Inequality and Europe's Political Malaise

Branko Milanović

Street art reading "The Future Is Europe" is seen on the side of building near to the European Council headquarters on June 23, 2017 in Brussels, Belgium. (Photo by Leon Neal/Getty Images)

> In this series of two independent articles, Branko Milanovic discusses the political effects of internal and external migration in the European Union. Milanovic acknowledges the political malaise created by the management of these flows and argues it may only be fixed by solving inequality within the Union and out of it.

Where are the limits of Europe?

We know that there is such a thing as an 'optimal currency area', although it is possible that the framers of the Lisbon treaty were not aware of it. The Greek crisis has popularised the concept. As the name says, it puts limits to what should (ideally) be a single currency area.

Similarly, in the 1990s, when at one end of the European continent countries like the USSR, Czechoslovakia and Yugoslavia dissolved, with their constituent member states applying to join the European Union, a like question was asked: why would you leave one union and join another, rather than keep your full independence? One of the answers came in a 1996 article, where I argued that there was a trade-off between independence in policy-making (say, full fiscal and monetary authority) and income. Countries such as Estonia and Slovenia were quite willing to give up monetary and (to a large degree) fiscal independence, in exchange for monetary transfers and the institutional framework provided by the EU.

But this reasoning still left the question: was there a point where a country might find the cost, in terms of forgone policy discretion, too onerous and so decide to stay out (thus placing a limit to the expansion of the union)? Perhaps Switzerland and Norway are such non-EU examples.

Limiting factor

Almost nobody looked at inequality as a limiting factor in the growth of a union. Yet there are at least three reasons why it may be.

First, a union with member states at very different income levels requires large transfers from the richer to the poorer to function normally. Secondly, a very unequal union is, by definition, composed of member states whose endowments of capital and labour are very different. Hence, the optimal economic policy for a poor member may not be the same as the optimal policy for a rich member. (We find here echoes of the optimal currency area.) Thirdly, and currently perhaps most importantly, if such a union implies freedom of movement systematic labour flows which then follow —with people moving from poorer to richer members— may be politically destabilising, if richer members are unwilling to accept migrants.

The third point may be largely responsible for ‘Brexit’. It could be argued that without the EU’s eastern enlargement there would have been no Brexit. Thus the EU, implicitly, faced a trade-off of its own: it could have the UK or Eastern Europe —but not both. Through a succession of steps, and largely unaware of this choice, the EU picked the latter.

Income differences

Behind the movement of people are the underlying differences in income among countries. This is why Romania is estimated to have ‘lost’ almost 2 million of its citizens since it joined the EU. But how large are income differences within the union?

Let us start with the most simple and most important, ignoring differences in income within countries and looking only at those between EU countries (thus in effect assuming that every person in a given member state has the mean income or per capita gross domestic product of that member state). And let us take as the measure of inequality the Gini coefficient, which ranges from 0, at full equality, to 100, when the entire income is held by one person/entity.

The results are quite striking. In 1980, when the EU was composed of only nine member states, the between-country Gini coefficient was just three points. Combining the nine members into one group added to the total EU inequality (through their differences in development) an utterly negligible quantity. More than nine tenths of EU9 inequality was due to within-country income differences (that is, income differences between poor and rich people within France, within the Netherlands and so on).

A decade later, in 1990, the between-country Gini for the now EU12 had already doubled to 6 points. Fast forward 14 years more and, with the eastern enlargement, the number of member states went up to 25 and the Gini yet again more than doubled to 13 points. It has increased further, but slightly (to 13.5), with the additions of Romania, Bulgaria, and Croatia. Now, the estimates of interpersonal inequality (that is, between all citizens) in the EU range between 37 and 39 Gini points. This means that one third of overall EU inequality (13.5 out of 37-39) is now systemically built in, due to the underlying differences in income among the member states.

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Compare the EU28 with the US50 —the United States composed of 50 members (its states). Overall US50 inequality is higher than that for the EU28: the Gini for the US is in the lower 40s, whereas the European Gini is in the mid-to-upper 30s. But only about one tenth of that inequality in the US is ‘caused’ by inequality between states while, as we have seen, a third of inequality in Europe is caused by differences in income between the member states.

Hard to fix

European inequality (which thus decomposed looks very much like Chinese inequality, similarly driven to a significant degree by provincial income differences) is much harder to fix. It requires strictly geographic transfers of purchasing power from rich to poor member states. Since the population compositions differ, this translates into transfers from (say) the Dutch to the Bulgarians. But an EU budget of 1 percent of total GDP is laughably small for such transfers.

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> investment and involvement in those countries—the opposite of what it is doing now.

The alternative solution is to let people migrate. This is what the EU has done, with political consequences which are obvious today. We can then legitimately ask: are there limits to EU enlargement—limits imposed by the higher inequality arising from the accession of new and poorer members? If Turkey alone joined, the underlying Gini of a new union would be 17 points. If the western Balkans' four candidate members joined as well, it would rise further to 17.5. This underlying inequality, which is not subject to domestic or EU-wide economic policies (the latter because the EU budget is so small), would then represent close to half of the overall inequality among 615 million citizens of the union.

It would be an unmanageable union.

This is why the EU should not continue with its unsustainable policy, which seems to offer candidate countries potential membership at the end a very long (or, rather, interminable) tunnel. That policy leads only to frustration on both sides. The EU should look at things as they are and create a new category of countries which will not be members for any realistic period of time.

