



REFORMING RESPONSIBILITY IN SPAIN

Heavy Lifting Ahead

By **BENITO ARRUÑADA**

Why is it that while commentators in some countries see light at the end of the tunnel, in others – notably Spain – confidence indicators continue to fall? The crisis of confidence in the Spanish economy has been brought on not so much by the present economic downturn as by two deeper crises that go back further: an institutional crisis and a crisis of values.

Due to this concurrence of problems and the uncertainty accompanying them, the loss of confidence has been more virulent in Spain than in other countries. The question is not just whether existing political institutions are capable of implementing the reforms that are needed in order to modernize the economy, but also whether Spanish citizens, or a sub-

stantial proportion of them, will accept those reforms. Could the values of certain sectors of the population, in particular a certain indolent apathy and conformism, be the main obstacle to reform?

Given the seriousness of the situation and its international visibility, Spain is an extreme case from which valuable lessons can be learned about the principles on which confidence in a country is founded.

In this article I shall address the issue from the point of view of the Spanish case, drawing on my research into contracts, institutions and values. I do not expect to be able to answer all the questions about confidence in a country, as some lie beyond these disciplines, but I do hope to be able to point to a few areas where something can be done.



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An Age-Old Error: Not Facing Up to Problems

Spain has been in a privileged position: As a member of the European Union since 1986, it has benefited from development aid and from being in the euro zone. For decades, Europe set a clear reform agenda, relieving Spanish institutions of the need to find their own way forward.

After years of rapid growth, the economic crisis has hit Spain very hard. With unemployment approaching 20 percent and a budget deficit spiraling out of control, the Spanish economy is struggling to recover and growth in GDP per capita is falling below that of its European neighbors. Worse still, Spain seems incapable of adopting the reforms that are needed to deal with the crisis. Given this state of affairs, all observers agree that economic recovery will not come soon. Indeed, some question whether it will come at all. Meanwhile, the country has sunk into a general mood of despondency and disbelief.

Initially, half the population seized on the idea that the economic crisis was something that came from outside Spain, that Spain was merely registering the passing effects of an international recession. In doing so, they exhibited a failing that traditionally has contributed to Spain's economic backwardness: an inability to adapt quickly when the world economy slows down.

Four features have marked the economic history of Spain since the 1950s. First, Spain has been slow to respond to crises. Second, the invariable response has been to liberalize markets. Third, these market reforms have always resulted in high rates of growth, outpacing Spain's European neighbors. Lastly, many of these liberalizations have remained unfinished or were cut short, as if, once the immediate crisis was over, the country slid back into complacency. (See **Figure 1**.)

The response to the present crisis fits this pattern. So far, it has consisted of little more than increasing government spending – and this despite the fact that Spain has been spending around 10 percent more than it produces for several years already. Given negative interest rates, it was only to be expected that citizens would run up debts. Society has reacted sensibly to the crisis by curbing private borrowing. The government, however,

EXECUTIVE SUMMARY

Confidence indicators in Spain are at an all-time low. The reason is not so much the economic crisis as the country's failure to introduce structural reform. The author discusses two partly complementary hypotheses, identifying the problem as one either of institutions or of values. The institutional hypothesis suggests that the political system fails to translate citizens' preferences into effective reform. According to the values hypothesis, many citizens reject any reform that will require them to work harder or consume less. Based on the reforms carried out over the last half-century and the characteristics of Spain's most successful companies and individuals, the author argues that what is needed to rebuild confidence and overcome the economic crisis is an injection of competition and responsibility.

has not been so judicious: neither before the crisis, when it neglected to save or to use the opportunity to push through reforms that would boost productivity; nor after, merely substituting public for private borrowing, and so deferring an adjustment that cannot be put off indefinitely.

A To-Do List for Reform

Heading the to-do list are measures to foster competition in the markets – measures that should have been taken years ago. A good place to start would be the labor market. Regulations inherited from the Franco years make it difficult for firms to compete and adapt to change. As a result, many are condemned to failure. Worst of all, the current system hinders the creation of the kind of jobs that make it worthwhile for employers and employees alike to invest in “human capital.” Yet human capital is what a modern economy needs if it is to achieve the level of productivity and the standard of living to which Spaniards aspire. In other words, human capital is the key to a new model of production.

