



Social Network

Business

Productivity,  
Motivation and  
Rewards

Insight

Travel

**KPMG**

cutting through complexity

**n.**

- 1.** The capacity to discern the true nature of a situation; penetration
- 2.** The act or outcome of grasping the inward or hidden nature of things or of perceiving in an intuitive manner.

# Foreword

Dear readers,

I am delighted to present to you our fifth edition of Insight. Our aim is straightforward – to discuss novel and exciting issues in economics, and explain them in simple English.

This year, we have decided to shift our attention to the concepts of motivation at the workplace, and how this leads to greater productivity. Productivity is a big issue in its own right – during the 2008-2013 crisis for instance, EU total factor productivity fell by an annual rate of 0.7%, potentially costing the European economy billions in lost output. And since we are continuously moving towards a knowledge-based economy, productivity is taking a new-found meaning, becoming ever more relevant and important.

Why do we say this? In a manufacturing setting, the current setup of labour and capital can only reach a certain level of productivity, beyond which it would become technically impossible to increase output. Unless technology improves, there is a ceiling on productivity, determined in part by physical limitations of man and machine. On the other hand, the human mind knows no boundaries. It is not constrained by decreasing marginal returns. Given the right environment, incentives and support facilities, innovation and creativity can go a long way. The key question, therefore, is how to unlock this potential to spur further economic growth and value creation.

The obvious answer is to reward effort by extrinsic performance-linked monetary compensation. However, whilst we do not dispute that this might be effective, there are other non-monetary mechanisms which can be just as, or even more powerful, than their monetary counterparts.

Furthermore, not all extrinsic motivators can be effective. In this issue, we show studies and experiments which can shed light on how people can be easily affected by non-monetary rewards – meaningfulness; ownership; and visual stimuli are some of the concepts we discuss.

Alas, without the proper organisational structures in place, increased motivation cannot hope to lead to increased output and performance. We explore this issue within the context of organisational design. We also consider how one might attempt to measure performance – it is useless trying to devise measures to enhance performance without actually being able to monitor it.

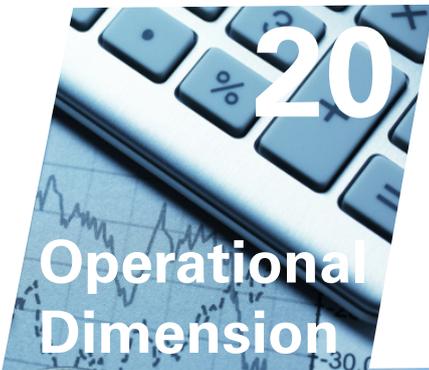
On a separate note I need to thank all those who replied to our summer survey of readers. We needed to take stock of what our audience thinks about this publication, what is appreciated and what is desired. I am delighted with your feedback – you have confirmed that this publication fills an important niche. You have also told us that you wish to see more of certain types of content. This feedback will be reflected in Insight in the coming year.

We will continue to follow our motto of 'cutting through complexity', and we hope to have achieved just that with this current publication, bringing you an interesting, enjoyable and, above all, thought-provoking read.

**Mark Bamber**  
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**Economics and Regulation**  
**Advisory Services**  
**KPMG in Malta**



# Contents



# Piecing together components of productivity



“  
Productivity isn't everything, but in the long run it is almost everything  
”

## Introduction

'Productivity' is a simple enough conceptual construct to grasp. It basically describes resource utilisation, whether it is labour or capital, man or machine. Yet, productivity is hard to measure, and much harder to stimulate, especially in a service-oriented economy.

In a macro environment, productivity is key for economic growth. If one thinks in terms of components driving growth (labour, capital, and the enabling surrounding structures supporting their interaction), at the most basic level, an economy can either invest in capital or increase its labour component (capability and/or capacity). Alternatively, it can increase productivity. The latter is probably the most cost effective.

In a nutshell, finding ways to stimulate productivity, either through innovative behavioural methods (discussed extensively in this publication) or via traditional methods of monetary rewards and compensation, not only benefits firms at the micro-level, but also contributes towards economic growth, competitiveness and a better quality of life.



Evidence shows that industries which usually experience strong productivity growth are often characterised with increases in wages. However, in actual fact there are studies which indicate that employment growth, wage growth and productivity growth are not always directly proportional. For example, Picot et al. (2006) find that even though employment grew more rapidly in high-knowledge industries, increases in wages of university and high school graduates displayed similar patterns across industries. This implies that employment growth was not accompanied by an acceleration of real wages of skilled employees in the sector.

Economic growth is a combination of factors including labour productivity. It is interesting to note that productivity is decomposed in labour, capital and some other factors. This means that labour

productivity is only one component of the equation and this needs to be intertwined with other components to achieve a specified output<sup>1</sup> namely capital and another factor usually attributed to technology. More specifically, economic theory usually refers to the term 'total factor productivity' which in economic jargon is referred to as the "Solow residual", named accordingly after the economist Robert Solow. This residual is a combination of all the factors that contribute towards productivity, mainly composed of technological advances. Although it could be difficult to quantify this component in quantitative terms, labour and capital are often highly dependent on technological advances as more efficient technological platforms provide the means for employees to work more efficiently. Of particular interest is a case study carried out by Brandolini

and Cipollone<sup>2</sup> in 2001 where they examined the dynamics of total factor productivity over 1981 to 2000 in Italy. Their evidence shows that when the quality of labour input, hours worked and capital utilisation are corrected for, the increase in total factor productivity accounts for over a third of the annual growth of real value added in the whole economy. Furthermore, a book written by Stephen Cohen and John Zysman in 1987, examined the reasons why American manufacturing was losing out to competition from abroad. The authors contributed this phenomenon to the fact that America was failing to take advantage of new technologies.

In a more recent study conducted in 2005<sup>3</sup>, it was shown that Nordic EU countries, in particular Sweden and Finland, have experienced stronger hourly labour

<sup>1</sup> More formally, in a simple Cobb Douglas production function  $Y = AK^{\alpha}L^{\beta}$  where A is TFP, K is capital and L is labour.

<sup>2</sup> Brandolini, A. and Cipollone, P. 2011. 'Multifactor productivity and labour quality in Italy, 1981 – 2000'. Banca d'Italia, No. 422.

<sup>3</sup> Annenkov, A. and Madaschi, C. 2005. 'Labour productivity in the Nordic EU countries – A comparative overview of explanatory factors'. European Central Bank Occasional Paper Series, No.39.

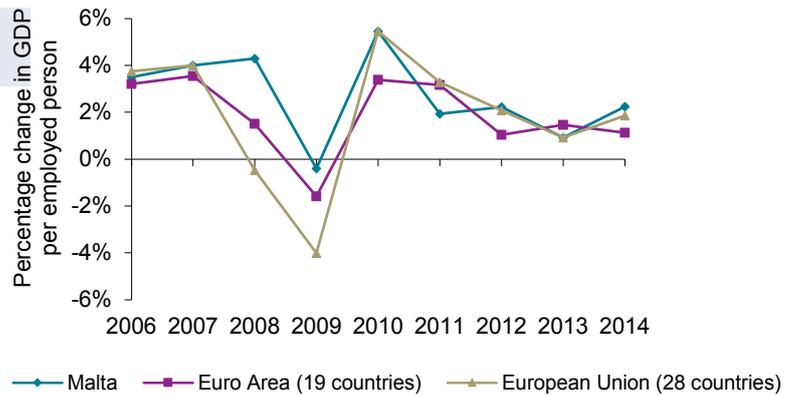
productivity growth when compared to the Euro Area owing to innovation and technological changes. Moreover, Denmark has also outperformed the largest Euro area countries especially in the ICT sector. In addition, the study highlights that the high degree of product and financial market competition coupled with investment in research and development have contributed to the stronger performance of Nordic EU countries.

### Why should we be concerned with economic productivity?

There are a number of economic benefits which arise from increased productivity. These are primarily related to improved country competitiveness as a result of lower unit labour costs. In view of this, lower unit labour costs could translate into cost savings. These cost savings could eventually be passed onto consumers in the form of lower market prices, thereby stimulating demand leading to higher output and an increase in employment. In theory, this implies that firms could provide higher remuneration packages to their employees. Higher wages may in turn boost consumption in the GDP equation, further stimulating economic growth. This economic spiral may therefore generate more government revenue arising from income taxes and VAT on consumption. Accordingly, rising labour productivity may have a positive stimulating effect on economic growth, leading to stable inflationary pressures and a healthy national output. Increases in the GDP per employed person may emanate from two main sources: higher employment or hours such that total labour input in the economy increases, or an increase in the output that each worker produces.

The above diagram shows labour productivity growth by considering the annual percentage change in GDP per person employed. Specifically over the period 2005 to 2014, labour productivity growth in Malta performed slightly better between 2006 and 2010 and moved in line with EU and Euro Area averages in later years. These movements could be attributed to cyclical factors mostly due to economic downswing that the EU has experienced in recent years, subsequent to the recent financial and economic crisis. Malta always registered a positive productivity growth with the exception of 2009. During this year, economic turmoil caused the EU average

### Labour productivity growth



Source: KPMG Analysis, Eurostat

productivity growth to fall by 4%, whilst in Malta this decreased by only 0.4%. This implies that the Maltese economy has been particularly resilient in view of external economic shocks. However, it is pertinent to note that this minimal effect on productivity was mainly attributable to the increase in service activities that expanded as a result of access to the Single Market.

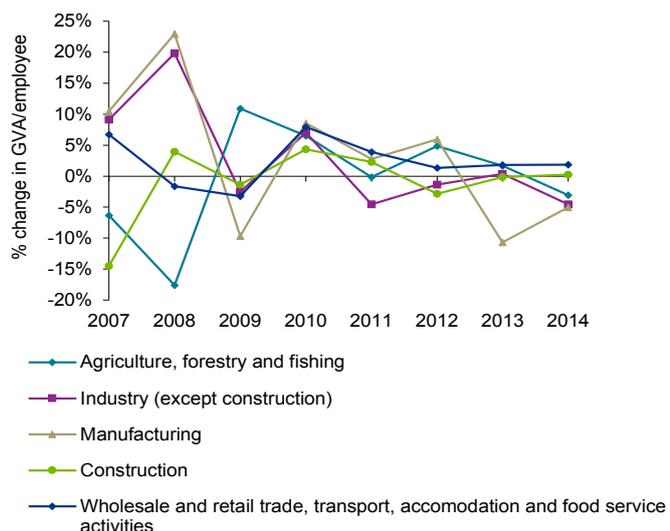
Examining sectoral productivity leads to a few interesting observations. Agricultural activity slowed down in 2008, but picked up in recent years owing to an increase in its gross value added (GVA). Moreover, over the past two years manufacturing productivity registered a minor decrease from a percentage increase of 6% in 2012 down to a decrease of 11% and 5% in 2013 and 2014 respectively. A sharp increase in productivity within the real estate sector was registered in 2011, however this was accompanied by a decrease in the number of persons employed within the industry.

