Rising consumption, but not without risks

Household consumption has rebounded very significantly since the start of the recovery in 2014. But the simultaneous drop in savings poses an important vulnerability in adverse scenarios.

Diana Posada and Daniel Fuentes

Abstract: As the financial health of households continues to improve, household consumption too is growing at an elevated rate. However, while GDP is now back at pre-crisis levels, household spending still remains below its 2008 peak. The short-term outlook for consumption is favourable and households look set to continue increasing their expenditures, supported by some residual pent up demand following the drop in durables consumption between 2008 and 2013. However, household consumption remains dependent on income growth and confidence to sustain momentum. A deterioration in these fundamentals could endanger the medium-term sustainability of household consumption growth. At the same time, the drop in household savings rate, at its lowest level since 2006, puts Spanish households in a vulnerable position at a time of rising inflation and monetary policy normalisation.

> “The economy is now back at pre-crisis levels of GDP but with household consumption still some 30 billion euros below the peak reached in the second quarter of 2008.”

Introduction

The financial situation of Spanish households continues to improve, facilitating the ongoing recovery in private consumption. This is occurring against the backdrop of an entrenchment of economic recovery driven by lax monetary policy, an improvement in the global environment and oil price developments.

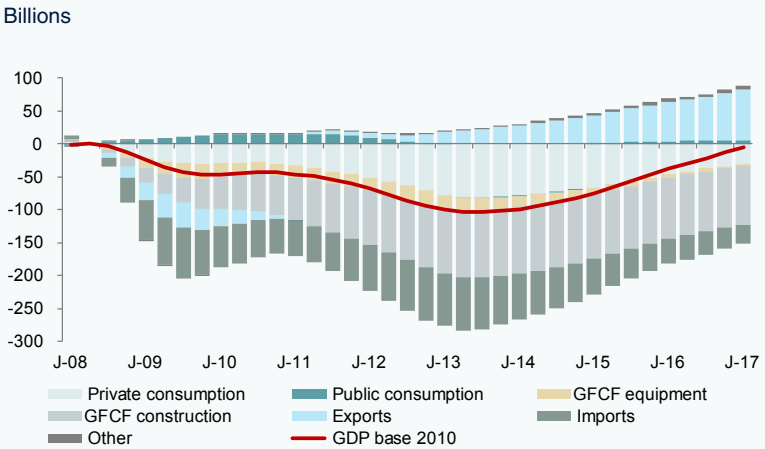
The pick up in consumption in recent years has been underpinned by a recovery in fundamentals. Household income has revived on the back of strong job creation. Meanwhile, consumer confidence is above pre-crisis peaks. Households have also benefited from a recovery in the price of their financial assets and, more recently, have begun to see their real estate assets regain value as well. Finally, the low interest rate environment has created incentives for consumption to the detriment of savings.

Thus, consumption has been an undeniable driver of the economic recovery, accounting for 60% of GDP growth over the last three years. Even so, close to ten years after the start of the crisis and with GDP now back at pre-crisis levels, household consumption still remains around 5% below its second quarter of 2008 peak. This disparity is explained by the changes that have taken place in the profile of aggregate demand, with domestic demand losing relative weight.

GDP amounted to 282 billion euros in the second quarter of 2008 – on a 2010 constant price basis – reaching a record annualised high of 1.12 trillion euros in the third quarter of the year. However, having essentially recovered the same level of GDP in the second quarter of 2017, the contribution from household consumption to aggregate demand remains some 30 billion euros below its pre-crisis level. This is because wage remuneration remains the main source of household income and the number of full-time equivalent employees is

Exhibit 1

Change in GDP (demand side) versus pre-crisis peak



Source: INE, Afi.

still around 2.2 million below third quarter 2008 levels.

The improvement in household disposable income is largely based on employment creation

Household income is one of the main determinants of household spending. In this regard, household income improved in 2016, registering growth of 2.5% [1] after 1.9% in the previous year. Together with a negative inflation rate of -0.2% for the year as whole, this helped bring about a third consecutive year of improvements in household purchasing power. However, the sharp spike in inflation at the start of 2017 dampened growth in Gross Disposable Income (GDI), which slowed to 1.5% in real terms. This trend could continue over the coming quarters.

The exceptional increase in employment remains crucial to the recovery in household income. Over the last three years, LFS employment has increased by nearly 1.8 million, reaching 18.8 million at the end of the second quarter of 2017 (compared to a record high of 20.8 million in the third quarter of 2007), and employment has continued to rise at an average rate of over 2.5% year-on-year over the last twelve months.

