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PRESS RELEASE

Ivie

Fourth BBVA Foundation-Ivie Report on Growth and Competitiveness.

The Challenges of Smart Development

Positive signals must be reinforced by actions to generate lasting, quality employment

- Spain needs bigger companies and better trained entrepreneurs in order to consolidate growth and employment creation
- The private sector has to get involved in R&D and innovation, but support must be selective based on full disclosure of the results of groups and institutions of relevance for the productive sector
- Human capital must be more fully harnessed, with attention to mismatches due to overqualification and the strengthening of competencies
- The need is for effective public policies that prevent social exclusion

Madrid, December 18, 2014.- Positive signals in recent quarters indicating a pickup in activity and the correction of imbalances need to be reinforced by measures conducive to mid-term growth that is stronger in value-added and does more to generate quality employment, and effective public policies that militate against social exclusion.

Unemployment has become Spain's biggest economic problem, holding back recovery at the same time as it drives up social exclusion and poverty. The way to fight it is to create increasingly productive jobs sustainable over time, avoiding the destruction in a few short years of many newly created firms and posts. Consolidating growth means taking steps to achieve a more productive economic fabric. Steps like increasing company size, improving entrepreneur training and incorporating knowledge and R&D and innovation in many more activities. In parallel, the country has to have an efficient, equitable and financially sustainable public system managed by objectives, with the prevention of social exclusion at the top of its agenda.

These are the conclusions of the ***2014 BBVA Foundation-Ivie Report: The Challenges of Smart Development***, fourth in the series initiated in 2011, which examines the obstacles in the path of these objectives and the levers that can aid progress. The report is the latest product of the Economic Research Program run jointly by the two institutions over the space of two decades. It has been prepared by a large team of university researchers and Ivie staff members, under the leadership of Francisco Pérez, Research Director of Ivie and a professor at the University of Valencia.

Lasting, productive employment

Of every 100 jobs generated each year of the crisis by new-start Spanish companies, barely 55 were still going five years later (against the 75 surviving in Germany, 68 in Italy and the 120 jobs which the initial 100 had turned into in France). The difference between Spain and these countries is explained by its higher rate of business failure and the surviving firms' lower job-creating capacity. The employment generated by sole traders is even less, as became evident during the crisis years: in 2007-2012 a bare 73% lasted out one year, and only half survived past the first three. Also, the small size of most firms limits their productivity and hampers job creation. Hence by 2013 large companies were creating jobs at the same rate as in 2006, while small firms were back to just 80%.

Companies are a vital source of growth because the private sector represents 80% of employment and investment. Yet the productivity of large corporations is twice that of microenterprises. Spain's business fabric stands out for the reduced size of most units: 94% are microenterprises of up to nine workers, generating 39.5% of employment, and a further 6.1% are SMEs – up to 249 workers – generating 35%. Large companies, by contrast, account for just 0.1% of the productive fabric but create 25.6% of jobs (equivalent percentages are 0.5% and 37.7% respectively in Germany, and 0.4% and 47.7% in the United Kingdom).

The stagnation of the small firm sector is partly because the legal and employment framework and current tax incentives tend to discourage them from growth and hold back productivity (for instance, companies are exempt from having to audit their accounts unless at least two of the following circumstances obtain over two consecutive years: having annual turnover of over 5.7 million euros, a headcount of over 50 employees and/or assets in excess of 2.85 million euros).

Having more large companies is a good thing. Not only are they more competitive, but they also positively influence the broader business landscape. For example, they disseminate technological and organizational advances among suppliers and clients and help to drive forward their internationalization. To do so, they draw on a more intense employment of human capital and professionalized management teams, two factors that enable a deepening specialization in technology-based activities.

A training effort to consolidate growth

Among the keys to ensuring higher mid-term returns on investment projects is a better trained entrepreneurial class. What this means, in essence, is professionalizing management in a country where the educational level of company executives (83.5% of whom have higher education studies) far exceeds that of entrepreneurs, whether they employ staff (37.6%) or are self-employed (33.7%).

The report's authors call for greater training efforts in a number of directions where they see serious shortcomings. On the one hand, most sole traders lack financial or even basic training, and this is frequently an obstacle to the viability of their business projects (43.5% of

Spain's self-employed have only completed compulsory education, compared to 23.8% in the EU-28). On the other, only one in every ten jobless persons with no more than compulsory education engages in continuous training (against 30% of those with higher education studies).