Furthermore, productivity within the financial and insurance services sector experienced a decline of 14% in 2008, at the start of the global economic downturn and picked up by 12% again in 2012 as a

result of an increase in the sector's GVA. The data also indicates that productivity growth within the construction industry was relatively stable in recent years owing to a slowdown in GVA growth.

There are a number of factors which are imperative for boosting productivity at a macro level. First is innovation which is the exploitation of new ideas, technologies, products or methods of working. If new technologies which make working processes more efficiently are explored, then labour productivity can be enhanced. Although this may be an obvious solution, the possible impacts on the employee's morale caused by such innovations at the micro level should also be considered. If new solutions are available to employees in the form of enhanced investment, this could be an effective way of boosting employee motivation and hence producing higher quality output. Additionally, skills could complement this aspect. As new technologies are adopted, the provision of training on these new technologies could also be effective towards enhancing productivity.

### Labour productivity growth by sector



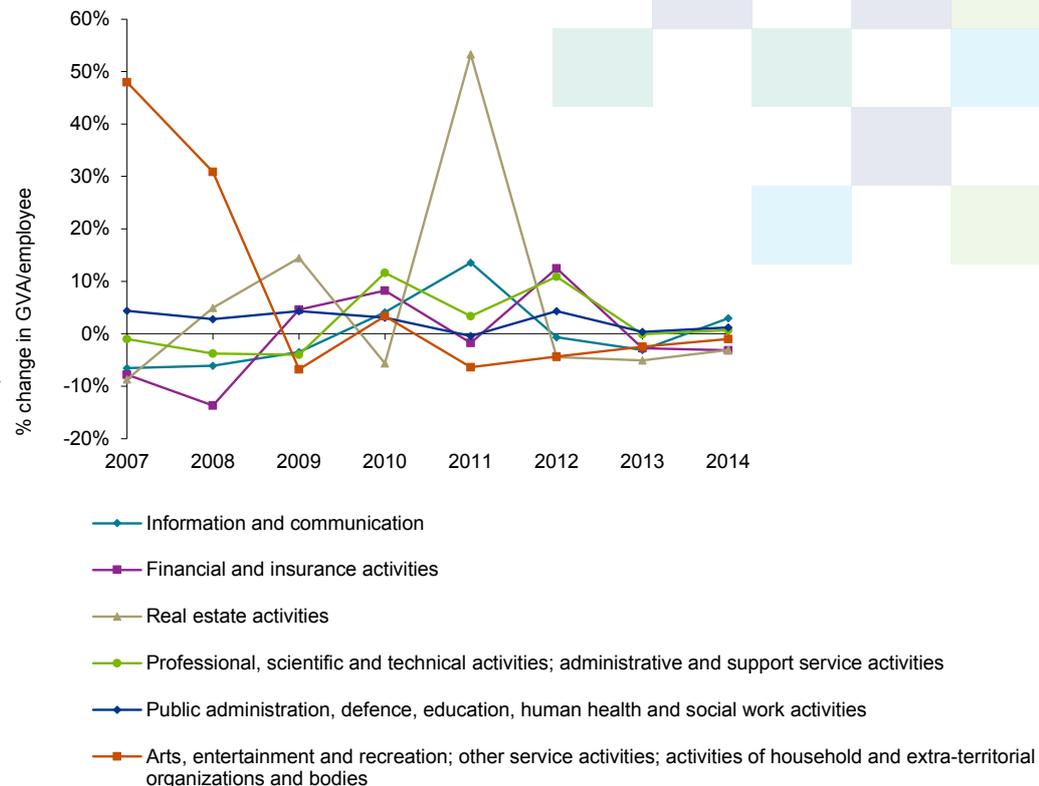
Source: KPMG Analysis, Eurostat

Furthermore, new firms which enter existing markets seek to augment their existing processes by adopting new technologies and innovative ideas. As competition in existing markets is augmented, existing firms attempt to organise their work more effectively, thereby promoting efficiency. Thus, policies designed to enhance the skills set of employees, innovation and competition could all lead to added economic productivity. For instance, measures enshrined in Malta's Operational Programme II for the 2014 – 2020 programming period could act as discretionary measures to enhance productivity over the long-run. Specifically, priority axis 1 concerns improvement in employment levels through incentives for employers and support measures for job seekers, whilst priority axis 3 concerns investment in education and training. All such measures under the European Social Fund are therefore tangible ways of boosting productivity growth within the Maltese economy.

### What about microeconomics?

In economics, one way of estimating national output is by calculating all the income claims of owners of resource inputs which include operating profits and compensation of employees. Consequently, labour productivity at the macro level is dependent on the productivity of firms at the micro level. It is therefore important that productivity should be improved upon at the firm level by implementing measures concerning up skilling and training of workers, motivational measures, and investments in capital. Additionally, labour productivity may also be dependent on the personal attributes and capacities of workers, including the intensity of their efforts. In view of this, it may therefore be worth considering implementing measures at the firm level to affect the behaviour of employees in a positive way.

Labour productivity growth by sector



Source: KPMG Analysis, Eurostat



# 50 Shades of Meaning - Influencing work ethic by environmental nuance

“

How do you nudge your main author of a successful publication to break the fourth wall in self-referential rhetoric to engage the audience? The answer may lie outside the realm of monetary compensation and traditional economics.

”

## Introduction

Consider the creation of this very article. To be able to string together a set of somewhat abstract concepts and translate them into a coherent and logical article with practical application requires, above all else, creativity. The author did have, needless to say, access to business-as-usual support facilities, which today are considered, by most standards, the *de facto* plain vanilla requirements of a normal working office environment. But are these facilities conducive enough to maximise the flow of creative juices at the workplace?



We live in an era which is increasingly becoming characterised by knowledge workers whose success is very much dependent on such proverbial juices. Juices which are the difference between an acceptable job and an outstanding job. And herein lies the challenge in the knowledge economy of workers.

How do you motivate an employee to live up to his potential and give 100%? How do you design a work environment which is a conduit to engage employees who want to go the extra mile? How do you nudge your main author of a successful publication to break the fourth wall in self-referential rhetoric to engage the audience? The answer may lie outside the realm of monetary compensation and traditional economics.

In reality, the output and tangible value-added of a knowledge worker is hard to quantify, and even harder to monitor. This is glaringly obvious when compared to, say, a factory worker checking an electronic component in an assembly line. The bottom line, therefore, is to find ways to ensure that a knowledge worker produces high quality work efficiently out of his own will – quality which is beyond that required by his superiors and clients alike.

### *Of LEGOs and men – the importance of meaning*

Adam Smith argued, back in 'Wealth of Nations' (1776), that productivity can be increased by using division of labour – the idea that a single worker would be responsible for a very specific task during the assembly or creation process. This

drives expertise and efficiency, but at the expense of ownership. In fact, division of labour can sometimes lead to worker alienation through dehumanisation and demotivation, because the labourer is robbed from his ability to conceive and create. In this sense, 'meaning' takes precedence over efficiency.

This concept is even more relevant in our knowledge driven economy - where quality is generally more important than quantity - especially since demotivation and productivity dips cannot be monitored to the same degree as in a manufacturing setting.

We can all agree that meaningfulness at the place of work injects us with an adrenaline-pumped sense of purpose, akin to that sort of 'high' only coffee lovers can

understand after a double shot of espresso. However, how important is it to have such meaningfulness? What magnitude of a productivity boost can we expect? This is a testable hypothesis which can only be answered through research. And that is exactly what Ariely et al. (2008) set out to do.

In the first experiment, the researchers wanted to test whether 'meaning' had any effect on labour supply, productivity and the reservation wage (the lowest wage one would accept to perform a particular task). The setup is quite basic, and involves a number of MIT students doing a repetitive and mundane task against payment (finding ten instances of consecutive letters on a sheet of paper). Initial payment for completion of a sheet was set at \$0.55 per sheet. Upon completion, students were asked whether they would like to work on another sheet, but payment for subsequent sheets linearly declined by \$0.05 each time.

Unbeknownst to the students, they were randomly assigned to three conditions: "Acknowledged", "Ignored", and "Shredded". In the "Acknowledged" group, students had to write their names on the sheet. The examiner then reviewed the sheet and filed it in a cabinet. In the Ignored group, the sheet (without a name) was filed on a large stack of papers without being reviewed for errors. Lastly, in the "Shredded" group, the sheet was literally put through a shredder before the students' eyes without being examined at all.

According to traditional labour supply models - which do not in any way or form incorporate the concept of meaning - the reservation wage ought to be highest in the "Acknowledged" group since such students would need to exert extra effort (associated with disutility) to make sure no errors have been made<sup>4</sup>. On the other hand, students in the "Shredded" group could, in theory, cheat, and this requires less conscientious effort.

Remarkably, results were the complete opposite: the lowest reservation wage was registered in the "Acknowledged" group, meaning that students were willing to work more (higher labour supply and higher productivity) for less: such is the power of 'meaning'.



<sup>4</sup> Mathematically, the labourer maximises an objective utility function (utility being a function of wage earned and cost of effort) by choosing the level of effort. The solution is found using the standard First Order Condition (FOC) of the objective function.

On the other hand, those having their work shredded completed the lowest amount of sheets and stopped earlier than the other groups.

A striking feature of this experiment is not the result reversal from traditional expectations, but the fact that the difference in results between the "Ignored" and the "Shredded" groups is not so strong. This has important implications. Of course, the probability of submitting a report to your superior only to having it shredded on the spot is decidedly slim. However, if the report is ignored, the effect on motivation is largely the same. In this experiment, a simple coaxing nod towards a completed sheet had a statistically significant effect on productivity – imagine what happens to productivity, motivation and morale after a more meaningful acknowledgement, such as an email or a simple text of gratitude for the hard work and dedication poured into a deliverable. Indeed, local employers are becoming more aware that such intrinsic motivators work – in 2013/2014, only 5% of employers utilised non-monetary recognition for effort, whereas this jumped to 34% in the following year.

The above experiment was then replicated, now using Legos instead of sheets of paper. Again, students were required to undertake a task (building a Bionicle Lego model), receiving payments according to a declining unit wage schedule. The only decision to be made by the students was whether to stop making Bionicles (and receive full payment) or to continue and assemble yet another one. However - and herein lies the novelty - one group (the meaningful group) could see their creation displayed on a table, whilst the other group had their "Bionicle" creations disassembled before being asked to re-assemble it again. In essence, this is akin to having the task being stripped of all meaning. Interestingly, results on 'average assembly time' (a measure of productivity) and 'average wage paid' (a measure of reservation wage), were starkly different, with those having their "Bionicles" displayed on the table exerting more effort (lower assembly time and higher average units assembled).

