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Europe's Supply-Side Revolution

Following Germany's lead, euro-zone nations are pursuing pro-growth reforms that Reagan and Thatcher would admire.

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Looking beyond the latest headlines about Greece's debt crisis, the long-term question for the European Union is: Can it grow? The conventional answer is that it's too sclerotic, too socialist, too indebted. Not so.

Germany is the largest economy in Europe, and it's been the first to recover and the best-performing developed economy since the start of the Great Recession. Since bottoming in 2009's first quarter, German output has grown at an annual rate of 2.8%, compared with 2.4% for the U.S. since its bottom in 2009's second quarter. Germany's unemployment rate is an astonishingly low 5.5%. German youth unemployment is lower than U.S. overall unemployment.

Skeptics point to Germany's success not as proof that Europe can grow, but as a reason why it can't. They worry about the imbalances of German competitiveness versus the large southern economies of Italy and Spain. They argue that the euro—the common currency of Europe—rules out devaluation by less competitive nations, which they hold out as the surest path to rebalancing.

But this is the blessing of the euro, not its curse. The common currency prevents politicians from fantasizing that they can devalue—and inflate—their way to prosperity. Instead, as Italy's new prime minister, Mario Monti, put it, growth "will have to come from structural reforms or supply-side measures."

That's how Germany became what it is today. A mere decade ago Germany was called "the sick man of Europe." It was still painfully digesting the unification of the former West Germany's relatively free and modern economy with the former Soviet-enslaved East. Ten years ago German unemployment was 8.2%—the same as Europe's overall—while U.S. unemployment was 5.7%. What did Germany do that allowed it to charge ahead and trade unemployment rates with the U.S.?

Starting in 2003, Germany under then-Chancellor Gerhard Schroeder began to implement a program of long-term structural reform called "Agenda 2010." The idea was to transform Germany into an economy where business has an incentive to invest, and where labor has an incentive—and an opportunity—to work. This was pro-growth reform that would be very familiar to Ronald Reagan and Margaret Thatcher.

The centerpiece were labor-market reforms designed by a former human-resources executive at Volkswagen AG. The power of unions and craft guilds was curtailed, making it easier for unskilled youth to enter the job market and easier for employers to hire and fire at will. Germany's lavish unemployment benefits were sharply cut back. An unemployed person in social-democratic Germany today can draw benefits for only about half as long as his counterpart in capitalist America.

The immediate reaction was a brief rise in unemployment, as German business was allowed for the first time to optimize its labor force. And there was a backlash by powerful union and guild interests, costing Mr. Schroeder his bid for re-election. But Germany was transformed.

Today's chancellor, Angela Merkel, who replaced Mr. Schroeder, has praised him for his "courage and determination." She is now spearheading the effort to repeat his Agenda 2010 template throughout Europe. Surely if Germany could start with the wreckage of a communist slave-state and make itself into the most dynamic developed economy in the world, its template could transform sluggish and over-indebted economies like Italy and Spain.

Prime Minister Monti in Italy, and Spain's new prime minister, Mariano Rajoy, are deeply committed to this vision, and they are well on their way to implementing it. It won't be easy. They're up against what Mr. Monti calls "the blocking powers of lobbies and special interests." Read: unions.

In Spain, Mr. Rajoy's government has already legislated new rules allowing companies to drop out of collective-bargaining agreements. Lavish statutory requirements for severance pay, making it financially impossible for businesses to fire workers as competitive conditions change, have been slashed.

With unemployment already at 23%, and youth unemployment at 49%, this would seem to be political suicide. But Mr. Rajoy was elected promising to implement these reforms, which originated with his predecessor José Luis Rodríguez Zapatero. The electorate seems to realize that, as the German experience shows, businesses will only dare to hire when they know they have the option to fire.

In Italy, Mr. Monti has raised the retirement age and is shaking up labor markets—crushing barriers to entry in previously protected professions from pharmacy and baking to taxi-driving. He isn't loved by incumbent pharmacists, taxi-drivers or bakers, but he's wildly popular with the electorate that realizes that more competition means more jobs and a higher standard of living.

Similar pro-growth reforms are taking place in Portugal. The dynamic Irish economy doesn't need them—it's still the Celtic tiger; all it needs is to shake off the shock of its banking crisis. Greece? That one is probably beyond reform. But a tiny nation with a GDP the size of Boston's won't hold back Europe's growth.

The transformation of Europe is being made possible—as serious reform is everywhere and always—by crisis. For all the strikes and protests and backlash (which Reagan and Mrs. Thatcher faced), Europe seems to know now that its tax-spend-borrow-and-protect social democratic past cannot be its future.

The discipline of debt is driving Europe to closer political integration, too. And this, in turn, feeds back into Europe's growth potential. It's not just that closer integration would realize economies of scale, accelerating those already begun by adopting a common currency. It's that if Europe's squabbling nations could only erase their political boundaries, its debt problems would vanish.

Consider Italy and Spain. Italy has a lot of debt, but the second lowest deficit-to-GDP ratio in Europe, after Germany. Spain has a large deficit, but the lowest debt-to-GDP ratio of the large

European economies, even Germany. If Spain and Italy were to become a single country—let's call it Spitaly—its fiscal profile would be almost identical to that of France. If all the 17 countries that use the euro were to combine into a single nation—call it Europa—its fiscal profile would be better than that of the U.S.

This is more than a thought experiment. Already Germany and France have bilaterally negotiated the beginning of a fiscal partnership, with harmonized tax rates and joint budgeting. And there are multilateral treaty changes being formalized now, among all 27 European Union members except for the recalcitrant U.K. and Czech Republic, that will enshrine stronger joint fiscal discipline and oversight.

In the 1970s, conventional wisdom held that the U.S. couldn't compete against Japan and, yes, Europe. But fear clarified our minds, and the supply-side revolution we dared to undertake in the 1980s restored America's growth and competitiveness. Conventional wisdom today holds that Europe is doomed. To the contrary. It is, bravely, starting its own supply-side revolution.

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