The type of permanent employment contract prescribed by current legislation is not conducive to long-term employment relationships, as employers must pay their workers however unproductive they may be and



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whatever their attitude. Naturally enough, employers take evasive action: first, by avoiding long-term employment; and second, by substituting capital for labor. On the other hand, temporary contracts – which could provide a framework for long-term employment relationships without the risk of opportunism inherent in permanent contracts – cannot be extended, and so are no use for that purpose.

The labor market is not the only market to suffer from a lack of competition. Owing to regulations framed during the dictatorship of Primo de Rivera and reinforced in the 1940s, house and apartment rentals – a flourishing industry in the early decades of the 20th century – today survives only in its most “unorganized” form, i.e., private rental agreements, benefiting from a lack of tax transparency. Retail distribution is still subject to entry restrictions, which not only contradict the European Services Directive but also block investment in a sector that could be a source of rapid job creation. Lastly, savings banks are bedeviled by perverse incentives: the people who control them are only able to extract rents by making them inefficient. These are just three examples of sectors in which not only have the necessary reforms not been carried out in recent decades but in which regulation has actually made things worse.

■ ABOUT THE AUTHOR

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Nor is the public sector exempt from the need for reform. To be efficient, public services should reallocate their resources by establishing market mechanisms, along the lines of what could be described as “automated administration,” and by giving participants stronger incentives, e.g., by linking the remuneration of public officials to their productivity and allowing users some choice of supplier. The idea is not to invent a bureaucratic market substitute, but to reduce the squandering of resources by gradually applying market-style incentives.

Education is a field in which Spain is missing the opportunity to introduce market mechanisms. Despite the high demand for state-funded private schools, instead of making it easier for parents to choose the schools they want, governments have limited these schools’ growth and so have restricted choice. All this in order to artificially maintain demand for state-run schools that otherwise would have fewer pupils. A better solution would have been to find out what people wanted and improve the schools where demand was low.

Cosmetic Reforms

The reforms actually implemented, however, are of a different kind. Scanning through newspaper archives, we find hundreds of modernization plans undertaken by governments of all stripes. The chief characteristic of these plans is that they increased the size of the public sector without stopping to consider how efficient or inefficient it was. They tried to seem modern without being modern. Above all, they were easy, even gratifying, for their sponsors, as they were chosen and designed so as not to step on anybody’s toes.

A flagrant example is the “New Enterprise Limited Company” (“*Sociedad Limitada Nueva Empresa*”), an initiative launched in 2003 to encourage business start-ups. It was a fiasco from the word go: the IT costs alone far exceed the capital of the few thousand companies formed since it began. Six years on, it is widely acknowledged as a failure, yet it continues.

How has Spain come to this: no reform where it matters most, and token reform everywhere else? What is stopping Spain’s leaders from grasping the nettle and at least

