

Please cite this paper as:

González Pandiella, A. (2014), "Moving Towards a More Dynamic Business Sector in Spain", *OECD Economics Department Working Papers*, No. 1173, OECD Publishing, Paris.
<http://dx.doi.org/10.1787/5jxszm2k7fnw-en>



OECD Economics Department Working
Papers No. 1173

Moving Towards a More Dynamic Business Sector in Spain

Alberto González Pandiella

JEL Classification: D21, D40, F10, G21, G24, G33,
H25, K20, L11, L12, L25, L50

ECONOMICS DEPARTMENT

MOVING TOWARDS A MORE DYNAMIC BUSINESS SECTOR IN SPAIN

ECONOMICS DEPARTMENT WORKING PAPERS No. 1173

By Alberto Gonzalez Pandiella

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ABSTRACT/RÉSUMÉ

Moving Towards a More Dynamic Business Sector in Spain

Policy efforts to revitalise entrepreneurship and investment in Spain are key to generating growth and new jobs. The government has a substantial reform program to make it easier to do business in Spain, which should in some cases be deepened. Boosting economic growth requires a new generation of high-growth companies and that resources flow towards the most productive firms. For this to happen, barriers to business growth have to be reduced by streamlining regulations and licencing procedures, internationalisation needs to be fostered, and competition strengthened. In addition, the negative impact of the crisis on companies, notably the high level of indebtedness and difficulties to obtain financing faced by some firms has to be relieved. This would be facilitated by more efficient insolvency procedures and further development of non-bank financing.

This Working Paper relates to the 2014 *OECD Economic Survey of Spain* (<http://www.oecd.org/eco/surveys/economic-survey-spain.htm>).

JEL classification: D21, D40, F10, K20, G21, G24, G33, H25, L11, L12, L25, L50

Keywords: Spain, business sector, productivity, firms size, young firms, entrepreneurship, internationalisation, exports, competition, competitiveness, indebtedness, corporate tax, regulations, licences, constant market share analysis, market share effect, structure effect, trade specialization, professional services, electricity, regulators, ports, judicial efficiency, insolvency, venture capital, mutual guarantee schemes, credit register

Dynamiser le secteur des entreprises en Espagne

Les efforts faits par les autorités pour revitaliser l'entrepreneuriat et l'investissement en Espagne revêtent un rôle essentiel pour soutenir la croissance et la création d'emplois. Un important programme de réformes a été mis en œuvre afin de faciliter l'activité d'entreprise en Espagne, dont certains aspects devraient être approfondis. Pour stimuler la croissance économique, il faut que voit le jour une nouvelle génération d'entreprises à forte croissance et que des ressources soient acheminées vers les entreprises les plus productives. Dans cette optique, les obstacles à la croissance des entreprises doivent être réduits en simplifiant les réglementations et les procédures d'agrément, l'internationalisation doit être encouragée et la concurrence doit être renforcée. En outre, les effets négatifs de la crise sur les entreprises, notamment le niveau élevé d'endettement et les difficultés rencontrées pour obtenir des financements, doivent être atténués, ce qui exige des procédures d'insolvabilité plus efficaces et un développement plus marqué des financements non bancaires.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de l'Espagne, 2014 (<http://www.oecd.org/fr/eco/etudes/espagne.htm>).

Classification JEL : D21, D40, F10, K20, G21, G24, G33, H25, L11, L12, L25, L50

Mots clefs : Espagne, le secteur des entreprises, la productivité, taille de firmes, les jeunes entreprises, l'entrepreneuriat, l'internationalisation, l'exportation, la concurrence, la compétitivité, l'endettement, l'impôt des sociétés, réglementations, certifications, l'analyse des parts de marché constantes, effet de part de marché, l'effet de la structure, la spécialisation du commerce, des services professionnels, l'électricité, les régulateurs, les ports, l'efficacité judiciaire, insolvabilité, capital-risque, sociétés de caution mutuelle, registre de crédit

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MOVING TOWARDS A MORE DYNAMIC BUSINESS SECTOR IN SPAIN

By Alberto Gonzalez Pandiella¹

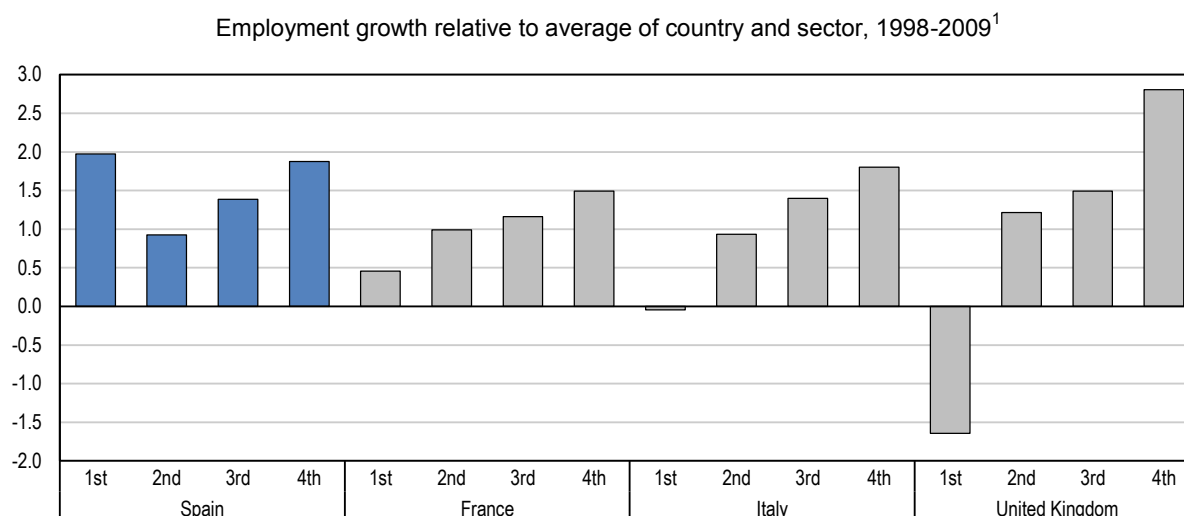
Policy efforts to revitalise entrepreneurship and investment in Spain are of paramount importance to absorb people and capital that have become idle during the crisis. Boosting economic growth requires a new generation of high-growth companies to invest in more productive activities where labour could be reallocated. Resources should flow to the most productive firms at the expense of the least productive ones, which had not been the case in the years prior to the crisis. Lifting the performance of the Spanish business sector requires meeting three inter-related challenges: reducing barriers to firm start-up and growth; increasing exporting and innovation; and boosting competition. Additional constraints created by the crisis should also be removed by rehabilitating highly indebted viable firms and facilitating the exit of the non-viable ones, while improving access to credit and capital. The government reform programme already underway in these areas should be deepened along these lines.

Key challenges affecting the Spanish business sector

Resources need to be reallocated to the most productive firms

An extensive literature has highlighted the important role of reallocation of resources across firms, even within narrowly defined sectors, for overall productivity growth (Arnold et al., 2008; Foster et al., 2002; Hsieh and Klenow, 2009). Firm-level evidence suggests that Spain has lacked flexibility to re-allocate resources to more dynamic and productive firms (Figure 1). In Spain, firms with low productivity had stronger employment growth than others before the crisis. This contrasts with United Kingdom, Italy and France that show a strong positive association between productivity and employment growth. Productivity differentials between Spain and other high-income OECD economies cannot be fully explained by the shift of resources towards the construction sector in the boom years (Mora-Sanguinetti and Fuentes, 2012), but result from a lack of flexibility preventing resources from being efficiently reallocated (Crespo Rodríguez et al., 2012).

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Figure 1. The link between productivity and employment growth across firms within industries

1. Or latest data available.

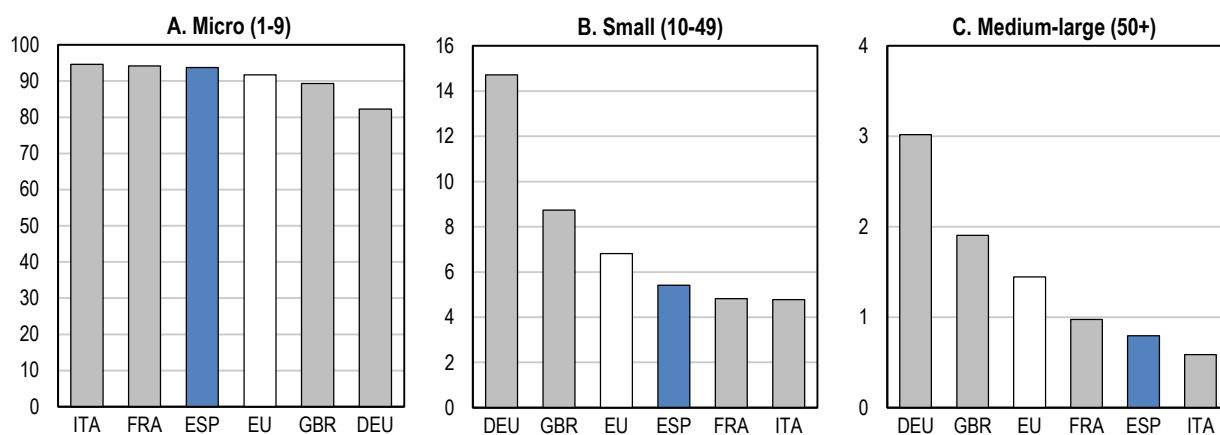
Source: OECD (2013), *OECD Economic Surveys: Brazil 2013*.

How to read this figure: The bars represent quartiles of firms within an industry ordered by productivity levels relative to the industry average. The height of the bars measures annual employment growth, relative to the average of the country and sector. A bar higher than zero means that employment growth in a set of firms was above average.

Implementing reforms that raise the productivity of existing firms, while at the same time fostering the flexibility needed for resource reallocation, will be one of the principal policy challenges for ensuring strong growth in the future. An environment that promotes reallocation and entrepreneurial risk-taking can also encourage innovative activity and investment in knowledge-based capital, which are associated with productivity improvements (OECD, 2013a; Andrews and Criscuolo, 2013). Structural policies can influence the ease with which such re-allocations occur (Andrews and Cingano, 2012). For example, administrative burdens can hamper firm entry, thresholds built into tax or labour codes can create disincentives for firms to grow beyond a certain size and credit markets may unduly favour incumbents at a time of crisis.

Barriers to firm start-up and growth are too high

Regulatory barriers to firm start-up, growth and exit discussed below have resulted in a business sector with many low productivity micro enterprises and too few medium and larger firms (Figures 2 and 2.3). These features can be observed both in the manufacturing and services sectors and have remained unchanged over time. This dual distribution has serious implications for aggregate job growth, productivity and employment quality because, as elsewhere, larger firms have higher productivity. Spain, together with Italy, has more firms per unit of gross domestic product (GDP) than any other major European economy (OECD, 2013b), signalling that the business sector is fragmented. Spanish dual firm distribution is more similar to the one observed in developing countries, where many low-productivity locally focused micro firms coexist with a few large export-oriented multinationals, than with the one observed in other advanced economies.

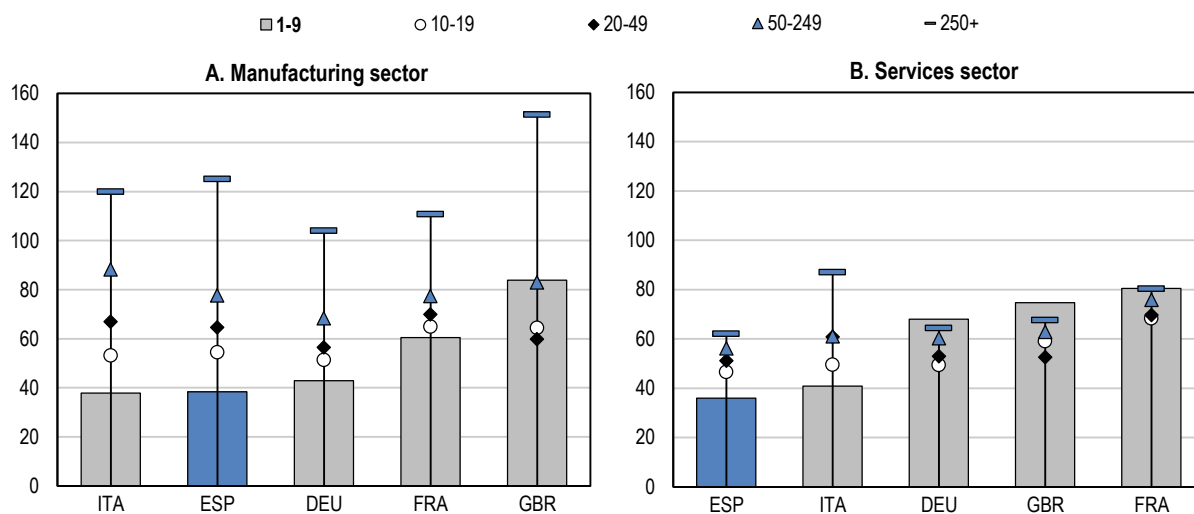
Figure 2. Distribution of firms by size classBased on the number of persons employed, per cent of total, 2010¹

1. The sector covered is the total business economy (including repair of computers, personal and household goods; excluding financial and insurance activities). The EU aggregate is an unweighted average of shares for 23 countries.

Source: OECD (2013), *Entrepreneurship at a Glance 2013*.

Figure 3. Productivity by firm size and branch¹

Value added at factor cost, thousand USD per person employed, 2010



1. Firm size classes based on the number of persons employed.

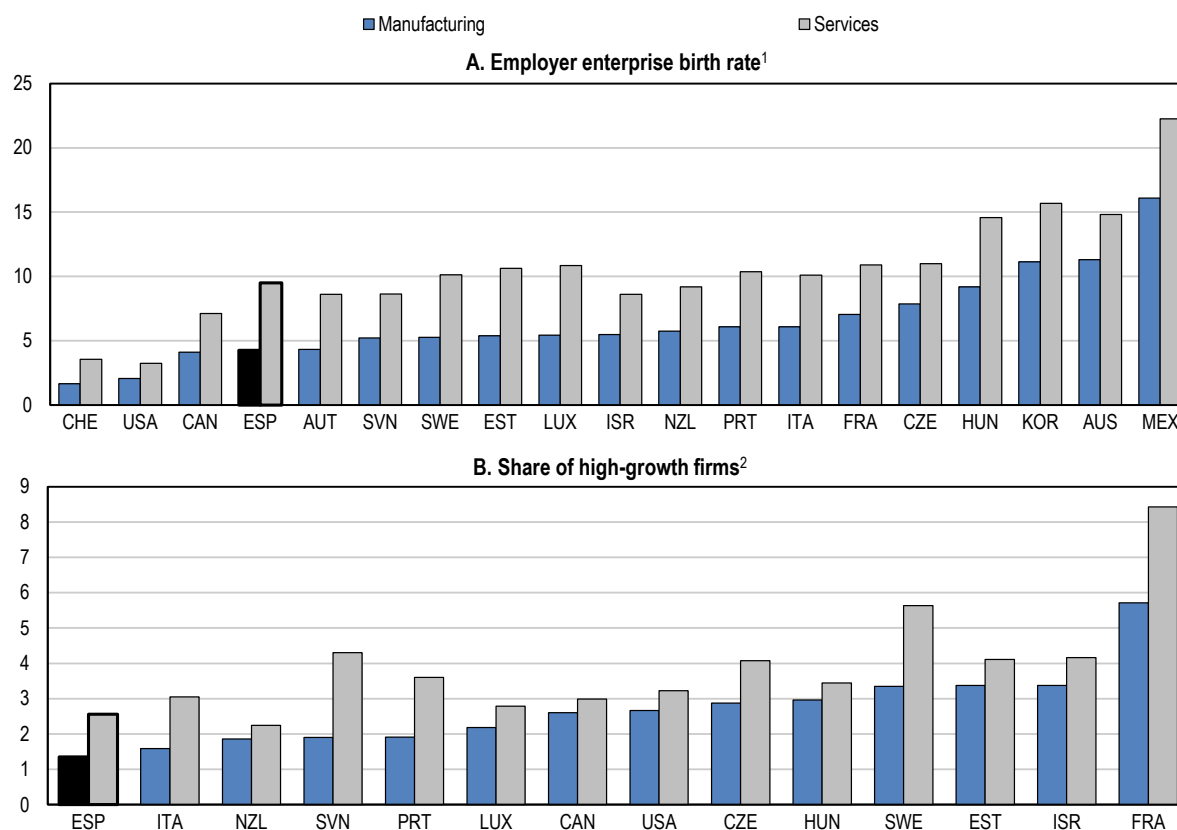
Source: OECD (2013), *Entrepreneurship at a Glance 2013*.

Barriers to start-ups have also resulted in low birth rates of firms and particularly of young high growth firms (Figure 4). Spain also has one of the lowest early stage entrepreneurship rates, a measure of start-up activity (Figure 5). This is a crucial impediment to aggregate economic performance and job creation. New enterprises yield a competitive pressure on incumbent companies, improving resource allocation by forcing inefficient firms out of the market. New start-ups also exploit knowledge unused or under-used by existing companies, drawing on knowledge spillovers to enter new and established markets (Acs et al., 2009). High start-up rates are strongly associated with high economic growth and job creation (Acs et al., 2006; Stangler and Litan, 2009). Net job-creation tends to be concentrated in few fast-growing

firms, rather than dispersed across a large number of averagely performing enterprises. In general, around 4-6% of high growth firms generate half to three quarters of all new jobs (Henrekson and Johansson, 2010).

