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Europe's Entitlement Reckoning

From Greece to Italy to France, the welfare state is in crisis.

In the European economic crisis, all roads lead through Rome. The markets have raised the price of financing Italy's mammoth debt to new highs, and on Tuesday Silvio Berlusconi became the second euro-zone prime minister, after Greece's George Papandreou, to resign this week. His departure may keep the world's eighth largest economy solvent for the time being, but it hardly addresses the root of the problem.

In Italy, as in Greece, Spain and Portugal and eventually France, the welfare-entitlement state has hit a wall. Successive governments on the Continent, right and left, have financed generous entitlements with high taxes and towering piles of debt. Their economies have failed to grow fast enough to keep up, and last year the money started to run out. The reckoning has arrived.

If the first step in curing an addiction is to acknowledge it, there is little sign of that in Europe. The solutions on offer are to spend still more money, to have the Germans bail out everybody else, or to ditch the euro so bankrupt countries can again devalue their own currencies. France's latest debt solution includes raising corporate, capitals gains and sales taxes.

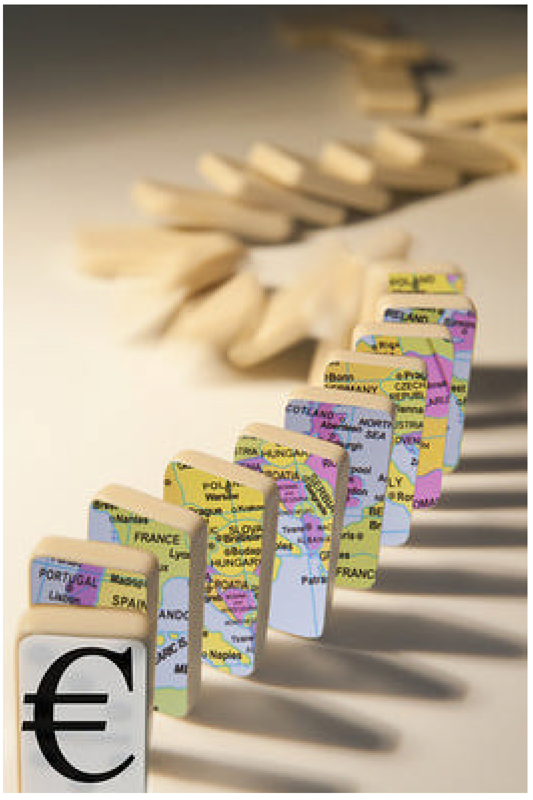
Yet Europe's problem isn't the euro. If it were, Hungary, Iceland and Latvia—none of which use the euro—would have been spared their painful days of reckoning. The same applies for Britain. Europe is in a debt spiral brought about by spendthrift, overweening and inefficient governments.

This is a crisis of the welfare state, and Italy is a model basket case. Mario Monti, who is tipped to lead a new government of technocrats, once described the Italian economy as a case of "self-inflicted strangulation." Government debt is 120% of GDP, making Italy the world's third largest borrower after the U.S. and Japan. Its economy last grew at more than 2% a year in 2000.

An aging and shrinking population is a symptom, but not a leading cause, of the eurosclerosis. A fifth of Italy's 60 million people are 65 or older and make increasingly expensive claims on state-paid pensions and other benefits. In fast-growing Turkey, only 6.3% fit that demographic. Italian women have on average 1.2 children, putting the country's birth rate at 207th out of 221 countries.

But the bulk of the responsibility lies with politicians. Mr. Berlusconi, Italy's richest man, promised a shake up each time he ran for office (in 1994, 1996, 2001, 2006 and 2008). He was the longest serving premier in post-war Italy, from 2001 to 2006, controlled parliament and could have pushed through reforms. He didn't. Promises to lower taxes and hack away at regulations and protections for Italy's powerful guilds—from taxi drivers to pharmacists to journalists—were broken.

"It is not difficult to rule Italy," Benito Mussolini once said, "it is useless." The so-called concertazione, or concert, of Italian coalition politics that brings together numerous parties in the Parliament makes for unstable and indecisive governments. So does the fear prominent in many European countries that any serious reform will provoke street protests. An unhappy byproduct of a welfare state is that it creates powerful interests that will fight to the last to preserve their free lunch, no matter the cost to the country.



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But now hard choices can no longer be postponed. And the solution to Europe's debt crisis must begin with reforming, if not dismantling, the welfare state. Europe rose from the economic grave in the 1960s, it rode the Reagan-Thatcher reform wave to more modest growth in the 1980s-'90s, and it can grow again. A decade ago, Germany was called the "sick man of Europe," bedeviled by Italian-like economic problems. But a center-left coalition, supported by trade unions and German society, overhauled labor and welfare codes and set the stage for the current (if still modest) export-led revival in Germany.

The road from Rome may now lead to Paris, Madrid and other debt-ridden European countries. But this is no cause for U.S. chortling, because that same road also leads to Sacramento, Albany and Washington. America's federal debt was 35.7% of GDP in 2007, but it was 61.3% last year and is rising on an Italian trajectory. The lesson of Italy, and most of the rest of Europe, is never to become a high-tax, slow-growth entitlement state, because the inevitable reckoning is nasty, brutish and not short.