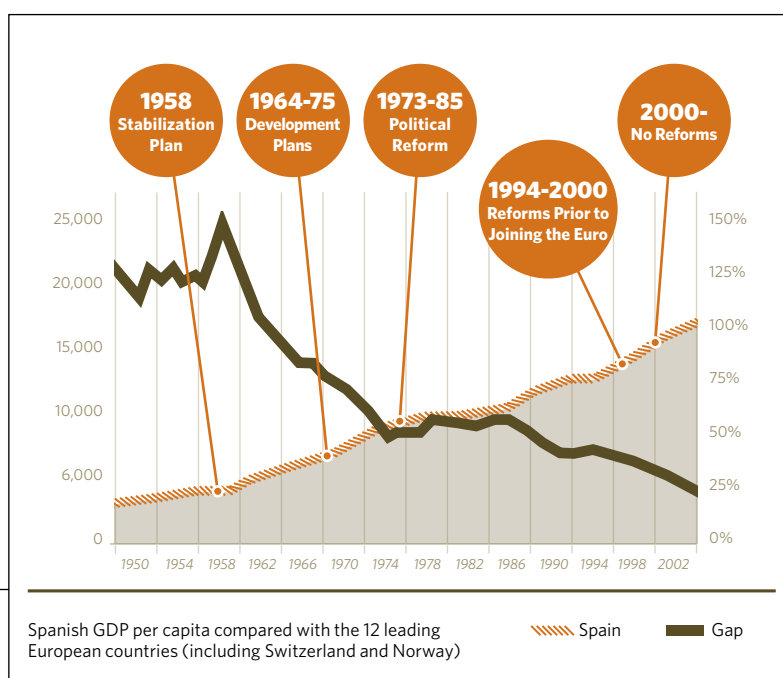


A Changing Gap

FIGURE 1

The economic distance between Spain and other European countries has diminished greatly but with serious halts since the second half of the 20th century. The successive narrowing and widening of the gap is correlated with the ebb and flow of economic liberalization.

Various liberalization plans – such as the 1958 Stabilization Plan, and the reforms of the '80s, in the run-up to Spain joining the E.U., and the late '90s, ahead of adopting the euro – served to close the gap between Spain and its main European counterparts. A few years into each reform, however, the impetus was lost. The same happened with the failed development plans of the 1960s, and the reversal, in the early '90s, of the deregulation of housing and retail markets introduced in the '80s. Consequently, any convergence was halted or even inverted.



proposing the kind of substantial change that could bring about economic recovery?

Two somewhat complementary hypotheses need to be considered: the reason for Spain's relative immaturity could lie in its institutions or in its values. According to the institutional hypothesis, the problem is that Spain's political system is incapable of translating citizens' preferences into actual reform. According to the values hypothesis, Spaniards do not really want any reform that would demand more effort or less consumption in the short term, regardless of the longer-term benefits.

Institutional Failures

There is reason to believe that the political system does not accurately represent the will of the people. Also, in the field of institutions, competition is insufficient and distorted. This is particularly true in the "political market," where a small number of political parties

enjoy high entry barriers, practice endogamy and nepotism, and lack internal democracy.

Competition, whether external or internal, is conspicuous by its absence. There are two reasons for this. First, parties are a species of state-owned enterprise. They are funded from the public purse – if not from corruption – based, in either case, on their prior market share. Second, closed lists prevent individual politicians from making a name and reputation for themselves. This makes political activity unattractive: it is insecure and rewards loyalty rather than ability. This combination leads to adverse selection, encouraging the view that the standards of politicians are declining and may already be lower than those of the country they govern.

Competition is similarly lacking in the marketplace of ideas. There is little diversity in the media in Spain, and media ownership is highly concentrated. Systematic use of propaganda – misleadingly named "public service



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advertising” – is tolerated, allowing political groups of all persuasions to use public money to further their interests, muddy the issues and coerce the media.

As a result, people are poorly informed. More serious than this, though, is the lack of transparency. Many Spaniards are unaware of the economic dilemmas they face simply because they cannot see them. In the past two years, for example, the expected value of future pensions has fallen at least as dramatically as in the United States. In the U.S., people know about it because much of their pension is invested in the stock market. In Spain, however, the fragility of the public pension system is hidden from view. The same is true of all kinds of taxes: retail prices include and camouflage sales tax; income tax withholdings are invisible and are calculated so that most employees are “rewarded” with a refund when they file their tax return; the cost of social security, too, is masked, in this case by the fallacy of separating social security contributions into an employer’s share and an employee’s share, as if both didn’t fall under the labor contract.

As a result of all these mechanisms, citizens neither *feel* that they are the ones who pay taxes nor intuitively grasp that they are the ones who finance government spending. For citizens to reach the age of majority, economically speaking, what matters is not so much the education or the information they receive as that the taxes they pay be transparent. Citizens need to be able to acquire the necessary information automatically and without effort.

The opacity of the system also has implications for government action. In Spain, there is much less demand for drastic solutions than in other countries. The government is correspondingly slower to respond to crises. It is no accident that today’s political leaders should use the same tactics as those of the

1970s, first denying everything, then fudging the issue, by which time several years have gone by. Anything but face up to an unpleasant truth: either Spaniards drastically reduce consumption or painful structural reforms will be needed.

