

# Thoughts and proposals for the next legislative period

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# 1. Executive Summary

General Elections will be held in our country in March of this year, and a new Government will be appointed for the next term of office. Once again, as is traditional on the eve of voting, *Círculo de Empresarios* is issuing a document addressed to the future legislators. At this moment, Spain faces a worrisome situation of political, economic and social uncertainty which makes *Círculo de Empresarios* ever so eager to constructively collaborate with the newly elected politicians with different proposals relating to the policies required to successfully confront the challenges lying ahead on the Spanish economic horizon. The objective of *Círculo* in this document is not to weigh in on questions of a merely immediate nature which take such precedence during political campaign, but rather to remind our next governing officials of the paramount importance of the structural elements as determinants of the well-being and prosperity of our society.

**The great economic challenge** which is foreseen not only in medium and long term, but also in the immediate future, is that of **competitiveness**. Spain, ranked at eighth place in the world economy by GDP, occupies much lower positions in competitiveness rankings (for example, it has fallen to twenty-ninth in the *World Economic Forum* ranking). Furthermore, after several years of sustained growth and superior to that of our European partners, signs of slowing down are multiplying. In addition, this is happening in the midst of huge uncertainties which characterize the international financial markets on a daily basis, beginning mid last year when the first symptoms of crisis in the subprime mortgage market surfaced in the United States. Under these circumstances, the capacity to maintain a path of steady growth toward increased levels of prosperity becomes even more pressing.

*Círculo de Empresarios* has paid and continues to pay particular attention to the question of competitiveness of the Spanish economy. As a matter of fact, it has been an underlying theme in all our documents of recent years, and even the main topic in many of them. Thus, the ideas here presented correspond to the arguments which have provided the base for the proposals expressed in these publications.

In the search for a larger dose of competitiveness for our economy it is essential to understand that Spain now moves within a highly globalized international environment. While this international environment gives rise to so many of our opportunities for prosperity, it is also the source of most of the risks which threaten

that prosperity. It is therefore of utmost importance that foreign policy be, as it is in other developed countries, an essential support in the internationalization process of the Spanish economy. For starters, to maximize the opportunities while minimizing the risks requires a **suitable, credible and solid institutional framework**. The Spanish economy should, above all, ensure its **market unity** and guarantee the **independence of the supervising bodies**, within a quality regulatory framework which also guarantees legal certainty. It is obvious that judicial independence, which is established in the Constitution, is absolutely necessary to reach this goal.

*Círculo* also wants to call for the participation of the citizens, via their institutions, in the processes of consultation, decision, management and control of public policy, just as in other advanced countries. Therefore, it advocates a civil society capable of taking on its own transformation.

Institutional quality seems to be the *sine qua non* condition for any realistic attempt to boost our competitiveness. But compliance with this requirement will not suffice. Many more measures are necessary, not only in strictly economic policy but in other areas as well, because the roots of competitiveness go deeper than the present situation and find support, above all, in the structural foundations of the economy.

Given the transfer of monetary sovereignty to the European Central Bank, one of the key economic policies in our country is fiscal. In this matter, it must first be pointed out that Spain has managed to reach **macroeconomic stability**, particularly in connection with the budget, practically unimaginable at the beginning of the last decade. Turning the public accounts balance into a surplus has been, no doubt, a significant achievement that is at the bottom of the very good economic results registered. However, the effort must be kept up.

**Budget stability, at all levels of administrations in our country**, is fundamental in this atmosphere of uncertainty that now pervades the world economy. This stability involves sensible budgetary balances, including during the phase of deceleration of public revenue that will accompany the slower actual growth. The budget balance must provide sufficient margin to give the tax authorities room to maneuver and permit them to generate greater confidence so that the budget policy may better fulfill its role. This applies to the Spanish economy in particular for several reasons. In the short term, because of its vulnerability and dependence on foreign financing as well as the sensitivity of private debt to the variations in interest rates. In

the longer term, because of the demographic evolution and the growing pressure on the social security pension system, presently the leading factor in the surplus.

A sustainable tax consolidation will eventually mean a reduction in size of the public sector, and a commitment to efficient management of government spending. On the side of revenue, the tax system will play a prominent part in the recovery of increased levels of competitiveness. Beyond the actual level of fiscal pressure, a **well structured tax system** will be the one to generate proper incentives, stimulating saving in general and long term saving in particular, as well as investment and jobs.

Finally, **the structural reforms are destined to be the great determinant of our economy's future**, because they will be the ones enabling it, or not, to confront present and future changes. *Círculo de Empresarios* has repeatedly indicated the areas that require most urgent reform and which would be most positive with a view to the future. Likewise, *Círculo* has insisted on the necessity of State pacts to guarantee the implementation of said reforms, isolating them from the vicissitudes of the political cycle whose temporary horizon is shorter than needed to witness all the positive effects of structural transformation.

Along the lines of the mentioned institutional quality, one of the pending structural reforms refers to the search for a more efficient public sector, capable of providing society with the different services essential to well-being and equity. This would require, among other things, a review of the distribution of powers between the territorial administrations according to the efficiency-equity tandem.

The principle of efficiency should also apply to the reform of the educational system, in order to turn it into a favorable framework for “life long learning”, necessary today for the adaptability and employability of individuals. This framework corresponds to an educative system articulated as a “network” with diverse itineraries that cross and connect with each other, so that an individual can leave at one moment and still reintegrate at a later point throughout his life. That's why **the reforms must apply to all the levels and phases of education, including training in the labor market.**

It is precisely this market that represents one of the spheres of our economic life most in need of a coherent and profound reform. Problems such as the elevated prevalence of temporary work or the still low participation of women indicate the inflexibility of the labor market, which reduce the power to create new jobs in our

country. It is necessary to end these conditions and replace them with greater flexibility, also contributing to a work-life balance.

It is also necessary to improve the operation of other key markets of the economy, as in the case of energy. This is a decisive sector where significant measures must be taken, including the consideration of the role of nuclear energy, in line with what other industrialized countries are doing, as one more ingredient in the energy mix necessary to guarantee the security of the supply.