### **A Labour of Love - the "IKEA effect"**

Doing work clearly entails exerting costly effort which is not pleasurable - that is why it is called work, and why people demand monetary compensation. However, even

though traditional labour models in economics explain how a rational worker chooses degree of effort (or supply of hours worked) in such a way as to maximise utility from compensation whilst exerting the least amount of effort, there are several other factors at play. In fact, some workers derive some form of utility from actually performing (and successfully completing) a task - let's call this a sense of accomplishment or pride.

This might explain, for instance, why some people still insist on washing their own car, painstakingly labouring for several hours, even though an automated car wash is far more efficient, and most probably more cost effective if one takes into account the opportunity cost of leisure time lost. Unless they are deriving some sort of pleasure from the experience itself (or strongly believe that a DIY approach gives better results), then manually washing your own car makes little sense. Yet people still do it.

This is not rocket science - we all know that doing something we love empowers the self and motivates us. But how strong is the effect? Does this exist in a non-voluntary work setting? And are we actually willing to pay for the experience (or accept a lower pay)?

Marketers and product promoters have known this for years. For instance, demand for instant cake mixes in the 1950s increased when the manufacturer took out a key ingredient from the mix (the egg) – the old cake mix recipe was too simple to follow, and the fact that the new recipe required housewives to add in a fresh egg themselves possibly made the task slightly more rewarding (Shapiro, 2004).

Others debate whether the spike in cake

mix sales was directly due to the removal of the egg, attributing the sales increase to the icing on the cake, quite literally - cake mixes were being sold with separate mixes for icing and for decoration. Whichever way one looks at it, the bottom line is that the resurgence in sales was related to the fact that those baking cakes could potentially bake fancier and tastier cakes – and that is rewarding in itself, even though it requires a greater deal of effort.

Agri-tourism and "haycations" also employ similar tactics – tourists pay a premium to live on a farm and help out with the harvesting of crops and daily farm tasks (Norton, et al., 2012).

The psychological effect underlying the intrinsic utility derived from self-creations was ingeniously termed the "IKEA effect", named after the Swedish company whose business model revolves around a 'do-it-yourself' concept of furniture assembly. In order to test the validity and extent of the "IKEA effect", Norton et al. (2012) conduct three simple experiments.

In the first experiment, the researchers segregated a number of participants in two groups: the first group (builders) were asked to assemble a mundane IKEA box, and the second group (non-builders) were given the same exact box, but already assembled. Both types of participants were then asked how much they were willing to pay to take the box home.

Assuming a rational-minded person, the builders ought to have a lower willingness to pay for the box, simply because they need to deduct the 'labour costs' they incurred in actually building it. On the contrary, builders were willing to pay a higher price than non-builders.

## **Non-Monetary Recognition**

% of employers in Malta



**2013 - 2014**



**2015**

In another experiment, participants were asked to build origami frogs and cranes, and to then place a value on it. Again, as expected, the value placed on an own-creation was significantly higher than the value placed on that same creation by an outsider. Furthermore, participants creating amateurish origami valued their creations on par with those created by experts, hinting at the fact that the "IKEA effect" is not only present, but also of considerable magnitude.

The "IKEA effect" has wide-ranging applications, not just from a marketing perspective, but also from an organisational design and human resources point of view. Norton et al. (2012) point out that the overvaluation which occurs due to self-creation can sometimes lead to inefficiencies at the workplace. For instance, tech companies which dedicate resources to building innovative products might find it hard to completely write off a failing project's sunk costs. More often than not, it is the project leader, and not the company's board of directors, who finds it overwhelmingly hard to scrap a seemingly failing project due to the personal over-valuation of the project's worth. In a similar vein, organisations may also be reluctant to adopt ideas which have been developed outside the organisation, and instead resort to ideas developed internally, even if such ideas are inferior than the competitors'.

Despite these organisational pitfalls arising due to the "IKEA effect", one can attempt to leverage on its potent effects, especially in motivating employees. We have already seen how making a task slightly more challenging induces a sense of accomplishment – assembling an IKEA box from different components results in a higher valuation from the creators. Now think of the art of assembly in a knowledge worker setting. IKEA furniture components become separate abstract ideas which have little to no value in isolation. But assembled together in a particular harmonious and logical order produces something which is greater than the sum of its components – for instance a strategy piece, a professional advice, or quantitative analysis.

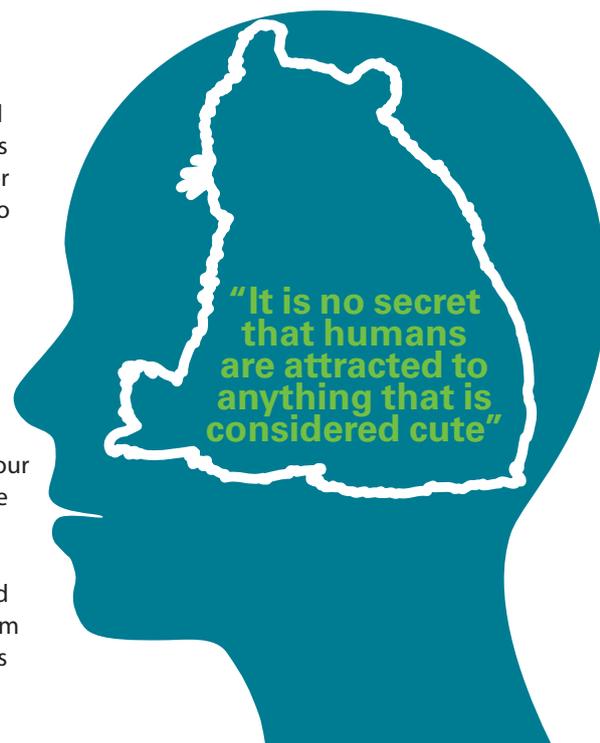
The point here is not so much related to the end deliverable, but rather to the journey undertaken in completing such deliverable. Micro-manage your employees by assigning specific tasks which follow a strict methodology, and you are likely going to demotivate. Give the right people freedom to execute and string together a set of ideas (components), and you are likely going to end up with a creation which is infused with care and dedication. Again, the idea of ownership here is crucial. Mirroring the effect from a consumer perspective, theoretically, employees would be willing to accept a lower pay for doing something they love. In a real working environment, this translates as working harder and longer, which is, for all intents and purposes, tantamount to working for a lesser pay.

### **Cuteness overload: how viewing cute images triggers productivity boosts**

We retain the focus on employee motivation and productivity, but shift our sights onto how we can influence these by altering the working environment.

It is no secret that humans are attracted to anything that is considered cute, from babies to furry and cuddly animals. This makes sense from an evolutionary and ethological perspective – ancestors having a genetic pre-disposition to treat "all things cute" (read offspring) favourably in a protective manner had more chance of survival, and therefore more likely to pass on such genetic makeup.

On a chemical level, the reward system of the brain is not just actively limited to when we view our own offspring, but is also activated when viewing features which are considered innately cute – roundness, symmetry, and soft textures – features which are often translated into aesthetically pleasing architecture, office space, or inanimate objects.



So how does this chemical reaction affect motivation and productivity at the office? Nittono, et al, (2012) performed a series of experiments to test whether the viewing of cute images (baby animals) had any correlation to task performance. Participants were asked to undertake a simple task – motor / non-motor skill – after looking at some images. One group was shown cute images of baby animals, whilst the other group was shown images of adult animals (which are relatively less cute). Indeed, the group which viewed baby animals (as opposed to adult animals) performed better in terms of carefulness, both in the motor skills domain and in perceptual cognition.

Here, we are not suggesting that we hang pictures of fluffy animals at the office, or allow employees to bring their pets to work (although some companies, like Google and Amazon, are already doing this to boost morale and productivity!). The take-home from these experiments is that little changes to the office environment can alter moods for the better, inspire creativity, and promote collaboration. Moving away from the minimalistic and modern office layout to a more relaxed and homey décor can have the same effect on productivity as when viewing cute baby animals!



# High Stakes, Costly Mistakes

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Human behaviour seldom obeys the rigid rules imposed by simple mathematical models, and carrots and sticks can give perverse results - giving a higher wage can lead to a reduction in number of hours instead of instigating greater effort.

”

## Introduction

Carrots and sticks are powerful constructs. Applied in the right context, they can either encourage or discourage behaviour. At the workplace, we mainly deal with carrots (monetary compensation) which are explicit in nature. Sticks, on the other hand, are silent and unassuming, but are still present nonetheless.



In a purely market context (say an employer employee relationship), there ought to be a monotonic correlation between effort and carrots (or sticks). Put simply, the larger the carrot, the greater the effort over a suitable range<sup>6</sup>. Conversely, a higher penalty of not meeting a deadline or a performance target (say, lack of bonus) would induce greater care in making sure such penalties are not incurred.

However, human behaviour seldom obeys the rigid rules imposed by simple mathematical models, and carrots and sticks can give perverse results – Bonuses can sometimes stifle productivity; imposing a fine for an undesirable action can actually promote it; and giving a higher wage can lead to a reduction in number of hours (or output produced) instead of instigating greater effort.

### *Traversing employment realms – from market norms to social norms*

Consider a child care centre – a necessity in today's world where female labour participation is on the rise. Parents can leave their children with professional carers, and then pick them up when they finish work. This is all well and good, as long as every party follows his or her part of the contract, including picking up children on time.

Being late for pick-up is not only a nuisance to carers and stressful to children, but also costly to the child care centre. One might argue that this undesirable behaviour can be deterred by introducing a fine or a penalty for late arrival. And this is exactly what some particular child care centres did in a field study in Israel, charging a fine

of 10 Israeli Sheqels per kid for a delay of 10 minutes or more (Gneezy & Rustichini, 2000).

Contrary to expectation, the number of late arrivals increased instead of decreased. Furthermore, when the fine was removed, late arrivals did not go back to their pre-fine levels. So what led to this behaviour? And how can we elicit some insight from this experiment, and apply it in a working environment context?

What actually happened was that a social norm (it is not acceptable to arrive late) was transformed into a market norm (arriving late has a price – it is acceptable to arrive late as long as you can meet the price). Before the imposition of the fine, parents did not know how important it was not to arrive late. This was akin to an incomplete contract.

<sup>6</sup> We qualify this statement due to the existence of the backward bending supply curve, where effort (or hours worked) increases with monetary compensation up to a certain level, but then decreases as leisure time forgone becomes more affordable.

Once a fine was imposed, parents learnt that arriving late was not important at all – 10 Israeli shekels are equivalent to around EUR 2.30. In this sense, the contract became complete. Even when the fine was removed, parents could not “unlearn” that arriving late was valued at a measly EUR 2.30.

The underlying fundamentals of such behaviours are related to the dichotomy between extrinsic and intrinsic incentives. Monetary incentives usually involve two types of effects: standard direct effects making the incentivised behaviour more attractive; and indirect psychological effects, which sometimes work in the opposite direction of the former. Distinguishing between the two is important when dealing with incentive packages.



