Spain: Large scope for progress*

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The ICI gives Spain a rank of 29, somewhere between the Baltics and Chile. The rank itself is not bad, and it is not surprising that Spain scores below Sweden, Finland, Switzerland, Taiwan, Japan, Korea, Germany, and Israel, countries with a well established track record of innovation and highly-developed and sophisticated high-tech sectors. What is noteworthy about Spain is that, whereas in 2008, its PPP-adjusted income per capita was US$30,589, that of Chile was less than half (US$14,529) and those of the Baltics ranged from US$17,106 in Latvia to US$20,561 in Estonia. In other words, for its stage of development—a rich industrial country with the world's 11th largest economy[1]—Spain's innovation capacity is lagging behind its true potential. What are the factors that have contributed to this mediocre performance? We focus our attention on three: fiscal management, market regulation (including the dysfunctionalities in Spain's labor market), and education.

Precarious public finances

The onset of the global financial crisis was met by calls from leading economists to respond to the contraction of demand with fiscal stimulus. It was essential to avoid repeating the mistakes of the Great Depression when the authorities, unwisely, sought instead to balance budgets and did not relax monetary policies to the extent that was necessary to revive domestic demand. The problem with fiscal stimulus in the middle of a crisis is that the authorities need to strike a careful balance between optimizing the benefits of increased expenditure, against the risk that too much stimulus might undermine confidence because the increase in public debt is perceived by investors as potentially unsustainable. This difficult balancing act is particularly important in countries that already have high levels of public debt, and where there is greater vulnerability to shifts in investor sentiment. If investors begin to question the solvency of the government, then what started out as an exercise aimed at softening the adjustment until consumer and investor confidence picked up and improved the economy's growth prospects, can quickly turn into a vicious circle, in which the increase in the cost of debt becomes rapidly prohibitive, confidence is undermined, and economic revival is put off.

This is what happened in Greece earlier this year and, in the context of a highly integrated region using a common currency, the Greek crisis led to contagion in Portugal and Spain, countries where the authorities were in the midst of implementing their own stimulus packages. In Spain, after having allowed the deficit to widen beyond 11 percent of GDP in 2009—a deficit without recent historical precedent—and having lost the confidence of investors, the government proceeded to introduce an adjustment package consisting of expenditure cuts and increases in taxes. This 180 degree turn in policy created social and political tensions, undermined the credibility of the government, and distracted attention from more urgent reforms, for instance in the labor market (see below). Among the 131 countries ranked in the ICI, Spain's budget deficit in 2009 was the sixth largest—that is, one of the worst in the world. The ICI, quite correctly, penalizes fiscal indiscipline because of the way it distorts resource allocation, for instance, constraining the ability of the government to spend more on education or on research and development. In Spain, R&D is equivalent to slightly less than 1.3 percent of GDP, well below the OECD average of 2.2 percent of GDP, and close to a quarter of the level in Israel.

Market regulation and a dysfunctional labor market

Of the five pillars used to build the ICI, Spain's worst performance by a significant margin corresponds to pillar 3, on the regulatory and legal framework. The World Bank's 2010 *Doing Business Report* database shows an extremely poor rank (146 out of 183 countries) for the "starting a business" indicators. In Spain it takes ten procedures and a total of 47 days to get a business started, compared to six procedures and six days in Portugal (a rank of 60) and five procedures and seven days in France (a rank of 22), Spain's two neighbors. Moreover, Spain does not perform well in the indicator measuring protection of investors (a rank of 93). This indicator captures such concepts as disclosure requirements—to assess, for instance, the extent of related-party transactions—extent of liability of directors, and ease of shareholder suits—measuring how easily investors can access the courts when their interests are damaged.

In all of these concepts, Spain's scores are mediocre at best, particularly considering Spain's high income per capita and large industrial country status. Consistent with this, Spain's ranking of 32 (a middling score of 6.1 on a 10-point scale) in the TI's *Corruption Perceptions Index* is also mediocre. The worst ranks, however, concern those indicators that capture aspects of the operations of the labor market, such as the obstacles that businesses might face to hiring workers, the rigidity of hours, the degree of flexibility that employers might have to adjust the payroll to changing market conditions, the costs of separation, and so on. Spain has a rank of 157 in the employing workers DBR indicator, compared to a rank of 1 in Australia and 9 in Denmark.