Figure 4. Firms: birth rate and high-growth by sector

2010 or latest year available

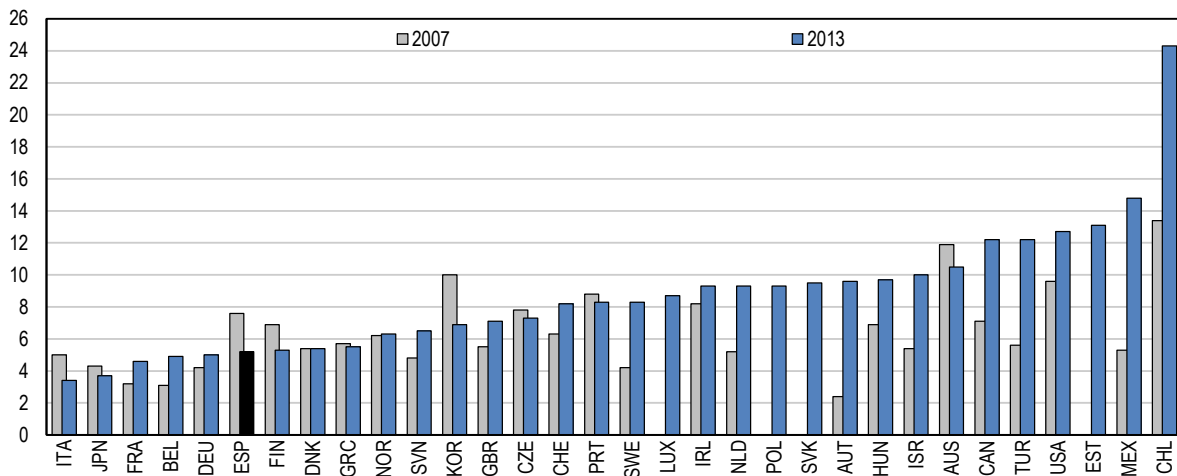


1. Number of births of employer enterprises as a percentage of the population of active firms with at least one employee. 2011 for Israel, Korea, New Zealand and United States; 2009 for Canada, Estonia, France and Slovenia; 2008 for Mexico, Sweden and Switzerland.
2. Number of high-growth firms as a percentage of the population of firms with ten or more employees. A firm is considered high-growth when it has an average annualised growth in employees greater than 20% a year, over a three-year period, and with ten or more employees at the beginning of the observation period. 2009 for Canada, France and Slovenia; 2008 for Sweden.

Source: OECD (2013), *Entrepreneurship at a Glance 2013*.

Figure 5. Early-stage entrepreneurship activity rate¹

Per cent of population (aged 18-64) who are either a nascent entrepreneur or owner-manager of a new business



1. Defined as the prevalence rate of individuals in the working age population who are actively involved in business start-ups, either in the phase in advance of the birth of the firm (nascent entrepreneurs), or the phase spanning 42 months after the birth of the firm (owner-managers of new firms). The payment of any wages for more than three months is considered the "birth event" of the firm. Individuals who are actively committing resources to start a business (that they expect to own or co-own) but for whom the business has not yet yielded wages or salaries are considered nascent entrepreneurs.

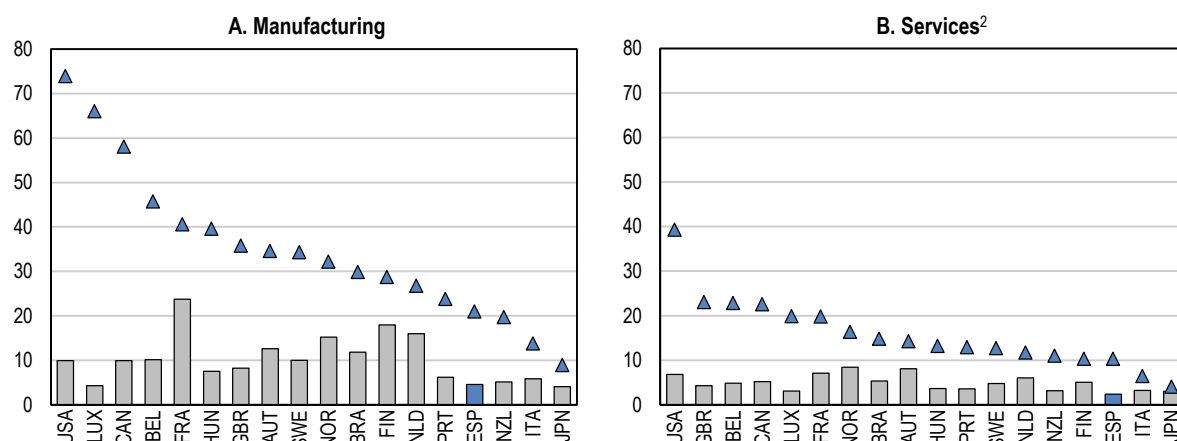
Source: GEM (2014), "Key Indicators", *Global Entrepreneurship Monitor Database*, Global Entrepreneurship Research Association, London Business School, May

Empirical evidence confirms this. Spanish young firms have a significantly higher contribution to employment creation than older businesses. Indeed, the more favourable job-creation behaviour of young firms with respect to mature firms is relatively more marked in Spain than in other economies (Criscuolo et al., 2014). Over 50% of new jobs in Spain between 2001 and 2011 were due to young firms, though such firms accounted for only about 20% of total employment. Start-ups tend to be smaller in Spain than in other countries, and they do not appear to grow much over time, both in manufacturing and services (Figure 6). This suggests that the high proportion of small firms and the low presence of larger businesses in Spain might be reflecting two different features: start-ups are often small and there is a large share of more mature businesses that do not grow.

Figure 6. Average size of firms by age and sectorNumber of employees, average over the period¹

■ Startups (0-2 years old)

▲ Old (over 10 years old)



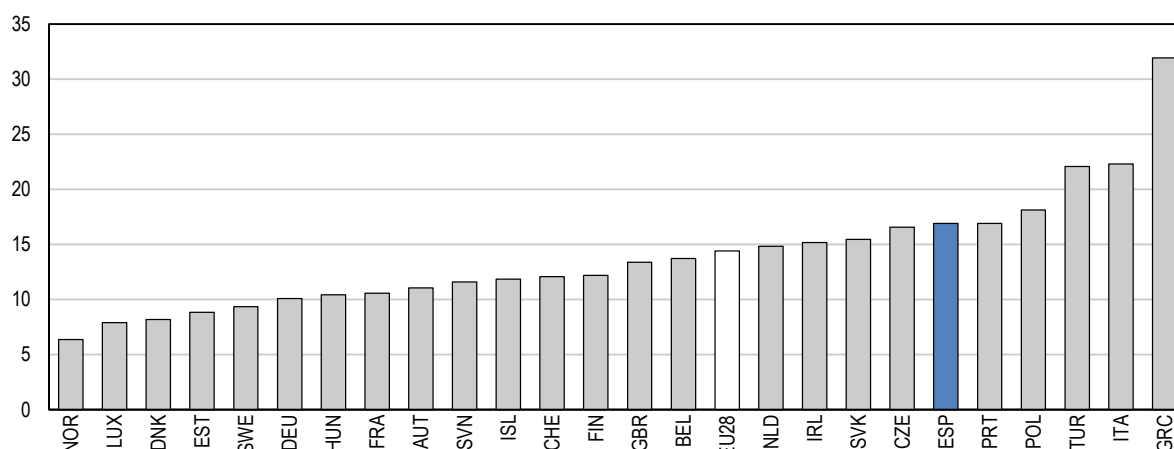
1. The period covered is 2001-11 for Belgium, Canada, Finland, Hungary, the Netherlands, the United Kingdom and the United States; 2001-10 for Austria, Brazil, Spain, Italy, Luxembourg, Norway and Sweden; 2001-09 for Japan and New Zealand; 2001-07 for France; and 2006-11 for Portugal. Owing to methodological differences, figures may deviate from officially published national statistics. For Japan data are at the establishment level, for other countries at the firm level. Data for Canada refer only to organic employment changes and abstract from merger and acquisition activity.
2. Non-financial business services.

Source: C. Criscuolo, P.N. Gal and C. Menon (2014), "The Dynamics of Employment Growth: New Evidence from 18 Countries", *OECD Science, Technology and Industry Policy Papers*, No. 14.

Spain displays relatively high rates of self-employment (Figure 7). On the positive side, this can be a signal of entrepreneurship. However, it can also be a sign that employers prefer to hire workers as independent contractors to benefit from lower social security contributions, which could increase the duality of the labour market and reduce labour skills. It could also indicate that the economy is not creating enough opportunities in the formal labour market. Indeed, a higher incidence of self-employment tends to be related to the size of the informal economy, which in Spain is estimated to be around 22% of GDP (Schneider et al., 2010), above the OECD average. On the one hand, the fall in construction activity, which tends to have a high incidence of informality, would have contributed to reduced informality. On the other hand, the recession reduced business and job opportunities in the formal economy and may have increased incentives for entrepreneurs and workers to move to the informal economy. Informality may be a source of jobs and livelihood in the short-term, but it hampers growth, job quality and productivity in the medium-term. Informal enterprises have an incentive not to grow to escape from tax authorities and there is a positive relationship between the size of the informal economy and the size of the micro-enterprise sector (OECD, 2013b). Informal firms also tend not to invest in modernising production. This translates into low productivity per worker and hence low wages. Moreover, the informal sector does not proportionally contribute to the financing of public services and infrastructure and acts as unfair competition to compliant firms.

Figure 7. Self-employment

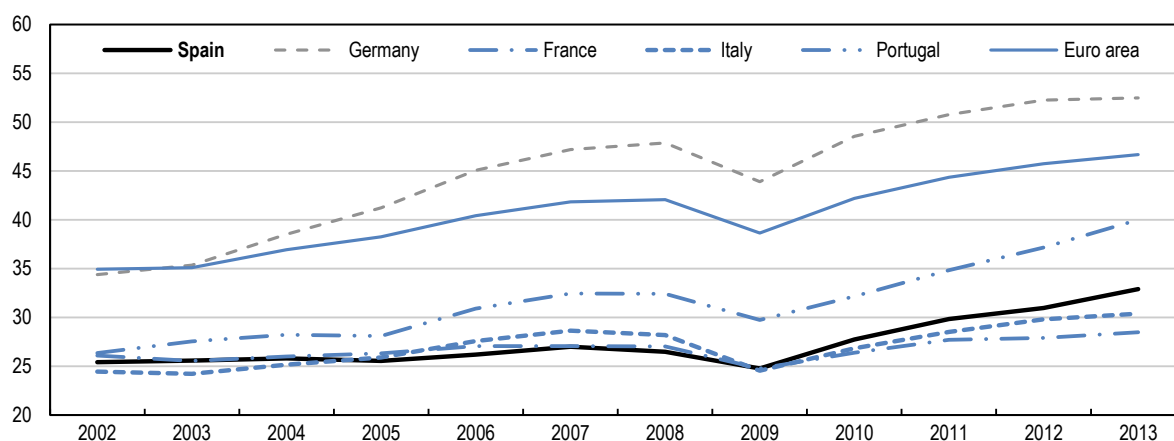
Self-employed as a percentage of total employment, age 15-64, 2013

Source: Eurostat (2014), "Employment and Unemployment (Labour Force Survey)", *Eurostat Database*, July.***Internationalisation and innovation are low***

Along with the collapse of the construction sector (and to a lesser extent the downsizing of the financial sector), the recovery of cost-competitiveness has allowed Spain to initiate a re-orientation of its productive system towards exporting sectors. The weight of exports in GDP has considerably increased, although it remains far below the euro area (Figure 8). It is essential that the Spanish business sector's efforts to internationalise its activities continue and extend.

Figure 8. Evolution of exports

Exports in volume, per cent of GDP

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), July.

Increasing further internationalisation would render positive effects on multiple fronts, since the performance of manufacturing exporting firms is significantly better than that of non-exporting firms (Table 2.1). They are substantially larger, have higher real productivity and physical capital stock per employee, rely more on skilled labour and are more likely to invest in research and development (R&D)

and adopt foreign technology. On average, roughly 80% of the firms reporting either product or process innovations in a given year were also exporters (BBVA, 2012).

Table 1. Characteristics of exporting firms versus non-exporting

Manufacturing sector, average 1990-2010¹

	Units	Exporting	Non-exporting
Size	Average number of employees	167	21
Productivity ²			
Value added	Thousand USD per employee	33.2	20.2
Output	Thousand USD per employee	104.7	48.8
Physical capital ²	Thousand USD per employee	31.4	12.3
Innovation			
Highly-qualified employees ³	% of total employees	3.6	0
White collar employees	%	28.6	21.4
R&D and technological adoption ⁴	Thousand EUR	24	0
Foreign capital structure	% of share capital of the company	26.3	3.1
Market share in main market	%	14.3	7.9
Finance ⁵			
Ratio of long-term debt over own funds		2.8	5.8
Real average cost of long-term debt	%	4.0	4.8
Temporary employment	%	9.3	12.9

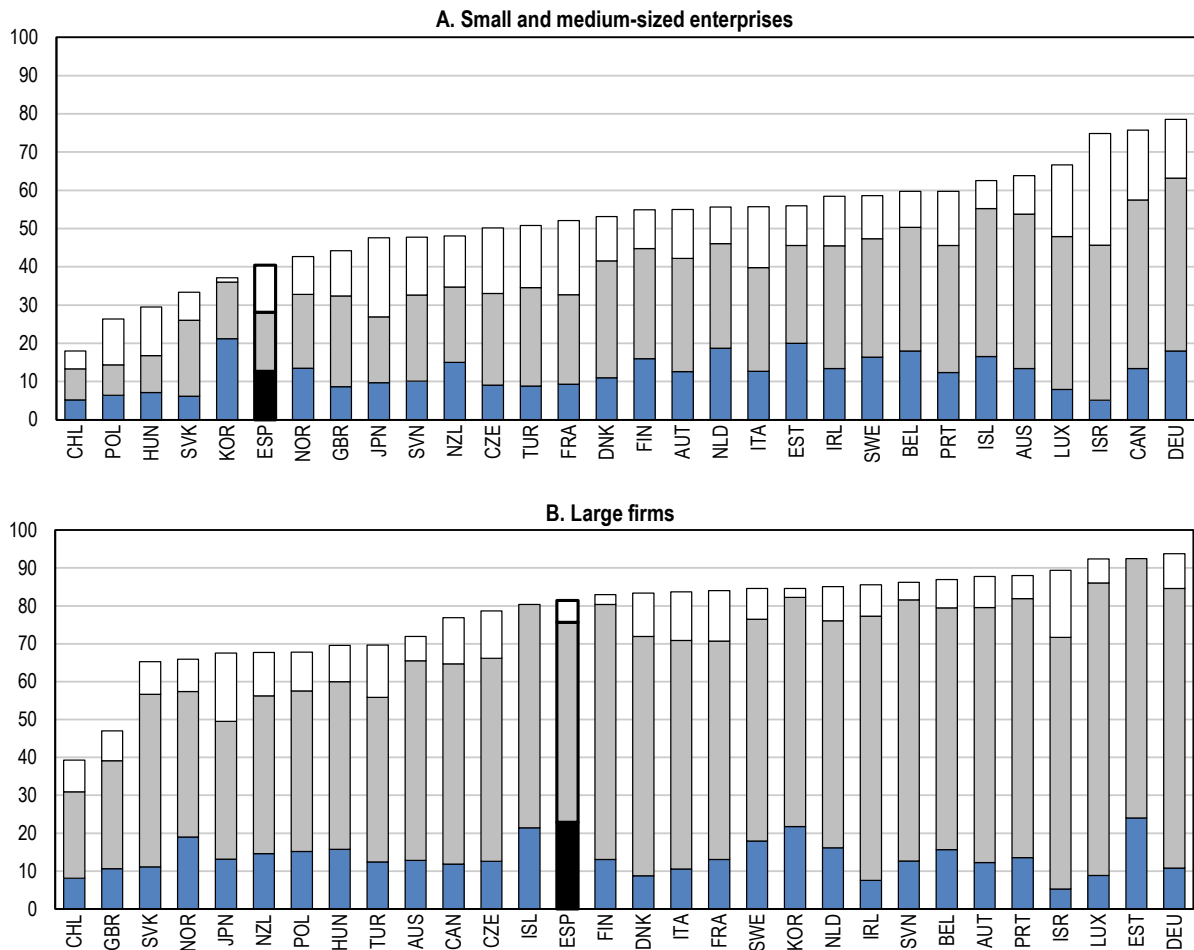
1. Median of the distribution except for foreign capital structure and market share which show the average. Data on employment, productivity, physical capital, qualifications and finance start in 1991.
2. Calculated using the perpetual inventory method, volume.
3. Engineers and graduates.
4. Expenditure on research and development (R&D) technology imports services.
5. Debt with financial institutions.

