

CEPS ESSAY



Thinking ahead for Europe

Can Spain break the curse of the periphery? The upcoming Spanish election and what it means for Europe

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On 11 September 2007, the Spanish Prime Minister José Zapatero told his country that Spain had entered the “Champions’ League of world economies”. One has to resist the malicious urge to feel a certain *schadenfreude* at such an uncanny combination of hubris and bad timing.

Nine years later, not only has the Spanish economy failed to reach its pre-crisis peak, but the political system appears to be in shambles as well. Seven months after the last elections, Spanish citizens are being asked to vote again, because no one has managed to put together a government.

A closer look at the country’s situation, however, produces a much more nuanced view. Both in politics and in economics, Spain resides at an inflection point situated between the European periphery and its core. If it plays its cards right, it has a fighting chance of re-joining the Champions’ League, a development that would have a tremendously positive message for the rest of Southern and Eastern Europe.

On the negative side, Spain is, with Italy, the only European country that could realistically break up the eurozone if the worst were to happen. So what is *likely* to happen if Podemos, Spain’s counterpart to Greece’s SYRIZA, surpasses the traditional Socialist Party and leads the next government?

This essay takes stock of the new world of Spanish politics one month before the early elections, which should take place on June 26th. It explores the main policy challenges that the next government is going to face and the likelihood that they are going to be addressed. Before plunging into the details of Spanish election campaign, let’s first put the issues into a long-term European economic context.

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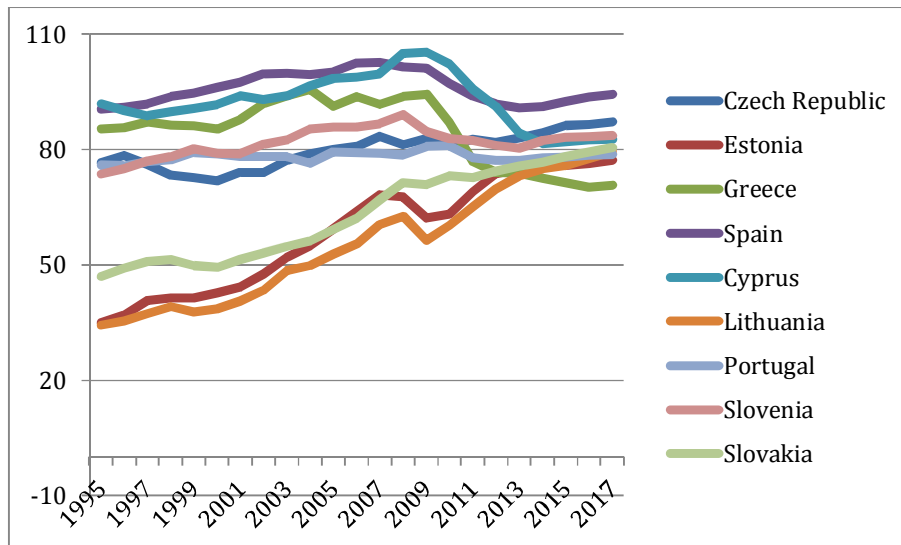
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Which league for Spain?

Spain is still the economic leader of the European periphery. (We exclude Italy, which, for purposes of this type of analysis is effectively two countries in one.) The figure below shows GDP per capita for the EU member states from the South and wealthier members from the East. The picture shows a remarkable convergence over the last decade to somewhere between 70 and 85% of EU average income per capita. Spain is the only exception, having stabilised at above 90% and is now restarting the convergence process.

Figure 1. Convergence of GDP per capita in selected EU member states in South and East, 1995-2017 (EU average = 100)



Source: AMECO.

While countries like Estonia, Lithuania or Slovakia managed a remarkable growth performance since the enlargement, they are still at the bottom of what one could call Europe's No 2 League. On the other hand, the Czech Republic and Slovenia, countries that have long been on par with Portugal and Greece, have not managed sustained convergence since the enlargement. So it would be somewhat premature for an Estonian or a Slovak Prime Minister to predict that their country will join the Champions' League sometime in the next decade. While it is by no means easy to get to the top half of the No 2 League, it is even tougher to break out of the periphery and join the core.

Spanish politicians, civil servants, think-tankers and academics with whom I have recently spoken during a week-long visit to the country might not have this figure taped to their wall, but they are unified in speaking about the need to find a "new economic growth model". Despite major differences on the exact prescription for change and (sometimes) virulent mutual dislike, they agree on much of the diagnosis.