However, even after this significant increase in employment, labour market slack remains considerable. The unemployment rate has fallen by nearly 9 percentage points from peak to the current rate of 17.2%, closing in on structural levels (between 14-16% depending on the estimate). But, considering other labour market imbalances, such as discouraged and inactive individuals wanting but not actually looking for work, as well as people working part-time involuntarily, the labour underutilisation rate [2] comes in at nearly 29% of the active population.

Labour market slack, together with other factors, such as scant productivity growth, low inflation expectations and certain structural changes in relation to wage bargaining power, is behind the anaemic growth in wages since the start of the recovery. Wage remuneration per salary-earner increased by 0.2% in real terms in 2016. However, the pick up in inflation at the start of 2017 has pushed real wage growth back into negative territory (-0.2% in the first quarter of the year).

In recent years, rising employment – as opposed to wages – has been the main factor driving the increase in overall wage earner remuneration which remains the principal contributor to household income (accounting for around 75% of GDI). Looking forward, increasing wages should compensate a degree of slowdown in employment creation as labour market slack begins to diminish, until that materialises, it is conceivable that wage remuneration will make a smaller contribution to household income growth.

Income from Gross Operating Surplus (GOS), *i.e.* income from business activity, is the second most important component of household GDI, representing around 25% of the total. The improvement in economic activity began to feed through to households in 2015 and increased in 2016, with GOS growing by 3.7% after rising by 2.2% the previous year. However, GOS growth may now have reached a ceiling and, as the economy begins to slow towards potential growth rates (estimated at around 1.5-2%), the contribution from business income could do the same thing.

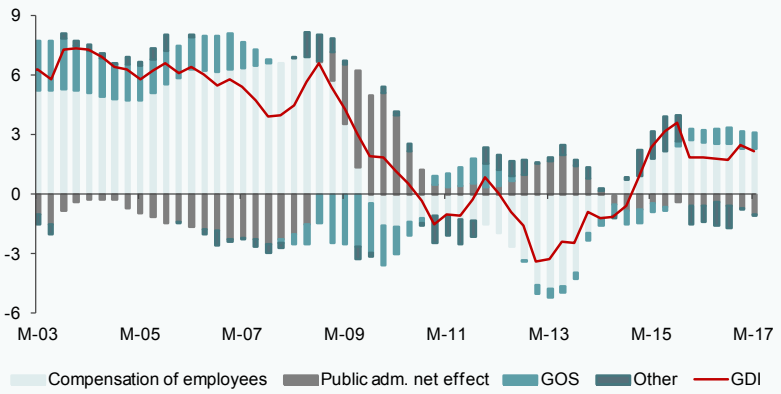
In terms of the other components of GDI, public administrations continue to have an overall net draining effect on household income due to larger increases in taxes and social contributions relative to the transfers received from the state. Tax payments and

> “As has been the case since the start of the recovery, household income growth has primarily been underpinned by strong employment creation.”

Exhibit 2

Household Gross Disposable Income

Year-on-year change and contributions, percentage



Source: INE, Afi.

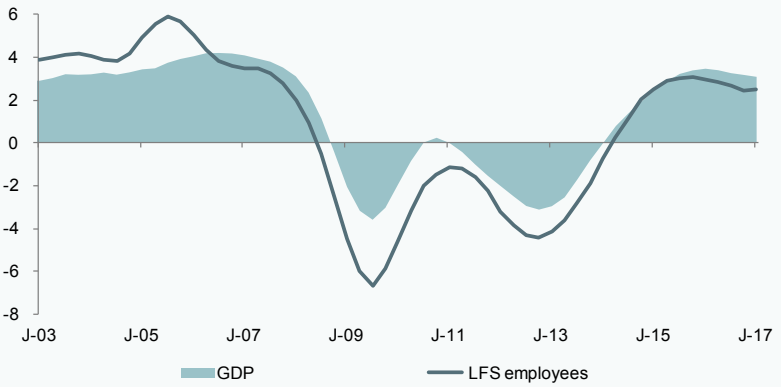
contributions have been on the rise over the last year as a proportion of GDI and now account for around 34.4%, above the historical average. In terms of property income, both interest income and payments continue to decline and are now at record lows (interest income accounts for 1.1% of GDI, some 7 billion euros, while payments are 0.9%, around 6 billion euros). The possible normalisation of monetary policy over the coming years will begin to reverse this trend.

Overall, the increase in household income in recent years has been underpinned primarily by strong job creation and the improvement in

Exhibit 3

GDP and LFS employment

Year-on-year change, 12-month moving average



Source: INE, Afi.

> “Households have seen the value of their real estate assets rise consistently since 2013, which is driving real estate investment. Even so, total household investment is only around 5% of GDI – half the historical average.”

economic activity. However, it is possible that these factors will begin to lose steam over the coming quarters and thus household income growth could also moderate.