“Standard economic theory predicts an increase in performance when employees are rewarded with a bonus. This thinking is based on the premise that work effort is unpleasant, effort and performance are positively correlated, and that performance money is desirable”

- Gneezy & Rustichini, 2000

### **Pay enough or none at all: when performance bonuses lead to lower performance**

Standard economic theory predicts an increase in performance when employees are rewarded with a bonus. This thinking is based on the premise that work effort is unpleasant, effort and performance are positively correlated, and that performance money is desirable (Gneezy & Rustichini, 2000).

This line of reasoning then leads us to believe that there is a monotonic relationship between performance and bonuses. In other words, the greater the bonus, the higher the expected work effort. Alas, experiments show that this might not be true. In fact, people may not readily accept a low bonus for fear that it might reduce their future bargaining position or maybe set a precedent for future work compensation. Alternatively, a token payment, say for something done out of good will like voluntary work or blood donation, may crowd out and kill such intrinsic motivation for altruism. Thus, pro-social norms would be converted into market norms, and this

lowers participation if the pay is not good enough.

Of course, this has implications at the place of work, and is especially relevant considering that in Malta, 84% of employers employ an individual bonus mechanism to reward performance<sup>7</sup>, with some job positions having fringe benefits amounting to around 20% of the basic remuneration package.

Within this context, Gneezy and Rustichini (2000) conducted a series of experiments to test whether effort reacts monotonically to performance bonuses. The experiments involved solving 50 quiz problems in 45 minutes, and getting paid either 10 cents of a sheqel, 1 sheqel, or 3 sheqels per correct answer, depending on the treatment group assigned. Another group were not paid at all.

Surprisingly, those earning nothing performed better than those earning 10 cents, but worse than the other two groups. This shows that rewards or bonuses replace intrinsic motivation, and if small enough, may result in a detrimental effect on performance. But how small is small?

Gneezy and Rustichini suggest that a discouraging payment need not be small in absolute terms, or small enough to be deemed insulting. A professor earning a high salary might find a bonus payment of, say EUR 200, to be demotivating. In this particular case, no payment at all would be better!

We have established that low performance bonuses typically have perverse effects on performance. But can we assume that above a certain monetary threshold, performance is positively linked to bonuses? Unfortunately, no. Experiments carried out in India show that performance on a series of tasks which require creativity and concentration dipped at very high

levels of monetary incentives, possibly due to nervousness (or high stakes) arising out of fear of failure. This type of behaviour, as predicted by the Yerkes-Dodson law which links arousal to performance (Ariely, et al., 2005), might make an employer think twice before dishing out costly performance bonuses – it might very well be the case that rewarding too much would result in supra-arousal and consequently in flaccid leadership and performance.

Of course, when determining the level of bonuses, one needs to keep in mind some key behavioural concepts – reference points and expectations.



<sup>7</sup> MISCO Salaries and Benefits Report, 2014-2015

## Reference Dependence – it's all relative!

Imagine an employer offers an employee two mutually exclusive compensation schemes. The first entails a large salary in the first year, but this changes by yearly decrements throughout the working life. The other option is a standard salary profile, starting out small, increasing only gradually. Although this is unlikely to be offered in reality, employees finding themselves in this hypothetical scenario would tend to prefer the latter compensation scheme, even if it makes financial sense to choose the former. The reason for this choice might be linked to several behavioural tendencies, such as loss aversion, reference dependence, and hyperbolic discounting.

For instance, in the case of loss aversion, losses loom larger than gains, in the sense that people prefer to avoid losses more than acquiring an equivalent gain. Thus, insofar as a wage decrement is viewed as a loss when compared to previous wage levels, people tend to prefer an increasing salary scheme.

Furthermore, once a given standard of living has been achieved (the reference point), it would be hard to go back to a lower quality of life when eventually salary decreases in the first compensation scheme scenario. Of course, it would make sense for employees to choose the first scheme, and invest excess compensation instead of using it for consumption. However, it would be hard to follow this with strict discipline – people discount the future heavily (hyperbolic discounting) and prefer to live in the now.

So how do these tie with performance bonuses? Put simply, an annual or bi-annual bonus payable for exceptional work might work in a perverse manner if the level of bonus becomes a reference point. In other words, there is an expectation that, at the least, this year's bonus would match last years. If there is an expectation that it would increase by, say, 20 percent from last year's, then falling short of this expectation would present a demotivating effect!

This relativity does not begin and end with the self – it extends to comparison with peers. If, say, an employee does get the expected 20 percent increment, but this is still a few

hundred euros less than the average (or a close colleague), then this would also induce demotivation.

Reference dependence does not solely condition motivation, but also productivity or labour effort in terms of supplying a given amount of hours. Employees who are privileged to choose the number of hours worked - and who are paid per hour or per unit - (e.g. taxi drivers, fruit pickers, real estate agents) are encouraged to increase effort when the pay per unit increases. This is called a positive wage elasticity of hours – that is, wages and effort move in the same direction. At least, this is what classical economics purports, but this is not always true.

Studies on New York cab drivers have shown that workers have an innate target of number of hours and target income. When these are reached, drivers tend to work less. This is in line with the target income hypothesis, as studied in Crawford & Meng (2011). Extending this line of reasoning to a knowledge worker, a high enough performance bonus

target' for that particular worker. In this case, any further monetary increments might not induce greater effort – on the contrary, it might contribute to a reduction in effort.

**“There is an exception that, at least, this year's bonus would match last year's”**

rewarding effort may well just approximate the set income



## Facts and Figures:

44%



Sales  
commissions

14%



Project based  
schemes

10%



Other cash  
incentives

84%



Individual bonus is the  
most common type of  
reward.

Performance related  
**rewards** and **incentives** are  
mostly based on **individual**  
performance rather than **team**  
performance.



30%

Goal  
sharing



Group  
Performance  
Rewards



16%  
Non -  
mandatory  
recognition  
awards



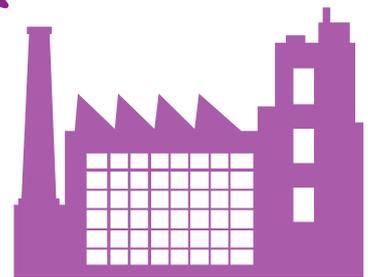
8%  
Profit  
sharing

# Facts and Figures:

**77%**  
use  
this  
tool

Most popular  
form of  
incentive is a  
performance  
individual bonus

**10%** of  
organisations do not  
offer any  
performance  
related pay



**Non-monetary recognition** is  
at **5%** - a stark difference  
**between this year and the**  
**next.**

**83%**  
of  
organisations  
focus on  
individual  
performance

**17%**  
of  
organisations  
focus on  
group  
performance

# The operational dimension

“

Although the worker may be motivated and considered as productive in normal circumstances, frustration and disappointment arising from the inefficiencies and ineffectiveness of processes may in turn adversely affect motivation and productivity levels.

”

## Introduction

In the preceding articles, we have broadened the discussion on motivation at the workplace from the realm of monetary compensation and traditional economics to the behavioural aspects which directly or indirectly influence productivity. However, motivating our workforce is only part of the puzzle or a cog in a complex system. There are other operational aspects or factors that can be expected to impinge on labour productivity.



Imagine for a moment a worker in a call-centre that is rewarded on the basis of efficiency factors such as number of calls taken during a shift. However, the level of service demand at peak times is far beyond the service process capability resulting in dropped calls, irate callers due to excessive waiting time in call queues, call redirection, etc. and, when such circumstances prevail or recur at frequent intervals, it clearly signals that the production or service delivery system is failing to attain the desired performance objectives. Although the worker may be motivated and considered as productive in normal circumstances, frustration and disappointment arising from the inefficiencies and ineffectiveness of processes may in turn adversely affect motivation and productivity levels.

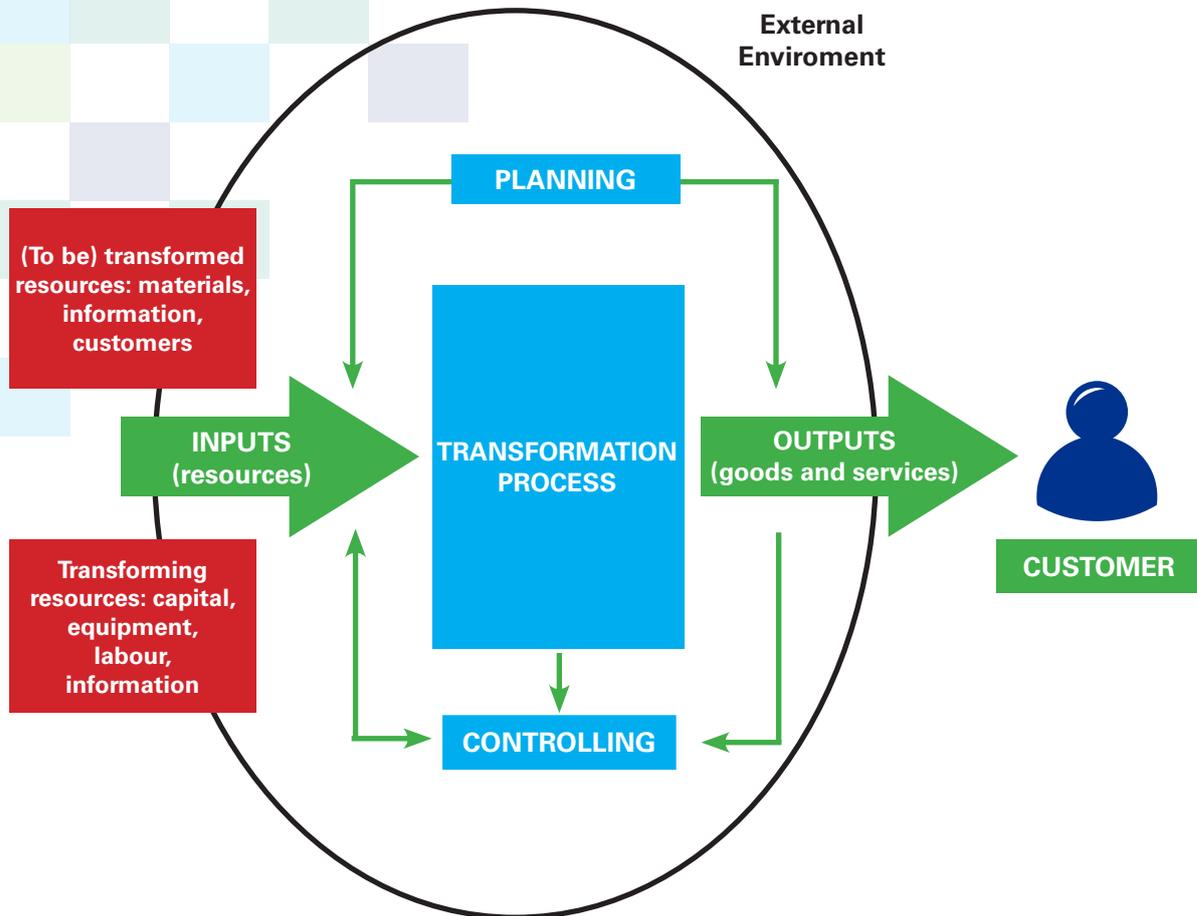
Let's contextualise all this and introduce the bigger picture at this point. Every

operation, or its component processes and activities (whether in a production or service environment) in an organisation, exists for a purpose. Essentially, and at the most basic level, they exist to transform inputs (resources of various kinds) into outputs (tangible goods or more-or-less intangible services) and can be schematically represented as a transformation model as shown in the figure on the next page.