## 2. Spain's position in a global economy

The general objective of any government that arises out of the upcoming elections will be to further raise the per capita income of the Spanish citizens, thereby continuing a process of convergence with the most advanced countries of the European Union, threatened at present by a situation of progressive deterioration.

In order to achieve this goal, the Spanish economy must be able to record significant growth rates for an extended period of time. That is to say, we must remain competitive and show a strong capacity to adapt to the changes, ever deeper and faster, which the world's economy is undergoing.

There are several tools available to achieve these goals: improvement of the institutional framework (broadly understood), macroeconomic stability and structural reforms.

### 2.1 The institutional framework

The success of any economic reform program will depend not only on its content, but also on a set of very relevant external factors, which we will generically refer to in this section as the institutional framework. Indeed, to improve competitiveness, it is necessary to establish a series of prior conditions of an eminently horizontal nature, notably among them, **the improvement of the institutional framework.**

As multiple studies make clear, well-run institutions are a fundamental factor when it comes to explaining midterm growth of a country. An institutional framework supported by an adequate set of rules and, above all, which is credible (in the sense of transparency and neutrality), is a fundamental element to guarantee continuation on the growth path. It is therefore necessary to make every effort to improve credibility, internal operation and independence of the institutions that supervise the market behavior.

Spanish society as a whole must equally join in the effort. Spain is not, nor has it been a country with a tradition of civilian presence and participation in public life.

Among other consequences, this has resulted in the gap between civil and political society, or, more to the point, political power usurping areas where a cohesive civil society, with respected and representative stable institutions, would contribute efficiently to improve democratic quality.

Consequently, apart from transparent and predictable institutions, the incoming Government should strive for **the improvement of the regulatory framework**. Therefore, whatever the content of the regulations that are enacted during the next parliamentary term of office may be, it is imperative that the different public administrations be aware of the relevance of improving the quality of regulation. And this applies to different respects.

In recent years, there has been an avalanche of regulations of diverse nature, enacted by different levels of the Administration, which lack internal coordination. This results in the creation of additional regulatory and administrative burdens which, far from helping the performance of our economy, hinder market efficiency, reduce actual competition and discourage innovation.

The **principles that inspire quality regulation** are well known: **necessity** (the rules are only enacted when they are necessary), **effectiveness** (the regulation effectively leads to the intended goals), **proportion** (balance between benefits and costs of complying with the rules), **transparency and consistency or non-contradiction**. All of these are principles that should guide the legislative endeavors of all administrations vested with law-making powers in our country (from the State to the city and town councils).

The concern for the quality of regulation (which has already spread throughout the European Union) should pervade our administrations as well. However, apart from achieving a high quality regulatory framework, this also involves a concentrated effort to prevent the growing **risk of breaking down the market unity**. In our country, the process of transferring powers to the autonomous regions has resulted in such a profound lack of coordination that, at times, the administrations turn their backs to the others when regulating, and even consider the differences as positive. This tendency threatens to break down (into seventeen) the Spanish internal market, which is already small in international terms. The next Government should strive to insure that this process does not continue and even to reverse it. The devolution is not being questioned, but an effort is required to make it compatible with a fully operative internal market.

Another of the crucial elements for economic growth is political stability. Spanish political life is undergoing **constant political confrontation** and a polarization of positions that greatly oversimplify the analysis of problems and, in fact, eliminate any real possibility for debate. This situation is totally negative, given that it treats society as puerile and further discourages comparison of matured and argumentative opinions. We Spaniards hope that our politicians promote stability, not instability.

Finally, in order to improve the conditions of competitiveness, it is mandatory to be able to rely on physical security and legal certainty, both elements becoming particularly relevant in periods affected by a lessened capacity for job creation. This environment of legal certainty, which demands real judicial independence, is an essential prerequisite for the credibility of a democracy and for the development of economic activity.

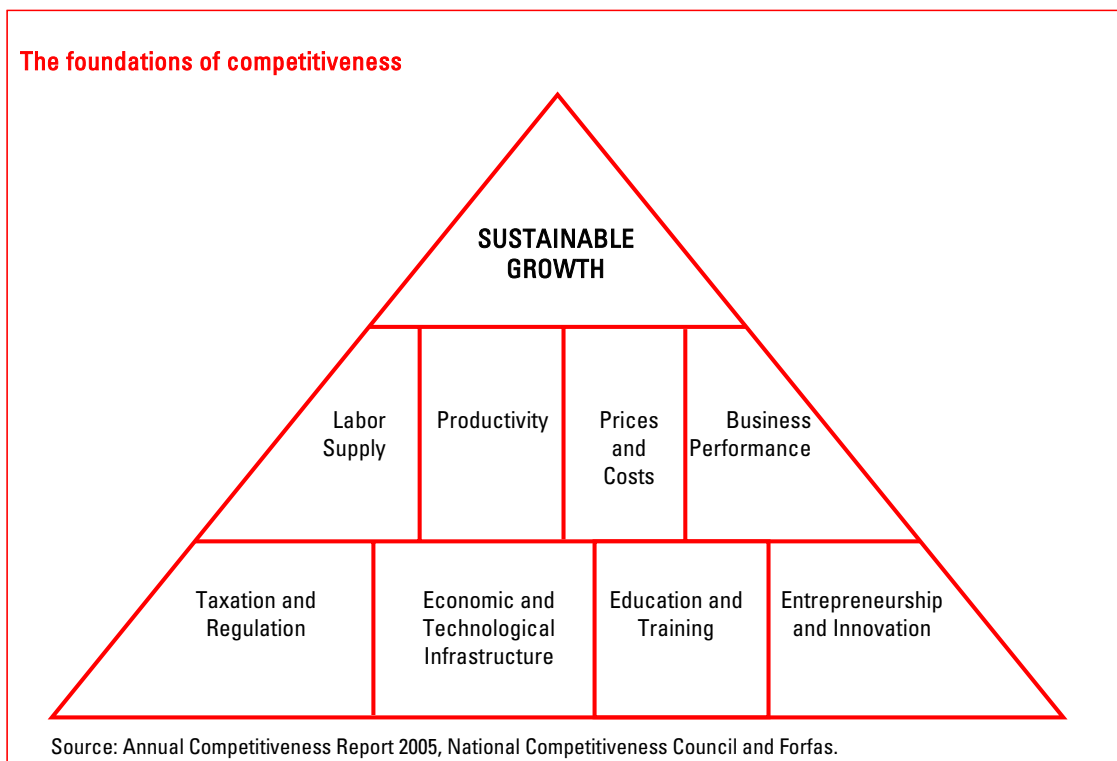
## 2.2 The challenge of competitiveness

All the elements discussed are necessary, but not sufficient, if the ultimate objective is to further increase the per capita income. A stable institutional framework and a quality regulation are not enough to preserve the national market. Additional measures designed to improve the competitiveness of the Spanish economy must also be adopted when considering that we have lost, via prices, the edge that the exchange rate provided us when the euro was introduced.