Source: M. Correa-López and R. Doménech (2012), "La internacionalización de empresas españolas" (The internationalisation of Spanish firms), *Documento de Trabajo*, No. 12/29, BBVA Research, Banco Bilbao Vizcaya Argentaria.

Increasing business innovation rates would also boost the number of exporting firms as innovative firms also tend to export more. It is also crucial for boosting business sector productivity in the medium-run. Business R&D was 0.7% of GDP in 2010, far below OECD (1.6%) and European Union (EU, 1.2%) averages. Around 50% of R&D is undertaken by large firms. This is one of the lowest percentages in the OECD and it couples with one of the most generous R&D tax credit schemes. The proportion of small and medium-sized enterprises (SMEs) that innovate is also well below OECD average (Figure 9). Few SMEs undertake new marketing, organisational methods or make product or process innovations. Around 80% of large companies do some kind of innovation, but this is again below rates observed in most OECD innovative countries. The government should deepen its efforts to expand the innovation system and encourage greater spillovers to the business sector (Haugh and Westmore, 2014).

Figure 9. Innovation types by firm sizePer cent of total firms in same category, 2008-10¹

■ Product or process innovation only ■ Product or process and marketing or organisational innovation □ Marketing or organisational innovation only



1. Or latest data available. For full details of coverage see notes to Chapter 5 in the source publication.

Source: OECD (2013), *OECD Science, Technology and Industry Scoreboard 2013*.

Competition and cost-competitiveness need boosting

Increasing competition across the Spanish economy, and particularly in network and professional services sectors that all firms rely on, is crucial for cost-competitiveness. Spain has undertaken several recent reforms to foster competition in goods and services markets. Prior to the recession profit margins grew faster than in other euro area countries. Profit margins have moderated since the recession but remain higher than in other euro area countries (Table 2.2). High margins reflect the need for firms to rebuild their finances in the context of tight credit conditions, but it also signals weaknesses in effective competition in some markets (Montero and Urtasun, 2014; Banco de España, 2014). As the recovery strengthens and external financing becomes available at lower cost, it is essential to continue to foster competition in goods and services markets to consolidate and reinforce competitiveness gains and to maximise the impact of other reforms, such as those in the labour market, on job creation.

Table 2. GDP deflator and contributions to changes¹

	Total (% growth) ²	Contributions to growth (% points)			
		Wages	Productivity	Profit margins	Taxes
1999-2008					
Spain	3.7	1.8	0.0	1.6	0.3
Euro Area	1.9	1.2	-0.3	0.8	0.2
France	1.9	1.5	-0.4	0.7	0.2
Germany	0.8	0.6	-0.6	0.5	0.2
Italy	2.4	1.2	0.0	1.0	0.2
Netherlands	2.6	1.9	-0.7	1.0	0.4
2009-13					
Spain	0.1	0.7	-1.4	0.5	0.3
Euro Area	1.2	0.9	-0.2	0.2	0.2
France	1.2	1.1	-0.3	0.1	0.3
Germany	1.4	1.0	0.1	0.1	0.2
Italy	1.4	0.7	0.1	0.2	0.4
Netherlands	1.0	0.8	0.0	0.3	0.0

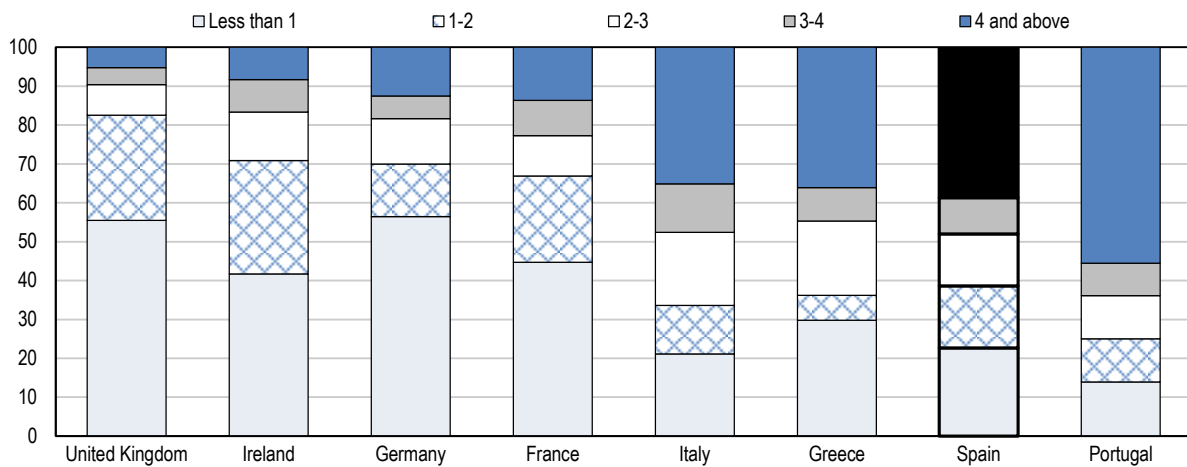
1. The total represents the sum of the contributions from wages, profit margins and taxes, and productivity (measured as output per worker). The contribution of profit margins has been calculated as a residual. Based on AMECO.
2. Average annual growth rates.

Source: OECD calculations based on BBVA (2014), "Spain Economic Outlook, First Quarter 2014 - Economic Analysis", BBVA Research, Banco Bilbao Vizcaya Argentaria.

How to read this table: The contributions to growth indicate how much of the changes in the GDP deflator are due to changes in wages, productivity, profit margins and taxes. Increases in wages, profit margins and taxes contribute to higher price increases, while higher productivity helps to reduce prices. For example, in the period 1999-2008 the GDP deflator increased by 3.7 percentage points in Spain. Most of the increase was due to increases in wages and profit margins. A small part of the increase was due to increases in taxes, while productivity had no impact.

Debt remains high and financing conditions are tight

The Spanish business sector is weighed down by a large share of highly indebted firms by international standards. At least one third of listed firms have a debt to EBITDA (earnings before interest, taxes, depreciation and amortisation) ratio of over four (Figure 10). There are substantial differences across sectors and also depending on firm size (Figure 11). The level of indebtedness, defined as debt over total net assets, for small and medium-sized companies is significantly lower than for large companies (although it should be noted that the coverage of small firms in the sample is very reduced). In the large corporate sector the strongest deleveraging has taken place in information and technology companies, while large construction firm's indebtedness kept increasing until 2011, following valuation corrections that translated into lower asset values. Large companies in all sectors considered have debt-to-assets ratios above 45%, while the ratio is above 35% for medium-sized firms.

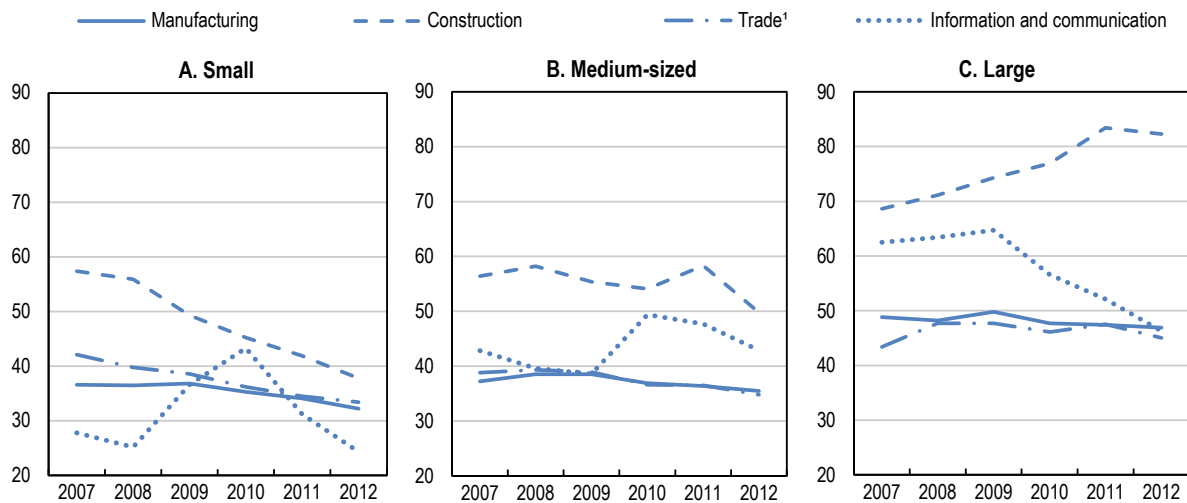
Figure 10. Debt-to-earnings ratio of firmsPer cent of firms with various debt-to-earnings ratios¹

1. Earnings before interest, taxes, depreciation and amortisation. Data for Greece, Ireland and Portugal covers a limited number of firms compared to the other countries.

Source: RBS (2014), "The Revolver", Royal Bank of Scotland, 22 May.

Figure 11. Debt ratios by firm size and sector

Debt to net assets ratio



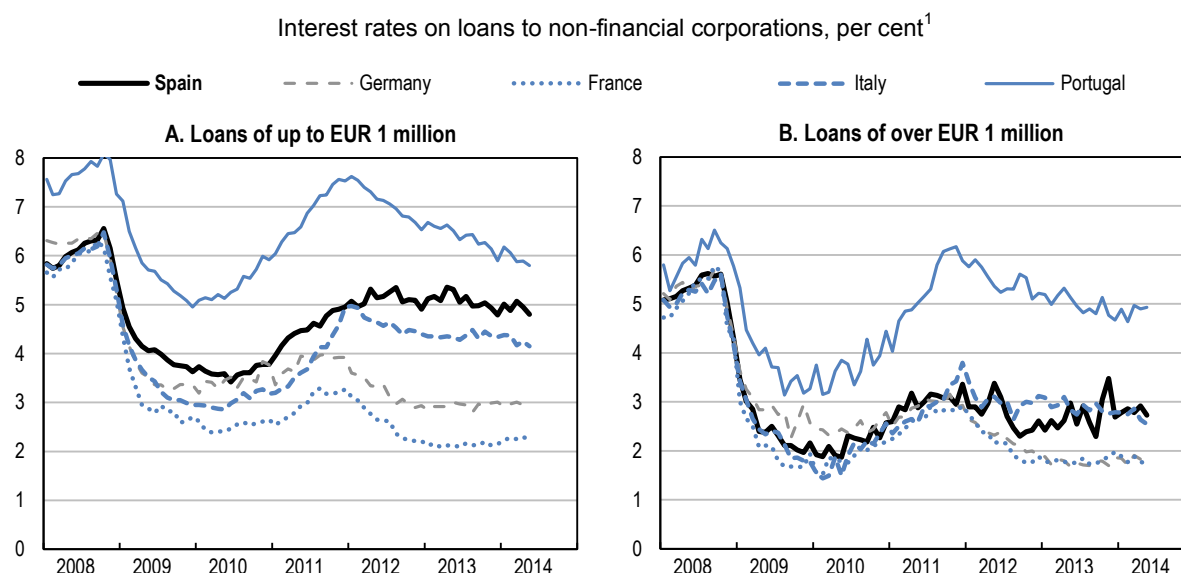
1. Wholesale and retail trade; repair of motor vehicles and motorcycles.

Source: Banco de España, Central de Balances.

These high levels of debt are holding back businesses, as excessively indebted firms are unlikely to invest and hire and if they ultimately prove unviable are using capital that could be reallocated to better performing firms. The government has made significant efforts to improve the debt restructuring and insolvency framework to help rehabilitate these firms and close down unviable ones. However, further efforts are required to quickly unburden the business sector, and by doing so indirectly the banking sector, otherwise the recovery is likely to remain very slow.

At the same time the cost of borrowing remains high. Conditions are especially tight for smaller loans, predominately used by SMEs (Figure 12). SMEs are particularly vulnerable to banking sector stress (Ryan et al., 2014), as they have more difficulties in establishing new banking relationships and they tend to use real-estate assets as collateral. In addition, alternatives to non-bank financing have been so far very limited.

Figure 12. Credit conditions



1. Narrowly defined effective rates (NDER) for operations with an initial rate fixation period of less than one year.

Source: ECB (2014), "MFI Interest Rates", *Statistical Data Warehouse*, European Central Bank, July.

Improving the regulatory framework to favour business dynamism and growth

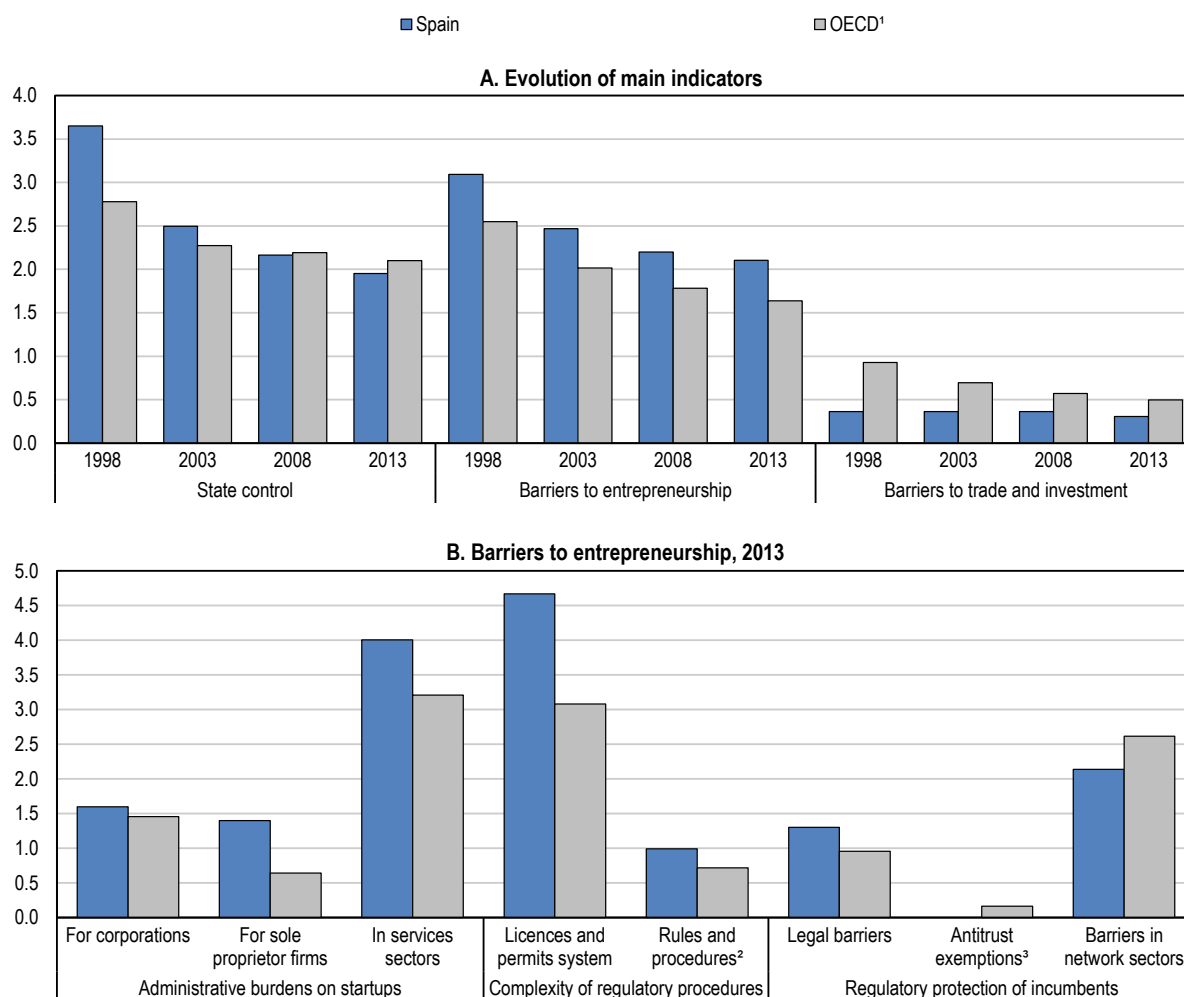
Favouring business start-ups

Fostering a dynamic and high performing business sector is complex and requires a broad combination of policies. Particularly important is the interaction between product and labour market policies. In Spain labour market policies that have resulted in dualism and precarious employment (Haugh and Westmore, 2014) are reinforced by product, service and financial market regulation that have favoured incumbents and left capital in unviable firms for too long. Broad reform of product, tax, insolvency and financial market policies is required to reduce barriers to firm entry and to spur reallocation of resources towards a new cohort of more productive, innovative, export intensive and quality-job rich enterprises.

Spain has been making good progress in improving measured product market regulations and converging towards best practices in the areas of state control and barriers to trade and investment. However, progress has been more muted in reducing barriers to entrepreneurship (Figure 13, Panel A).

Figure 13. Product market regulations in Spain

Indicator scale of 0-6 from least to most restrictive



1. The OECD aggregate is an average of data available (25-30 countries depending on the year covered).

2. Communication and simplification of rules and procedures.

3. Zero for Spain.

Source: OECD (2013), *Product Market Regulation Database*, www.oecd.org/economy/pmr.

Starting a business is perceived to be far more difficult in Spain than in other advanced economies. Spain has the second highest barriers to entrepreneurship in the OECD (OECD, 2013c). Spain also ranks 142nd (out of 185) with respect to ease to start a business (World Bank and IFC, 2014). The regulatory procedures have been too complex so far, especially the licences and permits system. Obtaining licences and permits is more difficult in Spain than in most OECD countries (Figure 13, Panel B). Contrary to best practices there are no standard procedures to use the “silence is consent” rule for issuing the licences required to open up a business. And there are not yet single contact points for issuing or accepting all notifications and licenses that are required to open up a private limited company. With the aim of addressing this, the entrepreneurship law (law 14/2013) foresees the creation of the so-called “Entrepreneur support points” (*Puntos de Atención al Emprendedor*) network.

