

# Chapter 1: Introduction and Summary

**Arjen Siegmann & Matthias Schäfer**

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To study the middle class is to study the 'household in the middle'. The middle class takes care of its own members, through work (paid and unpaid), and is neither poor nor rich. The household is the place where individuals live together and make joint decisions. They form the most free and fundamental structure of society. Their experience and outlook matter, and taking their perspective is different from adopting the usual macro-economic approach that takes the economy as the object of study.

The object of our study is the group of households with incomes that are in a range around the median household income. The median is literally the 'middle' in a sorted sequence of numbers, and a common range for the middle-income class is that of 60% to 200% of the median. Depending on the data that are available for each country, alternatives are used that are close to that range.

The nine countries featured in this volume have been chosen to represent the variety of economic and cultural situations in the European Union: some are founding members of the EU and prosperous, others are more recent members and less prosperous. Some are founding members, but with a disappointing development of prosperity and possibilities. But in each country, middle-class households share a common desire for stable employment and economic possibilities that extend as well to the new generation. Together they comprise around two-thirds of the population and combined GDP of the EU-28 countries.

We summarize the main findings below, and end with a finale of three 'big questions' for European policy makers.

## 1. The income perspective

We start in Chapter 2 with an overview of the size and income evolution of the middle-income class between mid-2000 and 2013, and a number of lessons stand out.

### **A few changes in the size of the middle-income class**

Between 2004 and 2013, the middle class in Ireland and Poland increased in size by almost 10 %-points. The middle class of Bulgaria and Germany decreased by almost 5 %-points; other countries show a size of the middle class that stays roughly the same.

The statements about the size of the middle class also hold for an alternative definition of middle class (for example, of 75% and 125% of median income). Hence, conclusions about middle-class size are not simply a matter of choosing a particular interval of the income distribution.

**Low income growth**

For most countries, the increase in median incomes has been close to zero. That holds also for Germany, for example, notwithstanding the huge improvement in employment. Only Bulgaria and Poland saw an increase in the median real household disposable income between 2007 and 2013: over more than 1%. Extending the period to 2015 gives a similar pattern.

**Household adaptation**

An important phenomenon that is not captured simply by the median household income is the role of household sizes. In the visualisation of Figure 2.3 in Chapter 2, this is represented by the term 'equivalised'. Equivalisation means that household incomes are adjusted for the size of the household: a household with one member counts for 1, a household with two members for 1.4, three members 1.7, and so forth. Equivalisation gives a fairer picture of the actual living standard of a household. Household members share the same house, heating and facilities that contribute to 'economies of scale' that makes living together, apart from the relational aspect, economically attractive. In the process of equivalisation, the total household income is divided by the adjustment factor; the resulting income is allocated to each individual member as his or her living standard.

Adjusting for household size increases considerably the net household income. All countries, except Ireland and Italy, now have a positive or near-zero growth of median incomes. The most remarkable effect is observed for Spain: the negative income growth of 3% becomes a zero. This is accompanied by an increase in the percentage of households with (dependent) children. A similar effect is found for France: the negative income growth per household goes together with a larger number of households with dependent children.

The overall picture is that of households that adapt to economic circumstances. Children remain living at home longer or even come back after having finished studies, middle-class households are now mostly dual-earners, and students make choices regarding their education. This is what we would expect from households who are not passive collectors of wages, but active entities in deciding their working hours and family composition, and taking care of each other. But all of this implies that the changing position of the middle class cannot simply be deduced from income statistics.

**Government policies**

Another aspect of adaption can be seen in government responses to the crisis of the past seven years. Due to the global financial crisis, subsequent recession and Euro crisis, all European governments have needed to reform their finances and enact austerity measures. The measures have not hit every household in the same way, and

governments have taken care to not overburden the lowest incomes. This form of social redistribution influences the income distribution and hence the middle class.

Another form of redistribution is through taxation, which includes not only tax subsidies but also direct social transfers such as welfare payments and pensions. In the social model that we observe in most European countries, these policy measures compress the income distribution based on market incomes. This reduces inequality and impacts the size of the middle class, which can be seen in the reduction in Gini-coefficients by social transfers, see Figure 9 of Chapter 2.