The increase in household wealth – both property and financial – is another factor supporting rising consumption

Household wealth continues to grow (5.8% year-on-year in the first quarter of 2017) reaching 540% of GDP, thanks primarily to increases in property wealth (+5ppts to 421% of GDP). Recovering real estate prices, especially housing – the main household investment asset – are behind this increase in property wealth. Non-state subsidised house prices increased by 2% in 2016 and continued growing at the same pace in the first quarter of the year. The recovery in house prices follow various years of significant adjustment in a sector which to a large extent amplified the effects of the crisis.

Households have seen the value of their real estate assets increase consistently since 2013, which at the same time is driving household investment in real estate. Nominal investment grew by almost 15% in the first quarter of the year (5.5% in 2016) and accordingly the sector's financing capacity stands at 1.2% of GDP, a minimum since 2010. However, to put this in context, the overall rate of household investment remains around 5% of household GDI, approximately half the pre-crisis average.

In addition to real estate wealth, household net financial wealth has also performed well of late. Net investment flows reached 2.4% of GDP in the twelve months to the first quarter of 2017. As a result, the stock of net financial assets is now at a record high of 1.3 trillion euros (119% GDP).

Exhibit 4

Household wealth

Trillions of euros

Source: Bank of Spain, Afi.

Exhibit 5 **Property wealth and house prices**

Sources: Bank of Spain, Ministry of Public Works, Afi.

Since the start of the crisis, households have focused their investment primarily in equities, particularly mutual funds, as well as insurance and pension funds. Furthermore, the environment of low interest rates, especially on bank deposits, has had a significant impact on Spanish households, who have traditionally held a significant proportion of their financial assets in deposits. As a result, there has been a substitution away from time deposits to sight deposits.

More rapid consumption growth relative to household income has pushed the household savings rate downward

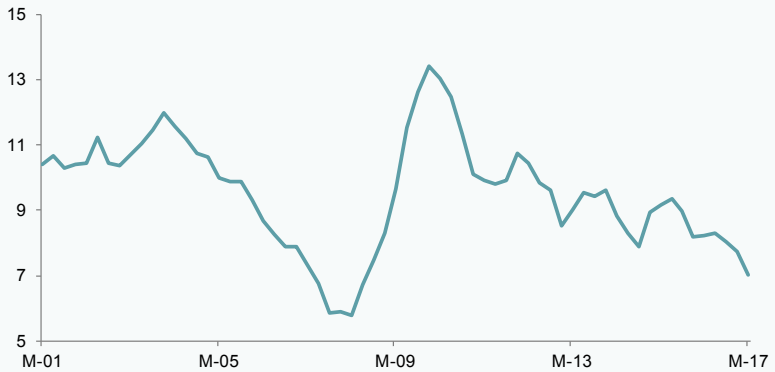
In recent years, household consumption has grown in line with fundamentals. However, consumption is currently ticking along at almost double GDI growth (consumption grew by 2.7% year-on-year on average over the last twelve months, compared to 1.5% growth in real GDI) meaning that households have begun to draw down savings as well as seek external financing to maintain their level of spending. The faster rate of growth of consumption relative to income is explained by the remnants of pent up demand –illustrated by the increase in consumer durables since the start of the recovery, following major retrenchment during the crisis.

The downward trend in the savings rate since 2010 has become more pronounced of late, potentially jeopardising the sustainability of medium-term household consumption. In contrast to previous years, which saw an increase in income lead to a concurrent rise in savings and consumption, in recent quarters, income growth is no longer proving compatible with a pick up in savings. Thus, the household savings rate continued tracking down in the first quarter of the year to reach

> “The housing savings rate is at its lowest level since 2006, spurred by an increase in consumption at the same time as income growth has slowed. This poses an important vulnerability in the case of adverse economic developments.”

Exhibit 6 **Household savings rate**

Percentage of GDI



Source: INE, Afi.

7% of GDI, significantly below the historical average of 9.5% and the euro area average of 12.3%. Spanish households' rates of saving are now the lowest among neighbouring economies, far below German (17%) and French (14%) households, putting Spanish households in a more vulnerable position at a time of rising inflation and monetary policy normalisation.

Beyond weak household income growth, various factors explain the reduction in the savings rate. Increased consumer confidence (which reached a peak in 2015 and has remained at a high level) together with less uncertainty regarding the current and future economic outlook, have likely reduced households' precautionary saving. Concerns about the future were the main reason for the jump in household savings between 2009 and 2011, which pushed the savings rate to a peak of 13%.