Crucially, firms have not been operating in a single market in Spain but rather have had to face the inconveniences of a regulatory framework, which is regionally and locally fragmented. A firm wishing to

operate in multiple regions of Spain has been in many cases required to obtain a separate licence or permit for their activity from the different regions where they wish to conduct business. In addition, often requirements have differed, forcing higher costs on firms who have to adapt products to local requirements (for example in labelling).

To tackle this and move towards a truly single market the government has introduced the Market Unity Law. This law is a flagship reform and, if fully implemented, has the potential to revolutionise doing business in Spain. It aims at simplifying business licensing requirements, by increasing the use of notification procedures (with *ex post* controls) and reducing the need for prior authorisations to exert economic activities. It also aims at ensuring that permits issued in one region will automatically be valid for the others. Thus, it has the potential to improve substantially the regulatory framework, foster competition and eliminate barriers preventing firms from taking advantage of economies of scale. The law is inspired by the EU Services Directive, but it is broader in scope. It provides for principles of free establishment and movement of goods and services in Spain and for their application in practice.

According to the law, all legal texts enacted at local, regional and central government level that may be considered inconsistent with the market unity will have to be amended in the following six months. So far 2 700 regulatory barriers, most at the regional level, have been identified as inconsistent with the market unity. This process is to be supported by enhancing administrative cooperation, and by setting up a procedure for responding quickly to complaints about obstacles to the single market. Spain's Competition Authority has been granted power to file administrative appeals with regard to situations contrary to the law. Legislative amendments will be discussed by regional and central government representatives in sectoral conferences. The law also entails measurement and monitoring procedures, which should help to assess implementation progress. These procedures include the elaboration of a directory of good and bad practices and the publication of regulatory quality indicators. A swift implementation of the law, while challenging both technically, due to the complexity of dealing with a large body of regulation, and politically, due to resistance by some regions, will be crucial to boost the performance of the Spanish business sector. Effective coordination and cooperation among the different levels of government will be critical, in particular when it comes to amending sector specific legislation.

Besides the law on market unity, another on-going initiative to improve business climate is *Emprende en tres*, an electronic one-stop-shop designed to present declarations of responsibility required for entrepreneurs to start up a new economic activity, and a reduced tax rate for new corporate starts-up introduced in 2013. The rate is 15% for new companies. Spain also foresees conducting annual reviews of the business regulatory framework to detect and remove obstacles hampering entrepreneurship, investment and business activities. This initiative is conducted by the Ministry of Economy and Competitiveness with the collaboration of ICEX (Spanish Export Agency) and Invest in Spain (the Spanish body in charge of public relations with foreign investors). First meetings with representatives of several industrial and services sectors, academics and research services are already taking place. In addition, the World Bank will undertake a subnational *Doing Business* study in Spain during 2014 and 2015, with the aim of identifying regulatory best practices among Spanish regions and spurring regulatory improvement.

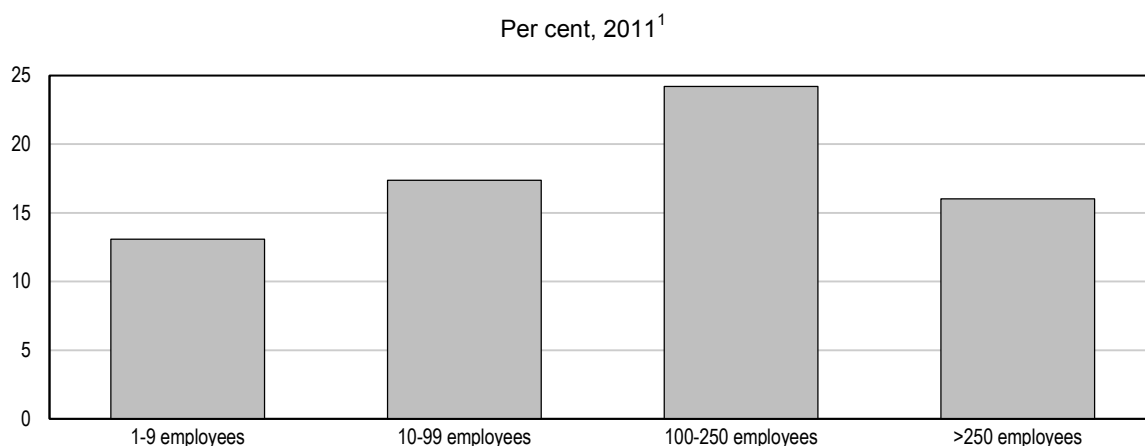
The law on Environmental Assessment 21/2013 also advocates for further standardising the legislation across Spain in the area of environmental assessment procedures, seeking greater collaboration and harmonisation across regions.

Favouring firms' growth

Spanish business framework conditions include multiple size-dependent regulations, originally aimed at supporting SMEs. One of them is the corporate tax that has special clauses depending on firm sizes both in terms of turnover and number of employees. The standard corporate tax rate is 30%. The corporate rate

for SMEs – defined for the tax as firms with an annual turnover below EUR 10 million – is 25% on profits up to EUR 300 000 and 30% above that. The rate is further reduced to 20% for SMEs with net revenues below EUR 5 million and fewer than 25 employees who have not decreased the number of workers they employ. Despite all these preferential rates for SMEs, larger firms are capable of optimising existing deductions, resulting in differences between statutory rates and effective rates that widen as turnover increases. The current configuration of the tax also implies differences in effective rates within the SME segment depending on the number of employees that the firms employ (Figure 14). The effective rate is highest for medium-sized enterprises having between 100 and 250 employees. This creates incentives for firms to remain small (“lock-in” effect), which has serious implications for aggregate productivity given the higher productivity that generally prevails in larger enterprises. All this indicates that the tax is not successful in supporting SMEs and may be penalising medium-size firms and biasing firm’s distributions towards smallest sizes, to the detriment of medium-sized. Reducing tax deductions would decrease the capacity of larger firms to avoid taxation. Using that fiscal space to establish a unique and lower corporate tax rate for all firms would provide better incentives for firm’s growth and would also align corporate taxation with the OECD average (25.3% in 2013, Figure 15), which would contribute to attracting investment. In this sense, the government announced in June 2014 a draft tax reform, which proposes broadening the base, reducing tax credits, reducing the standard tax rate to 25% by 2016 and suppressing the preferential rate for SMEs. The reduced rate for starts-up, introduced in 2013, is maintained.

Figure 14. Effective corporate tax rates by firm size

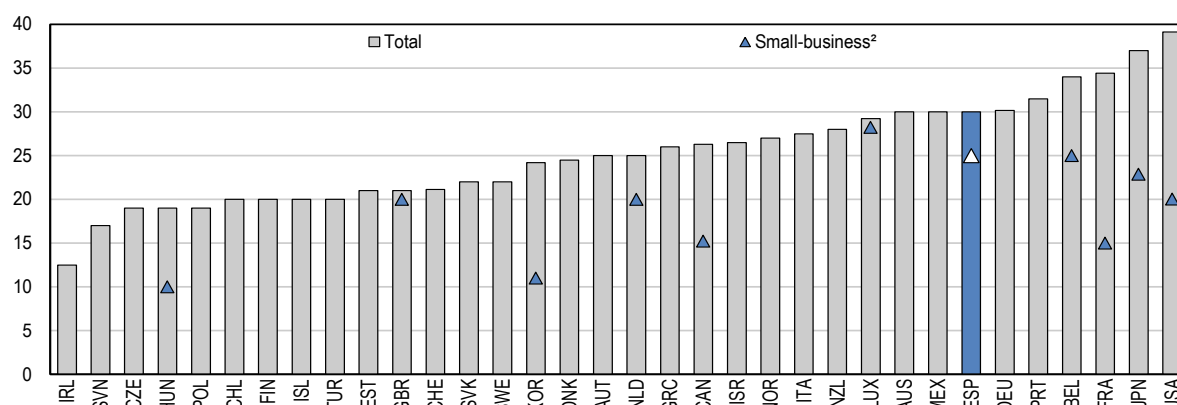


1. Since 2011 several measures have been adopted to broaden the corporate tax base.

Source: La Agencia Tributaria, Ministerio de Hacienda y Administraciones Públicas.

Figure 15. Statutory corporate income tax rates¹

Per cent, 2014



1. Basic combined central and sub-central (statutory) corporate income tax rate.
2. Rates typically applying for or targeted at small (incorporated) business, where such targeting is on the basis of size alone (e.g. number of employees, amount of assets, turnover or taxable income) and not on the basis of expenditures or other targeting criteria.

Source: OECD (2014), *OECD Tax Database*, www.oecd.org/tax/tax-policy/tax-database.htm.

Other size-dependant fiscal regulations, such as different levels of tax enforcement, also affect the size distribution (Almunia and López, 2013). Firms with more than EUR 6 million in reported revenue are monitored by the large taxpayers' unit, which involves more frequent tax audits and more information requirements. The effect of this kind of threshold on firm behaviour is strong. There is excess mass of firms, or "bunches", just below the revenue threshold and there is evidence that firms have deliberately reduced reported revenue by up to 7.5% to avoid falling in the high enforcement regime. There is also evidence that firms locating below the threshold misreport their material and labour input costs to evade taxes.

There are also size-contingent regulations in the labour market that start to bind at different firm sizes. They relate to different workers representation obligations, the availability of special employment contracts (e.g. *Contrato de emprendedores*), social security contributions deductions and flexibility to change or terminate employment contracts (Table 2.3). Risk prevention obligations also differ depending on the size of the company. Companies above 250 employees need to elaborate, negotiate and apply an equality plan. All these size-dependent regulations start biting at different sizes. This prevents a marked "cliff" effect as in France at 50 employees (Garicano et al., 2012) but it compounds a complex system difficult and costly to navigate.

Table 3. Firm size-dependent regulations in the labour marketSize level (based on number of employees) at which additional regulations start affecting firms¹

Number of employees	Workers representation	Hiring	Fiscal incentives	Firing flexibility	Equality	Risks prevention
6	+	+
9-10	+	..	—	—	..	+
25	+
30	+	—
50	+	—	—	+
100	+	—
250	+	..	—	..	+	+
300	—
500	+	+

1. The “plus” sign indicates when more demanding regulatory requirements kick in. The “minus” sign indicates at which size special conditions, such as fiscal incentives, are no longer available. For example, regulations on workers representation start operating when firms have six employees; when they reach 9-10 employees there are additional requirements and yet more kick in if the firm reaches 30 employees. As concerns hiring regulations, there is a special contract modality (*Contrato de emprendedores*), offering an extended trial period of one year and several hiring incentives and fiscal rebates. That contract modality is only available for firms with less than 50 employees.

Source: Confebask (2012), “Diseño de una política pública de redimensionamiento empresarial en Euskadi” (Designing a corporate resizing policy in the Basque Country), Informe final del grupo de trabajo de Confebask.

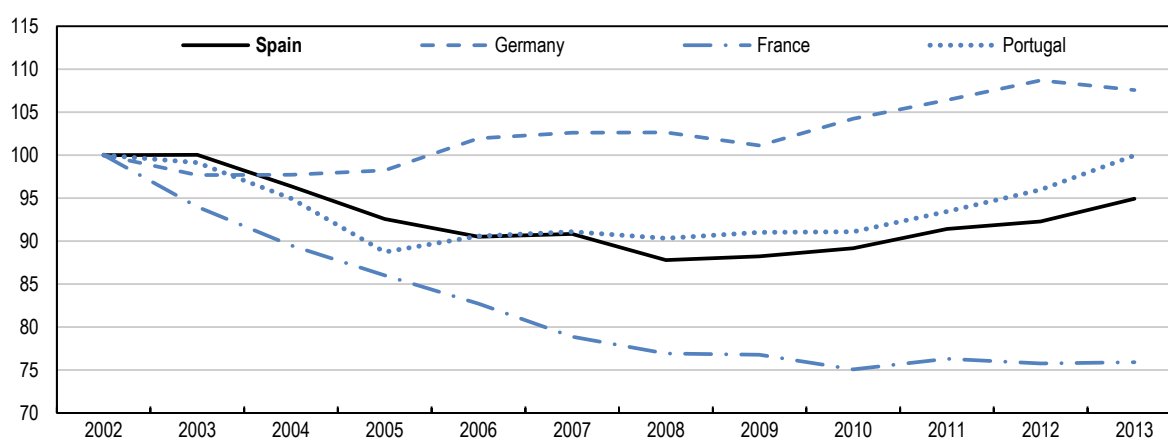
Size-dependent policies should be carefully designed to avoid they become unintended barriers to firm growth. In general, the emphasis should be on ensuring that policies support the specific needs of SMEs (for example providing direct innovation support, as young SMEs may not have the profits to claim R&D tax credits), rather than progressively tightening regulatory requirements with size, as is currently the case in Spain. When designing support policies, their potential effect on firms’ growth dynamics should be explicitly recognised and examined, with the aim of minimising distortions and potential “lock-in” effects.

In general, business regulations *de jure* or *de facto* tend to be more detrimental for medium-sized companies than for large or small companies. It is easier to ignore regulations when businesses are small. Large companies have more legal and administrative resources that enable them to legally optimise and exploit existing regulations. Medium-size companies neither can ignore regulations nor have resources to deal efficiently with them.

Increasing and deepening internationalisation

Export performance has been mixed

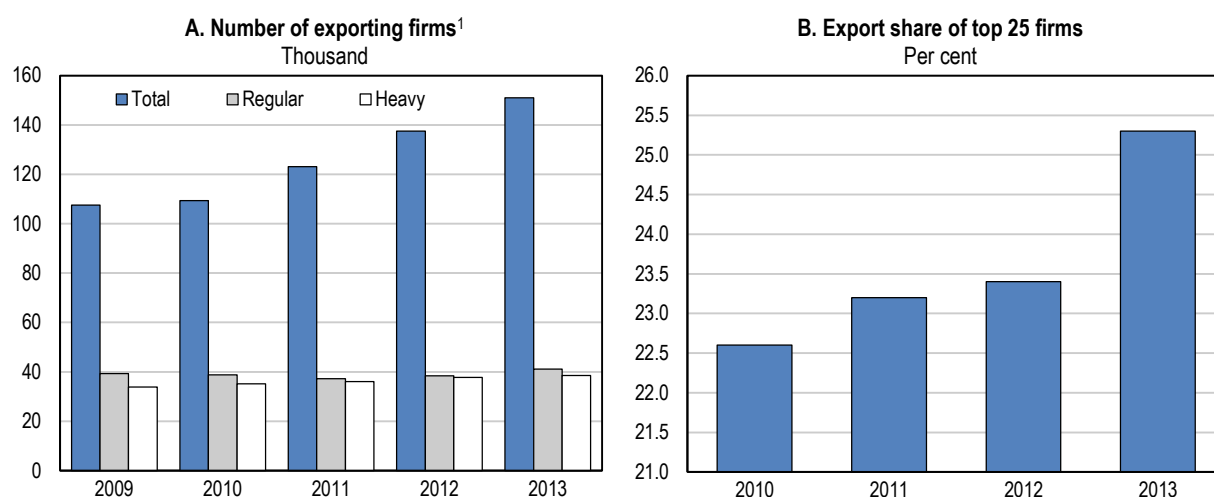
The Spanish external sector has led the recovery and export performance has been better in Spain than in other European economies (Figure 16). Both goods and services explain this performance. On the back of improving cost-competitiveness and the need to search for new markets given the weakness in domestic demand, goods exports have increased across most product categories. Additionally, services exports, notably tourism, have also grown steadily since 2008. To further lift exports Spain faces four main challenges: increasing the number of regular exporters; up-grading the technological content of exports; diversifying trading partners; and ensuring that the business environment is favourable for both goods and services exports.

Figure 16. Export performanceRatio of export volumes to export markets, index 2002 = 100¹

1. This measure includes both goods and services exports

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), July.

The export base has widened with an increasing number of firms becoming exporters (Figure 17, Panel A). Both the number of firms regularly exporting and the number of firms exporting above EUR 50 000 have remained constant though. Consequently exports are becoming increasingly concentrated in a few firms (Figure 17, Panel B): the top 25 exporters accounted for more than 25% of all exports in 2013; the top 100 exporters account for nearly 40% of exports.

Figure 17. Number of exporting firms and export concentration

1. Regular exporters are those that have exported for the last four consecutive years; heavy exporters are those whose export value exceeds EUR 50 000 per year.

