

## The Roots of European Division

With the European Parliament elections fast approaching, many fear a surge in support for populist anti-immigrant forces. But while Europe's political polarization may sometimes look like a culture war over migration, ultimately it stems from regional economic disparities that EU leaders must address writes **Federico Fubini for Project Syndicate**



Source: Shutterstock

Governments in some countries on the periphery of the European Union are staunchly opposed to immigration on nationalist grounds. And yet their constituents are increasingly worried about the opposite threat: that their friends and family members will pick up and leave. In fact, Hungarians, Poles, and Italians have already been departing their respective countries in droves, and recent polling finds that those who remain are far more worried about the citizens leaving than the foreigners coming in.

According to the European Council on Foreign Relations, 52% of Italians would support legislation making it “illegal for their own citizens to leave for long periods of time,” as would 50% of Poles and 49% of Hungarians. And similar attitudes can be found in Romania and Spain, albeit without the same levels of widespread “exit anxiety.”

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Nonetheless, with European Parliament election next week, the ruling parties in Budapest, Warsaw, and Rome are drumming up fears of an immigrant “invasion” that is supposedly already underway. The apparent contradiction between this message and what voters actually feel is worth considering as we try to predict what the next EU Parliament will look like.

One complicating factor is that nationalist and populist parties in some of the countries experiencing mass emigration actually thrive on the anxiety it creates. The free movement of people, after all, is one of the defining pillars of the European project, and increased intra-EU migration is often regarded as a sign of that project’s success.

## **The invisible transfer union**

Official statistics most likely underestimate the extent to which Central and Eastern Europeans have emigrated to other parts of the EU. According to studies based on Eurostat data, most Central and Eastern European member states have experienced double-digit population declines. Between 1989 and 2017, 20% of Romanians, 12% of Bulgarians, 7% of Poles, 5% of Hungarians, and 3% of Italians have lived and worked abroad.

Yet, because Eurostat data include only migrants who notify their governments of their departure, the actual figures are no doubt higher. Many migrants don’t bother cancelling their residence before leaving, but they all must register in their new host country in order to secure work. Hence, in 2017, Italy reported that 22,000 of its nationals had migrated to the United Kingdom, whereas the UK Department for Work and Pensions registered 50,000 new arrivals from Italy that year.

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The main destination for intra-EU migration, however, is Germany. According to Destatis, the German statistics office, net intra-EU migration into the country totalled 2.7 million between 2008 and 2017. All told, around two-thirds of the newcomers hailed from the 11 EU member states to Germany’s east and southeast; most of the remainder arrived from Portugal, Spain, Italy, and Greece.

Thus, in the space of less than a decade, the EU’s newest members have performed two

remarkable favours for the bloc's strongest economy. First, the influx of workers from Central and Eastern Europe has more than compensated for Germany's own natural demographic decline, which would have implied a loss of 1.6 million people between 2009-2017 (the country has registered more annual deaths than births since 1972).

Second, the EU's newest members have poured more than €100 billion (\$112 billion) of their own money into the German economy, through investments in education and training for the two million younger workers (average age 30) who have moved there. If one includes migrants from Southern Europe, even a cautious estimate of primary, secondary, and tertiary education costs would yield a figure well over €200 billion for the 2009-2017 period. Those Northern European politicians and pundits who are so horrified about the EU becoming a "transfer union" should take note.

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Needless to say, given that highly educated workers represent a disproportionately large share of the overall emigrant population, the EU core has benefited from this brain drain, while the periphery has lost out. Research by the International Monetary Fund shows just how much this loss of skilled labor and talent has hindered productivity growth in the source countries. The result has been to widen the income gap between the EU's most and least developed economies, thus further strengthening the incentive for workers to migrate from the periphery to the core.

## All work and no pay

It is no coincidence that liberal democracy and the rule of law have come under strain in the countries most scarred by emigration: Hungary, Poland, Romania, and Bulgaria. The predominantly younger people who leave are also among the more liberal and self-reliant cohorts of the electorate. With more open minds, and in pursuit of personal aspirations, they opt for what the economist Albert O. Hirschman would call "exit." Rather than staying at home and exercising "voice" against an increasingly illiberal status quo, they cede influence to those who are motivated primarily by "loyalty" to it.

That said, not all of the countries on the EU's periphery are in the same situation; in fact, there is a broad difference between Southern and Central/Eastern Europe. In the former, the average income lag vis-à-vis core EU countries is mostly cyclical and limited, and not far above 10% in terms of purchasing power. But Central and Eastern Europe is a different story. Despite strong growth, economic convergence with Western Europe has remained elusive.