The internal debate among Spain's elites on the new model is very sophisticated in at least two ways. First of all, it does not treat the crisis as a temporary aberration on an otherwise steady and guaranteed ascent towards success, but rather as a wake-up call that requires a comprehensive review of "how things always worked". Secondly, it goes beyond the usual

talk about the need for improved labour market, education and innovation performance and links these together with the need for a radical institutional upgrade of the Spanish state.

In other words, the Spaniards with whom I spoke understand that Champions' League education and innovation performance are conditional on improved governance. This applies to a variety of areas ranging from corruption of local and regional politicians and public participation in politics and policy-making through (in)efficiency of public administration and selection procedures of academics at the universities to strengthening competition by weakening oligopolies in energy, oil and telecommunications markets.

This recognition, however, also makes the politics of forming a government very difficult. Spain now has four major parties instead of two, and they do not line up neatly along the left-right axis with regard to these key issues. As a result, the country's politics have become a three-dimensional puzzle.

Deadlock and the 3D puzzle

Spain is now in the midst of a major political transition. Ever since the 1982 victory of Felipe González, national politics have been dominated by two parties – the Popular Party (PP) and the Socialist Party (PSOE) – one of which has always governed alone in the past, although sometimes supported by smaller regional parties.

In the December 2015 parliamentary elections, two new parties – Podemos and Ciudadanos – broke this duopoly. As Funke et al. (2015) note, this fragmentation is not unusual following a financial crisis, although Spain is unusual in not having a successful far-right party. Even though traditional parties managed (barely) to keep the 1st and 2nd place, they were no longer able to form a government on their own. Except for a grand coalition of PP and PSOE, no two parties could form a majority coalition either.

Since the opposition ran on a tough platform against PP and especially against its leader Mariano Rajoy, who is widely perceived as arrogant, out-of-touch and even corrupt, no one wanted to join a PP government, especially after Rajoy refused to step down. PSOE tried to put together a centre-left government with Ciudadanos and Podemos, even managing to hammer out a detailed 200-point agreement with Ciudadanos. But, unfortunately, Podemos refused to join or even support this government. And so the country must now move onto new elections...

Seems like a clear case of politicians' short-sighted squabbling, no? Actually, probably not.

First of all, the art of coalition-building is new, not just to Spanish politicians, but also to Spanish voters. While the people wanted a government, it seemed that they would not forgive their party if it gave up on its core values and messages. This is particularly true for the new parties.

Secondly, the 3D political game presents an unusually complicated puzzle.

One dimension is the traditional left-right division on economic and social policy. It is there that the four parties align most neatly, with PP and Ciudadanos on the right, PSOE on the moderate left and Podemos anywhere from left to loony left, depending on your point of view. However, even there one can hear the rumbles of a generational war that cuts across the left-right divide. The PP government made major cuts in public expenditure, but (like

Conservatives in the UK, but also nominally left-wing SMER in Slovakia), protected its core electoral group, namely pensioners.

Spain is also facing a new vs. old political division, reflected both among voters and political priorities. While PP and PSOE still have a lock on older voters, they are nearly extinct among people below 35, where Podemos and Ciudadanos reign. In addition to the people who feel socially excluded and politically disenfranchised, Podemos can also boast millions of educated, employed middle-class young Spaniards who are fed up with the system, or as Podemos calls it, with “La Casta”.

This division not only reflects a distrust on the part of younger voters of traditional politicians, but also policy priorities of the new parties. Whether they are talking of participation, anti-corruption or democratic regeneration, both the leaders and the voters of the upstarts emphasise that they are intent not just on seeing new faces, but also new rules of the game.

And as if these cleavages were not enough, Spaniards and their politicians are also divided by the nationalities’ issue, which is manifested particularly strongly with regard to the Catalan issue. While Catalonians are becoming independence-minded, only Podemos is sympathetic to those aspirations, while the other three parties (and most Spaniards) consider it an extremely dangerous game, with the very destiny of the country itself at stake.

The election results depend on which of the dimensions prevails in voters’ minds as they go to the polls.

The currently governing PP is betting on its hard-won reputation for economic competence and fear of communists (as they like to paint Podemos). After gruelling austerity, Spain is currently among the fastest-growing European economies, but there is a familiar gap between start of the economic turnaround and the time when voters genuinely begin to appreciate it. On the other hand, PP has implemented a tough programme of expenditure cuts in welfare, education and health, which tends to be politically lethal when coupled with corruption scandals. As a result, PP’s share of the vote declined from the previous 45% to 28% in the December 2015 election. No one, including its enemies, expects it will go much lower and if it succeeds in its campaign of polarisation, it can even go up.

