Eurofound

Developments in income inequality and the middle class in the EU

Introduction

Public perception is that inequality is on the rise and that the middle class is shrinking. This study analyses empirical evidence over 15 years to clarify the validity of this view. It provides a comprehensive picture of income disparities within and between the EU Member States from 2006 to 2021, covering a wide range of interrelated indicators capturing income inequality, the middle class, the degree of income polarisation and the role of public policies in these trends. It examines the effect of the Great Recession and the COVID-19 pandemic on income inequality and provides insights into the impact of the early stages of the cost-of-living crisis, using 2022 data on the material difficulties faced by European households.

Policy context

After years of being sidelined in the policy debate while European labour markets recovered after the Great Recession, inequality is firmly back on the front page following the COVID-19 pandemic and the ensuing cost-of-living crisis. Growing inequality and a shrinking middle class have emerged as concerns in public discourse since these developments threaten the cohesion of European societies.

Support measures were put in place during the pandemic to maintain employment and help families deal with the consequences of lockdowns, mainly through job retention schemes (and minimum income support systems), facilitated by escape clauses from EU fiscal rules.

In the aftermath of the pandemic, energy prices started soaring. The knock-on effects pushed inflation progressively upwards, leading to a cost-of-living crisis, prompting governments to implement policies to help the most vulnerable households deal with their worsening financial situation.

Labour markets and their institutions are basically national, but adopting an EU-wide approach to monitor income inequality is critical against a background of deepening EU integration and enlargement towards the east since the mid-2000s.

Key findings

- EU-wide income inequality declined significantly between 2006 and 2021. This was entirely driven by strong income convergence between EU Member States. Average income inequality within the Member States has remained broadly similar.
- This convergence is explained by remarkable income growth in the Member States that joined the EU with the 2004 enlargement (the EU13) and sluggish progress (or even declines) in many of the pre-2004 Member States (the EU14). In contrast to central and eastern European (CEE) countries, income levels in Mediterranean countries generally failed to converge with higher-income Member States.
- The stability in average income inequality across countries conceals diverging trends. Income inequality increased in around half of the Member States, especially several Nordic and Continental countries (among them Sweden and Denmark, which were much more egalitarian before), while it declined in just over half, mainly several CEE and Mediterranean countries (among them Romania, Portugal, Greece, Poland and Croatia, which were much more unequal initially).
- One of the factors driving income inequality is a widening of wage disparities (which has occurred in around half the Member States); another is the weakening redistributive role of the family in most countries. On the other hand, rising employment (and activity) rates in most countries have reduced inequality. So too has the welfare state's cushioning of inequality in market income (household income before taxes and benefits are taken into account), although the weakening of welfare states in some countries has contributed to growing inequality.

- The growth in income levels in the EU13 was in many cases stronger among lower-income earners, which reduced income inequality. The most positive examples are the CEE countries, although this was not the case in all, because the Great Recession had a particularly strong impact in the Baltic states and other EU13 Member States in the Mediterranean region.
- On the other hand, the more moderate income growth in the EU14, especially among the lowest-income earners, led to growing income inequality (and a shrinking middle class). This occurred in the Nordic countries and most Continental countries. Mediterranean countries present the bleakest picture owing to the protracted effects of the Great Recession on their labour markets.
- An essential difference between the Great Recession and the COVID-19 pandemic was the coordinated policy response across the EU27 during the pandemic, which resulted in employment levels falling more moderately and in fewer countries than during the Great Recession, continuing income growth across most countries (albeit more moderate than before the pandemic) and less significant increases in income inequality (despite it rising in around half of the countries).
- The welfare state plays a critical role in cushioning the effect of market income inequality, reducing it by an average of around 42% across Member States once social benefits and taxes are taken into account.
- A large middle class is characteristic of European countries, representing a majority of the population in all Member States, and this reflects inclusive societies. The size of the middle class fell in almost two-thirds of Member States; however, the analysis does not indicate a generalised significant shrinking of the middle class. It has become increasingly difficult for people with low educational attainment, young people and those out of work to enter the middle class.
- The share of people below the poverty threshold (60% of median income) increased in two-thirds of Member States between 2006 and 2021, which is consistent with the reduction in the size of the middle class, reflecting a movement from the middle class to the low-income class across many countries.
- The best indication of the early impact of the cost-of-living crisis in 2022 is the higher share of households unable to keep their homes adequately warm, since energy price levels grew well above average inflation in 2022. The most precarious households were hardest hit, especially people with low educational attainment, the young, women and those living in single-adult households (especially with children).

Policy pointers

- One of the main tools available to policymakers to reduce income inequality is a strong welfare state. Therefore policy tackling income inequality needs to focus on strengthening the redistributive role of social protection systems, especially in those Member States where the weakening of this role has contributed to growing income inequality.
- A strong welfare state is especially important during economic downturns. In the case of the COVID-19 pandemic, the massive increase in funds allocated to social benefits in 2020 and 2021, mainly through unemployment benefits to finance job retention schemes, prevented a more negative impact on European labour markets.
- Policymakers should be aware of the need to reach the most disadvantaged groups when designing social benefit policies, since many of the lowest-income earners fail to access the benefits they need.
- Most countries need to redesign benefit systems to make them more progressive. Redistributing income on a larger scale would improve the capacity of the welfare state to cushion market income inequality. Taxes on wealth, which are negligible across most countries, would provide more means for such redistribution.
- The situation of those at the bottom of the income distribution in recent years should be of concern among policymakers. Apart from the increase in the share of people below the poverty threshold in 2021 in half of the Member States, non-income data for 2022 covering the early stages of the cost-of-living crisis reflect the growing financial difficulties faced by households. This hardship could be alleviated by targeted policies addressing the uneven impact of soaring price levels across households.

Further information

The report *Developments in income inequality and the middle class in the EU* is available at https://eurofound.link/ef23002

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