The low interest rate environment is another factor dissuading households from saving and increasing the propensity to consume. Furthermore, it has helped facilitate household deleveraging. Household debt levels have now fallen to 713 billion euros which is a similar level to ten years ago and the equivalent of 64% of GDP. This is the lowest since the second quarter of 2005 and is closing in on the euro area average (59% of GDP). Accordingly, households' deleveraging needs are diminishing, and with that the requirement to put money aside in order to service debt payments. With deleveraging now well underway, the low cost of taking on debt has served as an incentive to finance household spending. New consumer lending rose by 28% in 2016 to 25.4 billion euros. Though still low in absolute terms, new lending has continued to grow in the first half of 2017. The easing of lending conditions in recent years is allowing both part of consumption to be financed by credit, while simultaneously sustaining the household deleveraging process.

In summary, given the favourable economic outlook, households are increasing consumption above income growth, resorting increasingly to savings and external financing. In so doing they are smoothing their consumption over time. However, this situation may not prove sustainable over the medium-term, since consumption should ultimately mirror household income developments.

Conclusion

The financial health of households continues to improve and accordingly household consumption grew at elevated rates of close to 2.7% last year. Income growth, supported by vibrant job creation (nearly 1.7 million new jobs since the start of the recovery) and the improvement in economic activity, has been the key factor in driving household demand for goods. This is especially the case for goods, such as cars and household appliances, whose purchases were delayed during the crisis. But it is not only income growth that has been of support, household wealth has also grown robustly since 2013. Household wealth initially benefited from the recovery in asset prices which, together with the deleveraging process undertaken by households in recent years, has enabled net financial wealth to reach record highs. More recently, the pick up in house prices – households' main investment asset – has served as a major boost to property wealth.

However, consumption is now growing faster than income and while some divergences can take place over the short-term, in the medium-run consumption ought to move in line with household income. As a consequence of the current imbalance, the household savings rate has dropped to 7% – its lowest since 2006 – which poses a potential vulnerability in adverse scenarios.

In order to maintain private consumption growth over the medium-term, the fundamentals underpinning consumption need to be sustained. This speaks of a need for wage increases to prop up household income, especially as labour market slack begins to dissipate.

Notes

[1] Data from the Quarterly non-financial accounts for the Institutional Sectors are presented on a rolling four-quarter basis to adjust for seasonal effects.

[2] This approach to measuring unemployment is commonly known as the labour underutilisation rate and is one of the measures typically used by the U.S. administration.

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A.F.I – Analistas Financieros Internacionales, S.A.

Wages, productivity and corporate management

The Spanish economy faces major challenges to sustainably and significantly raise productivity. Improving corporate management quality could help smaller Spanish industrial companies to boost productivity and ultimately wages.

Rafael Myro and Javier Serrano

Abstract: Companies which are better managed offer superior remuneration to their workers, perhaps as a mechanism for retaining talent, or to spur, or at least to compensate, greater engagement with the company's objectives, which is essentially an expression of good quality management. In Spain, there is a notable and sizeable deficit in terms of the quality of corporate management among industrial SMEs which contributes significantly to their lower levels of productivity relative to their counterparts in other large European countries. Reducing this deficit should be an urgent priority, not just for the companies themselves, but also for business organisations and certainly for industrial policy.

Introduction

The recovery in the Spanish economy has reopened a debate on the desirable path for wages. Initially, the focus has been on the minimum wage – which in Spain is further from the average than in other European economies – resulting in a notable increase

> “Wages and productivity need to move in unison to avoid calling into question Spain’s current advantage in unit labour costs, and by extension prices, which arose out of the sharp downward adjustment in employment and wages.”

(in a European context) of 8% in 2017. This was the result of a tug of war between the Government, which proposed a smaller increase, and some opposition groups, who advocated somewhat higher increases, aimed at bringing the minimum wage in line with other member states.

Meanwhile, in the crucial area of collective bargaining, the latest proposals from trade unions do not look to be excessively exorbitant – setting a range for wage increases of between 1.5% and 2.5% in 2017. These demands reflect both the expected pick up in inflation and probably quite a substantial part of the small anticipated increase in labour productivity. Slow progress on the latter is undoubtedly the key factor preventing wages from rising more rapidly. Wages and productivity need to move in unison to avoid calling into question Spain’s current advantage in unit labour costs, and by extension prices, which arose out of the sharp downward adjustment in employment and wages (Myro, 2015).

Fortunately, there is significant scope to improve productivity, because the dominant group of companies in Spain – those with fewer than ten employees – have lower levels of output per worker than their peers in other countries (Costa 2015; Serrano *et al.,* 2017). Nor do companies with 10 to 50 employees fare significantly better.

Boosting productivity depends on the accumulation of tangible and intangible assets. The latter is taking on increasing importance in advanced economies (Corrado *et al.,* 2006) but has surprisingly very little prominence within Spanish companies, especially the smallest ones. Innovation, training and specialisation of company workers, digitalisation and brand creation are all important elements of intangible assets.