A Failure of Values

There is room for improvement in many Spanish institutions, undoubtedly. Perhaps the main reason why they have not been reformed, however, has to do with values; specifically, the inertia of a large part of the electorate. It may even be that these institutions are helping to create the kind of unproductive, unfair society that a large proportion of Spanish citizens want: a subservient, conformist society.

According to this second hypothesis, many citizens do not want reforms that would stimulate competition, as this would require that they accept greater responsibility and each take their fair share of it. If this hypothesis is correct, the problem is not that politicians disregard the popular demand for change but that people opt for the lowest common denominator, the easy way out. In other words, the problem is largely one of values. So what values lie behind the conformism that is impeding change in Spain?

First, primitive envy continues to play a fundamental role. Like other nationalities, Spaniards are liable to sabotage competition in order to protect their privileges. The difference is that they also prevent their neighbors and colleagues from working harder and living better. From schools to factories, the peer pressure not to excel, not to compete, is intense. Anyone who succeeds is expected to share that success with the tribe; if not, the disapproval is immediate and unanimous.

Second, as my research in comparative social ethics reveals, in countries with a Catholic culture people tend to be too ready to



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forgive and forget after the event. The consequences are most apparent in criminal justice, but more important in the economy: forgiving crime amounts to forgiving inefficiency. In so doing, Spaniards punish those who have abided by the law and have done their best to be efficient. In traditionally Protestant countries, on the other hand, the general rule is that “the sinner pays for his sins.” In business, this translates as, “inefficient companies must be allowed to fail.” When the process of creative destruction described by Schumpeter is allowed to operate, competitive companies thrive. In Spain, by contrast, if a company goes bankrupt, whether because its managers run it into the ground or because its employees make it unmanageable, it is considered only natural that the government should rescue it with taxpayers’ money, effectively penalizing efficient companies that played clean. What incentives do companies have?

This inability to punish offenders and inefficiency after the event goes hand in hand with an urge to control everything beforehand. All kinds of blanket controls are imposed, leaving no room for personal responsibility. If traffic accidents are a problem, instead of punishing drivers who run over pedestrians, the authorities fill the streets with speed bumps. Because some companies commit fraud, all companies have to battle with red tape that not only represents a heavy financial burden but also constitutes a seedbed for corruption.

Besides this urge to control everything in advance, the inability to punish after the event makes the government incapable of liberalizing sensibly. Those who realize the evils of excessive control are right to say that the solution is greater freedom, but they tend to forget that greater freedom also means greater responsibility. This explains why Spanish society is saddled with ostensibly liberalized institutions and organizations that nevertheless remain virtually unaccountable. This very

basic deficiency affects such diverse bodies as the universities and the governments of Spain’s autonomous communities, which blithely spend tax funds they have not collected. It also affects unions, which are subsidized but cannot be held to account for the strikes they call. Even savings banks, which have been at liberty to raise salaries, invest unwisely and contaminate the financial system, but now expect to be bailed out, so as to spare their managers and employees a “traumatic” outcome.

Reasons for Hope

Despite all these economic, institutional and values-related problems, there are grounds for optimism.

On the economic front, the European framework provides a degree of security. Unfortunately, however, it is no longer a benchmark for reform. Until recently, it was obvious what reforms were needed because they were decided in Brussels and were not questioned. It was simply a matter of putting them into practice. As the peculiar adoption of the Services Directive shows, the challenge facing Spain now is to learn to make its own reforms. If it fails to do so, reforms will eventually be imposed on it from outside, but at the cost of coming perilously close to bankruptcy and, in the best of cases, having to be rescued. It is worth noting that, as yet, the markets consider default by the Spanish government only moderately likely (see **Figure 2**), so there is still hope that the country will react in time.

With respect to institutions, Spain enjoys great stability: In the recent past, it proved itself capable of making a remarkable transition to democracy, with very little conflict and relatively satisfactory results. In more difficult times, such as the years after 1975, Spain rose to the challenge and established rules of the game that have allowed it to advance. Given these precedents, it should not be too difficult to rekindle that spirit and reshape Spanish de-



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mocracy. The question is how far the situation must deteriorate before the country takes the bull by the horns.

If there is one main reason for optimism, it is that Spain has individuals and companies that are models of competitiveness. Given the right circumstances, Spaniards are capable of exceeding the highest expectations. Their example partly refutes the deficit-of-values hypothesis.

