment and Training Corporation (ETC)

Appendix B: Definition of covariates

The variables used as covariates in the regressions are defined as follows:

- A set of indicators for the **sector** of economic activity (four categories: manufacturing, construction, trade and other market services)
- A set of indicators for the firm's **size** by employees (three categories: 10-49, 50-199, 200+)
- A set of indicators for the **nature of the shock** faced by the firm (the five shocks listed in table 3; dummy variables that takes the value of 1 if the firm reported a 'strong' or 'moderate' decrease in the respective shock (positive in the case of uncertainty))
- **Competition**: two dummy variables that takes the value of 1 if the degree of competition in domestic and foreign markets, respectively, was considered to be 'severe' or 'very severe'
- **Labour share**: the share of labour in total costs (a continuous variable ranging from 0 to 1)
- **Collective bargaining**: a binary variable that equals 1 if a collective bargaining agreement is in place
- **Flexible wage component**: the percentage of the wage bill that is related to individual or firm performance bonuses (a continuous variable ranging from 0 to 1)
- **Share of foreign sales**: the percentage of sales due to revenues in foreign markets (a continuous variable ranging from 0 to 1)
- The shares of **low skilled manual workers**, **high skilled manual workers** and **high skilled non-manual workers** (continuous variables ranging from 0 to 1)
- **Share of temporary contract**: the share of workers with a temporary or fixed-term contract (a continuous variable ranging from 0 to 1)
- **Tenure less than 1 year**: the share of workers with a job tenure below 1 year (a continuous variable ranging from 0 to 1)
- **Skill shortages**: a binary variable that equals 1 if availability of local skilled labour is considered as 'relevant' or 'very relevant' obstacle in hiring workers with a permanent, open-ended contract.
- **Workforce turnover**: a binary variable that equals 1 if strong changes in worker flows were due to exits