However, corporate management quality is a particularly salient aspect, representing an asset which can be defined and measured in a variety of ways and which is gaining increasing attention in economic literature (Andrews and Westmore, 2014; Bloom *et al.,* 2017). The importance of this factor in Spain lies in the fact that the smallest companies are precisely those with the largest shortcomings in terms of management (Huerta and García, 2014; Yagüe and Campo, 2016). Some academics go even further, attributing the problem of the small average size of Spanish companies to poor quality corporate management (Huertas and Salas, 2014).

Based on the above, the main focus of this article is to measure and evaluate the impact of corporate management quality on company productivity. The second key focus is to go a little further, in an attempt to identify a positive and direct influence from management quality on wages, beyond the indirect effect through improved productivity. The hypothesis underlying this approach is that companies which are better managed offer superior remuneration to their workers, perhaps as a mechanism for retaining talent,

> “The importance of this factor in Spain lies in the fact that the smallest companies are precisely those with the largest shortcomings in terms of management.”

or to spur, or at least to compensate, greater engagement with the company's objectives, which is essentially an expression of good quality management.

In line with the above, this article explores the relationship between the quality of corporate management in industrial companies and productivity and wage levels over five years during the height of the crisis (2009-13), using data from the *Survey on Business Strategies* (ESEE) put together by Fundación SEPI. In doing so, this article starts by using an indicator of good corporate practices taken from Yagüe and Campo (2016) and provides an initial assessment of management in Spanish industrial companies. It then moves to estimate the impact of corporate management on productivity and wages. If it turns out that quality of corporate management is a factor which clearly influences productivity levels and worker remuneration, this will provide a robust basis for trade unions to consider adopting what is currently an uncommon strategy in Spain: encouraging workers and their highly-qualified representatives to become more involved in the management of the company. Doing so, would not only enable unions to improve the living standards of their members, but also boost the competitiveness of the company employing them.

Good management practices in Spanish industrial companies

The quality of company management includes a variety of different inter-related aspects, making it a challenge to measure, even more so given available data. That said, various attempts have been made to assess this variable. Among these is the model proposed by Yagüe and Campo (2016), selecting various aspects considered by the literature to be important for company management and for which ESEE provides information. Their measure is also very strongly related to company size, the degree of internationalisation, the legal form of a limited company, spending on training and foreign involvement in share capital. This is the approach used in this article, since it draws from information provided by ESEE, which is the database used.

The good management practices measured by Yagüe and Campo are grouped into six sections[1]. Table 1 provides information on the content of each practice.

Table 1 **Indicators used in the creation of the Management Quality Index**

Variables linked to leadership and management abilities	Technological guidance or committee
	Innovation activity plan
	Use of consultants for technology information
	Support by owners and family in leadership and management
	Expenditure on environmental protection
	Investment in environmental protection
	Degree of diversification
Variables linked to the operations management (processes, products and services)	Product standardization
	Normalization and quality control
	Scientific and technical information systems
	Total innovations
	Product innovations
	Process innovations

Table 1 **Indicators used in the creation of the Management Quality Index**

(continued)

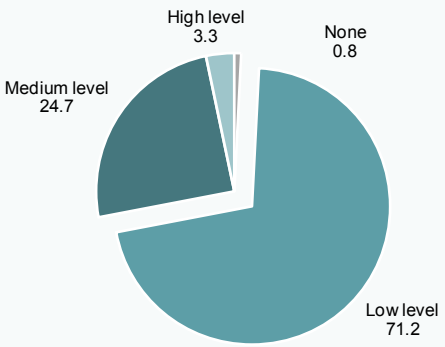
Variables linked to the operations management (processes, products and services) (con't)	Product and process innovations Acquisition of equipment for product improvement Organizational methods innovations Innovations in external relations management Merchandising innovations Process innovations of new equipment Software process innovations New techniques process innovations
Variables linked partnerships and resources	Technological cooperation agreements Technological collaboration with customers Technological collaboration with competitors Technological collaboration with suppliers Collaboration with universities or technological centres European Union research programme
Variables linked to staff management	External expenditure on diverse training (5 indicators) Hiring employees with experience in R&D public system Hiring employees with experience in R&D
Variables linked to the digital and technological policy and strategy	Own internet domain Web page on the firm server Online purchases from suppliers Online sales to final customers Online sales to firms Evaluation of alternative technologies Evaluation of technological change
Variables linked to measurement of results	Market surveys Innovation performance indicators Online sales impact indicator Identification of competitive position in main market Positive evolution of market share

Source: Yagüe and Campo, 2016.

Exhibit 1

Distribution of Spanish industrial companies by level of good management practices, 2013

Percentage



Source: Yagüe and Campo, 2016.