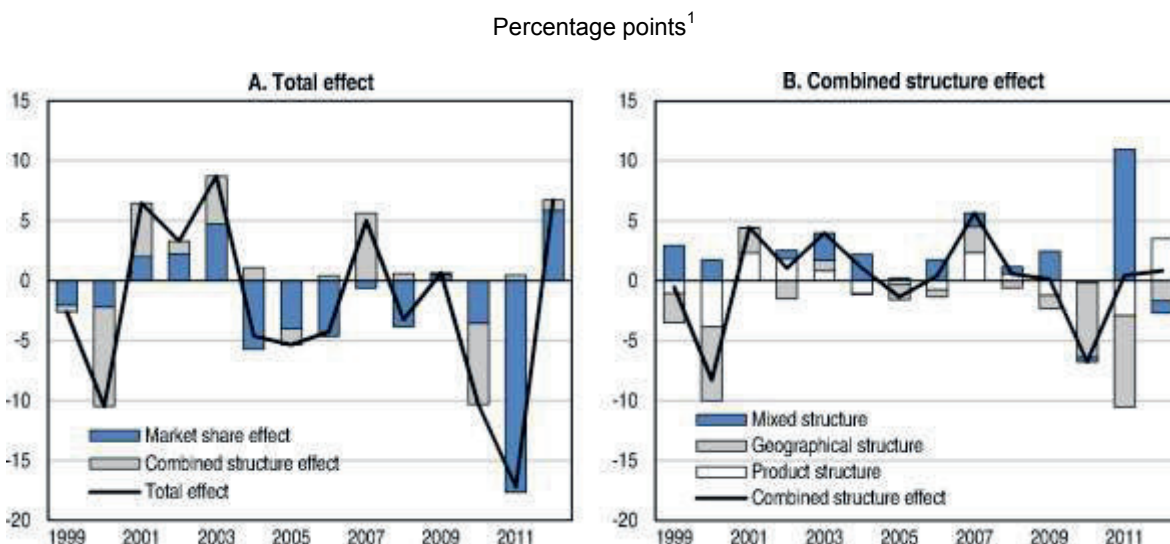
Source: ICEX (2014), "Perfil de la empresa exportadora española - enero-mayo 2014", España Exportación e Inversiones, Ministerio de Economía y Competitividad.

Export performance is influenced not only by changes in price and non-price-competitiveness, but also by the composition of exports, whether in terms of geographical destination or of type of product. For example, if a country specialises in exports of goods (or towards areas) where demand is particularly

strong, exports will increase even if competitiveness does not improve. A constant market share analysis (CMSA) can help to disentangle and measure these factors (González Pandiella, 2014). The basic idea underpinning this analysis is that changes in exports are due either to changes in individual market shares or to a specialisation in particularly dynamic markets or industries. A CMSA decomposes the difference between the growth of Spanish manufacturing exports and the growth of total exports of the rest of the world in two factors (Annex 2.A1). On one hand, the so-called market share effect captures the gain or loss in shares that would occur if the export structure, whether in geographical or sectoral terms, were to remain unchanged. It seeks to capture the extent to which changes in shares have been due to changes in price and non-price competitiveness. On the other hand, the structure effect quantifies the extent to which the country is benefiting from an advantageous position in terms of the composition of its exports. In turn, the structural effect can be divided into a product effect, a geographical effect and a mixed effect. The first two show the gain in share arising, respectively, from exporting products and from exporting towards regions where demand has been more dynamic. The mixed effect captures the interaction of both effects, given the impossibility of distinguishing perfectly between them.

The CMSA signals that, in the more recent periods, changes in market shares have been the main driving force behind Spanish manufacturing export performance (Figure 18, Panel A). The negative total effect indicates that Spanish exports grew less than world exports from 2003 to 2011, except in 2007. The main contributor was the market share effect, indicating that the below-average growth of exports was due to losses of competitiveness. However, a cross-country comparison reveals that losses of market shares were less pronounced in Spain than in other European advanced economies (Figure 19, Panel A), including Germany. Gains in competitiveness started to pay off in 2012 when Spanish goods exports grew above world exports.

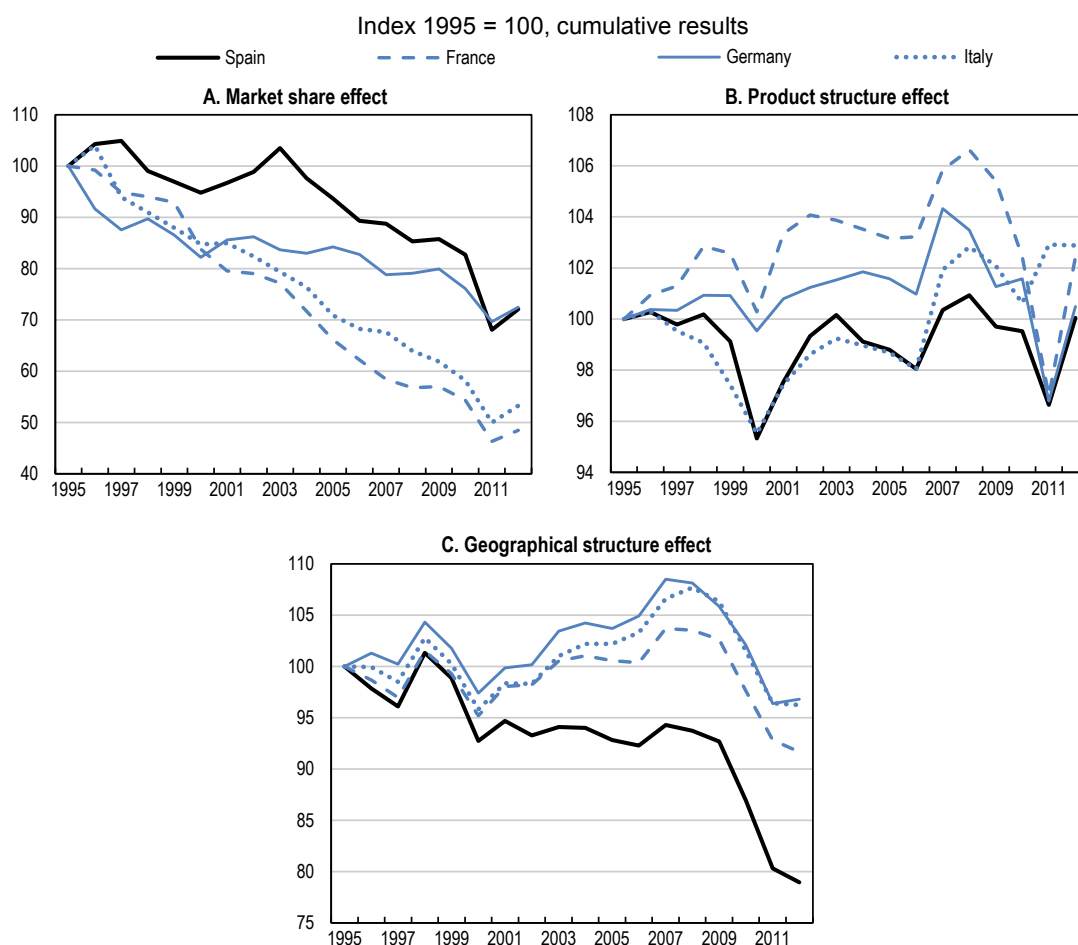
Figure 18. Main results of a constant market share analysis



1. Based on exports in US dollars, nominal values. The sector covered is manufacturing (excluding energy) plus agriculture, forestry and fishing.

Source: Calculations based on OECD (2014), *International Trade by Commodity Statistics* (ITCS Database), May.

How to read this figure: Total effect is the difference between the growth rates of Spanish exports and of world exports. The market effect aggregates the variation of shares in individual export markets. The combined structure effect can be decomposed into product and geographical structure effect plus a residual term (so-called mixed effect). Product and geographical effects are positive if a country has above average specialisation in markets that grow faster than overall world trade. Conversely, high specialisation in slow-growing markets gives rise to negative structure effects.

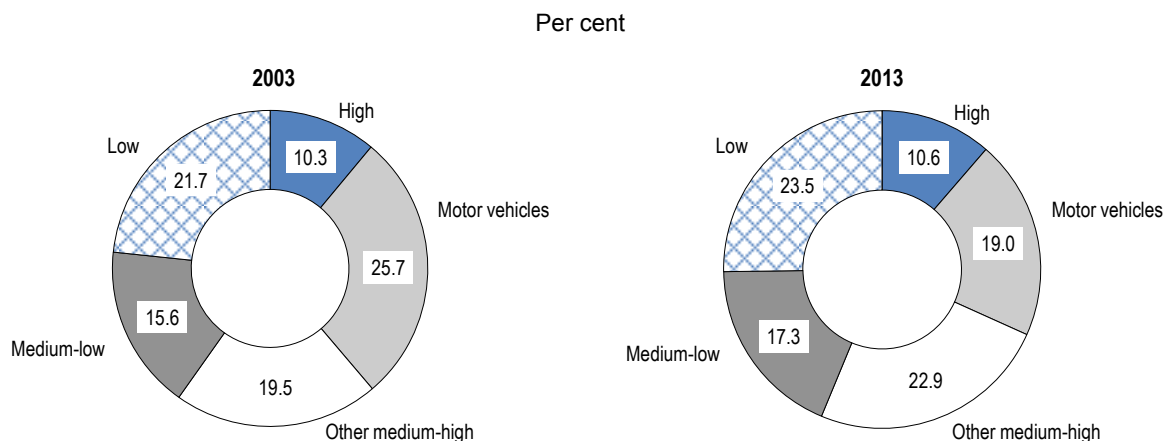
Figure 19. Cross-country constant market share analysis results¹

1. Based on exports in US dollars, nominal values. The sector covered is manufacturing (excluding energy) plus agriculture, forestry and fishing.

Source: Calculations based on OECD (2014), *International Trade by Commodity Statistics* (ITCS Database), May.

The CMSA also highlights that Spanish export performance could have been even better if industry and market specialisation were more geared towards more dynamic segments. For example the contribution of the product structure to export performance has remained broadly unchanged over time (Figure 19, Panel B). By contrast, Germany's evolution of product specialisation has been more favourable to its export performance, reflecting a higher specialisation in products experiencing higher growth such as medium to high technology products. Italy, had a similar evolution in product structure as Spain until 2006, and has also recently improved the contribution of product specialisation to export performance by shifting its sectoral export structure towards more dynamic products.

This highlights one of the main weaknesses of the Spanish external sector. Despite recent progress, the product structure has remained broadly unchanged in Spain during the last ten years (Figure 20). Low-technology exports have increased slightly even though this is an export segment that has grown below average in world trade. The share of motor vehicles and components in total exports has fallen but this remains a key sector in Spanish exports. Other medium-high technology exports have slightly increased but they have done so below aggregate growth. Last, the share of high-technology exports has remained unchanged.

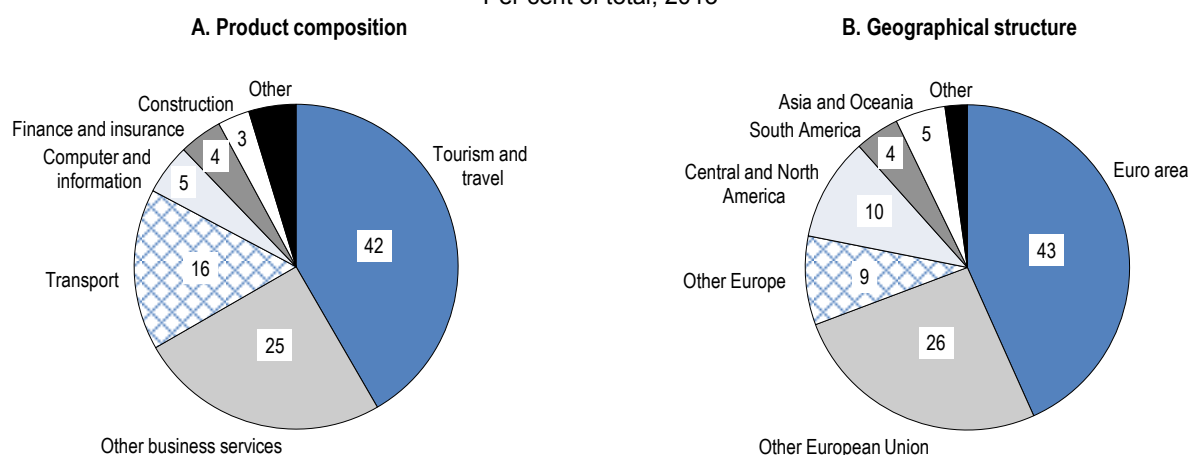
Figure 20. Spanish export structure by technology level¹

1. Based on exports in US dollars, nominal values. Manufacturing sector (excluding energy) plus agriculture, forestry and fishing. Products are grouped by the level of research and development intensity in the industry.

Source: Calculations based on OECD (2014), *International Trade by Commodity Statistics* (ITCS Database), May.

Spain's mix of trading partners has not been conducive to better goods export performance either (Figure 19, Panel C). This reflects an over-specialisation in European markets that have grown below average, such as France, Italy and Portugal. Around 63% of exports are destined for the European Union. At the same time there is an under-specialisation in more dynamic markets, such as China and other Asian economies. Exports to markets such as China and other emerging economies have recently increased, but by less than world exports to those destinations.

Internationalisation policy needs to take also strong account of the services sector. Services account for an increasing share of Spanish total exports and have significantly contributed to the rebalancing of the Spanish economy and the return of the current account balance to positive territory. Most services categories have grown since 2007, the exception is financial services. In terms of product composition, tourism and travel account for more than 40% of total exports (Figure 21, Panel A). Geographically, as in manufacturing goods, nearly 70% of export services are destined for the European Union (Figure 21, Panel B). As in goods, Spain faces the challenge of increasing penetration of its services exports into non-European markets and widening its product specialisation beyond labour-intensive services.

Figure 21. Exports of servicesPer cent of total, 2013¹

1. Total value of services exports is EUR 109.3 billion.

Source: Bank of Spain (2014), *Bolétin Estadístico* (database), July.

Policies to improve export performance

A broad mix of policies is needed to meet these challenges. To increase the number of regular exporters, Spain should take advantage of the group of Spanish multinationals with substantial international experience by establishing more formal mechanisms of collaboration between them and SMEs attempting to gain access to new markets.

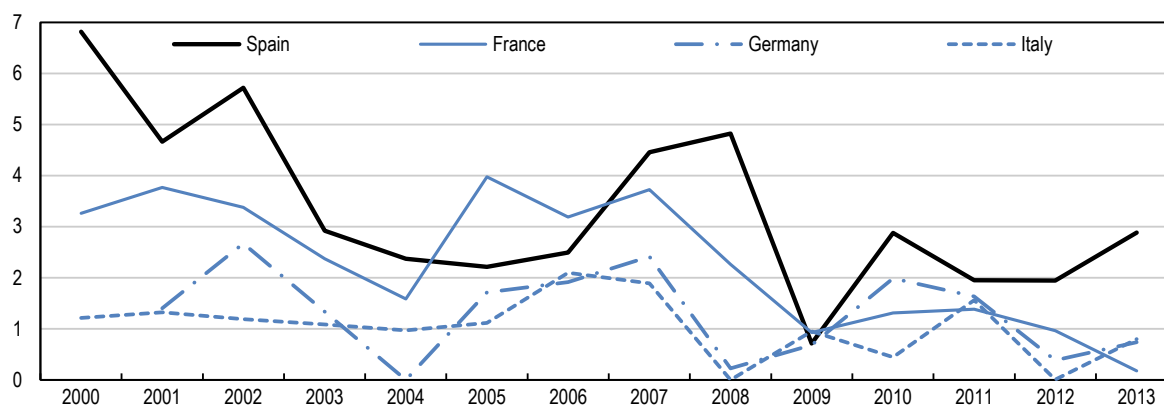
Moving towards a product structure with higher technology content requires stepping up business innovation activities. Innovation and export participation have been found to be heavily interlinked, both in Spain (Caldera, 2010) and internationally (Altomonte et al., 2013; Aw et al., 2011). Exporters often access diverse knowledge inputs not available in the domestic market (Salomon and Shaver, 2005). Product innovation is a very important driver of exports for Spanish firms, notably SMEs (Cassiman et al., 2010), suggesting that export promotion policies should be combined with policies focused on promoting product innovation. Thus, coordinating and integrating internationalisation and innovation policies under a single responsibility would likely be beneficial. It would allow effects of diverse policies to be internalised, avoid potential duplications and could increase synergies between various modes of innovation and internationalisation. In this sense, the Strategic Plan for the Internationalisation of the Spanish Economy includes measures for a closer collaboration between the export promotion agency, ICEX, and the Centre for Technological and Industrial Development (CDTI).

Efforts to improve business framework conditions are likely to have also a positive effect in attracting additional foreign direct investment (FDI). Encouraging greater FDI would help to boost the technological content of exports by bringing new technologies and processes to Spain. Indeed, economies such as Ireland have used foreign investment to establish entire new high technology industries such as medical devices and pharmaceuticals. Another of the measures of the Strategic Plan for the Internationalisation of the Spanish Economy is the establishment of a new programme to attract and facilitate direct foreign investment in the information and communication technology sector. Greater foreign investment would also provide more potential for linkages into global value chains for Spanish SMEs. FDI inflows into Spain have been falling since 2000 (Figure 22). Nevertheless, Spain has recently managed to attract and maintain a healthy pipeline of FDI in the automobile sector. FDI inflows increased in 2013, reflecting rising investor confidence and existing opportunities in some sectors under restructuring such as banking or construction.

Nevertheless, inflows into higher-technology sectors are more limited. Although Latin American countries are having an increasing role, the euro area remains the main source of direct investment.