Indeed, if we understand competitiveness in its most modern sense, that is, the capacity for sustained growth over time, the main challenge the Spanish economy faces is to improve its competitiveness. It's a matter of finding a model that allows Spain to continue to grow within the global environment where our traditional methods have lost many of their advantages. As we have stated previously<sup>1</sup>, this is the fundamental question which the Government elected in March should tackle.

<sup>1</sup>"Spain facing the new paradigm of competitiveness" *Círculo de Empresarios*, Madrid, July 2005.

In an effort to systematize the analysis of the measures to be adopted, the so-called pyramid of competitiveness (see graphic below), which includes the most relevant economic determinants in a country, is suggested as a starting point.



While it is certain that all those elements must be tackled by the new Government, given that there is clear room for improvement in all of them, it is also obvious that the efforts must concentrate in those areas where we suffer our greatest weaknesses in international terms.

Indeed, it must be emphasized that the benchmarking must always be international. As demonstrated below, in a global economy such as ours, any policy with economic effects should be designed with an international view.

### 2.3 An internationalized economy

It is increasingly necessary that the design of Spanish economic policy take into consideration a comparative international perspective. Globalization of the world economy and the very important economic internationalization of our country force us to broaden our perspective in the debates about economic policy measures.

As it becomes evident in the present situation, capacity for growth in Spain depends fundamentally on external conditions. The spread of phenomena such as the transnationalization of business decisions (companies breaking their value chain to find more efficient locations throughout the world for each of their activities) increasingly exposes us to competition in sectors and activities previously protected. Therefore, the international competitive position should set the guidelines for economic policy in such diverse areas as education, financial legislation, administrative costs, or taxation.

This international perspective does not seem to be present in the majority of the political debates, which often continue to revolve around issues more appropriate for countries that are more isolated than ours.



## 3. Budget and tax policy

### 3.1 Budget stability

In the present economic context, characterized by the uncertainty arising from the financial markets' turbulence (above all, in the monetary markets) following the *subprime* mortgage market crisis in the United States, budget stability is essential. This stability implies maintenance of a balanced budget, even in the phase of deceleration of public revenues which seems to be around the corner. Furthermore, it is desirable to have a budget balance that gives the tax authorities enough **room to maneuver in order to guarantee a framework of greater confidence so that the budget policy can fulfill its stabilizing (anticyclic) role** within a context of lower actual growth rates. This is especially true for the Spanish economy given its financial vulnerability, due to its foreign financial dependence and the sensitivity of private indebtedness to the variations in interest rates.

**On the other hand, budget stability should apply not only to the State or Social Security accounts, but also and foremost to the territorial administrations,** which most likely will have to deal with a slowdown of their income due to the lessened activity in the construction sector, as we will see in greater detail in later chapters.

#### *Budget reality*

If we examine the situation from a **short term perspective**, we can see how in recent years we have advanced and even gone deeper into the restructuring of public finance. This has been achieved thanks to the favorable evolution of growth, materialized in the surplus obtained by the State and, above all, by the Social Security System, benefiting from its financing via contributions within the context of high job creation rates.

However, this positive balance does not insure the effective existence of an ample scope for action if the situation worsens, since the tax consolidation has been based on the increase of income, higher than expected, and very dependent on the phase of the cycle (particularly of the income stemming from such activities as consumption and construction).

On the other hand, it seems that there is no real method to curb spending. What's more, it has grown more than the GNP<sup>2</sup>. The government has approved a series of items for revenue expenditure ("baby check", subsidies for rent, dental health plan ...) which force compliance with inescapable future commitments, limiting the room for maneuver and of no use in terms of structural reform. Finally, the possible slowdown in growth worsens the budget situation by increasing the cyclic expenses (for example, those associated with unemployment).

Available evidence in the case of Spain indicates that to assure a **sustainable fiscal consolidation** requires the **reduction in size of the public sector and a medium term policy of public spending growth below the increase of the nominal GNP**. Furthermore, the capacity of increasing spending to stimulate economic activity is showing itself limited in the Spanish context, given that it generates medium and long term costs which make it difficult to get back on the track of budget stability, once we have got off.

In short, tax policy allows a certain operating margin in the face of a slowdown, but it is such a small margin that it can disappear very quickly. Methods of true control (and effectiveness) of spending are still lacking at all levels of Spanish public administrations. It becomes apparent that the territorial administrations do not have the tradition, nor the tools or sufficient incentives to reliably face the periods of slower growth of their income (obtained either directly or through the State).

**From a medium term perspective**, a series of problems that threaten the sustainability of the system can be identified. On the one hand, we must point out the lack of development of a definitive financing system for the autonomous regions and municipal corporations. On the other hand, it's necessary to draw particular attention to the problems stemming from an aging population. For Spain, this is a crucial problem, which puts in danger the financial sustainability of the pension system and generates a substantial increase in health expenditure.

The surplus obtained by the Social Security System is based on favorable demographic conditions partly explained by the incorporation of young foreigners to the system and the relatively low rate of retirement. However, the rise in negative

<sup>2</sup> See "Spanish General Budget 2008: a budget beyond uncertainty", *Circulo de Empresarios*, October 2007.

factors such as population aging, unemployment increase or a slowdown in rates of enrollment in the Social Security System, may seriously damage sustainability.

With a long range perspective, the Reserve Fund of the Social Security System, in spite of reaching considerable volume (up to 4,7% of the GNP, almost nine monthly payments of pensions), does not seem sufficient to deal with the problems of long term sustainability that lie ahead. It is necessary to adopt additional measures to improve ways of contributing and sustainability in the long term. In conclusion, a profound reform of our public pension system is required.