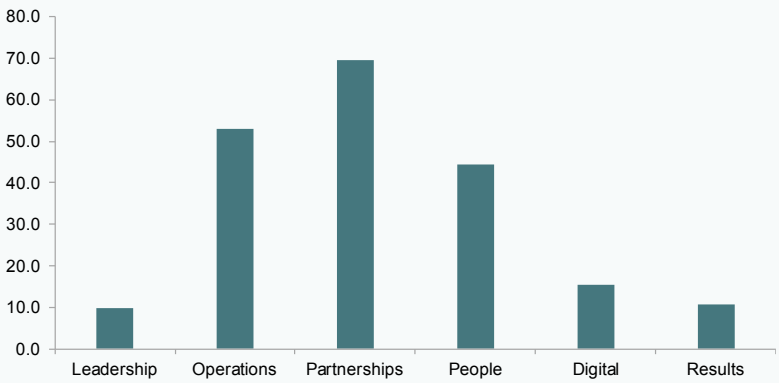
As can be seen in Exhibit 1, according to the above measures, the quality of smaller Spanish industrial company management is generally low. 71% of Spanish industrial companies follow few or none of the good management practices, failing to register on over 12 of the 46 practices contained in Table 1, and only 3.3% engage in 25 or more good practices, which is the threshold for high quality management. Differences between Autonomous Regions are relatively limited, with a variation coefficient of 0.14, with companies in Aragon and Catalonia performing relatively better and companies in the Balearic Islands, Andalusia and Extremadura performing the worst. Dispersion is considerably greater in terms of sectors. Companies working with basic metals, machinery, transport materials and chemicals tend to engage in more good practices, compared to companies involved in wood, furniture and metal products at the other extreme (Yagüe and Campo, 2016).

In terms of the different groups of good management practices, it is particularly surprising to see that many companies fail to follow even one of each of them, as illustrated in Exhibit 2. The perspective offered by this exhibit is even more negative when considering that in the leadership area, good practice focuses and improves over time only in the realm of family leadership, or that in terms of digital strategy, there are only significant signs of progress in relation to the internet domain (online purchases for suppliers also improve moderately), or that companies put little emphasis on market share and innovation in their measurement of results.

Either way, the greatest shortcomings are found in operations, partnerships and people. The latter two categories are especially relevant for labour productivity. Partnerships form the basis for company networks which are one of the crucial mechanisms through which innovation is created and technologies are spread. This is one explanation for the widening of the gap in terms of productivity between large and small companies, which is not specific to Spain and is a cause of general concern at present. Human capital, and particularly spending on training, affects employee productivity, engagement with the company

Exhibit 2

Percentage of companies without a single good practice in each dimension



Source: Yagüe and Campo, 2016.

and their ability to adapt to new tasks and necessities.

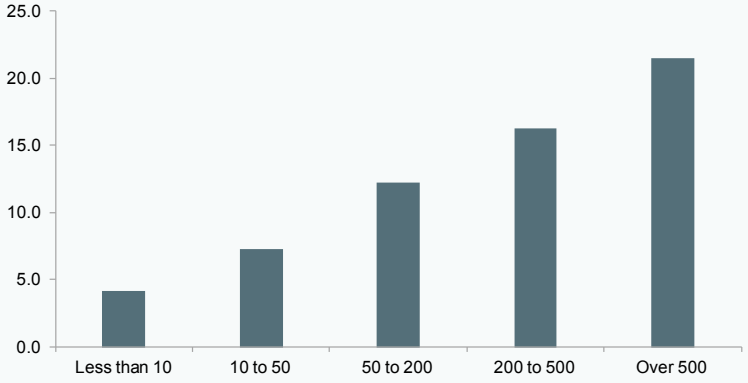
Finally, there is a clear relationship between good management practices and company size. Companies with more than 500 companies engage in five times the average number of good practices adopted by companies with less than ten employees, which only engage in slightly over four (Exhibit 3).

Based on this information, there is considerable scope for Spanish industry to improve management practices. This is a conclusion that emerges out of international work in this area, albeit less starkly. The

Exhibit 3

Quality of management and company size

Average number of good practices by average company size, measure in number of employees



Source: Authors' own elaboration from ESEE, Fundación SEPI.

> “ The greatest shortcomings are found in operations, partnerships and people. The latter two categories are especially relevant for labour productivity. ”

World Management Survey assesses the management quality of Spanish companies – not just industrial companies – assigning it a score of 2.5 out of 5. This somewhat more upbeat assessment relative to the conclusions arising from this analysis of the data is due to the fact that the former relies on opinions from managers in large companies and is extended to all Spanish companies. By contrast, Yagüe and Campo's indicator is constructed on information provided by each of the companies included in the ESEE.