As can be readily identified from the diagram, the performance of the system as a whole ultimately depends on the interaction of all of the various elements of the system; inputs (in the form of to-be transformed resources and transforming resources including labour), processes including related planning and control activities, and outputs. Consequently, the ability of a system to meet its strategic performance objectives cannot in general

be ascribed to a small number of resources or activities in isolation but need to be considered as the emergent properties of the system in its entirety.

At the heart of the transformation model is the transformation process itself – that is the process that produces the actual goods and services to be supplied to customers, and which in general terms, would typically consist of a set or sequence of interrelated or complimentary activities or tasks, carried out on a repetitive basis, and which tasks are allocated to a specific transforming resource. Therefore, the design of the process is a very critical component of the transformation process, and is typically composed of two key elements: task design and workflow design.



### Transformation model

There exists a third key element which is intrinsically connected to the two other elements and which is related to organisational design. These three elements involve strategic choices about the most appropriate levels of task specialisation (or horizontal specialisation), standardisation (or standard operating procedures), resource specialisation (or specificity of transforming resources) and standardisation.

Moreover, the organisation design element also involves strategic choices about the ways in which human resources carrying out the assigned tasks are grouped in the organisation structure and the allocation of focus of authority.

Intuitively speaking, one can readily identify the close interrelationship between having a well thought out process design and productivity. Put simplistically, it would be futile motivating our workforce to increase productivity without having in place well designed processes (across the three key elements).

Having looked at some aspects of the transformation model with a focus on process design, another perspective on

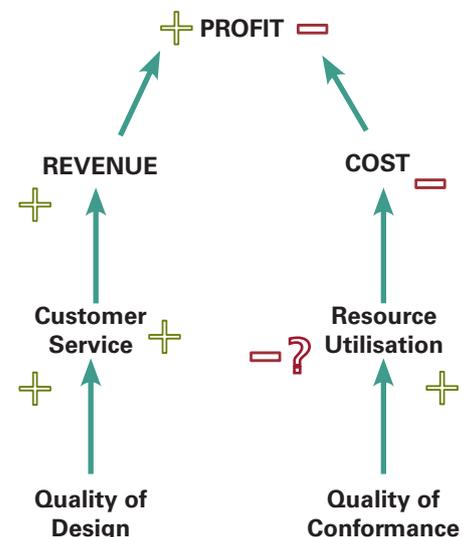
the importance of having a system which meets the required performance objectives is the quality of the outputs of the system, or the products and services delivered to customers. Instead of delving into the multi-faceted nature of quality per se, it is acknowledged that higher quality levels of products or services will in many cases be associated with higher levels of profitability.

In general, a higher level of conformance quality<sup>8</sup> can be expected to lead to a higher level of customer service, and which (in many cases) will lead to a higher level of resource utilisation. In turn, a higher level of resource utilisation or productivity can be expected to lead to a lower level of cost, which in turn leads to higher level of profit.

Likewise, in general, a higher level of design quality<sup>9</sup> will definitely lead to a higher level of customer service. However, this may tend to necessitate increased levels of resources to produce or deliver the service leading to a lower level of resource utilisation, unless the higher level of design quality is attained or associated with technical improvements or innovations in the process.

So what is the link between motivation and productivity and the operational dimension?

Clearly, an important aspect of task design is the area of job design and work organisation. Job design normally refers to the way in which specific tasks are defined (including what skills are needed to perform them), how tasks are grouped into specific jobs, and how workers are allocated to the jobs. Work organisation refers to the way in which tasks and jobs



<sup>8</sup> Conformance quality refers to the extent to which characteristics of the finished product or service delivered actually conform to the design specifications

<sup>9</sup> Design quality is the quality (in terms of planned performance) inherent in the design specifications of the product or the service

are coordinated (including information flows) and how production workers are motivated to perform their tasks and jobs as planned. In particular, we are here looking at the role that human beings play in the process. Generally speaking, the workforce is typically concerned about three aspects of their jobs; monetary rewards, health and safety aspects and quality of working life in general.

It follows therefore that these aspects need to be taken into account as relevant factors in job design and work organisation. Whilst monetary rewards will depend principally on the level of productivity achieved, the competitive conditions in the labour market and in the market for goods and services produced, quality of working life is generally held to depend also on the non-monetary factors affecting job satisfaction. Apart from the ergonomic element (or physiological aspect) of job design, yet another reaction to the application of the principles of scientific management, is the focus on the psychological aspects of job design. Various remedies are and can be termed 'behavioural' approaches, the most important aspects of which are job enlargement and job enrichment. The former refers to a substantial reduction in the degree of task specialisation, and advocates that carried out tasks should be enlarged, principally by combining tasks that were previously carried out separately by different resources, thereby relieving the monotony of the job to some extent.

Job enrichment refers to a substantial reduction in the degree of job specialisation, and advocates that jobs should be enriched principally by letting production workers perform both direct and indirect tasks. In turn, it is expected to provide for a more mentally stimulating job.

More recent approaches which critics of the approaches mentioned earlier advocate include the combination of job enlargement and enrichment with 'empowerment' (increasing the decision making authority of workers regarding how their jobs are planned and organised and how their performance is assessed). This approach is related to the 'socio-technical' approach developed by the Tavistock Institute.

Another approach focuses on the Lean Production system. In this system, work organisation is based on team working, involves job enrichment (but not necessarily job enlargement) and a more limited form of empowerment than in the earlier approach, with an emphasis on task standardisation.

In practice, both of these approaches have to deal with recent trends towards more flexible forms of working, in order to cope effectively with variation in demand, and workforce preferences in terms of when they work and what jobs they do. These

priorities, unfortunately, do not necessarily coincide.

From a quality perspective, although the workforce may be highly motivated and productive, a system that as a whole has not been designed to conform to the desired quality expectations or specifications, would render motivational and productivity gains futile.

In conclusion, focusing on workforce motivation, including considerations on non-monetary rewards, may lead to increased levels of productivity but should not be considered in isolation. Such efforts need to be made within the context of the organisation's performance objectives and design aspects of the transformation system in place. This includes process, task, workflow and organisational design perspectives.





# Managing the performance of performance management

“Financial measures are, by nature, lagging measures. They can show you the results, but never the causes.”

## Introduction

Helping the community. Environmental sustainability. Providing excellence to our clients. These are common objectives usually adopted by profit making organisations. However, as the name implies, the ultimate objective of profit making organisations is to make profits, however veiled it might be by corporate buzzwords. It follows therefore that most performance measures, KPIs and extrinsic rewards were traditionally based on a purely financial dimension.



Countless articles, management gurus and business leaders have emphasised that measuring financial performance is only a small part of the picture. Not only is there more to performance measurement than the financial aspect, but it is the non-financial aspects of a business that produce the financial results. This is because financial measures are, by nature, lagging measures. They can show you the results, but never the causes. This implies that an organisation is a complex chain of cause and effect, with the final part of the chain being financial results.

There are a number of frameworks for non-financial performance measurement, most notably the Balanced Scorecard by Kaplan and Norton as well as the Tableaux du Board and the Performance Prism by Accenture. The basic concept of these frameworks is the alignment of strategy throughout the whole organisation using cause-and-effect relationships measured

using both financial and non-financial KPIs. In this way, your performance management system is deeply rooted to the organisation's activities and includes a chain of leading and lagging measures that may give early warning signals to issues. More importantly, it makes it easier for management to identify what needs to be done to improve the situation, all within the strategic context of the organisation.

This concept works great in theory, but practice shows that there are a number of difficulties and pitfalls in implementing such systems. Why is it difficult to successfully implement such systems and reap their benefits?

### ***Linking measures to strategy***

Conceptual frameworks are exactly that - frameworks - and should be used as such. If you try to mould strategy to fit within the theoretical frameworks then you've got it

in reverse, and if frameworks are too rigid for your organisation, ditch the framework! The essence of it is to create a strategy map with cause-and-effect links that lead to the identification of strategic value drivers; a tangible set of actions that speak clearly to management.

### ***Quality over quantity***

Creating a map of the drivers of performance not only portrays a more realistic and tangible story of how your organisation works, it also homes into what really needs to be measured. This could potentially avoid a shotgun approach towards performance measure selection. More is not always better.

Top quality performance measures go beyond being relevant. The underlying hypothesis of causality needs to be put to the test. Is increased training resulting in fewer defects and shorter lead times? Do fewer defects and shorter lead times lead to more loyal customers? Are loyal customers really more profitable customers? What organisations believe is true, may not necessarily be true. Only testing such hypotheses can determine whether they are real or not.

### ***Rotten carrots***

If performance measurement systems identify relevant, top quality and causally-linked measures and targets, it follows that financial rewards should be linked to attaining them, right? Maybe, in theory, but it is not without its dangers. Personnel whose remuneration depends on reaching certain targets will do anything they can to achieve them, even at the detriment of the organisation itself. Such dysfunctional behaviour can range from neglecting unrewarded activities to downright cheating and manipulation of numbers.

Measures could also be attained by taking the easy way out. Consider a school where decreasing the number of dropouts and increasing the average pupil mark are the main measures and remunerates for its headmaster in relation to these measures. This could either be achieved the way the school intended, through better quality education, focusing on poor performers and nurturing high fliers or, more conveniently (and unethically), the worst performers could be expelled. The number of dropouts would be reduced and consequently average marks are increased!

The reality is, one cannot eliminate the risk of manipulation and dysfunctional behaviour. The key is embracing this fact and not assume that your personnel are not like the others, because they probably are. Having a good mix of measures could help mitigate this problem by reducing opportunity for tampering. Reducing the rigidity of links between performance measures and financial reward creates more room for professional judgement, thereby reducing the effectiveness of manipulation.