The Socialist PSOE has been one of the most successful left-wing political machines in Western Europe over the past 35 years in its ability to bring together blue-collar and white-collar voters. But now that has turned into a liability, and PSOE appears to be caught in the middle, between both the past and the future, and the left and the right. Its travails are similar to the problems facing Social Democrats across Europe or Hillary Clinton, but with 22% of the vote in the December election, they cannot afford to lose more ground.

Their biggest nemesis is Podemos (“Yes we can”), the party that is the most difficult to pin down since it is rooted in Latin American left-wing populism, Spanish Marxist-Leninist tradition as well as more recent social movements, such as the celebrated protests of May 15, 2011. Even its members and voters have different views on exactly what positions it would take in government. Its origins can be traced to NGOs, academia and social movements and its leaders place strong emphasis on participatory politics. It has disturbing links to Venezuela and some other regimes of ill-repute, and when it negotiated with PSOE, it reportedly requested ministries of hard power rather than social, education or labour portfolios. Many Spaniards trust it as the only force able to break the lock of “La Casta” on Spanish politics. At the moment, it is concentrating on achieving “Sorpasso”, receiving one more vote and seat

than PSOE. Its obvious role model is SYRIZA and its replacement of PASOK in Greece, but the economic and political situation in Spain does not appear to favour such a radical shift.

The last and, at the moment, the least of the big parties is Ciudadanos (Citizens). Although it has existed since 2006, until recently it was an obscure Catalan party fighting Catalan nationalism. Then it was catapulted into national politics by a combination of an extremely charismatic leader (Albert Rivera) and the demand for political change by disappointed PP and PSOE voters who are more liberal and anti-nationalist than Podemos fans. As one of its MPs told me, Ciudadanos is an “OECD party” of “best practice” policy ideas, unencumbered by too much ideological baggage. In the Netherlands or Denmark, it could be reformist Social Democrats and no one would bat an eyelash.

What does Spain need to do to join the Champions’ League?

All parties, with the possible exception of Podemos, are fully aware that fiscal sovereignty is the first condition of any ambitious modernisation effort. Between 2010 and 2014, Spain reduced its structural fiscal deficit from more than 7% of GDP to less than 2%. Since the economy’s performance falls far below its potential, the headline fiscal deficit is still around 5%. The debt is stabilising around a high 100% of GDP. The pre-election political concerns and post-election uncertainty led to a slightly more-expansive policy and since the headline deficit is still above the 3% threshold, the European Commission is soon going to recommend tougher action than it has previously. On the other hand, continuing growth should mean that Spain meets the 3% benchmark in 2017, even without much additional effort.

Spain is sick and tired of austerity, but despite the trauma of the crisis and the semi-rescue by the EU, Spain remains one of the most pro-European member states. As one observer told me: “Spaniards blame their own politicians and bankers, not Europe, for the mess.” But he also adds that “we did not expect Europe to be such a tough mother”.

There seems to be confidence that a combination of the country’s size and reform efforts should give it some wiggle room on the speed of further fiscal consolidation. Both PSOE and Podemos have openly expressed a willingness to increase taxes to achieve this, arguing that Spain collects significantly below the EU average in tax revenues. If Podemos led the government, there is even a possibility that it would engage in a ‘game of chicken’ over fiscal policy, especially if the inexperienced Podemos leadership miscalculated the European response. There appears to be little likelihood of this actually happening, however, and in any case, Podemos would probably not be able to form a government with such a radical programme with either PSOE or Ciudadanos.

There is general agreement that education, innovation and reform of the labour market are crucial policy areas for the next government to tackle.

In education, there is also a large consensus on unimpressive outcomes (e.g. in PISA), high drop-out rates in upper-secondary education and the mediocrity of the country’s universities and their lack of participation in the innovation cycle. On possible remedies, Spain faces a familiar, longstanding left-right division. When a regional PP functionary speaks about a lack of discipline and lower standards in schools and intellectuals close to PSOE or Podemos complain about the atrocious effects of publicly funded private schools on equality, you might as well be in the United States, the UK, France or ... nearly anywhere where education policy has become highly politicised. Ciudadanos and, to some extent, PSOE are trying to push a

third way of technocratic reform, but – given the power of trade unions in PSOE and of the Church in PP – this is not going to be an easy task.

On universities and innovation, the ideological divide is much less relevant, but that is true in many other places that have nonetheless not managed to make much progress. A foreign-educated academic declared it essentially impossible to get employed at a university without being ‘home-grown’. Given the salary levels and the environment, however, she was not much interested anyway. Spain thus has a pool of highly educated innovators and internationally successful firms, but research (Santana et al., 2016) shows that allocation of capital to firms by the financial sector had essentially zero correlation with how well they were able to use it. What economists euphemistically called “product market competition” also remains a big challenge for Spain.