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Consider the average annual income of Estonia, Hungary, Poland, and Romania. By 2016, the annual income of Western Europe (the average of Germany, France, the UK, Italy, the Netherlands, Belgium, Sweden, and Finland) was 42% above that of these countries, compared to 60% above in 1989. Yet in cash terms, the average annual income gap (all data are in 2011 dollars, adjusted for purchasing power) was \$14,751 in 1989 and had grown to just \$17,647 by 2016.

It is little wonder that so many Eastern Europeans head west. In 2018, Germany's gross hourly labor costs were six times higher than Bulgaria's, five times higher than Romania's, more than three times higher than in Poland and Hungary, and well over twice the level of the Czech Republic. Worse, over the past decade, Poland, Hungary, the Czech Republic, and Croatia have diverged from Germany in terms of labor's share of national income, which remains well below that of Western Europe generally.

To understand how this could happen, consider the German carmaker Audi's European supply chain, which encapsulates the larger problem. Audi builds its engines in Győr, Hungary, and then assembles them into a finished product 595 kilometres (370 miles) away in Ingolstadt, Bavaria. Worker productivity is pretty much the same in the Győr factory as in Ingolstadt. But the average Hungarian's monthly base pay represents less than one day of her German counterpart's gross labor cost. At the same time, Audi, like most other large foreign investors, pays almost no taxes in Hungary, owing to special tax breaks and the fact that the value added from the Győr factory is monetized in Germany with the sale of the final branded product.

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The low pay in factories east of the old Iron Curtain is the result of outdated minimum-wage laws that do not compare to the kind of collective bargaining that takes place in much of Western Europe. The minimum-wage model was instituted during the transition from communism in the early 1990s and has clearly proved to be self-defeating. In a race to the bottom, Eastern European countries have competed for pieces of large multinational firms' supply chains by keeping wages low and offering bespoke tax breaks at the expense of state revenues.

## **Representation without taxation**

Making matters worse, EU state-aid rules for promoting economic convergence may unwittingly be doing the opposite. The European Commission permits more substantial corporate-tax breaks in less developed areas, in order to foster job creation and economic growth. Southern Italy and other poorer regions enjoyed this special treatment decades ago, and now Eastern Europeans do.

But there is evidence to suggest that the Commission's regulatory forbearance is having unintended consequences. For example, last year, the German carmaker BMW was able to force Hungary and Slovakia into a bidding war over who could offer the most attractive tax benefits. In the end, Hungary beat Slovakia's offer of a 35% tax break. It offered 50% and will now be host to a new BMW factory.

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This was hardly a one-time occurrence. Investigative reporting by the nonprofit news organization Finance Uncovered has documented many instances of large foreign and domestic corporations receiving sweetheart deals in the EU's newer member states. For example, Audi's sizable profit margin in Hungary in 2015 was taxed at a rate of 0%, as were the supermarket Lidl's profits in the Czech Republic in 2014. Similar examples can be found in Poland and Bulgaria. Among the foreign-owned direct investors benefiting from special tax treatment in the region are Volkswagen's Škoda Auto and Taiwanese manufacturer Foxconn (in the Czech Republic), GE Infrastructure (in Hungary), and Russian energy giant Lukoil (in Bulgaria).

Moreover, Finance Uncovered has found that, contrary to economists' claim that low and flat taxes will increase tax revenue by stimulating economic activity, corporate-tax cuts in Eastern and Central Europe have merely shifted the tax burden onto ordinary citizens. Taxes on the sale of many goods and services in the region are now far above the OECD average, which indicates that governments have offset foregone corporate-tax revenue by soaking working-class households. Far from promoting intra-EU convergence, the Commission's free pass for sweetheart tax deals has merely fattened foreign investors' capital gains.

To be sure, foreign investment in the region has brought knowledge and skills, created jobs, and supported household incomes. The productive capital furnished through EU enlargement and cohesion policies is obviously worth protecting and developing further. The last thing either Eastern or Western Europeans should do is retreat behind closed borders and assume a zero-sum protectionist crouch.