### ***Who measures?***

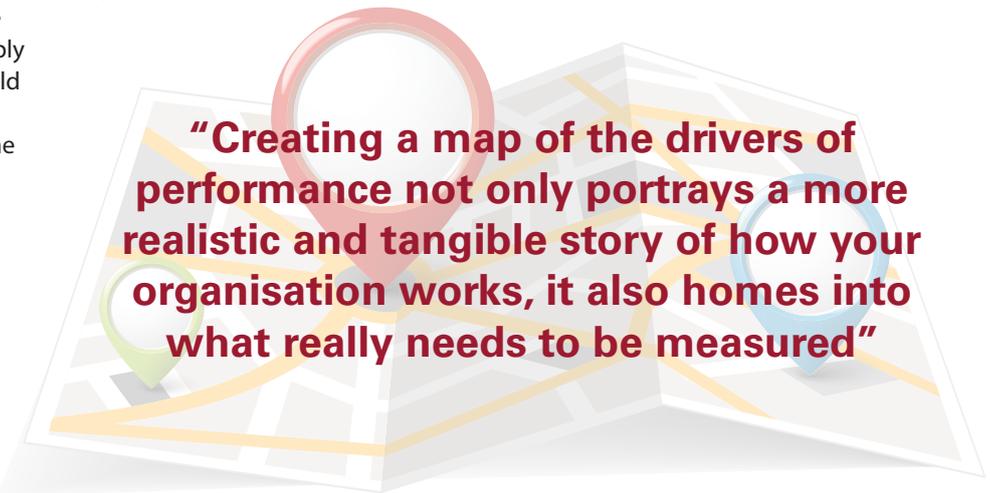
One of the major conflicts that tends to arise throughout performance measurement system processes arises between the finance function and the rest of the management team. The finance function is generally responsible for managing the performance management system, but it is management who is more intimate with how organisational realities are linked to performance. The finance function strives for simplicity in measurement whereas management would want to include every factor that may affect their performance. In summary, management has the expertise but is inhibited by self-interest whereas finance enjoys relative independence, but is less connected to the everyday realities of business.

The simple answer to this is effective communication and interaction between management and finance in order to strike the right balance between tangibility and manageability; a tough proposition to all involved!

### ***Keeping it fresh***

An organisation's strategy evolves over time, as does the environment it operates in. The dynamism of an organisation's reality could render a performance measurement system completely irrelevant or misleading. Performance measurement systems should be met with a culture of continuous improvement and refinement. Keep questioning the relevance of current strategy maps, value -drivers and causal links. And you can always dig deeper to further develop a better understanding of your organisation.

Never be satisfied, keep looking for ways to improve your performance.



**“Creating a map of the drivers of performance not only portrays a more realistic and tangible story of how your organisation works, it also homes into what really needs to be measured”**





# Economic Update

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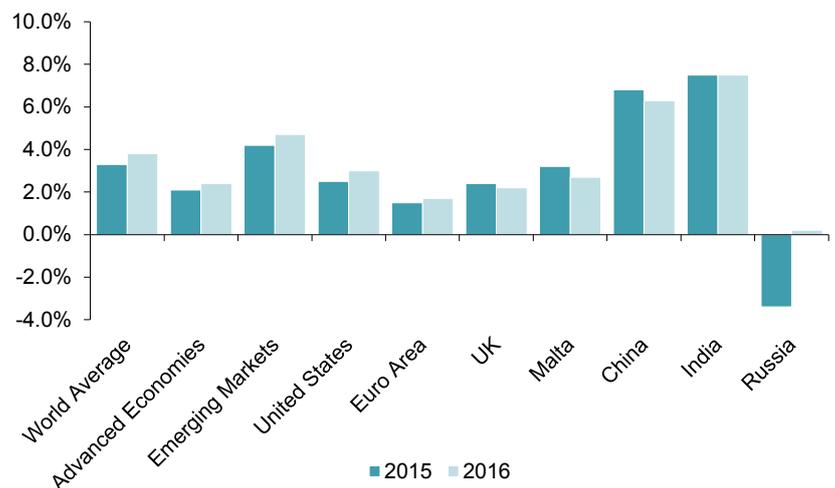
# Global Overview



2015 is likely to be remembered as a somewhat significant year. Despite the fact that the year has had far more than its fair share of bad news, it appears that global economic prospects are, for the most part, looking good.

The Western world, which has been feeling the effects of recession for the best part of the last decade, finally seems to be showing tangible signs of recovery. Perhaps unsurprisingly, the United States appears to be leading this recovery, with economic indicators showing clear year-on-year improvements in terms of real growth, inflation and employment. Consumer spending is up and confidence in the market is returning.

**Real GDP Growth**

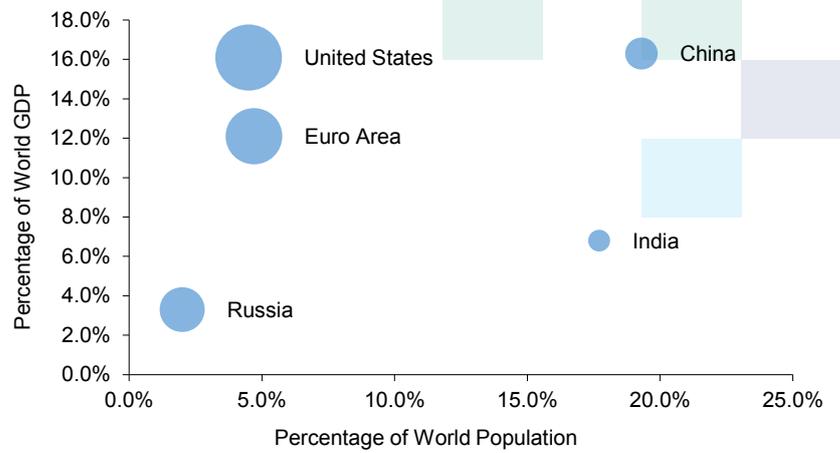


Source: IMF World Economic Outlook April 2013  
IMF World Economic Outlook Update July 2015

Europe is a mixed bag at the moment. On the one hand economic performance in the UK and Germany is improving, whilst on the other hand the Greek bailout crisis is a sign that fiscal responsibility is still critical to ensuring continued economic growth. Key factors underpinning the current economic situation are exceptionally low inflation rates, and a weak Euro currency.

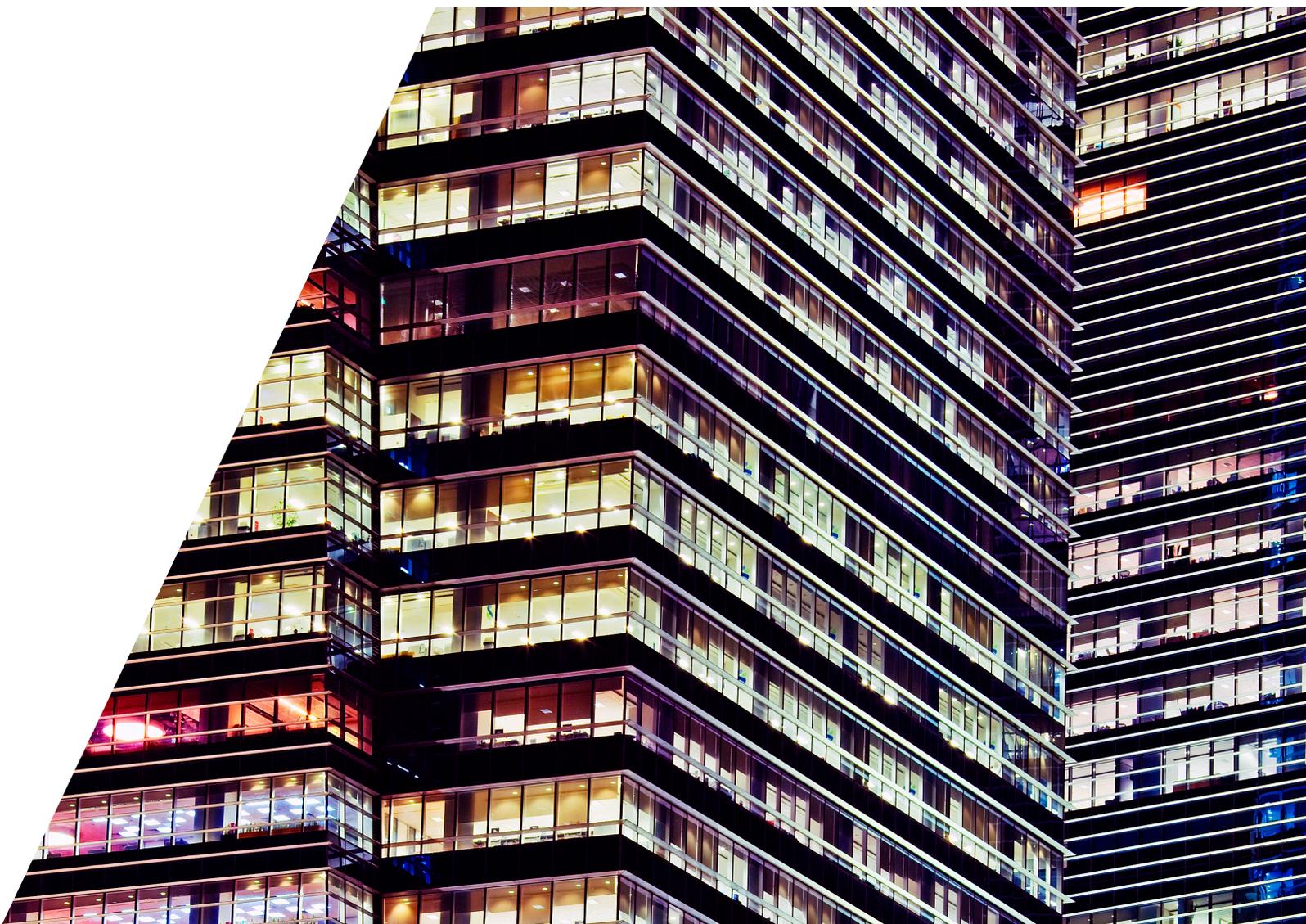
Malta has seen strong economic performance and outlook for the near future is good. Despite the nation's small size, limited resources and open economy, Malta has shown an impressive resistance to the troubles effecting its European neighbours.