The influence of corporate management on productivity and wages

This section of the article seeks to assess the effect of good management practices on the productivity and wages of Spanish industrial companies.

Table 2 provides a preliminary snapshot of the relationship between these three variables and some others which influence or are influenced by them. The information is grouped by company size[2], presenting median values –those which leave 50% of companies above and 50% below – as we consider them a better expression of the distributions of the variables' values than mean ones.

In line with the indicator of good management practices, the variables included in this table which measure efficiency and intangible assets - labour productivity, wages, human capital, permanent contracts, sales margin, use of productive capacity and net tangible fixed assets per worker[3] – increase as mean company size rises. But unit labour costs fall with size, because as size increases, wages increase to a lesser extent than productivity, meaning that the ratio between wages and productivity declines, and explaining why profit margins grow.

Therefore, essentially, as shown in Exhibits 4 and 5, wage distribution is less sensitive to company size than productivity. In other words, larger companies stand out more for higher productivity in relation to smaller companies than for higher wages.

At the same time, the distribution of wages is more bunched relative to central values than for productivity. This might relate to the existence of minimum wages, resulting from the automatic general application of collective agreements, and also suggests that larger companies pass on a smaller proportion of productivity gains to wages. Thus, their labour costs are lower and margins are higher.

The difficulties that larger companies seem to have in passing on productivity gains to wages could suggest insufficient remuneration of more qualified workers, which are used relatively intensively by these companies. This would also help explain the limited wage gap between the highest and least skilled workers (Puente, 2011).

We now turn to look at the effect of corporate management quality on productivity, keeping in mind the relationship of both variables to company size. In order do so, various equations have been estimated based on panel data analysis. These equations attempt to explain labour productivity in terms of corporate management quality, company size and other explanatory variables such as physical capital per worker (net tangible fixed assets per employee). Dummy variables have been included in the estimates to eliminate effects from different industrial sectors and regions.

Our results, not included here, indicate that good management practices have a positive, statistically significant impact

Table 2 **Main figures for Spanish industrial companies**

2009-2013

		Median values			Average values		
Company size (Number of workers)		Small Less than 50	Medium 50 to 200	Large Over 200	Small Less than 50	Medium 50 to 200	Large Over 200
Variables	Until of measure						
Management quality	No. of good practices	6	11	17	6.8	12.3	18.1
Wage	Thousands of euros (current)	28.0	36.2	44.0	30.4	37.9	45.6
Productivity	Thousands of euros (2010)	32.4	46.9	59.0	38.2	56.4	72.8
Unit Labour Cost	Euro per unit of output	0.9	0.8	0.7	1.3	1.1	0.9
Sales margin	% of sales	5.2	6.4	6.8	3.4	5.9	7.1
Human capital	% higher education	0.0	4.8	6.0	4.8	6.9	9.1
Permanent Employment	% of workforce	87.5	95.0	94.3	82.4	89.0	89.8
Capacity Utilisation	% of total	70.0	75.0	80.0	69.8	73.3	76.4
Growth in Sales Prices	% p.a.	0.0	0.0	0.0	0.2	0.6	0.2
Net tangible fixed assets per employee	Thousands of euros (current)	26.8	61.1	80.4	63.1	98.7	163.5
Companies analysed	Number	1219	695	469	1219	695	469
Companies analysed	% of total	51.0	29.0	20.0	51.0	29.0	20.0

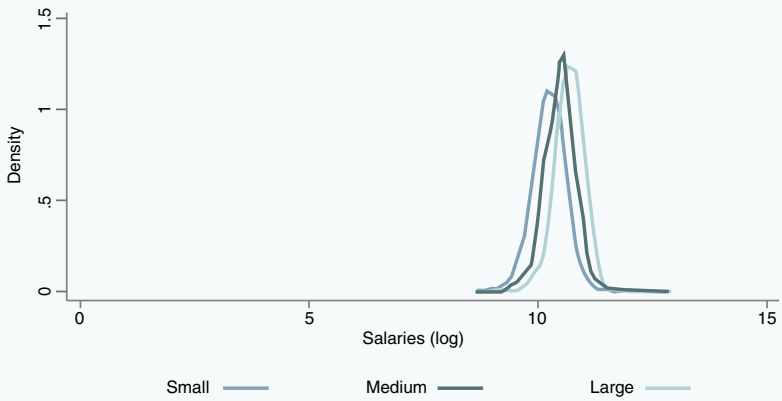
Source: ESEE, Fundación SEPI.

on productivity. A 10% increase in good management practices leads to a 0.81% increase in labour productivity. We also consider the power of wages as an explanatory variable for productivity, since productivity can increase due to wage incentives, in line with the efficiency wage hypothesis.