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But the unintended consequences of the current policy mix need to be addressed. Foreign

investment is enriching extractive local elites and distorting incentives as policymakers offer increasingly extreme concessions to attract projects from Germany and elsewhere. In the area surrounding the site of the new BMW factory in Debrecen, Hungary, cronies of Prime Minister Viktor Orbán have won generous local government contracts. Worse, to pull in BMW, Orbán rammed through a highly controversial “slave law” requiring workers to put in up to 400 extra hours per year, while allowing companies to defer overtime wages for up to three years.

## Everyone's problem

More broadly, the warped tax structure and failure to raise salaries in Eastern Europe is contributing to a hollowing out of the middle class across Europe. Workers in the newer, less developed member states know their productivity isn't far below Western levels, but they are nowhere close to being able to afford the same goods and services as their Western counterparts. Latest-generation iPhones, expensive medicines, and high-ranking postgraduate programs for their children are all out of reach, and this is fueling frustration and fatalism across the region.

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At the same time, the working and middle classes in parts of Western Europe are being undercut by the cheaper labor costs to the east. The political reaction is much the same: disgruntled voters have become more open to revanchist and Euroskeptic rhetoric by political leaders promising to “take back control.”

And emigration from East to West continues apace, both reflecting and reinforcing deep economic, demographic, and political divides that have come to threaten all of Europe. Regardless of what happens in the European Parliament election, the EU will have a decision to make: ignore its regional disparities and allow Western member states to continue extracting value from newer members, or accept that unless those disparities are addressed, Europe's enemies will only get stronger.

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### Author

**Alissa Lefebvre**

Economist

[alissa.lefebvre@ing.com](mailto:alissa.lefebvre@ing.com)

**Deepali Bhargava**

Regional Head of Research, Asia-Pacific

[Deepali.Bhargava@ing.com](mailto:Deepali.Bhargava@ing.com)

**Ruben Dewitte**

Economist

+32495364780

[ruben.dewitte@ing.com](mailto:ruben.dewitte@ing.com)

**Kinga Havasi**

Economic research trainee

[kinga.havasi@ing.com](mailto:kinga.havasi@ing.com)

**Marten van Garderen**

Consumer Economist, Netherlands

[marten.van.garderen@ing.com](mailto:marten.van.garderen@ing.com)

**David Havrlant**

Chief Economist, Czech Republic

420 770 321 486

[david.havrlant@ing.com](mailto:david.havrlant@ing.com)

**Sander Burgers**

Senior Economist, Dutch Housing

[sander.burgers@ing.com](mailto:sander.burgers@ing.com)

**Lynn Song**

Chief Economist, Greater China

[lynn.song@asia.ing.com](mailto:lynn.song@asia.ing.com)

**Michiel Tukker**

Senior European Rates Strategist

[michiel.tukker@ing.com](mailto:michiel.tukker@ing.com)

**Michal Rubaszek**

Senior Economist, Poland

[michal.rubaszek@ing.pl](mailto:michal.rubaszek@ing.pl)

**This is a test author**

**Stefan Posea**

Economist, Romania

[tiberiu-stefan.posea@ing.com](mailto:tiberiu-stefan.posea@ing.com)

**Marine Leleux**

Sector Strategist, Financials

[marine.leleux2@ing.com](mailto:marine.leleux2@ing.com)

**Jesse Norcross**

Senior Sector Strategist, Real Estate

[jesse.norcross@ing.com](mailto:jesse.norcross@ing.com)

**Teise Stellema**

Research Assistant, Energy Transition

[teise.stellema@ing.com](mailto:teise.stellema@ing.com)

**Diederik Stadig**

Sector Economist, TMT & Healthcare

[diederik.stadig@ing.com](mailto:diederik.stadig@ing.com)

**Diogo Gouveia**

Sector Economist

[diogo.duarte.vieira.de.gouveia@ing.com](mailto:diogo.duarte.vieira.de.gouveia@ing.com)

**Marine Leleux**

Sector Strategist, Financials

[marine.leleux2@ing.com](mailto:marine.leleux2@ing.com)

**Ewa Manthey**

Commodities Strategist

[ewa.manthey@ing.com](mailto:ewa.manthey@ing.com)

**ING Analysts**

**James Wilson**

EM Sovereign Strategist

[James.wilson@ing.com](mailto:James.wilson@ing.com)

**Sophie Smith**

Digital Editor

[sophie.smith@ing.com](mailto:sophie.smith@ing.com)

**Frantisek Taborsky**

EMEA FX & FI Strategist

[frantisek.taborsky@ing.com](mailto:frantisek.taborsky@ing.com)