**Share of GDP against Population**



**Note: Size of Bubble = GDP Per Capita**

Source: IMF World Economic Outlook April 2015, KPMG Analysis



# European Union



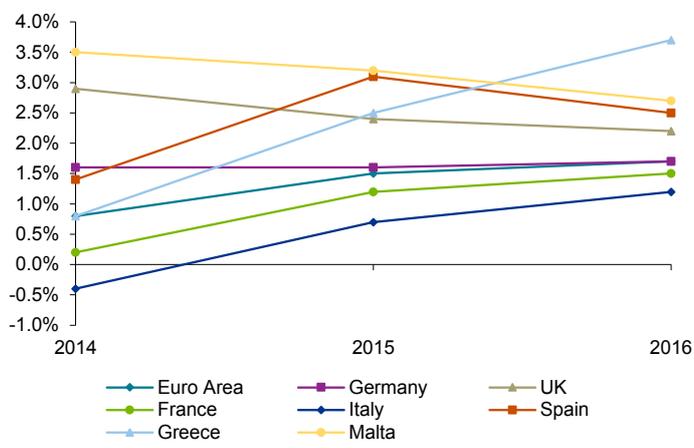
Throughout the last few years, economic performance in Europe has been fraught with challenges stemming from recession and financial instability. More recently, policy makers have begun gaining ground and future outlook is once again positive. During 2015, performance in Europe has been more or less in line with expectations, that is to say growth has been slow but stable, inflation has remained low, and unemployment has started to fall.

explained as a result of falling energy prices attributable to the low price of oil in early 2015. Measures taken by the ECB such as quantitative easing, will aim to remedy the low inflation rate through devaluation of the Euro. A highly depreciated Euro should in theory result in increased international demand for European exports, and should also increase the cost of goods and services

In addition to measures taken by the ECB, the Euro has also seen further depreciation as a result of the uncertainty surrounding Greece. In June 2015, Greece became the first developed nation to default on an IMF debt. The run up to this default and the immediate aftermath cast doubt over Greece's ability to meet the rest of its debt obligations. Failure to do so will cost the country's creditors over €300 billion. The deal reached between Greece and the other Eurozone nations mandates radical reforms including amongst others, the setting up of an asset management fund, and privatisation of government owned entities, and labour market reforms.

By contrast, Germany's future appears stable with slow growth predicted for the near future. Low energy prices have helped contribute to recent growth, and a depreciation of the Euro may boost exports to markets such as the US and China, further aiding economic prospects. However, despite rising private consumptions, investment remains relatively low, likely due to uncertainty regarding the future business environment. The Greek bailout crisis has also exposed Germany to significant financial losses. As the single largest contributor to the bailout, German institutions stand to lose around €56 billion should Greece fail to honour its debts.

**Real GDP Growth**

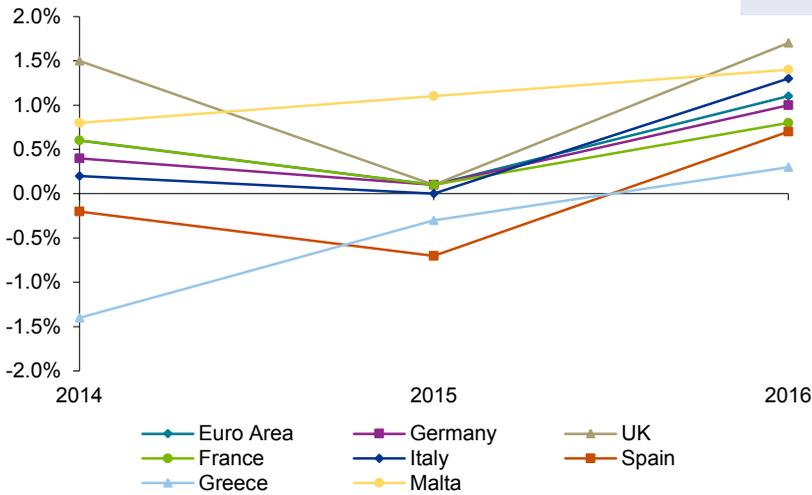


Source: IMF World Economic Outlook April 2015  
IMF World Economic Outlook Update July 2015

One of the main challenges currently facing the Euro Area is an exceptionally low inflation rate. This can be partially

imported into the Euro Area, contributing to a gradual increase in inflation rates.

**Inflation**



In the UK, growth continues to be strong and the position of public finances is improving. The primary motivator to economic growth is domestic demand, however private investment saw rapid growth during 2014, and is expected to remain high during 2015. Low inflation combined with rising wages is likely to contribute to increased consumer purchasing power in the coming years, however unless productivity continues to grow along with real wages, job creation may slow down. A minor cause of uncertainty in the UK's future is EU membership. Whilst an exit from the Union is an unlikely possibility, the results of negotiations with the EU will influence future investment in the country.

Source: IMF World Economic Outlook April 2015  
IMF World Economic Outlook Update July 2015



# Greek Debt Crisis

The Greek debt crisis is perhaps one of the most significant events in modern European history, as it has not only had a profound socio-economic effect on Greece, but it is also putting some of the core principles underlying the Eurozone to the test. The crisis has its roots in the economic recession of 2008 and the European

financial crisis which followed, however one can find warning signs stretching back all the way to 2001 when Greece first joined the currency union.

In order to safeguard the Euro, the ECB mandates certain convergence criteria which must be met before a nation can

join the currency union. These criteria relate to price stability, sound and sustainable public finances, exchange rate stability, and long-term interest rate performance. In 2004, it transpired that Greece had been under-reporting the extent of their government's deficit figures for the previous three years.

Timeline of the Greek Debt Crisis	
2001	Greece becomes the twelfth country to adopt the Euro.
2004	The Greek government admits under-reporting deficit figures between 2000 and 2003.
2009	Greece warns its deficit may rise to 12.5% of GDP. International credit rating agencies Moody's, Fitch and S&P begin downgrading Greece's credit rating.
February 2010	The Greek government approves the first of many austerity packages.
April 2010	Greece formally requests an international bailout.
May 2010	Greece accepts a €110 billion financial aid package from the IMF and other Euro Area states. Creditors insist on further austerity measures to ensure financial sustainability. Riots in the streets of Athens.
2011	Greece's financial situation worsens and creditors agree to a 50% haircut.
November 2011	Prime Minister George Papandreou resigns and is succeeded by a new coalition government.
2012	More austerity measures are introduced leading to further civil unrest and instability within the coalition government.

When the recession hit in 2008, the response of most governments was to pump their economies full of money through large stimulus packages in the hope of jump-starting investment and consumer spending. This proved to be a double edged sword for several European nations which could not support the additional strain this debt placed on their finances. In 2009, the Greek government warned that its deficit may rise as high as 12.5% of GDP. This prompted rapid downgrading of Greece's credit rating thereby making it harder to secure financing to support the high level of government expenditure. In early 2010, Greece formally requested an international bailout.

Over the course of the next few years Greece implemented several harsh austerity packages in order to ensure

continuing financial support from its lenders. All in all, around €323 billion Euro is owed by Greece to various creditors. In 2015, a new government came to power with the promise of resisting further requests for austerity by creditors. These promises were put to the test in June 2015. Greece needed to come up with €1.5 billion in order to meet a loan repayment to the IMF by the end of the month. After failing to negotiate an extension on the due date the government attempted to negotiate more favourable conditions to go along with the next instalment of bailout funds. Unfortunately, the negotiations were not successful and Greece defaulted on its debt to the IMF, the first developed economy to ever do so.

Subsequently, a new package of austerity measures was negotiated between Greece and other Eurozone nations. However

this deal has met opposition from some creditors, including the IMF, for being too harsh. The IMF specifically has stated that without further haircuts the current level of Greek debt is unsustainable.

Greece's future now depends upon the government's ability to pull off a complex balancing act. On the one hand, severe austerity measures must be put in place in order to ensure continuing bailout support without which the country will most certainly continue to default on its debts. On the other hand, it is essential that money is put aside for investment purposes in order to prevent the economy sliding deeper into recession, a situation which would dry up tax revenue and place an even greater burden on the social security systems over and above that imposed by the austerity measures.

Timeline of the Greek Debt Crisis (continued)	
2013	The government continues implementing further austerity measures.
January 2014	Greece posts a budget surplus equivalent to 1.5% of GDP for the 2013 financial year.
April 2014	Greece returns to international bond markets and is met by strong demand.
December 2014	The government's presidential candidate fails to win parliamentary support. Government collapses and elections are called.
January 2015	Left-wing party Syriza wins popular support and forms a new coalition government.
February 2015	Greece negotiates a four month extension on its debt.
June 2015	The Greek government enters into negotiations to secure financing in order to meet an IMF debt repayment at the end of the month. Negotiations fall through and capital controls are put in place to prevent a collapse of the banking system.
30 June 2015	Greece becomes the first developed nation to default on a debt to the IMF.
July 2015	European leaders and the Greek government agree upon an aggressive bailout proposal.

Source: <http://www.cnn.com/2015/06/24/greece-debt-crisis-timeline-it-all-started-in-2001.html?slide=1> [Accessed on 15/07/2015]



# Malta

As in past years, several key indicators show that Malta has managed to maintain strong economic performance when compared to other European nations. Economic growth is expected to be healthy with real GDP expected to increase by 3.2% during 2015 and 2.7% in 2016, and inflation is expected to be around 1.1%

during 2015 and rise to 1.4% in 2016. This is due in part to the economy adjusting following the energy tariff reductions in 2014, and in part due to strong consumer demand.

Unemployment figures are significantly better than the European averages. 2014

saw a strong increase in public sector job creation however, in the coming years, unemployment is expected to average out at around 5.9%.

Macroeconomics Indicators	2014	2015	2016
Real GDP Growth	3.5%	3.2%	2.7%
Inflation	0.8%	1.1%	1.4%
Unemployment	5.9%	5.9%	5.9%

Source: IMF World Economic Outlook April 2015

Unemployment Rate	2013	2014	2015	2016
Malta	6.4%	5.9%	5.9%	5.9%
Euro Area	12.0%	11.6%	11.0%	10.5%
EU	10.9%	10.2%	9.6%	9.2%

Source: European Commission Forecast Spring 2015

The government's financial position has also seen improvement with the debt-to-GDP ratio expected to fall to 65.4% by 2016. Recent data shows that both government revenue and expenditure are increasing. During Q1 2015, government revenue increased by 16.1% over the same period the year before, whilst expenditure increased by just 2.8% over the prior year.

However an item to note is Malta's relatively high exposure to Greek government debt. Taking into consideration the loans to Greece, and debt which has been guaranteed by Malta, the country is exposed to around €180 million of Greek debt. Whilst a far cry from the €56 billion of exposure faced by Germany, Malta's exposure is perhaps

more significant as it amounts to slightly over 3% of the nation's GDP as opposed to Germany's exposure amounting to around 2.4% of GDP<sup>10</sup>. For this reason, Maltese officials have strongly supported a solution to the crisis which would maximise Greece's ability to repay its debt.

The devaluation of the Euro could potentially bring about benefits for Malta. Tourism is one of the most important sectors in the Maltese economy. Data analysis shows that Malta's key tourism markets remain the UK (29%), Italy (16%), Germany (8%) and France (7%). The relevant strength of the Pound against the Euro, combined with positive economic trends in the UK could be good news for the local tourism industry due to

the substantial proportion of tourists originating from the UK.

