

The announcement by Mariano Rajoy, the Spanish prime minister, not to stick to the fiscal target agreed by the previous government is likely to be a game changer of the European governance debate. On the day of the signing of the fiscal compact, its spirit is put under test by one of the largest countries in EMU.

Under the current framework, Spain would have been required to reduce its budget deficit to 4.4% in 2012 and below 3% in 2013 – down from an estimated 8.5% level of 2011. This is a very ambitious fiscal consolidation path. While it is true that fiscal consolidations have less negative effects in times of confidence crisis as they allow regaining trust by international investors, their overall effect on the economy still is negative. In fact, starting from an unemployment rate of above 20%, the consolidation would have led to a significant increase in unemployment. So while slashing expenditures would have reduced the Spanish deficit, it would have been cruel for Spain to abide by the rules.

From a European point of view, Spain's apparent defiance of the rules of the Stability and Growth pact is worrying. The Commission now has no choice but to move forward with the procedure. In fact, the Council decided in March 2009 following a Commission recommendation and based on the economic forecast of the Commission that Spain should correct its excessive deficit by 2012. At that time, Spain was thus expected to adjust its deficit to below 3% in 2012. In November 2009, the Council decided that only by 2013 the deficit should be corrected to below 3% and an annual consolidation path was again confirmed by a Council decision of July 2011. Any deviation of the fiscal deficit path needs to be analysed in detail by the Commission. Only if exceptional circumstances during 2011 justified the slippage of 2011, the Commission may recommend that a further delay of the adjustment path is warranted. And only after a Council decision would the Spanish government be allowed to deviate from the path. If the Commission was to come to a different conclusion, it would need to start the next steps of the procedure, knowing that success would be good for Europe but bad for Spain.

The Commission will be closely watched in its decision. It is clear that after having followed a tough line on Belgium, deviating from the tough line would confirm the suspicion of smaller member states that large member states receive a special treatment. More importantly, Spain will be seen as a test case for the value of the new fiscal compact. A lax treatment of Spain will be interpreted as showing that the highest political commitment to fiscal discipline with a strong Treaty does not necessarily hold.

Looking forward, a number of important lessons can be drawn. First, the current fiscal set-up in Europe is incomplete. Asking a member state for large budget cuts in the midst of a major recession with high unemployment is impossible without outside help. In fact, fiscal federations such as the US have balanced budget rules for sub-national states. The viability of these rules, however, depends on the fact that unemployment insurance and other stabilisation functions are partly exercised at a federal level. In case of a large negative shock in one of its parts, the federation allows for a net flow of fiscal resources into the affected part.

Second, the current institutional set-up will be seen as insufficient for the creation of Eurobonds. After the moral hazard in Italy of last year and the apparent Spanish breaching of the rules on the day of signing up to those, trust in the large creditor countries will go down even further than the

current institutional set-up will be able to prevent free-riding behaviour on the others. The outcome of the upcoming debate between Madrid and Brussels will crucially shape the willingness to move forward towards Eurobonds. I also expect that it will be a crucial determinant of Berlin's willingness to increase the firewalls.

The fiscal compact that was meant to restore trust among its members and is seen as a "step towards political union", is thus in difficulty because it sets-up an incomplete fiscal union. Europe should now propose a simple bargain to Spain. Spain should abide by the rules and in turn receive large payments from the EU budget (for example by a special allocation of structural funds and a zero-interest loan to recapitalize the banking system) to dampen the effect of the consolidation. This solution would show a sensible way forward to the creation of a true fiscal union.