Perhaps it could wait until such potential members become richer on their own, which means the EU should by all means encourage greater Chinese investment and involvement in those countries —the opposite of what it is doing now. Or perhaps it could wait until convergence of incomes within EU members and lower all-EU inequality permits another round of enlargement —which is unlikely to happen before the second half of this century.

Europe's Curse of Wealth

I have already written before (in a tweet) that no one who travels through Western Europe, especially in summer, can fail to be impressed by the wealth and beauty of the continent as well as by its quality of life. The latter is less obvious in the United States (despite its higher per capita income) in part because of the greater size of the country and lower population density: America thus does not present to the traveler the spectacle of an impeccably maintained countryside dotted with numerous castles, museums, excellent restaurants with Wi-Fi, that one sees in France, Italy or Spain.

I think one can reasonably argue that no people in the history of the world have lived so well as west Europeans today—and Italians in particular. Yet, as everybody knows, there is a deep malaise and dissatisfaction across the continent, not least in Italy: unhappiness with how European politics work, with immigration, with the prospects of the younger generation, precariousness of jobs, inability to compete with a cheaper labour force from Asia or to catch up with American IT giants and US start-up culture. But I will not write about this today. Instead, I would like to focus on two 'curses of wealth' which paradoxically European prosperity lays bare.

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The first curse of wealth has to do with migration. The fact that the European Union is so prosperous and peaceful compared both to its eastern neighbours (Ukraine, Moldova, the Balkans, Turkey) and, more importantly, to the Middle East and Africa means that it is an excellent emigration destination. Not only is the income gap between the 'core' Europe of the former EU-15 and the Middle East and Africa huge, it has grown in size. Today, west European GDP per capita is just shy of $40,000; sub-Saharan Africa's GDP per capita is $3,500 (or a gap of about 11 to 1). In 1970, Western Europe's GDP per capita was $18,000, sub-Saharan Africa's $2,600 (a gap of 7 to 1). Since people in Africa can multiply their incomes tenfold by migrating to Europe, it is hardly surprising that, despite all the obstacles that Europe has recently begun placing in the way of migrants, they keep on coming. (Would, say, a Dutch citizen be indifferent to making 50,000 euro annually in the Netherlands compared to half-a-million in New Zealand?)

Inexorable movement

Given the size of the income gap, migration pressure will continue unabated or amplify for at least fifty or more years —even if Africa in this century begins to catch up with Europe (that is, to grow at rates higher than those of the EU). Nor is that pressure, in terms of the number of people who are banging on Europe's doors, static. Since Africa is the continent with the highest expected population growth rate, the numbers of potential migrants will rise exponentially. While the population ratio between today's sub-Saharan Africa and the EU is 1 billion vs. 500 million, in some 30 years, it will be more like 2.2bn to 500m.

But migration, as everybody knows, creates unsustainable political pressures on European countries. The entire political system is in a state of shock —as Italy's cries of having been left to fend for itself by its European partners in dealing with migration, or Austria's and Hungary's decisions to erect border walls, illustrate. There is hardly a country in Europe whose political system has not been shaken by the question of migration: right-wing shifts in Sweden, the Netherlands, and Denmark; accession to the parliament of AfD in Germany, the renewed appeal of Golden Dawn in Greece.

> European inequality is, in part, a «curse of wealth» too.

Other than migration, the second issue fuelling European political malaise is rising income and wealth inequality. European inequality is, in part, a 'curse of wealth' too. The wealth of the countries whose annual income increases over several decades does not rise only in proportion to income but by even more. This is simply due to savings and the accumulation of wealth. Switzerland is not only richer than India in terms of annual production of goods and services (the ratio between the two countries' GDP per capita at market exchange rates is about 50 to 1) but Switzerland is even "richer" in terms of wealth per adult (the ratio is almost 100 to 1).

The implication of the rising wealth/income ratio as countries grow more prosperous is that the amount of income from capital tends to increase faster than GDP. When wealth is heavily concentrated, as is the case in all rich countries, the rising capital share in total output almost automatically leads to an increase in inter-personal income inequality. To put it in simple terms: what is happening is that the income source that is very unequally distributed (profits, interest, dividends) is increasing faster than the source that is less unequally distributed (wages). Thus, if the very process of growth tends to produce higher inequality, it is clear that stronger measures to combat its rise are needed. But in Europe, as in the United States, there is lack of political will (and perhaps it is difficult to summon it in the era of globalization when capital is fully mobile) to increase taxes on high earners, to reintroduce in many countries inheritance tax, or to enact policies in favour of small, rather than big, investors. There is thus a policy paralysis in the face of political upheaval.

When one puts these two longer-term trends together —continued migratory pressure and a quasi-automatically rising inequality— or the two problems that today poison European political atmosphere, and one contrasts this with the difficulty of moving decisively towards solving either of them, it is not surprising that one might expect political convulsions to continue. They will not be done and dusted in a couple of years. Nor does it make sense to accuse 'populists' of irresponsibility or to believe that people's preferences have been distorted by 'fake news'. The problems are real. They require real solutions.

Branko Milanović
Branko Milanović is a Visiting Presidential Professor at the Graduate Center City University of New York and Senior Scholar at the Stone Center for Socio-economic Inequality. He served as a lead economist in the World Bank's Research Department for almost 20 years, leaving to write his seminal book on global income inequality, Worlds Apart (2005). He was a senior associate at the Carnegie Endowment for International Peace in Washington and has held teaching appointments at the University of Maryland and at the Paul H. Nitze School of Advanced International Studies at Johns Hopkins University.