Another factor which operators within the tourist industry may wish to pay attention to is the expenditure per capita of different visitors. While it is true that tourists from the UK make the largest single source of tourists and tourist expenditure, they spend noticeably less per capita than tourists from Germany or France. Efforts to attract tourists who are more likely to be big spenders could be beneficial to the local industry as the 'investment' put into attracting the tourist to Malta will yield higher returns.

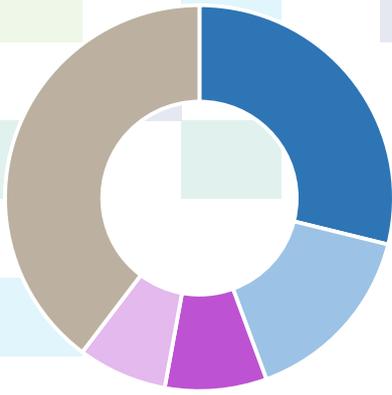
Government Gross Debt as a % of GDP	2013	2014	2015	2016
Malta	69.2%	68.0%	67.2%	65.4%
Euro Area	93.2%	94.2%	94.0%	92.5%
EU	87.3%	88.6%	88.0%	86.9%

Source: European Commission Economic Forecast Spring 2015

<sup>10</sup> [http://www.bloombergbriefs.com/content/uploads/sites/2/2015/01/MS\\_Greece\\_WhoHurts.pdf](http://www.bloombergbriefs.com/content/uploads/sites/2/2015/01/MS_Greece_WhoHurts.pdf) [Accessed on 15/07/2015]



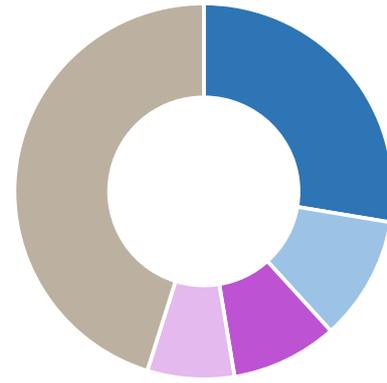
Total Tourists



■ United Kingdom ■ Italy ■ Germany ■ France ■ Other

Source: NSO

Total Expenditure



■ United Kingdom ■ Italy ■ Germany ■ France ■ Other

Tourist arrivals, nights and spending (2014)	Total tourists	Total nights	Total expenditure (€000s)	Expenditure per capita
United Kingdom	487,714	4,122,976	422,453	866
Italy	262,631	1,596,151	163,204	621
Germany	143,053	1,210,790	138,939	971
France	125,511	982,021	113,593	905
Other	670,901	5,610,174	690,577	1,029
	<b>1,689,810</b>	<b>13,522,112</b>	<b>1,528,766</b>	

Source: NSO, KPMG Analysis

Manufacturing in Malta	2011 (€000s)	2012 (€000s)	2013 (€000s)	2014 (€000s)
Total Gross Value Added	6,020,836	6,345,319	6,643,472	6,933,118
of which Manufacturing	789,545	807,616	745,319	736,218
	13.1%	12.7%	11.2%	10.6%

Source: NSO

Manufacturing is also another important industry in Malta, however in recent years its contribution to the economy, has been diminishing. Since 2011, total gross value added in the economy has increased by around 15%, however in that same time the manufacturing industry has shrunk by 7%. Hence, it is not surprising that the contribution to gross value added attributable to the manufacturing industry has fallen every year since 2011, when it stood at 13.1%, to 10.6% in 2014.

Reasons for the industry's decline could be numerous, however rising costs and low

demand are likely to be the main culprits.

This is corroborated by other economic indicators. Statistics show that between 2013 and 2014 the composition of Malta's exports continued its shift away from goods and towards services. The Balance of Payments Current Account recorded a fall of 9% in credit entries related to goods (indicating a fall in exports) and an increase of 2% in credit entries relating to services (indicating an increase in exports). Further to this, other data from the NSO shows that the number of individuals employed in 'manufacturing, mining and quarrying and

other industry' fell from 26,728 in the period October to December 2013, to 25,841 in the same period in 2014. This represents a decline in employment of around 3%. Average basic salaries to individuals in this industry rose from €16,243 to €16,420 during the same time frames, an increase of around 1%.

Balance of Payments	2013	2014	Change
Goods and Services (Cr.)	11,601,986	11,497,807	-1%
Goods	2,861,622	2,594,498	-9%
Services	8,740,364	8,903,309	2%

Source: NSO

Manufacturing in Malta: Labour Statistics	Oct -Dec 2013	Oct - Dec 2014	Change
Number of employees	26,728	25,841	-3%
Average basic salary	16,243	16,420	1%

Source: NSO



# U.S.A.



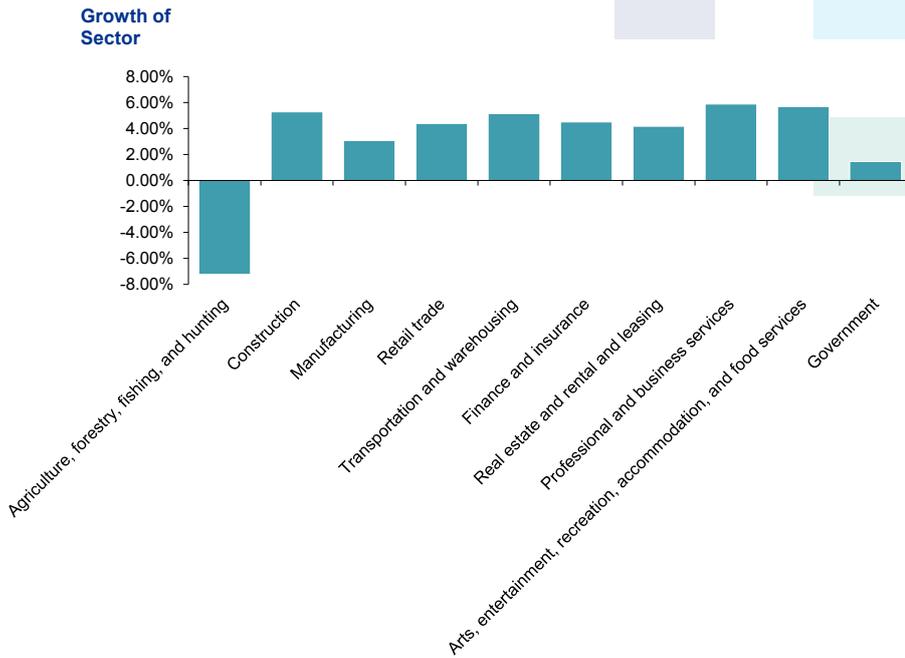
The United States has spent the past few years recovering from recession. Data shows that during 2014, the US saw real GDP growth of 2.4% which is expected to increase to 2.5% in 2015 and then to 3% during 2016. Events during the early months of 2015 are likely to contribute to lower growth than was predicted in past years. Specifically, these include harsh winter conditions and port closures along

with a reduction in capital investment in the oil industry brought about by the lowest oil prices in recent years. Unemployment figures also support the notion that the American economy is well on the road to recovery, with the unemployment rate predicted to fall from 6.2% in 2014 to 5.1% in 2016. Inflation numbers are also interesting to note as this is often indicative of increased consumer demand. During

2014, the inflation rate was 1.6%, and this is predicted to fall to 0.1% in 2015 likely due in part to the heavy drop in fuel and energy prices seen towards the beginning of the year. In 2016, things are expected to normalise and inflation of 1.5% is predicted.

Macroeconomic Indicators	2014	2015	2016
Real GDP Growth	2.4%	3.1%	3.1%
Inflation	1.6%	0.1%	1.5%
Unemployment	6.2%	5.5%	5.1%

Source: IMF World Economic Outlook April 2015



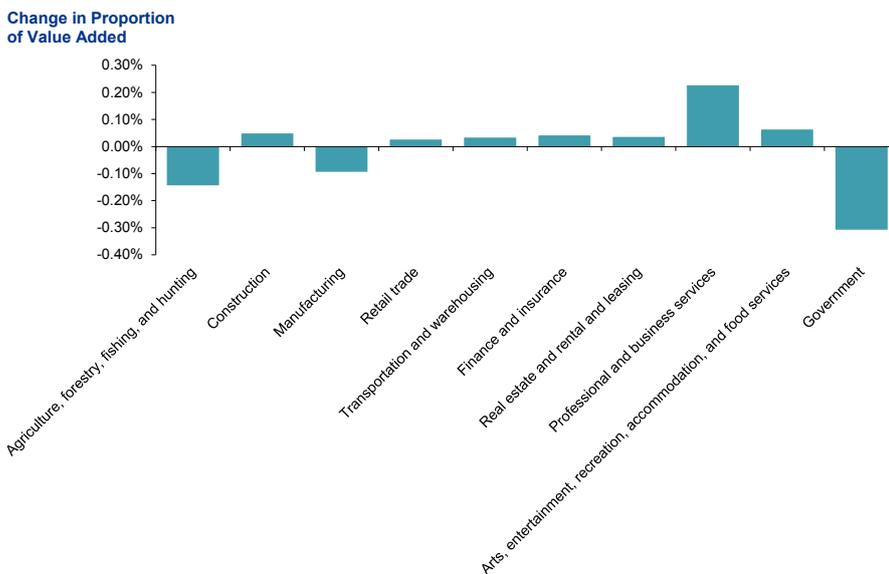
Source: US Bureau of Economic Analysis (BEA), KPMG Analysis

Positive trends continue when looking at individuals' personal incomes. Data from the US Bureau of Economic Analysis (BEA) shows that from 2013, total personal income has on average been rising. A breakdown of this data also shows that this is primarily due to rising employee compensation. This is further supported by the fact that despite increasing receipts of social security

benefits from government, income from unemployment insurance in early 2015 is almost half what it was on average during 2013. Furthermore, data on expenditure shows that tax payments, consumption expenditure and interest payments have all increased between 2013 and Q1 2015. This suggests that consumer confidence is improving and increased consumption

is one of the main driving forces of the recovery.

It is worth pointing out that the US is currently in the run up to the next presidential elections in 2016. Undoubtedly, the results of that election will have an impact on market performance and consumer confidence.



Source: US Bureau of Economic Analysis (BEA), KPMG Analysis

# Looking Forward



The global economic atmosphere is improving with growth predicted in major economies during the coming years. At this stage it is important for governments to practice fiscal responsibility and bring debt levels under control.

Despite a few minor setbacks early this year, the recovery in the US is well underway and the future looks bright.

The primary factors driving accelerated growth such as strong labour and financial markets, low fuel prices and a strengthening housing market, are all present and intact.

Future prospects for Europe are on-the-whole good. Low energy prices and a weak Euro will encourage investment and exports, while low inflation rates

lead to relatively strong growth in purchasing power, thus fuelling domestic consumption. However, there are still major challenges to face such as the sustainability of government finances, ensuring public support for the European Union, and also ensuring that the single currency monetary union does not falter.



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Printed in Malta.