Figure 22. Foreign direct investment inflows

Balance of payments basis, per cent of GDP



Source: OECD (2014), "FDI series of BOP and IIP aggregates", *OECD International Direct Investment Statistics* (database), July.

The cost to export remains high in international perspective (Table 4), and this is likely penalising exports to more distant destinations especially by SMEs and inhibiting market diversification. Maritime transport activities show low productivity and reducing these and other trading costs associated with more distant markets should be a priority (discussed below).

Table 4. Trading across borders

For a standardised cargo of goods using sea transport, June 2013¹

	Rank	Export		Import	
		Time (days)	Cost (USD per container)	Time (days)	Cost (USD per container)
Spain	32	10	1 310	9	1 350
Denmark	8	6	795	5	745
Germany	14	9	905	7	940
Italy	56	19	1 195	18	1 145
Netherlands	13	7	925	6	975
Portugal	25	15	780	13	925
United Kingdom	16	8	1 005	6	1 050
United States	22	6	1 090	5	1 315

1. The time and cost (excluding tariffs) necessary to complete every official procedure for exporting and importing the goods are recorded. Cost measures the fees levied on a 20-foot container in US dollars. All the fees associated with completing the procedures to export or import the goods are included. These include costs for documents, administrative fees for customs clearance and technical control, customs broker fees, terminal handling charges and inland transport. The cost measure does not include tariffs or trade taxes. Only official costs are recorded.

Source: World Bank and International Finance Corporation (2014), *Doing Business Data* (database), www.doingbusiness.org.

In addition to the measures already mentioned, the Plan for the Internationalisation of the Spanish Economy 2014-15, includes 41 measures aimed at broadening the Spanish export base, in particular SMEs, diversifying foreign markets and improving Spain's attractiveness for investors. The Plan encompasses the

above mentioned opinion surveys on regulation, the subnational *Doing Business* study by the World Bank and the market unity law. It also includes a new programme to facilitate the international mobility of investors, entrepreneurs, researchers and professionals, the setting up a new Global Window at ICEX, to provide information to SMEs on all available public support instruments, and renewed programmes to access new markets. Progress will be monitored through a set of indicators.

Strengthening competition and boosting cost competitiveness

Strengthening competition is also vital for sustaining and reinforcing the ongoing recovery of cost competitiveness needed to underpin further internationalisation of the economy. Countries with more competitive regulatory frameworks for services achieve higher added value, productivity and export growth in the manufacturing sectors that use services as inputs more intensively (Barone and Cingano, 2011). The potential beneficial effects are particularly strong for Spain, which is one of the OECD countries whose manufacturing exports embody higher value added from services (OECD, 2013d). Indeed, for Spain the adoption of the best regulatory practices in services could increase real goods exports by 18% (Correa-López and Doménech, 2014).

An important lever for boosting competition generally is to facilitate new firm entry and growth by allowing more flexibility in wage bargaining. New firms need to be able to offer different conditions from incumbents as a way of offsetting the often sizeable advantages of incumbency. Indeed, inflexible labour markets lead to less dynamic firm growth distributions (Bravo-Biosca et al., 2013). Stringent regulation increases the costs of downward adjustment and is likely to encourage a more conservative growth strategy (which in turns decreases the pressure on underperforming firms). Lower risk taking and slower job reallocation may in turn reduce productivity growth. Firms may be less willing to expand their workforce or enter into new markets if they cannot reduce their workforce later if their efforts prove to be unsuccessful. Recent changes in Spanish labour market regulations have provided a less stringent protection legislation regime that gives more scope for new firms to offer different wage and working conditions from incumbents. However, more can be done to decentralise wage-bargaining processes and thereby reduce the power of incumbent companies to use sectorial agreements as barriers to entry (Haugh and Westmore, 2014).

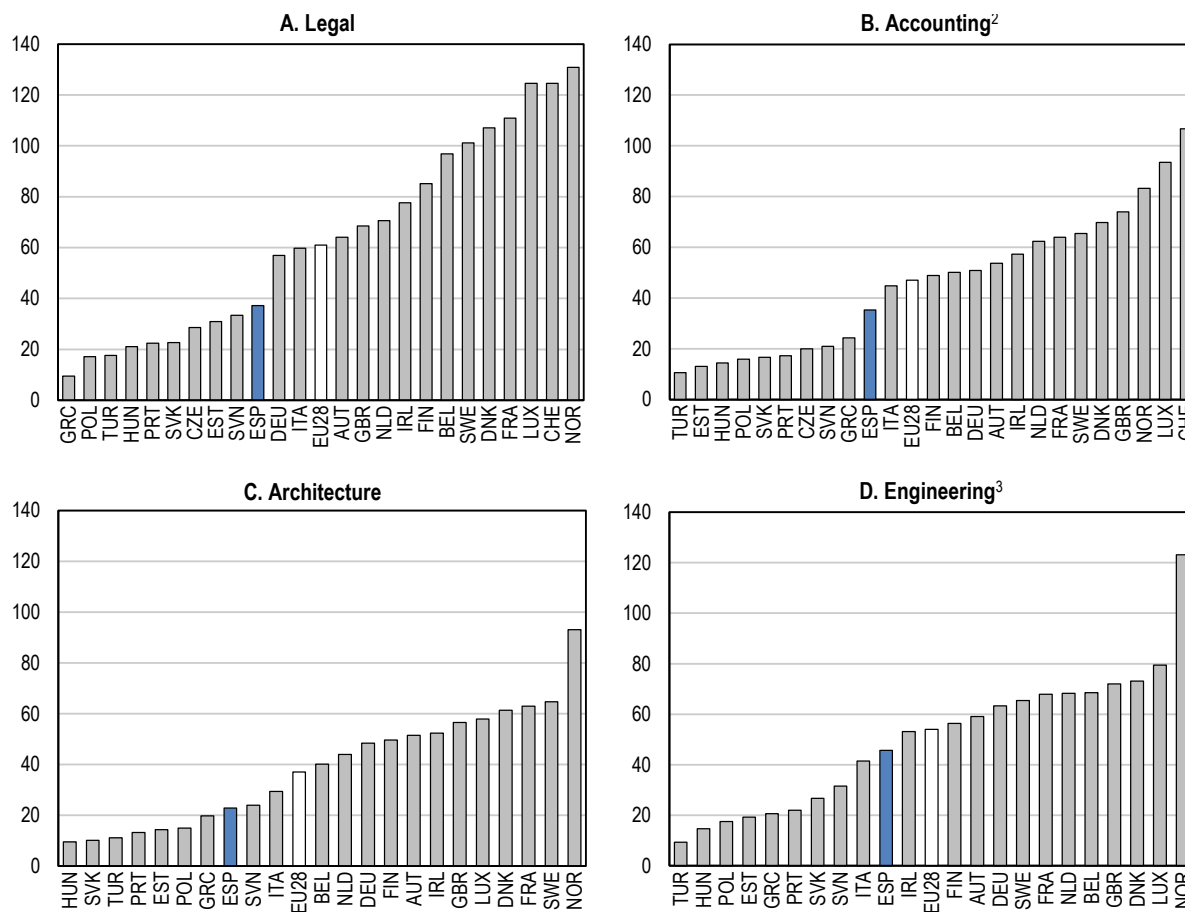
Actions need also to be taken to increase competition in sectors that provide inputs used by nearly all firms. This is an important avenue for reducing non-labour costs and improving competitiveness of Spanish firms in international markets. Areas of key concern include electricity, professional services, ports and oil distribution because of their pervasive use by the business sector and/or importance for exporting. Increasing the efficiency of the judicial system would also help to lower costs for a large part of the business sector.

Increasing competition in professional services

Business services, in particular professional services which account for 75% of business services, are markedly less productive in Spain than in other European economies (Figure 23). This is coupled with entry requirements that are above the OECD average (Figure 24) and practices far from those in the best performing countries. The services trade restrictiveness index for Spain is also above the OECD average in business services, particularly legal and accounting services (OECD, 2014). In addition, there is an unusually large number of professions for which there is a requirement to be a member of the professional body. Opening up these services to competition would increase productivity, drive down prices, improve the quality of the services and provide more job opportunities.

Figure 23. Productivity in professional services

Apparent labour productivity, gross value added in thousand euros per person employed, 2011¹

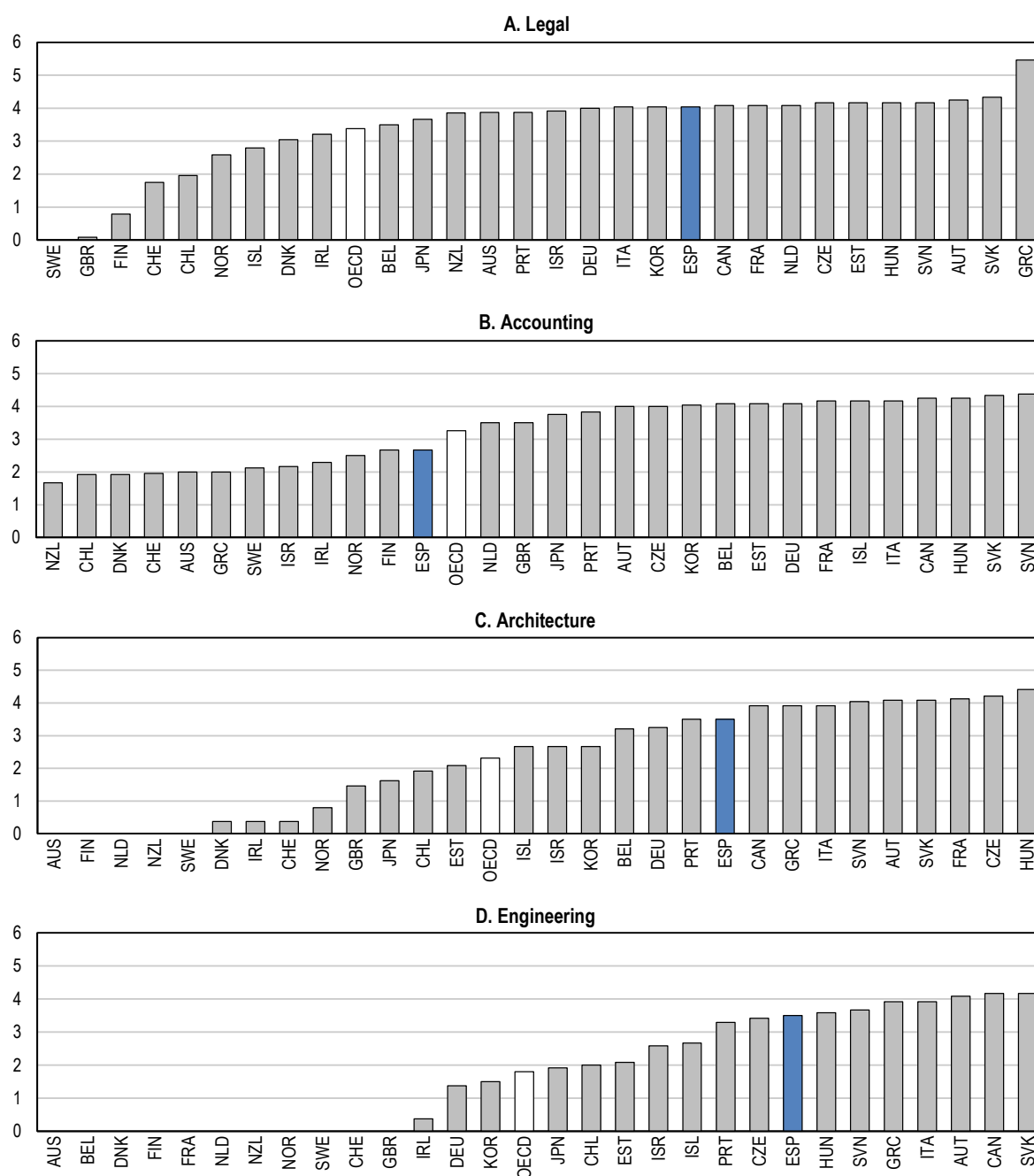


1. 2010 for Greece, 2009 for Turkey.

2. Accounting, bookkeeping and auditing; tax consultancy.

3. Including related technical consultancy.

Source: Eurostat (2014), "Structural business Statistics – Services", *Eurostat Database*, July.

Figure 24. Entry regulations in professional servicesProduct market regulation indicator, index scale of 0-6 from least to most restrictive, 2013¹

1. The OECD aggregate is an average of the data shown. The index is zero for countries where no bar appears.

Source: OECD (2013), *Product Market Regulation Database*, www.oecd.org/economy/pmr.

Further liberalisation of professional services has been planned for some time but the approval of the reforming law has been significantly delayed. The reform would provide a common framework for professional services and highly regulated professions based on the general principle of freedom of access to, and exercise of, those activities. The initial draft law foresaw a considerable reduction in the number of

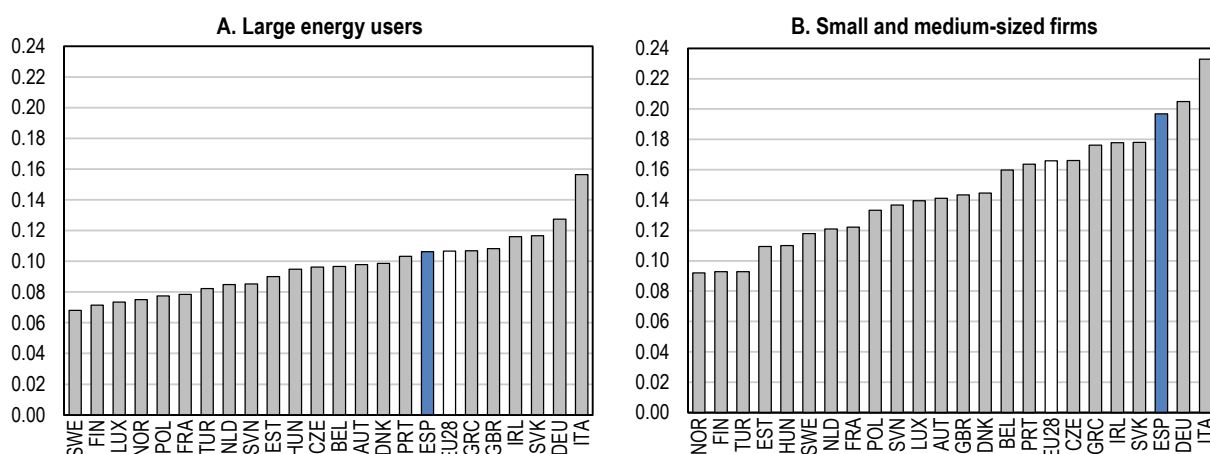
professions for which membership to the professional body would be compulsory. However, the final reform seems to be less ambitious than originally planned on this front. It would be important that the original ambition and spirit of the law is maintained by ensuring that membership fees cannot act as barriers to entry to the professions. The reform could also potentially increase the mobility and competition among providers of professional services throughout Spain and therefore can be framed within the effort being undertaken via the market unity law to create a truly unified domestic market. Once the law is approved, the consistency of sector specific legislation, including regional legislation and professional organisations' internal rules, with the new regulatory framework will also need to be swiftly ensured so that the liberalisation is fully effective.

Fostering competition in network industries

Spain has made good progress in liberalising network industries. At the same time some sectors, such as electricity and gas, are dominated by large vertically integrated companies. The electricity sector has recently been at the centre of intense debate because of reforms to eliminate the so-called electricity tariff deficit (see Assessment and Recommendations). Electricity prices are high in international comparison, especially for SMEs (Figure 25). The new electricity price mechanism has the potential to incentivise more effective price competition between different electricity providers. Nevertheless possible uncompetitive price setting practices have already been identified by the competition authority (CNMC, 2014a), which has claimed in multiple instances that the degree of competition in the wholesale market is insufficient (CNC, 2013a). The market is dominated by two firms (Endesa and Iberdrola) which are involved in all areas of activity and manage more than 70% of electricity demand via commercialisers and distributors. The existing separation between distribution and commercialisation activities has been deemed insufficient by the competition authority, despite existing requirements for legal and accounting separations. Competition in the electricity sector could be strengthened by reinforcing the separation between distribution and commercialisation, and also between distribution and other related activities such as the installation of measurement equipment, where distributors can take advantage of their incumbent position and information. Competition would be further boosted by ensuring a more level playing field between incumbents and potential entrants, such as independent commercialisers, and by reducing the cost associated to entering these activities.