The impact of government policies on the size and income of the middle class is a cause for concern. It is the aim of these policies to provide a social welfare state, but its redistributive effects have a limit. An overly strong effect of redistribution reduces the natural incentives that follow from having to earn a market income (i.e., from wages or entrepreneurship). An outsized degree of redistribution may lead to people opting out of the welfare system completely—through exploiting legal loopholes or by informal types of employment. The existence of these mechanisms suggests that we should monitor the social welfare state so that it helps the most vulnerable households and that the redistribution occurs as efficiently as possible.

## 2. Non-income-related perspectives

There are other trends than income that affect middle-income households. They are discussed under similar headers in the country-chapters and a number of common themes are the following:

### **Bubble and crash patterns in the real estate market**

Being able to afford a house is an essential feature of what people perceive as middle class. This does not necessarily mean ownership of a house, but it does mean a stable situation or the possibility for couples to start a family. Where this is hard, the middle-class outlook is negative.

The wealth situation of the middle classes is strongly defined by real estate property or housing. Hence, the rise and subsequent fall in house prices was felt by many middle-class households in Ireland, the Netherlands and Spain. It becomes harder to move when the equity in the house is negative, and the financial fall-out of a divorce becomes large. Moreover, the experience of a market crash reduces the perception of housing equity being a stable source of wealth for the future.

In Poland, a subset of households experienced a financial setback due to their mortgages being in Swiss Francs. The availability of such mortgages stemmed from financial liberalisation and European cross-border banking rules. But they resulted in high risks for some households that were not equipped to deal with such a level of

financial sophistication. It is an example of financial liberalisation leading to a higher vulnerability to shocks.

### **Insider-outsider problems in housing**

The affordability of housing is closely related to planning restrictions for building new houses. For people with a house, planning restrictions are a protection to nearby development that could lower the financial value of their house or the experienced value of the house and its surroundings. A typical middle-class problem is that of wanting to increase the possibilities of housing for their children, without encountering the drawback of real estate development near their own home.

The problem of housing supply is a force for bubble and crash patterns in the housing market. In a normally functioning market, the supply of houses would adjust (with a lag) to high prices, which exerts downward pressure on prices. However, if planning restrictions hamper new development, prices rise even further and speculative forces can make this even more of a problem.

The perception of a housing shortage is felt in almost every country in this study. In Germany, a “renters’ country”, the government has introduced a “rental price break” to maintain affordability. But it cannot hide scarcity in the availability of housing. It impacts the middle class and their outlook on the housing market. Building more houses seems the most obvious solution, but this needs to be balanced against the demands for green suburban surroundings and the countryside.

### **Work-life balance in the dual-earner model**

In many countries, a family needs to have two earners achieve at least a middle-class income. For some households, this leads to stress in combining breadwinning, education of children and taking over the family duties without depending on welfare.

The concerns are most visible in Ireland, the Netherlands and Poland, where prosperity is rising, but households feel a higher pressure in their working lives. No household wants to be left behind, and people are actively engaged in finding work that both pays well and is fulfilling. But there is a widespread realisation that economic well-being is realised in a more flexible, technologically advanced and globalised world that puts more work-life decisions in people’s own hands.

### **Job polarisation and temporary contracts**

In another set of countries, France, Italy and Spain, family stress does not necessarily come from finding the right work-life balance, but from finding work in the first place—or in keeping the job that provides the family’s income. These economic worries play an important role in the well-being of the family.

Economists worry about the potential effects that automation can have on the labour market. The worry is that new forms of work will increasingly be located in the low-end (deliveries, personal services, etc.) and high-end of the labour market, and

that employment for medium-skilled jobs will be reduced. The statistical overview in Chapter 2 shows how job polarisation is taking place in each of the countries of our sample.

In the short-term, job polarisation poses the risk that a laid-off worker in one of the displaced jobs cannot find the right job for his or her skill level. If educational opportunities to achieve a high-skilled job are limited, that individual might need to accept a job at a lower level of skill, and pay. In the longer term, job polarisation is a challenge for the education system and the structure of the job market, in ensuring that future generations can find productive work that pays enough to run a household.

Another trend is the slow increase in the use of temporary contracts, also visible across all countries in this book. Only a fraction of the total labour supply is affected by it, but the trends are clear and workers are acutely aware of them. On the one hand, the trend of temporary contracts follows from a demand by firms for flexible labour and the risks associated with a high employee protection for those with a permanent contract. And temporary contracts do lead to employment and new jobs. But the perception of workers is one of uncertainty and anxiety about finding a stable position to earn an income. Middle-class households feel the declining job security, together with the risk of losing their “social status”. For example, in Italy, a ‘posto fisso’ (permanent contract) is the hallmark of middle-class status, but it has become increasingly difficult to obtain.