**Adam Antoniak**

Senior Economist, Poland

[adam.antoniak@ing.pl](mailto:adam.antoniak@ing.pl)

**Min Joo Kang**

Senior Economist, South Korea and Japan

[min.joo.kang@asia.ing.com](mailto:min.joo.kang@asia.ing.com)

**Coco Zhang**



ESG Research  
[coco.zhang@ing.com](mailto:coco.zhang@ing.com)

**Jan Frederik Slijkerman**  
Senior Sector Strategist, TMT  
[jan.frederik.slijkerman@ing.com](mailto:jan.frederik.slijkerman@ing.com)

**Katinka Jongkind**  
Senior Economist, Services and Leisure  
[Katinka.Jongkind@ing.com](mailto:Katinka.Jongkind@ing.com)

**Marina Le Blanc**  
Sector Strategist, Financials  
[Marina.Le.Blanc@ing.com](mailto:Marina.Le.Blanc@ing.com)

**Samuel Abettan**  
Junior Economist  
[samuel.abettan@ing.com](mailto:samuel.abettan@ing.com)

**Franziska Biehl**  
Senior Economist, Germany  
[Franziska.Marie.Biehl@ing.de](mailto:Franziska.Marie.Biehl@ing.de)

**Rebecca Byrne**  
Senior Editor and Supervisory Analyst  
[rebecca.byrne@ing.com](mailto:rebecca.byrne@ing.com)

**Mirjam Bani**  
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)  
[mirjam.bani@ing.com](mailto:mirjam.bani@ing.com)

**Timothy Rahill**  
Credit Strategist  
[timothy.rahill@ing.com](mailto:timothy.rahill@ing.com)

**Leszek Kasek**  
Senior Economist, Poland  
[leszek.kasek@ing.pl](mailto:leszek.kasek@ing.pl)

**Oleksiy Soroka, CFA**  
Senior High Yield Credit Strategist  
[oleksiy.soroka@ing.com](mailto:oleksiy.soroka@ing.com)

**Antoine Bouvet**  
Head of European Rates Strategy  
[antoine.bouvet@ing.com](mailto:antoine.bouvet@ing.com)

**Jeroen van den Broek**

Global Head of Sector Research  
[jeroen.van.den.broek@ing.com](mailto:jeroen.van.den.broek@ing.com)

**Edse Dantuma**  
Senior Sector Economist, Industry and Healthcare  
[edse.dantuma@ing.com](mailto:edse.dantuma@ing.com)

**Francesco Pesole**  
FX Strategist  
[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

**Rico Luman**  
Senior Sector Economist, Transport and Logistics  
[Rico.Luman@ing.com](mailto:Rico.Luman@ing.com)

**Jurjen Witteveen**  
Sector Economist  
[jurjen.witteveen@ing.com](mailto:jurjen.witteveen@ing.com)

**Dmitry Dolgin**  
Chief Economist, CIS  
[dmitry.dolgin@ing.de](mailto:dmitry.dolgin@ing.de)

**Nicholas Mapa**  
Senior Economist, Philippines  
[nicholas.antonio.mapa@asia.ing.com](mailto:nicholas.antonio.mapa@asia.ing.com)

**Egor Fedorov**  
Senior Credit Analyst  
[egor.fedorov@ing.com](mailto:egor.fedorov@ing.com)

**Sebastian Franke**  
Consumer Economist  
[sebastian.franke@ing.de](mailto:sebastian.franke@ing.de)

**Gerben Hieminga**  
Senior Sector Economist, Energy  
[gerben.hieminga@ing.com](mailto:gerben.hieminga@ing.com)

**Nadège Tillier**  
Head of Corporates Sector Strategy  
[nadege.tillier@ing.com](mailto:nadege.tillier@ing.com)

**Charlotte de Montpellier**  
Senior Economist, France and Switzerland  
[charlotte.de.montpellier@ing.com](mailto:charlotte.de.montpellier@ing.com)

**Laura Straeter**

Behavioural Scientist  
+31(0)611172684  
[laura.Straeter@ing.com](mailto:laura.Straeter@ing.com)

**Valentin Tataru**  
Chief Economist, Romania  
[valentin.tataru@ing.com](mailto:valentin.tataru@ing.com)

**James Smith**  
Developed Markets Economist, UK  
[james.smith@ing.com](mailto:james.smith@ing.com)

**Suvi Platerink Kosonen**  
Senior Sector Strategist, Financials  
[suvi.platerink-kosonen@ing.com](mailto:suvi.platerink-kosonen@ing.com)