### 3.2 Tax policy

The tax system plays an important role in improving the competitive position of both the industries and the country, even more after the transfer of powers in monetary policy matters to the European authorities. Therefore, **a good taxation structure will generate adequate incentives, by promoting saving, investment and employment**<sup>3</sup>.

Given the free movement of capital and the growing internationalization of our economy, it seems obvious that tax policy can be a tool designed to improve competitiveness, and its design must be essentially based on an international comparison of the different situations.

It is not only a question of aggregate tax burden (which in Spain continues to be higher than in very competitive countries such as the United States), but also of its composition. The combination of both factors is what determines if incentives are conducive or counterproductive to our goal of improving our medium term growth capacity.

#### *Saving*

One of the main problems of the Spanish economy is the **insufficiency of national saving**, basically within the **private sector**, reflected in the current account deficit and the dependence on foreign financing.

<sup>3</sup> See "Improved competitiveness and the Spanish tax structure", *Círculo de Empresarios*, April 2006.

As it has become evident in recent times, this **excessive dependence on foreign saving can be a source of vulnerability**. Thus, a negative change in international finance conditions can undermine the capacity of the Spanish economy to invest and particularly affects those agents who are heavily indebted and have variable interest financing (as is the case of many Spanish homes). While it is a fact that insufficient saving has become more acute due to reduced or even negative interest rates, the tax policy could contribute to an increase in private saving.

Therefore it is imperative to design a more favorable tax treatment of savings, keeping in mind such aspects as compared taxation, the problem of an ageing population or the principle of tax neutrality.

- In the setting of **free movement of capital and absence of exchange rate risk**, compared tax treatment is one of the elements that conditions the geographic destination of the flow of national and international savings. In this context, the Spanish position is not favorable due to factors such as the existence of the Wealth Tax. **It would be desirable to reduce taxation on savings (both nominal and effective rates of taxation) and to eliminate the Wealth Tax** (which was initially intended to be transitory).
- On the other hand, the Spanish economy is facing a process of **an ageing population** more severe than in the other countries of the European Union and it looks like the public pension system is not prepared to handle this situation. Also, the Spanish households are among the Europeans with least long term savings accumulated, since they had to concentrate their savings in real estate and dedicate a smaller percentage to life insurance and pension plans. Therefore, **an improved tax treatment of savings with particular emphasis on that generated for the medium and long term, for example for pension plans**, should be taken into consideration as a method to put us into a situation at least similar to the countries around us.

## *Investment*

Just as saving, investment also contributes to improve the competitiveness of the economy.<sup>4</sup> In this area, the main problem we can identify in Spain relates to the concentration of investment in a specific sector- construction- and its unfavorable relative position in terms of direct foreign investment (DFI), given the high rates of the Corporation Tax.

In recent years, Spain has lived a period of growth in the construction sector and a surge in housing prices, due to both demographic and sociological factors as well as improved financial conditions, relatively low profitability of other investments and a tax framework that encourages home ownership. Thus, Spain stands out on an international scale for the comparatively favorable tax treatment given to real estate assets and for the high percentage of homeowners (more than 80%)<sup>5</sup>.

In light of the aforementioned weaknesses and in order to design a tax system, the following aspects should be taken into consideration:

- **Tax incentives for home purchase**, to the detriment of the rental market. Measures should be established to correct this bias, measures that would be part of a larger package, which would also encompass further improvements in the operation of the land and rental markets.
- On the other hand, as we have seen, Spain's ability to attract investment is poor. We must keep in mind that industries look for the most favorable conditions for all stages of their production in each country. In an attempt to attract streams of investment, the recent tendency of the European Union, and one into which Spain should continue to delve, **is the reduction of the tax rates with regard to the Corporation Tax**<sup>6</sup>.

<sup>4</sup>The IMD (*International Institute for Management Development*) recommends investment in traditional infrastructures and technologies, promotion of domestic investment, strengthening the appeal for DFI and investing decisively in education and continuing occupational training for workers.

<sup>5</sup>Tax incentives for the purchase of real estate have taken the form of a net subsidy that has promoted the demand for homes.

<sup>6</sup>The scale of reductions and deductions has been attenuated in Spain also. However, the Spanish nominal tax rate (25% for the Small and Medium Size Enterprises and 30% for large enterprises) is higher than the average in Europe (25%), an onerous tax system that adds costs to companies and is a deterrent to attracting investments.

- Finally, in order to encourage an improvement in competitiveness, **incentives to invest in research, development and innovation should be created** following the European lead<sup>7</sup>.

### **Labor**

The labor factor is the third element essential to competitiveness. Taxation plays an important role here since it alters the incentives of individuals when making decisions about entering the labor market, the active search for a job or the work hours offered. Oppressive taxation can persuade workers to dedicate less time to work or even to remain outside the labor market, affected by the so-called “tax-benefit trap” effect, resulting from the combination of taxes with social benefits. Furthermore, a lack of horizontal equity can arise, so that two taxpayers with the same income, even though from different sources, can be taxed differently. This predicament can lead to a huge increase in progressiveness, since the Treasury Department (*Hacienda Pública*) focuses its collection of taxes on a certain group of taxpayers.

By comparison, Spain’s level of labor taxation with respect to the total collected remains higher than that of other European countries. When designing a tax system and its implications on labor the following factors must be considered:

- **Horizontal equity**, which implies equal treatment for all incomes from any kind of work. It is essential to avoid large differences between employment income and other sources of income from work, such as professional services.
- Tax brackets<sup>8</sup> should continue to decrease, as well as the maximum marginal rates (to eliminate disincentives in the job market), and minimum rates (to provide incentive for the unemployed to join the labor market).
- **Systems of indirect valuation**: the persistence of modules (objective taxation regimes), which try to facilitate and simplify compliance with the tax

<sup>7</sup> In the last reform these deductions are slowly eliminated from the Corporation Tax.