### **Duality in the labour market**

In Italy and Spain, the problem of temporary jobs is magnified by the duality in the labour market: some, especially older workers, do have a permanent contract with a high degree of protection and social benefits. This is to some extent inevitable, as it would be quite hard to change existing labour relations. But it implies that the burden of flexibility falls largely on the younger generation, who adjust their expectation of middle-class life accordingly.

### **Public sector employment**

A significant side-effect of austerity measures taken between 2010 and 2015 is that employment in some public sectors (such as education, healthcare and government) were affected. At the same time, these are sectors that contain typically middle-class jobs. The austerity measures affected both the employment prospects in government-related sectors as well as the level of wages that make a middle-class life possible. The effect is particularly felt in countries where the association with a government job and middle-class status is strong, such as in France and Italy.

### **Social mobility**

There is more to the middle class than stability: it embeds the idea that there are opportunities to move up the social ladder. In Finland, Ireland, the Netherlands and

Poland, social mobility is high or improving. The relationship between the occupation of the parents and that of the child is becoming less strong, and education provides opportunities for development.

In more than half of the countries, the social mobility of the middle class is either not very high or declining. In Bulgaria, the strength of the association between the education of the parents and children has increased. In France, the neighbourhood matters for the quality of the schools where people can send their children to. In Germany, climbing the social ladder is more difficult for children from lower social positions. In Italy, the premium on a higher education is in long-term decline, making individual progress more elusive. In Spain, social mobility is low, which is partly explained by the functioning of the education system.

### **An increasing share of elderly people**

Because of the changes in job markets, work and social policies, there is a tendency in at least five countries whereby the elderly form an increasing share of the middle class (France, Ireland, Italy, the Netherlands and Spain). While it is quite understandable that middle-class adherence is rising with age, this has implications for the outlook of younger generations.

### **Urbanisation as a middle-class phenomenon**

For at least four countries (Bulgaria, Finland, Germany and Poland) there is a clear pattern of urbanisation. Many developments have driven urbanisation, and it represents the increasing importance of cities in the global economy. Hence, obtaining an income and the means to start a family are increasingly related to whether people can thrive in an urbanised society.

### **Household size in decline**

Almost all countries show a decline in the average household size and the number of children in the household. This fits with the pattern of Europe being an ageing continent. The causes of the smaller family size are manifold, such as social convention, examples, family income, social structures and the perception of the available help with children. However, one particular cause that arises from the country chapters is that of increased family stress, i.e., the need to combine (flexible) work and relationships with the stability in the household that is needed to raise children.

### 3. Perceptions of economic progress

Regardless of the objective income position and size of the middle class, people have certain perceptions about whether they see themselves as part of the middle class. Two perceptions stand out.

#### **Disillusionment about economic progress**

In a number of countries (France, Italy and Spain), the authors note disillusionment with the economic position of the middle class. It is not just that economic life might be a bit more stressful, or that job uncertainty has risen; it is the expectation of prosperity and the good life that is not met.

Poland and Bulgaria are two countries where economic progress has been rapid. For example, the chapter on Bulgaria shows how the median income has more than doubled in only ten years. Still, there is disillusionment among many middle-class households, who consider themselves 'left behind' in the economic development. Similar sentiments are felt in Poland.

#### **Anxiety about the future**

While in some countries the crisis-experience has been less devastating than in others, the recovery that has taken place across the board has not reassured most middle class households about the prospects for a prosperous future. This includes the fear of losing status, or of losing a job—or some particular other factor that is deemed beyond the control of the household. We see this in Finland, Germany, the Netherlands and Poland. These are countries where an outside observer may note that the economic development is actually quite good, but where a significant fraction of middle-class households see this differently. For Poland, this expectation is partly driven by the comparison with Western European countries and the living standard in Poland that does not match expectations.

### 4. Electoral trends and political representation

Households also contain voters and their experience and outlook are related to electoral trends. The trends are quite country-specific, but two observations stand out.

