Originally published in **The Financial Times**

April 30, 2012

Taxpayers must backstop Spain's budget

By MARTIN FELDSTEIN

Spain is rapidly approaching a liquidity impasse. Markets are nervous because it's not clear how the government will finance its budget deficit and the rollover of its maturing bonds. Spain's budget deficit now stands at 5 per cent of its gross domestic product and the bonds maturing in 2012 equal an additional 15 per cent of GDP. The IMF expects these large deficits and refinancing needs to continue for several years.

To meet its financing needs, the Spanish government needs the confidence of foreign and domestic investors. Those private investors must believe that Spain has a credible programme to eliminate the annual fiscal deficits and a back-up plan to deal with the maturing debt if there is a shortfall of buyers. If investors know there is such a plan that could be triggered in an emergency, it might never be needed. The Spanish government should quickly reduce its near-term fiscal deficits and develop an operational plan to deal with its needs in following years.

Spain's commercial banks have little remaining lending capacity, the result of their previous purchases of Spanish government bonds and of their losses on real estate loans. The Bank of Spain lacks the money-creating ability of the US Federal Reserve and the Bank of England to buy government bonds. And the European Central Bank is explicitly precluded from financing fiscal deficits of member governments.

The Spanish government must therefore depend on foreign and domestic investors who are now reluctant to lend to a government that may be insolvent. The challenge is to rebuild their confidence.

Although eliminating annual budget deficits is politically difficult, Italy has recently shown that it can be done by a combination of reforms to spending (particularly pension reforms) and strengthening tax collections. The IMF now forecasts that Italy will have a cyclically adjusted budget deficit this year of less than 0.5 per cent of its GDP and cyclically adjusted budget surpluses starting in 2013.

Like Italy, Spain should also be able to find the spending cuts and revenue gains, since Spanish government spending now exceeds 45 percent of GDP. The relative budget autonomy of the Spanish regions should be allowed to continue only if (as with the states in the US) they are required to limit their operating outlays to the funds that they receive from the central government and from their own taxes.

Even with tough political action, it will take years to achieve a balanced budget. That means there will continue to be budget deficits that need financing and therefore a possible delay in persuading investors to roll over existing debt as it matures. Building investor confidence during this process requires a plan to avoid a Greek-style default.

One part of such a plan is to negotiate access to the European Stability Mechanism, the €700bn fund created to protect member governments from default. But if the refinancing shortfall from private sources is very large, Spain will need to supplement the funds from the ESM.

Raising those additional funds by increasing taxes would push the Spanish economy into a deeper recession and would weaken the supply-side incentives needed to stimulate long-term growth. Although some of the increased supply of lending might be achieved by changing the required asset holdings of the Spanish banks, the current condition of those banks leaves very little scope for such additional lending.

An alternative emergency approach would be to mandate, on a temporary basis, bond purchases by Spanish households and businesses. Here's how such a plan might be implemented.

The Spanish government could use the income tax system to levy a temporary "lending surcharge" on individual incomes. In exchange for those surcharge payments, the households would receive an interest-bearing government bond with a maturity of five to 10 years. A similar surcharge could be levied on businesses based on corporate profits or the businesses' value added.

Having this back-up plan in place to fill any shortfall in Spain's finances could give private sector investors the reassurance they need to provide the funds that are needed. With private sector confidence that a default would be avoided, it should not even be necessary to draw on the ESM or to levy the surcharge on households and businesses. The Spanish government should therefore move quickly to enact such a plan before it is overcome by its current liquidity problems.

The writer is professor of economics at Harvard University and was President Ronald Reagan's chief economic adviser