<sup>8</sup> The reform approved in 2006 reduces the rate of the Personal Income Tax from five to four bands. Furthermore, the maximum rate drops from 45 to 43%, even though the minimum rate remains at 24%. On the other hand, salaried workers would not pay if their income is below 9.000 euros.

obligations of the small taxpayer, has several disadvantages<sup>9</sup>. Therefore, the progressive elimination of this regime would be positive, although not simple, given the risks of a certain loss of tax collection.

<sup>9</sup> It could increase the chance of fraud (it's possible to issue false invoices for other businessmen or professionals with no tax cost) and lead to the absence of horizontal equity theoretically unjustifiable (given that the different tax treatment derives exclusively from the sector where the activity is carried out).



## 4. Structural reforms

In recent years, the Spanish economy has not only experienced an outstanding growth, but also deep changes that affect different fields. We are witnessing the beginning of the demographic ageing process, which will continue and become more noticeable in the next years. We have also witnessed unprecedented waves of immigration, unmatched in volume and intensity.

The changes have not been limited to the social sphere; our economic environment has likewise been transformed. It has changed both internally and externally. For example, the Public Administration's decentralization process has advanced significantly, while we have witnessed the intensification of the globalization process and the presence of new players in the international scenario.

These are deep structural changes, which our economy has assumed pretty smoothly, undoubtedly because of the large expansive phase it has gone through during the last decade. But their scope is such that, in order to guarantee the future prosperity of our country, structural reforms are required in different spheres. Such reforms, on the other hand, would have been necessary even in the absence of some of these changes, although perhaps with more time to react.

Only **structural reforms** can bring about the improvements required in the institutional framework which supports our economy. As occurs with any other far-reaching change, these reforms may also imply some adjustment costs in the shorter term. However, the benefits fully justify assuming such costs. The greater the credibility and the commitment of the rulers in dealing with the implementation of the necessary reforms, the lesser the frictions in the adjustment, and the sooner we will see **the positive effects**, for example, **in the expectations** of the different economic agents. In this sense, whoever governs this country must overcome the nearsightedness normally displayed in the political cycle, and set its sight beyond the horizon of the four-year term of office.

The spheres of action are many and varied. Among the most important ones are the Public Administration, education, market regulation and operation, particularly in the case of the labor or energy markets.

## 4.1 The effectiveness of the Public Administration and the distribution of powers

### *The Public Administration Spain needs*

The **operating effectiveness and efficiency of the economic and social system necessarily depends on the quality and management of the Public Administrations**. In the case of our country, this is even more true because of the complexity resulting from our highly-decentralized system; there is a long way yet to go in order to ensure that the most is made out of the opportunities to provide service to society.

This is the way *Círculo* sees it; it has always defended the need for a much more efficient public sector, capable of guaranteeing the provision of a number of essential services to promote wellbeing and equity in our society. It should also be capable of guaranteeing that social, business and economic activity in Spain are developed within the certainty provided by the legal framework.

We are aware that this task is not simple. Different circumstances make this a complicated challenge. The unstoppable advance of globalization and our membership to the European Union require the Public Administration to **adapt to the more internationalized context in which it operates**. The demands for greater efficiency do not originate only from the steps other countries have already taken towards more effective, modern and competitive administrations; **the citizenry is also increasingly demanding** in its relation with the Administration, from which it expects more efficient and better quality services.

It is true that during the last 30 years, the priority for the public sector has been to make an enormous effort to cover the notable deficiencies that existed in many of the basic public services. Thanks to that effort, important milestones have been achieved, such as universal compulsory schooling and health care.

Now, having solved the original problems and reached the initial objective, it is time to deal with the second stage of the process: making the public sector an efficient provider of the services demanded by the Spanish society. It's not so much a question of adding more resources to the different areas of action, but rather of making a more efficient use of the same to offer quality services to all Spaniards. Accomplishing this requires different reforms, which should focus on several principal points.

One of such points is represented by the **control, transparency and accountability mechanisms**. Accountability, at least for the economic-financial activity of the Spanish public sector, is provided for by the Spanish Law. The Spanish Constitution, in article 136.2, provides that “The accounts of the State and of the state public sector will be submitted to the Court of Auditors and will be reviewed by the latter,...”.

For this principle to be effective, and not only within the scope of public accounts, it is necessary to introduce **transparency** as an ingredient of good governance. Among other elements, public access to the relevant information is required, once the different functions and responsibilities of the administrations have been clearly defined. This makes possible the continuous control by society, for which internal mechanisms must also be designed.

**Coordination between administrations** is another aspect that demands specific attention. Decentralization of powers increases some risks of inefficiencies. That is the case of the unnecessary duplication of services or the lack of definition of the responsibilities concerning one or another level of the Administration. A proper coordination between the different levels of the Public Administration would solve these problems. Likewise, it would allow to take advantage of network and scale economies, preventing the appearance of difficulties which arise from managing problems on a less than efficient scale in each case.

**Professional management** must contribute to the objectives proposed in a decisive manner. This is a matter of introducing adequate incentives for the efficient work of public agents. With competence criteria, it is possible to improve the management results to the extent such criteria can be used to evaluate and reward the work of public agents through the necessary control mechanisms.

As in the case of the professional and efficient management, **it would be advisable to use the synergies arising between public and private management**. The existence of public goods (such as citizens’ security) and the so-called merit goods (for example, University education) give the public sector an important role in the provision of such goods or services. However, this does not mean that the funding, production, management and supply must always and under any circumstance be performed by the administrations. In many circumstances, it is possible to achieve more effective and efficient results through an adequate combination of the public

sector and private management. Some examples are concerted health care or education.

The proposed reform can take advantage of the **possibilities offered by the new technologies**. Indeed, opportunities stem from the new challenges the Administration faces and one of the most noticeable ones is the use of information technologies and communication. The use of these technologies can decisively contribute both to the relation between the citizens and the Administration, and to the management of many services by the latter. As significant examples, a single health card could make the coordination of the Spanish health system easier; or an electronic Administration would reduce the costs incurred by the citizens and the Administration in paperwork and formalities.