Another area targeted for action is the labor market mismatch of university graduates, whose skills are often out of step with their formal qualifications, to the detriment of their employability. The authors point out that 95% of graduates occupying posts that do not correspond to their qualifications lack the competencies possessed by their counterparts in other countries. In support of this assertion, they refer to PIAAC report data, according to which 46.1% of Spaniards with higher education studies exhibit skills levels comparable to those of the average early school-leaver in the Netherlands, Austria, Japan or the Scandinavian countries.

The root of the problem lies in the inefficiency of the education system, but also in the fact that Spain's productive fabric offers fewer opportunities to acquire human capital, due to its specialization or because the prevalence of smaller firms means less attention goes to training. For the authors, the education system – public in the main – requires a more performance-oriented management approach which improves the productivity of the institutions delivering different types of education.

Another **driver for increased business competitiveness is for companies to become more involved in R&D and innovation activities** by means of selective investments. In Spain, the corporate sector contributes a bare 53% of R&D investment (63.3% in the EU-28), while only 0.84 euros in every 100 euros of revenues earned by Spanish firms are ploughed back into innovation (1.06 euros in the case of large corporations). Efforts here should pursue the optimization of resources through collaboration with the research and higher education institutions and groups holding the best track records (as measured by number of R&D projects undertaken, patents outstanding, papers published or the revenues raised per type of project from company commissions). In order to strengthen links with institutions specializing in these activities, firms should have readier access to transparent, reliable information on the results of the specialist groups and research and technological development centers best equipped to generate useful knowledge for input to the productive system. The report's authors suggest that is should be the Ministry of Economy and Competitiveness that audits this information and coordinates its collection, with the assistance of the CDTI (Centro de Desarrollo Tecnológico Industrial) and of regional authorities holding devolved powers in R&D and innovation matters. Generating and relaying information on the best, most productive R&D centers and those whose activity is closest to the business sector should encourage more companies to get involved.

Effective public policies

The Spanish public sector will also need to press on with its reform program in order to overcome the current situation. The report finds that it is not oversized in comparison to other European countries, but does face some serious problems: long-running deficits, due primarily to the tax system's deficient revenue-raising capacity; large inter-regional gaps (exceeding 50%) in expenditure per inhabitant that undermine equal opportunities in service access; and the subpar results of certain services.

The insufficiency of tax revenues is primarily due to the raft of benefits – reduced rates, exemptions and allowances – available on different taxes, totaling almost 80 billion euros in 2014, more than the sum projected for the public deficit. The tax reform in progress should have been bolder in tackling the dual goal of clawing back this lost income and redistributing tax charges, which currently fall disproportionately on earned income to the detriment of growth and employment. A more effective fight against fraud and the underground economy is not only a financial imperative but also a way to ensure a fair deal for productive agents who abide by the rules.

The public sector's efficiency shortcomings must be addressed as a matter of urgency, because they diminish the returns of funds spent on key policies. Two important examples here are the subpar productivity of many investments in infrastructure – railways, motorways, airports – due to low utilization rates, and the poor results of the education system. The literacy and mathematics scores of young people at the end of compulsory schooling (PISA reports) and adults (PIACC report) lie well below the international trend lines. For instance, educational spending per student is on a par with Japan but the latter's PISA scores exceed Spain's by a margin of 15%.

Another area in which training – curricular and continuous – falls short is in its contribution to employability. Continuous training is insufficient for the scale of the unemployment problem and is not considered to be working well – companies believe workers are not being offered the kind of skills employers demand. Further, only a small proportion of jobless people enter continuous training, especially among the lower skilled (9.7%), and the percentage is no higher among the long-term unemployed (8.8%).

Socially inclusive growth

The report stresses that the short-term challenges confronting Spain "are deep-seated and will not respond to simple remedies." Given the interdependences between companies' problems and how institutions manage the challenge of steering the economy back to sustained growth, it is necessary, say the authors, that the restoral of business competitiveness be accompanied by measures to ensure that development is socially inclusive. For this to come about, it is vital that job creation continues, that the jobs created are of good quality and that the public sector resolves its functional problems, which affect its financial sustainability and the efficiency and equity of its actions.

Spain is one of the worst performing among its partner countries in terms of the rise in inequality, poverty and unemployment. The report states that the population experiencing different kinds of poverty has grown substantially since 2007, and cites unemployment as the main culprit for this widening divide.

In 2013, 26.7% of the Spanish population suffered monetary poverty (income below 60% of the national mean disposable income); 18.3% suffered severe material deprivation (defined as experiencing hardship by at least three indicators on this list: not being able to take holidays one week a year, not being able to eat meat or fish at least every two days, not being able to heat the home adequately in winter, not having the means to meet unforeseen expenses, falling behind with payments on the principal residence or installment purchases in the past year, not having access to a car or owning a personal computer); and 15.7% lived in households whose active members were out of work 20% of the time. Finally, 5% of the population (2.3 million people) were simultaneously subject to the three types of deprivation, constituting the core of those at risk of social exclusion.