Spain suffers from a segmented labor market that has served the country poorly over the past couple of decades, a fact eloquently highlighted by an unemployment rate of close to 20 percent in mid-2010, and twice that high for youth and women. One part of the labor market consists of permanent contracts with high levels of job security linked to extremely high severance payments, while the other is made of temporary contracts with much lower firing costs, accounting for some 27 percent of total employment, more than twice the average for the OECD. Not surprisingly, employers have responded to such incentives by hiring an increasing number of workers under temporary contracts, often beyond the legal limits provided by the legislation. In the public sector, workers cannot be sacked and, therefore, absenteeism is high (18 percent) and there is widespread abuse of sick leave. If a publicly owned company is privatized, the workers have to be taken on to the public payroll. Accordingly, demand for public sector vacancies is extremely high; according to *The Economist*, "300 people apply for each new clerical job advertised by the Madrid government."[2] Since the large severance payments for permanent workers are forfeited if they change employment, turnover is low, contributing to lack of motivation and sclerosis. Better-educated younger workers under temporary contracts are thus the "buffer" during periods of economic distress and end up being overqualified (and underpaid) for the jobs they hold. An economy in which the highest aspiration of university graduates is to secure employment with the government and become a bureaucrat is not one likely to encourage a spirit of entrepreneurship and a culture of innovation. Labor market reform and the gradual elimination of the duality in the market is an essential precondition to putting in place the incentives that will encourage greater entrepreneurship and risk-taking.

Education

There is not a single Spanish university among the best 170 in the world.[3] According to this particular set of rankings, the University of Barcelona is the best in Spain, with a rank of 171, and there are no others among the top 200. We have already made reference to the relatively low level of R&D spending in Spain, which, as might be expected, has a counterpart in the inadequate funding provided by the government and the business community to the universities. There is no well-established tradition in Spain of active collaboration between the universities and the business sector, a fertile source of innovations in those countries that have succeeded in nurturing this critical relationship. Consequently, there is little use made of internships as a way of building up relevant skills and familiarizing the student with the demands of the job market. Spanish universities are by and large public entities and suffer from the same perverse incentives as the public sector. Pay is relatively poor, no one can be fired—except those on temporary contracts—and there are few mechanisms in place to encourage excellence in teaching and research. The cost of tuition covers a very small fraction of the expense incurred by the state. One implication of this is that students have no leverage to demand higher standards; since salaries are low, the university is not in a position to hire staff of exceptional quality—a damaging vicious circle. Not surprisingly, the most able emigrate, unable to find a meritocratic working environment that rewards performance and academic achievement.

The teaching of English in secondary schools is deficient and thus university students are ill-prepared for carrying out research at a sufficiently advanced level, with easy access to the vast library of research materials available in English. Student exchange programs are rare, depriving students of the expansion of intellectual horizons that these can bring. There is insufficient incorporation of the latest technologies into every aspect of the life of the university, whether it be for online course registration, access to bibliographical libraries, e-learning, and so on. Course curricula are not adequately updated, and thus do not reflect the rapidly changing needs of the Spanish labor market and the private sector. The concept of "advanced standing"—namely, that there will be students who because of earlier work experience could enter an academic program midway—is largely an alien concept. There is little effort to better integrate research, teaching, and work early on. Students are not adequately familiarized with various conventions, habits, and norms that govern academic life (academic literacies) and might encourage more in-depth learning.

Teacher evaluations—a reliable source of feedback in the modern university—are seldom used. It is additionally worrisome that, given the largely public nature of the better Spanish university, often there is no arm's-length relationship between government and university in terms of hiring, with the universities sometimes used to park out-of-work politicians. Excessive crowding is another problem, particularly in the early years of undergraduate training. Failure to address some of these glaring deficiencies will condemn Spanish universities to mediocrity and greatly hamper long-term innovation capacity—at all times and everywhere reliant on academic excellence.

[1] Using a PPP-adjusted measure of GDP. At current market exchange rates Spain ranks 9th in the world, with a GDP equal to US$1,602 billion, just below Russia (US$1,677 billion), and ahead of Brazil (US$1,573 billion).
[2] *The Economist,* 2010a. 3 June.
[3] According to: http://www.topuniversities.com/world-university-rankings

Figure 6. **Spain: Top priorities for policy reform**