*Distribution of powers and funding of Autonomous Regions (Comunidades Autónomas) and Municipal Corporations (Corporaciones Locales)<sup>10</sup>*

The above-indicated options, such as the adequate adoption of the new technologies or practices well-established in other nations, constitute sensible answers to the demands the Spanish society places on our Administration. However, the situation becomes more complicated due to the process underlying all these tendencies, which will continue to generate instability until its completion: the decentralization of the public administrations.

The decentralization of the Public Administration in Spain has advanced at different rates in the past thirty years, depending on when it took place and which level of Administration was involved. As a result, we still lack a stable framework of power distribution, or at least one that is seemingly durable. Such stability is an essential requisite to promote the competitiveness of the Spanish economy and the cohesion of our society.

The main reforms in this regard must be made at the two levels of territorial administrations and their relationship with the Central Administration.

<sup>10</sup> "A new model for Spanish Municipal Governments", *Círculo de Empresarios*, September 2007.

- **Municipal Corporations**

The intense process of decentralization of powers from the State Administration to the Autonomous Regions has entailed a delay in the development of the responsibilities of the Municipal Corporations. Our municipal governments are still a long way from their European counterparts, in terms of political and financial autonomy. The main problem is that these administrations have been forced to deal with the changes and demands of the Spanish society in a completely obsolete and rigid legal and economic framework, therefore limiting their possibility of giving efficient and effective response.

The proximity of Municipal Corporations to the citizenry offers distinct possibilities for a better organization of all Public Administrations. Among such opportunities are those concerning a better alignment of the services delivered with the actual needs of the citizens, as well as those regarding more effective control mechanisms and accountability because of the mentioned proximity.

A deep reform of the current system is essential in order to take advantage of such opportunities. What has been recently designated as a “second decentralization” must begin. This means that **it is necessary to promote both a better definition of the powers of the Municipal Administration and a modernization of its sources of funding.**

The reform should start by defining the services or goods which must be provided by the Municipal Corporations. Until now, Municipal Governments have taken charge in areas where the other administrations could not meet the needs of the population. Such lack of definition seems, at best, inefficient. Eventually, since the social and economic changes so require, it would be constructive to make a clear but flexible guide list of the powers of the Municipal Corporations.

The definition of these powers and, therefore, the delivery of the relevant services and goods, should be carried out in compliance with the subsidiarity principle and the efficiency criterion. This subsidiarity-efficiency binomial must guarantee that the Administration in charge will be the one better suited to assume the power in question. This redefinition must be open to a

devolution from the Autonomous Regions, so that the efficiency analysis is not limited by the powers assumed by the regional administrations.

Unfortunately, until today, the lack of coordination has been one of the greatest burdens in the whole decentralization process, and has entailed a very significant loss of efficiency. In addition to leading to a waste of resources because of the inefficient delivery of services and goods, it has stood in the way of the normal development of the economic activity. Thus, coordination among administrations is another essential element in the definition of powers and the exercise thereof by the Municipal Corporations.

In that same line, decentralization should never lead to disintegration. On the contrary, the aim of this process should be a rational articulation of the State, respecting the above indicated efficiency-subsidiarity tandem, and coordination among the different levels of the Administration constitutes an essential requisite to that end.

Of course, none of the above will be actually viable without quality regulation. The Municipal Corporations are producing a huge and growing amount of regulations. Such regulations are often complex and onerous for the economic agents. To improve competitiveness, Municipal Corporations should join the administrative simplification and regulatory quality improvement process already initiated by other administrations, in addition to the necessary inter-administration coordination in order to limit the risk of ending in a “regulatory jungle”.

An immediate question arises: how will the Municipal Corporations fund themselves in this competences framework? Obviously, at least in *Circulo's* opinion, the answer is an actual increase of the Municipal Corporations' fiscal co-responsibility. For this purpose, they must be given greater tax collection powers, without increasing the fiscal pressure from the whole of the administrations. The solution then requires a redistribution of the income from taxes among the three levels of the Administration, increasing the Municipal Corporations' share in the collection of certain taxes. Likewise, these administrations should be conferred broader regulating powers, in connection with both the compulsory and the facultative levy of taxes. Lastly, the volume of powers transferred to the Municipal Corporations should be increased, particularly the ones originating from the Autonomous Regions,

since the Regional Governments are still in charge of many powers that the town and city councils should assume, such as some social services.

- **Autonomous Regions**

The levels of autonomy transferred from the Central Administration to the Spanish Autonomous Regions are even higher than in some federal states. However, the decentralization process which has led to this situation seems to never end, which results in uncertainty, and the eternal emulation tendency among Autonomous Regions (all of them want the same powers as the one with the most powers, and the one with the most powers always wants to keep its edge).

To put an end to such uncertainty (and to close the model), *Círculo de Empresarios* understands that the autonomies system must permanently search for efficient answers to achieve important goals, such as equal treatment (the guarantee that all citizens will have access to a minimum level of public services) and shared tax responsibility (greater decision powers in tax matters for the Autonomous Regions to achieve financial autonomy, so that they are the ones accountable to their citizens).

The stability of the system requires a guarantee of its dynamic sufficiency. This means that the financing system must not only cover the current needs of the Autonomous Regions, but must also foresee the existence of variables that, due to their territorial heterogeneous behavior, end up causing different needs.

One danger should be avoided in the construction of this stable and sufficient system. Namely, tax autonomy cannot jeopardize the tax integrity of the State. That is to say, the autonomic regulation, which should apply to all regions while maintaining the necessary exceptions with regard to the *foral* regime, cannot prevail over the State regulation, and the State cannot be deprived of its regulatory and tax collection powers in the territory of the Autonomous Regions.

Such integrity and unity of the system will require an additional coordination effort. Until now, the development of the autonomic State has focused on the decentralization of powers, therefore giving little relevance to

coordination. But the latter is determinant to achieve overall efficiency in the management of powers and rationality in spending. At the same time, coordination will be simpler if transparency is promoted since, by creating better informed citizens, they will demand accountability which will in turn force the search for efficient solutions.