First, for many countries in this book we find a large middle class that is to some extent not satisfied with their economic position. There is no 'natural' support of voters for centre or centre-right parties, but rather for all sorts of parties that align with sentiments of the middle class.

Second, in Bulgaria and Ireland, voter support for centre-right parties is unchanged and strong. In these countries, the party that is in government is also quite stringent on immigration. The support of middle-class voters is large and did not change much during the refugee crisis of 2015/2016.

## 5. EU-wide trends and their impact on the middle class

Three trends that will affect all European countries are migration, globalisation and technological change. With regard to immigration, the refugee crisis of 2015/2016 was the dramatic climax to a large inflow of immigrants.

The digitalisation process now being witnessed has brought about a job polarisation phenomenon (in skills and earnings) that impacts the employment opportunities of the middle class. New technologies have created high- and low-skilled jobs, while destroying semi-skilled employment, as seen in the overview of Chapter 2. Such job polarisation as well as the reduction in employment in the middle of the education spectrum will have a significant effect on the income distribution and social class structure in all countries, whatever their stage of development.

### **The social system remains under pressure**

A middle-class concern in Finland, Germany and the Netherlands is that future immigration will undermine the social system. Although many immigrants from developed countries might be 'middle class' in their country of origin, they cannot be expected to be middle class in one generation in the new host country. It remains a large challenge to integrate new immigrants while maintaining the high level of social welfare that is there. People are aware of this, and it negatively influences their perspective of becoming or staying middle class.

Some countries in this book face an opposite challenge from migration, which is that of a 'brain drain' of a highly educated younger generation. This is the case in Bulgaria, Italy and Spain. They face the challenge of integrating new migrants from developed countries, while not being able to 'integrate' their own young generation in the economy. This situation brings to the fore the structure of the economy in these countries, which is apparently not well-adapted to highly educated and entrepreneurial workers. Especially these (often young) people are missing in the future perspective of these countries to establish a sound middle class.

### **Technology and globalisation pose opportunities as well as threats**

For many countries in this book, the combined challenges of technological development and globalisation are mostly seen as opportunities. These countries benefit from the increases in productivity<sup>1</sup> that technology brings, and from the potential for growth from worldwide trade and cooperation. The educational system functions, providing new generations with the cognitive and social skills that make it

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<sup>1</sup> See Graetz and Michaels (2015). Robots at Work, working paper, Harvard University. They find that robots increase wages and total factor productivity. The increased use of robots raised countries' average growth rates by about 0.37 %-points.

possible to earn a living and start a family. The jobs might be less certain than for previous generations, but incomes are growing and the work is there.

As far as we can see, the opposite is the case for France, Italy and Spain. There, the state of the education system, the structure of the labour market and other institutional aspects of the economy make for a less rosy outlook for the middle class.

## 6. Finale: Three Big Questions

This being a book about European countries, we feel that it is appropriate to formulate the major challenges that are relevant for the EU as a whole. We express them as the *big questions* that may provide some ideas for this debate and call us, in any event, to be humble and cautious in advocating concrete solutions and recommendations for the challenges ahead.

### I. Is there an expectations problem?

In Europe, one-half to two-thirds of respondents think that their children will be worse-off financially than their parents<sup>2</sup>. This book has also documented these patterns. In Bulgaria and Poland, median incomes have grown at high rates, but people are sceptical about the economic performance. In Italy and Spain, the worst of the economic crisis is over, but households feel that the economy is now much more unfair than before. In the Netherlands, Germany and Finland, the economy is doing fine, but households are worried about job security and future immigrant flows.

Expectations matter, and negative expectations might become self-fulfilling. But expectations are not easy to influence with words or good intentions. Moreover, ongoing changes in the structure of economic growth, from the Gig-economy to the use of AI as 'intangible capital'<sup>3</sup> might in the short-term increase the uncertainty. Households will continue to worry about how they, or their children, will earn a living in the future.

The chapters in this book show that households in the middle are not upbeat about the benefits of technology. Concrete examples on how technology improves economic outcomes within a fair and open marketplace are now more necessary than ever.

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<sup>2</sup> See Pew Research Center (2017) Global Publics More Upbeat about the Economy. But many are pessimistic about children's future. Pew Research Center, June.

<sup>3</sup> Brynjolfsson, E., Rock, D. & Syverson, C. (2017). Artificial Intelligence and the Modern Productivity Paradox: A Clash of Expectations and Statistics (No. w24001). National Bureau of Economic Research.