Figure 25. Electricity prices for industrial consumers

Prices excluding value added tax, euro per kilowatt/hour, 2013¹



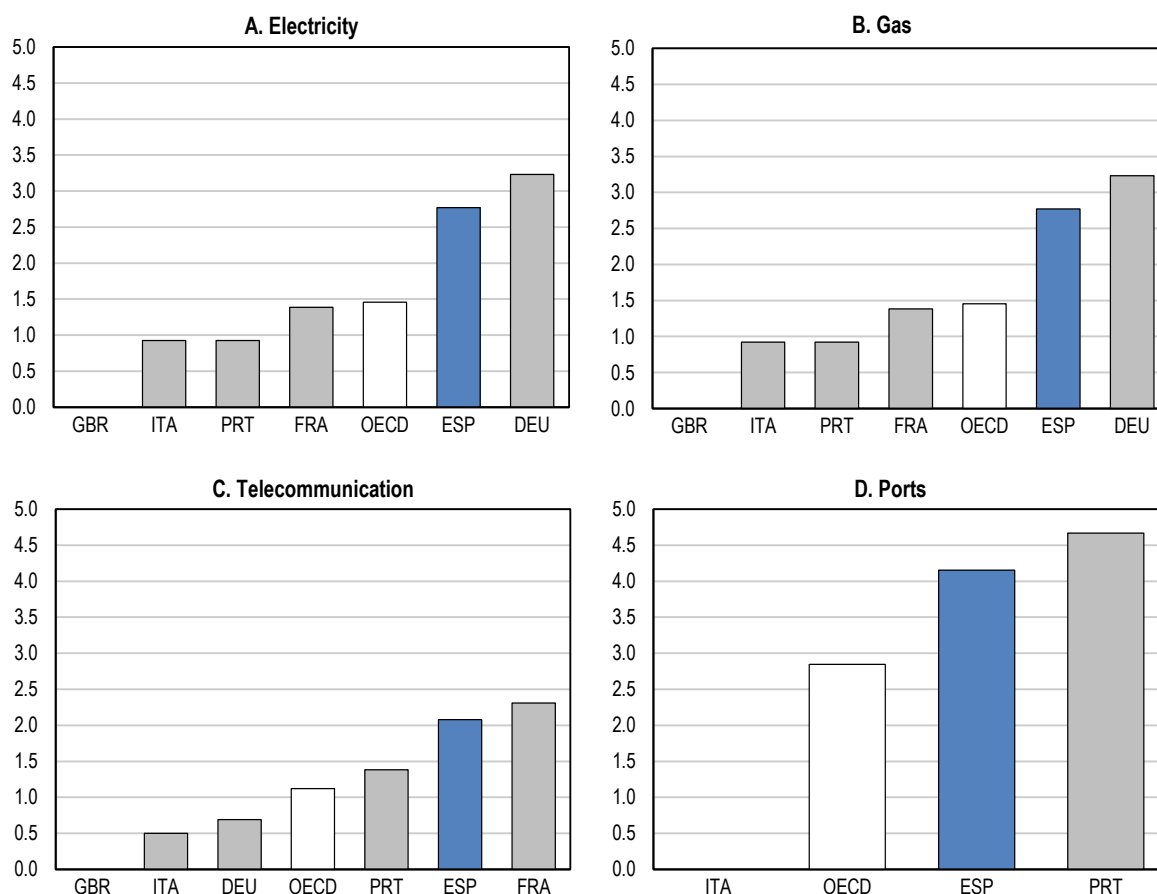
1. Average of data for the two semesters of 2013. The consumption bands covered are 2 000-20 000 megawatt/hours in Panel A and 0-500 megawatt/hours in Panel B.

Source: Eurostat (2014), "Energy Statistics – Prices", *Eurostat Database*, July.

In this context, ensuring that the regulator can act effectively to avoid undue barriers to entry is fundamental. In international perspective, there seems to be room to widen the scope of actions that the regulator can undertake in electricity and gas areas (Figure 26). In particular, it would be beneficial that the regulator reviews and approves contract terms between regulated entities or market actors, and issues industry standards, guidelines and codes of conduct, as done in other OECD countries.

Figure 26. Scope of action by regulators

Indicator of regulatory management, index scale of 0-6 from widest to lowest scope, 2013¹



1. The OECD aggregate is an average of the data available for OECD countries (17 only in Panel D). The index is zero for countries where no bar appears.

Source: OECD (2013), *Product Market Regulation Database*, www.oecd.org/economy/pmr.

Low cross-border transmission capacity with France has also contributed to inefficiencies and higher costs in the Spanish electricity sector. It prevents Spain from engaging in cross-border trade in electricity and gas, and from profiting from its overcapacity in electricity generation: only around 44 gigawatts are used at peak demand compared with 100 gigawatts installed. A new electricity interconnection with France was supposed to be operational in 2014 but its entry into service has been further postponed. More effective interconnections with Portugal and France would foster competition between electricity and gas companies, increase the liquidity of both markets, allow diversity of supply and provide a more competitive environment.

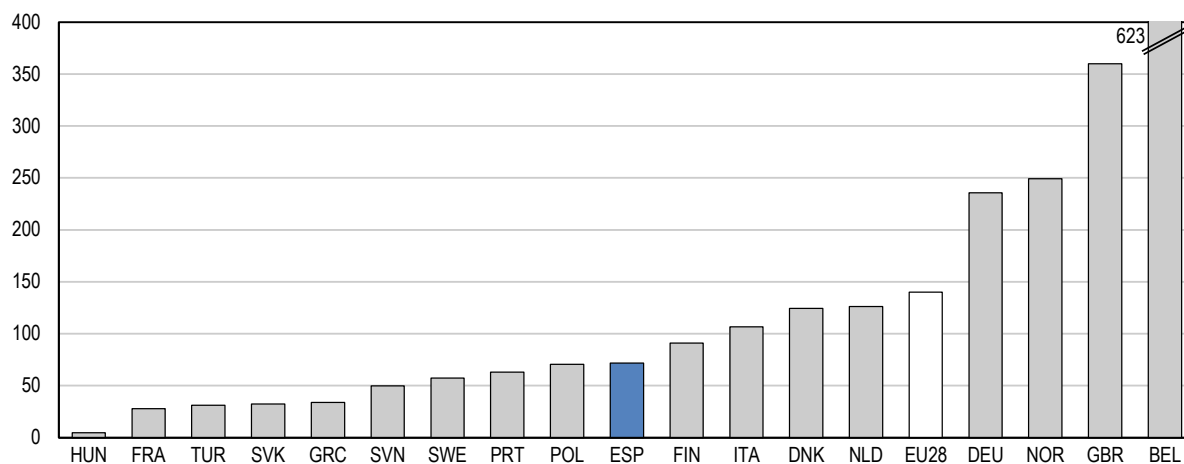
Boosting competition in ports

Boosting competition in ports and lowering costs for exporters is key to boosting cost-competitiveness of Spanish firms and fostering internationalisation. The port regulator is not an independent body, contrary to international best practices and to practices followed in other regulated sectors in Spain. Instead the regulator is a ministerial department or agency, whose decisions can be overturned by governmental or ministerial bodies. The port system in Spain is composed of 28 port authorities, which have ample autonomy and depend largely on regional authorities.

Sea and coastal freight water transport activities have low productivity (Figure 27), despite Spain having several ports that are large by European standards (e.g. Barcelona, Algeciras or Valencia), suggesting the possibility of significant economies of scale. One direct and damaging implication is that the cost to trade is significantly higher in Spain than in other OECD countries (discussed above). In some instances anticompetitive policies and undue barriers to entry have been identified (CNC, 2013b).

Figure 27. Productivity in sea and coastal freight water transport

Apparent labour productivity, gross value added in thousand euros per person employed, 2011¹



1. 2010 for Greece, 2009 for Belgium and Turkey, 2008 for United Kingdom.

Source: Eurostat (2014), "Structural business Statistics – Services", *Eurostat Database*, July.

Transport costs tend to have a disproportionate effect on trade volumes (Clark et al., 2004). In general, it has been estimated that raising transport costs by 10% can reduce trade volumes by more than 20% (Limao and Venables, 2000). While Spain's regulated port costs have been decreasing, stevedoring costs remain very high in international perspective, and these services typically account for the largest percentage of the total cost of moving goods through a port. Stevedoring activities are restricted to a pool of exclusive workers. Cargo-handling companies are not allowed to resort to the market to employ their staff. Instead, cargo-handling companies are required to participate financially in the capital of private companies, which in turn provide them with the required workforce. Only when the workforce proposed by these private companies is not suitable or not sufficient can the cargo-handling companies freely hire staff from the market. These restrictive labour practices discourage the entry of new cargo-handling providers, posing a barrier to attract new investment. This regime is having a significant impact in the productivity and competitiveness of Spanish ports and is hampering the Spanish export sector. According to the European Commission it violates the principle of free establishment of economic activity, although the issue has been brought to the court of justice of the EU. Access to stevedoring activities should be opened and adjusted to the EU legislation.

Increasing contestability in oil distribution

Oil distribution continues to be impaired by lack of sufficient contestability. These are important input markets for many other sectors of the economy, whose international competitiveness is hampered. Recent trend in gross margins in the fuel distribution sector are characteristic of uncompetitive markets (CNMC, 2014b). Consumers face high pre-tax fuel prices compared with international fuel prices and with pre-tax prices in other advanced European economies (Avedillo Carretero, 2013). The concentration in the automotive fuel sector remains too high and there is evidence of aligned pricing practices between the two main operators, REPSOL and CEPSA. There is also a high level of vertical integration between supply, refining and retail activities. Low-cost fuel retailers have a low market share and the competition between service stations located on major roads is low. In July 2013, the government simplified procedures for opening service stations and introduced some measures which reduce the power of established distributors against independent retailers. The number of openings of independent service stations has grown but increasing contestability in the distribution sector remains yet necessary. Simplifying the opening of service stations in supermarkets and hypermarkets and reducing the duration of long-term agreements giving exclusive operating rights over service stations have provided positive competition dynamics in the past in some regions, which should be further exploited.

Improving judicial efficiency

The judicial system is also an important source of costs for business and improving its efficiency is an important path for increasing cost-competitiveness and economic performance (Palumbo et al., 2013). More efficient judicial systems have a positive effect on the size of firms, both internationally (Kumar et al., 1999; Beck et al., 2006) and in Spain (García-Posada and Mora-Sanguinetti, 2013a). It also has a positive effect on the entry rate of Spanish firms (García-Posada and Mora-Sanguinetti, 2014).

The Spanish judicial system does not rank well internationally in terms of efficiency. Spain holds position 26 out of a total of 35 legal systems in its ability to resolve disputes before the first instance courts (Palumbo et al. 2013). Spain ranks 21st out of 31 OECD countries in terms of enforcing contracts (World Bank and IFC, 2014). Clearance rates are low, the case backlog remains high, and procedures are relatively lengthy (European Commission, 2013), despite some recent improvement (European Commission, 2014).

The government has adopted measures to enhance the efficiency of the judicial system, including reorganising the courts, implementing electronic judicial files and promoting out-of-court solutions to conflicts. However, significant problems remain. A critical problem from the business perspective are the so-called *recursos administrativos*, which are appeals against the public administration, over for example a tax liability or denial of a permit, that need to be undertaken before reaching the ordinary judicial system. These administrative appeals are slow to make findings and rarely conclude on the merits of the case. They should be replaced by time limited administrative mediation processes that would automatically be deemed as in a firm's favour if the time limit is exceeded.

In addition, despite significant investment in information and communication technologies, the new tools are not yet readily available in all courts. Promoting further mediation arrangements can provide faster and more efficient conflict resolutions. Increasing competition in the legal profession could also induce lower litigation and hence have a positive effect on the efficiency of the system. The pressure exercised by competition among lawyers would constrain their potential rents, thereby reducing the number of cases that the lawyers may find profitable to bring to court rather than settle (OECD, 2013e).

Tackling over-indebtedness and improving access to finance

Facilitating insolvency procedures to help restore credit growth

Boosting the performance of the business sector requires faster rehabilitation or closing down of the high number of firms that carry excessive debt burdens. Quickly restructuring corporate debts and putting viable firms on the path to recovery would in turn clean-up bank balance sheets allowing banks to focus on new lending and reallocating capital to new and more productive firms.

An efficient insolvency regime is a pre-requisite for achieving this but so far the Spanish insolvency law has proved of little use to facilitate the restructuring of viable firms and swift liquidation of unviable ones (Mora-Sanguinetti and Fuentes, 2012). Business bankruptcy rates in Spain were among the lowest in the world before the 2009 economic crisis. Existing procedures appeared to be unduly complex and judicial resolution periods tended to be too long, which is part of the broader judicial efficiency problems discussed above. In 2012 regular procedures lasted an average of 649 days, while the duration of simplified procedures, that are supposed to be shorter, was 665 days (Van Hemmen, 2013). To correct this inefficiency the government introduced several changes within its entrepreneurship law. The government has recently reviewed them again (Decree of refinancing agreements and debt restructuring) to make it easier to get prior agreements on write-offs, maturity extensions and debt-for-equity swaps, and to reduce the majority needed for creditor agreements to be approved. In many cases liabilities with tax and social security authorities account for a very significant part of the debt, but so far both authorities have not been allowed to restructure their debts. Clear guidelines for the participation of both authorities in the restructuring process should be established.

Bankruptcy rates are low for SMEs, and, in particular, for micro enterprises. In contrast with the low incidence of business bankruptcies, business related mortgage foreclosures have soared during the crisis. Small business owners tend to finance their firms with loans secured on their homes, and, if lenders repossess the collateral, that will be reflected as residential foreclosures instead of as bankruptcies. The small rate of small businesses filing for bankruptcy suggests that these procedures are more costly and drawn out than the main alternative procedure, the mortgage foreclosure, and that the personal bankruptcy law is unattractive to the individual debtor (García-Posada and Mora-Sanguinetti, 2013b). The challenges ahead are to enable viable SMEs to restructure unsustainable debt and get recapitalised; and to ensure nonviable SMEs cease their activities in an orderly fashion to allow effective redeployment of capital and other resources. Insolvency procedures often fail to meet the needs of SMEs (European Commission, 2012). Alternative procedures, proportionate to the size of the business, should be put in place to make adequate solutions available for all types of SMEs. Given the limited capacity of the judicial system and the need for rapid resolutions, promoting and facilitating voluntary out-of-court restructurings for SMEs could provide a cost-effective and swift alternative to court supervised proceedings.

The government recently introduced new out-of-court pre-insolvency payment procedures for SMEs (*acuerdo extrajudicial de pagos*). The payment agreement must be approved by 60% of creditors, have a maximum haircut of 25%, and involve a payment moratorium limited to three years. Public creditors are excluded from the negotiations. This new procedure is a decisive step to alleviate financial distress of SMEs in a swift manner. Nevertheless, its current configuration does not offer sufficient incentives for its use. The procedure could be made more effective by permitting the debt haircut to go above the current 25% maximum and the payment moratorium above three years. A significant proportion of SMEs' debts are liabilities with tax and social security authorities. Integrating these liabilities in the payment plan would be an additional step to make these procedures more effective. These procedures are facilitated by mediators. The government is planning to change the way mediators are selected, appointed and remunerated. This is welcome since the current system does not provide sufficient incentives to avoid long processes ending in the final liquidation of firms.

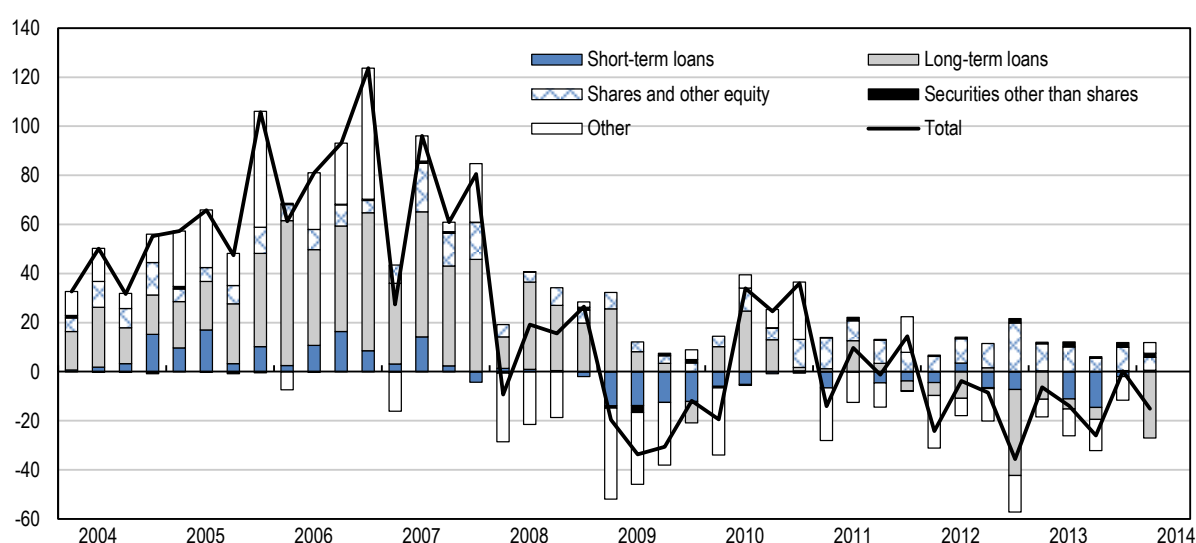
The recent entrepreneurship law created a new category to foster entrepreneurship (*empresario de responsabilidad limitada*), according to which the entrepreneur can preserve their main residence from any payment obligation originating from their entrepreneurship activities. This category puts undue emphasis on protecting housing assets to the detriment of other type of assets. In general, setting-up insolvency procedures providing clear and swift procedures for debt restructuring and resolution has been found to have a far more decisive impact in fostering entrepreneurship than partial measures to protect entrepreneurs' assets. In this sense, introducing a new personal insolvency framework allowing for a discharge of unresolved personal debt after liquidation or a payment plan for financially responsible individuals, as existing in other EU countries, is a preferable alternative to tackle over-indebtedness of individual entrepreneurs and increase entrepreneurship. Existing alternatives are too narrow in scope and too stringent in their requirements to be broadly used or to have a significant impact.