It is here that the ‘policy’ and ‘governance’ challenges of Spain interact most visibly. It is not corruption per se that is the biggest problem, but rather a culture of connections instead of meritocracy, not to mention an emphasis on regulation and risk aversion rather than on competition between individuals as well as between firms.

For some time now, Spain has had a two-tiered labour market, consisting on the one hand of insiders with permanent contracts and high employment protection and of outsiders, on the other, who are either unemployed or who cycle between temporary contracts. Atrocious levels of unemployment (26% at its peak in 2013) and a relatively strong consensus among elites on the need for change enabled the PP government to carry out partial liberalisation with mixed success. Employment is growing strongly and the unemployment rate is expected to drop below 20% this year or next.

The reality of the Spanish labour market, however, has changed much less than the laws. Wage-setting mechanisms, active labour market reform and labour contracts need significant modernisation, on which there seems to be broad agreement behind the scenes, but a big conflict once leaders step onto the stage. This is a policy area that will probably depend strongly on the shape of the new government. In particular, Podemos’ participation in government is likely to prevent further changes and could even mean a reversal of some of the previous policy measures.

Labour market reform is also inextricably tied to the governance issues and regionalism. Spain has ineffective active labour market policies, which are largely focused on job creating subsidies. Experts agree that a shift to investment in human capital that facilitates a reallocation of labour to growing sectors and enterprises is essential. Such a strategy, however, requires a much more effective state either as regulator or as purchaser; otherwise, the expenditure could be even less effective than the job subsidies.

On wage-setting, the PP government has tried to push wage bargaining from the regional and sectoral level more to the individual firm level to take into account different levels of productivity and market success. While many firms took advantage of temporary measures that allowed them to opt out of more centralised arrangements in times of economic difficulty, there is much less uptake of options for more long-term and systematic decentralisation of collective bargaining.

Without further reform, there is no reason to believe that Spain can drive unemployment below its long-term average rate of 15% or maybe not even that far. Its urgency therefore remains unabated, regardless of the current employment growth.

The country has been through a number of corruption scandals in recent years, which frequently revolve around a toxic mixture of real estate development, government-owned banks and zoning regulations. Regional and local politicians have been implicated in a number of these scandals, but some issues reach all the way to the top. It is these scandals that have led many Spaniards to believe that all politicians, despite ostensible policy differences, are simply members of a corrupt and self-serving *La Casta*.

To foreign observers and many members of the domestic elite, this seems slightly overwrought. The Spanish state is different from the Italian or Greek state. The central civil service receives high marks for cleanliness, quality and stability, and law enforcement institutions have shown themselves to be able to stand up to political corruption. There appears to be very little if any corruption at the retail level, whether in education, healthcare or other services.

As both the Spanish and the Irish cases showed, however, even limited governance and corruption problems can nearly destroy the state, if they are concentrated in important areas (e.g. the financial sector) and if they are allowed to get out of hand. Also, given the high level of decentralisation in Spain, the probity and quality of regional governments are of paramount concern. The crisis appears to be shifting the culture towards both vigorous monitoring of the state by the civil society and zero tolerance towards any abuse. Even though such a stance may be traumatic in the short run, it will, if sustained, lead to a new equilibrium of much less corruption and a partial restoration of public confidence.

Will this crisis go to waste?

Spain now has a new generation of leaders. With the exception of Prime Minister Rajoy, all the major party leaders are between 35 and 45 years of age. This is exceptional by nearly any standard. It also has a vigorous public debate on key policy issues and the political parties are learning to live within the new 3D political puzzle. In the past five years, successive governments have taken significant efforts to “save Spain from the troika”, as one economist put it.

Nonetheless, there is a lot of scepticism in Madrid about the ability of any new government to take on the crucial modernisation challenges. My personal view is slightly more optimistic.

The most positive sign is that – even with 3% economic growth – an appetite for far-reaching change is still in the air. It is true that desire for a broader shift towards meritocracy and competition is not universal. But *Ciudadanos*’ swift rise in the polls is linked to the fact that it is a strong proponent of such an approach. *Podemos* is both more radical vis-à-vis the current political system and similar to *SYRIZA* in focusing more on obtaining and consolidating power than on specific reforms. Under pressure from the upstarts, both traditional parties are evolving, although insiders from each were very vocal in their criticism of the level of institutional sclerosis.

If Spain can repeat its ascension to the Champions’ League – but this time on a more sustainable and long-term basis – it will hold many lessons for other ambitious policy-makers from Southern and Central and Eastern Europe. If not, mediocre policy performance, a high level of public debt and a slow-growth European environment can make for long-term misery.

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