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Spain Tests Europe's Resolve on Deficits

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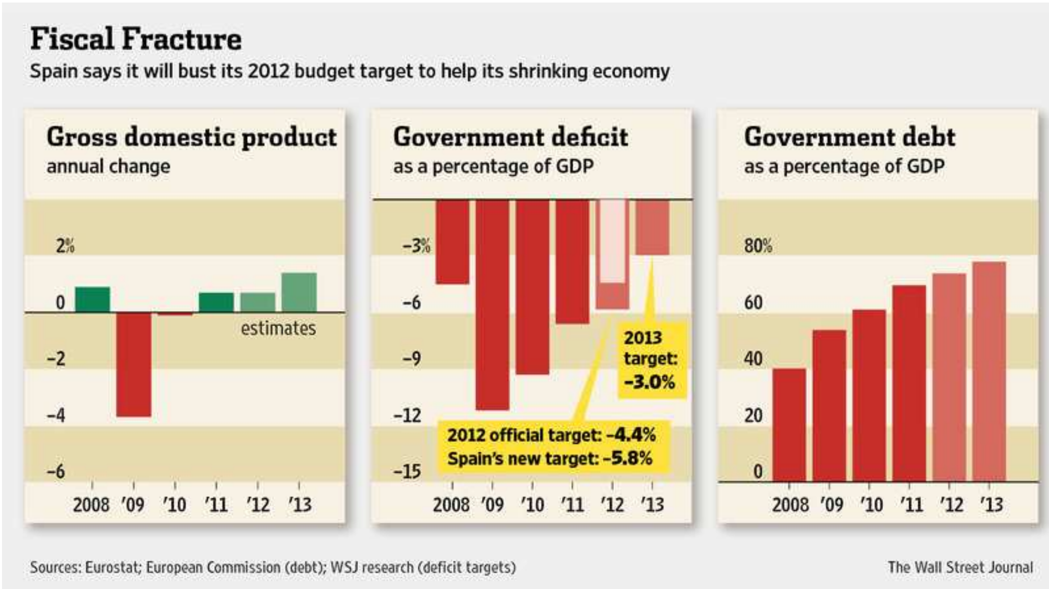
It hasn't taken long for the euro zone's new tough budget rules to face their first big test. Spain's stand-off with Brussels over the size of its 2012 budget deficit has presented officials in the city with a dilemma: How do they preserve the credibility of the tighter fiscal rules without triggering a Greece-style downward economic spiral by forcing Spain to slash its deficit too vigorously?

Spanish Prime Minister Mariano Rajoy formally opened the issue last week when he announced that Spain's new budget-deficit target would not be the 4.4% that his predecessor agreed last year with the European Commission in Brussels—but 5.8%.

The reason: last year's deficit turned out to be 8.5%-not the 6% target that this year's goal was based on. Hitting the agreed 2012 target would cut domestic demand by four percentage points, further squeezing Spain's already shrinking economy.

It wasn't only Mr. Rajoy's unilateral decision that upset the Brussels bureaucracy. It was the way he framed it, telling reporters: "This is a sovereign decision made by Spain that I am announcing now, to you."



Given that he had a short time before signed a new fiscal compact with 24 other European Union governments—the latest of a series of accords that explicitly cede budget sovereignty to Brussels—this undermined the very point of two years of German-inspired efforts to tighten euro-zone budgetary discipline.

For Germany and the European Central Bank, these budget agreements are central to the future of the euro zone. ECB president Mario Draghi described them Thursday as "pillars of trust" between countries.

"If Spain is given the leeway it seeks, it will effectively be driving a coach and horses through the euro zone's new German-inspired fiscal regime," says Nicholas Spiro of Spiro Sovereign Strategy in London.

In a possible signal that Mr. Rajoy should tread carefully, Spanish government bond yields have risen slightly over the last week, according to data from Tullett Prebon. Yields on Spanish 10-year bonds are now noticeably higher than Italy's: before Mr. Rajoy spoke they were lower.

Yet it's hard to find an economist who thinks slashing the deficit so sharply makes any sense. First, credibility is damaged in the event of a likely failure to meet the target; second, taking so much demand out of an economy already suffering 23% unemployment could seriously deepen the recession, which, among other things, will make it even tougher to reach the 3% deficit target that Mr. Rajoy still pledges to meet in 2013.

Alberto Alesina, a Harvard University economist who has extensively studied the impact of budget cuts on economies, says: "I think that way too much emphasis is placed by Brussels on the size, rather than on to the composition of the adjustment…By obsessing about the quantity rather than the quality of fiscal adjustments Europe is making big mistakes."

Mr. Alesina, whose views of the benefits of budget discipline have put him at odds with many Keynesian economists, says: "A deficit reduction in Spain obtained by raising taxes would be recessionary and would be a terrible idea now."

On this basis, Mr. Rajoy has already blotted his copybook by raising income taxes soon after he took office, leaving Spaniards, as the free-market Cato Institute said last week, paying among the highest income taxes in Europe.

Mr. Alesina says it's better for Spain to go for a smaller adjustment by cutting government spending than a larger one accomplished by raising taxes—particularly if the cuts are accompanied by further labor and other reforms to the structure of the economy. "If I were the prime minister of Spain, I would raise the deficit target but at the same time I would announce and commit to a credible plan of spending cuts relatively soon to come and push forward on structural reforms," he says.

But will Mr. Rajoy be given this leeway? European officials admit there's a divide within the European Commission on how hard to push back.

"The new rules put the European Commission in a very difficult position: While it has significantly reinforced its own powers in the context of the crisis, it recognizes that a strict interpretation of the new rules may actually undermine their credibility more than a more flexible one," says Mujtaba Rahman, a former EU official now with Eurasia Group in New York.

Some officials want to flex their new-found powers to show that, in contrast with the past, the reinforced budget rules really have teeth. They argue that there is more than Spain at stake here: the Netherlands and Hungary are also on track to miss their budget agreements this year and the officials don't want to give them more wiggle room.

Others argue that forcing Spain to meet its official target will backfire by provoking a further contraction of the recession-hit economy.

The outcome of this battle is as yet unclear. As they are now mandated to, officials in the Commission will be poring over Spain's numbers for last year, and studying the fine print of this year's plans.

One senior official says there may be room for compromise: Allow Mr. Rajoy some flexibility in his target this year in return for fundamental concessions that would credibly cut the deficit over many years. Among the issues to be examined, he says, is whether an agreement can be obtained to permanently rein in spending by Spain's autonomous regions and local governments. That would be a nasty nettle for any government in Madrid to grasp.