**Thijs Geijer**  
Senior Sector Economist, Food & Agri  
[thijs.geijer@ing.com](mailto:thijs.geijer@ing.com)

**Maurice van Sante**  
Senior Economist Construction & Team Lead Sectors  
[maurice.van.sante@ing.com](mailto:maurice.van.sante@ing.com)

**Marcel Klok**  
Senior Economist, Netherlands  
[marcel.klok@ing.com](mailto:marcel.klok@ing.com)

**Piotr Poplawski**  
Senior Economist, Poland  
[piotr.poplawski@ing.pl](mailto:piotr.poplawski@ing.pl)

**Paolo Pizzoli**  
Senior Economist, Italy, Greece  
[paolo.pizzoli@ing.com](mailto:paolo.pizzoli@ing.com)

**Marieke Blom**  
Chief Economist and Global Head of Research  
[marieke.blom@ing.com](mailto:marieke.blom@ing.com)

**Raoul Leering**  
Senior Macro Economist  
[raoul.leering@ing.com](mailto:raoul.leering@ing.com)

**Maarten Leen**  
Head of Global IFRS9 ME Scenarios  
[maarten.leen@ing.com](mailto:maarten.leen@ing.com)

**Maureen Schuller**

Head of Financials Sector Strategy

[Maureen.Schuller@ing.com](mailto:Maureen.Schuller@ing.com)

**Warren Patterson**

Head of Commodities Strategy

[Warren.Patterson@asia.ing.com](mailto:Warren.Patterson@asia.ing.com)

**Rafal Benecki**

Chief Economist, Poland

[rafal.benecki@ing.pl](mailto:rafal.benecki@ing.pl)

**Philippe Ledent**

Senior Economist, Belgium, Luxembourg

[philippe.ledent@ing.com](mailto:philippe.ledent@ing.com)

**Peter Virovacz**

Senior Economist, Hungary

[peter.virovacz@ing.com](mailto:peter.virovacz@ing.com)

**Inga Fechner**

Senior Economist, Germany, Global Trade

[inga.fechner@ing.de](mailto:inga.fechner@ing.de)

**Dimitry Fleming**

Senior Data Analyst, Netherlands

[Dimitry.Fleming@ing.com](mailto:Dimitry.Fleming@ing.com)

**Ciprian Dascalu**

Chief Economist, Romania

+40 31 406 8990

[ciprian.dascalu@ing.com](mailto:ciprian.dascalu@ing.com)

**Muhammet Mercan**

Chief Economist, Turkey

[muhammet.mercan@ingbank.com.tr](mailto:muhammet.mercan@ingbank.com.tr)

**Iris Pang**

Chief Economist, Greater China

[iris.pang@asia.ing.com](mailto:iris.pang@asia.ing.com)

**Sophie Freeman**

Writer, Group Research

+44 20 7767 6209

[Sophie.Freeman@uk.ing.com](mailto:Sophie.Freeman@uk.ing.com)

**Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

**James Knightley**

Chief International Economist, US

[james.knightley@ing.com](mailto:james.knightley@ing.com)

**Tim Condon**

Asia Chief Economist

+65 6232-6020

**Martin van Vliet**

Senior Interest Rate Strategist

+31 20 563 8801

[martin.van.vliet@ing.com](mailto:martin.van.vliet@ing.com)

**Karol Pogorzelski**

Senior Economist, Poland

[Karol.Pogorzelski@ing.pl](mailto:Karol.Pogorzelski@ing.pl)

**Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

**Viraj Patel**

Foreign Exchange Strategist

+44 20 7767 6405

[viraj.patel@ing.com](mailto:viraj.patel@ing.com)

**Owen Thomas**

Global Head of Editorial Content

+44 (0) 207 767 5331

[owen.thomas@ing.com](mailto:owen.thomas@ing.com)

**Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

**Peter Vanden Houte**

Chief Economist, Belgium, Luxembourg, Eurozone

[peter.vandenhoute@ing.com](mailto:peter.vandenhoute@ing.com)

**Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

**Chris Turner**

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

**Gustavo Rangel**

Chief Economist, LATAM

+1 646 424 6464

[gustavo.rangel@ing.com](mailto:gustavo.rangel@ing.com)

**Carlo Cocuzzo**

Economist, Digital Finance

+44 20 7767 5306

[carlo.cocuzzo@ing.com](mailto:carlo.cocuzzo@ing.com)