One thing that surprises outside observers, for example, is that Spain should produce so many world-class sportspeople. Recent years have witnessed the emergence of talents such as Pau Gasol in basketball, Rafael Nadal in tennis and Fernando Alonso in Formula One racing. How is it that a country like Spain can produce so

many top performers? What do these individuals have in common? The answers to these questions map out a whole program of measures to combat the economic crisis and rebuild confidence.

- To start with, they all perform in a highly competitive field – sport – that is governed by clear, stable rules. They can afford to invest years of their lives learning to play the game, safe in the knowledge that when they are ready to compete, the rules will not have changed and will be applied rigorously by independent, impartial judges. They know that if they play the game well, they will be able to compete on equal terms and that, within the rules, each is free to innovate and act as he likes.
- They have strong incentives. They are very well paid, but their pay is directly related to their performance: They earn a lot, but only if they play well, having invested years of effort and having accepted the risk of failure. No one rushes to console them if they fail.
- The activity they have chosen has no entry barriers. Their decision to compete has not been thwarted by the refusal of a public official to grant them a license, or by the power of a professional or trade association to hold several generations hostage; nor by their social background, their nationality or any other privilege.
- They have been free to train for their profession. From a very young age, they have invested a large part of their time and all their effort in their “human capital” as sportspeople. Throughout their careers, they have been able to choose their coaches and any other resources they needed quite freely, in fully competitive markets. Their training has not been constrained by educational plans, arrangements or reforms serving particular ideologies or interests.
- Their vocation has always been global. They shun narrow parochialism and have

Five-Year Implied Probability of Default

FIGURE 2

DEFAULT BY THE SPANISH GOVERNMENT IS ONLY MODERATELY LIKELY. PROSPECTS FOR OTHER E.U. COUNTRIES SUCH AS ITALY AND GREECE ARE WORSE.

COUNTRY	PROBABILITY OF DEFAULT
Argentina	52 %
Mexico	11.2 %
Greece	10.4 %
Brazil	9.2 %
Italy	6.2 %
SPAIN	6.1 %
Chile	5.6 %
Portugal	5 %
United Kingdom	4 %
Belgium	3 %
France	2.2 %
Germany	2 %
United States	1.9 %

NOTE: Percentage estimated from the market price of five-year credit default swaps (CDS) as of September 2009



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always been willing to go wherever they needed to go in order to learn. Thanks to all this, today they are able to compete and win at the highest level.

- Lastly, they are the first to hold themselves responsible for their failures, without making excuses for themselves or blaming everything on other people or “the system.”

These characteristics are not exclusive to top sportspeople. Many Spanish companies are leaders on the world stage. It is instructive to note in which industries they operate, namely those in which regulation was less heavy-handed (fashion, hotels, ceramic tiles) or less crippling (banking, utilities, public works) than was the case in neighboring countries. These are industries that have been relatively open to new entrants and in which competition has been governed by stable rules.

Like elite sportspeople, their leaders have not limited their ambitions to the domestic market. The achievements of companies such as Zara, Mango, Pronovias, Meliá, Barceló, Porcelanosa, BBVA, Santander, ACS, Ferrovial, Iberdrola and Telefónica demonstrate that, when the rules of the game are clear and the players are free to compete, Spaniards are capable of prospering and creating companies that lead the world.

A Watershed Moment

Spaniards are at a crossroads. They must decide what standard of living they want to achieve and, consequently, what values must govern their society. The lessons of history, of the best sportspeople and of the leading companies are clear: To return to the path of growth and recover confidence, free market competition must be the model not only in business but also in politics and public services.

In particular, all these areas need an injection of freedom and personal responsibility. The task is easier than it seems, as Spain has

great potential for growth. In the past, every time the country opened up to competition, the economy blossomed. What’s more, Spain today has a diversity of values and competitive experience it did not have a few decades ago. Spain does not need a new economic model. It just needs to liberate the potential of its economy, burdened as it is at present by a weight of restrictions and complexes handed down from the last century. □

Translated by **Stephen Waller**

■ TO KNOW MORE

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