The authors are aware that the tasks ahead "are tough challenges, but only by meeting them can we hope to win back society's trust in the possibility of collective improvement, seriously damaged in these years of economic and institutional crisis." The decline of trust in institutions – government, legislators and social agents – militates against the social acceptance of sacrifices, as many citizens believe that these could be avoided with a more honest public administration, with fewer cases of corruption.

Corruption and a lack of opportunities make people less willing to cooperate, thereby driving up social tensions and transaction costs: credit contracts due to the failure of confidence, lenders require more guarantees, companies demand cash payment, the number of fixed-term contracts augments and employment and investment decelerate. "Without this social capital, economies as complex as ours become harder to govern, economic efficiency is undermined and growth stalls," the report warns.

A proposal for actions to consolidate productive growth

Public sector reforms will not serve on their own to consolidate growth. Spain still has need of a more productive business fabric, able to lever investment efforts in the same way as in advanced economies. The authors insist that achieving this will require more investment in intangible assets that help maximize returns on physical capital investment and education spending: in-company training, organizational improvements, innovation in products and processes, and intensive use of ICT.

The report presents up to eight proposals for action to boost productive growth. **To foster business growth**, it proposes eliminating regulations that hinder competition and dissuade companies from growing in size, whose proliferation reflects a lack of coordination/harmonization between autonomous regions. At the same time, it underscores the need to help small firms comply with general requirements, such as account audits, designed to improve the operation of productive units. It proposes that large company best practices be used as a benchmark for smaller firms. Finally, it stresses the importance of attracting foreign direct investment to hasten the transformation of the productive fabric.

To promote knowledge incorporation within firms, the authors call for the rollout of continuous training programs for entrepreneurs, the self-employed and company employees that reduce, as far as possible, the high failure rate of businesses in their first few years. This would mean deploying training resources in face-to-face and e-learning formats, and raising social awareness of the impact of this problem on the self-employed. They also urge selective support for R&D and innovation.

To strengthen companies financially, steps should be taken to channel more finance to innovative projects by encouraging non-bank alternatives like venture capital, crowd funding or second markets. Innovative firms should strive to strengthen their own funds in order to finance intangible assets, which are value-generating but hard to dispose of. Although borrowing has become easier, and the extracost borne by Spanish SMEs vs. their European peers has been brought down (to 92 basis points), the conditions of access to credit still need improvement. At the same time, there is a need to reduce firms' excessive dependence on bank lending, which currently amounts to 58% of their external borrowings (10 percentage points below the peak levels of 2008). The report suggests that this could be done by facilitating their recourse to capital markets.

The authors also talk about lending support to the early restructuring of viable firms that are nonetheless financially vulnerable. This is important, because one of the brakes on Spain's recovery is the high debt levels of its companies, summing 112% of GDP against the 94.8% average of the euro area. Among the remedies they suggest is to encourage out-of-court settlements or debt restructuring programs with the involvement of the inland revenue. These measures, backed by a tax reform that gives the same treatment to equity and debt financing, would dissuade firms from taking on excessive debt.

Proposals for socially inclusive growth

The authors urge new actions through the public sector to promote socially inclusive growth. **To foster equal opportunities**, they advocate special measures for unemployed training, with particular attention to the long-term unemployed. They also call for the wider circulation of job opportunities and more efficient employment intermediation services, with ongoing personalized evaluation of measures deployed and intensive use of the European funds assigned to this end. A further proposal is to move to a more equitable distribution of regional funding to ensure that citizens have access to basic public services – security, health, education – in conditions of equality. Finally, they recommend prioritizing anti-poverty measures and promoting an education pact that reduces regulatory instability while improving learning performance.

To guarantee the financial stability of the public sector, the authors propose an ambitious tax reform with a fairer distribution of the tax burden than exists at present; a multi-pronged attack against fraud – through education, raising awareness of what it means, and repressive measures of inspection and penalties; and a campaign against the underground economy, which they stress may destroy as many jobs in declared as in undeclared activities.

To improve the efficiency of public services, the authors propose conducting a review of the share-out of powers and funding across different levels of government in order to eliminate duplication, inefficiencies and unjustified inter-regional asymmetries; setting expenditure priorities on a medium-term horizon and a system of results-oriented public management, with defined goals and ongoing assessment based on qualitative and quantitative indicators. Building a culture of evaluation in public policymaking, and adherence to European standards for the concession and programming of structural funds are indispensable steps to assess the sufficiency of funding and to achieve a more modern public sector accountable to citizens.