Moving towards more diversified financing

Bank-lending has been the predominant financing source in Spain. The crisis boosted bank disintermediation, in particular for larger firms that have increased issuance of corporate debt (Figure 28). Issuance remains though below those observed in more developed corporate bond markets, such as Germany, France or Italy. Market funding opportunities for SMEs have been more limited though. Moreover, SMEs have more difficulties to establish new banking relationships and they tend to use as collateral real-estate assets, whose value has fallen, which complicates further their access to credit.

Figure 28. Structure of non-financial corporations' liabilities

Net incurrence of liabilities, billion euros



Source: Bank of Spain (2014), *Financial Accounts of the Spanish Economy* (database), July.

The downsizing of the banking sector makes the development of alternative, capital market-based sources of finance more urgent, especially for SMEs. Developing non-bank financing, would also reduce banks' market power, which may help to make Spanish bank lending rates more responsive to monetary policy. Where banks in Europe face limited competition, and firms depend on them, financing constraints for SMEs have been found to be higher (Ryan et al., 2014). Moreover, in normal downturns, healthy banks help to cushion the shock, but when recessions have coincided with financial crises the impact on GDP has been three times more severe for bank-oriented economies than for market-oriented ones (Gambacorta et al., 2014). Access to bank finance can be particularly challenging for young and innovative firms that do

not have collateral or a track record. Thus, developing non-bank financing channels would make the Spanish financial system more balanced, more resistant to shocks and more prone to entrepreneurship. With that aim the government has launched a wide array of initiatives, including developing alternative securities markets, improving the public guarantee system and venture capital initiatives (discussed below). The effects of these initiatives will unfold progressively over time, and in the meantime measures to improve firms' access to bank finance are also required.

Improving access to bank financing

One way to improve the financing conditions of SMEs is to provide banks with funds to be used to make loans to SMEs. In Spain, this is done via the Official Credit institute (*Instituto de Crédito Oficial*, ICO) intermediation facilities. Through these facilities ICO provides funds to banks at a lower cost on the condition that the funds are lent for a certain kind of activity or type of firm, including SMEs. Banks assume fully the credit risk and charge a premium to remunerate their operating costs and the credit risk assumed. ICO sets a ceiling for this premium, which currently stands at about 4%. The German government agency Kreditanstalt für Wiederaufbau (KfW), OSEO in France and the European Investment bank (EIB) also use these kind of facilities. Via these facilities ICO granted credit amounting to EUR 14 billion in 2013 (an increase of 20% with respect to 2012), having a material impact in the incipient recovery in the flow of new credit. In the first half of 2014 credit disposition amounted to EUR 10.9 billion, which is a record figure. In the short-term, these facilities can be effective in improving firms' access to finance. Nevertheless, in the medium-term, the emphasis should move towards more market-based alternatives currently under development (discussed below) and to make firms less dependent on publicly supported bank finance.

Well-structured mutual guarantee schemes (MGS) can also play a decisive role in improving firms' access to bank finance. They spread some of the risk and thereby enable banks to extend loans to firms that would find it difficult to access credit otherwise or to do it under better conditions (Columba et al., 2009). For banks they can act as an important risk mitigation mechanism since they do not need to provision loans guaranteed by MGS.

In Spain, MGS are a special type of limited liability society with two types of shareholders: "participatory members", who subscribe some shares against the guarantee service (currently about 100 000 SMEs); and "protective members", which include local authorities, banks, chambers of commerce and other entities that are involved in SME development. Typically, the guarantees issued by MGS cover 100% of the bank loan. The Spanish system of public support to MGS is based on counter-guarantees granted by CERSA (Compañía Española de Reafianzamiento, SA), which is under the Ministry of Industry, Energy and Tourism (OECD, 2013b). CERSA can cover up to 75% of the risk, depending on size and conditions of the loan. The rest of the risk is covered by the MGS themselves. A new measure introduced recently in Spanish regulation allows banks benefiting from a guarantee from a MGS to request the reimbursement of its claim directly from the counter-guarantor, CERSA. This reduces significantly the counterparty risk of the bank with the MGS.

MGS could play an important role in the current financing environment, where SMEs face relatively strict financing conditions and banks must ensure a high level of capital quality. MGS offer the competitive advantage of being close to the borrowers. This allows an effective monitoring and screening of loan applications. It is estimated that banks can obtain 45% risk-weighted yields on operations with guarantees, compared with 16.5% without guarantees and that the cost of the loan for the SME would be reduced by 250 basis points (PWC, 2014). Moreover, MGS tend to provide firms with long-term financing, while SMEs usually obtain short-term loans from banks. Therefore they can contribute to SMEs moving towards a more balanced financing term structure.

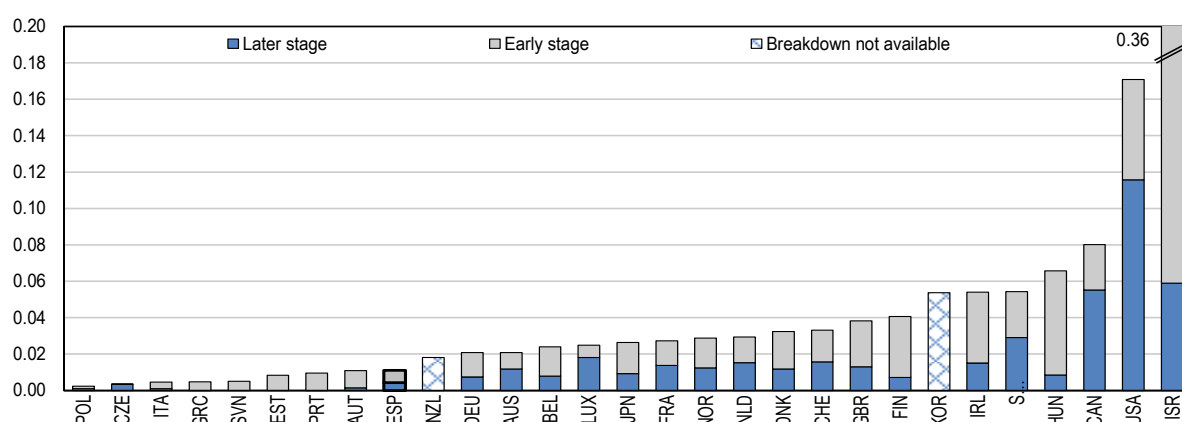
The use of MGS in Spain is lower than in other countries with a similar firm structure such as Italy and Portugal. The volume of outstanding guarantees amounted to 0.6% of GDP in Spain in 2011, compared with 2.2% and 1.9% in Italy and Portugal (OECD, 2013b). A more extended use of MGS in Spain will likely require a change in scale. There are currently 23 MGS in Spain, but some do not have sufficient capital to significantly expand their activity (PWC, 2014). In general, a change in scale, with mergers or consolidation can help reduce the relative costs of the service, as well as broaden the offer of guarantee instruments (OECD, 2013b). Larger MGS can also provide more professional management and screening tools. A consolidation process is underway, after the entrepreneurship law increased equity and resources requirements for MGS. At the same time, there is a trade-off between efficient scale and proximity to borrowers, which historically has been MGS' competitive advantage. Strengthening the public counter-guarantee by further increasing the resources of CERSA may also be required. That would imply an increase in contingent liabilities for the government. Thus, it should be accompanied by regular stress tests to check the solvency of the guarantee system.

Developing alternatives to bank-lending

Besides bank loans, alternative financing sources are important, especially for high-growth firms that want to diversify their funding basis or need a mix of debt and equity. As Spain's recovery gains steam, it will be critical to supplement bank lending with new sources of finance, so that bank capacity constraints do not hold back the necessary financing of new business. One of the main alternatives is venture capital, which has remained underdeveloped in Spain so far (Figure 29). To contribute to the development of the venture capital market, the government has launched a programme called Fond-ICO Global. It is the first public venture capital "fund of funds" created in Spain, and has a budget of EUR 1.2 billion. It seeks to promote the creation of privately managed venture capital funds investing in Spanish companies at different stages of development, with the goal to mobilise around EUR 5 billion of funds. The venture capital funds in which Fond-ICO Global invests must have a majority of private capital and a presence in Spain. The amount of capital invested by Fond-ICO Global in each fund will depend on the stages in which it invests and the size of the fund. The emphasis in ensuring a majority of private capital is welcomed, since government venture capital efforts have been found to have a positive impact when they have a minority position and not when they are leaders (Brander et al., 2012; Grilli and Murtinu, 2014). The selection of venture capital funds in which Fond-ICO participates is done via successive tender procedures. It would be important to ensure a systematic and unified evaluation of the results of the first tenders so that future calls can be adapted based on the results of that evaluation.

Figure 29. Venture capital investment

Per cent of GDP, 2012¹



1. 2011 for Canada, Estonia, Greece, Japan, New Zealand and Slovenia.

Source: OECD (2013), *Entrepreneurship at a Glance 2013*.

Stock markets geared towards smaller firms are important complement to venture capital schemes. Contrary to Germany or the United Kingdom where alternative stock exchanges are vibrant, the Spanish alternative market, MAB (*Mercado Alternativo Bursátil*), has remained less developed: 22 firms are currently listed, reflecting that not many SMEs comply with some of the requirements to list in the market (e.g. estimated value of the free float above EUR 2 million). Spain has also recently launched an alternative fixed-income market (MARF, in its Spanish acronym). MARF's potential issuers are large unlisted companies, with EBITDA levels of at least EUR 12 million. Given these requirements, a massive entry of issuers in this new market should not be expected (Guijarro and Mañueco, 2013). So far six issuances have taken place. MARF targets solely institutional investors and the minimum unit issue amount is EUR 100 000. The examples of Germany and Norway, with markets raising volumes of funds that represent 1% and 0.13% of GDP, are good benchmarks for MARF's potential capacity. Nevertheless, the predominance of small firms in the corporate sector in Spain will constrain the total funds that can be raised compared to other European economies more populated by medium-sized companies.

Other measures would also help firms financing

Access to credit by SMEs would also be improved if assessing borrower creditworthiness becomes easier. Mechanisms to facilitate the regular production of uniform, quality data on the most important aspects of the business of SMEs would help. Banque de France has been identified as the institution collecting the most comprehensive set of data on SMEs (IIF, 2013), and this is coupled with the lowest spread between loans to large companies and loans to SMEs in the euro area. Banque de France requires detailed reporting on all loans larger than EUR 25 000, and from this data they compile credit scores on around 280 000 companies operating in France, the majority of which are SMEs. The credit scores and related financial information, including aggregated bank claims for an individual SME, are made available to French banks. Establishing a comprehensive central credit registry similar to the Banque de France model would significantly reduce information asymmetries and contribute to banks providing SMEs with loans at better terms.

The current framework of public financial support for SMEs, which rests on a broad variety of instruments provided by various institutions, could also be simplified to make it easier for SMEs to absorb information and access support. Simplification and consolidation may increase the effectiveness and cost-efficiency of the system and avoid duplications. In addition to ICO there are several agencies and institutions providing financing support to Spanish companies such as Compañía Española de Financiación del Desarrollo (COFIDES) and Empresa Nacional de Innovación, SA (ENISA). In some cases these institutions have cross-shareholdings and the instruments they offer are very similar (Ayuso, 2013). Concentrating all financing support in ICO may contribute to achieving economies of scale and exploitation of all possible synergies, in addition to offering firms a clearer access point to support.

The financing of Spanish firms, in particular SMEs, is also seriously impaired by very late payments - or even failure to pay - in commercial transactions. To combat that, a new law (*Ley de Morosidad*) has established maximum terms of payment in commercial relations. These legal terms are compulsory and binding and therefore cannot be lengthened by mutual agreement of the parties. The maximum term is 30 days for administrative entities (from delivery of the document that accredits the total or partial fulfilment of the contract) and 60 days for private companies (from the date of receipt of the goods or rendering of services), in line with European Union directives. While payment terms have decreased, they remain above the maximums established by the law. The authorities should introduce sanctions for those firms systematically incurring late payments above the legal limits.

Recommendations to move towards a more dynamic business sector

Boosting start-ups

- Revamp the licence and permits system and reduce regulatory fragmentation by implementing the market unity law.
- Set-up one-stop shops for issuing and accepting all notifications and licenses that are required to open up a business.

Facilitating business growth

- Broaden the corporate tax base, lower the rate and eliminate regimes for small and medium-sized enterprises (SMEs).
- Review other size-dependant policies and regulations. Adapt them to avoid them becoming obstacles to firms' growth.

Fostering internationalisation

- Integrate internationalisation and innovation policies under a single responsibility.
- Establish formal mechanisms of collaboration between Spanish multinationals and SMEs attempting to gain access to new markets.
- Strengthen the port regulator and ensure that entry barriers are eliminated. Open access to stevedore activities.

Strengthening competition

- Make access to professions easier. Reduce the number of professions for which being a member of the professional body is required. Ensure that membership fees do not act as barriers to entry to the profession.
- Progressively reduce the degree of vertical integration in the electricity market.
- Widen the scope of actions of electricity and gas regulators.
- Favour entry in the oil distribution market to increase contestability and reduce anti-competitive practices.

Improving judicial efficiency

- Pursue efforts to increase efficiency in the judicial system by ensuring a broader deployment of information technology tools, fostering mediation alternatives and increasing competition in the legal profession.
- Replace special administrative appeals with the public administration with time-limited mediation procedures.

Tackling over-indebtedness

- Increase incentives for the use of out-of-court and in-court insolvency procedures by SMEs by allowing more flexible payment plans, higher debt haircuts and participation from tax authorities.
- Introduce a new out-of-court negotiated personal insolvency regime.
- Establish clear guidelines for the participation of tax authorities in debt restructuring processes.

Improving firms financing

- Continue to promote diversified financing sources for firms. In the short-term, adjust the Official Credit Institute (ICO) intermediation facilities to demand and make further use of mutual guarantee companies.

Recommendations to move towards a more dynamic business sector (*cont'd*)

- Make government financing support to firms more effective by considering a reduction in the number of government agencies involved and concentrating support in ICO.
- Ensure that private sector lead is maintained in venture capital schemes financed by FOND-ICO Global. Evaluate the results of first tenders and adapt consequently the subsequent calls.
- Establish a comprehensive credit registry for SMEs similar to the Banque de France model, including information on payment performance, financial transactions and balance sheet positions. Make that information available to all banks.
- Introduce sanctions for those firms systematically incurring in late payments above the legal limits.

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Annex

Constant market share analysis

Following Nyssens and Pouillet (1990) and Amador and Cabral (2008), the total change in the share of Spanish exports worldwide (i.e., the total effect, TE) is given by the difference between the growth rate of Spanish merchandise exports (g) and the growth rate of world merchandise exports (g^*):

$$TE = g - g^* = \sum_i \sum_j \theta_{ij} g_{ij} - \sum_i \sum_j \theta_{ij}^* g_{ij}^*$$

where

$$g_{ij} = \frac{X_{ij,t} - X_{ij,t-1}}{X_{ij,t-1}}$$

$$\theta_{ij} = \frac{X_{ij,t-1}}{\sum_i \sum_j X_{ij,t-1}}$$

$$g_{ij}^* = \frac{X_{ij,t}^* - X_{ij,t-1}^*}{X_{ij,t-1}^*}$$

$$\theta_{ij}^* = \frac{X_{ij,t-1}^*}{\sum_i \sum_j X_{ij,t-1}^*}$$

X_{ij} (X_{ij}^*) denotes nominal Spanish (world) exports of product i to market or destination j .

TE is algebraically decomposed into a market share effect (MSE) and a combined structure effect, comprising a product structure effect (PSE), a geographical structure effect (GSE) and a residual term (mixed structure effect, MIX).

$$TE = MSE + PSE + GSE + MIX$$

$$MSE = \sum_i \sum_j \theta_{ij} (g_{ij} - g_{ij}^*)$$

$$PSE = \sum_i (\theta_i - \theta_i^*) (g_i^* - g^*)$$

$$GSE = \sum_j (\theta_j - \theta_j^*) (g_j^* - g^*)$$

$$MIX = \sum_i \sum_j \left[(\theta_{ij} - \theta_{ij}^*) - (\theta_i - \theta_i^*) \frac{\theta_{ij}^*}{\theta_i^*} - (\theta_j - \theta_j^*) \frac{\theta_{ij}^*}{\theta_j^*} \right] g_{ij}^*$$

where:

$$\theta_i = \sum_j \theta_{ij} \text{ (share of product } i \text{ in Spanish exports)}$$

$$\theta_i^* = \sum_j \theta_{ij}^* \text{ (share of product } i \text{ in world exports)}$$

$$\theta_j = \sum_i \theta_{ij} \text{ (share of market } j \text{ in Spanish exports)}$$

$$\theta_j^* = \sum_i \theta_{ij}^* \text{ (share of market } j \text{ in world exports)}$$

$$g_i^* = \frac{\sum_j \theta_{ij}^* g_{ij}^*}{\theta_i^*} \text{ (growth rate of world exports of product } i)$$

$$g_j^* = \frac{\sum_i \theta_{ij}^* g_{ij}^*}{\theta_j^*} \text{ (growth rate of world exports to market } j).$$

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