## II. Have the four freedoms reached their limit?

With increasingly open borders between EU countries, member countries have begun to suffer from the so-called magnification effect. With low barriers to begin with, any new liberalisation has a redistributive effect that is a *factor* greater than the expected benefits. Dani Rodrik has argued forcefully that this effect puts a natural brake on globalisation, and explains a significant part of the populist backlash to international trade agreements<sup>4</sup>.

In some sense, the chapters in this book could be seen as backing up this argument. Although the European Union has grown in size and in the level of integration, middle-class households are more worried now about future prosperity than ever before. One of the reasons could be that they are witness of the disruptive (i.e., redistributive) effects that EU policies have on “their” labour market of origin. Companies regularly replace their factories within the EU, employees compete with workers from other countries, firms compete (by law) with contractors from other countries, and capital flows from surplus to deficit countries. As the economics goes, this increases the overall welfare in the economy. But as human perception goes, the mental costs may outweigh the economic benefits.

The experience of Poland and Bulgaria suggests that the disruption from economic growth itself can outweigh the perceived benefits for part of the population. And even if everyone benefits, the people who benefit the least can still feel left out. We all recognize how quickly we get used to an improvement in our position, but put a high value on salient losses. This is loss aversion at work<sup>5</sup>.

The major political question, as we see it, is about the aims of the supra-national institution that the EU is, and the institutional trust that it is enjoying. If one believes the magnification effect of international trade, then the EU could have a positive role in limiting the fall-out of trade agreements with non-EU partners. It is the EU’s responsibility to ensure that redistribution effects with new trading partners are clear beforehand, and that member states have the time and means to mitigate these effects and make adjustments.

If intra-EU trade is to be stimulated, then politicians operating in the EU context should be aware that any further opening to trade or a free movement of capital and labour could have quite salient effects on individual member states. This might be one of the largest problems facing Europe in the near-term.

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<sup>4</sup> Rodrik (2017) Populism and the economics of globalization. Working paper, Kennedy School, Harvard University.

<sup>5</sup> As described in Kahneman, D. (2011) *Thinking fast and slow*, Farrar, Straus and Giroux.

### III. What is the real understanding of subsidiarity?

The Christian-Democratic tradition puts a strong emphasis on the value of personal responsibility. Individuals, families and households should be able to take responsibility for their own lives, which also gives them the capacity to take responsibility for others. This is what makes living together personally and morally worthwhile and important. At the same time, the state is needed to ensure a public space that is safe and provides public goods and a safety net for people hit by unfortunate circumstances. On a national level, these notions have been articulated brilliantly and have been proven successful, as shown in the development of the post-war German economy, with its Social Market Economy, summed up in the quotation “free economy, strong state” of the ordoliberal thinker Alexander Rüstow<sup>6</sup>.

From this line of thinking, it is less clear how EU institutions fit into this model. They are the result of negotiations and visions of what the common future of European countries should look like. But these institutions need a constant check in terms of whether they put the responsibility on the right level. Subsidiarity is embedded in the European Treaty, but it needs not only to be acted out, but also to be proven in institutional arrangements as well as in the mind-set of the representatives of European institutions.

From the chapters of this book, one could argue that the role of the EU should be increased. For example, there are countries (Bulgaria and Italy) where households place a higher trust in EU institutions than in their own national democracy. However, overriding the nation state might lead to a slow collapse of national democracy and introduces the risk of more severe disruptions in public life in the longer term.

Another, possibly more fruitful, line of thinking forces the EU to state where it wants to put the responsibility. In formulating this attitude, the real fundament for a Political Union would be in the concrete requirements for new institutions, rather than in higher budgets or more centralized competences. The European Union can look back on a historically unique phase of freedom, peace and prosperity. But what has been achieved in the past is no guarantee for the future. It is our opinion that the current situation presents an enormous challenge: to reshape the founding and continuing principles upon which the European Union is based. The first hurdle, is to open up the debate on the “Future of Europe”. This debate would be inspired by the resolve of EU-citizens to create clarity on the role and the responsibility of the European Union and the member states.

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<sup>6</sup> Speech “Freie Wirtschaft, starker Staat” at the conference of “Verein für Socialpolitik” Dresden, 28. September 1932, in: *Printings of Verein für Socialpolitik*, vol. 187.