## 4.2 Education and training

Among the powers transferred to the Autonomous Regions, one of the most notable ones is education. **The education system is one of the mainstays in a society's aspirations towards greater levels of prosperity and progress.** In this sense, the quality of education is decisive for the present and future of any modern society. A better education gives a country more cultivated, critical and free citizens, more adaptable to all types of changes, from social to technological, including economic changes. Likewise, **quality teaching is a key factor to promote social cohesion and contribute to equal opportunities.**

From the economic point of view, the relationship between education and competitiveness arises because the former is a form of investment, namely **investment in human capital**. Therefore, a better educated society is more competitive to the extent that, given its greater and better human capital, it obtains profits from productivity and efficiency which benefit both the individual and society as a whole.

Education, which has been considered a universal right for decades, has also gained increasing importance from the macroeconomic point of view. This becomes evident in many developed countries, which have placed this matter in the centre of the debate about competitiveness.

Spain is not, nor can it be indifferent to this matter. We are witnessing a debate about the quality of our education and training, and as a result, we are becoming increasingly aware of its relevance to drive the competitiveness of our economy in the medium and long term. Our education system, during both its regulated and unregulated stages, shows deficiencies that can be summarized by the lack of flexibility towards the transformation experienced by our country and the economic environment we live in.

Indeed, international comparative studies indicate that our starting position to tackle today's education challenges is worse than the one of the countries we must measure up to in competitiveness matters. The PISA reports, one edition after the other, position Spanish secondary education students in the last places among OECD countries in matters as essential as reading comprehension or solving problems. Also, the rates of school drop out after reaching the legally required age are substantially greater in Spain compared to the whole of the European Union.

The problems of our education system are not limited to compulsory education. They also affect other spheres, such as vocational training. This education option has been weighted down by its recent past discredit, which hindered its development. Continued and occupational training for employment have failed to reach in our country the levels of progress and quality observed in the rest of Europe and in the developed world.

The Spanish University is not an exception; the diagnosis of the current situation is just as worrisome. Although it is true that, as in the case of the prior education stages, full access of the population to tertiary education has been achieved, it is also true that our universities are not included in the rankings of highest quality universities.

All measures aimed at improving the Spanish education system must embrace the **current paradigm of education in the developed world: *life-long learning***. The idea is as simple as it is powerful. In view of the diversity and rapid changes experienced nowadays by any person in the conditions he/she must operate, particularly employment conditions, a great flexibility is required, which can only be obtained by permanently updating knowledge and skills.

The foregoing requires at the same time a **unified understanding of the whole education system as a framework where such continued learning must take place**. The changing requirements of society demand an education system articulated as a **"network" of different itineraries** crossing over and interconnecting each other, which the individuals can depart from at a certain time and rejoin at a later time in their life.

Political consensus and stability would contribute decisively to a necessary **first step** in the education reform: the involvement and **awareness of society as a whole**. On the other hand, a unified system does not imply that all components must be

reformed in the same way. Some **recommendations** are **generic** and apply to all stages of education. **Others**, instead, are **specific** to each segment of the system.

Among the former, a peremptory need: the **continued training of educators**. Likewise, the administration of educational institutions is particularly important. Without a doubt, the education of our country would improve if such institutions had adequate mechanisms to promote **result control, independence and transparency**. Control systems would help to detect and repair deficiencies dynamically; the greater independence of the institutions would bring about greater levels of flexibility for each of them to adapt to the specific demands of their students, involving the same and the trainers or educators more actively in the learning process; transparency would complement independence, therefore generating greater responsibility of the institutions towards society.

Once such mechanisms are implemented, competition among institutions would promote the search for higher levels of quality to attract more and better students. Finally, these beneficial effects would be reinforced, by making management more professional, as we observe more and more frequently in other areas such as health care, with regard to hospital management.

### ***Compulsory Education***<sup>11</sup>

As we stated above, each area of the education system requires specific measures that contribute to improve its partial results and reinforce complementarities among stages. Of course, work must start at the earliest stages. The basic skills that will allow students to make progress at a later stage of their academic or employment life are developed during such stage. It must focus, above all, on **developing skills to acquire and process information** (reading comprehension), as well as to **elaborate, express and apply the knowledge acquired, analyze and solve problems** (mathematic language) and **acquire foreign language skills** (mainly English).

The development of these skills must be accompanied by teaching and learning methods that facilitate the task, such as the application of new technologies, early assessments or individualized support for students.

<sup>11</sup> *"Towards a new educational system. Bases for the improvement of compulsory education", Círculo de Empresarios, July 2006.*

### *Vocational Training*<sup>12</sup>

The development of skills is also an essential matter for Vocational Training which, in the first place, must seek a truly integrating nature in our country, coordinating the regulated and unregulated stages as the elements of a single system aimed at increasing the workers' employability. Regulated training should provide not only the skills inherent to the relevant specialization, through a greater practical training. It should **specially develop broader and more general skills, such as command of technology, verbal and written communication in the native and foreign languages** (English, above all), **team work**, etc.- to face the changing conditions in the working environment.

The development of all such skills should continue throughout the unregulated stages. To promote this process, it would be convenient, on the one hand, to simplify the current system of Continuing Vocational Training, giving companies more individual initiative capacity. Likewise, a good assessment system and public recognition of the skills acquired would encourage investment in training of workers and companies.

That system would also contribute to connect Occupational Training with the rest of Professional Training. The strengthening of the assessment and transparency of the training courses would provide potential users more information about the use and quality of such courses, allowing a more efficient allocation of the public funds (more funds for the most demanded courses).

### *University*<sup>13</sup>

In our country, University has advanced exactly the same way as in continental Europe, towards a model that gives priority to the homogeneity among the different institutions, therefore hindering the achievement of higher levels of quality through competition. Now that the Bologna process opens new expectations and possibilities,

<sup>12</sup> "Vocational training: a corporate necessity", *Círculo de Empresarios*, March 2007.

<sup>13</sup> "A university at the service of society", *Círculo de Empresarios*, December 2007.

it is time to consider the reform of our University to make it more efficient, and also more equitable.

In this task, **the Public Administrations** should focus on “facilitating”, this is, **creating the conditions that allow developing a quality University**. They should ensure, through a clear regulation, without interventionist mechanisms, aspects such as the institutional independence of universities, subsequent quality control, correct generation of information about results, competition and equal opportunities concerning access.