The results speak for themselves in terms of the relationship between corporate

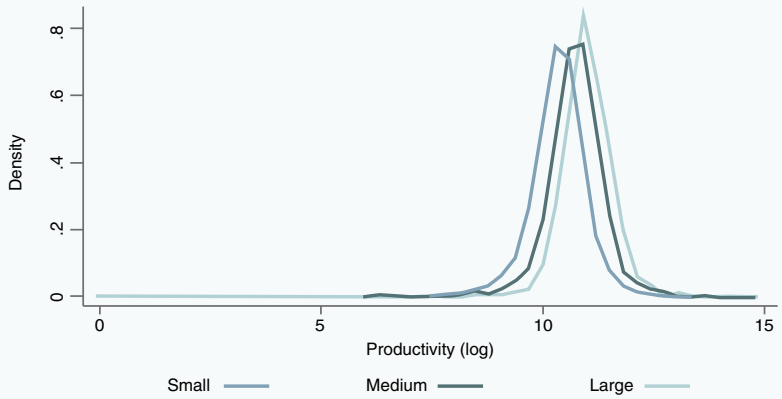
> “Wage distribution is less sensitive to company size than productivity —larger companies stand out more for higher productivity in relation to smaller companies than for higher wages.”

Exhibit 4 **Distribution of wages by company size**



Source: ESEE.

Exhibit 5 **Distribution of labour productivity by company size**



Source: ESEE.

management quality and wages, which is the main focus of this article.

Wages are related exclusively to corporate management quality, human capital and the percentage of permanent contracts. An increase of 10% in the number of good management practices results in a 0.33% increase in wages.

However, since company management quality has a positive impact on productivity, it might be assumed that the effect on wages is simply an indirect reflection of the former. That is not the case. Including productivity reduces the impact of management quality on wages but it remains high and significant – in fact, half the impact that productivity has on wages. Thus, companies which

are better managed pay their workers more handsomely. Improving corporate management has an appreciable impact on wages, probably because good corporate management leads to increased worker engagement in the company and recognition of their contribution.

In brief, the complete results of our estimates suggest that an increase in corporate good management practices of 10% increases productivity by around 0.81% and wages by 0.33%. Furthermore, since productivity and wages are mutually intertwined, it is likely that the final wage increase is even larger, not only due to the direct impact but also because of the indirect impact of improvements in corporate management quality.

Conclusions

The Spanish economy is facing a major challenge to sustainably and significantly raise productivity. This is the only sure way to strengthen competitiveness and deliver sustainable increases in wages and income per capita, which drive increases in output and employment. There is significant potential to boost productivity, especially among the multitude of very small companies in Spain, which have relatively reduced levels of comparable efficiency.

Wage earners will always be the first to benefit from increases in productivity, meaning that it should be a first order concern for them. Several intangible factors are important for increasing productivity, ranging from innovation to employee skills. However, corporate management quality – a complex, multi-faceted asset – appears to play a particularly crucial role among intangible factors. The results presented in this article show that both productivity and wages would stand to gain if companies were to increase their management quality.

Current management of Spanish industrial SMEs suffers from a number of notable shortcomings across the board, ranging from leadership to partnerships between companies and worker training. There is enormous scope for improvement in company management quality in Spain, which requires significant attention and major public and private sector investment. Private companies and their associations should be the most interested in making progress in this area. But public administrations should also support improvements in this intangible factor, which undeniably has positive externalities that are hard for the smallest companies to obtain by themselves. They should drive the creation of cooperation networks between companies, business associations and private and public organisations specialised in strategic and management consulting and technological transfer. Such networks are a key vehicle for disseminating new technologies and good management practices. Public administrations should also demand quality and capacity in terms of management of their procurements from companies and others who aspire to receive public support, instead of simply rewarding - as frequently happens - the companies which offer the cheapest price based on low wages.

Trade unions also have a useful role to play here, which has barely been given consideration until now. They could demand to have greater involvement in steering, control and improvement committees which exercise real influence over company management. Not only would this help the company to function more effectively but it would also increase the remuneration for their endeavours. In reality, their involvement is necessary - not just for the benefit of workers, but for society as a whole.

Notes

[1] All the variables have a value of 1 or 0, which relates to positive or negative responses to the questions posed to the company. In a few isolated cases the variables are continuous, but these have also been transformed into binary answers for the purposes of standardisation.

> “Good management practices have a positive, statistically significant impact on productivity.”

[2] The smallest companies are significantly underrepresented in ESEE's distribution by company size. Especially companies with less than 10 workers, the majority in the population. The median size of small companies is 18 workers and the mean is 21.5.

[3] This close relationship to company size does not mean that size drives variables such as productivity, wages, or management quality. By contrast, greater size could be the result of greater productivity, as explained by Moral Benito (2016), or better management quality, as shown by Huerta and Salas (2014).

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