On the other hand, **universities should modify their organization** by also applying the **principles of transparency, responsibility, independence and competitiveness**. Along this line, it would be necessary to introduce more professional forms of institutional government and management, together with competitive mechanisms for the selection, promotion and remuneration of the teaching staff.

Lastly, regarding the financing of the Spanish University, a new system is necessary to increase the resources received by the institutions, particularly the resources from the private sector, as well as to implement mechanisms to increase the system’s efficiency, by establishing subsequent controls of the results. Adequate financial incentives, combined with an ambitious scholarship policy (which promotes access of the best students to the universities of their choice) would allow the simultaneous improvement of the system, in terms of efficiency and equity.

### 4.3 Labor market

The labor market is the other fundamental area for the human capital. In the labor market, not only is the work factor assigned, by allocating the human capital, but also the training process continues. Additionally, the decisions that individuals take regarding this market –entry and departure, time dedicated to work, choice of occupation- interact with many others that are very important from a social and economic point of view. For example those are decisions closely related to the independence of young people, geographic mobility or birth rate.

In the last 10 years of economic growth there has also been a strong growth of employment. More jobs have been created in our country than in the rest of the

Eurozone, for example. However, our labor market still has important weaknesses, such as the enormous **rate of temporary jobs** or **rates of female activity still lower** than the ones observed in many countries around us. These weaknesses may have very negative consequences in the downward phase of the cycle which has already begun.

Therefore, it is necessary to undertake changes in this market, so that it can continue to generate employment and wealth, and turn into a factor that improves the life style of all persons residing in our country at the same time. In this sense, the reforms of the labor market must also aim at making the labor scope an adequate space to combine three fundamental elements in **immigration management**: openness, control and integration<sup>14</sup>. Opening to immigrants whose work and talent can contribute to the sustained growth of our economy; control so that immigration is an orderly process, which does not allow illegality or irregularity; and integration, to promote social cohesion of all participants. The balance of these three elements will lead to a more prosperous and cohesive society.

In general, the **regulation of the labor market should focus on making easier** the adoption of **more flexible forms of organization** by the companies, which are the best way for the latter to promote employment. They are also the best way of turning work-life balance into a true competitive advantage, which also contributes to the creation of new jobs. In this sense, the Spanish labor market still suffers from a certain rigidity which should be eased.

We find one of those **rigidities in our collective bargaining system**. Its current structure significantly limits the companies' individual capacity to establish their own forms of time and spatial work organization. It also fails to offer companies the flexibility they require to adapt to their particular circumstances. It is necessary to allow companies to seek specific solutions, adapted to their particular circumstances. This way, incentives to search for flexibility through less desirable mechanisms, such as temporary recruitment, would be reduced.

The use of temporary recruitment is very much a result of the current regulation for permanent recruitment. Indeed, the regulatory framework, which raises the costs of permanent recruitment, together with a certain short term perspective by the companies, make it difficult to increase such employment contracts and contribute to

<sup>14</sup> "Three key factors for an immigration policy: openness, control and integration", *Círculo de Empresarios*, December 2006.

the persistence of very high rates of temporary employment. The gap between the costs for the companies of both types of contracts should be narrowed.

Also, when regulating the different types of employment contracts, it would seem quite advisable to promote **part time employment**. Comparatively, the relative weight of these contracts in our labor market is below the European and other advanced economies' average. These contracts make work compatible with other parts of life, ranging from studies to taking care of dependants. This way, by improving the possibilities of work-life balance, they become mechanisms that enable those persons who would otherwise stay inactive, to join the market and remain active. Not only that. A redefinition of the regulatory framework as the one proposed would make training more attractive for workers and companies by, among other things, promoting compatibility between employment and training.

The duration of working life is yet another challenge for our labor market, given the current demographic tendencies. More exactly, it is necessary to establish mechanisms in order to extend working life. The problem of an ageing population which, on the positive side, means an increase in healthy life expectancy, can be tackled with innovative forms to take advantage of our elders' experience. At the same time, this requires a favorable regulation for both the companies and those who wish to reach retirement age, and even to a greater extent for those who wish to delay it.

#### 4.4 Energy

Yet another factor of production with a greater impact on the growth of the economy is energy. Even when technological development allows for a more efficient use of energy resources, the latter continue to be essential for economic activity in particular, and for human activity in general.

The energy problem for our country is worrisome in the near future. We face many determining factors, if not restrictions that affect our capacity to continue growing: an enormous dependence on external resources, environmental commitments acquired with the international community, impact from the environmental conditions of our territory...

In the field of electric power generation and supply we need a generation mix that allows for compatibility of different objectives: security of the supply, economic efficiency, environmental sustainability...

This being the situation, **the electric strategy** should be defined **through a regulatory pact between political parties** that guarantees stability and security in the long term. Given that the maturing time for decisions in the electric sector exceeds by far the political tempo, this matter should remain aside political party alternance.

When dealing with the **need for a generation mix**<sup>15</sup> that guarantees the security of the supply, one cannot discard the **promotion of renewable power technologies** (wind, solar, hydraulic, biomass...) since they contribute to a greater energetic independence –although to a limited extent- and require, in general, technological development. However, support must be temporary, transparent and assigned through a competitive process, clearly establishing the time horizon and developing alternative mechanisms to allow correct pricing.

At the same time, it is necessary to **consider nuclear energy as a key element to guarantee supply and fulfill the environmental commitments assumed by our country**. The most developed countries increasingly invest in this type of power generation. Spain must revisit these technologies without prejudices or taboos and actively seek, together with other countries, solutions for problems which are not yet fully solved. In any case, ensuring the extension of our nuclear plants' life would be an important step from the strategic point of view. In the longer term, the ones reaching the end of their life cycle should be replaced by last generation plants.

**Combined cycle generation with natural gas technology** should not be left out either. This requires a better operating coordination between gas and electric system operators, as well as providing the former with greater storage capacity. In this sense, it would be essential to have interconnection networks that permit massive exchanges of electricity and gas.

Lastly, progress should be made in the **liberalization process of the sector**, reviewing, among others, the tariff system and the market organization, including the suppression of both administrative barriers and prices and market distortions.

<sup>15</sup> "A new Energy for the Spanish electric sector. A long term view within the context of Kyoto", *Círculo de Empresarios*, May 2005.